

The Co-operative Group  
**Building a better society**  
Annual Report & Accounts 2010



“Our customers  
are at the heart of  
everything we do.”

Linzi Bale, The Co-operative Food, Cross Hands, Llanelli

The **co-operative**  
good for everyone

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“We have launched our revitalised brand, investing millions in our store and branch estate and transforming the face of our business on high streets and in communities the length and breadth of the UK.”

Len Wardle, Chair, The Co-operative Group

“We will continue to set ourselves challenging but achievable targets for both our business performance and our social goals because that is what our members ask for and expect.”

Peter Marks, Group Chief Executive

We're committed to actively engaging our members, despite our size and complexity. Membership is key to what we are as a co-operative, we're committed to expanding the number and diversity of our membership base. We want to ensure that we hear their views and reflect their needs in determining our vision for the future.



# Highlights

£13.7bn

Gross sales – up 9.1%

£625m

Underlying operating profit\* – up 31.4%

£546m

Underlying profit before payments to and on behalf of members\*\* – up 48.3%

5.8m

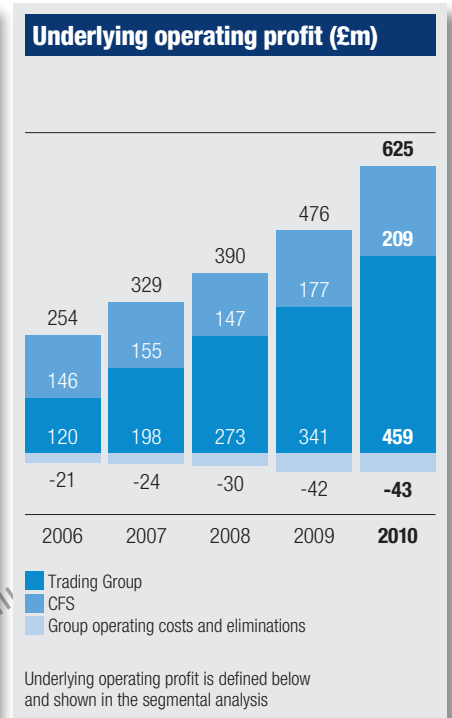
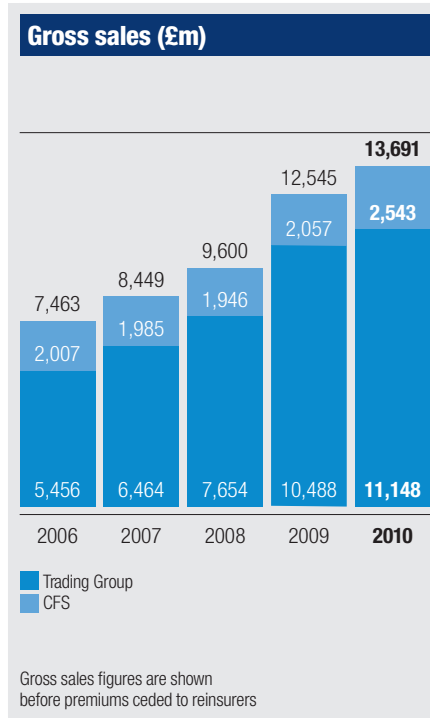
Number of members in the Group (as at 1/1/11)

£104m

Amount paid to members and communities

£4.8bn

Member funds – up 7.2%



\* Underlying Group operating profit measures the normal underlying business performance and removes from operating profit the following volatile or one-off costs: property disposal profits, investment property valuation fluctuations, significant items, fair value amortisation, Financial Services Compensation Scheme levies and short term investment fluctuations. It is shown in the segmental analysis (Note 1).

\*\* Underlying profit before payments to and on behalf of members is underlying Group operating profit less underlying interest (interest excluding fair value movement and other net financial income) plus the Group's share of the operating result of associates and joint ventures. A reconciliation to profits before payments to and on behalf of members can be found at the bottom of the consolidated income statement on page 62.

## Who we are

The Co-operative Group is a consumer co-operative with customer-facing businesses in food, financial services, pharmacy, funerals, travel, motors, electricals and legal services. We also have strong positions in farms, security and clothing. We have an annual turnover of £13.7bn, employ more than 110,000 people and operate over 5,000 retail trading outlets serving more than 17 million customers per week.

# 5,000

We operate over 5,000 trading outlets

# 17m

We serve more than 17m customers each week

# 5.8m

Number of members in the Group (as at 1 January 2011)

### The Co-operative model

Our members are our owners; they tell us what is important to them and we listen and act on it. It's fundamental to our business model. As a consumer co-operative, we run our business for the benefit of our members who share in our profits in proportion to how much they trade with us through the year. That means our members are involved in democratic decision-making. Our members also set our social and campaigning agenda. In fact, because our members wanted it, we've become pioneers in areas such as fairtrade and combating climate change. Of course, the more commercially successful we are, the more we can share with our members and support the causes they champion.

### The Group vision

In 2010, the Group Board reaffirmed our purpose and agreed a new vision and aims

#### Our purpose

To serve our members by carrying on business as a co-operative in accordance with co-operative values and principles.

#### Our vision

To build a better society by excelling in everything we do.

#### Our aims

- To be a commercially successful business
- To meet the needs of our customers and the communities we serve
- To respond to our members and share our profits
- To be an ethical leader
- To be an exemplary employer
- To inspire others through co-operation.

## “We are trusted.”

Dean Anderson, East Leake Co-operative Food

Customers are increasingly turning to trusted names and our leadership position in social responsibility gives us a strong position in the market.

### Visit us online

To find out more about us, visit our website – [www.co-operative.coop](http://www.co-operative.coop)





# What we do

## Food

### Key facts

5th largest food retailer in the UK  
 2,883 UK stores  
 17 million customers served each week  
 Focus on community and service  
 Great food within easy reach

### Highlights 2010

Integration of Somerfield  
 778 stores rebranded and upgraded  
 Total sales (inc VAT) up 6.2% to £8.2bn  
 Green Retailer of the Year for the third year running  
**Farms**  
 Britain's largest farmer. Joined our Food business.

## Financial Services

### Key facts

UK's most diversified mutual, following historic merger with Britannia Building Society  
 The Co-operative Bank, Insurance, Investments, Asset Management and Smile  
 Vision to become the UK's most admired financial services business  
 Strong financial position

### Highlights 2010

Integration of Britannia  
 World's Most Sustainable Bank award  
 Strong performance despite market weakness, with underlying operating result of £208.6m  
 Customer deposits of £34.2bn, up 5.3%

## Pharmacy

### Key facts

3rd largest pharmacy chain in the UK and the largest in Wales  
 Over 65 million prescriptions dispensed in 2010  
 More than 750 pharmacies in the UK

### Highlights 2010

Sales of £771.3m, despite tough market conditions  
 First full year of operation for the National Distribution Centre  
 221 branches refurbished

## Funeralcare

### Key facts

UK's leading funeral director  
 Over 850 funeral homes, crematoria and woodland burial grounds across the UK carrying out over 100,000 funerals each year  
 Committed to providing the best possible care

### Highlights 2010

Sales up from £287.4m (2009) to £316.0m  
 Funeral Plan sales up 29% compared to 2009  
 Significant investment in premises, vehicles and staff  
 New national TV advertising campaign launched

## Specialist Retail Businesses

### Legal Services

The Co-operative Legal Services is at the forefront of regulatory changes, due in October 2011, enabling a wide range of consumer-friendly legal services to be offered, with the aim of becoming the preferred provider of consumer legal services in the UK.

### Life Planning

Our Life Planning Business is responsible for the Group's Funeral Planning Business (Development,

Distribution and Investment) and in addition combines the Group's Will Writing Services to enhance the customer proposition.

### Travel

Travel agency offering the widest choice of holidays on the high street with more than 400 UK stores dealing with over three million holidaymakers a year.

## Specialist Commercial Businesses

### Sunwin Services Group

A support services business, offering managed security, IT services, cash management, and fire and security solutions.

### Motors

One of the top 50 car dealers in the UK, with over 23 sites across the Midlands and the North of England.

### E-Store

Online electrical store. Thousands of products at great prices.

### Corporate Clothing

Designs, manufactures and distributes business wear and uniforms, focusing on quality, style and choice.

## Estates

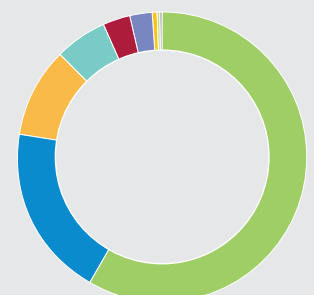
The Co-operative Estates is one of the largest and most diverse land and property operations in the UK, with interests that span retailing, property investment and land development.

### Highlights 2010

The development of the Group's new head office is well advanced and this represents the first phase of a Masterplan scheme pioneered by the Group to provide a new approach to urban regeneration in Manchester.

## Contribution to Group net revenue

- Food 58.4%
- Financial Services 19.4%
- Membership and Federal 9.9%
- Pharmacy 5.9%
- Specialist Commercial Businesses 3.0%
- Funeralcare 2.4%
- Specialist Retail Businesses 0.5%
- Estates 0.3%
- Farms 0.2%



# How we are governed

The Co-operative Group stands apart from other major businesses in the UK as an organisation which is owned, not by investor shareholders, but by more than five and a half million consumer members. It is registered under the Industrial and Provident Societies Acts 1965 to 2003. The Group's purpose is to serve its members by carrying on business as a co-operative in accordance with internationally recognised co-operative values and principles.

## Democratic structure

The Group has members, area committees, regional boards and a Group Board. It also has a Group Chief Executive, the Group Executive and a Group Secretary.

The principal board and committee structure of the Group and the broad composition of the democratic structure are outlined below.

## Members' meetings

In addition to the ability to trade with the Group's businesses and share in the profits, membership provides members with access to information, a voice in the Group, and the opportunity to be elected to a representative role in its governance structure. Good governance and democracy are part of what makes the Group different from other organisations. Members' meetings, which are held twice a year in the Group's seven democratic regions, are a chance for our members to find out more about the Group in their area and to have their say on the issues that are important to them and their community.

## Elections

Every one of our 5.8 million members has a say in how our organisation is run by holding elections to vote for member representatives across all regions. Elected members then meet up every month or so to make sure we're reflecting members' views. They also make sure we always follow our values and principles in the local community.

## Member Engagement Strategy

In 2009, a full consultation was undertaken with elected committees across the Group and the wider movement in order to develop a three-year Membership Engagement Strategy. This was agreed by the Group Values & Principles Committee in November 2009. The Membership Engagement Strategy is based on a foundation of co-operative values and principles, our aspirations for broadening the diversity of our engaged members and our Community Plan. It outlines the role of the Membership team and elected representatives in engaging members of the Group, and also what members can expect from their Society.

### Group Board

(20 members)

### Three principal subsidiary boards

Co-operative Financial Services (CFS) Board  
(20 members)

Food Board (15 members)

Specialist Businesses Board (14 members)

### Additional Group Committees

Group Audit & Risk Committee (5 members)  
Group Remuneration & Appointments Committee  
(6 members)

Group Governance Working Party (5 members)

Group Chair's Committee (4 members)

Group Values & Principles Committee  
(15 members)

7 Regional Boards (107 members)

48 Area Committees (587 members)

Regional Values & Principles Committee  
(95 members)

Customer Members (5.8 million members)

### The Co-operative values and principles

Membership is open to everyone as long as they share our values and principles. These values and principles influence the way we run all our businesses. Our members show these values by working together for everyone's benefit, and are encouraged to play a full part in the community.

#### Our co-operative values:

Self-help – we help people to help themselves

Self-responsibility – we take responsibility for and answer for our actions

Democracy – we give our members a say in the way we run our businesses

Equality – no matter how much a member can afford to spend or invest with us, they still have one vote

Equity – we carry out business in a way that is fair and unbiased

Solidarity – we work with others to achieve our common objectives

2005: 0.8 million members



2006: 2.0 million members



2007: 2.7 million members



2008: 3.4 million members



2009: 5.1 million members



2010: 5.8 million members



4,640

Number of members who attended regional meetings in 2010

97%

Analysis of satisfaction levels has been undertaken with 97% of respondents agreeing that the 2010 meetings were worthwhile

## Chair's statement

“We now have a new vision:  
To build a better society by  
excelling in everything we do.”

Len Wardle

In 2010, we agreed a new vision and aims for the Group.



Over the course of the last few years we have focused on getting The Co-operative Group into the right shape. Acquiring Somerfield gave our Food business the scale to truly start to take on our competitors, creating the big five from what was previously the big four. Our Financial Services business merged with Britannia to create a genuine alternative to the rest of the financial industry.

We have launched our revitalised brand, investing millions in our store and branch estate and transforming the face of our business on high streets and in communities the length and breadth of the UK. To have done so much, whilst continuing to deliver improved performance across the family of businesses against a backdrop of significant economic upheaval, is a considerable achievement.

### Our new vision

At the same time as all of this has been going on, there has been a recognition, at Board level, that we need to step back and review our long term ambitions for the Society. As the Group grows our goals should grow too and we should challenge ourselves to accomplish more than in the past. As such, we wanted to reframe our vision and aims and reaffirm our purpose to reflect the modern and successful co-operative business we have become.

“Our coverage is incredible, with a  
Food store in every UK postal area.”

David Roberts, Director of Property – Food

With the opening of The Strand Food store in February 2011, The Co-operative completes an enviable nationwide reach with a Food store in every UK postal area.



We invested a great deal of time thinking deeply about what mattered to our members and what ambitions we should set for ourselves collectively. We also invited contributions and comments from different stakeholders, including employees and members, to try to ensure that the route we chose to follow was one that would feel like a logical progression from where we are to where we wanted to be. Following the consultation we further refined our thoughts.

As you can see, we now have a new vision: to build a better society by excelling in everything we do. The vision is underpinned by a number of aims: to be a commercially successful business; to meet the needs of the customers and communities we serve; to respond to our members and to share our profits; to be an ethical leader; to be an exemplary employer; to inspire others through co-operation. I believe we now have a vision and set of aims that are bold and ambitious, that set our sights high for the future and which we can use to monitor and measure our success in the years to come.

### **A unified Group**

In 2010 we also took the opportunity to consider the Executive management structures of the business, taking a holistic view of how best to operate the retailing and financial services of the Group. Our aim has been to ensure we are maximising the potential of our unified co-operative brand and its cross selling opportunities, developing a consistent customer facing strategy and encouraging stronger collaboration between all parts of the Group.

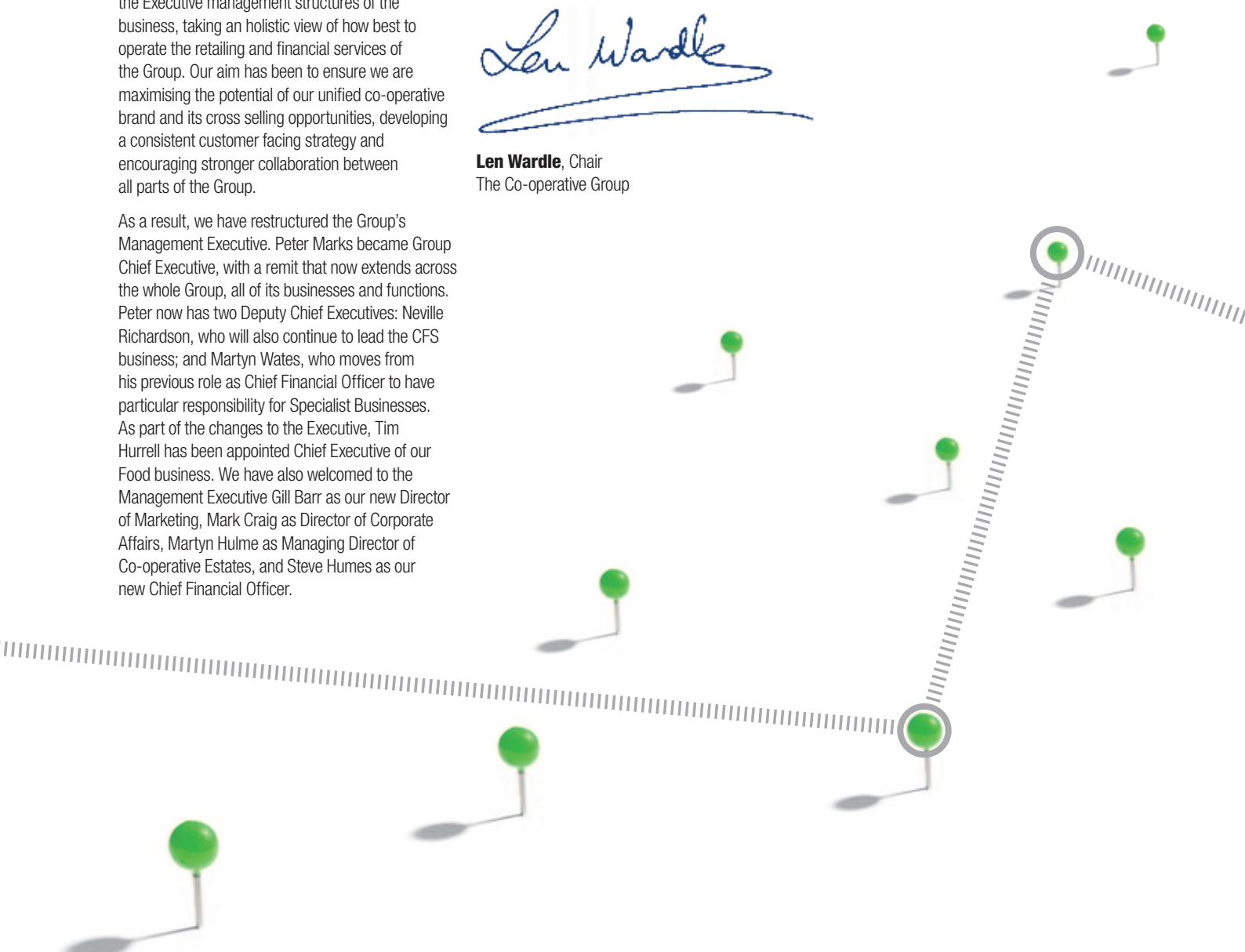
As a result, we have restructured the Group's Management Executive. Peter Marks became Group Chief Executive, with a remit that now extends across the whole Group, all of its businesses and functions. Peter now has two Deputy Chief Executives: Neville Richardson, who will also continue to lead the CFS business; and Martyn Wates, who moves from his previous role as Chief Financial Officer to have particular responsibility for Specialist Businesses. As part of the changes to the Executive, Tim Hurrell has been appointed Chief Executive of our Food business. We have also welcomed to the Management Executive Gill Barr as our new Director of Marketing, Mark Craig as Director of Corporate Affairs, Martyn Hulme as Managing Director of Co-operative Estates, and Steve Humes as our new Chief Financial Officer.

During 2011, we will be establishing a new and comprehensive operating model for the Group that will drive business performance in a unified way. This will enable us to identify synergies that by 2012 will mean we are operating as one unified business, better equipped to drive the Group forward.

There have been a few small but important changes at Board level. As I reported in the interim report in 2010, we appointed four Independent Professional Non-Executive Directors to our new subsidiary boards.

Undoubtedly, we currently find ourselves in challenging economic times but it is to the credit of Peter Marks and his Executive and, indeed, every single colleague who contributes to making The Co-operative Group what it is today, that we are able to report such a robust set of financial figures. I would like to end by offering my thanks to all our members, customers and employees for their continued commitment, loyalty and support.

**Len Wardle**, Chair  
The Co-operative Group



# Board of Directors

## 01 Len Wardle (r)

Age 66. Group Chair. Joined the Board in 1992. Former University Fellow. Member of the South East Regional Board. Director of Co-operative Food Ltd and of Co-operative Specialist Businesses Ltd. Non-Executive Director of Co-operative Financial Services Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd, and CIS General Insurance Ltd. Member of the Group Remuneration & Appointments Committee, the Governance Working Party, the Political Strategy Working Group, the Diversity Strategy Group and a representative on the Co-operative Party NEC. Also, a Director of Communicate Mutualty Ltd.

## 02 Chris Herries (r)

Age 64. Joined the Board in 2009. Retired Teacher/Oxfam District Manager/Horticulturalist. Member of the South & West Regional Board. Director of Co-operative Specialist Businesses Ltd. Member of the Group Remuneration & Appointments Committee, the Governance Working Party and the Diversity Strategy Group. Director of Co-operatives UK Ltd.

## 03 David Pownall (r)

Age 53. Joined the Board in 2007. Self Employed Plastering Contractor. Member of the North West & North Midlands Regional Board. Director of Co-operative Specialist Businesses Ltd. Director of Co-operative Action Ltd and Director of Co-operative Press Ltd.

## 04 Steven Bayes (r)

Age 49. Joined the Board in 2009. Nurse. Member of the North Regional Board. Director of Co-operative Specialist Businesses Ltd and a Director of Co-operatives UK Ltd.

## 05 Eric Calderwood (r)

Age 58. Joined the Board in 2006. University Lecturer/Retail Consultant. Member of the Scotland & Northern Ireland Regional Board. Director of Co-operative Food Ltd. Also, Director of Co-operatives UK Ltd and Chair of The Manx Co-operative Society.

## 06 Paul Flowers (r)

Age 60. Group Deputy Chair. Joined the Board in 2008. Superintendent Methodist Minister. Member of the North Regional Board. Chair of Co-operative Financial Services Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd, and CIS General Insurance Ltd. Chair of the Group Remuneration & Appointments Committee and the Diversity Strategy Group.

## 07 Nigel Keane (r)

Age 50. Joined the Board in 2009. Senior Policy Adviser. Member of the Cymru/Wales Regional Board. Director of Co-operative Specialist Businesses Ltd. Member of the Group Audit & Risk Committee and the Political Strategy Working Group.

## 08 Stuart Ramsay (r)

Age 53. Joined the Board in 2009. Computer Technician. Member of the Scotland & Northern Ireland Regional Board. Director of Co-operative Specialist Businesses Ltd. Member of the Group Values & Principles Committee, the Governance Working Party and the Political Strategy Working Group. Also, representative on the Co-operative Party NEC.

## 09 Herbert Daybell (r)

Age 63. Joined the Board in 2009. Retired Publisher. Member of Central & Eastern Regional Board. Director of Co-operative Food Ltd. Member of the Group Values & Principles Committee.

## 10 Ursula Lidbetter (i)

Age 48. Group Deputy Chair. Joined the Board in 2009. Chief Executive, Lincolnshire Co-operative Society. Chair of Co-operative Food Ltd. Member of the Group Audit & Risk Committee and the Group Remuneration & Appointments Committee.

## 11 Steve Watts (r)

Age 59. Group Deputy Chair. Joined the Board in 2000. Retired Pricing, Research and Information Manager. Member of Central & Eastern Regional Board. Chair of Co-operative Specialist Businesses Ltd. Non-Executive Director of Co-operative Financial Services Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd, CIS General Insurance Ltd and Unity Trust Bank plc. Member of the Group Remuneration & Appointments Committee.

## 12 Duncan Bowdler (r)

Age 52. Joined the Board in 2007. Food Trade Liaison Manager. Member of the North West & North Midlands Regional Board. Non-Executive Director of Co-operative Financial Services Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd and CIS General Insurance Ltd. Member of the Group Audit & Risk Committee and the Governance Working Party.

## 13 Marilynne Burbage (r)

Age 68. Joined the Board in 2009. Horticultural and Medicinal Plants Consultant. Member of the South East Regional Board. Director of Co-operative Specialist Businesses Ltd. Chair of the Group Values & Principles Committee, a member of the Governance Working Party, the Political Strategy Working Group and the Diversity Strategy Group. Also, a Director of The Co-operative Foundation.

“The Board is at the heart of the Group’s democratic structure.”

Len Wardle



**14 Ben Reid (i)**

Age 56. Joined the Board in 2000. Chief Executive of The Midcounties Co-operative. Non-Executive Director of Co-operative Financial Services Ltd, The Co-operative Bank plc, Co-operative Insurance Society Ltd and CIS General Insurance Ltd. Chair of the Group Audit & Risk Committee. Member of the Group Values & Principles Committee.

**15 Patrick Grange (r)**

Age 68. Joined the Board in 2007. Farmer and Business Consultant. Member of the North West & North Midlands Regional Board. Director of Co-operative Food Ltd. Member of the Group Audit & Risk Committee and the Group Remuneration & Appointments Committee.

**16 Ray Henderson (r)**

Age 64. Joined the Board in 2009. Retired Telecoms Engineer. Member of the North Regional Board. Director of Co-operative Food Ltd.

**17 Jenny Barnes (r)**

Age 50. Joined the Board in 2009. Civil Servant. Member of the South & West Regional Board. Director of Co-operative Food Ltd and a Director of Co-operative Press Ltd. Member of the Group Values & Principles Committee and the Diversity Strategy Group.

**18 Martyn Cheatle (i)**

Age 49. Joined the Board in 2010. Chief Executive, Midlands Co-operative Society. Director of Co-operative Food Ltd.

**19 Mark Smith (i)**

Age 51. Joined the Board in 2010. Chief Executive of The Southern Co-operative. Director of Co-operative Specialist Businesses Ltd.

**20 Richard Samson (i)**

Age 57. Joined the Board in 2005. Chief Executive of East of England Co-operative Society. Director of Co-operative Food Limited.

(r)appointed by the regions

(i)appointed by independent society members

**Subsidiary boards:**

**Co-operative Food Board:**

**Ursula Lidbetter**  
Group Deputy Chair & Chair of Food Board

**Len Wardle**  
Group Chair

**Jenny Barnes**  
Group Director

**Eric Calderwood**  
Group Director

**Martyn Cheatle**  
Group Director

**Herbert Daybell**  
Group Director

**Patrick Grange**  
Group Director

**Ray Henderson**  
Group Director

**John Longworth**  
Independent Professional Non-Executive Director

**Richard Samson**  
Group Director

**Euan Sutherland**  
Independent Professional Non-Executive Director

**Peter Marks**  
Group Chief Executive

**Neville Richardson**  
CFS Chief Executive & Group Deputy Chief Executive

**Martyn Wates**  
Chief Executive Specialist Businesses & Group Deputy Chief Executive

**Tim Hurrell**  
Chief Executive, Food

**Co-operative Specialist Businesses Board:**

**Steve Watts**  
Group Deputy Chair & Chair of Specialist Businesses Board

**Len Wardle**  
Group Chair

**Steven Bayes**  
Group Director

**Marilynne Burbage**  
Group Director

**Penny Coates**  
Independent Professional Non-Executive Director

**Mike Cutt**  
Independent Professional Non-Executive Director

**Chris Herries**  
Group Director

**Nigel Keane**  
Group Director

**David Pownall**  
Group Director

**Stuart Ramsay**  
Group Director

**Mark Smith**  
Group Director

**Peter Marks**  
Group Chief Executive

**Neville Richardson**  
CFS Chief Executive & Group Deputy Chief Executive

**Martyn Wates**  
Chief Executive Specialist Businesses & Group Deputy Chief Executive

**Co-operative Financial Services Board:**

**Paul Flowers**  
Group Deputy Chair & Chair of Financial Services Board

**Len Wardle**  
Group Chair

**Rodney Baker-Bates**  
Independent Professional Non-Executive Director & Deputy Chair of CFS

**Duncan Bowdler**  
Group Director

**David Davies**  
Independent Professional Non-Executive Director & Deputy Chair of CFS

**Peter Harvey**  
Independent Professional Non-Executive Director

**Paul Hewitt**  
Professional Non-executive Director

**Chris Jones**  
Independent Professional Non-Executive Director

**Stephen Kingsley**  
Independent Professional Non-Executive Director

**Bob Newton**  
Independent Professional Non-Executive Director

**Ben Reid**  
Group Director

**Steve Watts**  
Group Director

**Piers Williamson**  
Independent Professional Non-Executive Director

**Peter Marks**  
Group Chief Executive

**Neville Richardson**  
CFS Chief Executive & Group Deputy Chief Executive

**Martyn Wates**  
Chief Executive Specialist Businesses & Group Deputy Chief Executive

**Rod Bulmer**  
CFS Managing Director Retail

**Tim Franklin**  
CFS Chief Operating Officer

**Phil Lee**  
CFS Integration & Change Director

**Barry Tootell**  
CFS Chief Financial Officer





## Group Chief Executive's business review

“Since 2007 we have not only met but exceeded the targets we had set for ourselves. We have doubled sales, doubled profits and doubled the size of our membership.”

Peter Marks

In 2010, The Co-operative Group completed its first three-year plan following its merger with United Co-operatives.



5.8m

Members (+13%)

3,433m

Member points earned (+39.5%)

Platinum+

Highest ranking retailer or financial services business in the BiTC Corporate Responsibility Index

£546m

Underlying profits before payments to and on behalf of members (+48.3%)

£13.7bn

Gross sales (+9.1%)

£12.4m

Amount invested in communities and abroad during 2010



**The last three years have been a truly remarkable and exhilarating period for The Co-operative Group. 2010 marked the completion of our first three-year business plan following the merger between the Group and United Co-operatives in 2007. When we brought the two societies together we knew we were creating a business with the potential to radically reassert The Co-operative on the high street and secure the long term future of the consumer Co-operative Movement in the UK. At the time, we set ourselves some very ambitious performance targets not knowing that we would soon be heading into the most serious economic downturn and the toughest trading conditions for more than 60 years.**

So it is with some considerable pride, in my senior team and our colleagues across the Group, that we can report that since 2007 we have not only met but exceeded the targets we had set for ourselves. We have doubled sales, doubled profits and doubled the size of our membership. Along the way, we have revitalised The Co-operative brand, investing millions in our store and branch estate and significantly improving our customer offer. Furthermore, we recommitted ourselves to be, and prove that we are, the UK's leading ethical retailer and financial services provider.

### **Somerfield and Britannia**

In the past three years we have also carried out the biggest merger and the biggest acquisition in the Group's history, through joining forces with Britannia and acquiring the Somerfield food chain. These have been substantial step changes in the size and shape of the Group that will allow us to improve our customer offer still further and secure our position in our two core markets for years to come. Meanwhile, the rest of our family of businesses have continued to thrive, and indeed grow, often performing well above their competitors in the market.

But for me the most important achievement we have made is to restore our self-confidence and our ambition. We knew that The Co-operative Group was a business with a great past. Now we know we have a great future too.

None of this, of course, means that we can now rest on our laurels. Our competitors will not be looking to give the rejuvenated Co-operative an easy ride. In fact quite the reverse will be true. Now is the time to keep our foot firmly on the accelerator and that's just what we are doing.

### **A record year**

Despite the very gloomy economic conditions, 2010 was another record year for us, with solid results right across the Group. Underlying profits before payments to members have increased by an impressive £178m (48.3%) from £368m to £546m.

The essential and very substantial work associated with our major integrations has taken up a great deal of time and energy. As we fully expected from the outset, the job of building a massively expanded food business through the acquisition of Somerfield has had short term implications for performance. Hundreds of stores had to be temporarily closed and refitted, our national logistics network reconfigured and our whole customer offer reviewed. Both Somerfield and Britannia required significant management restructures at all levels too. But through all this we have succeeded in staying focused on the needs of our customers and members. We set ourselves very stretching targets for the year (a 27% increase in profits for the Group compared to 2009) and we have beaten that target, which is an excellent result considering the trading conditions in the economy generally.

On the following pages the performance of our business areas will be reviewed in greater detail.

As Group Chair Len Wardle has already commented, in 2010 we adopted a new vision and aims for the Group to help us frame our strategic thinking and provide KPIs for measuring our future success. Reflecting the business we have become, our vision is bold and ambitious: 'To build a better society by excelling in everything we do'. That will mean continuing to increase our profitability, responding to the needs of our members, providing excellent products and services to all of our customers, staying true to our social goals commitments and being an exemplary employer. These are challenging aims but ones which demonstrate that our co-operative commitment remains as fervent as ever.

### **Corporate responsibility**

Looking out from my office in New Century House in Manchester over the last year, I have been able to witness the single most tangible expression of our new found confidence – literally rising out of the ground. Our new head office will be a profound expression of our Co-operative values and of our corporate leadership. That we are building it at all is a testament to our business success in recent years. It is also a commitment to serve the needs of our members and customers as effectively as possible in the decades to come. Yes, it will be a new landmark on the Manchester skyline, but more significantly, its outstanding environmental credentials will make it a landmark for corporate responsibility in the UK.

During 2010, and as a direct result of the financial irresponsibility that led to near economic collapse, all political parties have been looking with admiration at The Co-operative way of doing business and ensuring sound governance. In fact, our way of doing things has never looked so modern to so many people. Co-operation is back in fashion and with good reason. It works – as this annual report clearly shows.



**“The single most significant expression of the reinvigorated 21st century Co-operative Group.”**

Peter Marks

The Group's new head office in Manchester began construction in 2010. It is a testament to our business success in recent years.

## Food

Food performance		
	2010 £m	+/-%
Net revenue	7,520.0	+4.8
Operating profit*	382.6	+33.3
Farms performance		
	2010 £m	+/-%
Net revenue	32.8	+37.8
Operating profit	6.0	+42.9
Key facts		
Stores	2,883	
Customers	17 million per week	
Employees	85,000	

\* Operating profit is before significant items.

**“Our Scottish colleagues also won the title Green Retailer of the Year for the third year running at the Scottish Retail Excellence Awards.”**

John McNeill, Regional Operations Director (Scotland, Northern Ireland and Isle of Man)

The Scottish Retail Excellence Awards are the most coveted in Scotland, honouring the sector's top achievers.

**Our Food business delivered a strong result in 2010 despite a difficult economic climate, extremely fierce trading conditions and challenges presented as a result of the Somerfield integration. Sales across the business were up 4.8% from £7.2bn to £7.5bn and operating profit before significant items was up 33.3% from £287.1m to £382.6m. Like-for-like sales in the core Co-operative stores increased by 3.8% compared to a market average of 1.8% for the same period. Given two winters in which our stores were hampered by severe weather conditions, a poor summer and an anticyclimactic World Cup which can normally be relied on to drive sales, the fact that our Food business has ended the year with an operating profit that is over 30% up on last year's figure is something of which we can all be genuinely proud.**

### Integration

2010 for our Food business was without doubt the year of integration. When we set out to create a combined Food business, from The Co-operative Food and Somerfield, within two years, we knew we were setting ourselves stretching targets that would demand intense effort to achieve. We also fully expected to see an impact on performance from the Somerfield estate while such a massive change programme was implemented. In the 12 months under review we refitted 524 Food stores to The Co-operative brand. By early 2011 the entire enlarged Food estate was operating as The Co-operative. We harmonised the ranges, including taking some key successes from Somerfield, so that the whole estate was offering the same Co-operative branded products. We have made particular effort to get our customer offer right, especially in the larger stores we now run, ensuring we have the range on offer that our customers expect. This is an ongoing project that will see further improvements in 2011. As well as adopting some of Somerfield's product ranges, we also took on board some of its till systems and other back office processes.

We have brought together our food marketing and buying operations to create a single commercial function focused on the customer offer. We have also created a new online training platform for colleagues in store. CITRUS is designed to keep store colleagues up to speed with everything from Health and Safety regulations to maintaining standards in store. After a successful pilot, over 15,000 users are now logged into the new software system across more than 3,000 stores.

Our Supply Chain function has undergone unprecedented change as a result of the Somerfield integration. There has been massive development of the logistics network – successfully incorporating one of Somerfield's depots at Lea Green, near St Helens, amongst other significant changes – and the roll-out of our SMART project which introduces a range of Somerfield tools that will help us properly manage our range, ensuring we get the right stock, in the right store at the right time. We also rolled out a new customer segmentation plan in 2010, changing the stock of our stores to ensure they are right for the customers and the areas in which they operate. This customer segmentation will greatly assist central replenishment, another major change planned for 2011. In the past, store managers have controlled the stock that comes into stores which has led to some significant differences across the estate. In future, stock will be managed centrally, freeing up store managers to concentrate on improving the customer experience.

It is impossible to overstate the significance and scale of the changes we have been implementing across the Food business over the last year. As always, the commitment and hard work of our colleagues is paramount to the project's success. Inevitably, it's they who are at the sharp end of the changes we are making and their understanding, commitment and loyalty to our brand is essential if we are to give good service to our customers. The Co-operative Way is a store manager development programme we have launched which celebrated its first annual graduation event in 2010. The graduates, a mix of existing Co-operative employees and those new to the business, each now have their own stores thanks to the programme. Central to the success of the programme has been the support of 145 academy store managers across the country who have helped with their development and training. 221 delegates started the training in 2010, resulting in the 153 successful managers graduating.

**“For the third year running we were named Responsible Retailer of the Year at the prestigious Oracle Retail Week Awards.”**

Tim Hurrell, Chief Executive, Food

Judges described the Group as an outstanding business whose breadth of initiatives and depth of commitment stood out from the rest of the shortlist.







“One of the best rewards you get when you take on community work, or just generally helping others, is seeing younger people fulfil their potential – you can’t beat that feeling.”

Luigi Ciaburri

Store Manager Luigi Ciaburri has worked at The Co-operative Food in Cross Hands, South Wales for more than two decades, and scooped the Community Champion title at the Good with Food Awards 2010.





“I deliver to over 100 regular customers. For me, the home delivery service is one way in which we make our customers’ lives just a little bit easier.”

Allan McDonald

Allan, 45, from Glenburn, in Paisley, has been delivering groceries for Somerfield – now The Co-operative Food – in Paisley for 12 years. During the December cold snap, he fought his way through ice and snow to check on his elderly customers and make sure they were safe and hadn’t run out of basic food items.



## Food continued

“Our customers’ views have shaped our work; we’ve improved our value through investment in pricing, we’ve stepped up our ambition on being ‘good with food’ through innovative new product development and ranging, we continue to lead the way in ethical sourcing and we’ve spearheaded all of this with a new TV campaign which is already driving our brand.”

Sean Toal, Commercial Director

In 2010 the Marketing and Trading functions of The Co-operative Food combined as a new Commercial team, which has completely reviewed our customer proposition.



### Awards

Our Food business has also enjoyed another bumper year for industry awards. For the third year running we were named Responsible Retailer of the Year at the prestigious Oracle Retail Week Awards. We were also named RSPCA People's Choice Supermarket of the Year for the second year running. The IGD Food Industry Awards presented us with both the Community Award, for our Charity of the Year partnership with RNID, and the Business Transformation Award for the roll-out of our innovative ‘Right for Us’ programme which uses the latest biometric technology to support store staff scheduling and more efficient payroll management. The Group was named Green Supermarket of the Year at the Grocer Awards and our Scottish colleagues won the title Green Retailer of the Year for the third year running at the Scottish Retail Excellence Awards. We also continued to win recognition for our food products including champagne, sandwiches, meat and fish and our Fairtrade range.

### Future growth

In 2011 we will continue with our rapid pace of improvement. Our stronger buying power through our increased scale is enabling us to offer members and customers better value across our ranges. We are also making more of seasonal events and developing more ‘hero’ products like the immensely popular bonfire bangers we promoted in 2010. Growth is still a key part of our strategy for Food with 50 new stores planned for 2011, increasing to 125 in 2012 and 175 in 2013. These developments will see us create 3,000 new jobs, doubly important during a period when the public sector will be losing many thousands of posts.

All of these initiatives are driving through the long term benefits of the Somerfield acquisition, ensuring that our increased size brings to our members and customers better value, better availability, better products and better execution.

### The Co-operative Farms

In recognition of the unique and profitable asset our Farms business has become, we moved it from our Estates business to The Co-operative Food in 2010 with the aim of achieving even greater advantage for the Group.

Our Farms business has delivered a great result in 2010, with an operating profit up 42.9% from £4.2m to £6.0m. This is especially noteworthy when you consider what a significant number of challenges the farming industry is currently contending with, ranging from the severe weather conditions that so affected our strawberry crops last year through to fuel price increases. However, global shortages, crop failures, protectionism, and agricultural problems in Russia and Australia that greatly inflated prices have helped the business secure better prices for its products in the market. Thankfully, our Farms business adapts to the various challenges each year. Taking strawberries as an example, our 2011 crop will greatly benefit from what we learned during the winter of 2009/2010 and implemented in time to reduce frost damage from the November temperature plunge. In 2010, our farming business also planted its first vineyard of 6,000 vines at Down Ampney, Wiltshire, which we are hoping will bring about our first own label English wine in 2013. Most of the vines are Ortega as selected by the Food Retail wine buyer.

2011 has a number of exciting new schemes and initiatives in the pipeline, ranging from a major new tenancy on an apple farm in Kent where we are planting 60,000 new trees in the first year alone to dramatically increase apple production – our aim is to provide all British-grown apples for Co-operative Food stores within the next seven years – to the launch of a tremendously exciting project that will see farms across our estate striving to protect the habitat of various species and learn more about them. Whether it is otters in Coldham, bats in Tillington or barn owls in Down Ampney, the aim is to study the challenges these animals face and pass on that greater understanding throughout the farming industry, thereby repairing some of the natural habitats that farming has damaged in the past.



“In 2010 we launched our innovative ‘Grown by us’ iPhone app which allows shoppers to scan Grown by us items on our shelves and see where they are grown.”

Ian Watson

Ian, from The Co-operative Farm in Louth, is one of the farmers featuring on the app, which tells customers about the farms and the produce grown there.

# Financial Services

Performance		
	2010 £m	+/-%
Operating result*	208.6	+17.7
Core tier 1 capital ratio	9.6%	+0.9
Bank customer funding ratio	107%	+3.0
Key facts		
	2010 £m	+/-%
Branches	339	+0.3
Employees	11,346	-2.7

\* Underlying operating profit per segmental analysis.

“People relate to our customer proposition – that’s why we are such regular award winners.”

John Kenwright, Team Manager, Manchester

2010 accolades included a Which ‘Best Buy’ award; three Moneywise customer service awards; ‘Best online motor insurance provider’ and ‘Best direct mortgage lender’ at the Your Money awards. The prestigious analysts JD Power named us ‘Best High Street Bank’, while The Co-operative Bank website topped the Forrester UK 2010 survey.



## Overview

As the UK financial services market continues to suffer from the current, unprecedented, global economic challenges, The Co-operative Financial Services (CFS) has continued to offer a member-owned, customer-led and ethically-guided alternative business model. This is one of the reasons why we were endorsed this year, with the naming of CFS as ‘The world’s most sustainable bank’. As the award implies, CFS is forging a business model focused on long term, sustainable success. CFS was also named a ‘recommended provider’ by Which? Magazine and was the highest-placed high street bank in the influential JD Power survey.

CFS has maintained and enhanced its financial strength, while delivering benefits for customers and members. Operating profits of £208.6m for 2010 were 17.7% higher than for 2009. Excluding the costs of reinvesting in strategic change, underlying operating profits were up 27.6% to £246.2m.

The capital and liquidity profile for the business remains strong. The Co-operative Bank (the Bank)’s core tier 1 ratio was 9.6% (2009: 8.7%), reflecting the strong capital base of the business, yet it is notable that CFS has not taken, or needed, government capital support. In addition, the excellent levels of customer funding in the Bank of 107% at December 2010, and the continued reduction in arrears, further attest to our principle of being financially prudent and strong.

CFS’ values-based approach to all aspects of the business seeks to balance financial strength with the needs of our customers and our people. Our continuing focus on an easy, fair, personal and responsible service, during a time of deep uncertainty for many of our customers, remains a key distinguishing factor. Despite a difficult mortgage market, CFS has increased its lending, with gross advances of £4.7bn, which illustrates the business’ continued support to families and small businesses during these difficult times. CFS is also sensitive to the depressed nature of the savings market and is doing what it can to balance savers’ interests with those of borrowers.

CFS saw a 79% increase in current account switchers in 2010. While this is testimony to the strength of, and trust in, our brand, the fact remains that the UK continues to have one of the lowest switching rates for primary bank accounts in the EU. Current accounts are the cornerstone role in retail banking and yet are a major barrier to greater competition. We want to find a solution that makes switching current accounts easier, and, in our submission to the Treasury Select Committee on competition and choice in retail banking, we recommended that a dedicated working group was set up to facilitate this. One issue it should consider is the introduction, longer-term, of a portable bank account and sort code for personal customers.

Since the merger with Britannia Building Society, CFS has continued to make excellent progress on the integration of two complementary operations. The fundamental transformation of the combined business is now well underway, with its focus on delivering an enhanced customer experience. As the first release of our Banking Transformation Programme (the replacement of our core banking systems), Business Online Banking is now offered to our Small and Medium Enterprise customers and FD Online to our Corporate customers. Both services offer enhanced functionality, improved security and have a more durable and responsive systems infrastructure. In addition, Co-operative current accounts are now available in all Britannia branches, and the core product range is aligned across Co-operative and Britannia channels.

## Retail

The Retail business delivered an operating profit of £26.5m. Excluding the cost of strategic change initiatives, underlying operating profitability was substantially improved at £58.0m (2009: £18.9m).

Continued growth in current account balances, tight cost control and lower impairment charges have been at the heart of a strong Retail Bank performance.

Operating profitability for the General Insurance business increased by 48.5% to £31.1m in 2010, benefiting from a successful year of growth.

# 79%

2010 saw a 79% increase in current accounts switched to us.

“I run my own business so I know all about customer service... the service I get from The Co-operative Bank is second to none.”

Mary Ann King

Mary has been both a personal and a business account holder with our Glasgow branch for 15 years.







“It is important for our teams to forge strong relationships with customers – particularly in their moment of need. We offer support and clarity during what can often be a very upsetting time. It’s the customer’s perception of us at times like these that really promotes customer advocacy.”

Debbie Speakman, Claims Team Manager, Manchester



## Financial Services continued

### Corporate and Markets (CAM)

The CAM operating result for 2010 of £147.7m was 21% up on 2009.

Corporate banking has delivered a sustained performance in another difficult year for the industry, driven by measured growth on the corporate banking asset book through selected high quality new business, combined with significant liability growth through term deposits.

The Platform intermediary mortgage business, refocused on the prime mortgage market, has continued to grow its presence in this marketplace throughout 2010, focusing on good quality prudent lending at strong margins being achieved and minimal arrears.

The Optimum portfolio, a closed book of intermediary and acquired mortgage book assets, reduced in size, in line with expectations, by 5%. Arrears have improved steadily during 2010, as the result of major improvements in the arrears management process with a focus on both existing arrears cases and pre-arrears cases.

Treasury has delivered effectively on its core responsibilities of ensuring a strong and stable liquidity base, providing diverse sources of wholesale funding to the Bank, managing market risk within risk appetite and delivering a strong financial performance on the investment portfolio.

### Performance highlights

The strength of the retail customer proposition has again been recognised by a range of awards.

CFS was named a 'recommended provider' by Which? Magazine, and won multiple categories at the Moneywise Customer Service awards.

The Co-operative Bank achieved the highest rating in the Forrester UK bank website benchmarking survey (beating NatWest, Santander, Barclays, Lloyds TSB and Halifax), and was the highest-placed high street bank in the influential JD Power survey.

The Co-operative Insurance won the 'Best Online Motor Insurance Provider 2010' at the 'Your Money' awards and also won 'Intelligent Choice Awards' for its customer service and cover from Consumer Intelligence. Customer satisfaction with general insurance products and service is at 74% for Motor and 71% for Household, compared to market averages of 65% and 60% respectively, according to GfK NOP Financial Research Survey (FRS), January 2010 to December 2010.

Life and savings was well ahead of the industry average for customer advocacy in the 2010/2011 ABI customer impact survey, where 79% of customers were 'likely' or 'very likely' to recommend the CFS life and savings business to others compared to an industry average of 69%.

### Summary and outlook

I believe that the excellent progress made in integrating the two businesses leaves CFS well positioned to deliver market-leading customer service. The benefits already provided to corporate customers through the Banking Transformation Programme will be extended to all customers over the next three years. We recognise the challenges ahead but are confident that our unique position within the industry, and the support of our people and customers, mean that we are favourably placed to achieve our vision.

**“We put the customer at the heart of everything we do – that’s why we stand out for customer satisfaction.”**

Sarah Garner, Product Manager, Manchester

We put the customer at the heart of everything we do – that’s why we stand out for customer satisfaction.

**“Customers don’t just buy from us – they trust us and come back to us. That’s why so many of them would recommend us to a friend.”**

Malcolm Martindale, Area Manager, London

According to the 2010 ABI customer impact survey, over 2 in every 3 CFS customers are 'very' or 'extremely likely' to recommend us to others.



# Pharmacy

Performance		
	2010 £m	+/-%
Net revenue	771.3	+3.5
Operating profit	33.4	+11.7
Key facts		
Branches	769	
Customers	202,000 per week	
Employees	6,709	

“The NDC has been a really exciting and positive experience. This new facility is something we are really proud of particularly when you get an inspector commenting that it was the finest pharmaceutical warehouse he had ever been in!”

Jonathan Bomphray

Jonathan is Head of Operations and Logistics at Pharmacy's new £16m National Distribution Centre in Stoke-on-Trent, the most advanced pharmaceutical facility of its kind in Europe.

In 2010, our Pharmacy business found its own unique way to express The Co-operative's ethical commitments. It launched its first ethical strategy, the centrepiece of which was the signing of a three-year partnership with UNICEF, worth £400,000, to support sanitation projects in the developing world. It's a commitment that will help to provide 7,800 latrines, reaching 195,000 people in 390 villages. Pharmacy has also begun a series of media campaigns to draw attention to health issues, including sexual health, for individuals. Its medicine checks during Ramadan again proved very popular in 2010.

Despite tough economic conditions and increased competition from food superstores, Pharmacy has maintained its market share and delivered an impressive improvement in performance with a sales increase of 3.5% from £745.0m to £771.3m in 2010. This has led to an increase in operating profit before significant items of 11.7% from £29.9m to £33.4m.

An important development in 2010 was the first full year of operation for our new National Distribution Centre (NDC) in Stoke-on-Trent. The investment in our NDC has proved to be invaluable in ensuring we have the right medicines available in all our branches and that this can be achieved with increased profitability. In 2010, we also received regulatory approval that allowed us to begin generic medicine production at our joint venture manufacturing facility in China. This will increase in 2011, making further significant improvements to our margins.

The business launched a number of new services in 2010, not least being the flu vaccinations we offered to help customers beat the winter blues, and played a key part in the development of Pharmacy Voice, a new representative body for the industry that will hopefully help to improve the way in which pharmacies liaise with government in 2011 and beyond.

Internally, we made significant investment in technology, with changes to our key patient medication record system in all branches, bringing them onto a single platform and ensuring real benefits both for colleagues and customers.

2011 already promises to be a challenging year, due to the government funding clawback, which began in earnest in October 2010, reducing the reimbursement prices for generic drugs. Our business model is strong, however, and the senior management team is geared towards driving good profits for the business and excellent products and customer service.



“As a Co-operative business, our responsibilities do not stop at caring for communities in the UK.”

John Nuttall, Managing Director

Pharmacy's ethical strategy is supporting sanitation projects across the developing world.



“The team here are the nicest bunch I’ve ever worked with – we work really well together to provide a professional, genuinely personal service to our customers.”

Sally Clarke

Sally, a Technician from our Aspley Pharmacy, won the prestigious Technician of the Year title at the Chemist & Druggist Awards, beating 5,000 nominees to the post.





“We just genuinely care about our clients. From the casual staff to the management, at every level, we care. It’s all about the clients. We involve them in everything we do.”

Deborah Conner

Deborah, Principal Funeral Director at our Amble branch, whose team scored 100 in their 2010 Funeral Excellence Score.



# Funeralcare

Performance		
	2010 £m	+/-%
Net revenue	316.0	+10.0
Operating profit	51.9	+18.8
Key facts		
Funeral homes	865	
Funerals	101,333	
Employees	4,084	

**Customer care is essential to every aspect of the Group's activities. But for our funeral business it is truly paramount. Funeralcare has built its continuing success on understanding client needs, often at a time of great emotional distress, and providing the utmost care to every aspect of funeral arrangement. That sensitivity, attention to detail, and dedication to service remains at the heart of the business.**

In 2010, our commitment to service, by colleagues at every level, has led The Co-operative Funeralcare to once again deliver an outstanding performance. Operating profit was up 18.8% from £43.7m to £51.9m. Funeral sales during the year were also up by 10.0% from £287.4m to £316.0m.

Members can take great pride in the Group continuing to be the UK's leading Funeral Director. We also aim to be recognised as the UK's number one provider of choice and in 2010 we developed a ground breaking national television advert, supported by press, radio, outdoor and online marketing campaigns. Our new advert focused on promoting the choices and options available to clients when arranging a funeral and our ability to meet their individual wishes.

We have continued to invest in the business, with £9.5m to improve our fleet of vehicles and £11.1m to improve our branch estate. We are developing our products and services including our masonry and woodland burial ground offer.

Funeralcare is committed to maintaining the highest standards and to ensure this we have a dedicated standards team who visit and audit our services and facilities; a 'mystery shop' programme to ensure we maintain a high service level and Customer Service Questionnaires which we ask all of our customers to complete. In 2010 26% of our customers returned completed questionnaires achieving a 98% customer satisfaction level.

Customer Service Questionnaires are also utilised to provide an overall summary of branch performance. A Funeral Excellence Score (FES) is calculated based on separate factors which determine the quality of customer service. The 2010 FES score exceeded our target, confirming our investment in customer care.

Supporting the local communities we serve has always been a priority for Funeralcare. In 2010, more than 8,500 community activities were carried out by teams across the business, ranging from memorial Christmas trees to the donation of more than 55,000 reflective badges to school children to promote road safety.

“Funeral Plan sales made a significant contribution to Funeralcare's success.”

Alison Close, Head of Strategy and Development

Branch Funeral Plan sales were up 29% compared to last year.



“We pride ourselves on our high standards. We continually strive for excellence.”

George Tinning, Managing Director

Over £20m was invested in Funeralcare's fleet and branch estate.

# Specialist Retail Businesses

Net revenue		
	2010 £m	+/-%
Legal Services	24.2	+19.2
Life Planning	36.0	+20.8
Operating profit		
	2010 £m	+/-%
Legal Services	3.9	+2.6
Life Planning	6.1	+35.6

“This is a great credit to all our Travel colleagues and a reflection of the excellent service they continue to provide.”

Mike Greenacre, Managing Director, The Co-operative Travel

The Co-operative Travel was voted National Travel Retailer of the Year at The British Travel Awards (BTA) for the second consecutive year. The BTAs are the most cherished national travel awards as they are the only awards voted for by consumers.



## Legal Services

The Co-operative Legal Services continues to grow strongly with sales up 19.2% from £20.3m to £24.2m. Profits have increased slightly by £0.1m to £3.9m. Our Personal Injury service has again performed well and has allowed us to extend our business-to-business proposition further with the development and launch of our Accident Management Services. Other initiatives have included relaunching our personal injury and will writing websites, together with continued support and development of our joint proposition with Life Planning. Our Legal Service business is currently growing rapidly thanks to great customer service and attractive rates and a strong range of Personal Injury, Probate and Will Writing services.

## Life Planning

Our Life Planning business is reporting another excellent year of trading with sales up 20.8% from £29.8m to £36.0m and operating profit up 35.6% from £4.5m to £6.1m. Success has been achieved through a combination of driving sales in existing channels, launching new distribution partners and the development of new products, such as Funeral Protect Plus which was launched in association with CUNA Mutual, one of the biggest credit unions in the UK and a recognisable name in the United States. In addition, improved controls and quality of processes, combined with tight management of costs has meant the business has managed to deliver an excellent performance. Highlights of the year include the creation of a Wills and Funeral planning customer offer resulting in a substantial increase in direct Funeral plan sales. This in turn led to the ability of our Legal Services business to identify new customers for will writing services during the last quarter of the year. 2011 will see the business acting on a number of new partnerships that are currently in the pipeline as well as further developments in the joint Legal Services and Life Planning propositions and distribution process.

## Travel

2010 proved to be an exceptionally challenging year for the whole travel industry. Severe pressure on margins in a highly competitive market were compounded by the global impact of the downturn in the economy, the Icelandic ash cloud which grounded flights and cost millions in compensation and other events such as the World Cup and the General Election, also adversely affected holiday sales.

It was evident early in the year that these challenges required a much broader, strategic review and it was against this backdrop that we entered into discussions with Thomas Cook to form a proposed new joint venture which was announced in October 2010. The new joint venture is currently awaiting approval from the regulatory authorities, but we believe it will be good news for our customers, members and the majority of Travel colleagues and will secure The Co-operative Travel brand on the high street for many years to come. Due to this proposal, the results of the Group's Travel business are required to be reported within discontinued operations, in accordance with Accounting Standard IFRS5. The results of the discontinued operations can be found in the Financial Review on page 39.

“The Co-operative's social values make us uniquely placed to provide a different claims service. The market needs our strong ethical brand where customers feel supported and cared for.”

Eddie Ryan, Managing Director, The Co-operative Legal Services

The Co-operative Legal Services Personal Injury service has performed well throughout 2010.



“I really love the fact that The Co-operative Travel is all about the people and putting the customer first.”

Louise Welsh

Louise is the Manager of our Kelso branch, which was our Branch of the Year winner.



“To me, it just makes sense to promote the brand and what it stands for wherever we can.”

Jennie Gould, E-Store





## Specialist Commercial Businesses

Net revenue		
	2010 £m	+/-%
Sunwin Services Group	29.1	+3.6
The Co-operative Motors	266.6	+34.9
E-Store	87.9	+11.5
The Co-operative Clothing	5.1	+15.9
Operating profit		
	2010 £m	+/-%
Sunwin Services Group	5.6	+24.4
The Co-operative Motors	2.9	+390.0
E-Store	2.1	+5.0
The Co-operative Clothing	0.5	+66.7

“Sunwin Managed Security achieved a score on the Approved Contractor Scheme that places the business in the top 10% of all large guarding companies in the UK.”

John Hilbert, National Manager, SMS

SMS attained a 16% increase on the Approved Contractor Scheme audit during 2010.

### Sunwin Services Group

Sunwin Services Group, which comprises Cash in Transit Services, ATM Support, IT Services, Sunwin Fire & Security and Sunwin Managed Security, has enjoyed a good year in difficult trading conditions where our customers, primarily in retail and banking, are looking at ways to reduce costs. Total sales in this financial year were up 3.6% from £28.1m to £29.1m. Operating profit was up 24.4% from £4.5m to £5.6m.

CVIT has seen sales increase 19% in the year by increasing its customer portfolio with a number of new national retail cash collection contracts won during the year. IT Services sales have increased 23% in the year due to an increased number of major projects being undertaken. New contracts won by Managed Security have enabled the business to increase sales by 25%. With our move into larger warehouse premises and a number of industry accreditations gained during the year Sunwin Services Group is well positioned to become an ever increasing presence in the security industry sector.

### The Co-operative Motors

Our car dealerships performed well in the midst of a volatile market, turning last year's loss of £1m into an operating profit of £2.9m this year. This was greatly assisted by the transformation of 19 dealerships that adopted The Co-operative brand.

New car sales performed well in the first half of 2010, but came under increasing pressure as the year wore on and the economy once again began to contract.

Working closely with our manufacturing partners meant that we were able to mitigate margin pressures through the delivery of target plans. These close partnerships resulted in us gaining the Land Rover franchise for Leeds with 2010 seeing its first full year of trading. This and significant sales improvements as a result of unswerving commitment to customer service, propelled it into one of Land Rover's top 10 best branches in the UK.

### E-Store

At a time when the biggest electrical retailers in the UK have performed poorly with trading losses and declining market share, our E-Store business has again performed well. Net revenue increased by 11.5% to £87.9m, and operating profit has increased to £2.1m. This performance is very encouraging as the UK electrical market was in decline in 2010, with e-commerce growth flat compared to 2009. Our market share has grown, primarily due to outstanding prices, excellent customer service, and our rapid and very reliable delivery service. Continued consumer recognition of our brand has helped improve our business.

Our delivery service still remains industry-leading with over 99% of products delivered to our customers on the chosen date, together with our two-hour delivery time slot. During the year we have collected over 15,000 old appliances from customers which have been recycled, and we have also recycled 250 tonnes of cardboard and polystyrene packaging. E-Store has strong links with other co-operative societies, managing the Co-operative Electrical Buying Group. The service includes buying, warehousing, distribution and promotions. Electrical sales throughout The Co-operative businesses performed well during 2010, benefiting from the ability to purchase container deals in large quantities with direct shipment from overseas to our warehouse.

### The Co-operative Clothing

The Co-operative Clothing delivered a very creditable result, improving its operating profit, which was up by £0.2m to £0.5m. The business' main focus for 2011 will be increased sales channels, spearheaded by a new catalogue for trade. Other improvements in 2010 included innovations such as automated labelling and ongoing improvements in warehouse processes with new conveyor and scanning machines. Clothing is developing new product ranges in suiting, beauty and catering, increasing the colour range of top selling shirts and blouses as well as looking to drive new sales and maximise current opportunities by e-marketing existing and new clients.



“Our range is popular, hard-working and cost-effective, and builds on The Co-operative's deserved reputation as one of the UK's most trusted brands.”

Dionne Moy, Sales and Marketing Manager

The Co-operative Clothing launched several new developments in 2010, including 'Aurora', a range of clothing for the beauty industry, which has proved popular in colleges and salons.

# Estates

Performance		
	2010 £m	+/-%
Revenue	35.7	+6.9
Underlying operating profit*	18.9	+2.7

\* Per segmental analysis.

“The Workplace Services team strive to exceed customer expectations and stretch the boundaries of traditional facilities management. Adding value in delivering against challenges we have set ourselves is where we stand out from our industry peers.”

Kate Morris

Kate is Head of Workplace Services, which won ‘Corporate Occupiers Excellence in FM team’ award at the annual British Institute of Facilities Management awards, recognising them as UK leaders in the provision of facilities services to corporate occupiers.



## The Co-operative Estates

Estates made a significant contribution to the Group in 2010, both in terms of business performance and the provision of key services to the trading businesses. Despite the depressed economic conditions, underlying operating profit was up 2.7% from £18.4m to £18.9m over the previous year. In addition, the revaluation of our investment property portfolio contributed an additional £14m to operating profit, ending the year at £339m, aided by an uplift in the property market and proactive portfolio management. Property disposals of £96.8m were completed in the year, which helped realise capital that can be invested in other Group projects and assist with Group cash flow.

The construction of the new head office got underway in the summer, marked by a Foundations event at which we were able to set out our vision for the building and the benefits it will bring to the business and to the wider community in Manchester. Over the lifetime of the project, around 4,000 jobs will be linked to its construction. We are working to ensure we maximise apprenticeships on the site and are forming links with schools, colleges and higher education to develop learning opportunities too. We have formed a partnership with a local charity working with the young homeless in the city, Lifeshare, and have already renovated their offices. The ambition of our new head office was recognised in 2010 when we won the Estates Gazette Green Award for Office Development of the Year. The building will be the first phase of our 20-acre masterplan which will see us leading a radical regeneration of a key part of the city centre that has suffered from under-investment for decades.

During 2010 we were commended on our energy efficiency programme right across the Group, when we were named Retailer of the Year at the annual Rosenblatt New Energy Awards, beating off other major retailers. The judges were very impressed by efforts from all of our businesses but in particular Food, which has embedded the programme into its daily business with an energy champion in every store, a dedicated team of regional energy managers, and monitoring of energy usage every half hour as well as delivering store refits with an average energy saving of 10%. The energy efficiency programme, led by Estates, has now saved the business over £25m during the last three years as well as reducing the Group’s carbon footprint.

The Estates workplace services team won a prestigious UK award during the year for Excellence in Facilities Management, recognising their progressive management processes with a portfolio of high maintenance buildings, while the Estates based Operational Risk team continued to ensure the businesses maintained compliance and actively managed risks during the year in the face of an increasingly regulatory business environment.



“As we prepare to move to our new offices, it’s been fantastic and inspiring to see the positive effect a new workplace can have on ways of working and the ability to deliver a better service.”

Martyn Hulme, Managing Director, The Co-operative Estates

As part of the new head office plans, The Co-operative is supporting Lifeshare, a Manchester charity for the homeless, by transforming its offices and helping it to better serve its client base of homeless and disadvantaged people.

“With the new head office we’re looking to create a modern working environment that supports an agile, performance-focused workforce. The work we’re doing now – around flexible working pilots, hot desking and a number of other initiatives – will really allow us to hit the ground running.”

Marianne De Souza

Flexible Working Project Manager Marianne De Souza has been spearheading a real cultural shift in the way head office colleagues work ahead of the move to the new head office in 2012.





# Our people

“The Co-operative Group has a leading-edge employee engagement programme, which balances our need to build an increasingly successful business with our concern for the wellbeing of our people.”

Richard Bide, Director of Human Resources

The Co-operative Group won the 2010 Personnel Today Award for Employee Engagement.



The Co-operative Group is a family of businesses and, like all families, we are made up of individuals. Around 110,000 people – including customer facing employees in stores and branches, supply chain colleagues, call centre colleagues and regional and head office colleagues – are working for the Group in thousands of locations. Together, they have delivered the success we are able to report for 2010.

Each year, a great deal of work goes on to try and improve the capability, the working experience and the quality of working life for each of our employees. As part of our new Group Vision, we have set ourselves the aim of being an exemplary employer.

### Somerfield and Britannia

Our integration projects in Food and CFS have led to significant changes and improvements in the way we manage and support our colleagues. The Somerfield acquisition resulted in the transfer of 27,000 former Somerfield employees to the Group’s payroll. Terms and conditions were also harmonised across the enlarged Food business.

We extended to former Somerfield colleagues our comprehensive Employee Assistance Programme which not only provides support for work related issues but also advice to resolve problems outside of work. The new Employee Recognition Scheme, which was introduced across our retailing businesses in 2009, was also made available to the former Somerfield estate in Spring 2010. The scheme uses an online gift shop to support a recognition culture in the workplace and provide managers with a simple and effective way to thank staff for outstanding achievement.

For CFS, the merger with Britannia required us to undertake a significant organisational redesign to bring together the two businesses and create one leadership team with integrated teams in the majority of areas. New terms and conditions have been designed which are expected to be implemented in April 2011.

### Employee development

To continue the success we have enjoyed in recent years and compete in an ever more competitive environment, we must invest in the training and development of our leadership community. We are identifying colleagues of high potential across the Group as part of a commitment to grow our own talent and develop our succession planning. A project started during 2010 and launched January 2011 provides a comprehensive Group leadership development curriculum for senior managers that they can easily access through an innovative online portal. We want our people to be the best that they can be because we know that by investing in people we are investing in the business. This can also be seen through our commitment to re-accreditation with Investors in People.

### Apprenticeship Academy

The investment in people goes beyond current colleagues as we look to recruit and retain the most able of tomorrow’s talent. In 2010, we launched a £21m campaign as part of our Inspiring Young People initiative which includes an ambitious new Apprenticeship Academy that will eventually offer young staff transferable skills, competencies and qualifications – not just a job. The new Co-operative Apprenticeship Academy is a key element of The Co-operative’s campaign, created to help reverse the negative image and treatment of those aged 25 and under and to support their future life goals and ambitions. We will offer our apprentices experience across our diverse family of businesses and the opportunity to work towards a nationally recognised qualification. As well as creating job opportunities, the eight point Inspiring Young People campaign will inspire those aged 25 and under to change their world for the better, through co-operative education, opportunities and campaigning.

“The Group seeks to provide an experience of work where all employees feel respected, valued and fully included as part of their team.”

Liz Bramley, Head of Engagement, The Co-operative Group

The Co-operative has continued to rise through the ranks of the Stonewall Workplace Equality Index, climbing 15 places to be ranked 64th in the latest Stonewall ‘Top 100’ employers list.

“Our graduate programme fully demonstrates our continued commitment to investing in developing our future leadership talent. Our graduates start adding value from day one, The projects they undertake allow them to quickly impact the bottom line and contribute to building a better society.”

Jackie Lanham, Director of Resourcing and Development, The Co-operative Group

Our graduate programme continues to go from strength to strength and has again climbed up the Times Top 100 list.

**Our graduate programme**

Our graduate programme continues to go from strength to strength and has again climbed up the Times Top 100 list. In 2010, we received over 2,000 applications for 18 jobs. Our graduate programme has two distinct streams – Business Management and our Finance programme. In addition, we have a graduate programme for future pharmacists; a Management Designate Programme in our funerals business to develop leadership skills for potential funeral industry managers of the future; and because we’re the UK’s biggest farmer, we offer our Farms Management Training Programme. CFS has recently launched a new graduate programme which is now open for 2011 applications. Whichever programme our graduates or colleagues join, they are offered the opportunity to get right to the heart of our commercial approach to business, with the sort of training and development most graduates dream of.

**Diversity and engagement**

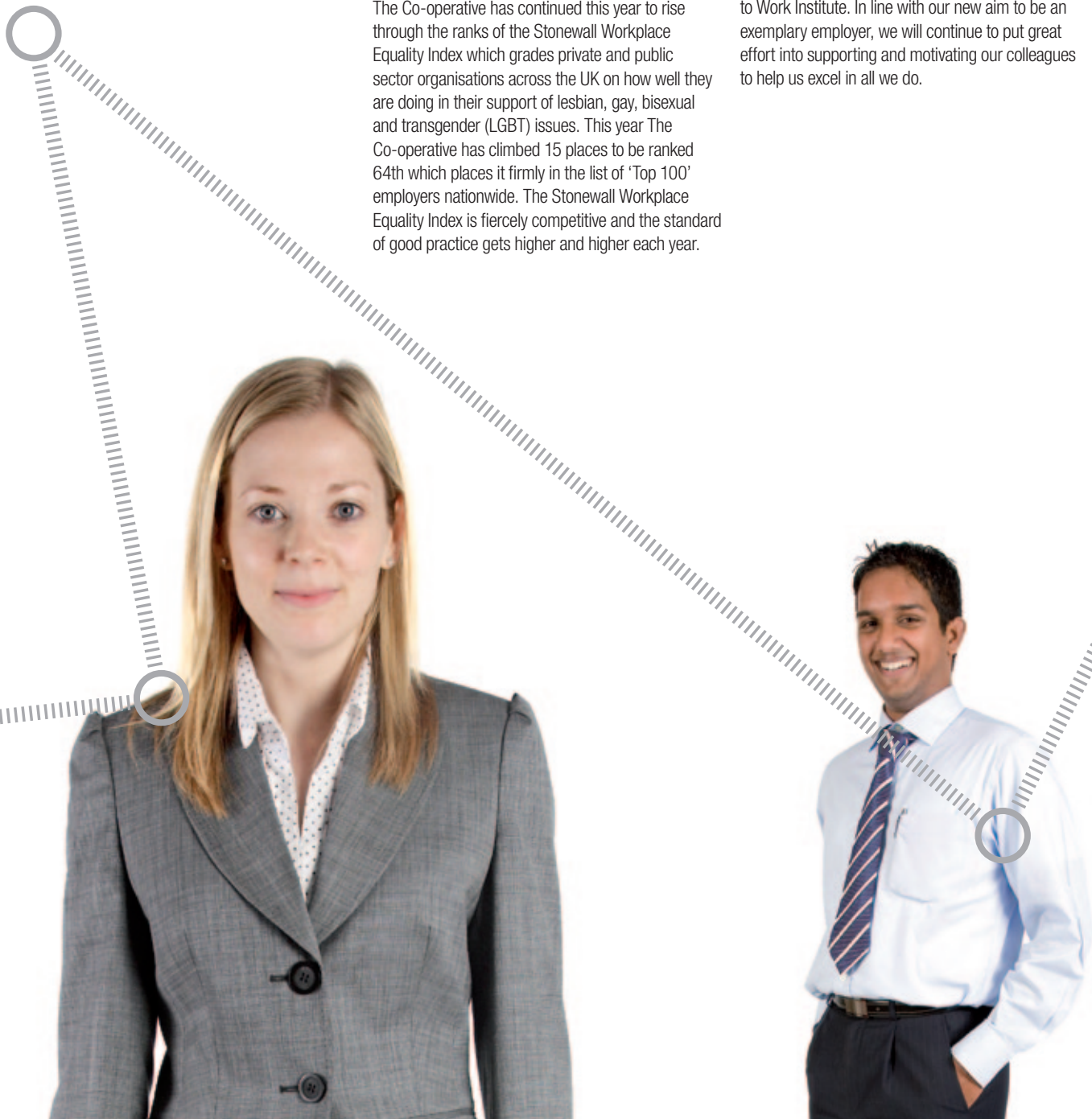
A commitment to promoting and celebrating diversity and colleague engagement is central to our people strategy for the Group.

The Co-operative has continued this year to rise through the ranks of the Stonewall Workplace Equality Index which grades private and public sector organisations across the UK on how well they are doing in their support of lesbian, gay, bisexual and transgender (LGBT) issues. This year The Co-operative has climbed 15 places to be ranked 64th which places it firmly in the list of ‘Top 100’ employers nationwide. The Stonewall Workplace Equality Index is fiercely competitive and the standard of good practice gets higher and higher each year.

We are competing not only against private business in the country but public sector bodies as well, such as police forces, universities and NHS Trusts. We are delighted that we continue to improve our score and remain one of the few retailers to make it into the Top 100.

Measuring engagement is an essential tool to help us understand how colleagues are feeling throughout the organisation. Our annual employee engagement survey across our retailing businesses, Talkback, received its highest ever response in 2010 and recorded a high engagement score. For the first time, the former Somerfield estate was included. Within CFS, the engagement survey is called ‘The Voice’ and is run twice a year. The response rate is high and engagement scores are being maintained at a high level through a period of significant change.

Meanwhile, we continue to be recognised externally for the successful implementation of our people strategy. In 2010 we received a number of awards including the Personnel Today Award for Employee Engagement. For the second year running we have made the top 50 list compiled by the Great Place to Work Institute. In line with our new aim to be an exemplary employer, we will continue to put great effort into supporting and motivating our colleagues to help us excel in all we do.



# Social goals

## Performance

£54.9m paid out to individual members from profits

£12.4m invested in the community

250,000 young people benefiting from Inspiring Young People activity

Over £1bn of Bank finance declined to businesses deemed unethical by customers

A set of clear values and principles has guided our business since its creation in the mid-nineteenth century, through times of challenge and prosperity alike. Our commitment to these values has provided us with considerable commercial strength; building customer confidence in our brand and an impressive reputation amongst the general public, while earning us many prestigious accolades. It is thanks to the work of Group colleagues that in 2010 we were named: **The Grocer's Green Supermarket of the Year; the FT Sustainable Bank of the Year; and the RSPCA's People's Choice Supermarket.**

While sustainability is very much 'business as usual' at The Co-operative Group, these awards testify to the boldness of our agenda, which has enabled us to improve the communities of many thousands of people across the world. Group Chief Executive, Peter Marks, visited some of our Fairtrade projects in Africa last year to see first hand how our business is helping those in the poorest countries trade their way out of poverty. There is still much more we can do, both abroad and closer to home. We are proud to say that in 2011 we have launched our boldest Ethical Plan and campaign yet. This aims to cement our position as the UK's most responsible business, and will call on millions of our customers and members to join us in working for a fairer world.

## Materiality, strategy and governance

The Co-operative Group's strategy for sustainability is informed by those issues of greatest relevance to our business and our stakeholders. The Group has always had a purpose beyond profit, and has recognised that certain injustices need to be tackled. A series of innovative ethical policies have built on our co-operative values and principles and been informed by the views of our member-customers. In 2010, we launched a new Pharmacy Ethical Strategy, and an Ethical Strategy for our funerals business followed in 2011.

We are owned by our members and are accountable to them through our unique democratic structure. Sustainability strategies are overseen by the Group Values and Principles Committee – comprising elected representatives drawn from our membership. Sustainability performance is linked to business KPIs, and as such, impacts upon remuneration of our Executive team. We remain accountable to all our stakeholders through our award-winning annual Sustainability Report – praised for its openness and honesty – which gives a detailed analysis of performance across all material social responsibility, ecological sustainability and economic indicators.

2011 has seen the launch of a landmark, three-year Ethical Operating Plan. The Plan sets out ambitious new targets and heralds a new era for sustainable development both in our business, and beyond. As well as improving our own performance in these areas, we will encourage our customers and members to take action and campaign to influence public policy.

**“By launching this Ethical Plan, The Co-operative is taking corporate sustainability into a new era. Other businesses will now be seeking to benchmark themselves against this Plan.”**

Jonathon Porritt, leading social and environmental commentator

The Co-operative Group has unveiled its new Ethical Operating Plan, launching its boldest sustainability targets and campaign to date.



**“It’s fantastic to see the contribution Fairtrade makes to other people’s lives.”**

Peter Marks, Group Chief Executive

The Co-operative is ensuring 11,000 tea farmers in Kenya get a fairer deal for their tea.



“The Co-operative British Youth Film Academy has given me an opportunity to become the person I aspired to be.”

John Montegrando

The Co-operative British Film Academy (BYFA) has given John the skills and confidence to turn his life around. With their support, he has been able to overcome drug abuse and homelessness. He is now directing BYFA feature films and will graduate from theatre school in 2011.



## Performance overview

### Keeping communities thriving

With a presence in every postal area in the UK, we are at the heart of the community. In 2010, £12.4m (4% of pre-tax profits), was invested in communities at home and abroad. In 2010, more than 1,600 local community groups were supported by members who donated their share of the profits to The Co-operative Community Fund, and colleagues volunteered more than 90,000 hours to assist a host of deserving projects. In 2011, we will be counting on our customers, members and employees, once again, to help meet our fundraising target of £5m for Mencap, The Co-operative Group's Charity of the Year, to improve the lives of young people with a learning disability around the UK. Furthermore, we plan that, by 2013, 10% of our profits available for distribution will be invested in the community, with at least £5m being targeted at tackling poverty around our stores and branches.

### Supporting co-operatives

We continue to uphold the principle of 'co-operation amongst co-operatives', and in 2010 supported the very first Co-operatives Fortnight, to raise the profile of co-operatives in communities across the UK. The Co-operative Enterprise Hub is now active nationwide, and is investing £7.5m over the next three years to enable co-operative businesses to start up and grow, through the provision of advice, training and finance. By 2013, we intend to have invested a total of £11m in the development of co-operatives, and set up an additional £20m international Co-operative Development Loan Fund.

### Inspiring young people

In June we were pleased to launch our new 'Inspiring Young People' programme, which helps 250,000 young people across the UK to change their world. In 2010, The Co-operative opened the first two of its Co-operative Academy schools, based in Manchester and Stoke-on-Trent, and a third will open in Leeds in 2011. The Co-operative Academies will deliver an innovative curriculum to students aged 11-19, providing access into work within a values-led ethos. This forms part of the Group's wider work supporting Co-operative Schools, which includes establishing a co-operative society for 120 schools, operating with co-operative values and principles. Our Green Schools programme is helping more than 100,000 children to make more sustainable choices, and has seen nearly 200 schools kitted out with renewable energy technologies.

In 2010, we completed the roll out of our 'Truth About Youth' initiative to challenge and change negative perceptions of young people, launched our 'Votes at 16' campaign to engage young people with the democratic process at an earlier age, and continued to champion financial literacy amongst young people. The Co-operative British Youth Film Academy provides opportunities for young people to gain the skills they need to break into the film industry, and our StreetGames Young Volunteers programme has enabled more than 2,600 volunteers to gain leadership skills and coach sports to other children in their local community. By 2013, The Co-operative Apprenticeship Academy will have created 2,000 new apprenticeships.

“Thanks to The Co-operative, we're helping communities to build their own wind farms.”

Energy4All Ltd

Energy4All grew out of the UK's first community-owned wind farm, Baywind Energy Co-operative, part financed by The Co-operative Bank over ten years ago. With further support from The Co-operative Enterprise Hub, it has developed seven other co-operatively owned wind farms across the UK.



“The Co-operative Group really champions causes that are important to people.”

Tim Knappett, Regional HR Manager

Tim was encouraged to pursue a life-long dream to be a beekeeper by the Group's Plan Bee campaign.





## Social goals continued

“CFS truly has sustainable banking as part of its DNA. It is unusual to find an institution that has ethics so genuinely grounded.”

FT Sustainable Bank of the Year judging panel

CFS won the prestigious FT Sustainable Bank of the Year award in 2010, beating 110 other financial institutions from 44 countries in the process.

### Protecting the environment

We have a long-standing commitment to the pursuit of ecological sustainability, through managing our own impacts responsibly and influencing the wider debate on environmental issues. Throughout 2010 we continued to drive a programme of energy efficiency in more than 600 of our most energy-intensive Food stores, and continued the training and development of over 3,000 in-store energy champions. Work is well underway on our new head office, which will set new standards in sustainable design, construction and operation in the UK. Our ambition doesn't stop here. We've set new targets to ensure virtually all operational waste is diverted away from landfill by 2013 and reduce operational greenhouse gas emissions by 35% by 2017. We take seriously our role as a campaigner and influencer of public policy. In 2010, we have been funding research into the impact of pesticides on the bee population as part of our Plan Bee campaign, and enabling people across the UK to take up beekeeping. We're also lobbying at an EU level to ensure that decision makers are fully aware of the catastrophic impacts associated with unconventional fossil fuels, such as tar sands, and have backed ground-breaking films and exhibitions highlighting these risks.

### Tackling global poverty

We continue to strive for a fairer world, where basic human needs are met and rights are respected. We remain second to none in terms of Fairtrade availability; our Fairtrade market share far exceeds that of our overall sales, and Fairtrade sales have nearly tripled in just three years. During Peter Marks' visit to Fairtrade projects in Kericho, Kenya, he met Merci Marl, one of 11,000 smallholder tea farmers we are helping organise into co-operatives in order to achieve the Fairtrade certification needed to supply businesses like ourselves. For Merci, the chance to be part of the Fairtrade system means the chance to provide the education her children need for a better life. As part of our new Plan, if a primary commodity can be Fairtrade, it will be Fairtrade by 2013. During 2010, we also continued to deliver water, sanitation and green energy solutions to communities in the developing world. In 2011, we will launch a new campaign to make poverty history through a revitalised third world debt campaign 'Unfinished Business'.

### Ethical finance

We have long recognised that the provision of ethical finance is crucial to the pursuit of sustainable development. The Co-operative Bank has seen its commercial lending grow 16-fold since the launch of its customer-mandated Ethical Policy in 1992, which prohibits investment in certain business areas. Indeed, over £1bn has, to date, been withheld from business activities that Bank customers deem unethical. In 2010, we launched a Social Banking Unit to better serve organisations with distinctly ethical or social purpose. Looking ahead, we will increase our commitment to fund energy efficiency and renewable solutions to £1bn. In an exciting development, the £1bn of investments that underpin our key general insurance products are now also subject to ethical screening.

### Responsible retailing

The Co-operative recognises the importance of its role in the drive to improve the nation's health, and continues to reduce the salt, saturated fat and sugar in own-brand products. What's more, we've stepped up our commitment to open and honest product labelling, and launched a new front of pack labelling scheme that shows both Guideline Daily Amount and 'traffic-light' information. It's our firm belief that our ethical and healthy offerings should be accessible to all, not just the few. That's why we will ensure that our Healthier Choice options are no more expensive than our standard lines, and the nutritional content of Simply Value products will be at least as good as standard equivalent lines.

We have long known that animal welfare is a priority for our members, and it is our intention that good baseline welfare standards are applied across our own-brand range. In 2010, our range of Elmwood higher animal welfare products was extended, with more than 140 Elmwood product lines now on the shelves, and sales tripling since the range was launched in 2008 to £110m. 2011 will see Elmwood standards being extended to fresh pork and sausage products, and the development of a dedicated supply chain for milk will deliver improved animal welfare standards for dairy cows.





# Looking forward

**We had hoped to see signs of economic recovery by the start of 2011 but the downturn is clearly biting deeper than we had expected. We now anticipate challenging trading conditions through to the end of this year and possibly beyond. The impact of the Government's Spending Review and significant job losses in the public sector have not yet been felt. I fear, though, that we should be preparing ourselves for the possibility of a long, slow climb out of the recession. Our businesses that attract discretionary spend (Travel, Motors, E-Store) are likely to be hardest hit. However, our broad range of business activities means the Group, overall, has some protection from the worst effects of the austerity measures.**

### Customer needs

With consumers feeling the squeeze on their spending, I know that all of our sectors will have to fight for their market share. That means we must make even greater efforts to ensure we are responding to the needs of our members and customers and are giving them good reasons to trade with us. Our products must be right and our service must be good. That's not always easy when driving major changes that cause considerable disruption – as we have done with our Food business. Now is the time though to give maximum attention to availability, cost, value and the overall shopping experience.

Despite the difficult economic environment that 2011 presents to us, I am more than confident that the strategic decisions we took to significantly grow the Group, through the merger with Britannia and the acquisition of Somerfield, will start to bring rewards by the end of the year. We should remember that these two big integrations are not yet complete. There is still significant investment underway in the back-office computer systems of the Bank and in reshaping our supply chain operation in Food.

### Transition

So, in 2011 we will still be a business in transition. We have revitalised our brand, invested millions in our store and branch estate, and improved our products and our service. But the journey is not complete. We are still getting ourselves in shape for the future. Our Board has recognised that one part of the transition should be ensuring that the Group is truly operating as one unified business. The first stage of the Unity programme has been to restructure our Management Executive, as set out in the Chair's report. We are now agreeing a new operating model for the whole Group that will help us to identify opportunities for greater collaboration between businesses and support functions and the leverage of our rejuvenated Co-operative brand. In achieving the benefits of the Unity programme we will ensure there is minimal disruption to normal business activity.

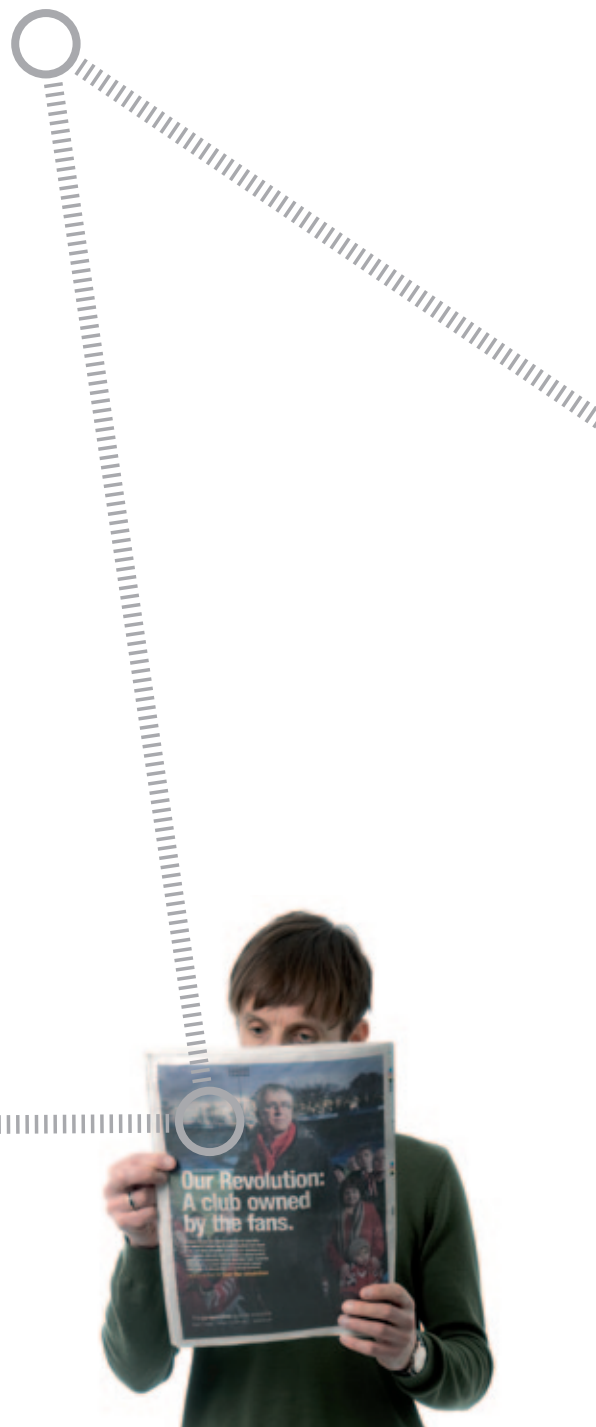
### A better society

We reached a milestone in 2010 by doubling our membership since 2007: clear recognition that the strength of our brand is growing by the year. As ever, we want more of our customers to recognise the rewards of membership and the value of taking an active role in the shaping of the Group and its priorities. Our ethics and social campaigning will again come to the forefront in 2011 as we re-establish The Co-operative Group as the pre-eminent ethical retailer and financial services provider. We have a leadership position in this area and we have no intention of relinquishing it. A national media campaign for the launch of our Ethical Operating Plan will make clear just what we mean by The Co-operative difference.

The good news for 2011 is that we are in an excellent place to weather the current downturn and make the most of opportunities when the economic situation improves. We will continue to set ourselves challenging but achievable targets for both our business performance and our social goals because that is what our members ask for and expect. It is that drive and ambition for excellence that I believe will secure our long term future and that gives me the confidence to say that we are firmly on the right path to meet our vision of creating a better society.

**Peter Marks**, Chief Executive

We launched the 'Join the Revolution' campaign on 7 March 2011.



# Management Executive

## 01 Peter Marks

Group Chief Executive. Age 61. Named Orange Leader of the Year 2009 in the National Business Awards. Entire working life spent within the Co-operative Movement. Instrumental in bringing about a number of major co-operative mergers over the past decade and the acquisition of the Somerfield supermarket chain. Non-Executive Director of The Co-operative Bank plc, Co-operative Insurance Society Limited and CIS General Insurance Limited.

## 02 Neville Richardson

Deputy Chief Executive. Age 52. Prior to joining the Group was Chief Executive of Britannia Building Society. Director of Mutuo (Communicate Mutuality Limited). Member of the Court of the University of Lancaster and of the Building Societies Association Council. Also Chief Executive of The Co-operative Bank plc, Co-operative Insurance Society Limited and CIS General Insurance Limited.

## 03 Martyn Wates

Deputy Chief Executive. Age 44. Has held various senior finance positions within the Co-operative Movement, including Chief Financial Officer of the Group. Director of various internal subsidiaries and Non-Executive Director of The Co-operative Bank plc, Co-operative Insurance Society Limited and CIS General Insurance Limited.

## 04 Tim Hurrell

Chief Executive, Food Retail. Age 57. Tim joined the Movement in 1997, having previously worked for Asda, Hillards and the CWS, after graduating from the University of Durham. He managed the food businesses in Yorkshire and United Co-operatives prior to the merger in 2007. Tim is a Director of the Association of Convenience Stores and a trustee of the industry's charity – Caravan.

## 05 Moira Lees

Group Secretary. Age 52. Heads the Group's Secretariat, covering the Governance, Membership and Legal functions. Also Secretary of Co-operative Financial Services. Has been with the Group since 1981. Has held a number of positions in the Co-operative Movement. Currently Chair of The Co-operative Academy of Manchester.

## 06 Steve Humes

Appointed Group Chief Financial Officer on 1 January 2011. Age 45. Over 10 years' experience with The Co-operative Group, the majority of which time has been as Director of Finance for the Food business. A qualified chartered accountant with extensive food retail and manufacturing experience prior to joining the Group.

## 07 Richard Bide

Director of Human Resources. Age 54. Joined the Executive in 2003. Richard joined the Group from Centrica plc, where he was Group Director of Human Resources. Prior to that, he was Group Director of Human Resources for Tate & Lyle plc, following 15 years with ICI plc in a wide range of HR-related roles.

## 08 Martyn Hulme

Managing Director Co-operative Estates. Age 49. Joined the Group Executive in September 2010 as Managing Director, Co-operative Estates. Has worked for The Co-operative Group for over 20 years in a variety of senior financial and operational posts. Previously held the role of Director of Strategic Planning & Change playing a leading part on many of the recent transformational changes within the Group. Director of various internal subsidiaries.

## 09 Mark Craig

Director of Corporate Affairs. Age 55. Joined the Management Executive in September 2010 as Director of Corporate Affairs, having joined The Co-operative Group at the time of the merger with United Co-operatives. Has spent his whole working life within the Co-operative Movement, having originally joined Co-operative Retail Service (CRS) in 1982, before moving to Oxford & Swindon Co-operative Society and then United Norwest Co-operatives.

## 10 Gill Barr

Group Marketing Director. Age 53. Joined the Group Executive in January 2011. Gill's previous positions include Marketing Director of John Lewis plc, and Business Development Director at Woolworth plc, as well as a range of senior positions within Kingfisher plc, KPMG and Freemans plc. Gill is also a Non-Executive Director of Morgan Sindall plc.

"The Management Executive drive business performance on a day to day basis."

Peter Marks



# Financial review

**The 2010 financial statements reflect an excellent year for the Group despite the difficult market conditions existing in the business areas in which it operates. The challenging issues around the integration of Somerfield business have almost all been addressed with completion planned during 2011. Progress with integrating Britannia continues to plan.**

## Revenue

Group net revenue was £12.9bn in 2010, an increase of £1.0bn (8.3%) on 2009. Revenue in the Trading Group was up by £0.5bn with a full year trading of the former Somerfield stores. Stores sold due to this acquisition have been moved to the discontinued line along with Travel after the announcement of the planned joint venture with Thomas Cook.

Strong performances despite the depressed economic environment have been achieved in several trading areas. Food, despite severe disruption caused by integration of the Somerfield estate, was 4.8% up on the prior year. The other large trading areas of Funerals and Pharmacy were up 10.0% and 3.5% respectively on last year's performance. This was achieved in Funerals against a falling death rate and in a Pharmacy market in which the government continued to increase its 'clawback' on the category 'M' products. A number of the smaller businesses, Life Planning, Motors, Legal Services and E-Store all achieved significant increases in sales revenue.

The Group Financial Services division, CFS, has led the market in the responsible and ethical provision of financial services. As the UK financial services market continues to suffer from unprecedented global economic challenges, CFS has maintained and enhanced its financial strength. Overall financial services revenue before reinsurance premiums and long term business was above last year by 31.4% at £2.1bn (which includes Britannia for a full year compared to five months in 2009).

## Operating profit

Whilst reported operating profit of £489m was 4.6% down, underlying Group operating profit (which adjusts for 'one-off' and non-trading items) at £624.8m was £149.3m (31.4%) higher than 2009. The underlying Trading Group operating profits of £459.3m were £118.4m (34.7%) up on previous year. The Co-operative Financial Services (CFS) underlying operating profit for 2010 was £208.6m compared with £177.2m in 2009, despite the continuing challenges and weakness of the financial services market.

The CFS Retail business on the back of continued growth in current account balances, tight cost control and lower impairment margins has delivered an operating profit of £26.5m. The General Insurance business operating profit has increased by 48.5% to £31.1m benefiting from a successful year of growth. The long term business, run solely for the benefit of policyholders, achieved healthy sales growth. Corporate and Markets (CAM) profits at £147.7m were 21% up on 2009, partly driven by measured growth in corporate banking through selected high quality new business, combined with significant liability growth through term deposits. The Platform intermediary mortgage business continues to grow its presence in the prime mortgage market focusing on quality product lending at strong margins with minimal arrears. Treasury delivered effectively on its core responsibilities of ensuring a strong and stable liquidity base, providing diverse sources of wholesale funding to the Bank, managing market risk within risk appetite and delivering a strong financial performance on the investment portfolio.

Significant items totalled a net figure of £117.4m in 2010 compared with £103.0m in 2009. The CFS items totalling £70.1m related predominantly to integration costs and the Bank Transformation Programme. The £47.3m relating to the Trading Group is principally related to the Somerfield integration.

## Financial income and expense

Net interest payable was £79.9m compared with £107.9m in 2009. The lower figure this year reflects reduced levels of debt through strong control of working capital and increased EBITDA. The mark to market movement in 2010 was a charge of £29.2m compared with a charge of £34.5m in 2009. This predominantly reflected movements in quoted debt and fixed interest hedging arrangements due to reductions in long term interest rates.

## Profit before payments to members

This is the figure which is the equivalent in a Plc of profit before tax. Although only marginally up year on year by 0.8%, at a headline level this has been impacted by several one-off factors, and also by the amortisation of fair values in CFS, created at the time of merger. The apparent volatility of these adjustments is evident in the swing from a substantial benefit of £99.1m in 2009 to a charge of £14.2m in 2010. However, it should be noted that these adjustments are designed to unwind over future periods and are broadly neutral over time with no cash flow impact. As shown in the table below the income statement, after adjusting for these one-off and non-trading items, the underlying profit before payments to members is 48.3% up on last year, due to underlying profitability up 31.4% year on year and net interest costs being 25.9% lower than last year.

## Payments to and on behalf of members

The Group paid out over £100m to and on behalf of its members during the year. A dividend of £88m was approved at the June 2010 AGM and a further interim dividend of £16m was approved at the November 2010 half year meeting, a total of £104m.

## Dividend strategy

The Group's policy is to distribute a maximum of 40% of profits available for distribution to and on behalf of our members. Profits available for distribution are broadly underlying trading profits less underlying interest and tax.

The policy determines that distributions are allocated across our stakeholder groups as follows:

	Allocation	Notes
Individual and corporate members	70%	The split between corporate and individuals is determined by their relative economic participation in the Group
Employee members	20%	
Community	10%	The Board can cap this at £10m at their discretion

The relative economic participation of corporate and individual members is determined by the proportion of trade conducted by the Group with its customers against that proportion conducted by other societies participating in joint co-operative buying groups across our businesses (principally Food, Travel and Healthcare). Based on this formula, individual members receive broadly three quarters of the 70% of total dividend available with the remaining quarter going to corporate members.

The amount available to individual members is used to fund member activity (historically around £6m to £8m) with the balance being distributed across our individual members, based on their trade with the Group. During 2010 our customer members received 2p for every point earned from trade with the Group. Points are earned across our businesses from bank accounts, mortgages and insurance policies in CFS to holidays in the Travel business, the vast majority of purchases in our Food stores and in many other areas. The rate at which points are awarded varies depending on product type – for example, whilst every £1 spent on qualifying purchases in a Food store earns one point, amounts borrowed or invested in mortgage or current account accrue points at a different rate.

**+9.1%**

Gross sales increased to £13.7bn



The allocation of dividend to each corporate member is based on the proportion of federal trade that they undertake with the various co-operative buying groups operated by the Group.

All employees who are members receive the same dividend, regardless of their salary, albeit pro-rated for part-time workers and starters and leavers in the year.

Community dividend is made available to members to decide how it is distributed. The awards paid out to communities from this dividend are determined by members principally through the Values & Principles Committee and examples of the key beneficiaries this year are included below and in more detail in the Group's sustainability report. This fund is also used to support the Co-operative Movement and its charities and a small charge is made to cover the costs of administering the funds.

The application of this policy in 2010 resulted in the following dividend across our stakeholder groups:

	<b>£m</b>
Payments to and on behalf of individual members	54.9
Payments to and on behalf of employee members	19.8
Payments to and on behalf of corporate members	19.4
Payment to and on behalf of the community and fellow co-operatives	9.9
	<b>104.0</b>

#### **Payments to and on behalf of individual members**

This comprised payments of £48.5m to customer members based on their trade across all of our businesses including Food, Banking, Insurance, Travel and many others. The payments represented a reward of 2p for every £1 spent with us by our customer members. A further £6.4m was spent supporting and promoting activity and initiatives on behalf of, and determined by, our individual members.

#### **Payments to and on behalf of employee members**

Our employees who are also members of the Group are a very important stakeholder in our business and received dividends based on hours worked and length of employment during the year with leavers and starters receiving a pro-rata payment. The payment represented a full-time equivalent of £500 per employee and is seen as a key element of our stakeholder strategy.

#### **Payments to and on behalf of corporate members**

The payment to our corporate members of £19.4m is also based on federal trade conducted with the Group including participation in joint buying groups across the Group, principally, although not exclusively, our Food, Travel and Pharmacy businesses. The distribution represented a £1.23 dividend for every £100 of qualifying purchases.

#### **Payments to and on behalf of the community and other co-operatives**

Finally a further £9.9m was allocated for distribution to and on behalf of communities and to support the wider Co-operative Movement. Our members have a say in the beneficiaries of these funds; full details of all key initiatives are presented in our Sustainability Report, and selected initiatives are outlined on pages 32 to 35 of this report.

Directors are recommending total dividend payments for 2010 of £150.2m including the £16.4m interim dividend already paid. This represents £21.8m proposed to corporate members, an individual dividend of £77.4m, community distributions of £10.0m and an employee dividend of £41.0m. This is subject to the approval of members at our AGM on 21 May 2011.

#### **Discontinued operations**

The net post tax loss of £26.9m relates to the Somerfield stores that have been disposed of during the year (prior year has also been adjusted for these stores) along with the results of the Travel division. It is highly probable that the Travel business will be transferred into a joint venture with Thomas Cook in 2011.

#### **Taxation**

The tax charge on continuing business is £63.5m (2009: 118.5m) excluding £44.0m (2009: £6.4m) relating to tax attributable for Co-operative Insurance policy holders' returns. The charge excluding tax relating to policyholders is £107.5m (2009: £124.9m). The effective tax rate excluding policyholder returns is 34.6% against a standard rate of tax of 28%. A reconciliation of the standard rate is shown in Note 13.

#### **Balance sheet capital and reserves**

The Group balance sheet has increased from £4.5bn to £4.8bn in 2010. The principal reasons are effectively the movement from a pension deficit of £284.3m to a small deficit of £3.3m (an improvement of £281m) and a retained profit movement to reserves of £220m. Trading Group fixed assets have only moved slightly year on year with Food refits and business as usual capital expenditure offset by depreciation. Working capital levels have reduced despite increased activity due to increased focus by the Trading divisions. The key banking covenants that were introduced on the restructuring of the Trading Group's finance for the Somerfield acquisition were all satisfied with significant headroom. Co-operative Financial Services has maintained and enhanced its strong balance sheet. It has continued its policy of prudence while delivering benefits for customers and members. The capital and liquidity profile for the business remains extremely strong. The Co-operative Bank core tier 1 ratio was 9.6% (2009: 8.7%), reflecting the strong capital base of the business, yet it is notable that CFS has not taken, or needed, government support. In addition, the excellent levels of customer funding within the Bank of 107% at December 2010 and continued reduction in arrears, further support our principle of being financially prudent and strong. CFS' values based approach to all aspects of business seeks to balance financial strength with the needs of customers and people. Despite a difficult mortgage market, CFS has increased its lending to both families and small business whilst remaining sensitive to the depressed nature of the savings market and maintains the difficult task of balancing savers' interest with those of borrowers.

#### **Pension costs**

In 2010 there is a £26.9m charge to the Income statement (2009: £5m charge) comprising a £71.8m current service cost (2009: £52.7m), interest on liabilities charge of £405.3m (2009: £332.7m) and expected return on plan assets credit of £450.7m (2009: £379.6m). Actuarial losses on liabilities of £275.3m (all schemes) have arisen principally due to a decrease in the discount rate of 0.4% year on year. These losses have been offset by actuarial gains on assets of £451.5m that relate to higher than expected asset returns broadly reflecting the growth of the Stock Market value during the year. The above factors have combined to reduce the opening deficit on the balance of £284.3m to a small deficit of £3.3m.

**+48.3%**

Underlying profit before tax is up to £546m

# Key Performance Indicators

The Trading Group and Co-operative Financial Services (CFS) have a common set of strategic priorities focusing on profitability, customer and employee satisfaction, engaging members and social and corporate responsibility. The different nature of the markets in which the Trading Group and CFS operate means that the measures developed to track their strategic objectives are slightly different and therefore considered separately.

## Common Group measures Growing and engaging membership

The Co-operative Group is jointly owned and democratically controlled by its members. Members of The Co-operative enjoy a share in our profits and can exercise their democratic control, with equal rights and benefits. Growing a strong and committed membership base is integral to our vision and beliefs and is an integral part of our brand. Growing engagement with our customers via membership is a key element in delivering competitive advantage and social goals. Whilst we are committed to growing our membership base, we recognise the importance of ensuring that our members are engaged with The Co-operative Group. True engagement will be reflected in both transactional and democratic participation.

The three key measures of member engagement and our share of profits paid to members are total points earned by members, number of members who traded with more than one business, and total profits paid to customer members via individual dividend. During 2010 our members traded with us to the value of 3,434 million points, an increase of 39.5% over 2009. Furthermore 1.4 million members traded with more than one business in the year, almost doubling last year's total. Finally, during 2010 we paid out £48.5m to members.

## Social and corporate responsibility

A key metric in determining our success in being an ethical leader and inspiring others through co-operation is the Business in the Community's (BitC) Corporate Responsibility (CR) Index. The Index is widely considered to be the foremost UK-based CR benchmark, assessing management practices in four key areas of corporate responsibility (community, environment, marketplace and workplace) and performance in a range of environmental and social impact areas. In 2010, The Co-operative Group retained its 'Platinum Plus' status, a ranking achieved by only ten businesses to date. This follows the achievement of a 96.5% score in the Index submission made in 2009. The Group scored 100% in five of the seven areas covering strategy, integration and management practices, and 100% scores were also attained in three of the six impact areas.

## Trading Group measures

### Financial

Our ethical, environmental and social policies and Co-operative values and principles of sharing profits with and for the benefit of our members are embedded in the DNA of our business. However, without being a commercially successful business we cannot deliver profit share to members and communities and we cannot champion and invest in environmental and social campaigns.

Growth in underlying operating profit is therefore a key measure in achieving our aim to be a commercially successful business. Underlying operating profit tracks the underlying profitability of the Group from core trading before any one-off or non-trading items such as property or business disposals or one-off integration costs. Underlying operating profit is the key measure on which management and the Board focus during the year and is shown, broken down by business in the segmental analysis in Note 1. The result for 2010 was £459.3m, an increase of 34.8% on last year.

## People

To achieve our vision of being an exemplary employer, it is vital that we create a great place for our people to work, grow and develop. To assess how successfully we have achieved this we measure colleague engagement levels in a survey called Talkback. The independently conducted survey (now in its seventh year) measures the level of employee engagement, as well as capturing a colourful snapshot of the overall employee experience. Using the Group's own extensive database of responses, high levels of employee engagement continue to be reliably linked to positive outcomes for business performance and employee experience.

The 2010 employee attitude survey generated the highest response rate ever, with almost 87,000 (86%) people choosing to respond, and the second highest engagement score ever. The engagement measure is expressed as a score between 0 and 100 and the 2010 score is 77, which is a two-point decline over the score of 79 achieved in 2009. The 2010 results reflected a small decline year on year as a result of a number of factors including tough retail trading conditions and some anticipated operational turbulence arising from the Somerfield integration programme. This year, all former Somerfield employees took part in Talkback and around 6,500 team results and action planning packs were distributed to managers, to enable a plan to be developed and implemented that will continue to change people's working lives for the better. Talkback has again demonstrably proven this year the link between high engagement, budget beating sales and low sickness related absence.



£48.5m

Paid out to members during 2010.

### CFS measures

In addition to the Financial, Customer and People aspects of the business the four quadrants of the CFS balanced scorecard also include Process. The philosophy of the CFS scorecard is fundamental to CFS as a business, and is a key differentiation from competitors like the big four banks. This is because it helps us ensure that in all decisions we make as a business we focus on the financial, customer, people and process implications of the decision.

In the long term focus across the scorecard will be equal. However due to specific short term business requirements it will sometimes be necessary to increase the focus on one area of the balanced scorecard. This may mean we take decisions that prioritise one quadrant over another. However all our business decisions are made in the context of all four quadrants.

The measures shown opposite are the key performance measures for each quadrant we will use over the three year Plan, and are used to inform the targets we agree with our Remuneration Committee for our Executive and Business Leader incentive schemes.

## How do we measure our success?

### Financial

Financial measures focus on profitability and underlying financial strength:

- **Profit**

This is our measure of operating profit for the business as a whole and includes operating profit (adjusted for significant items) before tax. The measure also incorporates new business profit for our life business.

**Shareholder profit before tax: £209.7m**

Progress: ●

- **Liquidity**

Our liquidity measure sets a minimum liquidity limit for the year in line with the Financial Plan.

**Minimum liquidity level: 107%**

Progress: ●

- **Surplus capital**

Similarly our surplus capital measure sets a minimum amount of capital for each year, below which the business should not operate. This minimum is set in line with the Financial Plan with due regard for our regulatory requirements.

**Amount of surplus capital: On target**

Progress: ●

### Customer

Customer measures address the key relationships through which we sustain and grow our business:

- **Customer advocacy**

We use an external survey to monitor advocacy of customers across the Retail businesses relative to appropriate peers. This gives us our customer advocacy measure.

**Customer advocacy: +7.5%**

Progress: ●

- **Primary current account customers**

Primary Current Account customers are defined as those who:

- Hold one of our standard current accounts.
- Credit their account with at least £800 per month.

**Primary account customers: 552,000**

Progress: ●

- **Products held per primary current account customer**

This measure monitors how well we are meeting the needs of our relationship customers (as defined above) by calculating the average number of active products they hold with us.

**Products per primary account holder: 2.59**

Progress: ●

To be the UK's most admired  
Financial Services Business

### People

People measures reflect the importance of internal, as well as customer advocacy:

- **Colleague engagement**

Our colleague engagement assessment is derived from our twice yearly internal colleague survey.

**Colleague engagement: 78.5%**

Progress: ●

### Process

Process measures focus on the efficiency of our business in delivering services to our customers:

- **Cost**

This measure focuses on our cost base. The target for this measure reflects the current combined business position and the outputs from the Financial Plan over a three year period.

**CFS efficiency ratio: 38.2%**

Progress: ●

- **Compliance with risk appetite**

We track this measure using key risk criteria across the business. Success means no material breaches against any of these criteria.

**Compliance with risk appetite: 100%**

Progress: ●

- On target
- Good progress
- Below target



# Principal risks and uncertainties

## Managing our risks

**Taking and managing risk is an inevitable part of doing business and, like all businesses, The Co-operative Group faces potential threats and opportunities that could affect long term performance. The key challenge is to identify the principal risks and to develop and monitor appropriate and proportionate responses.**

The Group is a complex mixture of retail trading and financial services businesses. Each business faces a variety of risks that could compromise its performance and ability to meet strategic objectives. The process used to identify and monitor key risks across all divisions of the Group is described on page 52.

Our risk management approach enables informed decision-making based on an assessment of the impact and likelihood of events, and seeks to balance risk and reward rather than eliminate risk entirely.

## Group risks

The most significant risks faced by the Group and related mitigation actions are set out below.

### Pension risks

The Group's pension arrangements are regarded as an important part of our rewards package for employees and a key element in the attraction and retention of our people.

As a result of recent mergers and acquisitions, the Group operates a number of Defined Benefit (final salary and career average) and Defined Contribution schemes; most of which are closed to new members. The majority of pension scheme members belong to a Group-wide defined benefit scheme based on career average earnings (PACE). The PACE scheme is open to all Trading Group employees.

The Bank and Co-operative Financial Services Management Services (CFSMS) currently participate in PACE in respect of pre 1 August 2009 employees. However, as an interim measure, since the merger between the Bank and Britannia Building Society, all new employees to CFS businesses are eligible to join the Defined Contribution section of the Britannia Pension Scheme (BPS). CFSMS is the principal employer of BPS and pays contributions to, and accounts for the BPS.

The Group's Defined Benefit schemes are potentially subject to significant funding volatility as a result of the exposure to changes in the value of the liabilities (as a result of changes in life expectancy, inflation and future salary increases), together with investment risks. In addition, the legislative and regulatory governance demands of running pension schemes, including the calculation and payment of benefits to over 150,000 members, are substantial.

The Group and the schemes' trustees continue to ensure that the schemes are managed effectively to best practice standards. Funding costs and risks are constantly monitored and the longer term strategy (including the investment strategy of each scheme) is regularly reviewed to control and mitigate risks.

### Business integration and change

In 2010, significant work was undertaken on the integration of Britannia into The Co-operative Financial Services (CFS) businesses, and Somerfield into the Food business. These integration programmes remain ongoing, and their continued success is critical to the Group's performance, as failure to manage these change programmes adequately could put at risk our objectives and financial targets.

The Group aims to minimise risks from these changes by adoption of disciplined project and programme management processes, use of experienced resources and close monitoring by Executive Management. Identification and management of change-related risks is integrated into day-to-day management of projects and programmes and is fully embedded within the risk management framework.

Effective governance structures have been established to evaluate the capacity and prioritisation of the change portfolio. Reviews of each programme are undertaken on a regular basis, considering resource requirements, progress, dependencies between projects, and risks.

In addition to managing change to processes and systems, it is essential to maintain good relations with colleagues during any period of change. Clear, relevant and timely communication of change is key to engagement and retention, as well as investment in training and development of colleagues.

### Economic impact on consumer spending

The ongoing impacts of the economic downturn continue to affect consumer spending and behaviour with pressures on disposable income, reduced job security and limited availability of credit. This has resulted in additional risk in remaining competitive in the markets in which we operate and adapting to changing spending patterns.

Close monitoring of performance and regular reviews of business strategy are key to responding to the needs of our customers. We seek to continually improve our understanding of our customers to ensure we deliver a competitive offering of products and services that appeal across our different markets.

### Financial and Treasury risks

The key financial risk to the Group relates to the generation and availability of sufficient funds to meet business needs, and to deliver our member payment responsibilities. The Group is exposed to changes in commodity prices and fluctuations in interest and foreign exchange rates, which can impact on financial performance. The Treasury function is responsible for managing various financial risks, including funding requirements and financial exposures as set out in Note 52.

Energy procurement is managed centrally by the Group within a hedging policy mandated by the Board.

### Damage to our reputation or brand

The successful rebranding programme has brought our businesses together under a single brand identity. As such, our various trading divisions are easily recognisable as being part of The Co-operative Group. The branding has also been adopted by a number of independent society members.

Our brand has strengthened, and along with our ethical stance and membership offer, it is one of the cornerstones of our reputation which drives our continued success. Anything that could damage that reputation in any of our business areas – for example, a failure in maintaining our ethical policies or an issue in product quality and safety – could impact the size of our customer base across the Group.

We regularly monitor our corporate reputation and police our brand standards within stores through mystery shopper exercises. The Executive take steps to address any areas that are seen to be potential weaknesses.

Within its risk management framework, CFS places great emphasis on putting customers and members first in all that it does.

### Competition

The Group operates across a number of highly competitive markets. Many of these markets are mature, with relatively low underlying growth, and competition from large and well-established organisations. Failure to compete effectively against existing players would have a detrimental impact on our sales and profitability; so too would failure to anticipate or react to new entrants in any of our markets.

We actively and continually monitor the competitive landscape and follow trends and developments in our respective markets. We track our performance through the use of KPIs such as market share, price position, promotions and measures of quality and service. We also monitor customer perceptions to make sure that we continue to attract and retain customers by delivering on price, product range, quality and service.

### Regulation

The Group operates in markets that are subject to various laws and regulations.

As a retailer, especially one operating in the fields of food retailing, pharmacy and funerals, the Group is subject to competition reviews, health and safety regulations and a variety of retailing legislation. This relates not only to the products we buy and sell, but also to virtually every area of our business, from packaging and labelling, to pharmacy dispensing and food hygiene. Failure to comply with relevant laws could have damaging consequences for our business, including punitive fines and harm to our reputation.

The safety and fair treatment of our customers and employees is of paramount importance to the Group, and we operate a strong compliance regime and undertake regular reviews in our trading businesses to ensure compliance and training needs are identified and addressed.

### Health & Safety

The Co-operative Group Health & Safety Policy Statement provides and outlines the clear and consistent responsibilities for all business areas of The Co-operative Group and ensures that every employee is aware of their statutory responsibility to ensure compliance is managed. Group managers responsible for managing risk and compliance receive periodic data and information to ensure they have the tools necessary to support the provision, and make available safe premises, safe work practices, and clear policy and procedures for all persons who enter and carry out work in or reside in Society premises. These policies and safe working procedures are being made available in electronic format and employees receive these guidelines as part of their induction, reviews and training programmes.

The Corporate Manslaughter and Corporate Homicide Act 2007 and the Health & Safety Offences Act 2008 legislation is now established and in place. The latter piece of legislation is now beginning to make an impact and is seen in cases of health and safety prosecution where any businesses deemed as a 'large enterprise' are automatically referred to the Crown Court for trial or sentence supported in 2009 where there is a higher level of fine and potential for custodial sentence of individuals who have been identified as being responsible for compliance failure. The Health & Safety Department

has compiled a set of Core Compliance Tools that will be the central mechanism for all parts of the Group to manage their responsibilities for health and safety, which will ensure compliance.

### Environmental compliance

With significant retrospective legal and ethical focus now being given to the 'handling' of historical incidents of contaminated land (Polluter Pays Principle) across the UK, the Group is seeking to introduce a number of complimentary mitigation/legacy packages and services in 2011 that will be embedded into the Group's 2011 Environmental Management Strategy.

### Data protection

The Group is committed to the protection of all personal information being processed and recognises the importance of keeping all member, employee and customer information secure and confidential. The primary aim is to ensure that all parts of the Group are aware of their responsibilities to enable them to comply with the Data Protection Act 1998. The Group has developed a consistent and co-ordinated management programme, incorporating recognised industry best practice, based around the eight principles of the Act. In 2010, extensive work continued across the Group as a whole and with individual business areas to deliver policies and procedures to raise awareness of data protection, particularly in the area of data security.

Additionally, the Group continually monitors regulatory developments, as changes to existing regulation or regulators bringing new areas or products under control may have cost implications for the Group or may otherwise adversely affect our business.

CFS operates in regulated markets and is subject to significant regulation. Whilst not a regulated entity itself, a number of the companies within CFS and their subsidiaries are authorised and regulated by the Financial Services Authority (FSA). Regulatory intervention and change is an ongoing feature of the UK financial services market and could affect the profitability of our business. CFS has a cautious appetite for regulatory risk and believes its approach, systems and controls would withstand any material regulatory challenge.

The Group works with the government and various trade bodies to help develop public policy and represent the views of our customers and members to improve the environment in which we operate. In 2010 Primary Authority Partnerships were agreed and signed off with Greater Manchester Council and Greater Manchester Fire & Rescue Services in respect of Retail Food Partnership and Petrol Forecourts, to ensure support of enforcement bodies to the Society and establish safe working practices and procedures. Further partnerships are being investigated that will provide similar support for other parts of the Group. Additionally there

was particular focus on working with SEPA and Environment Agency Business Directorate Partners on Environmental Compliance measures.

### Business disruption

The risk of an unplanned disruption to business in an organisation the size of The Co-operative Group is significant and a number of risk management tools are used to highlight and minimise the impact where possible.

If a major disruption occurred, such as the loss of a facility or critical IT system failure, not only would this have a detrimental impact on the business' ability to operate effectively and an adverse effect on financial results, but it could also cause longer term damage to the reputation of the Group.

Business continuity is designed to enable the recovery or continuation of critical business activities in the event of a sudden, unplanned incident that could seriously harm employees or compromise our ability to trade.

The Group works to continually enhance our resilience to operational threats of disruption to our people and ability to trade. Recent improvements have focused on stress testing the recovery facilities together with a rigorous programme of exercising each business area on the details within their business recovery plans. Within the year the level of compliance against business continuity was also benchmarked against other retailers and this review found that our arrangements were comparable or ahead of the market.

In 2010 the Group faced two incidences of unprecedented snow fall, one early in the New Year and the other throughout the month of December. In addition, there was the threat of industrial action with the rail union(s) at the end of quarter one. The proposed travel disruption did not materialise; however, the severe weather affected the head office as well as a significant number of our Food regional distribution centres. These incidents were managed in co-operation with the affected business areas, HR and a number of governmental bodies to ensure a co-ordinated response.

### Value of the Group's property investment portfolio

The investment property portfolio has increased in value in the year. However, further shocks to the economy, which could see a double dip in property values, cannot be ruled out. Otherwise we expect values to largely stabilise or show a small increase.

The investment portfolio is made up of relatively small, marketable properties with a geographical and sector spread and remains under continuing review.

## Principal risks and uncertainties continued

### Financial Services specific risks

The Bank, The Co-operative Insurance Society (CIS) and Co-operative Insurance Society General Insurance Limited (CISGIL) Boards are responsible for approving entity strategy, their principal markets and the level of acceptable risks articulated through their respective statements of risk appetite.

The Boards are also responsible for overall corporate governance, which includes ensuring that there are adequate systems of risk management and that the level of capital held in each entity is consistent with the risk profile of the respective business.

Board committees and senior management committees oversee and challenge the risk management process, identifying the key risks facing each business and assessing the effectiveness of planned management actions.

The following risks are specific to the CFS business.

#### Market risk

Market risk is managed separately in respect of CIS, CISGIL and Bank entities. CIS and CISGIL market risk arises from the mis-matching of assets and liabilities.

CIS with-profits policyholders have an expectation that a proportion of their savings will be invested in equities and property to maximise returns and provide some protection of their savings against future inflation. However, with-profits policies have traditionally also included a minimum guaranteed benefit to provide a minimum return to the policyholder, which requires investment in a substantial proportion of fixed-interest securities. These conflicting investment objectives inevitably lead to a degree of mismatching of assets and liabilities, and, as a result, market risk is a major potential risk to the solvency of the long term business fund.

There is no longer any equity exposure in the CISGIL fund, which comprises mainly short-dated bonds and gilts, and this has reduced the extent of market risk faced by the General Insurance business. However, there remains the risk that interest rates increase unexpectedly with an adverse impact on the market value of assets available to meet General Insurance liabilities.

Bank market risk arises from the effect of changes in market prices of financial instruments, on income derived from the structure of the balance sheet, execution of customer and inter-bank business and proprietary trading. The majority of the risk arises from changes in interest rates as the Bank does not trade in complex financial derivatives or commodities and has minimal exposure to foreign exchange movements.

#### Credit risk

Credit risk arises from exposure to the risk of loss if a counterparty fails to perform its financial obligations to CFS. For CIS and CISGIL, this includes issuers of corporate bonds, counterparties to financial transactions and reinsurers.

For the Bank, this could arise out of exposure to individuals, corporates, financial institutions and sovereigns. Reasons for Bank counterparty default include general economic or sector specific downturns and structural changes such as increased personal indebtedness.

As credit risk is the most significant risk to the Bank we ensure that there are robust systems, controls, strategies and procedures in order to mitigate the impact of this risk. These mitigants are operated within a wide-ranging governance framework that ensures adequate oversight and control of the risks involved.

#### Insurance & business risk

Insurance risk refers to fluctuations in the timing, frequency and severity of insured events relative to the expectations of the business at the time of underwriting.

The principal risk that CISGIL faces under its insurance contracts is that the actual claims and benefit payments exceed the carrying amount of the insurance liabilities.

In CIS, a significant potential risk is of increases in the cost of annuities in payment, the guaranteed benefits under deferred annuity contracts and guaranteed annuity options (GAOs) costs on personal pensions arising from further improvements to pensioner longevity above those assumed in provisioning.

In CIS there is a persistency risk, where more policies than expected reach their investment guarantee dates resulting in an increase in the expected costs of guarantees. In particular, there is a risk that more personal pension policyholders reach their normal retirement date which is the date on which GAOs become available. There is also the risk that profits from non-profit business fail to materialise as a result of more policies lapsing than expected.

Expense risk also exists in CIS. Although most of the long term business expenses can be charged directly to policyholders, there is a financial effect from higher expense charges to asset shares leading to a reduction in asset shares and so an increase in the cost of providing guaranteed benefits. In addition, for products written on fixed terms or on a fixed charge basis, such as non-profit business and stakeholder pensions, higher expenses will result in reduced profitability.

In CISGIL, insurance risk is made up of risks that arise in respect of claims that have already occurred and for which reserves are already held (reserving risk) and of claims that are yet to occur (underwriting risk).

The key insurance risks to CISGIL are the risk that there is a natural catastrophe which is significantly above the limit of the reinsurance programme on the property account, and the risk that motor bodily injury claims are materially worse than expected.

Business risk arises from changes to the Bank business, specifically the risk of not being able to carry out the Bank's business plan and desired strategy, including the ability to provide suitable products and services to customers. In a narrow sense, business risk is the risk that the Bank suffers losses because income falls or is volatile relative to the fixed cost base. However, in a broader sense, it is the Bank's exposure to a wide range of macro-economic, geopolitical, industry, regulatory and other external risks.



### **CFS operational risk**

Operational risk is defined within CFS as the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. This encompasses the effectiveness of risk management techniques and controls to minimise these losses within risk appetite.

Examples of such include internal and external fraud, loss or theft of confidential customer information, loss of key personnel, system capacity issues or program failure, process failures affecting payment settlement and external events over which CFS has limited controls such as terrorist attacks, floods and contagious disease.

Operational risks are identified, managed and mitigated through ongoing risk management practices including risk assessments, formal control procedures, training, segregation of duties, delegated authorities and business continuity planning. Operational risks are formally reviewed on a regular basis. Significant operational risks are regularly reported to Executive Directors, a management Operational Risk Committee, the Audit and Regulatory Compliance Committee (a formal Board sub-committee) and the Board itself. These meet regularly to monitor the suitability of the risk management framework and management of significant risks within CFS. Capital requirements in relation to operational risk are monitored by the Risk Management Committee.

CFS also has a corporate insurance programme to transfer specific risks to insurers as part of its risk management approach.

A particular development in 2010 has been the articulation of appetite for individual categories of operational risks and this will be developed further in 2011.

### **Change management risk**

CFS has a major transition programme to replace core systems and provide an integrated financial service to our customers. These projects and programmes involve change to processes, systems and people within defined costs and timescales to deliver predetermined benefits. Projects therefore inherently carry some degree of risk:

- Failure to deliver the expected changes to time/cost or quality
- Failure to realise expected benefits, implementation of the projects failing or impacting on normal business operations
- Increasing the risk profile of the business into which change has been implemented through weakened controls or inefficient processes.

Identification and management of change-related risks is therefore integrated into day-to-day management of projects and programmes.

Effective governance structures have been established to evaluate the capacity and prioritisation of the change portfolio. Reviews of each programme are undertaken on a regular basis, considering resource requirements, progress and risks.

A Business Implementation Management function has been established in Change Management to manage the release of change and provide clear sight of implementation dependencies between programmes.

The transformation impacts the whole business and thus, in addition to managing the change process, the Board and Executive are continually assessing the adequacy of the programme delivery supporting the achievement of the strategic outcomes.

### **Liquidity risk**

Liquidity risk arises from the timing of cash flows generated from CFS' assets, liabilities and off-balance sheet instruments. The liquidity management policies are reviewed and approved annually by the Risk Management Committee and compliance reviewed monthly by the Asset and Liability Committee (ALCO).

The Bank's retail assets are currently fully funded by retail deposits, ensuring there is no over-reliance on wholesale funding. There is a target funding ratio set in line with the Board approved strategic plan, which is being met. The Bank's structural liquidity risk management is therefore retail-based and is dependent on behavioural analysis of both customer demand and deposit and loan drawdown profiles by product category based on experience. The behaviour of retail products is reviewed by ALCO on a quarterly basis. In addition, the Bank has maturity mismatch limits to control the exposure to longer term mismatches.

The Bank's liquidity position is monitored on a daily basis and reported to ALCO each month. Treasury holds a pool of liquid assets on behalf of the Bank, and actionable management actions are in place to provide additional liquidity. These sources of liquidity are held in order to be available to meet unexpected liquidity requirements.

Marketable assets are maintained as a liquidity pool against potential retail outflows; the asset quality of these is controlled via credit limits. Concentration limits are set by issuer name and holding per bond to ensure diversity of assets.

The Bank has enhanced its liquidity risk management by introducing a liquidity risk framework which has a number of strategic and tactical measures that feed into an overall liquidity status score. The Bank's liquidity management framework is designed in line with FSA BIPRU regulations and industry guidelines, including Institute of International Finance (IIF) and Bank for International Settlements (BIS) recommendations.

### **Securitisation risk**

Securitisation risk is the residual credit risk arising from retaining an interest in the Bank's securitisation companies through the provision of subordinated debt and/or start up expense loans where applicable. The Bank has historically entered into securitisation transactions in which it sells mortgages to special purpose vehicles (SPVs). These SPVs are included as subsidiaries in the consolidated financial statements. The Bank continues to recognise these securitised assets as loans and advances to customers on the balance sheet and income from the securitised assets continues to be recognised as income. Securitisations provide a committed and linked source of funding for higher-risk mortgage lending.

The Bank has 14 years' experience issuing securitisations under the 'Leek' programme, and has built up a depth of knowledge, processes and management information to deal effectively with these funding vehicles. Securitisation has historically been used as part of a balanced portfolio management approach whilst helping to increase the diversification of funding sources available and also managing maturity mismatch risk and assisting overall credit risk management.

The appetite for securitisation risk is cautious, and the Bank has only acted as mortgage originator and servicing agent. The Bank does not provide liquidity facilities, bridging loans or repackaging nor does it act as underwriter or dealer in the securitisations. All transactions have relevant accounting and legal advice to ensure compliance with applicable regulatory/statutory rules and are also approved at Board level.

# Report of the Group Board of Directors

**The directors submit their report, business review and audited financial statements, for the 52 weeks ended 1 January 2011. The comparative information is for the 51 weeks ended 2 January 2010.**

## Business review

A full business review of the development and performance of the Group and its operating subsidiaries during the financial year and any significant events since the year end, are set out on pages 10 to 36 of this report. The report also includes a more specific financial review on pages 38 and 39 and the key financial and non-financial performance indicators on pages 40 to 41. In addition, the principal risks and uncertainties facing the Group are set out on pages 42 to 45. Note 51 of the financial statements provides details of the Group's principal subsidiaries and the nature of each organisation's business.

## Significant events since the year end

On 1 March 2011, the European Court of Justice ruled in favour of a gender equality challenge that means that insurance companies can no longer take into account, as a risk factor, the gender of an insured individual.

This ruling is effective from December 2012 and during 2011, the insurance businesses will consider this ruling in the pricing and provision of benefits in relation to its life and general insurance business.

## Principal activities

The major activities of the Group include food retailing, funerals, pharmacies, travel agencies, legal services and farming. It is the parent organisation of Co-operative Financial Services, whose operating subsidiaries – The Co-operative Bank Plc, Co-operative Insurance Society Limited and CIS General Insurance Limited – provide an extensive range of banking and insurance products and services.

## Changes to the Group Board

The names of the current members of the Board, their biographies and details of length of service are set out on pages 8 to 9.

Under the rules of the Group, a third of directors (or the number nearest to one third) are subject to re-election each year. Following a contested election, the following directors were appointed to the Board on 23 May 2010 for the first time: Martyn Cheattle, Chief Executive, Midlands Co-operative Society (three-year term) and Mark Smith, Chief Executive, The Southern Co-operative (two-year term).

Following a contested election, the following directors were re-elected to the Board for a three-year term with effect from 23 May 2010: Marilynne Burbage, Co-operative Group, South East Region; Richard Samson, Chief Executive, East of England Co-operative Society and Steve Watts, Co-operative Group, Central & Eastern Region.

With effect from the same date, the following directors were re-elected unopposed to the Board for a three-year term: Duncan Bowdler, Co-operative Group, North West & North Midlands Region; Paul Flowers, Co-operative Group, North Region and Chris Herries, Co-operative Group, South West Region.

Following his retirement as Chief Executive of Midlands Co-operative Society, John Fitzgerald stood down as a director on 19 March 2010. Also, Allan Smith, Head of Major Developments, The Channel Islands Co-operative Society, was not re-elected and therefore stood down as a director with effect from 22 May 2010.

Since the end of the financial year, Nigel Keane has indicated that he does not intend to seek re-election to the Group Board when his term of office ends in 2011.

## Results and distributions

The profit before taxation was £310.4m (2009: £303.9m), an increase of £6.5m on 2009, whilst the underlying profit before payments to members was £545.7 (2009: £367.9), an increase of £177.8m.

A more detailed review of the business is contained in the business review on pages 10 to 36.

The directors have recommended the following distributions in respect of 2010: a payment of £21.8m to independent society members at the rate of 132p per £100 of qualifying purchases from the Group during the year to 1 January 2011; individual payments of £61m; community distributions of £10m; and employee distributions of £41.0m based on employee membership of the Group. This is in addition to the interim dividend of £16.4m, which was approved at the Half-Yearly General Meeting on 6 November 2010.

## Directors and their interests

Due to the nature of the Group, directors are elected through the democratic process by both individual and independent society members. Directors elected by individual members hold shares directly in the Group, whilst those directors elected by the independent society members have an interest in the Group by virtue of their respective independent society members' shareholdings. It is not considered appropriate to detail the interests of each director in this report as they are not material. As a key role of the Group is to provide a federal service to its independent society members, material transactions are conducted with these members, some of whom are represented on the Board. Other than this, no director had a material interest at any time during the year in any contract of significance, with the Group or any of its subsidiary undertakings.

## Directors' and officers' indemnity insurance and indemnity

The Group maintains appropriate directors' and officers' liability insurance cover in respect of legal action against its directors and officers. The insurance cover was reviewed and renewed in 2010.

The directors, the Group Secretary and any of the Group's Approved Persons under the Financial Services and Markets Act 2000 from time to time have entered into a contract of indemnity with the Group in respect of certain liabilities they may incur whilst discharging their functions.

## Employees

The Group and its subsidiary undertakings employed 109,269 persons at 1 January 2011 (2 January 2010: 114,561) and their aggregate remuneration for the year (including discontinuing businesses) was £1,812.6m (2009: £1,701.4m).

## Provision of information and consultation with, and involvement of, employees

The Group has a long-established policy to inform and consult its employees and trade union representatives about business issues and matters that affect them at work. Over time, a flexible framework has been constructed, through which information is shared with, and opinions sought from, employees and trade union representatives. Internal communications are designed to ensure that employees are well informed about the business; these include a staff magazine called 'Us' and electronic communications channels to managers.

### Developing and engaging people

The Group recognises that competitive advantage comes from putting employees at the heart of the business strategy. The Group's clear commitment to employees is demonstrated through its strong focus on engagement, building organisational capability and nurturing and developing talent now and for the future. The Group continues to enhance current practices and develop innovative new solutions in support of this.

Investors in People re-accreditation supports the Group's aim to be an exemplary employer and the Group has a rolling programme of phased re-accreditation in place.

The Group Training and Development team successfully won a North West Regional Training Award for its Head Office Corporate Induction Programme. The whole new induction programme, including a policy, welcome pack and one-day workshop puts the Co-operative at its heart. The entry, in the Large Employer category, was considered to have shown an outstanding level of impact and benefits as a result of the training. Induction and employee engagement are crucial to the Group's brand.

### Managing and rewarding performance

The Group recognises that one of the keys to success is objective and effective performance management. Good performance is not solely about what is achieved but also about how it is achieved.

### Diversity

A Group Board Diversity Strategy Group was established in 2010 to co-ordinate the approach to diversity for all the Group's stakeholders. The Group aims to employ people who reflect the diverse nature of the UK population, and seeks to provide easy access to goods, services and facilities for customers, employees and members. The Group is a member of the Employers' Forum on Age; the Employers' Forum on Disability; the Employers' Forum on Belief; Opportunity Now Gender Equality; Race for Opportunity; and the Stonewall Diversity champions programme for sexual orientation.

The Group is currently positioned at Silver status in the external Opportunity Now benchmark for gender equality. The Group is an active member of the Stonewall champion programme which demonstrates a commitment to colleagues who are gay, lesbian and bisexual. It is also an Age Positive Employer Champion and removed the retirement age voluntarily in 2006 as part of its commitment to removing age discrimination.

Following the introduction of the Equality Act 2010, the Group has also refreshed its diversity policy and strategy.

### Employees with disabilities

The Group has included within its Diversity Policy provisions to consider employment applications from people with disabilities and to match vacancies with an individual's particular aptitudes and abilities. It is also a JobCentre Plus 'Two Ticks' employer, committing to interviewing any disabled candidate who meets the minimum job requirements.

The Group is a member of the Employers' Forum on Disability and took part in the Disability Standard benchmark in 2009/2010, the outcomes of which have been integrated into the diversity work streams for 2011.

A guide for managers has also been produced by the Group in relation to providing reasonable adjustments as required by the Equality Act 2010 as well as a quick guide outlining all of the changes that the Act has brought into effect.

### Supporting customers with disabilities

The programme to ensure that the Group was compliant for the introduction of the Equality Act 2010 in providing goods and services to customers was satisfactorily completed. A review is now underway to ensure that compliance is being maintained at the right level.

The Group's Travel business has developed a product for disabled customers and the Group's diversity team supports the travel business by providing disability awareness training for colleagues who promote this specialist package.

### Corporate responsibility and the environment

The social goals section can be found within the business review on pages 32 to 35. In addition, the Group's new Sustainability Report, which is to be published in Summer 2011, will describe how the Group manages its social, ethical and environmental impact.

### Political and charitable donations

In 2010 an annual subscription of £536,000 (2009: £476,000) was made to the Co-operative Party. In addition, £213,000 (2009: £180,000) was paid in grants to Co-operative Party Councils. The Group Board also authorised donations of some £40,500 to the Co-operative Party as a contribution to the political party's general election campaign. An in-kind donation of £5,000 was made by the Group to the Co-operative Party, reflecting the use of office space. The Co-operative Party reports these donations to the Electoral Commission in accordance with its reporting obligations as a registered political party under the Political Parties, Elections and Referendums Act 2000.

Furthermore, during the course of 2010, a number of donations were made direct to the Labour Party. This included a cash donation of £65,000 to the Labour Party, an in-kind donation of staff time that fell under the Electoral Commission's threshold, an in-kind donation of £450 for the use of office space and an in-kind donation of just under £10,000 towards the costs of a Leadership hustings event that was organised by the Labour Party and took place in New Century Hall in July 2010. In addition, expenditure of just over £5,000 was made to support various Labour Party activities at local or regional level.

Like many other businesses of a comparable size, the Group undertakes a programme of activity designed to showcase its corporate credentials to a wide audience of political opinion formers. This work includes a range of activities at party political conferences and, in 2010, the Group was represented at the conferences of The Co-operative Party, Liberal Democrat Party, Labour Party, Conservative Party and the Scottish National Party.



## Report of the Group Board of Directors continued

### Market value of land and buildings

Freehold and leasehold land and buildings held by the Group (excluding investment properties) are held on the balance sheet at historic cost and have not been revalued. These have been internally assessed at a market value of £2.261bn, which is £768m higher than historic cost.

### Supplier payment policy and practice

In many cases, the Group does not impose standard payment terms on its suppliers but agrees terms separately with each of them, whilst in others the use of standardised terms is regarded as consistent with much of the market. Every effort is made to pay suppliers in accordance with the terms that have been agreed. At 1 January 2011, trade creditors expressed as number of days outstanding was 44 days (2009: 43 days) for the Group.

### Statement of directors' responsibilities in respect of the directors' report and the financial statements

The directors are responsible for preparing the directors' report and the Group financial statements in accordance with applicable law and regulations.

Industrial and Provident Society law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with IFRSs as adopted by the EU.

The Group's financial statements are required by law to give a true and fair view of the state of affairs of the Group and of the profit or loss of the Group for that period.

In preparing the Group's financial statements, the directors are required to:

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

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and enable them to ensure that its financial statements comply with the Industrial and Provident Societies Acts 1965 to 2003. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

### Financial statements

So far as the directors are aware, there is no relevant information that has not been disclosed to the Group's auditor, and the directors believe that all steps have been taken that ought to have been taken to make them aware of any relevant audit information and to establish that the Group's auditor has been made aware of that information. A statement by the directors as to their responsibilities for preparing the financial statements is included in the statement of directors' responsibilities set out above. The directors' statement on going concern is included on page 53.

### Auditor

The current auditor is KPMG Audit Plc. In line with good corporate governance a tender process is underway to consider the appointment of the external auditor to the Group and, in accordance with Section 4(5) of the Friendly and Industrial Provident Societies Act 1968, a resolution to appoint an external auditor and authorise the directors to fix their remuneration is to be proposed at the next Annual General Meeting on 21 May 2011.

By Order of the Board  
**Moira Lees**, Group Secretary

29 March 2011

# Corporate governance statement

**The Co-operative Group is an Industrial and Provident Society that is jointly owned and democratically controlled by its members. It is unusual amongst other UK consumer co-operatives in that it has both independent society members and individual members. As a co-operative society, it is not mandatory for The Co-operative Group to comply with the Combined Code on Corporate Governance (the Combined Code); however, the Group is committed to the highest standards of corporate governance and recognises that good governance helps the business to deliver its strategy, strengthen member confidence and safeguard the long term interests of the Group.**

This Governance report describes the key governance mechanisms operating within the Group, through which it aims to conform to the spirit of the Combined Code, in a manner which recognises its unique member owned and democratically controlled structure.

The Group also adheres to a Corporate Governance Code of Best Practice, published by Co-operatives UK, which applies to consumer co-operatives within the UK. The Group will report on its compliance with this Code directly to Co-operatives UK, as appropriate, and full copies of this report will be made available on request from the Group Secretary.

## Co-operative Group rules

The Group Board initiated a revision of the Group's rules in March 2010. This review was completed during the autumn and at a Special General Meeting in November 2010 members approved a new rule book based on the recommendations of the review.

## Group Board composition and independence

The Group's rules provide for the Group Board to consist of 20 non-executive directors; 15 representing the individual members, elected by and from the Group's seven regions, and five representing the independent society members, elected by and from those independent society members. The number of votes of each independent society member is based on their level of trade with the Group.

The rules of the Group provide for directors to be elected for three-year terms; however, following the Constitutional Review in 2008, when all the Group Board were subject to re-election at the Annual General Meeting in 2009, seven directors were elected for three-year terms, six directors were elected for two-year terms and seven directors were elected for one-year terms. As a consequence, elections will be held in spring 2011 in respect of six seats; five elected from the Group's regional constituency and one elected from the independent society constituency.

Directors are expected to exercise their judgment when making decisions in the best interests of the Group as a whole, mindful of their responsibilities to members and other stakeholders. Independent society members enter into material transactions with the Group. In addition, independent society members may carry out similar trading activities to the Group; whilst this is inherent in the federal role and constitution of the Group, conflicts of interest are declared where appropriate during Group Board business and necessary safeguards are put in place.

The Group Board believes that all of its directors make valuable contributions to the operation of the Group. There is no senior independent director as the Group Board is wholly made up of non-executive directors. It is the Group Board's view that this role is not appropriate for their Board.

## Role and responsibilities of the Group Board and subsidiary boards

The role of the Group Board is to focus on the strategic objectives of the Group. It has three principal subsidiary boards – all industrial and provident societies. The details of the Co-operative Financial Services (CFS) Board, a number of whose own subsidiaries are regulated by the FSA, can be found in the separate CFS Financial Statements. The other two subsidiary boards of the Group have responsibilities set by the Group Board for specific areas – one for the Food business and one for the other customer-facing businesses (Specialist Businesses) and have been designed to improve the Group's governance and to provide greater scrutiny of its large and diverse businesses.

The current composition of the three subsidiary boards is shown on page 9. The rules of each of the subsidiaries allow for the appointment of Independent Professional Non-Executive Directors (IPNEDs) in order to expand the experience and skills of the subsidiary boards. In 2010, for the first time, two IPNEDs were appointed to each of the Food and Specialist Businesses Boards.

The Group Board met 10 times in 2010. It also annually devotes two days, alongside senior executives, to performance and longer-term planning, giving consideration both to the opportunities and risk of future strategy. The subsidiary boards generally meet once a month; each met at least 11 times in 2010 and they have responsibility for the detailed scrutiny of their respective businesses. These subsidiary boards also contribute towards the formulation of the strategy of the business.

The attendance of directors at scheduled Group Board, Food and Specialist Businesses Board and committee meetings is shown in the table on page 54. The attendance record of the CFS Board can be found in the separate CFS Financial Statements.

The responsibility of the Group Board is to direct the business of the Group, in particular:

- Ensuring that the Group's affairs are conducted and managed in accordance with its purpose and objects as set out in its rules, and in accordance with the best interests of the Group and its individual and independent society members
- Determining the vision and strategy of the Group in consultation with the Group Chief Executive and the Executive
- Overseeing the Group Chief Executive and the Executive in the day-to-day management of the business of the Group.

In addition, the Group Board is responsible for monitoring performance against key financial and non-financial indicators, overseeing the system of risk management, and setting standards in governance matters. The Board also receives regular reports from the three subsidiary boards.

## Corporate governance statement continued

### Board procedures

Board and committee papers are distributed at least one week in advance of meetings. This provides the opportunity for directors to prepare fully for meetings. The minutes of all meetings are circulated to all directors. As well as circulating papers as hard copies, the Group Board has access to its own secure website where papers are available together with additional supporting material (and which acts as a library of papers for directors).

There is regular communication between the directors, the Group Chair, the Group Chief Executive and the Group Secretary between meetings.

When a director is unable to attend Board or committee meetings, issues can be raised with the relevant Chair. Written questions for management on papers are encouraged from directors between meetings. A rolling schedule of matters arising from Board and committee meetings is followed through.

### The role of the Group Chair

The Group Chair, Len Wardle, is elected by and from the Group Board and is a Non-Executive Director. The Chair does not meet the independent criteria as defined by the Combined Code because of his length of service on the Group Board. He leads the Group Board in the determination of its strategy and in the achievement of its objectives. The Group Chair is responsible for organising the business of the Group Board, ensuring its effectiveness and setting its agenda. He has no involvement in the running of the day-to-day business of the Group. The Group Chair facilitates the effective contribution of directors and ensures that there is good communication with members. The Group Chair is supported by three Group deputy chairs.

### Group Board committees

The Group Board governs through clearly identified Board committees. These are the Audit & Risk Committee, the Remuneration & Appointments Committee, the Chair's Committee and the Governance Working Party. In addition, there is a Values & Principles Committee, which although not a formal Board committee, has Group Board and Regional Board representation and is accountable to the Group Board.

The terms of reference for the Audit & Risk Committee, the Remuneration & Appointments Committee, the Governance Working Party and the Values & Principles Committee were all reviewed and updated during the financial year.

Each committee is properly authorised under the constitution of the Group to take decisions and act on behalf of the Group Board within the guidelines and delegations laid down by the Group Board. The Group Board is kept fully informed of the work of these committees. Any issues requiring resolution will be referred to the Group Board. A summary of the operations of the principal committees is set out below.

### Group Audit & Risk Committee

The Committee comprises five members, all of whom have the necessary ability and experience to understand financial statements – Ben Reid (Chair of the committee), Duncan Bowdler, Patrick Grange, Nigel Keane, and Ursula Lidbetter (Group Deputy Chair). In addition, the Chair of the CFS Audit & Regulatory Compliance Committee together with the Chair of the CFS Risk Management Committee, attend meetings. Ben Reid fulfils the requirements of the Combined Code in relation to having recent and relevant experience.

The Committee met four times during the financial year. The main responsibilities of the Committee are to:

- Monitor the integrity of the Group's financial statements and any formal announcements relating to the Group's performance, together with any significant financial reporting judgments contained in the financial statements
- Monitor the effectiveness of the external audit process and make recommendations to the Group Board, for it to put to the members in general meeting, in relation to the appointment, reappointment and remuneration of the external auditor and to approve the remuneration and terms of engagement of the external auditor
- Review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- Ensure that an appropriate relationship between the Group and the external auditor is maintained, including reviewing non-audit services and fees, taking into account relevant ethical guidance on the provision of non-audit services by the external audit firm and report to the Group Board, identifying any matters in respect of which it considers that action or improvement is needed
- Review annually the Group's systems of internal controls and the processes for monitoring and evaluating the risks facing the Group
- Review the effectiveness of the Internal Audit function and approve, upon the recommendation of the Group Chief Executive, the appointment and termination of the head of that function

- Review the Group's whistleblowing procedures to ensure the arrangements are in place to support employees and suppliers to raise concerns on a confidential basis including support from an external independent service
- Review the minutes and receive reports of the CFS Audit & Regulatory Compliance Committee and its Risk Management Committee
- Annually review its terms of reference and recommend to the Board any changes required as a result of the review.

The Committee meets with Executive Management, as well as privately with the external auditor and Head of Internal Audit.

### Group Remuneration & Appointments Committee

The Committee currently comprises six members: Paul Flowers (Chair), Patrick Grange, Chris Herries, Ursula Lidbetter (Group Deputy Chair), Len Wardle (Group Chair) and Steve Watts (Group Deputy Chair).

The Committee's role in respect of Executive Management is to determine remuneration and employment policy, oversee contractual arrangements, review salaries, approve incentive schemes and any payments made under such schemes and recommend appointments to the Group Board.

In respect of directors, the Committee makes recommendations to the Group Board on director remuneration, which in turn makes recommendations to members in a general meeting for a decision. The Committee also makes recommendations on the appointment of IPNEDs and appointments to the subsidiary boards and committees. The Committee is supported by the CFS Remuneration & Appointments Committee in ensuring consistency, where appropriate, across the wider Group.

The Committee met eight times during the financial year and its report can be found on pages 55 to 60.

### Group Chair's Committee

The Committee comprises four members, Len Wardle (Group Chair), Paul Flowers (Group Deputy Chair), Ursula Lidbetter (Group Deputy Chair) and Steve Watts (Group Deputy Chair), together with any other directors the Board decides from time to time. It has authority to act between Group Board meetings if required. The remit of the Committee covers all areas reserved to the Group Board.



### **Governance Working Party**

The Governance Working Party meets as required to consider any matter that relates to the good governance of the Group that the Group Board requests. There are five directors on this body: Len Wardle (Group Chair), Duncan Bowdler, Marilynne Burbage, Chris Herries and Stuart Ramsay and it met four times during the financial year.

### **Values & Principles Committee**

Although this Committee is no longer a formal committee of the Board, it is monitored by and accountable to the Group Board and the Group Board receives regular reports as to its activities. Following changes to the Committee's terms of reference to include CFS representation, Ben Reid and Chris Jones were appointed in July 2010 to the Committee. Its membership currently includes five Group directors: Marilynne Burbage (Chair), Jenny Barnes, Herbert Daybell, Stuart Ramsay and Ben Reid and one CFS director: Chris Jones. There are also seven regional representatives from each of the Group's seven regions; one person appointed by the Membership Diversity Working Group and one representative appointed by independent society members.

The Committee is responsible for monitoring the Group's Membership engagement and community strategies. It also scrutinises the Group's Sustainability Report on behalf of the Group Board and is responsible for maintaining relationships with the wider Co-operative Movement. The Committee met four times during the financial year.

### **Provision of advice to directors**

A number of external consultants provide professional advice to the boards of the constituent parts of the Group. There is an agreed procedure by which directors may take independent professional advice at the Group's expense in furtherance of their duties.

### **Board training and development**

In 2010, a new Board Learning & Development Policy was introduced to support all non-executive directors.

During the course of the year newly elected directors and IPNEDs undertook a structured induction programme. This was designed to include key corporate governance and business information, including briefing sessions with Executive Management on the strategy and performance of key business areas.

In addition, new directors received information on the operation of the Group Board's committees, including the powers delegated to the committees, corporate governance practices and procedures and the powers reserved to the Executive together with the latest financial information.

Learning and development activity has also been organised for the Group Board, members of subsidiary boards and committees including the Group Audit & Risk Committee. In addition, one-to-one development support has been provided to a number of directors.

The directors' website has been used as a resource bank to enable directors to access, revisit and review copies of presentations and materials from the more formal development sessions.

### **Performance evaluation**

An interim self-assessment exercise of the effectiveness of the Group Board was carried out during the financial year to assess its operation following the changes to the governance structure in 2009.

In addition there were internal self-assessment evaluations of the Group Audit & Risk Committee and the Values & Principles Committee.

### **The Secretary to the Board**

The Group Secretary is professionally qualified and is responsible for advising the Group Board through the Group Chair on all governance matters. The directors have access to the advice and services of the Group Secretary. The Group's rules provide that the appointment and removal of the Group Secretary is a matter for the Group Board.

### **The role of the Chief Executive and the Executive**

The Group Chief Executive, Peter Marks is appointed by the Group Board and has direct charge of the Group on a day-to-day basis and is accountable to the Group Board for the financial and operational performance of the Group.

It is the responsibility of the Executive to implement the strategic objectives as agreed by the Group Board. The Executive, under the leadership of the Group Chief Executive, is responsible for the management of the Group.

With effect from 1 January 2011, a new Group structure was created to facilitate a common strategic approach for all the businesses. Under the changes, the CFS Chief Executive, Neville Richardson and Martyn Wates, Chief Executive – Specialist Businesses have been appointed as Group Deputy Chief Executives and together with Tim Hurrell, Chief Executive – Food report directly to the Group Chief Executive. Neville Richardson, has also been appointed to the Food and Specialist Businesses Boards.

### **Membership involvement**

As a co-operative, the Group is jointly owned by over 5.8 million individual members and in the region of 90 independent society members. Individual members of the Group exercise democratic control by serving on its 48 area committees and seven regional boards, or by voting in elections (260,000 individual members voted in 2010), attending twice yearly members' meetings held throughout the country or participating in other consultation initiatives.

The Group provides learning and development opportunities for members to ensure they have the necessary knowledge and skills to fulfil their role within the governance process. The Group regularly communicates with active members using magazines, mailings and the internet. Additionally, the Group encourages members to share their views and influence policies and standards through local area meetings, web chats and surveys.

## Corporate governance statement continued

### Group Audit & Risk Committee

#### Internal control

The Group Board has overall responsibility for the Group's system of internal controls, which aims to safeguard the Group's assets and to ensure that proper accounting records and financial reporting processes are maintained and that the financial information used within the business and for publication is accurate, reliable and fairly presents the financial position of the Group and the results of its business operations.

The Group Board is also responsible for reviewing the effectiveness of the system of internal controls. This has been in place for the year under review and is regularly reviewed by the Group Board. The system is designed to provide reasonable assurance of effective operations and compliance with laws and regulations, although any system of internal controls can only provide reasonable, not absolute, assurance against material misstatement or loss, and can only mitigate rather than eliminate the risk of failure to achieve business objectives.

Since the publication of the Turnbull Report in September 1999, 'Internal Control: Guidance for Directors on the Combined Code by the Institute of Chartered Accountants in England and Wales', the directors have continued to review the effectiveness of the Group on non-financial as well as financial controls, including operational controls, risk management and the Group's high-level internal control arrangements. The Group has adopted an internal control framework that contains the following key elements.

#### Control environment

The Group's control environment is designed to create an attitude of taking acceptable business risk within clearly defined limits. The control environment includes:

- An organisational structure with clear lines for responsibility, delegation of authority and reporting requirements
- Co-ordinated activity across the whole Group through Executive Management meetings
- Clearly defined policies for capital and revenue expenditure. Larger capital and revenue expenditure requires Group Board authorisation
- Comprehensive systems of financial reporting. The annual budget and long term plans of the Group and of each Division are reviewed and approved by the Group Board. Results are reported against budget and previous year. The relevant Executives consider any significant changes and variances, and remedial action is taken where appropriate
- A Code of Business Conduct covering relations with customers, members, employees, suppliers, community and competitors. The Code provides procedures to allow any employee to report, in confidence, suspected serious malpractice. An anti-fraud policy with guidance further supports the Combined Code
- Internal audit, compliance and operational functions that review the system of internal control, including a financial control self-assessment process.

#### Risk management

The Group Board and Executive Management teams have the primary responsibility for identifying the key business risks facing the Group.

The Group operates a risk management process that identifies the key risks facing each business. Each business has a risk register that identifies the likelihood and impact of those risks occurring and the actions being taken to manage them. Risk assessments are updated on a quarterly basis and reported to the appropriate Risk Management Committee and Audit & Risk Committee. The information is consolidated for the Group Risk Management Committee, which provides reports, four times a year, to the Group Audit & Risk Committee on how the key risks are being managed. The Group's Risk Management Committee has responsibility for establishing a coherent framework for the Group to manage risks. The objective of the committee is to assist the Group Board in carrying out its responsibility to ensure effective risk management and a system of control.

The specific responsibilities of the committee are currently as follows:

- Defining and maintaining the policy, methodology and standards for risk management
- Identification of significant risks affecting the Group as a whole, communicating these to the businesses and corporate departments to ensure progress and action plans to address the identified risk
- Oversight of the business risk management committees, including ensuring that progress is made on action plans reported
- Ensuring the systems of risk management are operating throughout the year
- Providing regular reports to the Group Board and Audit & Risk Committee that explain the significance and likelihood of the risks and the necessary actions being taken by management to manage those risks.

During the year under review, attendees at the Group Risk Management Committee meetings included the Group Chief Executive (Chair), the Group Chief Financial Officer, the Group Secretary, the CFS Chief Financial Officer, the CFS Director of Risk, the Director of Strategic Planning and Change (Secretary to Committee), the Pensions Finance and Risk Controller, the Head of Ethics, Social Goals and Sustainability and the Head of Internal Audit. The Committee met four times during 2010.

#### Control procedures

The Group's control procedures are designed to ensure complete and accurate accounting for financial transactions and to limit the potential exposure to loss of assets or fraud. Procedures and reference information are maintained in relation to the Group's rules, accounting policies and procedures, insurance, employees and Code of Business Conduct. These are issued to appropriate management who are trained in the procedures.

#### Information and communication

Communication takes place with all key stakeholders through a variety of media including the Group's Sustainability Report. Employees receive and provide information on strategy and objectives through their reporting lines and a formal performance measurement process. Newsletters, magazines, bulletins, events and electronic media communicate other information.

### Monitoring

The operation of the system of internal control is the responsibility of line management. It is subject to independent internal audit review and, where appropriate, review by the Group's external auditors and external regulators.

The Group Audit & Risk Committee, on behalf of the Group Board, reviews the reports of the Group on internal control. Full details of the operation of the Committee can be found on pages 50 and 52.

A key part of the process in assessing internal control by the Group Audit & Risk Committee is an annual 'letter of assurance' process by which the Executive Management confirm they have assessed the effectiveness of their systems of internal financial and non-financial controls, their compliance with Group policies (including those relating to safety, health and the environment), local laws and regulations (including the industry's regulatory requirements) and reporting any key control improvements required. The outcome of these letters is reported to the Group Audit & Risk Committee. The directors are then able to review the system of internal controls and ensure it complies with the Turnbull Report guidance.

### External Audit

One of the duties of the Group Audit & Risk Committee is to make recommendations to the Group Board in relation to the appointment of the external auditors. A tender for the external audit of the Group was undertaken in 2003 at which KPMG Audit Plc was successful. In line with good corporate governance a new tender exercise is currently underway and it is intended that a resolution to appoint the external auditor be put to the Group's Annual General Meeting on 21 May 2011.

Details of the amounts paid to the external auditors during the year for audit and other services are set out in the notes to the financial statements in Note 3.

The Committee has put in place safeguards to ensure that the independence of the audit is not compromised, including a policy on the conduct of non-audit services from the external auditor. The external auditors are permitted to provide some non-audit services that are not, and are not perceived to be, in conflict with their independence. At each meeting, the Committee receives a report providing details of assignments and related fees carried out by the external auditors, in addition to their statutory audit work. The pre-approval of the Committee is required for services above certain thresholds determined by the Committee.

In addition, the following assignments are prohibited from being performed by the external auditors:

- Bookkeeping or other services related to the accounting records or financial statements
- Financial information systems design and implementation
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Any other services that the Group Audit & Risk Committee may determine.

The performance of the external auditors is formally monitored annually to ensure it meets the needs of the Group and the results are reported to the Committee.

### Internal Audit

Internal Audit is an independent appraisal function that derives its authority from the Group Board through the Group Audit & Risk Committee. Its primary role is to provide reasonable and objective assurance about the adequacy and effectiveness of the Group's financial control framework and risk management.

Internal Audit seeks to discharge the responsibilities set down in its charter by reviewing the processes that ensure business risks are effectively managed; reviewing the financial and operational controls that help to ensure compliance with corporate objectives, policies and procedures and external legislation (other than those relating to safety, health and the environment and product regulatory compliance, which are the responsibility of other assurance functions) and, on an ad hoc basis, reviewing that value for money is obtained. Internal Audit also acts as a source of constructive advice and best practice, assisting senior management with its responsibility to improve the process by which business risks are identified and managed and to report and advise on the proper and effective use of resources.

### Statement on Going Concern

After making all appropriate enquiries, the directors have reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the Group's financial statements. More detail of the rationale for adopting the going concern basis is set out in the Accounting basis section of the Accounting Policies note.



## Corporate governance statement continued

### Attendance

The following table shows the attendance of current and former directors at scheduled Group Board, Food and Specialist Businesses Board and committee meetings and the attendance of IPNEDs at the Food and Specialist Businesses Board meetings.

Number of meetings	Group Board	Group Audit & Risk Committee	Group Remuneration & Appointments Committee	Specialist Businesses Board	Co-operative Food Board	Governance Working Party
Jenny Barnes	10 (10)				11 (11)	
Steven Bayes	10 (10)			11 (11)		
Duncan Bowdler <sup>+</sup>	10 (10)	4 (4)				4 (4)
Marilynne Burbage	10 (10)			11 (11)		4 (4)
Bob Burton			1 (2)			
Eric Calderwood	9 (10)				10 (11)	
Martyn Cheatele <sup>+</sup>	5 (6)				5 (5)	
Penny Coates <sup>~</sup>				5 (6)		
Mike Cutt <sup>~</sup>				6 (6)		
Herbert Daybell	10 (10)				11 (11)	
John Fitzgerald <sup>^</sup>	1 (3)				2 (3)	
Paul Flowers <sup>+</sup>	8 (10)		8 (8)			
Patrick Grange	10 (10)	4 (4)	6 (6)		11 (11)	
Ray Henderson	10 (10)				11 (11)	
Chris Herries	10 (10)		8 (8)	11 (11)		4 (4)
Nigel Keane	10 (10)	3 (4)		11 (11)		
Ursula Lidbetter	10 (10)	4 (4)	6 (6)	6 (6)	5 (5)	
John Longworth <sup>“</sup>					6 (6)	
David Pownall	10 (10)			11 (11)		
Stuart Ramsay	10 (10)			11 (11)		4 (4)
Ben Reid <sup>+</sup>	8 (10)	4 (4)				
Richard Samson	6 (10)				9 (11)	
Allan Smith <sup>#</sup>	2 (4)		0 (2)		4 (5)	
Mark Smith <sup>*</sup>	6 (6)			4 (5)		
Euan Sutherland					5 (6)	
Len Wardle <sup>+</sup>	10 (10)		8 (8)	11 (11)	11 (11)	4 (4)
Steve Watts <sup>+</sup>	10 (10)		8 (8)	11 (11)		

The number in brackets indicates the number of meetings a director was entitled to attend.

<sup>+</sup> Attendance as a director of CFS and its Boards are shown in the CFS Annual Report

<sup>\*</sup> Appointed 23 May 2010

<sup>^</sup> Retired 19 March 2010

<sup>#</sup> Stepped down 22 May 2010

<sup>~</sup> IPNED on Specialist Businesses Board, appointed 15 June 2010

<sup>“</sup> IPNED on Food Board, appointed 15 June 2010

# Remuneration report

As a Co-operative, the Group is required to produce its accounts in accordance with the Industrial and Provident Societies Act 1965 to 2003, the Industrial and Provident Societies (Group Accounts) Regulations 1969 and applicable accounting standards. In the interests of best governance practice as a guideline for its disclosure in relation to remuneration, the Group uses the disclosure requirements applicable to listed companies, as set out in the *Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008* (incorporated into the Companies Act 2006).

The Group Board is entirely non-executive, the directors being elected from its membership. It has three principal subsidiary boards which comprise Group Board directors, Executive and Independent Professional Non-Executive Directors (IPNEDs). The day-to-day management of the Group falls to Executives. For completeness, this report provides details of both Executives' and directors' remuneration.

This report will be put to an advisory vote of the Group's members at the Annual General Meeting on 21 May 2011.

## Introduction

The Remuneration report is presented by the Group Board and contains the following information:

- A description of the role of the Remuneration and Appointments Committee
- A summary of the Group's remuneration policy, including statements of policy on Executives' and directors' remuneration
- Details of the terms of the service contracts and the remuneration of each Executive for the 2010 financial year
- Details of the current terms of office and the remuneration of each director for the 2010 financial year.

## Role of the Remuneration and Appointments Committee (the Committee)

The Committee's terms of reference were last revised and approved by the Group Board on 15 September 2010. The principal terms of reference are to:

- Determine policy on remuneration and other main terms and conditions of employment for 2010 and beyond in respect of all Group employees who are members of the Group Executive, including the Group Chief Executive and the Co-operative Financial Services (CFS) Chief Executive
- Oversee contractual arrangements for Executives and approve the principal terms and conditions of their employment
- Review remuneration using comparisons against the agreed market policy for the Executive
- Make recommendations on Executive appointments and the terms and conditions relating to these
- Approve any relevant incentive schemes and ensure that they are in line with current market practice and support the Group's strategy and values, and authorise payments under any incentive schemes in line with their rules
- Receive, review and decide on issues raised in relation to The Co-operative Group Pension (Average Career Earnings) Scheme and any other retirement benefit scheme within the Group and advise the Board on them as appropriate.

In respect of the directors, including IPNEDs, the Committee's responsibilities include:

- Ensuring there is a timely review of the remuneration and expenses policy of directors and agreeing the process and resource for such review, which shall be independent
- Ensuring that in the event of any compensation payments being made to the directors, an independent process is in place to ensure the policy and the interpretation of the policy is fair, reasonable and transparent and avoids conflicts of interests and that such payments are in the wider interests of the Group and membership as a whole
- Considering and recommending to the Group Board the appropriate recruitment process for the appointment of IPNEDs to the Group's subsidiary boards
- Overseeing contractual arrangements including remuneration in respect of IPNEDs
- Ensuring there is a succession plan in place in respect of the position of Group Chair.

The terms of reference of the Committee are available on the Group's website.

Members of the Committee during 2010 comprised Paul Flowers (Group Deputy Chair who also chairs the Committee), Bob Burton (who stepped down on 15 April 2010), Patrick Grange, Chris Herries, Ursula Lidbetter (Group Deputy Chair), Allan Smith (who stepped down on 22 May 2010), Len Wardle (Group Chair) and Steve Watts (Group Deputy Chair). The Group Board believes that all members of the Committee are independent for the purpose of reviewing remuneration matters. The Group Chief Executive (Peter Marks), the Group Secretary (Moirá Lees) and the Director of Human Resources (Richard Bide) also attend the meetings of the Committee, except when their own remuneration or terms and conditions are being considered. Other individuals are invited to attend for specific agenda items when necessary.

The Committee members are all non-executive. They have no personal financial interests in the Committee's decisions and they have no involvement in the day-to-day management of the Group. The Committee met eight times in the period under review.

To ensure that it receives independent advice on remuneration matters, the Committee retained Hewitt New Bridge Street (a trading name of Aon Hewitt Limited, part of Aon Corporation) as its independent adviser during the year. Hewitt New Bridge Street supplied survey data and advised on market trends and other general remuneration issues. Other than specialist advice in relation to the Group's remuneration issues, Hewitt New Bridge Street does not provide other services to the Group. Addleshaw Goddard was also retained to provide legal advice with respect to Executive service contracts.

## Remuneration report continued

### Policy on Executives' remuneration

In determining the remuneration policy for Executives, the Committee has considered a number of factors including:

- The importance of attracting, retaining and motivating senior Executives of the appropriate calibre to further the success of the Group
- The linking of reward to individual and business performance and the strengthening of co-operative values, which include a strong belief in stewardship of all of the Group's resources and, therefore, ensures that Executives are not rewarded for the assumption of undue risk
- Ensuring that the interests of Executives are aligned with those of the Group and its members
- In conjunction with the CFS Remuneration and Appointment Committee, ensuring that pay practices in the Group as a whole are coherent.

The current policy is to pay basic salaries at a level around the market median, when compared with other organisations of comparable size and complexity, and also organisations in the same business sector. The Committee supports the principle of performance-related pay and operates both an annual bonus plan and a long term incentive plan, but does not consider it appropriate to follow the quantum available in public limited companies (plcs). Accordingly, the amounts payable under these plans are lower than in comparable plcs. Neville Richardson, CFS Chief Executive/Deputy Group Chief Executive and Steve Humes, Group Chief Financial Officer joined the Group Executive on 1 January 2011; their incentive arrangements are also based on measurable performance conditions.

The Committee considers that a successful remuneration policy needs to be sufficiently flexible to take account of future changes in the Group's business environment and in remuneration practice. The enlarged Group remains in a state of transition and, as a part of this process, the Committee will continue to keep under review an appropriate remuneration policy covering all major components of the remuneration package.

The main components of Executive remuneration are:

#### Basic salary

It is the Committee's policy to ensure that the basic salary for each Executive is appropriate and competitive for the responsibilities involved. Basic salaries for Executives are reviewed by the Committee, normally annually, having regard to competitive market practice (in particular, salary levels for similar positions in comparable companies), the level of salaries elsewhere in the Group and individual performance for the financial year. The normal month for salary review is January. Basic salary is the only element of remuneration that is pensionable. Salaries received by Executives in respect of 2010 are set out in Table 1.

### Annual incentive plan

Each Executive is eligible to participate in an annual performance-related bonus plan. The Committee reviews and sets bonus targets and levels of eligibility annually. Each Executive is eligible to receive a bonus of up to 60% of basic salary. Bonus is only payable for achieving or exceeding agreed performance targets. For 2010 performance bonus of up to 45% of salary was measured on financial performance. For Group Executives it was based on Group profit before tax. For Executives with business unit responsibilities, up to 15% of basic salary was based on Group profit before tax and up to 30% of salary on Divisional profit before tax. Profit before tax is a good indication of overall business success as it is driven by sales, costs and operational effectiveness. Return On Net Operating Assets (RONOA), another important financial measure, features in the long term incentive plan (see below).

The remaining 15% of salary is measured using non-financial, co-operative value measures using the Group's Balanced Scorecard.

### Long term incentive plan (LTIP)

A long term incentive plan, employing cumulative targets across a three-year period, was introduced for Executives in 2003. In addition to plans for 2008–10 and 2009–11, a plan covering the three-year period 2010–2012 is in place and described below. Details of bonus payments due under the plan for 2008–10 are set out in Table 1 on page 58.

The 2010 plan has been reviewed by the Committee in 2010, and, for the 2010–12 performance period, is now based on the achievement of measurable profit growth targets, underpinned by a RONOA target, and the non-financial measures relate to the Group's Balanced Scorecard, namely, employee engagement, growing customer satisfaction and corporate responsibility during the three-year period. For Executives, the threshold payment levels, subject to performance conditions being met, are 25% of basic salary for the Group Chief Executive and 12.5% to 25% of basic salary for other Executives (depending on the role), with a maximum payment for outstanding performance of 100% of basic salary for the Group Chief Executive and 50% to 100% of basic salary for other Executives (depending on the role).

### Clawback

With effect from the 2010 grant of LTIP, and for annual bonuses in respect of 2011 performance, a claw-back provision will apply, in line with emerging market practice. This enables the Committee to seek to recoup part or all of an annual bonus or LTIP payment, in the exceptional events that it was based on misstated performance results or an Executive is dismissed for gross misconduct.

### Service contracts

It is the Group's policy for the notice period in Executives' service contracts not to exceed one year. All the Executives have contracts which are terminable by one year's notice. In the event of termination, any payments due to an Executive would be based on the value of one year's notice, together with the value of other contractual benefits. Dates of appointment are disclosed in Table 1.

In normal circumstances, it is the Committee's policy to design service contracts for any newly recruited Executive in a similar form to the model which has been developed for existing Executives.

### Share plans

As a co-operative, the Group does not operate a share or share option plan.

### Non-executive directorships

The Committee has determined that, subject to the Committee's approval, Executives may accept one non-executive directorship, or similar, with an external organisation. This represents an important opportunity to further develop individuals' skills and experience which is beneficial to the Group. Any fees received for such a role would normally be paid to the Group.

### Pensions

The Group offers every employee the opportunity to join a pension scheme. Generally, the pension scheme in which an employee accrues pension benefits is determined by their original employer within the Group (or other business prior to merger with, or acquisition by, the Group). For current Executives, these are provided through The Co-operative Group Pension (Average Career Earnings) Scheme ('the PACE Scheme') and, following the merger with United Co-operatives on 29 July 2007, the United Norwest Co-operatives Employees' Pension Fund and the Yorkshire Co-operatives Limited Employees' Pension Fund ('the United Schemes').

The PACE Scheme, which is a registered occupational pension scheme, provides pensions based on 1/60th of average pensionable earnings, revalued by inflation for each year of pensionable service from 6 April 2006 (the date the PACE Scheme was implemented). Benefits accrued as at 5 April 2006, in respect of membership of the scheme preceding the PACE Scheme, continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier. Pensions are also payable to dependants on death and a lump sum is payable if death occurs in service.



The United Schemes, which are also registered occupational pension schemes, broadly provide pensions based on 1/60th of final pensionable salary for each year of pensionable service. Pensions are also payable to dependants on death and a lump sum is payable if death occurs in service.

Executives who are members of the PACE Scheme currently contribute 6% of their pensionable salary, whilst Executives who are members of the United Schemes contribute between 8% and 9% of their pensionable salary depending on the relevant scheme. The Group pays the balance of the cost of providing benefits.

The Group offers Executives the facility of opting out of future pension accrual under the relevant registered pension scheme when the value of their accrued pension reaches the lifetime allowance under the tax rules, in favour of a pension allowance of 16% of basic salary.

Peter Marks was paid a pension allowance of 16% of basic salary in lieu of pension provision. David Hendry did not receive a pension allowance. All other Executives were members of either the PACE Scheme or one of the United Schemes during the year.

Supplementary life cover is provided to Executives in order to provide total life cover of 4 x salary when aggregated with benefits from the relevant pension scheme, as appropriate.

Additional pension details are available in Table 2.

### Directors

The Group directors do not have service contracts. The years of their first election are shown in Table 3. Group directors elected in 2010 and onwards, (except in respect of casual vacancies) will be subject to a three-year term of office.

Group directors' fees are determined by the Group's members. With effect from January 2010, the basic remuneration for a Group director is £10,370 per annum. Group directors appointed to serve on the boards of CFS and Co-operative Food receive an additional annual fee of £15,555 and £10,370 respectively. At the 2010 Half Yearly General Meeting on 6 November, members agreed an increase in the annual fee payable for being a Group director sitting on the Co-operative Specialist Businesses Board. The fee increased from £7,259 to £10,370 per annum bringing this in line with the fees payable to Group directors sitting on the Co-operative Food Board. Group directors serving on various other boards and committees also receive additional fees as do the Chair and Deputy Chairs of the Group to reflect their additional responsibilities.

Fees are increased in line with the Retail Prices Index (RPI) every year. The increase in fees in 2010 was 3.7%.

The Group directors do not, by virtue of their Board position, participate in any of the Group's incentive plans or pension schemes.

The total fees received by each director are set out in Table 3.

Executives serving on the subsidiary boards do not receive a separate fee.

On 15 June 2010, two IPNEDs were each appointed to the Boards of Co-operative Food and Co-operative Specialist Businesses. Two IPNEDs have two year service contracts and two have three year service contracts and they receive an annual fee of £50,000, increasing by RPI from the start of each financial year. Their details are outlined in Table 3a. The Boards of CFS and its substantive subsidiaries also include six IPNEDs and one Professional Non-Executive Director and details of their fees can be found in the separate CFS Report and Accounts.

By the Order of the Board  
**Paul Flowers**, Committee Chair  
**Steve Watts**, Deputy Chair  
**Ursula Lidbetter**, Deputy Chair

29 March 2011

**Table 1 – Executives' emoluments**

	Date of appointment (Note 1)	Basic salary £000	Other supplements (Note 2) £000	Performance-related bonus Annual £000	Performance-related LTIP (2008 award) £000	Benefits in kind (Note 3) £000	2010 Total emoluments (Note 4) £000	2009 Total emoluments (Notes 4 and 9) £000
Peter Marks	29 July 2007	900	144	449	585	40	2,118	1,565
Patrick Allen (Note 5)	29 July 2007	137	–	–	–	17	154	361
Mike Austin	29 July 2007	192	–	102	153	27	474	328
Richard Bide	15 September 2003	321	–	159	250	15	745	510
Neil Braithwaite	29 July 2007	239	–	54	101	21	415	320
Mark Craig (Note 6)	1 September 2010	60	–	30	–	4	94	
David Hendry (Note 7)	29 July 2007	289	–	147	144	6	586	316
Martyn Hulme (Note 8)	1 September 2010	76	–	40	–	4	120	
Tim Hurrell	30 July 2008	595	–	166	302	26	1,089	940
Moira Lees	28 November 2007	276	–	135	92	21	524	406
John Nuttall	29 July 2007	279	–	148	192	21	640	384
Lynda Shillaw (Note 5)	29 July 2007	192	–	–	–	11	203	439
Martyn Wates	24 September 2007	515	–	257	302	25	1,099	836

Note 1 Date of appointment may differ from date service commenced with the Group.

Note 2 The figures for Peter Marks include a pension allowance in lieu of pension provision.

Note 3 Benefits in kind include car or car allowance, fuel cards and phone. In addition to the above, the Executive also receive life assurance.

Note 4 Excludes pension values (see Table 2).

Note 5 Patrick Allen ceased to be a member of the Executive on 20 July 2010. Lynda Shillaw ceased to be a member of the Executive on 31 August 2010.

Note 6 Mark Craig, Director of Corporate Affairs, became a member of the Executive on 1 September 2010.

Note 7 David Hendry stepped down from the Executive on 9 November 2010, and his emoluments are pro-rated to reflect this, but remains an employee of the Group.

Note 8 Martyn Hulme became a member of the Executive on 1 September 2010, replacing Lynda Shillaw as Managing Director, Estates.

Note 9 Figures for the 2009 comparatives relate to the 51-week period ending 2 January 2010, whereas 2010 emoluments are for the 52 weeks ended 1 January 2011.

## Remuneration report continued

**Table 1** continued – Potential payouts under the LTIP

Name of Executive	Date of award	Maximum payment (payable after 3-year performance period relating to each award)			Total
		Financial performance	Non-financial performance	Synergy	
Peter Marks	15/02/2010	£675,000	£225,000	–	£900,000
	10/02/2009	£440,000	£220,000	£220,000	£880,000
	<b>Total</b>				<b>£1,780,000</b>
Mike Austin	15/02/2010	£72,000	£24,000	–	£96,000
	10/02/2009	£70,500	£23,500	–	£94,000
	<b>Total</b>				<b>£190,000</b>
Richard Bide	15/02/2010	£178,875	£59,265	–	£238,500
	10/02/2009	£116,625	£58,313	£58,312	£233,250
	<b>Total</b>				<b>£471,750</b>
Neil Braithwaite	15/02/2010	£88,875	£29,625	–	£118,500
	10/02/2009	£87,000	£29,000	–	£116,000
	<b>Total</b>				<b>£234,500</b>
David Hendry	15/02/2010	£123,750	£41,250	–	£165,000
	10/02/2009	£120,750	£40,250	–	£161,000
	<b>Total</b>				<b>£326,000</b>
Tim Hurrell	15/02/2010	£446,250	£148,750	–	£595,000
	10/02/2009	£282,500	£141,250	£141,250	£565,000
	<b>Total</b>				<b>£1,160,000</b>
Moiria Lees	15/02/2010	£151,875	£50,625	–	£202,500
	10/02/2009	£90,000	£45,000	£45,000	£180,000
	<b>Total</b>				<b>£382,500</b>
John Nuttall	15/02/2010	£104,625	£34,875	–	£139,500
	10/02/2009	£102,375	£34,125	–	£136,500
	<b>Total</b>				<b>£276,000</b>
Martyn Wates	15/02/2010	£386,250	£128,750	–	£515,000
	10/02/2009	£250,000	£125,000	£125,000	£500,000
	<b>Total</b>				<b>£1,015,000</b>

Note 1 The above amounts are the maximum payable and are dependent on achieving stretch financial and non-financial targets as outlined on page 56.

Note 2 Patrick Allen and Lynda Shillaw left the Group's employment in 2010 and no payments are due to them under any incentive plans.

**Table 2 – Pension details of the Executive**

	Years of service	Total accrued pension at 1 January 2011 £000	Increase in accrued pension during the year £000	Increase in accrued pension during the year (net of inflation) £000	Transfer value of previous column at 1 January 2011 net of members' contributions £000	Transfer value of total accrued pension at 2 January 2010 £000	Transfer value of total accrued pension at 1 January 2011 £000	Increase in transfer values net of members' contributions £000
Peter Marks (Note 4)	43	–	–	–	–	–	–	–
Patrick Allen (Note 5)	6	39	3	2	7	420	462	30
Mike Austin	27	59	4	2	7	671	779	93
Richard Bide	7	28	6	5	51	336	439	84
Neil Braithwaite	13	52	5	3	5	677	781	90
David Hendry (Note 6)	4	–	–	–	–	–	–	–
Mark Craig (Note 7)	16	55	11	9	180	861	1,166	294
Martyn Hulme (Note 7)	20	77	11	8	89	816	1,018	190
Tim Hurrell	14	126	16	11	201	2,358	2,928	519
Moira Lees	29	129	20	15	210	1,661	2,104	426
John Nuttall	23	74	6	3	22	1,005	1,184	157
Lynda Shillaw (Note 8)	4	16	3	3	12	104	126	10
Martyn Wates	15	149	13	7	33	1,342	1,588	205

Note 1 The total accrued pension is that which would be paid annually on retirement at normal retirement age based on service to 1 January 2011 and includes any transferred-in benefits as appropriate. Under the terms of their contracts, existing Group Executives at 17 January 2007 may take these benefits from age 60 and new Executives after 17 January 2007 may take these benefits from age 65. The transfer values in the table above have been calculated on this basis. Years of service include, where appropriate, pre-merger service with United Co-operatives. Mark Craig joined United Co-operatives on 24 January 1994 and transferred-in benefits built up in other Co-operative schemes in respect of service from 4 October 1982.

Note 2 Members have the option of paying additional voluntary contributions to their respective pension scheme. Neither these contributions nor the benefits arising from them are shown in the above table.

Note 3 All transfer values have been calculated in accordance with the current transfer value method and basis in force for the scheme applicable to the Executive. This is set by the Trustee(s), after taking actuarial advice, to be consistent with the requirements of legislation and the rules of the scheme.

Note 4 Peter Marks was paid a pension allowance of 16% of basic salary in lieu of pension provision.

Note 5 Patrick Allen left the Group on 20 July 2010. He became entitled to a deferred pension under the United Norwest Co-operatives Employees' Pension Fund when he left the scheme at the same date. The details shown in the table are calculated at that date.

Note 6 David Hendry resigned from the Executive on 9 November 2010. He is not a member of an occupational pension scheme and does not receive a pension allowance.

Note 7 Mark Craig and Martyn Hulme became members of the Executive on 1 September 2010.

Note 8 Lynda Shillaw left the Group on 31 August 2010. She became entitled to a deferred pension under the PACE Scheme when she left the scheme at the same date. The details shown in the table are calculated at that date.



## Remuneration report continued

**Table 3 – Directors' remuneration (including compensation)**

	Year first elected	Term expires	2010 Remuneration £000	2009 Remuneration £000
Jenny Barnes	2009	2012	30	18
Steven Bayes (Note 10)	2009	2011	29	17
Duncan Bowdler	2007	2013	36	28
Marilynne Burbage (Note 10)	2009	2013	27	17
Eric Calderwood	2006	2012	34	26
Martyn Cheatle (Notes 3 & 4)	2010	2013	12	0
Herbert Daybell	2009	2012	31	19
John Fitzgerald (Notes 1 & 4)	2005	N/A	4	20
Paul Flowers (Notes 6 & 7)	2008	2013	103	32
Patrick Grange	2007	2011	34	30
Ray Henderson	2009	2012	30	17
Chris Herries (Note 10)	2009	2013	33	18
Nigel Keane (Notes 8 & 10)	2009	2011	32	17
Ursula Lidbetter (Notes 4 & 5)	2009	2011	28	12
David Pownall (Note 10)	2007	2012	29	23
Stuart Ramsay (Note 10)	2009	2011	28	17
Ben Reid (Note 4)	2000	2012	38	29
Richard Samson (Note 4)	2005	2013	21	20
Allan Smith (Notes 2 & 4)	2004	N/A	12	25
Mark Smith (Notes 3 & 10)	2010	2012	11	0
Len Wardle (Note 7)	1992	2011	135	135
Steve Watts (Notes 8, 9, 10 & 11)	2000	2013	67	50

Note 1 John Fitzgerald stepped down as a Group director on 19 March 2010.

Note 2 Allan Smith stepped down as a Group director on 22 May 2010.

Note 3 Martyn Cheatle and Mark Smith were appointed as Group directors with effect from 23 May 2010.

Note 4 The remuneration of some directors is paid, at their request, direct to their employers who release them to act as directors of the Group.

Note 5 Ursula Lidbetter stepped down from the Specialist Businesses Board and was appointed Chair of the Food Board and Group Deputy Chair on 16 June 2010.

Note 6 Paul Flowers was appointed Chair of the CFS Board and Group Deputy Chair on 15 April 2010 and his fee covers both roles.

Note 7 Includes Group car.

Note 8 Includes payments for loss of earnings, payable to the director's employer.

Note 9 A fee of £5,000 per annum was agreed with effect from 7 November 2010 for serving as director of Unity Trust Bank plc.

Note 10 The fee for serving on the Specialist Businesses Board was increased from £7,259 to £10,370 per annum on 7 November 2010.

Note 11 The fee for the Chair of the Specialist Businesses Board was increased from £7,259 to £10,370 per annum on 7 November 2010.

Note 12 Fees for the 2009 comparative relate to the 51 week period ending 2 January 2010 whereas 2010 fees are for the 52 weeks ended 1 January 2011.

**Table 3a – Independent Professional Non-Executive Directors (IPNEDs) remuneration**

	Subsidiary Board	Year appointed	Term expires	2010 Remuneration £000
John Longworth	Food	2010	2013	28
Euan Sutherland	Food	2010	2012	28
Penny Coates	Specialist Businesses	2010	2013	28
Mike Cutt	Specialist Businesses	2010	2012	28

Note 1 The IPNEDs receive a fee of £50,000 per annum.

Note 2 The IPNEDs were all appointed on 15 June 2010.

# Independent auditor's report to the members of Co-operative Group Limited

We have audited the financial statements of Co-operative Group Limited (the Society) for the year ended 1 January 2011 set out on pages 62 to 175. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU.

This report is made solely to the Society's members, as a body, in accordance with section 9 of the Friendly and Industrial and Provident Societies Act 1968. Our audit work has been undertaken so that we might state to the Society's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Society and the Society's members, as a body, for our audit work, for this report, or for the opinions we have formed.

## Respective responsibilities of directors and auditor

As more fully explained in the Statement of Directors' Responsibilities set out on page 48, the Society's directors are responsible for the preparation of financial statements which give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

## Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's website at [www.frc.org.uk/apb/scope/private.cfm](http://www.frc.org.uk/apb/scope/private.cfm).

## Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Society's affairs as at 1 January 2011 and of the Society's profit for the year then ended; and
- have been properly prepared in accordance with the Industrial and Provident Societies Acts 1965 to 2003 and the Industrial and Provident Societies (Group Accounts) Regulations 1969.

## Matters on which we are required to report by exception

We have nothing to report in respect of the following.

Under the Industrial and Provident Societies Acts 1965 to 2003 we are required to report to you if, in our opinion:

- a satisfactory system of control over transactions has not been maintained; or
- the association has not kept proper accounting records; or
- the financial statements are not in agreement with the books of account; or
- we have not received all the information and explanations we need for our audit.

In addition to our audit of the financial statements, the directors have engaged us to review their Corporate Governance Statement on pages 49 to 54 as regards the Society's compliance with paragraphs D1.1 (paragraph 5), D2.1, D2.4, D3.1 (paragraph 3) and D3.2 of the Co-operatives UK Limited's Corporate Governance Code of Best Practice issued in May 2005 ('the Code'). Under the terms of our engagement, we are required to review whether the Corporate Governance Statement reflects the Society's compliance with the five provisions of the Code specified for our review.

**Jonathan Hurst**, Senior Statutory Auditor  
for and on behalf of KPMG Audit Plc,  
Statutory Auditor  
Chartered Accountants  
Manchester

29 March 2011

# Consolidated income statement

for the year ended 1 January 2011

	Notes	52 weeks ended 1 January 2011			51 weeks ended 2 January 2010 (restated*)		
		Before significant items £m	Significant items (Notes 3 & 6) £m	Total £m	Before significant items £m	Significant items (Notes 3 & 6) £m	Total £m
<b>Gross sales</b>		<b>13,690.8</b>		<b>13,690.8</b>	12,544.6		12,544.6
Less:							
Value Added Tax and premiums ceded to reinsurers		<b>(804.7)</b>		<b>(804.7)</b>	(648.6)		(648.6)
<b>Net revenue</b>	1	<b>12,886.1</b>		<b>12,886.1</b>	11,896.0		11,896.0
Operating income	6	<b>96.9</b>	<b>30.0</b>	<b>126.9</b>	119.5	62.4	181.9
Operating expenses	3	<b>(12,362.8)</b>	<b>(147.4)</b>	<b>(12,510.2)</b>	(11,499.2)	(165.4)	(11,664.6)
Operating expenses – fair value amortisation	3	<b>(14.2)</b>	–	<b>(14.2)</b>	99.1	–	99.1
<b>Operating profit</b>		<b>606.0</b>	<b>(117.4)</b>	<b>488.6</b>	615.4	(103.0)	512.4
Financial expenses – interest payable	9	<b>(79.9)</b>		<b>(79.9)</b>	(107.9)		(107.9)
Financial expenses – fair value movement	10	<b>(29.2)</b>		<b>(29.2)</b>	(34.5)		(34.5)
Net financial income – other	11	<b>34.1</b>		<b>34.1</b>	40.7		40.7
<b>Net financial expenses</b>		<b>(75.0)</b>		<b>(75.0)</b>	(101.7)		(101.7)
Share of profit of associates and joint ventures	19			<b>0.8</b>			0.3
<b>Profit before payments to and on behalf of members</b>				<b>414.4</b>			411.0
Payments to and on behalf of members	12			<b>(104.0)</b>			(107.1)
<b>Profit before tax</b>				<b>310.4</b>			303.9
Income tax expense	13			<b>(107.5)</b>			(124.9)
Less: tax attributable to policyholders' returns	13			<b>44.0</b>			6.4
<b>Total taxation</b>	13			<b>(63.5)</b>			(118.5)
<b>Profit after tax but before loss on discontinued operations</b>				<b>246.9</b>			185.4
Loss on discontinued operations, net of tax				<b>(26.9)</b>			(25.1)
<b>Profit for the period</b>				<b>220.0</b>			160.3
Attributable to:							
Equity holders of the parent				<b>219.2</b>			155.5
Non-controlling interests				<b>0.8</b>			4.8
<b>Profit for the period</b>				<b>220.0</b>			160.3

\* For an explanation of the restatement of the prior period figures, refer to the accounting policies section.

Both profit before tax and total taxation are after deducting policyholder tax (tax payable by CIS in respect of its long term business).

<b>Non-GAAP measure: underlying profit before payments to and on behalf of members**</b>			
	Notes	52 weeks ended 1 January 2011 £m	51 weeks ended 2 January 2010 (restated*) £m
Analysed as:			
Profit before payments to and on behalf of members		<b>414.4</b>	411.0
Trading Group property disposal losses/(profits)	6	<b>7.5</b>	(36.1)
Significant items (net)	1	<b>117.4</b>	103.0
Trading Group change in value of investment properties	6	<b>(14.0)</b>	(3.5)
Financial expenses fair value movement	10	<b>29.2</b>	34.5
Net financial income other	11	<b>(34.1)</b>	(40.7)
Fair value amortisation	3	<b>14.2</b>	(99.1)
Short term investment fluctuations	1	<b>(0.4)</b>	(4.9)
Financial Services Compensation Scheme levies	1	<b>11.5</b>	3.7
<b>Underlying profit before payments to and on behalf of members</b>		<b>545.7</b>	367.9

\*\* For an explanation of this measure, refer to the accounting policies section.



# Consolidated statement of comprehensive income

for the year ended 1 January 2011

	Notes	2010 £m	2009 £m
<b>Profit for the period</b>		<b>220.0</b>	160.3
<b>Other comprehensive income:</b>			
Changes in available for sale assets		<b>(3.1)</b>	62.2
Actuarial gains/(losses) on employee pension schemes	21	<b>177.2</b>	(545.6)
Changes in cash flow hedges		<b>(24.6)</b>	(48.4)
Foreign currency translation differences for foreign operations		<b>1.0</b>	0.3
Tax on items taken directly to consolidated statement of comprehensive income	13	<b>(41.4)</b>	147.2
<b>Other comprehensive income for the period, net of tax</b>		<b>109.1</b>	(384.3)
<b>Total comprehensive income for the period</b>		<b>329.1</b>	(224.0)
<b>Total comprehensive income attributable to:</b>			
Equity holders of the parent		<b>328.9</b>	(227.5)
Non-controlling interest		<b>0.2</b>	3.5
		<b>329.1</b>	(224.0)

# Consolidated balance sheet

As at 1 January 2011

	Notes	2010 £m	2009 £m
<b>Assets</b>			
<b>Trading Group assets</b>			
Property, plant and equipment	16	2,463.3	2,517.1
Intangible assets	17	1,544.2	1,575.9
Biological assets		0.6	0.4
Investment property	18	339.1	321.6
Investments in associates and joint ventures	19	25.3	25.1
Other investments	19	4.6	4.6
Derivatives	20	14.8	10.6
Retirement benefits	21	276.8	5.1
Trade and other receivables	24	229.8	–
Deferred tax assets	22	134.1	284.3
<b>Total Trading Group non-current assets</b>		<b>5,032.6</b>	4,744.7
Inventories	23	586.1	557.3
Biological assets		3.1	2.7
Income tax receivable		–	9.9
Trade and other receivables	24	476.9	527.2
Cash and cash equivalents		400.0	346.9
Assets classified as held for sale	25	54.4	12.1
<b>Total Trading Group current assets</b>		<b>1,520.5</b>	1,456.1
<b>Total Trading Group assets</b>		<b>6,553.1</b>	6,200.8
<b>Financial Services assets</b>			
Cash and balances at central banks		1,735.6	1,703.0
Derivatives	20	1,728.8	1,704.3
Loans and advances to banks	26	2,394.1	1,781.5
Loans and advances to customers	27	34,999.1	34,097.2
Fair value adjustments for hedged risk	27	166.8	66.1
Investments	28	24,189.8	25,469.8
Investments in associates and joint ventures	19	2.7	2.0
Reinsurance contracts	29	3,102.0	3,019.0
Income tax		38.7	36.3
Intangible assets	17	317.3	216.8
Property, plant and equipment	16	169.2	190.6
Deferred tax assets	22	104.9	96.2
Prepayments and other receivables	30	526.9	560.6
<b>Total Financial Services assets</b>		<b>69,475.9</b>	68,943.4
<b>Total assets</b>		<b>76,029.0</b>	75,144.2

	Notes	2010 £m	2009 £m
<b>Liabilities</b>			
<b>Trading Group liabilities</b>			
Interest-bearing loans and borrowings	33	<b>1,619.7</b>	1,829.7
Trade and other payables	34	<b>627.1</b>	483.3
Derivatives	20	<b>119.3</b>	96.0
Provisions	35	<b>291.8</b>	415.0
Retirement benefits	21	<b>230.6</b>	252.7
Deferred tax liabilities	22	<b>253.9</b>	301.3
<b>Total Trading Group non-current liabilities</b>		<b>3,142.4</b>	3,378.0
Interest-bearing loans and borrowings	33	<b>159.4</b>	47.5
Income tax payable		<b>22.4</b>	–
Trade and other payables	34	<b>1,367.7</b>	1,454.7
Provisions	35	<b>146.1</b>	56.5
Liabilities classified as held for sale	25	<b>70.6</b>	–
<b>Total Trading Group current liabilities</b>		<b>1,766.2</b>	1,558.7
<b>Total Trading Group liabilities</b>		<b>4,908.6</b>	4,936.7
<b>Financial Services liabilities</b>			
Amounts owed to credit institutions	36	<b>3,815.4</b>	7,159.2
Customer accounts	37	<b>32,379.5</b>	30,821.2
Capital bonds	38	<b>1,794.7</b>	1,647.1
Derivatives	20	<b>1,237.1</b>	1,094.2
Insurance and participation contracts	29	<b>17,447.9</b>	16,364.1
Debt securities in issue	39	<b>4,212.2</b>	3,334.3
Investment contracts	40	<b>316.0</b>	259.9
Unallocated divisible surplus	41	<b>1,037.1</b>	1,052.8
Other borrowed funds	42	<b>975.4</b>	946.5
Income tax payable		<b>61.5</b>	81.9
Other liabilities and accruals	43	<b>2,751.1</b>	2,678.6
Deferred tax liabilities	22	<b>124.7</b>	126.5
Retirement benefit obligations	21	<b>49.6</b>	36.7
Provisions	44	<b>73.4</b>	81.6
<b>Total Financial Services liabilities</b>		<b>66,275.6</b>	65,684.6
<b>Total liabilities</b>		<b>71,184.2</b>	70,621.3
<b>Equity</b>			
Members' share capital	31	<b>69.9</b>	71.9
Retained earnings		<b>4,582.4</b>	4,237.1
Other reserves	32	<b>159.9</b>	178.6
<b>Total equity attributable to equity holders of the parent</b>		<b>4,812.2</b>	4,487.6
Non-controlling interests		<b>32.6</b>	35.3
<b>Total equity</b>		<b>4,844.8</b>	4,522.9
<b>Total equity and liabilities</b>		<b>76,029.0</b>	75,144.2

**Board's certification**

The financial statements on pages 62 to 175 are hereby signed on behalf of the Board pursuant to section 3(a)(1) of the Friendly and Industrial Provident Societies Act 1968.

**Len Wardle**, Chair

**Steve Watts**, Deputy Chair

**Peter Marks**, Group Chief Executive

**Maira Lees**, Group Secretary

29 March 2011



# Consolidated statement of changes in equity

for the year ended 1 January 2011

	2010								
	Members' share capital £m	Translation reserve £m	Hedging reserve £m	Revaluation reserve-property, plant and equipment £m	Available for sale investments reserve £m	Retained earnings £m	Total shareholder interest £m	Non-controlling interest £m	Total equity £m
Balance at 3 January 2010	71.9	1.0	70.0	94.4	13.2	4,237.1	4,487.6	35.3	4,522.9
Profit for the year						219.2	219.2	0.8	220.0
Other comprehensive income:									
Gains less losses on available for sale assets					2.7		2.7	(0.1)	2.6
Cumulative gains transferred to the income statement					(5.7)		(5.7)		(5.7)
Changes in cashflow hedges			(23.9)				(23.9)	(0.7)	(24.6)
Actuarial gains and losses on employee pension schemes						177.2	177.2		177.2
Foreign currency translation differences		1.0					1.0		1.0
Tax on items taken directly to other comprehensive income			7.2			(48.8)	(41.6)	0.2	(41.4)
<b>Total other comprehensive income</b>	<b>-</b>	<b>1.0</b>	<b>(16.7)</b>	<b>-</b>	<b>(3.0)</b>	<b>128.4</b>	<b>109.7</b>	<b>(0.6)</b>	<b>109.1</b>
<b>Contributions by and distributions to members:</b>									
Shares issued and interest credited less shares withdrawn	(2.0)						(2.0)		(2.0)
Members' share interest						(0.5)	(0.5)		(0.5)
Dividend Financial Services – non-controlling interests							-	(0.8)	(0.8)
Dividend Trading Group – non-controlling interests							-	(1.4)	(1.4)
<b>Total contributions by and distributions to members</b>	<b>(2.0)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(0.5)</b>	<b>(2.5)</b>	<b>(2.2)</b>	<b>(4.7)</b>
<b>Changes in ownership interests in subsidiaries:</b>									
Acquisition of non-controlling interest						(1.8)	(1.8)	(0.7)	(2.5)
<b>Changes in ownership interests in subsidiaries</b>						<b>(1.8)</b>	<b>(1.8)</b>	<b>(0.7)</b>	<b>(2.5)</b>
<b>Balance at 1 January 2011</b>	<b>69.9</b>	<b>2.0</b>	<b>53.3</b>	<b>94.4</b>	<b>10.2</b>	<b>4,582.4</b>	<b>4,812.2</b>	<b>32.6</b>	<b>4,844.8</b>

	2009								
	Members' share capital £m	Translation reserve £m	Hedging reserve £m	Revaluation reserve property, plant and equipment £m	Available for sale investments reserve £m	Retained earnings £m	Total shareholder interest £m	Non-controlling interest £m	Total equity £m
Balance at 11 January 2009	67.9	0.8	104.3	94.4	(32.9)	3,664.7	3,899.2	33.7	3,932.9
Profit for the period						155.5	155.5	4.8	160.3
Other comprehensive income:									
Gains less losses on available for sale assets					74.6		74.6	(1.0)	73.6
Gains recycled to profit or loss on impairment					(2.6)		(2.6)		(2.6)
Cumulative gains transferred to the income statement					(4.9)		(4.9)		(4.9)
Revaluation of equity shares					(3.2)		(3.2)		(3.2)
Transferred to other operating income on disposal of equity shares					(0.7)		(0.7)		(0.7)
Net fair value changes in cashflow hedges recognised directly in equity			(47.6)				(47.6)	(0.8)	(48.4)
Actuarial losses on employee pension scheme						(545.6)	(545.6)		(545.6)
Revaluation of property, plant and equipment				–			–		–
Foreign currency translation differences		0.3					0.3		0.3
Tax on items taken directly to other comprehensive income		(0.1)	13.3		(17.1)	150.6	146.7	0.5	147.2
<b>Total other comprehensive income</b>	–	0.2	(34.3)	–	46.1	(395.0)	(383.0)	(1.3)	(384.3)
<b>Contributions by and distributions to members:</b>									
Arising from transfer of engagements	4.1					812.6	816.7		816.7
Shares issued and interest credited less shares withdrawn	(0.1)						(0.1)		(0.1)
Members' share interest						(0.7)	(0.7)		(0.7)
Dividend Financial Services – non-controlling interests							–	(0.9)	(0.9)
Dividend Trading Group – non-controlling interests							–	(1.0)	(1.0)
<b>Total contributions by and distributions to members</b>	4.0	–	–	–	–	811.9	815.9	(1.9)	814.0
<b>Balance at 2 January 2010</b>	71.9	1.0	70.0	94.4	13.2	4,237.1	4,487.6	35.3	4,522.9

# Consolidated statement of cash flows

for the year ended 1 January 2011

	Notes	2010			2009		
		Financial Services £m	Trading Group £m	Total £m	Financial Services £m	Trading Group £m	Total £m
<b>Net cash from operating activities</b>	45,46	<b>(955.7)</b>	<b>520.8</b>	<b>(434.9)</b>	(2,493.3)	507.2	(1,986.1)
<b>Cash flows from investing activities</b>							
Acquisition of property, plant and equipment		<b>(38.4)</b>	<b>(343.3)</b>	<b>(381.7)</b>	(23.2)	(349.7)	(372.9)
Proceeds from sale of property, plant and equipment		<b>0.7</b>	<b>102.1</b>	<b>102.8</b>	0.1	191.3	191.4
Purchase of intangible assets		<b>(110.7)</b>	–	<b>(110.7)</b>	(84.0)	–	(84.0)
Acquisition of investments		–	<b>(5.7)</b>	<b>(5.7)</b>	(180.0)	(1.8)	(181.8)
Interest received/(paid)		<b>11.3</b>	–	<b>11.3</b>	(0.7)	0.1	(0.6)
Internal dividends (paid)/received		<b>(77.4)</b>	<b>77.4</b>	–	(76.8)	76.8	–
Disposal of business		–	–	–	–	529.0	529.0
Acquisition of business net of cash acquired	48	–	–	–	–	(1,698.0)	(1,698.0)
Cash and cash equivalents arising on transfer of engagements	47	–	–	–	1,535.6	2.5	1,538.1
Proceeds from sale and maturity of investment securities		<b>3,757.2</b>	–	<b>3,757.2</b>	3,162.4	–	3,162.4
Purchase of investment securities		<b>(1,506.2)</b>	–	<b>(1,506.2)</b>	(1,814.8)	–	(1,814.8)
<b>Net cash from investing activities</b>		<b>2,036.5</b>	<b>(169.5)</b>	<b>1,867.0</b>	2,518.6	(1,249.8)	1,268.8
<b>Cash flows from financing activities</b>							
Interest paid on borrowings		<b>(56.0)</b>	<b>(75.8)</b>	<b>(131.8)</b>	(27.0)	(106.5)	(133.5)
(Repayment)/issue of share capital	31	–	<b>(2.0)</b>	<b>(2.0)</b>	180.0	(0.1)	179.9
Repayment of subordinated loan stock		–	–	–	(105.0)	–	(105.0)
Increase/(decrease) in corporate investor shares	33	–	<b>9.6</b>	<b>9.6</b>	–	(10.9)	(10.9)
Preference dividends paid		<b>(5.6)</b>	–	<b>(5.6)</b>	(5.6)	–	(5.6)
Dividends paid to non-controlling shareholders in subsidiary undertaking		<b>(0.8)</b>	<b>(1.4)</b>	<b>(2.2)</b>	(0.9)	(1.0)	(1.9)
Payments to and on behalf of members		–	<b>(113.9)</b>	<b>(113.9)</b>	–	(96.1)	(96.1)
(Repayment)/issue of borrowings		–	<b>(116.6)</b>	<b>(116.6)</b>	–	1,081.9	1,081.9
Finance lease receipts		–	<b>1.9</b>	<b>1.9</b>	–	15.1	15.1
<b>Net cash from financing activities</b>		<b>(62.4)</b>	<b>(298.2)</b>	<b>(360.6)</b>	41.5	882.4	923.9
Net increase in cash and cash equivalents		<b>1,018.4</b>	<b>53.1</b>	<b>1,071.5</b>	66.8	139.8	206.6
Cash and cash equivalents at beginning of period		<b>2,383.7</b>	<b>346.9</b>	<b>2,730.6</b>	2,316.9	207.1	2,524.0
<b>Cash and cash equivalents at end of period</b>		<b>3,402.1</b>	<b>400.0</b>	<b>3,802.1</b>	2,383.7	346.9	2,730.6
<b>Analysis of cash and cash equivalents</b>							
Cash and balances with central banks		<b>1,735.6</b>	–	<b>1,735.6</b>	1,706.8	–	1,706.8
Less mandatory deposits with Bank of England	49	<b>(36.1)</b>	–	<b>(36.1)</b>	(34.0)	–	(34.0)
Loans and advances to banks	26	<b>1,478.7</b>	–	<b>1,478.7</b>	462.5	–	462.5
Short term investments		<b>230.2</b>	–	<b>230.2</b>	252.0	–	252.0
Cash and cash equivalents per balance sheet		–	<b>400.0</b>	<b>400.0</b>	4.8	346.9	351.7
Amounts due to credit institutions		<b>(6.3)</b>	–	<b>(6.3)</b>	(8.4)	–	(8.4)
		<b>3,402.1</b>	<b>400.0</b>	<b>3,802.1</b>	2,383.7	346.9	2,730.6

Cash and cash equivalents include deposits of £61.1m (2009: £67.1m) held in trustee-administered bank accounts of the Society, which can only be utilised to meet liabilities in respect of funeral bonds issued. Provisions for these liabilities are included in trade and other payables (see note 34).



# Accounting policies

## Policies applicable to all businesses

### 1. Accounting basis

The Co-operative Group Limited is an Industrial and Provident Society domiciled in England and Wales. The address of the Society's registered office is New Century House, Manchester M60 4ES.

The Group accounts have been prepared in accordance with the Industrial and Provident Societies Acts 1965 to 2002, the Industrial and Provident Societies (Group Accounts) Regulations 1969, and applicable International Financial Reporting Standards as endorsed by the EU (IFRS) for the year ended 1 January 2011. They consolidate the accounts of Group undertakings at the year end and, as permitted by statute and IAS 1, the financial statement formats have been adapted as necessary to give a fair presentation of the state of affairs and result of the Group. As allowed by Industrial and Provident Society statute, a separate set of financial statements for the Society are not included.

The financial statements follow the provisions of the Revised Statement of Recommended Practice on Accounting for Insurance Business (SORP) issued by the Association of British Insurers in 2005 (as amended in December 2006), insofar as these are compatible with the requirements of IFRS.

The accounts are presented in pounds sterling. They are prepared under the historical cost basis as modified by the revaluation of available for sale financial assets, financial assets and liabilities valued at fair value through profit or loss, derivative financial instruments, certain items of property, plant and equipment, biological assets, investment properties and, where applicable, assets held for sale and disposal groups.

The Group's operations comprise two key divisions: Trading Group (which is broken down into further reportable segments and includes the Group's corporate function) and Financial Services (which is also broken down into further segments such as Retail and CAM). Each of these divisions is material in itself and operates in very different industry sectors and regulatory environments.

The conventional financial statement formats for the Financial Services operations differ from those of the Trading Group. In order to reflect the performance of the Group as a single economic entity, the revenue of the Banking and Insurance Divisions, as defined in accounting policies 26, 27 and 30, has been included as revenue in the consolidated income statement. Operating expenses are analysed by nature, as defined by IAS 1. The segmental note analysis also separately discloses Group operating costs that relate to all three businesses. As permitted by IAS 1 in the case of diverse groups such as The Co-operative Group, a mixed presentation has been applied to the balance sheet: the assets and liabilities

of the Trading Group are analysed as current or non-current, the assets and liabilities of Financial Services are analysed in order of liquidity. Similarly, the cash flow statements of the Trading Group and Financial Services Divisions have been presented separately because of the differing nature of their operations. The reconciliations to cash from operating activities in notes 45 and 46 have been performed separately for Trading Group and Financial Services. These reconciliations are from operating profit in order that the cash flows of these operations can be linked more easily to their results as disclosed in the segmental analysis in note 1. Investment properties held by the long term business to earn long term rentals or for long term capital appreciation are included within Investments in the Financial Services assets.

The accounting policies set out below have been applied consistently to all periods presented in these financial statements, except where stated otherwise.

### Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages 8 to 36. The financial risks facing the Group, its liquidity position and borrowing facilities are described principally in note 52 to the accounts. In addition, notes 52 and 53 also include the Group's objectives, policies and processes for managing its capital, its financial risk management objectives and its financial instruments and hedging activities.

As noted in the Statement on Going Concern on page 53, the directors are required to assess whether the Society has adequate resources to continue in operational existence for the foreseeable future. In forming this view, the directors have considered the Trading Group and the Financial Services businesses (CFS) separately and then the Group as a whole.

The Trading Group has detailed procedures for assessing its capital and funding requirements, which are monitored regularly. Following the refinancing in 2008 to fund the Somerfield acquisition, the Trading Group meets its day to day working capital needs through a number of facilities totalling £2,090m. Capital repayments in relation to committed facilities commence in August 2011 with £100m repayable in 2011 and 2012. The remainder of the committed facilities are due for repayment between July 2013 and December 2018. The Trading Group has prepared detailed forecasts and projections for the period to July 2012 which, taking account of reasonably possible changes in trading performance in the current economic environment, show that the Trading Group is able to operate within the level of its current available facilities.

The Insurance business (covering both General and Life Insurance) is required to maintain a sufficient buffer over regulatory capital requirements in order to

continue to be authorised to carry on its business. The forecasts and objectives, taking into account a number of potential changes in trading performance, insurance and investment risk, show that the Insurance business should be able to operate at an adequate level of regulatory capital for the foreseeable future. The Insurance business has also considered a number of stress tests on capital and these provide assurance that it is sufficiently capitalised.

The Co-operative Bank meets its day-to-day liquidity requirements through managing both its retail and wholesale funding sources, and is required to maintain a sufficient buffer over regulatory capital requirements in order to continue to be authorised to carry on its business. The Bank's forecasts and objectives, taking into account a number of potential changes in trading performance and funding retention, show that the Bank should be able to operate at adequate levels of both liquidity and capital, for the foreseeable future. The Bank has also considered a number of stress tests on capital and liquidity and these provide assurance that the Bank is sufficiently capitalised and is comfortably in excess of liquidity stress tests.

Taking all these elements of the Group together, and after making all appropriate enquiries, the directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future and they continue to adopt the going concern basis in preparing the Group's financial statements.

### Critical accounting estimates and judgments in applying accounting policies

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

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

## Accounting policies continued

Judgments made by management in the application of IFRS that have significant effect on the financial statements and estimates with a significant risk of material adjustment in the next year are described in the following notes stated below:

- Pension assumptions (note 21)
- Provision for claims (note 35)
- Goodwill and impairment (note 17)
- Closure and restructuring provisions (notes 35 and 44)
- Ultimate liability from claims made under insurance contracts (note 29)
- Estimate of future benefit payments from long term insurance contracts (note 29)
- Fair value of investment contracts (note 40)
- Fair value of unlisted financial assets (note 52)
- Co-operative Bank impairment provision on loans and advances and structured investments (note 3)
- Co-operative Bank effective interest rate (Accounting policy 27 – Revenue recognition).

The Co-operative Group has applied all endorsed IFRSs that are effective for the Group's financial statements for the year ended 1 January 2011 and the comparative period.

### Restatement and changes in accounting policies

In accordance with IFRS 5, the income statement comparatives have been restated to show the results of businesses that have become discontinued in the current accounting year. More details of this are shown in note 14.

To show a fairer representation of the result of the CIS business, the Group now offsets the investment income made in note 7 within operating expenses. In prior years, the investment income was added to operating income. As a result, the 2009 balances have been restated to reflect this. There has been no impact on the reported profit or on net assets.

The Group has now adopted IFRS 3 *Business Combinations (2008)* and IAS 27 *Consolidated and Separate Financial Statements (2008)*. No significant acquisitions have occurred since adoption; however the Group is now applying these revised standards to any non-controlling interest buy-outs from previous acquisitions.

The Group has also adopted the following amendments to standards, interpretations and improvements in 2010 which have not had a significant impact on the Group's financial statements:

- Amended IAS 27 Consolidated and Separate Financial Statements (2008)
- The amendments to IAS 39 Financial Instruments: Recognition and Measurement
- IFRIC 17 Distribution of non-cash Assets to Owners
- IFRIC 18 Transfers of Assets from Customers
- Improvements to IFRSs 2009

### Standards, amendments and interpretations issued but not yet effective

The Group has not early adopted the following standards and statements which have been endorsed by the EU, but are not yet effective. The adoption of these standards is not expected to have a material impact on the Group's accounts when adopted, except where stated:

In August 2009, IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* was issued. This interpretation deals with the accounting involved when renegotiating debt instruments into equity instruments. The interpretation is effective for annual periods beginning on or after 1 July 2010 and it is expected that this will not have a significant impact on the Group's financial statements.

In November 2009, the IASB issued amendments to IAS 24 *Related Parties Disclosures*. These amendments changed the definition of related parties. The standard is effective from 1 January 2011 and it is expected that these amendments will not have a significant impact on the Group's financial statements.

In November 2009, the IASB issued *Prepayments of a Minimum Funding Requirement* (Amendments to IFRIC 14). Without the amendments, in some circumstances entities are not permitted to recognise as an asset some voluntary prepayments for minimum funding contributions. The amendments are effective for annual periods beginning 1 January 2011 and must be applied retrospectively. These amendments will not have a significant impact on the Group's financial statements.

In May 2010, the IASB issued Improvements to IFRSs 2010, which comprises amendments to 7 standards. Effective dates, early application and transitional requirements are addressed on a standard-by-standard basis. The majority of the amendments will be effective for the Group from 1 January 2011. The amendments are unlikely to have a material impact on the Group's financial statements.

In October 2010, the IASB reissued IFRS 9, incorporating new requirements on accounting for financial liabilities, and carrying over from IAS 39 the requirements for derecognition of financial assets and financial liabilities. IFRS 9 has not yet been endorsed by the European Union, but if endorsed, the standard will be effective for periods beginning on or after 1 January 2013 and will have a significant effect on the Group's financial statements. The Group does not plan to judge the extent of this impact until after IFRS 9's endorsement.

### Underlying profit before payments to and on behalf of members

This measure is used in order to provide a clear and consistent presentation of the underlying performance of the Group's ongoing business for the members. This measure is not defined by IFRSs, and therefore may not be directly comparable with the 'adjusted' profit measures of other societies or companies. The adjusted items are:

- Profit or loss on disposal of properties (notes 1 & 6);
- Significant items (accounting policy 6);
- Change in value of investment properties (notes 1 & 6);
- Fair value movements on loans and borrowings (note 10);
- Net financial income (which mainly relates to pension interest receivable) (note 11)
- Fair value amortisation (note 3)
- CFS short term investment fluctuations (note 1 and accounting policy 35)
- CFS Financial Services Compensation Scheme ('FSCS') Levies (notes 1 & 3)

### 2. Accounting dates

The financial statements are made up for the 52 weeks to 1 January 2011. Comparatives are for the 51 weeks to 2 January 2010. Since the financial year is virtually co-terminus with the calendar year 2010, the financial year figures are headed 2010 and the corresponding figures for the previous period are headed 2009.

The comparative amounts are not entirely comparable with the results of 2010 as they are based on a shorter period.

The Financial Services subsidiaries of the Group have prepared accounts with accounting periods ending 31 December. This differs from the parent of the Group and other Trading Group subsidiaries which have accounting periods ending on the first Saturday of each new year. For the year ending 1 January 2011, there are no significant transactions or events which need to be adjusted for to reflect the difference in reporting dates.

### 3. Basis of consolidation

The consolidated financial statements include the Society and its subsidiary undertakings.

Subsidiaries are those entities controlled by the Group. Control exists when the Society has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that are presently exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. The consolidated financial statements include the Group's share of the total comprehensive income of associates on an equity accounted basis, from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its interest in an associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of an associate.

### 4. Transfer of engagements accepted from incoming societies

Assets and liabilities accepted under a transfer of engagements are restated at fair value, including any adjustments necessary to comply with the accounting policies of the Group. See accounting policy 10 for more details on the calculation of goodwill under transfer of engagements.

### 5. Financial expenses

Financial expenses exclude interest in respect of Banking activities, which is shown within operating expenses.

### 6. Significant items

Non recurring items outside the normal operating activities of the Group that are material by both size and, nature are treated as significant items and disclosed separately on the face of the income statement.

The separate reporting of significant items helps provide an indication of the Group's underlying business performance. Events which may give rise to the classification of items as significant include individually significant restructuring and integration costs.

### 7. Derivatives and other financial instruments

Information in respect of derivatives and other financial instruments has for clarity been presented separately for the Trading Group, Banking and Insurance divisions. The policies applied are consistent across the Group.

#### Trading activities

##### Financial instruments (excluding derivatives)

The Trading Group classifies its financial assets and liabilities (excluding derivatives) as either:

#### 1. Loans and receivables

Loans and receivables are initially recognised at fair value, being cost inclusive of attributable transaction costs; and are subsequently carried at amortised cost using the effective interest method.

#### 2. Available for sale

Available for sale financial assets are equity investments, intended to be held for an indefinite period of time. These are measured at fair value with movements in the carrying value brought into other comprehensive income as they arise, except for changes in value arising from impairment, which are recognised in the income statement. On disposal, gains and losses recognised previously in other comprehensive income are transferred to the income statement. The fair value of equity investments is their quoted market price (bid value) at the balance sheet date.

#### 3. Financial assets and liabilities at fair value through profit or loss

These are:

- acquired or incurred principally for the purpose of selling or repurchasing in the near term;
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit taking; or
- upon initial recognition designated at fair value through profit or loss to eliminate or significantly reduce a measurement of recognition inconsistency.

These are measured at fair value with movements in the carrying value brought into the income statement as they arise.

No assets are classified as held to maturity.

The Trading Group measures all of its financial liabilities (excluding derivatives) at amortised cost, except quoted debt, which is measured at fair value through profit or loss.

The quoted debt is designated at fair value through profit or loss because this significantly reduces a measurement inconsistency (accounting mismatch) that would arise from measuring interest rate swaps or recognising gains and losses on them on different bases. There are a number of interest rate swaps whose execution and maturity dates link into the quoted debt.

Also, this group of financial assets and/or liabilities is managed and its performance is evaluated on a fair value basis in accordance with the risk management strategy.

#### Derivative financial instruments

The Trading Group uses derivative financial instruments to provide an economic hedge to its exposure to foreign exchange and interest rate risks arising from operational, financing and investment activities. In accordance with its treasury policy, the Trading Group does not hold or issue derivative financial instruments for trading purposes.

Derivatives entered into include swaps and forward rate agreements. Derivative financial instruments are measured at fair value and any gains or losses are included in the income statement.

Fair values are based on quoted market prices in active markets, and where these are not available, using valuation techniques such as discounted cash flow models. For further details refer to note 52.

Interest payments or receipts arising from interest rate swaps are recognised within net financial income/(expenses) in the period in which the interest is incurred or earned.

#### Banking activities

##### Financial instruments (excluding derivatives)

The Bank classifies its financial assets (excluding derivatives) as either:

- loans and receivables;
- available for sale; or
- financial assets at fair value through profit or loss.

No assets are classified as held to maturity.

The Bank measures all of its financial liabilities at amortised cost, other than those within the wholesale trading portfolio, which are measured at fair value through profit or loss.

## Accounting policies continued

### 1. Loans and receivables

Loans and receivables to customers and banks (except for specific assets designated at fair value through profit or loss – see below) are measured at amortised cost, being the amount advanced plus any unpaid interest, commissions and fees charged to the customer less amounts repaid or written off; less impairment provisions for incurred losses and adjusted for the cumulative amortisation arising from effective interest rate adjustments. Effective interest rate adjustments arise when future cash flows are discounted through the expected life of the financial instrument.

### 2. Available for sale

Available for sale financial assets are non-traded investment securities, intended to be held for an indefinite period of time. These are measured at fair value based on current bid prices where quoted in an active market. Where there is no active market or the securities are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques.

Movements in fair value are recorded in equity as they occur. On disposal, gains and losses recognised previously in equity are transferred to the income statement.

### 3. Financial assets at fair value through profit or loss

These are:

- acquired or incurred principally for the purpose of selling or repurchasing in the near term;
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short term profit taking; or
- upon initial recognition designated at fair value through profit or loss to eliminate or significantly reduce a measurement or recognition inconsistency.

These include pledged assets and derivative financial instruments that are not designated as effective hedges.

These are measured at fair value based on current bid prices where quoted in an active market. Where there is no active market or the securities are unlisted the fair values are based on valuation techniques including discounted cashflow analysis, with reference to relevant market rates, and other commonly used valuation techniques. Gains and losses arising from changes in the fair value are brought into the income statement as they arise.

### Financial asset and liability classification

The Co-operative Bank's accounting policies provide scope for assets and liabilities designated at inception into different accounting categories in certain circumstances as outlined above and defined as follows:

- In classifying financial assets and liabilities as 'trading', The Co-operative Bank has determined that it meets the description of trading assets for those assets and liabilities it acquires or incurs principally for the purpose of selling or repurchasing in the near term, or holds as part of a portfolio that is managed together for short term profit or position taking as set out in 3 above.
- In designating financial assets or liabilities at fair value through profit or loss, The Co-operative Bank has determined that it has met one of the criteria for this designation as set out in 3 above.
- In classifying assets as loans and receivables at amortised cost, The Co-operative Bank has determined it meets the description as set out above.

The Co-operative Bank makes estimates and assumptions that affect the reported assets and liabilities. Critical estimates and judgments are continually assessed and reviewed, and are based on historical experience and reasonable expectations of future events.

### Impairment provision

At the balance sheet date, the Bank assesses its financial assets (including loans and advances to customers, but excluding assets measured at fair value through profit or loss) for objective evidence that an impairment loss has been incurred.

The amount of the loss is the difference between:

- the asset's carrying amount
- the present value of estimated future cash flows (discounted at the asset's original or variable effective interest rate).

The amount of the impairment loss is recognised immediately through the income statement and a corresponding reduction in the value of the financial asset is recognised through the use of an allowance account.

The written-down value of the impaired loan is compounded back to the net realisable balance over time using the original effective interest rate. This is reported through interest and similar income within the income statement and represents the unwind of the discount.

A write-off is made when all or part of a claim is deemed uncollectable or forgiven after all the possible collection procedures have been completed and the amount of loss has been determined.

Write-offs are charged against previously established provisions for impairment or directly to the income statement. Any additional recoveries from borrowers, counterparties or other third parties made in future periods are offset against the write off charge in the income statement once they are virtually certain to be received. Provisions are released at the point when it is deemed that the risk of loss has reduced to the extent that a provision is no longer required.

Impairment losses on available for sale assets are recognised by transferring the difference between the amortised cost and current fair value out of equity to profit or loss. When a subsequent event causes the amount of impairment loss on an available for sale debt security to decrease, the impairment loss is reversed through profit or loss.

### Derecognition

Financial assets are derecognised when:

- the rights to receive cash flows from the asset have ceased; or
- the Bank has transferred substantially all the risks and rewards of ownership of the assets.

When available for sale financial assets are derecognised (or impaired) the cumulative gain or loss, including that previously recognised in reserves, is recognised in the income statement.

### Financial liabilities

Financial liabilities are contractual obligations to deliver cash or some other asset. Financial liabilities are recognised initially at fair value, net of directly attributable transaction costs.

Financial liabilities, other than derivatives and capital bonds, are subsequently measured at amortised cost

Certain non-derivative financial liabilities included within capital bonds have been designated at fair value upon initial recognition in the balance sheet. Changes in fair value are recognised through the income statement. The capital bonds are economically matched using equity linked derivatives, which do not meet the requirements for hedge accounting. Recording changes in fair value of both the derivatives and the related liabilities through the income statement most closely reflects the economic reality of the transactions. In doing so this accounting treatment eliminates a measurement inconsistency that would otherwise arise from valuing the capital bonds at amortised cost and the derivatives at fair value.



A financial liability is extinguished when the obligation is discharged, cancelled or expires. Any difference between the carrying amount of a financial liability extinguished and the consideration paid is recognised through the income statement.

### **Borrowed funds**

Borrowings are recognised initially at issue proceeds net of transaction costs incurred. Borrowings are subsequently stated at amortised cost; any difference between proceeds net of transaction costs and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method.

The Bank classifies capital instruments as financial liabilities or equity instruments in accordance with the substance of the contractual terms of the instruments. The Bank's preference shares are classified as financial liabilities as they carry the right to a fixed non-cumulative preferential dividend (further information is provided in note 42) and are subsequently presented in other borrowed funds. The dividends on these preference shares are recognised in the income statement as interest expense on an amortised cost basis using the effective interest method.

### **Offsetting**

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

### **Sale and repurchase agreements**

Securities sold subject to repurchase agreements (repos) are reclassified on the balance sheet as pledged assets when the transferee has the right by contract or custom to sell or repledge the assets. The liability to the transferee is also included on the balance sheet, in deposits from banks, other deposits or shares, as appropriate. The difference between sale and repurchase price is accrued over the life of the agreements using the effective interest rate method.

Securities purchased under agreements to re-sell (reverse repos) are classified as loans and advances to banks on the balance sheet, as appropriate.

Securities lent to counterparties are retained on the balance sheet.

Securities borrowed are not recognised on the balance sheet, unless they are sold to third parties, in which case the purchase and sale are recorded. The obligation to return them is recorded at fair value as a trading liability.

### **Derivative financial instruments and hedge accounting**

*Derivatives used for asset and liability management purposes:*

Derivatives are used to hedge interest and exchange-rate exposures related to non-trading positions. Instruments used for hedging purposes include swaps, forward-rate agreements, futures, options and combinations of these instruments. The Bank also uses equity derivatives to hedge the equity risks within its capital bonds.

*Derivative financial instruments are stated at fair value:* The gain or loss on re-measurement to fair value is recognised immediately in the income statement except where derivatives qualify for cash flow hedge accounting.

*Embedded derivatives:* A derivative may be embedded in another financial instrument, known as the host contract. Where the economic characteristics and risks of an embedded derivative are not closely related to those of the host contract, the embedded derivative is separated from the host and held on the balance sheet at fair value. Movements in fair value are posted to the income statement, whilst the host contract is accounted for according to the policy for that class of financial instrument.

*Cashflow hedges:* Where derivatives are designated as hedges of the exposure to variability in cash flows of a recognised asset and liability, or a highly probable forecast transaction, the portion of the fair value gain or loss on the derivative that is determined to be an effective hedge is recognised directly in equity. The ineffective part of any gain or loss is recognised immediately in the income statement.

Cumulative amounts recognised through equity are recycled to the income statement in the period in which the underlying hedged item matures and its associated gain or loss affects the income statement. When a hedging relationship is broken or the hedge becomes ineffective, the cumulative unrealised gain or loss remaining in equity continues to be held in equity, and is transferred to the income statement only when the forecast transaction is recognised. Fair values are based on quoted market prices in active markets, and where these are not available, using valuation techniques such as discounted cash flow models. For further details refer to note 52.

*Derivatives used for trading purposes:* Derivatives entered into for trading purposes include swaps, forward-rate agreements, futures, options and combinations of these instruments. Derivatives used for trading purposes are measured at fair value and any gains or losses are included in the income statement. The use of derivatives and their sale to customers as risk management products is an integral part of the Bank's trading activities. Fair values are based on quoted market prices in active markets, and where these are not available, using valuation techniques such as discounted cash flow models.

*Fair value hedge accounting for a portfolio hedge of interest rate risk:* As part of its risk management process the Bank identifies portfolios whose interest rate risk it wishes to hedge. The portfolios may comprise only assets, only liabilities or both assets and liabilities. The Bank analyses each portfolio into re-pricing time periods based on expected re-pricing dates, by scheduling cash flows into the periods in which they are expected to occur. Using this analysis, the Bank determines the amount it wishes to hedge and designates assets or liabilities from each portfolio as the hedged item.

The Bank measures the change in fair value of the hedged portfolio on a monthly basis. Provided that the hedge has been highly effective, the Bank recognises the change in fair value of each hedged item in the income statement with the cumulative movement in its value being shown on the balance sheet as a separate item. It is called fair value adjustment for hedged risk, either within assets or liabilities as appropriate. If the hedge no longer meets the criteria for hedge accounting, this amount is amortised to the income statement over the remaining average useful life of the hedge relationship.

The Bank measures the fair value of each hedging instrument monthly. The value is included in derivative financial instruments in either assets or liabilities as appropriate, with the change in value recorded in the income statement.

Any hedge ineffectiveness is recognised in the income statement as the difference between the change in fair value of the hedged item and the change in fair value of the hedging instrument.

*Mortgage commitments:* The Bank enters into derivative contracts to reduce the exposure to risk on mortgage commitments made (for example, where the Bank has made an irrevocable offer of a loan to a customer). Mortgage commitments and the corresponding derivative contracts are recorded at fair value with movements recognised in the income statement.

### **Insurance activities Investments**

*i) Financial assets designated as available for sale* CISGIL (CIS General Insurance Limited) classifies all holdings in debt securities as available for sale. Initial measurement is at fair value, being purchase price upon the date on which CISGIL commits to purchase plus directly attributable transaction costs. Subsequent valuation is at fair value with differences between fair value and carrying value recognised in equity as they arise. Any impairment losses and foreign exchange gains and losses are recognised in the income statement as they arise. On disposal, gains or losses previously recognised in equity are transferred to the income statement.

## Accounting policies continued

### ii) Financial assets at fair value through profit or loss

Investments, other than those in debt securities, are classified as financial assets at fair value through profit or loss within CISGIL. CIS designates investments backing long term business and shareholder reserves as financial assets at fair value through profit and loss on their initial recognition, other than loans secured by mortgages and advances to policyholders, advances to customers. Initial measurement is at fair value, being purchase price upon the date that CISGIL and CIS commit to purchase. Directly attributable transaction costs are expensed immediately on recognition. Subsequent valuation is at fair value with realised and unrealised gains and losses arising from changes in fair value of the financial assets included in the income statement in the period in which they arise.

### iii) Financial liabilities

Financial liabilities (other than investment contracts) primarily represent loans and borrowings. Initial measurement is at fair value, being consideration received plus any directly attributable transaction costs. Subsequently, financial liabilities are measured at amortised cost using the effective interest method. Financial liabilities (other than investment contracts) whose value is linked to the performance of and measured by reference to, the fair value of a matching portfolio of assets are designated at fair value through profit or loss at inception.

### iv) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than those that CIS intends to sell in the short term or that it has designated as at fair value through profit or loss. Loans and receivables are initially recognised at fair value, being cost inclusive of attributable transaction costs and subsequently carried at amortised cost using the effective interest method.

### v) Derivative financial instruments

Derivatives, although not traded in the same manner that the Bank trades derivatives, are accounted for as trading instruments. Derivatives are initially recognised at fair value on the date upon which the derivative contract is entered into and are subsequently re-measured at their fair value. Any resultant gain or loss is recognised in the income statement.

The fair value of listed investments is their quoted clean bid price at the balance sheet date. If the market for a financial asset is not active, fair value is established using appropriate valuation techniques. Financial instruments, assets and liabilities are recognised/derecognised by CIS/CISGIL on the date upon which it commits to purchase/sell the instruments.

CIS and CISGIL operate approved stock lending schemes whereby their securities are loaned to other institutions in accordance with the terms of

agreements with those institutions. Under these arrangements, ownership of the securities passes to the borrower but CIS/CISGIL has the right to demand the return of the loaned securities at any time. It also retains the right to receive the income to which it would have been entitled had the securities not been loaned. Accordingly, the securities continue to be recognised as investments in the balance sheet. CIS/CISGIL also participate in sale and repurchase (repo) arrangements in connection with its portfolio of government guaranteed securities (gilts). Under these arrangements, CIS/CISGIL sells gilts but is contractually obliged to repurchase them at a fixed price on a fixed future date. Securities that are the subject of repo arrangements at the balance sheet date are included in investments in the balance sheets at their bid value and the associated liability is recognised, being the capital amount owing under the repo arrangements.

CIS and CISGIL require all stock lending and repo transactions to be fully collateralised in an agreed form for their duration and equivalent collateral is returned at the completion of the loan period. Authorised collateral for stock lending arrangements comprises DBV or certificates of deposit. For repo arrangements, collateral is required in the form of cash.

### 8. Employee benefits

The Group operates defined benefit pension schemes whereby the benefits that employees receive on retirement depend on factors such as age, years of service and earnings.

A qualified actuary calculates the Group's net obligation in respect of the defined benefit schemes by estimating the amount of future benefits that employees have earned in return for their service to date. The benefit is then discounted to determine its present value, using a discount rate equal to the yield available as at the balance sheet date on appropriate AA credit-rated bonds. The net obligation is this value less the fair value of the scheme's assets.

The cost of benefits earned in return for service in the accounting period is calculated using the projected unit method and is recognised in the income statement. Benefit is attributed to periods of service under the plan's benefit formula. Where employee service will lead to a materially higher level of benefit in later years, benefit is attributed on a straight-line basis over the estimated remaining service life. The income statement also includes a cost in respect of the unwinding of the discount rate used to calculate the present value of the schemes' benefits and a credit in respect of the expected return on the schemes' assets.

When the benefits of the schemes are improved, the cost relating to past service is recognised immediately in the income statement.

Actuarial gains and losses that arise from experience adjustments and changes in actuarial assumptions

subsequent to 11 January 2004 are recognised in full in the Group's statement of comprehensive income. The charge to the income statement includes current service cost, past service cost, the interest cost of the scheme liabilities and the expected return on scheme assets.

The Group also operates small defined contribution schemes. Obligations for contributions to these plans are recognised as an employee benefit expense in the income statement in the periods during which services are rendered by employees.

### 9. Foreign currencies

Transactions in foreign currencies are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated into sterling at foreign exchange rates ruling at that date. Differences arising on translation are recognised in the income statement, except for differences on the translation of available for sale debt securities which are recognised in the statement of comprehensive income.

### 10. Intangible assets

#### i) Goodwill

In respect of acquisitions prior to 11 January 2004, goodwill is included on the basis of its deemed cost, which represents the amount recorded under previous UK GAAP.

Goodwill represents amounts arising on acquisition of subsidiaries, associates and joint ventures. In respect of business acquisitions that have occurred since 11 January 2004, goodwill represents the difference between the cost of the acquisition and the fair value of the identifiable assets, liabilities and contingent liabilities acquired.

Assets and liabilities accepted under a transfer of engagements are restated at fair value, including any adjustments necessary to comply with the accounting policies of the Group.

Goodwill is stated at cost less any accumulated impairment losses. Goodwill is allocated to cash-generating units and is not amortised but is tested annually for impairment. In respect of associates, the carrying value of goodwill is included in the carrying amount of the investment in the associate.

Negative goodwill arising on an acquisition is recognised directly in profit or loss.

For transfers of engagements on or after 3 January 2010, considerations transferred have been valued by reference to the fair value of the Group's interest in the acquiree using a valuation technique. The technique involves assessing the future net profit of the acquiree and then discounting to perpetuity using a discount rate that reflects current market assessment of the time value of money and risks specific to the acquiree.

Acquisition costs since 3 January 2010 are now expensed to the income statement when incurred.

Acquisitions of non-controlling interests on or after 3 January 2010 are accounted for as transactions with owners in their capacity as owners and therefore no goodwill is recognised as a result of such transactions. The adjustments to non-controlling interests are based on a proportionate amount of the net assets of the subsidiary. Previously, goodwill was recognised on the acquisition of non-controlling interests in a subsidiary, which represented the excess of the cost of the additional investment over the carrying amount of the interest in the net assets acquired at the date of the transaction.

#### ii) Software development

Costs incurred in the development of computer software for internal use are capitalised and classified as intangible assets where they are not an integral part of the related hardware and amortised over their useful life, which is generally three years.

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. Costs directly associated with the production of software products that are expected to generate economic benefits beyond one year are recognised as intangible assets. The expenditure capitalised includes direct employee costs. All other costs associated with developing or maintaining computer software programs are recognised within the income statement as an expense as incurred.

#### iii) Assets in the course of construction

Assets in the course of construction include directly attributable software development costs and purchased software that are not an integral part of the related hardware, as part of strategic projects that meet the capitalisation requirements under IAS 38 but have not been brought into use. The costs are held within the items in course of construction until the project has gone live or the related asset is brought into use. At that point it will be transferred out of this classification and will be amortised based on the useful economic life as defined by the intangible asset accounting policy specified in (ii).

#### iv) Customer lists

Customer lists represent the intrinsic value of the retail savings book in the Britannia Bank which was recognised on the transfer of engagement. The asset is being amortised over the estimated useful life of three years.

#### v) Other intangible assets

Other intangible assets include pharmacy licences and Deferred Acquisition Cost (DAC) assets that are acquired by the Group and are stated at cost less accumulated amortisation (see below) and impairment losses. Expenditure on internally generated goodwill and brands (except the brand generated as a result of Britannia Building Society transfer of engagement) is recognised in the income statement as an expense as

incurred. The Britannia brand was deemed to have a fair value on transfer of engagement and is subject to an annual impairment review.

#### vi) Subsequent expenditure

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

#### vii) Amortisation

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets. Goodwill and intangible assets with an indefinite useful life are systematically tested for impairment at each balance sheet date. Other intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

- Software development costs: 3–7 years
- Pharmacy licences: 20 years
- General Insurance DAC assets: Up to 1 year
- Long term business DAC assets (being the estimated life of a unit trust contract): Up to 6 years

#### 11. Property, plant and equipment

Where parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items of property, plant and equipment.

Cost includes purchase price plus any costs directly attributable to bringing the assets to the location and condition necessary for it to be capable of operating in the manner intended by management.

Depreciation is provided on the cost or valuation less estimated residual value of other tangible fixed assets (excluding freehold land) on a straight-line basis over the anticipated working lives of the assets.

Annual rates are, generally:

##### Property

- Freehold buildings 2%
- Leasehold property Period of lease (2% buildings)

##### Group plant

- Plant and machinery 7½% to 33⅓%
- Vehicles 15% to 33⅓% (Funeralcare vehicles are depreciated on a reducing balance basis of between 20% to 35%)

The residual value, if significant, is reassessed annually.

Freehold land that is subject to potential development is held as a separate class of property, plant and equipment and is carried at fair value. Movements in fair value are recognised in the statement of comprehensive income.

#### 12. Impairment

The carrying amounts of the Group's assets, other than assets held at fair value through profit or loss, biological assets, investment property, inventories and deferred tax assets, are reviewed at each balance sheet date and whenever there is any indication of impairment. If any such indication exists, the assets' recoverable amount is estimated.

For goodwill, and for assets that have an indefinite useful life and intangible assets that are not yet available for use, the recoverable amount is estimated at each balance sheet date.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to cash-generating units, and then to reduce the carrying value of other fixed assets.

An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent of the asset's carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

#### Calculation of recoverable amount

The recoverable amount is the greater of the fair value less costs to sell and value in use. Estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessment of the time value of money and risks specific to the asset.

#### 13. Leased assets

Leases where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Plant and vehicles acquired under finance leases are stated at an amount equal to the lower of fair value and the present value of the minimum lease payments at inception of the lease, less accumulated depreciation and any impairment losses.

Depreciation is provided on the same basis as for owned assets. Minimum finance lease payments are apportioned between the finance charge and the redemption of the outstanding liability. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Property held under operating leases that would otherwise meet the definition of investment property may be classified as investment property on a property by property basis. Where such leases are treated as investment properties, the assets are held at fair value and the leases are accounted for as finance leases.



## Accounting policies continued

Lease payments in respect of operating leases are charged to the profit and loss account on a straight-line basis over the period of the lease. Lease incentives received are recognised in the income statement as an integral part of the total lease expense and the aggregate benefit is recognised as a reduction of rental expense over the lease term on a straight-line basis.

For any leases where the Group is the lessor, the aggregate cost of incentives is recognised as a reduction of rental income over the lease term on a straight-line basis.

### 14. Discontinued operations and assets and liabilities held for sale

Non-current assets (or disposal groups comprising assets and liabilities) that are expected to be recovered primarily through sale rather than through continuing use are classified as held for sale. Immediately before classification as held for sale, the assets (or components of a disposal group) are remeasured in accordance with the Group's accounting policies. Thereafter generally the assets (or disposal group) are measured at the lower of their carrying amount and fair value less cost to sell. Any impairment loss on a disposal group is first allocated to goodwill, and then to remaining assets and liabilities on a pro rata basis, except that no loss is allocated to inventories, financial assets, deferred tax assets, employee benefit assets, investment property and biological assets, which continue to be measured in accordance with the Group's accounting policies. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

Discontinued operations are those operations that can be clearly distinguished from the rest of the Group, both operationally and for financial reporting purposes, that have either been disposed of or classified as held for sale and which represent a separate major line of business or geographical area or a subsidiary purchased with a view to resale. The Group's travel business has been classified as a discontinued operation following the announcement of its merger with Thomas Cook Group plc. The merger is expected to take place in the second half of 2011.

### 15. Bad and doubtful debts

The amount charged against operating profit comprises collective provisions against identifiable losses and, in the Banking activities, a collective provision to cover latent but unidentifiable losses due to doubtful debts. Both provisions are based on a year end appraisal of debtors, loans and advances on the basis of objective evidence that a loss has been incurred. Debtors, loans and advances are shown in the balance sheet after deducting these provisions. Debts are written off when there is no realistic prospect of further recovery of the amounts owing.

### 16. Income tax

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

An element of tax attributable to CIS comprises tax attributable to both policyholders' returns and shareholder's profit or loss. The returns and associated tax of the life business and its subsidiaries are attributable to the life policyholders. The profit or loss of the other than life insurance business is attributable to the shareholder.

### 17. Deferred taxation

Deferred tax is provided, with no discounting, using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: the initial recognition of assets or liabilities that affect neither accounting nor taxable profits, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

### 18. Dividends and payments to and on behalf of members

Shares issued by the Society are classified as debt or equity in accordance with the substance of the contractual rights and obligations conferred. All payments to holders of shares that are classified as debt, such as corporate investor shares, are charged to the income statement when the Society incurs the obligation to make such payments, and classified as financial costs.

Payments to members in their capacity as equity shareholders of the Parent Society, such as share interest, are treated as dividends, recognised as a liability when approved by the members in a general meeting and treated as an appropriation of profit.

Payments to non-members, or to equity shareholders in their capacity as customers or employees (rather

than as members), are treated as charges in the income statement. Where payments are non-contractual and distinguishable from the operating activities of the business, and payment is dependent on, and subject to, member approval in a general meeting, these payments are termed 'Payments to and on behalf of members', charged below operating profit (where material) and recognised when such payments are approved by the membership.

### 19. Segment reporting

Segmental information is presented so that each segment is a component of the Group which engages in business activities which it may earn revenue and incur expenses and whose operating results are regularly reviewed by the Group's Chief Executive Officer. The Group has not aggregated the financial results of certain segments as allowed under IFRS 8.

### 20. Cash and cash equivalents

Cash and cash equivalents comprise cash balances, call deposits and balances with an original maturity of three months or less. Bank overdrafts that are repayable on demand and form an integral part of the Group's cash management are included as a component of cash and cash equivalents for the purpose of the statement of cash flows.

### 21. Provisions

A provision is recognised in the balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

### 22. Biological assets

Biological assets are stated at fair value less estimated point-of-sale costs, with any resultant gain or loss recognised in the income statement. Point-of-sale costs include all costs that would be necessary to sell the assets, excluding costs necessary to get the assets to market.

### 23. Investment properties

Properties held for long term rental yields that are not occupied by the Group or property held for capital appreciation are classified as investment property. Investment property comprises freehold land and buildings. It is carried at fair value. Fair value is based on current prices in an active market for similar properties in the same location and condition, using the work of independent valuers. No depreciation is provided on these properties. Any gain or loss arising from a change in fair value is recognised in the income statement.

If an investment property becomes owner-occupied, it is reclassified as property, plant and equipment, and its fair value at the date of reclassification becomes its cost for subsequent accounting purposes. Similarly, transfers to the investment



property portfolio are made when owner-occupancy ceases and the property meets the criteria of an investment property under IAS 40. Prior to such a transfer the property is measured at fair value with any uplift recognised in the statement of comprehensive income.

#### 24. Inventories

Inventories are stated at the lower of cost, including attributable overheads, and net realisable value.

#### 25. Joint ventures

A joint venture is a contractual arrangement whereby the Group and one or more other parties undertake an economic activity that is subject to joint control. Joint control exists when the strategic financial and operating policy decisions relating to the activity require the unanimous consent of the parties sharing control.

The Group conducts its joint venture arrangements through jointly controlled entities and accounts for them using the equity method of accounting. Where the Group transacts with its jointly controlled entities, unrealised profits and losses are eliminated to the extent of the Group's interest in the joint venture.

### Policies applicable to banking activities

#### 26. Revenue – Banking

Revenue comprises interest receivable, fees and commissions receivable from customers.

#### 27. Revenue recognition Interest income

Interest income is recognised on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs, fees, discounts and premiums where appropriate. The EIR basis spreads the interest income over the expected life of the instrument. The EIR is the rate that, at the inception of the instrument, exactly discounts expected future cash payments and receipts through the expected life of the instrument back to the initial carrying amount. When calculating the EIR, the Group estimates cash flows considering all contractual terms of the instrument (for example prepayment options) but does not consider future credit losses.

On applying this approach to the mortgage portfolio, judgments are made in relation to estimating the average life of that portfolio. These judgments are made based on specific factors including product terms and historical repayment data. The estimates are updated in each reporting period to reflect actual performance. A key judgment area is the average life of the mortgage portfolio. A change in the average life by one year would have an increase of 0.2% in gross interest income.

#### Fees and commissions

Fee and commission income is predominantly made up of arrangement and other fees relating to loans and advances to customers that are included in the

effective interest calculation. Commitment fees received are accrued and included in the effective interest calculation upon completion or taken in full at the date the commitment period expires and completion does not occur.

All other fee and commission income that is not included in the effective interest calculation is recognised on an accruals basis as the service is provided.

Fees and commissions payable to introducers in respect of obtaining lending business, where these are direct and incremental costs related to the issue of a financial instrument, are included in interest income as part of the effective interest rate.

#### 28. Assets leased to customers – finance leases

Assets leased to customers are included within 'loans and advances to customers' and valued at an amount equal to the net investment in the lease, less any provisions for impairment. Income from assets leased to customers is credited to the income statement based on a pattern reflecting a constant periodic rate of return on the net investment in the lease.

#### 29. Insurance contracts

All financial guarantees in respect of intra-group funding between the Bank and its subsidiaries are treated as insurance contracts in accordance with IFRS 4.

### Policies applicable to the insurance activities

#### 30. Revenue – Insurance

Revenue comprises premium income arising from insurance and participating contracts.

#### 31. Revenue and income recognition Premium income from insurance and participating contracts

The accounting policy in relation to the revenue arising from insurance and insurance participating contracts is set out within the insurance-specific accounting policies (33 and 34).

#### Fee and commission income

Fees and commission received by CISGIL relate primarily to commission on outward reinsurance contracts and are earned over the lifetime of the related policy. Commission and fees in respect of fund management activity and sales of units are recognised in the period in which the services are provided.

#### Investment income

Interest income on assets at fair value through profit or loss is recognised in the income statement in operating expenses as it accrues on an effective interest basis. Where assets are designated as available for sale, income is recognised in the income statement based upon effective yield over the life of the asset, inclusive of any discount premium on purchase.

Dividend income is recognised in the income statement when the right to receive payment is established – this is the date on which the related investment is marked ex-dividend.

Rental income from investment properties is recognised in the income statement as it accrues.

#### 32. Classification of contracts

Contracts under which CIS/CISGIL accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary are classified as insurance contracts.

Contracts under which the transfer of insurance risk to CIS/CISGIL from the policyholder is not significant are classified as investment contracts.

A contract that qualifies as insurance remains an insurance contract until all the risks and obligations are extinguished or expire. However, an investment contract, classified as such on inception, could be reclassified as an insurance contract if it subsequently meets the definition provided above.

#### 33. General insurance business

All contracts of general insurance business are classified as insurance contracts. General insurance business is accounted for on an annual basis.

#### i) Claims

Claims paid are stated net of salvage and subrogation recoveries.

#### ii) Claims outstanding

Claims outstanding comprise provisions representing the estimated ultimate cost of settling:

- claims notified but not settled by the balance sheet date ('outstanding claims')
- claims incurred as a result of events prior to the balance sheet date but not notified as at that date ('IBNR' claims).

Provisions include attributable claims handling expenses. Claims provisions are set at a level such that no adverse run-off deviations are envisaged.

Adverse run-off deviations, which are material in the context of the business as a whole, are disclosed separately.

Anticipated reinsurance recoveries, and estimates of salvage and subrogation recoveries, are disclosed separately within assets under the headings of 'reinsurance assets' and 'insurance receivables and other assets' respectively.

#### iii) Unexpired risk provision

Additional provision is made for unexpired risks where the claims and expenses likely to arise after the end of the financial period in respect of contracts concluded before that date are expected to exceed the unearned premiums carried forward for those contracts. Provisions for unexpired risks are

## Accounting policies continued

calculated separately for categories of business managed together and are determined after taking account of future investment income.

Such provisions ensure that the carrying amount of liabilities less related deferred acquisition costs is sufficient to cover the estimated future cash flows including claims handling expenses, and therefore meets the minimum requirements of the liability adequacy test as set out in IFRS 4.

### iv) Acquisition costs

Costs directly associated with the acquisition of new business including commission payable are capitalised and amortised in accordance with the rate at which the gross premiums written associated with the underlying contract are earned.

### 34. Long term insurance business

#### i) Insurance and participating contracts

CIS has adopted FRS 27 'Life assurance', in so far as it is compatible with the requirements of IFRS. Accordingly, participating contract liabilities are stated on a realistic basis.

#### ii) Premiums

Premiums are accounted for on a due basis. For unit-linked business, the due date for payment is taken as the date the related liability is established.

#### iii) Claims

Claims incurred include maturities, deaths, surrenders and annuity payments. Maturity and annuity claims are recognised as they fall due for payment. Deaths and surrenders are accounted for upon notification. Consistent treatment exists between the recognition of a claim in the income statement and the calculation of future contractual liabilities. Claims incurred include related internal and external claims handling expenses.

#### iv) Long term business provision

The long term business provision is calculated having regard to the principles laid down in Chapter 1.2 of the Prudential Sourcebook for Insurers (INSPRU). It principally comprises the realistic value of CIS's participating contract liabilities and is calculated by determining asset shares and the cost of options guarantees and smoothing of investment returns. Major classes of non-participating business are valued using a gross premium valuation method. This approach meets the minimum requirements of the liability adequacy test.

Further details of the methods used to value long term business contract liabilities are given in note 52.

#### v) Participating contracts

A participating contract is one that gives the policyholder a right to receive, as a supplement to guaranteed minimum payments, additional payments:

(a) that are likely to form a significant portion of the total contractual payments,

(b) whose amount or timing is contractually at the discretion of the issuer; and that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company that issued the contracts.

#### vi) Unallocated Divisible Surplus (UDS)

CIS's long term business is transacted on a mutual basis and all surpluses arising on long term business are allocated, as appropriate, to participating contract holders. Its mutual status means that the long term business fund has no equity and the UDS represents amounts due to policyholders, the allocation of which is yet to be determined. Accordingly, the UDS is classified as a liability.

#### vii) Non-participating contracts

Insurance contracts without discretionary features are non-participating contracts. The value of future profits that are expected to arise on non-participating contracts (being the present value of future cash flows under these contracts) has been deducted when assessing the value of liabilities in respect of participating contracts.

#### viii) Non-participating Investment contracts

##### a) Liability measurement

The initial measurement amount of a financial liability is the fair value of the consideration received. The liabilities are designated at fair value at inception on the basis that the liabilities are managed on a fair value basis. Fair value is measured by reference to the carrying value of the assets supporting the liabilities.

##### b) Revenue

Amounts received from and paid to holders of investment contracts are accounted for as deposits received (or repaid) and are not included in premiums and claims in the income statement.

Other revenue associated with investment management and other services is recognised in the income statement in the period in which services are provided.

##### ix) Acquisition costs

Incremental costs incurred in the provision of investment management services are not deferred but are recognised when the related service is provided. Incremental costs directly related to the costs of acquiring new business in relation to unit trust management are deferred and recognised over the estimated contract life. The carrying amount is tested for impairment at each reporting date.

##### x) Reinsurance

Contracts with reinsurers that give rise to a significant transfer of insurance risk are accounted for as reinsurance contracts. Amounts recoverable under such contracts are recognised in the same period as the related claim. Amounts recoverable under reinsurance contracts are assessed for impairment at each balance sheet date. If objective

evidence of impairment exists, reinsurance assets are reduced to the level at which they are considered to be recoverable and an impairment loss is recognised in the income statement.

#### xi) Long term business profits

The whole of the profits of the long term business are applied for the sole benefit of the long term business policyholders. Similarly, any losses incurred within the fund are borne by the policyholders. This means that the segment trading result for the long term business is always nil.

### 35. Short term investment fluctuations (STIFs)

In managing its long term business, CIS assesses profit based upon a smoothed investment return as an internal measure and to determine a like-for-like result for year-on-year comparison. This involves determining expected longer-term rates of investment return and applying these to the fair value of investible assets. Any difference between the longer-term rate of return and the actual return is considered to represent a short term investment fluctuation.

## Policies applicable to Trading activities

### Revenue recognition

Gross sales is a non-GAAP measure representing the amounts receivable by the Group for goods and services supplied to customers, net of discounts but including VAT.

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured. Revenue is measured at the fair value of the consideration received, excluding discounts, rebates, VAT and other sales tax or duty. The following criteria must be met before revenue is recognised:

#### Sale of goods

Revenue is recognised at the point of sale.

#### Rental income

Rental income arising from operating leases on investment properties is accounted for on a straight-line basis over the lease term.

#### Dividends

Revenue is recognised when the Group's right to receive payment is established.

### 36. Funeral bonds

Funeral bond investments are held at fair value with movements in fair value included in financial income. A liability for the cost of funeral delivery is charged at the date of bond sale, based on the estimated third-party cost at the projected date of bond redemption. This is subject to a liability adequacy test at least annually. The liability is discounted and the unwinding of the discount is included in financial expenses. Other changes in the liability are included in operating profit.

# Notes to the financial statements

## 1. Operating segments

The Trading Group has 13 reportable segments, each of which offer different products and services. The results of each segment are reported to the Group Chief Executive every month. The Group has disclosed financial information for all segments and has not aggregated segments as allowed under IFRS 8.

A summary of the operations of each business unit can be found on pages 10 to 26.

	2010										
	Food Retail £m	Pharmacy £m	Funeral-care £m	Specialist businesses – retail & commercial (see page 80) £m	Estates £m	Farms £m	Corporate Member- ship and Federal £m	Total Trading Group £m	Financial Services (see page 83) £m	Group costs and other adjust- ments £m	Total £m
<b>Gross sales</b>	<b>8,209.3</b>	<b>785.3</b>	<b>319.8</b>	<b>501.0</b>	<b>35.7</b>	<b>32.8</b>	<b>1,285.6</b>	<b>11,169.5</b>	<b>2,542.6</b>	<b>(21.3)</b>	<b>13,690.8</b>
Less:											
Value Added Tax and premiums ceded to reinsurers	(689.3)	(14.0)	(3.8)	(52.1)	–	–	–	(759.2)	(45.5)	–	(804.7)
<b>Net revenue</b>	<b>7,520.0</b>	<b>771.3</b>	<b>316.0</b>	<b>448.9</b>	<b>35.7</b>	<b>32.8</b>	<b>1,285.6</b>	<b>10,410.3</b>	<b>2,497.1</b>	<b>(21.3)</b>	<b>12,886.1</b>
Including internal sales	7,520.0	771.3	316.0	501.3	35.7	57.9	4,950.6	14,152.8	2,497.1	(21.3)	16,628.6
Segment trading profit/(loss)	319.5	27.8	46.4	18.9	100.8	4.1	(58.2)	459.3	208.6	(2.9)	665.0
Internal rent, interest on working capital and Group operating costs	63.1	5.6	5.5	2.2	(81.9)	1.9	3.6	–	–	(40.2)	(40.2)
Underlying segment operating profit/ (loss)*	382.6	33.4	51.9	21.1	18.9	6.0	(54.6)	459.3	208.6	(43.1)	624.8
Change in value of investment properties	–	–	–	–	14.0	–	–	14.0	–	–	14.0
Property disposal losses	–	–	–	–	(7.5)	–	–	(7.5)	–	–	(7.5)
Financial Services Compensation Scheme levy	–	–	–	–	–	–	–	–	(11.5)	–	(11.5)
Short term investment fluctuations	–	–	–	–	–	–	–	–	0.4	–	0.4
Fair value amortisation	–	–	–	–	–	–	–	–	(14.2)	–	(14.2)
<b>Segment operating profit/(loss) before significant items</b>	<b>382.6</b>	<b>33.4</b>	<b>51.9</b>	<b>21.1</b>	<b>25.4</b>	<b>6.0</b>	<b>(54.6)</b>	<b>465.8</b>	<b>183.3</b>	<b>(43.1)</b>	<b>606.0</b>
Significant items (net)	(28.4)	–	–	–	–	–	(18.9)	(47.3)	(70.1)	–	(117.4)
<b>Segment operating profit/(loss) after significant items</b>	<b>354.2</b>	<b>33.4</b>	<b>51.9</b>	<b>21.1</b>	<b>25.4</b>	<b>6.0</b>	<b>(73.5)</b>	<b>418.5</b>	<b>113.2</b>	<b>(43.1)</b>	<b>488.6</b>
Net financial expenses											(75.0)
Share of profit of associates and joint ventures											0.8
Payments to and on behalf of members											(104.0)
<b>Profit before tax</b>											<b>310.4</b>
Additions to non-current assets	247.8	2.0	17.1	12.7	50.7	2.5	10.6	343.4	210.1	–	553.5
Depreciation	(210.0)	(9.1)	(16.0)	(6.1)	(2.0)	(1.5)	(6.5)	(251.2)	(30.6)	–	(281.8)
Amortisation	–	(24.5)	–	–	–	–	–	(24.5)	(27.6)	–	(52.1)
Total assets								6,553.1	69,475.9	–	76,029.0

## Notes to the financial statements continued

### 1. Operating segments continued

	2010						
	Specialist businesses – retail		Specialist businesses – commercial				Specialist businesses – retail & commercial
	Life Planning £m	Legal Services £m	Motors £m	Sunwin Services £m	E-store £m	Clothing £m	£m
<b>Gross sales</b>	<b>36.0</b>	<b>27.9</b>	<b>302.2</b>	<b>32.2</b>	<b>96.7</b>	<b>6.0</b>	<b>501.0</b>
Less:							
Value Added Tax	–	(3.7)	(35.6)	(3.1)	(8.8)	(0.9)	(52.1)
<b>Net revenue</b>	<b>36.0</b>	<b>24.2</b>	<b>266.6</b>	<b>29.1</b>	<b>87.9</b>	<b>5.1</b>	<b>448.9</b>
Including internal sales	<b>36.8</b>	<b>24.2</b>	<b>266.6</b>	<b>70.8</b>	<b>93.7</b>	<b>9.2</b>	<b>501.3</b>
Segment trading profit	<b>6.3</b>	<b>3.9</b>	<b>1.5</b>	<b>5.3</b>	<b>1.7</b>	<b>0.2</b>	<b>18.9</b>
Internal rent and interest on working capital	<b>(0.2)</b>	–	<b>1.4</b>	<b>0.3</b>	<b>0.4</b>	<b>0.3</b>	<b>2.2</b>
Underlying segment operating profit*	<b>6.1</b>	<b>3.9</b>	<b>2.9</b>	<b>5.6</b>	<b>2.1</b>	<b>0.5</b>	<b>21.1</b>
Change in value of investment properties	–	–	–	–	–	–	–
Property disposal losses	–	–	–	–	–	–	–
<b>Segment operating profit before significant items</b>	<b>6.1</b>	<b>3.9</b>	<b>2.9</b>	<b>5.6</b>	<b>2.1</b>	<b>0.5</b>	<b>21.1</b>
Significant items (net)	–	–	–	–	–	–	–
<b>Segment operating profit after significant items</b>	<b>6.1</b>	<b>3.9</b>	<b>2.9</b>	<b>5.6</b>	<b>2.1</b>	<b>0.5</b>	<b>21.1</b>
Additions to non-current assets	<b>0.2</b>	<b>5.3</b>	<b>3.2</b>	<b>3.8</b>	<b>0.1</b>	<b>0.1</b>	<b>12.7</b>
Depreciation	<b>(0.4)</b>	<b>(0.5)</b>	<b>(0.5)</b>	<b>(4.0)</b>	<b>(0.4)</b>	<b>(0.3)</b>	<b>(6.1)</b>
Amortisation	–	–	–	–	–	–	–

\* Underlying segment operating profit is segment operating profit before significant items, property disposals, the Financial Services Compensation levy, short term investment fluctuations, fair value amortisation and investment property valuation charges.

Federal operations (included within Corporate Membership and Federal) relate to the activities of a joint buying group that is operated by the Group for retail Co-operative Society members. All transactions between reportable segments are performed at arm's length. Internal rent is charged at an arm's length by the Property division dependent on usage of property. Interest on working capital is an internal charge to the businesses dependent on usage of working capital. It is charged by the Corporate Membership division. Internal rent and interest on working capital are deducted from the segment trading profit which the chief operating decision maker reviews. They are added back to reconcile to profit before tax. Sunwin Services provides cash in transit services to the Co-operative Bank. These transactions are eliminated from the Group's result.

Each segment derives its revenue and profits from the sale of retail goods and services. Pharmacy also derives revenue and profits from the manufacturing and distribution of medical products.

The results of the Group's travel business have been reported within the discontinued operations and therefore no longer appear in this analysis in the current or prior period.

The reporting lines of the Group's Farms business are now channelled through the Group's Food business. The Group has not aggregated this business within Food.

Additions to non-current assets excludes additions to financial instruments, deferred tax assets, post employment benefit assets and rights arising under insurance contracts.

The Group has no external revenue or non-current assets outside the United Kingdom, except non-current assets in the Tiajin Tasy Sants joint venture which had £nil revenue in the year (2009: £nil). The Group does not have a major customer who accounts for 10% or more of revenue.



**1. Operating segments** continued

	2009 (restated)										
	Food Retail £m	Pharmacy £m	Funeralcare £m	Specialist businesses – retail & commercial (see page 82) £m	Estates £m	Farms £m	Corporate Membership and Federal £m	Total Trading Group £m	Financial Services (see page 83) £m	Group costs and other adjustments £m	Total £m
<b>Gross sales</b>	7,732.4	757.9	290.8	394.4	33.4	23.8	1,271.5	10,504.2	2,057.3	(16.9)	12,544.6
Less:											
Value Added Tax and premiums ceded to reinsurers	(559.3)	(12.9)	(3.4)	(35.3)	–	–	–	(610.9)	(37.7)	–	(648.6)
<b>Net revenue</b>	7,173.1	745.0	287.4	359.1	33.4	23.8	1,271.5	9,893.3	2,019.6	(16.9)	11,896.0
Including internal sales	7,173.1	745.0	287.4	403.9	33.4	46.0	4,656.4	13,345.2	2,019.6	(16.9)	15,347.9
Segment trading profit/(loss)	240.7	22.1	38.7	11.8	84.7	2.6	(59.7)	340.9	177.2	(1.4)	516.7
Internal rent, interest on working capital and Group operating costs	46.4	7.8	5.0	2.3	(66.3)	1.6	3.2	–	–	(41.2)	(41.2)
Underlying segment operating profit*	287.1	29.9	43.7	14.1	18.4	4.2	(56.5)	340.9	177.2	(42.6)	475.5
Change in value of investment properties	–	–	–	–	3.5	–	–	3.5	–	–	3.5
Property disposal profits	–	–	–	–	36.1	–	–	36.1	–	–	36.1
Financial Services Compensation Scheme levy	–	–	–	–	–	–	–	–	(3.7)	–	(3.7)
Short term investment fluctuations	–	–	–	–	–	–	–	–	4.9	–	4.9
Fair value amortisation	–	–	–	–	–	–	–	–	99.1	–	99.1
<b>Segment operating profit/(loss) before significant items</b>	287.1	29.9	43.7	14.1	58.0	4.2	(56.5)	380.5	277.5	(42.6)	615.4
Significant items (net)	(26.0)	(2.3)	–	(0.1)	(0.3)	–	(20.5)	(49.2)	(53.8)	–	(103.0)
<b>Segment operating profit/(loss) after significant items</b>	261.1	27.6	43.7	14.0	57.7	4.2	(77.0)	331.3	223.7	(42.6)	512.4
Net financial expenses											(101.7)
Share of profit of associates and joint ventures											0.3
Payments to and on behalf of members											(107.1)
<b>Profit before tax</b>											303.9
Additions to non-current assets	229.8	34.5	15.6	6.2	13.0	6.7	–	305.8	357.7	–	663.5
Depreciation	(194.9)	(7.2)	(16.1)	(5.2)	(1.5)	(1.4)	(6.0)	(232.3)	(26.4)	–	(258.7)
Amortisation	–	(24.1)	–	(0.1)	–	–	–	(24.2)	(21.4)	–	(45.6)
Total assets								6,200.8	68,943.4	–	75,144.2

## Notes to the financial statements continued

### 1. Operating segments continued

	2009						
	Specialist businesses – retail		Specialist businesses – commercial				Specialist businesses – retail & commercial £m
	Life Planning £m	Legal Services £m	Motors £m	Sunwin Services £m	E-store £m	Clothing £m	
<b>Gross sales</b>	29.8	23.3	220.7	30.4	85.2	5.0	394.4
Less:							
Value Added Tax	–	(3.0)	(23.0)	(2.3)	(6.4)	(0.6)	(35.3)
Agency share of sales	–	–	–	–	–	–	–
<b>Net revenue</b>	29.8	20.3	197.7	28.1	78.8	4.4	359.1
Including internal sales	30.9	20.3	197.7	63.6	83.3	8.1	403.9
Segment trading profit	4.7	3.8	(2.4)	4.1	1.6	–	11.8
Internal rent and interest on working capital	(0.2)	–	1.4	0.4	0.4	0.3	2.3
Underlying segment operating profit*	4.5	3.8	(1.0)	4.5	2.0	0.3	14.1
Change in value of investment properties	–	–	–	–	–	–	–
Property disposal profits	–	–	–	–	–	–	–
<b>Segment operating profit before significant items</b>	4.5	3.8	(1.0)	4.5	2.0	0.3	14.1
Significant items (net)	–	–	–	(0.1)	–	–	(0.1)
<b>Segment operating profit after significant items</b>	4.5	3.8	(1.0)	4.4	2.0	0.3	14.0
Additions to non-current assets	0.3	0.1	0.3	4.8	0.6	0.1	6.2
Depreciation	(0.5)	(0.5)	(0.4)	(3.0)	(0.5)	(0.3)	(5.2)
Amortisation	–	(0.1)	–	–	–	–	(0.1)

**1. Operating segments** continued**CFS**

CFS has four reportable segments which are reviewed separately by the Group Chief Executive. For each of the business units, the Group Chief Executive reviews internal management reports every month. A summary of the operational and financial performance of Retail and CAM can be found on pages 14 to 17.

	2010					2009						
	Retail £m	CAM £m	Other Share- holder £m	Total Share- holder £m	Long term business £m	Total £m	Retail £m	CAM £m	Other Share- holder £m	Total Share- holder £m	Long term business £m	Total £m
Interest and similar income				<b>1,325.9</b>		<b>1,325.9</b>				952.0		952.0
Fee and commission income				<b>237.1</b>		<b>237.1</b>				217.6		217.6
Gross earned premiums				<b>495.9</b>	<b>483.7</b>	<b>979.6</b>				396.9	490.8	887.7
Premiums ceded to reinsurers				<b>(29.1)</b>	<b>(16.4)</b>	<b>(45.5)</b>				(21.5)	(16.2)	(37.7)
<b>Revenue</b>				<b>2,029.8</b>	<b>467.3</b>	<b>2,497.1</b>				1,545.0	474.6	2,019.6
<b>Underlying segment operating result</b>	<b>26.5</b>	<b>147.7</b>	<b>34.4</b>	<b>208.6</b>		<b>208.6</b>	5.6	122.6	49.0	177.2		177.2
Financial services compensation scheme levy				<b>(11.5)</b>		<b>(11.5)</b>				(3.7)		(3.7)
Short term investment fluctuations				<b>0.4</b>		<b>0.4</b>				4.9		4.9
Amortisation of fair value adjustments				<b>(14.2)</b>		<b>(14.2)</b>				99.1		99.1
<b>Segment operating result before significant items</b>				<b>183.3</b>		<b>183.3</b>				277.5		277.5
Significant items				<b>(70.1)</b>		<b>(70.1)</b>				(53.8)		(53.8)
<b>Operating result after significant items</b>				<b>113.2</b>		<b>113.2</b>				223.7		223.7

The whole of the profits of the long term business are applied for the sole benefit of the long term business policyholders. Similarly, any losses incurred within the fund are borne by the policyholders. This means that the segment trading result for the long term business is always nil. Within the segmental analysis and certain notes to the accounts, the CFS result is analysed between: Retail; CAM; Other Shareholder and long term business. Other Shareholder includes the results of CFS Management Services Limited, CFS Services Limited, CFS Limited and investment activity attributable to the Shareholder element of CIS Limited.

CFS monitor segment revenue only on a net basis (interest receivable net of interest payable). Therefore gross revenue is presented above at total CFS level and not on a segmental basis.

## Notes to the financial statements continued

### 2. Premiums – Financial Services

	2010 £m	2009 £m
<b>Gross premiums</b>		
Non-participation contracts	38.0	36.5
Participation contracts	445.7	454.3
General Insurance written premiums	574.2	424.3
Change in unearned premium provision	(78.3)	(27.4)
<b>Gross premium revenue</b>	<b>979.6</b>	887.7
<b>Outward reinsurance premiums</b>		
Non-participation contracts	(16.4)	(16.2)
Premium ceded	(27.6)	(23.2)
Change in unearned premium provision	(1.5)	1.7
<b>Premium ceded to reinsurers</b>	<b>(45.5)</b>	(37.7)
<b>Net earned premiums</b>	<b>934.1</b>	850.0
<b>Analysis of gross written premiums</b>		
Premiums under individual contracts	478.8	475.1
Premiums under Group contracts	4.9	15.7
	<b>483.7</b>	490.8
<b>Life contracts</b>		
Premiums from life assurance business	372.5	376.3
Premiums from pensions business	108.6	112.5
Premiums from permanent health business	2.6	2.0
	<b>483.7</b>	490.8
<b>General insurance contracts</b>		
Motor	333.8	239.9
Property	148.8	136.8
Other	13.3	20.2
	<b>495.9</b>	396.9



### 3. Operating expenses

	Trading Group		Financial Services		Group	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Cost of inventories sold	<b>(7,580.8)</b>	(7,300.5)	–	–	<b>(7,580.8)</b>	(7,300.5)
Interest expense and similar charges	–	–	<b>(1,102.7)</b>	(478.7)	<b>(1,102.7)</b>	(478.7)
Fee and commission expense (note 5)	–	–	<b>(116.8)</b>	(92.2)	<b>(116.8)</b>	(92.2)
Net claims paid and benefits (note 4)	–	–	<b>(1,244.4)</b>	(1,296.7)	<b>(1,244.4)</b>	(1,296.7)
Technical charges (includes change in reinsurance assets)	–	–	<b>(853.6)</b>	70.6	<b>(853.6)</b>	70.6
Unallocated divisible surplus (note 41)	–	–	<b>15.7</b>	(430.6)	<b>15.7</b>	(430.6)
Investment income (note 7)	–	–	<b>725.8</b>	757.0	<b>725.8</b>	757.0
Gains less losses arising from financial instruments and other assets (note 8)	–	–	<b>950.0</b>	467.3	<b>950.0</b>	467.3
Investment expenses and charges	–	–	<b>(92.7)</b>	(71.2)	<b>(92.7)</b>	(71.2)
Impairment losses on loans and advances	–	–	<b>(97.3)</b>	(116.1)	<b>(97.3)</b>	(116.1)
Impairment losses on investments	–	–	<b>1.5</b>	8.5	<b>1.5</b>	8.5
Financial Services Compensation levy (see page 87)	–	–	<b>(11.5)</b>	(3.7)	<b>(11.5)</b>	(3.7)
Employee benefits expense (note 21)	<b>(1,333.4)</b>	(1,316.5)	<b>(420.7)</b>	(332.4)	<b>(1,754.1)</b>	(1,648.9)
Depreciation and amortisation expense	<b>(275.7)</b>	(256.3)	<b>(58.2)</b>	(47.8)	<b>(333.9)</b>	(304.1)
Operating lease rentals	<b>(238.0)</b>	(141.1)	<b>(27.7)</b>	(20.7)	<b>(265.7)</b>	(161.8)
Subscriptions and donations	<b>(5.8)</b>	(4.4)	–	–	<b>(5.8)</b>	(4.4)
Auditors' remuneration and expenses (see detailed analysis on below)	<b>(1.4)</b>	(1.3)	<b>(2.7)</b>	(2.3)	<b>(4.1)</b>	(3.6)
Direct operating expenses of investment property:						
Generated rental income	<b>(1.7)</b>	(1.8)	<b>(2.6)</b>	(1.1)	<b>(4.3)</b>	(2.9)
Did not generate rental income	<b>(1.5)</b>	(0.8)	<b>(0.1)</b>	(0.1)	<b>(1.6)</b>	(0.9)
Other operating expenses	<b>(543.9)</b>	(574.1)	<b>(42.6)</b>	(312.2)	<b>(586.5)</b>	(886.3)
	<b>(9,982.2)</b>	(9,596.8)	<b>(2,380.6)</b>	(1,902.4)	<b>(12,362.8)</b>	(11,499.2)
Fair value amortisation (see page 86)	–	–	<b>(14.2)</b>	99.1	<b>(14.2)</b>	99.1
Total operating expenses	<b>(9,982.2)</b>	(9,596.8)	<b>(2,394.8)</b>	(1,803.3)	<b>(12,377.0)</b>	(11,400.1)
Significant items excluded from the above analysis are as follows:						
Restructuring costs					<b>(29.2)</b>	(39.2)
Integration costs					<b>(108.1)</b>	(111.5)
Goodwill and non-current asset impairment					–	(9.3)
Other costs					<b>(10.1)</b>	(5.4)
					<b>(147.4)</b>	(165.4)

The accounting policy on significant items is explained in the accounting policies section. Integration costs relate to the acquisition of Somerfield and transfer of engagements of Britannia in 2009. Restructuring costs include transformational changes to the Banking systems.

## Notes to the financial statements continued

### 3. Operating expenses continued

#### Auditors' remuneration and expenses

	Trading Group		CFS		Group	
	2010 £'000	2009 £'000	2010 £'000	2009 £'000	2010 £'000	2009 £'000
Audit of financial statements	<b>453</b>	621	<b>796</b>	968	<b>1,249</b>	1,589
Other services: amounts receivable by auditors and their associates in respect of:						
Audit of financial statements of subsidiaries pursuant to such legislation	<b>244</b>	334	<b>430</b>	428	<b>674</b>	762
Other services pursuant to such legislation	–	–	<b>202</b>	144	<b>202</b>	144
Other services relating to taxation	<b>353</b>	183	<b>53</b>	43	<b>406</b>	226
Services relating to information technology	<b>197</b>	40	<b>170</b>	115	<b>367</b>	155
Services relating to litigation	–	27	<b>6</b>	6	<b>6</b>	33
Services relating to recruitment and remuneration	–	–	–	–	–	–
Services relating to valuation and actuarial services	–	10	<b>25</b>	–	<b>25</b>	10
Services relating to corporate finance transactions entered into or proposed	–	20	<b>15</b>	77	<b>15</b>	97
All other services	<b>128</b>	33	<b>956</b>	477	<b>1,084</b>	510
<b>Total</b>	<b>1,375</b>	1,268	<b>2,653</b>	2,258	<b>4,028</b>	3,526

Services performed by the auditors relating to corporate finance transactions entered into which were capitalised by the Group and are not included in the above analysis were £nil for Banking (2009: £0.5m) and £nil for the Trading Group (2009: £nil).

#### Fair value amortisation

Britannia net assets have been restated to fair value on merger. This includes adjustments to reflect the interest rates charged and received on both assets and liabilities where a different rate may be prevalent in today's market. These adjustments unwind over future periods and in 2010 represent a net charge to the income statement of £14.2m (2009: credit of £99.1m).

#### CFS operating expenses

##### Impairment on loans and advances

The loan portfolios are reviewed on a continuous basis to assess impairment. In determining whether an impairment provision should be recorded, judgments are made as to whether there is objective evidence that a financial asset or portfolio of financial assets is impaired as a result of loss events that occurred after recognition of the asset and prior to the balance sheet date.

### 3. Operating expenses continued

- **Collective provisions**

Personal advances are identified as impaired by taking account of the age of the debt's delinquency, by product type. The provision is calculated by applying a percentage rate to different categories and ages of impairment debt. The provision rates reflect the likelihood that the debt in that category/age will be written off or charged off at some point in the future. The rates are based on historical experience and current trends, incorporate the effects of discounting at the customer interest rate and are subject to regular review. The provision is the product of the rate and the spot balance for the relevant arrears bucket.

- **Individual provisions**

Mortgage accounts are identified as impaired by taking account of the age of the debt's delinquency on a case-by-case basis based on arrears data held within the mortgages system. Individual provisions are raised on a case-by-case basis for each mortgage account in arrears. Each corporate account is assessed and allocated a 'risk grade' to enable the Bank to monitor the overall quality of its lending assets. Those of lesser quality, where the lending is potentially at risk and provisions for future loss may be required, are centrally monitored with specific management actions taken at each stage within laid down procedures and specific provisioning criteria. Provisions represent the likely net loss after realisation of any security.

#### **Investment securities**

Impairment has been assessed by:

- whether there is evidence that a loss event has occurred; and
- whether the loss event has a negative impact on future cash flows.

During the year there has been no further impairment of investment securities.

Further information on The Co-operative Bank's accounting policy on impairment is given on page 72.

#### **Financial Services Compensation Scheme levy**

The Financial Services Compensation Scheme (FSCS) provides compensation to customers of financial institutions in the event that an institution is unlikely, or is likely to be unable, to pay claims against it. As a result of a number of institutions' failures during 2008, the FSCS has borrowed £19.7bn on an interest only basis until March 2012 from HM Treasury in order to meet its obligations to the depositors. These borrowings are anticipated to be repaid wholly or substantially from the realisation of the assets of the failed institutions. The FSCS raises annual levies from the banking industry in order to meet its management expenses and compensation costs. The annual levies are based upon the individual institutions' proportion of protected deposits of the total market protected deposits at 1 January of each year. The Group has provided £20.9m for its share of levies that will be raised by the FSCS including the interest on the loan from HM Treasury in respect of the levy years to 31 March 2012. The provision includes estimates for the interest that the FSCS will pay on the loan and of the Group's market participation in the relevant periods.

At the date of these financial statements, it is not possible to estimate whether there will be ultimately additional levies on the industry, the level of the Group's market participation or other factors that may affect amounts or the timing of amounts that may ultimately become payable, nor the effect that such levies may have upon operating results in any particular periods.

## Notes to the financial statements continued

### 4. Net claims paid – General Insurance and Long term Business

	2010 £m	2009 £m
<b>Gross claims paid</b>		
Long term insurance contracts:		
– death benefits	127.0	134.7
– surrender benefits	391.6	470.7
– maturity claims	321.5	346.1
– annuity and other benefits	206.6	198.0
	<b>1,046.7</b>	1,149.5
General insurance contracts:		
– current and prior period claims	361.8	293.4
<b>Claims paid and benefits</b>	<b>1,408.5</b>	1,442.9
<b>Less recovered from reinsurers</b>		
Long term business:		
– death benefits	(9.9)	(11.7)
– annuity and other benefits	(139.5)	(121.9)
	<b>(149.4)</b>	(133.6)
General insurance:		
– current and prior period claims	(14.7)	(12.6)
<b>Amounts recovered from reinsurers</b>	<b>(164.1)</b>	(146.2)
<b>Net claims paid and benefits</b>	<b>1,244.4</b>	1,296.7

### 5. Fee and commission expense – Financial Services

	2010 £m	2009 £m
Commission	120.5	96.6
Change in deferred commission	(3.7)	(4.4)
	<b>116.8</b>	92.2

### 6. Operating income

	Trading Group		CFS		Group	
	2010 £m	2009 £m	2010 £m	2009 £m	2010 £m	2009 £m
Net (loss)/gain on disposal of property, plant and equipment	(7.5)	36.1	(0.8)	(1.5)	(8.3)	34.6
Change in value of investment property	14.0	3.5	(0.1)	3.5	13.9	7.0
Rental income of investment property	18.6	18.7	6.5	2.1	25.1	20.8
Other fee and commission income from Insurance activities	–	–	66.2	57.1	66.2	57.1
	<b>25.1</b>	58.3	<b>71.8</b>	61.2	<b>96.9</b>	119.5
Significant items excluded from the above analysis are as follows:						
Federal contribution to integration costs	30.0	–	–	–	30.0	–
Gain on disposals of stores to meet regulatory requirements relating to Somerfield acquisition	–	62.4	–	–	–	62.4
	<b>55.1</b>	120.7	<b>71.8</b>	61.2	<b>126.9</b>	181.9



**7. Investment income – Financial Services**

	2010 £m	2009 £m
<b>Financial assets</b>		
Interest income from debt securities at fair value through income or expense	<b>366.1</b>	357.3
Dividend income from equities at fair value through income or expense	<b>138.1</b>	138.0
Interest income from loans at amortised cost	<b>0.5</b>	0.6
Rental income from investment properties	<b>109.1</b>	118.2
Cash and cash equivalents interest income	<b>7.1</b>	14.2
Interest and similar income from deposits with credit institutions at fair value through income or expense	<b>0.2</b>	0.5
Interest income from available for sale financial assets		
Listed debt securities	<b>57.6</b>	55.8
Unlisted debt securities	<b>0.5</b>	0.4
Interest income from derivative financial instruments	<b>27.0</b>	63.8
Other	<b>19.6</b>	8.2
	<b>725.8</b>	757.0

**8. Gains less losses arising from financial instruments and other assets – Financial Services**

	2010 £m	2009 £m
Net gains/(losses) on remeasurement of financial and other assets at fair value through profit or loss		
Listed equities	<b>576.3</b>	944.8
Unlisted equities	<b>88.6</b>	42.9
Listed debt securities	<b>254.3</b>	58.8
Unlisted debt securities	<b>212.9</b>	(224.8)
Derivatives	<b>(76.8)</b>	(587.5)
Investment property – financial services	<b>101.9</b>	(1.8)
Net gains arising on available for sale listed debt securities	<b>5.7</b>	4.3
Foreign exchange net trading income	<b>–</b>	5.5
Net losses on remeasurement of financial liabilities at fair value through profit or loss	<b>(212.2)</b>	223.9
Other investments	<b>(0.7)</b>	1.2
	<b>950.0</b>	467.3

Property held for long term rental that is not occupied by CIS is classified as investment property and is included within investments for Financial Services. For further details refer to note 28.

**9. Financial expenses – interest payable**

	2010 £m	2009 £m
Loans repayable within five years	<b>(75.0)</b>	(90.6)
Loans repayable wholly or in part after five years	<b>(4.4)</b>	(16.5)
Corporate investor share interest	<b>(0.5)</b>	(0.8)
	<b>(79.9)</b>	(107.9)

**10. Financial expenses – fair value movement**

	2010 £m	2009 £m
Fair value movement on quoted debt	<b>(5.4)</b>	(32.8)
Fair value movement on interest rate swaps	<b>(19.1)</b>	(7.9)
Fair value movement on funeral bonds	<b>(4.8)</b>	(18.1)
Exchange gain on Yen borrowing/deposits and other forex contracts	<b>0.1</b>	24.3
	<b>(29.2)</b>	(34.5)

## Notes to the financial statements continued

### 11. Net financial income – other

	2010 £m	2009 £m
Net pension finance income	44.9	47.5
Unwinding of discount	(10.8)	(6.8)
	<b>34.1</b>	40.7

### 12. Payments to and on behalf of members

	2010 £m	2009 £m
To individual members	(54.9)	(54.5)
To employees who are members	(19.8)	(23.0)
To corporate members	(19.4)	(19.6)
Community distribution	(9.9)	(10.0)
Total payments to and on behalf of members	<b>(104.0)</b>	(107.1)

Full details of payments to members and proposed distributions relating to profits earned in 2010 are shown in the Financial Review on page 28.

### 13. Income tax expense

	2010 £m	2009 £m
Current tax charge	26.3	14.9
Deferred tax charge	26.6	93.7
Total tax excluding tax attributable to policyholders' returns	<b>52.9</b>	108.6
The tax charge/(credit) is represented by:		
Continuing business	63.5	118.5
Discontinuing business	(10.6)	(9.9)
	<b>52.9</b>	108.6

The tax on the Group's net profit before tax differs from the theoretical amount that would arise using the above standard rate of corporation tax of 28% (2009: 28%) as follows:

	2010 £m	2009 £m
Profit before tax	310.4	303.9
Current tax at 28% (2009: 28%)	86.9	85.1
Different basis of tax for UK life insurance – policyholder tax – current year	60.6	47.5
Different basis of tax for UK life insurance – policyholder tax – prior year	2.9	(41.1)
Different basis of tax for UK life insurance – accounting profit not subject to tax	(19.5)	–
Non-taxable profit on disposal of investments/assets	1.5	(16.3)
Expenses not deductible for tax (including significant items)	(5.1)	12.5
Depreciation and amortisation on non-qualifying assets	10.4	22.0
Non-taxable investment income	(3.8)	(5.1)
Adjustment in respect of previous periods	(21.1)	(2.6)
Preference dividend	1.6	1.6
Tax on sale of discontinuing activities	(10.6)	(9.9)
Foreign exchange	–	18.8
Losses taxed at lower rate	(3.6)	–
Restatement of deferred tax to 27%	(1.7)	(0.2)
Other	(1.6)	2.7
Income tax charge	<b>96.9</b>	115.0
Tax credit on discontinued operations	10.6	9.9
Income tax expense on continuing business	<b>107.5</b>	124.9
Less tax attributable to policyholders' returns	(44.0)	(6.4)
Total taxation on continuing businesses	<b>63.5</b>	118.5

**13. Income tax expense** continued**Tax on items taken directly to consolidated statement of comprehensive income**

	<b>2010</b> <b>Tax (expense)/</b> <b>benefit</b> <b>£m</b>	2009 Tax (expense)/ benefit £m
Changes in available for sale assets	–	(16.8)
Actuarial gains and losses on employee pension scheme	<b>(48.8)</b>	150.6
Effective portion of cash flow hedges transferred to the cash flow hedging reserve	<b>7.4</b>	13.5
Foreign currency translation differences for foreign operations	–	(0.1)
	<b>(41.4)</b>	147.2

Of the tax taken directly to the consolidated statement of comprehensive income, £55.2m relates to deferred taxation, as set out overleaf.

The Emergency Budget on 22 June 2010 announced that the UK corporation tax rate will reduce from 28% to 24% over a period of four years from 2011. The first reduction in the UK corporation tax rate from 28% to 27% was substantively enacted on 20 July 2010 and will be effective from 1 April 2011. This will reduce the Group's future current tax charge accordingly. The tax disclosures for the period reflect the deferred tax at the 27% substantively enacted rate. It has not yet been possible to quantify the full anticipated effect of the further 3% rate reduction, although this will further reduce the Group's future tax charge and reduce the Group's deferred tax assets and liabilities.

**Deferred taxation**

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 27% (2009: 28%).

	<b>2010</b> <b>£m</b>	2009 £m
At beginning of period	<b>47.3</b>	385.4
Income statement charge/(credit)		
– CIS Life Business	<b>17.8</b>	40.5
– Group (excluding CIS Life Business)	<b>26.6</b>	93.7
Charged to equity:		
Retirement benefit obligations (per above)	<b>48.9</b>	(150.6)
Other (per above)	<b>(1.0)</b>	(11.4)
Fair value on transfer of engagements – Plymouth & South West (note 47)	–	(3.7)
Fair value acquisition – Somerfield (note 48)	–	(182.0)
Fair value on transfer of engagements – Britannia (note 47)	–	(124.6)
At period end	<b>139.6</b>	47.3

The deferred tax charge in the income statement comprises the following differences:

	<b>2010</b> <b>£m</b>	2009 £m
Origination and reversal of temporary differences	<b>28.3</b>	(24.5)
Retirement benefit obligations	<b>27.2</b>	53.2
Unrealised appreciation on investments and rolled-over gains	<b>(0.7)</b>	(4.9)
Unrealised appreciation on investments	<b>(32.9)</b>	11.6
Utilisation of tax losses	<b>5.0</b>	5.0
Capital allowances on assets leased to customers	<b>(0.5)</b>	0.4
Capital allowances on fixed assets	<b>(4.1)</b>	44.2
Adjustments to tax charge in respect of previous periods	<b>8.0</b>	8.7
Change in tax rate to 27%	<b>(3.7)</b>	–
	<b>26.6</b>	93.7

## Notes to the financial statements continued

### 14. Loss on discontinued operations, net of tax

In October 2010, the Group announced that it would be merging its travel business with Thomas Cook Group plc in a new initiative. The venture will be 70% owned by Thomas Cook Group plc and 30% owned by the Group. As at 1 January 2011, the merger had not been completely ratified due to the current investigation by the Office of Fair Trading. The Group still considers the sale to be highly probable and therefore the travel businesses' results for the current and prior period have been included within the loss on discontinued operations. Discontinued operations in 2009 related to the disposal of a number of former Somerfield foodstores following local competition reviews by the Office of Fair Trading. A number of stores' results which were not sold in 2009 have also been included in the current year figure. A small proportion of the losses in both periods relate to the Group's former Department and Home Stores.

	2010 £m	2009 £m
<b>Results of discontinued operations</b>		
Net revenue	<b>428.2</b>	778.5
Expenses	<b>(464.8)</b>	(780.4)
Other operating income	<b>1.1</b>	2.4
Results from operating activities	<b>(35.5)</b>	0.5
Significant items	–	(25.7)
Interest payable	–	(9.8)
Share of losses of discontinued associates and joint ventures	<b>(2.0)</b>	–
Results from operating activities, net of income tax	<b>(37.5)</b>	(35.0)
Loss on sale of discontinued operations		
Income tax on discontinued operations	<b>10.6</b>	9.9
<b>Loss for the period</b>	<b>(26.9)</b>	(25.1)

Significant items in 2009 related to redundancies. The interest payable related to the interest on the bridging loan, which was directly attributable to the stores acquired with a view to resale.

The losses from the discontinued operations are attributable entirely to the owners of the Group.

The share of losses of discontinued associates and joint ventures relates to Co-operative Holidays Ltd (see note 19).

	2010 £m	2009 £m
Cash flows used in discontinued operations:		
Net cash from operating activities	<b>(7.2)</b>	(10.1)
Net cash from investing activities	<b>(7.8)</b>	(6.2)
Net cash used in financing activities	<b>(0.8)</b>	(10.3)
Net cash used in discontinued operations	<b>(15.8)</b>	(26.6)

Net consideration received by the Group on discontinued items sold in 2010 was £29.5m (2009: £475.8m). The consideration was entirely satisfied in cash in both periods.



## 15. Emoluments of directors

The total remuneration of the Group Board directors was as follows:

	2010 £000	2009 £000
Salaries	<b>786</b>	839
Payments to societies for directors' services	<b>18</b>	119
	<b>804</b>	958

Directors' emoluments fall into the ranges shown below:

	2010	2009
£nil to £5,000	<b>1</b>	–
£5,001 to £10,000	–	6
£10,001 to £15,000	<b>3</b>	10
£15,001 to £20,000	–	12
£20,001 to £25,000	<b>1</b>	3
£25,001 to £30,000	<b>6</b>	6
£30,001 to £35,000	<b>6</b>	1
£35,001 to £40,000	<b>2</b>	–
£40,001 to £45,000	–	–
£45,001 to £50,000	–	1
£50,001 to £55,000	–	–
£55,001 to £60,000	–	–
£60,001 to £120,000	<b>2</b>	–
£120,001 to £125,000	–	1
£125,001 to £130,000	–	–
£130,001 to £135,000	<b>1</b>	1
	<b>22</b>	41

Details of directors' and Executives' remuneration can be found on pages 52 to 57.

## 16. Property, plant and equipment

	Group	
	2010 £m	2009 £m
Trading Group	<b>2,463.3</b>	2,517.1
Financial Services	<b>169.2</b>	190.6
Total	<b>2,632.5</b>	2,707.7

	Group	
	2010 £m	2009 £m
The net book value of property comprises:		
Freehold	<b>1,431.6</b>	1,480.3
Long leasehold	<b>28.4</b>	28.3
Short leasehold	<b>18.1</b>	22.7
	<b>1,478.1</b>	1,531.3
Plant includes assets held under finance leases as follows:		
Cost	<b>29.5</b>	20.4
Accumulated depreciation	<b>(13.5)</b>	(3.9)
Net book value	<b>16.0</b>	16.5

## Notes to the financial statements continued

### 16. Property, plant and equipment continued For the year ended 1 January 2011

	Group		
	Property £m	Plant £m	Total £m
Cost or valuation:			
At 2 January 2010	<b>1,728.0</b>	<b>2,251.6</b>	<b>3,979.6</b>
Additions	<b>42.9</b>	<b>284.3</b>	<b>327.2</b>
Disposals	<b>(68.2)</b>	<b>(390.6)</b>	<b>(458.8)</b>
Transfer to/from assets held for sale	<b>(13.5)</b>	<b>(24.5)</b>	<b>(38.0)</b>
Other transfers	<b>28.0</b>	<b>(28.0)</b>	<b>–</b>
<b>At 1 January 2011</b>	<b>1,717.2</b>	<b>2,092.8</b>	<b>3,810.0</b>
Depreciation:			
At 2 January 2010	<b>196.7</b>	<b>1,075.2</b>	<b>1,271.9</b>
Charge for the year	<b>30.7</b>	<b>255.2</b>	<b>285.9</b>
Impairment	<b>3.4</b>	<b>14.0</b>	<b>17.4</b>
Disposals	<b>(16.3)</b>	<b>(369.2)</b>	<b>(385.5)</b>
Transfer to/from assets held for sale	<b>(3.4)</b>	<b>(8.8)</b>	<b>(12.2)</b>
Other transfers	<b>28.0</b>	<b>(28.0)</b>	<b>–</b>
<b>At 1 January 2011</b>	<b>239.1</b>	<b>938.4</b>	<b>1,177.5</b>
Net book value:			
<b>At 1 January 2011</b>	<b>1,478.1</b>	<b>1,154.4</b>	<b>2,632.5</b>
At 2 January 2010*	<b>1,531.3</b>	<b>1,176.4</b>	<b>2,707.7</b>

Within property, land of £49.1m is held at valuation (2009: £49.1m). The historical cost equivalent is £1.4m (2009: £1.5m). The impairment charge of £17.4m (2009: £5.8m) in the year related predominantly to loss making stores and depot closures relating to the rationalisation of the distribution network in the Food Retail business. No impairment charge went through the statement of other comprehensive income in the year (2009: £nil). Included within disposals are fully depreciated assets retired from business use. Other transfers represent fully depreciated leasehold improvements which have been transferred from plant to property.

\* The opening figures for cost and depreciation have been updated to include the £2.2m relating to assets held by discontinued businesses disclosed separately in the prior period.

**16. Property, plant and equipment** continued  
**For the period ended 2 January 2010**

	Group		
	Property £m	Plant £m	Total £m
Cost or valuation:			
At 10 January 2009	1,349.5	1,771.1	3,120.6
Additions	59.0	263.8	322.8
Arising on transfer of engagements	119.7	24.6	144.3
Business acquisitions	783.9	294.3	1,078.2
Business disposals	(487.4)	(17.1)	(504.5)
Transfer to investment properties	0.4	–	0.4
Transfer to/from assets held for sale	(46.9)	(1.2)	(48.1)
Other disposals and transfers	(47.9)	(83.9)	(131.8)
<b>At 2 January 2010</b>	<b>1,730.3</b>	<b>2,251.6</b>	<b>3,981.9</b>
Depreciation:			
At 10 January 2009*	215.7	933.8	1,149.5
Charge for the period	27.6	235.2	262.8
Impairment	2.3	3.5	5.8
Business disposals	–	–	–
Transfer to/from assets held for sale	(21.3)	(1.0)	(22.3)
Other disposals and transfers	(27.5)	(96.3)	(123.8)
<b>At 2 January 2010</b>	<b>196.8</b>	<b>1,075.2</b>	<b>1,272.0</b>
Less assets held by discontinued businesses	(2.2)	–	(2.2)
Net book value			
<b>At 2 January 2010</b>	<b>1,531.3</b>	<b>1,176.4</b>	<b>2,707.7</b>
At 10 January 2009*	1,130.3	837.3	1,967.6

\* Prior period closing net book value includes £3.5m of property assets held by discontinued businesses.

**17. Intangible assets**

	Group	
	2010 £m	2009 £m
Trading Group	<b>1,544.2</b>	1,575.9
Financial Services	<b>317.3</b>	216.8
Total	<b>1,861.5</b>	1,792.7
Deferred acquisition costs (see a below)	<b>57.4</b>	48.5
Other intangible assets (see b below)	<b>1,804.1</b>	1,744.2
<b>Total intangible assets</b>	<b>1,861.5</b>	1,792.7
<b>a) Deferred acquisition costs</b>		
At beginning of the period	<b>48.5</b>	40.0
Additions	<b>86.2</b>	77.2
Amortisation	<b>(77.3)</b>	(68.7)
<b>At end of the period</b>	<b>57.4</b>	48.5

Within the general insurance business, costs directly associated with the acquisition of new business, including commission, are capitalised and amortised in accordance with the rate at which the gross premiums written associated with the underlying contract are earned.

Long term insurance business deferred acquisition costs are no longer represented as an explicit asset under the realistic basis of reporting actuarial liabilities. Acquisition costs relating to investment contracts are recognised when incurred as the directors do not consider these costs to be recoverable from future income.

Other deferred acquisition costs of the long term business will be realised over a period of up to 6.8 years (2009: 6.5 years), being the expected term of a unit trust contract. Of the total value £13.6m (2009: £7.2m) is expected to be recovered after more than one year.

Incremental costs directly related to the costs of acquiring new business in relation to unit trust management are deferred and recognised in the same period as the related service income. The deferred costs are stated gross of a related deferred income liability (note 43). Amortisation is included within the fee and commission expense line item in the income statement.

## Notes to the financial statements continued

### 17. Intangible assets continued

#### b) Other intangible assets

#### For year ended 1 January 2011

	Group							Total £m
	Goodwill £m	Licences £m	Intellectual Property £m	Computer software £m	Customer lists £m	Brand £m	Assets in course of construction £m	
Cost:								
At 2 January 2010	1,275.0	503.2	0.8	89.1	44.0	2.0	96.0	2,010.1
Additions – acquired separately*	5.5	–	–	–	–	–	–	5.5
Additions – internally developed	–	–	–	3.1	–	–	110.7	113.8
Disposals	(3.6)	–	(0.8)	(9.7)	–	–	–	(14.1)
Transfers to held for sale (note 25)	(6.2)	–	–	–	–	–	–	(6.2)
Other transfers	–	–	–	57.0	–	–	(57.0)	–
<b>At 1 January 2011</b>	<b>1,270.7</b>	<b>503.2</b>	<b>–</b>	<b>139.5</b>	<b>44.0</b>	<b>2.0</b>	<b>149.7</b>	<b>2,109.1</b>
Amortisation:								
At 2 January 2010	133.6	68.6	0.3	59.7	3.7	–	–	265.9
Charge for the year	–	24.5	–	19.1	2.6	–	–	46.2
Impairment charge	0.1	3.1	–	–	–	–	–	3.2
Disposals	(0.8)	–	(0.3)	(9.2)	–	–	–	(10.3)
Other transfers	(3.8)	3.8	–	–	–	–	–	–
<b>At 1 January 2011</b>	<b>129.1</b>	<b>100.0</b>	<b>–</b>	<b>69.6</b>	<b>6.3</b>	<b>–</b>	<b>–</b>	<b>305.0</b>
Net book value:								
<b>At 1 January 2011</b>	<b>1,141.6</b>	<b>403.2</b>	<b>–</b>	<b>69.9</b>	<b>37.7</b>	<b>2.0</b>	<b>149.7</b>	<b>1,804.1</b>
At 2 January 2010	1,141.4	434.6	0.5	29.4	40.3	2.0	96.0	1,744.2

#### For period ended 2 January 2010

	Group							Total £m
	Goodwill £m	Licences £m	Intellectual Property £m	Computer software £m	Customer lists £m	Brand £m	Assets in course of construction £m	
Cost:								
At 10 January 2009	397.6	501.8	0.8	74.4	–	–	30.5	1,005.1
Arising on acquisitions	869.4	1.4	–	–	–	–	–	870.8
Arising on transfer of engagements	0.6	–	–	–	44.0	2.0	–	46.6
Additions – acquired separately	10.0	–	–	–	–	–	–	10.0
Additions – internally developed	–	–	–	3.2	–	–	83.7	86.9
Disposals	(2.6)	–	–	(3.8)	–	–	–	(6.4)
Transfers	–	–	–	15.3	–	–	(18.2)	(2.9)
<b>At 2 January 2010</b>	<b>1,275.0</b>	<b>503.2</b>	<b>0.8</b>	<b>89.1</b>	<b>44.0</b>	<b>2.0</b>	<b>96.0</b>	<b>2,010.1</b>
Amortisation:								
At 10 January 2009	126.5	44.5	0.2	45.8	–	–	–	217.0
Charge for the period	–	24.1	0.1	17.7	3.7	–	–	45.6
Impairment charge	7.3	–	–	–	–	–	–	7.3
Disposals	(0.2)	–	–	(3.8)	–	–	–	(4.0)
<b>At 2 January 2010</b>	<b>133.6</b>	<b>68.6</b>	<b>0.3</b>	<b>59.7</b>	<b>3.7</b>	<b>–</b>	<b>–</b>	<b>265.9</b>
Net book value								
<b>At 2 January 2010</b>	<b>1,141.4</b>	<b>434.6</b>	<b>0.5</b>	<b>29.4</b>	<b>40.3</b>	<b>2.0</b>	<b>96.0</b>	<b>1,744.2</b>
At 10 January 2009	271.1	457.3	0.6	28.6	–	–	30.5	788.1

The main components of the £1.14bn (2009: £1.14bn) of goodwill are Somerfield (£862m), Alldays (£86m), Conveco (£18m), and Balfour (£16m) within Co-operative Food, the non-controlling share purchase within Co-operative Legal Services (£15m) and Fairways (£10.5m) within Co-operative Funeralcare. The remaining goodwill largely represents a number of single store acquisitions (£41m) and small group acquisitions (£51m) in Food, £18m of pharmacies and smaller funeral branch acquisitions. Goodwill is not amortised but is subject to impairment reviews at least annually. Amortisation charges and impairment charges are recognised in operating expenses within the income statement.

\* Additions – acquired separately relates predominantly to the acquisition of the non-controlling interest in Co-operative Legal Services.



## 17. Intangible assets continued

### Goodwill

For the purposes of impairment testing of goodwill, the Group is regarded as several cash-generating units. Components of goodwill range from individual cash generating units, where stores were acquired individually, to groups of cash generating units, where groups of stores/branches were acquired as part of one transaction. Impairment testing is carried out at the level at which management monitor these components of goodwill. The impairment charge of £3.2m in the current period relates to the impairment of licences in Pharmacy branches (£3.1m) and goodwill in Food (£0.1m) following a review of the recoverable amount based on discounted future cash flows expected to be generated from the stores/branches. The impairment charge of £7.3m in 2009 related to Food (£1.4m), Travel (£3.9m) and Pharmacy (£2.0m). No impairment charge went through the statement of other comprehensive income in the period (2009: £nil).

In the Trading businesses, the cash-generating units' recoverable amounts are based on value in use using projections of the Group's performance based on the three-year plans approved by the Board. The discount rate is based on the cost of capital for each business and calculations range from 7.5 – 12% (2009: 7.5 – 12%). Business-specific growth rates are used to extrapolate cash flows beyond the three-year plan. The cash flows for each business have been risk adjusted as appropriate to their respective industry. For large acquisitions, buying benefits and synergies are included in cash flows when performing impairment testing at acquisition level.

For CGUs within Food, the key assumption used in the review for potential impairment of goodwill arising on the acquisition of Somerfield was that future EBITDA growth was projected as 2% from 2013 taken into perpetuity and discounted to present value. Buying benefits and synergies have been included in cash flows. Sensitivity analysis has been performed for the Somerfield goodwill figure and for both a 1% increase in discount rate and a decrease in EBITDA growth to 1% the cash flows remain well in excess of the current carrying value. For other individual stores/smaller groups, annual cashflows have been inflated for growth by 1% per annum taken into perpetuity and discounted to present value. Loss making stores are assumed to close within two years.

For Co-operative Funeralcare, average selling price increases and wage and cost inflation have been applied as per the assumptions in the three-year plan, cash flows have been projected for 10 years and into perpetuity from year 11 and discounted back to present value. Sensitivity analysis has been performed with both the growth rate and discount rate adjusted by +/- 1%, and under these sensitivities significant headroom is maintained.

Licences relate to the Pharmacy business. For the purposes of impairment testing of the Pharmacy licences, the recoverable amount was determined by discounting future cash flows expected to be generated from continuing use of the licences, assuming growth in profits of 3% per annum for 20 years. Sensitivity analysis demonstrated that a +/- 1% adjustment to the discount rate would have resulted in an additional impairment charge of £1.5m/reduction of £0.9m. A +/- 1% adjustment to the profit growth rate would have reduced impairment by £1.0m/increased by £1.6m.

For Co-operative Legal Services, average selling price increases and wage and cost inflation have been applied as per the assumptions in the three-year plan. The prudent assumption of no growth beyond year three has been applied. Sensitivity analysis has been performed with both the growth rate and discount rate adjusted by +/- 1%, and under these sensitivities significant headroom is maintained.

The Bank's goodwill recognised in 2009 relates to the transfer of engagements of Britannia Building Society. Further detail is provided in note 47. In accordance with IAS 38 the goodwill has been assessed as having an indefinite useful life. In assessing the recoverable amount of the goodwill the Group allocates the goodwill to the lowest cash generating unit (CGU) within the Group that is expected to benefit from the synergies of the business combination. A CGU is the smallest identifiable group of assets that generates cash inflows which are largely independent of the cash inflows from other assets of the Group.

The CGU, to which the goodwill has been allocated are the Retail, Corporate, Wholesale and Optimum and Platform reportable segments of the Bank. The recoverable amounts have been calculated by considering their value in use to the Bank. The key assumptions used in the calculation are shown below. These have been determined using past experience, understanding of the business and its industry, the expected lives of the assets and liabilities and recognition of current market events with respect to retail deposit taking business:

- Modest growth in assets of 2.5% per annum from 2014 onward;
- Net interest margin of 1.39% by 2014 thereafter growing by 1.5bps per annum until 2024;
- Other income of 0.14% of average total assets by 2014, thereafter growing by 0.2bps per annum until 2024;
- Management expenses of 0.72% of average total assets in 2014 reducing gradually to 0.57% by 2024;
- Loss provisions of 0.10% of total average assets each year from 2014 onward;
- Additional payments that would have been made to the members of Britannia Building Society had the transfer of engagements not occurred of 35% of profit before taxation in 2014, growing by 2.5% per annum to 40% in 2016, and remaining at 40% thereafter;
- A discount rate of 11% has been applied to the additional payments that would have been made to the members of Britannia Building Society.

The calculations have been flexed to assess the sensitivities to reasonable changes in the already conservative assumptions. This sensitivity analysis did not indicate any likely impairment of the goodwill.

### Asset in the course of construction and computer software

All additions to assets in the course of construction and computer software relate to additions from internally developed assets.

Assets in the course of construction includes an amount of £110.1m (2009: £77.6m) relating to the Business Transformation Project (bTp); a project to design and install a new banking system mainframe. These assets are not ready for use and so no amortisation has been charged to date. The anticipated amortisation for these assets is ten years from the date they are ready to use. Computer software includes £45.0m (2009: £nil) of assets relating to bTp which have been commissioned and which are being amortised over a period of ten years.

The carrying amount of the intangible assets represents various computer software development projects.

As part of the Change Portfolio a number of large projects are currently developing software. All projects have been reviewed at the end of the period for impairment.

## Notes to the financial statements continued

### 17. Intangible assets continued

#### Impairment testing for assets in the course of construction

Value in use was determined by discounting the future cash flows generated from the continuing use of the asset. Unless indicated otherwise, the value in use to 1 January 2011 was determined similarly to in the period ended 2 January 2010.

The value in use of assets in course of construction has been computed using the pre-tax discount rate of 12.5% p.a. for Banking Transformation Programme assets (2009: 12% p.a.) and 12% p.a. for other assets (2009: 12% p.a.). Any cashflow estimate exceeding the period covered by the most recent forecasts was computed by extrapolating the projections based on the budgets/forecasts using a steady growth rate for subsequent years, not exceeding the long term growth rate of 2.5% p.a. assumed for the sector in which the Group operates.

#### Sensitivity analysis of the carrying value

A sensitivity analysis has been performed on the assumptions used to determine the value in use for each asset in the course of construction as at 1 January 2011. Management has concluded that value in use is most sensitive to the discount rate. It is possible that changes in these assumptions could decrease the carrying value. An increase of one percentage point in the discount rate would have decreased the value in use by £38.9m (2009: £19.8m).

### 18. Investment properties – Trading Group

	2010 £m	2009 £m
Valuation at beginning of period	321.6	322.6
Revaluation surplus recognised in income statement	14.0	3.5
Arising on transfer of engagements	–	12.9
Additions	33.1	0.9
Transfers to property, plant and equipment	–	(0.4)
Disposals	(29.6)	(17.9)
<b>Valuation at end of period</b>	<b>339.1</b>	<b>321.6</b>

Investment properties have been valued as at 1 January 2011. The valuation was carried out by a mixture of external chartered surveyors: Colliers Conrad Ritblat Erdman, Strutt & Parker and Smiths Gore; as well as in-house valuers, on the basis of open market value in accordance with the RICS Appraisal and Valuation Manual.

The properties are valued individually, and yields therefore vary on a property-by-property basis. The transfers in from property, plant and equipment arise from the end of owner-occupancy at former trading and administrative locations. If an investment property becomes owner-occupied, it is reclassified as property, plant and equipment, and its fair value at the dates of reclassification becomes its cost for subsequent accounting purposes.

The mean ERV yield over the whole estate at the period end is 6.3% (2009: 6.7%).

In the case of investment properties, it is assumed that uplifts on valuation principally reflect future rentals.

Investment properties do not include those within Insurance activities. Details of these are included in note 28.

The valuation of investment properties comprises:

	2010 £m	2009 £m
Freehold	326.5	307.3
Long leasehold	12.6	14.1
Mixed tenure	–	0.2
	<b>339.1</b>	<b>321.6</b>

If investment properties were carried at historical cost, the cost and accumulated depreciation would be:

	2010 £m	2009 £m
Cost	235.9	217.9
Accumulated depreciation	(17.6)	(17.9)
Net historic cost value	<b>218.3</b>	<b>200.0</b>

## 19. Investments in associates and joint ventures

The Group's share of profits in relation to associates and joint ventures for the year was £0.8m (2009: profit of £0.3m).

Movements in investments in associates, joint ventures and other investments in the Trading Group are as follows:

	2010			2009		
	Investments in associates and joint ventures £m	Other investments £m	Total £m	Investments in associates and joint ventures £m	Other investments £m	Total £m
At beginning of the period	25.1	4.6	29.7	23.3	4.2	27.5
Additions	1.2	–	1.2	1.2	0.5	1.7
Transfer to held for sale	(2.1)	–	(2.1)	–	–	–
Disposals	–	–	–	(0.1)	(0.1)	(0.2)
Share of profit	0.1	–	0.1	0.4	–	0.4
Translation adjustments	1.0	–	1.0	0.3	–	0.3
<b>At end of the period</b>	<b>25.3</b>	<b>4.6</b>	<b>29.9</b>	25.1	4.6	29.7

Movements in investments in associates and joint ventures in CFS are as follows:

	2010 Investments in associates and joint ventures £m	2009 Investments in associates and joint ventures £m
At beginning of the period	2.0	–
Arising on transfer of engagements	–	2.1
Share of profit/(losses)	0.7	(0.1)
<b>At end of the period</b>	<b>2.7</b>	2.0

Summary financial information for significant joint ventures and associates (not adjusted for percentage held by the Group) are disclosed below:

	Ownership	Current assets £m	Non-current assets £m	Total assets £m	Current liabilities £m	Non-current liabilities £m	Total liabilities £m	Income £m	Expenditure £m
<b>2010</b>									
Britannia Personal Lending Limited	49%	21.7	22.6	44.3	27.3	17.0	44.3	2.5	1.5
Co-operative Holidays Limited	50%	0.5	–	0.5	2.6	–	2.6	19.8	23.9
Grangefern Properties	50%	2.9	36.5	39.4	1.8	16.5	18.3	2.3	1.3
SEA Estates	50%	0.3	8.6	8.9	8.2	–	8.2	1.0	0.2
Tiajin Tasly Sants Pharmaceutical Distributors	60%	7.7	21.0	28.7	2.5	10.7	13.2	–	0.7
<b>2009</b>									
Britannia Personal Lending Limited	49%	24.0	38.8	62.8	34.4	28.4	62.8	1.5	1.7
Co-operative Holidays Limited	50%	0.8	–	0.8	0.9	–	0.9	–	0.1
Grangefern Properties	50%	1.2	20.8	22.0	1.1	16.4	17.5	2.2	1.2
SEA Estates	50%	1.1	7.5	8.6	9.6	–	9.6	1.0	4.5
Tiajin Tasly Sants Pharmaceutical Distributors	60%	4.1	22.4	26.5	0.5	10.0	10.5	–	–

## Notes to the financial statements continued

### 19. Investments in associates and joint ventures continued

The Group holds 60% of the ordinary share capital of Tiajin Tasly Sants Pharmaceutical Distributors Ltd, incorporated in The People's Republic of China. The principal activity of Tiajin Tasly Sants Pharmaceutical Distributors Ltd is to manufacture generic medicines. The entity's result is not consolidated fully by the Group as despite having a 60% share interest, the Group has joint managerial control of the Board. The entity has a year end date of 31 December.

The Group owns 50% of the ordinary share capital of Co-operative Holidays Limited, incorporated in England and Wales. The entity's principal activity is to act as an 'inhouse' tour operator. This entity will be discontinued in 2011 and therefore the losses of this entity are included within discontinued operations (see note 14). The entity has a year end date of 31 October.

The Group holds 50% of the ordinary share capital of Grangefern Properties Limited, incorporated in England and Wales. The entity's principal activity is property investment and development. The entity has a year end date of 1 January.

As at 1 January 2011, the Group holds 50% of the ordinary share capital of SEA Estates LLP, incorporated in England and Wales. The entity's principal activity is property investment and development. The entity has a year end date of 4 January.

The Group owns 49% of the ordinary shares in Britannia Personal Lending Limited, incorporated in England and Wales. Its principal activity is unsecured personal lending. The entity has a year end date of 31 December.

All the above entities are jointly managed and controlled by the Group and a third party and are accounted for as joint ventures under the equity method.

There were no contingent liabilities or commitments in respect of these joint ventures as at 1 January 2011.

### 20. Derivatives

Group	2010		2009	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Trading Group (a)	14.8	(119.3)	10.6	(96.0)
Financial Services (b)	1,728.8	(1,237.1)	1,704.3	(1,094.2)

#### a) Trading Group

Derivatives held for non-trading purposes for which hedge accounting has not been applied:

	Contractual/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Interest rate swaps/collar	1,150.4	14.6	(119.3)
Forward currency transactions	7.6	0.2	–
<b>Total recognised derivative assets/(liabilities)</b>	<b>1,158.0</b>	<b>14.8</b>	<b>(119.3)</b>

Interest rate swaps and forward currency transactions are measured at fair value through the income statement.

The objectives and policies for financial instruments are included within note 52 on risk management.

#### b) Financial Services

##### Derivative financial instruments

The CFS Group has entered, as principal, into various derivatives either as a trading activity, which includes proprietary transactions and customer facilitation, or as a hedging activity for the management of interest rate risk, equity risk and foreign exchange rate risk. Positive and negative fair values have not been netted as the CFS Group does not have a legal right of offset.

Derivatives held for trading purposes:

The trading transactions are mainly interest rate related contracts including swaps, caps and floors, forward rate agreements and exchange traded futures. Trading transactions include derivatives where the Bank enters into a transaction to accommodate a customer together with the corresponding hedge transaction.

CIS has purchased a series of interest rate swaption contracts as an economic hedge against part of its exposure to guaranteed annuity options. The market value represents the initial margin and the daily variation margin as the contracts are settled on a daily basis in arrears. FTSE put options are held to mitigate the impact of equity price risk.



**20. Derivatives** continued

## Non-trading derivatives:

Non-trading transactions comprise derivatives held for hedging purposes to manage the asset and liability positions of the Group. Derivatives used to manage interest rate related positions include swaps, caps and floors, forward rate agreements and exchange traded futures. The foreign exchange rate positions are managed using forward currency transactions and swaps. Equity risk is managed using equity swaps.

	2010 Fair values		2009 Fair values	
	Assets £m	Liabilities £m	Assets £m	Liabilities £m
Derivatives held for trading:				
Interest rate swaps	256.4	(449.8)	148.7	(345.3)
Interest rate options	1.9	(1.9)	3.7	(3.7)
Interest rate swaptions	260.8	–	290.6	–
Interest rate futures	–	–	–	–
Forwards	–	(34.0)	1.2	(11.2)
Financial futures contracts	10.4	(10.1)	11.8	(19.0)
Total return swaps	188.5	(91.8)	104.0	(162.2)
Forward currency contracts	–	–	–	–
FTSE options	145.9	–	170.0	–
<b>Total derivative assets/(liabilities) held for trading</b>	<b>863.9</b>	<b>(587.6)</b>	730.0	(541.4)
Derivatives held for hedging:				
<i>Derivatives designated as cashflow hedges</i>				
Interest rate swaps	218.8	(161.9)	117.1	(69.6)
<i>Derivatives designated as fair value hedges</i>				
Interest rate swaps	75.0	(412.2)	121.0	(434.3)
<i>Derivatives held for non-trading purposes for which hedge accounting has not been applied</i>				
Interest rate swaps	23.1	(32.5)	11.8	(14.4)
Embedded derivatives – options	19.3	(17.8)	5.4	(4.0)
OTC interest rate options	–	(1.2)	–	(0.3)
Equity swaps	97.3	(0.3)	61.3	(6.8)
Forward currency transactions	431.4	(23.6)	657.7	(23.4)
<b>Total derivative assets/(liabilities) held for non-trading</b>	<b>864.9</b>	<b>(649.5)</b>	974.3	(552.8)
<b>Total recognised derivative assets/(liabilities)</b>	<b>1,728.8</b>	<b>(1,237.1)</b>	1,704.3	(1,094.2)

## Notes to the financial statements continued

### 21. Employee benefits and retirement benefit obligations

	Group	
	2010	2009
The average number employed by the Group in the UK (excluding discontinued businesses) was:		
Full-time	<b>43,908</b>	38,614
Part-time	<b>64,365</b>	57,574
	<b>108,273</b>	96,188

	2010 £m	2009 £m
Wages and salaries	<b>1,583.7</b>	1,509.3
Social security costs	<b>101.9</b>	89.2
Pension costs	<b>68.5</b>	50.4
	<b>1,754.1</b>	1,648.9

The pension assets and liabilities in the balance sheet are comprised as follows:

	2010 £m	2009 £m
<b>Trading Group assets</b>		
Surplus from The Co-operative Group Pension Scheme (PACE)	<b>273.0</b>	1.6
Add back EFRBS liabilities relating to CFS	<b>3.8</b>	3.5
Surplus from the Lothian, Borders and Angus scheme	<b>–</b>	–
	<b>276.8</b>	5.1
<b>Trading Group liabilities</b>		
Deficit in Somerfield pension schemes	<b>13.6</b>	54.3
Deficit in United Norwest Fund	<b>124.6</b>	108.9
Deficit in other former United Co-operatives Funds	<b>48.7</b>	43.0
Deficit in Plymouth and South West and Brixham Fund	<b>43.4</b>	44.9
Deficit in Lothian, Borders and Angus scheme	<b>0.3</b>	1.6
	<b>230.6</b>	252.7
<b>Financial Services liabilities</b>		
Deficit in Britannia pension schemes	<b>45.8</b>	33.2
EFRBS liabilities from the PACE scheme	<b>3.8</b>	3.5
	<b>49.6</b>	36.7

The Group operates a number of defined benefit pension schemes, the assets of which are held in separate trustee-administered funds.

The Group pension schemes consist of The Co-operative Group Pension (Average Career Earnings) Scheme (PACE), United Norwest Co-operatives Employees' Pension Fund, the Yorkshire Co-operatives Limited Employees' Superannuation Fund, the Leeds Co-operative Society Limited Employee Pension Fund, the Sheffield Co-operative Society Limited Employees' Superannuation Fund, the Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund, the Somerfield Pension Scheme, the Britannia Building Society Pension Scheme, the Plymouth and South West Co-operative Society Limited Employees' Superannuation Fund and Brixham Co-operative Society Limited Employees' Superannuation Fund. All of the former United Co-operatives pension schemes are closed to new entrants. In addition there exists the United Norwest Co-operatives Limited 1989 Discretionary Early Retirement Benefits Scheme (closed to new entrants from 5 November 1995) which provides additional benefits for long-serving employees who commenced employment prior to 6 November 1994, and the Leeds Co-operative Society Limited Managerial Staff Pensions Scheme.

Details of the principal schemes are given below:

The pension costs are assessed in accordance with actuarial advice using the projected unit method.

The most recent valuation of the schemes was carried out by a qualified actuary. The date of the last full valuations of the six principal schemes are shown below. The assumptions used by the actuary are the best estimates chosen from a range of possible actuarial assumptions which may not necessarily be borne out in practice. The Group is currently performing scheme valuations for the PACE, Somerfield and Plymouth and South West schemes. These are expected to be concluded in 2011.

**21. Employee benefits and retirement benefit obligations** continued

	<b>PACE Scheme</b>	<b>United Norwest Fund</b>	<b>Somerfield Schemes</b>	<b>Britannia Scheme</b>	<b>Yorkshire Fund</b>	<b>Sheffield Fund</b>	<b>Leeds Fund</b>	<b>Lothian Borders &amp; Angus Fund</b>	<b>Plymouth &amp; South West Fund</b>	<b>Brixham Fund</b>
Date of last full actuarial valuation	April 2007	January 2008	April 2007	April 2008	January 2008	January 2008	January 2008	January 2009	March 2007	March 2008

The actuarial valuations of the schemes have been updated to 1 January 2011 in accordance with IAS 19.

	<b>2010</b>	2009
The principal assumptions used to determine the liabilities of the Group's pension schemes were:		
Discount rate	<b>5.20%</b>	5.60%
Rate of increase in salaries	<b>5.20%</b>	5.30%
Future pension increases where capped at 5.0% p.a.	<b>3.70%</b>	3.80%
Future pension increases where capped at 2.5% p.a.	<b>2.50%</b>	2.50%
<b>Assumptions used to determine net pension cost for the PACE scheme are:</b>		
Discount rate	<b>5.60%</b>	5.70%
Expected long term return on scheme assets	<b>6.50%</b>	6.40%
Rate of increase in salaries	<b>5.30%</b>	4.75%
<b>Assumptions used to determine net pension cost for the former United Co-operatives schemes are:</b>		
Discount rate	<b>5.60%</b>	5.70%
Expected long term return on scheme assets	<b>7.30%</b>	6.50%
Rate of increase in salaries	<b>5.30%</b>	4.75%
<b>Assumptions used to determine net pension cost for the Somerfield scheme are:</b>		
Discount rate	<b>5.20%</b>	5.80%
Expected long term return on scheme assets	<b>5.30%</b>	5.10%
Rate of increase in salaries	<b>5.30%</b>	4.75%

The fair value of the scheme's assets, which are intended to be realised in the future, may be subject to significant change before they are realised.

	<b>Group</b>	
	<b>2010 £m</b>	2009 £m
Trading Group	<b>46.2</b>	(247.6)
Financial Services	<b>(49.6)</b>	(36.7)
Net pension liability	<b>(3.4)</b>	(284.3)

The average life expectancy (in years) for mortality tables used to determine scheme liabilities for the various different schemes at 1 January 2011 are as follows:

	<b>Member currently aged 65 (current life expectancy)</b>		<b>Member currently aged 45 (life expectancy at age 65)</b>	
	<b>Male</b>	<b>Female</b>	<b>Male</b>	<b>Female</b>
PACE Scheme	<b>21.7</b>	<b>23.3</b>	<b>23.2</b>	<b>24.9</b>
United Norwest Fund, Yorkshire Fund, Sheffield Fund and Brixham Fund	<b>21.9</b>	<b>24.1</b>	<b>23.3</b>	<b>25.6</b>
Leeds Fund	<b>20.9</b>	<b>23.0</b>	<b>22.3</b>	<b>24.7</b>
Lothian Fund	<b>22.3</b>	<b>23.2</b>	<b>23.3</b>	<b>21.9</b>
Plymouth Fund	<b>21.6</b>	<b>23.4</b>	<b>22.9</b>	<b>25.0</b>
Britannia Scheme	<b>23.4</b>	<b>25.7</b>	<b>24.9</b>	<b>27.3</b>
Somerfield Scheme	<b>21.9</b>	<b>23.2</b>	<b>23.4</b>	<b>24.8</b>

Net pension finance income of £44.9m in the income statement includes £49.3m in respect of the PACE scheme, £0.3m net pension finance income in respect of the four defined benefit schemes operated by the former United Co-operative Group, £2.9m net pension finance cost in respect of Somerfield and a net pension finance cost of £2m for all remaining schemes and includes £378m interest on liabilities and £422.9m expected return on scheme assets. Net pension finance income in the Britannia Building Society pension scheme of £0.7m is credited in operating expenses in the Income Statement.

## Notes to the financial statements continued

### 21. Employee benefits and retirement benefit obligations continued

#### i) The Co-operative Group Pension (Average Career Earnings) Scheme (PACE)

	2010 £m	2009 £m
<b>The amounts recognised in the balance sheet are as follows:</b>		
Present value of funded obligations	<b>(5,794.2)</b>	(5,509.0)
Present value of unfunded liabilities	<b>(4.1)</b>	(3.8)
Fair value of plan assets	<b>6,071.3</b>	5,514.4
Net retirement benefit asset	<b>273.0</b>	1.6

A movement in the discount rate of 0.1% would impact the scheme's liabilities by £140m, an adjustment to price and salary inflation of 0.1% would impact liabilities by £120m. An increase in the assumed long term rate of improvement in mortality from 1.0% p.a. to 1.5% p.a. would increase the liabilities by £230m.

The pension scheme assets include property occupied by the Group with a fair value of £nil (2009: £1.1m).

	2010 £m	2009 £m
<b>The amounts recognised in the income statement are as follows:</b>		
Current service cost	<b>46.1</b>	36.4
Interest on liabilities	<b>304.9</b>	264.9
Expected return on scheme assets	<b>(354.2)</b>	(322.9)
Gains on settlement and curtailments	–	–
	<b>(3.2)</b>	(21.6)
Actual return on scheme assets	<b>688.4</b>	429.7

	2010 £m	2009 £m
<b>Changes in the present value of the scheme liabilities are as follows:</b>		
Opening defined benefit liabilities	<b>5,512.8</b>	4,803.4
Current service cost	<b>46.1</b>	36.4
Interest on liabilities	<b>304.9</b>	264.9
Contributions by members	<b>21.3</b>	20.4
Actuarial losses recognised in equity	<b>123.5</b>	581.3
Benefits paid	<b>(210.3)</b>	(193.6)
Gains on settlements and curtailments	–	–
Closing defined benefit liabilities	<b>5,798.3</b>	5,512.8



**21. Employee benefits and retirement benefit obligations** continued

	2010 £m	2009 £m
<b>Changes in the fair value of the scheme assets are as follows:</b>		
Opening fair value of scheme assets	5,514.4	5,204.6
Expected return on scheme assets	354.2	322.9
Actuarial gains recognised in equity	334.2	106.8
Contributions by the employer	57.4	53.2
Contributions by members	21.3	20.4
Benefits paid	(210.2)	(193.5)
Closing fair value of scheme assets	6,071.3	5,514.4

The Group expects to contribute £67.7m to its PACE scheme in 2011.

	2010	2009
<b>The weighted-average asset allocations at the period end were as follows:</b>		
Equities	31%	35%
Liability-driven investments	54%	54%
Alternative growth	9%	6%
Property	4%	4%
Cash	2%	1%
	<b>100%</b>	<b>100%</b>

To develop the expected long term rate of return on assets assumption, the Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of the 6.5% (2009: 6.4%) assumption for the year ended 1 January 2011.

	2010 £m	2009 £m	2008 £m	2007 £m	2006 £m
<b>Amounts recognised in the balance sheet:</b>					
Defined benefit liabilities	(5,798.3)	(5,512.8)	(4,803.4)	(5,077.3)	(5,056.9)
Scheme assets	6,071.3	5,514.4	5,204.6	5,511.7	5,344.0
Surplus	273.0	1.6	401.2	434.4	287.1
<b>History of experience gains and losses:</b>					
Experience adjustment on scheme liabilities	(377.0)	—	—	65.5	(238.8)
% of scheme liabilities	7%	—	—	1%	5%
Experience adjustment on scheme assets	334.2	106.8	(535.2)	(24.3)	130.1
% of scheme assets	6%	2%	10%	0%	2%

## Notes to the financial statements continued

### 21. Employee benefits and retirement benefit obligations continued

#### ii) United Norwest Co-operatives Employees' Pension Fund

	2010 £m	2009 £m
<b>The amounts recognised in the balance sheet are as follows:</b>		
Present value of funded obligations	<b>(491.2)</b>	(425.2)
Fair value of plan assets	<b>366.6</b>	316.3
Net retirement benefit deficit	<b>(124.6)</b>	(108.9)

The pension scheme assets include property occupied by the Group with a fair value of £nil (2009: £nil).

	2010 £m	2009 £m
<b>The amounts recognised in the income statement are as follows:</b>		
Current service cost	<b>9.8</b>	8.4
Interest on liabilities	<b>23.7</b>	19.8
Expected return on scheme assets	<b>(24.0)</b>	(16.6)
Gains on settlement and curtailments	<b>–</b>	–
	<b>9.5</b>	11.6
Actual return on scheme assets	<b>30.2</b>	45.8

	2010 £m	2009 £m
<b>Changes in the present value of the scheme liabilities are as follows:</b>		
Opening defined benefit liabilities	<b>425.2</b>	355.1
Current service cost	<b>9.8</b>	8.4
Interest on liabilities	<b>23.7</b>	19.8
Contributions by members	<b>3.8</b>	3.9
Actuarial losses	<b>44.5</b>	50.9
Benefits paid	<b>(15.8)</b>	(12.9)
Gains on settlement and curtailments	<b>–</b>	–
Closing defined benefit liabilities	<b>491.2</b>	425.2

	2010 £m	2009 £m
<b>Changes in the fair value of the scheme assets are as follows:</b>		
Opening fair value of scheme assets	<b>316.3</b>	251.1
Expected return on scheme assets	<b>24.0</b>	16.6
Actuarial gains	<b>6.2</b>	29.2
Contributions by the employer	<b>32.1</b>	28.4
Contributions by members	<b>3.8</b>	3.9
Benefits paid	<b>(15.8)</b>	(12.9)
Closing fair value of scheme assets	<b>366.6</b>	316.3

The Group expects to contribute £25.4m to the United Norwest pension scheme in 2011.

**21. Employee benefits and retirement benefit obligations** continued

	2010	2009
<b>The weighted-average asset allocations at the period end were as follows:</b>		
Equities	<b>0%</b>	48%
Diversified growth	<b>70%</b>	22%
Bonds	<b>21%</b>	23%
Property	<b>5%</b>	5%
Cash	<b>4%</b>	2%
Total scheme assets	<b>100%</b>	100%

To develop the expected long term rate of return on assets assumption, the Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of the 7.3% (2009: 6.5%) assumption for the period ended 1 January 2011.

	2010 £m	2009 £m	2008 £m	2007 £m
<b>Amounts recognised in the balance sheet:</b>				
Defined benefit liabilities	<b>(491.2)</b>	(425.2)	(355.1)	(384.8)
Scheme assets	<b>366.6</b>	316.3	251.1	285.2
Deficit	<b>(124.6)</b>	(108.9)	(104.0)	(99.6)
<b>History of experience gains and losses:</b>				
Experience adjustment on scheme liabilities	–	–	9.3	–
% of scheme liabilities	–	–	2.6%	–
Difference between expected and actual return on scheme assets	<b>6.2</b>	29.2	(57.1)	0.8
% of scheme assets	<b>1.7%</b>	9.2%	(22.7%)	0.3%

**iii) Somerfield Pension Scheme**

The Somerfield Pension Scheme comprises of four sections:

1. A defined benefit section for employees who were members of the original Somerfield Pension Scheme, closed to new entrants in 1999/2000;
2. A defined benefit section for employees who were members of the Kwik Save Retirement Benefits Scheme closed to new entrants and merged into the Somerfield Pension Scheme in 1999;
3. A closed defined benefit section providing lump sum retirement and death benefits for some Kwik Save employees. This was a separate scheme until merged into the Somerfield Pension Scheme on 5 April 2006; and
4. A defined contribution section.

	2010 £m	2009 £m
<b>The amounts recognised in the balance sheet are as follows:</b>		
Present value of funded obligations	<b>(641.0)</b>	(581.8)
Fair value of plan assets	<b>627.4</b>	527.5
Net retirement benefit asset	<b>(13.6)</b>	(54.3)

The pension scheme assets include property occupied by the Group with a fair value of £nil (2009: £nil).

## Notes to the financial statements continued

### 21. Employee benefits and retirement benefit obligations continued

	2010 £m	2009 £m
<b>The amounts recognised in the income statement are as follows:</b>		
Current service cost	1.6	1.9
Interest on liabilities	31.9	25.0
Expected return on scheme assets	(29.0)	(19.7)
	4.5	7.2
Actual return on scheme assets	101.3	69.5

	2010 £m	2009 £m
<b>Changes in the present value of the scheme liabilities are as follows:</b>		
Opening defined benefit liabilities/defined benefit liabilities acquired upon acquisition of Somerfield	581.8	519.1
Current service cost	1.6	1.9
Interest on liabilities	31.9	25.0
Contributions by members	0.9	1.3
Actuarial losses	46.7	51.5
Benefits paid	(21.9)	(17.0)
Closing defined benefit liabilities	641.0	581.8

	2010 £m	2009 £m
<b>Changes in the fair value of the scheme assets are as follows:</b>		
Opening fair value of scheme assets/Scheme assets acquired upon acquisition of Somerfield	527.5	456.9
Expected return on scheme assets	29.0	19.7
Actuarial gains	72.3	49.8
Contributions by the employer	19.6	16.8
Contributions by members	0.9	1.3
Benefits paid	(21.9)	(17.0)
Closing defined scheme assets	627.4	527.5

The Group expects to contribute £19.6m to the Somerfield Pension Scheme in 2011.

	2010	2009
<b>The weighted-average asset allocations at the period end were as follows:</b>		
Equities	15%	13%
Bonds	52%	71%
Other*	33%	16%
Total scheme assets	100%	100%

\* As well as cash and current assets, this category includes cash based investments held by the bond managers for the purpose of managing the swaps portfolios. There is also a small holding in a specialist tactical asset allocation fund.

To develop the expected long term rate of return on assets assumption, the Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of the 5.3% (2009: 5.1%) assumption for the year ended 1 January 2011.

Following a recent legislative change, the inflation rates used to revalue the benefits of deferred members of both the funded and unfunded sections of the scheme prior to retirement has automatically changed from being based on the retail price index (RPI) to being based on the consumer price index (CPI). This has resulted in a 0.5% reduction in assumed revaluation rates which amounts to a £13.8m reduction in liability for the scheme which has been recognised as an actuarial gain.



**21. Employee benefits and retirement benefit obligations** continued

	2010 £m	2009 £m
<b>Amounts recognised in the balance sheet:</b>		
Defined benefit liabilities	<b>(641.0)</b>	(581.8)
Scheme assets	<b>627.4</b>	527.5
Deficit	<b>(13.6)</b>	(54.3)
<b>History of experience gains and losses:</b>		
Experience adjustment on scheme liabilities	<b>(6.1)</b>	2.8
% of scheme liabilities	<b>(0.95%)</b>	0.5%
Experience adjustment on scheme assets	<b>72.2</b>	49.8
% of scheme assets	<b>11.5%</b>	9.4%

Only two years' history has been disclosed because this scheme only became part of the Group in 2009.

**iv) Britannia Building Society Pension Scheme**

	2010 £m	2009 £m
<b>The amounts recognised in the balance sheet are as follows:</b>		
Present value of funded obligations	<b>(549.4)</b>	(478.1)
Present value of unfunded obligations	<b>(5.6)</b>	(4.7)
Fair value of plan assets	<b>509.2</b>	449.6
Net retirement benefit asset	<b>(45.8)</b>	(33.2)

The pension scheme assets include property occupied by the Group with a fair value of £nil (2009: £nil).

	2010 £m	2009 £m
<b>The amounts recognised in the income statement are as follows:</b>		
Current service cost	<b>11.1</b>	3.9
Interest on liabilities	<b>27.2</b>	11.0
Expected return on scheme assets	<b>(27.9)</b>	(10.8)
	<b>10.4</b>	4.1
Actual return on scheme assets	<b>58.8</b>	37.0

	2010 £m	2009 £m
<b>Changes in the present value of the scheme liabilities are as follows:</b>		
Opening defined benefit liabilities	<b>482.8</b>	411.9
Current service cost	<b>11.1</b>	3.9
Interest on liabilities	<b>27.2</b>	11.0
Contributions by members	<b>2.8</b>	1.0
Actuarial losses	<b>41.3</b>	58.7
Benefits paid	<b>(10.2)</b>	(3.7)
Closing defined benefit liabilities	<b>555.0</b>	482.8

## Notes to the financial statements continued

### 21. Employee benefits and retirement benefit obligations continued

	2010 £m	2009 £m
<b>Changes in the fair value of the scheme assets are as follows:</b>		
Opening fair value of scheme assets	449.6	411.9
Expected return on scheme assets	27.9	10.8
Actuarial gains	30.9	26.3
Contributions by the employer	8.1	3.3
Contributions by members	2.8	1.0
Benefits paid	(10.1)	(3.7)
Closing defined benefit assets	509.2	449.6

The Group expects to contribute £10.8m to the Britannia pension schemes in 2011.

	2010	2009
<b>The weighted-average asset allocations at the period end were as follows:</b>		
Equities	28%	26%
Diversified growth	17%	20%
Liability driven instruments	54%	54%
Property	1%	0%
Total scheme assets	100%	100%

To develop the expected long term rate of return on assets assumption, the Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of the 6.2% (2009: 6.4%) assumption for the year ended 1 January 2011.

	2010 £m	2009 £m
<b>Amounts recognised in the balance sheet:</b>		
Defined benefit liabilities	(555.0)	(482.8)
Scheme assets	509.2	449.6
Deficit	(45.8)	(33.2)
<b>History of experience gains and losses:</b>		
Experience adjustment on scheme liabilities	–	–
% of scheme liabilities	–	–
Difference between expected and actual return on scheme assets	30.9	26.2
% of scheme assets	6.1%	6.0%

Only two years' history has been disclosed because these schemes only became part of the Group in 2009.

Following a recent legislative change, the inflation rates used to revalue the benefits of deferred members of both the funded and unfunded sections of the scheme prior to retirement has automatically changed from being based on the retail price index (RPI) to being based on the consumer price index (CPI). This has resulted in a 0.5% reduction in assumed revaluation rates which amounts to a £10m reduction in liability for the scheme which has been recognised as an actuarial gain.

**21. Employee benefits and retirement benefit obligations** *continued***v) Yorkshire Co-operatives Limited Employees' Superannuation Fund, Sheffield Co-operative Society Limited Employees' Superannuation Fund, Leeds Co-operative Society Limited Employee Pension Fund, United Norwest Co-operatives Limited 1989 Discretionary Early Retirement Benefits Scheme, Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund, the Plymouth & South West Co-operative Society Limited Employees Superannuation Fund and the Brixham Co-operative Society Limited Employees' Superannuation Fund.**

	2010 £m	2009 £m
<b>The amounts recognised in the balance sheet are as follows:</b>		
Present value of funded obligations	<b>(333.8)</b>	(304.8)
Present value of unfunded liabilities	<b>(12.1)</b>	(11.5)
Fair value of scheme assets	<b>253.5</b>	226.9
Net retirement benefit deficit	<b>(92.4)</b>	(89.4)

The pension scheme assets include property occupied by the Group with a fair value of £nil (2009: £nil).

	2010 £m	2009 £m
<b>The amounts recognised in the income statement are as follows:</b>		
Current service cost	<b>3.2</b>	2.1
Interest on liabilities	<b>17.7</b>	10.7
Expected return on scheme assets	<b>(15.6)</b>	(9.6)
Past service cost	<b>0.5</b>	–
	<b>5.8</b>	3.2
Actual return on scheme assets	<b>23.6</b>	24.4

	2010 £m	2009 £m
<b>Changes in the present value of the scheme liabilities are as follows:</b>		
Opening defined benefit liabilities	<b>316.3</b>	176.3
Defined benefit liabilities acquired upon transfer of engagements	<b>–</b>	104.6
Current service cost	<b>3.3</b>	2.1
Interest on liabilities	<b>17.6</b>	10.7
Contributions by members	<b>1.1</b>	1.1
Past service costs	<b>0.5</b>	–
Actuarial losses	<b>19.3</b>	29.4
Benefits paid	<b>(12.2)</b>	(7.9)
Closing defined benefit liabilities	<b>345.9</b>	316.3

	2010 £m	2009 £m
<b>Changes in the fair value of the scheme assets are as follows:</b>		
Opening fair value of scheme assets	<b>226.9</b>	136.3
Scheme assets acquired upon transfer of engagements	<b>–</b>	62.1
Expected return on scheme assets	<b>15.6</b>	9.6
Actuarial gains	<b>8.0</b>	14.9
Contributions by the employer	<b>14.2</b>	10.8
Contributions by members	<b>1.1</b>	1.1
Benefits paid	<b>(12.3)</b>	(7.9)
Closing fair value of scheme assets	<b>253.5</b>	226.9

The Group expects to contribute £9.8m to the Yorkshire, Sheffield, Leeds, Lothian Borders & Angus, Plymouth & South West and Brixham pension schemes in 2010.

## Notes to the financial statements continued

### 21. Employee benefits and retirement benefit obligations continued

	2010	2009
<b>The weighted-average asset allocations at the period end were as follows:</b>		
Equities	<b>41%</b>	50%
Diversified growth	<b>23%</b>	5%
Bonds	<b>28%</b>	34%
Property	<b>5%</b>	5%
Cash	<b>3%</b>	4%
Liability-driven instruments	<b>0%</b>	2%
Total scheme assets	<b>100%</b>	100%

To develop the expected long term rate of return on assets assumption, the Group considered the current level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the target asset allocation to develop the expected long term rate of return on assets assumption for the portfolio. This resulted in the selection of a range between 6.2%–7.3% (2009: 6.4%) assumption for the year ended 1 January 2011.

	2010 £m	2009 £m	2008 £m	2007 £m
<b>Amounts recognised in the balance sheet:</b>				
Defined benefit liabilities	<b>(345.9)</b>	(316.3)	(176.3)	(142.5)
Scheme assets	<b>253.5</b>	226.9	136.3	108.1
Deficit	<b>(92.4)</b>	(89.4)	(40.0)	(34.4)
<b>History of experience gains and losses:</b>				
Experience adjustment on scheme liabilities	<b>6.0</b>	(1.6)	1.0	(0.4)
% of scheme liabilities	<b>1.7%</b>	(0.5%)	0.6%	(0.3%)
Experience adjustment on scheme assets	<b>8.0</b>	14.9	(16.4)	(2.8)
% of scheme assets	<b>3.1%</b>	6.6%	(12.0%)	(3.0%)

Four years' history has been disclosed for the Yorkshire, Sheffield and Leeds schemes, three years for the Lothian Borders & Angus scheme and two for the Plymouth & South West and Brixham schemes – this being the period that has elapsed since they became part of the Group.



## 22. Deferred taxation

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 27% (2009: 28%).

	<b>Group</b>	
	<b>2010</b>	2009
	<b>£m</b>	£m
Net deferred tax comprises:		
<b>Deferred tax asset</b>		
Trading Group	<b>(134.1)</b>	(284.3)
Financial Services	<b>(104.9)</b>	(96.2)
	<b>(239.0)</b>	(380.5)
<b>Deferred tax liability</b>		
Trading Group	<b>253.9</b>	301.3
Financial Services	<b>124.7</b>	126.5
	<b>378.6</b>	427.8
Net deferred tax liabilities	<b>139.6</b>	47.3
Comprised of:		
Other temporary differences	<b>(92.9)</b>	(61.1)
Temporary differences arising on derivatives and interest	<b>13.4</b>	(41.4)
Other temporary differences arising on fair value and merger with Britannia Building Society	<b>(34.5)</b>	(26.2)
Retirement benefit obligations	<b>(0.9)</b>	(79.6)
Capital allowances on fixed assets	<b>32.9</b>	13.0
Capital allowances on assets leased to customers	<b>3.5</b>	4.0
Unrealised gains on investments, investment properties and rolled-over gains	<b>309.5</b>	356.2
Claims equalisation reserve	<b>6.9</b>	5.9
Tax losses	<b>(77.1)</b>	(103.0)
Acquisition costs deferred	<b>(21.2)</b>	(20.5)
	<b>139.6</b>	47.3

The main components of the deferred tax liability are tax allowances on property plant and equipment and intangible assets of £36.4m (2009: £17.0m), unrealised appreciation of investments of £120.8m (2009: 141.7m), potential liability on rolled-over gains of £188.6m (2009: £219m), and net retirement obligations of £12.5m (2009: £32.7m).

These liabilities are offset by deferred tax assets arising in respect of acquisition costs of £21.2m (2009: £20.5m), timing differences arising on derivatives and interest of nil (2009: £41.4m), and net retirement benefit obligations of £13.4m (2009: £112.3m), carried forward tax losses of £77.1m (2009: £103.0m) largely arising on acquisition of Somerfield and Britannia, plus £34.5m arising on fair value differences on the acquisition of Britannia (2009: £26.2m), taxation of special purposes vehicles under securitisation regime of £36.9m (2009: £11.4m) and deferred tax relief on other accounts provisions including holiday pay and onerous lease provisions of £35.6m (2009: £110.7m).

## Notes to the financial statements continued

### 23. Inventories

	Group	
	2010 £m	2009 £m
Raw materials and consumables	7.2	7.3
Work in progress	0.6	0.2
Finished goods and goods for resale	578.3	549.8
	<b>586.1</b>	557.3

The year end inventories provision is £11.9m (2009: £33.5m), of which the majority relates to Food Retail in 2010 and 2009. A charge of £24.8m (2009: £2.3m) has been released to the income statement in the year and £nil (2009: £16.0m) acquired as part of business acquisitions in the period.

There was no inventory pledged as security for liabilities at year end or in the prior period.

### 24. Trade and other receivables – Trading Group

	2010 £m	2009 £m
Trade receivables	287.5	312.9
Prepayments and accrued income	115.0	121.4
Other receivables	304.2	92.9
	<b>706.7</b>	527.2

	2010 £m	2009 £m
Non-current	229.8	–
Current	476.9	527.2
	<b>706.7</b>	527.2

Trade receivables and other receivables are classified as loans and receivables.

Trade receivables are stated net of an impairment provision of £7.8m (2009: £8.8m). £0.5m (2009: charge of £1.4m) has been credited to the income statement in the period. The provision is calculated in line with individual businesses' impairment policies and any adjustment to the level of provision is recognised within the income statement in operating profit.

Trade receivables include amounts totalling £45.3m (2009: £24.9m), which are overdue but not considered to be impaired, age analysed as follows:

	2010 £m	2009 £m
<b>Amounts overdue:</b>		
Less than 3 months	42.4	22.2
3 to 6 months	0.1	1.4
More than 6 months	2.8	1.3
	<b>45.3</b>	24.9

Amounts overdue but not impaired typically comprise high volume/low value balances for which the individual trading businesses do not seek collateral but continue to work with counterparties to secure settlement. No other receivables are overdue.

## 25. Assets and liabilities held for sale and discontinued operations

### Discontinued operations

As per note 14, the travel business is expected to merge into a separate venture with Thomas Cook Group plc in 2011. As the business is available for sale in its present condition and its sale is highly probable, the businesses' assets and liabilities have been reclassified as held for sale. Depreciation in the travel business ceased at the end of 2010 as prescribed in IFRS 5. There was no gain or loss in the income statement when the travel business' assets were transferred to assets held for sale. The majority of the prior period figures represent certain foodstores which were required to be disposed of by the Group following its acquisition of Somerfield and local competition reviews by the Office of Fair Trading. A small number of foodstores which are earmarked for disposal in 2011 are within the current year figure.

### Assets classified as held for sale

	2010 £m	2009 £m
Property, plant and equipment	27.9	11.6
Goodwill	6.2	—
Trade and other receivables	20.3	—
Cash and cash equivalents	—	—
Inventories	—	0.5
<b>Assets held for sale</b>	<b>54.4</b>	<b>12.1</b>

### Liabilities classified as held for sale

	2010 £m	2009 £m
Trade and other payables	(70.6)	—
<b>Liabilities held for sale</b>	<b>(70.6)</b>	<b>—</b>

## 26. Loans and advances to banks – Financial Services

	Group	
	2010 £m	2009 £m
Items in the course of collection from other banks	139.9	149.0
Placements with other banks	1,338.8	313.5
Included in cash and cash equivalents	1,478.7	462.5
Other loans and advances to banks	915.4	1,319.0
	<b>2,394.1</b>	<b>1,781.5</b>

## 27. Loans and advances to customers – Financial Services

	Group	
	2010 £m	2009 £m
Total shareholder	35,160.3	34,155.5
Long term business	5.6	7.8
Loans and advances to customers including fair value adjustment for hedged risk	35,165.9	34,163.3
Fair value adjustment for hedged risk	(166.8)	(66.1)
<b>Loans and advances to customers</b>	<b>34,999.1</b>	<b>34,097.2</b>
	<b>2010 £m</b>	<b>2009 £m</b>
Total shareholder	35,382.9	34,349.5
Gross loans and advances	(222.6)	(194.0)
Less allowance for losses on loans and advances	<b>35,160.3</b>	<b>34,155.5</b>

## Notes to the financial statements continued

### 27. Loans and advances to customers – Financial Services continued

#### Fair value adjustments for hedged risk

The Group has entered into interest rate swaps that protect it from changes in interest rates on the floating rate liabilities that fund its portfolio of fixed rate mortgages. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed rate mortgages. The changes in fair value of fixed rate mortgages are disclosed on the balance sheet as fair value adjustments for hedged risk immediately below the loans and advances to customers. Fair value adjustments to loans and advances to customers attributable to portfolio-hedged risk in the Group are £166.8m (2009: £66.1m).

#### Securitisation

Loans and advances to customers include £11,204.9m (2009: £9,492.7m) securitised under The Co-operative Bank's securitisation and covered bond programmes. The Co-operative Bank remains exposed to substantially all of the risks and rewards of ownership of these assets. Included within Group deposits by banks (note 26) are £454.3m (2009: £466.7m) of loans from external third parties and within Group debt securities in issue (note 28) are £1,898.1m (2009: £2,683.7m) of floating rate notes, all secured on these mortgage assets. In February 2010, the Group completed a new £2.5bn prime mortgage securitisation.

#### Concentration of exposure

The Group's exposure is virtually all within the United Kingdom. The following industry concentrations of gross advances before provisions, effective interest rate adjustments and suspended interest are considered significant.

	2010 £m	2009 £m
Gross loans and advances		
Property and construction	<b>4,544.6</b>	4,498.1
Retail, distribution and services	<b>500.1</b>	446.9
Business and other services	<b>3,824.3</b>	3,675.2
Personal	<b>26,513.9</b>	25,729.3
	<b>35,382.9</b>	34,349.5

	2010 £m	2009 £m
Long term business		
<b>Analysis of long term business loans and advances to customers</b>		
Secured by mortgages	<b>2.9</b>	3.5
Secured by insurance policies	<b>2.7</b>	4.0
Other loans	<b>–</b>	0.3
	<b>5.6</b>	7.8

#### Allowance for losses on loans and advances

	2010				2009			
	Individual Mortgage £m	Individual Corporate £m	Collective £m	Total £m	Individual Mortgage £m	Individual Corporate £m	Collective £m	Total £m
At beginning of the period	<b>2.3</b>	<b>51.3</b>	<b>140.4</b>	<b>194.0</b>	1.5	45.6	140.8	187.9
Charge against profits	<b>7.2</b>	<b>35.5</b>	<b>63.9</b>	<b>106.6</b>	1.5	33.4	81.2	116.1
Amounts written off	<b>(0.9)</b>	<b>(30.5)</b>	<b>(44.9)</b>	<b>(76.3)</b>	(0.7)	(26.5)	(79.2)	(106.4)
Recoveries	–	–	–	–	–	(0.1)	–	(0.1)
Unwind of discount of allowance	–	<b>(1.0)</b>	<b>(1.2)</b>	<b>(2.2)</b>	–	(1.4)	(2.4)	(3.8)
Interest charged on impaired loans	–	<b>0.5</b>	–	<b>0.5</b>	–	0.3	–	0.3
<b>At end of the period</b>	<b>8.6</b>	<b>55.8</b>	<b>158.2</b>	<b>222.6</b>	2.3	51.3	140.4	194.0

Loans and advances to customers include £74.1m (2009: £48.2m) of financial assets at fair value through profit or loss designated at initial recognition to eliminate or significantly reduce a measurement or recognition inconsistency. Of these, £20.0m (2009: £21.0m) are secured by real estate collateral.

The net impairment charge in note 3 is £97.3m (2009: £116.1m). This includes amounts recovered of £9.3m against amounts previously written off. The recoveries have been made from the mortgagors and from other parties involved in the origination or acquisition of the mortgages.



**27. Loans and advances to customers – Financial Services** continued**Loans and advances to customers include finance lease receivables:**

	2010 £m	2009 £m
Gross investment in finance leases, receivable:		
No later than one year	<b>28.4</b>	32.8
Later than one year and no later than five years	<b>66.2</b>	75.9
Later than five years	<b>78.7</b>	73.3
	<b>173.3</b>	182.0
Unearned future finance income on finance leases	<b>(44.2)</b>	(40.6)
Net investment in finance leases	<b>129.1</b>	141.4
The net investment in finance leases may be analysed as follows:		
No later than one year	<b>21.2</b>	25.4
Later than one year and no later than five years	<b>44.9</b>	54.5
Later than five years	<b>63.0</b>	61.5
	<b>129.1</b>	141.4

There are no unguaranteed residual values for any of the finance leases. The Co-operative Bank enters into finance lease and hire purchase arrangements with customers in a wide range of sectors including transport, retail and utilities. The accumulated allowance for uncollectible minimum lease payments receivable is £0.8m (2009 : £1.7m)

**28. Investments – Financial Services**

	Group	
	2010 £m	2009 £m
Investments comprise:		
<b>Fair value through profit or loss:</b>		
Listed equities	<b>5,501.1</b>	5,047.3
Unlisted equities	<b>969.8</b>	820.8
Listed debt securities	<b>6,506.6</b>	6,779.7
Unlisted debt securities	<b>2,153.7</b>	1,997.9
	<b>15,131.2</b>	14,645.7
<b>Available for sale:</b>		
Unlisted equities	<b>9.7</b>	9.0
Listed debt securities	<b>3,360.0</b>	2,470.9
Unlisted debt securities	<b>573.0</b>	2,991.8
	<b>3,942.7</b>	5,471.7
<b>Total fair value through profit or loss and available for sale investments</b>	<b>19,073.9</b>	20,117.4
Loans at amortised cost	<b>1,917.3</b>	2,486.2
Deposits with credit institutions	<b>1,548.1</b>	1,288.1
Investment properties	<b>1,650.5</b>	1,578.1
	<b>24,189.8</b>	25,469.8

The above investments are held by Co-operative Insurance Society Ltd, CIS General Insurance Limited, The Co-operative Bank plc and The Co-operative Asset Management Limited.

All investment properties are held to generate rental income until such time that the Group considers it appropriate to realise its investment. Investment properties are carried at fair value.

At the balance sheet date, CIS and CISGIL had securities with a market value of £102.9m (2009: £271.7m) on loan under approved stock lending arrangements. Eligible collateral totalling £105.6m (2009: £278.8m) was held as security.

Government guaranteed securities with a market value of £870.2m (2009: £1,057.1m) which were the subject of repurchase contracts are included in debt securities in the analysis above. A liability of £870.5m (2009: £1,071.2m) is included within financial liabilities in respect of the associated repurchase liability.

## Notes to the financial statements continued

### 29. Insurance contracts liabilities and reinsurance assets – Financial Services

#### a) Analysis of insurance and participating contract liabilities

	2010 £m	2009 £m
<b>Gross</b>		
Long term insurance contracts:		
– Insurance contracts	<b>2,675.5</b>	2,426.6
– Insurance participating contracts	<b>13,223.0</b>	12,494.7
– Investment participating contracts	<b>586.0</b>	573.3
	<b>16,484.5</b>	15,494.6
General insurance contracts:		
– Claims reported (including claims settlement)	<b>517.4</b>	457.1
– Claims incurred but not reported	<b>130.4</b>	165.1
– Claims settlement expenses	<b>16.4</b>	17.3
– Unearned premiums	<b>299.2</b>	220.9
– Provision for unexpired risks	–	9.1
Total gross insurance liabilities	<b>17,447.9</b>	16,364.1
<b>Recoverable from reinsurers</b>		
Long term insurance contracts:		
– Insurance contracts	<b>(1,857.8)</b>	(1,822.9)
– Insurance participating contracts	<b>(1,190.1)</b>	(1,148.6)
	<b>(3,047.9)</b>	(2,971.5)
Recoverable from reinsurers		
– Claims reported	<b>(25.3)</b>	(20.5)
– Claims incurred but not reported	<b>(25.1)</b>	(21.8)
– Unearned premiums	<b>(3.7)</b>	(5.2)
Total reinsurers share of insurance liabilities	<b>(54.1)</b>	(47.5)
	<b>(3,102.0)</b>	(3,019.0)
<b>Net</b>		
Long term insurance contracts:		
– Insurance contracts	<b>817.7</b>	603.7
– Insurance participating contracts	<b>12,032.9</b>	11,346.1
– Investment participating contracts	<b>586.0</b>	573.3
	<b>13,436.6</b>	12,523.1
General insurance contracts:		
– Claims reported (including claims settlement)	<b>492.1</b>	436.6
– Claims incurred but not reported	<b>105.3</b>	143.3
– Claims settlement expenses	<b>16.4</b>	17.3
– Unearned premiums	<b>295.5</b>	215.7
– Provision for unexpired risks	–	9.1
	<b>909.3</b>	822.0
<b>Total net insurance liabilities</b>	<b>14,345.9</b>	13,345.1

## 29. Insurance contracts liabilities and reinsurance assets – Financial Services *continued*

### b) General insurance contracts – assumptions, changes in assumptions and sensitivity

#### i) Basis of assessing liabilities

CISGIL uses a combination of recognised actuarial and statistical techniques to assess the ultimate cost of claims. These include:

- Projecting historic claims payment and recoveries data;
- Projecting numbers of claims;
- Adjusting case estimates for future inflation and onto a provisioning basis;
- Deriving average costs per claim to apply to claim numbers;
- Projecting historic claims incurred data (payment plus estimates) – Chain Ladder techniques; and
- Bornhuetter Ferguson/Cape Cod techniques.

Extensive use of detailed claims data including individual case estimates is made to derive patterns in average claim costs and timings between occurrence and estimate/payment of claims. The most common method used is the Chain Ladder method. This technique involves the analysis of historical claims development trends and the selection of estimated development factors based on this historical pattern. The selected development factors are then applied to cumulative claims data for each accident year which is not yet fully developed to produce an estimated ultimate claims cost for each accident year. A degree of judgment is required in selecting the most appropriate development factors.

The Chain Ladder method can be quite volatile for relatively undeveloped origin periods so a Bornhuetter-Ferguson/Cape Cod method is often used in such cases. This method uses some prior expectation of the ultimate claims, and stabilises the projected ultimate by weighting between the prior expected ultimate and the projected based on the assumed development factors. The Cape Cod method differs from the Bornhuetter-Ferguson method in that it uses a trending of ratios (such as the Average Cost) to arrive at a prior expected ultimate for use in the projections.

The work is undertaken and supervised by suitably qualified personnel. Claims provisions are separately computed for each claim type such as bodily injury, accidental damage, storm, flood and subsidence. All provisions are calculated with explicit allowance for reinsurance and subrogation recoveries. Provisions are not discounted for investment return other than any required additional provision for unexpired risks, periodic payment settlements and provisions relating to asbestos exposure within the electric industry (EIROS claims).

The EIROS reserve was based on a report produced for the industry by EMB (an actuarial consultancy) at the end of 2009, which gave EMB's estimate of both the undiscounted and discounted incurred but not reported (IBNR) reserves as at the end of the third quarter 2009. This was the most recent report available when we calculated our year end 2010 reserves.

The average period to settlement of such claims is:

- 11.9 years for Employers' liability
- 15.3 years for Public and Product's liability
- 12.3 years in total

In both cases, the discount rate is 4.0%. The current EIROS reserve amounts to £2.6m.

The criteria adopted for estimating the period that will elapse before the claims are settled used the run-off pattern from previous experience.

As outlined in note 52 there is significant uncertainty in the assessment of liabilities and provisions are set to be adequate to cover the eventual cost. Sensitivity analysis is performed to assist the selection of key parameters and, hence, the provisions adopted. There is a governance process in place to ensure that provisions are subject to detailed review regarding the appropriateness of key assumptions and the quantum of the provisions established.

The overall objective of CISGIL's reserving policy is to produce reliable and accurate estimates. Assumptions underlying the reserving calculations are agreed by a reserving committee and methodologies are peer reviewed throughout the calculation process. Provisions are approved and signed off by the quarterly reserving forum executive committee.

Periodic reports are produced by the actuarial team and presented to the Periodic Reporting Committee (PRC) in order to advise management of the performance of the GI business. Detailed reports are produced on a quarterly basis providing information on the performance of the business against plan. These reports are presented to the Quarterly Reserving Forum Committee (QRF) and form the basis of reporting the GI performance to the Board on a quarterly basis.

#### ii) Key assumptions

Principal assumptions underlying the claims provisions include:

- Explicit allowance for future inflation at rates varying from 0.00% to 8.25% pa according to the claim type. The range of future inflation rates is largely unchanged from that used at the previous period end; and
- For bodily injury claims, allowance has been made for:
  - i) Use of the appropriate Ogden Tables
  - ii) Increased awards for general damages in accordance with the 10th edition of the JSB guidelines
  - iii) A small proportion of large claims being settled by periodic payments; and
  - iv) Improvements in the case estimation techniques resulting in earlier recognition of the size of the claims

## Notes to the financial statements continued

### 29. Insurance contracts liabilities and reinsurance assets – Financial Services continued

The gross insurance provision for claims and loss adjustment expenses arising in respect of previous periods of £380.6m (2009: £418.4m) includes a movement of £27.3m (2009: £30.6m) arising from changes in assumptions and release of surplus. Details are as follows:

- Fire and accident release of surplus, £5.8m
- Motor release of surplus, £20.8m
- Movement on claims handling expenses, £0.7m

#### iii) Sensitivity analysis

There is greater uncertainty over motor claims provisions than other provisions as they typically involve claims for bodily injury and associated legal costs and therefore typically have a longer period to settlement. Motor provisions represent the most significant proportion of the total general insurance outstanding claims liabilities (gross of salvage and subrogation). Sensitivity information is given for motor claims provisions together with limited information for all other classes. The following table indicates the effect on gross claims provisions (gross of reinsurance and salvage and subrogation) of changes in key assumptions. Impacts to net technical provisions have an equivalent impact to profitability. The impact of the increased uncertainty on the profit and loss risk is mitigated through holding management margin on the best estimate reserves that is proportional to the level of uncertainty.

#### Assumption

	Change in parameter	2010		2009	
		Effect on gross provision £m	% effect	Effect on net provision £m	% effect
<b>Motor</b>					
Average cost of claims for last three years – bodily injury	10%	<b>36.0</b>	<b>8.80%</b>	20.3	4.90%
Average cost of claims for last three years – legal	10%	<b>16.7</b>	<b>4.10%</b>	14.9	3.60%
Mean term to settlement – bodily injury and legal	+½ year	<b>10.5</b>	<b>2.60%</b>	11.8	2.90%
Rate of future inflation – bodily injury and legal	1%	<b>9.5</b>	<b>2.30%</b>	8.2	2.00%
Ogden discount rate – bodily injury	-¼%	<b>6.7</b>	<b>1.40%</b>	3.4	0.70%
<b>Other classes</b>					
Mean term to settlement (liability)	+½ year	<b>0.4</b>	<b>2.10%</b>	0.7	2.50%
Mean term to settlement (non-liability)	+½ year	<b>0.9</b>	<b>1.40%</b>	0.7	1.20%
Rate of future inflation (liability)	1%	<b>0.8</b>	<b>3.80%</b>	1.9	6.90%
Rate of future inflation (non-liability)	1%	<b>0.9</b>	<b>1.30%</b>	0.7	1.30%

In 2010 the impact of a ¼% change in the Ogden rate relates to a change from the rate used in the evaluation of the reserves.

### c) Changes in General Insurance liabilities and reinsurance assets

#### i) Change in insurance contract liabilities (net of salvage and subrogation)

	Gross	Unexpired risk provision	Salvage and subrogation	Net
At beginning of the year	639.5	9.1	(41.4)	607.2
Movement in the year	24.7	(9.1)	(4.6)	11.0
At end of the year	<b>664.2</b>	<b>–</b>	<b>(46.0)</b>	<b>618.2</b>

#### ii) General insurance – claims and loss adjustment expenses

	2010			2009		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Notified outstanding claims	<b>457.2</b>	<b>(20.5)</b>	<b>436.7</b>	434.7	(22.6)	412.1
Claims incurred but not reported	<b>165.0</b>	<b>(21.8)</b>	<b>143.2</b>	229.3	(14.5)	214.8
Claims settlement expenses	<b>17.3</b>	<b>–</b>	<b>17.3</b>	18.9	–	18.9
At the beginning of the financial period	<b>639.5</b>	<b>(42.3)</b>	<b>597.2</b>	682.9	(37.1)	645.8
Claims paid during the period	<b>(383.9)</b>	<b>6.6</b>	<b>(377.3)</b>	(359.0)	7.4	(351.6)
Increase in liabilities: – arising from current and previous period claims	<b>408.6</b>	<b>(14.7)</b>	<b>393.9</b>	315.6	(12.6)	303.0
<b>Total movement</b>	<b>24.7</b>	<b>(8.1)</b>	<b>16.6</b>	(43.4)	(5.2)	(48.6)
Notified claims	<b>517.4</b>	<b>(25.3)</b>	<b>492.1</b>	457.2	(20.5)	436.7
Incurred but not reported	<b>130.4</b>	<b>(25.1)</b>	<b>105.3</b>	165.0	(21.8)	143.2
Claims settlement expenses	<b>16.4</b>	<b>–</b>	<b>16.4</b>	17.3	–	17.3
At the end of the financial period	<b>664.2</b>	<b>(50.4)</b>	<b>613.8</b>	639.5	(42.3)	597.2

**29. Insurance contracts liabilities and reinsurance assets – Financial Services** continued**iii) General Insurance – provisions for unearned premiums**

	2010			2009		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
<b>Unearned premium provision</b>						
At beginning of the period	220.9	(5.2)	215.7	193.5	(3.5)	190.0
Increase in the period	574.2	(27.6)	546.6	424.3	(23.2)	401.1
Release in the period	(495.9)	29.1	(466.8)	(396.9)	21.5	(375.4)
Movement in the period	78.3	1.5	79.8	27.4	(1.7)	25.7
<b>At end of the period</b>	<b>299.2</b>	<b>(3.7)</b>	<b>295.5</b>	220.9	(5.2)	215.7

**iv) General Insurance – provisions for unexpired risk**

	2010			2009		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
<b>Unexpired risk provision</b>						
At the beginning of the financial period	9.1	–	9.1	6.7	–	6.7
Increase in the financial period	–	–	–	9.1	–	9.1
Release in the financial period	(9.1)	–	(9.1)	(6.7)	–	(6.7)
Movement in the financial period	(9.1)	–	(9.1)	2.4	–	2.4
<b>At the end of the financial period</b>	<b>–</b>	<b>–</b>	<b>–</b>	9.1	–	9.1

Additional provision is made for unexpired risks where the claims and expense, likely to arise after the end of the financial year, in respect of contracts concluded before that date, are expected to exceed the unearned premiums at the end of the financial year. The provision primarily relates to the motor class of business, however the full provision has been released during the year.

**v) Analysis of claims development – gross of reinsurance**

	Accident year										
	2001 £m	2002 £m	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	Total £m
At end of accident year	507.1	591.8	572.0	550.5	480.1	419.3	384.5	347.3	325.9	411.3	4,589.8
– One year later	484.4	559.7	542.8	527.1	468.3	412.1	387.8	319.7	333.1	–	4,035.0
– Two years later	475.8	560.3	526.5	495.3	439.9	402.6	378.2	310.2	–	–	3,588.8
– Three years later	486.2	550.6	507.6	467.2	414.0	393.5	364.2	–	–	–	3,183.3
– Four years later	488.8	547.4	499.5	450.3	422.9	387.1	–	–	–	–	2,796.0
– Five years later	488.3	548.1	498.9	453.9	418.6	–	–	–	–	–	2,407.8
– Six years later	484.9	540.3	494.0	453.1	–	–	–	–	–	–	1,972.3
– Seven years later	481.5	546.5	496.4	–	–	–	–	–	–	–	1,524.4
– Eight years later	482.9	543.4	–	–	–	–	–	–	–	–	1,026.3
– Nine years later	485.3	–	–	–	–	–	–	–	–	–	485.3
Estimate of cumulative claims	485.3	543.4	496.4	453.1	418.6	387.1	364.2	310.2	333.1	411.3	4,202.7
Cumulative payments to date	(467.4)	(528.2)	(474.9)	(437.1)	(382.0)	(341.4)	(314.8)	(249.1)	(227.8)	(161.6)	(3,584.3)
Provision before discounting	17.9	15.2	21.5	16.0	36.6	45.7	49.4	61.1	105.3	249.7	618.4
Provision for prior years before discounting											31.3
Discounting											(1.9)
<b>Gross outstanding claims liabilities</b>											<b>647.8</b>

	£m
Gross claims reported	517.4
Gross claims incurred but not reported	130.4
<b>Gross outstanding claims liabilities</b>	<b>647.8</b>



## Notes to the financial statements continued

### 29. Insurance contracts liabilities and reinsurance assets – Financial Services continued

#### Analysis of claims development – net of reinsurance

	Accident year										Total £m
	2001 £m	2002 £m	2003 £m	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	
At end of accident year	504.0	585.6	569.6	547.2	477.6	416.6	372.6	334.6	313.1	398.4	4,519.3
– One year later	480.6	553.0	540.7	525.1	465.8	408.9	377.8	305.5	320.7	–	3,978.1
– Two years later	471.6	553.8	524.5	493.3	437.4	400.8	369.8	296.3	–	–	3,547.5
– Three years later	480.9	541.0	505.6	465.2	411.0	392.5	357.8	–	–	–	3,154.0
– Four years later	480.1	537.8	497.5	448.0	420.1	386.0	–	–	–	–	2,769.5
– Five years later	479.6	538.5	495.4	451.6	414.1	–	–	–	–	–	2,379.2
– Six years later	476.2	531.1	491.7	450.8	–	–	–	–	–	–	1,949.8
– Seven years later	471.5	533.6	493.2	–	–	–	–	–	–	–	1,498.3
– Eight years later	474.9	531.2	–	–	–	–	–	–	–	–	1,006.1
– Nine years later	477.5	–	–	–	–	–	–	–	–	–	477.5
Estimate of cumulative claims	477.5	531.2	493.2	450.8	414.1	386.0	357.8	296.3	320.7	398.4	4,126.0
Cumulative payments to date	(464.5)	(522.1)	(473.5)	(435.0)	(380.9)	(341.2)	(309.7)	(243.3)	(223.6)	(157.9)	(3,551.7)
Provision before discounting	13.0	9.1	19.7	15.8	33.2	44.8	48.1	53.0	97.1	240.5	574.3
Provision for prior years before discounting											25.0
Discounting											(1.9)
<b>Net outstanding claims liabilities</b>											<b>597.4</b>

	£m
Net claims reported	492.1
Net claims incurred but not reported	105.3
<b>Net outstanding claims liabilities</b>	<b>597.4</b>

#### d) Capital position statement 2010

	Long term business (excl. stakeholder) £m	With-profits stakeholder fund £m	Shareholder funds £m	Total Long term business £m
<b>Available capital resources</b>				
Shareholders' funds held outside fund	–	–	200.0	200.0
Shareholders' funds held in fund	–	–	–	–
<b>Total shareholders' funds</b>	–	–	200.0	200.0
Adjustments onto regulatory basis:				
– UDS	1,010.7	–	–	1,010.7
– Adjustments to assets	(60.2)	–	–	(60.2)
<b>Total available capital resources</b>	<b>950.5</b>	<b>–</b>	<b>200.0</b>	<b>1,150.5</b>
With-profits liabilities on realistic basis:				
– Options and guarantees	1,113.6	–	–	1,113.6
– Other policyholder obligations	11,461.7	227.6	–	11,689.3
<b>Total participating contract liabilities</b>	<b>12,575.3</b>	<b>227.6</b>	<b>–</b>	<b>12,802.9</b>
– Non-participating life assurance	817.7	–	–	817.7
<b>Insurance and participating contract liabilities per capital position statement</b>	<b>13,393.0</b>	<b>227.6</b>	<b>–</b>	<b>13,620.6</b>

**29. Insurance contracts liabilities and reinsurance assets – Financial Services** continued  
**Capital position statement 2009**

	Long term business (excl. stakeholder) £m	With-profits stakeholder fund £m	Shareholder funds £m	Total Long term business £m
<b>Available capital resources</b>				
Shareholders' funds held outside fund	–	–	200.0	200.0
Shareholders' funds held in fund	–	–	–	–
<b>Total shareholders' funds</b>	–	–	200.0	200.0
Adjustments onto regulatory basis:				
– UDS	1,029.7	–	–	1,029.7
– Adjustments to assets	(22.1)	–	–	(22.1)
<b>Total available capital resources</b>	1,007.6	–	200.0	1,207.6
With-profits liabilities on realistic basis:				
– Options and guarantees	1,101.6	–	–	1,101.6
– Other policyholder obligations	10,877.7	198.2	–	11,075.9
<b>Total participating contract liabilities</b>	11,979.3	198.2	–	12,177.5
– Non-participating life assurance	603.7	–	–	603.7
<b>Insurance and participating contract liabilities per capital position statement</b>	12,583.0	198.2	–	12,781.2

**Reconciliation to insurance and participating contracts liability**

	2010 £m	2009 £m
Insurance and participating contract liabilities as per capital position statement	<b>13,620.6</b>	12,781.2
Add back reinsurance	<b>3,047.9</b>	2,971.5
Outstanding claims reserves	<b>121.0</b>	106.8
General insurance gross contract liabilities	<b>153.8</b>	209.6
Less funeral bonds held by Trading Group	<b>(305.0)</b>	(364.9)
<b>Insurance and participating contract liabilities</b>	<b>16,638.3</b>	15,704.2

**e) Long term life insurance contracts – assumptions, changes in assumptions and sensitivity**

**i) Capital management policies and objectives**

The liabilities of the long term business fund shown in the capital position statement are calculated following FSA rules and guidance. CIS has a general reserve of £317m which is available to support both long term business and general insurance business in run-off. The general reserve is shareholder capital and is held outside the long term business fund. However, as at 1 January 2011, £200m of the general reserve was allocated to the long term business fund.

The whole of the profits of the long term business are applied for the sole benefit of the long term business policyholders. This includes the making of reserves with the aim of preserving the strength of the fund for the benefit of current and future life assurance and pensions policyholders. Similarly, any losses incurred within the fund are borne by the policyholders, either through a reduction in the working capital of the fund or through a reduction in their benefits.

The working capital of the fund is the excess of assets within the fund over the amount needed to meet liabilities, including those arising from the regulatory requirement to treat customers fairly when setting discretionary benefits. The working capital is managed to ensure that the long term business fund can meet its solvency requirements under a range of adverse conditions and to meet business plans.

Risks that may affect the long term business fund are managed according to documented risk management policies, which require risks and capital to be monitored and reported regularly, and decisions made according to delegated authorities; details are provided in note 52 Risk Management. Actions to control risk and manage the working capital of the fund include the use of reinsurance, the matching of assets and liabilities (including using derivatives) and the setting of discretionary benefits at appropriate levels, as described in the Principles and Practices of Financial Management (PPFM).

In exceptional circumstances, assets held outside the fund (share capital and general reserve), if available, may be used to help meet the long term business fund's solvency requirements. In some circumstances, this may require a transfer of assets into the fund. In such cases the fund would be managed with the aim of repaying these assets (accumulated with interest at an appropriate level) over time from within the fund.

## Notes to the financial statements continued

### 29. Insurance contracts liabilities and reinsurance assets – Financial Services continued

#### ii) Policy options and guarantees

Personal and free-standing pension scheme pure endowment contracts issued prior to March 1999 contain options guaranteeing a minimum annuity rate at vesting. The value of the options is calculated using a market consistent stochastic approach. For a representative set of policies, the asset shares are projected to the date of vesting. If, based on projected market interest rates at the date of vesting, the annuity that would then be payable is less than the guaranteed annuity, additional provision is made with the additional costs being calculated on a market consistent basis. Assumptions used in the calculation relating to expenses, mortality experience and the proportion of policies that reach vesting are best estimates based on experience investigations carried out during 2010. At 1 January 2011, provisions amounting to £559.2m (2009: £512.0m) have been made to cover the future cost of meeting guarantees of this type.

For accumulating with-profits business, provision has been made for the guarantee that no market value reduction will apply on death or on surrender of premiums paid prior to 1 April 2000 if ten or more years prior to the date of surrender. The value of the guarantee is calculated using a market consistent stochastic approach, and assuming that annual bonuses are at expected future levels. Provision has been made for the current value of the excess of the guaranteed payout on surrender over the projected asset share. Expense and mortality assumptions used in the calculation are best estimates based on experience investigations carried out during 2010. At 1 January 2011, provisions amounting to £48.7m (2009: £65.0m) have been made to cover the future cost of meeting guarantees of this type.

The cost of meeting maturity guarantees on life and pensions savings products is calculated stochastically using market consistent interest rates. It is assumed that annual bonuses continue to be declared at the levels applicable following the bonus declaration arising out of the current valuation. Provision has been made for the present value of the excess of the guaranteed payout at maturity over the projected asset share. Expense and mortality assumptions used in the calculation are best estimates based on experience investigations carried out during 2010. At 1 January 2011, provisions amounting to £551.8m (2009: £560.0m) have been made to cover the future cost of meeting guarantees of this type.

#### iii) Basis of assessing liabilities

The long term business provision is calculated twice a year having regard for the principles laid down in Chapters 1.2 and 1.3 of the Prudential Sourcebook for Insurers (INSPRU). In December 2006, FSA issued a policy statement (PS06/14) allowing insurers to move the capital and reserving requirements of non-profit business to a more realistic basis. CIS adopted the changes under this policy statement at 12 January 2008, and continues to do so at 1 January 2011.

#### iv) Participating business methodology

Provisions for participating business are calculated as the value of the with-profits benefits reserve plus the cost of options, guarantees and smoothing. Retrospective methods are used to calculate with-profits benefits reserves for all products apart from whole-of-life policies for which a prospective method is used.

Retrospective methods of calculation involve the accumulation of monthly cash flows in respect of premiums plus investment income (including unrealised gains/losses and allowances for allocations in respect of past miscellaneous surplus) less policy charges, expenses and tax.

Prospective methods are used to calculate with-profits benefits reserves for all Ordinary and Industrial Branch whole-of-life policies. Prospective methods of calculation involve determining the present value of the future cash flows in respect of premiums plus investment return, less policy charges and expenses, benefits payable (including guaranteed benefits, bonuses declared and an element of potential future bonuses) and tax.

The cost of guarantees, options and smoothing is calculated using a market consistent stochastic model. Policies are grouped by similar nature, term and size for each product. Stochastic projections are performed using grouped model points representing individual contracts. The market consistent asset model has been used to calculate the costs of guarantees, options and smoothing.

The model is calibrated according to the rules within INSPRU and tests are performed to ensure that the model reproduces current market prices of traded instruments and is arbitrage-free.

#### v) Non-participating business methodology

Reserves for conventional non-participating business are valued prospectively, using a gross premium approach, by subtracting the actuarial value of the estimated future premium income from the value of the future benefit outgo. Prudent assumptions are used in these calculations but some allowance is made for expected future lapses.

The value of future profits that are expected to arise on non-participating contracts (being the present value of future cash flows under these contracts) is calculated using realistic assumptions and, for presentational purposes, is deducted from the reserves to determine the provision for conventional participating business.

Provisions for unit-linked policies are determined by reference to the value of the units allocated to policies at the accounting date.

Although the gross insurance liabilities and the related reinsurance are fairly stated on the basis of the information currently available, the eventual liability may vary as a result of subsequent information and events.

The provisions, estimation techniques and assumptions are periodically reviewed with any changes in estimates reflected in the income statement as they occur.

**29. Insurance contracts liabilities and reinsurance assets – Financial Services** continued**vi) Assumptions used in valuing the realistic liabilities**

The overall objective of the CIS reserving policy is to produce reliable and accurate estimates. Assumptions used in valuing the realistic liabilities are proposed by the Actuarial Function Holder and agreed by the CIS Board.

In general, assumptions used in the valuation of realistic liabilities are based on the results of the most recent experience investigations and are considered to be best estimates of future experience. Where data is not significant enough to make firm conclusions, industry data is also considered. The assumptions sensitive to the value of the realistic liabilities are:

- interest rates;
- future bonuses;
- expenses and expense inflation;
- mortality, morbidity and persistency; and
- tax.

**vii) Interest rates used in valuing the realistic liabilities**

A risk-free future interest rate of 3.99% (2009: 4.45%) is assumed when calculating prospective asset shares and the value of in-force business on non-participating contracts in compliance with the requirements of INSPRU.

Liabilities for non-participating contracts require a prudent assumption to be made regarding future interest rates and are determined by reference to recent investment returns on assets backing the contracts and consideration of the long term view of these returns.

In calculating the value of in-force business on non-participating contracts, future profits are discounted using an interest rate that is 1% above the risk-free rate of return.

In determining the value of options and guarantees, the interest rate is stochastic with an average of the risk-free curve across all scenarios. The risk-free curve varies by duration.

**viii) Future bonuses**

Prospective asset share calculations and the valuation of options and guarantees use the latest proposed annual rates, and assume they will continue at these levels.

**ix) Expenses and expense inflation**

Expense assumptions for prospective asset shares and value for the in-force business on non-participating contracts are determined based on the latest experience and are adjusted, where appropriate, to reflect any expected changes in patterns in the future.

Reserves for non-participating contracts require a prudent explicit allowance to be made for the future expenses of maintaining contracts in force.

The level of future expense inflation is determined with reference to historical trends and expectations of how future per policy expenses will change. The assumption used in determining the provisions is calendar year specific up to 2017 reverting to a long term assumption of 5.1% pa (2009: 5.1% pa).

**x) Mortality, morbidity and persistency**

Wherever appropriate, mortality and persistency assumptions used are based on the results of the most recent experience investigations. Mortality assumptions are based on percentages of standard tables published by the Continuous Mortality Investigations Bureau (CMIB) and vary by product. Persistency assumptions (including early retirement rates on pension policies) vary by product and the number of years that a policy has been in force. Where data is not of a significant enough size to make firm conclusions, industry data is also considered. Critical illness assumptions are also based on percentages of standard tables published by CMIB.

In valuing guaranteed annuity options on personal pension policies, on retirement at the normal retirement age and after allowing for any tax-free cash sums, all guaranteed annuity options that are 'in-the-money' are assumed to be taken.

Mortality, morbidity and persistency assumptions have been updated to reflect the results of the 2010 experience investigations and new CMIB models for future assumed annuitant mortality improvements, but these changes have not had a major impact on the insurance contract liabilities.

**xi) Tax**

It is assumed that the current tax legislation and associated tax rates remain unchanged. The tax rate assumption used for netting interest rates and expenses is 20% (2009: 20%).

## Notes to the financial statements continued

### 29. Insurance contracts liabilities and reinsurance assets – Financial Services continued

#### xii) Sensitivity analysis

The capital position of the long term business fund is sensitive to a number of economic and insurance variances since the fund contains a number of different policyholder options and guarantees as described in section (ii) above. Some of the main sensitivities of the fund can be examined by applying the stress tests prescribed by the FSA in calculating the Risk Capital Margin (RCM). The tests carried out in calculating the RCM and the sensitivity of the working capital to each test are as follows:

#### RCM stress test

	Reduction in working capital £m
20% fall in equity values and 12.5% fall in property values	56
17.5% change in long term gilt yields	14
32.5% improvement in persistency rates	63
Increase of 113 basis points in bond yields for credit risk test	82
<b>Total RCM before management actions</b>	<b>215</b>

In calculating the RCM, it has been assumed that no management action would be taken under the stressed conditions.

The RCM has been calculated to be £215m (2009: £320m). The excess working capital of the fund after the RCM is therefore £735m (2009: £688m) or £935m (2009: £888m) if the additional capital available outside the long term business fund is included. The RCM is covered 4.4 times (2009: 3.2 times) by working capital (excluding the £200m allocated from the general reserve).

	Reduction in working capital £m
<b>Other stress tests</b>	
5% fall in assurance mortality rates	0
5% fall in annuitant mortality rates	35
10% increase in renewal expenses	54
1% increase in renewal expense inflation	98

#### f) Change in long term insurance liabilities and reinsurance assets

	2010			Net £m
	Non-participating insurance contracts £m	Participating insurance contracts £m	Reinsurance £m	
At the beginning of the year	2,426.6	13,311.1	(2,956.5)	12,781.2
New liabilities	145.6	178.1	–	323.7
Changes in liabilities during the year	(8.2)	(929.8)	–	(938.0)
Effect of changes in non-economic assumptions	41.5	3.0	–	44.5
Effect of changes in asset shares	–	1,274.8	–	1,274.8
Effect of changes in economic conditions	(56.9)	(12.8)	–	(69.7)
Other	126.9	156.9	(79.7)	204.1
At the end of the year	2,675.5	13,981.3	(3,036.2)	13,620.6
Outstanding claims	–	132.7	(11.7)	121.0
<b>Insurance contract liabilities</b>	<b>2,675.5</b>	<b>14,114.0</b>	<b>(3,047.9)</b>	<b>13,741.6</b>

In 2010, new annuity liabilities of £153.2m have been included within 'new liabilities' under non-participating insurance contracts above. Previously these were disclosed within 'changes in liabilities during the year'.



**29. Insurance contracts liabilities and reinsurance assets – Financial Services** continued**g) Movement in working capital of the long term business fund**

	2010 £m	2009 £m
At beginning of the period	<b>1,007.6</b>	573.4
Opening adjustments	<b>(102.3)</b>	(17.1)
Changes to insurance assumptions	<b>(31.2)</b>	71.4
Economic variances	<b>97.6</b>	335.1
Insurance variances	<b>(3.4)</b>	20.2
Other factors	<b>(17.8)</b>	24.6
<b>At end of the period</b>	<b>950.5</b>	1,007.6

**Opening adjustments**

Opening adjustments consist of:

- improvements to the actuarial models used to calculate the working capital; and
- classification of an inter-company balance as inadmissible for FSA returns only.

**Changes to insurance assumptions**

Changes to insurance assumptions include:

- changes to expense, mortality and persistency assumptions to reflect the latest experience investigations.

**Economic variances**

Economic variances arise from the following:

- investment returns more than (2009: more than) the assumed risk-free rate helping to reduce (2009: reduce) the cost of meeting policy guarantees;
- a decrease (2009: increase) in risk-free rates which has increased (2009: decreased) the cost of policy guarantees; and
- assumed equity and interest rate volatility which has decreased (2009: decreased) the cost of policy guarantees.

**Insurance variances**

Insurance variances include:

- variances between actual and assumed experience during the financial period;
- changes to endowment mis-selling compensation costs;
- new business profits or losses; and
- one-off expenses.

**Other factors**

Other factors include:

- the impact of changes to the short term assumed asset mix reflecting current asset holdings; and
- changes to some of the assumed future rates of section 32 buyout bonds.

## Notes to the financial statements continued

### 30. Prepayments and other receivables – Financial Services

	2010 £m	2009 £m
Receivables arising from insurance:		
– arising from insurance operations	<b>169.6</b>	119.1
– salvage and subrogation recoveries	<b>46.0</b>	41.4
– reinsurance operations	<b>2.3</b>	1.9
Other receivables:		
– accrued interest and rent	<b>164.6</b>	193.2
– prepayments and accrued income	<b>59.0</b>	147.4
– outstanding income	<b>1.8</b>	6.1
– amounts receivable for investments sold	<b>19.9</b>	18.8
– other receivables	<b>11.2</b>	10.6
Trade receivables	<b>1.4</b>	1.7
Other assets	<b>51.1</b>	20.4
	<b>526.9</b>	560.6

### 31. Share capital

	Nominal and paid-up value Members' share capital	
	2010 £m	2009 £m
Representing:		
Corporate shares of £5 each	<b>8.5</b>	8.5
Individual shares of £1 and 10p each	<b>61.4</b>	63.4
	<b>69.9</b>	71.9

IFRIC 2 determines the features that allow shares to be classified as equity capital.

#### Members' share capital

Members' share capital comprises corporate and individual shares. The rights attached to shares are set out in the Society's rules. Shares held by corporate members (corporate shares) are not withdrawable and are transferable only between corporate members with the consent of the Society's Board. Shares held by individual members (individual shares) are withdrawable on such period of notice as the Society's Board may from time to time specify.

As the Board has an unconditional right to refuse redemption of both classes of shares, both corporate and individual shares are treated as equity shares.

Both classes of share maintain a fixed nominal value, attract a limited rate of interest and do not carry voting rights per se. Voting for corporate members is in proportion to trade with the Society. Each individual member has one vote in the appropriate region of the Society and each region has voting rights calculated on the same basis as a corporate member.

Corporate members receive a payment on trade transacted with the Society.

#### Distribution of reserves in the event of a winding-up

The Society's rules state that any surplus in the event of a winding-up shall be transferred to one or more societies registered under the Industrial and Provident Societies Acts 1965 to 2002. Such societies must be in membership of Co-operatives UK Limited and have the same or similar rule provisions as regards surplus distribution on a dissolution or winding-up as the Society. If not so transferred, the surplus shall be paid or transferred to Co-operatives UK Limited to be used and applied in accordance with co-operative principles.

### 32. Reserves

The nature and purpose of each reserve is described below. Refer to the Statement of Changes in Equity on pages 66 and 67 for a full reconciliation of the changes in each reserve.

#### Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the Tasly Sants Pharmaceutical Distributors Limited investment (see note 19).

#### Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in fair value of cashflow hedging instruments related to hedged transactions that have not yet occurred.

#### Revaluation reserve – property, plant and equipment

The fair value comprises the cumulative net change in the fair value of available for sale financial assets until the investments are derecognised or impaired.

#### Available for sale investments reserve

CISGIL classifies the majority of holdings in debt securities as available for sale. Subsequent valuation is at fair value with differences between fair value and carrying value recognised in equity as they arise.

### 33. Interest-bearing loans and borrowings – Trading Group

This note provides information about the contractual terms of the Group's interest-bearing loans and borrowings. For more information about the Group's exposure to interest rate and foreign currency risk, see note 52.

	2010 £m	2009 £m
Non-current liabilities:		
Secured bank loan	189.7	193.1
Unsecured bank loans	1,146.6	1,360.0
5½% Eurobond Issue 2013*	210.6	206.2
7½% First Mortgage Debenture Stock 2018*	53.7	52.3
Other loans	5.4	5.9
Non-current portion of finance lease liabilities	13.7	12.2
	<b>1,619.7</b>	1,829.7

	2010 £m	2009 £m
Current liabilities:		
Current portion of secured bank loan	3.4	2.9
Current portion of unsecured bank loans	100.0	–
Corporate investor shares	46.3	36.7
Current portion of finance lease liabilities	5.8	4.4
Other unsecured loans	3.9	3.5
	<b>159.4</b>	47.5

\* These drawdown loan commitments are designated as financial liabilities at fair value through the income statement. All of the other liabilities, except the finance lease liability, are classified as loans and receivables in accordance with IAS 32.

#### Corporate investor shares

Corporate investor debt may be issued to existing corporate members who hold fully paid corporate shares and are registered Industrial and Provident Societies. The terms and conditions under which such loans are withdrawn or repaid, and the rate of interest payable, is determined from time to time by the Society's Board.

#### Terms and repayment schedule

The 7½% First Mortgage Debenture Stock 2018, which is secured over freehold and leasehold properties with a carrying amount of £100m, has an original value of £50m to be paid to holders upon maturity.

The 5½% Eurobond Issue 2013 has an original value of £200m to be paid to holders upon maturity.

The unsecured bank loans consist of a £1,246.6m term loan which is fully drawn as at 1 January 2011, plus a £300m revolving credit facility which is drawn at £5.9m as at 1 January 2011.

Whilst both these facilities terminate in full on 15 July 2013 the term loan does have two intermediate repayment instalments of £100m on 31 August 2011 and 2012.

## Notes to the financial statements continued

### 33. Interest-bearing loans and borrowings – Trading Group continued

#### Finance lease liabilities

Finance leases have the following maturities in the Trading Group:

	2010 £m	2009 £m
Less than one year	5.8	4.4
Greater than one year but less than five years	12.7	10.3
Greater than five years	1.0	1.9
	<b>19.5</b>	16.6

Under the terms of the lease agreements, no contingent rents are payable.

### 34. Trade and other payables – Trading Group

	2010 £m	2009 £m
Amounts falling due within one period:		
Trade payables	910.5	888.5
Value-added tax, PAYE and social security	15.7	–
Accruals and deferred income	199.0	202.5
Payments proposed to and on behalf of members	27.0	36.8
Funeral bonds	0.1	1.2
Other payables	215.4	325.7
	<b>1,367.7</b>	1,454.7

	2010 £m	2009 £m
Amounts falling due after more than one period:		
Funeral bonds	622.3	475.0
Other payables	4.8	8.3
	<b>627.1</b>	483.3

### 35. Provisions – Trading Group

	Provision for claims £m	Onerous leases £m	Integration provision £m	Litigation £m	Other £m	2010 Total £m	2009 Total £m
At beginning of the period	71.4	204.2	78.4	53.5	64.0	471.5	223.5
Arising on transfer of engagements	–	–	–	–	–	–	27.1
Credit to income statement	–	(8.7)	(7.9)	(7.6)	(0.2)	(24.4)	(1.1)
Arising from acquisitions	–	–	–	–	5.2	5.2	184.3
Charge to income statement	41.6	20.3	29.4	–	6.6	97.9	122.1
Disposal of business	–	–	–	–	–	–	–
Discounting	–	10.8	–	–	–	10.8	6.8
Payments	(37.0)	(18.4)	(46.1)	(6.3)	(11.4)	(119.2)	(89.3)
Transfer from payables	–	(1.6)	–	–	(2.3)	(3.9)	(1.9)
<b>At end of the period</b>	<b>76.0</b>	<b>206.6</b>	<b>53.8</b>	<b>39.6</b>	<b>61.9</b>	<b>437.9</b>	471.5

	2010 £m	2009 £m
Non-current	291.8	415.0
Current	146.1	56.5
	<b>437.9</b>	471.5

**35. Provisions – Trading Group** continued

The provision for claims relates to potential liabilities arising from past events. The provision includes an assessment, based on historical experience, of claims incurred but not reported at the year end. The claims are expected to be settled substantially over the next three years. Discounting does not materially impact the level of the provision.

The provision for leases primarily relates to properties that are no longer used for trading. The provision is net of estimated rental income from sub-letting the properties. The provision is calculated on a property by property basis by reference to the headlease term and includes property holding costs such as rates. Rental streams are assumed to terminate at the next break point from sub-letting. The leases expire at dates ranging over many years and payments under lease commitments, net of amounts receivable under sub-lettings, will be approximately £52.3m payable in the next five years (2009: £56.4m). The costs have been discounted at rates ranging from 3.5% to 8%.

The integration provision relates principally to redundancies from recent mergers and acquisitions. Costs are expected to be incurred over the period 2011–2014 with the majority being incurred in 2012 and 2013.

The litigation provision represents management's prudent estimate of potential litigation. The majority of these costs are expected to be incurred within the next one to three years.

Other provisions comprise numerous smaller individual provisions including potential asbestos in properties, contract terminations and the cost of exercising a potential option in a commercial contract. The expected timing of payment varies across these provisions, and an unknown amount may be incurred after two to three years.

**36. Amounts owed to credit institutions – Financial Services**

	2010 £m	2009 £m
Items in course of collection	<b>45.3</b>	53.9
Deposits from other banks	<b>2,893.3</b>	6,028.5
	<b>2,938.6</b>	6,082.4
Gilt repo liability	<b>870.5</b>	1,071.2
Other	<b>6.3</b>	5.6
	<b>3,815.4</b>	7,159.2

Gilt Repo liability represents CIS repurchase liabilities in respect of government guaranteed securities which are the subject of repurchase contracts. The government guaranteed securities are included within investments. Amounts owed to credit institutions are measured at amortised cost.

Other represents overnight borrowings and overdraft balances.

**37. Customer accounts – Financial Services**

	2010 £m	2009 £m
Retail	<b>26,906.1</b>	26,693.1
Corporate	<b>4,900.1</b>	3,577.1
Other	<b>573.3</b>	551.0
	<b>32,379.5</b>	30,821.2

The Group has entered into interest rate swaps that protect it from changes in interest rates on the floating-rate assets that are funded by its fixed-rate customer accounts. Changes in the fair values of these swaps are offset by changes in the fair values of the fixed-rate customer accounts. Included within customer accounts are 'fair-value-hedged' fixed-rate accounts with a total nominal value of £84.7m (2009: £3,359.3m) against which there are fair value adjustments for hedged risk of £0.2m (2009: £9.7m), giving a total carrying value of £84.9m (2009: £3,369.0m).



## Notes to the financial statements continued

### 38. Capital Bonds – Financial Services

	2010 £m	2009 £m
Retail	<b>1,794.7</b>	1,647.1

The capital bonds are fixed-term customer accounts with returns based on the movement in an index (e.g. FTSE 100) over the term of the bond.

The capital bonds have been designated on initial recognition at fair value through income and expense and are carried at their fair value.

The fair values for the capital bonds are obtained on a monthly basis from the third parties that issue these products. These external valuations are reviewed independently using valuation software to ensure the fair values are priced on a consistent basis.

None of the change in the fair value of the capital bonds is attributable to changes in the liability's credit risk.

The maximum amount the Group would contractually be required to pay at maturity for all the capital bonds is £1,756.0m (2009: £1,653.2m).

The Group uses swaps to create economic hedges against all of its capital bonds. The gain on capital bonds in the income statement for the year is £28.5m (2009: £41.8m). However, taking into account changes in fair value of the associated swaps, the net impact to the income statement for the year is a loss of £0.3m (2009: loss of £0.2m).

### 39. Debt securities in issue – Financial Services

	2010 £m	2009 £m
Certificates of deposits	<b>638.8</b>	294.9
Commercial papers	<b>20.1</b>	71.5
Fixed and floating notes	<b>3,553.3</b>	2,967.9
<b>Debt securities in issue</b>	<b>4,212.2</b>	3,334.3

The Group has entered into cross currency interest rate swaps that protect it from changes in exchange rates and interest rates on its debt securities in issue. Changes in the fair values of these swaps are largely offset by changes in the fair value of the sterling equivalent carrying value of the debt securities in issue.

### 40. Investment contracts – Financial Services

Investment contract liabilities all arise from unit-linked contracts, and are measured at fair value by reference to the fair value of the underlying portfolio of assets and are designated in this measurement category at inception. None of the change in the liability is attributable to changes in the credit risk of the underlying assets.

The maturity value of these financial liabilities is determined by the fair value of the linked assets at maturity date. There will be no difference between the carrying amount and the maturity amount at maturity date.

The movement in the liability arising from investment contracts is summarised below:

	2010 £m	2009 £m
At beginning of the period	<b>259.9</b>	190.9
Contributions	<b>33.6</b>	34.1
Account balance paid on surrender and related benefits	<b>(13.1)</b>	(12.2)
Movement in fair value	<b>35.6</b>	47.1
<b>At end of the period</b>	<b>316.0</b>	259.9

	2010 £m	2009 £m
Movement in fair value comprises:		
Investment return credited and related benefits	<b>34.8</b>	46.5
Management charges	<b>(2.9)</b>	(2.2)
Other income – management rebate	<b>3.7</b>	2.8
	<b>35.6</b>	47.1

**41. Unallocated divisible surplus – Financial Services**

	2010 £m	2009 £m
At beginning of the period	1,052.8	622.2
Transfer (to)/from the income statement	(15.7)	430.6
<b>At end of the period</b>	<b>1,037.1</b>	1,052.8

The unallocated divisible surplus comprises the excess long term business net assets over the policyholder liabilities of the long term business. As long term business is transacted on a mutual basis, the unallocated divisible surplus represents amounts due to participating contract holders, the allocation of which has yet to be determined and is therefore classified as a liability.

**42. Other borrowed funds – Financial Services**

	2010 £m	2009 £m
£150,000,000 Step up callable subordinated Notes 2019	150.0	150.0
60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each	60.0	60.0
Floating rate subordinated Notes 2016	104.1	102.8
Subordinated Notes 2021	150.0	150.0
Fixed rate subordinated Notes 2024	144.0	130.6
Fixed rate subordinated Notes 2033	99.1	91.9
Perpetual subordinated bonds	253.2	246.6
Issue costs, discounts and accrued interest	15.0	14.6
	<b>975.4</b>	946.5

The 2009 restatement relates to a reclassification of accrued interest.

**Step-Up callable subordinated Notes 2019**

The Notes were issued on 1 April 2004 at a discount of 0.946%. The Notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The Notes carry an interest rate of 5.875% per annum to (but excluding) 2 April 2014, and thereafter the interest rate will be determined by reference to the gross redemption yield on the five year benchmark gilt, and a margin of 2.25%. Interest is payable annually in arrears on 2 April. The Bank may redeem all, but not less than all, of the Notes at their principal amount on 2 April 2014.

**60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each**

The preference shares carry the right to a fixed non-cumulative preferential dividend on the capital for the time being paid up, at the rate of 9.25% per annum exclusive of any associated tax credit. The dividends are payable on 31 May and 30 November each year and take priority over dividends to any other class of share in the capital of The Co-operative Bank.

On a return of capital on a winding-up, the assets of The Co-operative Bank shall be applied in repaying the preference share capital in priority to any payments to the holders of any other class of shares in the capital of The Co-operative Bank. The amount receivable by the holders of the preference shares shall be the greater of the capital paid up or the average quoted price during the three months immediately preceding the date of the notice convening the meeting to consider the resolution to wind up.

The holders of the preference shares shall have the right to vote at a general meeting of The Co-operative Bank only if and when, at the date of the notice convening the meeting, the dividend due to them has been in arrears for six months or more or if a resolution is to be proposed at the meeting abrogating or varying their rights or privileges or for the winding-up of The Co-operative Bank or other return of capital and then only on that resolution.

**Floating-rate subordinated Notes 2016**

The Notes were issued on 18 May 2006 at a discount of 0.14%. The Notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The Notes are denominated in euros and interest is calculated at three months euribor plus a margin of 0.28%. The first interest coupon was paid in August 2006.

The Notes are hedged with a cross currency swap converting the exposure into sterling which pays floating rate at three months LIBOR with a margin on interest coupon of 0.34125% and receives floating rate of three months euribor plus a margin on interest coupon of 0.28%. The cross currency swap matures on 18 May 2011. The Bank may redeem all, but not less than all, of the Notes at the principal amount on 18 May 2011, and on any quarterly interest payment date thereafter.

**Subordinated Notes 2021**

The Notes were issued on 16 November 2006 at a discount of 0.189%. The Notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank. The Notes carry an annual interest rate of 5.625% up to and including the interest payment date on 16 November 2016, when the interest basis changes to floating rate. During the fixed rate period, interest is payable semi-annually in arrears on 16 May and 16 November.

## Notes to the financial statements continued

### 42. Other borrowed funds – Financial Services continued

From 17 November 2016, the Notes carry a floating interest rate of three months LIBOR plus a margin of 1.75%. Interest is payable quarterly in arrears on 16 February, 16 May, 16 August and 16 November, commencing on the interest payment date falling in February 2017 up to and including the maturity date.

The Bank may redeem all, but not less than all, of the Notes at the principal amount on 16 November 2016, and on any quarterly interest payment date thereafter.

#### Fixed rate subordinated Notes 2024

The Notes were issued on 17 March 2004 at a discount rate of 1.148%. The Notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank.

The Notes carry an annual interest rate of 5.75% to maturity. The Notes are hedged with interest-rate swaps that convert the interest rate payable into floating rates at six months LIBOR plus a margin of 0.72%. The fixed receipt leg of the swap is received annually to match the payment to the noteholders. The floating payment leg of the swap is payable semi annually in June and December. The interest rate swaps mature on 2 December 2019.

The Bank may redeem all, but not less than all, of the Notes at the principal amount on 2 December 2019, and on any quarterly interest payment date thereafter.

#### Fixed rate subordinated Notes 2033

The Notes were issued on 28 March 2002 at a discount rate of 0.93%. The Notes are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank.

The Notes carry an annual interest rate of 5.875% to maturity. Interest is payable semi-annually in March and September.

Of the Notes, £100m are hedged with interest rate swaps that have a floating pay leg at six months libor payable in March and September. The fixed interest rate receivable leg on the swaps, are £25m at 5.405% and £75m at 5.225%. The annual interest receivable leg on the swap is matched to the dates on the Notes.

#### Perpetual subordinated Bonds

Following the transfer of engagements of Britannia Building Society, the Britannia permanent interest bearing shares (PIBS) were converted into perpetual subordinated debt of Co-operative Financial Services (perpetual subordinated bonds).

From 1 August 2009, the Bank assumed a liability to each PIBS Holder for a subordinated deposit equal to the principal amount of their PIBS. These deposits have automatically been applied in subscription to either perpetual subordinated bonds having an annual interest rate of 13% in respect of the 'first perpetual subordinated bonds' or perpetual subordinated bonds having an annual interest rate of 5.5555% in respect of the 'second perpetual subordinated bonds' for an amount corresponding to the principal amount of that holders PIBS.

The Trustee for the holders of the Perpetual Subordinated Bonds is The Law Debenture Trust Corporation p.l.c. whose registered office is Fifth Floor, 100 Wood Street, London EC2V 7EX.

The Financial Services Authority must give prior written consent to the early repayment, including the purchase of the Notes or stock by the Group, for cancellation of any subordinated bond.

**43. Other liabilities and accruals – Financial Services**

	2010 £m	2009 £m
Arising out of direct insurance operations	4.6	3.5
Accruals and deferred income	365.6	338.9
Other taxation and social security	9.6	8.3
Other payables	32.4	57.9
Amounts due for investments purchased	1.8	4.7
Trade payables	146.8	221.9
Other reinsurance liabilities	2,160.0	2,001.4
Net asset value attributed to unit holders	30.3	42.0
	<b>2,751.1</b>	2,678.6

Liabilities arising from reinsurance operations include a financial liability of £2,150.1m (2009: £1,992.4m), which is valued at fair value through Income or expense. The liability is owed to a major reinsurer under a reinsurance arrangement to reinsure the majority of CIS's remaining obligations in respect of annuities in payment and a proportion of those in deferment. Under the reinsurance arrangement, CIS is contracted to pay premiums in accordance with a schedule of payments covering a period up to 2066. At inception of the contract, CIS recognised its premium obligation in full within the income statement by a charge representing the net present value of the contracted payments, and continues to recognise a financial liability to the extent that the premium has yet to fall due for payment. At inception of the contract, CIS also purchased a debt security, cash flows from which will fund the discharge of the financial liability as amounts fall due for payment.

The value of the financial liability is linked to the value of the debt security and accordingly both the asset and liability were designated in the measurement category of fair value through income or expense at inception. All of the change in the fair value of the liability is attributable to changes in the fair value of the debt security and does not reflect changes in the credit risk of the liability.

The maturity value will be determined by the fair value of the debt security at maturity date. There will be no difference between the carrying amount and the maturity value at maturity date. Of the discounted liability value, £57.8m (2009: £53.9m) is due to be settled within one year giving rise to a cash outflow of £58.2m (2009: £54.2m) (inclusive of interest). The amount to be settled after more than one year is £2,172.1m (2009: £1,963.8m).

Other payables in CFS include finance lease obligations as follows:

	Present value of lease payments		Future minimum lease payments	
	2010 £m	2009 £m	2010 £m	2009 £m
Due within one year	–	–	–	–
Due between one year and five years	0.1	0.1	0.1	0.1
Due after five years	1.3	1.2	1.7	1.8
	<b>1.4</b>	1.3	<b>1.8</b>	1.9

The future minimum lease payments have been discounted at LIBOR over the term of the lease to give the present value of these payments.

**44. Provisions – Financial Services**

	Provisions for restructuring £m	FSCS levy £m	Regulatory/ Other £m	2010 Total £m	2009 (restated) Total £m
At beginning of period	14.0	20.6	47.0	81.6	30.1
Arising on transfer of engagements	–	–	–	–	33.6
Utilised	(19.2)	(11.2)	(8.4)	(38.8)	(9.2)
Charge to income statement	13.9	11.5	22.2	47.6	40.6
Provision released	(1.1)	–	(15.9)	(17.0)	(13.5)
<b>At end of period</b>	<b>7.6</b>	<b>20.9</b>	<b>44.9</b>	<b>73.4</b>	81.6

**Provisions for restructuring**

Restructuring provisions principally relate to the extensive restructuring and modernisation of the business, and the subsequent redundancy costs. Also included within this total are integration provisions relating principally to redundancies from the recent Britannia transfer of engagements. The majority of these costs are expected to be incurred within the next year.

## Notes to the financial statements continued

### 44. Provisions – Financial Services continued

#### Financial Services Compensation Scheme (FSCS) levy

In common with other financial institutions authorised by the Financial Services Authority (FSA), the Group contributes to the Financial Services Compensation Scheme (FSCS). The FSCS covers financial institutions authorised to do business in the United Kingdom. When an institution is unlikely, or likely to be unable, to pay claims against it, its customers may be able to claim compensation from the FSCS. The FSCS raises funds to meet the known compensation claims through levies on other FSA – authorised institutions. As a result of a number of institutions failing during 2008, the FSCS received funds from HM Treasury in order to meet its obligations to depositors. These borrowings are anticipated to be repaid wholly or substantially from the realisation of the assets of the failed institutions. The FSCS raises annual levies from the banking industry in order to meet its management expenses and compensation costs. The annual levies are based upon the individual institutions proportion of protected deposits of the total market protected deposits at year end each year.

The Group has provided £20.9m (2009: £20.6m) for its share of the levies that will be raised by the FSCS including the interest on the loan from HM Treasury in respect of the levy years 31 March 2010 to 31 March 2012 respectively. The provision includes estimates for the interest the FSCS will pay on the loan and of the Group's market participation in the relevant years.

At the date of these financial statements, it is not possible to estimate whether there will ultimately be additional levies on the industry, the level of the Group's market participation or other factors that may affect amounts or the timing of amounts that may ultimately become payable, nor the effect that such levies may have upon operating results in any particular year. The Financial Services Commission in the Isle of Man operates a similar scheme. Britannia International Limited has provided £0.3m (2009: £0.3m) for the year ended 1 January 2011 in respect of this scheme.

#### Regulatory/Other

Provisions have been made in respect of various potential customer compensation claims. Claims are investigated on an individual basis and, where appropriate, compensation payments are made. The release of regulatory/other provisions relates to a disputed claim which was resolved during the year.

#### Vacant property

CFS has a number of leasehold properties available for rent. Provisions are made when either the sub-lease income does not cover the rental expense or the property is vacant. The provision is based on the expected outflows during the remaining periods of the leases using the discount rate applied in the goodwill calculations of 11%.

### 45. Reconciliation of operating profit to net cash inflow from operating activities – Trading Group

	2010 £m	2009 £m
Operating profit after significant items (continuing activities) (see note 1)	<b>418.5</b>	331.3
Add: Losses on discontinued businesses before interest and tax	<b>(37.5)</b>	(25.2)
Less: Group operating costs	<b>(40.2)</b>	(40.8)
	<b>340.8</b>	265.3
Add back:		
– Depreciation and amortisation charges	<b>275.7</b>	260.6
– Property, plant and equipment and intangible asset impairment	<b>20.6</b>	13.2
– Loss/(profit) on disposal of non-current assets (including those in significant items)	<b>7.5</b>	(98.5)
– Change in value of investment properties	<b>(14.0)</b>	(3.5)
Effect of non-cash pension costs	<b>(10.8)</b>	(18.6)
Movements in working capital:		
– (Increase)/decrease in inventories	<b>(28.8)</b>	50.4
– (Increase)/decrease in receivables	<b>(149.6)</b>	69.4
– Increase/(decrease) in payables and provisions	<b>20.2</b>	(0.5)
Tax received/(paid)	<b>59.2</b>	(30.6)
<b>Net cash inflow from operating activities</b>	<b>520.8</b>	507.2



**46. Reconciliation of operating profit to net cash inflow from operating activities – Financial Services**

	2010 £m	2009 £m
Operating profit after significant items (see note 1)	<b>113.2</b>	223.7
(Increase)/decrease in prepayments and accrued income	<b>(29.3)</b>	305.3
Increase/(decrease) in accruals and deferred income	<b>35.6</b>	(66.1)
Interest payable on subordinated liabilities	<b>45.4</b>	17.1
Effect of exchange rate movements	<b>(2.8)</b>	(96.0)
Impairment losses on loans and advances	<b>97.3</b>	116.1
Impairment losses on investments	<b>(1.5)</b>	(4.0)
Effect of non-cash pension costs	<b>3.3</b>	0.2
Depreciation and amortisation	<b>55.6</b>	49.1
Interest amortisation	<b>(6.3)</b>	(12.6)
Amortisation on investments	<b>(42.5)</b>	(1.4)
Profit on sale of investments	<b>0.8</b>	–
Decrease in intangible assets	<b>(13.0)</b>	(5.6)
Loss on disposal of non-current assets	<b>0.5</b>	1.5
Unwind of fair value adjustments on transfer of engagements	<b>14.2</b>	(99.1)
Preference dividend	<b>5.6</b>	5.6
Net cash flow from trading activities	<b>276.1</b>	433.8
Decrease in deposits by banks	<b>(3,143.8)</b>	(1,108.5)
Increase in customer accounts	<b>1,639.1</b>	872.0
Decrease/(increase) in debt securities in issue	<b>471.6</b>	(1,035.5)
Decrease/(increase) in loans and advances to bank	<b>401.5</b>	(1,037.5)
Increase in loans and advances to customers	<b>(900.9)</b>	(1,005.2)
Net movement of other assets and other liabilities	<b>267.8</b>	(58.0)
Non-current assets transferred to assets held for trading	–	–
Increase in property, plant and equipment	–	(43.1)
Investment property movement	<b>(47.8)</b>	43.4
Fair value through profit and loss movement	<b>(508.5)</b>	638.6
Derivative financial instruments movement	<b>(83.9)</b>	452.3
Assets available for sale movement	<b>77.0</b>	(256.7)
Assets held for sale	–	–
Movement in deferred acquisition costs	<b>(1.8)</b>	(7.9)
Reinsurance assets	<b>(23.4)</b>	167.8
Loan receivables at amortised cost	<b>2.2</b>	2.5
Insurance and other receivables	<b>(65.9)</b>	(0.5)
Insurance and participation contract provisions	<b>964.3</b>	(258.9)
Unallocated divisible surplus	<b>(15.7)</b>	430.6
Investment contracts	<b>56.1</b>	69.0
Amounts owed to credit institutions	<b>(200.7)</b>	(743.2)
Other provisions	<b>(12.0)</b>	12.0
Insurance and other payables	<b>(4.6)</b>	(0.2)
Other reinsurance liabilities	<b>0.4</b>	2.5
Net asset value attributable to unit holders	<b>(11.8)</b>	42.0
United Kingdom corporation tax paid	<b>(91.0)</b>	(104.6)
<b>Net cash outflow from operating activities</b>	<b>(955.7)</b>	(2,493.3)

## Notes to the financial statements continued

### 47. Transfer of engagements

#### i) Transfer of engagements of Britannia Building Society

The initial accounting for Britannia was determined provisionally in the 2009 Financial Statements. In accordance with IFRS 3 (revised), adjustments to the initial provisional accounting for Britannia disclosed in the 2009 Financial Statements have been recognised as if the final accounting had been completed at the acquisition date. The impact of these adjustments is not material to the overall level of adjustments to the carrying values of Britannia assets and liabilities that were made on merger and there is no change to the amount of goodwill arising. Comparative information for the period ended 2 January 2010 has been adjusted; there was no material impact on the reported profit for 2009.

The revised fair values of the assets and liabilities of Britannia on merger are set out below:

		Final merger fair values	Provisional merger fair values
Cash and balances at central banks		591.8	591.8
Loans and advances to banks		956.1	956.1
Loans and advances to customers	a	22,912.5	22,885.5
Fair-value adjustments for hedged risk		–	–
Investment securities		6,144.2	6,144.2
Derivative financial instruments		1,086.6	1,086.6
Investments in joint ventures		2.1	2.1
Goodwill		–	–
Intangible assets		46.0	46.0
Investment properties		123.7	123.7
Property, plant and equipment		82.6	82.6
Other assets		9.4	9.4
Prepayments and accrued income		122.2	122.2
Deferred tax assets		132.2	132.2
<b>Total assets</b>		<b>32,209.4</b>	<b>32,182.4</b>
Deposits by banks		(6,117.6)	(6,117.6)
Customer accounts		(18,304.7)	(18,304.7)
Capital bonds		(1,593.2)	(1,593.2)
Debt securities in issue		(3,667.3)	(3,667.3)
Derivative financial instruments		(721.1)	(721.1)
Other liabilities		(54.0)	(54.0)
Accruals and deferred income		(242.4)	(242.4)
Provisions for liabilities and charges	b	(33.6)	(14.2)
Current tax liabilities	c	(53.5)	(45.9)
Subordinated liabilities		(309.5)	(309.5)
Subscribed capital		(240.0)	(240.0)
Available for sale reserve		–	–
Cashflow hedging reserve		–	–
<b>Total liabilities and reserves</b>		<b>(31,336.9)</b>	<b>(31,309.9)</b>
<b>Net identifiable assets</b>		<b>872.5</b>	<b>872.5</b>
Deferred consideration		49.6	49.6
Imputed consideration		811.2	811.2
Business combination costs		12.3	12.3
<b>Goodwill recognised on business combination</b>		<b>0.6</b>	<b>0.6</b>

Explanation of material changes to fair value adjustments:

- a) The carrying value of loans and advances to customers has been increased following a review of the probabilities of default of assets that were neither past due or impaired at the merger date.
- b) Based on further information that became available, the Bank has reassessed the fair value of provisions for liabilities and charges.
- c) The above adjustments to fair values increased the expected level of the Bank's tax liabilities.

#### ii) Transfer of engagements of Plymouth and South West Co-operative Society

On 6 September 2009, the Plymouth and South West Co-operative Society transferred its engagements to The Co-operative Group under section 51 (1) of the Industrial and Provident Societies Acts.

On 2 January 2010, provisional values were included for some assets and liabilities acquired. No adjustments have been made since.

## 48. Acquisitions

### i) Acquisition of the Somerfield group

On 27 February 2009, the Group completed its acquisition of a 100% equity interest in the Somerfield group. The acquisition took place to confirm the Co-operative Group as the nation's fifth largest food retailer and to realise significant cost benefit synergies across the two businesses.

At 2 January 2010, provisional values were included for some asset and liabilities acquired. No adjustments have been made since.

	Recognised values on acquisition £m	Adjustments in 2010 £m	Recognised values at 1 January 2011 £m
Property, plant and equipment	596.3	–	596.3
Goodwill	–	–	–
Inventories	176.5	–	176.5
Trade receivables	84.8	–	84.8
Other receivables	45.6	–	45.6
Cash and cash equivalents	48.1	–	48.1
Assets classified as held for sale	477.6	–	477.6
Current trade payables	(276.7)	–	(276.7)
Current other payables	(355.6)	–	(355.6)
Short term borrowings	(563.3)	–	(563.3)
Current tax payable	(8.5)	–	(8.5)
Non-current other long term payables	(6.5)	–	(6.5)
Long term borrowings	(957.6)	–	(957.6)
Deferred tax	182.0	–	182.0
Provisions	(178.3)	–	(178.3)
Pension liability	(62.2)	–	(62.2)
<b>Net identifiable liabilities</b>	<b>(797.8)</b>	<b>–</b>	<b>(797.8)</b>

### ii) Other 2010 acquisitions

No goodwill was acquired separately through new acquisitions in 2010. A summary of balances acquired in 2009 are disclosed below:

	2010 Total fair value £m	2009 Total fair value £m
Property, plant and equipment	–	4.3
Intangible assets	–	–
Inventories	–	–
Payables	–	(0.5)
Cash	–	0.1
Net assets	–	3.9
Goodwill and intangibles	–	3.0
Purchase consideration	–	6.9
Cash flow on acquisition:		
Cash consideration	–	(6.9)
Bank balances acquired	–	0.1
Cash outflow	–	(6.8)

There are no significant fair value adjustments included in the above. At 2 January 2010, provisional values have been included for some assets and liabilities acquired.

## Notes to the financial statements continued

### 49. Commitments and contingent liabilities

a) Capital expenditure committed by the Group at year end was £186.1m (2009: £47.1m). This all related to property, plant and equipment.

b) Commitments under operating leases:

At 1 January 2011, the future minimum lease payments under non-cancellable operating leases were:

Group	2010		2009	
	Land and buildings £m	Other £m	Land and buildings (restated) £m	Other £m
Within one year	181.3	11.0	175.3	5.9
In two to five years	635.2	23.3	623.4	8.8
In over five years	2,737.4	–	2,733.8	0.4
	<b>3,553.9</b>	<b>34.3</b>	3,532.5	15.1

The total of future minimum sublease payments expected to be received under non-cancellable subleases less than 50 years is £311.2m (2009: £249.7m restated).

c) Banking activities

The table below gives the nominal principal amounts, credit equivalent amounts and risk-weighted amounts of contingent liabilities and commitments. The nominal principal amounts indicate the volume of business outstanding at the balance sheet date and do not represent amounts at risk. The credit equivalent and risk-weighted amounts have been calculated in accordance with the FSA guidelines implementing the Capital Requirements Directive (CRD).

The contingent liabilities of the Bank as detailed below arise in the normal course of banking business and it is not practical to quantify their future financial effect.

	2010				2009	
	Contract amount £m	Credit equivalent amount <sup>(i)</sup> £m	Average risk weight £m	Risk-weighted amount £m	Contract amount £m	Risk-weighted amount £m
i) Contingent liabilities:						
Guarantees and irrevocable letters of credit	134.2	108.9	91.0%	99.1	118.9	89.5
	<b>134.2</b>	<b>108.9</b>	<b>91.0%</b>	<b>99.1</b>	118.9	89.5
ii) Other commitments:						
Documentary credits and short term trade related transactions	2.8	0.6	83.3%	0.5	2.1	0.4
Forward assets purchases and forward deposit placed	165.8	165.8	8.8%	14.6	164.5	78.2
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments) <sup>(ii)</sup>	4,590.9	2,782.0	39.2%	1,089.3	4,822.9	1,032.9
	<b>4,759.5</b>	<b>2,948.4</b>	<b>37.5%</b>	<b>1,104.4</b>	4,989.5	1,111.5

#### Notes

(i) Under the CRD, credit conversion factors are applied to exposures subject to the Standardised and Foundation IRB approach, primarily Corporate and Wholesale exposures as defined by BIPRU.

Under the retail IRB approach, the Credit Equivalent amount is defined as Exposure at Default.

(ii) Undrawn loan commitments include revocable commitments which are unused credit card limits of £2,344.9m (2009: £2,621.9m).

**49. Commitments and contingent liabilities** continued**Assets pledged**

Assets are pledged as collateral under repurchase agreements with other banks. These deposits are not available to finance the Group's day-to-day operations. Mandatory reserve deposits are also held with the Bank of England in accordance with statutory requirements.

	<b>Asset</b>	
	<b>2010</b>	2009
Mandatory reserve deposits	<b>36.1</b>	34.0

At 1 January 2011, the mandatory reserve deposits held with the Bank of England were £36.1m (2009: £34.0m).

Investment securities with a carrying value of £1,550.9m (2009: £3,697.0m) have been sold under sale and repurchase agreements. These assets have not been derecognised as the Group and Bank have retained substantially all the risks and rewards of ownership. Included within deposits by banks are the related liabilities of £1,349.1m (2009: £2,998.8m). Also £988.6m (2009: £nil) of amounts owed by other Co-operative Group undertakings, held by Bank, have been sold under sale and repurchase agreements, included within deposits by banks are the related liabilities of £778.6m (2009: £nil).

The Group and Bank have loans and advances to banks of £70.0m (2009: £nil) under reverse sale and repurchase agreements and against which it holds gilts with a fair value of £70.0m (2009: £nil). These transactions are conducted under terms that are usual and customary to standard stock lending, securities borrowing and reverse purchase agreements. The Group is permitted to sell or repledge the assets received as collateral in the absence of their default. The Group is obliged to return equivalent securities. At 1 January 2011 the fair value of collateral repledged amounted to £70.0m (2009: £nil). The Group and Bank do not adjust for the fair value of securities received under reverse sale and repurchase agreements.

**Payment protection insurance**

The Financial Services Authority (FSA) set out its requirements for this industry wide issue in a policy statement published on 10 August 2010. This amended the 'Disputes Resolution: Complaints' section of the FSA Handbook which sets out the rules for handling such complaints. Firms were initially required to comply with these new rules by 1 December 2010. However, in October 2010, the British Bankers Association (BBA) launched a judicial review on the basis that the FSA's policy statement applies incorrect standards for the management of complaints relating to PPI sales and also that it retrospectively applied rules with higher standards than those in place at the time of sale. Pending the outcome of this review, the implementation of the FSA's policy statement is on hold and therefore it is not practicable to make a reliable estimate of the amount of any provision that may be required.



## Notes to the financial statements continued

### 50. Related party transactions and balances

#### a) Trading Group

The nature of the relationship of related parties and the extent of material transactions and balances with them are set out below or are disclosed elsewhere within the financial statements.

	Relationship	2010 £m	2009 £m
Sales to associated undertakings and joint ventures on normal trading terms	(i)	0.4	–
Subscription to Co-operatives <sup>UK</sup> Limited	(ii)	0.9	0.9

i) Details of the Society's principal subsidiaries are set out in note 51.

ii) The Society is a member of Co-operatives Limited.

The Society's corporate members include consumer Co-operative societies, which, in aggregate, own the majority of the corporate shares with rights attaching as described in note 31. The sales to corporate members, on normal trading terms, were £1,295.9m (2009: £1,271.5m) and the amount due from corporate members in respect of such sales was £62.5m at 1 January 2011 (2009: £56.6m).

#### Transactions with directors and key management personnel

Disclosure of key management compensation is set out in the Remuneration Report. A number of trading transactions are entered into with related parties in the normal course of business. Key management are considered to be Board Executive members and directors of The Co-operative Group. The average value of all transactions greater than £1,000 with the Trading Group was £8,257 (2009: £7,011).

#### b) Banking activities

A number of banking transactions are entered into with related parties in the normal course of business. These include loans and deposits. Key management are considered to be Board Executive members of the Group. The volume of related party transactions, outstanding balances at the period end and related income and expense for the period are as follows:

	Directors and key management personnel	
	2010 £m	2009 £m
Loans, credit card and mortgage balances outstanding	0.7	1.0
Deposits at beginning of the period	0.7	1.5
Interest and fee expense	–	–
Net movement	0.1	(0.8)
Deposits at end of the period	0.8	0.7

#### c) Insurance activities

The Society enters into transactions with key management personnel in the normal course of business. Details of the transactions carried out during the period and balances are as follows:

	2010 £m	2009 £m
At beginning of the period	133,420	39,151
Net movement	308,313	94,269
At end of the period	441,733	133,420

## 51. Principal subsidiary and associated undertakings

The principal subsidiary and associated undertakings of the Society, which are registered in England and Wales except where stated, are:

	Society holding %	Nature of business
<b>Co-operative Financial Services Ltd:</b>	100	Holding society
CIS General Insurance Ltd	100	General insurance
CFS Management Services Ltd	100	Service company
CFS Services Ltd	100	Financial services
The Co-operative Asset Management Company Ltd	100	Asset management
<b>Co-operative Insurance Society Ltd (v):</b>	100	Life assurance
Hornby Road Investments Ltd (v)	100	Investment holding
CIS Unit Managers Ltd (v)	100	Investment holding and management
CIS Policyholder Services Ltd (v)	100	Provision of financial services
<b>The Co-operative Bank plc (v):</b>	100	Banking
Britannia Treasury Services Ltd	100	Holding company
Britannia Development and Management Company Ltd	100	Property investment
Britannia Asset Management Ltd	100	Holding company
Illius Properties Ltd	100	Property investment
Britannia Covered Bonds LLP	100	Mortgage acquisition and guarantor of covered bonds
Unity Trust Bank plc (iv) (v)	27	Banking
Co-operative Bank Financial Advisers Ltd (v)	100	Financial advisers
The Covered Bond LLP	100	Financial services
<b>Trading:</b>		
Alldays Finance Ltd	100	Holds investments
Co-operative Clothing Ltd	100	Clothing manufacturing
Co-operative Group Healthcare Ltd	100	Pharmaceutical retailing
Co-operative Brands Ltd	100	Holds intellectual property
Co-operative Legal Services Ltd (vii)	100	Legal services
Co-operative Life Planning Ltd	100	Life Planning
Co-operatives E-Store Ltd	100	E-Retailing
CRS (Properties) Ltd (iii)	100	Property management
Farmcare Ltd	100	Farming
Funeral Services Ltd	100	Funeral directors
Millgate Insurance Brokers Ltd	100	Insurance broking
National Co-operative Chemists Ltd	99	Pharmaceutical retailing
Rochpion Properties (4) LLP	100	Holds property
The Fairways Partnership Ltd (vi)	100	Funeral directors
The Fairways Funeral Partnership Ltd (vi)	100	Funeral directors
The Co-operative Trust Corporation Ltd (vii)	100	Charity
The Co-operative Pharmacy National Distribution Centre Ltd	100	Pharmacy distribution
Donald Wardle & Son Ltd	100	Pharmacy
Somerfield Stores Ltd	100	Food retailing
Sunwin Services Group (2010) Ltd	100	Cash in transit, security services
The Co-operative Motor Group Ltd	100	Motors retailing
Co-operative Group Food Ltd	100	Food retailing
Co-operative Group Estates Services Ltd (iii)	100	Property management
Co-op Group Travel 1 Ltd	100	Travel agents

All of the above have been fully consolidated into the Group's accounts. For information on the Group's principal associated undertakings, refer to note 19.

### Notes

- i) All the principal subsidiaries have been audited by KPMG Audit Plc or its associate.
- ii) All of the Group's financial services subsidiaries have a year end of 31 December 2010. For more details on this, refer to the Group's accounting policies on page 70.
- iii) All the other principal trading subsidiaries have year ends that are co-terminus with the Society, with the exception of CRS (Properties) Ltd and Co-operative Group Estates Services Ltd (both 31 January).
- iv) Unity Trust Bank plc is a subsidiary of the Group because The Co-operative Bank plc elects a majority of directors and appoints the chair and managing director of Unity Trust Bank plc.
- v) Indirectly held subsidiaries.
- vi) The non-controlling shareholdings of these subsidiaries were acquired on 16 February 2010.
- vii) The non-controlling shareholdings of these subsidiaries were acquired on 18 June 2010.
- viii) All transactions between entities are in the usual course of business and are at arms-length.

## Notes to the financial statements continued

### 52. Risk management

The Board is responsible for approving the Group's strategy, its principal markets and the level of acceptable risks. The Group operates a risk management process that identifies the key risks facing each business. Each business and division has a risk register that identifies the likelihood and impact of those risks occurring and the actions being taken to manage those risks. For further information regarding the Group's approach to risk management please refer to the 'Principal risks and uncertainties' section from page 42 to 45.

The principal risks facing the Group are set out below in the context of a) Trading Group risk; b) Banking risk; and c) Insurance risk.

#### Trading Group risk

##### Credit risk

Credit risk arises from the possibility of customers and counterparties failing to meet their obligations to the Trading Group. Management has a credit policy in place and the exposure to credit risk is monitored on an ongoing basis. Credit evaluations are performed on all customers requiring credit over a certain amount. The Trading Group does not require collateral in respect of financial assets. The majority of businesses in the Trading Group have cash-based rather than credit-based sales hence customer credit risk is relatively small.

Investments are allowed only in liquid securities and only with counterparties that have a credit rating equal to or better than the Trading Group. Transactions involving derivative financial instruments are with counterparties with whom the Trading Group has a signed netting agreement as well as sound credit ratings. Given their high credit ratings, management has no current reason to expect that any counterparty will fail to meet its obligations.

At the balance sheet date there were no significant concentrations of credit risk. Further information regarding the age profile of trade receivables is shown in note 24. The carrying value of all balances that attract a credit risk, which represents the maximum exposure, is set out below:

	Carrying amount 2010 £m	Carrying amount 2009 £m
Trade and other receivables (excluding prepayments and accrued income)	591.7	405.8
Interest rate swaps	14.6	10.5
Forward exchange contracts	0.2	0.1
Cash deposits	400.0	346.9

#### Interest rate risk

##### Hedging

Interest rate risk arises from movements in interest rates that impact on the fair value of the assets and liabilities and related finance flows. The Trading Group adopts a policy of ensuring that between 30-80% of its exposure to changes in interest rates on borrowings is on a fixed-rate basis. The fixed proportion as at 1 January 2011 was 60%. Interest rate swaps, denominated exclusively in sterling, have been entered into to achieve an appropriate mix of fixed and floating rate exposure within the Trading Group's policy. The swaps mature over the next seven years following the maturity of the related loans (see the following table) and have fixed swap rates ranging from 1.98% to 5.68%. At 1 January 2011, the Trading Group had interest rate swaps/collar with a notional contract amount of £1,150.4m (2009: £1,146.3m).

The Trading Group does not designate interest rate swaps or forward foreign exchange contracts as hedging instruments. Derivative financial instruments that are not hedging instruments are classified as held for trading by default and thus fall into the category of financial assets at fair value through the income statement. Derivatives are subsequently stated at fair value, with any gains and losses being recognised in the income statement.

The net fair value of swaps/collar at 1 January 2011 was a net liability of £104.7m (2009: £85.5m) comprising assets of £14.6m (2009: £10.5m) and liabilities of £119.3m (2009: £96.0m). These amounts are recognised as fair value derivatives.

**52. Risk management** continued**Effective interest rates and repricing analysis**

In respect of income-earning financial assets and interest-bearing financial liabilities, the following table indicates their effective interest rates at the balance sheet date and the periods in which they reprice.

	2010						
	Effective interest rate	Total £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
Cash and cash equivalents	<b>0.563%</b>	<b>400.0</b>	<b>400.0</b>	–	–	–	–
Secured debt:							
First mortgage debenture 2018	<b>7.625%</b>	<b>(50.0)</b>	–	–	–	–	<b>(50.0)</b>
Investment Properties Loan	<b>0.758%</b>	<b>(193.1)</b>	<b>(1.8)</b>	<b>(1.7)</b>	<b>(3.1)</b>	<b>(186.5)</b>	–
Effect of interest rate swap	<b>4.487%</b>	–	–	–	–	–	–
Unsecured bond issued:							
% Fixed-rate sterling eurobond	<b>5.875%</b>	<b>(200.0)</b>	–	–	–	<b>(200.0)</b>	–
% Effect of interest rate swaps	<b>–3.393%</b>	<b>200.0</b>	–	–	–	<b>200.0</b>	–
Other unsecured loans	<b>0.584%</b>	<b>(1,252.0)</b>	<b>(1,246.4)</b>	<b>(0.2)</b>	<b>(0.5)</b>	<b>(4.9)</b>	–
Effect of interest rate swaps	<b>2.577%</b>	–	<b>744.0</b>	–	<b>(126.0)</b>	<b>(50.0)</b>	<b>(568.0)</b>
Corporate investor shares	<b>1.337%</b>	<b>(46.3)</b>	<b>(42.6)</b>	<b>(3.7)</b>	–	–	–
Finance lease liabilities		<b>(19.5)</b>	<b>(2.9)</b>	<b>(2.9)</b>	<b>(5.2)</b>	<b>(7.5)</b>	<b>(1.0)</b>
		<b>(1,160.9)</b>	<b>(149.7)</b>	<b>(8.5)</b>	<b>(134.8)</b>	<b>(248.9)</b>	<b>(619.0)</b>

	2009						
	Effective interest rate	Total £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
Cash and cash equivalents	0.490%	346.9	346.9	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50.0)	–	–	–	–	(50.0)
Investment Properties Loan	0.612%	(196.0)	(1.4)	(1.5)	(3.5)	(10.6)	(179.0)
Effect of interest rate swap	4.633%	–	–	–	–	–	–
Unsecured bond issued:							
% Fixed-rate sterling eurobond	5.875%	(200.0)	–	–	–	(200.0)	–
% Effect of interest rate swaps	–3.600%	200.0	–	–	–	200.0	–
Other unsecured loans	0.591%	(1,366.4)	(1,360.0)	–	–	(6.4)	–
Effect of interest rate swaps	2.347%	–	750.3	–	(6.3)	(176.0)	(568.0)
Corporate investor shares	1.360%	(36.7)	(31.8)	(4.9)	–	–	–
Finance lease liabilities		(16.6)	(2.0)	(2.4)	(2.6)	(7.7)	(1.9)
		(1,318.8)	(298.0)	(8.8)	(12.4)	(200.7)	(798.9)

**Foreign currency risk**

The Trading Group is exposed to foreign currency risk on purchases that are denominated in a currency other than sterling. The currencies giving rise to this risk are primarily Euro and US Dollars.

The Trading Group hedges at least 90% of all trade payables denominated in a foreign currency. At any point in time the Trading Group also hedges 90% of its estimated foreign currency exposure in respect of orders placed and not invoiced over the following four months. The Trading Group uses forward exchange contracts to hedge its foreign currency risk. The forward exchange contracts have maturities of less than one year after the balance sheet date. Where necessary, the forward exchange contracts are rolled over at maturity.

In respect of other monetary assets and liabilities held in currencies other than sterling, the Trading Group ensures that the net exposure is kept to an acceptable level, by buying or selling foreign currencies at spot rates where necessary to address short term imbalances.

At 1 January 2011, the Trading Group had forward currency transactions, primarily in Euro, US Dollars and Japanese Yen, with a notional contract amount of £7.6m (2009: £16.0m).

## Notes to the financial statements continued

### 52. Risk management continued

#### Liquidity risk

As at 1 January 2011, the Trading Group had available borrowing facilities totalling £2,089.7m (2009: £2,036.0m), which comprised uncommitted facilities of £50.0m (2009: £40.0m) and committed facilities of £2,039.7m (2009: £1,996.0m). These are detailed below:

#### Bank facilities as at 1 January 2011

	Expiry	£m
Uncommitted facilities	<b>July 2011/August 2011</b>	<b>50.0</b>
Syndicate Term Loan	<b>July 2013</b>	<b>1,246.6</b>
Syndicate Revolving Credit Facility	<b>July 2013</b>	<b>300.0</b>
Bilateral Facility	<b>March 2015</b>	<b>50.0</b>
Secured Investment Property Bilateral	<b>September 2015</b>	<b>193.1</b>
		<b>1,839.7</b>
Debtenture	<b>December 2018</b>	<b>50.0</b>
Eurobond issue	<b>December 2013</b>	<b>200.0</b>
		<b>2,089.7</b>

The following are the maturities of financial liabilities as at 1 January 2011:

	Carrying amount £m	Contractual cash flows £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
<b>Non-Derivative Financial liabilities</b>							
Secured bank loans	(193.1)	(193.1)	(1.8)	(1.7)	(3.1)	(186.5)	–
Secured debenture	(53.7)	(50.0)	–	–	–	–	(50.0)
Unsecured bank facility	(1,252.0)	(1,252.0)	(0.3)	(100.2)	(100.5)	(1,051.0)	–
Sterling Eurobond	(210.6)	(200.0)	–	–	–	(200.0)	–
Finance lease liabilities	(19.5)	(19.5)	(2.9)	(2.9)	(5.2)	(7.5)	(1.0)
Trade and other payables	(1,994.8)	(1,994.8)	(669.0)	(698.7)	–	(10.3)	(616.8)
<b>Derivative Financial liabilities</b>							
Interest rate swaps used for hedging	(119.3)	(119.3)	(0.1)	(0.3)	(2.3)	(3.8)	(112.8)

The following are the maturities of financial liabilities as at 2 January 2010:

	Carrying amount £m	Contractual cash flows £m	6 months or less £m	6–12 months £m	1–2 years £m	2–5 years £m	More than 5 years £m
<b>Non-Derivative Financial liabilities</b>							
Secured bank loans	(196.0)	(196.0)	(1.4)	(1.5)	(3.5)	(10.6)	(179.0)
Secured debenture	(52.3)	(50.0)	–	–	–	–	(50.0)
Unsecured bank facility	(1,366.4)	(1,366.4)	–	–	(100.0)	(1,266.4)	–
Sterling Eurobond	(206.2)	(200.0)	–	–	–	(200.0)	–
Finance lease liabilities	(16.6)	(16.6)	(2.0)	(2.4)	(2.6)	(7.7)	(1.9)
Trade and other payables	(1,959.1)	(1,959.1)	(702.3)	(733.4)	–	(10.3)	(513.1)
<b>Derivative Financial liabilities</b>							
Interest rate swaps used for hedging	(96.0)	(96.0)	–	–	(0.9)	(4.1)	(91.0)

#### Sensitivity analysis

##### Interest rate risk

At 1 January 2011 if sterling (GBP) market interest rates had been 1% higher/lower with all other variables held constant, post-tax profit for the year would have been GBP £12.7m (2009: GBP £17.9m) higher and GBP £9.2m (2008: GBP £5.0m) lower respectively, mainly arising from the revaluation of the Society's £250m quoted debt marked to market through the consolidated income statement. Profit is relatively less sensitive to movements in GBP interest rates due to the level of borrowings' fixed-interest cover in place as disclosed under 'hedging'.

##### Foreign exchange risk

At 1 January 2011, if the Euro, US dollar, Australian dollar and New Zealand dollar had all strengthened by 10% against sterling (GBP) with all variables held constant, post-tax profit for the year would have been £0.4m (2009: £1.2m) lower, mainly as a result of foreign exchange losses on translation of EUR-denominated trade payables. Conversely, if the Euro, US dollar, Australian dollar and New Zealand dollar had all weakened by 10% against sterling (GBP) with all variables held constant, post-tax profit for the year would have been £0.4m (2009: £1.1m) higher.

#### Guarantees

In the course of conducting its operations, the Trading Group is required to issue bank guarantees and bonds in favour of various counterparties. These facilities are provided by the Trading Group's banking syndicate and as at 1 January 2011 the total amount of guarantees/bonds outstanding is £83.7m (2009: £70.9m).



**52. Risk management** continued**Fair values of the Trading Group**

The fair value of financial assets and liabilities together with the carrying amounts shown in the balance sheet at 1 January 2011 are as follows:

	Carrying amount 2010 £m	Fair value 2010 £m	Carrying amount 2009 £m	Fair value 2009 £m
<b>Financial assets</b>				
Trade and other receivables	<b>706.7</b>	<b>706.7</b>	527.2	527.2
Cash and cash equivalents	<b>400.0</b>	<b>400.0</b>	346.9	346.9
<b>Derivative financial assets and liabilities</b>				
Interest rate swaps:				
Assets	<b>14.6</b>	<b>14.6</b>	10.5	10.5
Liabilities	<b>(119.3)</b>	<b>(119.3)</b>	(96.0)	(96.0)
<b>Non-derivative financial liabilities</b>				
Forward exchange contracts:				
Assets	<b>0.2</b>	<b>0.2</b>	0.1	0.1
Liabilities	-	-	(0.1)	(0.1)
Secured debt:				
First mortgage debenture 2018	<b>(53.7)</b>	<b>(53.7)</b>	(52.3)	(52.3)
Other secured loans	<b>(193.1)</b>	<b>(193.1)</b>	(196.0)	(196.0)
Unsecured bond issue:				
Fixed-rate sterling eurobond	<b>(210.6)</b>	<b>(210.6)</b>	(206.2)	(206.2)
Funeral bonds	<b>(622.4)</b>	<b>(622.4)</b>	(476.2)	(476.2)
Unsecured bank facilities:				
Other unsecured loans	<b>(1,253.0)</b>	<b>(1,253.0)</b>	(1,366.4)	(1,366.4)
Corporate investor shares	<b>(46.3)</b>	<b>(46.3)</b>	(36.7)	(36.7)
Finance lease liabilities	<b>(19.5)</b>	<b>(19.5)</b>	(15.7)	(15.7)
Trade and other payables (excluding accruals, deferred income and funeral bonds)	<b>(1,168.6)</b>	<b>(1,168.6)</b>	(1,251.0)	(1,251.0)

**Estimation of fair values**

The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the table.

**Securities**

Fair value is based on quoted market prices at the balance sheet date without any deduction for transaction costs.

**Derivatives**

Forward exchange contracts are either marked to market using listed market prices or by discounting the contractual forward price and deducting the current spot rate. For interest rate swaps, broker quotes are used. Those quotes are back-tested using pricing models or discounted cash flow techniques.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate is a market-related rate for a similar instrument at the balance sheet date. Where other pricing models are used, inputs are based on market-related data at the balance sheet date.

**Interest-bearing loans and borrowings**

These are shown at amortised cost or are determined in whole by using quoted market prices.

**Trade and other receivables/payables**

For receivables/payables, the notional amount is deemed to reflect the fair value.

**Hierarchy of fair values**

The fixed rate sterling eurobond and the first mortgage debenture values are determined in whole by using quoted market prices. The interest rate swap values are determined in whole by counterparties who use quoted market prices. The forward exchange contracts are valued using an internal valuation technique. All other assets and liabilities stated in the table above are held at par value.

**Interest rates used for determining fair value**

The Trading Group uses the government yield curve as of 1 January 2011 plus an adequate constant credit spread to discount financial instruments.

The interest rates used are as follows:

	2010	2009
Derivatives	<b>0.91–3.30%</b>	0.95–3.99%
Loans and borrowings	<b>4.91–7.30%</b>	4.95–8.02%

## Notes to the financial statements continued

### 52. Risk management continued

#### Banking risk

##### Credit risk

Credit risk is the current or prospective risk to earnings and capital arising from a borrower's failure to meet the terms of any contract with the Bank or its failure to perform as agreed. Credit risk is an integral part of many of our business activities and is inherent in traditional banking products (loans, commitments to lend and contingent liabilities, such as letters of credit) and in 'traded products' (derivative contracts such as forwards, swaps, options, repurchase agreements, and securities borrowing and lending transactions).

The credit risk policies are approved by the Risk Management Committee (RMC) (delegated authority from the Board) annually and are the responsibility of the Business Leader Banking Risk. The policies determine the criteria for the management of retail, corporate and wholesale risk, including securitisation, market exposures and credit management standards, country, sector and counterparty limits, along with risk appetites and delegated authorities.

All authority to take credit risk derives from the CFS Board. This is delegated through authorities to individuals or committees via the Chief Executive. The level of credit risk authority delegated depends on seniority and experience, varying according to the quality of the counterparty or any associated security or collateral held.

The Bank's retail secured and unsecured credit policy is to establish credit criteria which determine the optimum balance between volume growth (generating higher income) and higher bad debts, so as to maximise overall profitability within the Bank's risk appetite. The majority of retail credit risk related decisions are based on well founded and robust decision mechanisms designed to segregate customers into risk categories. There is a suite of bespoke, externally and internally developed application and behavioural scorecards derived from sound historic data. It is the responsibility of the Credit Risk Control Unit to design, select, implement, maintain and monitor these systems. The Portfolio Credit Committee (PCC) and RMC receive regular reports on the performance of the portfolios.

The Bank's Corporate Sector Policy is to maintain a broad sectoral spread of exposures which reflect the Bank's areas of expertise. Credit exposures to corporate and business banking customers are assessed individually. The quality of the overall portfolio is monitored using a credit grading system calibrated to expected loss. All aspects of credit management are controlled centrally. The Risk Management Committee receives regular reports on the performance of the portfolio. The Exposures Committee receives regular reports on new facilities, sector exposures, bad debt provisions and the realisation of problem loans.

Cash and balances at central banks are considered to be risk free and have been excluded from the following analysis of credit exposure.

##### Credit exposure

	2010 Gross balance £m	2010 Credit commitments £m	2010 Credit risk exposure £m	2009 Credit risk exposure £m
Loans and advances to banks	2,394.1	176.0	2,570.1	1,895.3
Loans and advances to customers	35,199.9	4,717.7	39,917.6	39,289.0
Investment securities	1,930.3	–	1,930.3	2,500.7
Investment securities – available for sale	3,058.1	–	3,058.1	4,529.2
Derivative financial instruments	931.9	–	931.9	1,023.0
	<b>43,514.3</b>	<b>4,893.7</b>	<b>48,408.0</b>	49,237.2
Allowance for impairment losses on loans and advances			<b>(222.6)</b>	(194.0)
Impairment losses on investment securities			<b>(85.3)</b>	(86.4)
Carrying amount			<b>48,100.1</b>	48,956.8

**52. Risk management** continued**Credit risk analysis**

	Loans and advances to banks £m	Loans and advances to customers £m	Investment Securities Loans and receivables £m	Investment Securities Available for sale £m	Derivative financial instruments £m	2010 Total £m	2009 Total £m
<b>Individually impaired</b>							
90 days past due or evidence of impairment	–	1,715.4	25.0	72.3	–	1,812.7	2,197.2
Impairment recognised	–	(64.4)	(8.5)	(72.3)	–	(145.2)	(134.0)
Carrying amount	–	1,651.0	16.5	–	–	1,667.5	2,063.2
<b>Collectively impaired</b>							
Less than 90 days past due	–	243.7	119.2	–	–	362.9	336.4
90–179 days past due	–	18.4	–	–	–	18.4	22.6
180 days plus past due	4.6	143.4	–	–	–	148.0	147.6
Impairment recognised	–	(158.2)	(4.5)	–	–	(162.7)	(146.4)
Carrying amount	4.6	247.3	114.7	–	–	366.6	360.2
<b>Past due but not impaired</b>							
0–29 days past due	–	253.7	–	–	–	253.7	281.0
30–59 days past due	–	125.3	–	–	–	125.3	125.0
60–89 days past due	–	123.6	–	–	–	123.6	52.1
Carrying amount	–	502.6	–	–	–	502.6	458.1
<b>Neither past due or impaired</b>							
Low to medium risk	2,565.5	32,134.9	1,786.1	2,974.9	931.9	40,393.3	38,445.5
Medium to high risk	–	5,159.2	–	10.9	–	5,170.1	7,629.8
Carrying amount	2,565.5	37,294.1	1,786.1	2,985.8	931.9	45,563.4	46,075.3
<b>Total carrying amount</b>	<b>2,570.1</b>	<b>39,695.0</b>	<b>1,917.3</b>	<b>2,985.8</b>	<b>931.9</b>	<b>48,100.1</b>	<b>48,956.8</b>

**Analysis of impaired assets and associated collateral****Impaired assets**

Loans and securities are considered impaired where it is determined that the Bank will be unable to collect all principal and interest outstanding, according to the contractual terms of the agreements.

The loan portfolios are reviewed on a periodic basis, usually once a month, to assess impairment. In determining whether a bad debt provision should be recorded, judgments are made as to whether there is objective evidence that a financial asset or portfolio of financial assets is impaired as a result of loss events that occurred after recognition of the asset and prior to the balance sheet date.

Corporate loans and retail mortgage lending with evidence of impairment including 90 days past due are individually assessed for impairment. Collectively impaired assets include unsecured retail lending balances.

At the balance sheet date, the Bank assesses its debt securities for objective evidence that an impairment loss has occurred. For a debt security this may be the disappearance of an active market. For available for sale debt securities particular consideration is given to evidence of any significant financial difficulty of the issuer or measurable decrease in the estimated cash flows from the investments.

During 2010, 541 (2009: 534) in the Group were renegotiated, including 86 (2009: 8) in the Bank. The balance of these loans as at 1 January 2011 in the Group was £63.2m (2009: £95.2m), including £5.8m (2009: £28.1m) in the Bank. These loans are classified as loans neither past due nor impaired, for so long as the mortgagors comply with the terms of their renegotiated contracts.

**Past due but not impaired**

Loans and securities are considered past due where the contractual interest or principal payment are in arrears, however there are certain mitigating circumstances that may deem it necessary not to raise a provision for past due accounts (e.g. amount/days past due are immaterial). Provisions can be raised where accounts are not past due, this could be the stage of collection of amounts owed to the Bank or a specific event such as bankruptcy.

In the table past due but not impaired represents the outstanding balances on mortgages and unsecured retail lending where borrowers have failed to make payments when contractually due and the Bank expects that all contractual payments will be collected. This includes credit card exposures less than 30 days and 45 days for other retail unsecured lending. For mortgages, accounts up to 90 days in arrears but with no provision are classed as past due but not impaired.

Within the credit risk analysis table, low to medium risk has been defined as exposures where the PD is 1% or below over a 1 year time horizon for exposures on IRB approach under Basel II and slotting category strong/good/satisfactory for specialised lending exposures under the slotting approach. Medium to high risk has been defined as a PD of greater than 1% over a 1 year time horizon for exposure on IRB approach under Basel II and slotting category weak for specialised lending exposures under the slotting approach.

## Notes to the financial statements continued

### 52. Risk management continued

Within the treasury debt security portfolio 82% (2009: 82%) of exposures have an external credit rating equivalent to Fitch A or above.

The factors considered in determining if financial assets are individually impaired are stated above and within critical judgments on page 70.

#### Fair value adjustments and provisions held against impaired exposures

When Britannia merged with The Co-operative Bank, the Britannia lending portfolios were carried into the newly merged entity at their fair value, taking account of future lifetime expected loss on the lending portfolios at 31 July 2009. The lifetime expected loss adjustment is offset against the Britannia gross lending balances in the combined entity's financial statements. The utilisation and allocation of the FVA is reviewed on a regular basis.

#### Description of collateral

The Bank uses collateral and guarantees to mitigate credit risk. Collateral is regularly revalued and guarantees reviewed to ensure continuing effectiveness.

The majority of collateral held is not eligible financial collateral, it is residential real estate collateral for retail mortgages or either residential or commercial real estate collateral held against corporate lending.

When calculating the value of collateral for regulatory capital risk mitigation purposes, the appropriate valuation criteria contained within BIPRU is applied.

When assessing the collateral valuations for corporate lending policy purposes, a more conservative written down value is used, stepped according to the risk level of the asset.

Where exposures are agreed on a secured basis, security cover is taken into account only where:

- the security is legally enforceable and is of a tangible nature and type;
- an appropriate, recent and reliable valuation is held; and
- a prudent margin is applied to the valuation, for the type of security involved.

Eligible financial collateral includes gilts held as part of reverse repo agreements, and cash as part of collateralised swaps or against corporate lending.

The guarantees include parental guarantees held against subsidiary exposures.

	2010 £m	2009 £m
At the reporting date the value of collateral held as security against financial assets was as follows:		
Fair value of collateral on financial assets which are past due but not impaired	<b>895.4</b>	966.9
Fair value of collateral on individually impaired financial assets	<b>1,956.1</b>	2,037.3
Carrying value of assets obtained by taking possession of collateral or calling on guarantees	<b>186.6</b>	229.0

All Eurozone exposures continue to be closely monitored, especially those to financial institutions in Portugal, Ireland, Italy, Spain and Belgium. The Bank has no exposure to Greece. Underlying term assets are deemed to be in run off, with associated counterparty and country limits reducing as assets mature and there is no new term exposure. All of the residual direct wholesale term exposure to these countries matures by mid-2012. The Bank's exposure to these Eurozone countries (as valued for credit risk purposes) represented 2.4% of total Bank exposures.

#### Market risk

Market risk arises from the effect of changes in market prices of financial instruments, on income derived from the structure of the balance sheet, execution of customer and interbank business and proprietary trading. The majority of the risk arises from changes in interest rates.

#### Interest rate risk

Interest Rate Risk Policy Statements, approved by the RMC on behalf of the Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the Bank's Asset and Liability Committee (ALCO) which meets monthly and its prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. It sets limits within which treasury and balance sheet management manage the effect of interest rate changes on the Bank's overall net interest income. Treasury is responsible for interest rate risk management for the Bank. The principal analytical techniques involve assessing the impact of different interest rate scenarios and changes in balances over various time periods.

The Board receives reports on the management of balance sheet risk and, each month, ALCO reviews the balance sheet risk position and the utilisation of wholesale market risk limits.

#### Non-treasury interest rate risk

The Bank (excluding wholesale) uses a gap report and earnings approach to managing interest rate risk, focusing in detail on the sensitivity of assumed changes in interest rates on net interest income for one year. Higher level analysis is performed for subsequent years.

ALCO monitors the non-trading interest rate risk which is split between certain wholesale portfolios, banking and investment books, and the rest of the Bank's balance sheet. The following describes the Bank non-trading portfolios excluding these certain wholesale portfolios. These positions are managed by treasury. All interest rate risk is centralised into treasury using appropriate transfer pricing rates.

Gap reports are based on defined time periods. ALCO set guidance limits around the gap, principally that the sum of positions maturing in greater than 12 months and non-sensitive balances (includes non-maturity deposits) is no more than a set limit.

Risk limits are formally calculated at each month end. Interest rate risk and effectiveness of hedging is monitored daily using gap positions, incorporating new business requirements. Draw down risk, in particular for fixed rate mortgages, is managed through weekly balance sheet meetings. Treasury undertake hedges for interest rate risk using derivative instruments and investment securities which are executed via the dealing room to wholesale markets, and loans and deposits which are executed internally with Treasury.

**52. Risk management** continued

The table below illustrates the sensitivity analysis relating to the 'core' Bank, a primary measure in the approach to managing interest rate risk.

The table illustrates the Present Value (PV) change based on a 1% shock in interest rates at the beginning of the year across the yield curve on the Bank's balances excluding wholesale treasury and customer currency balances (subject to a 0% floor), which are managed within the treasury risk framework. The shock results are driven by product pricing and product mix. The extent of rate movements and low rate environment have impacted the repricing of liability products resulting in larger exposure to rate shocks.

**Change in net interest income over the 12 months based on 100bp shock in interest rates at the beginning of the year (£m)**

	<b>100bp parallel increase</b>	<b>100bp parallel decrease</b>
<b>2010</b>		
At the year end	<b>(9.0)</b>	<b>10.7</b>
Average for the year	<b>(12.8)</b>	<b>13.5</b>
Maximum sensitivity for the year	<b>(35.3)</b>	<b>37.3</b>
Minimum sensitivity for the year	<b>(0.2)</b>	<b>0.4</b>
<b>2009</b>		
At the period end	(0.2)	1.9
Average for the period	(4.4)	5.7
Maximum sensitivity for the period	(23.3)	25.6
Minimum sensitivity for the period	3.4	(3.7)

**Treasury interest rate risk**

Treasury executes short term funding and hedging transactions with the wholesale markets on behalf of the Bank and its customers. It also generates incremental income from proprietary trading within strict risk limits. There are two prime measures of risk supplemented by additional controls such as maturity and stop loss limits. Risk units express the various repricing and maturity mismatches as a common unit of measurement. Value at Risk (VaR) measures the daily maximum potential gain or loss due to recent market volatility within a statistical confidence level of 95% and a one day holding period. Simulation is being developed to provide VaR calculations to cover the combined core banking book positions. The VaR methodology has inherent limitations in that market volatility in the past, may not be a reliable predictor of the future, and may not reflect the time required to hedge or dispose of the position, hence VaR is not used as the sole measure of risk.

**PV100**

This illustrates the change in valuation on a fixed income portfolio experienced given a 1% increase and decrease in interest rates for treasury, representing treasury banking book and trading book combined. PV100 is the effect on the net present value (NPV) of the treasury portfolio to a parallel shift of 100 basis points upon the base yield curve. The effects of a 1% increase in interest rates are (£11.0m) (2009: £0.4m) and a 1% decrease £9.1m (2009: (£0.2m)).



## Notes to the financial statements continued

### 52. Risk management continued

#### Currency risk

The Bank's Treasury foreign exchange activities are primarily:

- providing a service in meeting the foreign exchange requirements of customers;
- maintaining liquidity in euros and US dollars by raising funds and investing these to generate a return; and
- performing limited intraday trading and overnight positioning in major currencies to generate incremental income.

The table below provides an analysis of The Co-operative Bank's assets and liabilities by currency at 1 January 2011.

	Sterling £m	US Dollars £m	Euro £m	Other £m	2010 Total £m	2009 Total £m
<b>Assets</b>						
Cash and balances at central banks	1,735.6	–	–	–	1,735.6	1,706.8
Loans and advances to banks	1,879.9	35.4	475.3	3.5	2,394.1	1,781.5
Loans and advances to customers	34,683.2	61.6	217.4	15.1	34,977.3	34,073.7
Fair value adjustments for hedged risks	166.8	–	–	–	166.8	66.1
Investment securities – loans and receivables	1,500.0	68.1	294.0	55.2	1,917.3	2,486.2
Investment securities – available for sale	1,900.4	379.8	444.9	260.7	2,985.8	4,457.3
Derivative financial instruments	931.5	0.1	0.3	–	931.9	1,023.0
Equity shares	7.2	–	–	–	7.2	7.2
Investments in joint ventures	2.5	–	–	–	2.5	1.8
Goodwill	0.6	–	–	–	0.6	0.6
Intangible fixed assets	45.1	–	–	–	45.1	46.1
Investment properties	162.3	–	–	–	162.3	137.7
Property, plant and equipment	98.5	–	–	–	98.5	121.5
Amounts owed by group undertakings	0.6	–	–	–	0.6	91.0
Other assets	47.2	0.7	2.9	1.7	52.5	22.1
Prepayments and accrued income	16.2	–	–	–	16.2	30.1
Deferred tax assets	87.0	–	–	–	87.0	86.1
<b>Total assets</b>	<b>43,264.6</b>	<b>545.7</b>	<b>1,434.8</b>	<b>336.2</b>	<b>45,581.3</b>	<b>46,138.8</b>
<b>Liabilities</b>						
Deposits by banks	1,480.8	473.0	840.4	144.4	2,938.6	6,082.4
Customer accounts	32,205.8	23.6	88.9	1.7	32,320.0	30,828.2
Capital bonds	1,794.7	–	–	–	1,794.7	1,647.1
Debt securities in issue	4,007.4	–	204.8	–	4,212.2	3,334.3
Fair value adjustment for hedged risk	–	–	–	–	–	–
Derivative financial instruments	689.2	5.2	6.8	1.2	702.4	591.3
Other borrowed funds	975.4	–	–	–	975.4	946.5
Amounts owed to group undertakings	188.5	–	–	–	188.5	329.2
Other liabilities	141.3	1.5	2.8	1.2	146.8	221.9
Accruals and deferred income	131.3	–	–	–	131.3	158.0
Provisions	55.8	–	–	–	55.8	52.8
Current tax liabilities	42.5	–	–	–	42.5	71.0
Deferred tax liabilities	–	–	–	–	–	–
<b>Total liabilities</b>	<b>41,712.7</b>	<b>503.3</b>	<b>1,143.7</b>	<b>148.5</b>	<b>43,508.2</b>	<b>44,262.7</b>
<b>Net on-balance sheet position</b>	<b>1,551.9</b>	<b>42.4</b>	<b>291.1</b>	<b>187.7</b>	<b>2,073.1</b>	<b>1,876.1</b>

At 1 January 2011 the Group and Bank's open position was £0.4m (2009: £0.7m) representing a potential loss of £nil given a 3% depreciation in sterling (2009: £nil). The open position is monitored against limits in addition to limits in place on individual currencies. All figures are in £ sterling equivalent.

## 52. Risk management continued

### Liquidity risk

Liquidity risk arises from the timing of cash flows generated from the Group's assets and liabilities (including derivatives). The Group's liquidity management policies are reviewed and approved annually by the RMC and compliance reviewed monthly by ALCO.

Liquidity risk arising from the structure of the balance sheet (structural liquidity) is managed to policies developed by ALCO. Liquidity risk is defined as the Board approved survival period under stress scenarios.

The Bank has enhanced its liquidity management framework by introducing a liquidity risk framework which has a number of strategic and tactical measures that feed into an overall liquidity status score. The Bank's liquidity management framework is designed in line with FSA BIPRU regulations and industry guidelines, including Institute of International Finance (IIF) and Bank for International Settlements (BIS) recommendations.

The Bank manages liquidity risk by applying:

- a systematic control process embedded in the Bank's operations; and
- controlled end to end liquidity management with:
  - net outflows monitored to ensure they are within FSA limits;
  - maintenance of a well diversified deposit base;
  - management of stocks: high quality primary liquidity including cash, and secondary liquidity including certificates of deposit;
  - target strategic ratios; and
  - stress testing.

The strategic measures set by ALCO and monitored monthly are:

- wholesale borrowing ratio – the amount of the wholesale borrowing compared to total liabilities;
- liquid asset ratio – amount of total assets that are liquid assets; and
- customer loan/deposit ratio – amount of customer loans funded by customer deposits.

Day-to-day cash flow (tactical liquidity) is managed by Treasury within guidelines laid down by ALCO and in accordance with the standards established for all banks by the FSA.

The Bank has a high proportion of retail assets funded by retail deposits, ensuring there is no over reliance on wholesale funding. There are customer funding and wholesale funding ratios as described above which are set in line with the Board approved strategic plan. The Group's structural liquidity risk management is therefore retail based and is dependent on behavioural analysis of both customer demand and deposit and loan drawdown profiles by product category based on experience over the last ten years. The behaviour of retail products is reviewed by ALCO and in addition the Group has maturity mismatch limits to control the exposure to longer term mismatches.

The Bank's liquidity position is monitored on a daily basis and reported to ALCO each month. Treasury holds a pool of liquid assets on behalf of the Bank, and management actions are in place to provide additional liquidity when required. These sources of liquidity are held in order to be available to meet unexpected liquidity requirements.

### Liquidity gap

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

The Bank manages liquidity on a behavioural rather than contractual basis, reflecting where actual behaviour differs from contractual maturity:

- retail and corporate deposit bases are very stable, with deposits being attracted to the Bank by good customer service and its ethical policy. As a result, the deposit base remains stable whereas the contractual maturity is immediate for instant access deposits; and
- personal loan and visa balances are repaid earlier than their contractual maturity date.

These behavioural adjustments are based on historical experience of customer behaviour over a period of up to ten years.

## Notes to the financial statements continued

### 52. Risk management continued

#### Gross contractual cashflow maturity analysis

The following is an analysis of gross contractual cash flows of financial liabilities held at the balance sheet date:

2010	Carrying value £m	Gross nominal (inflow)/ outflow £m	Less than 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m
<b>Non-derivative liabilities</b>							
Deposits by banks	2,938.6	2,931.0	776.3	415.8	774.4	964.5	–
Customer accounts	32,320.0	32,588.8	20,347.0	1,856.8	6,811.5	3,573.5	–
Capital bonds	1,794.7	1,749.4	11.4	64.1	254.8	1,362.6	56.5
Debt securities in issue	4,212.2	5,006.4	303.9	695.6	397.4	1,172.4	2,437.1
Other borrowed funds	975.4	1,799.6	45.8	4.7	58.0	420.8	1,270.3
Amounts owed to other group undertakings	188.5	188.5	188.5	–	–	–	–
	<b>42,429.4</b>	<b>44,263.7</b>	<b>21,672.9</b>	<b>3,037.0</b>	<b>8,296.1</b>	<b>7,493.8</b>	<b>3,763.9</b>
<b>Derivative liabilities</b>							
Net outflow	702.4	794.2	139.5	37.5	121.6	295.5	200.1
	<b>43,131.8</b>	<b>45,057.9</b>	<b>21,812.4</b>	<b>3,074.5</b>	<b>8,417.7</b>	<b>7,789.3</b>	<b>3,964.0</b>
Other liabilities	376.4	–	–	–	–	–	–
<b>Total recognised liabilities</b>	<b>43,508.2</b>	<b>45,057.9</b>	<b>21,812.4</b>	<b>3,074.5</b>	<b>8,417.7</b>	<b>7,789.3</b>	<b>3,964.0</b>
Unrecognised loan commitments	4,759.4	4,759.5	4,499.3	62.5	188.2	9.5	–
<b>Total liabilities</b>	<b>48,267.6</b>	<b>49,817.4</b>	<b>26,311.7</b>	<b>3,137.0</b>	<b>8,605.9</b>	<b>7,798.8</b>	<b>3,964.0</b>

2009	Carrying value £m	Gross nominal (inflow)/ outflow £m	Less than 1 month £m	1-3 months £m	3-12 months £m	1-5 years £m	Over 5 years £m
<b>Non-derivative liabilities</b>							
Deposits by banks	6,082.4	6,092.8	531.4	4,309.4	710.3	540.5	1.2
Customer accounts	30,828.2	30,894.6	21,020.5	1,173.6	6,330.9	2,369.6	–
Customer accounts – capital bonds	1,647.1	1,594.3	11.6	42.8	343.8	1,139.9	56.2
Debt securities in issue	3,334.3	4,256.5	570.0	232.6	898.0	2,515.7	40.2
Other borrowed funds	946.5	2,119.8	115.4	64.2	82.0	438.1	1,420.1
Amounts owed by group undertakings	329.2	329.2	92.6	236.6	–	–	–
	43,167.7	45,287.2	22,341.5	6,059.2	8,365.0	7,003.8	1,517.7
<b>Derivative liabilities</b>							
Net outflow	591.3	773.1	89.1	34.8	217.7	377.6	53.9
	43,759.0	46,060.3	22,430.6	6,094.0	8,582.7	7,381.4	1,571.6
Other liabilities	503.7	–	–	–	–	–	–
<b>Total recognised liabilities</b>	<b>44,262.7</b>	<b>46,060.3</b>	<b>22,430.6</b>	<b>6,094.0</b>	<b>8,582.7</b>	<b>7,381.4</b>	<b>1,571.6</b>
Unrecognised loan commitments	4,642.3	4,642.3	4,517.8	60.7	–	63.8	–
<b>Total liabilities</b>	<b>48,905.0</b>	<b>50,702.6</b>	<b>26,948.4</b>	<b>6,154.7</b>	<b>8,582.7</b>	<b>7,445.2</b>	<b>1,571.6</b>

**52. Risk management** continued**Gross expected cashflow maturity analysis – behavioural**

The following is an analysis of gross expected cash flow maturity. Liquidity cashflows are managed on a behavioural basis reflecting the actual behaviour of customers based on historic cashflow profiles over a period of ten years.

**Behavioural cashflow analysis**

	Carrying value £m	Gross nominal (inflow)/ outflow £m	Less than 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m
<b>2010</b>							
<b>Non-derivative liabilities</b>							
Deposits by banks	2,938.6	2,931.0	776.3	415.8	774.4	964.5	–
Customer accounts	32,320.0	32,588.7	2,187.8	2,091.0	4,213.8	24,096.1	–
Capital bonds	1,794.7	1,749.4	11.4	64.1	254.8	1,362.6	56.5
Debt securities in issue	4,212.2	4,980.8	303.9	670.0	397.4	1,172.4	2,437.1
Other borrowed funds	975.4	1,799.6	45.8	4.7	58.0	420.8	1,270.3
Amounts owed to other group undertakings	188.5	188.5	188.5	–	–	–	–
	<b>42,429.4</b>	<b>44,238.0</b>	<b>3,513.7</b>	<b>3,245.6</b>	<b>5,698.4</b>	<b>28,016.4</b>	<b>3,763.9</b>
<b>Derivative liabilities</b>							
Net outflow	702.4	794.2	139.5	37.5	121.6	295.5	200.1
Other liabilities	43,131.8 376.4	45,032.2 –	3,653.2 –	3,283.1 –	5,820.0 –	28,311.9 –	3,964.0 –
<b>Total recognised liabilities</b>	<b>43,508.2</b>	<b>45,032.2</b>	<b>3,653.2</b>	<b>3,283.1</b>	<b>5,820.0</b>	<b>28,311.9</b>	<b>3,964.0</b>
Unrecognised loan commitments	4,759.4	4,759.5	4,499.3	62.5	188.2	9.5	–
<b>Total liabilities</b>	<b>48,267.6</b>	<b>49,791.7</b>	<b>8,152.5</b>	<b>3,345.6</b>	<b>6,008.2</b>	<b>28,321.4</b>	<b>3,964.0</b>

	Carrying value £m	Gross nominal (inflow)/ outflow £m	Less than 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m
<b>2009</b>							
<b>Non-derivative liabilities</b>							
Deposits by banks	6,082.4	6,092.7	531.4	4,309.3	710.3	540.5	1.2
Customer accounts	30,828.2	30,880.9	1,954.3	2,339.6	4,638.9	21,948.1	–
Customer accounts – capital bonds	1,647.1	1,594.3	11.6	42.8	343.8	1,139.9	56.2
Debt securities in issue	3,334.3	4,256.4	570.0	232.6	898.0	2,515.6	40.2
Other borrowed funds	946.5	2,119.9	115.4	64.2	82.0	438.1	1,420.2
Amounts owed by group undertakings	329.2	329.2	92.6	236.6	–	–	–
	43,167.7	45,273.4	3,275.3	7,225.1	6,673.0	26,582.2	1,517.8
<b>Derivative liabilities</b>							
Net outflow	591.3	773.1	89.1	34.8	217.7	377.6	53.9
Other liabilities	43,759.0 503.7	46,046.5 –	3,364.4 –	7,259.9 –	6,890.7 –	26,959.8 –	1,571.7 –
<b>Total recognised liabilities</b>	<b>44,262.7</b>	<b>46,046.5</b>	<b>3,364.4</b>	<b>7,259.9</b>	<b>6,890.7</b>	<b>26,959.8</b>	<b>1,571.7</b>
Unrecognised loan commitments	5,016.2	5,016.2	4,891.7	60.7	–	63.8	–
<b>Total liabilities</b>	<b>49,278.9</b>	<b>51,062.7</b>	<b>8,256.1</b>	<b>7,320.6</b>	<b>6,890.7</b>	<b>27,023.6</b>	<b>1,571.7</b>

## Notes to the financial statements continued

### 52. Risk management continued

#### Fair values of financial assets and liabilities

The table below sets out a summary of the carrying and fair values of those financial assets and liabilities not presented on the Group and Bank balance sheets at fair value unless there is no significant difference between carrying and fair values.

Category (as defined by IAS 39)	2010		2009	
	Carrying value £m	Fair value £m	Carrying value £m	Fair value £m
<b>Financial assets</b>				
Loans and receivables:				
Loans and advances to banks	2,394.1	2,391.8	1,781.5	1,780.5
Loans and advances to customers	35,144.1	35,771.0	34,139.8	34,758.0
Investment securities	1,917.3	2,036.4	2,486.2	2,489.4
<b>Financial liabilities</b>				
Financial liabilities at amortised cost:				
Deposits by banks	2,938.6	2,971.1	6,082.4	6,084.7
Deposits from customers	32,320.0	32,400.8	30,828.2	30,919.6
Debt securities in issue	4,212.2	4,831.7	3,334.3	2,475.2
Other borrowed funds	975.4	1,107.4	946.5	787.0

Key considerations in the calculation of fair values are as follows:

#### (a) Loans and advances to banks include inter-bank placements and items in the course of collection.

Loans and advances to banks include inter-bank placements and items in the course of collection. The fair value of floating rate placements and overnight deposits is their carrying amount. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money-market interest rates for debts with similar credit risk and remaining maturity. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations.

#### (b) Loans and advances to customers

Fixed rate loans and advances to customers are revalued to fair value based on future interest cash flows (at funding rates) and principal cash flows discounted using the zero coupon rate. Forecast principal repayments are based on redemption at the earlier of maturity or repricing date with some overlay for historic behavioural experience where relevant. The eventual timing of future cash flows may be different from the forecast due to unpredictable customer behaviour. It is assumed there is no fair value adjustment required in respect of interest rate movement on variable rate assets. A credit loss adjustment has been applied based on expected loss amounts derived from the Bank's regulatory capital calculations.

#### (c) Customer accounts

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount repayable on demand. The estimated fair value of fixed interest-bearing deposits and other borrowings without quoted market price is based on discounted cash flows using interest rates for new debts with similar remaining maturity.

#### (d) Customer accounts – capital bonds

The estimated fair value of Customer accounts – capital bonds is based on independent third-party valuations using forecast future movements in the appropriate indices.

#### (e) Debt securities in issue and other borrowed funds

The aggregate fair values are calculated based on quoted market prices. For those notes where quoted market prices are not available, a discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity.

#### (f) Investment securities

Fair value is based on quoted market prices. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics.

#### (g) Derivatives

Futures and options are marked to market using listed market prices. For interest rate swaps, the estimated fair value is based on discounted cash flows using prevailing money-market interest rates for instruments with similar remaining maturity.







**52. Risk management** continued**Valuation of financial instruments**

The following table analyses financial assets at fair value by the three-tier valuation appearance as defined within IFRS 7.

Category (as defined by IAS 39)	Fair value measurement at end of the reporting period using:			
	Quoted market prices in active markets Level 1 £m	Valuation techniques using observable inputs Level 2 £m	Valuation techniques using unobservable inputs Level 3 £m	Total £m
<b>2010</b>				
<b>Financial assets</b>				
Loans and receivables designated at fair value				
Loans and advances to customers	–	62.3	11.8	74.1
Transfer in/(out)				–
<b>At end of the year</b>	–	62.3	11.8	74.1
<b>Available for sale financial assets</b>				
Investment securities – available for sale	902.9	2,054.2	–	2,957.1
– listed	902.9	1,443.3	–	2,346.2
– unlisted	–	610.9	–	610.9
Investment securities – designated at fair value	–	28.7	–	28.7
Transfer in/(out)				–
Equity shares	–	–	7.2	7.2
Transfer in/(out)				–
<b>Available for sale financial assets</b>	<b>902.9</b>	<b>2,082.9</b>	<b>7.2</b>	<b>2,993.0</b>
<b>Derivative financial instruments</b>				
Interest rate swaps				
– designated as fair value hedges	–	75.0	–	75.0
Transfer in/(out)				–
– designated as cashflow hedges	–	218.8	–	218.8
Transfer in/(out)				–
– at fair value through income and expense	–	90.1	–	90.1
Transfer in/(out)				–
Cross currency interest rate swaps				
– designated as fair value hedges	–	–	–	–
Transfer in/(out)				–
Other	–	548.0	–	548.0
Transfer in/(out)				–
<b>Total derivative financial instruments</b>	–	<b>931.9</b>	–	<b>931.9</b>
<b>Total assets carried at fair value</b>	<b>902.9</b>	<b>3,077.1</b>	<b>19.0</b>	<b>3,999.0</b>
<b>Financial liabilities designated at fair value</b>				
Deposits from banks	–	–	–	–
Capital bonds	–	1,794.7	–	1,794.7
<b>Total financial liabilities designated at fair value</b>	–	<b>1,794.7</b>	–	<b>1,794.7</b>
<b>Derivative financial instruments</b>				
Interest rate swaps				
– designated as fair value hedges	–	411.0	–	411.0
– designated as cashflow hedges	–	161.9	–	161.9
– at fair value through income and expense	–	86.6	–	86.6
Cross currency interest rate swaps				
– designated as fair value hedges	–	1.2	–	1.2
Other	–	41.7	–	41.7
<b>Total derivative liabilities</b>	–	<b>702.4</b>	–	<b>702.4</b>
<b>Total liabilities carried at fair value</b>	–	<b>2,497.1</b>	–	<b>2,497.1</b>

## Notes to the financial statements continued

### 52. Risk management continued

Category (as defined by IAS 39)	Fair value measurement at end of the reporting period using:				Total £m
	Quoted market prices in active markets Level 1 £m	Valuation techniques using observable inputs Level 2 £m	Valuation techniques using unobservable inputs Level 3 £m		
2009					
<b>Financial assets</b>					
Loans and advances to customers	–	36.4	11.8		48.2
Transfer in/(out)					–
<b>At end of the period</b>	–	36.4	11.8		48.2
<b>Available for sale financial assets</b>					
Investment securities – available for sale	942.7	3,514.6	–		4,457.3
Transfer in/(out)					–
– unlisted	–	–	–		–
Transfer in/(out)					–
– Equity shares	–	–	7.2		7.2
Transfer in/(out)					–
<b>Total available for sale financial assets</b>	942.7	3,514.6	7.2		4,464.5
<b>Derivative financial instruments</b>					
Interest rate swaps					
– designated as fair value hedges	–	0.5	–		0.5
Transfer in/(out)					–
– designated as cashflow hedges	–	118.1	–		118.1
Transfer in/(out)					–
– at fair value through income and expense	–	170.1	–		170.1
Transfer in/(out)					–
Cross currency interest rate swaps	–	635.5	–		635.5
Transfer in/(out)					–
– designated as fair value hedges	–	–	–		–
Transfer in/(out)					–
Other	–	98.8	–		98.8
Transfer in/(out)					–
<b>Total derivative financial instruments</b>	–	1,023.0	–		1,023.0
<b>Total assets</b>	942.7	4,574.0	19.0		5,535.7
<b>Financial liabilities designated at fair value</b>					
Deposits from banks	–	103.8	–		103.8
Capital bonds	–	1,647.1	–		1,647.1
<b>Total financial liabilities designated at fair value</b>	–	1,750.9	–		1,750.9
<b>Derivative financial instruments</b>					
Interest rate swaps					
– designated as fair value hedges	–	–	–		–
– designated as cashflow hedges	–	70.5	–		70.5
– at fair value through income and expense	–	479.1	–		479.1
Cross currency interest rate swaps					
– designated as fair value hedges	–	–	–		–
Other	–	41.7	–		41.7
<b>Total derivative liabilities</b>	–	591.3	–		591.3
<b>Total liabilities carried at fair value</b>	–	2,342.2	–		2,342.2

The floating rate notes within available for sale assets have been restated from level 1 to level 2 in 2009 in line with emerging industry practice.

**52. Risk management** continued

Movements in fair values of instruments with significant unobservable inputs were:

	Fair value at 2 January 2010 £m	Purchases £m	Sales £m	Transfers of engagements £m	Profit or loss including impairment £m	Other comprehensive income, net of impairment £m	Fair value at 1 January 2011 £m
<b>Group</b>							
Loans and advances to customers	11.8	–	–	–	–	–	11.8
Equity shares	7.2	–	–	–	–	–	7.2
	<b>19.0</b>	–	–	–	–	–	<b>19.0</b>
<b>Bank</b>							
Loans and advances to customers	11.8	–	–	–	–	–	11.8
Derivative assets	39.2	–	–	–	(5.2)	–	34.0
Equity shares	7.2	–	–	–	–	–	7.2
Derivative liabilities	–	–	–	–	(21.3)	–	(21.3)
Amounts owed to other Co-operative Group undertakings	(3,397.6)	(3,076.2)	625.1	–	–	–	(5,848.7)
	<b>(3,339.4)</b>	<b>(3,076.2)</b>	<b>625.1</b>	–	<b>(26.5)</b>	–	<b>(5,817.0)</b>

	Fair value at 10 January 2009 £m	Purchases £m	Sales £m	Transfers of engagements £m	Profit or loss including impairment £m	Other comprehensive income, net of impairment £m	Fair value at 2 January 2010 £m
<b>Group</b>							
Loans and advances to customers	13.8	(0.5)	–	–	(1.5)	–	11.8
Equity shares	8.8	–	–	1.5	(3.1)	–	7.2
	22.6	(0.5)	–	1.5	(4.6)	–	19.0
<b>Bank</b>							
Loans and advances to customers	13.8	(0.5)	–	–	(1.5)	–	11.8
Debt securities	29.9	–	–	–	9.3	–	39.2
Equity shares	8.8	–	–	1.5	(3.1)	–	7.2
Amounts owed to other Co-operative Group undertakings	(1,996.3)	(250.7)	648.9	(1,799.5)	–	–	(3,397.6)
	<b>(1,943.8)</b>	<b>(251.2)</b>	<b>648.9</b>	<b>(1,798.0)</b>	<b>4.7</b>	–	<b>(3,339.4)</b>

**Valuation techniques**

Fair values are determined according to the following hierarchy:

**(a) Level 1 – Quoted market prices in active markets**

Financial instruments with quoted prices for identical instruments in active markets. The best evidence of fair value is a quoted market price in an actively traded market.

**(b) Level 2 – Valuation technique using observable inputs**

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

The valuation techniques used to value these instruments employ only observable market data and relate to the following assets and liabilities:

**Loans and advances to customers**

Loans and advances to customers include corporate loans of £62.3m (2009: £36.4m) which are fair valued through income or expense using observable inputs. Loans held at fair value are valued at the sum of all future expected cash flows, discounted using a yield curve based on observable market inputs.

**Derivative financial instruments**

OTC (i.e. non-exchange traded) derivatives are valued using valuation models which are based on observable market data. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. The Bank enters into vanilla foreign exchange and interest rate swap derivatives, for which modelling techniques are standard across the industry. Examples of inputs that are generally observable include foreign exchange spot and forward rates, and benchmark interest rate curves.



## Notes to the financial statements continued

### 52. Risk management continued

#### (c) Level 3 – Valuation technique with significant unobservable inputs

This is used for financial instruments valued using models where one or more significant inputs are not observable.

The small proportion of financial assets valued based on significant unobservable inputs are analysed as follows:

##### Loans and advances to customers:

Loans and advances to customers include 25-year fixed rate mortgages £11.8m (2009: £11.8m) which are fair valued through income or expense using unobservable inputs. 25-year fixed rate mortgages are valued using future interest cash flows at the fixed customer rate and estimated schedule of customer repayments. Cash flows are discounted at a credit adjusted discount rate; the credit adjustment is based on the average margin of new long dated (five years or greater) fixed rate business written in the last six months, and subject to quarterly review. The eventual timing of future cash flows may be different from that forecast due to unpredictable customer behaviour, particularly on a 25-year product. The valuation methodology takes account of credit risk and has decreased the valuation by £0.1m in 2010 (2009: increase of £0.2m). A reasonable change in the assumptions would not result in any material change in the valuation.

##### Equity shares:

Primarily, equity shares relate to investments held in Vocalink Limited which are unquoted shares. The valuation of such shares is based on our percentage shareholding of the most recent public information valuation issued by the Company.

##### Derivative financial instruments:

Derivative financial instruments including internal interest rate swaps have been entered into during the year between the Bank and The Covered Bond LLP (LLP) and the Bank and Silk Road Finance Number One (Silk Rd 1).

The purpose of the swap is to convert the fixed and base rate linked revenue receipts of the pool of mortgage assets to the same LIBOR linked basis as the intercompany loan. Under this swap arrangement the LLP or Silk Rd 1 pays to the swap counterparty, the monthly mortgage revenue receipts of the pool of assets and receives from the swap counterparty LIBOR plus a contractual spread on the same notional balance; the spread being sufficient to cover the intercompany loan and any expenses.

The swap is valued based on an assumed amortisation profile of the pool of assets to the bond maturity date (assuming some annual prepayment), an assumed profile of customer receipts over this period, and LIBOR prediction using forward rates. Swap cash flows are discounted to present value using mid-yield curve zero coupon rates, i.e. no adjustment is made for credit losses, nor for transaction or any other costs.

The fair value of the swap is based on a valuation model that reflects the mortgage cash flows over a three year period using a discount rate based on LIBOR spreads. This derivative eliminates on consolidation.

##### Amounts owed to other Co-operative Group undertakings

Deposits from customers includes deposits by the LLP and Silk Rd 1 subsidiaries relating to the legal transfer of loans and advances on issue of the Bank's covered bonds and securitisation. The deposit is fair valued to eliminate an accounting mismatch of the swap derivative as discussed above.

Revaluation of the £5.9bn (2009: £3.4bn) mortgage pool from carrying to fair value is based on assumed timing of future mortgage capital and revenue receipts, discounted to present value using a credit adjusted discount rate.

The amortisation profile is as per the swaps valuation methodology, assuming some annual prepayment, but is extended beyond any bond maturity, until all the mortgages themselves mature, which is circa 25 years. Similarly, the revenue receipts are calculated as per the swap valuation methodology, but extended until all the mortgages mature. For fixed rate mortgages revenue receipts are based on fixed customer rates within the assumed amortisation profile. For tracker, SVR and discount products revenue receipts are assumed to be based on forward LIBOR rates plus the product margins. Fixed and tracker mortgages are assumed to revert to SVR at end of any offer period. All mortgages in the covered bond pool were originated pre 31 December 2007.

The fair value of the swap is based on a valuation model that reflects the mortgage cash flows over a three year period using a discount rate based on LIBOR spreads. This derivative eliminates on consolidation.

##### Primary financial instruments used by the Bank

The main financial instruments used by the Bank, and the purposes for which they are held, are outlined below:

##### Customer loans and deposits

The provision of banking facilities to customers is the prime activity of the Bank and customer loans and deposits are major constituents of the balance sheet. Customer loans include retail mortgages, corporate loans, credit cards, unsecured retail lending and overdrafts. Customer deposits include retail and corporate current and saving accounts. The Bank has detailed policies and procedures to manage risks. In addition to mortgage lending, much of the lending to corporate and business banking customers is secured.

##### Debt securities, wholesale market loans and deposits

Debt securities include structured investments and credit trading funds. Debt securities also underpin the Bank's liquidity requirements and generate incremental net interest and trading income.

The Bank issues medium-term notes within an established euro medium-term note programme and also issues certificates of deposit and commercial paper as part of its normal treasury activities. These sources of funds alongside wholesale market loans are invested in marketable, investment grade debt securities, short term wholesale market placements and used to fund customer loans.

**52. Risk management** continued**Capital funds – subordinated note issues and preference shares:**

The Bank has a policy of maintaining prudent capital ratios and utilises a broad spread of capital funds. In addition to ordinary share capital and retained earnings, the Bank has issued £60million preference shares and, when appropriate, also issues perpetual and fixed term subordinated notes.

**Foreign exchange:**

The Bank undertakes foreign exchange dealing to facilitate customer requirements and to generate incremental income from short term trading in the major currencies. Structured risk and trading related risk are managed formally within position limits approved by the Board.

**Derivatives:**

The Bank undertakes foreign exchange dealing to facilitate customer requirements and to generate incremental income from short term trading in the major currencies. Structured risk and trading related risk are managed formally within position limits approved by the Board.

The most frequently used derivative contracts are interest rate swaps, exchange traded futures and options, caps and floors, forward rate agreements, currency swaps and forward currency transactions. Terms and conditions are determined by using standard industry documentation. Derivatives are subject to the same market and credit risk control procedures as are applied to other wholesale market instruments and are aggregated with other exposures to monitor total counterparty exposure which is managed within approved limits for each counterparty.

**Insurance risk**

CIS and CISGIL issue contracts that transfer insurance risk or financial risk or both. This section summarises these risks and the way CIS and CISGIL manages them.

**Our approach to risk management**

CISGIL and CIS operate in regulated markets and are subject to significant government regulation.

The CFS group of companies including Co-operative Financial Services Limited, Co-operative Insurance Society Limited (Life and Savings business), CIS General Insurance Limited and The Co-operative Bank plc have a common Board composition.

CFS has developed and implemented a common governance and organisation structure, with the same committee structure supporting each Board within the CFS group.

The Board is responsible for approving the CFS strategy, its principal markets and the level of acceptable risks articulated through its statement of risk appetite. It is also responsible for overall corporate governance, which includes ensuring that there is an adequate system of risk management and that the level of capital held is consistent with the risk profile of the business.

The Board has established Board Committees and Senior Management Committees to administer, oversee and challenge the risk management process, identifying the key risks facing the business and assessing the effectiveness of planned management actions.

Specific Board authority has been delegated to Board Committees and the Chief Executive who may, in turn, delegate elements of his discretions to appropriate Executive Directors and their senior line managers.

**Insurance risk**

The risk under any contract derives from the possibility that the insured event occurs and the uncertainty of the amount and timing of the resulting claim.

The principal risk that CISGIL and CIS face under their insurance contracts is that the actual claims and benefit payments exceed the carrying amount of the insurance liabilities. This could occur because the frequency or severity of claims and benefits are greater than estimated. Insurance events and the actual number and amount of claims and benefits will vary from year to year from the estimates established.

**(a) General insurance risk****Principal risks covered**

The major classes of general insurance business written are motor and property, together with some liability, pecuniary loss and personal accident risks. Almost all risks under general insurance policies cover a 12-month duration and all risks directly underwritten are confined to the UK market.

Motor cover provided is principally in respect of private vehicles or to small businesses, with limited underwriting of fleet business. Principal risks under motor policies are bodily injury to third parties, accidental damage to property including policyholders' and third parties' vehicles and theft of, or from, policyholders' vehicles.

Property cover is residential household. Principal risks under property policies are damage from storm and flood, fire, escape of water and subsidence and theft of or accidental damage to contents.

CISGIL has entered into an indemnification agreement with Co-operative Insurance Society Limited (CIS), a fellow subsidiary within CFS, to assume financial responsibility for the run-off of general insurance business formerly written by CIS. In return CISGIL received a premium in 2006, settled by transfer of assets, equivalent to the net technical liabilities of this business included in CIS's financial statements at 2005 year end. This exposes CISGIL to the risk of these assets being insufficient to cover the claims arising from this business, although this risk is diminishing over time.

**Frequency and severity of claims**

The frequency and severity of property claims can be affected by several factors, the most significant being weather events. In addition, there is a possibility of a very large individual commercial property claim arising from fire and/or consequential loss. The most significant factors affecting the frequency and severity of motor claims are judicial, legislative and inflationary changes and the frequency and severity of large bodily injury claims. Sensitivity analysis is disclosed in note 29.

## Notes to the financial statements continued

### 52. Risk management continued

#### Risk management objectives and strategy

CISGIL's objective in managing general insurance risk is to ensure that insurance risks are understood and accepted in accordance with detailed underwriting rules developed with regard to the documented insurance risk appetite and that pricing appropriately reflects the underlying risk. General insurance risk is managed through the underwriting strategy, reinsurance arrangements, proactive claims handling and the claims provisioning process.

The underwriting strategy attempts to ensure that the underwritten risks are well diversified in terms of type and amount of risk, industry/demographic profile and geography and only those risks that conform with underwriting criteria are accepted. Exposure mix and the frequency and average costs of claims are monitored throughout the year and where significant deviations from expectation are identified, remedial action is taken. A programme of reinsurance is in place that sets retention levels in accordance with the risk appetite of the business.

The overriding objective in claims handling is to ensure all claims are properly scrutinised and paid where they fall within the terms and conditions of the policy. The proper scrutiny of claims is facilitated by the use of various technical aids such as a pricing database, weather validation and fraud databases and the use of claims specialists.

#### Concentration of risk

The bias of the portfolio towards personal contracts reduces the risk of large single losses and there is no significant concentration of risk in any geographical area of the UK. Excess of loss reinsurance cover is used to mitigate losses from individual large claims, particularly large bodily injury and commercial losses.

Statistical modelling with specialised software is produced to assess CISGIL's exposure to natural hazards such as windstorm and flood events, including a large east coast flood, which would significantly affect the property portfolio. Weather event catastrophe reinsurance cover is the most important component of the reinsurance programme and is set to restrict losses from a single event.

#### Sources of uncertainty in the estimation of future claim payments and premium receipts

The nature of insurance contracts is that the obligations of the insurer are uncertain as to the timing or quantum of liabilities arising from contracts. CISGIL takes all reasonable steps to ensure that it has information regarding its claims exposures. However, given the uncertainty in establishing claims provisions, it is likely that the final outcome will prove to be different from the original liability established.

Uncertainty over the timing of claims relates to liabilities which have occurred but are not yet reported and the interval between claim notification and settlement. Recognised statistical methods are used to assess the payment of claims, both in respect of claims already notified and those yet to be notified. Bodily injury claims and associated legal costs, which are a significant element of outstanding claims on the motor and liability accounts, have a longer period to settlement, potentially several years. Periodic payment orders (PPOs) are a specific form of settlement of these claims, where the underwriter is required to pay regular inflation adjusted amounts for the life of the claimant, thus significantly extending the period to final settlement. There is a higher degree of uncertainty associated with these long tail claims than property damage claims which are settled more quickly. By their nature, the statistical methods used to assess the timing of future payments rely, to some extent, on past patterns being repeated in future.

In terms of monetary values placed on claims liabilities, uncertainty arises from a number of sources. Inflation assumptions, to which long tail claims are sensitive, are set with regard to current conditions and expectations for economic influences relevant to the claim type but future experience may diverge. Bodily injury claims in particular are sensitive to changes in the legislative and regulatory environments where court decisions, guidance from the Lord Chancellor or statutory changes can affect unsettled liabilities.

In addition to cost inflation and other external factors referred to above, the amount and timing of claim payments will be affected by changes in the organisation's claims handling processes. The allowance in provisions represents CISGIL's current view of the degree of this acceleration. Estimations are also made in respect of pipeline premiums, non-recoverable premium debts and doubtful reinsurance recoveries. In calculating the pipeline premiums, projections are based on past patterns of premium processing. Changes in processing cycles and in attrition rates could alter these past trends.

### (b) Long term insurance risk

#### Principal risks covered

The majority of the long term business consists of participating savings business, including deferred pensions. In addition, cover is provided in respect of mortality risk (both term insurance and whole of life) and critical illness. Principal risks associated with these policies arise from policyholder mortality or longevity, morbidity and persistency.

Improvements in pensioner longevity pose a potential risk of increases in the cost of annuities in payment, guaranteed benefits under deferred annuity contracts and cost of guaranteed annuity options (GAOs) on personal pension contracts.

Persistency risk arises where more policies than expected reach their investment guarantee dates, resulting in a potential increase in the cost of guarantees. This is particularly significant in relation to personal pension contracts where the risk is that more policyholders than expected reach their retirement date, which is the date on which GAOs become available.

#### Frequency and severity of claims

Factors that could increase the overall frequency of claims include epidemics for term assurance products, increased healthcare screening (such as cancer screening) resulting in earlier or more claims than expected for critical illness products, and more rapid improvements in longevity than expected for in-payment and deferred annuity business (for example from developments in medical science).

For participating policies, a significant amount of the insurance risk is shared with the participating contract holders. Insurance risk is also shared on critical illness and waiver of premium policies, both of which allow for premium rate reviews to enable changes in actual experience from expectation to be reflected in future premiums. A premium review is conducted annually for these policies. For all other policies, there are no mitigating terms and conditions that reduce the insurance risk accepted.

**52. Risk management** continued

Insurance risk is affected by the policyholders' rights to terminate the policy, pay reduced or no future premiums or to take up a guaranteed annuity option. Consequently, the amount of insurance risk is subject to policyholder behaviour.

**Risk management objectives and strategy**

CIS's objective in managing long term business insurance risk is to ensure that insurance risks are understood and accepted in accordance with its documented underwriting policy and that policy pricing appropriately reflects the underlying risk. CIS manages long term business insurance risk through the use of appropriate underwriting, product design and pricing and the use of reinsurance arrangements. Risk is managed and monitored across the portfolio.

The majority of term assurance and critical illness policies are reinsured on a quota share basis. A significant proportion of in-payment annuity business and deferred annuity business is also reinsured.

**Sources of uncertainty in the estimation of future benefit payments and premium receipts**

Uncertainty in the estimation of future benefit payments and premium receipts arises from the uncertainty regarding long term changes in mortality levels and variability in policyholder behaviour regarding termination and alteration of policies.

The amount of insurance risk under contracts with guaranteed annuity options depends upon the number of policyholders who exercise their option. The lower the current market interest rate is in relation to the rates implicit in the guaranteed annuity option, the greater the likelihood that policyholders will choose to exercise the option.

**Concentration of insurance risk**

The existence of guaranteed annuity options on personal pension products gives rise to a significant concentration of financial risk and insurance risk.

**(c) Financial risk**

CIS is exposed to risk through the insurance and participating contracts that it issues (and its ceded reinsurance contracts) and through its holdings of financial assets and liabilities (including investment contracts, borrowings and derivatives). In particular a key financial risk is that the proceeds from financial assets and property are insufficient to fund the obligations arising under long term insurance, investment contracts and general insurance business in run-off. CIS manages this risk separately for general insurance business in run-off and long term business and then according to the categories of market risk, credit risk and liquidity risk.

CISGIL is exposed to financial risk through its financial assets, financial liabilities (including borrowings), reinsurance assets and insurance liabilities. In particular a key financial risk is that the proceeds from financial assets are insufficient to fund the obligations arising under general insurance contracts. CISGIL manages financial risk according to the sub-categories of market risk, credit risk and liquidity risk.

**Financial risk management objective and strategy**

The principal objective of CIS' and CISGIL's financial risk management strategy is to optimise the return on investments commensurate with an acceptable level of financial and insurance risk. Financial risk is managed within an asset and liability management framework (ALM) to ensure that this objective is achieved. An overriding constraint on CIS's and CISGIL's investment strategy is to ensure that at all times the fund has sufficient assets to meet its solvency and capital requirements.

The whole of the profits of the long term business must be applied for the sole benefit of the long term business policyholders. This includes the creation of reserves with the aim of preserving the strength of the fund for the benefit of the current and future long term business policyholders. Similarly any losses incurred within the fund are borne by the long term business policyholders, either through a reduction in the working capital of the fund or through a reduction in their benefits. The working capital of the fund is the excess of assets within the fund over the amount needed to meet liabilities, including those arising from the regulatory requirement to treat customers fairly when setting discretionary benefits. The working capital is managed to ensure that the long term business fund can meet its solvency requirements under a range of adverse conditions and to meet business plans. In exceptional circumstances, assets held outside the fund (share capital and general reserve) may, if available, be used to help meet the long term business fund's solvency requirements.

Risks that may affect the long term business fund are managed according to documented risk management policies, which require risks and capital to be regularly monitored and reported, and decisions made according to delegated authorities. Actions to control risk and manage the working capital of the fund include the use of reinsurance, matching assets and liabilities (including using derivatives) and setting discretionary benefits at appropriate levels, as described in the Principles and Practices of Financial Management (PPFM).

The risk management committee specifically monitors ALM exposures and controls the effectiveness of the market and credit policies. Exposures to market and credit risk are managed through diversifying investments across asset classes, issuers and markets.

CIS Shareholder funds reflect assets backing reserves and are principally invested in equities. CIS has reduced the exposure to the volatility of equity prices experienced in recent years by selling equity futures whilst retaining the underlying equity holdings.

The principal ALM technique used in CISGIL is to invest in assets that are predominantly fixed interest securities with a similar duration profile to the liabilities under the general insurance contracts.

The principal ALM technique of CIS's long term business fund is to match the assets to the insurance and investment contract liabilities with reference to the type of benefits payable to contract holders. Separate asset portfolios and funds are maintained in respect of traditional with-profits policies, accumulating with-profits policies, non-participating policies and linked-liabilities.

As part of its ALM framework, CISGIL and CIS set a strategic asset allocation range with reference to a suitable benchmark for each asset class taking account, separately, of the short term insurance and investment liabilities, shareholder and long term insurance and investment liabilities, long term investment performance and the financial risks. Controls and limits are set for each risk and sub-risk type and managed within the risk management procedures accordingly. CISGIL and CIS consider the capital adequacy and solvency of each insurance fund when establishing and controlling the assets and risk limits.

## Notes to the financial statements continued

### 52. Risk management continued

#### Principal financial risks affecting CISGIL and CIS

Market risk is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk is of particular importance to the long term business fund where a significant proportion of assets is held in equities, property and alternative investments such as hedge funds.

Financial risk within the long term business fund is managed as follows:

- long term insurance liabilities in respect of non-participating policies are closely matched with fixed interest securities. This close matching is achieved by holding assets whose cash flows correspond to the expected aggregate cash flow on the non-participating business;
- interest rate swaps and swaptions are held to meet the expected guaranteed annuity option liabilities;
- for unit-linked investment contracts, assets are matched with liabilities;
- equity options and futures are held to reduce a proportion of the equity price risk arising from backing guaranteed benefits on participating contracts with equities;
- financial assets held to meet expected participating policy guarantee costs (other than equity options), and the working capital of the fund, are invested in fixed-interest securities to reduce cashflow interest rate risks; and
- a portfolio of gilt total return swaps and interest rate swaps are held to hedge the risk of adverse movements in swaps spreads.

Borrowings at variable interest rates expose CIS to cashflow interest rate risk, whereas borrowings at fixed rates create an exposure to fair value interest rate risk. CIS' policy is to maintain the majority of borrowings in instruments of duration less than three years.

CIS manages its cashflow interest rate risk by using interest rate swaps and deposits. CIS enters into interest rate swaps and gilt repurchasing arrangements to manage borrowing requirements.

CISGIL normally matches the insurance liabilities arising under its general insurance contracts with a portfolio of fixed-interest debt securities of a similar average duration to the liabilities arising under those contracts. To enhance certainty over the investment return generated from these assets, management practice is generally to maintain holdings to maturity. Short term insurance liabilities are not directly sensitive to the level of money-market rates, as they are contractually non-interest bearing. However, interest rate risk arises because of the time value of money and the potential duration to settlement of claims. The value of assets held is subject to volatility from changes in short term money-market interest rates and proceeds from maturing investments are subject to risk over the future return on reinvestment. Index-linked investments are used to match periodical payment liabilities by amount and duration.

CISGIL matches cash flows of assets and liabilities in this portfolio by estimating their mean duration. The mean duration of liabilities is calculated using historical claims data to determine the expected settlement pattern for claims arising from insurance contracts in force at the balance sheet date (both incurred claims and future claims arising from the unexpired risks at the balance sheet date). Mean durations are:

	2010	2009
Net insurance liabilities	<b>2.53 years</b>	2.34 years
Financial assets	<b>2.93 years</b>	3.34 years

#### Sensitivity analysis

The only significant aspect of market risk to which CISGIL is exposed is interest rate risk. The market value of CISGIL's assets is subject to volatility from changes in short term money-market interest rates; furthermore proceeds from maturing investments are subject to risk over the future return on reinvestment. An increase of 100 basis points in interest yields would reduce the carrying value of CISGIL's assets at the end of the financial year by £29.3m (2009: £34.1m). CISGIL invests predominantly in fixed-rate securities and has adopted a policy of recognising investment assets on an 'available for sale' basis, therefore the impact upon profit during the period would not be material and would instead be recognised directly in other comprehensive income as a reduction of £21.1m net of tax (2009: £24.6m). Conversely the impact of a decrease of 100 basis points in interest yields would be recognised directly in other comprehensive income as an increase of £22.5m net of tax (2009: £26.6m).

CISGIL has issued £65m (2009: £105m) of subordinated debt at varying margins above three-month LIBOR. The effect on profit of a 1% movement in three-month LIBOR would be £0.47m per annum net of tax (2009: £0.76m).

The sensitivity analysis above assumes a reasonably possible movement in one variable with all other variables held constant. Furthermore, the calculation assumes that a change in base rate would have an immediate and equal impact at all points on the yield curve.

The only significant aspect of market risk to which the other than long term business fund is exposed is equity price risk as it has no material holdings in interest bearing securities. The market value of the assets in this fund fluctuate in accordance with underlying equity market values. However, this risk has been significantly reduced by selling equity futures. An increase of 10% in equity values would increase the balance sheet carrying value of equities in the other than long term business fund at the end of the financial period by £28.2m (2009: £48.5m). This would be largely offset by an increase in the value of financial liabilities in respect of financial futures contracts. However, the futures do not provide a perfect hedge against changes in value of the equities portfolio, and the change in the liability would be expected to lie within the range £32.0m to £23.7m (2009: £56.0m to £41.0m) giving a net profit impact, pre-tax, of between +4.5m and -£3.8m (2009: +/- £7.5m). A 10% reduction in equity values would produce the reverse impact on pre-tax profit, being between +£3.8m and -£4.5m (2009: +/- £7.5m), as the movement would be offset by a movement in equity futures. This sensitivity analysis is based upon a change in one assumption while holding all other assumptions constant.

Fluctuations in the value of assets held in respect of participating policies will be met by an equivalent change to policyholder benefits subject to any guarantees provided under such policies. Where policy guarantees mean that such fluctuations cannot be met by a change to policyholder benefits, changes to asset values will be met by the working capital of the long term business fund. In addition, fluctuations in financial assets backing non-participating policies and participating policy guarantees will also impact the working capital of the fund. Examples of how particular market risk scenarios impact the working capital of the fund are illustrated in note 29 (e) (xii).



**52. Risk management** continued**Credit risk**

CISGIL's and CIS's principal credit risk exposure arises in connection with default of debt securities and reinsurance counterparties, either failing to meet financial obligations when due or entering into restructuring arrangements that may adversely affect the market value of the debt security or reinsurance recoverable. In addition, credit risk exposure also arose in CISGIL in connection with adverse movement in credit spreads impacting on its corporate bond portfolio.

CISGIL and CIS have established a credit policy and exposure framework to monitor counterparty and credit-risk exposures, on an ongoing basis through the use of appropriate risk limits. CISGIL and CIS structure the levels of counterparty risk and asset concentration risk that they accept by placing limits and controls over the exposure to a single debt instrument and counterparty, or counterparty group, and seek to actively diversify investment holdings and counterparty exposures across markets and economic segments. Counterparty exposures are subject to review at least annually and, where concern exists over counterparty credit quality, the exposure is monitored and actively managed.

Where reinsurance is used to manage insurance risk, a risk is created that the reinsurer fails to meet its obligations in the event of a claim. Creditworthiness of reinsurers is considered regularly, together with reinsurer exposures. Additionally, in respect of the reinsurance of in-payment and deferred annuity business, CIS has taken a charge over assets to safeguard expected future reinsurance recoveries.

Financial responsibility for the benefits and burdens of the general insurance business of CIS in run-off has been passed to CISGIL, a fellow society within the CFS Group, via an indemnification agreement. If CISGIL were unable to fulfill its contractual obligations, financial responsibility for these claims would revert to CIS.

Other risk mitigation techniques employed to manage exposure to counterparty default include transacting only through a diversified range of authorised counterparties or brokers and the requirement for derivative transactions (including investment and trading in futures, swaptions, stock lending and gilt repo transactions) to be fully collateralised regularly for CIS and on a daily basis for CISGIL.

At the balance sheet date there were no significant concentrations of credit risk. The table below provides an analysis at the balance sheet date of the credit rating of financial assets subject to credit risk.

	2010						2009
	AAA £m	AA £m	A £m	Bs and below £m	Not rated £m	Total £m	Total £m
Reinsurance assets	<b>0.7</b>	<b>35.0</b>	<b>3,058.0</b>	–	<b>8.3</b>	<b>3,102.0</b>	3,019.0
<i>Financial assets at fair value through income or expense (held for trading purposes)</i>							
Listed equities	–	–	–	–	–	–	4,803.3
Unlisted equities	–	–	–	–	–	–	820.8
Listed debt (fixed rate)	<b>3,220.2</b>	<b>614.4</b>	<b>1,627.8</b>	<b>1,027.5</b>	<b>16.7</b>	<b>6,506.6</b>	6,767.7
Listed debt (floating rate)	–	–	–	–	–	–	–
Unlisted debt (fixed rate)	<b>3.6</b>	–	–	–	–	<b>3.6</b>	5.5
Unlisted debt (floating rate)	–	<b>2,150.1</b>	–	–	–	<b>2,150.1</b>	–
Deposits with approved credit institutions (fixed rate)	–	<b>808.9</b>	<b>727.8</b>	–	<b>6.2</b>	<b>1,542.9</b>	1,519.8
Derivatives	<b>1.3</b>	<b>485.0</b>	<b>310.6</b>	–	–	<b>796.9</b>	681.2
<i>Financial assets designated at fair value through income or expense</i>							
Listed equities	–	–	–	–	–	–	244.0
Unlisted equities	–	–	–	–	–	–	–
Listed debt (fixed rate)	–	–	–	–	–	–	12.0
Unlisted debt (fixed rate)	–	–	–	–	–	–	–
Unlisted debt (floating rate)	–	–	–	–	–	–	1,992.4
<i>Non-current assets – available for sale</i>							
Listed debt (fixed rate)	<b>20.1</b>	<b>171.0</b>	<b>527.2</b>	<b>173.9</b>	<b>24.4</b>	<b>916.6</b>	1,002.5
Listed debt (variable rate)	–	–	<b>25.1</b>	<b>3.1</b>	–	<b>28.2</b>	–
Unlisted debt (fixed rate)	–	–	–	<b>4.9</b>	–	<b>4.9</b>	4.9
Deposits with approved credit institutions (fixed rate)	–	–	–	–	–	–	–
Derivatives	–	–	–	–	–	–	–
<i>Loans and receivables at amortised cost</i>							
Loans	–	–	–	–	<b>5.6</b>	<b>5.6</b>	7.8
Insurance receivables and other assets	<b>29.4</b>	<b>54.4</b>	<b>65.3</b>	<b>28.8</b>	<b>306.9</b>	<b>484.8</b>	433.7
Cash and cash equivalents	–	<b>9.7</b>	<b>49.5</b>	–	–	<b>59.2</b>	55.9
<b>Total assets bearing credit risk</b>	<b>3,275.3</b>	<b>4,328.5</b>	<b>6,391.3</b>	<b>1,238.2</b>	<b>368.1</b>	<b>15,601.4</b>	21,370.5

## Notes to the financial statements continued

### 52. Risk management continued

The maximum exposure to credit risk is represented by the carrying value of each financial asset and reinsurance balance in the table.

Collateral is held as security for reverse repo balances of £687.6m (2009: £333.8m) reported within deposits with approved credit institutions and the unlisted floating rate debt of £2,150.1m (2009: £1,992.4m).

CIS makes provision for the possible impairment of policyholder debts where these are more than one month overdue.

CISGIL makes provisions for the possible impairment of financial assets where there is objective evidence that an impairment loss has been incurred.

### Liquidity risk

CISGIL and CIS are exposed to calls on their available cash resources mainly from claims arising. Liquidity risk is the risk that cash may not be available at a reasonable cost to pay obligations when due. CISGIL and CIS have established a liquidity risk policy and manage such risk through the requirement to hold a proportion of financial assets in cash and liquid fixed-interest stocks to pay claims for a specified time period in stressed conditions. The minimum financial assets proportion is determined using CISGIL and CIS's internal economic capital assessment and the estimated extreme case net outflows and by regularly reviewing the nature, cause, effect and probability of extreme case scenarios in the light of changing natural, social and economic conditions.

CISGIL and CIS are active in the gilt repo market as part of its cash management activities and maintain short term borrowing facilities to enable settlement.

The following table indicates the time profile of undiscounted cash flows arising from financial liabilities (based upon contractual maturity) and insurance liabilities (based upon estimated timing of outflow of amounts recognised in the balance sheet).

	Carrying value £m	Gross nominal outflow £m	Up to one year £m	1-5 years £m	5-10 years £m	10-15 years £m	Over 15 years £m
<b>2010</b>							
Insurance and participating contract liabilities <i>Financial liabilities at fair value through income or expense (held for trading)</i>	<b>17,752.9</b>	<b>17,752.9</b>	<b>2,357.8</b>	<b>4,892.3</b>	<b>3,858.6</b>	<b>2,738.8</b>	<b>3,905.4</b>
Derivatives <i>Financial liabilities designated at fair value through income or expense</i>	<b>534.7</b>	<b>534.7</b>	<b>534.7</b>	–	–	–	–
Investment contract liabilities	<b>316.0</b>	<b>316.0</b>	<b>316.0</b>	–	–	–	–
Other financial liabilities <i>Financial liabilities at amortised cost</i>	<b>2,150.1</b>	<b>4,643.4</b>	<b>58.2</b>	<b>362.0</b>	<b>500.1</b>	<b>496.8</b>	<b>3,226.3</b>
Loans and borrowings	–	–	–	–	–	–	–
Amounts owed to credit institutions (fixed rate)	<b>870.5</b>	<b>870.7</b>	<b>870.7</b>	–	–	–	–
Insurance and other payables	<b>161.5</b>	<b>161.5</b>	<b>144.6</b>	<b>16.5</b>	<b>0.4</b>	–	–
Other reinsurance liabilities	<b>9.9</b>	<b>9.9</b>	<b>9.9</b>	–	–	–	–
Subordinated debt	<b>65.0</b>	<b>69.1</b>	<b>1.3</b>	<b>32.8</b>	<b>35.0</b>	–	–
Cash and cash equivalents	<b>6.0</b>	<b>6.0</b>	<b>6.0</b>	–	–	–	–
Net asset value attributable to unit holders	<b>30.3</b>	<b>30.3</b>	<b>30.3</b>	–	–	–	–
	<b>21,896.9</b>	<b>24,394.5</b>	<b>4,329.5</b>	<b>5,303.6</b>	<b>4,394.1</b>	<b>3,235.6</b>	<b>7,131.7</b>
Other liabilities	<b>1,154.4</b>						
<b>Total recognised liabilities</b>	<b>23,051.3</b>						

**52. Risk management** continued

2009	Carrying value £m	Gross nominal outflow £m	Up to one year £m	1–5 years £m	5–10 years £m	10–15 years £m	Over 15 years £m
Insurance and participating contract liabilities	16,729.0	16,729.0	2,218.7	4,716.7	3,600.7	2,528.7	3,664.2
<i>Financial liabilities at fair value through income or expense (held for trading)</i>							
Derivatives	502.9	502.9	502.9	–	–	–	–
<i>Financial liabilities designated at fair value through income or expense</i>							
Investment contract liabilities	259.9	259.9	259.9	–	–	–	–
Other financial liabilities	1,992.4	4,454.2	54.2	262.4	446.4	606.4	3,084.8
<i>Financial liabilities at amortised cost</i>							
Loans and borrowings	172.0	172.1	172.1	–	–	–	–
Amounts owed to credit institutions (fixed rate)	1,071.2	1,071.8	1,071.8	–	–	–	–
Insurance and other payables	184.1	184.1	174.8	9.3	–	–	–
Other reinsurance liabilities	9.0	9.0	9.0	–	–	–	–
Subordinated debt	105.0	113.8	1.8	35.8	76.2	–	–
Cash and cash equivalents	5.6	5.6	5.6	–	–	–	–
Net asset value attributable to unit holders	42.1	42.1	42.1	–	–	–	–
	21,073.2	23,544.5	4,512.9	5,024.2	4,123.3	3,135.1	6,749.0
Other liabilities	1,195.2						
Total recognised liabilities	22,268.4						

**CISGIL liquidity risk**

CISGIL is exposed to calls on its available cash resources mainly from claims arising. Liquidity risk is the risk that cash may not be available to pay obligations when due at a reasonable cost. The Board sets limits on the minimum proportion of maturing funds available to meet such calls and on the minimum level of borrowing facilities in place to cover claims at unexpected levels of demand.

A liquidity risk policy has been established and risk is managed through the requirement to hold a proportion of financial assets in cash and liquid fixed interest stocks to pay claims for a specified time period in stressed conditions, where liquid assets are considered to be:

Asset type	Value included as liquid asset
Gilts	100%
Cash	100%
Corporate bonds:	
AAA	80%
AA	70%
A	60%
BBB	50%
All other investments	0%

The stressed condition which is assessed is a one in 100 year windstorm loss before reinsurance recoveries. The requirement is that 20% of the ultimate cost of the storm is required in cash to cover immediate payments. This is considered reasonable for liquidity, as there is always a delay to payment and CISGIL is to some extent in control of the period to payment. The ultimate cost is calculated by GI capital and risk at least every year, based on the Individual Capital Assessment (ICA) models. Based on the latest catastrophe model the one in 100 year windstorm loss is £99m, giving a liquidity requirement of £19.8m against actual liquid assets of £611m.

CISGIL has access to overnight borrowing facilities with The Co-operative Bank plc a fellow subsidiary. Overnight borrowings are subject to The Co-operative Bank's regulatory related counterparty exposure limits. These borrowings are on normal commercial terms and represent an unsecured, uncollateralised obligation of CISGIL. CISGIL is active in the gilt repo market to facilitate liquidity risk management and maintains short term borrowing facilities to enable settlement.

**CISL liquidity risk**

Liquidity risk is the risk that cash may not be available at a reasonable cost to pay obligations when due. CIS is exposed to calls on its available cash resources mainly from claims arising, collateral arrangements on derivatives and reinsurance contracts.

## Notes to the financial statements continued

### 52. Risk management continued

A liquidity risk policy has been established and risk is managed through the requirement to hold a proportion of financial assets in cash and liquid stocks to pay claims and other cash flows for a specified time period in stressed conditions, where liquid assets are considered to be:

Asset type	Value included as liquid asset
Gilts	100%
Cash	100%
Corporate bonds:	
AAA	80%
AA	70%
A	60%
BBB	50%
Equity	60%
All other investments	0%

The minimum liquid assets proportion is currently approximately 11% of the long term business fund. This is determined using the Society's internal economic capital assessment and is regularly reviewed considering the nature, cause, effect and probability of extreme case scenarios in the light of changing natural, social and economic conditions. The current extreme scenario assumes:

- increase in claims and surrenders by 50%;
- increase in expenses by 10%;
- reduction in asset values by 10%, with no investment income;
- no new business premiums income received;
- no reinsurance recoveries received; and
- contractual payments occurring at the earliest possible date.

In addition, a minimum of £700m of gilts are held to meet extreme collateral payments on derivative contracts.

Based on the latest internal assessment, the liquidity requirement is £1.6bn (2009: £1.6bn) against actual available liquid assets of £7.4bn (2009: £8.0bn).

CIS is active in the gilt repo market as part of its cash management activities and maintains short term borrowing facilities to enable settlement.

### Currency risk

Currency risk is the risk that cash flows or fair values fluctuate as a result of changes in foreign exchange rates. CIS writes contracts of insurance in the UK and insurance and investment liabilities are denominated in sterling. The shareholder funds are invested solely in assets denominated in sterling. The long term business fund invests in an internationally diversified range of assets. Currency futures are used to ensure that the currency risk to the fund is not significant.

CISGIL writes contracts of insurance in the United Kingdom and insurance liabilities and borrowings are denominated in sterling. Funds are invested solely in assets denominated in sterling and consequently there is no significant exposure to currency risk.

### Fair values

The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the financial statements:

#### (a) Securities

Fair value for listed debt and equity securities is based on clean bid prices at the balance sheet date without any deduction for transaction costs.

Fair values in respect of unlisted equity securities, participation in collective investment pools and partnerships are determined using a range of valuation techniques. These include reference to other recent arm's length transactions, reference to other transactions that are substantially the same, and discounted cash flow techniques.

Fair value of unlisted debt securities represents the discounted expected principal and interest cash flows.

For unlisted debt securities, where model valuation is used, the valuation is driven by the assumptions used in the model and will be sensitive to changes in these assumptions. The most significant holding for which valuation is based upon a model relates to an unlisted loan note held by the long term business fund which, at the year end date, is valued at £2,150.1m (2009: £1,992.4m). The floating rate note is structured such that cash flows will fund the discharge of an equivalent financial liability arising from a reinsurance arrangement. The valuation of the loan note is sensitive to changes in the gilt yield curve however any change in value would be offset by an equivalent change in the value of the financial liability.

#### (b) Derivatives

Index futures and forward contracts are marked to market using clean bid listed market prices at the balance sheet date without any deduction for transaction costs. All other derivatives are valued at broker quotes, which are validated using pricing models or discounting techniques.

#### (c) Convertible loan notes

Fair value is based on clean bid prices, if available. Otherwise, a valuation technique is used.

**52. Risk management** continued**(d) Trade and other receivables and payables**

For receivables and payables with a remaining life of less than one year, the nominal amount is deemed to reflect the fair value. All other receivables and payables are discounted to determine the fair value.

**(e) Interest rates used for determining fair values**

Interest rate assumptions used in the valuation of unlisted debt and loan receivables are based upon gilt yields of appropriate maturity.

In all instances fair values equate to carrying values.

<b>Balance sheet categories 2010</b>	<b>Designated at fair value £m</b>	<b>Loans and receivables £m</b>	<b>Available for sale £m</b>	<b>Other amortised cost £m</b>	<b>Total £m</b>
<b>Assets</b>					
Financial assets at fair value through profit or loss	<b>16,674.1</b>	–	–	–	<b>16,674.1</b>
Available for sale financial assets	–	–	<b>949.7</b>	–	<b>949.7</b>
Loans and advances to customers	–	<b>5.6</b>	–	–	<b>5.6</b>
Derivative financial instruments	<b>796.9</b>	–	–	–	<b>796.9</b>
Insurance receivables and other assets	–	<b>232.8</b>	–	–	<b>232.8</b>
Cash and cash equivalents	–	<b>59.2</b>	–	–	<b>59.2</b>
Other assets	–	<b>206.0</b>	–	–	<b>206.0</b>
<b>Total financial assets</b>	<b>17,471.0</b>	<b>503.6</b>	<b>949.7</b>	–	<b>18,924.3</b>
Non-financial assets					<b>4,756.1</b>
<b>Total assets</b>					<b>23,680.4</b>
<b>Liabilities</b>					
Investment contract liabilities	<b>316.0</b>	–	–	–	<b>316.0</b>
Derivative financial instruments	<b>534.7</b>	–	–	–	<b>534.7</b>
Loans and borrowings	–	–	–	–	–
Amounts owed to credit institutions	<b>870.5</b>	–	–	–	<b>870.5</b>
Insurance and other payables	–	–	–	<b>138.7</b>	<b>138.7</b>
Other reinsurance liabilities	<b>2,150.1</b>	–	–	<b>1.5</b>	<b>2,151.6</b>
Other borrowed funds	–	–	–	<b>65.0</b>	<b>65.0</b>
Overdrafts	–	–	–	<b>6.0</b>	<b>6.0</b>
Other liabilities	–	–	–	<b>22.8</b>	<b>22.8</b>
<b>Total financial liabilities</b>	<b>3,871.3</b>	–	–	<b>234.0</b>	<b>4,105.3</b>
Non-financial liabilities					<b>18,946.0</b>
<b>Total liabilities</b>					<b>23,051.3</b>
Capital and reserves					<b>629.1</b>
<b>Total liabilities and equity</b>					<b>23,680.4</b>



## Notes to the financial statements continued

### 52. Risk management continued

2009	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Other amortised cost £m	Total £m
<b>Assets</b>					
Financial assets at fair value through income or expense	16,165.6	–	–	–	16,165.6
Available for sale financial assets	–	7.8	1,007.4	–	1,015.2
Loans and advances to customers	–	–	–	–	–
Derivative financial instruments	681.2	–	–	–	681.2
Insurance receivables and other assets	–	247.6	–	–	247.6
Cash and cash equivalents	–	55.9	–	–	55.9
Other assets	–	147.3	–	–	147.3
<b>Total financial assets</b>	<b>16,846.8</b>	<b>458.6</b>	<b>1,007.4</b>	<b>–</b>	<b>18,312.8</b>
<b>Non-financial assets</b>					<b>4,816.2</b>
<b>Total assets</b>	<b>16,846.8</b>	<b>458.6</b>	<b>1,007.4</b>	<b>–</b>	<b>23,129.0</b>
<b>Liabilities</b>					
Investment contract liabilities	259.9	–	–	–	259.9
Derivative financial instruments	502.9	–	–	–	502.9
Loans and borrowings	–	–	–	172.0	172.0
Amounts owed to credit institutions	1,071.2	–	–	–	1,071.2
Insurance and other payables	–	–	–	156.7	156.7
Other reinsurance liabilities	1,992.5	–	–	–	1,992.5
Other borrowed funds	–	–	–	105.0	105.0
Overdrafts	–	–	–	5.6	5.6
Other liabilities	–	–	–	30.0	30.0
<b>Total financial liabilities</b>	<b>3,826.5</b>	<b>–</b>	<b>–</b>	<b>469.3</b>	<b>4,295.8</b>
<b>Non-financial liabilities</b>					<b>18,166.0</b>
<b>Total liabilities</b>					<b>22,461.8</b>
<b>Capital and reserves</b>					<b>667.2</b>
<b>Total liabilities and equity</b>					<b>23,129.0</b>

**52. Risk management** continued**Valuation of financial instruments**

The following table details financial assets held by the Group which are measured at fair value. As per IFRS 7 March 2009, an entity is required to provide a breakdown of such assets and detailing the basis on which the fair value has been determined. The valuations are categorised into a three level hierarchy:

- Level 1 – fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 – fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3 – fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Guidance on classification between the various levels continues to evolve. Formerly certain debt securities whose fair value is determined using prices from brokers, dealers and/or pricing services were classified in Level 1 if the quoted prices indicated the market for those securities was actively trading. Based upon recent guidance issued by the Committee of European Securities Regulators (CESR), CIS & CISGIL now classifies these securities in Level 1 only if it can be demonstrated on an individual security by security basis that these are quoted in an active market, i.e. that the price quotes obtained are representative of actual trades in the market (through obtaining binding quotes or through corroboration to published market prices). Otherwise, these are classified in Level 2. Comparatives for 2009 have been similarly reclassified with the most significant movements from Level 1 to Level 2 at end 2009 being in respect of deposits with approved credit institutions, corporate bonds and amounts owed to approved credit institutions in respect of gilt repo liabilities.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<b>2010</b>				
<b>Financial assets</b>				
Financial assets at fair value through income or expense	<b>5,780.7</b>	<b>491.5</b>	<b>232.5</b>	<b>6,504.7</b>
Listed debt – fixed rate	<b>2,624.8</b>	<b>4,798.4</b>	–	<b>7,423.2</b>
Listed debt – floating rate	–	<b>28.2</b>	–	<b>28.2</b>
Unlisted debt – fixed rate	<b>4.9</b>	<b>3.6</b>	–	<b>8.5</b>
Unlisted debt – floating rate	–	<b>2,150.1</b>	–	<b>2,150.1</b>
Deposits with credit institutions	–	<b>1,509.1</b>	–	<b>1,509.1</b>
Total financial instruments at fair value through profit or loss	<b>8,410.4</b>	<b>8,980.9</b>	<b>232.5</b>	<b>17,623.8</b>
Derivative financial instruments	<b>10.4</b>	<b>786.5</b>	–	<b>796.9</b>
<b>Total financial assets at fair value</b>	<b>8,420.8</b>	<b>9,767.4</b>	<b>232.5</b>	<b>18,420.7</b>
<b>Financial liabilities</b>				
Investment contract liabilities – unit linked	–	<b>316.0</b>	–	<b>316.0</b>
Derivative financial instruments	<b>10.1</b>	<b>524.6</b>	–	<b>534.7</b>
Other financial liabilities				
– Gilt repos	–	<b>870.5</b>	–	<b>870.5</b>
– Debt securities	–	<b>2,150.1</b>	–	<b>2,150.1</b>
<b>Total financial liabilities at fair value</b>	<b>10.1</b>	<b>3,861.2</b>	–	<b>3,871.3</b>
<b>2009</b>				
<b>Financial assets</b>				
Financial assets at fair value through income or expense	5,225.9	479.5	185.0	5,890.4
Listed debt – fixed rate	2,054.0	5,728.2	–	7,782.2
Unlisted debt – fixed rate	–	10.4	–	10.4
Unlisted debt – floating rate	–	1,992.4	–	1,992.4
Deposits with credit institutions	–	1,497.6	–	1,497.6
Financial assets at fair value through income or expense	7,279.9	9,708.1	185.0	17,173.0
Derivative financial instruments	11.8	669.4	–	681.2
Total financial assets at fair value	7,291.7	10,377.5	185.0	17,854.2
<b>Financial liabilities</b>				
Investment contract liabilities – unit linked	–	259.9	–	259.9
Derivative financial instruments	19.0	483.9	–	502.9
Other financial liabilities	–	–	–	–
– Gilt repos	–	1,071.2	–	1,071.2
– Debt securities	–	1,992.4	–	1,992.4
Other financial liabilities	19.0	3,807.4	–	3,826.4

## Notes to the financial statements continued

### 52. Risk management continued

The assets held at the balance sheet date and categorised as Level 3, utilising 'valuation techniques using significant unobservable inputs', mainly comprise a number of small individual investments in close-ended private equity funds; the table below shows a reconciliation between the opening balance and closing balance for the period:

<b>Consolidated and Society Assets</b>	<b>Level 3 financial instruments at fair value through income or expense 2010 £m</b>	Level 3 financial instruments at fair value through income or expense 2010 £m
Opening balance	<b>185.0</b>	206.5
Gains/(losses) in income and expense	<b>24.0</b>	(17.0)
Gains/(losses) in other comprehensive income	–	–
Purchases	<b>49.3</b>	18.5
Issues	–	–
Settlements	<b>(25.8)</b>	(6.8)
Transfers in	–	–
Transfers out	–	(16.2)
<b>Closing balance</b>	<b>232.5</b>	185.0

Transfers out reflect the reclassification of a listed equity holding as Level 1.

<b>Consolidated and Society Assets</b>	<b>Level 3 financial instruments at fair value through income or expense 2010 £m</b>	Level 3 financial instruments at fair value through income or expense 2010 £m
Total gains for the period included in income and expense for Level 3 assets held at the end of the reporting period	<b>24.0</b>	(17.0)

### 53. Capital resources

	Trading Group		CFS	
	2010 £m	2009 £m	2010 £m	2009 £m
Share capital	69.9	71.9	64.9	64.9
General reserve	–	–	317.0	317.0
Retained earnings and other reserves	1,944.4	1,524.9	2,415.1	2,387.4
	<b>2,014.3</b>	1,596.8	<b>2,797.0</b>	2,769.3
Perpetual non-cumulative preference share	–	–	60.0	60.0
Subordinated debt	–	–	884.6	869.0
<b>Total capital resources</b>	<b>2,014.3</b>	1,596.8	<b>3,741.6</b>	3,698.3

#### Capital management

The Group's policy is to maintain a strong base and to be more prudent than industry norms as it is not able to raise equity externally. The Group still recognises the need to maintain a balance between the potential higher returns that might be achieved with greater gearing and the advantages and security afforded by a sound capital position.

Co-operative Trading Group is not a regulated entity and manages capital to ensure an appropriate balance between investing in the future growth of the Society whilst paying distributions to stakeholders.

The Co-operative Bank plc, CIS General Insurance Limited and Co-operative Insurance Society Limited are regulated entities. Their submissions to the FSA in the period have shown that these individually regulated operations have complied with all externally imposed solvency requirements throughout the period.

Retained earnings exclude cumulative gains on cashflow hedges of £53.3m (2009: gain of £70.0m) and cumulative gains on available for sale assets of £10.1m (2009: gain of £13.2m).

Capital resources include a general reserve of £317m which is currently held within Co-operative Insurance Society Limited outside the long term business fund. £200m of the reserve has been hypothecated to support the long term insurance business and the remainder is available to meet the obligations of both the long-term and general insurance business as it runs off within this legal entity.

The following are also included in the calculation of total CFS capital resources:

- The Co-operative Bank plc preference shares which carry the right to a fixed non-cumulative preference dividend at a rate of 9.25%, payable 31 May and 30 November;
- Subordinated debt which consists of two debt issues by The Co-operative Bank plc, £150m Step up callable subordinated Notes 2019 and £150m callable subordinated Notes 2021 fixed rate until 2016, then moving to floating rate;
- Floating rate subordinated Notes 2016 were issued on 18 May 2006 at a discount of 0.14%. The Bank may redeem all, but not less than all, of the Notes at the principal amount on 18 May 2011, and on any quarterly interest payment date thereafter;
- Fixed rate subordinated Notes 2024 were issued on 17 March 2004 at a discount of 1.148%. The bank may redeem all, but not less than all, of the Notes at the principal amount on 2 December 2019, and on any quarterly interest payment date thereafter;
- Fixed rate subordinated Notes 2033 were issued on 28 March 2002, at a discount of 0.93%. The Notes are an unsecured obligation of the Bank and in the event of the winding-up of the Bank, the claims of noteholders will be subordinated in right of payment to the claims of depositors and other creditors of the Bank;

From 1 August 2009, the Bank assumed a liability to each PIBS holder for a subordinated deposit equal to the principal amount of their PIBS. These deposits have automatically been applied in subscription to either perpetual subordinated bonds having an interest rate of 13% in respect of the 'first perpetual subordinated bonds' or perpetual subordinated bonds having an interest rate of 5.5555% in respect of the 'second perpetual subordinated bonds' for an amount corresponding to the principal amount of that holder's PIBS.

The right of repayment to the holders of subordinated debt are subordinated to the claims of depositors and other creditors of the Bank. Subordinated debt is stated at its regulatory value.

#### 54. Events after the reporting period

There were no events after the reporting period.

## Analysis of profits from regional business activities (unaudited)

	2010		2009	
	Sales £m	Profit £m	Sales £m	Profit £m
Central and Eastern	<b>1,368</b>	<b>91.6</b>	812	70.5
North	<b>1,661</b>	<b>116.7</b>	1,355	94.2
North West and North Midlands	<b>1,342</b>	<b>98.1</b>	991	88.3
Scotland and Northern Ireland	<b>1,197</b>	<b>90.3</b>	892	75.8
South East	<b>1,381</b>	<b>95.7</b>	739	64.4
South West	<b>1,436</b>	<b>106.9</b>	723	67.4
Wales/Cymru	<b>631</b>	<b>53.1</b>	402	38.8
Sales and contribution from regional business activities	<b>9,016</b>	<b>652.4</b>	5,914	499.4
Sales and profit from non-regional businesses and regional business overhead	<b>1,822</b>	<b>(247.4)</b>	4,758	(118.4)
Co-operative Financial Services	<b>2,497</b>	<b>208.6</b>	2,020	277.5
Discontinued items	<b>(428)</b>	<b>35.5</b>	(779)	(0.5)
Intercompany eliminations and group operating costs	<b>(21)</b>	<b>(43.1)</b>	(17)	(42.6)
Net revenue and operating profit before significant items	<b>12,886</b>	<b>606.0</b>	11,896	615.4

Regional businesses are The Co-operative Food, The Co-operative Funeralcare, The Co-operative Travel, The Co-operative Pharmacy and The Co-operative Motor Group. The regional profits represent store contribution and are before central administration costs, significant items, profits of associated undertakings and after central charges in respect of internal rents, which are designed to reflect the use of Trading Group property by the business at a commercial rate.

Please note that sales and store contribution relating to Somerfield stores is now included in the sales and contribution from regional business activity. In 2009 they were included in sales and profit from non-regional businesses and regional business overheads.





**Design by Radley Yeldar**

Printed at APS Group, an ISO 14001 and FSC certified company.

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**Co-operative Group Limited**

Registered under the Industrial and Provident Societies Act

Registered office: New Century House, Manchester M60 4ES

Registered number: 525R

[www.co-operative.coop](http://www.co-operative.coop)

