

The Medical Defence Union Limited

(Registered number 21708)

Consolidated Financial Statements

for the year ended 31 December 2005



CHAIRMAN'S REPORT

For the last 121 years the MDU has been justifiably proud of its ethos 'Doctors for Doctors'. The same applies for our dental colleagues. As you will read in Dr Saunders' report, the financial state and general stature of the company has markedly improved in recent times. This is in large part a reflection of the major influence of the medical and dental members of the Board and other committees. After all, they are best placed by far to influence the kaleidoscopic range of factors which affect our professions. In saying this I do not seek to diminish in any way the invaluable and essential help we receive from our Joint Venture partners and non-medical colleagues. Indeed, I acknowledge with gratitude their contribution and guidance.

The services which the MDU provides for its members are many and varied. I would like to take this opportunity to pay tribute to those colleagues who provide these services and to describe some of the main aspects of their work during 2005.

The MDU's professional services to members are provided principally by internal departments: membership, claims handling, advisory, legal and dental. Each department uses its own specialist expertise and skills to assist individuals and also contributes to the general work of the company on behalf of all our members.

Members need to continue to discuss their changing requirements with the membership services department. The membership team took over 133,500 calls during 2005 and 20,084 of these in the busiest month alone. In that same busy month the department received and answered over 3,000 pieces of correspondence from members.

In 2005 the extent of our support to members was demonstrated by the claims handling department, with the highest ever settlement of £4 million for a severely brain-damaged baby. It also saw the second case involving an MDU member to reach the House of Lords within a six-month period. The judgment in *Gregg v Scott* was delivered in late January. The patient's non-Hodgkins lymphoma initially went undiagnosed and it was claimed the delay of nine months in beginning treatment had reduced his chance of a cure, defined in terms of 10 years' survival,

from 42% to 25%. The patient was not entitled to be compensated for the 'loss of chance of a better outcome'. It was a significant finding for MDU members generally.

The MDU's in-house solicitors were involved in this case. Specialising in clinical negligence, they represent our members in just under half our medical and dental claims, the rest going to an external panel of solicitors. In-house solicitors also work with the medical and dental advisory departments on criminal cases, complaints to the regulatory bodies and disciplinary proceedings.

Our medico-legal advisers have seen a doubling in members' requests for assistance with the GMC in the last few years. This has meant in turn a significant increase in the involvement of our in-house solicitors. Looking at the cases they closed in 2005 when representing members in GMC conduct investigations, in over 90% of cases no action was taken, or there was no finding of serious professional misconduct or impaired fitness to practise. These cases were under the GMC's old and new procedures because the new procedure was introduced in November 2004. On the dental side, the solicitors assisting dental members with GDC conduct allegations were successful in avoiding any sanctions against our members in over 90% of cases.

A new aspect of our work during 2005, demonstrating the way in which the MDU's advisory services are evolving to assist with new medico-legal challenges, was the assistance offered to members with complaints to the Healthcare Commission. There were 73 cases: 61 medical and 12 dental. These figures are considerably lower than referrals for Independent Review under the previous second stage of the NHS complaints procedure. This is because the Commission is referring one in three cases back to the first stage of the procedure for local resolution. It is too early to judge if the new second stage is a more successful and fairer way of resolving complaints against our members, but my colleagues are hopeful.

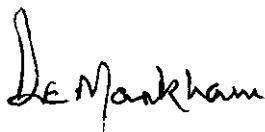
Every year there are a whole host of proposals to change the status quo: from aspects of the clinical negligence procedure, to the wider regulatory and legal framework within which our members practise. The MDU is dependent on our professional services colleagues who contribute their expertise to ensure that debate on these matters is fully informed and takes

account of our members' interests. For example, the MDU contributes to the Civil Justice Council's deliberations. The CJC is responsible for overseeing and co-ordinating the review and modernisation of civil justice. We are also heavily involved in consultations with the regulators about proposed changes to their guidance (GMC and GDC) that governs our members' professional lives, as well as proposed changes to their new disciplinary procedures. This includes commenting on and suggesting amendments to the GDC's new private dental complaints procedures.

This brief glimpse at some of the highlights of the MDU's work would tempt me to say that we have achieved very many successes on behalf of our members, but it would be inappropriate to use such a term because for our members they are invariably serious matters. Whether or not a claim is settled, or charges are not proved, allowing the member to remain free to practise, the events often have a lasting effect on members and their families. However, I do know, because members often write or phone to tell us, that when they are going through these ordeals they are extremely grateful for the attention to detail and professionalism demonstrated by those colleagues who assist them.

I must report sad news of the deaths of Miss Mary Anderson and Mr Andrew Morrison, both of whom had retired from Council having given long and valuable service to the MDU.

This will be my final report as your Chairman. I pay tribute to my friends and colleagues at the MDU who over the last 26 years have given me much support and encouragement, particularly during my tenure as Chairman. Without them my task would have been much more difficult if not impossible.



David Markham
Chairman of the Board of Management
President of the MDU

OFR

I am pleased to report that 2005 was a good year for the MDU. Membership numbers continue to rise and member satisfaction with our services remains high, as measured by regular independent surveys.

As predicted in previous Annual Reports indemnity payments and associated legal costs, in respect of the MDU's discretionary claims, continue to fall. This is in line with the company's business plans where significant progress has been achieved and is reflected in the accounts.

This is due to several factors. First, it is your Board's policy to restrict the business to the UK and Ireland and to place the provision of indemnity on an insured basis. In turn this means that, increasingly, members' claims fall to be dealt with under the terms of the insurance policies issued by the Zurich Insurance and Converium Insurance companies, and are met from funds provided by these companies. Careful control of claims with strict attention to detail is a particular strength of the MDU and most claims are managed without the need to use external firms of lawyers, drawing on the specialist skills and competencies of the internal claims and legal departments of MDU Services. Claims are managed to the MDU's protocols, which include advice and guidance contributed by Cases Committees whose members are all clinicians representing a wide range of medical and dental specialties throughout the UK.

Managing the business in this way has significant advantages for members. By concentrating on "these islands" resources are focussed to best effect. Insurance gives to members the certainty of assistance that only contractual indemnity can provide whilst transferring financial risk to the much larger balance sheets of insurance companies.

However, discretionary assistance remains a significant part of the many benefits of membership. It is the basis upon which your board grants assistance with matters other than claims, such as disciplinary and regulatory problems, and it enables the Board to consider assistance with anything which may fall outside the terms of the insurance contract. Members' demands for assistance continue to rise and form a very significant and costly part of our business. To meet this need the Medical Advisory department now has 53 medico-legal advisers and in the Dental Defence Union there are 7 dento-legal advisers.

In 2005 we were able to extend the insurance cover provided to dental members who now have the additional benefit, upon retirement from practice, of a run off endorsement to the insurance policy. This enables retired dental members and, where necessary, their estates, to report claims in retirement to be dealt with under the terms of the insurance policy and no longer on a discretionary basis. It is part of your Board's business plan to introduce a similar benefit for medical members in due course. Members will then have the protection of insured contractual indemnity throughout their professional life and into retirement.

Indemnity, for clinical negligence claims, is likely to be a compulsory requirement for continued registration. Following recent legislation, both the GDC and the GMC are considering what types of indemnity would be acceptable and the terms and conditions of that indemnity. The MDU believes that, apart from NHS Indemnity, only contractual insured indemnity should be permitted as this gives the maximum certainty to both practitioners and their patients.

The MDU group of companies is a complex set of businesses. The MDU itself remains a mutual company, owned by its members. MDU Investments manages the MDU's funds. MDU Re, newly established in 2005, is a Guernsey based company and is the successor to MDU Insurance. It provides re-insurance and other insurance-based services to the group. MDU Services is a joint venture company, with Converium AG, and employs the staff and provides all services to the MDU and its members. It is regulated as an insurance intermediary by the Financial Services Authority.

Ireland

Members will recall from previous Annual Reports that the Department of Health and Children (DoHC) imposed a Clinical Indemnity Scheme against the wishes of Irish consultants in February 2004. It is not dissimilar to NHS Indemnity save that it affords indemnity for both private and public practice in state hospitals going forward. The MDU had held regular and detailed discussions with DoHC officials since the early 1990s regarding its intentions in this respect. Despite repeated assurances to the contrary, the DoHC did nothing to tackle the problem of historic obstetric liabilities, and seemed to think it was acceptable for other MDU members to carry that burden. The DoHC had full knowledge of the problems thus created. The Board decided in 2004, in the interests of all the MDU's members, that in some Irish obstetric cases it would not exercise its discretion to assist or continue to assist and such decisions continue to be made.

The Irish Government has said that no Irish person who has suffered from a medical mishap would be left without compensation and no consultant would be left without cover in all reasonable circumstances and in accordance with law. Currently there are no discussions taking place with the DoHC and the matter rests with the courts. As last year the situation remains unclear and unsatisfactory despite our best efforts.

Financial Review

Income

Subscription income for the year ended 31st December 2005 was £152.9m (2004 £137.5m). Over 97% of subscriptions come from our UK members, the remainder being from our members in Ireland.

Added to the subscription income are investment income/gains for the year of £1.7m bringing the total mutual income for the MDU group in 2005 to £154.6m (2004 £140m).

Expenditure

During the year the MDU paid out on behalf of its members £41m in discretionary indemnity claims and legal costs (2004 £51m). This reduction, which is in line with expectations, results from the planned transfer of risk to individual insurance policies for the MDU's UK and Irish members. Within the £41m of indemnity and legal payments for 2005, £7m (17%) relates to our Irish members' claims.

Insurance and reinsurance premiums were £100m in 2005 (2004 £94m).

The insurance premium provides each paying member of the MDU in the UK with the security of a £10m individual insurance policy in his/her name. The insurance policy covers claims first made in the policy period, including indemnity and legal costs, arising from an incident whilst a member.

The MDU has an extensive reinsurance programme, which includes additional protection for discretionary claims. The amount of reinsurance recoveries in 2005 was £5.9m (2004 £3.4m).

In overall terms the MDU's estimated gross obligations in respect of outstanding indemnity claims have reduced by £38.5m in the year (2004 £28.5m).

Medical and Dental advisory costs along with administrative and finance costs amounted to £23m in 2005 (2004 £22.5m).

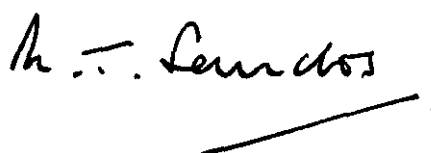
The financial statements this year under FRS17 – Retirement Benefits, reflect for the first time the MDU's obligation for pension provision. This has resulted in the restatement of certain figures for comparative amounts shown for the year ended 31 December 2004. The provision this year, see note 12(b) is £9.1m (2004 - £8.2m).

Assets/Indemnity Provision

The balance sheet for the MDU now shows total assets of £79.6m compared to £82.9m in 2004. As explained in last year's report, this anticipated reduction in the fund is due to settlement of claims in the year and will continue as the MDU settles claims notified prior to the issue of individual insurance policies to its members. When these claims have been paid, the fund will again accumulate.

In assessing the provision for indemnity, the MDU takes account of all reported incidents notified up to the balance sheet date. This includes all notifications from members including incidents relating to potential claims, pre-claims where incidents are still being investigated and actual claims where there has been a demand for compensation or where legal proceedings have been served. It does not include any case where the Board has declined to exercise or to continue to exercise its discretion to assist. The level of indemnity provision, see note 12(a), has been estimated taking all the above factors into consideration and is shown in the accounts up to the value of the total net book assets. The joint venture arrangements provide the MDU with additional reinsurance and capital funding.

Dr Michael Saunders
Chief Executive



MDU REPORT AND ACCOUNTS 2005

REPORT OF THE BOARD OF MANAGEMENT

The directors present their report and the financial statements for the year ended 31 December 2005.

Activities

The group's activities encompass the joint venture interest in MDU Services Limited. The joint venture partner is Converium AG. Through MDU Services Limited, the group provides paying members with insurance policies for claims of clinical negligence. These are underwritten by Converium Insurance (UK) Ltd in the UK and by Zurich Insurance Ireland Limited in Ireland. MDU Services Ltd is authorised and regulated by the FSA as an insurance intermediary.

The MDU's activities include the discretionary provision, in accordance with the *Memorandum and Articles of Association*, of indemnity and advisory services for its members.

The MDU provides advice and assistance to governments and other bodies relating to risk management and the handling of indemnity claims.

Review of business

Members' attention is drawn to the Report of the Chairman and the Operating and Financial Review, in which the salient features of the year are highlighted. The financial statements on pages [12] to [28], set out the financial results of the year's activities.

The MDU continues to set subscriptions which the directors, on the advice of the consulting actuaries, consider sufficient to meet insurance premiums, overheads and foreseeable discretionary indemnity payments and legal costs.

Disabled employees

The MDU group gives full consideration to applications for employment from disabled people where the requirements of the job can be adequately fulfilled by a handicapped or disabled person.

Where existing employees become disabled it is the MDU's policy wherever practicable to provide continuing employment under normal terms and conditions and to provide training and career development and promotion where possible.

Directors

The following served as directors in 2005:

D E Markham *#▽	
P Armstrong	
M Arnold*#	(Resigned 17 March 2006)
Hedley E Berry *▽	
A D Chambers *#	
C C Evans *#▽	
M M Gallivan ▽	
The Lord Glenarthur *#	
Sir Robin Mountfield *#▽	
M S Richmond	(Appointed 22 November 2005)
P D Robinson	
M T Saunders *▽	
C M Tomkins ▽	
T J Walley	(Resigned 20 September 2005)
P R Williams ▽	

* Members of the Remuneration Committee
Members of the Audit Committee
▽ Directors or alternate directors of MDU Services Limited

In accordance with the Articles of Association, the following directors are due to retire by rotation and, being eligible, offer themselves for re-election at the next Annual General Meeting:

C C Evans
P R Williams
P Armstrong
M M Gallivan

Corporate Governance

Although the MDU is not a listed company, the Board is committed to the highest standards of corporate governance and seeks to apply the Principles set out in the Combined Code, to the extent appropriate for the MDU. Set out below is a summary of the MDU's approach to corporate governance. The participation of MDU members on the Board is a particular feature and strength of the governance arrangements.

Seven members of the MDU serve on the Board in a non-executive capacity. There are three executive directors, two of whom are also MDU members. The Board also has three non-executive directors who are not members of the MDU. The non-executive directors are sufficiently strong in numbers and independence to provide a proper balance on the Board.

The posts of Chairman and Chief Executive are separate. This distinguishes the running of the Board from executive responsibility for the business. The Chairman was non-executive at time of his appointment.

All Board members are subject to election by MDU members at the first Annual General Meeting after their appointment. All, including the Executive Directors, are also subject to retirement by rotation and re-election at least every three years.

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The Board met five times in the year. The Board has a schedule of matters reserved to it for decision, including the following:

- Approval of commercial strategy
- Changes to corporate structure
- Internal control arrangements
- Board and Committee appointments
- Contracts not in the ordinary course of business

The Board has a procedure for directors to obtain independent advice.

The Board has an Audit Committee, which meets as often as necessary. The Committee is chaired by Prof Andrew Chambers, an independent director. Prof Chambers is Professor of Internal Auditing at London South Bank University and Professor Emeritus of London's City University. The Committee consists of the Chairman of the Board, and the Vice-Chairman of the Board, who are both members of the MDU, all the non-executive members of the Board who are not members of the MDU and two non-executive members of the Board of MDU Services Ltd. The Committee meets with the internal and external auditors, and the Committee spends time alone with both the internal and external auditors. The Committee reviews risk management and internal control arrangements, and their effectiveness. It guides the activities and reviews the results of internal audit. The Committee also reviews the scope and results of the external audit, and reviews the annual financial statements and other information in the Annual Report before publication. The Committee meets the MDU's actuarial advisers each year and reviews the results of their work.

The Board's Nomination Committee, chaired by the Chairman of the Board, makes recommendations on the appointment of directors. Membership of the Nomination Committee varies according to the nature of the vacancy. The Committee prepares a description of the role and capabilities required for a particular appointment. It selects a shortlist of candidates for consideration by the Board, on merit and against objective criteria.

There is an induction process for new directors. This is tailored to meet the needs of individuals. It is designed to give new directors knowledge of the business and of their role in it as directors.

The Remuneration Committee, also chaired by the Chairman of the Board, makes recommendations on the remuneration of non-executive directors and members of the Council and of committees. The remuneration of the Executive Directors is determined by the Remuneration Committee of MDU Services Ltd. Members of this Committee, including the Chairman of the MDU, are identified in the Annual Report of MDU Services Ltd.

The Remuneration Committees work on the basis that remuneration should be sufficient to attract, retain and motivate individuals of the quality required to run the company successfully, but without paying more than is necessary.

The Board is ultimately responsible for the internal control and risk management of the MDU and for the effectiveness of these systems. The Audit Committee has authority to advise the Board on these matters. Management is responsible for identifying, assessing, managing and monitoring risk, and for developing, operating and monitoring the system of internal control. Control is exercised through an organisational structure with clearly defined levels of responsibility and authority and appropriate reporting procedures. Information is regularly provided at all levels and compared with budgeted targets which are reviewed on a quarterly basis. The Board considers regular reports on the risks inherent in the business.

The internal control and risk management systems cannot eliminate risks to the business, but they are designed to manage them. Internal controls can provide only reasonable and not absolute assurance against material misstatement or loss. The Board, with advice from the Audit Committee, has reviewed the effectiveness of the risk management and internal control of the group.

The financial statements are prepared on a going concern basis. In deciding to adopt the going concern basis the directors have reviewed the group's business plans and budgets and taken account of the discretionary nature of the company's indemnity obligations and the steps taken for future funding.

The MDU uses the Annual Report and Annual General Meeting to communicate with members about the business. It values highly communications with members, and encourages members to attend the Annual General Meeting.

Statement of directors' responsibilities

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and the group and of the surplus or deficit of the group for that period.

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, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on a going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are required to ensure that their report and other information included in the Annual Report is prepared in accordance with company law in the United Kingdom. They must also maintain and ensure the integrity of the company's website, in particular those pages displaying audited financial statements.

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 enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible 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.

Auditors

On 23 May 2005, PKF transferred their business to PKF (UK) LLP, a limited liability partnership. Under section 26(5) of the Companies Act 1989, the company consented to extend the audit appointment to PKF (UK) LLP from 23 May 2005. Accordingly, the audit report has been signed in the name of PKF (UK) LLP and a resolution for the reappointment of PKF (UK) LLP will be proposed at the Annual General Meeting.

By order of the Board of Management



N J BOWMAN
COMPANY SECRETARY

25 April 2006

Consolidated Income and Expenditure Account

for the year ended 31 December 2005

		2005		Restated 2004	
	Notes	£'000	£'000	£'000	£'000
Members' subscriptions			152,900		137,528
Investment income	2		1,724		2,408
Realised (losses)/gains from disposal of investments			(4)		167
Total mutual income			154,620		140,103
<u>Less:</u>					
Medical and dental advisory services		12,545		11,730	
Indemnity, legal, reinsurance and insurance costs	3	130,079		113,848	
Administrative costs		9,377		9,108	
Finance cost		1,116		1,692	
Total mutual expenditure			153,117		136,378
Result from mutual activities			1,503		3,725
Income from non-mutual activities			11,617		11,030
Less: share of joint venture's turnover			(11,617)		(11,030)
Share of operating profit in joint venture	7		415		266
Result before taxation	4(a)		1,918		3,991
Taxation charge	5(a)		(318)		(262)
Result after taxation transferred to accumulated fund	13		1,600		3,729

All activities relate to continuing operations.

Consolidated Statement of Total Recognised Gains and Losses

for the year ended 31 December 2005

	Notes	2005	Restated 2004
		£'000	£'000
Result after taxation excluding share of profits of joint venture		1,185	3,463
Actuarial (loss) on pension scheme	13, 15	(1,600)	(3,600)
Share of joint venture's profit for the year		415	266
Taxation charge on investment gains	5(b)	<u>-</u>	<u>(129)</u>
Total recognised gains and losses since the last annual report		<u>-</u>	<u>-</u>

Note of Historical Cost Gains and Losses

for the year ended 31 December 2005

	2005	Restated 2004
	£'000	£'000
Reported result before taxation	1,918	3,991
Realisation of investment gains of previous years	<u>-</u>	<u>1,028</u>
Historical cost result before taxation	<u>1,918</u>	<u>5,019</u>
Historical cost result after taxation	<u>1,600</u>	<u>4,757</u>

Consolidated and Company Balance Sheets

as at 31 December 2005

	Notes	2005		Restated 2004	
		Group £'000	Company £'000	Group £'000	Company £'000
Fixed assets					
Tangible assets	6	886	886	1,070	1,070
Investments	7	25,247	2,367	36,791	2,367
Investment in joint venture					
Share of gross assets		9,588	-	8,119	-
Share of gross liabilities		(7,551)	-	(6,473)	-
	7	2,037	-	1,646	-
		28,170	3,253	39,507	3,437
Current assets					
Investments	8	-	-	4	-
Debtors - amounts falling due within one year	9	16,758	24,514	14,601	33,171
Debtors - amounts falling due after more than one year	10	37,897	38,740	32,841	33,796
Cash at bank and in hand		8,284	8,013	7,640	7,374
		62,939	71,267	55,086	74,341
Creditors - amounts falling due within one year	11	11,472	11,301	11,731	10,543
Net current assets		51,467	59,966	43,355	63,798
Total - fixed assets and net current assets		79,637	63,219	82,862	67,235
Provisions					
Indemnity	12(a)	70,456	54,038	74,565	58,938
Other provisions	12(b)	9,181	9,181	8,297	8,297
Total Provisions		79,637	63,219	82,862	67,235
Reserves					
Accumulated fund	13	-	-	-	-
Total - provisions and reserves		79,637	63,219	82,862	67,235

Approved by the Board of Management on 25th April 2006

Director

De Markham

Director

Th. J. L. L. L. L.

Consolidated Cash Flow Statement

as at 31 December 2005

	Notes	2005		2004	
		£'000	£'000	£'000	£'000
Net cash (outflow) from operating activities	14(a)		(11,955)		(26,958)
Returns on investments					
Interest received		<u>1,773</u>		<u>2,409</u>	
Net cash inflow from returns on investments			1,773		2,409
Corporation tax paid			(718)		(235)
Capital expenditure and financial investment					
Sales of fixed assets		-		18	
Transfer to Cash Fund		-		24,706	
Sales of investments		<u>-</u>		<u>38,374</u>	
Net cash inflow from capital expenditure and financial investment			-		63,098
(Decrease)/Increase in cash	14(b)		<u>(10,900)</u>		<u>38,314</u>

Reconciliation of Net Cash Flow to Movement in Net Funds

for the year ended 31 December 2004

		2005	2004
		£'000	£'000
(Decrease)/Increase in cash	14(b)	<u>(10,900)</u>	<u>38,314</u>
Movement in net funds		(10,900)	38,314
Net funds as at 1 January 2005		<u>44,431</u>	<u>6,117</u>
Net funds at 31 December 2005		<u><u>33,531</u></u>	<u><u>44,431</u></u>

Notes to the Financial Statements

as at 31 December 2005

1 Accounting Policies

(a) Basis of preparation of financial statements

The Group financial statements have been prepared under the historical cost convention, and in accordance with the Companies Act 1985 and applicable accounting standards. As permitted by the Companies Act 1985, the financial statements formats have been adapted, as necessary, to give a true and fair view of the state of affairs of the Company and Group. As explained in accounting policy note 1(l) FRS17 Retirement Benefits has been adopted in full. This has resulted in the restatement of certain figures for the comparative amounts shown for the year ended 31 December 2004.

(b) Basis of consolidation

The consolidated income and expenditure account and balance sheet include the financial statements of the company and its subsidiary undertakings made up to 31 December 2005. No income and expenditure account is presented for The Medical Defence Union Limited as permitted by section 230 of the Companies Act 1985.

MDU Services Limited, in which the Group holds an interest on a long term basis and is jointly controlled by the Group and Converium AG under a contractual agreement, is treated as a joint venture. In the Group financial statements the joint venture is accounted for using the gross equity method.

(c) Members' subscriptions

Members' subscriptions consists of subscriptions for members' services and insurance premiums received from members for payment to Converium Insurance (UK) Limited in the UK and Zurich Insurance Ireland Ltd in Ireland. These are accounted for on the basis of amounts due and received by the Group before the balance sheet date, without apportionment.

Subscriptions retained by the Company and Group, net of insurance premiums paid, referred to in note (d) below, represent additional income for the funding of indemnity payments and the provision of advisory services to members. It is not practical to allocate a separate fair value to these two components.

(d) Indemnity, legal, reinsurance and insurance costs

Expenditure on indemnity payments including the movement on the indemnity provision between the beginning and end of the year and legal charges covers the aggregate of all indemnity settlements, and legal services provided for members, together with insurance premiums, including those collected on behalf of and paid over to Converium Insurance (UK) Limited in the UK and Zurich Insurance Ireland Ltd in Ireland as and when received from members. These costs include plaintiffs' costs, payments on account, legal costs, representation at service committee appeals, at hospital enquiries and at the General Medical and Dental Councils, and legal assistance to members.

Notes to the Financial Statements

as at 31 December 2005

1 Accounting Policies (continued)

(e) Indemnity provision

Provision is made for the outstanding cost of settlement and related claimants' costs for indemnity cases from all reported incidents notified as at the balance sheet date up to the amount of Group and Company net book assets as the Group and Company liabilities cannot exceed their assets (see note 12(a)). The provision is calculated on the advice of the consulting actuaries and has been discounted to allow for future investment returns in accordance with FRS 12.

The estimated value of this provision is stated before estimated recoveries from insurers, which are disclosed separately as debtors and calculated by the consulting actuaries. The provision will be paid over an extended period and subject to agreement by all parties. The movement on the provision separately identifies the unwinding of the discount which is disclosed as a finance cost in the income and expenditure account. The principal financial assumption used in the calculation of the finance cost is that the rate used to unwind the discount is 3.125% per annum.

No provision is made for claims that may arise from incidents occurring before the balance sheet date but not reported to the Group at that date or for defendant legal costs, nor for claims where The Medical Defence Union Limited has not exercised its discretion to assist. Nearly all paying members now have an insurance policy and, for those who do, such claims are covered under the terms of the policy.

The principal financial assumptions used in the actuaries calculation of the indemnity provision for the Company and the Group are that claims inflation will be 7.7% per annum (2004: 7.6% per annum) over the period of settlement and that a net discount rate of 2.7% per annum (2004: 2.8% per annum) is used to discount the claims payments to the balance sheet date.

(f) Non-mutual activities

Income from non-mutual activities and share of joint venture turnover represents the Group's share of the turnover of MDU Services Limited comprising expenses recharged to The Medical Defence Union Limited for the year ended 31 December 2005.

Share of operating profit in joint venture represents the Group's share of the profit before tax of MDU Services Limited for the year ended 31 December 2005.

(g) Tangible fixed assets and depreciation

The cost of tangible fixed assets is written off evenly over their estimated useful economic lives. Reviews are made periodically of the estimated remaining lives of individual assets, taking account of commercial and technological obsolescence as well as normal wear and tear.

▪ Leasehold property Improvements:

Refurbishment costs on leasehold properties are written off over the shorter of the length of the lease and 10 years.

Notes to the Financial Statements

as at 31 December 2005

1 Accounting Policies (continued)

(h) Investments

Investments are included at cost less any necessary provision for impairment.

(i) Foreign currencies

Transactions in foreign currencies are recorded at the rate of exchange ruling at the date of transaction or at the contracted rate if the transaction is covered by a forward exchange contract. *Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange at the balance sheet date or the appropriate forward contract rate. All differences are taken to the income and expenditure account.*

(j) Deferred taxation

Deferred taxation is provided using the full provision method following adoption of FRS19. Deferred taxation is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date.

Deferred tax assets and liabilities are calculated at the tax rate expected to be effective at the time that the timing differences are expected to reverse, and are not discounted. Deferred tax assets are recognised to the extent that it is regarded more likely than not that they will be recovered.

(k) Investment income

Investment income is accounted for on an accruals basis.

(l) Pension costs

Under the terms of the arrangements between the Company and MDU Services Limited the Company is responsible for any deficit of the pension scheme for which MDU Services Limited is the principal employer. This year FRS17 has been fully adopted. This has resulted in a change to the accounting policy for the defined benefit scheme as detailed below. Comparative figures for the year ended 31 December 2004 have been restated, where necessary, to take account of this change in accounting policy.

The assets of the defined benefit pension scheme are measured at their market value at the balance sheet date and the liabilities of the scheme are measured using the projected unit method. *The discount rate used is the current rate of return on an AA corporate bond of equivalent term to the liabilities.* The following is charged to the Income and Expenditure Account:

- the increase in the present value of pension scheme liabilities arising from employee service in the current period;
- the increase in the present value of pension scheme liabilities as a result of benefit improvements over the period during which such improvements vest;
- *gains and losses arising on settlements/curtailments;*
- a credit in respect of the expected return on the scheme's assets; and
- a charge in respect of the increase during the period in the present value of the scheme's liabilities because the benefits are one period closer to settlement.

Actuarial gains and losses are recognised in the statement of total recognised gains and losses.

Notes to the Financial Statements

as at 31 December 2005

2 Investment Income	2005	2004
	£'000	£'000
Loan and bank interest	<u>1,724</u>	<u>2,408</u>
3 Indemnity, Legal, Reinsurance and Insurance Costs		Restated
	£'000	£'000
Indemnity paid	29,941	38,264
Reduction in indemnity provision (see note 12a)	(5,425)	(27,539)
Reinsurance recoveries	(5,886)	(3,384)
Legal costs	11,160	12,331
Reinsurance and insurance costs	<u>100,289</u>	<u>94,176</u>
	<u>130,079</u>	<u>113,848</u>
4 (a) Result Before Taxation		
Result before taxation has been arrived at after charging/(crediting) the following:	£'000	£'000
Depreciation (note 6)	184	187
Auditors' remuneration - as auditors	59	47
- for non-audit work	116	131
(b) Directors' Remuneration		
	£'000	£'000
Fees	310	299
Directors' emoluments	262	209
Amounts due and receivable under long term incentive plans	<u>117</u>	<u>68</u>
	<u>689</u>	<u>576</u>
The highest paid director of The Medical Defence Union Limited received:		
Emoluments and benefits under long term incentive schemes	<u>229</u>	<u>166</u>
Accrued annual pension (excluding indexation)	<u>65</u>	<u>52</u>
	No	No
Average number of employees in the year	3	3

Notes to the Financial Statements
as at 31 December 2005

5 Taxation	2005	2004
	£'000	£'000
(a) Income and Expenditure Account		
Corporation tax for the year at 30 per cent (2004: 30 per cent) on income and capital gains from investments	277	415
Adjustment in respect of previous years	33	(336)
	<u>310</u>	<u>79</u>
Deferred taxation	(16)	(6)
Share of joint venture's taxation charge	24	189
Taxation charge	<u>318</u>	<u>262</u>

Factors affecting tax charge for the year

The tax assessed for the year is less than the standard rate of corporation tax in the UK (30 per cent). Reconciling items are explained below:

	£'000	Restated £'000
Result from mutual activities before taxation	<u>1,503</u>	<u>3,725</u>
Result before taxation multiplied by standard rate of corporation tax in the UK of 30% (2004 : 30%)	451	1,118
Effects of :		
Tax on non-exempt income	271	371
Non taxable credit relating to pension scheme	(480)	(1,080)
Capital allowances less than depreciation	35	4
Capital loss not utilised	-	2
Adjustments to tax charge in previous periods	33	(336)
	<u>310</u>	<u>79</u>

(b) Statement of Total Recognised Gains and Losses	2005	2004
	£'000	£'000
Corporation tax for the year at 30 per cent (2004: 30 per cent) on capital gains from investments	<u>-</u>	<u>129</u>

Notes to the Financial Statements

as at 31 December 2005

6 Fixed Assets - Tangible Group and Company

Leasehold Properties and Improvements under 50 years

£'000

Cost

At 1 January & 31 December 2005

1,873

Depreciation

At 1 January 2005

803

Provided in year

184

At 31 December 2005

987

Net Book Amount

At 31 December 2005

886

At 31 December 2004

1,070

7 Fixed Assets - Investments Group

Cash & Investment in Cash Fund

£'000

At 1 January 2005 - at cost

36,791

Net decrease in cash

(11,544)

At 31 December 2005

25,247

Group

Joint Venture - Group

£'000

At 1 January 2005

1,646

Share of operating profit in joint venture

415

Share of taxation on operating profit in joint venture

(24)

At 31 December 2005

2,037

Notes to the Financial Statements
as at 31 December 2005

7 Fixed Assets - Investments (continued)

Company	Subsidiary Undertakings	Joint Venture	Total
	£'000	£'000	£'000
Cost - as at 1 January & 31 December 2005	10	2,357	2,367

The Company, either directly or indirectly, holds the entire issued ordinary share capital of the following subsidiaries which principally affect the figures shown in the Company's financial statements: directly MDU Investments Limited, an investment company, incorporated in England and indirectly MDU Insurance Limited and MDU Reinsurance Limited insurance companies, incorporated in Guernsey.

The Directors of the Company consider that disclosure of dormant subsidiary undertakings would result in a statement of excessive length and have therefore, as permitted under Schedule 5 of The Companies Act 1985, dispensed with the requirement.

The investment in the joint venture represents the Company's interest in 75% of the ordinary shares and 50.1% of the voting shares of MDU Services Limited. This company was incorporated as a limited liability company in England and certain aspects of the discretionary cover provided by The Medical Defence Union Limited are being operated by MDU Services Limited on an agency basis. The other party to the joint venture is Converium AG. The Company's interest comprises 100% of the A and B ordinary shares and F participating preference shares of MDU Services Limited.

8 Current Assets - Investments

	Group £'000
Cost of investments at 1 January 2005 and 31 December 2005	51
Provision for diminution in value of investments at 1 January 2005	47
Additional provision charged in year	4
Provision for diminution in value of investments at 31 December 2005	51
Market Value	
At 31 December 2005	-
At 31 December 2004	4

The above investments represent those investments which it is the intention of the Company to dispose of.

Notes to the Financial Statements

as at 31 December 2005

9 Debtors - amounts falling due within one year

	2005		2004	
	Group	Company	Group	Company
	£'000	£'000	£'000	£'000
Amounts owed by subsidiary undertakings	-	7,740	-	19,344
Amounts owed by joint venture	12,559	12,559	10,651	10,651
Other debtors	621	237	1,547	232
Prepayments and accrued income	1,617	1,617	1,138	1,138
Reinsurance and insurance recoveries	1,961	2,361	1,265	1,806
	16,758	24,514	14,601	33,171

10 Debtors - amounts falling due after more than one year

	2005		2004	
	Group	Company	Group	Company
	£'000	£'000	£'000	£'000
Reinsurance and insurance recoveries	32,935	33,778	32,841	33,796
Premiums recoverable	4,962	4,962	-	-
	37,897	38,740	32,841	33,796

11 Creditors

	2005		2004	
	Group	Company	Group	Company
	£'000	£'000	£'000	£'000
Falling due within one year:				
Taxation and social security	230	122	280	17
Other creditors and accruals	11,242	11,179	11,451	10,526
	11,472	11,301	11,731	10,543

Notes to the Financial Statements
as at 31 December 2005

12 Provisions

(a) Indemnity Provisions

	Group	Company
	£'000	£'000
At 1 January 2005 - as previously reported	82,765	67,138
Prior year adjustment - (see note 13)	<u>(8,200)</u>	<u>(8,200)</u>
At 1 January 2005 - restated	74,565	58,938
Finance costs	1,316	772
Reduction in indemnity provision	<u>(5,425)</u>	<u>(5,672)</u>
At 31 December 2005	<u>70,456</u>	<u>54,038</u>

In accordance with the Group's accounting policy for indemnity provisions explained in note 1(e), the charge to the Income and Expenditure account has been increased by £34.1m, representing a reversal of previous years restrictions (2004: increase of £2.8m restated), to maintain the indemnity provision at no more than the net assets of the Group. This sum will be covered by the Group's future business contributions and by the Group's reinsurance programme and capital funding if required. In aggregate the restriction on the indemnity provision is £93.2m (2004: £127.3 restated).

(b) Other Provisions

Group and Company

	Pensions	Deferred	Total
	Liability	Tax	Tax
	£'000	£'000	£'000
At 1 January 2005 - as previously reported	-	97	97
Prior year adjustment - (see note 13)	<u>8,200</u>	<u>-</u>	<u>8,200</u>
At 1 January 2005 - restated	8,200	97	8,297
Movement in year	<u>900</u>	<u>(16)</u>	<u>884</u>
At 31 December 2005	<u>9,100</u>	<u>81</u>	<u>9,181</u>

As explained in accounting policy note 1(l) the Company is responsible for any deficit of the pension scheme for which MDU Services Limited is the principal employer. As at 31 December 2005 the scheme had an excess of liabilities over assets, under FRS 17, of £9.1m (2004: £8.2m restated) and so the Company has provided for a liability equal to this deficit.

The deferred tax liability represents the potential tax owing, due to capital allowances on leasehold improvements being less than the depreciation that has been charged to date in the financial statements.

Notes to the Financial Statements

as at 31 December 2005

13 Reserves

Group and Company

Accumulated Fund
£'000

At 1 January 2005 - as previously reported	-
Pension provision	(8,200)
Indemnity provision	8,200
At 1 January 2005 - restated	-
Result for year	1,600
Actuarial (loss) on pension scheme	(1,600)
At 31 December 2005	-

Under the accounting policy followed in respect of the indemnity provision (accounting policy 1(e)) the indemnity provision cannot exceed the Group or Company net assets. The prior year adjustment in respect of the provision for pension costs according necessitates a corresponding reduction in the indemnity provision at 31 December 2004 (£5.7m at 1 January 2004).

14 Notes to the Consolidated Cash Flow Statement

(a) Reconciliation of surplus before taxation to net cash (outflow) from operating activities

Restated

	2005 £'000	2004 £'000
Result before taxation	1,918	3,991
Share of operating profit in joint venture	(415)	(266)
Investment income	(1,724)	(2,402)
Realised losses/(gains) from disposal of investments	4	(167)
Depreciation	184	187
(Increase) in debtors	(2,205)	(1,917)
(Increase) in debtors due in more than one year	(5,056)	(117)
Increase in creditors	164	392
(Decrease) in provisions	(4,825)	(26,659)
Net cash (outflow) from operating activities	(11,955)	(26,958)

(b) Analysis of net funds

	At 1 January 2005 £'000	Cash Flows £'000	At 31 December 2005 £'000
Cash held for investment and investment in cash funds	36,791	(11,544)	25,247
Deposits at bank	7,640	644	8,284
	44,431	(10,900)	33,531

Cash includes Investment Cash Funds which are repayable on notice of not more than one working day.

Notes to the Financial Statements

as at 31 December 2005

15 Pension costs

As explained in accounting policy note 1(i) the Company is responsible for any deficit of the pension scheme for which MDU Services Limited is the principal employer. MDU Services Limited provides a pension scheme that provides defined benefits for employees who accepted employment before 1 January 2003, and defined contributions for employees who accepted employment after 31 December 2002. The assets of the Scheme are held under trust separately from those of MDU Services Limited. The funding of the Scheme is based on regular triennial actuarial valuations. The last full actuarial valuation of the Scheme was carried out as at 31 March 2003 and has been updated to 31 December 2005 by qualified independent actuaries for the purpose of reporting pension costs.

The major assumptions made by the Actuary in the updates were:

	31 Dec 2005	31 Dec 2004	31 Dec 2003
Rate of Increase in Salaries	4.0%	4.0%	3.9%
Rate of Increase in Pensions	2.8%	2.7%	2.7%
Discount Rate	4.7%	5.2%	5.4%
Inflation Assumption	2.9%	2.9%	2.8%

	Long term rate of return expected at			Fair Value at		
	31 Dec 2005	31 Dec 2004	31 Dec 2003	31 Dec 2005 £'000	31 Dec 2004 £'000	31 Dec 2003 £'000
Equities	7.0%	7.5%	7.8%	34,800	29,700	26,700
Govt. Bonds	4.0%	4.5%	4.8%	-	7,700	8,600
Corp. Bonds	4.7%	5.0%	N/A	15,600	3,300	N/A
Other	3.5%	3.5%	3.8%	300	500	700

The approximate fair value of assets and liabilities of the Scheme were:

	31 Dec 2005 £'000	31 Dec 2004 £'000	31 Dec 2003 £'000
Total market value of assets	50,700	41,200	36,000
Present value of Scheme liabilities	59,800	49,400	41,700
Net Pension (liability) before deferred taxation	(9,100)	(8,200)	(5,700)

Movement in (deficit) during the year

	2005 £'000	2004 £'000
(Deficit) in Scheme at beginning of year	(8,200)	(5,700)
Current service cost	(1,800)	(1,500)
Contributions	2,300	2,300
Other finance income	200	300
Actuarial (loss)	(1,600)	(3,600)
(Deficit) in Scheme at end of year	(9,100)	(8,200)

Notes to the Financial Statements

as at 31 December 2005

15 Pension costs (continued)

Analysis of the amount charged to Income & Expenditure

	2005	2004
	£'000	£'000
Current service cost	1,800	1,500
Past service cost	-	-
Total operating charge	1,800	1,500

Analysis of the amount credited to other finance income

	2005	2004
	£'000	£'000
Expected return on Scheme assets	2,800	2,600
Interest on Scheme liabilities	(2,600)	(2,300)
Net return	200	300

Analysis of amounts recognised in the statement of total recognised gains and losses (STRGL)

	2005	2004
	£'000	£'000
Actual return less expected return on Scheme assets	5,600	1,100
Experience (losses) arising on the Scheme liabilities	(800)	(300)
Changes in assumptions underlying the present value of the Scheme	(6,400)	(4,400)
Actuarial (loss) recognised in the STRGL	(1,600)	(3,600)

History of experience gains and losses

	2005	2004
	£'000	£'000
Actual return less expected return on Scheme assets	5,600	1,100
As a percentage of the Scheme assets	11.0%	2.7%
Experience (losses) arising on the Scheme liabilities	(800)	(300)
As a percentage of the present value of the Scheme liabilities	1.3%	0.6%
Actuarial (loss) recognised in the STRGL	(1,600)	(3,600)
As a percentage of the present value of the Scheme liabilities	2.7%	7.3%

Notes to the Financial Statements

as at 31 December 2005

16 Financial Commitments

Group and Company

Annual commitments in respect of non cancellable operating leases are as follows:

	Land and Buildings	
	2005	2004
	£'000	£'000
Operating leases which expire after five years	<u>965</u>	<u>965</u>

17 Contingent Liabilities

Claims are made against The Medical Defence Union Limited in the ordinary course of business. Having obtained legal advice on such claims and on the basis of the information available, in the opinion of the directors no provision is needed for such claims.

18 Members' Liability

The Medical Defence Union Limited is a company limited by guarantee not exceeding £1 per member.

19 Related Party Transactions

The Group has taken advantage of the exemptions available in respect of its wholly owned subsidiary undertakings and the disclosure of related party transactions within the Group and balances eliminated on consolidation.

During the year the Group entered into transactions, in the ordinary course of business with MDU Services Limited, a joint venture company in which the Group has an interest in 75% of the ordinary shares and 50.1% of the voting shares. The trading balance outstanding at 31 December is disclosed in note 9 to these accounts. On behalf of the Group, MDU Services Limited collected subscriptions from the Group's members of £153,846,000 (2004: £137,523,000); handled claims on behalf of the Group amounting to £35,206,000 (2004: £41,134,000) and overheads and other costs totalling £22,528,000 (2004: £21,957,000) were recharged to the Group during the year.

Independent Auditors' Report to the members of The Medical Defence Union Limited

We have audited the group and parent company financial statements (the 'financial statements') of The Medical Defence Union Limited for the year ended 31 December 2005 which comprise the consolidated income and expenditure account, the consolidated and company balance sheets, the consolidated cash flow statement, the consolidated statement of total recognised gains and losses and the related notes. The 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 have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if 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 other information contained in the annual report and consider whether it is consistent with the audited financial statements. The other information comprises only the directors' report, the chairman's statement and the operating and financial review. 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 other information.

Basis of 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.

Independent Auditors' Report to the members of The Medical Defence Union Limited (continued)

Basis of opinion (continued)

We planned and performed our audit so as to obtain all the information and explanations 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 December 2005 and of the group's result for the year then ended; and
- have been properly prepared in accordance with the Companies Act 1985.



PKF (UK) LLP
Registered Auditors
London, UK
25th April 2006