

**The Co-operative Group**  
Annual Report 2013

**The co-operative**

Here for you for life

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# Strategic report

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## A message from Ursula Lidbetter

**This report will make painful reading for our Members, customers, colleagues and other stakeholders. 2013 was the worst year in our history, and the report that follows lays bare some fundamental failings of management and governance. Against such a backdrop, the many good things that occurred in the past year will inevitably be drowned out. I therefore want to take the opportunity to highlight some of them here:**

- **We celebrated our 150th anniversary, with a chance to look back over a proud history that has seen the Co-operative Group as a force for good for millions of people over many generations.**
- **In November we welcomed Her Majesty the Queen with HRH Prince Philip to open our new home in Angel Square, Manchester.**
- **Also in November, we were delighted to be joined by HRH Princess Anne as Patron of Carers Trust at a dinner to mark our most successful ever period of charity fundraising, with over £5m raised for this highly worthwhile charity.**
- **We established the Co-operative Young Members' Board to provide an insight into the views, issues and aspirations of young people aged between 16-25.**
- **Through our Apprenticeship Academy we identified 810 opportunities for young people to study for a nationally recognised qualification while working in one of our businesses, earning a competitive salary and gaining transferable and professional skills. Over 2,000 young people have now benefited from this programme.**

**During a most difficult period, our c.87,000 colleagues stuck resolutely to the task of serving our Members and customers throughout our diverse businesses. I am hugely grateful to them for their loyalty and for sticking with us in adversity. We owe it to all of them to recover the fortunes of this great organisation, an obligation that I and the Executive team are determined to fulfil.**



**Ursula Lidbetter**  
Chairman

# Key Events

## January 2013

- The Co-operative Group reveals Carers Trust as the Charity of the Year for 2013

## February 2013

- The food industry was impacted by the contaminated meat product issue. The Co-operative Group responded swiftly taking a leadership position.

## April 2013

- Withdrawal from the process of buying Lloyds Banking Group branch assets ('Project Verde')

## May 2013

- Moody's Rating Agency downgrade the Co-operative Bank
- Euan Sutherland joins the Co-operative Group as Chief Executive Officer
- Barry Tootell, Paul Flowers, Steve Humes and Martyn Wates leave the business
- Richard Pym and Niall Booker appointed to the Co-operative Bank's Board, Richard Pennycook, Alistair Asher and Nick Folland appointed to the Group Executive

## June 2013

- The Co-operative Group announces requirement for £1.5bn recapitalisation of the Co-operative Bank
- Treasury Select Committee announces enquiry into Lloyds Banking Group assets sale

## July 2013

- Independent review of the events surrounding the Co-operative Bank announced, to be led by Sir Christopher Kelly
- The Group completes its sale of the Life and Savings business

## November 2013

- Recapitalisation plan for the Co-operative Bank confirmed
- Len Wardle resigns as Chair of the Co-operative Group with immediate effect following revelations about the former Bank Chairman
- Ursula Lidbetter appointed as Chair of the Co-operative Group
- One Angel Square declared the most environmentally-friendly building in the world by Building Research Establishment Environmental Assessment Method (BREEAM)
- Her Majesty The Queen and HRH Prince Philip officially open One Angel Square

## December 2013

- HRH the Princess Royal, Patron of Carers Trust, recognises the work of the Co-operative's charity champions at a 'Dinner of Dreams' event
- The Co-operative Group and the Co-operative Bank announce successful completion of the Liability Management Exercise – £1.5bn recapitalisation plan for the Co-operative Bank
- Lord Myners appointed to Group Board as Senior Independent Non-Executive Director and to Chair Governance Review

## January 2014

- The Co-operative Group announces the Terms of Reference for the Independent Review of the Group's governance led by Lord Myners
- The Co-operative Group confirms retention of its General Insurance business

## February 2014

- Decision reached that Pharmacy and Farms business disposals are required in order to reduce Group debt

## March 2014

- Euan Sutherland resigns as Co-operative Group Chief Executive
- Richard Pennycook appointed as Interim Group Chief Executive

## April 2014

- Paul Myners announces he will not seek election for his position as Senior Independent Non-Executive Director at the Group AGM

# Key Performance Indicators

Our key performance indicators focus on Financial, People, Customer, Membership and Social Responsibility. Over the past year we have faced significant challenges across many of these key areas and work is underway to make significant improvement.

## Financial

As a Co-operative business we operate for the benefit of our Members, with whom our profits are shared. Our key financial aims are to grow profitability, measured in terms of underlying profit before member payments, and to deliver an acceptable return on capital employed (ROCE). Overall Group underlying profit before member payments (excluding discontinued businesses) shows that even without the losses attributed to the Bank, there is still a downward trend on the rest of the Group's profits. Trading Group ROCE of 6.9% was down from 8.6% in 2012. The fall in profitability is largely due to the decline in the Food business' profits from £383m in 2010 to £247m in 2013 and the rise in central overheads from £98m in 2010 to £192m in 2013.

## People

Our people are vital to our success and given the challenges faced by the Group in recent years it is essential that colleagues continue to feel a sense of belonging and commitment to the business. Changes were made to how the Group compiled and measured the sustainable engagement score for the 2013 Talkback survey. Core engagement scores under the old scoring system have been taken comparing 2013 with just 2012 which shows the Trading Group scored 74 (2012: 70) and the Banking Group 59 (2012: 68). Under the new scoring system, the score was 78% for the Trading Group and 62% for the Banking Group. Due to the new performance metrics, a direct comparison cannot be struck for previous years before 2012.

## Customer

One of our strategic aims is to build trust and loyalty with our customers whilst at the same time sharing concern for each community we operate in. Performance in customer satisfaction is measured through regular customer surveys in Food, Pharmacy and Funeralcare while in the Banking Group the survey places greater focus on advocacy.

In Food a new customer satisfaction study replaced the Customer Satisfaction Index (CSI) measure and reports a score out of 10 rather than a percentage. This business achieved its 7.4 target. As this is a new study, no direct comparisons can be performed with previous years. Pharmacy still uses CSI as a measure scoring 93.4% v 93.2% (2012), above the 2013 target of 90%. In Funeralcare, 98.5% of customers were 'very satisfied' or 'fairly satisfied' compared to 98.6% (2012). Customer service questionnaires are also used to calculate a Funeral Excellence Score (FES). The 2013 FES was 93.8 v 93.3 (2012), exceeding the 2013 target of 91.

The Banking Group introduced a new Customer Satisfaction tracker which reports on 'relationship satisfaction' (the percentage of customers scoring between 8 and 10 on satisfaction). Both the Bank and General Insurance scored 77%. Prior year comparatives cannot be provided due to the new scoring system.

## Membership

Membership engagement lies at the heart of our business. The more engaged our Members are the more successful our business is.

The Group measures Membership engagement in three ways:

- Total number of Members
- The number of Members trading with more than one Co-operative business
- Total customer dividend paid to customer Members

During 2013 our Membership grew from 7.6m to 8.1m. As a profit share, our dividend\* will fluctuate according to Group profitability. Due to the reduced profit the Group has not been able to pay a dividend as large as in prior years and in 2013 we returned £38.5m to Members, down £12.9m from 2012. However, the Group has rewarded its Members with an additional voucher scheme at the end of 2013. The £38.5m includes £12.7m of redeemed discount vouchers\*\* which received positive feedback from Members across the country and produced an exceptional redemption rate of 72%. The strategy on Membership and how Members will be rewarded for their trade is constantly evolving and will be part of the strategy review announced in May.

## Social responsibility

Since 2009, we have been benchmarking ourselves against the Corporate Responsibility Index (CRI) operated by Business in the Community (BitC). This is the foremost UK corporate responsibility standard and assesses management practice in a range of environmental and social impact areas, including:

- Community
- Environment
- Marketplace
- Workplace

2013 saw a slight reduction in our score from 98% to 97%, but the Co-operative Group retained its 'Platinum Plus' status (now called Platinum Big Tick). This was achieved by 32 businesses in 2013 and by only 3 other retail businesses.

\* Because Member payments are approved by Members at the Annual General Meeting ('AGM'), the dividend paid to Members in 2013 is based on 2012 trade with the Group and 2012 Group profitability.

\*\* £12.7m has been charged to operating expenses.

## Report from Group Chair – Ursula Lidbetter



**The Group entered 2013 focused on the future development of the organisation. Our Food business was developing its True North strategy and underlying performance from our trading businesses was encouraging.**

In April, however, following a protracted period of due diligence, we withdrew from the planned expansion of our banking arm by way of the acquisition of branches and accounts from Lloyds Banking Group (Project Verde).

In May, we welcomed our new Chief Executive, Euan Sutherland, recruited from outside the organisation to revitalise the Group for the next generation. Within days of his joining, an unfolding crisis in our Bank emerged that risked not only its future but that of the entire Group. There followed a six notch downgrade by Moody's in the credit rating of the Bank, as the extent of a significant capital shortfall became apparent. In order to meet regulatory capital requirements as laid down by the Prudential Regulation Authority (PRA) the Bank was required to raise a further £1.5bn of new Tier 1 capital which it achieved by means of the Liability Management Exercise (LME) explained on page 11. Although this reduced the Group's ownership in the Bank to a 30% stake, this action was essential in order to safeguard the Bank for customers, colleagues and Members. The battle to save the Bank dominated our activity for the remainder of the year, only concluding on 20 December 2013.

The near-collapse of the Bank led to a wholesale change of leadership at both the Group and Bank. Euan moved decisively to recruit a new team well equipped to deal with the crisis. We were particularly fortunate that Richard Pym agreed to take the role of Chair at the Bank during such a crucial period. His experience and authoritative leadership have helped steer the Bank through this difficult phase. Appointments to the Group Executive team were equally important, with Richard Pennycook, Alistair Asher and Nick Folland all contributing greatly to the process of recapitalising the Bank. In that effort, they were helped enormously by a large team of professional advisers from UBS, HSBC, Allen & Overy and Alix Partners. Additionally, we could not have succeeded without the support of our syndicate banks and the considered response of our pension trustees, and I thank them too for their contribution. Finally, I would like to acknowledge the contribution of Andrew Bailey and his team at the PRA for their calm guidance through a difficult time.

It was at this point that I was appointed by the Board as Chair of the Group, with a determination to resolve the weaknesses of our governance structure which had been made plain by the events of the year.

The unprecedented nature of our crisis has inevitably led to the establishment of a number of inquiries by official bodies, including the Financial Conduct Authority, the Treasury, the Prudential Regulation Authority, the Treasury Select Committee and the police. We are co-operating fully with each of these. We also commissioned our own reviews. The first, by Sir Christopher Kelly, has been examining the circumstances that led to the Bank crisis, and will report its findings ahead of our Annual General Meeting. This will give us detailed and clear insight into what went wrong. Later in the year, Lord Myners agreed to undertake an independent governance review on behalf of the Board, whilst also agreeing to join the Group Board as Senior Independent Non Executive Director. His review produced a preliminary update in March 2014, with the full report expected ahead of the AGM. This will give us clear recommendations for dealing with the governance weaknesses which have been exposed in recent months and which we expect to be highlighted in the Kelly Review. Lord Myners will stand down from our Board at the AGM in May. We are indebted to him for being so generous with his time and expertise.

The near-failure of our Bank also highlighted wider financial weaknesses across the Group. In particular, our overall indebtedness is too high for an organisation of our nature. When the recent problems arose, we had limited resources with which to cover losses. Consequently, and regrettably, we have had to take some difficult decisions to sell some of our businesses. This will change the shape of our Group significantly as we adapt our strategy and cost base accordingly. Our new strategy will be presented to Members at the 2014 Annual General Meeting, along with further plans to reduce our debts.

It is a matter of great regret that Euan Sutherland felt compelled to resign subsequent to the year-end. Without question his leadership saved our Bank, and he built a top-flight team capable of redefining the purpose and relevance of our Co-op. We wish Euan every success in his future career, and we thank Richard Pennycook for agreeing to step in as interim Chief Executive during this difficult time for the Group. We will commence the search for a new permanent Chief Executive once the Governance Reforms have been completed.

As Group Chair, I recognise the scale of the change required to our governance. This essential and urgent work is critical to our future and will enable us to build a more effective organisation which can deliver for all our Members, customers and colleagues.

**Ursula Lidbetter**  
Chair

# Interim Group Chief Executive report



## A disastrous year – 2013

I joined the Group in the summer of 2013 as your Interim Finance Director, and have since taken on the role of Interim Chief Executive. At both points, the Group faced a crisis. This annual report goes some way to explaining how this happened, and what we intend to do about it. It is in the nature of business that crises do occur, and need to be fixed. A large part of my career has been spent in similar situations, having arrived at moments of crisis in six other organisations. Whilst the issues at the Co-operative Group need urgent attention, it is clear to me that with the right, decisive action we can once again restore the Group to financial health. That action will include the need for fundamental reform of the way the Society is governed, if the Group is to be able to navigate successfully the issues that a business of its size and complexity faces. With the continuing support of our Members and colleagues, the Executive team now in place will make that happen. Equally as important, we need to redefine the fundamental purpose of the organisation. The credibility, trustworthiness and financial strength of the Group built up over nearly 150 years have been stripped away over the past five years. And yet if ever there was a time for the revival of a campaigning organisation owned by its Members, all of whose profits can be put to work in the communities where they live, it is now.

In the detail of our annual report, we provide commentary on the performance of each of our key businesses, some of which performed adequately in 2013. The year itself, though, will always be remembered for an overall statutory comprehensive loss of £2.487bn (2012: loss of £529m). The scale of this disaster will rightly shock our Members, our customers and our colleagues.

The loss arose principally from three causes. Firstly, the continuing losses reported by the Bank as a result of the impairment of corporate loans, conduct issues and failed computer development projects. Secondly, the write-off of our accumulated 115 year investment in the Bank following its emergency recapitalisation, in which we participated but in the process saw our shareholding fall from 100% to 30%. And thirdly, a partial write-off of the goodwill created on the 2009 acquisition of the Somerfield food business following a strategic review of that business.

Whilst 2013 was disastrous for the Group, when set in a longer term context we also have to recognise that underperformance has characterised the past few years. Our Bank also posted heavy losses in 2012 (loss before tax £673m), whilst Trading Group Operating Profit is down 71% over the past three years. Additionally, just under £1.3bn of one-off costs and charges have been recorded over the past five years. The classification of these charges as "significant items" signalled that they were non-recurring, or one-off in nature, but even in 2009 when the lowest level of charges were recorded they totalled over £100m.

Whilst the near-failure of the Bank was a disaster, Members can take some pride in the rescue response by the Group. Had the Bank failed, the consequences would have been far reaching. Current account holders and savers may well have been inconvenienced in accessing their money for a period of time, whilst those saving above the level at which the government provides protection may have faced losses on their savings. Small business customers may have been starved of vital liquidity and there could well have been contagion risks to other small financial institutions. Additionally, the many retail bondholders in the Bank who depend upon their investment with us to provide a pension income would have lost everything. And the effects would not have been limited to the Bank – the impact of cross default provisions in certain of the Group's borrowing agreements, had they not been addressed, would have put the whole Group at risk of going into administration. Over a six month period, we worked hard to put in place a solution to save the Bank, and this concluded in December. It was the first rescue of a European Bank since the Banking Crisis began that did not involve recourse to the taxpayer. It required the Group to contribute well above its 'fair share' of the rescue funding, in particular in order to protect small bondholders. Without question, this was the Co-operative Group 'doing the right thing'. In addition, we ensured that, for the first time, the Bank has its ethical agenda enshrined in its constitution. This was vital, given that we were unable to retain our 100% ownership of the Bank. Through this mechanism, we can ensure that the Bank operates in a way that is true to its name, and if this were ever to change, it can no longer call itself the Co-operative Bank. The operational separation of the Bank from the Group is underway – it is both complex and costly. This is an unfortunate consequence of an ownership change that was never planned for.

During the intense and protracted period where key Executives were absorbed with saving the Bank, we were fortunate to have colleagues throughout the wider Group who stuck to the task of delivering for their businesses and their customers. You can learn more about their performance in the business review section from pages 15 to 18.

## A weakened state

The Group's balance sheet reflects the recent history of poor results. Debt has risen from £0.6bn five years ago to £1.4bn at 4 January 2014. At this level, most Group debt ratios are adverse to those recorded by listed company peers, reflected in our sub-investment grade credit rating of B+ awarded by Standard and Poor's in January 2014. Group debt did in fact reduce by £286m in the year, but as a result of business disposals and a sale and leaseback of the Group's new head office (itself another form of debt) rather than through solid cash generation by our businesses. The Group's balance sheet also reflects the accumulated legacy of obligations taken on in the past, but now holding back our financial progress. The onerous lease provision of £197m (with over rented provision and holding costs £232m), included within note 26 to the accounts reflects an allowance for future rents on 645 units nationwide that are not in use by the Group, but where we have the rental obligation. The net rent liability for these properties through the full term of their leases totals £443m, and we have to work hard to mitigate that by finding sub-tenants for all this surplus property, itself the size of a national retail business. We reduced the goodwill recorded on the balance sheet relating to the Group's acquisition of Somerfield by £247m (£226m impairment and £21m relating to 2013 disposals) reflecting our change in strategy for the Food business. By the conclusion of the True North programme, over 60% of the store space acquired in the Somerfield transaction will have been divested by the Group.

## Interim Group Chief Executive report continued

### Turnaround and transformation – 2014 to 2016

We have stabilised the Group, with the support of many stakeholders, and we are ready to begin the process of recovery, but the deep, sustainable change needed is only deliverable with governance reforms. As Ursula mentions in her report, a combination of the Kelly Inquiry and the Myners Review will help us to ascertain where failings have arisen and what needs to be done to address them. This will be painful for those concerned, but there will be no sugar-coating. Whilst we await the detailed reports, it is clear that they will reveal major failings of governance, leadership and accountability. Eighty seven thousand colleagues and 8.1m Members will look to the Group Board, our Regional Boards and the independent societies for an appropriate response.

Our short term plan for the Turnaround Phase is simple. We need to invest in our retained businesses, and operate them effectively in highly competitive markets. We need to reduce a bloated cost base in order to generate cash for that investment and to enable us to reduce our levels of debt. And finally we need to ensure that we generate good proceeds from the businesses that are for sale in order to accelerate further the necessary debt reduction. All of these activities are under way. In our largest business, Food, the True North strategy announced last year is bearing fruit, and we have seen a sustained period of market outperformance. We have also begun a rigorous programme to take costs out of the business. Whilst there will be difficult decisions ahead, we have made a great start, identifying a budgeted £100m of savings by the end of 2014, with much more required.

The transformation phase of our recovery is ready to begin. A new Executive team is in place and leading the way. Over many months, a detailed review of all our businesses has been undertaken, and plans developed for each. Additionally, a fundamental review of the Purpose of our organisation has been undertaken. Whilst we have no automatic right to exist, it has confirmed to us that in the 21st Century, just as in the 19th, we should have a place in the communities of the United Kingdom. The work has been undertaken co-operatively with the Group Board, with extensive input from colleagues, Members, customers and the general public. It has been further informed by the Have Your Say poll, conducted on our behalf by YouGov and representing one of the largest such consultations ever undertaken. Over 180,000 people responded and the results are currently being analysed. At the heart of our Purpose will be our determination to be distinct, remain true to the essence of our Co-operative roots and deliver for our Members, customers and the communities in which they live. We know we need to make that meaningful to everyone who cares about the Co-operative.

### Looking ahead

When I look back over the last year, while the problems created by a few have made the headlines, the quiet determination of the many gave us much to be proud of. First and foremost, our colleagues worked tirelessly for our customers and Members. In return, they have shown us huge loyalty. I thank them all.

The Group is now very publicly at a crossroads – past mismanagement means we lost our way, but we will revitalise our Purpose, improve our commercial operations and rebuild belief in the Co-operative. Whilst I am not going to reveal the results of the Have Your Say poll here, I can make clear that we still enjoy the goodwill of the nation, and they are urging us to succeed. We have a huge job ahead of us – transforming this organisation will take at least four years and the path will not always be smooth. Through all the events of the past year, however, I have never lost my faith that this is a great business that holds a special place in the hearts and minds of people in communities up and down the United Kingdom. This country needs a strong Co-operative and that is what the management team and I are determined to deliver.

Thank you for your support.



**Richard Pennycook**  
Chief Executive Officer

# Strategic and business model

## Our organisation

The Co-operative Group is a national Co-operative society operating primarily in the retail, funeral care and financial services' sectors.

Our roots date back to 1844, when the Co-operative Model was established by the Rochdale Pioneers. The principles of Members purchasing a share to join a Co-operative Society that trades fairly with its Members was established over 150 years ago and to this day the founding principles set by the Rochdale Pioneers provide the basis for our business model.

As a Co-operative, we provide goods and services to the communities in which we operate. Our surplus profits are distributed to our Members and local communities and our democratic structure means Members can have a real say in how the organisation is run, including giving Members the opportunity to be elected to positions on the Group Board.

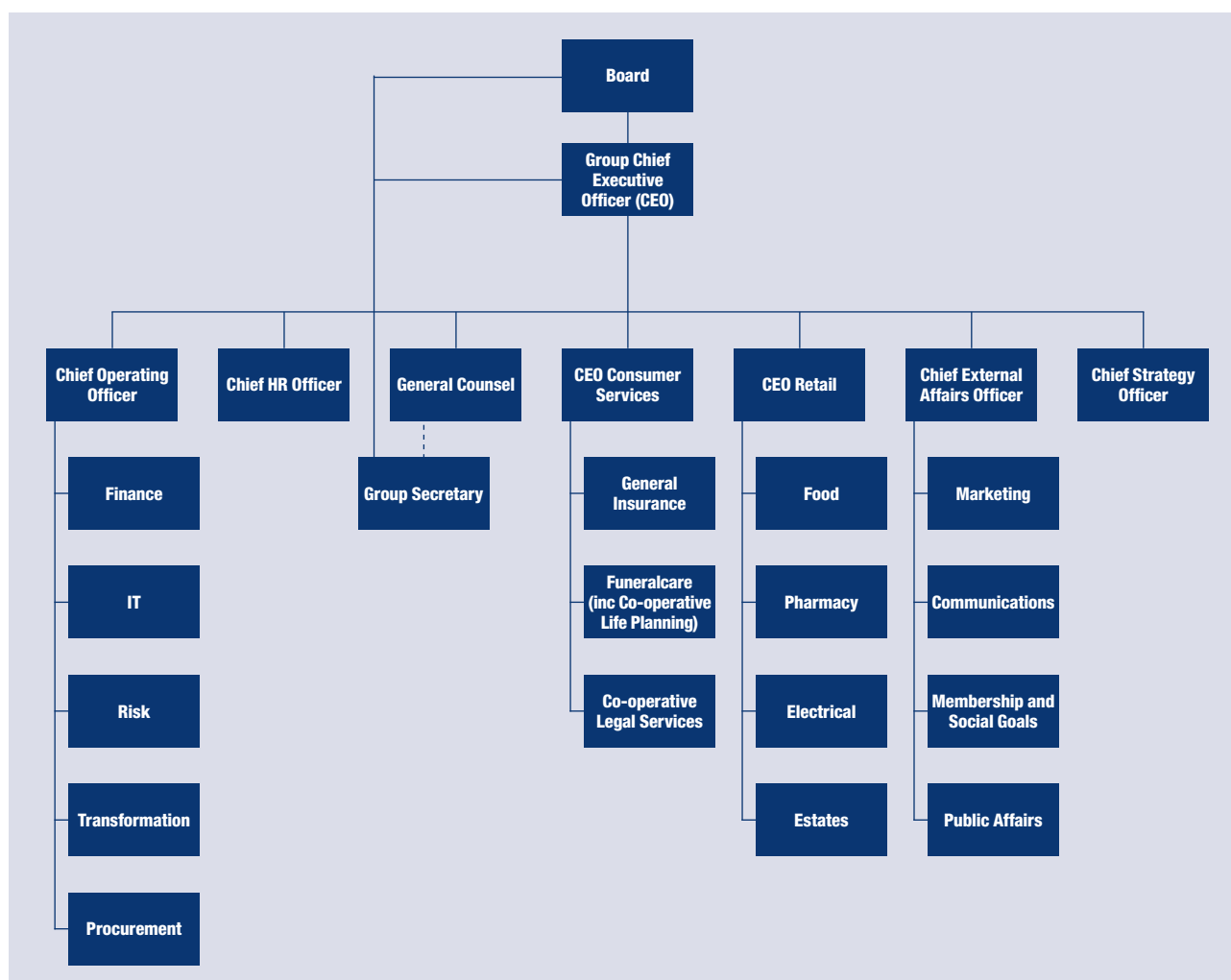
## How we create value

In each of our business areas we look to procure goods and services in an ethical and sustainable way that meet the needs of our Members and customers. We operate a food buying group which includes Independent Society Members, some of which trade under their own Co-operative Society brand. We invest heavily in our communities and each year donate considerable sums of money to local organisations through our community fund and 'Social Goals' projects. As a Co-operative, Members and customers have a real say in how the organisation operates. At our twice-yearly meetings, Members are able to table motions, challenge the Board and vote on decisions that directly affect the way the Group operates.

## Our future strategy

In mid 2013 at the same time as developing and successfully completing the Liability Management Exercise to recapitalise the Bank (further detail can be found in the Financial Review on page 10), the Group Board began a strategic review of the business. The results of this, together with the wider strategic plans and Purpose for the Group are due to be unveiled at the Group's forthcoming AGM.

## Our operational structure 2014



Decisions related to the Group's share in the Co-operative Bank and the Group joint venture with Co-operative travel lie with the Group Board.

# Finance review

## Overview

There are several main features of the Group's financial performance in 2013 that need to be reviewed and considered separately:

- The significant issues around the recapitalisation of the Bank and the reduction in the Group's shareholding;
- The underlying performance of the other trading businesses all of which demonstrated robust performances in challenging markets;
- The partial impairment of the goodwill which arose on the Somerfield acquisition, which has turned the Trading Group's performance into an operating loss; and
- The increase in central corporate costs, which have resulted in erosion to the overall Group underlying profit. These corporate costs have built up over a number of years, with a significant spike in 2013.

The Bank's trading performance, coupled with the loss which resulted from the reduction in the Group's ownership of the Bank to 30% following completion of the Bank's recapitalisation plan, are the dominant figures in the Group income statement, with a £2.1bn loss reported within discontinued operations. In addition, impairment charges against goodwill within the Food (£226m) and Legal Services (£13m) businesses have caused the Trading Group to also report an operating loss for 2013. Due to these impairment charges, an operating loss of £148m has been recorded, compared to an operating profit of £142m in the previous period.

Our trading businesses delivered a solid performance in tough markets. Underlying operating profit from businesses, excluding central corporate costs, was down £6m to £402m. The Food business, with its increased focus on its core convenience market, showed clear signs of stabilisation in the second half of the year, culminating in an excellent sales performance over the Christmas and New Year period that was ahead of several of its rivals. For the last four months of the year it consistently tracked ahead of the Institute of Grocery Distribution (IGD) market pool. Funerals held market share and its underlying operating profit exceeded the prior year. The Pharmacy business, despite further reductions in government funding, outperformed the market and also exceeded its prior year performance.

In terms of cash flow, the Trading Group continued to invest in its trading businesses, spending approximately £239m (previous period £410m), principally on Food (store refits, acquisitions and supply chain), Funeralcare (motor vehicles and crematoria) and Pharmacy (store refits). This reduction in overall capital expenditure compared to the prior year arose as a result of the need to provide an initial injection of £50m into the Bank under the terms of the Liability Management Exercise at the end of January 2014. A further £70m of capital expenditure savings have been identified for 2014. The Trading Group has also agreed significant amendments to its syndicate banking arrangements to accommodate their commitments to the Bank, and the continuing divestment programme will release additional capital tied up in trading and non-trading assets. Net debt was reduced by £286m to £1.4bn in the Trading Group, mainly as a result of the sale of non-core businesses and property disposals.

## Headlines

	2013 £m	2012 £m	+ / (-) Change
Revenue	<b>10,534</b>	10,967	(3.9%)
Underlying operating profit from businesses	<b>402</b>	408	(1.5%)
Central corporate costs	<b>(192)</b>	(111)	(73.0%)
Underlying segment operating profit	<b>210</b>	297	(29.3%)
Loss before tax	<b>(277)</b>	(64)	(332.8%)
Member payments	<b>(55)</b>	(104)	(47.1%)
Loss on discontinued operations	<b>(2,069)</b>	(511)	(304.9%)
Trading Group Capital Expenditure	<b>239</b>	410	(41.7%)
Trading Group net debt	<b>1,400</b>	1,686	17.0%

## Financial statements

The financial statements are prepared for the year ended 4 January 2014. For Trading Group and corporate entities this represents a 52 week accounting period compared to 53 weeks for 2012. The results of the Bank for the period prior to completion of the recapitalisation on 20 December 2013 are included in the discontinued operations line, which includes the trading loss for the period, together with the loss which arose on disposal on 20 December 2013. Discontinued operations also include the results of the Group's Life and Savings business, prior to its disposal on 31 July 2013.

In 2013, the Group ceased to present significant items separately on the face of the Income statement and has instead included one-off items within the reconciliation of underlying profit (a non-GAAP measure) to reported profit (as described in detail in the accounting policies section). These one-off items are considered to be outside normal operating activities and are material by size and/or nature.

## Trading performance

Overall Group revenue was down by £433m (3.9%) from 2012, reflecting the fact that there was an extra trading week in the prior year (£182m adverse impact), the disposal of a number of motor branches in the first half of the year (£161m adverse impact) and slightly weaker trading performance (£90m).

In Food, total sales (excluding VAT) fell 2.8% from £7,442m to £7,237m. Like-for-like food store sales (excluding VAT and fuel) fell by 0.2% across the estate as a whole, however like-for-like sales in the core convenience estate rose 1.6%. Positive like-for-like sales of 0.6% in the second half of the year showed a marked improvement on the first half performance of -1.1%. This improvement was as a result of the impact of the new Food Strategy including successful promotions in Quarter 4. Sales over the Christmas trading period (3 weeks to 4 January 2014) were particularly encouraging, with like for like sales in the total Food estate up 3.4% compared to the prior year and up 5.3% in our core convenience stores. Food underlying operating profit fell 8.2%, mainly due to additional discount vouchers, but was supported by a much better second half performance which, coupled with tight control of operating and overhead costs, enabled investment in prices and promotions to improve value for customers. We continued our strategic priority of tightening our focus on the convenience sector, with 30 new convenience stores added to the estate and 67 closures/disposals during the year.

## Finance review continued

Funeral sales rose by 3.4% to £370m, with underlying profit increasing by £2m (3.3%) due to tight cost control. This profit improvement came in spite of a £1.5m adverse impact of the business changing its accounting estimate in relation to prepayments on funeral benefit options.

Pharmacy sales overall declined by £4m to £760m. Like for like prescription growth remained positive at 2.2% and over-the-counter sales grew by 1.7%. This sales growth, along with a continuance of strong cost control and distribution efficiencies, led to a 17.9% increase in underlying operating profit.

Co-operative Legal Services saw sales fall 1.2%, impacted by an inability to accept referral fees having a detrimental effect on Personal Injury income. The business remains loss making as it continues to invest in its expansion through marketing, advertising and personnel costs.

Electricals performed well considering the challenges faced in this competitive market, with sales up 5.8% and underlying profits up 19.0% to £1m.

Corporate costs in the Trading Group increased by £81m, largely due to:

- A £10m increase in pension costs, mainly due to increased participation brought on by auto enrolment;
- A £10m increase in I.T. costs, from new I.T. projects;
- A £15m increase in property costs mainly relating to the move to the new head office;
- A £16m increase in provisions for legal and onerous lease costs following a re-assessment of court claims and changes to assumptions on onerous lease liabilities ; and
- A £13m reduction in costs recovered from the Bank.

## Banking Group

In May 2013, it was announced that the Bank had a capital shortfall of approximately £1.5bn. In response to this, the Group developed a plan (the Liability Management Exercise or 'LME') to create an additional £1.5bn of capital, the key elements of which comprised:

- A preference share waiver by the Co-operative Group;
- Tier 2 debt held by the noteholders was replaced by new equity;
- A cash subscription by the Co-operative Group (£333m) and bondholders (£125m) for new equity; and
- The cancellation of existing debt with the issuance of new debt (£129m) which created additional Tier 1 capital in the Bank.

The £333m cash subscription by the Group is payable in four tranches with £20m paid prior to the year-end, £50m paid on 31 January 2014, £100m payable by 30 June 2014 and the remaining £163m payable by 31 December 2014.

As a result of the LME, as of 20 December 2013, the Group's equity stake in the Bank fell from 100% to 30% and therefore the Bank became a separate standalone business and its assets and liabilities were deconsolidated from the Group financial statements. However, the trading losses up to that date are consolidated in the Group's income statement. The capital benefit (increase in Tier 1 capital) in the Bank has not been consolidated as this happened after the loss of control.

The General Insurance business produced an underlying operating profit of £36m (2012: £13m) driven by strong performance in the home portfolio and a better year in the motor portfolio, partly offset by reducing premiums and investment income.

## Loss on discontinued operations

The loss on discontinued operations comprises:

	2013 £m	2012 £m
Bank result to 20 December 2013*	(1,441)	(509)
Bank loss on disposal (see below)	(625)	–
Project Verde costs	(2)	(13)
Life and Savings result	(1)	11
<b>Loss on discontinued operations</b>	<b>(2,069)</b>	<b>(511)</b>

\* as described in the accounting policies section, the results at 31 December 2013 have been approximated to 20 December 2013 given the limited days' trade occurring during the period.

The Bank's trading loss up to the date of disposal of £1.4bn was driven mainly by corporate loan and credit impairments, high operating costs, impairment of the I.T. intangible asset, known as Finacle, and increased conduct provisions.

The loss on disposal of the Bank arises as follows:

	2013 £m
Investment in associate recognised at fair value	221
Net assets derecognised as at 20 December 2013	(331)
Deferred cash consideration payable	(320)
Debt issued as part of LME transaction	(129)
Disposal and separation costs	(78)
Recycle of available for sale and cashflow hedge reserves	12
<b>Loss on disposal of Bank</b>	<b>(625)</b>

The loss on disposal of the Bank reflects the deconsolidation of the assets and liabilities of the Bank together with a commitment to pay £320m (discounted) of cash and the issuance of £129m of debt for which the Group received shares valued at 30% of the equity of the Bank. Following the Liability Management Exercise and the disposal of 70% of the Bank, there was a requirement by the Prudential Regulatory Authority (PRA) to separate the people and systems of the Bank from the Trading Group. Together with the costs of the LME transaction this resulted in an overall loss on disposal of £625m.

The result of the Life and Savings business includes £52m of separation costs to build a separate clone system for the business and was net of a receipt of £50m to release the business from certain pension obligations.

## Finance review continued

### Financial position and cash flow

During the year, the Trading Group renegotiated its syndicated bank facilities in order to allow it to meet its obligations under the Bank recapitalisation plan. The capital injections into the Bank required by the PRA during 2014 are permitted within the new agreement terms which are designed to ensure that future investment in the Trading Group can continue. Including the bond issuance in 2011, which totalled £800m, net debt stands at £1.4bn, which will allow the Group to continue to fund its ongoing investment plans.

At the year-end date, principally as a result of the recognition of an impairment charge of £239m in respect of goodwill, the net assets of the Trading Group fell below the level required by the Total Net Asset covenant within the terms of the Group's secured and unsecured bank loan facilities. In addition, following the reduction in the Group's investment in The Co-operative Bank, the tangible net assets of the Group fell below the level required by the Total Borrowings to Tangible Net Assets Ratio covenant within the terms of the Group's 7.5/8% First Mortgage Debenture stock 2018, which had previously been measured against the gross assets of the Group including the Bank. Both of these covenant issues have been remedied subsequent to the year-end by agreement of an amendment to the covenant calculation within the syndicated loan facility, and agreement with the Debenture holders to remove the Total Borrowings to Tangible Net Assets Ratio covenant within this facility.

Despite these issues having been remedied and the fact is that the debt remains payable in accordance with its original repayment terms, from an accounting perspective, as the covenant amendments were obtained after the year-end, the Group is deemed not to have had an unconditional right to defer payment as at the balance sheet date. As a consequence the balance sheet is required to be presented as if all debt that could technically have become repayable as a result of failure to meet the original covenant definitions, whether by default, cross default or cross acceleration, has become a current liability. It is worth noting, however, that at no stage in this process was the debt commercially repayable on demand.

An adjusted Balance Sheet, Loans and Borrowings Note (note 24) and risk management tables (note 33) have been included within the accounts to illustrate the amended terms of the debt as at the date of signing the accounts.

There remain plans to continue controlled divestment of non-core, non-trading assets to release capital to support continued investment in customer-facing trading businesses and to help keep overall debt at an acceptable level.

Trading Group net debt reduced in the year by £286m driven principally by the receipt of proceeds from the sale and leaseback of the new Head Office (£143m), the sale of a large portion of the investment property portfolio and other estate disposals (£220m) and the disposal of the remaining motor dealerships (£39m). Working capital also improved significantly due to a reduction in underlying Food stockholdings and a general improvement in creditor terms. A summary of the movements in net debt are below:

	£m	£m
<b>Opening net debt</b>		<b>(1,686)</b>
Operating cash flow	312	
Working capital movements	107	
Capital expenditure	(239)	
Proceeds from disposal of property and businesses	432	
Increased debt from LME	(129)	
Payments to Members	(64)	
Payments to pension schemes	(56)	
Underlying interest on borrowings	(100)	
Other	23	
<b>Closing net debt</b>		<b>(1,400)</b>

### Reconciliation of underlying operating profit to loss before tax

Underlying operating profit (a non GAAP measure) is used as the primary indicator of business performance. The reconciliation of underlying operating profit to loss before tax is summarised and explained below.

	2013 £m	2012 £m
Underlying segment operating profit	<b>210</b>	297
Underlying interest payable	<b>(100)</b>	(106)
Underlying profit before payments to Members	<b>110</b>	191
One-off items	<b>(311)</b>	(80)
Property and business disposals	<b>(29)</b>	(50)
Change in value of investment properties	<b>(18)</b>	(25)
Finance income	<b>13</b>	10
Non-cash finance income/(costs)	<b>13</b>	(10)
Share of profit of associates and joint ventures	<b>–</b>	4
(Loss)/profit before Member payments	<b>(222)</b>	40
Member payments	<b>(55)</b>	(104)
Loss before tax	<b>(277)</b>	(64)

## Finance review continued

### One-off items

These principally comprise goodwill impairment of £239m (2012:£nil), acquisition and restructuring costs of £60m (2012: £86m) and a change in accounting estimate regarding funeral benefit options of £12m (2012:£nil).

Goodwill which arose on the Somerfield acquisition has been partially impaired (by £226m) as a result of the impact of Food's new business strategy, 'True North'. One key focus of True North is the planned disposal or closure over time of larger stores in the Food's business's retail estate. Goodwill in relation to Co-operative Legal Services has also been impaired by £13m following a reassessment of its business plan, which has assumed a slower growth rate than previously applied.

Acquisition and restructuring costs principally relate to:

- Executive restructuring and development of the new strategy;
- Corporate reorganisation costs (Project Unity);
- The completion of the modernisation and rationalisation of the Food business's physical distribution network which has taken place over several years, accommodating merger and acquisition impacts along the way; and
- Acquisition and deal costs relating primarily to costs incurred in connection with the planned sale of General Insurance before the decision was made to retain this business.

Costs in relation to the aborted purchase of the Lloyds branches (Verde) have been included within the loss on discontinued operations.

Since 2008, the Group has entered into contracts with a number of insurance companies in respect of life planning products (funeral benefit option plans). A refinement of the estimated prepayment attached to these sales has resulted in a one-off charge of approximately £12m to the Funeral business.

Pension finance income relates to net pension scheme interest derived from the difference between the interest on scheme liabilities and the expected return on scheme assets.

Non cash finance income/costs include non-cash mark to market adjustments on quoted debt and interest swaps. These are both volatile, non-trading items and collectively amounted to a £13m credit in 2013 compared with a £10m debit in 2012.

### Net capital expenditure

	2013 £m	2012 £m
Capital Expenditure	239	410
Disposal Proceeds	(432)	(57)

Capital investment of £239m chiefly comprised store/branch refurbishments of £63m (2012: £63m), acquisition of new stores/branches of £31m (2012: £69m), distribution depots and equipment of £48m (2012: £45m) and vehicles of £34m (2012: £34m).

Disposal proceeds principally arise from the sale and leaseback of the new head office completed very early in the year that released cash of £143m back into the Group, together with significant disposals of investment property, of which in excess of £100m was disposed of in a single transaction in the final quarter of the year.

### Tax

The tax credit on continuing business is £45m (2012: £18m restated) reflecting the loss in the year and the recognition of payments for Group relief to The Co-operative Bank plc at a rate of 20%. The effective tax rate was 16.2% (2012: 28.1%), compared to a standard blended rate of tax of 23.25% (2012: 24.5%). The main reasons for the effective tax rate being different to the standard rate of tax are explained in note 8 to the financial statements. Due to the trading loss arising in the period, the Group will not be taxpaying in respect of the current year.

### Pensions

The key movements in the pension schemes' valuations during the year were:

	2013 £m	2012 (restated) £m
Combined opening surplus/net deficit	191	132
Service and administrative costs	(89)	(97)
Net pensions interest income	14	10
Net actuarial (losses)/gains	(82)	16
Contributions	150	146
Other	(11)	(16)
Combined closing net surplus	173	191

The IAS 19 net surplus reduced by £18m during 2013. Changes in actuarial assumptions produced a net increase in liabilities of £461m. These increases were largely offset by an increase of £368m in asset values due to the Group's asset-liability matching strategy and also strong equity and property asset rises in 2013.

There have been three main changes to the actuarial assumptions from the prior year. Firstly, the discount rate used to assess the pension liabilities has reduced from 4.6% to 4.45%, following a fall in the corporate bond rate. Secondly, the inflation rate has increased from 3.3% to 3.6% following changes to the Office of National Statistics' inflation metrics. These two changes both had a negative effect on the net surplus and accounted for a c.£550m increase in pension liabilities during 2013. The third change to actuarial assumptions, related to future salary increases, which have decreased from RPI + 1.5% to CPI + 1%, following a Group review of likely future trends. These three changes produced a net increase in pension liabilities of £461m.

The service cost reduced by £9m compared to 2012. This is mainly due to a fall in pensionable wage within the Group following redundancies and non-Core business disposals made in 2012-2013 and in particular, the sale of the Life and Savings business in July 2013.

Contributions to the scheme are up £4m year on year due to a special, one-off contribution of £15m into Pace. This was made by the Group's former Life fund as part of the agreement to sell the Life and Savings business to Royal London. The £15m special contribution was partially offset by reduced contributions from the Group due to the fall in pensionable wage as detailed above. This £15m has been included as income within the loss on discontinued operations in the income statement.

The way in which the Group has accounted for net pension interest income has changed in 2013 following the Group's mandatory adoption of IAS 19 revised. Prior year net pension income, operating profit and actuarial losses have been restated to reflect the change in accounting policy. Further details of the restatement can be found on page 108.

## Finance review continued

Within the statement of other comprehensive income, the Pace pension surplus attributable to non-Group entities relates to the notional estimated share of the Pace surplus attributable to the Bank for accounting purposes at 4 January 2014. As the Group is the only participating employer with a right to refund in respect of any remaining surplus, the Group accounts for the entire scheme. Further information is provided in note 16.

### Member payments

Members can earn a share of Group profits (a 'dividend') based on their level of trade with the Group's family of businesses. The total dividend paid is based on the previous year's performance. The current policy follows a guideline of 40% of underlying trading profit, less underlying finance costs, minority interests and tax, being available for distribution. This is calculated as the sum of distributable profits from the two parts of the Group, being the Trading Group and the Banking Group. Subject to profitability, the ability and desirability of paying dividends from the Banking Group is also dependent on the need to retain capital within that business.

Dividends are recorded in the income statement once they have been approved. In 2013 the Group approved and paid a final dividend relating to 2012 profits. The split of the dividend between the various member categories is subject to Board approval. Dividends paid in 2012 are summarised in the table below.

The dividend payment fell 47.1% compared to the prior year, due to the reduced profits across the Group.

	2013 £m	2012 £m
To individual Members	(26)	(53)
To employees who are Members	(13)	(24)
To corporate Members	(10)	(17)
Community distribution	(6)	(10)
<b>Total</b>	<b>(55)</b>	<b>(104)</b>

**Individual dividend:** Dividends paid in 2013 related to trade conducted in 2012, when 5.7 million Members traded with the Group earning 3.4 billion points. This generated a payment of £34m including a discretionary top up of £8m which together with the interim dividend paid in 2012, brought the pay out to 1.0p per point (2011: 1.75p).

**Employee dividend:** A dividend totalling £13m (after National Insurance) was paid to more than 85,000 eligible employee Members in 2013, equating to a rate of £164 per full time employee (2012: £300). Employee dividend is paid to all employee Members on an equal basis pro rated to hours worked, subject to them being a member and in employment for greater than 12 months prior to the start of the financial year.

**Corporate dividend:** Corporate Members receive a dividend based on their participation in Co-operative buying groups operated by the Group, the largest of which is run within the Food business. In 2013 Corporate Members received a £10m dividend based on their federal trade with these various buying groups, at a rate of 64p per £100 of qualifying transactions (2012: £1)

**Community dividend:** A community dividend of £7m (including a £1m discretionary top-up from unclaimed dividend reserves) was made available for the benefit of communities in which we trade and to support Co-operative organisations including the Co-operative Party and Co-operatives UK. These initiatives are determined through the Group Values & Principles Committee. Further details of many of the initiatives and good causes some of which are supported by Community dividend, are given in the Group's Sustainability Report which is published later this summer.

In total, the Group spent £27.3m of cash on a variety of Member engagement, Co-operative support and community investment initiatives. Of this, £22.6m was paid by the Group itself either as a revenue expense (£7.3m) or from dividends on profit generated in previous years (£15.3m), of which £7.9m relates to the Community Dividend and £7.4m relates to the Individual Member Dividend. This includes amounts paid out of distributions carried over from previous years. Expenditure was broken down between team costs (£6.5m), regional democratic costs (£4.2m), Co-operative subscriptions (£2.4m) and Membership and community activity (£9.5m).

A further £4.7m was managed and spent by the Group on behalf of other organisations. £4.5m of this was spent on behalf of the Co-operative Community Investment Foundation, a registered charity (number 1093028). This organisation paid out £2.8m in grants from the Community Fund, £1.4m to projects involving young people and £0.1m on Environmental projects in the former United Co-operatives trading region.

The charity is funded from four sources: donations from Group Members who forgo all or part of their dividend from Group; grants from the Group in the form of dividends on profit generated in previous years; affinity partnerships with the Salvation Army and Unilever; and income generated on an investment held with Royal London, currently valued at £11.9m. The investment was started using £9.6m of grants made by United Co-operatives Limited, prior to the transfer of engagements to Group in July 2007.

In addition, £0.2m has been generated from a levy on carrier bags in Wales. This has been used to fund environmental projects in that region, chiefly through Wildlife Trust Wales.

## Business review

### Food

<b>Revenue</b> <b>£7.24bn</b> (down from £7.44bn)	<b>Underlying operating profit</b> <b>£247m</b> (down from £269m)
<b>Operating loss (after goodwill impairment charge and other one-off costs):</b> <b>£35m</b> (down £218m)	<b>Employees</b> <b>69,482</b>
	<b>Stores</b> <b>2,779</b>

Our Food business is in a period of transition, and the 2013 results reflect this. Sales fell from £7.44bn to £7.24bn as a result of store disposals, a shorter accounting period and price reductions, and underlying operating profit was down from £269m to £247m.

The Food operating loss is after an impairment charge of £226m relating to goodwill which arose on our investment in Somerfield, reflecting the fact that, moving forward, the business's focus will increasingly be on convenience stores within the estate.

### True North strategy

True North is the start of an exciting, five-year journey to transform our business and the way it operates. It is also part of our long term commitment to providing real value to our customers and putting them at the heart of everything we do as a food retailer: promising fair value, streamlining promotions, developing our own label range to a high standard and refreshing our estate of stores, including new store formats.

Launched in March 2013, the True North journey has been the absolute focus of our activity and has been brought to life for our customers and colleagues in a number of ways.

In September, we began refreshing and revitalising our own brand ranges, launching 'Loved by Us' with new lines across Food to Go, Ready Meals, Pizzas and Pies supported by successful multi-channel media campaigns.

Pricing has been identified as a key priority and we have launched a number of initiatives to improve our value proposition in the eyes of our customers, including reducing nearly 1,000 prices on products that were most out-of-line with our competitors.

In the last quarter of the year Members spending between £5 and £100 were given a coupon for 10% of their transaction. The coupons could be used against a future purchase and we saw an exceptional redemption rate of 72%, far ahead of industry standards. We have also continued the use of 'smart coupons', issued at the till, to give discounts to our Members.

To attract younger customers and build deeper relationships with them, we became the first supermarket to offer a 10% student discount for holders of the N.U.S. Extra Card. We also launched our first mobile app for customers, Members and colleagues: The Co-operative Food Deals app, which allows users to find their closest store and check on our best deals. We intend to do more going forward to look at how our digital offer should best meet our customers' requirements.

In November, we began the roll out of our new store formats and we have been pleased with their early performance. Improving the look and feel of our stores is a key priority and resource continues to be applied to our new formats and the store refit programme. By the end of 2014, 75% of the Food estate will have been refreshed since 2012.

While we have been selling larger stores, we have also been adding new outlets that are more suited to our focus on the convenience store market. In 2013, we opened 32 stores and a further 32 contracts were exchanged for stores that will open in 2014. A large number of these are situated in and around London, where we have traditionally been under-represented. Our London stores in particular have outperformed our initial expectations.

The business successfully improved supply chain processes and reduced stock levels, improving cash flow and enabling our stores to run more smoothly. This was achieved through better ordering disciplines and improved relationships with our suppliers. March 2013 saw the completion of the Logistics service network, which will help drive product availability through the supply chain and into stores, meaning customers will be able to get what they want when they want it.

In early 2014, we confirmed that the Farms division was no longer part of our go-forward strategy, and we are currently exploring options for the sale of this part of the business.

### General Insurance

<b>Revenue</b> <b>£476m</b> (2012: 580m)	<b>Underlying operating profit</b> <b>£36m</b> (2012: £13m)
<b>Employees</b> <b>1,291</b>	<b>Sites</b> <b>5</b> (Manchester, Leek, Bury St Edmunds, Rugby and Nottingham)

When we announced our 2012 year-end results we indicated our intention to sell our General Insurance (GI) business to concentrate the Banking Group on its core Bank retail offer. As the scale of the Bank's capital shortfall became clear, it was decided that the proceeds of the sale of GI would be used as part of the Group's contribution to the Bank's refinancing. Following the recapitalisation, however, we were able to review our plans and we decided to keep this profitable business.

In 2013 GI achieved a significant improvement in underlying operating profit to £36m (2012: £13m), on revenue of £476m sales (2012: £580m) due mainly to better claims experience compared to the prior year, more than offsetting the impact of the fall in premium income and the significant reduction in investment income. The result is driven by the continued strong performance of the Home portfolio, supported by markedly improved profitability in the Motor portfolio. Key successes include our award-winning service, improved underwriting performance and increased customer reach due to our brand campaign and appearance on aggregator, or price comparison, websites. We will continue to grow our business around our core proposition of fairness and we believe our General Insurance business can build on its current success and has considerable future potential.

## Business review continued

### Separation of Banking Group Functions

A key challenge faced by the Group towards the end of 2013 was the work required to separate many of the unified back office functions that were brought together throughout the Group in 2012 as part of Project Unity. A number of corporate functions were merged as part of this cost saving exercise, which although delivering significant savings for the Group, needed to be reversed as the Co-operative Bank plc became a separate employing entity following separation. This work will continue into early 2014.

### Funerals

<b>Revenue</b> <b>£370m</b> (£358m)	<b>Underlying operating profit</b> <b>£62m</b> (£60m)
<b>Employees</b> <b>4,230</b>	<b>Branches</b> <b>926</b>

The Co-operative Funeralcare had a successful 2013, with strong sales and healthy profits driven by the expansion of our estate, the introduction of new products and services and the establishment of new channels and partners. Sales for 2013 were £370m, 3.4% up on 2012. Underlying operating profit too was also up at £62.1m, a 3.3% increase on last year.

In 2013, we opened 16 new funeral homes, invested £3.1m in crematoria development and £9.5m in our fleet of vehicles.

We have also invested heavily in our online services. In December, we introduced a new website where clients can purchase, as well as manage, a pre-paid funeral plan online. A significant number of people have taken advantage of this service.

Training and development of colleagues is critical in ensuring clients receive the best service and having officially introduced a National Vocational Qualification in Funeral Operations and Services, 2013 saw 415 employees join Funeralcare as apprentices.

We also introduced a new management development programme, MySteps, to support all leaders across our funeral business.

### Pharmacy

<b>Revenue</b> <b>£760m</b> (£764m)	<b>Underlying operating profit</b> <b>£33m</b> (£28m)
<b>Employees</b> <b>6,980</b>	<b>Branches</b> <b>782</b> branches including Out Patient Departments

Our Pharmacy business delivered a creditable performance in a tough market, which continued to suffer from the impact of government funding on medicine pricing. Sales were down £4m or 0.5% on 2012, underlying operating profit was up £5m on the prior year, which was a 17.9% increase on 2012. Prescription like-for-like sales were up 2.2% and Over the Counter (OTC) like for likes were up 1.7%.

Pharmacy achieved these results as a result of an increased focus on customer care. Success was enabled by market leading like for like prescription growth and maintenance of our number one position for customer service. We further improved our OTC offering, again delivering sector-leading growth.

Following a successful pilot in 2012, we have rolled out our Branch Transformation Programme which remodels our branches to provide customers with an improved pharmacy experience. The programme also involves dedicated training to support our focus on excellent customer service. In total we have remodelled 80 branches as part of the programme. We have successfully relocated 11 branches to maximise market share potential and meet customer demand, with a further 20 identified for 2014. This is in line with our ongoing commitment to protect, grow and enhance our business for the benefit of our customers.

We have maintained our strong scores in the Customer Satisfaction Index – our average score was 93.4% – reflecting our focus and investment in training and colleague engagement and an improvement on the 2012 figure of 93.2%.

Our diversification into new areas has continued and in May we won our first three year dispensing contract to supply HM Prisons in Nottinghamshire and Doncaster with patient medicines. Medicines are delivered from our nearby existing pharmacies and this has created additional jobs within the business. Our five outpatient contracts in NHS hospitals continue to perform well with excellent customer service and strong sales across all sites.

As part of the wider strategic review of all its businesses, The Group has decided that the Pharmacy business will not be part of its future strategy. The business is currently being considered partially or in its entirety, for sale. Further updates on this decision will be included in the half year report for the Group.

### Co-operative Legal Services

<b>Revenue</b> <b>£33m</b> (£33m)	<b>Underlying operating loss</b> <b>£9.1m</b> nil
<b>Employees</b> <b>560</b>	<b>Operating loss after goodwill impairment</b> <b>£22m</b>
	<b>Sites</b> <b>3</b> (Manchester, London, Bristol)

The Legal Services business remains in the early stages of its development, and this is reflected in the performance for 2013. Sales were broadly flat with losses arising from regulatory change, uncertainty about the future of our General Insurance business, and decisions to invest in future growth. We are now looking to consolidate and optimise the portfolio, with further restructuring planned, to work more closely with Funeralcare and General Insurance as part of the newly formed Consumer Services division.

Regulatory change, including the Jackson reforms, had the most significant impact upon our Personal Injury business. The restructuring of the PI business announced at the end of 2013 has been completed in line with our plans. However, following the decision not to sell the General Insurance business we are now able to explore opportunities to work more closely with our insurance business.

## Business review continued

Goodwill of £13m relating to this business has been impaired during the year following a reassessment of its business plan, which has assumed a slower growth rate than previously applied. This means that the overall operating loss of this business stands at £22m for 2013 (2012: £2m loss).

During 2013 we continued to invest in our Family Law business developing a transparent fixed fee pricing proposition for our customers. The business achieved £1.2m revenue in its first full year of trading; however, we remain focused on ensuring we have an efficient operating model to take the business forward.

Probate and Wills remain key areas for growth and we will continue to work more closely with Funeralcare during 2014.

### Electrical

<b>Revenue</b> <b>£88m</b> (£83m)	<b>Underlying operating profit</b> <b>£1m</b> (£1m)
<b>Employees</b> <b>118</b>	<b>Sites</b> <b>3</b> (Barnsley, Luton and Manchester)

Co-operative Electricals saw a strong sales increase in 2013. The second half of the year saw like-for-like increases in 25 of the 26 weeks. Sales and traffic peaked on 'Cyber Monday' (the first Monday in December – the Monday after Thanksgiving in America) and Christmas Day, with a 56% increase in web traffic in December (22% increase overall in 2013). To support customer demand and to enhance our service to customers we provided a free Sunday delivery option for customers. Our profits remain flat, reflecting our commitment to offering customers value in this competitive market.

The year also saw the launch of our social media marketing strategy, using the social media platform 'Snapchat' and launching the '#FightthePrice' marketing campaign on twitter.

The UK is expected to see a recovery in the housing market which will lead to an increase in kitchen appliance sales. We also expect to see demand increase this summer, particularly for large screen TVs, thanks to the World Cup.

### Estates

<b>Revenue</b> <b>£28m</b> (£36m)	<b>Underlying operating profit</b> <b>£11m</b> (£19m)
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The Co-operative Estates generated an income for the Group of £28m at year-end (2012: £36m) with an underlying operating profit of £11m (2012: £19m).

The commercial property market saw signs of improvement in 2013, particularly in the second half of the year, although this varied considerably by geographical region and property sector.

One of the key strategies for Estates in 2013 was to increase non-core property disposals, freeing up funding capital for use in the trading businesses. Examples of this include the exit of 40 properties generating £103m as part of a non-core disposal project. This had an impact on 2013 income and profits, which were therefore lower than in 2012.

Estates also continues to deliver large parts of the Group's sustainability agenda, with further progress on renewable power and pioneering work on energy-saving fridge doors in the Food business. Estates has achieved its 2007 target of reducing the Group's energy usage by 40%, delivering a cost saving of over £100m.

During 2013, 1 Angel Square, the Group's new business support centre based in Manchester, won a number of prestigious awards and was accredited as the greenest office building in the world during the year. In November, the building was opened by Her Majesty the Queen and His Royal Highness the Duke of Edinburgh. The sale and leaseback of the building generated cash proceeds during the year of £143m. The Co-operative Group has retained the right to lease the building beyond an initial term of 25 years.

The regeneration of North Manchester will continue through delivery of the NOMA masterplan scheme as the Group's legacy buildings are vacated and prepared for redevelopment. In April 2014 the Group announced a joint venture partnership with Hermes Real Estate. The deal is expected to complete in mid-May.

A new office base has also been established near St Paul's in London, allowing for consolidation of Group activities currently based in the capital.

During 2013 a number of longer term collaborative partnerships were developed with core suppliers, with a strategic lifecycle approach to key assets across our stores, branches and office buildings. This approach is exemplified by the launch of a new online facilities helpdesk and wide-ranging related projects in store and depot maintenance, cleaning and refrigeration.

In 2013 the Group picked up the prestigious 'Business Continuity Team of the Year' at the Continuity Insurance & Risk Awards. A major focus in the second half of the year has been the development of a new risk management system to be rolled out in 2014.

## Discontinued operations

### The Co-operative Bank Plc

During 2013 a number of now well-documented factors contributed to the Bank's overall loss of £1,441m. The main factors that continued to significantly impact the profitability of the business were credit impairment, provisions for conduct risk, intangible asset impairment, high operating costs and the overall flat market conditions caused mainly by a low interest environment. Further detail specific to the Bank's performance can be found in the Co-operative Bank's separate Annual Report.

### Recapitalisation plan

The financial results for the Banking Group in 2013 reflect the underlying issues at the Co-operative Bank that came to light in May 2013 and that were dealt with through the Bank's LME which was successfully implemented in December 2013 without recourse to Structured State support.

Under the terms of the Bank capital recovery plan, the Bank is now a separate, stand alone business with the Group holding a significant shareholding. In this Annual Report for the Group, the Bank's results are within 'discontinued operations' and going forward, the Bank's result will be shown within the 'profit/loss from associates' line.

Through the capital recovery plan, we raised £1.5bn of core Tier 1 equity, as required by the banking regulator (PRA) by December 2013. This was achieved without any government help and is so far a unique solution to resolving a bank crisis in the UK. The Bank's unique ethical stance has been protected and recognised as central to its future development and has been enshrined within its new constitution.

## Business review continued

### Life and Savings

In July 2013, The Banking Group successfully completed the sale of the Life and Savings Business to Royal London. To ensure a smooth transition for customers the Banking Group operates a number of Service Level Agreements with Royal London while the infrastructure is embedded with the new owner.

### Our people

The challenges that the Group faced in 2013 underlined the immediate and urgent need to improve leadership and performance across our businesses. Euan Sutherland took up his post as Chief Executive in May and we then reframed, reshaped and raised the calibre of the Group Executive all of whom have contributed to guiding the business through the crisis. This was a significant investment in attracting talent from outside the business in order to tackle the issues that we faced and the challenges that we know lie ahead. In March 2014 Richard Pennycook stepped into the role of Interim CEO following the decision by Euan to leave the business. Richard's appointment ensures a stability as the Group focuses on rebuilding. The business started 2014 with a team of experienced leaders who are focussed on the transformation of the Group, of which one of their key priorities is to continue to upgrade talent and people performance. The People Strategy for 2014 will focus on ensuring that our workforce becomes a high performing team, each member of which has clear accountabilities aligned to the organisation's purpose and objectives.

### 2013 developments

#### Clear communications

The Executive made a commitment to communicate more openly and frequently with colleagues on an ongoing basis. Members of the Executive Team, including the Chief Executive, issue regular messages via the intranet and senior leaders frequently host informal face to face briefings in the Support Centre and other sites. In addition, there has been full internal communications around all major announcements – including an increased use of video. These initiatives are designed to break down some of the barriers and silos that have traditionally existed within the Group and demonstrate the Executive's strong commitment to two-way communication, whilst encouraging colleagues to become ambassadors for change.

Reinforcing the two-way nature of our communications has been a consistent theme of 2013. In October, colleagues and managers of all grades, from all business units and functions, took part in focus groups to discuss their perceptions and experiences of the Co-operative Group. The outputs of these focus groups have been fed into discussions about the Group's future direction and Strategy. Throughout 2014 colleagues will be invited to participate in strategy meetings and workshops as the business moves into the next phase of its development.

#### Colleague feedback and resultant action

The Group's colleague engagement survey, Talkback, has been running for 11 years. Every employee has the opportunity to have their say about working at the Co-operative. Talkback measures employee engagement within each team. It asks colleagues about a range of workplace issues, such as their manager's performance, how valued they feel by their business and what they think of the Group's retail products.

Colleagues identified two clear priorities for the business to improve on: inspirational leadership and a focus on delivering great customer experience every time, every day. All colleagues believe the business can do this better.

### Equality and diversity

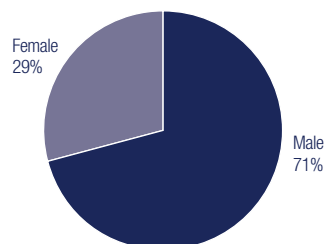
Our commitment to fairness and diversity for colleagues remained high on the Group's agenda in 2013 and the business was named the UK's third best organisation to work for by The Stonewall Workplace Equality Index which grades private and public sector organisations across the UK on how well they are doing in their support of lesbian, gay and bisexual (LGB) matters. For the fifth consecutive year the Group is the only retailer in the Top 100. The Group's inclusive LGBT employee network Respect has also been awarded Stonewall's 'Star Performer Network Group' for the fourth consecutive year.

#### Gender breakdown

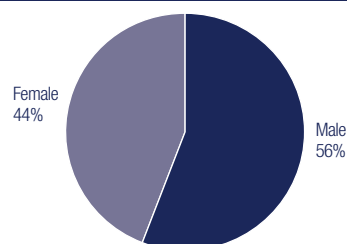
A breakdown by gender of the number of persons who were Directors of the Company, senior managers and other employees as at the year-end, is set out below. Our gender diversity throughout the Group remains strong. At Executive level, 3 out of 7 current Executives are female. On the Board, 2 out of 21 are female one of which is the Group Chair.

A breakdown of the number of men and women across the business at the end of the financial year and the number of men and women who were managers is below (excluding Bank).

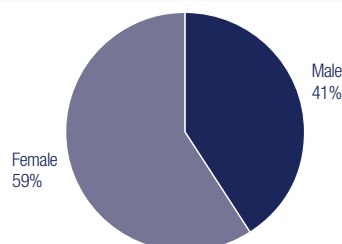
#### Executive



#### Management



#### Group



## Business review continued

### Inspiring young people

The Co-operative Group continues to motivate and inspire young people and provide them with opportunities to gain skills, knowledge and experience, helping prepare talent for the future. We launched our Apprenticeship Academy in 2011 to address growing youth unemployment and the lack of training opportunities for young people, aiming to benefit at least 2,000 people between 2011 and 2013. Apprentices have the opportunity to study for a nationally recognised qualification while working in one of our businesses, earning a competitive salary and gaining transferable and professional skills. During 2013 we identified 810 apprenticeship opportunities across the Group, bringing the total number of apprentices to 2,025. We work in partnership with third-party training providers to ensure our apprenticeship and training opportunities are of the highest quality and reflect our values and principles. The Apprenticeship Academy has been awarded several accolades, including a Business in the Community Big Tick Award for Inspiring Social Action in Young People and the North West (Manchester, Cheshire and Staffordshire) Award for Employer Newcomer of the Year 2013.

In September 2013 we launched The Co-operative Legal Services (CLS) Academy to improve access to legal careers and greater professional development opportunities. Learning pathways through the Academy have been designed in partnership with Manchester Metropolitan University and are delivered to CLS employees online by its law and business academics. By incorporating CLS's existing apprenticeship scheme and MMU's postgraduate programmes, employees can access a career pathway that will enable them to progress from an apprentice to a qualified lawyer during their employment.

In 2013, The Co-operative Young Members' Board was established to provide a greater understanding of the thoughts, views, issues and aspirations of people aged between 16 and 25. The Young Members' Board, made up of 15 young people, has been working on specific business challenges set by the Group Board, as well as taking part in projects with Co-operative employees and senior managers. They have been contributing to the Group's Strategy and Purpose work, the development of our next generation of food stores and product development. They are also working on projects to enable the Group to engage with as wide a group of young people as possible, including a young Members' website.

### Into 2014

As part of our commitment to transform the Group, we will continue to develop more effective and cost efficient ways of working. This work is part of the wider Transformation Strategy for the Co-operative Group and is essential as we move into the next phase of our journey. Close scrutiny and challenge on all costs will become workplace culture and every colleague will play an important role in making this happen.

One of the people priorities for 2014 is to transform the culture of the organisation; this is being led by the Executive team and is designed to build a more aligned and effective workforce. We believe this will result in a significant shift in expected behaviours. To deliver on the business' renewed ambition, changes will be made to colleague reward and recognition. The ambition for 2014 is to ensure colleagues are paid fairly, undertake meaningful work and have opportunities for personal growth. We will continue our focus of putting colleagues at the heart of the Co-operative Group.

### Social goals

In 2013, we continued to deliver on our commitment to adhere to the highest social and environmental standards for the benefit of our customers, Members, colleagues and communities. Our Sustainability Report contains a full overview of our performance, with the highlights from the past year set out below.

As an organisation with a strong heritage in being socially responsible, we remain focused on responding to the needs of all those with an interest in our business. Looking ahead, our future will continue to be shaped by listening and responding to the needs of the communities we serve.

### Keeping communities thriving

We are proud to be a community retailer and, through our presence in every UK postal area, we provide access to products and services at the heart of the local community. In 2013, our work led to an investment of £15.7m in UK communities.

The Co-operative Membership Community Fund supports local groups and voluntary organisations throughout the UK, by awarding small grants. In 2013, the Fund awarded £2.8m, providing support for 2,270 community groups and charities.

In 2013, over £5m was raised by colleagues, Members and customers through our Charity of the Year partnership with Carers Trust. The money raised is being used to deliver a programme of support, advice and opportunities, designed by and for young adult carers to help transform the lives of over 20,000 carers aged 14-25 throughout the UK.

### Inspiring young people

Since its launch in 2010, over 1 million young people have benefited from our Inspiring Young People programme – a range of projects that motivate and inspire young people, and provide them with opportunities to gain skills, knowledge and experience.

The programme has a strong education theme, as can be seen in the Green Schools Revolution, which brings inspiring and engaging activities on sustainability issues to over 6,100 primary and secondary classrooms across the country. We also continue to work with Co-operative Academies, delivering an innovative curriculum, with a values-led ethos. This forms part of wider work supporting Co-operative Schools, of which there are now 520.

### Supporting co-operatives

The Co-operative Enterprise Hub provided its unique offer of free, bespoke business support to aspiring and existing Co-operative businesses throughout 2013. Almost 400 enterprises received support during the year, with over 1,800 enterprises to date being assisted by the Hub at critical points in their development. We saw a continuation of the trend towards communities 'doing it for themselves' in 2013, with the Hub supporting many local communities determined to save or reopen their local shops, pubs and village halls.

## Business review continued

### Responsible retailing

Responsible retailing was at the heart of our founding principles and we have sought to make healthy and ethical offerings accessible to as many people as possible.

We have made our healthier range options no more expensive than our standard lines, with the nutritional content of our value range being at least as good as our standard lines. We are committed to providing consumers with open and honest food labelling, and have led the way on restricting the marketing of less healthy products to children.

In 2013, we extended our farming group model across our chicken, pork, beef, lamb and dairy suppliers, helping us deliver good baseline animal welfare standards and high quality products, reduce our environmental impacts, and bring benefits to British farmers.

### Protecting the environment

Since October 2013, new Government regulations<sup>1</sup> require all UK quoted companies to report on their greenhouse gas emissions (GHG) as part of their annual Directors' Report. The Co-operative has long campaigned for the introduction of such regulation and for this requirement to apply to all large businesses.

The Co-operative Group measures its direct GHG emissions in carbon dioxide equivalent (CO<sub>2</sub>e) using the latest UK Government guidance<sup>2</sup>. The direct GHG footprint encompasses energy consumption (electricity, gas, diesel, gas oil), refrigerant leakages in our Food business, all business travel (air, rail and road) and fertiliser consumption<sup>3</sup>. All greenhouse gas data and related commentary is externally assured<sup>4</sup>.

The Co-operative Group<sup>5</sup> reduced its total GHG emissions by 3% in 2013, achieving an overall reduction of 45% compared to 2006 – equivalent to saving almost 600,000 tonnes of GHG emissions – and putting us on track to achieve our target of 50% emissions reduction by 2020. We have achieved these reductions through a range of measures on energy, transport and refrigerants, with the majority coming from a 41% reduction in energy consumption since 2006. This has not only saved around £71 million in energy costs (based on 2013 prices) but has also significantly reduced the Co-operative Group's exposure to future energy cost and carbon price increases.

We sourced just over 98% (887GWh) of our electricity from renewables in 2013, generating 7.5% of our total electricity needs from our own portfolio of wind, hydro and solar power projects. Our Pharmacy and Funeralcare businesses maintained their policies of achieving carbon neutrality in 2013 by offsetting operational greenhouse gas emissions, for the second and third year in a row respectively.

Direct greenhouse gas emissions (unaudited)	Total emissions (tCO <sub>2</sub> e)	Carbon intensity (emissions per unit revenue) (tCO <sub>2</sub> e/£m)
2006	1,307,975	n/a*
2010	889,931	76.84
2011	780,548	66.93
2012	738,738	62.21
2013	715,722	62.85
	45% since 2006	
	3% since 2012	

\* Metric for 2006 is not available, due to changes in our business portfolio.

Source of emissions (unaudited)	Total emissions (tCO <sub>2</sub> e)
Fuel combustion (Gas, Gas Oil)	42,049
Electricity consumption*	402,052
Refrigerant leakages	120,752
Transport**	145,717
Fertiliser use	5,153
<b>Total</b>	<b>715,722</b>

\* If electricity from renewable sources is accounted as zero carbon then emissions from electricity would be 7,393 tCO<sub>2</sub>e

\*\* includes all road distribution, home delivery, business travel and rail freight

1. The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.  
 2. Department for Environment, Food and Rural Affairs, Environmental Reporting Guidelines: Including Mandatory greenhouse gas emissions reporting guidance, June 2013 ([https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/206392/pb13944-env-reporting-guidance.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206392/pb13944-env-reporting-guidance.pdf)).  
 3. We have reported on all of the emission sources required under the Companies Act 2006 (Strategic Report and Directors' Reports) Regulations 2013. These sources fall within our consolidated financial statement. We do not have responsibility for any emission sources that are not included in our consolidated statement.

4. Assurance is provided by DNV GL in accordance with the AA1000 Assurance Standard (2008). For further information please see the Co-operative Group Sustainability Report 2013.  
 5. Excluding the Co-operative Bank.  
 6. Remaining emissions from gas, brown electricity, business travel, and head office refrigerants once green electricity supply is discounted.

## Business review continued

We have reduced the volume of waste produced by 40% since 2006 whilst increasing the proportion of waste that is reused or recycled by 15%.

	Total waste (tonnes)	Percentage recycled/reused
2006 <sup>i</sup>	158,176	57%
2009	120,198	59%
2010	116,394	60%
2011 <sup>ii</sup>	102,213 <sup>iii</sup>	58%
2012	100,550 <sup>iv</sup>	59%
2013 <sup>v</sup>	94,577	72%
Reduction (%) since 2006	40%	
Reduction (%) since 2012	6%	

In 2013, we rolled out our project to backhaul waste from our food stores to regional depots. By removing waste collections from 2,800 stores and collecting from depots instead, we will save 225,000 skip collections every year. Not only is this significantly reducing the amount of unrecyclable waste we send to landfill, but it will also save around £2m from our waste bill in our Food business.

We have gained recognition for our sustainable product sourcing, and are one of the UK's leading retailers on forest and marine stewardship, as well as having market-leading commitments on the sustainable procurement of high-risk products such as palm oil.

## International communities

We believe that, when undertaken fairly, trade has an unparalleled capacity to improve quality of life.

We remain second to none in the UK for availability of Fairtrade products and continue to sell more Fairtrade for the size of our business than any of our competitors. Uniquely, we have gone beyond Fairtrade – seeking to deliver benefits for producer communities above and beyond what can be achieved by the Fairtrade premium alone. In turn, this helps to secure supply across many of our Fairtrade product categories. Our approach also involves championing the role that smallholder farmers and co-operatives can play in feeding the world's growing population.

In partnership with CARE International UK, we support lendwithcare.org, which allows people in the UK to lend directly to entrepreneurs in the developing world, helping them work their way out of poverty. By the end of 2013, over 105,000 loans had been made with a total value of almost £3.8m.

For every sale of our own-brand bottled water – Fairbourne Springs – three pence per litre is donated to The One Foundation to fund clean water projects in rural communities across Africa. Since the start of our partnership with The One Foundation in 2007, our customers have funded improved access to clean water for over 1 million people.

## Human rights

We are a member of the Ethical Trading Initiative and our Sound Sourcing Code of Conduct identifies the labour standards we expect to be applied across suppliers of our own-brand products. Our approach combines: a robust monitoring programme to help ensure fair treatment of workers in our supply chains around the world; working in partnership and building capacity with suppliers to achieve continuous improvement; and employee training to improve awareness and understanding of our own impacts on workers and communities.

We are the only major UK retailer to have a Human Rights and Trade Policy, which sets out the exceptional circumstances in which we will curtail trade with a particular state or settlement and Co-operative General Insurance's investments in fixed-income bonds that underpin home and car premiums are ethically screened against human rights criteria. We also factor human rights considerations into our choice of suppliers of goods not for resale through our Sustainable Procurement and Supplier Policy.

<sup>i</sup> All figures restated to account for sale of the Co-operative Bank.

<sup>ii</sup> Reduction in recycled rate predominantly due to the introduction of reusable trays. In 2011, reusable trays removed the need for an estimated 12,500 tonnes of cardboard.

<sup>iii</sup> Figure restated to account for overstating of card and plastic recycling.

<sup>iv</sup> Ibid.

<sup>v</sup> Increase in reuse/recycling rate is largely due to the introduction of waste backhauling and the increase in waste sent to recycling and anaerobic digester facilities rather than disposal by landfill.

# Directors' report

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# Principal risks and uncertainties

## Managing our risks

### Background

The past year has been traumatic for the Group. The massive losses caused predominantly by the Bank and the Group's subsequent dilution of the Group's stake resulting in loss of control of the Bank have been well publicised and included elsewhere in this report.

Several investigations have since been launched in a determined effort to learn lessons for the future. These have not yet concluded but the Directors are committed to implementing the changes necessary to improve the structure and governance of the Group.

The issues in the Bank highlighted broader weaknesses in the Group's governance framework that have damaged the organisation's reputation. These include a series of costly strategic misjudgements that have undermined the Group's competitive position and severely eroded its capital base.

Although an overly complicated Governance structure including Group Board, Regional Boards and Area Committees allowed poor decision making to go unchallenged, the Group has taken positive action to address these issues by appointing Lord Myners as Senior Independent Non-Executive Director of the Group to undertake an independent governance review. This review will be concluded shortly, although a progress update has already been issued. Where appropriate, the recommendations from the review will be considered as part of the development of the Group's governance framework.

External advisers have also been appointed by the Group specifically to assist in improving the robustness of its risk framework.

### Risk process

The Board is responsible for approving the Group's strategy, the principal markets it operates in and the level of acceptable risks. The Group operates a risk management process that identifies the key risks facing each business. Each business and function has a risk register that identifies the likelihood and impact of those risks occurring and the actions being taken to manage those risks. The Group also maintains a Group Key Risk Register which describes the key risks faced by the Group and assesses their likelihood and impact, as well as the controls and procedures implemented to mitigate them.

The key risks are reviewed and monitored by the internal Group Risk Management Committee which reports to the Group Audit and Risk Committee, which in turn is accountable to the Group Board.

The Group's risk management approach is based on an assessment of the impact and likelihood of events, and seeks to balance risk and reward rather than eliminate risk entirely.

#### 1: Identify

Risks are identified by colleagues from all businesses and functions.

#### 2: Assess

The likelihood and impact of these risks are assessed by management and the Board.

#### 4: Implement

Responsibility for actions and controls to mitigate risks are delegated to appropriate colleagues in the Group.

#### 3: Identify and mitigate

Plans are developed to identify actions and controls to mitigate the risks.

The most significant risks faced by the Group, as considered by management and the Board, and related mitigation actions are set out on page 24 onwards.

## Principal risks and uncertainties continued

### 1. Group risks

Risk	Mitigation
<p><b>Governance reform</b></p> <p>As set out above, Lord Myners has made recommendations in his interim report setting out the need for Governance reform. There is a major risk that if steps are not taken to improve the Group's Governance and there are further disruptions around how the Group is governed then the reputation of the Group may suffer. This could ultimately affect brand image (see brand and reputation section below) and lead to a negative impact with other stakeholders such as suppliers and our banking syndicate.</p>	<p>The Board is considering the Lord Myners interim report with a view to submitting the report to a vote at the General Meeting to be held on 17 May 2014. A sub-committee of the Board has been established to consider the findings of the Lord Myners report and to make appropriate recommendations to the Board on the route to reform. The Directors continue to pro-actively engage with its key stakeholders (including customers, suppliers and external lenders) on this matter.</p>
<p><b>Group's Interest in the Co-operative Bank plc</b></p> <p>The Group is committed to making a capital contribution to the Bank of £333m by 31 December 2014 (of which £263m remains outstanding at 17 April 2014).</p> <p>Additionally there are risks to the Group's brand and reputation as the Bank continues to use the Co-operative Brand.</p> <p>The Group is exposed to the risk that the Bank acts in a way to bring the Co-operative brand into disrepute, which could have a negative impact on the Co-operative Group's customer base, reducing trade for all businesses by leading to a loss of trust and confidence amongst consumers.</p> <p>The Group is exposed to a risk that the carrying value of its investment in the Bank is impaired. This could happen:</p> <ol style="list-style-type: none"> <li>1. If the Bank's trading performance were to deteriorate (risks to performance include credit risk, operational risk, liquidity risk and conduct risk).</li> <li>2. Through a dilution of the Group's shareholding in the Bank.</li> </ol>	<ul style="list-style-type: none"> <li>• A project team has been established, reporting directly to the CFO, to review and monitor funding plans to support the capital contribution. The terms of the Group's banking facilities allow some flexibility in the sources of funds. For example, the plans have recently been flexed following the Group's decision to withdraw from the GI sale process.</li> <li>• Meeting this commitment is challenging but management is confident of success. In the unlikely event that this is not met, the Group would relinquish its investment in the Bank (more details are provided within the Going Concern paragraphs of the Accounting Policies section)</li> <li>• The Group is entitled to representation on the Bank Board to enable it to monitor and control its investment on an ongoing basis. This representation has, however, been withdrawn while the Bank conducts its current capital raising exercise.</li> <li>• The Bank recently announced its intention to raise around £400m of additional CET1 in the form of new ordinary shares. This provides the Group with the opportunity, but not an obligation, to subscribe for further shares in the Bank. The Group will consider the full details of the issue in due course. Should the Group not subscribe, their shareholding will be diluted. The implications of any such dilution on the carrying value of investment will be closely monitored.</li> </ul>
<p><b>Adverse economic conditions</b></p> <p>The Group's performance could be impacted by the adverse UK economic conditions as well as market trends in the specific business markets it operates. For example, the recent announcement of price reductions by our competitors could impact our sales and margins.</p> <p>Although the Bank of England has stated that growth is well underway, the Group, along with many other retailers, believes that this growth is fragile. Consumers' disposable incomes remain under pressure from price inflation and further government austerity measures.</p>	<ul style="list-style-type: none"> <li>• Economic indicators and impacts are monitored closely.</li> <li>• The Group's ranges of goods and services and their price positions are constantly reviewed and adapted to reflect changing customer demands and expectations.</li> <li>• Financial forecasts are frequently updated to reflect prevailing conditions, trends and outlook.</li> <li>• Pro-active management of costs.</li> <li>• As already described, the Co-operative Bank plc incurred significant losses in 2013 partly through not fully monitoring, or understanding, the full implications of economic conditions – particularly in relation to the property market.</li> </ul>
<p><b>Business strategy</b></p> <p>Each business in the Group contributes to the risk that if its strategy is not effectively implemented, the long term aims of the Group will not be met and performance will suffer. This includes key areas such as the True North strategy in Food.</p>	<ul style="list-style-type: none"> <li>• Regular review of strategy by senior management, Executive and Board.</li> <li>• Group Board Strategy Away Days held to review strategy.</li> <li>• Phased implementation of projects so that learnings can be captured.</li> <li>• Communication of strategy through various channels.</li> <li>• Significant resource invested in developing strategy.</li> </ul>

## Principal risks and uncertainties continued

### 1. Group risks continued

Risk	Mitigation
<p><b>Failure of major supplier</b></p> <p>As a result of the economic downturn there is a risk major suppliers or business partners going into administration, causing a serious interruption to our ongoing business.</p>	<ul style="list-style-type: none"> <li>• Financial healthchecks of prospective new suppliers during tender process.</li> <li>• Regular monitoring of the financial position of our suppliers, especially those we suspect of having difficulties.</li> <li>• Identification of alternative sources of supply where we are aware of potential difficulties.</li> <li>• Restrictions on the levels of mutual dependency in key supplier relationships.</li> </ul>
<p><b>Brand and reputation</b></p> <p>The Group's reputation is at risk from significant adverse events. 2013 proved a challenging year for the Group. Recent events in connection with the Bank have led to increased media scrutiny and negative coverage in all social media which has put pressure on the Co-operative Group brand.</p>	<ul style="list-style-type: none"> <li>• Robust operational standards and regular compliance audits are undertaken in each business.</li> <li>• Continual monitoring of our corporate reputation and brand standards.</li> <li>• Commitment to our Social Goals Strategy, reported through the annual Sustainability Report.</li> <li>• Monitoring of all social media sites and proactive response to any key issues arising.</li> <li>• Close monitoring by senior management, and proactive PR to manage the impact of key events.</li> <li>• Consideration of brand, ethics and reputation risks in decision-making processes.</li> </ul>
<p><b>Pension costs</b></p> <p>The Group's pension arrangements are regarded as an important part of the rewards package for employees and a key element in the attraction and retention of our people. The pension funding position is highly sensitive to assumptions for discount rates, inflation and life expectancy.</p> <p>Therefore, any variation from these assumed values has the potential to introduce volatility to the Group's results.</p> <p>Risk also arises from the schemes because the value of their asset portfolios and returns from them may be less than expected.</p> <p>UK legislation requires the Trustees of the pension arrangements to carry out valuations at least every three years and to target full funding against a basis that prudently reflects the risk exposures of the pension arrangements.</p> <p>Actions taken by the Pensions Regulator, or changes to European legislation, could result in stronger funding standards, which could materially affect the Group's cash flow.</p>	<ul style="list-style-type: none"> <li>• The Group and the schemes' trustees continue to carefully monitor the pension risks, taking action where necessary to adjust contributions to the schemes and revising the schemes' investment strategy to mitigate the risks.</li> <li>• The Pace scheme operates a comprehensive risk management framework, including allocating 75% of assets to a liability matching portfolio. The two main objectives of the liability matching portfolio are to hedge interest rate and inflation risk and to generate some excess return above gilts in a risk controlled manner to improve the funding level.</li> <li>• The Pace scheme was awarded "Best Use of Risk Reduction Strategies" at the Professional Pensions Pension Scheme of the Year Awards 2013. The award reflects the growing use of risk reduction strategies by schemes and corporate sponsors and is judged on how the potential risk reduction offerings are assessed and implemented, as well as how the strategy fits with the scheme asset portfolio and possible future developments.</li> <li>• Engagement of external advice and actuaries as appropriate.</li> <li>• In-house monitoring of the funding positions of all schemes in between statutory triennial actuarial valuations and of changes in legislation so pension strategy can be reassessed as required.</li> <li>• Continuous engagement of employees on all relevant pension issues.</li> <li>• Following the recent separation of the Bank from the Group, a review of the full implications for the future pension strategy is underway. As described in note 16, a further impact is expected in relation to the disposal of Bank in future years when the split of Pace is determined and the resulting share of surplus/deficit at that time is derecognised.</li> </ul>

## Principal risks and uncertainties continued

### 1. Group risks continued

Risk	Mitigation
<p><b>Business disruption</b></p> <p>The Group could be exposed to any significant incident such as a terrorist attack, pandemic or information loss which would adversely affect business operations.</p>	<ul style="list-style-type: none"> <li>• Robust disaster recovery plans and business continuity developed and tested on a regular basis.</li> <li>• Continuous improvement in the resilience of IT infrastructure.</li> <li>• Progressive premises strategy centred around more modern buildings and facilities.</li> </ul>
<p><b>Energy prices</b></p> <p>The Group has significant energy requirements and is constantly exposed to the risk of rising energy prices.</p>	<ul style="list-style-type: none"> <li>• The Group operates a buying policy under which an agreed proportion of forecast energy requirements is secured at fixed prices.</li> </ul>
<p><b>Business integration and change</b></p> <p>The risk of failure to achieve anticipated benefits from various business transformation programmes being implemented across the Group. Failure to manage these change programmes adequately could put at risk our objectives and financial targets.</p>	<ul style="list-style-type: none"> <li>• Adoption of disciplined project and programme management processes.</li> <li>• Processes to monitor capacity and prioritise projects at business unit and Group level.</li> <li>• Appropriate approval, monitoring and post investment appraisal processes in place.</li> <li>• Effective governance structures for all major programmes with close monitoring by Executive Management and, where appropriate, the Board.</li> <li>• Regular reviews of each programme are undertaken considering resource requirements, progress, dependencies between projects, and risks.</li> <li>• Engagement of key stakeholders and colleagues involved in and affected by change.</li> </ul>
<p><b>Data protection</b></p> <p>The Group holds a significant volume of confidential personal data and could be adversely affected if any of this data were to be lost or compromised. This could give rise to legal or regulatory penalties as well as commercial costs.</p>	<ul style="list-style-type: none"> <li>• We have robust data protection policies and procedures in place.</li> <li>• We are undertaking an extensive programme of work across the Group to implement heightened controls against the risk of loss of data and card data compromise.</li> <li>• Continuous improvement in physical and IT security processes.</li> <li>• Thorough investigation of any incidents arising and implementation of corrective action.</li> </ul>
<p><b>Financial capacity and financial risk management</b></p> <p>The Group must be able to generate and maintain sufficient funds to meet business needs while managing interest rate, forex and liquidity risks (more details of financial risk management are given in note 33).</p> <p>The requirement for Group to make a capital contribution to the Bank of £333m by 31 December 2014 has added pressure to its financial covenants. (Also see above).</p>	<ul style="list-style-type: none"> <li>• We have rigorous Treasury policies and procedures to ensure that funding is in place at all times with appropriate covenants to meet the needs of the Group.</li> <li>• The 2013 Liability Management Exercise process and associated disposal of the Bank has led to some amendments to covenants as described in more detail in the Going Concern paragraphs within the General Accounting Policies section.</li> <li>• Short, medium and long term cash flow forecasts are prepared and reviewed on a regular rolling basis.</li> <li>• Diversified sources and maturity of borrowings.</li> <li>• Continuous engagement with banks, bondholders and other finance providers to keep them up to date with business developments and future finance requirements.</li> <li>• Close monitoring of existing facility limits and covenant headroom.</li> <li>• Ongoing review and monitoring of interest-rate and other credit related risks are undertaken by Treasury.</li> </ul>

## Principal risks and uncertainties continued

### 1. Group risks continued

Risk	Mitigation
<p><b>Ethical sourcing</b></p> <p>Ethical trading is at the heart of our business. A major incident could undermine this key point of difference; alienate customers and severely damage sales and profits. As our scale and profile grows this brings greater visibility to our brand.</p>	<ul style="list-style-type: none"> <li>• We have clear sourcing policies in place, comprehensively reviewed and communicated.</li> <li>• Technical auditing and due diligence of new suppliers and ongoing rigorous monitoring of compliance with standards.</li> <li>• Continuing training and development of all employees involved in purchasing.</li> <li>• General widespread communication and awareness of all of our values and principles including ethical sourcing.</li> </ul>
<p><b>Own label food scare</b></p> <p>We have successful and extensive own brand ranges of food products. We are at risk of a serious food scare or incident that results in public liability and damages public confidence in our brand.</p>	<ul style="list-style-type: none"> <li>• The Food business has tightened supply chain controls, and a testing programme has been re-scoped to give better controls and an enhanced level of customer surveillance.</li> <li>• We deploy robust technical quality assurance policies, procedures and audits.</li> </ul>
<p><b>Regulatory compliance</b></p> <p>CISGIL, Legal Services and a number of other Trading businesses operate in highly regulated environments. This brings a necessary cost of compliance and a risk that non-compliance could mean fines, reputational damage and, in extreme cases, inability to operate.</p>	<ul style="list-style-type: none"> <li>• Employment of suitably qualified and experienced compliance and risk officers as appropriate to each business area.</li> <li>• Comprehensive risk and audit functions.</li> <li>• Full and continuous engagement with relevant authorities.</li> </ul>

### 2. Bank separation risks

Risk	Mitigation
<p><b>Separation risks</b></p> <p>Following the LME transaction, plans are in place to separate the Bank from the Group and are expected to continue into 2014/15.</p> <p>This is a complex process with a transitional period during which responsibility and delivery of services and operations currently provided by the Group, will be transferred to the Bank.</p> <p>Risks to the Group centre around delivery of these services and potential financial exposure should the services be deficient during the transitional period.</p> <p>The physical separation of resources and assets, particularly IT infrastructure increases this risk.</p> <p>There are also risks associated with attracting and retaining high calibre employees during this transitional period.</p>	<ul style="list-style-type: none"> <li>• A specific separation programme has been established with a Director appointed to run the programme.</li> <li>• There is an effective governance structure for the programme with close monitoring by Executive Management and, where appropriate, the Board.</li> <li>• Regular reviews are undertaken considering resource requirements, progress, dependencies between projects, and risks.</li> <li>• A senior IT Director has been seconded full-time to the separation programme to focus specifically on the IT separation issues.</li> <li>• HR are also represented on the separation programme and are fully aware of the people issues with training, development and talent management being a key focus area for HR going forward.</li> </ul>

## Principal risks and uncertainties continued

### 3. CISGIL risks

#### CISGIL risks

##### General Insurance risk

General Insurance risk refers to inherent uncertainties as to the occurrence, amount and timing of insurance liabilities.

- The major classes of general insurance business written are motor and property, together with some commercial liability, pecuniary loss, pet insurance and personal accident.
- CISGIL's objectives in managing general insurance risk are: To achieve acceptable returns by ensuring that insurance risks are carefully selected in accordance with risk appetite, underwritten in accordance with risk strategy and priced to reflect the underlying risk; Reserve risk volatility is minimised through robust reserving and modelling approaches and continual review, and; Catastrophe risk is mitigated through the use of appropriate reinsurance arrangements.
- Continuing adverse motor claims trends impact both underwriting risk for business being written and reserve risk for existing policies.
- Insurance risk is managed through CISGIL's underwriting strategy, reinsurance arrangements, proactive claims handling and claims provisioning process.

##### Market risk

Market risk is the risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market risk drivers such as interest rates and market prices of assets and liabilities.

- CISGIL invests primarily in high-quality fixed and variable interest bonds issued by corporations.
- CISGIL's objective is to achieve acceptable returns while minimising volatility through minimal exposure to equities and other volatile instruments.
- Interest-rate risk is largely mitigated through investing in fixed interest securities with a similar duration profile to insurance liabilities.
- The most significant aspect of market risk to which CISGIL is exposed is changes in credit-spreads, over and above risk-free interest rates, upon corporate bonds. This risk is managed through limits for exposure to credit-ratings and individual counterparties.

##### Conduct risk

Conduct risk is the risk that CISGIL's behaviours, offerings or interactions will result in unfair outcomes for customers. This is related to the overall Group's regulatory compliance risk and applies specifically for financial services firms.

- Conduct risk may arise from any aspect of the way business is conducted, the sole test being whether the outcome is an unfair one for customers.
- CISGIL's objective is to ensure our conduct and treatment of customers and the quality of our customer experience is maintained through the application of systems and controls in conjunction with ongoing oversight and monitoring from risk functions.
- A full review of all products was carried out in 2013, and a rigorous assessment is carried out for all new products and changes.
- CISGIL mitigates and prevents emerging conduct risk through established systems and controls including ongoing oversight and monitoring.

## Board biographies

### Ursula Lidbetter (i)

Age 51. Group Chair. Joined the Board in 2009. Chief Executive, Lincolnshire Co-operative. Member of the Co-operative Group Remuneration and Appointments Committee.

### Jenny Barnes (r)

Age 53. Joined the Board in 2009. Public Sector Worker. Member of the South & West Regional Board. Director of Co-operative Food Board. Member of the Values and Principles Board.

### Steven Bayes (r)

Age 52. Joined the Board in 2009. Nurse. Member of the North Regional Board. Chair of Co-operative Specialist Businesses Board. Member of the Co-operative Group Remuneration and Appointments Committee.

### Marc Bicknell (r)

Age 38. Joined the Board in October 2013. Chief Internal Auditor and Chartered Accountant. Member of the North Regional Board. Director of the Co-operative Food Board. Member of the Group Audit and Risk Committee.

### Duncan Bowdler (r)

Age 55. Joined the Board in 2007. Trade and Legislation Manager. Member of the North West & North Midlands Regional Board. Non-Executive Director of the Co-operative Banking Group Limited. Member of the Group Audit and Risk Committee.

### John Brodie (i)

Age 49. Joined the Board in 2012. Chief Executive, Scottish Midland Co-operative Society. Director of Co-operative Food Board.

### Eric Calderwood (r)

Age 61. Joined the Board in 2006. University Lecturer. Member of the Scotland & Northern Ireland Regional Board. Director of Co-operative Food Board. Chair of the Group Remuneration and Appointments Committee.

### Martyn Cheatle (i)

Age 52. Joined the Board in 2010. Chief Executive, Midlands Co-operative Society. Director of Co-operative Food Board. Chair of the Group Audit and Risk Committee.

### Herbert Daybell (r)

Age 66. Joined the Board in 2009. Retired Publisher. Member of the Central & Eastern Regional Board. Director of Co-operative Food Board. Chair of the Values and Principles Board.

### Patrick Grange (r)

Age 71. Joined the Board in 2007. Farmer and Business Consultant. Member of the North West & North Midlands Regional Board. Acting Chair of Co-operative Food Board. Member of the Group Audit and Risk Committee and of the Co-operative Group Remuneration and Appointments Committee.

### Michael Harriott (r)

Age 52. Joined the Group Board in May 2013. Member of the South & West Regional Board. Director of Co-operative Specialist Businesses Board.

### Ray Henderson (r)

Age 67. Joined the Board in 2009. Company Secretary. Member of the North Regional Board. Director of Co-operative Food Board. Member of the Values and Principles Board.

### Liz Moyle (r)

Age 65. Joined the Board in 2011. Director of Co-operative Specialist Businesses Board. Member of the Co-operative Group Remuneration and Appointments Committee and of the Values and Principles Board.

### Munir Malik (r)

Age 66. Joined the Group Board in May 2013. Accountant. Member of the South East Regional Board. Director of Co-operative Specialist Businesses Board. Member of the Values and Principles Board.

### David Pownall (r)

Age 56. Joined the Board in 2007. Self Employed Plastering Contractor. Member of the North West & North Midlands Regional Board. Director of Co-operative Specialist Businesses Board. Member of the Values and Principles Board.

### Stuart Ramsay (r)

Age 56. Joined the Board in 2009. Computer Technician. Member of the Scotland & Northern Ireland

Regional Board. Director of Co-operative Specialist Businesses Board. Member of the Values and Principles Board.

### Ben Reid (i)

Age 59. Joined the Board in 2000. Chief Executive of The Midcounties Co-operative. Member of the Values and Principles Board.

### Mark Smith (i)

Age 54. Joined the Board in 2010. Chief Executive of The Southern Co-operative. Director of Co-operative Specialist Businesses Board. Member of the Group Audit and Risk Committee.

### Jennifer de Villiers (r)

Age 67. Joined the Group Board in May 2013. Member of Central & Eastern Regional Board. Director of Co-operative Specialist Businesses Board.

### Lord Myners CBE (IPNED)

Age 65. Joined the Board in December 2013. Senior Independent Non Executive Director. Former Chairman of Marks and Spencer, Member of the Court of the Bank of England and Treasury Minister. Produced a report in 2004 for the UK Government on the governance of financial mutuals.

(r) regional representative

(i) independent society representative

(IPNED) independent professional non-executive director

## Board composition

### Co-operative Food Board

**Patrick Grange**

Acting Chair of Co-operative Food Board

**Jenny Barnes**

Group Director

**Marc Bicknell**

Group Director

**John Brodie**

Group Director

**Simon Burke**

IPNED

**Eric Calderwood**

Group Director

**Martyn Cheatle**

Group Director

**Herbert Daybell**

Group Director

**Ray Henderson**

Group Director

**Ursula Lidbetter**

Group Chair

**John Longworth**

IPNED

**Steve Murrells**

Chief Executive, Food

### Co-operative Banking Group Board

**Peter Harvey**

IPNED

Chair of Co-operative Banking Group Board

**Duncan Bowdler**

Group Director

**Bob Newton**

Independent Professional

Non-Executive Director

**Richard Pennycook**

Non Executive Director

**Mark Summerfield**

Non Executive Director

### Co-operative Specialist Businesses Board

**Steven Bayes**

Group Deputy Chair

Chair of Specialist Businesses Board

**Penny Coates**

IPNED

**Michael Cutt**

IPNED

**Jennifer De Villiers**

Group Director

**Michael Harriott**

Group Director

**Ursula Lidbetter**

Group Chair

**Liz Moyle**

Group Director

**David Pownall**

Group Director

**Stuart Ramsay**

Group Director

**Mark Smith**

Group Director

**Munir Malik**

Group Director

## Executive biographies

### **Richard Pennycook** **Interim Chief Executive Officer**

Joined the Group in 2013 after nearly eight years as Group Finance Director at WM Morrison Supermarkets Plc ('Morrisons'). At Morrisons he had responsibility for the Group's finance, IT, strategy and multichannel development. Previous roles include Group Finance Director at RAC and JD Wetherspoon. Became Interim CEO in March 2014.

### **Sam Walker** **Chief HR Officer**

Joined the Group in 2013 from Britvic Soft Drinks. Has over 25 years experience in HR across a number of sectors including media, FMCG, pharmaceuticals and utilities. She has also worked within marketing, sales and operations.

### **Nick Folland** **Chief External Affairs Officer**

Joined the Group in 2013 from Kingfisher where he led the Net Positive, sustainability agenda having also been the General Counsel and Company Secretary.

### **Steve Murrells** **Chief Executive, Retail**

Joined as Chief Executive of The Co-operative Food in 2012. Previously CEO of Danish meat company, Tulip. Has a long history in fresh food retailing, having held a number of senior positions with Tesco, including CEO for One Stop Stores and Commercial Director of Fresh Foods. Has also worked within buying and trading for Sainsbury's.

### **Alistair Asher** **Group General Counsel**

Joined the Group in 2013 from Allen & Overy where he has been a senior partner. Alistair has had a 34 year career with Allen & Overy, 26 as a partner.

### **Paula Kerrigan** **Group Chief Strategy Officer**

Joined the Group in 2013 from Kingfisher where she was responsible for finance for Central Support functions having also held strategy and finance roles across Europe and Asia.

### **Claire Davies** **Group Secretary**

Joined the Group in 2014 from Lloyds Banking Group. Claire is a solicitor and has more than 27 years' experience in a variety of legal, compliance and company secretarial positions.

## Governance review



**Good corporate governance is essential to the effective operation of organisations. It plays a vital role in maintaining both the integrity and efficiency necessary to help businesses deliver their strategy – and, in our case, perform for Members.**

The events of 2013 demonstrated, in a very public way, that elements of the Group's corporate governance arrangements had not kept pace with the growth and evolution of the Group and were therefore not fit for purpose.

### Introduction from the Chair

In July 2013, following announcement of the £1.5bn capital shortfall in the Co-operative Bank plc, the Group Board, in conjunction with the Board of the Bank and the newly formed executive teams of both businesses, commissioned an independent review on behalf of our Members to establish the causes of the events that led to the Group's current difficulties. The outcome of this review, which is led by Sir Christopher Kelly, is expected to be reported to Members ahead of the AGM in May 2014. The review will include an analysis of decision making, management structures, culture, governance and other factors.

The Board fully expects the Kelly Review to be critical of the practices and behaviours that contributed to the crisis. Recognising that the Group faces ongoing challenges in terms of damage to its reputation as well as its business performance, the Board is determined to improve the robustness and integrity of the Group's governing structures and procedures and is already taking action in this regard.

On 10 December 2013, Lord Myners was appointed as the Senior Independent Non-Executive Director of the Group. The appointment of an independent director was the first of many steps towards governance reform. As a leading business figure and public servant, Lord Myners has brought to the Group extensive business, financial, governance, public policy and political experience. As part of his role, Lord Myners was asked to lead, on behalf of the Board, an extensive Governance Review. The purpose of the Review is to examine in detail the effectiveness of the Board and its interaction with management with the aim of strengthening Board structures, improving working processes and policies and safeguarding standards.

In March 2014, Lord Myners published a preliminary report which included draft recommendations designed to deliver a robust governance and leadership model that is consistent with best practice standards whilst ensuring adherence to the Group's core co-operative values and principles.

In April 2014, Lord Myners announced his intention to step down from the Board at the 2014 AGM. Prior to stepping down, he will deliver his full report which we expect to receive ahead of the AGM.

The Society keenly awaits the publication of the Myners' Report which will be an important driver of the reform programme.

The Group Board has confirmed its commitment to governance reform. In this regard, it has agreed that a resolution will be put to Members in a Special General Meeting to be held immediately after the AGM.

This resolution seeks agreement to the following proposals:

- The creation of a Board of directors elected by Members that is individually and collectively qualified to lead an organisation of the size and complexity of the Co-operative Group;
- The establishment of a structure that gives the Co-operative Group's Members appropriate powers to hold the Board properly to account for the performance of the business and adherence to Co-operative values and principles;
- A move to the concept of 'one Member one vote' with appropriate representation for independent Co-operative societies;
- The inclusion of necessary provisions in the Rules to protect against de-mutualisation.

The Board will be responsible for considering and implementing the governance reforms. To this end, it has established a sub-committee reporting to the Board and comprising three Board directors including myself as Chair, to ensure a clear route to reform which will include effective consultation and engagement with key stakeholders. In due course, the final recommendations will be put to a Members' meeting.

The findings of both the Kelly and Myners' Reviews will help to shape the Group's future governance framework and constitution. The Group will not shy away from difficult decisions and will ensure that lessons identified in both reviews are learnt and addressed. The Board wishes to express its gratitude to both Sir Christopher Kelly and Lord Myners as well as their respective teams for their diligence and patience during the review period. Both can be assured that they will have made a valuable personal contribution towards strengthening not only the Group's business model and governance structures but to securing its future.

The last year has been a difficult one for the Group and its Members. It has left the Board in no doubt as to the importance and long-term benefits of sound governance principles. The Board is clear that it needs to modernise and to embed the very best standards of corporate governance, while, at the same time, ensuring that the voices of all our Members and customers resonate through the business.

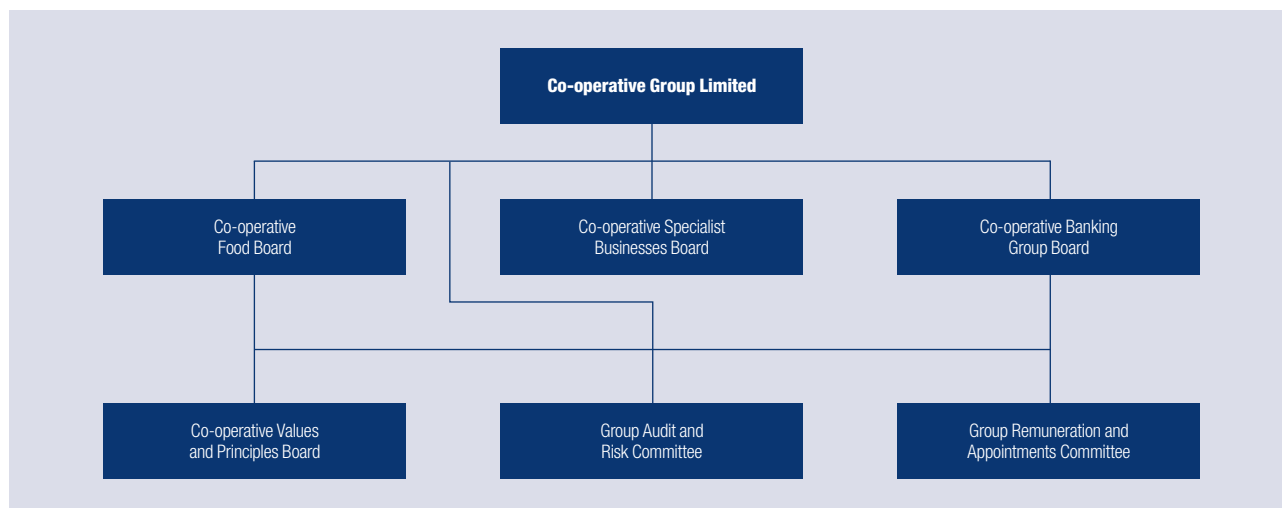
The Board is committed to learning the lessons of the past, to rebuilding trust in our organisation and to building a sustainable business not just for today but for future Members. As Chair, I am determined to ensure that the Society delivers on this commitment.

**Ursula Lidbetter**  
Group Chair

## Governance review continued

### Our governance structure

The diagram below shows our Board structure which is currently subject to review.



The Group has three principal subsidiaries, all of which are industrial and provident societies:

The Boards of Co-operative Food Holdings Ltd (the Food Board) and Co-operative Specialist Businesses Limited (the Specialist Businesses Board) have specific oversight of the Food business and other customer facing businesses, such as Funerals, Pharmacy and Legal Services. They are designed to improve the Group's governance by allowing Directors to have greater scrutiny of its large and diverse portfolio. In addition to the elected Directors, appointed by and from the Group Board, the Board has also appointed two Independent Non-Executive Directors to serve on each of these boards.

The Co-operative Banking Group (CBG), now holds the Group's 30% equity share of the Co-operative Bank (Bank), and has the right to appoint 2 out of the 9 directors on the Bank's Board. CBG also has responsibility for oversight of the General Insurance business (CISGIL), the Reclaim Fund (RFL) and CFS Management Services (CFSMS).

### Membership involvement

As a co-operative, the Group is jointly owned by its individual and Independent Society Members. Individual Members of the Group exercise their democratic rights by serving as representatives on its 48 Area Committees and seven Regional Boards, or by voting in elections (237,578 individual Members voted in 2013 via both postal and online methods), attending twice yearly Members' meetings held throughout the country or participating in other consultation initiatives. Independent Society Members currently elect up to five eligible individuals to serve on the Board of the Group.

The approach to the involvement of Members in the governance of the Group is one of the issues that will be considered by the Governance review commissioned by the Board.

### Compliance with the UK Corporate Governance Code

The Group is an Industrial and Provident Society. As such it is not mandatory for the Group to comply with the UK Corporate Governance Code (the Code) published by the Financial Reporting Council; in fact, the democratic nature of the Group and its ownership by Members makes certain provisions of the Code difficult to apply. However, where possible and appropriate, the Group aims to conform to the key principles of the Code to ensure alignment with good practice.

The Group also adheres to the spirit of the Corporate Governance Code for Consumer Co-operatives, published by Co-operatives UK. This Code was revised and re-launched in November 2013 and has been adopted by the principal consumer co-operatives within the UK. The Group will report on its compliance with this Code directly to Co-operatives UK.

### Leadership

#### Role and responsibilities of the Group Board and Subsidiary Boards

The Group Board is responsible for the long term success of the Group, setting its strategy and maintaining the policy and decision making framework within which this strategy is implemented. It ensures that the necessary financial and human resources are in place to meet strategic aims; monitors performance against key financial and non-financial indicators; oversees the system of risk management; and sets values and standards in governance matters, brand and Membership. The Board also operates in accordance with the International Co-operative Alliance Values and Principles, actively engaging and maintaining close relations with its Members and encouraging active member participation in its governance practices.

## Governance review continued

The Board directs the business in the following ways:

- 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 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; and
- determining capital allocation to subsidiaries.

The role of the Subsidiary Boards is to lead and direct the respective businesses and to monitor their performance.

## Group Board composition and independence

The composition of the Group Board is determined by the Rules. The Group Board currently consists of 21 directors; 15 of which are elected from Regional Member Constituencies and five from Independent Co-operative Societies. The Rules permit the appointment of up to three Independent Professional Non-Executive Directors (IPNEDs) of which one has been appointed to date. On 10 December 2013, the Board appointed Lord Myners as its first IPNED and Senior Independent Director. Lord Myners will remain as a Director until the 2014 AGM on 17 May when he will not seek election and will therefore step down following that meeting.

Lord Myners has extensive business, financial, governance, public policy and political experience and is leading the Governance Review on behalf of the Board.

The names of the Members of the Board at the end of 2013, their biographies and details of length of service are set out on page 29.

The Code requires at least half of the Board, excluding the Chair, to be Independent Non-Executive Directors.

All of the Group's directors are Non-Executive and in accordance with the Code, it is for the Board to determine whether a director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. In this regard, the Board has concluded that those directors elected as individuals from the Regional Members' Constituency (with the exception of Duncan Bowdler who is an employee of the Group) are independent. In addition, the Senior Independent Director, Lord Myners is considered to be independent.

Directors elected from Independent Society Members (including the Group Chair) represent Independent Societies which enter into material transactions with the Group and may carry out similar trading activities. They are therefore not regarded as independent.

All directors are expected to exercise their judgement when making decisions in the best interests of the Group as a whole, mindful of their legal duties and responsibilities to Members and other stakeholders.

## Appointment of directors

Under the Rules of the Group, one third of the elected directors are subject to re-election each year. Elections were held during the year and as a result the following directors were re-elected to the Board in 2013 for a three year term of office: Martyn Cheatle (Central England Co-operative); Duncan Bowdler (North West & North Midlands Region); Paul Flowers, (North Region).

Steve Watts (Central and Eastern Region), was not successful in being re-elected and stepped down following the AGM on 17 May 2013. Marilynne Burbage (South East Region) and Christine Herries (South & West Region) chose not to seek re-election and also stood down following the 2013 AGM.

With effect from 18 May 2013, the following directors were appointed to the Board for the first time for a three year period: Munir Malik (South East Region), Jennifer de Villiers (Central & Eastern Region) and Michael Harriott (South & West Region).

Following the resignation of Paul Flowers (North Region) on 12 June 2013, a casual vacancy election was held and Marc Bicknell was elected to the Board for the first time for a three year period.

Len Wardle, Group Chair (South East Region), also stepped down as Chair of the Group on 8 November 2013, and as a director from 19 November 2013, creating a vacancy in the elected Members' constituency. This vacancy will be filled as part of the 2014 Director elections the results of which will be announced prior to the 2014 AGM.

## Group Chair

Following the resignation of Len Wardle, the Group Board appointed Ursula Lidbetter (Lincolnshire Co-operative), to act as Group Chair with effect from 19 November 2013. Ursula has been a non-executive director on the Group Board since 2009 and was previously a Deputy Chair of the Group and Chair of the Food Board. As Ursula was elected to the Board from the Independent Society Members' constituency, she was not considered on appointment to be independent.

The role of the Group Chair is to lead the Group Board in the determination of its strategy and in the achievement of its objectives. The Group Chair is responsible for leading the Group, organising the business of the Group Board, ensuring its effectiveness and setting its agenda. Although the current chair has an executive role as CEO of the Lincolnshire Co-operative, she has no involvement in the day to day running of the business of the Group. The Group Chair facilitates the effective contribution of directors, ensures constructive relations between the directors and the Group executive management, ensures directors receive accurate, timely and clear information and ensures that there is effective communication with Members.

The division of responsibilities between the Chair and the Chief Executive is clearly defined and has been approved by the Board.

## Governance review continued

### The Secretary to the Board

The Group Secretary is responsible for advising the Group Board and the Group Chair on all governance matters. All directors have access to the advice and services of the Group Secretary. Under the Group's Rules, the appointment and removal of the Group Secretary is a matter for the Group Board.

Moira Lees retired as Group Secretary in December 2013, following 32 years with the Group, the last six as Group Secretary. Following an extensive recruitment and selection process, the Board announced in December 2013, that Claire Davies would be taking up the role as the new Group Secretary in March 2014. Claire Davies is a solicitor and has more than 27 years' experience, mainly in the Financial Services sector. She has held a variety of legal, compliance and company secretarial positions including roles at Ernst & Young, The Woolwich, Legal & General and Lloyds Banking Group. In her role as Group Secretary, Claire reports to the Group Chair and works alongside the General Counsel. During the period December 2013 to March 2014, Harry Baines undertook the role of Interim Group Secretary.

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

The Chief Executive has direct responsibility for the Group on a day-to-day basis and is accountable to the Group Board for the financial and operational performance of the Group.

Euan Sutherland succeeded the outgoing Chief Executive, Peter Marks on 9 May 2013 and was, until that date, an independent non-executive director serving the Food Board.

Euan Sutherland resigned as Group Chief Executive on 11 March 2014 and Richard Pennycook, Group Chief Financial Officer was appointed as Interim Group Chief Executive Officer with effect from the same date.

The responsibility of the Executive is to implement the strategic objectives as agreed by the Group Board and, under the leadership of the Chief Executive, to undertake the day-to-day management of the Group.

Neither the Chief Executive nor any other member of the Group Executive team is a director of the Group.

### How the Board operates

#### Meetings

In addition to regular Board meetings, the Group Board holds separate meetings with senior executives to consider performance and longer term planning, giving consideration both to the opportunities and risks to the strategy. During 2013, the Group has undertaken a significant review of its strategy and has held a number of additional meetings specifically dedicated to the consideration of strategy.

The Subsidiary Boards meet once a month to consider their respective businesses. The number of meetings of the Group Board and main Board committees and directors' attendance is set out below. In addition, the Board holds private sessions in the absence of senior management to discuss specific issues on a case by case basis.

### Attendance

During 2013, the Board held 21 meetings, of which 9 were scheduled as part of the annual calendar of meetings. The increase in the number of meetings reflects the challenges faced by the Group during the year and the need for Board attention to specific matters as they arose, often at short notice.

The table below sets out the frequency and related attendance of directors at Board and Committee meetings for the period under review. In the event that a director is unable to attend a meeting, it is the practice of the Chair to seek (and receive) a satisfactory reason for their absence. Directors who are unable to attend meetings nevertheless receive papers and are given the opportunity to submit their views on the business to be transacted.

#### Attendance for Group Board and Subsidiary Meetings (unaudited)

	Group Board	Group Audit & Risk Committee	Group Remuneration & Appointments Committee
Jenny Barnes	20 (21)		
Steven Bayes	21 (21)		7 (7)
Marc Bicknell	6 (6)		
Duncan Bowdler	18 (21)	8 (8)	
John Brodie	17 (21)		
Eric Calderwood	19 (21)		13 (13)
Martyn Cheadle	17 (21)	8 (8)	
Herbert Daybell	20 (21)		
Jennifer de Villiers	14 (14)		
Patrick Grange	17 (21)	6 (8)	5 (5)
Michael Harriott	14 (14)		
Ray Henderson	20 (21)		
Ursula Lidbetter	21 (21)	6 (7)	13 (13)
Munir Malik	14 (14)		
Liz Moyle	20 (21)		5 (5)
David Pownall	19 (21)		
Stuart Ramsay	21 (21)		
Ben Reid	16 (21)		
Mark Smith	14 (21)	8 (8)	

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

## Governance review continued

### Board Committees

The Group Board governs through clearly identified Board Committees which are detailed in this report. Each of these Committees has a role in ensuring the effectiveness of the Group. In accordance with the provisions of the Code, the terms of reference for the Group Remuneration and Appointments Committee and the Group Audit and Risk Committee are available on the Group's website at [www.co-operative.coop](http://www.co-operative.coop).

The Board ensures that its Committees are provided with sufficient resources to enable them to undertake their duties. The Board Committees formally report to the Board on their proceedings after each meeting and generally on all matters and activities for which they are responsible through the Committee Chairs and via access to Committee minutes.

**Group Audit and Risk Committee** – the report of the Group Audit and Risk Committee is given on pages 38 to 41.

**Group Remuneration and Appointments Committee** – Information on the Group Remuneration & Appointments Committee is in the Committee's report on pages 42 to 58.

**Group Chair's Committee** – The Group Chair's Committee has the authority to act between Group Board meetings if required. The remit of the Committee covers all areas reserved to the Group Board.

The Members of the Group Chair's Committee are:

- Ursula Lidbetter (Group Chair)
- Steven Bayes
- Eric Calderwood
- Martyn Cheatle
- Herbert Daybell

The Values & Principles Board (V&P Board), was established by resolution of the Group Board on 13 June 2013. It incorporates the work previously undertaken by the Values and Principles Committee, the Political Strategy Committee and the Board Diversity Strategy Committee. Its remit in respect of Governance is currently suspended, pending conclusion of the Group's Governance Review. The V&P Board acts as the custodian of the Co-operative Group's values and principles. Its primary purpose is to consider matters relating to the Group's Co-operative objectives and, where appropriate, make recommendations to the Group Board. It is responsible for Governance at Regional level and for monitoring the Group's Membership engagement and social goals strategies. It is also actively involved in setting the Group's ethical policies, scrutinising the Group's Sustainability Report on behalf of the Group Board and maintaining relationships with the wider Co-operative Movement.

Members of the V&P Board are:

- Herbert Daybell (Chair)
- Jenny Barnes
- Ray Henderson
- Munir Malik
- Liz Moyle
- David Pownall
- Stuart Ramsay
- Ben Reid
- Ursula Lidbetter (ex-officio)

### Board effectiveness

#### Board statement on diversity

The Board is committed to the promotion of the benefits of diversity of all types, and actively pursues a policy and practice of equality and opportunity in employment for all colleagues, regardless of age, disability, ethnicity, gender, religion or belief or sexual orientation ensuring the Group can benefit from the broader balance of skills and experience that diversity offers.

In 2012, the Board approved a policy for Board Diversity applicable to the Group Board and its key Subsidiary Boards. This policy sets how each Board will achieve its vision of promoting diversity in the Boardroom by having a composition that reflects the diversity of the communities it serves.

The policy includes all aspects of diversity and, in particular, responds to the Co-operative Women's Challenge 2020 which aims to ensure that women are fairly represented at all levels within Co-operative businesses. It also takes account of the provisions of the UK Corporate Governance Code revised in September 2012 to include the recommendations of the 'Women on Boards' report published by Lord Davies in February 2011. The policy aims to address the representation of women on the Group Board by setting interim targets for the percentage of female directors serving on the Group Board of:

- a minimum of 33% of female directors by 2016;
- a minimum of 40% by 2018.

Targets have also been set for the Group's Area Committees and Regional Boards, (through which appointments are made to the Group Board via the democratic election process). The policy aims to ensure that the composition of the Group Board reflects the diverse composition of the UK population, as illustrated in the 2011 UK Census.

Of the 21 directors currently on the Group Board, four of these are women, representing 19% of the total. Of these, Ursula Lidbetter was appointed Chair of the Co-operative Group in November 2013 and is the first woman to hold this position.

The recruitment of IPNEDS is conducted using external search consultants. The Group has engaged the services of independent search consultants, JCA and Warren Partners to act on behalf of the Group Board and Subsidiary Boards respectively. Both firms have signed up to a voluntary industry code which seeks to establish a balance of men and women on the Board by ensuring at least 30% of the candidates on 'longlists' are women.

The policy also covers other aspects of diversity including Black, Asian, Minority Ethnic and Refugee Members (BAMER); Lesbian, Gay, Bisexual and Transgender (LGBT) Members; Members with disabilities and Members with caring responsibilities, for which targets have been set at area committee level. To ensure that the democratic structure represents the communities it serves, targets will also be established for all of these groups at regional board level. In 2013, the first BAMER Director, Munir Malik, was elected onto the Group Board.

## Governance review continued

### Performance evaluation

The Code requires the Board to undertake a formal and rigorous annual evaluation of its own performance and of its Committees and individuals.

No internal or external assessment of the main Group Board took place during the year due to Board commitments in respect of the recapitalisation of the Co-operative Bank. However, the annual self-assessment of the Group Audit and Risk Committee was completed in December 2013.

The Governance Review will include an overall assessment of the effectiveness of the Board and its sub committees, including skills and experience and will make recommendations based on its findings.

### Induction and continuing professional development

The Co-operative Group is committed to providing effective learning and development for all its Directors. In line with the Code, all newly elected directors are required to undertake a structured induction programme designed to include key corporate governance and business information, including briefing sessions with executive management on the strategy and performance of key business areas. During 2013, the four new Directors participated in these sessions.

A Board Learning and Development Policy supports all directors. Thematic learning and development sessions for Boards and Board Sub Committees have taken place periodically. For example, Members of the Group Audit and Risk Committee received training on Tax, Pensions and IT processes and systems, and Members of the Specialist Businesses Board received training on the Pharmacy governance framework.

In addition, directors receive 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.

All directors have the opportunity to attend meetings of the subsidiary Boards or any of the Committees as observers. Director development includes regular visits to key trading outlets and meetings with senior executives where appropriate, together with round table sessions on specific areas.

Individual learning and development records are issued to all non-executive directors summarising activity undertaken through the year.

### Succession planning

The term of office of one third of the Board expires each year, giving the opportunity for new directors with different skills and experience to be elected to the Group Board. To ensure that newly appointed directors have the skills and knowledge required to effectively undertake their duties, all candidates must have completed the Group Board Development Centre qualification in advance of being nominated to stand for a position on the Group Board.

The Development Centre requires the submission of 'a portfolio of evidence' in respect of eight competencies, followed by a 'professional discussion' with an independent assessor. The eight competencies being: Strategic; Financial; Co-operative Group Knowledge; Values & Principles; Stakeholder; Legal Responsibilities; Business and Analytical.

The Group Board considers its appointments to its main Subsidiary Boards and Committees on an annual basis. Directors are asked to indicate their interest to serve on a Board or Committee. This is then considered by the Group Remuneration and Appointments Committee which makes recommendations to the Group Board based on the individual skills and experience of Directors.

### Conflicts of interests

The Board has adopted a Conflicts of Interests Policy, which is contained within the Code of Conduct for Directors and the Group Rules.

The Policy outlines how conflicts of interest will be dealt with and the process for directors to follow when notifying the Group of an actual or potential conflict. When deciding whether to authorise a conflict or a potential conflict of interest, only those that have no interest in the matter under consideration are able to take part in the decision, vote on the matter, or be counted towards the quorum for that part of the meeting.

The potential for conflicts of interest to arise where directors are elected by Independent Society Members to sit on the Group Board is recognised, and the most appropriate governance response to this situation (which flows from the current Rules of the Group) is one of the factors that will be considered by the Governance Review commissioned by the Board.

The Board has considered the current external appointments of all directors which may give rise to a situational conflict and has authorised potential conflicts where appropriate.

### 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. As a key role of the Group is to provide a federal service to its Independent Society Members, significant 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.

### Insurance and indemnities

The Group maintains appropriate directors' and officers' liability insurance cover in respect of legal action against its directors and officers in relation to Group business. The insurance cover was reviewed and renewed in 2013.

The directors, the Group Secretary and the other Group 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.

### Professional advice and Board support

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 the furtherance of their duties.

# Group Audit and Risk Committee report



## The Group Audit and Risk Committee is extremely supportive of the latest UK Corporate Governance Code.

Although it has been noted that the Group is not required to comply with the Code, the Committee has agreed that the Group should seek to comply with the spirit of the Code and best practice guidelines where it is able, as it allows the Committee to further strengthen its role as an independent oversight Committee and to add value to the Group.

To this end, a review of the requirements of the Code will be undertaken during the year and recommendations made as appropriate.

### Introduction from the Committee Chair

The Code invites the Committee to report on the significant issues considered during the year. Details considered by the Committee are contained later in this report, however from my perspective, without a doubt, the two most important issues were:

- i. the affordability and financial proposals surrounding the proposed acquisition of 632 bank branches from Lloyds Banking Group; and
- ii. the recapitalisation of the Co-operative Bank plc.

In addition to routine business, the focus for the Committee for the next year will include:

- i. the Group's debt and funding position;
- ii. the impact on the Group's strategy of the resignation of the Chief Executive Officer;
- iii. the monitoring of the Group's 30% equity holding in the Co-operative Bank plc;
- iv. the governance and monitoring of the Co-operative Banking Group (CBG) and its subsidiary entities;
- v. funding and valuation of the Group's pension schemes; (vi) the impact of restructuring and the cost reduction programme – Project Orion; (vii) business and asset disposals; and
- vi. the carrying value of intangible and tangible fixed assets.

**Martyn Cheatle**  
Chair

## Group Audit and Risk Committee report continued

### Group Audit and Risk Committee

#### The Role of the Group Audit and Risk Committee

In addition to specific arising issues, the Committee works to an annual schedule of regular standing items, which it is required to do under its terms of reference. Items on the agenda are focused to coincide with the Group's annual financial reporting cycle. The Committee regularly reports its findings to the Group Board and where appropriate, the Food and Specialist Businesses Subsidiary Boards.

The main responsibilities of the Committee are set out in its terms of reference which are available on the Group's website: [www.co-operative.coop](http://www.co-operative.coop). These include to:

- Monitor the integrity of the Group's published financial statements and financial information
- Review the quality and effectiveness of the external audit and the procedures and controls to ensure auditor independence
- Review and monitor the effectiveness of the internal audit function
- 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 the effectiveness of the Group's systems of internal controls and the processes for monitoring and evaluating the risks facing the Group
- Review the Group's systems and controls in relation to employee and stakeholder whistleblowing procedures

The Group Audit and Risk Committee also has responsibility for oversight of the Co-operative Banking Group (CBG), which included the Co-operative Bank plc until the point of its separation from the Group on 20 December 2013. Up until that point, the CBG Audit Committee and CBG Risk Committee both reported into the Group Audit and Risk Committee via their respective committee chairs.

In anticipation of the Bank separation, the Bank established a separate Audit Committee on 30 August 2013, and this Committee gave separate reports to the Group Audit and Risk Committee up until the point of separation on 20 December 2013 and also at subsequent committee meetings as part of the year end process. The Group Audit and Risk Committee will continue to monitor its 30% holding in the Bank.

The entities which fall under CBG include: Co-operative General Insurance Ltd, The Reclaim Fund Ltd, and CFS Management Services Limited (CFSMS), will for the time being, report directly into the Group Audit and Risk Committee whilst a review of governance of this area is undertaken.

The terms of reference were reviewed during the year to ensure they remained appropriate to the Group's key focus areas.

#### Composition of the Group Audit and Risk Committee

The Committee is appointed by the Group Board and comprises four Members as follows:

- Martyn Cheadle (Chair of the Committee)
- Marc Bicknell
- Duncan Bowdler
- Patrick Grange
- Mark Smith

Steve Watts served as a member of the Committee until 19 May 2013, when he stepped down as a main Group Director. Ursula Lidbetter also stepped down as a member of the Committee following her appointment as Group Chair on 19 November 2013. Marc Bicknell was subsequently appointed to the Committee on 10 December 2014.

The Board considers that the varied background of all Members of the Committee, and their collective skills, knowledge and experience of the Group, allows them to fulfil the Committee's remit and to oversee the Group's auditors. There are three Members of the Committee who are considered by the Board to possess recent and relevant financial experience. Mark Smith and Martyn Cheadle are both certified accountants and Marc Bicknell is a Chartered Accountant and a Local Authority Chief Internal Auditor. Due to the nature of the Group's constitution, there are currently no independent non-executive directors serving on the Committee.

At the invitation of the Chair, the Chief Executive, Chief Financial Officer, Director of Group Internal Audit, Group Financial Controller and Head of Accounting, together with other senior management, attended Committee meetings as appropriate. The external auditors also attend Committee meetings and a private meeting is routinely held with the internal and external auditors to allow them the opportunity for discussions without the presence of management.

During the year under review, the Chair of the Co-operative Banking Group Audit Committee together with the Chair of the CBG Risk Committee, also attended meetings of the Committee.

#### Number of Group Audit and Risk Committee meetings and attendance

During the year, the Committee met eight times. This was four more than scheduled as dedicated meetings were held to focus on the two major areas for the Group this year. Full details of Directors' attendance at Committee meetings is shown on page 35.

#### Activities of the Group Audit and Risk Committee during the year

In addition to regular governance items, the Committee focused on two major areas during the year:

- Lloyds Bank Branch Financial and other Assets – the Committee considered in detail the scope and findings of the financial and other due diligence surrounding the proposed transaction by the Group's then subsidiary, the Co-operative Bank, of the acquisition of 632 bank branches of Lloyds Banking Group. On 24 April, 2013, the Group announced that it had withdrawn from the process as it was not deemed to be in the best interests of the Group's Members.
- Recapitalisation of the Co-operative Bank plc – in June, 2013, it was announced that the Bank required additional Common Equity Tier 1 capital in order to meet current and longer-term requirements. The Group, as ultimate parent at the time, put in place a detailed and comprehensive solution to meet these capital requirements in order to ensure the future of the Bank. The Committee reviewed and closely monitored these plans throughout the year and will continue to do so until all its commitments have been met.
- Review of the Group's financial position and financing arrangements
- Review of the Internal Control environment

In addition the Committee focused on the following key issues during the year:

- A review of the published financial information, including the Annual and Interim reports. To assist with consideration of these, reports were received by management and the external auditor.

## Group Audit and Risk Committee report continued

- The process surrounding risk in the Group continued to be monitored by the Committee and in particular detailed reports were received on: the proposed acquisition of the Lloyds banking branches and the LME;
- The Committee received regular reports from KPMG and representatives from KPMG were consulted throughout the debates during meetings;
- An annual review of the Group's Pension Schemes was undertaken and the Committee also received a whistleblowing and anti-bribery report;
- Principal accounting matters affecting the Group based on reports from both Group management and the external auditors.

### Annual review of effectiveness

During 2013, the Committee conducted a review of its performance and the results of this review have been reported to the Committee.

### Training for committee Members

Although much of the focus during the year was firstly on the proposed Lloyds acquisition, then latterly on the recapitalisation of the Bank, the Committee undertook training sessions during the year which covered: Pensions Risk and Valuation; Taxation Strategy and IT risks. A training schedule is agreed each year which is designed to ensure sufficient time is dedicated to regulatory updates and changes in best practice.

### External auditor

The Group's auditor is KPMG Audit Plc.

One of the duties of the Group Audit and Risk Committee is to make recommendations to the Board in relation to the appointment of the external auditors. In line with good corporate governance an external audit tender exercise last took place in 2011.

At the Annual General Meeting held on 18 May 2013, Members agreed to re-appoint KPMG Audit Plc as auditor of the Group. Given the current challenges facing the Group, it is essential that the auditors have an in-depth understanding and knowledge of the Group's business operations. Continuity is important to the Group and the Board has therefore decided to put KPMG LLP forward (as KPMG Audit Plc has instigated an orderly wind down of business). A resolution concerning their appointment will be put to the forthcoming 2014 Annual General Meeting.

### Independence, objectivity and fees

The Committee regularly reviews the other services being provided to the Group by the external auditor and has in place a formal policy to ensure that this does not impair their independence or objectivity.

During the year, the Committee reviewed and updated its policy on the provision of non-audit services and the employment of external auditors.

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 external auditors are permitted to provide some non-audit services that do not conflict with their independence and at each meeting; the Committee receives a report providing details of assignments (including fees) carried out by the external auditors, in addition to their statutory audit work. Pre-approval of the Committee is required for services above certain thresholds determined by the Committee. In addition, the following 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 and Risk Committee may determine.

Recognising the substantial changes in management and improvements in systems, processes and controls implemented across the Group, in 2013 the audit committee requested KPMG extend the mandate of the audit partner by a year to cover the financial statements of the period ended 4 January 2014, to maintain and enhance audit quality.

In line with good practice, the External Audit partner is required to rotate from his role following the signing of the 2013 year-end accounts. Succession plans were discussed both with Executive Management and with the Committee Chair and a new audit partner was introduced into the External Audit team at the beginning of 2014 to prepare for succession of the existing partner.

### Performance

The Committee's normal practice is to undertake a formal annual assessment of the performance of the external auditor, through questionnaires and feedback completed by senior managers and Directors. However, due to unforeseen business pressures this was not completed during 2013.

### Internal Audit

Internal Audit is an independent appraisal function that derives its authority from the Group Board through the Group Audit and 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 out 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.

Internal Audit also acts as and is 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.

Internal Audit reports are submitted to the Group Audit and Risk Committee on a regular basis, with significant issues being discussed by the 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 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 key elements of the system of internal control are aligned to the recommendation of The Committee of Sponsoring Organisation of the Treadway Commission (COSO). The system is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against misstatement or loss.

## Group Audit and Risk Committee report continued

Assisted by the Group Audit and Risk Committee, the Group Board formally reviews the effectiveness of the system of internal control annually. The internal control framework 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
- 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 and action 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 Code
- Internal audit, compliance and operational functions that review the system of internal control, including a financial control self-assessment process

### Risk assessment

The Group Board and Executive Management teams have the primary responsibility for identifying the key business risks facing the Group. Management is responsible for identifying the risks facing the business and for establishing controls and procedures to monitor and mitigate those risks. The Board is responsible for ensuring that there is a robust risk management process and for regularly reviewing the identified key risks. Details on the Group key risks can be found on pages 23 to 28.

Each business has a risk register that identifies the likelihood and impact of risks within their area 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 Committee. The information is consolidated for the Group Risk Management Committee, which provides reports on how these risks are being managed to the Group Audit and Risk Committee.

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.

Attendees at the Group Risk Management Committee meetings include the Chief Executive (Chair), the Chief Financial Officer, the Group Secretary, the Head of Planning and Reporting, (Secretary to committee), the Pensions Finance and Risk Controller, the Director of IT Operations and the Director of Group Internal Audit. Up until the Bank separation on 20 December 2013, the CBG Chief Risk Officer also attended meetings.

### Control activities

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.

### 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. In addition, colleagues receive a regular Chief Executive's business update electronically via the internal intranet site.

### 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, to 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.

A key part of the process of assessing internal control, by the Group Audit and Risk Committee, is an annual 'letter of assurance' process. In this Executive Management confirm they have assessed the effectiveness of the systems of internal controls they are responsible for. This includes compliance with Group policies, local laws and regulations and any key control improvements required. The outcome of these assurances are reported to the Group Audit and Risk Committee. The directors are then able to review the system of internal controls and ensure it complies with relevant regulatory guidance.

The Audit and Risk Committee considers that there have been no material losses or contingencies that have not been disclosed.

# Remuneration report

## Committee Chairman's summary

I am pleased to present the Remuneration and Appointments Committee's (the 'Committee') Remuneration Report for 2013.

2013 was a difficult year for the Group and this has continued into early 2014 with changes to our Board and Executive team dominating the activities of the Committee. In May 2013, the crisis in our Bank highlighted the under-investment in skills at the top of the Group and the urgent need to re-shape and strengthen the Group Executive team. We responded to this by recruiting a number of experienced executives from outside the Group. This team worked to save the Bank, without recourse to taxpayer money and, in doing so, prevented significant brand and potential financial damage to the Group.

Due to the extraordinary circumstances around this time, and the urgent need to secure the commitment of the Executive team and attract the skills required to deal with the Bank crisis, its aftermath and the turnaround agenda the Committee decided to put in place a two-year retention scheme (the 'Retention Programme'). Further details of the programme are included in this report. The current Executive members have agreed that the 2014 Retention Programme payment is now subject to performance measures.

As we move away from the immediate issues of 2013, further changes have been made to the Executive team to create a smaller, more efficient team, but with bigger roles with increased responsibilities compared to previous years. The Committee believes this team has the potential to lead the Group through the period of turnaround. As part of these changes, Mark Craig, Director of Co-operative Relations and Rebecca Skitt, Chief HR Officer, have left the Group. In addition, Martyn Hulme, Managing Director Co-operative Estates, Gill Barr, Marketing Director and Andy Haywood, Chief Information Officer, have left the Executive though continue to oversee their respective functions within the business. Rod Bulmer, Paula Kerrigan and Sam Walker have joined the Executive as CEO Consumer Services, Chief Strategy Officer and Chief HR Officer respectively. In addition, Claire Davies joined in March 2014 as the Group Secretary following the retirement of Moira Lees in December 2013.

In March 2014 Euan Sutherland resigned as Group Chief Executive and subsequently waived his right to his 2013 payment under the Retention Programme. Pending a new CEO being recruited, the Committee is pleased that Richard Pennycook has been appointed to this role on an interim basis. Richard is highly experienced and capable and has already created an Executive team to drive the turnaround and changes in the Group.

The Committee considers it important that the total target remuneration package for Executive team Members is around market median for companies of a similar size to the Co-operative Group. Given the nature of the Group's ownership, we cannot award share options or other share-based incentives to Executives, so in structuring median-level remuneration packages, we have given greater weight to base salary to ensure total reward is competitive with peers and we can attract the level of talent and capability required for the future. In addition, Richard Pennycook will receive an allowance of £400,000 per annum during his period as interim Group Chief Executive. This is not pensionable, is not included in calculations of bonus or long-term incentive plan ('LTIP') and will not increase any payments he may be due under the 2014 Retention Programme.

The re-shaping of the Executive team in 2013 and the recent changes to its composition have also meant that the Committee had to oversee the exit of former Executives. We know that Members feel passionately about the issue of executive pay and in particular about rewards for failure. The Committee and Board share those concerns. We have looked at all payments for those who have left on a case-by-case basis, with individuals only receiving what the Group is contractually obliged to pay plus an element to compensate for statutory employment obligations where necessary.

This report includes the details of settlement agreements for Stephen Humes, Martyn Wates, Rebecca Skitt and Mark Craig.

In terms of the Board changes, Paul Flowers left the Group Board and other associated roles on 12 June 2013 and Len Wardle resigned from his position as the Group Chair on 18 November 2013 (further details are on page 58). The Committee was pleased that Ursula Lidbetter took up the role of Group Chair following Len's departure and that Lord Myners agreed to join the Board as the Senior Independent Director. Lord Myners does not intend to stand for re-election at the 2014 Annual General Meeting ('AGM').

Looking more widely to reward for the Group as a whole, a review of the reward strategy for all colleagues across the Group is underway, from which new remuneration policies are being developed. Some components of the new remuneration policy for Executives are already in place with the Retention Programme and re-positioning of base salary levels to reflect increased roles and responsibilities. The reward strategy review will form a key part of the Committee's work for 2014 and remuneration policies across the Group are expected to be adopted in 2015. The reward strategy development work will be shared in more detail at the AGM in May 2014, but in overview, the Committee is committed to reviewing the base pay structures for all colleagues, reviewing total compensation and market positioning for all colleagues and reviewing how bonuses apply to the whole organisation, whilst ensuring that the new policy is aligned to the outcomes of the Strategic and Governance Reviews at all levels.

## Major decisions on Executive remuneration

The major decisions taken by the Committee (against the context and background discussed above) were:

- The urgent need to deal with the crisis facing the Group and turnaround the business led to new, experienced Executives being recruited.
- In order to retain the high calibre Executives already in place and attract the additional skills required to strengthen the team, the Retention Programme was agreed by the Committee in May 2013.
- A redesigned 'Turnaround LTIP' was adopted for 2013-2015 based on specific, business focused performance targets that are key to the delivery of the turnaround plan.
- Deciding to pay zero under the 2011-2013 LTIP due to the events of 2013.
- For departing Executives, the Committee considered the most appropriate course of action, requiring some Executives to be placed on garden leave, and in each case, not paying more than was necessary under contractual obligations but including an element to compensate for statutory employment obligations where necessary.

## Remuneration report continued

- Agreeing new remuneration packages for Executives with increased roles and responsibilities following further changes to the Executive team.
- Agreeing that zero bonus should be payable under the Annual Incentive Plan for the year 2013 for colleagues in our management grades. However, whilst the vast majority of colleagues did not receive a bonus, a discretionary bonus was agreed to reward high performers for their contribution throughout the year and to colleagues in high performing business units. Consideration for a discretionary bonus relating to 2013 was also extended to colleagues in lower levels who have not previously been eligible for a bonus scheme in addition to awards being made at all levels within our top 40 performing food stores.

### Remuneration policy:

- This report reflects the current remuneration policy in place for Executives. As noted above this is under review as part of the wider review of reward strategy and the new remuneration policy for the Executives will seek to align reward and performance, whilst underpinning the strategy of the Group.
- As in previous years, this report will be put forward for an advisory vote only at the AGM on 17 May 2014. As a result of the significant work being undertaken on reward strategy and remuneration policies, the Committee does not propose to put the current remuneration policy forward for a binding vote at the 2014 AGM as a new policy is being developed.

### Disclosure

The Group is required to produce its accounts in accordance with the Industrial and Provident Society Acts 1965 to 2003, the Industrial and Provident Societies (Group Accounts) Regulations 1969 and applicable accounting standards.

Where possible and appropriate, and in the interests of good practice, the Group has used the new disclosure requirements applicable to quoted companies, as set out in the Large and Medium Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (the 'Regulations') as a guideline for its disclosure in relation to remuneration. Although not mandatory for the Group, our aim is to report in line with requirements and other governance codes applicable to quoted companies. This report does not include the new disclosures in the Regulations which show year on year comparative data, due to the upgrade in calibre of the Executive team and the increased remuneration packages to support this upgrade, and the Committee's view that year on year comparisons are therefore not relevant for this 2013 Remuneration Report.

Additional information is provided in this report in accordance with the Committee's terms of reference.

### Members' views

The Committee is committed to openness and transparency, taking the views of Members into account.

**Eric Calderwood,**  
Remuneration and Appointments Committee Chairman

## Remuneration report continued

### Remuneration and Appointments Committee (the 'Committee')

#### Role of the Committee

The Committee is responsible for determining and overseeing the Remuneration Policy for the Group to ensure a consistent approach across the Group and its subsidiaries.

#### Terms of reference

The Committee's terms of reference were revised and approved by the Group Board on 17 July 2013. The principal terms of reference are to:

- Determine policy on remuneration and other main terms and conditions of employment in respect of all Group employees who are Members of the Group Executive ('Executives');
- Oversee contractual arrangements for Executives and approve the principal terms and conditions of their employment;
- Review remuneration using comparisons against market benchmarks for the Executive roles;
- Make recommendations on Executive appointments and the terms and conditions relating to these;
- Approve any relevant variable pay schemes and ensure that they support the Group's strategy, values and objectives, and authorise payments under any variable pay schemes in line with their rules; and
- Receive, review and decide on issues raised in relation to retirement benefit schemes across the Group and advise the Board on these issues as appropriate.

In respect of the Directors, including the Independent Professional Non-Executive Directors ('IPNEDs'), on the Group Subsidiary Boards, the Committee's responsibilities include:

- Ensuring there is a timely review of the remuneration and expenses policy for directors and agreeing the process and resource for an independent review;
- 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, avoids conflicts of interest 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; and
- 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.

#### Independent advice

In carrying out its responsibilities, the Committee has access to independent advice as required. During 2013, the Committee retained New Bridge Street (an Aon Hewitt company) as its independent remuneration adviser. 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, New Bridge Street does not provide other services to the Group and on this basis, the Committee considers New Bridge Street to be operating in an independent manner.

New Bridge Street is a signatory of the Remuneration Consultants' Code of Conduct which requires its advice to be objective and impartial.

Hogan Lovells has recently been appointed to provide independent legal advice to the Committee as required.

#### Members

The Members of the Committee during the 2013 financial year:

- Eric Calderwood, Committee Chair (appointed to Committee Chair on 17 July 2013)
- Ursula Lidbetter
- Steven Bayes (appointed to the Committee on 9 April 2013)
- Patrick Grange (appointed to the Committee on 17 July 2013)
- Liz Moyle (appointed to the Committee on 17 July 2013)
- Chris Herries (resigned on 18 May 2013)
- Len Wardle (resigned on 19 November 2013)
- Steve Watts (resigned on 18 May 2013)
- Paul Flowers (resigned on 12 June 2013)

The Group Chief Executive, the Group Secretary and the Group Chief HR Officer are also invited to attend the meetings of the Committee, but are not present 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 Group Board believes that all Members of the Committee are independent for the purpose of reviewing remuneration matters.

The Committee met 13 times in the period under review.

The Committee Chairman's summary provides an overview of the major decisions taken by the Committee during the year.

#### Executive Remuneration policy

As discussed previously, a new Executive remuneration policy is being developed as part of the reward strategy review and therefore the Committee does not consider it appropriate to put the existing remuneration policy forward for a binding vote at the 2014 AGM. The remainder of this section describes the remuneration components and policy currently in place, and that applied to the Executives during 2013.

For the year 2013, a number of factors influenced the approach to the remuneration policy for Executives including:

- The importance of attracting senior Executives with the required skills and experience.
- Ensuring these Executives were retained throughout the period of crisis.
- Creating an Executive team capable of leading the Group going forward which has led to a smaller team, each with bigger roles and responsibilities.
- Establishing links between reward and performance. For example payments under the 2013-2015 Turnaround LTIP are subject to performance measures which are based on specific turnaround objectives, including recapitalisation of the Bank, cost savings and other business critical issues.

## Remuneration report continued

### Remuneration policy table for 2013

The main components of Executive remuneration are summarised in the table below:

	Element	Link to strategy	Summary and operation	Maximum opportunity	Clawback provision	Change since 2012?
<b>Fixed elements</b>	Base salary	Compensation to attract and retain talented leaders needed to guide and lead the Group.	Reviewed annually. Experience and performance levels taken into account when considering benchmarks.	Usually, any increases would take account of increases for the wider employee population, unless there are exceptional circumstances. Base salary levels were re-positioned as part of the re-shaping of the Executive team in 2013 and more recently following the changes in the Executive team resulting in bigger roles with greatly increased responsibilities and base salaries have been increased to reflect this.	N	N
	Benefits <sup>1</sup>	Competitive benefits proposition ensures talent is attracted/retained and able to undertake duties.	Benefits are provided in line with normal market practice, including car allowance, fuel, healthcare cover and life cover.	Car allowance £16,000. Healthcare cover at family level.	N	N
	Pension <sup>2</sup>	To provide competitive pension and protection benefits to attract and retain talented leaders.	The Group provides either a Defined Benefit or a Defined Contribution pension plan (on the same basis as applies to all other employees in the Group) and/or an allowance so that the total value of the pension element is broadly the same as the value of the Defined Benefit pension plan.	Defined Benefit pension plan accrual (when eligible) and/or cash alternative of up to 16% of salary or employer pension contributions of up to 16% of salary.	N	N
<b>Variable elements</b>	Annual Incentive Plan ('AIP')	For 2013 and 2014, the Executives are not eligible to participate in the AIP. For these years, the AIP has been replaced with the Retention Programme. From 2015 onwards, the intention is that the Executives will participate in the AIP.			N/A	Y
	Long-Term Incentive Plan ('LTIP')	To incentivise senior management towards the achievement of long term specific performance targets and results, and promote the behaviours considered by the Committee to be key to the success of the Group.	The 2013-2015 Turnaround LTIP is intended to address specific business issues and focus Executives on performance aspects deemed critical to the future success of the Group. The performance measures are: to re-capitalise the Bank; to successfully rebalance the cost base of the Group and achieve cost saving targets; establish a revised senior leadership structure and populate to the satisfactory of the Committee and operate a revised performance management process for the whole Group by the end of 2015; to have defined, communicated and embedded in the financial plan a new Group purpose and strategy; and safeguard the reputation of the Group throughout the turnaround. At the end of the performance period, the Committee will assess the overall performance of the Group and can reduce any payments under the 2013-2015 LTIP as it determines appropriate.	For the 2013-2015 LTIP cycle, maximum potential opportunity is 100% of salary for the Executives.	Y	Y
<b>Other</b>	Retention Programme	To retain the Executives throughout the crisis and the period of turnaround.	This is a two year programme which replaces the AIP for 2013 and 2014. Payments are made to Executives in each year, equal to the maximum potential bonuses that would be due under the AIP. Payments under the 2014 component of the Retention Programme are subject to performance conditions.	100% of salary for 2013 and 2014.	N	Y

Notes to the table:

1 Benefits

It is the Committee's policy to ensure that the benefits for each Executive are appropriate and competitive in regard to market practice. As is commonplace, there are a number of benefits which relate to hierarchy and at managerial grades healthcare benefit and car allowance would be applicable. There are Group-wide benefits which are generally the same for Executives and all other employees in the Group, for example employee member dividend and staff discounts.

2 Pensions

The Group offers every employee the opportunity to join a registered occupational pension scheme.

## Remuneration report continued

Executives have the option to join The Co-operative Pension Scheme ('Pace') or take a cash allowance in lieu of pension.

Pace includes the defined benefit section (Pace Complete) and the defined contribution sections (Pace Essential and Pace Extra). All employees can choose to join Pace Complete once they have completed two or more consecutive years' service.

- Pace Complete provides defined benefit pensions based on 1/60th of average pensionable earnings, revalued by inflation for each year of pensionable service. Benefits accrued as at 5 April 2006, in respect of Membership of the scheme preceding Pace, continue to be linked to final pensionable salary at a member's date of leaving or retirement, whichever is earlier. Benefits accrued as at 6 October 2012 in respect of the closed United Norwest Co-operatives Employees' Pension Fund ('the United Scheme') also continue to be linked to final pensionable salary. Both schemes also provide pensions to dependants on death.
- Members of Pace Essential, into which all eligible employees will be automatically enrolled, currently pay 1% of pay and the Group pays 2%. Members of Pace Extra, which is available to all employees, currently pay 4% of pay and the Group pays 8%.
- Under all sections a lump sum is payable if death occurs in service.
- All Members of Pace have the choice of making pension contributions by salary sacrifice.

Executives who are Members of Pace Complete currently contribute 8% of their pensionable salary or 7% of pensionable salary (until October 2013) if they were a contributing member of Pace at 31 December 2011. The Group pays the balance of the cost of providing defined benefits.

Where an Executive may be impacted by the Annual Allowance or the Lifetime Allowance they have the facility of opting out of future pension accrual in favour of a pension allowance or opting for restricted pension accrual based on a capped pensionable salary of £187,500 and receiving a restricted pension allowance in lieu of pension provision based on salary above £187,500. Where paid, the rate of pension allowance is based on the employer contribution rate to Pace Complete. This is currently 16% of pensionable salary.

Executives who join Pace Extra are provided with an additional 8% of pay as a pension contribution or pension allowance for the period they are ineligible to join Pace Complete.

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

## Additional information/footnotes

### Clawback

Clawback provisions apply to annual and long-term incentive arrangements (not including the Retention Programme). This enables the Committee to seek to recoup part or all of an annual or long-term incentive payment if the Group's results were materially misstated or should have been assessed materially differently or where an individual ceases to be employed by the Group as a result of misconduct.

## Any differences in policy of the directors and the wider employees

Remuneration policies for employees generally include annual pay review and all-employee benefits. Senior employees can receive additional benefits such as car or car allowance, and could be eligible to participate in long-term incentives. As above, a review of reward strategy is underway across all colleagues from which new organisation-wide remuneration policies are being developed with the view of implementation in 2015. As above, this review will consider the base pay, bonus and other variable pay arrangements for all colleagues and work is currently being undertaken to understand the different market comparisons of total compensation for each business area to help us define intentions for the future.

## Approach to recruitment remuneration

The remuneration package for an externally recruited new Executive would be set in accordance with the remuneration policy applicable to Executives, for example, a new Executive would participate in the annual and long term incentive arrangements on the same basis as existing Executives.

The following additional items of remuneration would be considered when recruiting an Executive:

- Relocation. In exceptional circumstances and where necessary, the Committee would consider contributing towards relocation costs.
- Forfeiture of previous awards. The Committee will consider compensating a new Executive for variable remuneration awards lost from a previous employer. The exact type and amount will vary depending on the variable remuneration plans operated by the previous employer. Any awards will not be more generous than, and will mirror as far as possible, the terms of the forfeited awards.

## Service contracts and exit payment policy

It is the Group's policy that the notice period in Executives' service contracts should not exceed one year. All the Executives have contracts which can be terminated by one year's notice. In the event of termination, the Committee would seek to minimise payments due to an Executive and these would be based on contractual obligations plus an element to compensate for statutory employment obligations where necessary.

Where it is deemed commercially beneficial for an individual to remain under a contract of employment with the Group, they are placed on garden leave and only contractual payments are made. The Committee has discretion, to determine whether, and to what extent, a leaver is permitted to retain LTIP awards they hold, and to retain eligibility for annual bonus in respect of the period they have served. In exercising its discretion the Committee will take account of the reasons for leaving, performance and contractual commitments.

## External appointments

Subject to the Committee's approval, Executives may accept normally no more than one external, non-executive appointment, where the Committee determines that this does not conflict with the performance of their duties with the Co-operative Group, and where the appointment further develops the individual's skills and experience for the benefit of the Group. Provided the external appointment is not related to the Executive's role with the Group, they are normally permitted to retain the non-executive fees they may earn for the appointment.

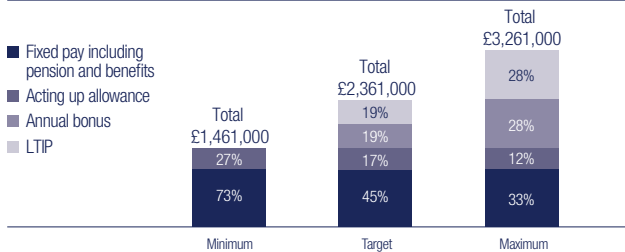
## Remuneration report continued

### Illustrations of application of remuneration policy

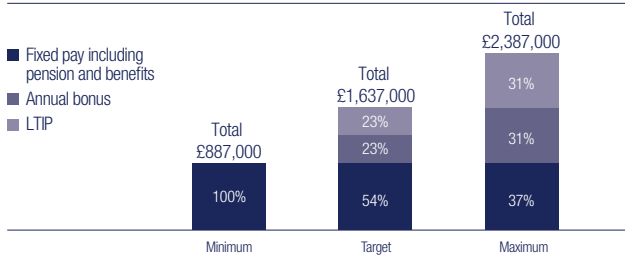
The charts below are to illustrate the potential remuneration packages for two Executives in a future year when an annual bonus scheme and LTIP are operating, i.e. these charts are not based on the remuneration arrangements in place for the period of turnaround and therefore do not include the Retention Programme. The charts also do not include any one-off arrangements for example relocation or compensation for forfeited awards at a previous employer. The Executives which have been chosen for this are Richard Pennycook in his capacity as Interim CEO and Steve Murrells as the CEO of the largest business within the Group, the Retail business.

Once the new Executive remuneration policy is in place, updated charts to illustrate this future policy will be included in the relevant remuneration report.

#### Interim Chief Executive Officer – Richard Pennycook



#### Chief Executive Officer, Retail – Steve Murrells



Assumptions used in these charts:

- Maximum annual bonus of 100% of salary.
- Maximum opportunity under an LTIP award of 100% of base salary.
- Acting up allowance included for Richard Pennycook of £400,000 per annum.
- Annual bonus and LTIP payments at target performance are assumed to be half of maximum opportunity.
- Fixed pay includes annual equivalent base salary as at 4 January 2014, estimated value of benefits (being car allowance of £16,000 and healthcare benefit of approximately £1,000) and pension benefit equivalent to 16% of salary.

### Statement of considerations of employment conditions elsewhere in the Group

As mentioned previously, a review of reward strategy is underway covering all colleagues with the view of implementing new remuneration policies in 2015. Specific focus will be given to the base pay, bonus and other variable pay arrangements for all colleagues with the intention of ensuring that total compensation is fair and appropriate and the pay arrangements for all colleagues will be taken into account in developing the remuneration policy for the Executives.

## Remuneration report continued

### Annual Report on remuneration

#### Single figure of remuneration

The tables below show the remuneration received by the Executives during the 2013 financial year.

**Table 1a – 2013 remuneration for Executives in post as at 4 January 2014**

	Date of appointment (Note 1)	Date of stepping down from Executive	Base salary	Taxable benefits	Annual performance related bonus	Long term performance bonus	Pension benefits	Retention Programme	Other	Total	Base salary	Taxable benefits	Annual performance related bonus	Long term performance bonus	Pension benefits	Other	Total
			(Note 2)	(Note 3)	(Note 4)	(Note 5)	(Note 6)	(Note 7)	(Note 8)	(Note 2)	(Note 3)	(Note 4)	(Note 5)	(Note 6)	(Note 8)	(Note 9)	
			2013	2013	2013	2013	2013	2013	2013	2013	2012	2012	2012	2012	2012	2012	2012
			£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Euan Sutherland	1 May 2013	11 Mar 2014	1,000	1	–	–	161	–	1,000	2,162	–	–	–	–	–	–	–
Alistair Asher	1 Jul 2013		245	9	–	–	39	475	–	768	–	–	–	–	–	–	–
Gill Barr	31 Jan 2011	17 Mar 2014	314	17	–	–	67	314	–	712	313	18	–	–	71	–	402
Mark Craig	1 Sep 2010	17 Mar 2014	188	23	–	–	41	188	–	440	188	25	–	–	9	–	222
Nick Folland	11 May 2013		265	11	–	–	44	425	165	910	–	–	–	–	–	–	–
Andy Haywood	4 Jan 2012	17 Mar 2014	334	17	–	–	74	350	–	775	303	17	–	–	57	77	454
Martyn Hulme	1 Sep 2010	17 Mar 2014	287	17	–	–	81	300	–	685	265	18	50	6	37	–	376
Steve Murrells	16 Jul 2012		642	32	–	–	103	650	188	1,615	296	16	–	–	48	246	606
Richard Pennycook	1 Jul 2013		429	16	–	–	72	750	–	1,267	–	–	–	–	–	–	–
Rebecca Skitt	11 Mar 2013	12 Feb 2014	489	6	–	–	79	650	–	1,224	–	–	–	–	–	–	–

## Remuneration report continued

### Table 1b – 2013 remuneration for Executives who left during the 2013 financial year

Notes	Date of appointment (Note 1)	Date of stepping down from Executive	Base salary	Taxable benefits	Annual performance related bonus	Long term performance bonus	Pension benefits	Retention Programme	Other	Total	Base salary	Taxable benefits	Annual performance related bonus	Long term performance bonus	Pension benefits	Other	Total		
			(Note 2)	(Note 3)	(Note 4)	(Note 5)	(Note 6)	(Note 7)	(Note 8)	(Note 2)	(Note 3)	(Note 4)	(Note 5)	(Note 6)	(Note 8)	(Note 2)	(Note 3)	(Note 4)	(Note 5)
			£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000		
Peter Marks	10	29 Jul 2007	18 May 2013	455	16	–	–	59	–	–	530	1,014	44	–	103	171	–	1,332	
Stephen Humes	11	1 Jan 2011	15 May 2013	179	6	–	–	57	–	–	242	499	17	–	9	86	–	611	
Wayne Lee	12	1 Oct 2012	10 Mar 2013	42	1	–	–	–	–	–	43	63	2	–	5	–	–	70	
Moira Lees	13	28 Nov 2007	20 Dec 2013	320	16	–	–	79	350	–	765	302	17	–	23	51	–	393	
Martyn Wates	14	24 Sep 2007	27 May 2013	230	9	–	–	72	–	–	311	591	23	197	59	100	–	970	
Barry Tootell	15	22 Jul 2011	10 May 2013	182	7	–	–	41	–	–	230	522	18	–	–	102	–	642	
Niall Booker	16	10 Jun 2013	20 Sep 2013	346	3	–	–	31	–	–	380	–	–	–	–	–	–	–	

#### Notes to Tables 1a and 1b

- The date of appointment may differ from the date service commenced with the Group.
- 2013 base salaries are for the 52 weeks ending 4 January 2014 and 2012 salaries are for the 53 weeks ending 5 January 2013, and for new/former Executives, the figures relate to the period from commencing/up to ceasing their role as an Executive.
- Taxable benefits include car, fuel, car cash allowance, employee member dividend and healthcare (where applicable).
- Annual performance related bonus refers to the bonus in respect of the relevant financial year under the Annual Incentive Plan (AIP). The Executives were not eligible for an annual performance related bonus under the AIP for 2013.
- Long term performance related bonus refers to the LTIP awards with performance periods ending in the relevant financial year. No payment was made under the 2011-2013 LTIP.
- Pension includes benefits accrued in the year from participation in pension schemes (using new disclosure calculation rules and factor of 20) and cash allowances in lieu of retirement benefit.
- Retention Programme payments are payments made relating to 2013, being the first year of the two-year programme, as described above in the Committee Chairman's summary. Payment is subject to continued employment to a specified date. Payment is due in April 2014. Euan Sutherland waived his entitlement to his 2013 payment of £1.5m under the Retention Programme.
- Other payments in 2013 include:
  - A payment of £1m to Euan Sutherland as compensation for incentive scheme awards that he forfeited on resignation from his previous employer.
  - Payments totalling £165,000 to Nick Folland as compensation for incentive scheme awards that he forfeited on resignation from his previous employer.
  - Payments totalling £188,000 to Steve Murrells, comprising £100,000 as compensation for incentive scheme awards that he forfeited on resignation from his previous employer and £88,000 as part of continuing obligations under the relocation arrangements agreed on his recruitment.
- Other payments in 2012 include:
  - A payment of £77,000 to Andy Haywood as compensation for incentive scheme awards that he forfeited on resignation from his previous employer.
  - Payments totalling £246,000 to Steve Murrells, comprising £198,000 relocation expenses agreed on Steve's recruitment and £48,000 as part of continuing obligations under the relocation arrangements.
- Figures relating to the 2012 financial year have been restated and recalculated in accordance with the new disclosure rules.
- Peter Marks retired from the Group on 18 May 2013.
- Stephen Humes was served notice on 15 May 2013 and remained on garden leave until 28 February 2014 when his employment terminated. The figures in the table above represent his earnings for services provided to the Group until he was placed on garden leave. The payments made to him whilst on garden leave are shown on page 53.
- Wayne Lee ceased to be acting HR Director on 10 March 2013.
- Moira Lees retired from the Group on 20 December 2013.
- Martyn Wates was served notice on 27 May 2013 and remained on garden leave until 7 March 2014 when his employment terminated. The figures in the table above represent his earnings for services provided to the Group until he was placed on garden leave. The payments made to him whilst on garden leave are shown on page 53.
- Barry Tootell was placed on garden leave and removed from the Group Executive and as an Executive Director of the Co-operative Bank plc on 10 May 2013. He resigned from the Co-operative Bank plc on 13 December 2013. The figures in the table above represent his earnings for the period of time that he was a member of the Group Executive. The payments relating to the period whilst he was on garden leave are reported in the 2013 the Co-operative Bank plc Remuneration Report.
- Niall Booker was Deputy Group CEO from 10 June 2013 to 20 September 2013. The figures in the table above represent his earnings for the period of time that he was a member of the Group Executive. His full remuneration including his role based allowance is reported in the 2013 the Co-operative Bank plc Remuneration Report.

## Remuneration report continued

### LTIP scheme interests

Awards are made annually under the Long Term Incentive Plan ('LTIP'), and any payments due are made in cash, subject to the achievement of performance conditions over a three year period.

**Table 2a – LTIP awards held by Executives in post at 4 January 2014**

Name of Executive	Award	Notes	Maximum award opportunity at start of the year £	Maximum 2013-2015 award opportunity granted £	Awards vested in year £	Awards lapsed in year £	Maximum award opportunity at the year-end £	Awards lapsed since the year-end £
Euan Sutherland	2013-2015	1, 3	–	1,500,000	–	–	1,500,000	–
Alistair Asher	2013-2015	1	–	475,000	–	–	475,000	–
Gill Barr	2013-2015	1	–	314,000	–	–	314,000	–
	2012-2014		230,625	–	–	–	230,625	–
	2011-2013	2	225,000	–	–	225,000	–	–
Mark Craig	2013-2015	1, 4	–	188,000	–	–	188,000	109,710
	2012-2014		138,375	–	–	–	138,375	34,594
	2011-2013	2	135,000	–	–	135,000	–	–
Andy Haywood	2013-2015	1	–	350,000	–	–	350,000	–
	2012-2014		225,000	–	–	–	225,000	–
Martyn Hulme	2013-2015	1	–	300,000	–	–	300,000	–
	2012-2014		195,000	–	–	–	195,000	–
	2011-2013	2	172,500	–	–	172,500	–	–
Nick Folland	2013-2015	1	–	425,000	–	–	425,000	–
Steve Murrells	2013-2015	1	–	650,000	–	–	650,000	–
	2012-2014		615,000	–	–	–	615,000	–
Richard Pennycook	2013-2015	1	–	750,000	–	–	750,000	–
Rebecca Skitt	2013-2015	1, 5	–	650,000	–	–	650,000	433,333

#### Notes to Table 2a

1. Awards for 2013-2015 were made under the 2013-2015 Turnaround LTIP. Performance under this LTIP is measured over the three financial years ending with the 2015 financial year. Any payments are subject to the achievement of performance measures which are based on specific turnaround objectives, including recapitalisation of the Bank, cost savings and other business critical issues.
2. The performance measures for the 2011-2013 LTIP were met in part. The Committee used its discretion to reduce the payments due under this LTIP to zero in light of the recent events.
3. Euan Sutherland is under his notice period; his exit arrangements will be finalised in the coming months and reported in the 2014 remuneration report.
4. Mark Craig was made redundant on 1 April 2014 and retains the parts of the 2012-2014 LTIP and 2013-2015 LTIP that relate to the period of time he was in employment, these remain subject to the original performance measures and the original performance periods.
5. Rebecca Skitt was placed on garden leave on 28 February 2014 and part of her 2013-2015 award lapsed. She continues to hold one third of her 2013-2015 award and this remains subject to the original performance measures and the original performance period.

## Remuneration report continued

### Table 2b – LTIP awards for Executives who left during the 2013 financial year

Name of Executive	Award	Notes	Maximum award opportunity at start of the year £	Maximum 2013-2015 award opportunity granted £	Awards vested in year £	Awards lapsed in year £	Maximum award opportunity at the year-end £	Awards lapsed since the year-end £
Peter Marks	2012-2014	2	994,000	–	–	536,905	457,095	–
	2011-2013	1	970,000	–	–	970,000	–	–
Stephen Humes	2012-2014	3	490,000	–	–	–	490,000	490,000
	2011-2013	1	400,000	–	–	400,000	–	–
Moirá Lees	2013-2015	4	350,000	–	–	236,849	113,151	–
	2012-2014	4	222,000	–	–	76,161	145,839	–
	2011-2013	1	216,750	–	–	216,750	–	–
Martyn Wates	2012-2014	5	579,000	–	–	–	579,000	579,000
	2011-2013	1	565,000	–	–	565,000	–	–
Barry Tootell	2012-2014	6	512,500	–	–	512,500	–	–
	2011-2013	6	305,250	–	–	305,250	–	–

Notes to Table 2b

- The performance measures for the 2011-2013 LTIP were met in part. The Committee used its discretion to reduce the payments due under this LTIP to zero in light of the recent events.
- Peter Marks retired on 18 May 2013 and part of his award lapsed. The portion of the award retained is based on the period of time he was employed by the Group. The maximum opportunity is still subject to the performance conditions and payment will not be determined until the end of the performance period.
- Stephen Humes was given notice on 15 May 2013 and was on garden leave until 28 February 2014 when his employment terminated. All of his awards lapsed on cessation of his employment.
- Moirá Lees retired on 20 December 2013 and part of her awards lapsed. The portions of the awards retained are based on the period of time she was employed by the Group. The maximum opportunities are still subject to the performance conditions and payment will not be determined until the end of the performance periods.
- Martyn Wates was given notice on 27 May 2013 and was on garden leave until 7 March 2014 when his employment terminated. All of his awards lapsed on cessation of his employment.
- Barry Tootell resigned on 13 December 2013 and all of his awards lapsed.

## Total pension entitlements

The table below shows the pension entitlements for the Executive. The figures shown below reflect the period that the individuals were appointed to the Group Executive only. Comparative figures for 2012 are shown in brackets and have been recalculated using the new disclosure rules.

### Table 3a – pension entitlements for Executives in post at 4 January 2014

Notes	Years of service Note 1	Total Defined Benefit Pension accrued at 4 January 2014 Note 2 £'000	Increase in Defined Benefit Pension during year (gross of inflation) £	Increase in Defined Benefit Pension during year (net of inflation) £	Value of Previous Column x 20 (net of Members contributions) Note 3 £'000	Employer Contributions to Defined Pension £'000	Payment in lieu of Pension Benefit £'000	Total Pension Benefits £'000	Defined Benefit Pension Normal Retirement Date (Age)
Euan Sutherland	4	0	–	–	–	–	161	161	–
Alistair Asher	4	0	–	–	–	–	39	39	–
Gill Barr	5	2	6	3,148	3,078	47 (51)	20 (20)	67 (71)	65
Mark Craig	6	19	80	4,486	2,820	41 (9)	–	41 (9)	65
Nick Folland	7	0	–	–	–	37	7	44	–
Andy Haywood	8	2	7	3,697	3,619	55 (57)	19	74 (57)	65
Martyn Hulme	9	23	92	3,704	1,764	35 (0)	46 (37)	81 (37)	65
Steve Murrells	4	1	–	–	–	–	103 (48)	103 (48)	–
Richard Pennycook	4	0	–	–	–	–	72	72	–
Rebecca Skitt	4	0	–	–	–	–	79	79	–

## Remuneration report continued

### Table 3b – pension entitlements for Executives who left during the 2013 financial year

	Notes	Years of service Note 1	Total Defined Benefit Pension accrued at 4 January 2014 Note 2 £'000	Increase in Defined Benefit Pension during year (gross of inflation) £	Increase in Defined Benefit Pension during year (net of inflation) £	Value of Previous Column x 20 (net of Members contributions) Note 3 £'000	Employer Contributions to Defined Pension £'000	Payment in lieu of Pension Benefit £'000	Total Pension Benefits £'000	Defined Benefit Pension Normal Retirement Date (Age)
Peter Marks	4	45	–	–	–	–	–	59 (171)	59 (171)	–
Stephen Humes	10	13	58	3,403	2,201	39 (34)	–	18 (52)	57 (86)	65
Wayne Lee	11	13	33	762	50	0 (0)	–	–	0 (0)	65
Moira Lees	12	32	140	4,335	1,359	27 (0)	–	52 (51)	79 (51)	65
Martyn Wates	13	18	169	5,382	1,773	35 (0)	–	37 (100)	72 (100)	65
Barry Tootell	14	5	29	1,918	1,358	22 (47)	–	20 (55)	42 (102)	65
Niall Booker	15	0	–	–	–	–	–	31	31	–

General notes to Tables 3a and 3b

- Years of service include, where appropriate, pre-merger service with United Co-operatives.
- Total Defined Pension Benefit is that which would be paid annually on retirement at normal retirement age based on service to 4 January 2014 and includes any transferred-in benefits as appropriate. There is no additional pension benefit payable in the event of an Executive's early retirement.
- Pension scheme Members have the option of paying additional voluntary contributions to their respective pension scheme. Neither any contributions paid nor any benefits arising from them are shown in the above table.

Individual notes to Tables 3a and 3b

- Indicates that this Executive was paid a pension allowance in lieu of pension provision.
- Gill Barr has restricted pension accrual and was paid a restricted pension allowance.
- 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 and his years of service are counted from this date.
- Nick Folland was paid a pension allowance in lieu of pension provision until he joined the Defined Contribution Pension.
- Andy Haywood opted for restricted pension accrual from 24 March 2013 and was paid a restricted pension allowance.
- Martyn Hulme opted out of Pace from 6 April 2012 and became entitled to a deferred pension from Pace when he left the scheme. He was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under the Pace rules and account has been taken of this in the above table.
- Stephen Humes was served notice on 15 May 2013 and remained on garden leave until 28 February 2014 when his employment terminated. The figure in the table above represents pension benefits for services provided to the Group. He has restricted pension accrual and was paid a restricted pension allowance. The total pension benefits whilst on garden leave up to 4 January 2014 were £62,000.
- Wayne Lee ceased to be acting HR Director on 10 March 2013. He left the Group on 20 September 2013 and became entitled to a deferred pension.
- Moira Lees retired from the Group on 20 December 2013. She opted out of Pace from 6 April 2011 and became entitled to a deferred pension. She was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under the Pace rules and account has been taken of this in the above table.
- Martyn Wates was served notice on 27 May 2013 and remained on garden leave until 7 March 2014 when his employment terminated. The figure in the table above represents pension benefits for services provided to the Group. He opted out of the United Scheme from 27 May 2011 and became entitled to a deferred pension. He was paid a pension allowance in lieu of pension provision. Deferred pensions are revalued under the United Scheme rules and account has been taken of this in the above table. The total pension benefits whilst on garden leave up to 4 January 2014 were £58,000.
- Barry Tootell was placed on garden leave and removed from the Group Executive on 10 May 2013. He resigned on 13 December 2013 and became entitled to a deferred pension. He has restricted pension accrual and was paid a restricted pension allowance. The figures in the table above represent his pension benefits for the period of time that he was a member of the Group Executive (the benefits whilst on garden leave are reported in the 2013 the Co-operative Bank plc Remuneration Report).
- Niall Booker was Deputy Group CEO from 10 June 2013 to 20 September 2013. The figure in the table above represents his pension benefits for the period of time that he was a member of the Group Executive. His full pension benefits are reported in the 2013 the Co-operative Bank plc Remuneration Report.

## Remuneration report continued

### Payments for loss of office

Details of the settlement agreements for Executives which have been agreed are shown below. The table below does not include any Executive who retired during the year.

Stephen Humes	<p>Stephen Humes was placed on garden leave on 15 May 2013 and his employment was terminated on 28 February 2014.</p> <p>Payments made during the 2013 financial year:</p> <ul style="list-style-type: none"> <li>The payments made to Stephen Humes whilst on garden leave from 15 May 2013 up to 4 January 2014 were: base salary £321,000; benefits £12,000 and total pension benefits £62,000.</li> </ul> <p>Payments made since the year-end and to be made in 2014:</p> <ul style="list-style-type: none"> <li>The payments made to Stephen Humes whilst on garden leave from 5 January 2014 until 28 February 2014 were base salary £92,000; benefits £3,000 and total pension benefits £7,000.</li> <li>An amount of £196,448 in respect of base salary and contractual benefits for the remainder of the notice period and as part of the legal agreement on cessation of employment.</li> </ul>
Martyn Wates	<p>Martyn Wates was placed on garden leave on 27 May 2013 and his employment was terminated on 7 March 2014.</p> <p>Payments made during the 2013 financial year:</p> <ul style="list-style-type: none"> <li>The payments made to Martyn Wates whilst on garden leave from 27 May 2013 up to 4 January 2014 were: base salary £361,000; benefits £14,000 and total pension benefits £58,000.</li> </ul> <p>Payments made since the year-end and to be made in 2014:</p> <ul style="list-style-type: none"> <li>The payments made to Martyn Wates whilst on garden leave from 5 January 2014 until 7 March 2014 were base salary £82,000; benefits £4,000 and total pension benefits £13,000.</li> <li>An amount of £198,430 in respect of base salary and contractual benefits for the remainder of the notice period and as part of the legal agreement on cessation of employment.</li> </ul>
Rebecca Skitt	<p>Rebecca Skitt was placed on garden leave on 28 February 2014 and will continue to be on garden leave for six months from that date. Her base salary, benefits and pension up to 28 February 2014 will be reported in the 2014 Remuneration Report.</p> <p>The following terms have been agreed as part of Rebecca Skitt's settlement agreement:</p> <ul style="list-style-type: none"> <li>An amount of £385,362 which relates to base salary and contractual benefits for the remaining six months of her notice period, payable in 2014.</li> <li>Payment of £650,000 under the 2014 Retention Programme which is payable in early 2015 (payment of the 2013 Retention Programme payment is shown in Table 1a).</li> <li>Rebecca Skitt retains one third of the 2013-2015 LTIP award which remains subject to the original performance measures and the original performance period (any payment due under the 2013-2015 LTIP is payable early 2016).</li> </ul>
Mark Craig	<p>Mark Craig was made redundant on 1 April 2014. From 5 January 2014 until 1 April 2014, Mark Craig was an active member of the Executive and received his base salary, benefits and pension as normal; this detail will be reported in the 2014 Remuneration Report.</p> <p>The following terms have been agreed as part of Mark Craig's settlement agreement:</p> <ul style="list-style-type: none"> <li>An amount of £188,000 which relates to base salary for his notice period, payable in 2014.</li> <li>Contractual benefits being pension of £30,080 and retaining the car for the 12 month notice period.</li> <li>Redundancy payments of £238,444 based on the Group's redundancy policy and a statutory redundancy payment of £12,825.</li> <li>Mark Craig retains the parts of the 2012-2014 LTIP and 2013-2015 LTIP that relate to the period of time he was in employment and these remain subject to the original performance measures and the original performance periods.</li> </ul>
Euan Sutherland	<p>Euan Sutherland is under his notice period; his exit arrangements will be finalised in the coming months and reported in the 2014 remuneration report.</p>

## Remuneration report continued

### Relative importance of spend on pay

This disclosure is based on the new requirement under the Regulations in order to illustrate the various different elements of expenditure.

	2013	2012
Total wages (including pension and social security costs and excluding the Co-operative Bank plc and Life & Savings employees)	<b>£1,479m</b>	£1,522m
Dividends (including payments to individual Members, employee Members and corporate Members)	<b>£49m Paid in 2013 relating to 2012 profits</b>	£94m Paid in 2012 relating to 2011 profits
Community distribution	<b>£6m</b>	£10m

### Implementation of policy next year

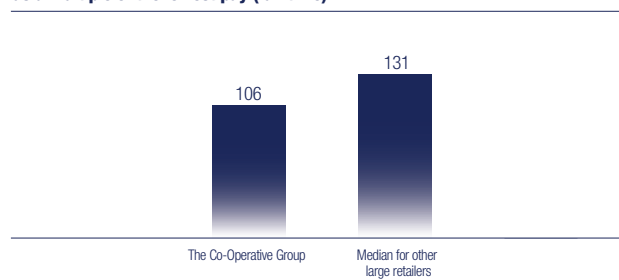
As mentioned previously, a review of reward strategy is underway covering all colleagues. The new remuneration policies resulting from this review are intended to be implemented in 2015. For 2014, the existing policies will be applied.

### Statement of voting at the 2012 AGM

In respect of the resolution to approve the 2012 remuneration report at the AGM held on 26 May 2012, 85% of votes cast were for the remuneration report. 4% of votes cast were against the remuneration report. 18 votes were withheld. Abstentions have not been counted.

### Highest to lowest ratio relating to the 2013 financial year

#### Chief Executive total pay for the financial year 2013 as a multiple of the lowest pay (full time)



Data taken from the most up-to-date market data available at time of analysis. Highest total pay for the 2013 financial year = salary, bonus paid in relation to the 2013 financial year, expected value of long term incentives at grant, pension and benefits, net of income tax and employees' national insurance (based on 2013/14 rates), sourced from Report & Accounts. To illustrate the CEO cost for 2013, this data includes the pro rata information for both Peter Marks and Euan Sutherland up to the date of retirement and from the date of joining respectively. Lowest total pay for the 2013 financial year = salary (based on the over 18 hourly rate and standard full-time working week) and bonus paid in relation to the 2013 financial year (salary and bonus data sourced from IDS' 'Pay and Conditions in Retail'), assumed combined pension and benefits worth 10% of base salary, net of income tax and employees' national insurance (based on 2013/14 rates).

### Non-executive Directors ('Directors')

#### Key events during the year

Paul Flowers left the Group Board and other associated roles on 12 June 2013 and details of his settlement agreement are on page 58.

Len Wardle resigned from his position as the Group Chair on 18 November 2013 and no further payments were made to him from this date. The Group agreed that Len could retain his Group car until 14 February 2014 (Len purchased the car from the lease company on this date).

## Remuneration report continued

### Director fee policy

The Group Board is made up entirely of non-executive directors, of which 20 are elected Directors and one is an Independent Professional Non-Executive Director ("IPNED"). Elected Directors' fees are determined by the Group's Members. At the AGM on 26 May 2012, Members agreed that with effect from 2013 onwards, the annual fee increases of elected Group Directors and other elected Members will be aligned to that of the most recently implemented Co-operative Group managerial salary increase.

The fee policy operated for 2013 is set out in the table below:

Role	Link to strategy	High level details and operation	Opportunity
Chair	To pay a basic fee covering the duties as chair of the Group.  Car or alternative arrangements that may be classed as a taxable benefit benefits are available to the Chair only.	The level of fee is periodically reviewed with reference to comparable market data and approved by Members in General Meeting.  The Chair may be provided with a Group car (or alternative arrangements should they not want to take the car).	The basic fee for the chair is £120,368 per annum. No additional fees are paid.  No current taxable benefit is claimed by the Chair.
Director	To pay a basic fee covering the duties as a director of the Group Board plus additional fees for duties within the Co-operative family.	The level of fee is periodically reviewed with reference to comparable market data, and approved by Members at an AGM. Additional fees are paid to those who serve on the subsidiary Boards of Co-operative Food Holdings Limited and Co-operative Specialist Businesses Holdings Limited (and previously Co-operative Banking Group); to the Group deputy Chairs; and to those who serve on other boards and committees.	The basic remuneration for a Group director is £11,574 per annum. In addition, the members of the Co-operative Food and Specialist Businesses Boards receive a fee of £11,574 per annum (the Chairs of these Boards receive a further £11,574 per annum).  Additional fees for other committees vary depending on the duties/committee and range from £1,157 to £5,787 per annum.  An elected director sitting on the Co-operative Banking Group Board receives an additional fee of £17,361 per annum. For an elected director who also serves as a director of the Co-operative Bank plc, this was increased to £60,000 with effect from 1 November 2013.
IPNED – Lord Myners	To provide an annual fee covering Lord Myners' duties as an IPNED of the Group.	The Group Board agreed the terms and conditions of the appointment of Lord Myners.	Lord Myners waived his right to fees and agreed to serve for a nominal fee of £1 per annum.
Pension Trustees	To provide an annual fee for appointment to a Group Pension Fund Board.	The Group has a number of Pension Fund Boards to which directors may be appointed from time to time.	The annual fee for Chair of a Pension Fund Board is £5,787 per annum and a member of a Pension Fund Board receives £3,472 per annum. The Chair of Pace receives a fee of £11,279 per annum.

None of the Group directors, by virtue of their Board position, participate in any of the Group's incentive plans or pension schemes, nor does this include share options or other performance related elements.

On recruitment, a Director's remuneration arrangements are determined in accordance with the above policy.

The Group directors do not have service contracts, but receive letters of appointment. The years of their first election are shown in the tables below. All Group directors are subject to a three year term of office (unless they are filling a casual vacancy).

The Co-operative Group Rule Book provides for the termination of the office of a Director.

## Remuneration report continued

### Single figure table – Director's fees paid in 2013

The fees shown in Tables 4-6 do not include fees of less than £500.

**Table 4a – Current Directors**

	Year first elected	Term expires	Notes	2013 Group Board £'000	2013 Group Audit & Risk Comm £'000	2013 Group Remuneration & Appointments Comm £'000	2013 Group Values & Principles Comm/Board £'000	2013 Governance Committee, Board Diversity Strategy Committee, Political Strategy Committee, Enterprise Hub £'000	2013 Other committees and Boards (see Table 4b) £'000	2013 Benefits £'000	2013 Total £'000	2012 Total £'000
Ursula Lidbetter (Chair)	2009	2014	1, 2	26	3	2	–	–	20	–	51	40
Jenny Barnes	2009	2015	3	12	–	–	1	1	20	–	34	32
Steven Bayes	2009	2014	4	12	–	2	–	–	26	–	40	34
Marc Bicknell	2013	2016	5	3	–	–	–	–	4	–	7	–
Duncan Bowdler	2007	2016	3, 6	12	3	–	–	1	27	–	43	42
John Brodie	2012	2015	2	12	–	–	–	–	12	–	24	13
Eric Calderwood	2006	2015	7	12	–	4	–	–	25	–	41	38
Martyn Cheatle	2010	2016	2, 8	12	5	–	–	–	12	–	29	27
Herbert Daybell	2009	2015	3, 9	12	–	–	1	1	24	–	38	40
Jennifer de Villiers	2013	2016	10	7	–	–	–	–	12	–	19	–
Patrick Grange	2007	2014	11, 12	12	3	1	–	–	28	–	44	41
Michael Harriott	2013	2016	10	7	–	–	–	–	11	–	18	–
Ray Henderson	2009	2015	13	12	–	–	–	–	19	–	31	32
Munir Malik	2013	2016	10	7	–	–	1	–	11	–	19	–
Liz Moyle	2011	2014	11, 3, 14	12	–	1	1	1	19	–	34	29
David Pownall	2007	2015	3, 15	12	–	–	–	1	24	–	37	36
Stuart Ramsay	2009	2014	3, 9	12	–	–	1	1	19	–	33	34
Ben Reid	2000	2015	2, 16	12	–	–	1	–	27	–	40	38
Mark Smith	2010	2014	2	12	3	–	–	–	12	–	27	23

## Remuneration report continued

### Table 4b – Current Directors – Breakdown of other fees

	Food Board £'000	Specialist Businesses Board £'000	Co-operative Banking Group and its committees £'000	Regional Board and Area Committee £'000	Co-operatives UK and Co-operative Press Boards £'000	Pension Fund Trustee £'000	2013 Total of other fees £'000
Ursula Lidbetter (Chair)	20	–	–	–	–	–	20
Jenny Barnes	12	–	–	7	1	–	20
Steven Bayes	–	15	–	7	1	3	26
Marc Bicknell	3	–	–	1	–	–	4
Duncan Bowdler	–	–	20	7	–	–	27
John Brodie	12	–	–	–	–	–	12
Eric Calderwood	12	–	–	7	1	5	25
Martyn Cheatle	12	–	–	–	–	–	12
Herbert Daybell	12	–	–	7	–	5	24
Jennifer de Villiers	–	7	–	4	1	–	12
Patrick Grange	12	–	–	7	–	9	28
Michael Harriott	–	7	–	4	–	–	11
Ray Henderson	12	–	–	7	–	–	19
Munir Malik	–	7	–	4	–	–	11
Liz Moyle	–	12	–	7	–	–	19
David Pownall	–	13	–	7	1	3	24
Stuart Ramsay	–	12	–	7	–	–	19
Ben Reid	–	–	27	–	–	–	27
Mark Smith	–	12	–	–	–	–	12

### Table 5 – Current Independent Non-Executive Directors

	Year first elected	Term expires	Notes	Benefits £'000	Group Board £'000	2013 Total £'000	2012 Total £'000
Lord Myners	2013	2016	17	–	–	–	–

Notes to Tables 4 and 5:

- Ursula Lidbetter was appointed Group Chair with effect from 18 November 2013. On this date, she stood down from her positions as Chair of the Food Board and a member of the Group Audit and Risk Committee.
- The remuneration of some directors is paid, at their request, direct to their employers who release them to act as directors of the Group.
- The Members of the Governance Committee, the Board Diversity Strategy Committee and the Enterprise Hub were stood down with effect from 22 October 2013 when these forums ceased to exist following the creation of the Group Values and Principles Board.
- Steven Bayes was appointed Chair of the Specialist Businesses Board with effect from 11 September 2013.
- Marc Bicknell was elected to the Group Board on 7 October 2013, appointed to the Food Board on 9 October 2013 and appointed to the Group Audit and Risk Committee on 10 December 2013.
- Duncan Bowdler received a fee of £17,361 per annum to cover his appointments on the Co-operative Banking Group and the Co-operative Bank Boards. Duncan Bowdler stood down from the Co-operative Bank Board on 9 October 2013. He was appointed to the Co-operative Banking Group Remuneration and Appointments Committee on 17 July 2013 until he resigned on 9 October 2013. He resigned from the Co-operative Banking Group Audit and Risk Committee on 31 August 2013.
- Eric Calderwood was appointed as Chair of the Group Remuneration and Appointments Committee on 18 July 2013.
- Martyn Cheatle was Chair of the Group Audit and Risk Committee throughout the financial year.
- Members of the Political Strategy Committee stood down from this committee when it ceased to exist with effect from 17 July 2013.
- Jennifer de Villiers, Michael Harriott and Munir Malik were elected as directors of the Group with effect from 19 May 2013 and appointed to the Group Specialist Businesses Board on 13 June 2013.
- Patrick Grange and Liz Moyle were appointed as Members of the Group Remuneration and Appointments Committee with effect from 18 July 2013.
- Patrick Grange was appointed Acting Chair of the Food Board with effect from 21 November 2013 and received an additional fee of £2,893 per annum for this position.
- Ray Henderson and David Pownall were appointed to the Group Values and Principles Board with effect from 22 October 2013. The Group Values and Principles Board replaced the Group Values and Principles Committee and all Board Members previously sitting on that Committee were nominated to stand again on the Group Values and Principles Board.
- Liz Moyle was appointed the Group Values and Principles Committee with effect from 13 June 2013.
- David Pownall was appointed Acting Chair of the Specialist Businesses Board on 12 June 2013 and stepped down on 11 September 2013. He received an additional fee of £2,893 per annum for this position.
- Ben Reid sat on the Co-operative Banking Group Board until 9 October 2013 and on the Board of the Co-operative Bank until he stood down on 31 December 2013. He received a basic aggregate fee of £17,361 per annum for sitting on both Boards until 1 November 2013 when the fee for sitting on the Co-operative Bank Board was increased to £60,000 per annum. He was a member of the Co-operative Banking Group Audit Committee until 9 October 2013.
- Lord Myners was appointed to the Board on 11 December 2013 and has agreed to serve for a nominal fee of £1 per annum. He does not sit on any other Boards or Committees or associated organisations of the Group.

**Table 6a – Former Directors**

	Year first elected	Resignation date	Notes	2013 Group Board £'000	2013 Group Audit & Risk Comm £'000	2013 Group Remuneration & Appointments Comm £'000	2013 Group Values & Principles Comm/Board £'000	2013 Governance Committee, Board Diversity Strategy Committee, Political Strategy Committee, Enterprise Hub £'000	2013 Other committees and Boards (see Table 6b) £'000	2013 Benefits £'000	2013 Total £'000	2012 Total £'000
Marilynne Burbage	2009	18 May 2013		4	–	–	1	1	7	–	13	31
Paul Flowers	2008	12 June 2013	1, 3	–	–	–	–	–	60	4	64	132
Chris Herries	2009	18 May 2013		4	–	1	–	1	11	–	17	42
Len Wardle	1992	19 November 2013	2, 3	107	–	–	–	–	24	4	135	145
Steve Watts	2000	18 May 2013	4	4	1	1	–	–	14	–	20	52

**Table 6b – Former Directors – Breakdown of other fees**

	Food Board £'000	Specialist Businesses Board £'000	Co-operative Banking Group and its committees £'000	Regional Board and Area Committee £'000	Co-operatives UK and Co-operative Press Boards £'000	Pension Fund Trustee £'000	2013 Total of other fees £'000
Marilynne Burbage	–	4	–	3	–	–	7
Paul Flowers	–	–	55	3	–	2	60
Chris Herries	–	4	–	3	1	3	11
Len Wardle	–	–	15	6	–	3	24
Steve Watts	–	9	2	3	–	–	14

## Notes to Tables 6:

- The fee paid to Paul Flowers covered his role as Chair of the Co-operative Banking Group and the Co-operative Bank Boards and Group Deputy Chair.
- Len Wardle stood down from his position as Group Chair on 18 November 2013 and stood down from all other Group appointed positions with effect from 19 November 2013. Len Wardle received a fee of £17,361 per annum for his role as a Director on the Boards of the Co-operative Banking Group and the Co-operative Bank. He stood down from the Co-operative Bank Board with effect from 9 October 2013 but remained on the Board of the Co-operative Banking Group until he stood down from the Group Board on 19 November 2013.
- Benefits include a Group car for Paul Flowers and Len Wardle (the benefit is calculated up to the year-end for Len Wardle).
- The 'other committees' fee for Steve Watts includes a fee for his role on the Board of Unity Trust Bank Plc.

**Payments for loss of office**

Details of the settlement agreements for Directors which have been agreed are shown below. The table below does not include any Directors who left the Board without a settlement agreement.

Paul Flowers	<p>Paul Flowers stepped down from the Co-operative Banking Group Board on 5 June 2013 and the Group Board on 12 June 2013.</p> <p>Subject to the terms and conditions of a settlement agreement dated 14 June 2013, the Group agreed to pay Paul Flowers compensation for the termination of his appointments the sum of £95,000 in relation to fees to the end of his elected term to be paid in three instalments.</p> <p>The first instalment of £31,000 gross was paid on 28 July 2013. The issues which arose in the media regarding Paul Flowers' conduct were in breach of the provisions of the settlement agreement. As a result, the Group has ceased the second and the third instalments of £32,000 each which were due to be paid 12 months and 24 months after the first instalment. The Group has also requested re-payment of the first instalment of £31,000 from Paul Flowers in correspondence to Paul Flowers but to date has not received a response. Paul Flowers' recent interview on BBC Newsnight on 25 March 2014 was in further breach of the provisions of the agreement.</p>
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## Other Statutory disclosures

### Results and distributions

The continuing loss before taxation was £277m (2012: loss of £64m). The Directors do not recommend a final dividend.

The Group Board determined not to pay an interim dividend in 2013. Instead Members trading with Co-operative Food earned a special member discount based on their shopping prior to Christmas which was treated as an operating cost.

### Going concern

The financial statements are prepared on a going concern basis as the Directors have a reasonable expectation that the Society and the Group has access to adequate resources to enable it to continue in operational existence for the foreseeable future.

In assessing the appropriateness of the going concern basis of preparation, the Directors have firstly considered the going concern position and outlook of the Trading Group, including its ability to meet its capital commitments to the Co-operative Bank plc and the amendments to financing covenants obtained by the Trading Group post year end, the General Insurance business and the Reclaim Fund separately, as they are independently funded. The Directors have then, taking these individual assessments into account, considered the overall going concern position of the Group.

In making their assessment, the directors have considered a wide range of information relating to present and future conditions, including future forecasts of profitability, cash flow and covenant compliance, and available capital resources. The directors have also considered the current uncertainty surrounding potential changes to the Group's governance structures, and the potential impact that this uncertainty may have on the Group's external lenders, customers, suppliers and other stakeholders.

Further information relevant to the directors' assessment is provided within the basis of preparation section of the financial statements (page 70).

### Employees and employment of disabled persons

The Group and its subsidiary undertakings, including the Co-operative Banking Group, employed 88,327 persons at 4 January 2014 (5 January 2013: 99,201) and their aggregate remuneration for the year was £1,479m (2012: £1,522m).

The Group welcomes applications for employment by disabled persons, having regard to their particular skills and abilities. Where necessary reasonable adjustments are made to the recruitment process to ensure every applicant has an equal opportunity to gain employment within the Group. We are Members of Business Disability Forum and work closely with Job Centre Plus, Mencap and Remploy to ensure that we have a transparent recruitment process where candidates can flourish.

If a colleague states they are disabled or has a medical condition which impacts on their work, they are referred to occupational health for guidance on reasonable adjustments.

If a staff member becomes disabled during the course of their employment, they will be given an appropriate level of support to enable them to continue in their current role – or if this is not possible, an alternative one. We are signed up to the Two Tick Disability symbol and adhere to the five commitments regarding recruitment, training, retention, consultation and disability awareness.

More information on the provision of information and consultation with, and involvement of, employees, developing and engaging people, managing and rewarding performance and diversity is contained in the 18 pages of the Strategic Report which also includes a breakdown of gender ratios within the business.

### Corporate responsibility and the environment

The sustainable development section can be found within the Strategic Report on pages 19 and 20. The Group's new Sustainability Report, which was published in June 2013, describes how the Group manages its social, ethical and environmental impact and includes new reporting requirements on the disclosure of greenhouse gas emissions.

### Political donations

Like many other businesses of a comparable size, the Group undertakes an engagement programme, with a wide range of political opinion formers and decision-makers, designed to protect, promote and enhance the Group's corporate reputation. During the course of 2013, much of this activity has inevitably focused on 'protection' with significant engagement about key business issues, particularly in Whitehall and Westminster. In addition, on issues of sectoral relevance, the Co-operative Group is an active participant in the work of business trade associations.

Quite separately to this corporate activity, the Group has a long tradition of supporting the Co-operative Party, which was created in 1917 by the UK Co-operative Movement in order to promote its values and principles. The Co-operative Party works to raise awareness of the benefits of Co-operative and mutual models, and to influence governments towards support for more Co-operative action.

A motion was approved by Members at the Half Yearly Meeting on 3 November 2012 to permit political expenditure, including donations to political parties, up to a maximum ceiling of £1.185m for 2013. During the course of 2013, actual donations have come to just over £810,000 (2012: £880,000).

During the year, an annual donation of £579,446 (2012: £563,000) was made to the Co-operative Party by way of contribution to the operating costs (including personnel and occupation costs). This national donation has not been contingent on any of the Party's policy objectives or campaigns; elements of the Party's programme of activity mirror elements of the Group's historical social goals agenda including support for the development of Fairtrade and international development and climate change. In addition, £200,000 (2012: £242,000) was paid in grants to Co-operative Party Councils. A number of donations (including in-kind contributions) totalling £28,150 (2012: £28,500) were made to the Co-operative Party to support a range of activity, including at its party conference and also at the Labour Party Conference. The Co-operative Party reports 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 2013, a number of donations were made to support various Labour Party events, or organisations with Labour links, particularly at a local level, with a value of no more than £4,000 (2012: £11,550).

## Other Statutory disclosures continued

### Compliance with grocery supplier code of practice ('the Code')

The Code was introduced on 4 February 2010 following a Competition Commission investigation of the market for the supply of groceries in the UK. The Code applies to all grocery retailers with a turnover greater than £1bn and aims to address a number of findings of the investigation by placing those retailers under specific obligations regarding their supplier relationships, including a requirement to deliver an annual compliance report (of which this is a summary) to the Office of Fair Trading.

We expect to work purposefully and collaboratively with our suppliers in the long term interests of our customers and Members, and believe this approach has served us well in the past and will continue to do so in the future. Naturally, we take our responsibilities under the Code seriously.

Consequently, a significant investment has continued to be made in robust compliance processes and systems (both within our Food business and, to the extent it retails grocery items, our Pharmacy operation). This includes work commissioned by our appointed Code Compliance Officer, a rolling programme of internal audits to test compliance, a comprehensive training programme for all employees involved in dealings with our suppliers, an online supplier portal, and the provision of regular reports to the Group's Audit and Risk Committee to ensure that Committee retains effective oversight of Code compliance generally.

A modest number of alleged breaches of the Code has been asserted by suppliers, but all but one of these (which remains under investigation currently) have been found, on examination, not to constitute a breach of the provisions of the Code.

We have interacted with the Code Adjudicator since her appointment both by way of scheduled meetings (directed at the sharing of best practice amongst other things) and timely response to any questions she has raised with us.

### Statement of Co-operative Group Board responsibilities in respect of the Annual Report and financial statements

The Directors are responsible for preparing the Annual Report 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 the directors have elected to prepare the financial statements in accordance with IFRSs as adopted by the EU.

The Group 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 financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently
- make judgements and estimates that are reasonable and prudent
- state whether applicable 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 Society and enable them to ensure that its financial statements comply with the Industrial and Provident Society 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 Society'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.

### Audit

As recommended by the Group Audit and Risk Committee as discussed on page 40, a resolution to appoint KPMG LLP as auditor of the Group and to authorise the directors to fix their remuneration will be proposed at the 2014 Annual General Meeting.

By Order of the Board

**Claire Davies, Group Secretary**  
17 April 2014

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

We have audited the financial statements of the Co-operative Group Limited (the 'Society') for the period ended 4 January 2014 set out on pages 63 to 180. 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 and, in respect of the reporting on corporate governance, on terms that have been agreed. 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, in respect of the reporting on corporate governance, those matters we have agreed to state to them in our 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 60 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 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 Financial Reporting Council's website at [www.frc.org.uk/auditscopeukprivate](http://www.frc.org.uk/auditscopeukprivate).

## Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the Society's affairs as at 4 January 2014 and of the Society's loss for the period then ended;
- have been properly prepared in accordance with IFRSs as adopted by the EU; 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 32 to 37 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  
St James Square, Manchester, M2 6DS  
17 April 2014

# Financial accounts

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# Consolidated income statement

## for the period ended 4 January 2014

	Notes	Period ended 4 January 2014 Total £m	Period ended 5 January 2013 (restated*) Total £m
<b>Revenue</b>	2	<b>10,534</b>	10,967
Operating expenses – normal	3	<b>(10,511)</b>	(10,933)
Operating expenses – impairment of goodwill	11	<b>(239)</b>	(2)
Other income	4	<b>68</b>	110
<b>Operating (loss)/profit</b>	1	<b>(148)</b>	142
Finance income	5	<b>13</b>	10
Finance costs	6	<b>(87)</b>	(116)
Share of profit of associates and joint ventures	13	<b>–</b>	4
<b>(Loss)/profit before member payments</b>		<b>(222)</b>	40
Member payments	7	<b>(55)</b>	(104)
<b>Loss before tax</b>	1	<b>(277)</b>	(64)
Taxation	8	<b>45</b>	18
<b>Loss after tax but before loss on discontinued operations</b>		<b>(232)</b>	(46)
Loss on discontinued operations, net of tax	9	<b>(2,069)</b>	(511)
<b>Loss for the period</b>		<b>(2,301)</b>	(557)
Attributable to:			
Equity holders of the parent		<b>(2,267)</b>	(559)
Non-controlling interests		<b>(34)</b>	2
<b>Loss for the period</b>		<b>(2,301)</b>	(557)

### Non-GAAP measure: underlying profit before member payments\*\*

	Notes	Period ended 4 January 2014 Total £m	Period ended 5 January 2013 Total £m
Analysed as:			
(Loss)/profit before member payments (as above)		<b>(222)</b>	40
Add back/(deduct):			
One-off items	1	<b>311</b>	80
Property and business disposals	1	<b>29</b>	50
Change in value of investment properties	1	<b>18</b>	25
Finance income	1	<b>(13)</b>	(10)
Non-cash finance (income)/costs	1	<b>(13)</b>	10
Share of profit of associates and joint ventures	1	<b>–</b>	(4)
<b>Underlying profit before member payments</b>		<b>110</b>	191

\* See general accounting policies section on page 74 for more details of the restatement.

\*\* For a definition of underlying profit before member payments, refer to note 1.

# Consolidated statement of comprehensive income

## for the period ended 4 January 2014

	Notes	Period ended 4 January 2014 Total £m	Period ended 5 January 2013 (restated) Total £m
<b>Loss for the period</b>		<b>(2,301)</b>	(557)
<b>Other comprehensive (losses)/income:</b>			
<b>Items that will never be reclassified to the income statement:</b>			
Remeasurement losses on employee pension schemes	16	(82)	16
Pace pension surplus attributable to non Group entities	16	–	–
Restriction of pension surplus under IFRIC 14	16	(11)	(16)
Related tax on items	8	20	2
		<b>(73)</b>	2
<b>Items that are or may be reclassified to the income statement:</b>			
Changes in available for sale assets		(70)	50
Changes in cash flow hedges		(82)	(15)
Foreign exchange surplus transferred to the income statement		–	(2)
Related tax on items		39	(7)
		<b>(113)</b>	26
<b>Other comprehensive (losses)/income for the period net of tax</b>		<b>(186)</b>	28
<b>Total comprehensive losses for the period</b>		<b>(2,487)</b>	(529)
<b>Total comprehensive losses attributable to:</b>			
Equity holders of the parent		<b>(2,453)</b>	(530)
Non-controlling interests		<b>(34)</b>	1
		<b>(2,487)</b>	(529)

Of the above, £43m debit (2012: £13m credit) of the changes in available for sale assets and £82m debit (2012: £15m debit) of the changes in cash flow hedges relate to discontinued operations. £31m of the tax credit (2012: £1m credit) that was or may be reclassified to the income statement related to discontinued operations. Of the total loss on discontinued operations, including other comprehensive income, £34m (2012: £nil) related to non-controlling interests. None of the above related to associates or joint ventures. Going forward, the Group will account for its 30% share of the Bank's other comprehensive income within the above, but for 2013 this was not material for the period between the date of the disposal of the Co-operative Bank Plc (Bank) and the year end.

The Pace pension surplus attributable to non Group entities relates to the notional estimated share of the Pace surplus attributable to the Bank for accounting purposes at 4 January 2014. As the Group is the only participating employer with a right to refund in respect of any remaining surplus, the Group accounts for the entire scheme. Refer to note 16 for more information.

# Consolidated balance sheet

## as at 4 January 2014

	Notes	Adjusted* As at 4 January 2014 Total £m	As at 4 January 2014 Total £m	As at 5 January 2013 Total £m
<b>Assets</b>				
<b>Trading Group assets</b>				
Property, plant and equipment	10	2,277	2,277	2,440
Goodwill and intangible assets	11	1,234	1,234	1,518
Investment properties	12	98	98	273
Investments in associates and joint ventures	13	64	64	59
Investments in funeral plans	14	517	517	–
Derivatives	15	29	29	82
Pension assets	16	410	410	426
Trade and other receivables	19	23	23	36
Deferred tax assets	17	184	184	133
<b>Total Trading Group non-current assets</b>		<b>4,836</b>	4,836	4,967
Inventories and biological assets	18	526	526	528
Trade and other receivables	19	464	464	666
Cash and cash equivalents		200	200	180
Assets held for sale	20	59	59	–
<b>Total Trading Group current assets</b>		<b>1,249</b>	1,249	1,374
<b>Total Trading Group assets</b>		<b>6,085</b>	6,085	6,341
<b>Financial Services assets</b>				
Cash and balances at central banks		64	64	5,429
Derivatives	36a	–	–	819
Loans and advances to banks	36b	–	–	1,904
Loans and advances to customers	36c	–	–	33,406
Fair value adjustments for hedged risk	36c	–	–	354
Investments	21	971	971	8,184
Investments in associates and joint ventures	13	221	221	4
Reinsurance contracts	22	57	57	67
Income tax		–	–	93
Intangible assets	11	47	47	303
Property, plant and equipment	10	34	34	163
Deferred tax assets	17	73	73	72
Prepayments and other receivables	19	620	620	412
Assets held for sale	20	–	–	24,013
Reclaim fund assets	34	451	451	435
<b>Total Financial Services assets</b>		<b>2,538</b>	2,538	75,658
<b>Total assets</b>		<b>8,623</b>	8,623	81,999

## Consolidated balance sheet continued

	Notes	Adjusted* As at 4 January 2014 Total £m	As at 4 January 2014 Total £m	As at 5 January 2013 Total £m
<b>Liabilities</b>				
<b>Trading Group liabilities</b>				
Interest-bearing loans and borrowings*	24	1,463	6	1,501
Trade and other payables	25	706	706	601
Derivatives	15	67	67	122
Provisions	26	292	292	290
Pension liabilities	16	229	229	228
Deferred tax liabilities	17	183	183	219
<b>Total Trading Group non-current liabilities</b>		<b>2,940</b>	1,483	2,961
Interest-bearing loans and borrowings*	24	87	1,544	313
Income tax payable		105	105	86
Trade and other payables	25	1,373	1,373	1,356
Provisions	26	133	133	124
<b>Total Trading Group current liabilities</b>		<b>1,698</b>	3,155	1,879
<b>Total Trading Group liabilities</b>		<b>4,638</b>	4,638	4,840
<b>Financial Services liabilities</b>				
Amounts owed to credit institutions	27	9	9	3,625
Customer accounts	36d	–	–	35,960
Capital bonds	36e	–	–	888
Derivatives	36a	–	–	968
Insurance contracts	22	866	866	1,051
Debt securities in issue	36f	–	–	4,714
Other borrowed funds	36g	–	–	1,259
Income tax payable		90	90	–
Trade and other payables	25	517	517	255
Deferred tax liabilities	17	6	6	6
Pension liabilities	16	8	8	7
Provisions	26	75	75	187
Reclaim fund liabilities	34	377	377	361
Liabilities held for sale	20	–	–	23,353
<b>Total Financial Services liabilities</b>		<b>1,948</b>	1,948	72,634
<b>Total liabilities</b>		<b>6,586</b>	6,586	77,474
<b>Equity</b>				
Members' share capital	23	70	70	70
Retained earnings		1,804	1,804	4,145
Other reserves		162	162	275
<b>Total equity attributable to equity holders of the parent</b>		<b>2,036</b>	2,036	4,490
Non-controlling interests		1	1	35
<b>Total equity</b>		<b>2,037</b>	2,037	4,525
<b>Total equity and liabilities</b>		<b>8,623</b>	8,623	81,999

\* The Adjusted balance sheet as at 4 January 2014 includes a reclassification of certain of the Group's interest bearing loans and borrowings to non-current liabilities to reflect the amended terms of certain borrowings, as agreed post balance sheet date but prior to signing the accounts (see post balance sheet event note 39 and Interest bearing loans and borrowings note 24).

### Board's certification

The financial statements on pages 63 to 180 are hereby signed on behalf of the Board pursuant to Section 3(a)(1) of the Friendly and Industrial Provident Societies Act 1968.

**Ursula Lidbetter** Chair  
**Steven Bayes** Deputy Chair  
**Claire Davies** Group Secretary  
 17 April 2014

# Consolidated statement of changes in equity

## for the period ended 4 January 2014

	Notes	Members' share capital £m	Retained earnings £m	Other reserves £m	Total shareholder interest £m	Non-controlling interests £m	Total equity £m
Balance at 5 January 2013		70	4,145	275	4,490	35	4,525
Loss for the period		–	(2,267)	–	(2,267)	(34)	(2,301)
Other comprehensive income:							
Gains less losses on available for sale assets		–	–	(14)	(14)	–	(14)
Available for sale cumulative gains transferred to the income statement		–	–	(56)	(56)	–	(56)
Net changes in fair value of cash flow hedges		–	–	–	–	–	–
Net cashflow hedge gains transferred to the income statement		–	–	(82)	(82)	–	(82)
Foreign exchange surplus transferred to the income statement		–	–	–	–	–	–
Re-measurement losses on employee pension schemes	16	–	(82)	–	(82)	–	(82)
Pace pension surplus attributable to non Group entities		–	–	–	–	–	–
Restriction of pension surplus under IFRIC 14	16	–	(11)	–	(11)	–	(11)
Tax on items taken directly to other comprehensive income	8	–	20	39	59	–	59
<b>Total other comprehensive expense</b>		–	(73)	(113)	(186)	–	(186)
<b>Distributions to Members:</b>							
Members' share interest		–	(1)	–	(1)	–	(1)
Dividend - non-controlling interests		–	–	–	–	–	–
<b>Distributions to Members</b>		–	(1)	–	(1)	–	(1)
<b>Balance at 4 January 2014</b>		<b>70</b>	<b>1,804</b>	<b>162</b>	<b>2,036</b>	<b>1</b>	<b>2,037</b>

### Other reserves

Other reserves comprise the following:

#### Reclaim Fund capital reserve

This reserve comprises the surplus held within the Reclaim Fund Limited. The surplus has not been transferred to retained earnings because the profits are ultimately payable to the Big Lottery Fund and are therefore not available for distribution by the Group. The period end balance is £74m (2012: £74m) following the surplus created in other income in 2010. Further details of the balance sheet items can be found in note 34.

#### Hedging reserve

The hedging reserve comprised the effective portion of the cumulative net change in fair value of the Bank's cash flow hedging instruments. The period end balance is £nil (2012: £63m credit). There was a £82m debit (2012: £14m debit) movement during the period offset by a £19m tax credit (2012: £5m tax credit) relating to this movement. Following the disposal of the Bank, this reserve no longer exists within the Group as at 4 January 2014.

#### Revaluation reserve – property, plant and equipment

This reserve relates to the surplus created following the revaluation of certain assets in the Trading Group in previous periods. There have been no movements during the current or prior periods.

#### Available for sale investments reserve

CISGIL (and Co-operative Bank in prior periods) mainly hold debt securities as available for sale investments. Subsequent valuation is at fair value with differences between fair value and carrying value recognised in equity as they arise. The period end balance is a £7m debit (2012: £43m credit). There has been a £14m loss (2012: £168m gain) following the revaluation of available for sale assets during the period. £56m of losses (2012: £118m of gains) were transferred to the income statement during the period. A tax credit of £20m (2012: £12m debit) has also affected this reserve. Following the disposal of the Bank, the remaining balance relates solely to CISGIL as at 4 January 2014.

## Consolidated statement of changes in equity continued

	Notes	Members' share capital £m	Retained earnings £m	Other reserves £m	Total shareholder interest £m	Non-controlling interests £m	Total equity £m
Balance at 31 December 2011		70	4,703	248	5,021	35	5,056
Loss for the period (restated)		–	(559)	–	(559)	2	(557)
Other comprehensive income:							
Gains less losses on available for sale assets		–	–	168	168	–	168
Available for sale cumulative gains transferred to the income statement		–	–	(118)	(118)	–	(118)
Net changes in fair value of cash flow hedges		–	–	17	17	(1)	16
Net cashflow hedge gains transferred to the income statement		–	–	(31)	(31)	–	(31)
Foreign exchange surplus transferred to the income statement				(2)	(2)		(2)
Actuarial gains and losses on employee pension schemes (restated)	16	–	16	–	16	–	16
Restriction of pension surplus under IFRIC 14 (restated)	16		(16)	–	(16)		(16)
Tax on items taken directly to other comprehensive income	8	–	2	(7)	(5)	–	(5)
<b>Total other comprehensive income/expense</b>		–	2	27	29	(1)	28
<b>Distributions to Members:</b>							
Members' share interest		–	(1)	–	(1)	–	(1)
Dividend – non-controlling interests		–	–	–	–	(1)	(1)
<b>Distributions to Members</b>		–	(1)	–	(1)	(1)	(2)
<b>Balance at 5 January 2013</b>		70	4,145	275	4,490	35	4,525

For further explanations on the restatements above, refer to note 16.

# Consolidated statement of cash flows

## for the period ended 4 January 2014

	Notes	Period ended 4 January 2014 Trading Group £m	Period ended 5 January 2013 Trading Group £m	Period ended 4 January 2014 Financial Services £m	Period ended 5 January 2013 Financial Services £m	Period ended 4 January 2014 Total £m	Period ended 5 January 2013 Total £m
<b>Net cash from operating activities</b>	28	<b>419</b>	442	<b>(2,915)</b>	1,105	<b>(2,496)</b>	1,547
<b>Cash flows from investing activities</b>							
Acquisition of property, plant and equipment		<b>(236)</b>	(378)	<b>(47)</b>	(33)	<b>(283)</b>	(411)
Proceeds from sale of property, plant and equipment		<b>363</b>	41	<b>12</b>	1	<b>375</b>	42
Purchase of intangible assets (excluding deferred acquisition costs)		<b>(3)</b>	(7)	<b>(25)</b>	(85)	<b>(28)</b>	(92)
(Acquisition)/proceeds from sale of investments		<b>(129)</b>	11	<b>(220)</b>	1	<b>(349)</b>	12
Disposal of businesses, net of cash disposed		<b>69</b>	5	<b>(5,222)</b>	–	<b>(5,153)</b>	5
Acquisition of businesses, net of cash acquired		–	(25)	–	–	–	(25)
Income from investments		–	–	<b>51</b>	–	<b>51</b>	–
Proceeds from sale and maturity of investment securities		–	–	<b>6,681</b>	2,617	<b>6,681</b>	2,617
Purchase of investment securities		–	–	<b>(4,495)</b>	(4,961)	<b>(4,495)</b>	(4,961)
<b>Net cash from/(used in) investing activities</b>		<b>64</b>	(353)	<b>(3,265)</b>	(2,460)	<b>(3,201)</b>	(2,813)
<b>Cash flows from financing activities</b>							
Interest paid on borrowings		<b>(100)</b>	(112)	<b>(0)</b>	(87)	<b>(100)</b>	(199)
Decrease in corporate investor shares	24	<b>(20)</b>	(5)	–	–	<b>(20)</b>	(5)
Preference dividends paid		–	–	<b>(47)</b>	(6)	<b>(47)</b>	(6)
Dividends paid to non-controlling shareholders in subsidiary undertaking		–	(1)	–	(1)	–	(2)
Member payments		<b>(64)</b>	(104)	–	–	<b>(64)</b>	(104)
Additional payments into pension schemes		<b>(56)</b>	(57)	–	–	<b>(56)</b>	(57)
Repayment of borrowings, net of derivatives	24	<b>(353)</b>	(51)	<b>(84)</b>	(21)	<b>(437)</b>	(72)
Issue of borrowings, net of derivatives	24	<b>129</b>	160	–	–	<b>129</b>	160
Finance leases issued/(repaid)		<b>1</b>	(6)	–	–	<b>1</b>	(6)
<b>Net cash used in financing activities</b>		<b>(463)</b>	(176)	<b>(131)</b>	(115)	<b>(594)</b>	(291)
Net increase/(decrease) in cash and cash equivalents		<b>20</b>	(87)	<b>(6,311)</b>	(1,470)	<b>(6,291)</b>	(1,557)
Cash and cash equivalents at beginning of period		<b>180</b>	267	<b>6,748</b>	8,218	<b>6,928</b>	8,485
<b>Cash and cash equivalents at end of period</b>		<b>200</b>	180	<b>437</b>	6,748	<b>637</b>	6,928
<b>Analysis of cash and cash equivalents</b>							
Cash and balances with central banks		–	–	<b>64</b>	5,429	<b>64</b>	5,429
Less mandatory deposits with the Bank Of England		–	–	–	(39)	–	(39)
Loans and advances to banks	36b	–	–	–	851	–	851
Short-term investments		–	–	–	85	–	85
Cash held in Reclaim fund	34	–	–	<b>382</b>	435	<b>382</b>	435
Cash and cash equivalents per balance sheet		<b>200</b>	180	–	–	<b>200</b>	180
Amounts owed to credit institutions	27	–	–	<b>(9)</b>	(13)	<b>(9)</b>	(13)
		<b>200</b>	180	<b>437</b>	6,748	<b>637</b>	6,928

Cash and cash equivalents include deposits of £50m (2012: £52m) held in trustee-administered bank accounts of the Society, which can only be utilised to meet liabilities in respect of funeral plans. These liabilities are included in trade and other payables (see note 25). Also included within cash and cash equivalents is £1m (2012: £8m) of cash proceeds relating to property sales which are within the Group's solicitors' bank facilities, but are accessible to the Group to exclusively repay debt facilities. The cash held in the Reclaim Fund of £382m (2012: £435m) is not distributable to the Group.

Included in the above are cash flows from discontinued operations. An analysis of these can be found in note 9.

# General Accounting Policies

This section sets out details of the general Group accounting policies that relate to the financial statements as a whole. Details of other accounting policies are included within the notes to the financial statements to which they relate. This allows readers quick and easy access to the relevant policy. This section also sets out new accounting standards, amendments and interpretations endorsed by the EU and their potential future impact on the Group financial statements.

## General information

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 1 Angel Square, Manchester, M60 0AG.

## Basis of preparation

The Group accounts have been prepared in accordance with the Industrial and Provident Societies Acts 1965 to 2003, the Industrial and Provident Societies (Group Accounts) Regulations 1969, and applicable International Financial Reporting Standards as endorsed by the EU (IFRS) for the period ended 4 January 2014. 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 permitted by Industrial and Provident Society statute, a separate set of financial statements for the Society are not included.

The financial statements also 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 and are principally prepared on the basis of historical cost. Areas where other bases are applied are identified in the relevant accounting policy in the notes. Amounts have been rounded to the nearest £m.

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

## Basis of consolidation

The financial statements consolidate Co-operative Group Limited ('the Society'), which is the ultimate parent 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. For further information on classification of the Group's investment in the Bank as an associate, refer to note 13.

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.

Special purpose entities (SPEs) are entities that are created to accomplish a narrow and well defined objective.

An SPE is consolidated if, based on an evaluation of the substance of its relationship with the Group and the SPE's risks and rewards, the Group concludes that it controls the SPE.

The assessment of whether the Group has control over an SPE is carried out at inception. No further assessment of control is carried out unless changes in the structure or terms of the SPE or additional transactions between the Group and the SPE occur.

## General Accounting Policies continued

### Mixed presentation and definitions of Trading Group and Financial Services

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 to separately present the Group's Financial Services activities (formerly referred to as the Co-operative Banking Group) from its Trading Group entities (the Trading Group). In 2012, the Banking Group consisted of the Bank (Co-operative Bank Plc and its subsidiaries, the Group's General Insurance business, mainly Co-operative Insurance Society General Insurance Ltd (CISGIL) and the Group's Life and Savings business, mainly Co-operative Insurance Society Ltd (CISL). However, following the sale of CISL and 70% of the Bank during 2013, the current year balance sheet of Financial Services only includes CISGIL, other smaller entities (mainly holding, ancillary companies and the Reclaim Fund Ltd) and the Group's remaining 30% investment in the Bank. These entities have been renamed as Financial Services for the purpose of this report. As the prior year Financial Services balance sheet still contains Bank balances which are best ordered in terms of their liquidity and differ from that of the Trading Group, the Financial Services and Trading Group balance sheets are still disclosed separately for this period end.

The Trading Group includes Food, Pharmacy, Funeralcare, Estates, Federal, the Group's corporate function and other smaller businesses such as Legal Services, Electricals and Sunwin Services. The Group's Motor business including Albert Farnell Ltd was also sold during 2013. The assets and liabilities of the Trading Group are analysed as current or non-current.

The Group has never eliminated interest payable and cash between Trading Group and the Bank. Amounts owed between the Trading Group and Bank at year-end were immaterial and therefore no fair value adjustments were made on disposal.

As the Bank was a major subsidiary of the Group for the vast majority of the year, accounting policies relevant to the operations of the Bank are disclosed in notes 35 and 36 where applicable.

Before the sale of the Life and Savings business, funeral plan investments in the Trading Group with CISL were eliminated on consolidation with insurance liabilities in CISL also being eliminated. Following the sale of CISL during 2013, funeral plan investments have not been eliminated meaning that Trading Group net assets have effectively been increased by £452m with a corresponding increase in liabilities in the Financial Services balance sheet.

### Adjusted balance sheet and notes

At the year-end date, principally as a result of the recognition of an impairment charge of £226m in respect of goodwill, the net assets of the Trading Group fell below the level required by the Total Net Asset covenant within the terms of the Group's secured and unsecured bank loan facilities. In addition, following the reduction in the Group's investment in the Co-operative Bank plc on 20 December 2013, the tangible net assets of the Group fell below the level required by the Total Borrowings to Tangible Net Assets ratio covenant within the terms of the Group's 7.5/8% First Mortgage Debenture stock 2018, which had previously been measured against the gross assets of the Group including the Bank. Both of these covenant issues have been remedied post year-end following agreement of an amendment to the covenant calculation within the syndicated loan facility, and agreement with the Debenture holders to remove the Total Borrowings to Tangible Net Assets ratio covenant within this facility.

In accordance with relevant accounting standards, however, because the covenant amendments were obtained post year end, the Group is deemed not to have had an unconditional right to defer payment under these funding agreements as at the balance sheet date. As a consequence the balance sheet has been presented on the basis that all debt that could technically have become repayable as a result of failure to meet the original covenant definitions, whether by default, cross default or cross acceleration, has been classified within current liabilities, even though the covenant issue has subsequently been resolved. This presentation does not reflect the amended terms of the debt as at the date of signing the accounts.

To assist a reader of the accounts in better understanding the effect of those amended terms, as agreed post balance sheet date but prior to signing the accounts, an adjusted Balance Sheet, Loans and Borrowings Note (Note 24) and risk management tables (Note 33) have been included within the accounts to illustrate the impact on these areas of the accounts as if the amendments had been in place at the year end.

### Accounting dates

The financial statements are made up for the 52 weeks ended 4 January 2014. Comparatives are for the 53 weeks ended 5 January 2013. Since the financial periods are virtually co-terminus with the calendar years, the current period figures are headed 2013 and the comparatives are headed 2012. The comparative amounts are not entirely comparable with the results of 2013, which are based on a shorter period.

The Financial Services subsidiaries of the Group have prepared accounts for the period ended 31 December. This differs from the parent of the Group and other Trading Group subsidiaries which have accounting periods ended on the first Saturday of each new year (unless 31 December). For the period ending 4 January 2014, there are no significant transactions or events which need to be adjusted to reflect the difference in reporting dates. Although the Group disposed of 70% of the Bank on 20 December, its results have been consolidated up to 31 December, except for the impacts of the Liability Management Exercise (LME) as there were no other material transactions between the disposal date and the Bank's reporting date. As such, none of the Bank's result (or other comprehensive income) is included in the share of profit of associates and joint ventures line of the income statement.

## General Accounting Policies continued

### One-off costs

For 2013, the Group has changed its practice of classifying significant items separately within the income statement. Non-recurring items outside the normal operating activities of the Group that were material by both size and nature were previously classified as significant items and disclosed in a separate column on the face of the income statement. Following the disposal of the Bank, there has been a significant change in the entity's operations. The majority of significant items in the past have related to the Bank and therefore following its disposal and the inclusion of these costs within discontinued operations, the Group has re-assessed and changed its practice of disclosing one-off costs to be more in line with retail industry practice. In 2013, due to the significant impact it has had on the results for the period, the charge in relation to impairment of goodwill has been disclosed separately in the income statement. One-off costs include costs relating to activities such as large restructuring programmes, one-off impairments not relating to individual stores and costs or income which would not normally be seen as costs or income relating to the underlying principal activities of the Group.

However, to help the reader make a more informed judgement on the underlying profitability of the Group, a non-GAAP measure: underlying profit before member payments has been presented. This is shown at the bottom of the income statement and reconciled back to the statutory measure of profit before member payments. Added back in this non-GAAP measure are property and business disposals, the change in value of investment properties, one-off costs and non cash finance income and costs.

### 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 do so and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

### Going concern

The Directors have considered the Group's business activities, together with the factors likely to affect its future development, performance and position (as set out in the Business Review on pages 15 to 21). The Directors have also assessed the financial risks facing the Group, its liquidity position and available borrowing facilities. These are principally described in Note 24 to the accounts. In addition, Notes 24 and 33 also include details of the Group's objectives, policies and processes for managing its capital, its financial risk management objectives and its financial instruments and hedging activities.

In assessing the appropriateness of the going concern basis of preparation, the Directors have firstly considered the going concern position and outlook of the Trading Group, General Insurance business and Reclaim Fund separately, as they are independently funded. Details of the relevant factors in relation to the going concern position of each of these businesses are set out below. The Directors have then, taking these individual assessments into account, considered the overall going concern position of the Group.

#### The Trading Group

The Trading Group meets its working capital requirements through a number of separate funding arrangements, as set out in detail in note 24, certain of which are provided subject to continued compliance with certain covenants (Debt Covenants).

Profitability and cash flow forecasts for the Trading Group, prepared for the period to July 2015 (the forecast period), and adjusted for sensitivities considered by the Board to be reasonably possible in relation to both trading performance and cash flow requirements, indicate that the Trading Group will have sufficient resources available within its current funding arrangements to meet its working capital needs, and to meet its obligations as they fall due.

In making this assessment, the directors have considered the ability of the Trading Group to satisfy its commitment to make a £313m capital contribution to the Co-operative Bank plc (the 'Bank') under the terms of the Liability Management Exercise, in respect of which £263m remained outstanding as at 17 April 2014 (£100m of which is payable by 30 June 2014 and £163m by 31 December 2014). The Group plans to fund this commitment through deferral of capital expenditure, asset and business disposals.

The directors have a high level of confidence that these plans will be successful, although they recognise that, as with all such plans, there is a degree of execution risk. The Group has a number of alternative actions that it could take in order to meet its commitment to the Bank, and is therefore confident that these plans provide assurance that the commitment will be met.

In the unlikely event that the Group is unable to meet its commitment, the Bank, under the terms of the commitment, would have the right to remove the Group's nominated Directors from the Bank's Board of Directors, and transfer ownership of the Group's shares in the Bank to a third party, or to the Bank pending disposal to a third party. The receipts of such a sale of the Group's investment in the Bank would be applied to the outstanding balance owed by the Group (which at 17 April 2014 amounted to £263m), with any excess proceeds returned to Group, or any shortfall remaining outstanding as an interest bearing loan that would not be due for repayment in the foreseeable future. Should this be the case, then the Society and the remaining Group would still be able to continue to operate, as a going concern, within the terms of its existing available funding arrangements.

The Directors have also assessed the potential impact on the Group's going concern position of the planned rights issue which was announced by the Bank subsequent to the year end. For the purpose of their going concern assessment the Directors have assumed that the Group does not take up its rights. Further information on the rights issue is given in note 39 Events After the Reporting Period.

The directors have also considered the ability of the Trading Group to comply with its Debt Covenants at both 31 December 2013 and throughout the forecast period.

## General Accounting Policies continued

Based on the audited balance sheet at 4 January 2014, without further action the Group would have been in breach of two of its Debt Covenants (principally as a result of the recognition of an impairment charge of £226m in respect of goodwill and the de-consolidation of the Bank following the LME); firstly the net asset covenant within the Group's unsecured bank loan facilities and secondly the Total Consolidated Borrowings to Total Consolidated Net Worth covenant in relation to the 7.5/8% First Mortgage Debenture stock. Subsequent to the year end, amendments to the relevant Debt Covenants have been reached with the banking syndicate and the 7.5/8% First Mortgage Debenture stock holders respectively to enable the Group to comply with those covenants, and it is forecast to remain in compliance throughout the period of its forecasts.

In accordance with relevant accounting standards, however, because the covenant amendments were agreed subsequent to the year end, the Group was deemed not to have an unconditional right to defer payment for more than 12 months at the balance sheet date. As a consequence, the balance sheet has been presented on the basis that the debt that could technically have become repayable, whether by default, cross default or cross acceleration within 12 months (totalling £1,457 million) has been classified within current liabilities, even though the potential covenant issues have subsequently been resolved.

This balance sheet presentation does not reflect the amended terms of the debt as at the date of signing the accounts. Therefore, to assist a reader of the accounts in better understanding the effect of the amended terms, as agreed post balance sheet date but prior to signing the accounts, an adjusted Balance Sheet, Loans and Borrowings (Note 24) and risk management tables (Note 33) have been included within the accounts to illustrate the impact on these areas of the accounts as if the amendments had been in place at the year end.

The directors have also considered the current uncertainty surrounding potential changes to the Group's governance structures, and the potential impact that this uncertainty may have on the Group's external lenders, customers, suppliers and other stakeholders. A sub-committee of the Board has been established to consider the findings of Lord Myners' report and to make recommendations to the Board on the route to reform. The Board will propose a resolution to the General Meeting on 17 May 2014 seeking approval to the principles of reform. Management is aware of the impact that the current uncertainty surrounding the potential governance changes is having, and could continue to have, on the Group's reputation, and continues, therefore, to pro-actively engage with its key stakeholders (including customers, suppliers and external lenders) on this matter.

### General Insurance Business

The Group's insurance business has to comply with a number of regulatory capital requirements. Current forecasts show that the insurance business should be able to operate within its regulatory capital requirements for the foreseeable future. In making this assessment, the insurance business has considered a number of stress tests on capital, none of which result in a breach of existing externally imposed capital requirements. The insurance business will continue to manage its capital in accordance with these requirements.

### The Reclaim Fund

The Reclaim Fund Limited is run on a not-for-profit basis to manage dormant account monies. It is regulated principally by the Financial Conduct Authority which requires capital to be held in respect of its activities as a Banking firm. During 2011 the Reclaim Fund created capital reserves of £73.7m. Upon transfer of dormant accounts monies from UK Financial Institutions to the Reclaim Fund, the right of individual account holders to reclaim their money is also transferred, therefore the Company holds a provision for future repayments of individuals' balances. Any surplus generated is distributed to the Big Lottery Fund in the current or future years.

After consideration of the factors set out above, and, after making all appropriate enquiries, the Directors have a reasonable expectation that the Society and the Group has access to adequate resources to enable it 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.

## Critical accounting estimates and judgements in applying accounting policies

The preparation of financial statements in conformity with IFRS requires management to make judgements, 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 judgements 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.

Judgements and estimates made by management in the application of IFRSs that have a 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:

- Classification of discontinued operations (Note 9)
- Non-current asset impairment (Notes 10 & 11) and financial asset impairment (Note 36c)
- Accounting for the disposal and valuation of the Group's investment in Co-operative Bank Plc (Note 13)
- Pensions (Note 16)
- Provisions (Note 26)
- General Insurance claims and reserves (Note 22)

The Group has applied all endorsed IFRSs that are effective on a European basis for the Group's financial statements for the period ended 4 January 2014 and the comparative period.

## General Accounting Policies continued

### Restatement and changes in accounting policies

Following the disposal of 70% of the Group's interest in the Bank the results of this business have been included within discontinued operations in accordance with IFRS 5. The comparatives have also been restated in order that the prior year results are on a comparable basis.

As disclosed in note 9 and note 20 the General Insurance business was classified as held for sale at the half year but following a decision to cancel the sale of this business, is now included as if it was never held for sale in the period.

Following the adoption of IAS 19 revised on 6 January 2013, the comparatives have been restated in order to be on a comparable basis. The main effect of the revised standard is that it eliminates the 'expected return on assets' from the measurement of a pension's expense and instead charges a cost of finance against its net unfunded liability or surplus position. This is performed by determining a discount rate in reference to market yields from high quality corporate bonds ahead of any previously assumed actual long-term rate expected on the assets held. Details of the restatement can be found in note 16.

IFRS 13 Fair value measurement (2011) was adopted by the Group on 6 January 2013. The standard establishes a single framework for measuring fair value. As a result of adopting this standard, the Group has included additional disclosures. This IFRS has been applied prospectively in accordance with the transitional provisions, meaning that there has been no restatement of the comparatives.

IAS 1 Revised Presentation of Financial Statements was also adopted by the Group on 6 January. The Group has modified its presentation of items in the statement of other comprehensive income to present separately items that would be reclassified to profit or loss from those that would never be. The prior period information has also been amended to aid comparability.

IFRS 7 Amendments related to the offsetting of assets and liabilities. This amendment increases disclosures around the offsetting of assets and liabilities.

The Group has decided to early adopt amendments to IAS 36 Recoverable Amount Disclosures for Non-Financial Assets. This standard has the impact of increasing disclosure around recoverable values of non-financial assets.

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

The Group has not early adopted the following standards and statements. The adoption of these standards is not expected to have a material impact on the Group's accounts when adopted. In particular, from analysing IFRS 10, management have concluded that the adoption of this new standard will not change the accounting currently applied to its investments, in particular in the Bank or the Travel business going forward.

- IFRS 10 Consolidated financial statements (2011)\*
- IFRS 11 Joint Arrangements (2011)\*
- IFRS 12 Disclosure of Interests in Other Entities (2011)\*
- Amended IAS 27 Consolidated and Separate Financial Statements (2011)\*
- Amended IAS 28 Investments in associates and joint ventures (2011)\*
- Amendments to IAS 19 Defined benefit plans: employee contributions\*\*
- Amendments to IAS 32 Offsetting financial assets and financial liabilities
- Amendments to IAS 39 Novation of Derivatives and Continuation of Hedge Accounting
- IFRIC 21 Levies (2013)\*\*
- IFRS 9 (Financial Instruments: Classification and Measurement (2013))\*\*

This new standard replaces IAS 39 (Financial Instruments: Recognition and Measurement (2009)). IFRS 9 Financial Instruments includes requirements for recognition and measurement, derecognition and hedge accounting. IFRS 9 was originally issued in November 2009, reissued in October 2010, and then amended in November 2013. The current version of IFRS 9 does not include a mandatory effective date but is available for adoption (subject to local endorsement requirements). An effective date will be added when all phases of the project are complete and a final version of IFRS 9 is issued. The standard is currently being drafted and so a detailed assessment of its impact is not currently possible.

\* Despite these standards becoming effective for periods beginning on or after 1 January 2013, The European Union has set a European effective date of 1 January 2014.

\*\* Not yet endorsed by the EU, except IFRS 9 which was endorsed on 1 January 2014 and has an effective date of 1 January 2018.

# Notes to the financial statements

## 1. Operating segments

The segmental information presented below reflects the key components of the Group, the operating results of which are regularly reviewed by the Chief Operating Decision Maker (CODM) which is the Group's Chief Executive Officer.

A summary of the operations of the businesses and further financial information on all segments can be found in the business reviews on pages 15 to 18.

	2013				
	Revenue from external customers <sup>(f)</sup> £m	Underlying segment operating profit <sup>(a)</sup> £m	Operating loss £m	Additions to non-current assets <sup>(e, f)</sup> £m	Depreciation and amortisation <sup>(e)</sup> £m
Food	7,237	247	(35)	170	(211)
Pharmacy	760	33	33	13	(35)
Funeralcare	370	62	50	26	(20)
General Insurance	476	36	36	70	(65)
Estates	28	11	–	1	(2)
Federal <sup>(g)</sup>	1,462	–	–	–	–
Corporate costs and other	201	(179)	(232)	29	(16)
<b>Total</b>	<b>10,534</b>	<b>210</b>	<b>(148)</b>	<b>309</b>	<b>(349)</b>

	2012 (restated)				
	Revenue from external customers <sup>(f)</sup> £m	Underlying segment operating profit <sup>(a)</sup> £m	Operating profit £m	Additions to non-current assets <sup>(e, f)</sup> £m	Depreciation and amortisation <sup>(e)</sup> £m
Food	7,442	269	183	194	(225)
Pharmacy	764	28	35	9	(35)
Funeralcare	358	60	60	27	(19)
General Insurance	580	13	8	61	(64)
Estates	36	19	3	14	(2)
Federal <sup>(g)</sup>	1,421	–	–	–	–
Corporate costs and other	366	(92)	(147)	141	(12)
<b>Total</b>	<b>10,967</b>	<b>297</b>	<b>142</b>	<b>446</b>	<b>(357)</b>

- a) Underlying segment operating profit is a non-GAAP measure of segment operating profit before property disposals, change in value of investment properties and one-off costs.
- b) Each segment derives its revenue and profits from the sale of goods and provision of services, mainly from retail.
- c) The Group identifies its operating segments based on its divisions, which are organised mainly on the differing products and services it offers its customers. The reportable operating segments (and the captions) reported above are based on the reporting lines into the CODM and whether the respective division's results meet the IFRS 8 minimum reporting thresholds. If a division's CEO does not report into the CODM, and its results are smaller than the minimum thresholds, then that division's results have been reported in 'Other'. 'Other' includes the Group's Legal Services, Electricals, Sunwin Services and Motors businesses and their results have been combined as allowed by IFRS 8. Other Financial Services entities (mainly holding, ancillary companies and the Reclaim Fund Ltd) are also within other.
- d) The operating segments disclosed have been changed and restated where relevant following the divestment of the Bank and the Life business. The Bank's results are now reported within discontinued operations and going forward will be included within the share of profits of associates and joint ventures and joint ventures line, which are not part of the underlying segment operating profit which the CODM reviews on a regular basis. The Life Business (which was also included within the Group's Financial Services division) was sold in August 2013 and its results are also included within discontinued operations. This means that the only reportable segment within Financial Services is the General Insurance business, whose results are now regularly reviewed by the CODM and so have been included. The Trading Group operating segments have also been restated as there is no longer a Specialist Businesses reporting line into the CODM. As a result, the segments are based on individual products and services as described above. The Group's Life Planning business' results are now included within Funeralcare's result, consistent with how the CODM reviews its results. The Food underlying segment operating profit has been reduced by £19m to include impairment of stores previously reported within significant items. Corporate costs and other has been restated by £7m due to pension administrative costs being accounted for in operating costs as directed by IAS 19R when previously they were debited to finance income (see note 16 for further details).
- e) Additions to non-current assets is derived on a cashflow basis and includes additions to financial instruments, deferred tax assets and post employment benefit assets. Depreciation and amortisation includes amortisation of deferred income relating to the Co-operative Travel brand.
- f) The Group's external revenue and non-current assets arise primarily within the United Kingdom. The Group does not have a major customer who accounts for 10% or more of revenue. There are no material transactions between the main operating segments stated above.

## Notes to the financial statements continued

### 1. Operating segments continued

- g) Federal relates to the activities of a joint buying group that is operated by the Group for other independent Co-operative societies. This is run on a cost recovery basis and therefore no profit is derived from its activities.
- h) Transactions between operating segments excluded in the above are £24m of sales of Sunwin Services Group, £9m sales of Co-op Electrical and £3m of sales of the General Insurance business.
- i) A reconciliation between underlying segment operating profit and operating (loss)/profit is as follows:

	2013						Total £m
	Food £m	Pharmacy £m	Funeralcare £m	General insurance £m	Estates £m	Corporate costs & other £m	
Underlying segment operating profit	247	33	62	36	11	(179)	210
One off items:							
– Acquisition and restructuring costs	(6)	–	–	–	–	(54)	(60)
– Impairment of goodwill	(226)	–	–	–	–	(13)	(239)
– Change in accounting estimate regarding funeral benefit options	–	–	(12)	–	–	–	(12)
One off items	(232)	–	(12)	–	–	(67)	(311)
Property and business disposals	(50)	–	–	–	7	14	(29)
Change in value of investment properties	–	–	–	–	(18)	–	(18)
Operating (loss)/profit	(35)	33	50	36	–	(232)	(148)

	2012 (restated)						Total £m
	Food £m	Pharmacy £m	Funeralcare £m	General insurance £m	Estates £m	Corporate costs & other £m	
Underlying segment operating profit	269	28	60	13	19	(92)	297
One off items:							
– Acquisition and restructuring costs	(32)	–	–	(5)	–	(49)	(86)
– Reversal of China Joint Venture impairment	–	6	–	–	–	–	6
One off items	(32)	6	–	(5)	–	(49)	(80)
Property and business disposals	(54)	1	–	–	9	(6)	(50)
Change in value of investment properties	–	–	–	–	(25)	–	(25)
Operating profit/(loss)	183	35	60	8	3	(147)	142

Acquisition and restructuring costs mainly relate to costs incurred in modernising our corporate central teams and food distribution network. For more details on the impairment of goodwill refer to note 11 and for the change in accounting estimate in relation to Funeral Benefit Options, refer to note 19.

## Notes to the financial statements continued

### 1. Operating segments continued

j) A reconciliation between underlying segment operating profit and loss before tax is provided below:

	Note	2013 £m	2012 (restated) £m
Underlying segment operating profit		<b>210</b>	297
Underlying interest payable	6	<b>(100)</b>	(106)
Underlying profit before payments to Members		<b>110</b>	191
One-off items (see above)		<b>(311)</b>	(80)
Property and business disposals	3	<b>(29)</b>	(50)
Change in value of investment properties	3	<b>(18)</b>	(25)
Finance income	5	<b>13</b>	10
Non-cash finance income/(costs)	6	<b>13</b>	(10)
Share of profit of associates and joint ventures*	13	<b>–</b>	4
(Loss)/profit before member payments		<b>(222)</b>	40
Member payments	7	<b>(55)</b>	(104)
Loss before tax		<b>(277)</b>	(64)

\* Due to the proximity of the results of the Bank at 31 December 2013 to the transaction date at 20 December 2013 (see page 71 for details), there is no share of the Bank's result to record in the period post disposal.

### 2. Revenue

	2013 £m	2012 (restated) £m
Sale of goods	<b>8,174</b>	8,554
Provision of services	<b>422</b>	412
Federal sales	<b>1,462</b>	1,421
Gross earned premiums	<b>509</b>	611
Premiums ceded to reinsurers	<b>(33)</b>	(31)
Net revenue	<b>10,534</b>	10,967
Value Added Tax	<b>825</b>	877
Gross sales	<b>11,359</b>	11,844

## Notes to the financial statements continued

### 2. Revenue continued

#### Accounting policies

##### Gross sales

A non-GAAP measure representing the amounts receivable by the Group for goods and services supplied to customers, net of discounts but including VAT.

##### Sale of goods

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 customer discounts (except staff discounts), rebates, VAT and other sales tax or duty. For the sale of goods, revenue is recognised at the point of sale. The revenue recognition accounting policy for prepaid funeral plans is discussed in more detail in note 25.

##### Provision of services

Provision of services relates to activities in Funeralcare, Legal Services and Sunwin Services Group. Revenue is recognised when the service is rendered and the revenue can be reliably measured.

##### Gross earned premiums

Gross written premiums comprise receivables on those contracts which were inceptioned during the period, irrespective of whether they relate in whole or in part to a later accounting period, together with any necessary adjustments to amounts reported in prior periods.

Gross written premiums:

- Are stated gross of commission and exclude any taxes or levies based on premiums
- Include an estimate of the premiums receivable on those contracts which inceptioned prior to the period end but which have not been notified by the balance sheet date ('pipeline premium'). When calculating pipeline premiums it is assumed, where appropriate, that options to renew contracts automatically will be exercised

Gross written premiums (whether paid in advance or by instalments) are earned evenly over the period of the contract (usually 12 months). The treatment of outward reinsurance premiums is similar to gross premiums written.

### 3. Operating expenses

Operating (loss)/profit is stated after charging the following:

	2013 £m	2012 (restated) £m
Cost of sales		
– Trading activities	<b>(7,083)</b>	(7,373)
– Claims incurred, net of claims recovered from reinsurers	<b>(331)</b>	(502)
– Fee and commission expense	<b>(20)</b>	(22)
Employee benefits expense (see below)	<b>(1,479)</b>	(1,522)
Net loss on property and business disposals	<b>(29)</b>	(50)
Change in value of investment properties	<b>(18)</b>	(25)
Operating lease rentals	<b>(209)</b>	(198)
Impairment of non-current assets	<b>(263)</b>	(23)
Depreciation	<b>(259)</b>	(268)
Amortisation	<b>(90)</b>	(89)
Subscriptions and donations	<b>(3)</b>	(2)

Depreciation, amortisation and impairment of non-current assets relate to continuing businesses. The figures in notes 10 and 11 also include charges relating to discontinued operations.

Net loss on disposal of property and business disposals includes a profit of £14m in relation to the disposal of the Albert Farnell motors business. The result of this business is not classified as a discontinued business as disclosed in note 9.

## Notes to the financial statements continued

### 3. Operating expenses continued

#### Employee benefits expense

	2013 £m	2012 (restated) £m
Wages and salaries	(1,290)	(1,342)
Social security costs	(78)	(77)
Pension costs – defined benefit schemes	(89)	(97)
Pension costs – defined contribution schemes	(22)	(6)
	<b>(1,479)</b>	<b>(1,522)</b>

The average number of people employed by the Group in the UK (excluding discontinued businesses) was:

	2013	2012 (restated)
Full-time	30,366	31,538
Part-time	57,680	61,637
	<b>88,046</b>	<b>93,175</b>

#### Remuneration of key management

For details regarding remuneration of the Group Board and the Executive refer to pages 42 to 58.

	2013 £m	2012 £m
<b>Auditors' remuneration and expenses</b>		
Audit of these financial statements	0.9	1.0
Amounts receivable by the Society's auditor in respect of:		
Audit of financial statements of subsidiaries in respect of the Society	0.5	0.5
Other services pursuant to such legislation	–	0.1
Services relating to:		
Other tax advisory services	–	0.2
Corporate finance services	3.9	3.3
Information technology services	–	1.0
Pensions services	–	0.3
All other services	0.4	1.0
Total	<b>5.7</b>	<b>7.4</b>

In both the current and prior period, the above figures include auditors' remuneration and expenses in respect of discontinued operations. Of the total amounts presented, £1.5m relates to continuing operations in 2013 (2012: £3.3m) and £3.9m relates to services provided to the Bank including total audit fees of £0.6m and non-audit fees of £3.3m (predominantly relating to LME and Project Verde advisory costs). £1.5m of the above has been offset against the Bank's other borrowed funds as allowed by IAS 39. No other costs in relation to services performed by the auditors were capitalised during the current or prior period.

#### Accounting policies

##### Operating expenses

Operating expenses are analysed by nature, as defined by IAS 1.

Fees and commission payable mainly relates to commission payable to broker intermediaries that is incurred over the lifetime of the related policy. All other fee and commission payable is recognised on an accruals basis as the service is provided.

## Notes to the financial statements continued

### 4. Other income

Income from activities outside the normal trading activities of the Group include:

	<b>2013</b>	2012 (restated)
	<b>£m</b>	£m
Investment income	<b>28</b>	52
Gains less losses arising from financial instruments	<b>13</b>	23
Rental income from investment property	<b>13</b>	19
Fee and commission income	<b>14</b>	16
	<b>68</b>	110

#### Accounting policies

##### Investment income

Interest income on CISGIL financial assets designated as available for sale and loans and receivables are recognised within investment income on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees, and discounts and premiums where appropriate. This income is treated as other income rather than as a finance income or cost as it relates specifically to a Financial Services entity.

The EIR basis spreads the interest income over the expected life of the instrument. The EIR is the rate that, at 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 EIR, General Insurance estimates cash flows considering all contractual terms of the instrument (for example prepayment options) but does not consider future credit losses.

Interest income on assets designated as fair value through income and expense is recognised within investment income in the income statement as it accrues on an effective interest basis.

##### Gains less losses arising from financial instruments

Investments in the General Insurance business, other than those in debt securities, are classified as financial assets at fair value through the income statement. They are included within other income as they are not part of the normal funding arrangements of the Group.

##### Rental income from investment property

Rental income arising from operating leases on investment properties is accounted for on a straight-line basis over the lease term. For accounting policies relating to investment property, refer to note 12.

##### Fee and commission income

Fees and commission receivable mainly relates to sundry fee/commission income from CISGIL's aggregator partner and is earned over the lifetime of the related policy or when services are provided, as deemed appropriate. All other fee and commission income is recognised on an accruals basis.

### 5. Finance income

	<b>2013</b>	2012 (restated)
	<b>£m</b>	£m
Net pension finance income	<b>13</b>	10

The prior period figure has been restated from £47m in line with the revision to IAS 19. For more information on pension interest and expected return on planned assets, refer to note 16.

## Notes to the financial statements continued

### 6. Finance costs

	2013 £m	2012 £m
Loans repayable within five years	(87)	(91)
Loans repayable wholly or in part after five years	(12)	(14)
Corporate investor share interest	(1)	(1)
Underlying interest payable	(100)	(106)
Fair value movement on quoted Group debt	21	(21)
Fair value movement on Group interest rate swaps	2	23
Discount unwind of provisions (note 26)	(10)	(12)
Non-cash finance income/(costs)	13	(10)
Total finance costs	(87)	(116)

Fair value movements on forward currency transactions were immaterial in the current and prior period.

### 7. Member payments

	2013 £m	2012 £m
To individual Members	(26)	(53)
To employees who are Members	(13)	(24)
To corporate Members	(10)	(17)
Community distribution	(6)	(10)
	(55)	(104)

Further details of Member payments are shown in the Finance Review on pages 10 to 14.

#### Accounting policies

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 ("Members") that are classified as debt, such as corporate investor shares (see note 24), 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 accounted for as an appropriation of profit. Vouchers to Members which are not formally approved at a general meeting are considered discounts and are deducted from revenue (see note 2).

Payments to Members in their capacity as customers or employees are treated as charges in the income statement. Additionally Members are allocated funds to distribute to charitable and Co-operative organisations which are also treated as charges to 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 and the Society making a profit within the year, these payments are termed 'Member payments', charged below operating profit (where material) and recognised when such payments are approved by the membership.

## Notes to the financial statements continued

### 8. Taxation

	2013 £m	2012 (restated) £m
Current tax (charge)/credit current year	(66)	18
Current tax (charge)/credit – adjustments in respect of prior years	(5)	27
Deferred tax (charge)/credit – current year	(75)	139
Deferred tax credit/(charge) – adjustments in respect of prior years	33	(5)
Total tax (charge)/credit	(113)	179
Deduct tax charge/(credit) on discontinued businesses	158	(161)
Total tax credit on continuing businesses	45	18

The tax on the Group's net profit before tax differs from the theoretical amount that would arise using the standard applicable blended rate of corporation tax of 23.25% (2012: 24.5%) as follows:

	2013 £m	2012 (restated) £m
Loss before tax	(277)	(64)
Current tax credit at 23.25% (2012: 24.5%)	64	16
Expenses not deductible for tax (including one-off costs)	(68)	(17)
Depreciation and amortisation on non-qualifying assets	(8)	(14)
Adjustment in respect of previous periods	28	32
Losses taxed at lower rate/utilisation of losses	17	1
Restatement of deferred tax to 20% (2012: 23%)	12	–
Tax credit on continuing business	45	18

### Tax benefit/(expense) items taken directly to consolidated statement of comprehensive income

	2013 Tax (expense)/ benefit £m	2012 (restated) Tax (expense)/ benefit £m
Changes in available for sale assets	20	(12)
Actuarial gains and losses on employee pension scheme	20	2
Effective portion of cash flow hedges transferred to the cash flow hedging reserve	19	5
	59	(5)

Of the tax taken directly to the consolidated statement of comprehensive income, £37m credit (2012: £6m) relates to deferred taxation. See note 17 on deferred tax.

The 2013 Budget on 20 March 2013 announced that the UK corporation tax rate will reduce to 20% with effect from 1 April 2015. Reductions in the rate from 24% (effective from 1 April 2012) to 23% (effective from 1 April 2013), and to 21% (effective from 1 April 2014) were substantively enacted on 26 March 2012, 3 July 2012 and 17 July 2013 respectively. This will reduce the company's future current tax charge accordingly. The deferred tax liability at 31 December 2013 has been calculated based on the rate of 20% substantively enacted at the balance sheet date.

### Accounting policies

Income tax on the profit or loss for the period 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 reserves, in which case it is recognised in other comprehensive income. 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.

### 9. Loss on discontinued operations, net of tax

On 20 December 2013, the Group announced the completion of 'the Liability Management Exercise (LME) by the Co-operative Bank plc'. As a result of this exercise, the Group's equity stake in the Bank reduced from 100% to 30%. From this date the Group is no longer able to exercise control over the Bank, and therefore the Group has ceased to account for its investment as a subsidiary. The results of the Bank and its subsidiaries have therefore been included within discontinued operations in both the current (up to 20 December 2013) and the prior period. As the Group can continue to demonstrate significant influence over the Bank, the Group now accounts for its investment as an associate (see note 13 for more information). The various elements of the LME have been treated as one overall transaction, being the loss of control of a subsidiary, as permitted by IAS 27.

## Notes to the financial statements continued

### 9. Loss on discontinued operations, net of tax continued

The cost to the Group of completing the LME was £527m which consisted of a discounted deferred cash consideration of £320m, the issue of new debt to bondholders of £129m (see note 24) and disposal and separation costs of £78m. The deferred cash consideration was £333m (discounted to £320m) on the date of the LME with £20m paid before the year-end and the remaining £313m comprising several tranches: £50 million payable no later than 31 January 2014, £100 million payable by 30 June 2014 and £163m payable by 31 December 2014. The disposal and separation costs include £39m of advisory fees and £39m of estimated costs of separating of key Group IT systems into separate Bank systems. As a result of the reduction in its shareholding in the Bank from 100% to 30%, the Group derecognised net assets of the Bank of £331m and instead recognised an investment in associate, which was fair valued at £221m (see note 13). This created a loss on disposal of £625m as illustrated in the following table.

As disclosed in note 30 there are a number of ongoing separation issues as a result of the LME and in particular the impact of the LME on the Group pension scheme Pace in which the Bank participates. The loss on disposal of £625m therefore does not include any impact of potential transfer of the Bank's share of the Pace liabilities to the Bank. The impact of this is dependent upon agreement with the Bank in relation to scheme liabilities properly attributable to the Bank. Several factors will require consideration and as such, this may not be agreed in 2014. The Group and the Bank have agreed to enter into good faith discussions but are not yet substantively underway. There may therefore be a further subsequent profit or loss on discontinued operations in relation to the final agreement of the treatment of the Bank's share of Pace liabilities.

On 1 August 2013, the Group announced the sale of CIS Limited (the entity responsible for the Life Insurance business) to Royal London Group. This sale included a number of its wholly owned subsidiaries and TCAM Limited (whose principal activity is the management of the life fund investment portfolio). The results of both CIS Limited and TCAM Limited in the current and prior period have been included in discontinued operations. The loss on disposal from this transaction is shown in the following table.

During the last two years, the Group has sold its clothing and motor businesses and also parts of its cash in transit business. As these businesses are not considered to be separate, major operating lines of the Group, they have not been disclosed as discontinued operations as defined by IFRS 5. At the half year, the General Insurance business was classified as discontinued. On 20 January 2014, the Group announced the decision to cancel the sale of this business. As a result of the business not being actively marketed at the year-end, the results of CIGIL are classified as continuing operations for the whole of the period.

	2013 £m	2012 (restated) £m
<b>Results of discontinued operations</b>		
Revenue	<b>1,465</b>	1,795
Expenses	<b>(3,283)</b>	(3,704)
Other income	<b>559</b>	1,292
Results from operating activities	<b>(1,259)</b>	(617)
Loss on sale of discontinued operations (see below)	<b>(636)</b>	–
Share of profit of associates	–	1
Loss before tax	<b>(1,895)</b>	(616)
Tax – relating to operating activities*	<b>(179)</b>	105
Tax – relating to the loss on sale of discontinued operations	<b>5</b>	–
Loss for the period	<b>(2,069)</b>	(511)

\* Included within tax relating to operating activities is income tax relating to tax attributable to policyholder returns of £16m (2012: £56m).

Further details of income and expenses relating to the Co-operative Bank plc, the Life and Savings business and TCAM Limited can be found in note 35.

Expenses above include £2m (2012: £13m) related to the aborted Project Verde.

	Note	Bank £m	Life and Savings £m	Total £m
<b>Loss on sale of discontinued operations</b>				
Investment in associate recognised at fair value	13	221	–	221
Cash consideration received		–	90	90
Net assets derecognised as at 20 December 2013/1 August 2013 (see below)		(331)	(217)	(548)
Deferred cash consideration (payable)/receivable	25, 19	(320)	168	(152)
Interest-bearing loans and borrowings issued as part of LME transaction	24	(129)	–	(129)
Disposal and separation costs**		(78)	(52)	(130)
Recycle of available for sale and cashflow hedge reserves		12	–	12
Loss on sale of discontinued operations		(625)	(11)	(636)

\*\* £58m of costs in relation to the disposal of and separation of the Group from the Bank and Life and Savings were provided or accrued at 4 January 2014, the remainder was paid in cash in the period.

A summary of the assets and liabilities held by the subsidiaries at the point of their disposal is shown below together with Group's provisional assessment of the fair value of the Bank's assets and liabilities at the disposal date, including the impact of the LME. This fair value exercise has been undertaken as part of the assessment of the appropriate carrying value of the Group's investment in the Bank, which reflects both the provisional fair value of underlying assets and liabilities and goodwill, in accordance with IAS 28.

## Notes to the financial statements continued

### 9. Loss on discontinued operations, net of tax continued

	Bank pre-disposal £m	Bank at fair value (provisional) £m	Life & Savings pre-disposal £m
<b>Assets</b>			
Cash and balances at central banks	5,274	5,399	155
Insurance receivables	–	–	3,859
Derivatives	556	556	–
Loans and advances to banks	1,594	1,594	–
Loans and advances to customers	30,322	27,947	–
Fair value adjustments for hedged risk	108	108	–
Investments	4,669	4,667	19,729
Investments in associates and joint ventures	5	5	–
Intangible assets	111	111	10
Income tax	–	–	6
Property, plant and equipment	115	115	–
Deferred tax assets	–	–	–
Prepayments and other receivables	256	576	–
<b>Total assets disposed of</b>	<b>43,010</b>	<b>41,078</b>	<b>23,759</b>
<b>Liabilities</b>			
Amounts owed to credit institutions	2,758	2,758	–
Customer accounts	32,463	32,488	–
Capital bonds	538	538	–
Derivatives	539	539	1,503
Insurance and participation contracts	–	–	18,065
Debt securities in issue	4,195	4,702	–
Other borrowed funds	1,256	234	–
Income tax payable	–	–	–
Trade and other payables	261	323	–
Deferred tax liabilities	93	93	54
Pension liabilities (see note 16)	–	–	–
Provisions	576	576	9
Insurance payables	–	–	2,624
Net asset value attributable to unit holders	–	–	76
Unallocated divisible surplus	–	–	1,211
<b>Total liabilities disposed of</b>	<b>42,679</b>	<b>42,251</b>	<b>23,542</b>
<b>Net assets/(liabilities) disposed of</b>	<b>331</b>	<b>(1,173)</b>	<b>217</b>
<b>Fair value of assets and liabilities of Bank post disposal at 30%</b>		<b>(352)</b>	

The net assets disposed of of £331m include non-controlling interests of £34m.

	2013 £m	2012 restated £m
Cash flows used in discontinued operations:		
Net cash from operating activities	<b>(2,277)</b>	857
Net cash from investing activities	<b>(3,983)</b>	(2,383)
Net cash used in financing activities	<b>(131)</b>	(35)
Net cash used in discontinued operations	<b>(6,391)</b>	(1,561)

## Notes to the financial statements continued

### 9. Loss on discontinued operations, net of tax continued

#### Accounting policies

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 exclusively with a view to resale.

### 10. Property, plant and equipment

	2013 £m	2012 £m
Trading Group	2,277	2,440
Financial Services	34	163
Total	2,311	2,603

#### For the period ended 4 January 2014

	Property £m	Plant and equipment £m	Total £m
Cost or valuation:			
At 5 January 2013	1,689	2,489	4,178
Additions	73	210	283
Reclassified as assets held for sale (see note 20)	(50)	(10)	(60)
Disposals	(63)	(140)	(203)
Disposals arising from loss of control of subsidiary	(109)	(155)	(264)
<b>At 4 January 2014</b>	<b>1,540</b>	<b>2,394</b>	<b>3,934</b>
Depreciation:			
At 5 January 2013	281	1,294	1,575
Charge for the period	32	257	289
Impairment	15	19	34
Reclassified as assets held for sale (see note 20)	(1)	–	(1)
Disposals	(12)	(113)	(125)
Disposals arising from loss of control of subsidiary	(41)	(108)	(149)
<b>At 4 January 2014</b>	<b>274</b>	<b>1,349</b>	<b>1,623</b>
Net book value:			
<b>At 4 January 2014</b>	<b>1,266</b>	<b>1,045</b>	<b>2,311</b>
At 5 January 2013	1,408	1,195	2,603
Capital work in progress included above	1	47	48

Within property, land of £49m (2012: £49m) is held at valuation (IFRS 13 level 3 hierarchy). The historical cost equivalent is £1m (2012: £1m). This relates to agricultural land held for development purposes, but farmed by the Group whilst the development potential is explored. The assets were fair valued because the historical cost from many decades ago did not represent the true potential value of the farmland that could be developed. The carrying amount of £49m is tested annually for impairment in line with the Group's approach to all property, plant and equipment. Valuations are based on rental yields in an active market at similar sites.

The impairment charge of £34m (2012: £21m) mainly comprises impairment of loss making stores in Food (£20m) and £10m relating to an office building earmarked for sale. No impairment charge went through the statement of other comprehensive income in the period (2012: £nil) as the charge relates to assets held at original cost which have not previously been revalued. Impairment losses relating to continuing businesses are recognised in operating expenses in the income statement.

The transfer to assets held for sale relates to vacant property and land previously occupied by the Group, that is expected to be sold to a joint venture as part of the Group's NOMA development. This includes buildings occupied by the Bank. For further details see note 20.

The disposals from loss of control of subsidiaries relates to the reduction of the Group's investment in the Bank from 100% to 30% on 20 December 2013.

## Notes to the financial statements continued

### 10. Property, plant and equipment continued

#### For the period ended 5 January 2013

	Property £m	Plant and equipment £m	Total £m
Cost or valuation:			
At 31 December 2011	1,761	2,311	4,072
Additions	220	288	508
Acquisition of subsidiaries	5	1	6
Transfers from Financial Services investments	11	–	11
Disposals	(308)	(111)	(419)
<b>At 5 January 2013</b>	<b>1,689</b>	<b>2,489</b>	<b>4,178</b>
Depreciation:			
At 31 December 2011	256	1,103	1,359
Charge for the period	32	266	298
Impairment	3	18	21
Disposals	(10)	(93)	(103)
<b>At 5 January 2013</b>	<b>281</b>	<b>1,294</b>	<b>1,575</b>
Net book value:			
<b>At 5 January 2013</b>	<b>1,408</b>	<b>1,195</b>	<b>2,603</b>
At 31 December 2011	1,505	1,208	2,713
Capital work in progress included above	4	50	54

	2013 £m	2012 £m
Plant and equipment includes assets held under finance leases as follows:		
Cost	35	53
Accumulated depreciation	(21)	(23)
Net book value	14	30

No other assets of the Group are held under finance lease.

Disposals in the prior period of £316m (net book value) included £136m relating to the sale and leaseback of 1 Angel Square. This had unconditionally exchanged on 21 December 2012 and was therefore accounted for as a disposal in 2012. The sale was completed and the cash received on 8 February 2013. The lease is accounted for as an operating lease under IAS 17.

### Critical accounting estimates and judgements

#### Impairment

The carrying amount of property, plant and equipment is reviewed at each balance sheet date and if there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. 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 associated goodwill allocated to cash-generating units, and then to reduce the carrying value of other fixed assets.

The recoverable amount is the greater of the fair value less costs to sell and value in use. The value in use of an asset is estimated by taking the relevant business' five year plan and discounting the cash flows associated with that asset at a post tax rate of between 7 – 10% dependent on the business. Certain central corporate costs and tax are also allocated to the asset on a reasonable basis. Cash flows beyond five years use a steady or declining growth rate dependent on the business. Fair value less costs to sell are measured using internal valuations based on the rental yield of the property.

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.

## Notes to the financial statements continued

### 10. Property, plant and equipment continued

#### Accounting policies

Where parts of an item of property, plant and equipment have materially 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 (excluding freehold land) on a straight-line basis over the anticipated working lives of the assets except for Funeralcare vehicles which are depreciated on a reducing balance basis of between 20% and 35%.

Useful lives are, generally:

#### Property

Freehold buildings – 50 years

Leasehold property – shorter of period of lease or 50 years

#### Plant & equipment

Plant and machinery – 3 to 13 years

Vehicles – 3 to 6 years

The residual value, if significant, is reassessed annually.

Freehold land that is subject to potential development is carried at fair value. Movements in fair value are recognised in the statement of comprehensive income.

The derecognition of property, plant and equipment occurs when the entity loses the future economic benefits associated with the asset. For a property disposal, this usually relates to when the property is unconditionally exchanged.

#### 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.

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.

#### Sale and leaseback

A sale and leaseback transaction is one where a vendor sells an asset and immediately reacquires the use of that asset by entering into a lease with the buyer. The accounting treatment of the sale and leaseback depends upon the substance of the transaction and whether or not the sale was made at the asset's fair value. For sale and finance leasebacks, any apparent profit or loss from the sale is deferred and amortised over the lease term. For sale and operating leasebacks, generally the assets are sold at fair value, and accordingly the profit or loss from the sale is recognised immediately in the income statement. Following initial recognition, the lease treatment is consistent with those principles described above.

## Notes to the financial statements continued

## 11. Goodwill and intangible assets

	2013 £m	2012 £m
Trading Group	1,234	1,518
Financial Services	47	303
Total	1,281	1,821

## For period ended 4 January 2014

	Goodwill £m	Licences £m	Computer software £m	Deferred acquisition costs £m	Other £m	Assets in course of construction £m	Total £m
Cost:							
At 5 January 2013	1,296	503	202	238	46	284	2,569
Additions – acquired separately	1	1	20	70	–	6	98
Transfers	–	–	138	–	–	(138)	–
Disposals	(21)	–	(8)	–	–	–	(29)
Disposals arising from loss of control of subsidiary	–	–	(304)	–	(46)	(150)	(500)
<b>At 4 January 2014</b>	<b>1,276</b>	<b>504</b>	<b>48</b>	<b>308</b>	<b>–</b>	<b>2</b>	<b>2,138</b>
Amortisation:							
At 5 January 2013	132	150	93	206	17	150	748
Charge for the period	–	25	31	65	4	–	125
Impairment	239	1	140	–	2	–	382
Transfer to assets held for sale	–	–	–	–	–	–	–
Disposals	–	–	(9)	–	–	–	(9)
Disposals arising from loss of control of subsidiary	–	–	(216)	–	(23)	(150)	(389)
<b>At 4 January 2014</b>	<b>371</b>	<b>176</b>	<b>39</b>	<b>271</b>	<b>–</b>	<b>–</b>	<b>857</b>
Net book value:							
<b>At 4 January 2014</b>	<b>905</b>	<b>328</b>	<b>9</b>	<b>37</b>	<b>–</b>	<b>2</b>	<b>1,281</b>
At 5 January 2013	1,164	353	109	32	29	134	1,821

## For period ended 5 January 2013

	Goodwill £m	Licences £m	Computer software £m	Deferred acquisition costs £m	Other £m	Assets in course of construction £m	Total £m
Cost:							
At 31 December 2011	1,274	503	183	177	46	220	2,403
Additions – acquired separately	25	–	1	–	–	–	26
Additions – internally developed	–	–	1	61	–	85	147
Transfers	–	–	21	–	–	(21)	–
Disposals	(3)	–	(4)	–	–	–	(7)
<b>At 5 January 2013</b>	<b>1,296</b>	<b>503</b>	<b>202</b>	<b>238</b>	<b>46</b>	<b>284</b>	<b>2,569</b>
Amortisation:							
At 31 December 2011	131	125	72	142	12	–	482
Charge for the period	–	25	24	64	5	–	118
Impairment	3	–	–	–	–	150	153
Disposals	(2)	–	(3)	–	–	–	(5)
<b>At 5 January 2013</b>	<b>132</b>	<b>150</b>	<b>93</b>	<b>206</b>	<b>17</b>	<b>150</b>	<b>748</b>
Net book value:							
<b>At 5 January 2013</b>	<b>1,164</b>	<b>353</b>	<b>109</b>	<b>32</b>	<b>29</b>	<b>134</b>	<b>1,821</b>
At 31 December 2011	1,143	378	111	35	34	220	1,921

## Notes to the financial statements continued

### 11. Goodwill and intangible assets continued

#### Goodwill

The components of goodwill are as follows:

	2013 £m	2012 £m
Food	856	1,102
Other businesses	49	62
	<b>905</b>	<b>1,164</b>

The components of Food goodwill include £611m (2012: £868m) that is allocated to the group of CGUs that is Food as a whole; £86m (2012: £86m) allocated to stores acquired with the Alldays group; £149m (2012: £148m) assessed against other specific components of the Food business, none of which is individually significant; and £10m (2012: £nil) allocated to stores earmarked for disposal (see below for details of this re-allocation).

Within other businesses is goodwill relating to Funeralcare, Pharmacy and Legal Services.

Additions in the prior period include £18m in relation to the purchase of David Sands Limited on 24 April 2012 and £6m in relation to the acquisition of 10 Costcutter stores (for further details see note 32).

#### Impairment

The components of the impairment charge are as follows:

	2013 £m	2012 £m
<b>Included in operating expenses within continuing operations:</b>		
Goodwill in Food	226	2
Goodwill in Legal Services	13	–
Licences in Pharmacy	1	–
<b>Included in discontinued operations</b>		
Finacle asset in Financial Services	140	150
Brand in Financial Services	2	–
Goodwill in Financial Services	–	1
	<b>382</b>	<b>153</b>

The £142m of impairment in Financial Services occurred prior to the LME transaction on 20 December 2013. This impairment is therefore part of the operating loss from discontinued operations in the income statement.

#### Critical accounting estimates and judgements

##### Goodwill

A cash generating unit (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. Goodwill is allocated to CGUs or groups of CGUs as explained in the policy below. It is reallocated where appropriate based on relative values to reflect changes in the way goodwill is reported.

In the trading businesses, the CGUs' recoverable amounts are based on value in use estimates, using projections of the Group's performance based on the five-year plans approved by the Board. The discount rate is based on the cost of capital for each business and calculations range from 7 – 10% (2012: 7 – 11%). Business-specific growth rates are used to extrapolate cash flows beyond the five year plan. The cash flows for each business are risk adjusted as appropriate to their respective industry. Certain central corporate costs have been allocated as appropriate to each CGU.

The goodwill that arose on the acquisition of Somerfield is allocated to Food as a whole to reflect the synergies (principally buying benefits) that benefit the whole estate. Accordingly, impairment testing is carried out using the whole estate as the group of CGUs. The key assumption used in the review for potential impairment of this goodwill is cash flows from operation of stores (projecting growth at 1-3% (2012: 1-3%) based on management's best estimate based on the profile of the stores, and including an allocation of corporate central costs) taken into perpetuity and discounted to present value at a rate of 8% (2012: 8%). In each of the current and comparative year, sensitivity analysis has been performed on this testing for a 1% increase in discount rate and a decrease in growth to 1%; the cash flows remain well in excess of the current carrying value.

## Notes to the financial statements continued

### 11. Goodwill and intangible assets continued

In 2013, the True North strategy was implemented which shifts the focus of Food onto smaller convenience stores. As a result, a significant portion of the Food estate, including larger stores, will be closed or sold and the proceeds reinvested in smaller stores, often in different catchment areas. This represents a significant restructuring of the Food business, and as such the goodwill of £236m associated with the stores intended for disposal has been separately identified from that remaining within the wider food business and assessed for impairment. Within this group of CGUs, impairment testing has been carried out using discounted post tax cash flows from the business' 5 year plan up to the date of disposal (including an allocation of central corporate costs) and estimated disposal proceeds at a discount rate of 7.3%. The key assumption within the estimate of value in use is estimated disposal proceeds, which have been based on contracts or latest negotiations at the Balance sheet date where available, and otherwise have been estimated by RICS qualified property specialists employed by the group. The NPV of the disposal group calculated on this basis is £354m, resulting in an impairment of £226m.

For other Food individual stores/smaller groups such as Alldays, annual cashflows have been inflated for growth by between 1% and 3% (2012: 1-3%) per annum (dependent on the size of the acquisition group) taken into perpetuity and discounted to present value also using a 7.3% (2012: 7.1%) discount rate and after allocating Corporate costs.

For Funeralcare, average selling price increases and wage and cost inflation have been applied as per the assumptions in the five year plan. Cash flows have been projected based on the five year plan and into perpetuity from year 6 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.

For Legal Services, average selling price increases and wage and cost inflation have been applied as per the assumptions in the five year plan. During 2013, the Group impaired £13m of goodwill. This was due to a reassessment of the business plan which assumed a slower growth rate than previously applied. This change therefore lowered the value in use of this cash generating unit and an impairment was recognised. The discount rate used to assess the revised value in use of Legal Services was 9.5% (2012: 9.6%).

#### Licences and goodwill – Pharmacy

For the purposes of impairment testing of Pharmacy licences and goodwill, the recoverable amounts were determined by discounting future cash flows at a discount rate of 8.4% , assuming growth in profits of 3% per annum for 20 years. Sensitivity analysis has been performed with both the growth rate and discount rate adjusted by +/- 1%, and under these sensitivities significant headroom is maintained and the impact on impairment is immaterial.

#### Assets in the course of construction and computer software

Assets in the course of construction related solely to Financial Services. The remaining £2m is held by CFSMS. In the prior period they included an amount of £86m relating to the implementation of Finacle; a project to design and install a new core banking system. Impairment losses of £150m were recognised in relation to this asset in the prior period following the annual impairment testing exercise, with the remainder of the asset written off in the current period. In addition, computer software included £45m of assets relating to the Finacle Implementation project which were being amortised over a period of 10 years prior to the sale of the Bank.

### Accounting policies

#### Goodwill

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. 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.

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. Where impairment is required the amount is recognised in the income statement and cannot be written back.

Negative goodwill arising on an acquisition is recognised directly in the income statement.

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.

## Notes to the financial statements continued

### 11. Goodwill and intangible assets continued

#### Computer software

Stated at cost less cumulative amortisation and impairment. In Financial Services, all costs directly attributable 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 up to a maximum of ten years.

#### Other intangible assets

These 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.

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 was being amortised over the estimated useful life of three years prior to disposal.

#### 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 assets in the 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 above.

#### 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.

#### Amortisation

This is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets. Goodwill with an indefinite useful life is 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 (Core systems – maximum of 10 years)
- Pharmacy licences: 20 years
- General Insurance deferred acquisition cost assets: Up to 1 year

#### Impairment

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount (the greater of the fair value less costs to sell and value in use). 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.

The carrying amounts of the Group's intangibles are reviewed at each balance sheet date and whenever there is any indication of impairment. 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. If any such indication of impairment exists, the assets' recoverable amount is estimated.

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.

#### Deferred acquisition costs

Costs directly associated with the acquisition of new business in the General Insurance business, including commission, are capitalised and amortised in accordance with the rate at which the gross written premiums associated with the underlying contract are earned.

## Notes to the financial statements continued

### 12. Investment properties

	2013 £m	2012 £m
Valuation at beginning of period	273	340
Additions	2	3
Disposals	(154)	(45)
Transfers to investments in joint ventures (see note 13)	(5)	–
Revaluation deficit recognised in income statement	(18)	(25)
<b>Valuation at end of period</b>	<b>98</b>	<b>273</b>

As part of the Group's strategy to realise cash proceeds from its investment portfolio there have been disposals of £154m during the period. Included within this total is a sale of 40 properties to one party for £103m.

The remaining investment properties have been valued as at 4 January 2014 (IFRS 13 level 3 hierarchy). The valuation was carried out by a number of external chartered surveyors: CBRE 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.

In the case of investment properties, it is assumed that uplifts on valuation principally reflect future rentals.

The mean ERV (Estimated Rental Value) yield over the whole estate at the period end is 3.4% (2012: 6.5%). The yield has reduced since the prior period as the Group has sold the bulk of the income producing assets in 2013.

Direct operating expenses of investment property are not considered material to the Group in either the current or prior period. Rental income is disclosed in note 4. The transfer to investments in joint ventures represents the transfer of Biggleswade wind farm to a joint venture. For further details see note 13.

#### Accounting policies

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 and are 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. ERV is the Group's external valuers' opinion as to the open market rent, which on the date of valuation, could reasonably be expected to be obtained on a new letting or rent review.

On disposal of an investment property, the gain or loss on the disposal is recognised within the change in value of investment property line within the income statement.

Properties are valued individually, and yields therefore vary on a property-by-property basis. 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 in full and the property meets the criteria of an investment property under IAS 40. Separate portions of an owner occupied property which are not occupied by employees are transferred to investment property if these portions can be sold separately or leased out separately under a finance lease. Prior to such a transfer the property is measured at fair value with any uplift recognised in the income statement.

## Notes to the financial statements continued

### 13. Investments in associates and joint ventures

The Group's share of profits in relation to associates and joint ventures for the period was £nil (2012: £5m before restatement to reclassify £1m in relation to Britannia Personal Lending Limited to discontinued operations). The Group's interest in the Travel business contributed profits of £nil. Due to the approximation of the results of the Bank at 31 December 2013 to the transaction date at 20 December 2013 (see page 71 for details), there is no share of the Bank's post disposal result to record in 2013.

	2013		2012	
	Income £m	Investments £m	Income (restated) £m	Investments £m
TCCT Holdings UK Limited (Travel)	–	46	2	46
Biggleswade Windfarm Limited (Estates)	–	5	–	–
White Mill Windfarm Limited (Estates)	–	4	1	4
Coldham Windfarm Limited (Estates)	–	3	1	3
Pharmacy associates and joint ventures	–	1	–	1
Other investments	–	5	–	5
Trading Group	–	64	4	59
The Co-operative Bank plc	–	221	–	–
Britannia Personal Lending Limited (Financial Services)	–	–	–	4
Financial Services	–	221	–	4
<b>Total</b>	<b>–</b>	<b>285</b>	<b>4</b>	<b>63</b>

Britannia Personal Lending Limited is an associate of the Co-operative Bank plc and therefore this investment has been disposed of in the period and is now incorporated within the carrying value of the Bank.

The split of investments, including movements in investments in associates, joint ventures and other investments are as follows:

	2013			2012		
	Associates and joint ventures £m	Other investments £m	Total £m	Associates and joint ventures £m	Other investments £m	Total £m
At beginning of period	58	5	63	65	5	70
Addition of associates	221	–	221	–	–	–
Transfer from investment property	5	–	5	–	–	–
Share of profits – continuing businesses	–	–	–	4	–	4
Share of profits – discontinued businesses (as above)	–	–	–	1	–	1
Disposal	–	–	–	(12)	–	(12)
Disposals arising from loss of control of subsidiary	(4)	–	(4)	–	–	–
<b>At end of period</b>	<b>280</b>	<b>5</b>	<b>285</b>	<b>58</b>	<b>5</b>	<b>63</b>

The table below shows the aggregated financial information of the Group's joint ventures and associates (excluding the Co-operative Bank plc) if they were not adjusted for percentage owned. The Bank's balance sheet is prepared on a liquidity basis and therefore it is not presented in this format.

	2013 £m	2012 £m
Current assets	122	303
Non-current assets	290	394
Total assets	412	697
Current liabilities	345	596
Non-current liabilities	48	37
Total liabilities	393	633
Income	350	338
Expenditure	349	328

The total assets of the Bank were £43,396m and the total liabilities £41,619m at 31 December 2013. Since the Bank is a financial services company, a current/non-current split is not available.

## Notes to the financial statements continued

### 13. Investments in associates and joint ventures continued

The Group's investment in the Co-operative Bank plc, incorporated in England and Wales, reduced from 100% to 30% on 20 December 2013. Whilst the Group has a 30% shareholding of ordinary share capital, there is no statute or agreement for the Group to hold half of the voting rights nor does the Group have the power to appoint more than two of the nine Directors of the Board. The Group therefore does not control the Bank's Board of directors (which governs the financial and operating policies of the Bank) and consequently the Bank is not a subsidiary and is not consolidated into the Group accounts. As the Group has representation on the Board of directors and participates in the policy making process this proves that the Group has a significant influence over the Bank. Therefore the Bank will be equity accounted for as an associate in accordance with IAS 28. For further details of this transaction see note 9 on discontinued operations. The entity has a year-end date of 31 December and its principal activity is banking.

The Group owns 30% of the ordinary shares in TCCT Holdings UK Limited, incorporated in England and Wales. Its principal activity is as a travel agency and tour operator. The entity has a year-end date of 30 September. This is in line with the year-end of the majority shareholder, Thomas Cook Group plc.

The Group owns 20% of the ordinary share capital of Coldham Windfarm Limited, incorporated in England and Wales. The entity's principal activity is the operation of a windfarm. The entity has a year-end date of 31 December.

The Group does not have the power to control the Board of the above three entities, accordingly they are not consolidated in the Group accounts but are equity accounted for as associates under IAS 28.

The Group owns 50% of the ordinary share capital of White Mill Windfarm Limited, incorporated in England and Wales. The entity's principal activity is the operation of a windfarm. The entity has a year-end date of 31 December.

The Group owns 50% of the ordinary share capital of Biggleswade Wind Farm Limited, incorporated in England and Wales. The entity's principal activity is the operation of a windfarm. The entity has a year-end date of 30 June. This was included within investment property until 2013 when the Group sold 50% to a joint venture party at the point that the windfarm started to operate (see note 12).

The above two entities are jointly managed and controlled by the Group and a third party. They are accounted for as joint ventures under the equity method.

### Critical accounting estimates and judgements

The investment in the Bank is recorded based on a valuation of the Group's equity holding of 30% of the ordinary share capital of the Bank. The valuation (IFRS 13 level 3 hierarchy) has been derived and confirmed by a range of methodologies based on the Bank's business plan and using appropriate market multiples for the banking industry adjusted for the risks appropriate to the Bank's circumstance and risk profile.

The key assumptions within the valuations relate to the Bank's 5 year plan profit growth and the extent to which any value is ascribed to the Bank's non core businesses. The valuation methodologies taken include a price to book value multiple applied to 2013 closing equity, a dividend discount model and a price earnings multiple applied to 2017 equity. The multiples used are considered consistent with competitor banks adjusted for the appropriate risk and capital structure of the Bank. Further valuations have been performed on a sum of the parts basis assessing the core and non-core element of the Bank separately and then jointly. Where relevant these valuations use a discount rate of 17% to discount the 2017 valuation back to present value. This discount rate is higher than used in other Group businesses due to the additional business risk the Bank faces in the future.

The Group has adopted a prudent approach within the overall range of possible valuations which indicate a range between £674m to £807m. The key valuation methodology used within that range was a price to book value ratio based on Bank capital at year end, using a multiple of 0.4 to arrive at a valuation of £735m of which the Group's 30% share is £221m.

The Group has assessed the Bank valuation of the Bank implied from the market trading in the Bank's debt securities immediately prior to 20 December 2013. The Group considers there was insufficient trading volumes for these to be considered a reliable valuation basis, without significant adjustment for market imperfections.

### Contingent liabilities and commitments of associates and joint ventures

The table below gives the contract amounts and risk weighted amounts of contingent liabilities and commitments within the Co-operative Bank plc. The contract amounts indicate the volume of business outstanding at the Bank's balance sheet date and do not represent amounts at risk. The risk weighted amounts have been calculated in accordance with the PRA rules.

## Notes to the financial statements continued

### 13. Investments in associates and joint ventures continued

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.

	2013		2012	
	Contract amount £m	Risk-weighted amount £m	Contract amount £m	Risk-weighted amount £m
<b>Unaudited</b>				
i) Contingent liabilities				
Guarantees and irrevocable letters of credit	86	45	169	121
	<b>86</b>	<b>45</b>	169	121
ii) Other commitments:				
Documentary credits and short term trade related transactions	1	–	4	1
Forward assets purchases and forward deposit placed	570	152	53	–
Undrawn formal standby facilities, credit lines and other commitments to lend (includes revocable and irrevocable commitments) (a)	3,433	684	4,713	1,065
	<b>4,004</b>	<b>836</b>	4,770	1,066

#### Notes

(a) Undrawn loan commitments include revocable commitments which are unused credit card limits of £1,968m (2012: £2,048m).

The following sections (Conduct Issues, Consumer Credit Act issues, Regulatory and other investigations, Legal Proceedings and Mortgage securitisation representations and warranties) specifically represent the considerations documented in the accounts of The Co-operative Bank plc in respect of contingent liabilities.

### Conduct Issues

Given the high level of scrutiny regarding financial institutions' treatment of customers and business conduct from regulatory bodies, the media and politicians, there is a risk that certain aspects of the Bank's current or historic business, including, amongst other things, mortgages and relationship banking, may be determined by the Financial Conduct Authority (FCA) and other regulatory bodies or the courts as not being conducted in accordance with applicable laws or regulations, or fair and reasonable treatment in their opinion. In particular, there is currently a significant regulatory focus on the sale practices and reward structures that financial institutions have used when selling financial products. There is a risk that there may be other regulatory investigations and action against the Bank in relation to conduct and other issues that the Bank is not presently aware of, including investigations and actions against it resulting from alleged mis-selling of financial products or the ongoing servicing of those financial products. The nature of any future disputes and legal, regulatory or other investigations or proceedings into such matters cannot be predicted in advance. Furthermore, the outcome of any ongoing disputes and legal, regulatory or other investigations or proceedings is difficult to predict.

### Consumer Credit Act issues

The Consumer Credit Act regulates consumer lending and governs the way in which entities, including banks, providing consumer credit to retail customers carry out business. From 1 April 2014 the Financial Services and Markets Act 2000 also applies alongside certain retained provisions of the Consumer Credit Act. The Consumer Credit Act includes very detailed, prescriptive and highly technical requirements for lenders affecting customer documentation and which, in turn, impact how operational processes and IT systems are configured. While the Bank has identified certain instances where its documentation or processes have not been fully compliant with the technical requirements and has provided accordingly, there may be other instances which have not yet been identified. Breaches may have the effect of triggering periods of non-compliance during which an affected customer is not liable to pay interest.

Interest refunds would therefore need to be made in certain cases where a period of non-compliance has been previously triggered. The Bank is considering the operational implementation of the refunding of interest to customers where applicable. The Bank has not yet determined all aspects of such processes. The Bank has made no provision to pay interest on the amount of any refund.

An amount of £109.5m (2012: £nil) has been provided in the Bank's accounts to refund interest following identification of a number of breaches of the requirements of the Consumer Credit Act. As part of this process of identification, detailed and technical legal analysis has been carried out as to whether breaches of the technical requirements have in fact occurred, the nature of those breaches and the consequences which follow (which differ according to the precise nature of the breach). Such legal analysis by its nature involves judgement and assessment of the facts of particular circumstances. In the event that such legal analysis and judgements are determined to be wrong, the Bank could be exposed to a material additional liability. The amount of £109.5m which has been provided is the best estimate of the liability based on the legal analysis.

## Notes to the financial statements continued

### 13. Investments in associates and joint ventures continued

#### Regulatory and other investigations

The Bank is the subject of multiple regulatory and other investigations and enquiries into events at the Bank and circumstances surrounding them. These include:

- The Treasury Select Committee has been conducting an ongoing review which began in Q2 2013 and has focused on numerous concerns surrounding the Bank. The Committee will publish a report of its findings, the timing of which is not yet known.
- The Sir Christopher Kelly review was announced on 12 July 2013. Sir Christopher was jointly appointed by the Co-operative Group Limited and the Bank to review the events that led to the Bank's capital action plan to address its £1.5bn capital shortfall. It is looking at the decision to merge the Bank with Britannia Building Society in 2009 and the proposed acquisition of the Verde assets of Lloyds Banking Group. It will include an analysis of strategic decision making, management structures, culture, governance and accounting practices and aspects of the role of the Bank's auditors. The intention is for the findings to be publicised at the Co-operative Group's Annual General Meeting in May 2014.
- The Treasury announced by press release on 22 November 2013 that it would conduct an independent investigation into events at The Co-operative Bank plc and the circumstances surrounding them from 2008 including the Verde transaction and Britannia merger. The investigation will include a review of the conduct of regulators and Government but is not anticipated to commence until it is clear that it will not prejudice the outcome of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) enforcement investigations.
- The PRA announced on 6 January 2014 that it is undertaking an enforcement investigation in relation to the Bank and as part of that investigation will consider the role of former senior managers.
- The FCA announced on 6 January 2014 that it will be undertaking enforcement investigations into events at the Bank. The investigation will look at the decisions and events up to June 2013.

The Bank is co-operating with all the investigating authorities. It is not possible to estimate the financial impact upon the Bank should any adverse findings be made.

#### Legal Proceedings

The Bank is engaged in various other legal proceedings in the United Kingdom involving claims by and against it which arise in the ordinary course of business, including debt collection, mortgage enforcement, consumer claims and contractual disputes. The Bank does not expect the ultimate resolution of any of these proceedings to which the Bank is party to have a material adverse effect on its results of operations, cash flows or the financial position of the Bank. Provisions have been recognised for those cases where the Bank is able reliably to estimate the probable loss where the probable loss is not de minimis.

#### Mortgage securitisation representations and warranties

In connection with the Bank's mortgage securitisations and covered bond transactions, the Bank makes various representations and warranties relating to the mortgage loans, including in relation to ownership, compliance with legislation and origination procedures. If the representations and warranties are breached subject to any applicable materiality determination, the Bank may be required to repurchase the affected mortgage loans or in some circumstances pay compensation to the securitisation vehicle.

There is a risk that a number of the underlying matters giving rise to conduct and legal provisions could have given rise to breaches of such representations and warranties. Accordingly there is a risk that the Bank may be required to pay compensation to repurchase affected mortgage loans in amounts that may reduce the Bank's liquidity.

The Bank is unable to estimate the extent to which the matters described above will impact it or how future developments may have a material adverse impact on the Bank's net assets, operating results or cash flows in any particular period.

#### Accounting policies

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. The Group's associates are also accounted for under the equity method. The Group records its share of the associate's post tax profit or loss within the income statement and its share of the net assets within investments. In accordance with IAS 28, the Group's share of any associate and joint venture result is adjusted for any fair value adjustments made within day one considerations which have subsequently crystallised. There were no such instances in the current or prior period.

Investments which have originated from the Group losing control of a subsidiary such as the Bank and the Travel business, are originally recorded at fair value on the date the Group loses control.

Other investments include investments where the Group does not have significant influence over the respective business. These investments are accounted for at cost.

## Notes to the financial statements continued

### 14. Investments in funeral plans

The Group holds investments in respect of funeral plan policies which are invested in either Individual Whole of Life Policies, Trusts or life assurance products. In prior periods, the vast majority of these investments were held between the Group's Life Planning business and the Life and Savings business and therefore were eliminated on consolidation. Following the sale of the Life and Savings business, the Group must now disclose these as external balances. Funeral plan accounting policies can be found in note 25.

Funeral plan investments:

	2013 £m	2012 £m
At start of period	–	–
Transferred in following sale of Life and Savings business (as above)	452	–
New plan purchases	85	–
Plans redeemed or cancelled	(37)	–
Interest and bonus applied	17	–
<b>At end of period</b>	<b>517</b>	–

### 15. Derivatives

Derivatives held for non-trading purposes for which hedge accounting has not been applied are as follows:

	2013			2012		
	Contractual/ notional amount £m	Fair value assets £m	Fair value liabilities £m	Contractual/ notional amount £m	Fair value assets £m	Fair value liabilities £m
Interest rate swaps	1,201	29	(67)	1,605	82	(122)
Forward currency transactions	–	–	–	7	–	–
<b>Total recognised derivative assets/(liabilities)</b>	<b>1,201</b>	<b>29</b>	<b>(67)</b>	1,612	82	(122)

Interest rate swaps and forward currency transactions are measured at fair value (IFRS 13 level 2 hierarchy) through the income statement (see note 6).

#### Accounting policies

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 prices and where these are not available, using valuation techniques such as discounted cash flow models. For further details refer to note 33.

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.

## Notes to the financial statements continued

### 16. Pensions

The pension assets and liabilities in the balance sheet comprise:

	<b>Assets 2013 £m</b>	Assets 2012 £m	<b>Liabilities 2013 £m</b>	Liabilities 2012 £m	<b>Net 2013 £m</b>	Net 2012 £m
<b>Trading Group schemes in surplus</b>						
The Co-operative Group Pension Scheme (Pace)	<b>7,487</b>	6,919	<b>(7,126)</b>	(6,532)	<b>361</b>	387
40% of Pace attributable to non Group entities	<b>(2,995)</b>	–	<b>2,850</b>	–	<b>(145)</b>	–
Asset limitation (IFRIC14)	<b>2,995</b>	–	<b>(2,850)</b>	–	<b>145</b>	–
Somerfield Pension Scheme	<b>804</b>	766	<b>(759)</b>	(732)	<b>45</b>	34
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund	<b>61</b>	60	<b>(57)</b>	(55)	<b>4</b>	5
	<b>8,352</b>	7,745	<b>(7,942)</b>	(7,319)	<b>410</b>	426
<b>Trading Group schemes in deficit</b>						
United Norwest Co-operatives Employees' Pension Fund	<b>455</b>	430	<b>(584)</b>	(563)	<b>(129)</b>	(133)
Other former United Co-operatives Funds	<b>148</b>	144	<b>(189)</b>	(182)	<b>(41)</b>	(38)
Plymouth and South West and Brixham Funds	<b>79</b>	76	<b>(138)</b>	(133)	<b>(59)</b>	(57)
	<b>682</b>	650	<b>(911)</b>	(878)	<b>(229)</b>	(228)
<b>Financial Services schemes in deficit:</b>						
Britannia Pension Scheme	<b>631</b>	603	<b>(604)</b>	(587)	<b>27</b>	16
Less asset limitation (IFRIC 14)	<b>(27)</b>	(16)	–	–	<b>(27)</b>	(16)
	<b>604</b>	587	<b>(604)</b>	(587)	–	–
Britannia unfunded obligations	–	–	<b>(3)</b>	(3)	<b>(3)</b>	(3)
EFRBS liabilities from the Pace scheme (unfunded)	–	–	<b>(5)</b>	(4)	<b>(5)</b>	(4)
	<b>604</b>	587	<b>(612)</b>	(594)	<b>(8)</b>	(7)

## Notes to the financial statements continued

### 16. Pensions continued

#### Retirement benefit obligations

The Group operates a number of defined benefit pension schemes, the assets of which are held in separate trustee-administered funds for the benefit of its employees and former employees. The Group also provides pension benefits through defined contribution arrangements.

The main Group pension scheme is the Co-operative Pension Scheme (Pace). The Group, and its subsidiary businesses, also operate nine other pension schemes, listed below by value of invested scheme assets, which are closed to future accrual. The largest of these are the Somerfield Pension Scheme (the 'Somerfield Scheme') and the Britannia Pension Scheme (the 'Britannia Scheme'). The Co-operative Bank (the 'Bank') and some Bank subsidiary businesses also participate in Pace and the Britannia Scheme. Following the disposal of the Bank and its subsidiaries, the Pace and Britannia schemes are now multi employer schemes.

Under the scheme specific funding regime established by the Pensions Act 2004, trustees have to undertake a full actuarial valuation at least every three years. The Group is currently progressing scheme funding valuations for the Pace scheme, Somerfield Scheme, and Plymouth and South West Co-operative Society Limited Employees' Superannuation Fund, which will be concluded in 2014.

The effective date of the last full valuations of the schemes are shown below:

The Co-operative Pension Scheme ('Pace')	5 April 2010
Somerfield Pension Scheme ('Somerfield Scheme')	31 March 2010
Britannia Pension Scheme ('Britannia Scheme')	5 April 2011
United Norwest Co-operatives Employees' Pension Fund ('United Fund')	31 January 2011
Yorkshire Co-operatives Limited Employees' Superannuation Fund ('Yorkshire Fund')	31 January 2011
Plymouth and South West Co-operative Society Limited Employees' Superannuation Fund ('Plymouth Fund')	31 March 2010
Lothian Borders & Angus Co-operative Society Limited Employees' Pension Fund ('Lothian Fund')	24 January 2012
Sheffield Co-operative Society Limited Employees' Superannuation Fund ('Sheffield Fund')	31 January 2011
Leeds Co-operative Society Limited Employee Pension Fund ('Leeds Fund')	31 January 2011

Any shortfall in the assets directly held by the schemes, relative to their funding target, will be financed over a period that ensures the contributions are reasonably affordable to the Group. The expected contribution for all pension schemes over the 2014 fiscal year is £153m, this includes contributions in respect of all defined benefit and defined contribution sections and scheme expenses where these are payable by the employer. The expected contribution also includes those in respect of Pace and the Britannia Scheme that are expected to be reimbursed by Bank, although there is no binding agreement to this effect. The actual contributions paid by the Group will depend on the outcome of the actuarial valuations due to be completed in 2014, as well as the terms agreed with Bank.

The basis on which liabilities are valued for funding purposes differs to the basis required under IAS 19 (2011). The Group may therefore be required to pay contributions to eliminate a funding shortfall when a surplus is reported in the disclosure.

For IAS 19 (2011) disclosure purposes, pension costs are prepared following actuarial advice and are calculated using the projected unit method. The most recent valuation of the schemes was carried out by independent qualified actuaries. The assumptions used by the actuaries are the best estimates chosen from a range of possible actuarial assumptions which may not necessarily be borne out in practice.

The asset disclosed represents the maximum economic benefit available to Group in respect of its pension obligations. The Group has been able to recognise the entire surplus in Pace and the Somerfield Scheme since it can recoup surplus via a combination of refunds and reductions in contributions. There is no requirement in Pace that the surplus has to be shared amongst Co-operative Group Limited's subsidiaries. The Group has no right to a refund of surplus in respect of the Britannia Scheme; therefore the surplus calculated has not been recognised.

#### Retirement benefit risks

Pension risk may be defined as the risk of exposure to pension scheme liabilities and risks inherent in the valuation of scheme liabilities and assets. The liability associated with the pension schemes is material to the Group, as is the cash funding required. The contributions that the Group is required to make to its pension schemes may change over time and the Group may be obliged to make large one-off payments to the pension schemes if certain events occur.

#### Retirement benefit governance

Group considers and manages its pension risks through the Pensions Strategy and Risk committee forums. Where appropriate, recommendations are made by these forums to Group Board for approval. The key objective is to ensure that the Group's Pension Strategy continues to be appropriate and within acceptable cost and risk parameters.

#### Retirement benefit scheme information

##### Closed schemes

All pension schemes, apart from Pace, were closed to new accrual in 2012, although employees who were accruing final salary linked benefits retained this link in respect of pension accrued through service before closure.

## Notes to the financial statements continued

### 16. Pensions continued

#### Discretionary benefits

The United Norwest Co-operatives Limited 1989 Discretionary Early Retirement Benefits Scheme (closed to new entrants from 5 November 1995) and the Leeds Co-operative Society Limited Managerial Staff Pensions Scheme provide additional benefits for long-serving employees who commenced employment prior to scheme closure.

#### Unfunded retirement benefits

There are unfunded pension arrangements in place for certain current and former senior Group executives. The Britannia Scheme also includes a section of unfunded obligations in place for certain executive directors.

#### Material schemes

The Group's largest three defined benefit pension schemes make up over 90% of scheme assets. Additional information regarding the nature of, and risks associated with, the three largest schemes is provided below. The other Group schemes are all UK based schemes and as such meet the same regulatory and reporting requirements and have not been disaggregated as their characteristics (other than those noted above) do not represent materially different risks to those discussed below for Pace, the Somerfield Scheme and the Britannia Scheme.

#### Pace

##### Nature of Scheme

Pace is a non-segregated, multi-employer, hybrid pension scheme consisting of a defined benefit section ('Pace Complete') and two tiers of defined contribution sections ('Pace Extra' and 'Pace Essential'). The Co-operative Bank (the 'Bank'), along with other Group subsidiary and associated entities, also participate in Pace.

Employees are automatically enrolled into membership of Pace Essential when joining the Group, however, all employees also have the option of joining the Pace Extra section. Once they have completed two or more consecutive years' service, employees can also choose to join the defined benefit section, Pace Complete.

Pace Extra and Pace Essential provide benefits based on the value of a member's fund which is used to purchase an annuity at retirement. Members of Pace Essential make contributions of 1.0% with participating employers contributing 2.0% of pensionable salary. Members of Pace Extra make contributions of 4.0% with participating employers contributing 8.0% of pensionable salary. Pace Complete provides benefits based on a member's average career salary and length of contributory membership. In addition, for Members with benefits accrued on a defined benefits basis prior to 6 April 2006, those benefits will continue to be linked to final salary until they cease pensionable service. Each participating employer is responsible for funding a proportion of Pace Complete liabilities, as determined by the Group.

The weighted average duration of the defined benefit obligation is approximately 25 years.

##### Funding the liabilities

Pace Trustees Ltd acts as 'Trustee' of the Pace scheme. The Group may terminate the scheme at any time by giving written notice to the Trustee. On termination, no further contributions would become payable unless required to meet any funding shortfall.

UK legislation requires the Trustee to carry out valuations at least every three years and to target full funding against a basis that prudently reflects the scheme's risk exposure. The Scheme Actuary completed an actuarial valuation of Pace Complete as at 5 April 2010, in accordance with the scheme specific funding requirements of the Pensions Act 2004. The results of the valuation showed that Pace Complete had a shortfall of £248m. The Group agreed to pay annual deficit recovery contributions of £20m from 1 April 2011 until 31 March 2019 to eliminate the funding shortfall.

This cost is shared between all employers participating in Pace. There is no contractual agreement or formal allocation of defined benefit liabilities between the participating employers. As at 4 January 2014 the Trading Group pays 50% and Financial Services (CFSMS) pays 10% of the total deficit recovery contributions, with the remaining 40% recharged to the Bank.

Based on advice from the Scheme Actuary, the Group agreed to pay contributions (payable by each participating employer in respect of current employed Members) in respect of future service in Pace Complete of 16.7% of pensionable salaries. From 6 October 2012, this was reduced to 16.0% of pensionable salaries to reflect an increase in member contributions to 8.0%.

A one off special contribution of £15m was paid to Pace from the Life Fund on 1 August 2013 and has been recognised in P&L within the loss on discontinued operations. This contribution was in relation to the sale of the Life and Savings business to Royal London, which was not a participating employer in Pace but provided a funding guarantee to one of the participating employers.

##### Funding objective

The Group's objective is for Pace Complete to target 100% funding on a basis that should ensure that benefits can be paid as they fall due. The Trustee has a long-term secondary strategy to work progressively towards being fully funded on a self-sufficient basis. If funding improves as a result of better than expected investment returns the Trustee uses the opportunity to reduce funding volatility by decreasing the proportion of growth assets held.

## Notes to the financial statements continued

### 16. Pensions continued

#### Governance

The Chair of the Trustee Board is appointed by and from the Trustee Directors and the Board comprises Directors appointed by the Group, Member Nominated Directors (MNDs) elected by scheme Members and an Independent Trustee elected by the Trustee Board. The Trustee is responsible for the development and implementation of appropriate policies for the investment of the assets of Pace Complete. The Trustee consults with the Group in developing investment strategy and delegates the responsibility for implementing and monitoring the strategy to an Investment Committee.

#### Investment strategy

Some risk arises from Pace Complete because the value of the asset portfolio and returns from it may be less than expected. There is also a risk of a mismatch between the scheme's assets and liabilities and differences in sensitivity to changes in financial and demographic factors.

The Trustee, with advice from its investment adviser and in consultation with Group, agreed to target an investment strategy more closely matched to Pace liabilities to reduce funding level volatility. The scheme has implemented a programme of hedging interest rate and inflation risk and this was progressed considerably during the 2013 financial year by extending interest rate and inflation hedging using both nominal and real yield triggers. The scheme took advantage of market volatility by regularly re-setting an incremental trigger whereby the hedge increased gradually over time. Through this implementation, the hedges were increased over the year at advantageous market levels.

#### Other risks

The introduction of the automatic enrolment legislation requires qualifying employees to be automatically enrolled into a workplace pension scheme and that a minimum level of contributions is paid (which are due to increase in 2017 and 2018). Pace Essential was designed with this legislation in mind and the Group's contributions exceed the minimum level required and are planned to increase to 3.0% of pensionable salary in 2017 and 5.0% of pensionable salary in 2018.

Actions taken by the Pensions Regulator, changes to European legislation, or changes in the financial strength of the Group could result in stronger funding requirements, which could materially affect the Group's cash flow. However, because the Group has a right to a refund of any surplus assets, subject to the requirements of section 37 of the Pensions Act 1995, there would be no further balance sheet effect.

There is also a risk that changes in the assumptions for life expectancy, interest rates or in price inflation could result in a deficit in the scheme. Other assumptions used to value the defined benefit obligation are also uncertain, although their effect is less material.

#### Multi-employer provisions

Prior to the re-capitalisation of Bank during 2013, Pace was a defined benefit plan that shares risks between entities under the common control of the Group. As a Group wide pension scheme, Pace exposes the participating employers to actuarial risks associated with the current and former employees of other Group companies. There is no contractual agreement or stated Group policy for charging the net defined benefit cost for the scheme as a whole measured in accordance with IAS 19 (2011) to individual Group entities. Therefore the Group has not previously disclosed an IAS 19 surplus attributable to each participating employer.

There is no contractually agreed share of pension liabilities but an approximate share of deficit funding contributions was agreed for each participating employer following the last actuarial valuation. Since the Group has a majority share, it believes it can estimate that share with sufficient reliability for accounting purposes. The Group has therefore used the share of deficit recovery contributions paid over the 2013 financial year to notionally and approximately attribute a share of IAS 19 (2011) pension cost to participating employers. However, Pace shows a balance sheet surplus and Bank is not entitled to a share of the surplus. The statement of other comprehensive income therefore shows a net zero adjustment which first of all excludes the £145m portion of the scheme no longer attributable to the Group, but then adds this back based on the principles of IFRIC 14 because only the Group is entitled to the surplus in the scheme.

Because of this, in effect, the net defined benefit cost of the pension scheme is therefore recognised fully by the Group. Other businesses participating in Pace account for pension costs in respect of the scheme on a defined contribution basis (recognised as an expense in the income statement as incurred).

#### Other guarantees

With effect from April 2006, CFSMS became a participating employer in Pace and employees were seconded to work for CIS General Insurance Ltd ('CISGIL'), a separate Group subsidiary business. CISGIL provides a guarantee to pay any amount due to Pace arising from employees seconded to CISGIL should CFSMS default on its pension funding responsibilities.

#### Winding up

Although currently there are no plans to do so, with Group approval, the Trustee could choose to wind up Pace (following termination by the Group). In this case, unless otherwise transferred to an approved pension arrangement or paid as a lump sum to the member, the benefits would be secured with insurance policies and annuity contracts. The cost of securing benefits with an insurance company would be significantly more than the defined benefit obligation calculated in accordance with IAS 19 (2011).

Liabilities may also arise for the Group as an employer participating in a defined benefit pension scheme in certain circumstances set out in legislation, for example on ceasing to participate in the pension scheme or becoming insolvent. The liability will be the value of the employer's share of the deficit at the time, calculated by reference to the cost of buying out the scheme's liabilities in the insurance market.

The Pace scheme is not sectionalised and operates on a 'last man standing' basis. In the event that other participating employers become insolvent and the full statutory debt is not recovered on insolvency, the Group would become liable for the remaining liabilities.

## Notes to the financial statements continued

### 16. Pensions continued

#### Somerfield Pension Scheme

##### Nature of Scheme

The Somerfield Scheme is a sectionalised hybrid pension scheme consisting of defined benefit sections and a defined contribution section, both of which closed to future accrual in November 2012. Following closure of the Somerfield Scheme, all active Members at the date of closure started to accrue benefits in Pace, unless they elected not to join Pace.

In January 2013 the funds of Members of the defined contribution section, that were actively contributing at the date of closure, were also transferred to Pace. The funds of Members of the defined contribution section who were no longer making contributions when the scheme closed to accrual in November 2012 currently remain in the scheme as preserved benefits. The defined contribution section commenced wind-up on 1 May 2013 and is expected to be completed during the 2014 financial year, with preserved benefits being transferred to other arrangements.

The accrued benefits of all Members of the defined benefit section continue to be held in the scheme. The assets of the Somerfield Scheme relating to the defined benefit sections are held in a general fund.

The weighted average duration of the defined benefit obligation is 19 years.

##### Funding the liabilities

Somerfield Pension Trustees Limited is the corporate body that acts as 'Trustee' of the Somerfield Scheme. UK legislation requires the Trustee to carry out valuations at least every three years and to target full funding against a basis that prudently reflects the scheme's risk exposure. The Scheme Actuary completed an actuarial valuation of the Somerfield Scheme as at 31 March 2010, in accordance with the scheme specific funding requirements of the Pensions Act 2004. The results of the valuation showed that the Somerfield Scheme had a shortfall of £51.5m. Group agreed to pay annual contributions of £18.4m until 31 March 2014 to eliminate the funding shortfall.

In addition to contributions to repay the funding shortfall, the Group agreed to pay £1m per annum until 31 March 2014 towards the administration expenses incurred by the scheme, including the Pension Protection Fund Levy.

##### Funding objective

The Group's objective is for the Somerfield Scheme to target 100% funding on a basis that should ensure that benefits can be paid as they fall due.

##### Governance

The Chair of the Trustee Board is appointed by and from the Trustee Directors and the Board comprises nominees of the Group, including an Independent Trustee, and elected scheme Members. The Trustee, in consultation with the Group, is responsible for the risk management arrangements for the Somerfield Scheme, agreeing suitable contribution rates, investment strategy and for taking professional advice as appropriate. The Trustee consults with the Group in developing investment strategy and delegates the responsibility for implementing and monitoring the strategy to an Investment Committee.

##### Investment strategy

Some risk arises from the Somerfield Scheme defined benefit section because the value of the asset portfolio and returns from it may be less than expected. There is also a risk of a mismatch between the scheme's assets and liabilities and differences in sensitivity to changes in financial and demographic factors.

The Trustee's objective is to invest the scheme's assets in the best interest of the Members and beneficiaries. Within this framework the Trustee has agreed a number of objectives to help guide them in their strategic management of the assets and control of the various risks to which the Somerfield Scheme is exposed.

The Trustee with advice from its investment advisor and in consultation with Group, has agreed to hedge the majority of interest rate and inflation characteristics of the scheme's liabilities up to the value of 90% of the scheme's total assets. A 'swap overlay' was introduced in February 2006 to control the inflation and interest risks inherent in the scheme's liabilities.

The Trustee continues to develop the investment strategy and review opportunities for further reduction in, or re-balancing of, expected risks when these arise.

##### Other risks

Actions taken by the Pensions Regulator, changes to European legislation, or changes in the financial strength of the Group could result in stronger funding standards, which could materially affect the Group's cash flow. However, because the Group has a right to a refund of any surplus assets, subject to the requirements of section 37 of the Pensions Act 1995, there would be no further balance sheet effect.

There is also a risk that changes in the assumptions for life expectancy, interest rates or in price inflation could result in a deficit in the scheme. Other assumptions used to value the defined benefit obligation are also uncertain, although their effect is less material.

The Group is the Principal and Statutory Employer of the Somerfield Scheme. A Group subsidiary, Somerfield Stores Ltd, is also a Statutory Employer to the scheme. The Group provides a guarantee in respect of Somerfield Stores Ltd employer debt that may become payable to the Somerfield Scheme upon insolvency or winding up of the scheme.

## Notes to the financial statements continued

### 16. Pensions continued

#### Other guarantees

The Group has granted an additional guarantee in respect of participating employers' liabilities in relation to the Somerfield Scheme up to 105% funding on the section 179 Pensions Act 2004 valuation basis. This enables the calculation of the risk-based element of the Pension Protection Fund levy to be based on the Group's insolvency rating.

#### Winding up

Although currently there are no plans to do so, with Group approval, the Trustee could choose to wind up the scheme. In this case, unless otherwise transferred to an approved pension arrangement or paid as a lump sum to the member, the benefits would be secured with insurance policies and annuity contracts. The cost of securing benefits with an insurance company would be significantly more than the defined benefit obligation calculated in accordance with IAS 19 (2011).

Liabilities may also arise for the Group as an employer participating in a defined benefit pension scheme in certain circumstances set out in legislation, for example on ceasing to participate in the pension scheme or becoming insolvent. The liability will be the value of the deficit at the time, calculated by reference to the cost of buying out the scheme's liabilities in the insurance market.

#### Britannia Pension Scheme

##### Nature of Scheme

The Britannia Scheme is a multi-employer, hybrid scheme, consisting of a funded defined benefit section, a defined contribution section and a section of unfunded obligations in place for certain executive directors. The scheme closed on 6 October 2012 with active Members at the date of closure being invited to join Pace for future pension accrual. The funded element of the defined benefit section pays pensions based on service to 6 October 2012 and final pay for employees who commenced employment prior to 1 September 2001, when it closed to new Members. Members of the defined contribution section that were active at the date of closure were given the option to transfer their funds to a Pace defined contribution section. The Trustee agreed to wind-up the defined contribution section from February 2013, with any remaining Members given the option of transferring their funds to an alternative approved pension arrangement, or securing benefits with an insurance contract. The unfunded element is a no charge supplementary arrangement for certain executive directors. Benefits under the unfunded arrangements are valued on the same assumptions as the funded defined benefits and are disclosed as unfunded obligations.

The weighted average duration of the defined benefit obligation is 23 years.

##### Funding the liabilities

Britannia Pension Trustees Limited is the corporate body that acts as 'Trustee' of the Britannia Scheme. UK legislation requires the Trustee to carry out valuations at least every three years and to target full funding against a basis that prudently reflects the scheme's risk exposure. The Scheme Actuary completed an actuarial valuation of the Scheme as at 5 April 2011, in accordance with the scheme specific funding requirements of the Pensions Act 2004. The results of the valuation showed that the Britannia Scheme had a shortfall of £3.7m. CFSMS agreed to pay a lump sum of £3.7m by 30 April 2012 to eliminate this shortfall.

##### Funding objective

The Group's objective is for the Britannia Scheme to target 100% funding on a basis that should ensure that benefits can be paid as they fall due. The membership of the scheme is substantially made up of CFSMS employees and funding costs recharged to the Bank where applicable.

##### Governance

The Chair of the Trustee Board is appointed by and from the Trustee Directors and the Board comprises an Independent Trustee, nominees of Group and elected scheme Members. The Trustee, in consultation with CFSMS and the Bank, is responsible for the risk management arrangements for the Britannia Scheme, agreeing suitable contribution rates, investment strategy and for taking professional advice as appropriate.

##### Investment strategy

Some risk arises from the Britannia Scheme defined benefit section because the value of the asset portfolio and returns from it may be less than expected. There is also a risk of a mismatch between the scheme's assets and liabilities and differences in sensitivity to changes in financial and demographic factors.

The Trustee's objective is to invest the scheme's assets in the best interest of the Members and beneficiaries. Within this framework the Trustee has agreed a number of objectives to help guide them in their strategic management of the assets and control of the various risks to which the Britannia Scheme is exposed.

## Notes to the financial statements continued

### 16. Pensions continued

#### Multi-employer provisions

Following the merger of Britannia Building Society by Bank in 2009, a Financial Services subsidiary undertaking, Co-operative Financial Services Management Services Limited (CFSMS) became the sponsoring, and a statutory employer of the Britannia Scheme. Three other participating, and statutory, employers of the Britannia Scheme are Bank wholly owned subsidiary entities. The majority of employed Members were employed by CFSMS and provided services to Bank prior to Bank's re-capitalisation. The assets and liabilities of the scheme are still consolidated into the Group accounts as CFSMS remains under control of the Group and remains the sponsoring employer of the scheme. However, following the loss of control of the Bank, Group and Bank have entered discussions with the Trustee of the Britannia Scheme with regard to transferring the status of Statutory (and Sponsoring) Employer to Bank. As Bank subsidiary entities are also participating employers of the Britannia scheme, like Pace, the scheme is a multi employer pension scheme in accordance with IAS 19. However, as the overwhelming majority of employees belonging to this scheme are employees of CFSMS as at 4 January, the share of the Britannia scheme with non-Group entities is immaterial. The net defined benefit cost of the scheme is recognised fully by the Principal Employer, CFSMS, and included in the Group's consolidated accounts. As the Group does not have a right to a refund of surplus in respect of the Britannia Scheme, the net asset of £27m (excluding unfunded obligations) has been restricted to zero. The Bank itself is not a participating employer in the scheme. Therefore, in its individual financial statements it recognises the recharges from CFSMS as an expense in the income statement as incurred.

Following the Bank's re-capitalisation, the Group agreed that, for so long as the Principal Employer of the Britannia Scheme is an entity outside of Bank's control, such employer will not take any action in relation to the scheme without Bank's prior agreement where such action would or might be expected to increase the liabilities of the Bank or contributions payable by Bank in connection with the Britannia Scheme.

The Bank itself is not a participating employer in the scheme. Therefore in its individual financial statements it recognises the recharges from CFSMS as an expense in the income statement as incurred.

#### Other guarantees

Bank has granted an additional guarantee in respect of participating employers' liabilities in relation to the Britannia Scheme up to 105% funding on the section 179 Pensions Act 2004 valuation basis. This enables the calculation of the risk-based element of the Pension Protection Fund levy to be based on Bank's insolvency rating.

#### Other risks

Risks arising in the Britannia Scheme are identified by CFSMS, with the impact of any changes to contribution rates assessed under the Bank's risk management framework. As the Bank provides a guarantee in relation to CFSMS's funding obligations, the Bank is exposed to potential future increases in required contributions and capital held for pension risk.

Actions taken by the Pensions Regulator, changes to European legislation, or changes in the financial strength of CFSMS or the Bank could result in stronger funding standards, which could materially affect Group's cash flow and balance sheet.

There is also a risk that changes in the assumptions for life expectancy, interest rates or in price inflation could result in a deficit in the scheme. Other assumptions used to value the defined benefit obligation are also uncertain, although their effect is less material.

#### Winding up

Although currently there are no plans to do so the Trustee could choose to wind up the Britannia Scheme. In this case, unless otherwise transferred to an approved pension arrangement or paid as a lump sum to the member, the benefits would be secured with insurance policies and annuity contracts. The cost of securing benefits with an insurance company would be significantly more than the defined benefit obligation calculated in accordance with IAS 19 (2011).

Liabilities may also arise for CFSMS as an employer participating in a defined benefit pension scheme in certain circumstances set out in legislation, for example on ceasing to participate in the pension scheme or becoming insolvent. The liability will be the value of the employer's share of the deficit at the time, calculated by reference to the cost of buying out the scheme's liabilities in the insurance market.

## Notes to the financial statements continued

### 16. Pensions continued

#### Critical accounting estimates and judgements

The actuarial valuations of the schemes have been updated to 4 January 2014 in accordance with IAS 19.

	2013	2012
The principal assumptions used to determine the liabilities of the Group's pension schemes were:		
Discount rate	4.45%	4.60%
Rate of increase in salaries	3.60%	4.80%
Future pension increases where capped at 5.0% pa – Retail Price Index	3.60%	3.30%
Future pension increases where capped at 5.0% pa – Consumer Price Index	2.60%	2.80%
Future pension increases where capped at 2.5% pa – Retail Price Index	2.50%	2.50%
Future pension increases where capped at 2.5% pa – Consumer Price Index	2.50%	2.50%

The average life expectancy (in years) for mortality tables used to determine scheme liabilities for the largest schemes at 4 January 2014 are as follows:

	Member currently aged 65 (current life expectancy)		Member currently aged 45 (life expectancy at age 65)	
	Male	Female	Male	Female
Pace Scheme	22.4	24.1	24.3	26.0
United Norwest Fund	22.1	24.2	23.9	26.1
Britannia Scheme	22.5	24.7	24.3	26.6
Somerfield Scheme	22.6	24.9	23.8	26.2

#### Critical accounting estimates and judgements – Sensitivity of defined benefit obligations

The measurement of the Group's defined benefit liability is particularly sensitive to changes in certain key assumptions, which are described below. The methods used to carry out the sensitivity analyses presented below for the material assumptions are the same as those the Group has used previously. The calculations alter the relevant assumption by the amount specified, whilst assuming that all other variables remained the same. This approach is not necessarily realistic, since some assumptions are related: for example, if the scenario is to show the effect if inflation is higher than expected, it might be reasonable to expect that nominal yields on corporate bonds will increase also. However, it enables the reader to isolate one effect from another.

Discount rate	This has been selected following actuarial advice received by Group in respect of all defined benefit schemes operated by Group, taking into account the duration of the liabilities. The overall rate is the weighted average of the specific discount rates adopted for individual schemes. An increase or decrease in the discount rate of 0.1% would result in a £183m decrease or a £183m increase, respectively, in the present value of the defined benefit obligation.
Inflation	Inflation is a significant assumption as it is used to determine salary-related benefits and pension increases before and after retirement. The assumption adopted is consistent with discount rate adopted. An increase or decrease in the inflation rate of 0.1% would result in a £163m increase or a £163m decrease, respectively, in the present value of the defined benefit obligation.
Mortality rates	The mortality assumptions adopted are based on those recommended by the actuaries that advise the scheme management and reflect the most recent information as appropriate. The largest scheme is the Pace scheme and the assumptions used indicate that the future life expectancy of a male (female) pensioner reaching age 65 in 2013 would be 23(25) years and the future life expectancy from age 65 for a male (female) non-pensioner member currently aged 40 of 27 (28) years. An increase in the assumed long term rate of improvement in mortality from 1.25%pa to 1.5% would increase liabilities by £154m.

## Notes to the financial statements continued

### 16. Pensions continued

The fair value of the plan assets at the period end were as follows:

	2013 £m	2012 £m
Cash and cash equivalent	403	196
Equity instruments	2,728	2,481
Debt instruments	4,728	4,657
Real estate	441	400
Derivatives	(440)	(497)
Investment funds	1,805	1,761

As all the above pension schemes are not subject to materially different risks, the following disclosures are made in total across all pension schemes:

	2013 £m	2012 £m
<b>The amounts recognised in the balance sheet are as follows:</b>		
Present value of funded obligations	(9,447)	(8,772)
Present value of unfunded liabilities	(18)	(19)
Element of Pace attributable to non Group entities	(145)	–
Asset limitation (IFRIC 14)	118	(16)
Fair value of plan assets	9,665	8,998
Net retirement benefit asset	173	191

	2013 £m	2012 £m
<b>The amounts recognised in the income statement are as follows:</b>		
Current service cost	(81)	(90)
Interest expense on DBO	(397)	(383)
Interest income on plan assets	411	393
Administrative expenses and taxes	(8)	(7)
	(75)	(87)

Net pension finance income of £13m (2012: £10m) in the Income Statement excludes £1m net pension finance income (2012: £2m cost) from the Britannia scheme. This is because it is part of Financial Services and therefore shown within operating profit, consistent with other lines of interest income in Financial Services companies.

	2013 £m	2012 £m
<b>Changes in the present value of the defined benefit obligation (DBO) are as follows:</b>		
Opening defined benefit obligation	8,791	8,454
Current service cost	81	90
Interest expense on DBO	397	383
Participant contributions	30	28
Remeasurements:		
a. Effect of changes in demographic assumptions	1	156
b. Effect of changes in financial assumptions	399	10
c. Effect of experience adjustments	68	(40)
Benefit payments from plan	(302)	(290)
Closing defined benefit obligation	9,465	8,791

## Notes to the financial statements continued

### 16. Pensions continued

	2013 £m	2012 £m
<b>Changes in the fair value of the plan assets are as follows:</b>		
Opening fair value of plan assets	8,998	8,586
Interest income	411	393
Return on plan assets (excluding interest income)	386	142
Administrative expenses paid from plan assets	(8)	(7)
Employer contributions	135	146
Contributions arising from settlements*	15	–
Participant contributions	30	28
Benefit payments from plan	(302)	(290)
Closing fair value of plan assets	9,665	8,998

\* Within the year, a special, one-off contribution of £15m was paid to the Pace scheme. This was made by the Group's former Life fund as part of the agreement to sell the Life and Savings business to Royal London. This £15m has been included within the loss on sale of discontinued operations in the income statement.

	2013			2012		
	Asset £m	DBO £m	Asset ceiling £m	Asset £m	DBO £m	Asset ceiling £m
<b>Changes in the effect of the asset ceiling are as follows:</b>						
<b>Britannia Pension Scheme</b>						
As at the start of the period	603	(587)	(16)	570	(608)	–
Service cost	–	–	–	–	(10)	–
Interest income/(expense)	27	(26)	(1)	26	(28)	–
Administrative expenses paid from plan assets	(1)	–	1	(1)	–	–
Employer contributions	–	–	–	11	–	–
Benefits paid	(16)	16	–	(13)	13	–
Actuarial gains/(losses)	18	(7)	(11)	10	46	(16)
At end of the period	631	(604)	(27)	603	(587)	(16)
<b>Pace</b>						
As at loss of control of Bank (20 December 2013)	2,995	(2,850)	145	–	–	–
Amount attributable to the Bank reversed	(2,995)	2,850	(145)	–	–	–
At end of the period	–	–	–	–	–	–

Due to Pace now being a multi employer scheme from 20 December 2013, 40% of the assets and liabilities have been notionally for accounting purposes been allocated to Bank and then reversed due to the Bank having no right to a refund of the surplus per IFRIC 14. When the share of Pace and Britannia schemes are transferred over to the Bank, the Group will incur a further loss or gain on the sale of the pension scheme depending on if the scheme is in a surplus or deficit respectively at the point of transfer.

## Notes to the financial statements continued

### 16. Pensions continued

#### Effect of IAS 19 revised

From 6 January 2013, the Group adopted IAS 19 revised. The new revised standard requires the Group to use a corporate bond rate rather than higher equity rates when assessing the return on pension assets. The second change as a result of the adoption of IAS 19 revised was for the Group to include administrative expenses on the pension schemes within operating profit rather than deducted from interest income. The Group has never used the 'corridor approach' when recognising its pension liabilities and so the changes to IAS 19 have not affected the Group's overall balance sheet.

The change in accounting policy caused the following restatements to the prior year numbers:

	Note	2013 £m	2012 as reported* £m	Prior year adjustment £m	2012 restated £m
<b>Operating expenses</b>					
Pension costs	3	(89)	(88)	(9)	(97)
<b>Finance income</b>					
Net pension finance income	5	13	47	(37)	10
<b>Taxation</b>					
		45	10	8	18
<b>Other comprehensive income</b>					
Remeasurement losses on employee pension schemes		(82)	(30)	46	16
Tax on related items		20	6	(8)	2

\* The above restatement disregards any restatements to discontinued operations. The impact of the prior year adjustment on 2012 profits was a £44m reduction to reported profit before tax and a £39m reduction to post tax profits. Other comprehensive income would have been £39m higher meaning no effect on prior year reserves nor the overall 2012 balance sheet. Had IAS 19R not been adopted by the Group, 2013 post tax profits would have been approximately £40-£50m higher. The approximate reduction caused by IAS 19R on profit after tax (with an equal and opposite effect on other comprehensive income) on periods before those presented in this Annual Report are as follows: 2011: £59m; 2010: £45m; 2009: £23m; 2008: £32m.

### 17. Deferred taxation

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 23% (2012: 23%).

	2013 £m	2012 £m
Net deferred tax comprises:		
<b>Deferred tax asset</b>		
Trading Group	184	133
Financial Services	73	72
	257	205
<b>Deferred tax liability</b>		
Trading Group	(183)	(219)
Financial Services	(6)	(6)
	(189)	(225)
<b>Net deferred tax assets/(liabilities)</b>		
Trading Group	1	(86)
Financial Services	67	66
	68	(20)

## Notes to the financial statements continued

### 17. Deferred taxation continued

	2013 £m	2012 £m
Comprised of:		
Other temporary differences	26	67
Temporary differences arising on derivatives & interest	1	(17)
Other temporary differences arising on fair value & merger with Britannia Building Society	–	(56)
Retirement benefit obligations	(35)	(43)
Capital allowances on fixed assets	157	87
Capital allowances on assets leased to customers	–	1
Unrealised gains on investments, investment properties and rolled-over gains	(132)	(154)
Claims equalisation reserve	(6)	(7)
Tax losses	57	102
	<b>68</b>	<b>(20)</b>

The main components of the deferred tax liability are the potential liability on rolled over gains of £132m (2012: £154m), net retirement obligations of £35m (2012: £43m) and timing differences arising on claims equalisation reserves of £6m (2012: 17m).

These liabilities are offset by deferred tax assets arising in respect of re tax allowances on property plant and equipment and intangible assets of £157m (2012: £88m), carried forward tax losses of £57m (2012: £102m), and deferred tax relief on other accounts provisions including holiday pay and onerous lease provisions of £27m (2012: £39m).

Deferred income taxes are calculated on all temporary differences under the liability method using an effective tax rate of 20% (2012: 23%).

	2013 £m	2012 restated £m
At beginning of period	(20)	(151)
Income statement (charge)/credit		
– Group	(42)	118
Disposals	93	–
Charged to equity:		
– Retirement benefit obligations	20	16
– Other	17	(3)
At end of period	<b>68</b>	<b>(20)</b>

#### Accounting policies

Deferred tax is provided for, 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 for utilisation. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

## Notes to the financial statements continued

### 18. Inventories and biological assets

	2013 £m	2012 £m
Inventories	520	523
Biological assets	6	5
	<b>526</b>	528

Inventories are comprised of the following:

	2013 £m	2012 £m
Raw materials, consumables and work in progress	9	11
Finished goods and goods for resale	511	512
	<b>520</b>	523

The period end inventory provision is £16m (2012: £20m) and relates largely to the Food and Pharmacy businesses. A credit of £4m (2012: charge of £2m) has been made to the income statement largely relating to the Food business and was a result of improved leakage performance in the period. Inventory held at fair value less cost to sell is not material in either period. There was no inventory pledged as security for liabilities in the current or prior period. Further analysis of biological assets are not disclosed as they are not considered material for the Group.

#### Accounting policies

Inventories are stated at the lower of cost, including attributable overheads and net realisable value.

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.

### 19. Trade and other receivables

	2013 £m	2012 £m
Non-current	23	36
Current	464	666
Trading Group	487	702
Financial Services	620	412
	<b>1,107</b>	1,114

	2013 £m	2012 £m
Trade receivables	281	374
Prepayments and accrued income	398	225
Amounts receivable from disposal of businesses	168	–
Other receivables	134	315
Receivables arising from insurance	126	200
	<b>1,107</b>	1,114

Trade receivables are stated net of an impairment provision of £9m (2012: £8m). £3m (2012: £nil) has been charged to the income statement during the period offset by a credit of £2m (2012: £nil).

Part of the consideration receivable on the sale of the Life and Savings business on 31 July 2013 has been deferred. The outstanding amount of £168m is expected to be received within the next 12 months. Further details on the ageing of trade and other receivables of the Trading Group can be found in note 33.

Of the Financial Services receivables, £15m is recoverable in greater than one year and the remainder is receivable in less than one year.

The Group have changed their accounting estimate in respect of future cancellations of Funeral Benefit Options ('FBOs'). As a result, a higher proportion of costs associated with gaining and administering FBOs are expensed at the point of sale. The impact on 2013 has been: a £1m decrease in underlying operating profit representing a further charge in relation to plans sold during 2013; and a £12m charge in relation to plans sold in prior years. This element of the charge has been reported within one-off items (see note 1). The effect of this change in future periods is expected to be a £1m decrease in underlying operating profit per annum.

## Notes to the financial statements continued

### 19. Trade and other receivables continued

Trade receivables include amounts totalling £46m (2012: £33m), which are overdue but not considered to be impaired, age analysed as follows:

	2013 £m	2012 £m
<b>Amounts overdue:</b>		
Less than 3 months	34	28
3 to 6 months	5	3
More than 6 months	7	2
	<b>46</b>	<b>33</b>

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.

#### Accounting policies

##### Bad and doubtful debts

The amount charged against operating profit comprises collective provisions against identifiable losses and, in Financial Services' 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. Receivables, 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.

##### Impairment

The carrying amounts of the Group's receivables 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. Any adjustment to the level of impairment provision is recognised within the income statement in operating profit.

### 20. Assets and liabilities held for sale

In the Trading Group, the assets held for sale in the current period relate to the sale of buildings, including the CIS Tower and surrounding land and buildings of the Group's NOMA estate to a joint venture. This sale was deemed as being highly probable within 12 months at year end. As part of the sale, the CIS Tower will be leased back to the Group on a 15 year lease with a break clause at year 10. The lease will be treated as an operating lease for future reporting periods in accordance with IAS 17. The net book value of £59m is lower than the fair value less costs to sell and therefore there is no impairment on reclassification to assets held for sale. The disclosures in the prior period related to the Life and Savings Business and TCAM which were sold on 31 July 2013.

	Assets held for sale		Liabilities held for sale	
	2013 £m	2012 £m	2013 £m	2012 £m
Trading Group	59	–	–	–
Financial Services	–	24,013	–	(23,353)
Total	<b>59</b>	<b>24,013</b>	<b>–</b>	<b>(23,353)</b>

#### Assets classified as held for sale

	2013 £m	2012 £m
Property, plant and equipment	59	–
Intangible assets	–	13
Trade and other receivables	–	208
Loans and advances to customers	–	1
Derivatives	–	1,244
Investments	–	18,931
Reinsurers' share of technical provisions	–	3,616
	<b>59</b>	<b>24,013</b>

## Notes to the financial statements continued

### 20. Assets and liabilities held for sale continued

#### Liabilities classified as held for sale

	2013 £m	2012 £m
Derivatives	–	(1,168)
Deferred tax	–	(36)
Amounts owed to credit institutions	–	(27)
Insurance contracts	–	(17,702)
Investment contracts	–	(360)
Unallocated divisible surplus	–	(1,286)
Net assets attributable to unit holders	–	(56)
Trade and other payables	–	(2,683)
Income tax payable	–	(24)
Provisions	–	(11)
	–	(23,353)

Further details of assets and liabilities held for sale can be found in note 37.

At the half year, the General Insurance business was classified as held for sale. At 4 January 2014 the business had ceased being actively marketed and subsequently the Group announced the decision to withdraw from the sale of this business. The recoverable amount of the business was higher than its carrying value on the date of the decision to withdraw the business from sale. Adjustments for depreciation and amortisation in 2013 are now included as if the entity was never held for sale during the period.

#### Accounting policies

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.

### 21. Investments

	2013 £m	2012 £m
<b>Fair value through profit or loss:</b>		
Listed equities	–	1,845
Deposits with credit institutions	208	342
<b>Held-for-trading:</b>		
Listed debt securities	–	960
<b>Available for sale:</b>		
Unlisted equities	–	10
Listed debt securities	763	4,322
Unlisted debt securities	–	237
	763	4,569
<b>Total fair value through profit or loss and available for sale investments</b>	<b>971</b>	<b>7,716</b>
Loans at amortised cost	–	295
Investment properties	–	173
	971	8,184

The current period investments are held by CISGIL. The prior period figures included investments held by the Co-operative Bank plc when it was a consolidated subsidiary of the Group.

## Notes to the financial statements continued

### 21. Investments continued

#### Accounting policies

CISGIL classifies its financial assets (excluding derivatives) as either:

- Available for sale
- Financial assets at fair value through income or expense
- Loans and receivables.

#### i) Recognition of financial assets and financial liabilities

Financial assets are recognised by CISGIL on the trade date which is the date it commits to purchase the instruments. Loans and receivables are recognised when the funds are advanced.

All other financial instruments are recognised on the date that they are originated.

#### ii) Derecognition of financial assets and financial liabilities

Financial assets are derecognised when they are qualifying transfers and:

- The rights to receive cash flows from the assets have ceased
- CISGIL has transferred substantially all the risks and rewards of ownership of the assets

A financial liability is derecognised when the obligation under the liability is discharged, cancelled or expires. When an existing liability is replaced by the same counterparty on substantially different terms or the terms of an existing liability are substantially modified, the original liability is derecognised and a new liability is recognised, with any difference in carrying amounts recognised in the income statement.

#### iii) Financial assets designated as available for sale

CISGIL classifies the 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 movements recognised in other comprehensive income as they arise. Where there is evidence of impairment, the extent of any impairment loss is recognised in the income statement.

On disposal, gains or losses previously recognised in other comprehensive income are transferred to the income statement.

#### iv) Financial investments at fair value through income or expense

Investments, other than those in debt securities, are designated as financial assets at fair value through income or expense, where they are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information is provided internally to key management personnel on that basis. Initial measurement is at fair value, being purchase price upon the date on which CISGIL commits to purchase. Directly attributable transaction costs are expensed immediately on recognition.

Subsequent valuation is at fair value with changes in fair value being recognised in gains less losses within the income statement in the period in which they arise. On disposal, gains or losses (being proceeds less carrying amount) are recognised in gains less losses arising from financial instruments within the income statement. Where there is no active market or the investments are unlisted, the fair values are based on commonly used valuation techniques.

#### v) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and CISGIL does not intend to sell immediately or in the near term. For CISGIL this includes insurance premium debt receivables but excludes salvage and subrogation. These are initially measured at fair value plus transaction costs that are directly attributable to the financial asset. Subsequently these are measured at amortised cost. The amortised cost is the initial amount at recognition less principal repayments and impairment provisions for incurred losses.

#### vi) Financial liabilities

Financial liabilities are contractual obligations to deliver cash or other financial assets. Financial liabilities are recognised initially at fair value, net of directly attributable transaction costs. Financial liabilities, other than derivatives, are subsequently measured at amortised cost.

Financial liabilities primarily represent borrowed funds. Borrowings are recognised initially at fair value, which equates to 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.

## Notes to the financial statements continued

### 21. Investments continued

#### vii) Impairment of financial assets

##### Assessment

At the balance sheet date, CISGIL assesses its financial assets not carried at fair value through income or expense for objective evidence that an impairment loss has occurred.

Objective evidence that financial assets are impaired can include default by a borrower or issuer, indications that a borrower or issuer will enter bankruptcy or the disappearance of an active market for that financial asset because of financial difficulties.

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 for amortised cost assets or at the current market rate for available for sale assets)

##### Impairment of financial assets classified as available for sale

Available for sale assets are assessed at each balance sheet date to see whether there is objective evidence of impairment. In such cases, any impairment losses are recognised by transferring the cumulative loss that has been recognised in other comprehensive income to the income statement.

When a subsequent event causes the amount of impaired loss on available for sale investment securities to decrease, and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through the income statement. However any further recovery in fair value of an impaired available for sale equity security is recognised in other comprehensive income.

##### Impairment of financial assets carried at amortised cost

The amount of the impairment loss on assets carried at amortised cost 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.

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 received.

Provisions are released at the point when it is deemed that following a subsequent event the risk of loss has reduced to the extent that a provision is no longer required.

#### viii) Gains less losses arising from financial assets

Gains less losses arising from financial assets represents unrealised fair value movements of assets held at fair value through income or expense as well as realised gains/losses on available for sale assets.

##### Sale and repurchase agreements

CISGIL participates in sale and repurchase (repo) arrangements in connection with its portfolio of government guaranteed securities (gilts). Under these arrangements, CISGIL sells gilts but is contractually obliged to repurchase them at a fixed price on a fixed future date. Securities which are the subject of repo arrangements at the balance sheet date are included in financial instruments at fair value through income or expense in the balance sheet at their bid value and the associated liability is recognised, being the capital amount owing under the repo arrangements.

CISGIL also participates in reverse repo transactions whereby CISGIL buys gilts but is contractually obliged to sell them at a fixed price on a fixed future date. Cash collateral pledged under reverse repo arrangements are classified as deposits with credit institutions within financial investments at fair value through income or expense on the balance sheet. CISGIL requires all reverse 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. Collateral is required in the form of cash or gilts.

## Notes to the financial statements continued

### 22. Insurance contracts liabilities and reinsurance assets

#### a) Analysis of insurance contract liabilities

	2013 £m	2012 £m
Gross general insurance contracts:		
– Claims reported	495	574
– Claims incurred but not reported	145	186
– Claims settlement expenses	17	18
– Unearned premiums	207	273
– Provision for unexpired risks	2	–
<b>Total gross insurance liabilities</b>	<b>866</b>	1,051
Recoverable from reinsurers		
– Claims reported	(23)	(32)
– Claims incurred but not reported	(32)	(33)
– Unearned premiums	(2)	(2)
<b>Total reinsurers' share of insurance liabilities</b>	<b>(57)</b>	(67)
Net general insurance contracts:		
– Claims reported	472	542
– Claims incurred but not reported	113	153
– Claims settlement expenses	17	18
– Unearned premiums	205	271
– Provision for unexpired risks	2	–
<b>Total net insurance liabilities</b>	<b>809</b>	984

Liabilities are stated as positive in the above analysis.

#### Indemnification agreement

On 15 January 2006, CISGIL assumed responsibility for the benefits and burdens arising from the run off of general insurance liabilities of the Co-operative Insurance Society Limited (CISL) under the terms of an indemnification agreement. Insurance contract liabilities at the end of the period include the following liabilities from the policies written by CISL:

	2013 £m	2012 £m
Outstanding claims	41	48
Claims incurred but not reported	22	17
<b>Total gross insurance liabilities</b>	<b>63</b>	65

#### Critical accounting estimates and judgements

#### b) General insurance contracts – assumptions, changes in assumptions and sensitivity

##### i) Basis of assessing liabilities

CISGIL has access to historical data and trends relating to the general insurance business of Life and Savings for which it has now assumed responsibility.

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 on to a provisioning basis
- Deriving average costs per claim to apply to claim numbers
- Projecting historic claims paid and incurred data (payment plus estimates) – statistical actuarial techniques including chain ladder, Bornhuetter-Ferguson and Cape Cod

## Notes to the financial statements continued

### 22. Insurance contracts liabilities and reinsurance assets continued

Detailed claims data, including individual case estimates, are used to derive patterns in average claims 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 judgement 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).

Discounted reserves in respect of periodic payment settlements are £24m (2012: £23m) and EIROS discounted reserve amounts to £3m (2012: £3m). Further details around expected settlement patterns for claims arising on these reserves are disclosed within the insurance section.

The EIROS reserve was based on a report produced for the industry by Towers Watson (an actuarial consultancy) at the end of 2013, which gave Towers Watson's estimate of both the undiscounted and discounted incurred but not reported (IBNR) reserves as at the end of the second quarter 2013. This was the most recent report available when we calculated our year-end 2013 reserves.

In respect of business yet to be earned, the adequacy of the premium to cover future claims costs and expenses is assessed to determine the need for an Additional Provision for Unexpired Risks ('APUR') by comparing the discounted premium and outgoings. As at the end of 2013 there is a need for an APUR of £2m.

As outlined within the risk management section, there is significant uncertainty in the assessment of liabilities, and provisions are set to be adequate to cover the anticipated eventual cost. Sensitivity analysis is performed to assist the selection of key parameters and, hence, the provisions adopted. 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 reserves. Assumptions underlying the reserving calculations are agreed by the Quarterly Reserving Committee (QRC). Methodologies are peer reviewed throughout the calculation process. Provisions are approved and signed off by the QRC, and any margin above the actuarial best estimate reserve is set by the Chief Financial Officer.

Periodic reports are produced by the actuarial team and presented to the Periodic Reserving Committee in order to advise management of the performance of the business. More detailed reports are produced on a quarterly basis providing information on the performance of the business against plan. These reports are presented to the QRC and form the basis of reporting the performance to the Board.

#### ii) Key assumptions

Principal assumptions underlying the claims provisions include:

- Future inflation rates are in line with those recently implied in the claims data
- For bodily injury claims, allowance has been made for:
  - i) use of the appropriate Ogden Tables
  - ii) awards for general damages in accordance with the 10th edition of the JSB guidelines
  - iii) a proportion of large claims being settled by periodic payments
  - iv) improvements in the case estimation techniques resulting in earlier recognition of the size of the claims

The gross insurance provision for claims and loss adjustment expenses arising in respect of prior years of £427m (2012: £440m) includes a movement of £47m (2012: £44m) arising from a release/(increase) of reserves, as follows:

	2013 £m	2012 £m
Fire and Accident release of reserves	7	3
Motor release/(increase) of reserves	43	(43)
Increase in claims handling reserves	(3)	(4)
Movement in gross insurance liabilities	47	(44)

## Notes to the financial statements continued

### 22. Insurance contracts liabilities and reinsurance assets continued

#### iii) Sensitivity analysis

There is greater uncertainty over motor claims provisions than other provisions as they often involve claims for bodily injury and associated legal costs which 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. The impact of the increased uncertainty on the income statement risk is mitigated through holding management margin on the best estimate reserves that is proportional to the level of uncertainty.

#### Assumption

	2013			2012	
	Changes in parameter	Effect on gross provision £m	% Effect	Effect on gross provision £m	% Effect
<b>Motor</b>					
Average cost of claims for last three years – bodily injury and legal	10%	65	12.3%	67	13.7%
Mean term to settlement – bodily injury and legal	+1/2 year	10	1.9%	11	1.9%
Rate of future inflation – bodily injury and legal	1%	18	3.5%	19	3.2%
Ogden discount rate – bodily injury	-1/4%	2	0.4%	5	0.8%
<b>Other classes</b>					
Mean term to settlement (liability)	+1/2 year	–	2.1%	–	2.1%
Mean term to settlement (non-liability)	+1/2 year	1	1.4%	1	1.3%
Rate of future inflation (liability)	1%	1	4.9%	1	5.2%
Rate of future inflation (non-liability)	1%	1	1.3%	1	1.3%

#### c) Changes in General Insurance liabilities and reinsurance assets

##### i) Change in insurance contract liabilities (net of salvage and subrogation)

	2013				2012			
	Gross risk provision £m	Unexpired risk provision £m	Salvage & subrogation £m	Net £m	Gross £m	Unexpired risk provision £m	Salvage & subrogation £m	Net £m
At beginning of period	778	–	(62)	716	737	–	(47)	690
Adjustment following sale of Life Savings business*	(22)	–	–	(22)	–	–	–	–
Movement	(99)	2	37	(60)	41	–	(15)	26
At end of period	657	2	(25)	634	778	–	(62)	716

Additional provision is made for unexpired risks where the claims and expense, 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 at the end of the financial period. The provision related to the motor class of business. Salvage and subrogation is included within assets as part of receivables arising from insurance (see note 19).

## Notes to the financial statements continued

### 22. Insurance contracts liabilities and reinsurance assets continued

#### ii) General Insurance – claims and loss adjustment expenses

	2013			2012		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Claims reported	574	(32)	542	602	(31)	571
Claims incurred but not reported	186	(33)	153	118	(36)	82
Claims settlement expenses	18	–	18	17	–	17
At beginning of period	778	(65)	713	737	(67)	670
Adjustment following sale of Life Savings business*	(22)	22	–	–	–	–
Claims paid during period	(436)	7	(429)	(525)	9	(516)
Increase in liabilities:						
– arising from current and previous period claims	337	(19)	318	566	(7)	559
Total movement	(121)	10	(111)	41	2	43
Claims reported	495	(23)	472	574	(32)	542
Claims incurred but not reported	145	(32)	113	186	(33)	153
Claims settlement expenses	17	–	17	18	–	18
At end of period	657	(55)	602	778	(65)	713

\* Prior to the sale of the Life and Savings business, there was a Group indemnification adjustment applied to gross up claims provisions reinsured with third parties.

This has been adjusted in the current period.

#### iii) General Insurance – provisions for unearned premiums

	2013			2012		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
<b>Unearned premium provision</b>						
At beginning of period	273	(3)	270	327	(4)	323
Increase in period	443	(32)	411	556	(30)	526
Release in period	(509)	33	(476)	(610)	31	(579)
Movement in period	(66)	1	(65)	(54)	1	(53)
<b>At end of period</b>	<b>207</b>	<b>(2)</b>	<b>205</b>	<b>273</b>	<b>(3)</b>	<b>270</b>

## Notes to the financial statements continued

### 22. Insurance contracts liabilities and reinsurance assets continued

#### iv) Analysis of claims development – gross of reinsurance

	Accident year								Total £m
	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	
At end of accident year	1,368	385	347	326	411	498	502	368	4,205
– One year later	1,265	388	320	333	456	531	473	–	3,766
– Two years later	1,199	378	310	341	481	528	–	–	3,237
– Three years later	1,207	364	301	329	467	–	–	–	2,668
– Four years later	1,196	367	297	320	–	–	–	–	2,180
– Five years later	1,186	367	294	–	–	–	–	–	1,847
– Six years later	1,184	363	–	–	–	–	–	–	1,547
– Seven years later	1,196	–	–	–	–	–	–	–	1,196
Estimate of cumulative claims	1,196	363	294	320	467	528	473	368	4,009
Cumulative payments to date	(1,116)	(348)	(289)	(299)	(410)	(431)	(328)	(147)	(3,368)
Gross outstanding claims before discounting	80	15	5	21	57	97	145	221	641
Discounting									(1)
<b>Gross outstanding claims liabilities</b>									<b>640</b>

	£m
Gross claims reported	495
Gross claims incurred but not reported	145
<b>Gross outstanding claims liabilities</b>	<b>640</b>

#### v) Analysis of claims development – net of reinsurance

	Accident year								Total £m
	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	
At end of accident year	1,363	373	335	313	398	482	490	351	4,105
– One year later	1,261	378	306	321	434	516	456	–	3,672
– Two years later	1,196	370	296	326	458	516	–	–	3,162
– Three years later	1,204	358	292	318	445	–	–	–	2,617
– Four years later	1,193	360	290	310	–	–	–	–	2,153
– Five years later	1,181	359	287	–	–	–	–	–	1,827
– Six years later	1,180	355	–	–	–	–	–	–	1,535
– Seven years later	1,189	–	–	–	–	–	–	–	1,189
Estimate of cumulative claims	1,189	355	287	310	445	516	456	351	3,909
Cumulative payments to date	(1,114)	(341)	(282)	(294)	(402)	(425)	(323)	(142)	(3,323)
Net outstanding claims before discounting	75	14	5	16	43	91	133	209	586
Discounting									(1)
<b>Net outstanding claims liabilities</b>									<b>585</b>

## Notes to the financial statements continued

### 22. Insurance contracts liabilities and reinsurance assets continued

	£m
Net claims reported	472
Net claims incurred but not reported	113
<b>Net outstanding claims liabilities</b>	<b>585</b>

It is to be expected that releases will normally be made to prior years claims as current reserves are set such that no adverse deterioration is expected. However, from time to time the random occurrence of significant large individual claims or events being worse than expected can give rise to a required strengthening, in addition to normal claims development being adverse. The 2013 result includes movement on prior year reserves of £49m (2012: £50.3m). This is largely due to a change in the accounts for salvage and subrogation.

#### Accounting policies

Contracts under which 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. A contract that qualifies as insurance remains an insurance contract until all the risks and obligations are extinguished or expire. All contracts of general insurance business written by CISGIL are classified as insurance contracts. General insurance business is accounted for on an annual basis.

##### i) Unearned premium provision

For general insurance business, the proportion of written premiums relating to periods of risk beyond the year-end is carried forward to future accounting periods. The relevant proportion is calculated using the daily pro rata basis. Outward reinsurance premiums are treated as earned in accordance with the profile of the reinsured contracts.

##### ii) Claims incurred

Insurance claims incurred comprises claims paid during the year, together with related handling costs and the change in the gross liability for claims in the period net of related recoveries including salvage and subrogation.

##### iii) Claims outstanding

Claims outstanding comprises provisions representing the estimated ultimate cost of settling:

- Estimates on claims reported by the balance sheet date ('claims reported')
- Expected additional cost in excess of claims reported for all claims occurring by the balance sheet date ('claims incurred but not reported')

Aggregate claims provisions include attributable claims handling expenses and 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, would be separately disclosed in the notes to the financial statements including the claims development tables. 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. The outstanding reserves are discounted in respect of periodical payments and a portion of liability type claims from the electric industry ('EIROS') for which separate assets are held of appropriate term and nature.

##### iv) Unexpired risk provision

Additional provision is made for unexpired risks where the claims and expenses, 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 less deferred acquisition costs carried forward for those contracts. Provision for unexpired risks is calculated for each category of business. Where categories of business are managed together a combined calculation is performed. Surpluses and deficits within each category are offset within the calculation. The provision is determined after taking account of future investment return arising on investments supporting the unearned premium provision and unexpired risk provision. Such provisions ensure that the carrying amount of unearned premiums provision less related deferred acquisition costs is sufficient to cover the current 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 (Insurance Contracts).

##### v) Acquisition costs

Costs directly associated with the acquisition of new business, including commission, are capitalised and amortised in accordance with the rate at which the gross written premiums associated with the underlying contract are earned. See note 11.

##### vi) 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. Premiums, claims and receivables are presented on a gross basis in the income statement and balance sheet.

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.

## Notes to the financial statements continued

### 23. Share capital

	Nominal and paid-up value Members' share capital	
	2013 £m	2012 £m
Representing:		
Corporate shares of £5 each	9	9
Individual shares of £1 and 10p each	61	61
	<b>70</b>	<b>70</b>

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 2003. Such societies must be in membership of Co-operatives<sup>UK</sup> Limited and have the same or similar rule provisions as regards to 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<sup>UK</sup> Limited to be used and applied in accordance with Co-operative principles.

### 24. Interest-bearing loans and borrowings

This note provides information about the contractual terms of the Trading Group's interest-bearing loans and borrowings. For more information about the Group's exposure to interest rate and foreign currency risk, and a breakdown of IFRS 13 level hierarchies in relation to these borrowings, see note 33.

	Adjusted* 2013 £m	2013 £m	2012 £m
Non-current liabilities:			
Secured bank loan	–	–	149
Unsecured bank loans	450	–	450
5½% Eurobond Notes due 2020**	467	–	471
6¼% Eurobond Notes due 2026**	362	–	368
7¼% First Mortgage Debenture Stock 2018**	50	–	55
11% final repayment subordinated notes due 2025**	109	–	–
Instalment repayment notes (final payment 2025)	19	–	–
Corporate investor shares	–	–	1
Other loans	–	–	4
Non-current portion of finance lease liabilities	6	6	3
	<b>1,463</b>	<b>6</b>	<b>1,501</b>

## Notes to the financial statements continued

### 24. Interest-bearing loans and borrowings continued

	Adjusted* 2013 £m	2013 £m	2012 £m
Current liabilities:			
Secured bank loan	–	–	4
Unsecured bank loans	50	500	–
5½% Eurobond Notes due 2020**	–	467	–
6¼% Eurobond Notes due 2026**	–	362	–
5½% Eurobond Notes due 2013**	–	–	206
7½% First Mortgage Debenture Stock 2018**	–	50	–
11% final repayment subordinated notes due 2025**	–	109	–
Instalment repayment notes (final payment 2025)	1	20	–
Corporate investor shares	26	26	45
Current portion of finance lease liabilities	3	3	5
Other secured loans	–	–	50
Other unsecured loans	7	7	3
	<b>87</b>	<b>1,544</b>	<b>313</b>

\* The Adjusted balance sheet as at 4 January 2014 includes a reclassification of certain of the Group's interest bearing loans and borrowings to non-current liabilities to reflect the amended terms of certain borrowings, as agreed post balance sheet date but prior to signing the accounts (see post balance sheet event note 39).

\*\* These drawn down 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 39.

### Corporate investor shares

Corporate investor shares may be issued to existing corporate members who hold fully paid corporate shares and are registered Industrial and Provident Societies. The rate of interest payable is determined by the London Interbank Offered Rate (LIBOR).

### Terms and repayment schedule

The 7.625% First Mortgage Debenture Stock 2018, which is secured over freehold and leasehold properties has an original value of £50m (carrying amount of £50m) to be paid to holders upon maturity.

The 5.625% Eurobond Issue 2020 has an original value of £450m (carrying amount of £467m) and the 6.25% Eurobond Issue 2026 has an original value of £350m (carrying amount of £362m). These bonds have each been paying an additional 1.25% coupon since 8 July 2013 following the downgrade of the Group's credit rating to sub investment grade. Both these Bonds are to be paid to holders upon maturity.

On 20 December 2013 the Group issued two subordinated debt instruments; £109m 11% final repayments notes due 2025 and £20m instalment repayment notes, final payment 2025. The £200m 5.875% Eurobond Issue 2013 was repaid in October 2013.

The unsecured bank loans consist of a £450m term loan which is fully drawn as at 4 January 2014. The Group also holds a £450m revolving credit facility of which £4m was drawn as at 4 January 2014 (£5m at 5 January 2013). Both of these facilities terminate on 26 July 2017.

The Group also holds £15m (GBP equivalent) of uncommitted facilities, renewed annually, and a bi-lateral facility of £50m which expires in March 2015.

### Reconciliation of movement in net debt

Net debt is a measure that shows the Trading Group's net indebtedness to banks and other external financial institutions and comprises the total of cash and short-term deposits less deposits held in trustee-administered bank accounts and current and non-current interest-bearing loans and borrowings.

## Notes to the financial statements continued

### 24. Interest-bearing loans and borrowings continued

#### For period ended 4 January 2014 adjusted

	Start of period £m	Non cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of period £m
Cash and cash equivalents	180	–	20	–	–	200
Less:						
– Deposits held in trustee-administered bank accounts	(52)	–	2	–	–	(50)
– Interest-bearing loans and borrowings – non-current	(1,501)	37	–	1	–	(1,463)
– Interest-bearing loans and borrowings – current	(313)	(17)	224	19	–	(87)
Net debt	(1,686)	20	246	20	–	(1,400)

#### For period ended 4 January 2014

	Start of period £m	Non cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of period £m
Cash and cash equivalents	180	–	20	–	–	200
Less:						
– Deposits held in trustee-administered bank accounts	(52)	–	2	–	–	(50)
– Interest-bearing loans and borrowings – non-current	(1,501)	37	–	1	1,457	(6)
– Interest-bearing loans and borrowings – current	(313)	(17)	224	19	(1,457)	(1,544)
Net debt	(1,686)	20	246	20	–	(1,400)

#### For period ended 5 January 2013

	Start of period £m	Non cash movements £m	Cash flow £m	Movement in corporate investor shares £m	Transfer from non-current to current £m	End of period £m
Cash and cash equivalents	267	–	(87)	–	–	180
Less:						
– Deposits held in trustee-administered bank accounts	(58)	–	6	–	–	(52)
– Interest-bearing loans and borrowings – non-current	(1,534)	(13)	(159)	(1)	206	(1,501)
– Interest-bearing loans and borrowings – current	(163)	–	50	6	(206)	(313)
Net debt	(1,488)	(13)	(190)	5	–	(1,686)

## Notes to the financial statements continued

### 24. Interest-bearing loans and borrowings continued

#### Finance lease liabilities

Finance leases have the following maturities in the Trading Group:

	2013 £m	2012 £m
Less than one year	3	5
Greater than one year but less than five years	6	3
Greater than five years	–	–
	<b>9</b>	<b>8</b>

Under the terms of the lease agreements, no contingent rents are payable. The difference between the total future minimum lease payments and their present value is immaterial.

#### Accounting policies

Financial instruments (excluding derivatives)

The Trading Group classifies its financial 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 represent 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, and liabilities at amortised cost.

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
- 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 its financial liabilities (excluding derivatives) in two main ways. Quoted debt is designated at fair value through profit or loss when the Group enters into transactions designated to offset (e.g. 2012 refinancing when the Group used interest rate swaps designed to offset). Other material financial liabilities such as the debt raised from the LME are measured at amortised cost.

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.

## Notes to the financial statements continued

### 25. Trade and other payables

	2013 £m	2012 £m
Current	<b>1,373</b>	1,356
Non-current	<b>706</b>	601
Trading Group	<b>2,079</b>	1,957
Financial Services	<b>517</b>	255
	<b>2,596</b>	2,212

	2013 £m	2012 £m
Trade payables	<b>849</b>	900
Value added tax, PAYE and social security	<b>18</b>	39
Accruals and deferred income	<b>419</b>	348
Member payments payable	<b>25</b>	34
Funeral plans	<b>619</b>	561
Deferred consideration	<b>300</b>	–
Other payables	<b>364</b>	328
Other reinsurance liabilities	<b>2</b>	2
	<b>2,596</b>	2,212

Further details on the maturity profile of trade and other payables of the Trading Group can be found in note 33.

Deferred consideration relates to the additional contribution which the Group is required to inject into the Bank as part of the LME as disclosed in note 9.

#### Accounting policies

##### Prepaid funeral plans (plans)

A small proportion of revenue is recognised on the sale of each plan, equivalent to the upfront marketing and administration costs incurred in the initial sale. The proportion of the plan value that is recognised varies depending on the sales channel, reflecting different underlying costs of the different channels.

A liability for the funeral delivery of a plan is recognised at the date of plan sale. Both the initial plan investment and the liability for the funeral delivery are recorded at the plan value less the revenue recognised on sale. Investment growth is added to the plan investment each year, and the liability adjusted accordingly. A liability adequacy test is performed by a qualified Actuary every 3 years on the funeral plan liability to ensure it at least reflects the anticipated cost of delivering the funeral in the future. In between actuarial valuations the underlying assumptions of investment growth and cost inflation are reviewed by management to ensure the plan liability continues to at least reflect the anticipated cost of delivering the funeral in the future.

The value of the financial liability was 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.

##### Funeral benefit options (FBOs)

FBOs are attached to Guaranteed Over 50's life insurance plans (GOFs) sold by the Group's 3rd party insurance partners. An FBO is the assignment of the sum assured proceeds of a GOF policy to Funeralcare for the purposes of undertaking their funeral. In exchange the GOF customer is awarded a discount on the price of the funeral.

At the point of assignment of an FBO, no revenue is recognised by the Group and instead an element of costs incurred are deferred onto the Balance Sheet and then expensed at the point of redemption. A separate provision is made to cover the expected cancellations of FBOs. No investment or liability is recognised for FBOs as the option does not guarantee a funeral and are our partner's liability. Any difference between the funeral price and the sum assured at the point of redemption is the liability of the deceased estate or whoever takes responsibility for arranging the funeral.

## Notes to the financial statements continued

### 26. Provisions

	2013 £m	2012 £m
Non-current	292	290
Current	133	124
Trading Group	425	414
Financial Services	75	187
	<b>500</b>	601

	Self Insurance £m	Onerous leases £m	Restructuring & integration £m	Litigation £m	FSCS levy £m	PPI £m	Regulatory/ other £m	2013 Total £m	2012 Total £m
At beginning of the period	82	232	70	13	40	116	48	601	532
Credit to income statement	–	(5)	(13)	–	–	–	(3)	(21)	(18)
Charge to income statement	44	36	67	9	30	103	477	766	303
Provisions utilised on disposal	–	(5)	–	–	–	–	–	(5)	–
Discounting	–	10	–	–	–	–	–	10	12
Payments	(34)	(36)	(42)	(8)	(26)	(85)	(44)	(275)	(228)
Reclassification	–	–	–	–	(4)	–	4	–	–
Disposals arising from loss of control of subsidiary	–	–	–	–	(40)	(134)	(402)	(576)	–
<b>At end of the period</b>	<b>92</b>	<b>232</b>	<b>82</b>	<b>14</b>	<b>–</b>	<b>–</b>	<b>80</b>	<b>500</b>	601

### Critical accounting estimates and judgements

#### Self Insurance

This provision relates to potential liabilities arising from past events that have been incurred but not yet reported. The provision includes an assessment, based on historical experience, of claims incurred but not reported at the period end. The claims are expected to be settled substantially over the next three years. Discounting does not materially impact the level of the provision.

#### Onerous leases

This provision primarily relates to properties that are no longer used for trading. The provision is recorded 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 business rates. Rental streams are assumed to terminate at the next most likely break point. The leases expire at dates ranging over many years and payments under lease commitments, net of amounts receivable under sub-lettings, will be approximately £76m (2012: £82m) payable over the next five years. The vast majority of costs have been discounted at a rate of 3.5% (2012: 2.96%). 8% (2012: 8%) has been used on costs relating to the former Somerfield head office where the provision was fair valued at this rate on acquisition in 2009.

#### Restructuring and integration

These provisions relate to costs associated with the rationalisation of corporate head office and divisional central support functions for which costs are expected to be incurred over the next three years. At the period end the Group provided for £39m of costs relating to the separation of IT systems and other change management from the Bank.

#### Litigation

The provision represents management's prudent estimate of costs arising from potential litigation. The majority of these costs are expected to be incurred within the next one to three years.

#### Financial Services Compensation Scheme (FSCS) levies

The FSCS has provided compensation to customers of financial institutions following the collapse of deposit takers in 2008. The compensation paid out to consumers is currently funded through loans from HM Treasury. In the prior period, the Group had provided £40m for its share of the levies raised by the FSCS including the interest on the loan from HM Treasury in respect of the levy years to 31 March 2014. The provision included £28m in respect of this interest levy. Since the Group lost control of the Bank, the majority of the provision has been disposed of and the balance relating to CFSMS has been reclassified to 'other'.

## Notes to the financial statements continued

### 26. Provisions continued

#### PPI

This provision related solely to the Co-operative Bank plc and therefore now forms part of the Group's investment in associate.

#### Regulatory/other

The largest single element is £23m relating to our obligation to develop a separate IT platform for the Life and Savings business following its sale to Royal London. The remainder of the balance within other comprises numerous smaller provisions including those which 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. Other provisions also include potential contract termination costs. The expected timing of payment varies across these provisions and may be incurred after two to three years.

#### Accounting policies

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.

### 27. Amounts owed to credit institutions

	2013 £m	2012 £m
Items in course of collection	–	49
Deposits from other banks	–	3,563
Overnight borrowings and overdraft balances	9	13
	<b>9</b>	<b>3,625</b>

Included in the prior year within deposits from other banks are liabilities of £1,881m secured on investment securities with a carrying value of £1,984m which have been sold under sale and repurchase agreements.

#### Accounting policies

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

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

## Notes to the financial statements continued

## 28. Reconciliation of operating profit to net cash inflow from operating activities

	Trading Group		Financial Services		Total	
	2013 £m	2012 (restated) £m	2013 £m	2012 (restated) £m	2013 £m	2012 (restated) £m
Operating (loss)/profit	(181)	122	33	20	(148)	142
(Losses)/profits on discontinued operations before interest and tax	(30)	(1)	(1,865)	(672)	(1,895)	(673)
Depreciation and amortisation charges (excluding DACs)	275	285	74	59	349	344
Non-current asset impairments	262	24	151	150	413	174
Profit on disposal of non-current assets	(25)	(5)	–	–	(25)	(5)
Change in value of investment properties	18	25	–	–	18	25
Effect of exchange rate movements	–	–	(1)	10	(1)	10
Effect of non-cash pension costs	(7)	6	–	2	(7)	8
Decrease in inventories and biological assets	2	82	–	–	2	82
(Increase)/decrease in receivables	(19)	(107)	(69)	43	(88)	(64)
Increase/(decrease) in payables and provisions	124	(42)	207	(182)	331	(224)
Interest payable on subordinated liabilities	–	–	96	81	96	81
Impairment losses on loans and advances	–	–	518	480	518	480
Impairment losses on investments	–	–	(19)	(5)	(19)	(5)
Interest amortisation	–	–	(4)	(6)	(4)	(6)
Amortisation on investments	–	–	153	(65)	153	(65)
Fair value amortisation	–	–	216	(15)	216	(15)
Unwind of fair value adjustments on transfer of engagements	–	–	46	–	46	–
Preference dividend	–	–	38	6	38	6
Tax received/(paid)	–	53	14	(86)	14	(33)
<b>Net cash flow from/(used in) trading activities</b>	<b>419</b>	<b>442</b>	<b>(412)</b>	<b>(180)</b>	<b>7</b>	<b>262</b>
Decrease in deposits by banks	–	–	(855)	309	(855)	309
Increase in customer accounts	–	–	(4,088)	356	(4,088)	356
(Increase)/decrease in debt securities in issue	–	–	(613)	480	(613)	480
Increase in loans and advances to banks	–	–	67	(68)	67	(68)
Increase in loans and advances to customers	–	–	2,907	54	2,907	54
Net movement of other assets and other liabilities	–	–	(1)	(15)	(1)	(15)
Investment property movement	–	–	(30)	107	(30)	107
Fair value through profit and loss movement	–	–	288	(125)	288	(125)
Derivative financial instruments movement	–	–	38	210	38	210
Assets available for sale movement	–	–	(28)	226	(28)	226
Movement in deferred acquisition costs	–	–	(5)	4	(5)	4
Reinsurance assets	–	–	89	(108)	89	(108)
Loan receivables at amortised cost	–	–	–	1	–	1
Insurance and other receivables	–	–	(149)	35	(149)	35
Insurance and participation contract provisions	–	–	(163)	56	(163)	56
Unallocated divisible surplus	–	–	(75)	233	(75)	233
Investment contracts	–	–	62	46	62	46
Amounts owed to credit institutions	–	–	(25)	(730)	(25)	(730)
Other provisions	–	–	70	138	70	138
Insurance and other payables	–	–	(4)	(34)	(4)	(34)
Other reinsurance liabilities	–	–	(2)	52	(2)	52
Net asset value attributable to unit holders	–	–	14	56	14	56
Increase in intangible assets	–	–	–	2	–	2
<b>Asset and liability movements in Financial Services</b>	<b>–</b>	<b>–</b>	<b>(2,503)</b>	<b>1,285</b>	<b>(2,503)</b>	<b>1,285</b>
<b>Net cash flow from/(used in) operating activities</b>	<b>419</b>	<b>442</b>	<b>(2,915)</b>	<b>1,105</b>	<b>(2,496)</b>	<b>1,547</b>

## Notes to the financial statements continued

### 28. Reconciliation of operating profit to net cash inflow from operating activities continued

The cash flows above and in the cash flow statement include discontinued operations and reclaim fund cash flows.

#### Accounting policies

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.

### 29. Commitments and contingent liabilities

a) Capital expenditure committed by the Group at the year-end was £8m (2012: £78m). This all related to property, plant and equipment.

b) Commitments under operating leases:

The Group's operating leases include stores, warehouses, vehicles and farming equipment. These have varying terms, restrictions and renewal rights. At 4 January 2014, the future minimum lease payments under non-cancellable operating leases were:

	2013		2012	
	Land and buildings £m	Other £m	Land and buildings £m	Other £m
Within one year	185	14	200	17
In two to five years	655	17	703	22
In over five years	2,018	–	2,374	–
	<b>2,858</b>	<b>31</b>	<b>3,277</b>	<b>39</b>

The prior period figures include the commitments of Financial Services of £22m within one year, £61m in two to five years and £380m in over five years. For a comparison of continuing businesses between 2013 and 2012 these amounts should be removed from the prior period.

The total of future minimum sublease payments expected to be received under non-cancellable subleases less than 50 years is £254m (2012: £426m). Of the £426m in the prior period, £11m related to the Bank.

c) The Co-operative Group Ltd Funeral Prepayment Trust (a funeral plan trust) has a charge over the Goole estate, which is Group owned land. Any significant changes to, or sale of the Goole estate, would require the approval of the trustees because of the charge. The trust is not part of the Group but is a vehicle set up to manage funeral plan assets in accordance with legislation in respect of funeral plan investments.

d) The Group has considered the impact of the various ongoing regulatory or other investigations and enquiries into events at the Co-operative Bank that are set out in detail in note 13 including those conducted by Sir Christopher Kelly, the PRA, the Treasury Select Committee, the FCA and the FRC. The Group has considered whether the outcome of such investigations into the Bank could impact the Group and has concluded at this stage it is simply too uncertain to ascertain whether or to what extent these could constitute contingent liabilities for the Group but that the likelihood of financial penalties being levied directly against the Group is currently low.

### 30. 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	2013 £m	2012 £m
Sales to associated undertakings and joint ventures on normal trading terms	(i)	2.9	1.2
Subscription to Co-operatives <sup>UK</sup> Limited	(ii)	1.0	1.0

i) Details of the Society's associates and joint ventures are set out in note 13.

ii) The Society is a member of Co-operatives<sup>UK</sup> 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 23. The sales to corporate members, on normal trading terms, were £1,494m (2012: £1,455m) and the amount due from corporate members in respect of such sales was £76m at 4 January 2014 (5 January 2013: £75m). A distribution of £10m (2012: £17m) was paid to Corporate members based on their trade with the Group.

## Notes to the financial statements continued

### 30. Related party transactions and balances continued

#### 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 key management in the normal course of business and are at arms length. Key management are considered to be members of the management executive and directors of the Co-operative Group. Other than the compensation set out in the Remuneration Report, there were no transactions greater than £1,000 with the Group's key management personnel or directors (2012: £13,360).

#### b) Financial Services

A number of banking transactions are entered into with key management in the normal course of business. These include loans and deposits. The volume of related party transactions, outstanding balances at the period end and related income and expense for the period are as follows:

	2013 £m	2012 £m
Loans, credit card and mortgage balances outstanding	0.3	1.0
Deposits at beginning of period	1.1	1.0
Net movement	(0.9)	0.1
Deposits at end of period	0.2	1.1

#### 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:

	2013 £m	2012 £m
At beginning of period	0.2	0.5
Net movement	(0.2)	(0.3)
At end of period	–	0.2

#### d) Transactions with associates and joint ventures

There were no transactions between the Group and its Travel associate in either period. The Bank is now an associate and is therefore a related party to the Group. The Group uses the Bank's banking facilities, including current accounts, deposit accounts, overdrafts and facility loans. At 4 January 2014 the total balance held with the Bank was £26.7m (overdrawn) and, in addition, the Group held a £50m bilateral loan facility.

As at 4 January 2014, the Group, through its subsidiary Co-operative Banking Group Limited, owed £313m (discounted to £300m) to the Bank under an Undertaking to Pay entered into as part of the LME. The total balance was £333m (discounted to £320m) at 20 December 2013 however £20m was paid before the year-end in accordance with the agreed payment schedule. The Undertaking to Pay will be satisfied in several tranches during 2014, with £50 million due by no later than 31 January 2014, £100 million due by 30 June 2014 and £163 due by 31 December 2014.

The Undertaking to Pay provides that should the Group fail to meet its obligations:

- a) the Group must pay default interest at 9% p.a. accruing on a daily basis;
- b) the Group waives all rights in respect of its new ordinary shares;
- c) the Group waives all rights under the Relationship Agreement;
- d) the Group must procure the resignation of any nominee directors of the Bank appointed by it;
- e) the Bank may direct the security trustee to exercise any of its rights under the Intra-group Loan and the associated security; and
- f) at the request of the Bank, the Group must transfer all or some of its new ordinary shares to a third party or the Bank for nil consideration in accordance with procedures set out in the Commitment Agreement.

## Notes to the financial statements continued

### 30. Related party transactions and balances continued

#### Intra-group Loan

On 4 November 2013, the Bank, the Co-operative Banking Group Ltd (a direct subsidiary of Co-operative Group Ltd) and Co-operative Group Ltd entered into an intra-group loan facility (the Intragroup Loan) whereby the Co-operative Group Ltd will make available to the Co-operative Banking Group Ltd during 2014 a term loan facility of up to £313m to be utilised by way of advances. The maturity date of the loan facility is 27 July 2019. The purpose of the Intra-group Loan is to support the Co-operative Banking Group Ltd's Undertaking to Pay. The Co-operative Banking Group Ltd is expecting to satisfy its Undertaking to Pay from the deferred proceeds receivable from the sale of the Life and Savings business (the Insurance Proceeds). The Co-operative Banking Group Ltd can draw down under the Intra-group Loan should the Insurance Proceeds not be available to satisfy the Undertaking to Pay. The Co-operative Banking Group Ltd has assigned to the Bank its rights against the Co-operative Group Ltd in the event that the Co-operative Group Ltd fails to provide the Co-operative Banking Group Ltd with a loan under the intra-Group loan agreement. A security assignment in respect of the Insurance Proceeds has been entered into between the Co-operative Banking Group Ltd and the Co-operative Group Ltd as security trustee for itself and the Bank to secure the Co-operative Banking Group Ltd's Undertaking to Pay and the Co-operative Banking Group Ltd's obligations as borrower under the Intra-group Loan.

#### Transactions with CFSMS

The Group has a significant relationship with the Bank through one of its subsidiaries, CFS Management Services Limited (CFSMS). CFSMS undertakes the provision of supplies and services on behalf of the Bank. This relationship was in place for the whole of the year but will change over 2014 and beyond as the Bank separates from the Group. Further details are provided below:

#### CFSMS-Bank Framework Agreement

On 16 February 2006, the Bank and CFSMS entered into the CFSMS-Bank Services Agreement pursuant to which CFSMS provides assets such as office equipment, materials and office space, and other facilities and services, and consultants who act as secondees to the Bank. The Bank provides CFSMS with an indemnity for all liabilities, losses, damages, costs and expenses of any nature as a result of CFSMS entering into and performing the agreement in respect of the assets, services and personnel provided to the Bank.

As a result of the LME, the Bank and CFSMS intend to replace the CFSMS-Bank Services Agreement with appropriate revised arrangements under a CFSMS-Bank Framework Agreement. Once agreed by the Bank and the Group as part of the separation process, the CFSMS-Bank Framework Agreement will establish a flexible contractual framework that will enable the Bank to obtain from CFSMS the existing services and secondees, and procure the supply of third party procured services and assets that CFSMS provides to the Bank under the CFSMS-Bank 2006 Agreement and will also cover any new services for a transitional period.

Under the CFSMS-Bank Framework Agreement, CFSMS will be entitled to provide services on a shared basis to other members of the Co-operative Banking Group Ltd from time to time. CFSMS will be required to provide the services at the same standards as those received before commencement.

An exit plan will be prepared and will be kept updated. During the exit period, CFSMS would be required to provide any reasonable assistance required by the Bank to allow the secondees, assets or third party procured services to continue to be enjoyed without interruption or adverse effect.

#### Employees

CFSMS has previously employed a significant number of employees which perform tasks on behalf of the Bank (either on a full time or part of their time basis). Staff costs were then recharged to the Bank. The employment contracts of most of the employees that perform all of their tasks on behalf of the Bank have been transferred from CFSMS to the Bank with effect from 23 January 2014. Where CFSMS employees continue to provide services to the Bank, this is covered by service agreements between the companies. The transfer was required to support the legal separation of the Bank from the Group. Further transfers will occur in 2014 as the Bank completes its separation.

#### Tangible/Intangible Assets

Since its inception in 2006, CFSMS has held legal title to the majority of the tangible and intangible assets of the Co-operative Banking Group. This included the work in progress assets, in particular, the Core IT Banking system replacement. As part of the separation activity, in 2014, the Bank intends to purchase the legal title of all Bank specific assets currently held by CFSMS.

#### Separation

The Group and the Bank have also agreed the basis on which Project Unity and the CFSMS Arrangements will be unwound. Prior to the LME, certain functions of the Bank were centralised and carried out by the Group. There are two key arrangements in place under which the Bank receives the supply of services, assets and/or personnel:

- 1) Between 2011 and 2013, the Bank transferred a number of functions and a substantial number of personnel to the Group and entered into arrangements whereby the Group would provide certain services to the Bank. This project is known as Project Unity. Two key agreements in connection with Project Unity are:
  - The existing IT Services Agreement in relation to the provision of IT services to the Bank and other members of the Co-operative Banking Group
  - A Professional Master Services Agreement where the same parties entered into a number of individual service contracts in relation to the provision of other services

## Notes to the financial statements continued

### 30. Related party transactions and balances continued

2) CFSMS was established as a direct subsidiary of the Co-operative Banking Group in 2005 to enable economies of scale through the sharing of employees and sourcing of third party services across the Co-operative Banking Group, including the Bank. CFSMS provides services to the Bank under the CFSMS – Bank Services Agreement referred to above, under which the Bank gives a broad indemnity to CFSMS in respect of activities carried on by CFSMS for the Bank. Following the announcement of the Bank's recapitalisation plan in June 2013 (the June Plan), the Bank and the Group worked to amend certain provisions of the Project Unity and CFSMS Arrangements. Those amendments were close to finalisation when the Group announced on 21 October 2013 that it was in discussion with bondholders, and that many elements of the June Plan would need to change in material respects to reflect the fact that the Bank would no longer be a subsidiary of the Group. The change to the June Plan meant that there would be significant cost impacts if the Project Unity and CFSMS Arrangements were to continue in the form originally envisaged. In addition, the Bank did not consider it appropriate for the provision of personnel or supply of certain third party services and assets to the Bank to be housed in an entity that has ceased to be part of the same group as the Bank.

#### Separation principles

Accordingly, the Group and the Bank have been working towards renegotiation of the arrangements under which the Bank receives staff and services from the Group. These negotiations are complex and ongoing. Pending finalisation of the revised arrangements, the Group and the Bank agreed high level principles (the Separation Principles) to govern their separation discussions. The Separation Principles include an overarching agreement to act in good faith and, amongst other things:

- Until alternative arrangements for Project Unity and the CFSMS Arrangements are agreed, the Group will continue to provide services to the Bank under the same terms that such services are currently provided
- For those costs allocated by the Group in its sole discretion, the Group and the Bank will take reasonable steps to avoid the Bank incurring costs incremental to those it currently incurs
- The Group and the Bank will mitigate costs arising for the Group or the Bank from (i) the Group being a less than 50% shareholder of the Bank or (ii) agreed steps taken in connection with the separation process
- An additional mark-up (of no more than 20%) may be charged by the Group for services provided under Project Unity after the LME but not in respect of the first 12 months in respect of all services
- Costs will be allocated between the Group and the Bank on an equitable basis
- A working group consisting of representatives from the Bank and the Group will be established to address and oversee the separation work-stream. The Group and the Bank have also agreed the basis on which Project Unity and the CFSMS Arrangements will be unwound

#### Pensions

On 4 November 2013, the Group and the Bank entered into an undertaking pursuant to which the Group agreed with the Bank, subject to certain exceptions, not to require the Bank to cease to participate in Pace in connection with the Bank's Liability Management Exercise or any subsequent reduction in the Group's shareholding in the Bank (including to nil). Should either Group or the Bank so request, the parties will enter into good faith discussions to agree on the separation of Pace, so that the scheme liability properly attributable to the Bank and an equivalent proportion of the scheme's assets would be transferred to a separate tax registered pension scheme, or a segregated section of Pace. Neither party shall be under an obligation to agree to any separation of the scheme that would result in a requirement to make material payments to or in respect of the scheme.

#### Services previously combined under Project Unity

As part of separation, the Bank will enter into a new IT Services Agreement (the New IT Service Agreement) and a new Master Services Agreement (the New MSA). It is intended that the day to day operational management of the services supplied under the New IT Service Agreement is monitored by a Group contract manager (as the supplier of services), a Bank contract manager (as a customer), functional leads for Group and the Bank and risk, audit and compliance for the Bank. Under the New IT Service Agreement, the Group will provide the Bank with the following services: colleague technology services, network services, core services, service management services and change management services. The New MSA will be a framework agreement intended to establish a flexible contractual arrangement to enable the Bank and CFSMS to obtain certain professional services from Group as agreed from time to time in service contracts. Service contracts will be entered into in relation to secretariat, legal, corporate affairs, marketing, finance, corporate HR, people services, estates, Illius (property management), risk and internal audit.

#### CFSMS Arrangements

The existing CFSMS- Bank Services Agreement will be terminated once the terms of CFSMS Bank Framework Agreement have been finally agreed.

## Notes to the financial statements continued

### 31. Principal subsidiary undertakings

The principal subsidiary undertakings of the Society, which are registered in England and Wales, are:

	Society holding %	Nature of business
<b>Financial Services:</b>		
Co-operative Banking Group Ltd	100	Holding society
CIS General Insurance Ltd	100	General insurance
CFS Management Services Ltd	100	Service company
CIS Finance Ltd	100	Financial services
Reclaim Fund Ltd	100	Reclaim Fund
<b>Trading:</b>		
Co-operative Group Holdings (2011) Ltd	100	Property management
Co-operative Group Food Ltd	100	Food retailing
Somerfield Stores Ltd	100	Food retailing
Farmcare Ltd	100	Farming
Co-operative Group Healthcare Ltd	100	Pharmaceutical retailing
National Co-operative Chemists Ltd	99	Pharmaceutical retailing
The Co-operative Pharmacy National Distribution Centre Ltd	100	Pharmacy distribution
Donald Wardle & Son Ltd	100	Pharmacy
Co-operatives E-Store Ltd	100	Electricals online
Funeral Services Ltd	100	Funeral directors
Co-operative Life Planning Ltd	100	Life Planning
Co-operative Legal Services Ltd	100	Legal services
The Co-operative Trust Corporation Ltd	100	Charity
Sunwin Services Group (2010) Ltd	100	Cash in transit, security services
Co-operative Brands Ltd	100	Holds intellectual property
Millgate Insurance Brokers Ltd	100	Insurance broking
Rochpion Properties (4) LLP	100	Holds property

All of the above have been fully consolidated into the Group's accounts. For further information on the Group's principal associated undertakings, refer to note 13.

#### Notes

- i) All of the principal subsidiaries are audited by KPMG Audit plc.
- ii) All of the Group's Financial Services subsidiaries have a year-end of 31 December 2013.
- iii) All transactions between entities are in the usual course of business and are at arms length.
- iv) During the period the Group's share of the Co-operative Bank plc reduced from 100% to 30% (see note 9).
- v) During the period the Group completed the asset sale of the remaining non Land Rover Motor garages in the Group estate, therefore, despite still owning the entity, Co-operative Group Motors Ltd is not considered to be a principal subsidiary undertaking.
- vi) Albert Farnells Ltd was sold to Vertu Motors plc on 12 June 2013.
- vii) The Fairways Partnership Ltd and Fairways Funeral Partnership Ltd transferred engagements to Funeral Services Limited on 4 January 2014.
- viii) David Sands Ltd transferred engagements to Co-operative Group Food Ltd on 6 April 2013.

## Notes to the financial statements continued

### 32. Acquisitions

#### Acquisition of David Sands Limited

On 24 April 2012, the Group completed its acquisition of a 100% equity interest in the convenience store retailer, David Sands Limited including its 28 food stores, distribution depot and head office. For a purchase consideration of £26m, net identifiable assets with a fair value of £8m were received, with £18m of goodwill recognised.

The hindsight period for any adjustments to the estimated fair values came to an end on 24 April 2013. No material adjustments were identified.

### 33. Financial risk management

The principal financial risks facing the Trading Group are set out below. Overall group risks and the strategy used by the Group to mitigate these risks are discussed in the Principal Risks and Uncertainties section on pages 23 to 28.

#### Introduction

The Trading Group meets its working capital needs through a number of facilities totalling £1,944m. During 2013, the Group repaid in full a £153m Investment Properties Loan and a £200m Sterling Eurobond. Furthermore, as part of the agreement to support the Co-operative Bank, the Group's Syndicated Bank Facilities have been amended to £900m, comprising a fully drawn Term Loan of £450m and a Revolving Credit Facility of £450m. Under this agreement, repayment of £50m against the term loan is due in 2014. The remaining facilities of £1,894m are predominantly due for repayment between 2017 and 2026 demonstrating the establishment of core medium and long term funding for the Trading Group.

#### 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 for 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 the policy on 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 19. The carrying value of all balances that attract a credit risk, which represents the maximum exposure, is set out below:

	Carrying amount 2013 £m	Carrying amount 2012 £m
Trade and other receivables (excluding prepayments and accrued income)	371	587
Interest rate swaps	29	82
Cash deposits	200	180

#### 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 40-80% of its exposure to changes in interest rates on borrowings is on a fixed-rate basis. The fixed proportion as at 4 January 2014 was 78% (at 5 January 2013: 60%). This increase was primarily due to the £129m fixed rate debt instruments issued by the Group in December 2013. 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 thirteen years following the maturity of the related loans (see the following table) and have fixed swap rates ranging from 3.27% to 5.68% (at 5 January 2013: 1.98% to 5.68%). At 4 January 2014, the Trading Group had interest rate swaps with a notional contract amount of £1,201m (at 5 January 2013: £1,605m).

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 at 4 January 2014 was a net liability of £38m (2012: £40m) comprising assets of £29m (2012: £82m) and liabilities of £67m (2012: £122m). These amounts are recognised as fair value derivatives.

## Notes to the financial statements continued

### 33. Financial 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:

	Effective interest rate	Total £m	Adjusted 2013**				
			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	0.563%	200	200	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50)	–	–	–	(50)	–
Unsecured bond issues:							
5 5/8%* Fixed-rate sterling eurobond	6.875%	(450)	–	–	–	–	(450)
5 5/8% Effect of interest rate swaps	–2.312%	–	(375)	–	–	–	375
6 1/4%* Fixed-rate sterling eurobond	7.500%	(350)	–	–	–	–	(350)
6 1/4% Effect of interest rate swaps	–1.379%	–	(150)	–	–	–	150
Unsecured subordinated notes:							
11% Final Repayment Subordinated Notes	11.000%	(109)	–	–	–	–	(109)
Instalment Repayment Subordinated Notes	11.000%	(20)	–	(1)	(1)	(4)	(14)
Other unsecured loans	4.737%	(507)	(53)	(4)	(50)	(400)	–
Effect of interest rate swaps	4.034%	–	676	–	–	(451)	(225)
Corporate investor shares	2.137%	(26)	(20)	(6)	–	–	–
Finance lease liabilities		(9)	(2)	(1)	(4)	(2)	–
		(1,321)	276	(12)	(55)	(907)	(623)

	Effective interest rate	Total £m	2013				
			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	0.563%	200	200	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50)	(50)	–	–	–	–
Unsecured bond issues:							
5 5/8%* Fixed-rate sterling eurobond	6.875%	(450)	(450)	–	–	–	–
5 5/8% Effect of interest rate swaps	–2.312%	–	–	–	–	–	–
6 1/4%* Fixed-rate sterling eurobond	7.500%	(350)	(350)	–	–	–	–
6 1/4% Effect of interest rate swaps	–1.379%	–	–	–	–	–	–
Unsecured subordinated notes:							
11% Final Repayment Subordinated Notes	11.000%	(109)	(109)	–	–	–	–
Instalment Repayment Subordinated Notes	11.000%	(20)	(20)	–	–	–	–
Other unsecured loans	4.737%	(507)	(507)	–	–	–	–
Effect of interest rate swaps	4.034%	–	–	–	–	–	–
Corporate investor shares	2.137%	(26)	(20)	(6)	–	–	–
Finance lease liabilities		(9)	(2)	(1)	(4)	(2)	–
		(1,321)	(1,308)	(7)	(4)	(2)	–

\* With effect from 8<sup>th</sup> July 2013 an additional 1.25% coupon is currently being paid on these bonds (see note 24).

\*\* The Adjusted balance sheet as at 4 January 2014 includes a reclassification of certain of the Group's interest bearing loans and borrowings to non-current liabilities to reflect the amended terms of certain borrowings, as agreed post balance sheet date but prior to signing the accounts (see interest bearing loans and borrowings note 24 and post balance sheet event note 39).

## Notes to the financial statements continued

### 33. Financial risk management continued

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:

	Effective interest rate	Total £m	2012				
			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	0.563%	180	180	–	–	–	–
Secured debt:							
First mortgage debenture 2018	7.625%	(50)	–	–	–	–	(50)
Investment Properties Loan	1.829%	(153)	(2)	(2)	(4)	(145)	–
Effect of interest rate swap	4.716%	–	–	–	–	–	–
Unsecured bond issues:							
5 7/8% Fixed-rate sterling eurobond	5.875%	(200)	–	(200)	–	–	–
5 7/8% Effect of interest rate swaps	–3.773%	–	(200)	200	–	–	–
5 5/8% Fixed-rate sterling eurobond	5.625%	(450)	–	–	–	–	(450)
5 5/8% Effect of interest rate swaps	–2.213%	–	(450)	–	–	–	450
6 1/4% Fixed-rate sterling eurobond	6.250%	(350)	–	–	–	–	(350)
6 1/4% Effect of interest rate swaps	–1.137%	–	(150)	–	–	–	150
Other unsecured loans	2.785%	(457)	(2)	(1)	(4)	(450)	–
Effect of interest rate swaps	2.623%	–	652	(50)	–	(568)	(34)
Corporate investor shares	2.000%	(46)	(34)	(11)	(1)	–	–
Finance lease liabilities		(8)	(3)	(2)	(2)	(1)	–
		(1,534)	(9)	(66)	(11)	(1,164)	(284)

#### 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 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 six months 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 4 January 2014, the Trading Group had forward currency transactions in Euro and US Dollars with a notional contract amount of £8m (2012: £7m).

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Liquidity risk

This is the risk that the Group will not have sufficient facilities to fund its future borrowing requirements and will require funding at short notice to meet its obligations as they fall due. The Group's funding maturity profile is managed to ensure appropriate flexibility through a mix of short, medium and long term funding together with diversified sources of finance, at a reasonable cost, to meet the Group's needs.

As at 4 January 2014, the Trading Group had available borrowing facilities totalling £1,944m (2012: £2,253m), which comprised uncommitted facilities of £15m (2012: £50m) and committed facilities of £1,929m (2012: £2,203m). These are detailed below:

#### Bank facilities as at 4 January 2014

	2013		2012	
	Expiry	£m	Expiry	£m
Uncommitted facilities	<b>August 2014</b>	<b>15</b>	July 2013/ August 2013	50
Syndicate Term Loan	<b>July 2017</b>	<b>450</b>	July 2017	450
Syndicate Revolving Credit Facility	<b>July 2017</b>	<b>450</b>	July 2017	500
Bilateral Facility	<b>March 2015</b>	<b>50</b>	March 2015	50
Secured Investment Property Bilateral			September 2015	153
		<b>965</b>		1,203
Debenture	<b>December 2018</b>	<b>50</b>	December 2018	50
Eurobond issue – 2020	<b>July 2020</b>	<b>450</b>	July 2020	450
Final repayment notes – 2025	<b>December 2025</b>	<b>109</b>	n/a	–
Instalment repayment notes – 2025	<b>December 2025</b>	<b>20</b>	n/a	–
Eurobond issue – 2026	<b>July 2026</b>	<b>350</b>	July 2026	350
Eurobond issue – 2013	<b>n/a</b>	<b>–</b>	December 2013	200
		<b>1,944</b>		2,253

The following are the maturities of financial liabilities as at 4 January 2014 based on the adjusted balance sheet\*:

	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	(50)	(50)	–	–	–	(50)	–
Unsecured bank facility	(507)	(507)	(53)	(4)	(50)	(400)	–
Sterling Eurobond 2020	(467)	(450)	–	–	–	–	(450)
Sterling Eurobond 2026	(362)	(350)	–	–	–	–	(350)
Final repayment subordinated notes – 2025	(109)	(109)	–	–	–	–	(109)
Instalment repayment subordinated notes – 2025	(20)	(20)	–	(1)	(1)	(4)	(14)
Finance lease liabilities	(9)	(9)	(2)	(1)	(4)	(2)	–
Trade and other payables	(2,079)	(2,079)	(1,348)	(25)	(647)	(21)	(38)
<b>Derivative financial liabilities</b>							
Interest rate swaps used for hedging	(67)	(67)	–	–	–	(51)	(16)

## Notes to the financial statements continued

### 33. Financial risk management continued

The following are the maturities of financial liabilities as at 4 January 2014:

	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	(50)	(50)	(50)	–	–	–	–
Unsecured bank facility	(507)	(507)	(507)	–	–	–	–
Sterling Eurobond 2020	(467)	(450)	(450)	–	–	–	–
Sterling Eurobond 2026	(362)	(350)	(350)	–	–	–	–
Final repayment subordinated notes – 2025	(109)	(109)	(109)	–	–	–	–
Instalment repayment subordinated notes – 2025	(20)	(20)	(20)	–	–	–	–
Finance lease liabilities	(9)	(9)	(2)	(1)	(4)	(2)	–
Trade and other payables	(2,079)	(2,079)	(1,348)	(25)	(647)	(21)	(38)
<b>Derivative financial liabilities</b>							
Interest rate swaps used for hedging	(67)	(67)	–	–	–	(51)	(16)

The following are the maturities of financial liabilities as at 5 January 2013:

	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	(153)	(153)	(2)	(2)	(4)	(145)	–
Secured debenture	(55)	(50)	–	–	–	–	(50)
Unsecured bank facility	(457)	(457)	(2)	(1)	(4)	(450)	–
Sterling Eurobond 2013	(206)	(200)	–	(200)	–	–	–
Sterling Eurobond 2020	(471)	(450)	–	–	–	–	(450)
Sterling Eurobond 2026	(368)	(350)	–	–	–	–	(350)
Finance lease liabilities	(8)	(8)	(3)	(2)	(2)	(1)	–
Trade and other payables	(1,957)	(1,957)	(1,296)	(60)	(36)	(67)	(498)
<b>Derivative financial liabilities</b>							
Interest rate swaps used for hedging	(122)	(122)	–	(2)	–	(80)	(40)

\* The Adjusted balance sheet as at 4 January 2014 includes a reclassification of certain of the Group's interest bearing loans and borrowings to non-current liabilities to reflect the amended terms of certain borrowings, as agreed post balance sheet date but prior to signing the accounts (see interest bearing loans and borrowings note 24 and post balance sheet event note 39).

## Sensitivity analysis

### Interest rate risk

The valuations of Group's quoted debt and Swaps have been determined by discounting expected future cash flows associated with these instruments at the market interest rate yields as at the Group's year end. This is then sensitised by overlaying a +1% increase to the interest rate yield curve and a 1% reduction in the interest rate yield curve. At 4 January 2014 if sterling (GBP) market interest rates had been 1% higher/lower with all other variables held constant, the post-tax result for the period would have been GBP £68m (2012: GBP £68m) higher and GBP £75m (2012: GBP £109m) lower respectively, mainly arising from the revaluation of the Society's £959m quoted debt (2012: £1,050m) 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 4 January 2014 and 5 January 2013, if the Euro, US dollar, Australian dollar and New Zealand dollar had all strengthened or weakened by 10% against sterling (GBP) with all variables held constant, there would have been no material impact to post-tax profit.

### 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 4 January 2014 the total amount of guarantees/bonds outstanding is £45m (2012: £56m).

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Fair values of the Trading Group

The basis fair value of those financial assets and liabilities recorded at their fair value in the balance sheet at 4 January 2014 and 5 January 2013 respectively are as follows:

	2013			2012		
	Quoted market prices in active market Level 1 £m	Valuation techniques using observable inputs Level 2 £m	Valuation techniques using unobservable inputs Level 3 £m	Quoted market prices in active market Level 1 £m	Valuation techniques using observable inputs Level 2 £m	Valuation techniques using unobservable inputs Level 3 £m
<b>Non financial assets held at fair value</b>						
Property, plant and equipment	–	49	–	–	49	–
Investment properties	–	98	–	–	273	–
Investments in associates and joint ventures	–	46	–	–	46	–
Biological assets	–	6	–	–	5	–
<b>Financial assets</b>						
Trade and other receivables	–	487	–	–	702	–
Cash and cash equivalents	–	200	–	–	180	–
<b>Derivative financial assets and liabilities</b>						
Interest rate swaps:						
Assets	–	29	–	–	82	–
Liabilities	–	(67)	–	–	(122)	–
<b>Non-derivative financial liabilities</b>						
Secured debt:						
First mortgage debenture 2018*	(50)	–	–	(55)	–	–
Other secured loans	–	–	–	–	(153)	–
Unsecured bond issue:						
Fixed-rate sterling eurobond	(829)	–	–	(1,045)	–	–
Unsecured subordinated notes:						
Final Repayment Subordinated Notes**	(109)	–	–	–	–	–
Instalment Repayment Subordinated Notes***	(20)	–	–	–	–	–
Funeral bonds	–	–	(619)	–	–	(561)
Unsecured bank facilities:						
Other unsecured loans	–	(507)	–	–	(457)	–
Corporate investor shares	–	(26)	–	–	(46)	–
Finance lease liabilities	–	–	(9)	–	–	(8)
Trade and other payables (excluding accruals, deferred income and funeral bonds)	–	(1,199)	–	–	(1,153)	–

\* This debenture is secured against a £100m Trading Group portfolio of land and properties.

\*\* As these notes were issued on 20th December 2013 a trading market price had not yet been established.

\*\*\* Due to the expected illiquid nature of these notes they are reflected at a par valuation.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### 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, such as the Group's interest rate swaps, 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 the period end plus an adequate constant credit spread to discount financial instruments.

The interest rates used are as follows:

	2013	2012
Derivatives	0.63% – 2.55%	0.58% – 2.73%
Loans and borrowings	3.88% – 10.56%	4.33% – 6.15%

### CISGIL Risk Management

CIS General Insurance Limited (CISGIL) issues contracts that transfer insurance risk and is exposed to financial risk through its holdings of financial assets and liabilities. This section summarises these risks and the way CISGIL manages them.

#### Developments during 2013

Prior to 2013 CISGIL's risk management framework was integrated with Financial Services. During 2013 CISGIL established its own risk management framework appropriate to a stand-alone general insurer. As a result, over the course of 2013 CISGIL:

- Revised its risk classification and established a comprehensive risk register
- Revised its risk appetite and limits
- Established its own suite of risk policies and control standards
- Created a stand-alone 2nd Line Risk function
- Revised and enhanced its governance structure and delegated authority framework

The following section summarises the risk management structure that was in place at the end of 2013.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Our approach to risk management

CISGIL operates a three lines of defence governance model to ensure appropriate responsibility and accountability is allocated to the management, reporting and escalation of risks.

Business management is the first line of defence. It is responsible for implementing and operating processes to identify, measure, manage, monitor and report risks. This includes those risks deriving from the development of new products, processes or other business change. It manages the risks that reside within the business areas on a day-to-day basis and implements effective monitoring and control processes to ensure that the business risk profile is understood and maintained within Board defined risk appetite.

The Chief Risk Officer and second Line Risk function are the second line of defence. They own the risk management framework, oversee and challenge its implementation and operation by the first line of defence, and consider current and emerging risks across CISGIL. They also provide review and challenge of the delegated authority framework and oversee appropriate escalation of breaches, mitigating actions and reporting to the Executive Risk Committee and Board.

Internal audit act as the third line of defence. They independently challenge the overall management of the framework and provide assurance to the CISGIL Board Audit Committee and senior management on the adequacy of both the first and second lines. The Chair of the CISGIL Board Audit Committee oversees the internal audit function and risk-based audit plan. CISGIL has contracts in place with external consultants to provide internal audit capability.

#### Risk management structure

The Board is responsible for approving the general insurance 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 in place.

CISGIL has developed and implemented a governance and organisation structure, which supports the Board. The Board has established risk and audit sub-committees, and senior management committees, to:

- Oversee the risk management process
- Identify the key risks facing the business
- Assess the effectiveness of planned management actions

Specific Board authority has been delegated to the Board sub-committees and the Managing Director, Insurance Division who may, in turn, delegate elements of these discretions to appropriate members of the senior management team.

#### Risk management committees

##### The CIS General Insurance Board (Board)

The responsibilities of the Board include:

- Setting the overall Risk Strategy
- Approving the design and implementation of risk management approaches, including the Risk Management Framework Policy and the Risk Appetite Statements and metrics that underpin them
- Delegating authority for oversight of the risk management framework, systems and high-level limits to the Board Risk Committee
- Delegating authority for cascading the setting and approval of the more granular risk limits and tolerances to the Managing Director, Insurance Division
- Using the output of the semi-annual certification process, to approve the effectiveness of the Risk Management Framework with support from internal audit through their risk-based review programme
- Reviewing and challenging Board Risk Committee reports on the effectiveness of the risk management framework and systems

##### CISGIL Board Risk Committee (BRC)

BRC responsibilities include:

- Providing oversight and advice to the Board on current and potential risks and the overall risk framework including risk appetite, risk tolerance and risk management strategies
- Reviewing and challenging the design of the Risk Management Framework, risk appetite limits and tolerances and recommending to the Board for approval
- Reviewing and challenging the implementation of the Risk Management Framework through the semi-annual certification process and reviewing the quality and effectiveness of the Risk Management Framework, systems and function
- Reviewing and challenging internal controls and process of risk management including the coverage of the risk taxonomy
- Monitoring the organisation's performance and compliance against high-level risk appetite limits and tolerances
- In co-operation with the Board Audit Committee, monitoring identified risk control failings and weaknesses and management actions taken to resolve them
- Reporting on the effectiveness of the Risk Management Framework and systems to the Board.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### CISGIL Board Audit Committee (BAC)

BAC responsibilities include:

- Review and oversight of financial statements and annual reports before submission to the Board
- Assisting the Board in carrying out its responsibilities relating to internal control, including control breaches and remediation;
- Exercising oversight of identified risk control framework failings and weaknesses as well as management actions taken to resolve them
- Oversight of internal and external assurance and audit

#### CISGIL Executive Committee (ExCo)

The ExCo responsibilities include:

- Overseeing the establishment and maintenance of appropriate risk management systems and controls in line with the Board agreed Risk Management Framework
- Supporting the Managing Director, Insurance Division in developing, reviewing and approving detailed risk appetite limits and tolerances as delegated by the Board
- Ensuring the implementation of the risk strategy set by the Board so as to deliver an effective risk management environment for CISGIL

#### CISGIL Executive Audit Committee (EAC)

The EAC responsibilities cover ensuring the timely issue resolution and decision making governance on the results of audits relating to CISGIL from regulators, external auditors and internal audit.

#### CISGIL Executive Risk Committee (ERC)

The ERC responsibilities include:

- Driving the detailed implementation of the CISGIL Risk Management Framework approved by the Board
- Providing a mechanism for ensuring that the CISGIL-wide risk and capital management requirements, developments, and processes are in place
- Supporting the Managing Director, Insurance Division in developing the Risk Strategy, Risk Management Framework, and Risk Appetite Statement and recommending to the Board Risk Committee for review, challenge and recommendation to the Board for approval
- Supporting the Managing Director, Insurance Division in approving risk policies, proposing risk appetite limits and tolerances to the Board Risk Committee for review, challenge and recommendation to the Board for approval
- Reviewing approaches to stress testing, risk management reporting and governance, and referring them to the Board Risk Committee for review, challenge and recommendation for approval by the Board
- Supporting the Managing Director, Insurance Division in semi-annually reviewing the effectiveness of the Risk Management Framework, systems and function and providing a report to the Board Risk Committee
- On a periodic basis, assessing the performance of the Risk Management Framework
- Monitoring the business's risk profile against the agreed limits and tolerances and reporting on these to the Board Risk Committee

#### Senior Management Committees

CISGIL has other committees that advise and support the Managing Director, Insurance Division and members of the senior management team in carrying out their responsibilities.

#### Remuneration Committee

Remuneration is authorised by a combined committee covering CISGIL and other Financial Services entities.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Principal risks

The following are considered to be the principal risks facing CISGIL:

Risk type	Definition
i <b>Insurance risk</b>	The inherent uncertainties as to the occurrence, amount and timing of insurance liabilities
ii <b>Market risk</b>	The risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market risk drivers e.g. interest rates, market prices of assets and liabilities
iii <b>Credit risk</b>	The risk to earnings and capital arising from a counterparty's failure to meet their legal and contractual obligations
iv <b>Liquidity risk</b>	The current and prospective risk to earnings or capital arising from CISGIL's inability to meet its obligations when they come due without incurring unacceptable losses

For each of these principal risks, CISGIL Board has approved risk policies and risk appetite statements with underpinning metrics. The metrics have approved limits within which business operations are to be conducted, along with thresholds to give early warning of emerging issues.

#### i. Insurance risk

Insurance risk comprises 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). Underwriting risk includes risks from claims arising from natural or man-made catastrophe events.

The major classes of general insurance business written are motor and property, together with some commercial liability, pecuniary loss, pet insurance and personal accident. CISGIL underwrites motor and home personal lines business written directly or through brokers, and therefore bears the insurance risk on these policies. Most commercial business is underwritten by Aviva with CISGIL receiving commission and not bearing the insurance risk. A small number of commercial accounts are underwritten by CISGIL and 100% reinsured with Aviva, due to which CISGIL bears the ultimate insurance risk although the risk of Aviva failing to meet its commitments is minimal. CISGIL bears the insurance risk for pet insurance written historically but new pet business is underwritten by Allianz. Almost all general insurance policies are written in the UK market covering risks over a twelve month duration.

Motor cover is principally in respect of private vehicles and commercial vehicles, with limited fleet business. CISGIL underwrites and bears the insurance risk for private vehicles. Commercial vehicle cover generally refers to small businesses with a single vehicle. This has been underwritten by CISGIL historically but is currently in the process of being migrated to an external broker Bollington, who are placing the policies with other insurers. Fleet motor cover is underwritten by Aviva. Principal risks under motor policies where CISGIL bears the insurance risks are bodily injury to third parties, accidental damage to property including policyholders' and third parties' vehicles, and theft of or from policyholders' vehicles. 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.

Property cover is primarily residential household, which is underwritten by CISGIL, with commercial property business being 100% reinsured with Aviva. Principal risks under property policies where CISGIL bears the insurance risks 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 Royal London (CIS) Limited, formerly Co-operative Insurance Society Limited (CISL), now a subsidiary of Royal London Group, to assume financial responsibility for the run off of general insurance business formerly written by CISL. In return, CISGIL received a premium in 2006, settled by transfer of assets, equivalent to the net technical liabilities of this business included in CISL's annual report and accounts 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. A Part VII transfer from CISL to CISGIL of this business in run off took place on 31 March 2014. This transfer will not affect how CISGIL manages the risks in its business.

#### Objectives and strategy

CISGIL's objectives in managing general insurance risk are:

- To achieve acceptable returns by ensuring that insurance risks are carefully selected in accordance with risk appetite, underwritten in accordance with risk strategy and priced to reflect the underlying risk
- Reserve risk volatility is minimised through robust reserving and modelling approaches
- Catastrophe risk is mitigated through the use of appropriate reinsurance arrangements

Insurance risk is managed through the underwriting strategy, reinsurance arrangements, proactive claims handling and the claims provisioning process. The objective of the underwriting strategy is to ensure that the underwritten risks are diversified in terms of type and amount of risk, industry/demographic profile and geography, and only those risks which 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 which is determined in accordance with the risk appetite of the business as further described below.

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 weather validation and fraud databases, and the use of claims specialists.

## Notes to the financial statements continued

### 33. Financial risk management continued

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. CISGIL manage this risk through the Reserving Committee which formally reviews claims reserves on a quarterly basis.

#### Reinsurance

Part of the CISGIL insurance risk strategy includes a reinsurance programme to reduce its losses to large exposures. There are two major reinsurance programmes in place;

- Catastrophe excess of loss cover to restrict losses from a single weather event such as flood or storm
- Individual excess of loss cover to restrict losses from individual large claims, particularly large bodily injury claims on the motor book

The appropriate level of reinsurance is determined by management and approved by the Board. Management relies on outputs from CISGIL's capital model. The choice of reinsurance optimises the risk/reward trade off and ensures an objective, risk-based approach to decision making which makes efficient use of capital.

#### ii. Market risk

Market risk is the risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market risk drivers such as interest rates and market prices of assets and liabilities.

CISGIL invests primarily in high-quality fixed and variable interest bonds issued by corporations ('corporate bonds') and in short-term sterling deposits with financial institutions ('cash'). The value of, or income from, assets held is subject to volatility from changes in both market interest-rates and additional spreads related to the specific credit-worthiness of the issuer ('credit-spreads'). Proceeds from maturing investments are also subject to risk over the future return on reinvestment.

CISGIL is also exposed to market interest-rates through:

- The discounted present value placed upon future claims. All future claims are discounted for economic assessment purposes including the Individual Capital Assessment (ICA). However, IFRS short term insurance reserves (normally less than five years) are not directly affected by market interest-rates as they are undiscounted
- £65m of issued subordinated debt, from a total of £85m, which pays interest at varying margins above three month LIBOR. The remaining £20m pays a fixed coupon of 10% per annum

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 direct exposure to currency risk.

In summary, the principal market risks that CISGIL is exposed to are:

- Changes in interest-rates, which impact both asset and liability values, and investment income
- Movements in credit-spreads which impact the market value of corporate bonds
- Default or delay in payments due upon corporate bonds or cash

#### Objective and strategy

CISGIL's objective is to achieve acceptable returns through the use of highly rated government and corporate bonds while minimising volatility through minimal exposure to equities and other volatile instruments. To enhance certainty over the investment return generated from these assets, management practice is generally to maintain holdings to maturity.

CISGIL determines its strategic asset allocation through considering the risk/reward trade off and the impact upon capital adequacy and solvency of the overall company, which relies on outputs from CISGIL's capital model. CISGIL's investments are managed by Royal London Asset Management (CIS) Limited (RLAM) with whom CISGIL have an agreed investment mandate with limits for exposure by credit-rating, maximum terms and maximum exposure to individual counterparties. The Investment Committee oversees RLAM, monitoring and managing asset exposures against the strategic asset allocation and approved limits.

CISGIL manages credit-spread and default risks from corporate bonds through the limits for exposure to credit-ratings and individual counterparties. Other risk mitigation techniques employed to manage exposure to counterparty default include transacting only through a diversified range of authorised counterparties and the requirement for certain transactions (including cash, investment and trading in futures, stock lending and gilt repo transactions) to be fully collateralised on a daily basis. The Investment Committee oversees the monitoring and management of these risks and exposures against limits.

## Notes to the financial statements continued

### 33. Financial risk management continued

Interest-rate risk is managed through investing in fixed interest securities with a similar duration profile to the liabilities under the general insurance contracts. 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). Index-linked investments and other specific debt securities are used to match periodical payment liabilities and provisions relating to asbestos exposure within the electric industry ('EIROS' claims) by amount and duration. In order to do this, an expert opinion on life expectancy is used along with an expectation of long term average earnings. Mean durations are:

	2013 years	2012 years
Insurance liabilities	3.20	2.99
Financial assets	2.53	1.99

	Amount £m	Duration years
<b>Periodical payments</b>		
Insurance liabilities	39	17.0
Financial assets	41	16.1
<b>EIROS claims</b>		
Insurance liabilities	2	10.4
Financial assets	3	13.7

#### Sensitivity analysis

The most significant aspect of market risk to which CISGIL is exposed is changes in credit-spreads upon corporate bonds. The resulting movements in the market values of corporate bonds directly affect CISGIL's internal economic assessment of solvency, including the ICA. As CISGIL has adopted a policy of recognising most investment assets on an 'available for sale' basis, movements in market values of these assets are recognised in other comprehensive income and so have limited impact upon reported IFRS profits.

An increase of 100 basis points in credit-spreads would reduce the carrying value of CISGIL's assets at the end of the financial period by £18m (2012: £21m). This would reduce the value placed upon these assets in CISGIL's internal economic assessment of solvency, including the ICA, by the same amount. On an IFRS basis it would result in a reduction in other comprehensive income of £14m net of tax (2012: £16m). The impact of a decrease of 100 basis points in credit-spreads would have similar but opposite effects.

The method used for this calculation increases the implied redemption yield by 100 basis points and uses this modified yield to calculate the revised market value of each bond in the portfolio. The calculation assumes that a change in credit-spreads would have an immediate and equal impact at all points on the yield curve and upon all corporate bonds regardless of their credit-rating. The probability of this credit-spread change over one year is assessed as 24% (2012: 19%) using the CISGIL capital model.

CISGIL has £65m (2012: £65m) of issued subordinated debt at varying margins above three month LIBOR. The effect on profit of a 100 basis point movement in three month LIBOR was immaterial in the current and prior period. Additionally, CISGIL has a further £20m of subordinated debt with a fixed coupon of 10% which is not sensitive to a change in LIBOR.

#### iii. Credit risk

Credit Risk is the risk to earnings and capital arising from a counter party's failure to meet their legal and contractual obligations. CISGIL does not aim to earn a return from credit risk hence its appetite for credit risk is very low. Potential losses arising from credit risk are minimised by the use of high quality reinsurers and highly rated investments.

CISGIL's principal credit risk exposures are as follows:

- Default upon cash, being deposits with approved financial institutions
- Movements in credit-spreads which impact the market value of corporate bonds, and default or delay in payments due upon corporate bonds or cash
- Reinsurance counterparties failing to meet financial obligations or entering into restructuring arrangements that may adversely affect reinsurance recoveries
- Default or delay in repayment upon loans and receivables
- Default or delay in repayment of insurance receivables and other assets

CISGIL manages credit risks associated with cash and corporate bonds as part of market risk. See market risk section above for details.

## Notes to the financial statements continued

### 33. Financial risk management continued

Where reinsurance is used to manage insurance risk, there is a risk that the reinsurer fails to meet its obligations in the event of a claim. CISGIL places limits over exposure to a single reinsurance counterparty, or counterparty group, based upon their credit-worthiness. These limits apply when reinsurance is initially placed, usually annually, and then regularly monitored and managed by the Investment Committee. Where concern exists over reinsurer credit quality, watch lists are maintained and actively managed.

Insurance receivable and other assets are primarily premium debtors, with an element of salvage and subrogation recoveries and some accrued interest.

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 those assets subject to credit risk, and excludes any assets that were classed as impaired at that date (of which there were none at period end). Credit ratings are determined by taking an average of ratings provided by Moody's Investors Service, Standard & Poor's and Fitch.

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
<b>2013</b>						
Financial assets at fair value through income or expense:						
– Deposits with approved credit institutions (fixed rate)	–	–	208	–	–	208
Available for sale assets:						
– Listed debt (fixed rate)	73	179	430	38	–	720
– Listed debt (variable rate)	–	–	31	12	–	43
Reinsurance assets	–	25	29	–	3	57
Insurance receivables and other assets	1	2	8	–	198	209
	<b>74</b>	<b>206</b>	<b>706</b>	<b>50</b>	<b>201</b>	<b>1,237</b>

	AAA £m	AA £m	A £m	BBB and below £m	Not rated £m	Total £m
<b>2012</b>						
Financial assets at fair value through income or expense:						
– Deposits with approved credit institutions (fixed rate)	–	–	314	–	–	314
Available for sale assets:						
– Listed debt (fixed rate)	28	77	495	110	27	737
– Listed debt (variable rate)	–	–	33	4	–	37
Loans and receivables at amortised cost	–	–	–	–	50	50
Reinsurance assets	–	15	22	–	7	44
Insurance receivables and other assets	–	2	9	3	211	225
	28	94	873	117	295	1,407

The maximum exposure to credit risk, before making allowance for collateral held, is represented by the carrying value of each financial asset in the table. Collateral of £179m (2012: £282m) is held as security against a reverse repo with balance of £180m as at period end (2012: £275m). Cash collateral pledged sits within deposits with approved credit institutions within financial investments at fair value through income or expense on the balance sheet as a result of CISGIL's documented risk management policy.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Eurozone risk

CISGIL has no direct exposure to the sovereign debt of European countries. There is currently limited detailed knowledge of indirect exposure to European sovereign debt. Indirect exposure is managed as knowledge of an institution's direct exposure is made public. At this point, if the exposure is considered to be in excess of the risk appetite, action will be taken to reduce the risk through the sale of the relevant holdings. Indirect exposure to European countries is also considered as part of the reinsurance placement. The asset profile of the prospective companies is analysed and those which are over exposed are not included in placement of the programme.

The table below shows exposure to European countries arising from corporate bonds. CISGIL has no exposures to European countries as a result of repo arrangements.

	Up to 1 year £m	1 to 5 years £m	5 to 10 years £m	Total £m
<b>2013</b>				
France	–	7	–	7
Germany	–	43	28	71
Netherlands	–	9	–	9
Spain	–	29	–	29
Sweden	–	31	35	66
Switzerland	–	–	–	–
	–	119	63	182
<b>2012</b>				
France	–	7	26	33
Germany	–	–	8	8
Norway	–	11	–	11
Spain	19	6	–	25
Sweden	–	60	13	73
Switzerland	–	7	–	7
	19	91	47	157

#### iv. Liquidity risk

Liquidity risk is the current and prospective risk to earnings or capital arising from an inability to meet obligations when they come due without incurring unacceptable losses. CISGIL's objective is to meet all funding obligations as they fall due primarily through the use of highly liquid investment instruments.

The Board's risk appetite is that liquid assets should be at least equal to 20% of the ultimate cost of a 1-in-100 year windstorm loss before reinsurance recoveries. The ultimate cost is calculated based upon the catastrophe component of CISGIL's capital model. The latest model assesses the ultimate cost of a 1-in-100 year windstorm as £147m (2012: £158m), giving a minimum requirement for £29m (2012: £32m) of liquid assets against actual liquid assets of £764m (2012: £773m).

Asset type	Value included as liquid assets
Gilts	100%
Cash	100%
Corporate bonds: AAA	80%
AA	70%
A	60%
BBB	50%
All other investments	0%

## Notes to the financial statements continued

### 33. Financial risk management continued

The level of cash and other assets held are monitored regularly and managed through the Investment Committee, with oversight by the ERC and the Board. This includes monthly reporting of liquid assets against risk appetite limits.

In addition, CISGIL has access to overnight borrowing facilities with the Bank. Overnight borrowings are subject to the Bank's regulatory exposure limits for related counterparties. These borrowings are on normal commercial terms and represent an unsecured, uncollateralised obligation of CISGIL.

The following table indicates the time profile of undiscounted cash flows arising from financial liabilities (based upon contractual maturity), and the discounted cash flows arising from insurance liabilities (based upon estimated timing of amounts recognised in the balance sheet). Included in the analysis on insurance contract liabilities below is £40m (2012: £36m) of discounted reserves relating to PPO and EIROS.

	Carrying value £m	Gross nominal out flow £m	Up to 1 year £m	1 to 2 years £m	2 to 3 years £m	3 to 4 years £m	4 to 5 years £m	More than 5 years £m
<b>2013</b>								
Insurance contract liabilities	<b>866</b>	<b>866</b>	<b>470</b>	<b>132</b>	<b>66</b>	<b>42</b>	<b>27</b>	<b>129</b>
Financial liabilities at amortised cost:								
Subordinated debt	<b>85</b>	<b>92</b>	<b>33</b>	<b>3</b>	<b>3</b>	<b>53</b>	–	–
Insurance and other payables	<b>18</b>	<b>18</b>	<b>18</b>	–	–	–	–	–
Cash and cash equivalents	<b>9</b>	<b>9</b>	<b>9</b>	–	–	–	–	–
	<b>978</b>	<b>985</b>	<b>530</b>	<b>135</b>	<b>69</b>	<b>95</b>	<b>27</b>	<b>129</b>

	Carrying value £m	Gross nominal out flow £m	Up to 1 year £m	1 to 2 years £m	2 to 3 years £m	3 to 4 years £m	4 to 5 years £m	More than 5 years £m
<b>2012</b>								
Insurance contract liabilities	1,051	1,051	563	134	92	54	43	165
Financial liabilities at amortised cost:								
Subordinated debt	85	94	33	2	2	57	–	–
Other reinsurance liabilities	2	2	2	–	–	–	–	–
Insurance and other payables	22	22	22	–	–	–	–	–
Cash and cash equivalents	12	12	12	–	–	–	–	–
	1,172	1,181	632	136	94	111	43	165

#### CISGIL Fair values of financial assets and liabilities

The following summarises the major methods and assumptions used in estimating the fair values of financial instruments reflected in the annual report and accounts:

##### a) Deposits with credit institutions

The fair value of financial assets designated at fair value through income or expense, being short term (less than one month) fixed rate deposits, approximates to their nominal amount.

##### b) Available for sale assets

Fair value of listed debt securities is based on clean bid prices at the balance sheet date without any deduction for transaction costs.

Available for sale assets are regularly reviewed for impairment. Objective evidence of impairment can include default by a borrower or issuer, indications that a borrower or issuer will enter bankruptcy or the disappearance of an active market for that financial asset because of financial difficulties.

These reviews give particular consideration to evidence of any significant financial difficulty of the issuer or measurable decrease in the estimated cash flows from the investments.

##### c) Borrowed funds

Fair value measurement is calculated on a discounted cash flow basis using prevailing market interest rates.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### d) Other financial assets

For receivables and payables with a remaining life of less than one year, the nominal amount is deemed to reflect the fair value, where the effect of discounting is immaterial.

	2013 Carrying value £m	2013 Fair value £m	2012 Carrying value £m	2012 Fair value £m
<b>Financial liabilities</b>				
Other borrowed funds	85	85	85	83

#### Financial asset and liability classification

The table below analyses financial instruments by measurement basis as detailed by IAS 39 (Financial Instruments: Recognition and Measurement).

	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Other amortised cost £m	Total £m
<b>2013</b>					
<b>Assets</b>					
Financial assets at fair value through income or expense	208	–	–	–	208
Available for sale assets	–	–	763	–	763
Other financial assets	–	184	–	–	184
<b>Total financial assets</b>	<b>208</b>	<b>184</b>	<b>763</b>	<b>–</b>	<b>1,155</b>
Non-financial assets					117
<b>Total assets</b>					<b>1,272</b>
<b>Liabilities</b>					
Other borrowed funds	–	–	–	85	85
Overdrafts	–	–	–	9	9
Other financial liabilities	–	–	–	18	18
<b>Total financial liabilities</b>	<b>–</b>	<b>–</b>	<b>–</b>	<b>112</b>	<b>112</b>
Non-financial liabilities					877
<b>Total liabilities</b>					<b>989</b>
Capital and reserves					283
<b>Total liabilities and equity</b>					<b>1,272</b>

## Notes to the financial statements continued

### 33. Financial risk management continued

	Designated at fair value £m	Loans and receivables £m	Available for sale £m	Other amortised cost £m	Total £m
2012					
<b>Assets</b>					
Financial assets at fair value through income or expense	314	–	–	–	314
Available for sale assets	–	–	774	–	774
Other financial assets	–	213	–	–	213
<b>Total financial assets</b>	314	213	774	–	1,301
Non-financial assets					136
<b>Total assets</b>					1,437
<b>Liabilities</b>					
Other borrowed funds	–	–	–	85	85
Overdrafts	–	–	–	13	13
Other financial liabilities	–	–	–	24	24
<b>Total financial liabilities</b>	–	–	–	122	122
Non-financial liabilities					1,039
<b>Total liabilities</b>					1,161
Capital and reserves					276
<b>Total liabilities and equity</b>					1,437

The following table provides an analysis of financial assets and liabilities that are valued or disclosed at fair value, by the three level fair value hierarchy as defined within IFRS7 (Financial Instruments: Disclosure):

- 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)

Based upon guidance issued by The Committee of European Securities Regulators (CESR), CISGIL classifies debt 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).

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Valuation of financial instruments

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<b>2013</b>				
<b>Assets</b>				
Financial assets at fair value through income or expense	–	208	–	208
Available for sale assets	–	763	–	763
<b>Total financial assets at fair value</b>	–	971	–	971
<b>Liabilities</b>				
Other borrowed funds	–	85	–	85
<b>Total financial liabilities</b>	–	85	–	85

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<b>2012</b>				
<b>Assets</b>				
Financial assets at fair value through income or expense	–	314	–	314
Available for sale assets	–	773	–	773
<b>Total financial assets at fair value</b>	–	1,087	–	1,087
<b>Liabilities</b>				
Other borrowed funds	–	83	–	83
<b>Total financial liabilities</b>	–	83	–	83

The valuation techniques using observable inputs relate to debt securities that would otherwise be fair valued using quoted market prices but where there has been short term temporary market inactivity and borrowed funds with no active market price. In obtaining relevant fair values for financial assets, CISGIL has obtained security specific prices from third party market makers based on what the third parties would have traded these particular securities for at the year-end date. Financial liabilities have been valued using observable inputs including discounted cashflows and comparable credit spreads.

The following table allows comparison of debt securities (other than those classified at fair value through income or expense) on the basis of the current carrying amount, fair value and amortised cost (pre impairment).

Investments in debt securities as available for sale financial assets:

	2013 £m	2012 £m
Carrying amount	763	773
Fair value	763	773
Amortised cost	773	775

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Bank risk management

As at 5 January 2013, the Bank was still controlled by the Group and therefore a separate risk management note with full disclosures was included within the Group's 2012 Annual Report in accordance with the relevant IFRSs. Although the Bank is now an associate (from 20 December 2013), due to the significant financial risks that the Bank is faced with and as the Group remains the largest shareholder of the Bank, the Group has disclosed below the nature and changes of the significant financial risks facing the Bank and its policies for mitigating those risks as would be disclosed under the principles of IFRS 12, which the Group are adopting from 5 January 2014. The numbers in the following tables have not been adjusted to reflect the fair value adjustments set out in note 9. Accordingly the numbers presented below are those reported in the Bank's own 2013 financial statements. Some comparatives have been omitted on the basis that the Bank was not an associate last year. For full disclosures including comparatives relating to the Bank's financial risk management in accordance with the relevant IFRSs, please refer to the Co-operative Bank Plc's own 2013 Annual Report.

The following are considered to be the most significant financial risks facing the Bank. All sections of the Bank's risk management note are audited unless specifically stated.

Risk Type	Definition
<b>Credit risk</b>	Credit risk is the risk that borrowers will fail to make repayments which they have previously agreed to make. The risk to the Bank includes the amounts lent not being repaid, loan interest not being received, cash flows being received later than expected, and increased collection costs.
<b>Liquidity and funding risk</b>	Liquidity and funding risk is the risk that the Bank cannot pay amounts that it owes when they fall due, or can only do so at excessive cost. The risk can arise either because: the Bank has insufficient funds to pay the amounts it owes; or even though the Bank has sufficient funds, those funds have been invested and so are not readily available.
<b>Market risk</b>	Market risk is the risk of losses arising due to changes in market prices, The Bank's biggest exposure to market risk is from changes in interest rates.

#### Credit Risk

##### Overview

Credit risk is one of the principal risks set out in the risk management framework and is an integral part of the business activities of this and all other banks. It is inherent in both 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 and options, repurchase agreements, securities borrowing and lending transactions). The inherent risks arising from general economic conditions have been increased by the period of significant turbulence and uncertainty affecting the global economy and the global financial system, and the Eurozone in particular. The Bank continues to be exposed to these risks and their consequences, including lower consumer confidence, high levels of unemployment, interest rate volatility and increased cost of credit, which may result in increased credit risk which could have a material adverse effect on the Bank's business.

##### Credit Risk Policy

All authority to take credit risk derives from the Bank's Board. This authority is delegated to the Bank CEO who then sub-delegates to appropriate committees and individuals. The level of credit risk authority delegated depends on seniority and experience, and varies according to the quality of the counterparty, associated security or collateral held. The Bank's policy for credit risk is approved annually by the ERC (Executive Risk Committee) and defines appropriate standards and principles for the effective management of credit risk throughout the Bank's divisions. Credit risk management is an essential element of the Bank's operations. As with all principal risks, the Bank Board requires that the credit business is managed in line with the risk strategy and risk appetite set by the Bank's Board. Risk measurement is based on a set of metrics, which are aligned with the Bank's Board agreed risk appetite and support the limits framework. These metrics undergo periodic review to assure that they are fit for purpose, i.e., are able to recognise both emerging and current risks. Credit risk models are subject to biennial review by the Model Risk Forum. In May 2013, in order to strengthen internal risk controls, the Bank Executive, with the approval of the Board Risk Committee and the Board, moved all corporate lending authority to the three principle Executive Lending Committees; the Large Credit Committee, the Small Credit Committee and the Strategic Transactions Committee. This has proven especially beneficial during the restructuring of this portfolio into that of Co-operative Asset Management (CoAM) and Business and Commercial Banking (BaCB) as new underwriting procedures for these businesses are being formulated. The Credit Risk Management Forum considers key management information to support the oversight and challenge of the credit risk embedded in each division and across the credit risk life cycle. This includes appropriate benchmarking information from similar portfolios in the market and is key to calibrating risk appetite.

The Credit Risk Management Forum is supported by an additional three forums that exist to support the Credit Risk Director in discharging the second line mandate. These include an Impairment Charge Forum, implemented in June 2013, that exists to ensure that the credit risk impairment and loss recognition policy standard is being implemented effectively and that there is sufficient evidence to support the credit risk impairment stock. In addition, an Impairment Adequacy Forum was implemented in the second half of 2013 as a mechanism for approving and reviewing the refresh of impairment parameters and post model adjustments. The third forum is the Treasury Credit Risk Management Forum which provides day-to-day oversight of the credit risk exposure in the Treasury division. The retail division of the core bank uses both application and behavioural scoring techniques to rank a customer's risk of default and this is embedded into the front end of the business, in common with other retail banks. The non-core division, which includes corporate lending, includes a number of specialist models to reflect the embedded credit risk of sectors such as private finance initiatives (PFI) and commercial property. The performance of all rating systems is governed by the Credit Risk Model Review Forum with oversight from a new Model Risk Policy Committee that met for the first time during the third quarter of 2013.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Credit exposure

The following analysis of credit exposure shows:

- Carrying amounts by class of asset in the balance sheet
- The gross credit exposure by class of asset (excluding allowance for losses but including credit commitments)
- The net credit exposure by class of asset (including allowance for losses and credit commitments)

Cash and balances at central banks are credit exposures with the Bank of England and have been excluded from the analysis.

	Loans and advances to banks	Loans and advances to customers	Investment securities	Derivative financial instruments	Total
<b>Analysis of balance in note</b>					
Gross balance	1,594	31,275	4,519	556	37,944
Less: allowance for losses	–	(952)	(20)	–	(972)
	1,594	30,323	4,499	556	36,972
<b>Analysis of credit risk exposure</b>					
Not impaired	1,594	27,895	4,500	549	34,538
Impaired	–	3,574	20	7	3,601
	1,594	31,469	4,520	556	38,139
Credit commitments	570	3,520	–	–	4,090
<b>Gross credit risk exposure</b>	2,164	34,989	4,520	556	42,229
Less:					
Fair value adjustments	–	(194)	–	–	(194)
Allowance for losses	–	(952)	(20)	–	(972)
<b>Net credit risk exposure</b>	2,164	33,843	4,500	556	41,063

#### Credit risk management

The credit risk team is part of the Risk Directorate, with an independent reporting line from business management, and provides second line risk oversight. Accountability for the origination of credit risk sits with business management subject to compliance with key credit criteria, policy and risk appetite.

Where business management recommends the sanction of a facility that is outside of its discretion then recommendation is made to the Large and Small Credit Committees. The loan portfolios are periodically reviewed to assess impairment. A loan is deemed to be impaired when there is objective evidence that a loss event has occurred on or before 31 December 2013. Once a loan is defined as impaired, the impairment provision is calculated as the difference between the current carrying value of the asset and the expected future recovery, discounted at the loan's effective interest rate, taking into account the expected charge off rate and any supporting collateral. The table below analyses the gross balance by impairment classification for the core (Retail and BaCB) and non-core (Corporate CoAM and Optimum) divisions. They include credit commitments, impairment provisions and fair value adjustments as recorded within the Bank's 2013 financial statements.

The increase in impairment provisions in the year to 31 December 2013 was driven primarily by revised collateral values for the corporate business and updated experience in support of our credit risk impairment policy, as well as the extended period of economic downturn which has impacted the values we have been able to realise from collateral placed against impaired loans. The Non-core business continues to have additional impairment risk given the underlying assets, which includes Optimum, a book of predominantly interest-only intermediary and acquired mortgage book assets. Worsening economic and market conditions and/or increasing interest rates and/or a fall in house prices could result in the Non-core assets suffering from more than expected impairments which would adversely impact on the Bank's operating results and financial position (in particular, its net interest margin) and, in the longer term, its ability to comply with its regulatory capital requirements. The Non-core business' corporate asset book is also relatively concentrated, with the result that a small number of borrowers account for a large proportion of the total loans outstanding. A significant impairment of any of these borrowers would result in a disproportionate impact on the Bank's operating results and financial position.

## Notes to the financial statements continued

### 33. Financial risk management continued

	Core Retail banking Secured £m	Unsecured £m	BaCB £m	Unity Trust Bank £m	Non-core Corporate £m	Optimum £m	Total £m
<b>Analysis of balance</b>							
Gross loans and advances	15,525	1,295	841	188	6,504	6,922	31,275
Less: allowance for losses	(5)	(160)	(6)	(8)	(738)	(36)	(953)
	15,520	1,135	835	180	5,766	6,886	30,322
<b>Analysis of credit risk exposure</b>							
Not impaired	15,380	1,078	825	167	4,526	5,919	27,895
Impaired	145	217	16	21	1,978	1,003	3,380
	15,525	1,295	841	188	6,504	6,922	31,275
Credit commitments	41	2,222	399	42	816	–	3,520
<b>Gross credit risk exposure</b>	15,566	3,517	1,240	230	7,320	6,922	34,795
Less:							
Fair value adjustments	–	–	–	–	–	–	–
Allowance for losses	(5)	(160)	(6)	(8)	(738)	(36)	(953)
<b>Net credit risk exposure</b>	15,561	3,357	1,234	222	6,582	6,886	33,842
<b>Of the above:</b>							
Assets held at FV	9	–	125	–	–	–	134
Assets held at amortised cost	15,511	1,135	710	180	5,766	6,886	30,188
Credit commitments	41	2,222	399	42	816	–	3,520
	15,561	3,357	1,234	222	6,582	6,886	33,842
Total corporate (including BaCB and Unity Trust Bank)					8,038		
FV adjustments to assets held at amortised cost	(305)	(44)			(829)	(1,197)	(2,375)
<b>Fair value (inc commitments)</b>	15,256	3,313			7,209	5,689	31,467

#### Liquidity risk (unaudited)

The Bank's business faces inherent risks concerning liquidity, particularly if the availability of traditional sources of funding such as retail and corporate deposits and, to a lesser extent, unsecured wholesale funding (these being the principal sources of the Bank's funding) become limited and/or more expensive. This may result in an inability to operate in the ordinary course, and/or a failure to meet liquidity requirements, and/or may adversely impact the Bank's business and/or the implementation of its strategy.

As the Bank's main source of funds is deposits, the Bank faces the risk of not being able to replace funds when they are withdrawn or, if a significant number of depositors withdraw their funds, of not being able to meet its obligations to fund such withdrawals, repay lenders in accordance with its financing arrangements or fulfil commitments to lend. However, despite the steps that the Bank has taken to maintain its levels of total liquidity, as the Bank relies on its customer deposits to provide funding for the Bank, any severe decline in customer confidence in the Bank could increase the amount of deposit withdrawals in a short space of time or over a sustained period.

Given the relative size of the Bank's deposit base as compared with its other sources of funding, the Bank is particularly exposed to any serious loss of confidence by its depositors. If the Bank experiences an unusually high level of withdrawals exceeds what the Bank can manage through liquidity controls and contingency planning, this may have a negative effect on the Bank's business and could, in extreme circumstances, prevent the Bank from meeting its financial obligations as they fall due, meeting its regulatory minimum liquidity requirements or fulfilling its commitments to lend. In these circumstances, the Bank may be subject to a resolution procedure under the Banking Act.

In the period to 31 December 2013, however, the Bank has continued to maintain a sufficiently strong liquidity position, with a liquid asset ratio of 16.0% at the balance sheet date (2012: 14.6%). In addition, during 2013, the Bank proactively managed its liquidity position, maintaining a regulatory liquidity buffer, and has continued to restructure existing exposures to further improve the funding profile and ensure its financial obligations are met as and when they fall due. From a management perspective, liquidity is monitored on a daily basis via a suite of liquidity risk metrics supported by cashflow forecasts and stress tested forecasts.

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Liquidity framework (unaudited)

The Bank's liquidity risk management framework comprises:

- A defined risk appetite, controls and governance in the Bank's liquidity management policies
- Articulation of how liquidity risk is identified, measured, monitored and managed in the Individual Liquidity Adequacy Assessment (ILAA) and procedures and governance in place to mitigate the risk
- Liquidity risk quantification and mitigation techniques and processes
- Management actions linked through to stress testing and liquidity planning models, enabling a method of mitigating the effects of a number of stress scenarios for varying periods of time and to ensure that the Bank operates within its agreed risk appetite parameters in all planning models
- Ongoing development and enhancement of the Bank's liquidity risk appetite framework
- A process to attribute the cost, benefit and risks of liquidity to specific business lines via the Bank's funds transfer pricing mechanism

The Bank Board's risk appetite for liquidity risk is defined in terms of: survival periods which measure the ability of liquid assets to support the Bank's activity over time under a number of stress scenarios; adherence to strategic liquidity risk measures; and compliance with all regulatory liquidity risk limits.

The stress tests encompass survival across various timescales and a range of adverse liquidity events, both firm specific and market wide, which endeavour to cover all aspects of the liquidity risk to which the Bank is exposed.

The strategic measures approved by the Bank's Board include: customer loan/deposit ratio, 95% (2012: 92%) – the ratio of customer loans to customer deposits; encumbrance ratio, 27% (2012: 27%) – the ratio of encumbered assets divided by total assets; regulatory framework – Net Stable Funding ratio and Internal Liquidity Guidance; and internal liquidity stress tests – the survival period of the Bank under a range of stressed scenarios.

#### Liquidity risk management overview (unaudited)

Liquidity risk arising from the structure of the balance sheet and stresses occurring from cash withdrawals from customers are managed in line with policies developed by the Liquidity Management Forum (LMF), the Assets and Liabilities Committee (ALCO) and the Bank's Board. The Bank's liquidity management policies are reviewed and approved annually by the BRC (on behalf of the Bank's Board) and compliance is reviewed by LMF, ALCO and the Bank's Board. The Bank's policy is to have sufficient funds available at all times to meet demands from depositors, to fund agreed advances, to meet other commitments as and when they fall due, and to ensure the Bank's Board risk appetite is met.

The Bank monitors its liquidity position on a daily basis via liquidity risk metrics. LMF oversees the operational liquidity management. LMF convenes at least once a month but can convene as frequently as required. A range of indicators, details of cashflows and media coverage are monitored to attempt to detect early signs of liquidity risk either in the market or specific to the Bank. The LMF, ALCO and the Bank's Board discuss the actual liquidity position and projected position incorporating business plans. More frequent meetings are held if necessary, ie when the markets have a heightened period of stress or liquidity shortage.

The liquidity position is reported at least monthly to ALCO and the Bank's Board. The Bank also monitors the adequacy of its controls to provide assurance that liquidity risk is being appropriately managed, and regularly assesses its funding position. This is supported with detailed contingency funding plans and recovery options which are tested and reviewed on a regular basis. The Bank's liquidity management framework is designed in line with FCA and PRA BIPRU regulations and industry guidelines.

#### Liquid asset portfolios (unaudited)

The Bank calculated its total liquidity resources as at 31 December 2013 as £11,193m (2012: £8,658m). The table below analyses the Bank's liquidity portfolio by product and liquidity value. Primary liquidity is liquid assets that are eligible under BIPRU 12.7 and secondary liquidity is all other liquid assets (excluding non-buffer assets described below), including self-issued retained securitisations.

	2013 £m
<b>Qualifying stock</b>	
Operational balances with central banks	<b>5,077</b>
Gilts	<b>790</b>
Central government and multilateral development bank bonds	<b>1,112</b>
<b>Total primary liquidity</b>	<b>6,979</b>
<b>Total secondary liquidity</b>	<b>4,215</b>
<b>Total liquidity</b>	<b>11,194</b>
<b>Average balance</b>	<b>9,357</b>

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Liquidity gap

Details of contractual maturities for assets and liabilities underpin the management of liquidity risk. However, in order to reflect more accurately the expected behaviour of the Bank's assets and liabilities, measurement and modelling of the behavioural aspect of each is constructed.

Gross cash flows include interest and other revenue cash flows. The following table is an analysis of:

- Gross undiscounted contractual cash flows of financial assets and liabilities held at the balance sheet date
- Behavioural adjustments that reflect the actual behaviour of customers based on historic cash flow profiles over a period of ten years

	Carrying value £m	Gross nominal flow £m	Less than 1 month £m	1–3 months £m	3–12 months £m	1–5 years £m	Over 5 years £m
<b>31 December 2013</b>							
<b>Bank Group Contractual cash flows</b>							
<b>Assets</b>							
Cash and balances at central banks	5,419	5,419	5,419	–	–	–	–
Loans and advances to banks	1,594	1,594	1,594	–	–	–	–
Loans and advances to customers	30,430	44,368	1,475	453	2,810	11,852	27,778
Investment securities	–	–	–	–	–	–	–
Loans and receivables	24	28	7	–	–	3	18
Available for sale	2,732	3,137	68	137	102	1,092	1,738
Fair value through income or expense	1,743	1,889	7	14	198	1,637	34
Held for trading	–	–	–	–	–	–	–
Derivative financial instruments	556	267	2	8	27	24	206
Amounts owed by other Co-operative Group undertakings	–	–	–	–	–	–	–
Other assets	898	–	–	–	–	–	–
<b>Total recognised assets</b>	<b>43,396</b>	<b>56,702</b>	<b>8,572</b>	<b>612</b>	<b>3,137</b>	<b>14,608</b>	<b>29,774</b>
<b>Liabilities</b>							
Deposits by banks	2,758	2,992	1,833	41	153	964	–
Customer accounts	32,463	33,349	21,145	1,797	2,213	8,195	–
Customer accounts – capital bonds	538	536	10	95	146	285	–
Debt securities in issue	4,195	5,391	75	34	628	3,964	689
Derivative financial instruments	539	1,031	14	35	107	354	522
Other borrowed funds	196	434	–	6	17	91	320
Other liabilities	930	–	–	–	–	–	–
<b>Total recognised liabilities</b>	<b>41,619</b>	<b>43,733</b>	<b>23,077</b>	<b>2,008</b>	<b>3,264</b>	<b>13,853</b>	<b>1,531</b>
Unrecognised loan commitments	4,004	4,003	3,578	–	–	425	–
<b>Total liabilities</b>	<b>45,623</b>	<b>47,736</b>	<b>26,655</b>	<b>2,008</b>	<b>3,264</b>	<b>14,278</b>	<b>1,531</b>
<b>Behavioural adjustments</b>							
Loans and advances to customers	–	–	112	194	1,146	7,829	(9,281)
Customer accounts	–	–	20,901	(977)	(6,283)	(13,641)	–
<b>Net cash flow – behavioural</b>		<b>8,966</b>	<b>2,929</b>	<b>(2,178)</b>	<b>(5,264)</b>	<b>(5,482)</b>	<b>18,962</b>

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Market risk

Market risk is the risk of loss as a result of the value of financial assets or liabilities (including off balance sheet instruments) being adversely affected by movements in market rates or prices. This loss can be reflected in the near term earnings by changing net interest income, or in the longer term because of changes in the economic value of future cash flows.

The main source of market risk within the Bank is driven by mismatches between the repricing profiles of asset and liability customer products within the retail and corporate businesses and certain characteristics embedded within these products and basis risk. Treasury also creates market risk through its various portfolio management activities along with currency risk.

#### Interest rate risk

Interest rate risk policy statements, approved by the ERC on behalf of the Bank's Board, specify the scope of the Bank's wholesale market activity, market risk limits and delegated authorities. The policy is managed by the Bank Market Risk Forum (BMRF) and ALCO. Their prime task is to assess the interest rate risk inherent in the maturity and repricing characteristics of the Bank's assets and liabilities. The Bank seeks to minimise the volatility of future earnings from interest rate changes and all interest rate risk exposure is removed from the Core and Non-Core divisions and consolidated at the centre where it is managed from the core balance sheet within agreed limits. 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 Bank's Board receives reports on the management of balance sheet risk and BMRF and ALCO review the balance sheet risk positions and the utilisation of wholesale market risk limits.

#### Non-treasury interest rate risk

The Bank (excluding wholesale treasury risk) uses a PV01, gap report and earnings approach for managing interest rate risk, focusing in detail on the sensitivity of assumed changes in interest rates on net interest income for one year.

BMRF 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 sets 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) are no more than a set limit.

Non-maturity deposits, which are non-interest bearing, are separated into a stable 'core' element, based on a long run average, and the residual balance, which can fluctuate. In the gap report, the residual balance (along with interest bearing non-maturity deposits) is deemed to re-price or mature within one month. The 'core' non-maturity deposits are within the non-sensitive balance on the gap report, along with non-dated capital and other non-sensitive balances. ALCO sets guidance around the treatment of non-sensitive balances to reinvest in fixed rate assets in periods up to five years to smooth the income based upon the prevailing interest rate environment.

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. The asset and liability management team undertakes hedges for interest rate risk using derivative instruments and investment securities which are executed via the Treasury markets team to external wholesale markets, and loans and deposits which are executed internally with the Treasury markets team.

Basis risk is the risk that different assets and liabilities re-price with reference to different indices and at different times. This exposes the Bank to income volatility if indices do not move in a ratio of one to one. The overall exposure to basis risk has remained a net base rate asset throughout 2013 as customers continue to favour variable rate mortgages (where the introductory rate is linked to Bank of England base rate) and a large proportion of the liquidity of the Bank is placed in the Bank of England reserve account. Basis risk is monitored by BMRF and ALCO monthly and action is taken as required, which includes pricing, new products or external hedging.

The table illustrates the greater than 12 month net gap position at the end of the period on the Bank's balances, excluding wholesale treasury and customer currency balances which are managed within the treasury risk framework. The gap is driven by product pricing and product mix. The gap is calculated by placing all assets and liabilities at the earliest of their re-pricing or maturity date and then summing by time band. The aim is to have assets evenly spread so that the Bank is not exposed to sudden rate movements. The net position shows the amount that the Bank is either over or under invested at a point in time. A £100m positive gap position would equate to the Bank's income increasing by £1m per annum if rates increased by 1%. The maximum sensitivity for the period shown below equates to approximately a £8.0m (2012: £10.9m) decrease in income if rates increased by 1%.

	2013 £m
<b>Net greater than 12 month gap position</b>	
At period end	<b>(802)</b>
Average for period	<b>(376)</b>
Maximum sensitivity for period	<b>(802)</b>
Minimum sensitivity for period	<b>(45)</b>

## Notes to the financial statements continued

### 33. Financial risk management continued

#### Treasury interest rate risk

Treasury manage the Bank's liquid asset portfolios and executes derivative instruments with the wholesale markets on behalf of the Bank and its customers. Treasury operates a trading book, however currently there are no exposures as at the end of 2013 (2012: £nil). The Bank assesses the interest rate risk arising within the liquid asset portfolios via key measures; Value at Risk and PV01, with associated delegated limits. These are supplemented by additional controls such as maturity and stop loss limits.

#### Value at risk (VaR)

VaR measures the daily maximum potential gain or loss due to market volatility within a statistical confidence level of 95% and a one day holding period. The VaR methodology employed is historical simulation using a time series of one year to latest day and was £0.4m at 31 December 2013 for the treasury portfolios. A number of limitations should be considered in relation to the VaR model: historic data is not necessarily a reliable predictor of future events; the model, by definition, does not capture potential losses outside the 95% confidence level, particularly those events that are extreme in nature; and VaR is based on exposures at close of business and, therefore, does not necessarily reflect intra-day exposures.

The outputs from the VaR model were reviewed in 2013 to ensure that they were consistent with methodology employed. The Bank does not have PRA VaR model permission and VaR is not used in regulatory reporting. The maturity method is used for reporting general interest rate risk for prudential reporting purposes.

#### PV01

The Bank also employs PV01 which illustrates the change in valuation on a fixed income portfolio given a 1 basis point increase in rates. A negative PV01 figure relates to a net asset position and will create a loss if rates rise. A positive PV01 figure relates to a net liability position and will create a profit if rates rise. The effects of a 1 basis point increase in interest rates are £0.01m (2012: £0.04m) and a 1 basis point decrease £0.01m (2012: £0.04m).

#### Swap spread risk

The Bank is also exposed to swap spread risk arising within the liquid asset portfolios whereby a proportion of assets are held in fixed rate government securities and are accompanied by an interest rate swap to hedge against changes in interest rates. However, there remains a risk associated with the possible movement in the spread between sovereign debt yields and swap rates and therefore creates market value volatility. For example the market value falls if the yield on the sovereign debt increases more than swap rates, as the market value loss on the sovereign debt will then be higher than the market value profit on the swap. The risk is only crystallised if the sovereign debt and the associated swap are sold. The market value movements are monitored and the risk is controlled via government versus swap mark to market limits.

## Notes to the financial statements continued

### 34. Reclaim Fund assets and liabilities

The Group is required to consolidate Reclaim Fund Limited ('RFL') as it is a 100% owned subsidiary of the Group. However the Fund is a not for profit organisation whose surplus is entirely for the benefit of Big Lottery Fund and the Group derives no financial benefit from RFL nor can it access RFL's reserves. For this reason RFL's balance sheet has not been consolidated on a line-by-line basis but instead is separately disclosed within the Group balance sheet. The analysis of Reclaim Fund assets and liabilities is set out below:

	<b>2013</b>	2012
	<b>£m</b>	£m
Cash	<b>382</b>	435
Investment securities	<b>69</b>	–
Reclaim Fund assets	<b>451</b>	435
Provision for reclaims of dormant account balances	<b>239</b>	211
Provision for future distributions to Big Lottery Fund	<b>138</b>	150
Reclaim Fund liabilities	<b>377</b>	361

#### Accounting policies

The calculation of the provision for future repayments of dormant account balances is inherently complex, with significant amounts of uncertainty. The Directors have applied a cautious level of stress within the calculation of the provision which they believe implicitly accounts for the long term nature of the provision.

The Group also records a provision for future distributions to the Big Lottery Fund. This represents amounts which the RFL intends to pay over to the Big Lottery Fund in future periods of which timing is uncertain. The Dormant Bank and Building Society Accounts Act (2008) dictates that the RFL is obliged to pay over the excess of dormant account monies received, after deduction of running costs to the Big Lottery Fund for ongoing distribution to the benefit of the community. Distributions to the Big Lottery Fund are recognised in the Income statement when a constructive or legal obligation exists for payment.

#### Investment securities

Held to maturity assets are non-derivative financial assets with fixed or determinable payments and fixed maturities that management has the positive intention and ability to hold to maturity. They are initially recognised at fair value plus directly attributable transaction costs and are subsequently carried at amortised cost using the effective interest method.

## Notes to the financial statements continued

### 35. Detailed analysis of loss on discontinued operations, net of tax

The results of discontinued operations are disclosed in note 9. Further details of these results during the period are set out in the following note including details of the key accounting policies, key estimates and judgements applied in arriving at these results. The results below are stated after Group consolidation adjustments and therefore do not replicate the results disclosed in the statutory accounts of the below entities.

#### Income and expenses relating to The Co-operative Bank plc were as follows:

	2013 £m	2012 £m
Revenue	1,299	1,483
Operating expenses	(2,622)	(2,195)
Other income	44	38
<b>Operating loss</b>	<b>(1,279)</b>	<b>(674)</b>
Share of losses of associates and joint ventures	–	1
Tax	(162)	164
<b>Loss for the period</b>	<b>(1,441)</b>	<b>(509)</b>

Further details of this income and expenses is as follows:

#### Revenue

	2013 £m	2012 £m
The Co-operative Bank plc:		
– Interest and similar income	1,265	1,380
– Fee and commission income	35	101
Net revenue	1,300	1,481

### Accounting policies

#### Interest and similar income

Interest income is recognised on an effective interest rate (EIR) basis, inclusive of directly attributable incremental transaction costs and fees including arrangement and broker fees, valuation and solicitor costs, discounts and premiums where appropriate and early redemption fees. The EIR basis spreads the interest income and expense over the expected life of each 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 assets' future credit losses except for assets acquired at a deep discount. On applying this approach to the mortgage portfolio, judgements are made in relation to estimating the average life of that portfolio. These judgements 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 judgement area is the average life of the mortgage portfolio. A change in the average life by one year would result in an increase of 0.2% in gross interest income.

For assets acquired at a value significantly below the carrying value in the acquiree's financial statements because they have incurred losses, expectations of future losses are higher than at origination, and interest spreads have widened because of deteriorating market conditions, the calculation of EIR is the same as shown above with the exception that the estimates of future cash flows include credit losses.

#### Fee and commission income

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 deferred and included in the EIR 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, such as a loan closure fee or an arrears fee, that is not included in the effective interest calculation, is recognised on an accruals basis as the service is provided.

## Notes to the financial statements continued

### 35. Detailed analysis of loss on discontinued operations, net of tax continued

#### Operating expenses

The operating loss is stated after charging the following:

	2013 £m	2012 £m
Cost of sales		
– Banking activities – Interest expense and similar charges	(931)	(922)
– Banking activities – Fee and commission expense	(72)	(74)
Fair value amortisation	(216)	–

#### Other income

Income from activities outside the normal trading activities of the Bank include:

	2013 £m	2012 £m
Net gains on sale of investment securities – loans and receivables	43	16
Fair value amortisation	–	15
Rental income from investment property	1	7
	44	38

#### Fair value amortisation

When Britannia Building Society transferred its engagements to the Co-operative Bank plc in 2009, net assets were restated to fair value on merger. Fair value amortisation 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 2013 represent a net charge to the income statement of £216m (2012: credit of £15m).

#### Income and expenses relating to the Life & Savings business (including TCAM) were as follows:

	2013 £m	2012 £m
Gross earned premiums	173	327
Less premiums ceded to reinsurers	(7)	(15)
Net premiums	166	312
Expenses:		
Claims paid	(549)	(1,075)
Technical charges	62	42
Change in unallocated divisible surplus	75	(233)
Investment expenses and charges	(55)	(107)
Fee and commission expenses	(19)	(21)
Other operating expenses	(157)	(108)
Other income:		
Fee and commission income and income from service activities	42	75
Investment income	340	594
Gains less losses arising from financial instruments and other assets	133	585
Results from operating activities	38	64
Income tax including tax attributable to policyholder returns	(16)	(60)
Minority interest	(15)	7
Taxation	(2)	–
Result for the period, net of income tax	5	11

## Notes to the financial statements continued

### 35. Detailed analysis of loss on discontinued operations, net of tax continued

Further details of this income and expenses were as follows:

	2013 £m	2012 £m
<b>Gross premiums:</b>		
Non-participation contracts	15	29
Participation contracts	158	298
<b>Outward reinsurance premiums:</b>		
Non-participation contracts	(7)	(15)
Net premiums	166	312
<b>Analysis of gross written premiums:</b>		
Premiums under individual contracts	171	323
Premiums under group contracts	2	4
<b>Gross earned premiums</b>	<b>173</b>	<b>327</b>

	2013 £m	2012 £m
<b>Life Contracts:</b>		
Premiums from life assurance business	127	237
Premiums from pensions business	45	88
Premiums from permanent health business	1	2
	<b>173</b>	<b>327</b>

### Investment income

	2013 £m	2012 £m
Interest income from debt securities at fair value through profit or loss	198	346
Dividend income from equities at fair value through profit or loss	80	129
Rental income from investment properties	57	106
Cash and cash equivalents interest income	5	11
Interest income from derivative financial instruments	–	2
	<b>340</b>	<b>594</b>

### Net gains/(losses) on remeasurement of financial and other assets at fair value through income or expense

	2013 £m	2012 £m
Listed equities	677	383
Unlisted equities	88	56
Listed debt securities	(481)	298
Unlisted debt securities	(120)	120
Derivatives	(193)	(142)
Investment properties	34	(8)
Net losses on remeasurement of financial liabilities at fair value through profit or loss	120	(120)
Other investments	8	(2)
	<b>133</b>	<b>585</b>

## Notes to the financial statements continued

### 35. Detailed analysis of loss on discontinued operations, net of tax continued

	2013 £m	2012 £m
<b>Gross claims paid</b>		
Long term insurance contracts:		
– death benefits	94	148
– surrender benefits	270	515
– maturity claims	181	370
– annuity and other benefits	111	204
<b>Less recovered from reinsurers</b>		
Long term business:		
– death benefits	(5)	(11)
– annuity and other benefits	(102)	(151)
<b>Net claims paid</b>	<b>549</b>	<b>1,075</b>

### 36. Bank disclosures

Following the LME transaction on 20 December 2013, the Bank's assets and liabilities have been derecognised from the Group's balance sheet. The Group's remaining 30% investment in the Bank is now shown as an investment in an associates (see note 13). Details of the Bank's assets and liabilities in the prior period when the Group consolidated its investment are shown in the following note.

#### 36a Derivatives

	Assets		Liabilities	
	2013 £m	2012 £m	2013 £m	2012 £m
	–	819	–	(968)

#### Derivative financial instruments

The Bank, as principal, entered 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 Group does not have a legal right of offset.

Derivatives held for trading purposes:

Trading transactions are wholly 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.

Non-trading derivatives:

Non-trading transactions comprise derivatives held for hedging purposes to manage the asset and liability positions of the Bank. 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.

## Notes to the financial statements continued

### 36. Bank disclosures continued

	Fair value assets		Fair value liabilities	
	2013 £m	2012 £m	2013 £m	2012 £m
Derivatives held for trading:				
Interest rate swaps	–	196	–	(167)
Interest rate options	–	1	–	(1)
<b>Total derivative assets/(liabilities) held for trading</b>	<b>–</b>	<b>197</b>	<b>–</b>	<b>(168)</b>
Derivatives held for hedging:				
Interest rate swaps designated as cash flow hedges	–	120	–	(52)
Interest rate swaps designated as fair value hedges	–	111	–	(630)
Interest rate swaps held for non-trading purposes for which hedge accounting has not been applied	–	45	–	(63)
Embedded derivatives – options	–	61	–	–
OTC interest rate options	–	–	–	(3)
Equity swaps	–	63	–	–
Forward currency transactions	–	222	–	(52)
<b>Total derivative assets/(liabilities) held for non-trading</b>	<b>–</b>	<b>622</b>	<b>–</b>	<b>(800)</b>
<b>Total recognised derivative assets/(liabilities)</b>	<b>–</b>	<b>819</b>	<b>–</b>	<b>(968)</b>

## Accounting Policies

### 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 based on quoted market prices in active markets, and where these are not available, using valuation techniques such as discounted cashflow models. All derivatives are carried as assets when the fair value is positive and liabilities when the fair value is negative. The gain or loss on re-measurement to fair value is recognised immediately in the income statement except where derivatives qualify for cashflow hedge accounting.

On initial designation of derivatives and qualifying hedged items as a hedge, the Bank formally documents the relationship between the hedging instrument(s) and hedged item(s) including the risk management objective and strategy in undertaking the hedge transaction together with the method used to assess effectiveness of the hedging relationship.

The Bank makes an assessment, both at the inception of the hedge relationship as well as on an ongoing basis as to whether the hedging instruments are expected to be 'highly effective' on offsetting the changes in fair value or cash flows of the respective hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80%–125%.

### Cash flow hedges

Where derivatives are designated as hedges of the exposure to variability in cash flows of a recognised asset or 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 in the income statement immediately. The accumulated gains and losses recognised in equity are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss recognised at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was recognised in equity is immediately reclassified to the income statement.

### Fair value hedges

Where a derivative is designated as the hedging instrument to hedge the change in fair value of a recognised asset or liability or a firm commitment that could affect income or expense, changes in the value of the derivative are recognised immediately in the income statement together with changes in the fair value of the hedged item that are attributable to the hedged risk. Fair values are based on quoted market prices in active markets, or where these are not available, using valuation techniques such as discounted cash flow models.

If the derivative expires or is sold, terminated, or exercised, or no longer meets the criteria for fair value hedge accounting, or the designation is revoked, then hedge accounting is prospectively discontinued. Any adjustment up to that point, to a hedged item for which the effective interest method is used, is amortised to income or expense as part of the recalculated effective interest rate of the item over its remaining life.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### 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 repricing time periods based on expected repricing dates, by scheduling cash flows into the periods in which they are expected to occur. Using this analysis, the Bank decides the amount it wishes to hedge and designates as the hedged item an amount of assets or liabilities from each portfolio equal to this.

On a monthly basis, the Bank measures the change in fair value of the portfolio relating to the risk that is being hedged. 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, 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.

#### Embedded derivatives

A derivative may be embedded in another 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 (and the host contract is not carried at fair value through income or expense), the embedded derivative is separated from the host and held on 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 relevant accounting policy for that particular asset or liability.

#### 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.

### 36b Loans and advances to banks

	2013 £m	2012 £m
Items in the course of collection from other banks	–	104
Placements with other banks	–	747
Included in cash and cash equivalents	–	851
Other loans and advances to banks	–	1,053
	–	1,904

#### Accounting policies

##### 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 by banks. The difference between sale and repurchase price is accrued over the life of the agreements using the EIR method.

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

### 36c Loans and advances to customers

	2013 £m	2012 £m
Gross loans and advances	–	34,403
Less allowance for losses on loans and advances	–	(643)
Less fair value adjustments for hedged risk	–	(354)
	–	33,406

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### Fair value adjustments for hedged risk

The Bank entered into interest rate swaps that protected it from changes in interest rates on the floating rate liabilities that funded its portfolio of fixed rate mortgages. Changes in the fair values of these swaps were offset by changes in the fair values of the fixed rate mortgages.

#### Securitisation

Loans and advances to customers included £10,997m securitised under the Bank's securitisation and covered bond programmes. The Bank remained exposed to substantially all of the risks and rewards of ownership of these assets. Included within deposits by banks were £58m of loans from external third parties and within debt securities in issue were £4,145m of fixed and floating rate notes, all secured on these mortgage assets.

#### Concentration of exposure

The Bank's exposure is virtually all within the United Kingdom

#### Allowance for losses on loans and advances

	2012				Total £m
	Individual Mortgage £m	Individual Corporate £m	Collective retail £m	Collective corporate £m	
As at 31 December 2011	9	105	166	12	292
Charge against profits	9	380	43	11	443
Amounts written off	(7)	(47)	(30)	(1)	(85)
Unwind of discount of allowance	–	(4)	(3)	–	(7)
As at 5 January 2013	11	434	176	22	643

Loans and advances to customers included £154m of financial assets at fair value through income or expense designated at initial recognition to eliminate or significantly reduce a measurement or recognition inconsistency. Of these £49m were secured by real estate collateral.

#### Loans and advances to customers include finance lease receivables:

	2013 £m	2012 £m
Gross investment in finance leases, receivable:		
– No later than one year	–	22
– Later than one year and no later than five years	–	69
– Later than five years	–	73
	–	164
Unearned future finance income on finance leases	–	(44)
Net investment in finance leases	–	120
The net investment in finance leases may be analysed as follows:		
– No later than one year	–	16
– Later than one year and no later than five years	–	48
– Later than five years	–	56
	–	120

There were no unguaranteed residual values for any of the finance leases. The Bank entered into finance lease and hire purchase arrangements with customers in a wide range of sectors including transport, retail and utilities. The accumulated allowance for uncollectable minimum lease payments receivable was £nil.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### Accounting policies

##### Financial instruments (excluding derivatives)

##### Recognition

The Bank initially recognises loans and advances, deposits, debt securities issued and other borrowed funds on the date at which they are originated.

Financial assets are recognised on the trade date which is the date the Bank commits to purchase the instruments. All other financial assets and liabilities are initially recognised on the trade date at which the Bank becomes a party to the contractual provisions of the instrument.

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

- Loans and receivables
- Available for sale
- Financial assets at fair value through the income statement

##### 1) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and the Group does not intend to sell immediately or in the near term. These are initially measured at fair value plus transaction costs that are directly attributable to the financial asset. Subsequently, these are measured at amortised cost using the effective interest method. The amortised cost is the amount advanced less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the amount advanced and the maturity amount less impairment provisions for incurred losses.

Loans and receivables mainly comprise loans and advances to banks and customers except where the Bank has elected to carry the loans and advances to customers at fair value through income or expense as described in 3) below and assets reclassified from available for sale in 2) below.

##### 2) Available for sale

Available for sale financial assets are debt securities that are not held for trading and are 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 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. In exceptional circumstances, for instance where the market in the securities has become inactive, the Bank has reclassified such assets as loans and receivables. Any transfer back from loans and receivables, upon reclassification, would be 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.

##### 3) Financial assets at fair value through income or expense

These are either:

- 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
- Upon initial recognition designated at fair value through income or expense to eliminate or significantly reduce a measurement and recognition inconsistency or where management specifically manages an asset or liability on that basis i.e. capital bonds

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 within trading income as they arise.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### Critical accounting estimates and judgements

##### 4) Impairment provision

At the balance sheet date, the Bank assesses its financial assets not at fair value through income or expense for objective evidence that an impairment loss has been incurred.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower, a breach of contract, such as default or delinquency in interest of principal payments, the granting by the Bank to the borrower, for economic and legal reasons relating to the borrower's financial difficulty, a concession that the Bank would otherwise not consider, indications that a borrower or issuer will enter bankruptcy or other financial reorganisation, or the disappearance of an active market for security.

The Bank considers evidence for impairment for loans and advances at both a specific asset and collective level. All secured loans and advances are assessed for impairment using a range of criteria graded for levels of risk. Accounts at risk of impairment are monitored and impaired where they display clear indications of underperformance. Loans and advances that do not meet the criteria for individual impairment are collectively assessed for impairment by grouping together loans and advances of similar risk characteristics.

When assessing collective impairment for secured retail loans, the Bank estimates incurred losses on those mortgages where there has been a material deterioration in the borrower's external credit score in the last 12 months or where the loan is identified as being subject to forbearance. When assessing collective impairment for unsecured retail loans, the Bank estimates losses on loans with delinquency greater than a pre-determined trigger point. In addition the Bank makes provision on all loans arising from fraud and loans transferred to Debt Collection Agencies. In respect of unsecured loans the Bank uses statistical modelling of historical trends of probability of default, timing of recoveries and the amount of loss incurred. The model's results are adjusted for management's judgment as to whether current economic and credit conditions are such that actual losses are likely to differ from those suggested by historical modelling. Once impaired, accounts are subjected to higher levels of impairment according to both their relevant stage of delinquency, that is the number of days in arrears, and their consequent likelihood of ultimately being charged off. Default rates, loss rates and future recoveries are regularly benchmarked against actual outcomes to ensure that they remain appropriate.

Collective risk cover provides further balance sheet protection for total impairment losses. The amount of collective risk cover is adjusted monthly by the Bank. The Bank reviews all loans and considers the potential loss which might arise were the borrowers to fail (notwithstanding that continued trading remains the expectation). Trigger events may include a deteriorating balance sheet, material losses, trading difficulties (e.g. loss of material contracts or suppliers), breach of financial covenants, poor account conduct, arrears and material reduction in value of security. A collective impairment provision is raised against these loans based on the total estimated loss that may arise and the propensity for the borrower to fail.

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 for amortised cost assets and at the current market rate for available for sale assets)

Where the debt is secured, the assessment reflects the expected cash flows from the realisation of the security, net of cost to realise, whether or not foreclosure or realisation of the collateral is probable.

#### Impairment of financial assets carried at amortised cost

The amount of the impairment loss on assets carried at amortised cost 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.

A write-off is made when all or part of a claim is deemed uncollectible 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 received.

Provisions are released at the point when it is deemed that following a subsequent event the risk of loss has reduced to the extent that a provision is no longer required.

#### Impairment of financial assets classified as available for sale

Available for sale assets are assessed at each balance sheet date to see whether there is objective evidence of impairment. In such cases, any impairment losses are recognised by transferring the cumulative loss that has been recognised directly in equity to income or expense.

When a subsequent event causes the amount of impaired loss on available for sale investment securities to decrease and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through the income statement. However any further recovery in fair value of an impaired available for sale equity security is recognised directly in equity.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### 5) Derecognition of financial assets

Financial assets are derecognised when they are qualifying transfers and:

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

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

### 36d Customer accounts

	2013 £m	2012 £m
Customer accounts	–	35,960

In the prior period the Co-operative Bank plc had 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.

### 36e Capital Bonds

	2013 £m	2012 £m
Retail	–	888

Capital bonds are fixed term customer accounts with returns based on the movement in an index (e.g. FTSE 100). The capital bonds were designated on initial recognition at fair value through income and expense and carried at fair value. The fair values for the capital bonds were obtained on a monthly basis from the swap counterparties. These external valuations were reviewed independently using valuation software to ensure the fair values were priced on a consistent basis. None of the change in the fair value of the capital bonds was attributable to changes in the liability's credit risk. In the prior period, the maximum amount the Bank was contractually required to pay at maturity for all the capital bonds was £888m. The Co-operative Group plc used swaps to create economic hedges against all of its capital bonds. The gain on capital bonds in the income statement in the prior period was £33m. However, taking into account changes in fair value of the associated swaps, the net impact to the income statement for the prior period was a gain of nil.

### 36f Debt securities in issue

	2013 £m	2012 £m
Certificates of deposits	–	158
Commercial papers	–	8
Fixed and floating notes	–	4,548
	–	4,714

The Bank 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 sterling equivalent carrying value of the debt securities in issue.

Debt securities in issue include fixed and floating rate notes, the majority of which are secured on portfolios of variable and fixed rate mortgages. The notes are redeemable in part from time to time, such redemptions being limited to the net capital received from mortgagors in respect of the underlying assets. There is no requirement for the Bank to make good any shortfall out of general funds. The maturity date of the notes matches the maturity date of the underlying assets.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### 36g Other borrowed funds

	2013 £m	2012 £m
£60,000,000 9.25% non-cumulative irredeemable preference shares of £1 each	–	60
Perpetual subordinated bonds	–	292
£150,000,000 Step up callable subordinated notes 2019	–	38
Floating rate subordinated notes 2016	–	22
5.625% Subordinated notes 2021	–	9
9.25% Subordinated notes 2021	–	275
7.875% fixed rate subordinated notes 2022	–	235
Fixed rate subordinated notes 2024	–	174
Fixed rate subordinated notes 2033	–	125
Issue costs, discounts and accrued interest	–	29
	–	1,259

As part of the re-capitalisation of the Co-operative Bank plc on 20 December 2013, the £60m of preference shares were all transferred to the Co-operative Group with all economic rights of the shares forfeited. The perpetual subordinated bonds were transferred to the Co-operative Group Limited and subsequently cancelled. All remaining subordinated bonds were cancelled during the period. The below relates to details of each borrowed fund in the prior period.

#### £60m 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 Bank.

On a return of capital on winding up, the assets of the 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 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 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 Bank or other return of capital and then only on that resolution.

#### £150m 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. On 19 December 2012 the Bank invited investors to exchange their holdings in the above instrument for a new subordinated note, which resulted in the redemption of £112m of the notes (representing 74.8% of the amount outstanding), leaving £38m outstanding.

#### 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%. From 18 May 2011 interest has been calculated at three months EURIBOR plus a margin of 0.78%. The first interest coupon was paid in August 2006. The notes were hedged with a cross currency swap converting the exposure into sterling which paid a floating rate at three months LIBOR with a margin on interest coupon of 0.34125% and received floating rate of three months EURIBOR plus a margin on interest coupon of 0.28%. The cross currency swap matured on 18 May 2011.

On 28 April 2011 the Bank redeemed €149m of the notes (representing 81% of the amount outstanding) leaving €35m outstanding. The Bank had the option to call the outstanding notes in whole but not in part on the interest payment date falling on or nearest to May 2011, and now at any interest payment date thereafter subject to prior consent of the Financial Services Authority.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### 5.625% fixed rate 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.

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. On 19 December 2012 the Bank invited investors to exchange their holdings in the above instrument for a new subordinated note, which resulted in the redemption of £141m of the notes (representing 94.2% of the amount outstanding), leaving £9m outstanding.

#### 9.25% fixed rate subordinated notes 2021

On 28 April 2011 the Bank issued £275m fixed rate subordinated notes due 2021, issued at par. The notes are an unsecured obligation of the Bank and in the event of 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 9.25% up to (but excluding) 28 April 2021. Interest is payable annually in April. There is no option to redeem the notes early.

#### 7.875% fixed rate subordinated notes 2022

On 19 December 2012 the Bank issued £235m fixed rate subordinated notes due 2022, issued at par. 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 7.875% up to 18 December 2022. Interest is payable annually in arrears in December. There is no option to redeem the notes early.

#### 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 2 December 2019 (reset date). During this period 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.

From the reset date the interest rate will be calculated based on the Five Year Benchmark Gilt rate plus a margin of 1.94%. The Five Year Benchmark Gilt rate being the Gross Redemption Yield determined by the UK government security having a maturity date falling on or nearest the fifth anniversary of the determination date (the determination date being two days prior to the reset date), converted to an annualised yield. The Gross Redemption Yield being calculated on the basis set out by the UK Debt Management Office in the publication 'Formulae for Calculating Gilt Prices from Yields'. From the reset date the interest will be paid annually in arrears until maturity or redemption.

The notes are callable in whole but not in part, at the principal amount, on 2 December 2019, subject to the prior consent of the Financial Services Authority.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### 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 note holders 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 payment 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 semi-annual interest receivable leg on the swap is matched to the dates on the notes.

#### Perpetual subordinated bonds

Perpetual Subordinated Bonds (PSBs) with a par value of £110m were issued in 1992 at a discount of 0%. PSBs with a par value of £200m were issued in 2005 at a discount rate of 0%. Both the £110m and £200m PSBs are an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of the bondholders will be subordinated in right of payment of all creditors (including subordinated creditors) of the Bank.

The PSBs with a par value of £110m carry an annual interest rate of 13%. Interest is payable semi-annually in January and July.

The PSBs with a par value of £200m carry an annual interest rate of 5.5555% up until the reset date. This coupon is payable semi-annually in June and December. From the reset date of 14 December 2015 the interest rate will be amended to the rate for three month deposits in sterling plus a margin of 2.05% per annum. The interest payments will then be made quarterly in arrears in March, June, September and December, with the interest resetting at each interest payment date.

During the period up until the reset date the PSBs are hedged with an interest rate swap that converts the interest rate payable into floating rates at six months LIBOR plus a margin of 1.175%. The semi-annual interest receivable and payable on the swap is aligned to the interest payment dates of the notes. The interest rate swap matures on 14 December 2015.

Given prior relevant supervisory consent, the Bank may elect to repay all, but not less than all, of these PSBs on 14 December 2015 or on any interest payment date thereafter at their principal amount.

### Accounting Policies

#### Borrowed funds

Borrowings are recognised initially at fair value, which equates to 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 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 EIR method.

#### Perpetual subordinated bonds

Perpetual subordinated bonds are carried at their nominal value plus any premium and a fair value adjustment for hedged risk where items are designated as part of a fair value hedge relationship. Interest payable on perpetual subordinated bonds is recognised in the income statement using the EIR method.

## Notes to the financial statements continued

### 36. Bank disclosures continued

#### 36h Fair value hierarchy for the Bank's financial instruments carried at fair value

The following table analyses financial assets and liabilities carried at fair value in 2012 by the three level fair value hierarchy as defined in IFRS 13.

	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
<b>Non-derivative financial assets:</b>				
Held for trading:				
– Investment securities	960	–	–	960
Designated at fair value:				
– Loans and advances to customers	–	142	11	153
– Investment securities	1,845	–	–	1,845
Available for sale financial assets				
– Investment securities	2,185	1,605	–	3,790
– Equity shares	–	–	6	6
Derivative financial instruments	–	783	36	819
<b>Total assets carried at fair value</b>	<b>4,990</b>	<b>2,530</b>	<b>53</b>	<b>7,573</b>
<b>Non-derivative financial liabilities:</b>				
Designated at fair value				
Customer accounts – capital bonds	–	888	–	888
Derivative financial instruments	–	955	13	968
<b>Total liabilities carried at fair value</b>	<b>–</b>	<b>1,843</b>	<b>13</b>	<b>1,856</b>

## Notes to the financial statements continued

### 37. Detailed analysis of assets and liabilities held for sale

Details of assets and liabilities relating to the Life & Savings business (including TCAM) in the prior year, together with details of accounting policies, estimates and judgements are as follows:

#### Derivatives – assets classified as held for sale

	2013 £m	2012 £m
Derivative financial assets at FVTPL – held for trading:		
Financial future contracts	–	2
Interest rate swaptions	–	428
Interest rate swaps	–	657
FTSE options	–	108
Forwards	–	5
Total return swaps	–	44
	–	1,244

#### Derivatives – liabilities classified as held for sale

	2013 £m	2012 £m
Financial future contracts	–	1
Interest rate swaps	–	1,115
Total return swaps	–	26
Forwards	–	26
	–	1,168

#### Investments – assets classified as held for sale

	2013 £m	2012 £m
Listed equities	–	4,029
Unlisted equities	–	976
Listed debt securities – fixed rate	–	8,619
Listed debt securities – floating rate	–	1
Unlisted debt securities – fixed rate	–	3
Unlisted debt securities – floating rate	–	2,608
Deposits with credit institutions – fixed rate	–	1,227
Investment properties	–	1,468
	–	18,931

The value of securities pledged in connection with repo and other transactions was £565m. The value of securities received in connection with repo and other transactions was £450m. A liability of £25m was included within financial liabilities in respect of repurchase liabilities.

## Notes to the financial statements continued

### 37. Detailed analysis of assets and liabilities held for sale continued

#### Analysis of insurance and participating contract liabilities

	2013 £m	2012 £m
<b>Gross</b>		
Long term insurance contracts:		
– Insurance contracts	–	3,572
– Insurance participating contracts	–	13,904
– Investment participating contracts	–	671
– Adjustment for funeral bonds	–	(445)
	–	17,702
<b>Recoverable from reinsurers</b>		
Long term insurance contracts:		
– Insurance contracts	–	(2,231)
– Insurance participating contracts	–	(1,385)
	–	(3,616)
<b>Net</b>		
Long term insurance contracts:		
– Insurance contracts	–	1,341
– Insurance participating contracts	–	12,519
– Investment participating contracts	–	671
<b>Net insurance liabilities</b>	–	14,531
– Adjustment for funeral bonds	–	(445)
<b>Net liabilities after adjustment for funeral bonds</b>	–	14,086

Liabilities are stated as positive in the above analysis.

#### Capital position statement 2012

	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	200
Shareholders' funds held in fund	–	–	–	–
<b>Total shareholders' funds</b>	–	–	200	200
Adjustments onto regulatory basis:				
– Unallocated divisible surplus	1,240	–	–	1,240
– Adjustments to assets	(21)	–	–	(21)
<b>Total available capital resources</b>	1,219	–	200	1,419
With-profits liabilities on realistic basis:				
– Options and guarantees	1,527	–	–	1,527
– Other policyholder obligations	11,292	257	–	11,549
<b>Total participating contract liabilities</b>	12,819	257	–	13,076
– Non-participating life assurance	1,342	–	–	1,342
<b>Insurance and participating contract liabilities per capital position statement</b>	14,161	257	–	14,418

## Notes to the financial statements continued

### 37. Detailed analysis of assets and liabilities held for sale continued

#### Reconciliation to insurance and participating contracts liability

	2013 £m	2012 £m
Insurance and participating contract liabilities as per capital position statement	–	14,418
Add back reinsurance	–	3,616
Outstanding claims reserves	–	113
Less funeral bonds	–	(445)
<b>Insurance and participating contract liabilities</b>	<b>–</b>	<b>17,702</b>

#### Long term life insurance contracts – assumptions, changes in assumptions and sensitivity

##### 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. CISL has a general reserve of £200m which is a separate shareholder-owned fund held outside the long term business which, if available, may be used in exceptional circumstances to help meet the long term business fund's solvency requirements.

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 CISL's risk management section. 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.

##### 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 2012. At 31 December 2012, provisions amounting to £837m had 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. 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 2012. At 31 December 2012 provisions amounting to £53m were 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 2012. At 31 December 2012 provisions amounting to £641m were made to cover the future cost of meeting guarantees of this type.

##### 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, the FSA issued a policy statement (PS06/14) allowing insurers to change the capital and reserving requirements of non-profit business to a more realistic basis. The Society adopted the changes under this policy statement at 12 January 2008, and continued to do so at 31 December 2012.

## Notes to the financial statements continued

### 37. Detailed analysis of assets and liabilities held for sale continued

#### 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.

#### 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. Additional sterling reserves of £5m for insurance contracts and £6m for investment contracts to provide for the excess of expenses over anticipated charges is made.

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.

#### Assumptions used in valuing the realistic liabilities

The overall objective of the CISL 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 CISL 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 most significant in the valuation of the realistic liabilities are:

- Interest rates
- Future bonuses
- Expenses and expense inflation
- Mortality, morbidity and persistency
- Tax

#### Interest rates used in valuing the realistic liabilities

A risk free future interest rate of 2.32% 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.

## Notes to the financial statements continued

### 37. Detailed analysis of assets and liabilities held for sale continued

#### 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.

#### Expenses and expense inflation

Expense assumptions for prospective asset shares and value of 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 6.1% per annum.

#### 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 Investigation 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 2012 experience investigations and new CMIB models for future assumed annuitant mortality improvements, but these changes have not had major impacts on the insurance contract liabilities.

#### 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 was 20%.

#### 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. 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 are cumulative, so the results of each stress depend on the impact of the stresses which precede it, and the individual results may change if the stresses were applied in a different order.

#### RCM stress tests (applied cumulatively)

	Reduction in working capital	
	2013 £m	2012 £m
20% fall in equity values and 12.5% fall in property values	–	66
Increase of 89 basis points in bond yields for credit risk test	–	21
17.5% fall in long term gilt yields	–	(6)
32.5% improvement in persistency rates	–	133
<b>Total RCM before management actions</b>	<b>–</b>	<b>214</b>

In calculating the RCM, it has been assumed that no management action would be taken under the stressed conditions.

The RCM was calculated to be £214m. The excess working capital of the fund after the RCM was therefore £1,005m. The RCM was covered 5.7 times by working capital.

## Notes to the financial statements continued

### 37. Detailed analysis of assets and liabilities held for sale continued

#### Other stress tests (applied cumulatively)

	Reduction in working capital	
	2013 £m	2012 £m
5% fall in assurance mortality rates	–	2
5% fall in annuitant mortality rates	–	53
10% increase in renewal expenses	–	70
1% increase in renewal expense inflation	–	151

All long term insurance liabilities and reinsurance in relation to the Life & Savings business were sold in the period.

### 38. Capital resources

	2013 £m	2012 £m
Share capital	70	70
General reserve	–	200
Retained earnings and other reserves	1,966	4,220
	<b>2,036</b>	4,490
Perpetual non-cumulative preference shares	–	60
Subordinated debt	–	1,112
<b>Total capital resources</b>	<b>2,036</b>	5,662

#### Capital management

The Group defines capital as its share capital, reserves and up until 20 December, its financial liabilities in the Bank as stated below. The Group's policy is to maintain a strong base and to be more prudent than industry 'normal' levels 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. Due to the two very different natures of our businesses, the Group manages capital separately between the Trading Group and Financial Services, which now mainly comprises the General Insurance business. Since the Bank is now an associate, the capital position of the Bank is not part of the overall capital management strategy of the Group.

The Trading Group is not regulated and manages capital to ensure an appropriate balance between investing in the future growth of the Group whilst making member payments to stakeholders. The Group annually assesses the affordability of proposed member payments against actual. During the period, the Group made member payments of £55m (2012: £104m) to its stakeholders and invested in future growth through capital expenditure of £239m (2012: £528m). Total member funds decreased during the period by £2,454m (2012: a decrease of £531m).

CIS General Insurance Limited is a regulated entity. Its submissions to the FCA in the period have shown that this entity's individually regulated operations have complied with all externally imposed solvency requirements throughout the period.

The following were also included in the calculation of total Financial Services capital resources in the prior period:

- The Co-operative Bank plc preference shares which carried the right to a fixed non-cumulative preference dividend at a rate of 9.25%, payable 31 May and 30 November
- Subordinated debt which consisted of three debt issues by the Co-operative Bank plc, £150m step-up callable subordinated notes 2019, £150m subordinated notes 2021 fixed rate until 2016, then moving to floating rate and £275m subordinated notes 2021 fixed rate until 2021
- Floating rate subordinated notes 2016 were issued on 18 May 2006 at a discount of 0.14%. The Bank could 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 2022 were issued on 19 December 2012, at par. The notes were an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders would be subordinated in right of payment of the claims of depositors and other creditors of the Bank
- Fixed rate subordinated notes 2024 were issued on 17 March 2004 at a discount of 1.148%. The Bank could 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 were an unsecured obligation of the Bank and in the event of the winding up of the Bank, the claims of noteholders would have been subordinated in right of payment of the claims of depositors and other creditors of the Bank
- Upon transfer of engagements, the Britannia permanent interest bearing shares (PIBS) were converted into perpetual subordinated debt of the Bank (Perpetual Subordinated Bonds)

## Notes to the financial statements continued

### 39. Events after the reporting period

#### Interest bearing loans and borrowings

As detailed in the going concern section, at the year-end date, principally as a result of the recognition of an impairment charge of £226m in respect of goodwill, there was a covenant issue which has been addressed following the year-end by an amendment to the net asset covenant calculation being obtained from the Banking syndicate to ensure that the Trading Group is able to satisfy this covenant within the terms of the Group's unsecured bank loan facilities (total facilities of £900m of which £454m was drawn down at the year-end, as set out in note 24). In addition, following the reduction in the Group's investment in The Co-operative Bank plc on 20 December 2013, an amendment has been obtained following the year-end from the 2018 Debenture stock holders to ensure that the Total Consolidated Borrowings to Tangible Consolidated Net Worth covenant within the terms of the Group's 7.5/8% First Mortgage Debenture stock 2018 is satisfied.

However, in accordance with relevant accounting standards, because the covenant amendments were received post year-end, the Group was deemed not to have an unconditional right to defer payment for more than 12 months at the balance sheet date. As a consequence the balance sheet has been presented on the basis that all debt that could technically have become repayable, whether by default, cross default or cross acceleration has been classified within current liabilities, even though the covenant issue has subsequently been resolved. This presentation does not reflect the amended terms of the debt as at the date of signing the accounts.

To assist a reader of the accounts in better understanding the effect of those amended terms, as agreed post balance sheet date but prior to signing the accounts, an adjusted Balance Sheet, Loans and Borrowings Note (note 24) and risk management tables (note 33) have been included within the accounts to illustrate the impact on these areas of the accounts as if the amendments had been in place at the year-end.

#### Co-operative Bank Rights Issue

On 24 March, The Co-operative Bank announced a plan to raise capital of £400m. This is in addition to its existing £1.5bn recapitalisation plan, towards which the Group last year committed to contribute £333m of capital. The Group has provided £70m to date, with a further £100m due on 30 June and the remaining £163m to be contributed during the second half of 2014. When the Board of the Bank has finalised the structure of its capital raising, the Group will decide upon its participation in this exercise.

The Directors have also assessed the potential impact on the Group's going concern position of the planned rights issue. The Group is not committed to take up its rights under the issue, and any cash outflow in respect of the rights issue would be subject to consent by the Group's banking syndicate. Accordingly, in considering going concern, the Directors have assumed that the Group does not take up any rights and do not intend to take up rights in a way that would detrimentally affect their going concern assessment.

#### Transfer of employees

During the year, the majority of the employees in the Bank had contracts with CFS Management services Limited (CFSMS) and the cost of their services was recharged to subsidiaries, including the Bank. Following the legal separation of the Bank from the Group, employment contracts for the majority of these employees transferred from CFSMS to the Bank. The transfer took place under the Transfer of Undertakings (Protection of Employment) Regulations 2006.

Further transfers will occur in 2014 as the separation of Bank from the Group completes.

## Analysis of profits from regional business activities (unaudited)

	2013 Sales £m	Profit £m	2012 (restated)	
			Sales £m	Profit £m
Central and Eastern	1,171	90	1,250	85
North	1,450	90	1,607	91
North West and North Midlands	1,198	75	1,250	69
Scotland and Northern Ireland	1,155	95	1,151	90
South East	1,401	107	1,404	102
South and West	1,327	94	1,373	89
Wales/Cymru	546	47	573	43
Sales and contribution from regional business activities	8,248	598	8,608	569
Sales and profit from non-regional businesses and regional business overheads	1,810	(424)	1,779	(285)
Financial services	476	36	580	13
Net revenue and underlying segment operating profit	10,534	210	10,967	297

Regional businesses are The Co-operative Food, The Co-operative Funeralcare, The Co-operative Pharmacy and The Co-operative Motor Group. The Co-operative Motor Group was disposed of over the course of the period. The regional profits represent store contribution and are before central administration costs, one-off 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. The 2012 Financial services result has been restated to reflect the reduced equity state in the Bank.

**Co-operative Group Limited**

Registered under the Industrial and Provident Societies Act

Registered office: 1 Angel Square, Manchester M60 0AG

Registered number: 525R

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