

**DIRECTORS' REPORT AND FINANCIAL STATEMENTS**

**HERMES PENSIONS MANAGEMENT LIMITED**

**31 DECEMBER 2006**

**Registered No: 1661776**



## HERMES PENSIONS MANAGEMENT LIMITED

### BUSINESS REVIEW

#### Overview

Hermes Pensions Management Ltd is wholly owned by and the principal fund manager for the BT Pension Scheme, the largest in the UK. As such, we seek to add value for our shareholder as much through value-enhancing fund management as through returns such as dividends. Our over 200 other clients are also mainly pension funds, with a similar time-horizon for their investments and similar needs.

We seek to look on the world through the eyes of our clients, the pension fund trustees, and their underlying beneficiaries. This means we think about absolute as well as relative performance, we actively consider diversification, we look to act as an owner or assist clients to act as owners, and we tend to have a longer-term focus than the average fund manager. These approaches have helped us to take contrarian stances on occasion.

#### Hermes activities

The fund management industry is highly competitive. Increasingly it is dominated by large companies which take advantage of scale benefits and small boutiques or multi-boutiques which offer specialist investment skills. These companies generate strong returns, companies caught between these two ends of the spectrum are increasingly struggling to generate these good returns. Hermes is therefore re-emphasising its position as a multi-boutique with a range of specialist products gathered under a lean central function which provides services to those product areas. As we re-emphasise this position we continue to consider whether all of our service offerings are strongly differentiated enough to be boutique-like fund management products and whether there are further areas we could seek to add. This may drive some reshaping of our business over the next few years.

Hermes has been traditionally strong in a number of boutique areas, including real estate and corporate governance/engagement funds – our Focus Funds. Our funds investing in illiquid markets, such as small caps in developed markets and more general investments in emerging markets, are also strong offerings. In recent years we have also rebuilt a capacity in private equity, and developed new fields of expertise such as commodities investment and funds of hedge funds. Our Equity Ownership Service (EOS) makes available our corporate governance and engagement expertise to clients whether we manage their funds or not. EOS and the Focus Funds are built on the premise that companies with active and engaged owners are worth more than those without that advantage. The active and responsible approach to ownership is reflected across our work, not least in private equity and real estate investment.

#### 2006 review

This has been a strong year for Hermes. As ever, the driver for this is positive investment performance for our clients, which generates strong fee flows for us.

Turnover was £115.6 million against £84.2 million last year, retained profit was £28.6 million against £7.8 million last year. £9.1 million of the retained profit relates to a gain on disposal of investment in Innisfree Limited.

The success this year was driven by good performance in some areas in particular. Among those generating good returns for the business were our UK and European small companies active portfolios, our private equity activities, real estate investment – all of which now have strong positive outperformance over multiple-year periods – and the Focus Funds area, where all four funds generated strong outperformance in 2006. Real estate had a particularly strong

## HERMES PENSIONS MANAGEMENT LIMITED

### BUSINESS REVIEW (continued)

#### 2006 review (continued)

year in 2006, outperforming a benchmark that itself advanced markedly. The UK Focus Fund recovered from a poor 2005 to finish ahead of its high-water mark, the European Focus Fund for the fourth year in a row turned in strongly market-beating performance, and our Japanese joint venture with Nissay Asset Management, the Nissay Hermes Stewardship Fund, also performed well. Our Equity Ownership Service business was marginally profitable for the first time in 2006. Areas where performance was disappointing this year were emerging markets and Asia-Pacific ex Japan active investment where the 2006 performance dragged down previously strong historic numbers.

#### Measurement

- Financial KPIs

We measure our performance in comparison to peers. For the pension fund market, this is best captured by the WM50. This year the BT Pension Scheme again outperformed this index, returning 12.7% against its benchmark of 11.3%. This represents an outperformance of 1.4% or approximately £420 million in monetary terms. Over the longer term, the Scheme has outperformed its benchmark by 0.68% annualised for three years and 0.84% annualised for five years.

Each individual portfolio performance is measured relative to the relevant investment market. We assess the performance of each investment portfolio on at least a monthly basis. However, we are not a slave to this timescale because contrarian investing by its nature may underperform over shorter periods of time. We will respond to short-term underperformance by using it as a discipline to ensure that we spot problems arising at an early stage and take any necessary action. Staff are rewarded for the outperformance which their work generates, but to ensure that they are not focused on the short-term but look to longer-term performance, our typical pay scheme rewards outperformance over both one and three years.

- Non-financial KPIs

#### Customer acquisition

We added a total of 60 client mandates across the business in 2006, amounting to some £2.2 billion of commitments. This exceeded our budget target of around £1.5 billion. Particularly important wins were for EOS and the segregated fixed income businesses, as well as ongoing growth in HPUT and the European Focus Fund.

#### Staff retention

As a largely people-based business, staff retention and development are crucial issues for our current and future success. Overall staff turnover last year was 12.3% including the effect of some re-organisations and normal term retirements. In the main investment and support functions, turnover was lower providing considerable continuity for critical activities. We invested further in the development of staff and future leaders across the business.

Our absence levels are also monitored and continue to be below 3% which itself is a high standard industry benchmark, and an indication of good levels of commitment.

## HERMES PENSIONS MANAGEMENT LIMITED

### BUSINESS REVIEW (continued)

#### 2006 review (continued)

##### The future

Company performance in future years will continue to depend on investment performance for our clients. It is therefore inherently unpredictable, particularly over individual calendar years.

By gaining additional clarity of focus on our strategic positioning as a multi-boutique we hope to build a firmer foundation for future profitability, and we aim to increase our focus on those structures which are most likely to generate performance for clients. This thinking lies behind the review of our index-tracking business which we announced in February, no decisions have been taken on this as yet but we continue to consider what is best for our clients, for the future of the Company and our staff. We are also considering ways of expanding the boutique of products that we offer our clients, this may include geographical expansion of products which are currently performing well in particular regions – such as expanding our portfolio of engagement funds – or developing additional products, such as increasing our range of commodity and fund-of-fund offerings. We have recently recruited to give ourselves added capacity in the currency investment area. Our strong reputation in a range of areas, including as a fund of funds manager, as an active owner and as a responsible investor more generally, offer the foundation for various opportunities for our business.

##### Key risks and mitigants

- Investment performance

To generate long-term performance for our clients, we often take contrarian investment positions. By definition, this will mean that over some periods of time we will underperform the market. However, we aim to have staff and structures which will generate performance over the long-term horizons that our clients need.

- Key clients

There are two reasons why we might lose clients. First, we may fail to generate the investment performance they expect. This is discussed above. Second, their needs or investment structure may change such that our role for them is no longer required. We seek to mitigate this risk in two ways: by staying in close contact with clients such that we understand how their needs are changing and how we might be able to service the new needs, and also by diversifying our client base so that the loss of any one client does not have too significant an impact. See below under key relationships.

- Key staff

Fund management is a people business with Company performance dependent on investment performance generated by individuals and the structures around them. Therefore, if we fail to retain key staff our business could be significantly impaired. Hermes maintains its good staff retention through a culture which bolsters team-working and a communal spirit, which encourages an appropriate work-life balance, which offers significant training and development opportunities and which rewards staff appropriately for their contribution to the business.

## HERMES PENSIONS MANAGEMENT LIMITED

### BUSINESS REVIEW (continued)

#### Key risks and mitigants (continued)

- Business disruption

Our business might be disrupted for a number of different reasons that are out of our immediate control. We mitigate this by having a business continuity framework which we test on a regular basis. We rent space at an alternative site to which key staff can go to maintain core operations in the short-term until business returns to normal. This site now provides mirrored systems and provides rapid point of failure recovery.

#### Key social, environmental and ethical risks

- Social – staff retention and satisfaction  
Discussed above
- Environmental – direct impacts  
As a Company operating from a single site, our direct impacts are limited. We control these with housekeeping measures minimising the use of power for lighting and computers, encouraging minimal paper usage and offering recycling facilities.
- Ethical – maintenance of high compliance standards  
As discussed above, we maintain a robust compliance culture to avoid the risk that regulatory failings might lead to our facing penalties and reputational damage.
- Social, Environmental & Ethical – indirect impacts  
These impacts are potentially rather more significant than the above. As an investment institution with interests in companies all round the world, we have influence over the social, environmental and ethical footprints of the globe's leading companies. We seek to use this influence through our EOS business and through co-operation with other institutions to ensure that investee companies appropriately manage their own risks. We are also among the leading players in carrying the socially responsible investment into the real estate market.

#### Key relationships

- Client relationship with BT Pension Scheme  
While we have diversified our client base away from the BT Pension Scheme, the scheme still represents some 55% of our overall assets under management. Maintaining the strength of this relationship is therefore crucial to the success of Hermes. While we will continue to diversify our client base, we also seek to maintain a positive working relationship with the Scheme, with the individual directors of the trustee board and with the Scheme sponsor. Our continuing to generate strong performance for the Scheme will clearly continue to be an important factor in ensuring that this relationship remains positive.
- Relationships with our other clients  
We have nearly 250 clients other than the BT Pension Scheme, the largest of which is Royal Mail Pension Plan which represents 33% of our assets under management, and we seek to maintain strong relationships with them. Again, investment performance will be the key element in ensuring the relationships endure. In addition, we have client servicing teams whose role is to stay in close touch with these clients and to ensure that Hermes continues to offer them the services which they require.

**HERMES PENSIONS MANAGEMENT LIMITED****BUSINESS REVIEW (continued)****Key relationships (continued)**

- **Regulatory relationship with the Financial Services Authority**  
The FSA is our main regulator and authorises the activities of the Company and of its key staff. We have a robust compliance culture and maintain close contact with the FSA and thereby expect to maintain our good reputation and authorisation to operate fund management services.

## HERMES PENSIONS MANAGEMENT LIMITED

### DIRECTORS' REPORT

Directors	R Bernays	(Chairman)
	M Anson	(Chief Executive – appointed 31 January 2006)
	D R Barford	(Non executive – appointed 1 January 2006)
	J A Biles	(Non executive)
	Sir Tim Chessells	(Non executive)
	D W Davies	(Non executive)
	R Gray	(appointed 20 October 2006)
	M G Quirke	
	C M Metcalfe	(resigned 18 September 2006)
	C W Mustoe	(resigned 31 May 2006)
	D J Pitt-Watson	(resigned 1 May 2006)
	A Watson	(resigned 31 January 2006)

Secretary M S Green

Registered Office Lloyds Chambers, 1 Portsoken Street, London E1 8HZ

The directors who served throughout the year, except as noted, are listed above

During the year the directors had no interests in the shares of the Company or any other Group Company

The directors submit their report and the audited financial statements for the year ended 31 December 2006

### ELECTIVE RESOLUTIONS

The Board of Hermes Pensions Management Limited has used the written resolution procedures pursuant to S381A of the Companies Act 1985 to pass the following elective resolutions

- a) that pursuant to S366A of the Companies Act 1985, the Company has elected to dispense with the holding of Annual General Meetings (until the election is revoked),
- b) that pursuant to S252 of the Companies Act 1985, the Company has elected to dispense with the laying of accounts and reports before the Company in general meeting, and
- c) that pursuant to S386 of the Companies Act 1985, the Company has elected to dispense with the obligation to appoint auditors annually

### RISK MANAGEMENT

The Board has responsibility for the Company's systems of risk management and internal control. The report of the Audit Committee details how these systems are assessed. The risk management process takes into account the requirements of the Company's regulating authority, the Financial Services Authority.

## **HERMES PENSIONS MANAGEMENT LIMITED**

### **DIRECTORS' REPORT (continued)**

#### **RISK APPETITE**

The Group's appetite for risk is extremely limited. Rigorous controls are in place to mitigate the risks inherent in the business.

#### **RISK CATEGORIES**

The Board considers that the following risk elements (as identified in the Financial Services Authority's Integrated Prudential Sourcebook) are relevant to the business,

- Credit Risk
- Interest rate Risk
- Market Risk
- Liquidity Risk
- Operational Risk
- Insurance Risk

Information relating to the specific risks and the controls and systems in place to negate such risks are included within item q) in the Accounting Policies section of the Notes to the Accounts.

#### **FINANCIAL INSTRUMENTS**

Group operations are primarily financed from retained earnings and a loan from the BT Pension Scheme, the Group's ultimate parent.

The Group also has other financial instruments such as debtors, creditors, loans, investments and cash. These mostly arise from the Group's operations. The Group has a policy of identifying and controlling the risks associated with such instruments. These risks include interest rate risk, liquidity risk, currency risk and credit risk. Bearing in mind the nature of the exposure to financial instruments within the Group and the limited risks associated, the Directors are satisfied that there is adequate control of the risks.

#### **RESULTS**

The results for the year are shown on the attached profit and loss account. The directors do not recommend the payment of a dividend (2005 - £nil).

The directors consider the results of the Company to be satisfactory and that the Company is well placed to take advantage of future opportunities.

#### **EMPLOYEE INVOLVEMENT**

During the year meetings are held to discuss the performance of the Group. Opportunity is given at these meetings for senior executives to be questioned about matters which concern the employees.



**HERMES PENSIONS MANAGEMENT LIMITED****DIRECTORS' REPORT (continued)****DISABLED POLICY**

Applications for employment by disabled persons are always fully considered, bearing in mind the aptitudes of the applicant concerned. In the event of members of staff becoming disabled every effort is made to ensure that their employment with the Group continues and that appropriate training is arranged. It is the policy of the Group that the training, career development and promotion of disabled persons should, as far as possible be identical with that of other employees.

**STATEMENT ON DISCLOSURE OF INFORMATION TO AUDITORS**

Under Section 234ZA of the Companies Act 1985 the directors, having made enquiries of fellow directors, management and the Company's auditors, confirm that

- so far as they are aware, there is no relevant audit information of which the Company's auditors are unaware, and
- they have taken all reasonable steps they ought to have taken as directors in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information

This confirmation is given and should be interpreted in accordance with the provisions of s234ZA of the Companies Act 1985

Approved by order of the Board of Directors and signed on behalf of the Board



M Anson  
Director

30 April 2007

## **HERMES PENSIONS MANAGEMENT LIMITED**

### **REPORT OF THE AUDIT COMMITTEE**

#### **MEMBERSHIP**

The Audit Committee currently comprises three non-executive directors, John Biles (Chairman), Sir Tim Chessells and David Davies. Members of the Committee are appointed by the Board following recommendations from the Nominations Committee.

Each member of the Committee brings relevant financial experience from senior executive levels. The Committee Chairman, John Biles is considered by the Board to have significant, recent and relevant financial experience. The Board considers that each member of the Committee is independent although Sir Tim Chessells, as Chairman of the BT Pension Scheme, the Group's ultimate parent, does not meet the definition of independence in the Combined Code.

#### **SUMMARY OF TERMS OF REFERENCE**

- 1 To monitor the integrity of Hermes' annual financial statements and any formal announcements relating to the Company's financial performance, reviewing significant financial reporting judgements contained in them
- 2 To review Hermes' internal financial controls and internal control and risk management systems
- 3 To monitor and review the effectiveness of the Hermes' internal audit function
- 4 To make recommendations to the Hermes Board in relation to the appointment of the external auditor and their remuneration and terms of engagement
- 5 To review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- 6 To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm
- 7 To monitor and review the effectiveness of the arrangements put in place by management to comply with the requirements and recommendations of relevant regulatory bodies, including the FSA
- 8 To review material litigation and trends in litigation and in legal risk
- 9 To review annually the Committee's effectiveness and its terms of reference and make any proposals for change to the Hermes Board

In addition the Committee reports to the Board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken.

#### **WORK OF THE COMMITTEE DURING 2006**

The Committee reviewed and endorsed, prior to submission to the Board, the Company's financial statements. It considered Internal Audit reports and risk management updates, agreed external audit strategy and plans and received updates on management responses to audit recommendations.

**HERMES PENSIONS MANAGEMENT LIMITED****REPORT OF THE AUDIT COMMITTEE (continued)****POLICY ON AUDITOR INDEPENDENCE**

When commissioning non-audit work from Deloitte and Touche LLP, Hermes management will consider such work in four categories

- 1 The assignment will normally be given to Deloitte and Touche LLP when it is clearly linked to the Hermes audit or which regulators would expect the auditors to perform
- 2 Even though other advisors could provide the work, Deloitte & Touche LLP will be asked to do work where there are demonstrable efficiencies from using them, derived from the knowledge they gain from audit work
- 3 Deloitte and Touche LLP will not normally be given work where there is a potential for a conflict of interest during the supply of non-audit services. Such services may include actuarial, valuation, remuneration and accounting services together with investment advice or investment banking
- 4 In all other cases when Hermes requires non-audit services Deloitte & Touche will be regarded equally with all other suppliers and, if appropriate, will be asked to submit proposals for consideration alongside other suppliers

## **HERMES PENSIONS MANAGEMENT LIMITED**

### **REPORT OF THE REMUNERATION COMMITTEE**

#### **MEMBERSHIP**

The Remuneration Committee currently comprises three non executive directors, David Davies (Chairman), Richard Bernays and Sir Tim Chessells

#### **SUMMARY OF TERMS OF REFERENCE**

The Remuneration Committee shall be responsible for and shall have authority to take decisions in relation to the following

- 1 To determine and agree with the Hermes Board the framework for the remuneration of the Chief Executive Officer ("CEO"), the Chairman and other Designated Persons (executive directors of Hermès Pensions Management Limited and senior managers of the Hermes group of companies with total remuneration exceeding an agreed specified figure)
- 2 To provide oversight in respect of ensuring appropriate terms are established for Designated Persons service contracts
- 3 To set targets for performance related pay schemes, determine whether targets have been met and make appropriate and relevant awards as the Remuneration Committee deems fit
- 4 To determine policy for and scope of pensions arrangements for Designated Persons
- 5 To ensure that contractual terms on termination and payments made for Designated Persons are fair and to mitigate any damage payments
- 6 To determine the total individual remuneration packages for Designated Persons
- 7 To approve major changes in employee benefit structures throughout Hermes

#### **WORK OF THE COMMITTEE DURING 2006**

The Committee reviewed and endorsed salary and annual bonus awards and awards under Hermes long term incentive plans. During 2006 the Committee approved a review of remuneration for Hermes administrative staff which broadly increased base salaries but reduced bonus opportunity. The object of this was to benchmark both base pay and bonus to market levels. Total compensation remained largely unchanged. The Committee receives regular reports on market salary comparators.

#### **DIRECTORS' EMOLUMENTS**

Details of directors' emoluments, all approved by the Remuneration Committee, are shown in note 5 to the financial statements

## **HERMES PENSIONS MANAGEMENT LIMITED**

### **REPORT OF THE NOMINATION COMMITTEE**

#### **MEMBERSHIP**

The Nomination Committee currently comprises three non-executive directors, Richard Bernays (Chairman), John Biles and David Barford, together with the Chief Executive, Mark Anson

#### **SUMMARY OF TERMS OF REFERENCE**

- 1 Identifying and nominating for the approval of the Board, candidates to fill Hermes Board vacancies as and when they arise
- 2 To evaluate the balance of skills, knowledge and experience on the Hermes Board in order to prepare a description of the role and capabilities required for a particular appointment
- 3 To review annually the time required from a non-executive director
- 4 To give full consideration to succession planning
- 5 To regularly review the structure, size and composition of the Hermes Board and make recommendations to the Board with regard to any changes
- 6 To keep under review the leadership needs of Hermes, both executive and non-executive
- 7 To keep under review the performance of the non-executive directors of the Company
- 8 To keep under review the performance of the Chief Executive Officer of the Company
- 9 To review annually the Nomination Committee's effectiveness and its terms of reference and make any proposals for change to the Hermes Board
- 10 To ensure that on appointment to the Hermes Board, non-executive directors receive a formal letter of appointment setting out what is expected of them
- 11 To approve the appointment of any director to the board of a subsidiary operating company of Hermes

#### **WORK OF THE COMMITTEE IN 2006**

During the year the Committee approved the appointments of Mark Anson and Roger Gray to the Board of Hermes Pensions Management Limited. The Committee also approved a number of appointments to the Boards of subsidiary operating companies.

**HERMES PENSIONS MANAGEMENT LIMITED****STATEMENT OF DIRECTORS' RESPONSIBILITIES**

The directors are responsible for preparing the Annual Report and the financial statements. The directors have chosen to prepare the accounts for the Company and the Group in accordance with United Kingdom Generally Accepted Accounting Practice (UKGAAP).

Company law requires the directors to prepare such financial statements for each financial year which give a true and fair view in accordance with UKGAAP of the state of affairs of the Company and of the Group and of the profit or loss of the Company for that period and comply with UK GAAP and the Companies Act 1985.

In preparing those 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 accounting standards have been followed, and
- 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 which disclose with reasonable accuracy at any time the financial position of the Company and the Group and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for the system of internal control, for safeguarding the assets of the Company and the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

## **INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF HERMES PENSIONS MANAGEMENT LIMITED**

We have audited the group and parent company financial statements of Hermes Pensions Management Limited for the year ended 31<sup>st</sup> December 2006 which comprise Group Profit and Loss Account, the Group and Company Balance Sheets, the Group Cash Flow Statement, the Group Statement of Total Recognised Gains and Losses and the related notes 1 to 29. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' 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 company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### **Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any further information outside the Annual Report.

**INDEPENDENT AUDITORS' REPORT TO THE MEMBER OF  
HERMES PENSIONS MANAGEMENT LIMITED (CONTINUED)**

**Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

**Opinion**

In our opinion

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the group's and the parent company's affairs as at 31<sup>st</sup> December 2006 and of the group's profit for the year then ended,
- the financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Directors' Report is consistent with the financial statements



**Deloitte & Touche LLP**

Chartered Accountants and Registered Auditors  
London

30 April 2007



**HERMES PENSIONS MANAGEMENT LIMITED**  
**CONSOLIDATED PROFIT AND LOSS ACCOUNT**  
**FOR THE YEAR ENDED 31 DECEMBER 2006**

	Notes	2006 £'000	2005 Restated £'000
TURNOVER	1	115,555	84,221
Administrative expenses		<u>(100,173)</u>	<u>(77,062)</u>
OPERATING PROFIT		15,382	7,159
Share of net operating profit of associates	2	323	387
Dividends receivable		24	259
Profit / (loss) on investments		<u>9,187</u>	<u>(6)</u>
PROFIT ON ORDINARY ACTIVITIES BEFORE INTEREST AND TAXATION		24,916	7,799
Interest receivable and similar income			
- Group		3,613	2,340
- associates		-	83
Other finance income	16	500	300
Interest payable			
- Group	3	(850)	(990)
- associates	3	<u>(5)</u>	<u>(4)</u>
PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION	4	28,174	9,528
Tax on profit on ordinary activities	6	<u>451</u>	<u>(1,705)</u>
PROFIT ON ORDINARY ACTIVITIES AFTER TAXATION		28,625	7,823
Equity minority interests	25	<u>(9)</u>	<u>(8)</u>
RETAINED PROFIT FOR THE FINANCIAL YEAR	18	<u>28,616</u>	<u>7,815</u>

All of the results are derived from continuing operations

**HERMES PENSIONS MANAGEMENT LIMITED****CONSOLIDATED STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES  
FOR THE YEAR ENDED 31 DECEMBER 2006**

	Notes	2006 £'000	2005 Restated £'000
Retained profit for the financial year		28,616	7,815
Unrealised surplus on revaluation of investments		-	126
Foreign exchange translation difference on foreign currency investment in associate		-	(8)
		<hr/> 28,616	<hr/> 7,933
Defined Benefit Pension Scheme – Actuarial gain on assets	16	2,000	6,300
Defined Benefit Pension Scheme – Actuarial gain on liabilities	16	3,400	200
Defined Benefit Pension Scheme – Actuarial loss on change in assumptions	16	(2,900)	(7,300)
Deferred tax credit – reduction in pension liabilities	6	3,698	-
Total recognised gains relating to the Year	18	<hr/> 34,814	<hr/> 7,133

**HERMES PENSIONS MANAGEMENT LIMITED****CONSOLIDATED BALANCE SHEET AT 31 DECEMBER 2006**

	Notes	2006 £'000	2005 Restated £'000
<b>FIXED ASSETS</b>			
Intangible assets – goodwill	9	4,508	5,303
Tangible assets	10	7,775	6,345
Investments	11	1,258	8,521
		<u>13,541</u>	<u>20,169</u>
<b>CURRENT ASSETS</b>			
Insurance assets attributable to unit-linked policyholders	12	22,091,679	20,334,796
Debtors	14	52,256	26,592
Cash at bank and in hand		97,253	71,453
		<u>22,241,188</u>	<u>20,432,841</u>
<b>CREDITORS - amounts falling due within one year</b>	15	(71,604)	(55,472)
Amounts due to unit-linked policyholders	12	<u>(22,091,679)</u>	<u>(20,334,796)</u>
<b>NET CURRENT ASSETS</b>		<u>77,905</u>	<u>42,573</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>		<u>91,446</u>	<u>62,742</u>
<b>CREDITORS - amounts falling due after more than one year</b>	15	<u>(10,338)</u>	<u>(5,476)</u>
<b>NET ASSETS EXCLUDING PENSION LIABILITIES</b>		<u>81,108</u>	<u>57,266</u>
Pension liabilities	16	<u>(10,360)</u>	<u>(16,600)</u>
<b>NET ASSETS INCLUDING PENSION LIABILITIES</b>		<u>70,748</u>	<u>40,666</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital	17	30,000	30,000
Revaluation reserves	18	-	252
Non-distributable capital reserves	18	98	98
Capital contribution from parent company	18	510	510
Profit and loss account	18	39,996	9,671
<b>EQUITY SHAREHOLDER'S FUNDS</b>		<u>70,604</u>	<u>40,531</u>
Minority Interest	25	<u>144</u>	<u>135</u>
<b>TOTAL CAPITAL EMPLOYED</b>		<u>70,748</u>	<u>40,666</u>

These financial statements were approved by the Board of Directors and authorised for issue on 24 April 2007

Signed on behalf of the Board of Directors



M Anson  
Director

**HERMES PENSIONS MANAGEMENT LIMITED****COMPANY BALANCE SHEET AT 31 DECEMBER 2006**

	Notes	2006 £'000	2005 Restated £'000
<b>FIXED ASSETS</b>			
Tangible assets	10	7,775	6,345
Investments	11	26,782	25,993
		<u>34,557</u>	<u>32,338</u>
<b>CURRENT ASSETS</b>			
Debtors	14	40,676	23,271
Cash at bank and in hand		13,670	22,019
		<u>54,346</u>	<u>45,290</u>
CREDITORS - amounts falling due within one year	15	(37,473)	(40,942)
<b>NET CURRENT ASSETS</b>		<u>16,873</u>	<u>4,348</u>
<b>TOTAL ASSETS LESS CURRENT LIABILITIES</b>		51,430	36,686
CREDITORS – amounts falling due after more than one year	15	(10,338)	(2,607)
<b>NET ASSETS EXCLUDING PENSION LIABILITIES</b>		<u>41,092</u>	<u>34,079</u>
Pension liabilities	16	(10,360)	(16,600)
<b>NET ASSETS INCLUDING PENSION LIABILITIES</b>		<u>30,732</u>	<u>17,479</u>
<b>CAPITAL AND RESERVES</b>			
Called up share capital	17	30,000	30,000
Capital contribution from parent company	18	510	510
Profit and loss account	18	222	(13,031)
<b>EQUITY SHAREHOLDER'S FUNDS</b>		<u>30,732</u>	<u>17,479</u>

These financial statements were approved by the Board of Directors and authorised for issue on 24 April 2007

Signed on behalf of the Board of Directors



M Anson  
Director

**HERMES PENSIONS MANAGEMENT LIMITED****CONSOLIDATED CASH FLOW STATEMENT  
FOR THE YEAR ENDED 31 DECEMBER 2006**

	Notes	2006 £'000	2005 Restated £'000
NET CASH INFLOW FROM OPERATING ACTIVITIES	20	<u>17,821</u>	<u>17,633</u>
RETURNS ON INVESTMENTS AND SERVICING OF FINANCE			
Interest received		3,613	2,210
Interest paid		(850)	(990)
Dividends paid		(1,020)	(510)
Dividends received from associates		24	259
NET CASH INFLOW FROM RETURNS ON INVESTMENTS AND SERVICING OF FINANCE		<u>1,767</u>	<u>969</u>
TAXATION			
Corporation tax paid		(2,903)	(1,760)
TAX PAID		<u>(2,903)</u>	<u>(1,760)</u>
CAPITAL EXPENDITURE AND FINANCIAL INVESTMENT			
Payments to acquire tangible fixed assets	10	(3,872)	(2,007)
Purchase of investments		(789)	(106)
Sale of investments		13,786	-
NET CASH INFLOW /(OUTFLOW) FROM CAPITAL EXPENDITURE AND FINANCIAL INVESTMENT		<u>9,125</u>	<u>(2,113)</u>
NET CASH INFLOW BEFORE FINANCING		<u>25,810</u>	<u>14,729</u>
FINANCING			
Loan to associate		(10)	(94)
NET CASH INFLOW FROM FINANCING		<u>(10)</u>	<u>(94)</u>
INCREASE IN CASH	21	<u><u>25,800</u></u>	<u><u>14,635</u></u>

## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006

#### ACCOUNTING POLICIES

The financial statements are prepared in accordance with applicable law and United Kingdom Accounting Standards. The particular accounting policies adopted by the directors are described below.

##### a) Changes in accounting policies

In accordance with FRS 26 the Group has opted not to restate comparative figures for the year ended 31st December 2005. The Group's prior year accounting policies have been used to prepare the comparative information. The main changes in the Group's financial statements result from the application of the definition of 'Insurance Contracts' to unit linked business. Contracts that contain significant insurance risk are classified as insurance contracts and contracts with insignificant transfer of risk from the policyholder to the Group are classified as financial instruments under FRS 26. All contracts issued by the Group are classified as investment contracts. On inception of such contracts, amounts received from the holders of contracts are accounted for as deposits and disclosed as 'investments held to cover unit-linked liabilities' and the associated obligation as 'liabilities for unit-linked investment contracts' on the balance sheet, they are not accounted as premiums or changes in technical provisions in the technical account. Similarly, cancellation of units at the point of claim are accounted for as a decrease in the balance sheet lines items and not as a claim payable in the technical account. Investments are valued at a bid price which represents a change from 2005 where investments were valued on a mid price basis.

##### b) Accounting convention

The financial statements are prepared under the historical cost convention except for the following:

- i) Fixed asset investments, which are held at a directors' valuation
- ii) Investments included in life insurance assets, which are revalued to bid value. This is a change in the policy adopted in previous years arising from the implementation of FRS 25 and FRS 26.

##### c) Turnover

Turnover is recognised on an accruals basis.

##### d) Basis of consolidation

The Group financial statements consolidate the financial statements of the Company and its subsidiary undertakings drawn up to 31 December each year. Acquisitions are accounted for in accordance with the provisions of FRS 6, as discussed in Note 27.

Subsidiary companies of the group include general partners of limited partnerships where the substance of the arrangements is that the group provides investment management services in return for investment management fees. The group's beneficial interest in the limited partnerships is restricted to the fees it earns from managing the partnerships. Furthermore, the limited partnerships were set up for the beneficial interest of external

## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### ACCOUNTING POLICIES (continued)

##### d) Basis of consolidation (continued)

parties who collectively own the entire equity of the partnerships. The directors have departed from the Companies Act 1985 requirements and accounted for the interests in such partnerships at cost on the basis that this reflected the substance of the arrangements and to consolidate would not give a true and fair view. The effect of this departure is quantified in note 23.

##### e) Goodwill

Goodwill arising in respect of acquisitions is capitalised in the year in which it arises within intangible fixed assets and amortised over its estimated useful life up to a maximum of 20 years with a full year's charge for amortisation in the year of acquisition. The directors regard the following as the estimated useful lives of goodwill arising in those acquisitions:

Hermes Focus Asset Management Ltd	- 20 years
Hermes Assured Ltd	- 5 years

##### f) Associates

In the Group financial statements investments in associates are accounted for using the equity method. The consolidated profit and loss account includes the Group's share of associates' profits less losses while the Group's share of the net assets of the associates is shown in the consolidated balance sheet. Goodwill arising on the acquisition of associates is accounted for in accordance with the policy set out above. Any unamortised balance of goodwill is included in the carrying value of the investment in associates.

##### g) Foreign exchange

Transactions denominated in foreign currencies are translated into the functional currency at the rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are retranslated at the rates ruling at that date. These translation differences are dealt with in the profit and loss account.

##### h) Tangible fixed assets

Depreciation is provided on cost in equal annual instalments over the estimated useful lives of the assets. The expected useful lives are as follows:

Fixtures, fittings and equipment	- 4 years
Leasehold improvements	- Period of the lease

##### i) Financial assets and liabilities

Investments are recognised and derecognised on a trade basis where the purchase or sale of an investment is under a contract whose terms require delivery of the investment within the timeframe established by the market concerned, and are initially measured at fair value, net of transaction costs except for those financial assets classified as at fair value through profit or loss,

## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### ACCOUNTING POLICIES (continued)

##### i) Financial assets and liabilities (continued)

which are initially measured at fair value

Financial assets are classified into the following specified categories: financial assets as 'at fair value through profit or loss' (FVTPL) or 'loans and receivables'. The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

##### Effective interest method

The effective interest method is a method of calculating the amortised cost of a financial asset and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset, or, where appropriate, a shorter period.

Income is recognised on an effective interest basis for debt instruments other than those financial assets designated as at FVTPL.

##### Financial assets at FVTPL

Financial assets are classified as at FVTPL where the financial asset is either held for trading or it is designated as at FVTPL.

A financial asset is held for trading if

It has been acquired principally for the purpose of selling in the near future, or

It is a part of an identified portfolio of financial instruments that the Company manages together and has a recent actual pattern of short-term profit-taking, or

It is a derivative that is not designated and effective as a hedging instrument.

A financial asset other than a financial asset held for trading may be designated as at FVTPL upon initial recognition if

Such designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise, or

The financial asset forms part of a Group of financial assets or financial liabilities or both, which is managed and its performance is evaluated on a fair value basis, in accordance with the Company's documented risk management or investment strategy, and information about the Grouping is provided internally on that basis, or

It forms part of a contract containing one or more embedded derivatives and FRS 26 permits the entire combined contract (asset or liability) to be designated as at FVTPL.

Financial assets at FVTPL are stated at fair value, with any resultant gain or loss recognised in profit or loss. The net gain or loss recognised in profit or loss incorporates any dividend or interest earned on the financial asset.



## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### ACCOUNTING POLICIES (continued)

##### i) Financial assets and liabilities (continued)

The following methods are used to determine the fair value of financial assets and liabilities,

Equity securities are valued at quoted market bid prices

Fixed maturity securities are valued at quoted market bid prices

Derivatives are valued at quoted market bid prices

Cash and deposits are valued at actual amounts with consideration made with regard to any possible impairment

##### Loans and receivables

Trade receivables, loans and other receivables that have fixed or determinable payments that are not quoted in an active market are classified as 'loans and receivables'. Loans and receivables are measured at amortised costs using the effective interest method less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables where the recognition of interest would be immaterial.

##### Impairment of financial assets

Financial assets, other than those at FVTPL, are assessed for indicators of impairment at each balance sheet date. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted. For financial assets carried at amortised cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of estimated cash flows, discounted at the original effective interest rate.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets with the exception of trade receivables where the carrying amount is reduced through the use of an allowance account. When a trade receivable is uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are credited against the allowance account. Changes in the carrying amount of the allowance account are recognised in profit or loss.

If, in a subsequent period the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through profit or loss to the extent that the carrying amount of the investment at the date the impairment was reversed does not exceed what the amortised cost would have been had the impairment not been recognised.

##### Other financial liabilities

Other financial liabilities including borrowings are initially measured at fair value net of transaction costs.

## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### ACCOUNTING POLICIES (continued)

i) Financial assets and liabilities (continued)

Other financial liabilities are subsequently measured at amortised cost using the effective interest method with interest expenses recognised on an effective yield basis

The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period

The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or where appropriate a shorter period

j) Operating leases

Rentals in respect of operating leases are charged to the profit and loss account on a straight-line basis over the period of the lease

k) Pension benefits

Pension benefits under the Group's defined benefit scheme are funded over the employees' periods of service. The Company's contributions are based on the most recent actuarial valuation of the fund as at 30 June 2006. Pension benefits are accounted for in accordance with FRS17 as disclosed in note 16

l) Investment income

Income from investments is accounted for on an accruals basis

m) Bonus costs

Provision is made for bonuses attributable to performance prior to the balance sheet date

n) Deferred taxation

Deferred taxation is provided in full on timing differences that result in an obligation at the balance sheet date to pay more tax, or a right to pay less tax at a future date, at rates expected to apply when they crystallise based on current tax rates and law. Timing differences arise from the inclusion of items of income and expenditure in taxation computations in periods different from those in which they are included in financial statements. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered. Deferred tax balances are not discounted

o) Current taxation

Current tax, including UK corporation tax and foreign tax, is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date

## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### ACCOUNTING POLICIES (continued)

p) Long-term life insurance business

Assets attributable to unit-linked policyholders are valued at bid value  
Amounts due to unit-linked policyholders represent the value of in force units at the balance sheet date

Expenses incurred in the operation and establishment of the Life business are deducted in arriving at operating profit

q) Risk categories

The Group has in place a system of controls and processes to mitigate the risks identified

*Credit Risk*

i) Fund specific – Within a number of the funds operated by Hermes Assured Limited (HAL), particularly fixed interest funds, HAL takes investment positions gaining exposure to other parties. Applicable limits are stated in the objectives and constraints of each fund. The risk is assessed by qualified and trained professionals using a range of information and tools

ii) Transaction related – An inevitable consequence of investment transactions within the HAL funds is the involvement of counterparties, particularly brokers. A process is in place to assess the suitability of counterparties

iii) Insurance contract related – All insurance contracts entered into by HAL include annual management charges (AMC) to be paid by the policyholders. A risk assessment of policy holders is carried out prior to policy acceptance

*Market Risk*

HAL's investment policies are structured in a way that matches liabilities with assets i.e. the policies match the mandated portfolios and if the Company (and its appointed fund manager Hermes Investment Management Limited – another Company within the Group) operate within the set parameters of the funds Objectives and Constraints then any Market Risk connected with the funds lies with the policyholders and not the Company

The fund manager has a number of methods for reviewing fund performance and ensuring adherence to fund mandates. Portfolio / fund performance is reviewed by an individual Investment Analyst, overseen by the Investment Director and discussed regularly with the Chief Investment Officer

*Liquidity Risk*

The Company's liquidity risk relates to its cash dealings with clients, day to day dealing activity, the funding of operational expenses and meeting solvency requirements as determined by the regulator (Financial Services Authority)

The Business Support Committee of the Company is assured, on a monthly basis, that day to day regulatory solvency has been maintained. The Company

# HERMES PENSIONS MANAGEMENT LIMITED

## NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

### ACCOUNTING POLICIES (continued)

#### q) Risk categories (continued)

retains a high level of liquidity to ensure that regulatory solvency requirements are continuously met. There is a funding arrangement in place with the ultimate parent organisation, the BT Pension Scheme, should this be required at any point.

#### *Operational Risk*

Operational Risk occurs in all areas of the Group's activities. Risk assessments are carried out annually and considered by the Board. The Board is also advised of key performance indicators and made aware of any significant errors or omissions that have occurred on a quarterly basis.

#### *Insurance Risk*

The type of business operated by the Group indicates that there is no insurance risk. The Group does not operate guaranteed or with profits policies and policy cash inflows are reviewable and may vary in size. Policy fees are set at a level above the marginal cost of operating the funds.

#### *Interest rate Risk*

The type of business operated by the Group indicates that there is no significant interest rate risk.

## 1 TURNOVER

Turnover comprises the value of services provided in the UK by the Group exclusive of VAT and is analysed as follows:

	2006 £'000	2005 Restated £'000
Continuing operations		
Investment management services	107,840	76,607
Miscellaneous fees	1,286	2,610
Recharge to associate	376	-
Recharges to Focus Funds	302	864
Management fees from assurance activities	5,751	4,140
	<u>115,555</u>	<u>84,221</u>

Investment management services include performance fees based upon rolling three year performance periods. These are recognised in the year the performance period ends.

All of the Group's operations are that of investment management and are carried out in the United Kingdom.

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****2 ASSOCIATES****Share of Net Operating Profit of Associates**

	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>Restated</b>
		<b>£'000</b>
35 9% share of Innisfree operating profit	-	260
40% share of UOB Hermes Asia Management Plc	38	-
33% share of Nippon Life Investments Europe	289	-
25% share of Activa operating (loss) / profit	(2)	129
Amortisation of goodwill in Activa	(2)	(2)
	<u>323</u>	<u>387</u>

The Company had the following interests in the performance and position of its associates at 31 December 2006

<b>Innisfree</b>	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>£'000</b>
Turnover	-	4,670
Profit before tax	-	660
Tax	-	(159)
Profit after tax	-	501
Fixed assets	-	37
Current assets	-	6,627
Current liabilities	-	(2,560)
Long term liabilities	-	(1,080)

Hermes Investment Management Limited sold its holding in Innisfree on 10 April 2006

<b>Activa</b>	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>£'000</b>
Turnover	767	668
Profit before tax	37	131
Tax	(14)	(29)
Profit after tax	23	102
Fixed assets	48	43
Current assets	630	318
Current liabilities	(531)	(176)

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****2 ASSOCIATES (continued)**

<b>NLI Investments Europe Ltd</b>	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>£'000</b>
Turnover	913	-
Profit before tax	316	-
Tax	(98)	-
Profit after tax	218	-
Fixed assets	-	-
Current assets	1,232	-
Current liabilities	284	-

The Company acquired a 33% holding in NLI Investments Europe Ltd on 30 January 2006

<b>Hermes UOB Asia Limited</b>	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>£'000</b>
Turnover	293	-
Profit before tax	20	-
Tax	(2)	-
Profit after tax	18	-
Fixed assets	-	-
Current assets	54	-
Current liabilities	3	-

**3 INTEREST PAYABLE**

	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>£'000</b>
Interest payable or similar charges in respect of		
Bank loans and overdrafts (excluding Group loans)	-	2
Interest on loans from ultimate parent	850	988
Interest from associates	5	4
	<u>855</u>	<u>994</u>

Interest payable to the ultimate parent relates to the loan from the BT Pension Scheme as indicated in Note 15 – Creditors

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****4 PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION**

	2006 £'000	2005 £'000
Profit on ordinary activities before taxation is stated after charging		
Depreciation of tangible fixed assets	2,442	2,580
Amortisation of goodwill	795	794
Rentals under operating leases		
- Charges	1,352	741
- Receipts	(216)	(216)
Auditors' remuneration		
Audit fees - Group	120	187
- Company	32	22
Regulatory reporting	31	30
Other services		
- Group Tax services	83	63
Management consultancy	338	129
Further assurance work	23	20
- Company Tax services	50	40

Fees payable to the company's auditors and their associates in respect of associated pension schemes were £15,000 (2005 - £5,000)

**5 INFORMATION REGARDING DIRECTORS AND EMPLOYEES**

Total emoluments of directors excluding pension contributions were

Directors	Salary £	Annual bonus £	Benefits £	Long term incentive scheme £	Fees £	Total 2006 £	Total 2005 £
M G Quirke	207,417	518,400	9,819	823,200	-	1,558,836	465,463
M Anson	280,769	799,400	11,884	250,200	-	1,342,253	-
D J Pitt-Watson	98,370	412,437	4,350	86,834	-	601,991	1,319,091
R Gray	53,846	100,000	2,692	-	-	156,538	-
C M Metcalfe	138,305	-	7,364	-	-	145,669	858,163
N C W Mustoe	88,063	-	4,208	-	-	92,271	969,891
A Watson	32,551	-	1,298	-	-	33,849	1,770,582
R Bernays	-	-	-	-	79,167	79,167	50,000
D R Barford	-	-	-	-	25,000	25,000	-
D W Davies	-	-	-	-	50,000	50,000	40,000
J A Biles	-	-	-	-	35,000	35,000	11,666
Sir Tim Chessells	-	-	-	-	-	-	-
<b>TOTAL</b>	<b>899,321</b>	<b>1,830,237</b>	<b>41,615</b>	<b>1,160,234</b>	<b>189,167</b>	<b>4,120,574</b>	<b>5,484,856</b>

Fees paid to non-executive directors include amounts for Chairing the Audit Committee (J A Biles), for Chairing the Remuneration Committee and as Chairman of Hermes Assured Limited (D W Davies)

Fees exclude any amounts for acting as a trustee of BTPS as detailed in note 24

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****5 INFORMATION REGARDING DIRECTORS AND EMPLOYEES (continued)**

The following changes in directorship have taken place during 2005 and 2006 affecting comparison between the yearly totals,

J A Biles – appointed 1 September 2005  
 D R Barford – appointed 1 January 2006  
 M Anson – appointed 31 January 2006  
 A Watson – resigned 31 January 2006  
 D J Pitt-Watson – resigned 1 May 2006  
 C M Metcalfe – resigned 18 September 2006  
 N C W Mustoe – resigned 31 May 2006  
 R Gray – appointed 20 October 2006

The long term incentive scheme amount relating to D J Pitt-Watson relates to the additional value earned in 2006 under the five year Shadow Option Scheme up to his resignation on 1 May 2006. This scheme is classified as a cash-settled share option scheme under FRS 20 Share-based payment. Options are exercisable at a price based on the Enterprise Value Model which values the Company based on its profits multiplied by the market price earnings ratio at the year end. This calculation is updated every year and options re-valued accordingly. Options vest equally in the three instalments being 3, 4 and 5 years after the date of the grant. Options are forfeited if the employee leaves the Company before the options vest.

The annual bonus and long term incentive scheme rewards together comprise 71% (2005 – 80%) of total emoluments. These rewards are based on the results of the Group, investment performance and the successful completion of individual management objectives.

Amounts awarded to all excluding D J Pitt-Watson under the Hermes Group long-term incentive plan are payable in two tranches. 50% is payable in March 2007 and the remaining 50% is payable in March 2009. The amount awarded to D J Pitt-Watson was paid at the resignation date.

The Company's pension scheme is a defined benefit scheme and the accrued benefit of the highest paid director was £4,366 (2005 - £2,488). The total number of directors who accrue benefits under the scheme is 2 (2005 - 4).

	2006 No	2005 No.
Average number of persons employed by the Group and Company in the year		
Investment management	176	164
Administration	144	134
	<u>320</u>	<u>298</u>



**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****5 INFORMATION REGARDING DIRECTORS AND EMPLOYEES (continued)**

	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>£'000</b>
Staff costs during the year in respect of these directors and employees were		
Wages and salaries	72,380	35,117
Social security costs	4,569	3,830
Pension cost related to Group scheme (see Note 16)	4,400	3,400
Unfunded pension costs	200	84
	<u>81,549</u>	<u>42,431</u>

The unfunded pension cost relates to the increase in the year in the Company's liability to pay a pension in excess of that provided by the Hermes Group Pension Scheme

**6 TAX ON PROFIT ON ORDINARY ACTIVITIES**

	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>Restated £'000</b>
a) Profit and loss account		
UK corporation tax at 30%	5,745	1,306
Share of tax charge in associate	134	188
Adjustment in respect of prior periods	(13)	90
	<u>5,866</u>	<u>1,584</u>
Deferred tax		
Time differences, origination and reversal	(5,625)	163
Adjustment in respect of prior periods	(692)	(42)
Tax on profit on ordinary activities	<u>(451)</u>	<u>1,705</u>
Statement of total recognised gains and losses		
Deferred tax		
Time differences, origination and reversal	750	-
Adjustment in respect of prior periods	(4,448)	-
Total deferred tax	<u>(3,698)</u>	<u>-</u>
Total tax on items in statement on total recognised gains and losses	<u>3,698</u>	<u>-</u>

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****6 TAX ON PROFIT ON ORDINARY ACTIVITIES (continued)**

- b) The tax charged in the period is lower than the standard rate of corporation tax in the UK (30%) The differences are explained below

	2006 £'000	2005 Restated £'000
Profit on ordinary activities multiplied by the standard rate of corporation tax in the UK of 30% (2005 - 30%)	8,452	2,858
Non-taxable income	(2,230)	(2,420)
Capital allowances in excess of depreciation not provided for in deferred tax	(789)	149
Short term timing differences not provided for in deferred tax	975	1,030
Tax losses	(529)	(123)
Adjustment in respect of prior periods	(13)	90
	<u>5,866</u>	<u>1,584</u>

	2006 Provided £'000	2006 Unprovided £'000	2005 Provided £'000	2005 Unprovided £'000
c) <b>The Group</b>				
Deferred tax asset				
Accelerated capital allowances	(2,468)	(2)	-	(3,182)
Tax losses	(983)	(188)	(227)	(147)
Short term timing differences	(2,411)	(1,226)	(60)	(9,094)
	<u>(5,862)</u>	<u>(1,416)</u>	<u>(287)</u>	<u>(12,423)</u>

**The Company**

## Deferred tax asset

Accelerated capital allowances	(2,468)	-	-	(3,179)
Short term timing differences	(3,564)	-	-	(6,454)
	<u>(6,032)</u>	<u>-</u>	<u>-</u>	<u>(9,633)</u>

The deferred tax assets of £5,862,000 (2005 - £287,000) have been recognised in 2006 as there is now sufficient certainty of recovery of those assets within a relatively short period of time. Deferred tax assets totalling £1,416,000 (2005 - £12,423,000) have not been recognised in respect of losses and short term timing differences as the Group is not sufficiently certain that it will be able to recover those assets within a relatively short period of time.

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****6 TAX ON PROFIT ON ORDINARY ACTIVITIES (continued)**

	Group £'000
d) <b>Movement on Deferred Tax</b>	
1 January 2006	(287)
Inadmissible assets	1,469
Tax losses	(983)
Short term timing differences	(3,593)
Capital allowances	(2,468)
31 December 2006	<u>(5,862)</u>

**7 CAPITAL STATEMENTS**

The capital statements shown below relate to Insurance business within Hermes Assured Limited, a wholly owned subsidiary

**Available capital**

	UK Non-participating £'000	Life Business Shareholders Funds £'000	Total Life Business £'000
Shareholders funds outside fund	-	4,417	4,417
Shareholders funds held in fund	6,543	-	6,543
<b>Total shareholders funds</b>	<b>6,543</b>	<b>4,417</b>	<b>10,960</b>
Adjustments onto regulatory basis			
Assets inadmissible for regulatory purposes	(5,898)	(4,285)	(10,183)
<b>Total available capital resources</b>	<b>645</b>	<b>132</b>	<b>777</b>

The Company has linked liabilities due of £22,091,679,000 (2005 £20,334,796,000) These are fully matched by linked assets

There is no other qualifying capital within the Company

**Capital movements**

	UK Non-participating £'000	Life Business Shareholders Funds £'000	Total Life Business £'000
<b>Total available capital resources</b>			
<b>1 January 2006</b>	<b>3,495</b>	<b>4,200</b>	<b>7,695</b>
New business and other factors	(2,850)	(4,068)	(6,918)
<b>Total available capital resources</b>	<b>645</b>	<b>132</b>	<b>777</b>
<b>31 December 2006</b>			

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****7 CAPITAL STATEMENTS (continued)**

The Company operates a non-participating fund within the United Kingdom. It does not have any with profit funds and it does not have any overseas operations.

The total available capital resources for each section of the statement shows the capital on a regulatory basis that is available to meet the regulatory capital requirements of that part of the business.

The available surplus held in the non-participating fund is attributable to shareholders, and, subject to meeting the regulatory requirements of this business this capital is available to meet requirements elsewhere in the Company. Any transfer of surplus may give rise to a tax charge.

The non-participating fund must meet the minimum solvency requirements determined in accordance with Financial Services Authority (FSA) regulations. At 31 December 2006 the Company reported a deficiency of capital of £1,362,000 against a capital requirement of £2,139,000. This situation arose as a result of a technical breach of admissibility limits which existed between 29 December 2006 and 2 January 2007. These limits state that a maximum of £2,000,000 can be held with any one counterparty. At 31 December 2006 £11,316,000 was held on deposit with the Company's bankers, RBS. This situation was rectified on 2 January 2007. The FSA was notified of this occurrence. At no point during the year did the Company, in reality, have negative assets.

**8 PROFIT OF THE PARENT COMPANY**

As permitted by Section 230 of the Companies Act, the profit and loss account of the parent Company is not presented as part of these accounts. The parent Company's profit for the year amounted to £7,055,000 (2005 Restated - £6,004,000).

**9 INTANGIBLE FIXED ASSETS**

	<b>Goodwill £'000</b>
<b>The Group</b>	
Cost	
At 1 January 2006 and 31 December 2006	<u>8,614</u>
Accumulated amortisation	
At 1 January 2006	3,311
Charge for the year	795
At 31 December 2006	<u>4,106</u>
Net book value	
At 31 December 2006	<u><u>4,508</u></u>
At 31 December 2005	<u><u>5,303</u></u>

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****10 TANGIBLE FIXED ASSETS**

	Leasehold improvements £'000	Fixtures, Fittings and equipment £'000	Total £'000
<b>The Group and the Company</b>			
Cost			
At 1 January 2006	5,972	9,111	15,083
Additions	(199)	4,071	3,872
Disposals	-	(3,128)	(3,128)
At 31 December 2006	5,773	10,054	15,827
Accumulated depreciation			
At 1 January 2006	2,411	6,327	8,738
Charge for the year	259	2,183	2,442
Disposals	-	(3,128)	(3,128)
At 31 December 2006	2,670	5,382	8,052
Net book value			
At 31 December 2006	3,103	4,672	7,775
At 31 December 2005	3,561	2,784	6,345

**11 INVESTMENTS HELD AS FIXED ASSETS**

	Investment in associates £'000	Listed investments £'000	Unlisted Investments £'000	Total £'000
<b>The Group</b>				
At 1 January 2006 as restated	3,696	4,808	17	8,521
Reclassification of investment	15	-	(15)	-
Share of retained profit for the year	58	-	-	58
Loan to associate	105	-	-	105
Acquisition	777	-	12	789
Disposal	(3,405)	(4,808)	-	(8,213)
Goodwill amortisation	(2)	-	-	(2)
At 31 December 2006	1,244	-	14	1,258

The Group has implemented the provisions of FRS 25/26 in this years financial statements and has applied the relevant accounting policy in considering the value of each class of asset. There was no financial impact on the figures provided above as a result of this exercise.

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****11 INVESTMENTS HELD AS FIXED ASSETS (continued)**

The Investments in associates are

	<b>£'000</b>
<b>Activa</b>	
Share of net assets	119
Loans to associate	105
Goodwill arising on acquisition less amortisation	22
	<u>246</u>
<b>NLI Investments Europe</b>	
Share of net assets	<u>947</u>
<b>Hermes UOB Asia</b>	
Share of net assets	<u>53</u>

**£'000**

**The Company****Shares in subsidiary and associate undertakings**

At 1 January 2006 as restated	25,993
Purchase of shares	777
31 December 2006	<u>26,770</u>
Other investment	12
	<u>26,782</u>

On 10 April 2006 Hermes Investment Management Ltd sold the Company's holding of 107,600 shares in Innisfree Ltd

On 30 January 2006 the Company acquired 2000 shares (33% of the issued share capital) in NLI Investments Europe Limited at a cost of £777,000

On 13 December 2006 the parent company of HPML – BT Pension Scheme gifted its shares worth £510,000 in HFAME to the Company. The Company also acquired shares worth £457,000 in HFAME from subsidiary HFAM, at cost

Information on subsidiaries and associates is disclosed in note 22

# **HERMES PENSIONS MANAGEMENT LIMITED**

## **NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)**

### **12 INSURANCE ASSETS ATTRIBUTABLE TO UNIT-LINKED POLICYHOLDERS**

#### **The Group**

All insurance assets and liabilities relate to Hermes Assured Limited, a wholly owned subsidiary of the Company and are as follows

- a) At 31 December 2006, the insurance assets attributable to unit-linked policyholders comprised

	2006 £'000	2005 £'000
Equities and unit trusts	14,490,102	13,914,474
Overseas investments	6,697,483	5,553,784
Fixed interest stocks	839,970	720,084
Cash unit trusts	2,261	10,553
Cash	5,188	82,433
Derivatives	1,137	910
Dividends and accrued interest	55,538	52,558
Total insurance assets	22,091,679	20,334,796
Amounts due to unit-linked policyholders	22,091,679	20,334,796

Implementation, in 2006, of FRS 25 and FRS 26 required a revision of investment valuation from a market value to a fair value amount for the 2006 results. This adjustment reduced the value of assets by £21,422,000 as indicated in Note 13. Changes in value of technical provisions. This is matched by an adjustment to the linked liabilities of the Company. In the above table Market value in 2005 represents a mid market price and Fair Value in 2006 represents a bid value price. This change in treatment arises as a result of the implementation of FRS 25 and FRS 26.

- b) At 31 December, the summarised income and expenditure account of the Life business comprised

	2006 £'000	2005 £'000
Gross premiums written	-	9,550,839
Net claims incurred	-	(1,040,412)
Unrealised gains	1,377,542	2,481,876
Realised gains	558,843	344,703
Investment income receivable	624,329	491,306
Other technical income	6,002	4,340
Change in technical provisions for linked liabilities	(2,560,714)	(11,828,312)
Net operating expenses	(3,957)	(3,684)
Balance on long term business technical account	2,045	656

Under the provisions of FRS 25 and FRS 26 the contracts provided by Hermes Assured Limited are now classified as investment rather than insurance contracts. As a result of this change there are no Gross premiums written or Net claims incurred in 2006. The comparable figures are shown as Cash inflows and outflows in Note 13.

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****13 CHANGE IN VALUE OF TECHNICAL PROVISIONS****The Group**

	<b>2006 £'000</b>	<b>2005 £'000</b>
Opening technical provision for linked liabilities	20,334,796	8,506,484
Change in technical provisions	2,560,714	11,828,312
Cash inflows arising from investment contracts	1,277,348	-
Cash outflows arising from investment contracts	(2,081,179)	-
	<u>22,091,679</u>	<u>20,334,796</u>

The Change in technical provisions figure incorporates a £21,422,000 adjustment arising from the implementation of FRS 25 and FRS 26 and adoption of bid price rather than mid price valuation of assets

**14 DEBTORS**

	<b>2006</b>		<b>2005</b>	
	<b>Group £'000</b>	<b>Company £'000</b>	<b>Group Restated £'000</b>	<b>Company £'000</b>
Due within one year				
Owed by subsidiaries	-	22,776	-	12,871
Owed by associates	259	140	235	730
Owed by parent	7,067	123	1,536	298
Trade debtors	2,128	442	20,223	369
Taxation	7,371	6,606	2,515	1,343
Other debtors	2,675	2,539	589	1,178
Prepayments and accrued income	<u>32,756</u>	<u>2,900</u>	<u>1,399</u>	<u>1,332</u>
	52,256	35,526	26,497	18,121
Due after one year				
Subordinated loan – subsidiary	-	5,000	-	5,000
Loan to associate	-	150	95	150
	<u>52,256</u>	<u>40,676</u>	<u>26,592</u>	<u>23,271</u>



**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****15 CREDITORS**

	<b>2006</b>		<b>2005</b>	
	<b>Group £'000</b>	<b>Company £'000</b>	<b>Group £'000</b>	<b>Company £'000</b>
Amounts falling due within one year				
Owed to parent	10,000	10,000	18,430	17,830
Other creditors	5,976	3,682	713	310
Unfunded pension liability	958	958	758	758
Accruals and prepaid income	54,670	22,833	35,571	22,044
	<u>71,604</u>	<u>37,473</u>	<u>55,472</u>	<u>40,942</u>
Amounts falling due after more than one year				
Other creditors	10,338	10,338	5,402	2,607
Deferred Taxation	-	-	74	-
	<u>10,338</u>	<u>10,338</u>	<u>5,476</u>	<u>2,607</u>

The amount owed to parent represents a loan from the BT Pension Scheme which is repayable on demand. The interest on the loan is calculated and paid quarterly at LIBOR + 1%.

**16 PENSION COMMITMENTS**

The Group operates a defined benefit scheme, Hermes Group Pension Scheme (the "Scheme"), funded by the payment of contributions to a separately administered trust fund.

The financial statements provide for full adoption of FRS 17 – Retirement Benefits.

Contributions to the Scheme are determined with the advice of independent qualified actuaries on the basis of triennial valuations using the Projected Unit method.

The actuarial valuation was updated at 31 December 2006 by a qualified actuary using assumptions that are consistent with the requirements of FRS 17. The most recent full valuation took place on 30 June 2006. Investments have been valued, for this purpose, at fair value.

The contributions of the Company throughout the year were 13.8% of pensionable payroll, in line with the Schedule of Contributions. Members of the scheme contribute 5% of pensionable earnings.

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****16 PENSION COMMITMENTS (continued)**

The major assumptions used for the actuarial valuation were

	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Rate of increase in salaries	3.0	2.8	2.8	2.8
Rate of increase in pensions in payment	3.0	2.8	2.8	2.8
Discount rate	5.1	4.75	5.3	5.4
Inflation assumption	3.0	2.8	2.8	2.8

The fair value of the assets in the Scheme, the present value of the liabilities in the Scheme and the expected rate of return at each balance sheet date were

	<b>2006</b>	<b>2006</b>	<b>2005</b>	<b>2005</b>	<b>2004</b>	<b>2004</b>	<b>2003</b>	<b>2003</b>
	<b>%</b>	<b>£m</b>	<b>%</b>	<b>£m</b>	<b>%</b>	<b>£m</b>	<b>%</b>	<b>£m</b>
Equities	7.70	46.4	7.70	40.5	8.25	32.0	8.25	28.3
Bonds	4.60	5.8	4.20	5.2	4.70	3.9	4.80	1.6
Other	5.90	7.1	5.60	5.1	6.60	4.0	6.40	3.3
Total fair value of assets		59.3		50.8		39.9		33.2
Present value of Scheme liabilities		(74.1)		(67.4)		(54.6)		(47.5)
Deferred tax credit		4.4		-		-		-
Deficit in the Scheme		<u>(10.4)</u>		<u>(16.6)</u>		<u>(14.7)</u>		<u>(14.3)</u>

Analysis of the amount that has been charged to operating profit

	<b>2006</b>	<b>2005</b>
	<b>£m</b>	<b>£m</b>
Current service cost	4.4	3.4
Total operating charge	<u>4.4</u>	<u>3.4</u>

Analysis of amounts included in Other finance income

	<b>2006</b>	<b>2005</b>
	<b>£m</b>	<b>£m</b>
Expected return on scheme assets	(3.7)	(3.2)
Interest on pension scheme liabilities	3.2	2.9
Net return	<u>(0.5)</u>	<u>(0.3)</u>

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****16 PENSION COMMITMENTS (continued)**

Analysis of the actuarial loss recognised in the statement of total recognised gains and losses

	2006 £m	2005 £m
Actual return less expected return on pension Scheme assets, i.e. gain	2 0	6 3
Experience gains and losses arising on the Scheme liabilities, i.e. gain	3 4	0 2
Changes in assumptions underlying the present value of the Scheme liabilities, i.e. loss	(2 9)	(7 3)
Actuarial gain / (loss)	<u>2 5</u>	<u>(0 8)</u>

## Balance Sheet reconciliation

	2006 £m	2005 £m
Fair value of Scheme assets	59 3	50 8
Present actuarial value of Scheme liabilities	<u>(74 1)</u>	<u>(67 4)</u>
Deficit in Scheme	(14 8)	(16 6)
Related deferred tax	<u>4 4</u>	<u>-</u>
Net pension liability	<u>(10 4)</u>	<u>(16 6)</u>

## Analysis of the movement in the Scheme deficit during the year

	2006 £m	2005 £m
Movement in deficit during the year		
Deficit in Scheme at 1 January	(16 6)	(14 7)
Current service cost	(4 4)	(3 4)
Contributions paid	3 2	2 0
Other finance income	0 5	0 3
Actuarial gain / (loss)	2 5	(0 8)
Deferred tax credit	<u>4 4</u>	<u>-</u>
Deficit in Scheme at 31 December	<u>(10 4)</u>	<u>(16 6)</u>

## HERMES PENSIONS MANAGEMENT LIMITED

## NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

## 16 PENSION COMMITMENTS (continued)

## History of experience gains and losses

	2006 £m	2005 £m	2004 £m	2003 £m	2002 £m
<b>Difference between the expected and actual return on Scheme assets:</b>					
Amount (gain) / loss	(2 0)	(6 3)	(1 5)	3 4	(7 8)
Percentage of Scheme assets	3 37%	12 40%	3 76%	10 24%	30 23%
<b>Experience gains and losses on Scheme liabilities:</b>					
Amount (gain) / loss	(3 4)	(0 2)	0 0	2 3	(6 2)
Percentage of the present value of Scheme liabilities	4 59%	0 30%	0 0%	4 84%	14 09%
<b>Total actuarial gain recognised in the statement of total recognised gains and losses:</b>					
Amount (gain) / loss	(2 5)	0 8	0 1	4 8	(14 5)
Percentage of the present value of Scheme liabilities	3 37%	1 19%	0 18%	10 11%	32 95%

## 17 CALLED UP SHARE CAPITAL

	2006 £'000	2005 £'000
Authorised		
100,000 (2005 100,000) ordinary shares of £1 each	<u>100,000</u>	<u>100,000</u>
Called up, allotted and fully paid		
30,000 (2005 30,000) ordinary shares of £1 each	<u>30,000</u>	<u>30,000</u>

## HERMES PENSIONS MANAGEMENT LIMITED

## NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

## 18 COMBINED STATEMENT OF MOVEMENTS IN SHAREHOLDER'S FUNDS AND STATEMENT OF MOVEMENTS ON RESERVES

The Group	2006 Called up Share Capital £'000	2006 Revaluation reserves £'000	2006 Non- distributable capital reserves £'000	2006 Contribution from parent company £'000	2006 Profit and loss account £'000	2006 Total £'000	2005 Restated Total £'000
At 1 January restated	30,000	252	98	510	9,671	40,531	33,908
Profit for the financial year	-	-	-	-	28,616	28,616	7,815
Disposal of investments	-	(252)	-	-	(3,404)	(3,656)	-
Dividend paid	-	-	-	-	(1,020)	(1,020)	(510)
Foreign exchange differences	-	-	-	-	-	-	(8)
Defined Benefit Pension Scheme							
- Actuarial gain on liabilities	-	-	-	-	3,400	3,400	200
Defined Benefit Pension Scheme							
- Actuarial gain on assets	-	-	-	-	2,000	2,000	6,300
Defined Benefit Pension Scheme							
- Actuarial loss on change in assumptions	-	-	-	-	(2,900)	(2,900)	(7,300)
Reclassification of reserves of associate Company's per FRS 9	-	-	-	-	(65)	(65)	-
Deferred tax credit on pension liabilities	-	-	-	-	3,698	3,698	-
Revaluation of investments	-	-	-	-	-	-	126
At 31 December	30,000	-	98	510	39,996	70,604	40,531

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****18 COMBINED STATEMENT OF MOVEMENTS IN SHAREHOLDER'S FUNDS AND STATEMENT OF MOVEMENTS ON RESERVES (continued)**

The Company	2006 Issued share capital £'000	2006 Capital contribution from parent £'000	2006 Profit and Loss Account £'000	2006 Total £'000	2005 Restated Total £'000
At 1 January	30,000	510	(13,031)	17,479	11,316
Profit for the financial year	-	-	7,055	7,055	6,004
Foreign exchange differences	-	-	-	-	(8)
Acquired investment	-	-	-	-	967
Defined Benefit Pension Scheme - Actuarial gain on liabilities	-	-	3,400	3,400	200
Defined Benefit Pension Scheme - Actuarial gain on assets	-	-	2,000	2,000	6,300
Defined Benefit Pension Scheme - Actuarial loss on charge in assumptions	-	-	(2,900)	(2,900)	(7,300)
Deferred Tax Credit on Pension Liabilities	-	-	3,698	3,698	-
At 31 December	30,000	510	222	30,732	17,479

**19 COMMITMENTS UNDER OPERATING LEASES**

The Group and Company annual commitments for the year to 31 December 2007 under operating leases are as follows

	2006 Land and buildings £'000	2006 Other £'000	2005 Land and buildings £'000	2005 Other £'000
Operating Leases which expire within				
1 year	-	9	-	20
2 - 5 years	-	58	-	95
Over 5 years	1,287	-	1,803	-
	1,287	67	1,803	115

All operating leases which are related to land and buildings are subject to five yearly upward only rent reviews

The Company has sub-let part of the buildings and expects to receive £216,336 in rent during 2007 (2006 - £216,336)

# **HERMES PENSIONS MANAGEMENT LIMITED**

## **NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)**

### **20 RECONCILIATION OF OPERATING PROFIT TO NET CASH INFLOW FROM OPERATING ACTIVITIES**

	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>Restated £'000</b>
Operating profit	15,382	7,159
Difference between pension contributions and actuarial gain	1,200	-
Depreciation charges	2,442	2,580
Amortisation charges	795	794
Increase in debtors	(1,777,109)	(11,839,465)
Increase in creditors	1,775,111	11,846,565
Net cash inflow from operating activities	<u>17,821</u>	<u>17,633</u>

### **21 RECONCILIATION OF NET CASH FLOW TO MOVEMENT IN NET FUNDS**

	<b>2006</b>	<b>2005</b>
	<b>£'000</b>	<b>Restated £'000</b>
Increase in cash in year	<u>25,800</u>	<u>14,635</u>
Movement in net funds in year	25,800	14,635
Net funds at beginning of year	<u>71,453</u>	<u>56,818</u>
Net funds at end of year	<u>97,253</u>	<u>71,453</u>

Net funds at 31 December 2006 comprised cash of £97,252,667  
(2005 - £71,453,031)

### **22 ADDITIONAL INFORMATION ON SUBSIDIARIES AND ASSOCIATES**

<b>SUBSIDIARY UNDERTAKINGS</b>	<b>ACTIVITY</b>
Hermes Focus Asset Management Limited	Investment management Company
Hermes Focus Asset Management Europe Limited	Investment management Company
Hermes Investment Management Limited	Investment management Company
Hermes Real Estate Investment Management Limited	Investment management Company
Hermes Administration Services Limited	Administration Company
Hermes Assured Limited	Life Assurance Company
Hermes SLP Limited	Special limited partner to Hermes UK Focus Funds
Hermes UOB Capital Management Limited	Investment management Company
Hermes Equity Ownership Services Limited	Investment management Company
Hermes Private Equity Limited	Investment management Company
Hermes UOB GP Limited	General partner to limited partnership of Hermes UOB European Private Equity Fund
Hermes UOB SLP GP Limited	Special limited partner to special limited partnership of Hermes UOB European Private Equity Fund
Hermes Private Equity GP Ltd	General partner to Hermes Equity LP investor in Apax Europe V Private Equity Fund

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****22 ADDITIONAL INFORMATION ON SUBSIDIARIES AND ASSOCIATES (continued)**

Hermes Asset Management Limited	General Partner to Hermes Private Equity Partners I LP and Hermes Private Equity Partners II LP
HPEP GP Limited	General Partner to Hermes Private Equity Partners I LP and Hermes Equity Partners II LP
Hermes Secretariat Ltd	Dormant
Hermes Lens Asset Management Ltd	Dormant
Hermes X-Leisure (Nominees) Ltd	Dormant
Hermes Shelf Company No 1 Ltd	Dormant
Hermes Investment Management (Nominees) Ltd	Dormant
Hermes Focus Fund Co-Investment Trustee Ltd	Dormant
<b>ASSOCIATES AND JOINT VENTURES</b>	<b>ACTIVITY</b>
Activa Capital	Investment management Company
UOB Hermes Asia Management Pte Ltd	Investment management Company
NLI Investments Europe Ltd	Investment management Company

Subsidiary undertakings are owned as to 100% of ordinary share capital except for Hermes UOB Capital Management Limited, Hermes UOB GP Limited and Hermes UOB SLP GP Limited which are owned as to 60% of ordinary share capital

All subsidiaries have been consolidated in the accounts. All are incorporated in Great Britain and registered and operate in England and Wales apart from Hermes UOB GP Limited and Hermes UOB SLP GP Limited, which are incorporated, registered and operate in Scotland

HFAME became a wholly owned subsidiary of the Company on 13 December 2006 upon transfer of the remaining shares in HFAME, at nil value, by the Company's parent, BT Pension Scheme. In 2005 HFAME had been reported as an associate but on acquisition the merger accounting provisions of FRS 6 have been applied leading to a restatement of the 2005 results. The full impact of this restatement is included in Note 27.

Investments in associates relate to ordinary share capital

Activa Capital is 25% owned and is incorporated, registered and operates in France

UOB Hermes Asia Management Pte Ltd is owned as to 40% of ordinary share capital and is incorporated, registered and operates in Singapore

On 30 January 2006 the Company acquired 33% of the issued share capital of NLI Investments Europe Limited

Innisfree Limited was an associate until 10 April 2006, when Hermes Investment Management Ltd sold the Company's holding of 107,600 shares (35.9%)



## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### 23 LIMITED PARTNERSHIPS

As described in accounting policy c) the results of the Hermes UOB Special Limited Partner LP and Hermes UOB General Partner LP have not been consolidated. Had these been consolidated the effect on net assets, retained profit and total recognised gains and losses would have been nil.

#### 24 RELATED PARTY TRANSACTIONS

During the year there were transactions with the following related parties

##### The Trustees of the BT Pension Scheme

The following fees were paid by the Hermes Group on behalf of the BT Pension Scheme in respect of the Trustees' services to the BT Pension Scheme

	2006 £'000	2005 £'000
Sir Tim Chessells (Chairman)	75	75
S B Birkenhead	9	28
D W Davies	-	18
C N J Long	23	23
D M MacDonald	21	21
H Marchant	24	24
W McClory	21	21
D R Barford	30	-
L Cullen	27	-
Total fees	<u>230</u>	<u>210</u>

##### Hermes Group Pension Scheme

Certain activities of the Scheme are carried out by the Hermes Group, all of the costs of which are borne by Hermes Pensions Management Limited. These costs have not been apportioned for accounting purposes between those attributable to the Scheme and those attributable to the Hermes Group as functions maintained for both entities cannot be divided meaningfully between them.

##### Parent Undertaking

The Company is a wholly owned subsidiary and consolidated into the accounts of the BT Pension Scheme, which are available to the public. As such, the Company has not disclosed related party transactions with the BT Pension Scheme, as it is taking advantage of the exemption in FRS8 available to wholly owned subsidiaries.

##### Subsidiaries

The Company prepares Group accounts into which all of its subsidiaries are consolidated. The Company has not disclosed related party transactions with subsidiaries as it is taking advantage of the exemption in FRS8.

## HERMES PENSIONS MANAGEMENT LIMITED

### NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)

#### 24 RELATED PARTY TRANSACTIONS (continued)

##### Associated Undertakings

##### Hermes Focus Asset Management Europe Ltd

HFAME became a full subsidiary of HPML on 13 December 2006 upon a transfer of the remaining shares (nil value) from the parent of HPML, BT Pension Scheme. The Company has utilised the merger accounting provisions of FRS 6 and has reported HFAME as a subsidiary throughout the year, and subsequently has restated the 2005 results as included at Note 27.

##### Activa Capital

Activa is an associate of Hermes Private Equity Management (HPEM) which is a 100% subsidiary of Hermes Pensions Management Ltd. During the period HPEM received dividends of £8,237 from Activa.

##### Hermes UK Focus Funds

The Hermes UK Focus Funds are partnerships investing in UK equities. Hermes Focus Asset Management Limited (HFAM) is the General Partner. During the year there were the following transactions between the UK Focus Funds and HFAM:

- HFAM received £4,077,911 (2005 - £3,132,461) from the Hermes UK Focus Fund, £1,165,654 (2005 - £1,033,826) from the Second Hermes UK Focus Fund and £2,480,729 (2005 - £2,186,446) from the Third Hermes UK Focus Fund as profit share.
- HFAM recharged £72,059 (2005 - £73,640) of expenditure to the Hermes UK Focus Fund, £26,388 (2005 - £31,017) to the Second Hermes UK Focus Fund and £41,978 (2005 - £48,685) to the Third Hermes UK Focus Fund. This expenditure represented the direct costs of the partnerships.

##### Hermes UK Small Companies Focus Fund

The Hermes UK Small Companies Focus Fund (UKSCFF) is a partnership investing in UK Small Company equities. HFAM is the general partner. During the year there were the following transactions between UKSCFF and HFAM:

- HFAM received £2,131,843 (2005 - £1,761,673) from UKSCFF as profit share.
- HFAM recharged £31,700 (2005 - £29,423) of expenditure to UKSCFF. This expenditure represented the direct costs of the partnership.

##### European Focus Funds I, II and III

The European Focus Funds are limited partnerships investing in European equities. Hermes Focus Asset Management Europe Limited (HFAME) is a general partner. During the year there were the following transactions between the European Focus Funds and HFAME:

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****24 RELATED PARTY TRANSACTIONS (continued)****European Focus Funds I, II and III (continued)**

- HFAME received £6,721,922 (2005 – £4,191,028) from the European Focus Fund I and £855,523 (2005 – £649,153) from the European Focus Fund II and £934,859 (2005 – £704,542) from European Focus Fund III as profit share
- HFAME was also accruing £12,004,118 (2005 - £5,134,623) due from the European Focus Fund I £1,932,431 (2005 - £935,021) due from the European Focus Fund II and £1,345,868 (2005 - £375,140) from the European Focus Fund III as performance related profit share
- HFAME recharged £41,209 (2005 – £36,728) of expenditure to the European Focus Fund I, £41,209 (2005 – £36,728) of expenditure to the European Focus Fund II and £41,209 (2005 – £36,728) of expenditure to the European Focus Fund III This expenditure represented the direct costs of the partnerships

**25 MINORITY INTEREST - EQUITY**

The minority interest of £144,096 (2005 - £135,065) included within the consolidated balance sheet and the £8,542 included within the Consolidated profit and loss account relates to the 40% shareholding of Hermes UOB Capital Management Limited (HUCM) owned by UOB Global Capital LLC

**26 ULTIMATE PARENT UNDERTAKING**

The directors regard the BT Pension Scheme as the Company's immediate and ultimate parent and controlling entity It is also the parent of the largest and smallest Group to prepare Group accounts into which the results of the Company are consolidated The accounts of the BT Pension Scheme can be obtained at Lloyds Chambers, 1 Portsoken Street, London E1 8HZ

**27 PRIOR YEAR ADJUSTMENT**

During the year the Group acquired further shares in the Company HFAME and the Company became a subsidiary The Group had decided to apply the provisions of FRS 6 relating to merger accounting and as a result of this is required to restate the results of the prior year The impact of this restatement is provided below

The effects of this revised reporting are summarised as follows -

	<b>2005</b>
	<b>£m</b>
Profit and loss account	
Increase in operating profit	3,979
Reduction in value of operating profit of associates	(1,818)
Increase in interest receivable	155
Increase in taxation charge	(684)
Increase in profit for the financial year	<u>1,632</u>

**HERMES PENSIONS MANAGEMENT LIMITED****NOTES TO THE ACCOUNTS - YEAR ENDED 31 DECEMBER 2006 (continued)****27 PRIOR YEAR ADJUSTMENT (continued)**

Balance sheet	<b>2005</b>
	<b>£m</b>
Investment	(2,235)
Debtors	6,168
Cash	6,557
Creditors – amounts falling due in less than one year	(6,678)
Creditors – amounts falling due after more than one year	<u>(1,180)</u>
Increase in net assets	2,632
 Reserves	 <b>2005</b>
	<b>£m</b>
Increase in profit and loss reserve	2,122
Capital contribution	<u>510</u>
Increase in reserves	2,632

**28 LITIGATION**

An action was brought against Hermes Investment Management Limited (HIML), a Company within the Group, in South Korea in respect of the actions of a former fund manager and alleged breaches of the South Korean Securities and Exchange Act. The Company was found not guilty by the South Korean courts and cleared of all charges. Although the South Korean authorities have the right of appeal, which they have exercised, the Company has been advised that it did not breach the relevant legislation as was confirmed by the Judge at the Court of first instance. Accordingly no provision has been made in the accounts of the Group for any costs associated with the case.

**29 POST BALANCE SHEET EVENT**

On 21 February 2007 the Group announced a review of its equity index tracking activities. This review is expected to conclude in July 2007.