

CML Microsystems Plc



Transition to International Financial Reporting Standards

15th November 2005

CML Microsystems Plc

Transition to International Financial Reporting Standards

Introduction

CML Microsystems Plc (“CML” or “the Group”) has historically prepared its consolidated financial statements under UK Generally Accepted Accounting Practice (UK GAAP). Following the adoption by the United Kingdom of a European Union (EU) Regulation issued on 19th July 2002, the Group is required to prepare its financial statements in accordance with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) from 1st April 2005. Accordingly the interim results for the period ended 30th September 2005 will be the Group’s first results to be prepared and reported under IFRS.

The Group’s financial performance and position is altered by the adoption of IFRS, however, there is no change to the cash flows of the Group. This document explains how the Group’s reported UK GAAP financial results for the year ended 31st March 2005 and its financial position as at that date would have been reported under IFRS. Although this document has been prepared in accordance with our current understanding of IFRS the accounting policies applied assume that all existing standards in issue from the International Accounting Standards Board (“IASB”) will be fully endorsed by the EU. Since these standards are subject to ongoing amendment by the IASB and subsequent endorsement by the EU these first IFRS statements are subject to possible change. This document includes:

- the Group’s consolidated Income statements for the period ended 30th September 2004 and year ended 31st March 2005;
- the Group’s consolidated balance sheets at 30th September 2004 and 31st March 2005 ;
- the Group’s consolidated cash flow statements for the period ended 30th September 2004 and the year ended 31st March 2005;
- the Group’s consolidated statement of changes in equity for the year ended 31st March 2005 and the period ended 30th September 2004;
- a reconciliation of the Group’s consolidated Income statements for the period ended 30th September 2004 and year ended 31st March 2005, from those prepared under UK GAAP to IFRS;
- a reconciliation of the Group’s consolidated balance sheets at 31st March 2004, 30th September 2004 and 31st March 2005, from those prepared under UK GAAP to IFRS;
- the Group’s accounting policies applied in the preparation of this financial information.

In conjunction with our auditors, the Group has reviewed the changes necessary to comply with IFRS. The financial information presented in this document is unaudited. The auditors, Baker Tilly, have reviewed this announcement and the financial information and accounting policies contained therein.

Financial Impact Summary

The full effect of the financial impact of IFRS in respect of the Group’s year ended 31st March 2005 reported results is set out in detail later in this document. A summary of the effect on the income statement for the year ended 31st March 2005 is:

Reconciliation of profit for the year ended 31 st March 2005	2005 £’000
UK GAAP profit for year (before dividend)	419
Exchange differences (net of tax)	(7)
Share based payments (net of tax)	(56)
Removal of amortisation of goodwill	1,561
Employee benefits – pension charge (net of tax)	57
Capitalised research and development expenditure in excess of amortisation (net of tax)	512
IFRS underlying profit on ordinary activities before tax	<u>2,486</u>

The key areas which will affect the financial statements and accounting policies as reported under UK GAAP are goodwill, share-based payments, employee benefits, dividends and accounting for research and development costs. The reporting under IFRS will change the Group's financial performance and position; however, there is no change to the cash flows of the Group.

CML Microsystems Plc IFRS Results

IFRS 1 "First-time Adoption of International Financial Reporting Standards" lays out the procedures that the Group must follow when it adopts IFRS for the first time as the basis for preparing its consolidated financial statements. Although in general the Group is required to apply the new accounting standards retrospectively to determine its opening balance sheet this standard allows companies adopting IFRS for the first time to take certain exemptions from the full requirements of IFRS in the year of transition. The group has elected to take the following exemptions:

IFRS 2 – Share-based payments

The Group has elected to apply the exemption that allows entities to apply IFRS 2 to share based payment awards granted after November 2002.

IFRS 3 – Business combinations

The Group has elected not to apply IFRS 3 retrospectively to acquisitions that took place prior to the date of transition. As a result, the carrying amount of goodwill in the UK GAAP balance sheet at 31st March 2004 is brought forward to the IFRS opening balance sheet without adjustment.

IAS 19 – Employee benefits – actuarial gains and losses

The Group has elected to recognise all cumulative actuarial gains and losses at the date of transition.

IAS 21 – Foreign currencies

The Group has elected to deem the cumulative amount of exchange differences arising on consolidation of the net investments in subsidiaries at 1st April 2004 to be zero.

Key financial impacts

The most significant adjustments arising from the transition to IFRS were highlighted in the 2005 Report and Accounts. These are set out in more detail below:

Presentation of financial statements

The presentation of the Groups primary financial statements has been presented in accordance with IAS 1 "Presentation of Financial Statements".

Goodwill

Under UK GAAP the Group was amortising the goodwill arising on the acquisition of Hyperstone AG over a 36-month period. Under IAS 38 intangible assets with an indefinite life shall not be amortised, but tested for impairment annually. Though the Board considered the approach taken under UK GAAP to be the more prudent, it has complied, as it is required to do, with the accounting approach under IAS 38.

Share-based payments

In accordance with IFRS2 the Group has recognised the cost of outstanding share options granted. The fair value has been calculated using the Black-Scholes model. Deferred tax is provided based upon expected future deductions relating to share based payments and is recognised over the vesting period of the scheme concerned.

Employee benefits

Under IAS 19 the Group is required to separately recognise the operating and financing costs of defined benefit pension schemes. The group has adopted the amendment to IAS 19 issued on 16th December 2004 that allows all actuarial gains and losses to be charged or credited to equity rather than in the income statement. Actuarial gains and losses will be recognised in full immediately in the statement of recognised income and expenditure. Deferred tax is provided based upon the expected future deductions or additions as appropriate.

Dividends

IFRS requires that dividends declared after the balance sheet date should not be recognised as a liability until approved by shareholders. Accordingly the dividend for the year ended 31st March 2005 and 31st March 2004 is not accrued in the balance sheet as at those dates.

Accounting for research and development

The Group is continually engaged in significant research and development in respect of new products and has concluded that the majority of this meets the criteria as set out in IAS 38 for capitalisation. Though the Board considers that the previous method of accounting under UK GAAP to be a more prudent approach it has, as it is required to do, adopted accounting for this expenditure under IAS 38.

Accordingly the Group has retrospectively reviewed all research and development expenditure previously charged to the profit and loss account under UK GAAP to determine its opening balance for this new asset class, amortising the asset over the appropriate period that has been decided to be between 2 and 4 years. This change in accounting policy has had the most significant impact on the Groups results when restated under IFRS since over the last four years the Groups overall research and development expenditure has significantly increased (2002-£1,942k; 2003-£2,276k; 2004-£2,817k; 2005-£3,578k) which when capitalised and amortised must result in an increase in profits when restated.

Cash flow statement

Although there is no effect on the underlying cash receipts and expenditure of the Group, there are significant presentational changes. Under IAS 7 “Cash Flow Statements”, the movement in cash and cash equivalents includes short –term investments with maturity of less than three months.

The format of the of the cash flow statement shows cash flows analysed between operating, investment and financing activities. Cash flows relating to tax are classified within operating cash flows whereas under UK GAAP these items were classified separately from operating activities.

George W Gurry
Chairman

15th November 2005

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CML Microsystems Plc
Consolidated Income Statement (under IFRS)

	Year ended 31st March 2005 £'000	Six months ended 30th September 2004 £'000
Revenue	23,457	11,440
Cost of sales	(8,597)	(4,435)
Gross profit	<u>14,860</u>	<u>7,005</u>
Distribution and administration costs	(12,507)	(5,819)
	2,353	1,186
Other operating income	581	276
Operating profit before adjustments	<u>2,934</u>	<u>1,462</u>
Restructuring costs	(420)	-
Share based payment	(79)	(39)
Operating profit after adjustments	<u>2,435</u>	<u>1,423</u>
Finance cost	(249)	(118)
Finance income	119	47
Profit before tax	<u>2,305</u>	<u>1,352</u>
Taxation	181	(381)
Profit for the period attributable to equity shareholders	<u>2,486</u>	<u>971</u>
Earnings per share		
Basic	16.77p	6.66p
Diluted	16.64p	6.56p

Statement of Recognised Income and Expenditure (under IFRS)

	Year ended 31st March 2005 £'000	Six months ended 30th September 2004 £'000
Profit for the period attributable to equity shareholders	2,486	971
Foreign exchange differences	(40)	77
Actuarial losses	(493)	-
Deferred tax	148	-
Recognised gains and losses relating to the period	<u>2,101</u>	<u>1,048</u>

CML Microsystems Plc
Consolidated Balance Sheet (under IFRS)

	31st March	30th September
	2005	2004
	£'000	£'000
Assets		
Non current assets		
Property, plant and equipment	7,193	6,828
Investment properties	3,150	3,150
Intangible assets - Research & development	5,089	4,629
Intangible assets - Goodwill on consolidation	3,512	3,512
Deferred tax asset	1,573	1,066
	<u>20,517</u>	<u>19,185</u>
Current assets		
Inventories	1,723	1,991
Trade receivables and prepayments	4,093	3,837
Cash and cash equivalents	8,449	8,471
	<u>14,265</u>	<u>14,299</u>
Total assets	<u>34,782</u>	<u>33,484</u>
Liabilities		
Current liabilities		
Bank loans and overdrafts	4,378	4,378
Trade and other liabilities	4,086	4,788
Current tax liabilities	272	418
	<u>8,736</u>	<u>9,584</u>
Non current liabilities		
Deferred tax liabilities	2,624	2,408
Provisions	420	-
Long term liabilities	3,504	3,093
	<u>6,548</u>	<u>5,501</u>
Total liabilities	<u>15,284</u>	<u>15,085</u>
Net Assets	<u>19,498</u>	<u>18,399</u>
Equity		
Share capital	744	741
Convertible warrants	120	240
Share premium	3,752	3,630
Share based payments	83	42
Capital Redemption Reserve	255	255
Foreign exchange differences	(40)	77
Retained earnings	14,584	13,414
Shareholders' equity	<u>19,498</u>	<u>18,399</u>

CML Microsystems Plc
Consolidated Cash Flow Statement (under IFRS)

	Year ended 31st March 2005 £'000	Six months ended 30th September 2004 £'000
Operating activities		
Net profit for the period before income taxes	2,305	1,352
Adjustments for:		
Depreciation	663	289
Movement in pension deficit	(82)	-
Amortisation of research and development	3,354	1,301
Share based payments	79	39
Exceptional restructuring costs	420	-
Interest expense	235	118
Interest income	(119)	(47)
Increase in working capital	243	385
Cash flows from operating activities	7,098	3,437
Income tax refunded	142	284
Net cash flows from operating activities	7,240	3,721
Investing activities		
Purchase of tangible fixed assets	(1,351)	(593)
Investment in intangible assets	(4,093)	(1,579)
Disposals of tangible fixed assets	99	53
Interest income	119	47
Net cash flows from investing activities	(5,226)	(2,072)
Financing activities		
Issue of ordinary shares	47	41
Dividends paid to group shareholders	(1,556)	(1,556)
Interest expense	(235)	(118)
Net cash flows from financing activities	(1,744)	(1,633)
Increase in cash and cash equivalents	270	16
Movement in cash and cash equivalents:		
At start of period	8,245	8,245
Increase	270	16
Effects of exchange rate changes	(66)	210
At end of period	8,449	8,471

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Consolidated Statement of Changes in Equity

	Share Capital £'000	Convertible Warrants £'000	Share Premium £'000	Share based payments £'000	Capital redemption reserve £'000	Foreign Exchange differences £'000	Retained earnings £'000	Total £'000
At 1st April 2004	740	240	3,590	3	255	-	13,999	18,827
Shares issued	4		163					167
Warrants converted		(120)						(120)
Foreign Exchange differences						(40)		(40)
Net actuarial losses recognised directly to equity							(493)	(493)
Dividends paid							(1,556)	(1,556)
Profit for period							2,486	2,486
Share based payments				79				79
Deferred tax							148	148
At 31st March 2005	744	120	3,753	82	255	(40)	14,584	19,498
	Share Capital £'000	Convertible Warrants £'000	Share Premium £'000	Share based payments £'000	Capital redemption reserve £'000	Foreign Exchange differences £'000	Retained earnings £'000	Total £'000
At 1st April 2004	740	240	3,590	3	255	-	13,999	18,827
Shares issued	1		40					41
Foreign Exchange differences						77		77
Net actuarial losses recognised directly to equity								
Dividends paid							(1,556)	(1,556)
Profit for period							971	971
Share based payments				39				39
At 30th September 2004	741	240	3,630	42	255	77	13,414	18,399

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Reconciliation of the group's consolidated income statement for the year ended 31st March 2005

	Year ended 31 st March 2005 Under UK GAAP	IAS10 Dividend	IAS19 Employee Benefits	IAS38 Intangible Assets	Foreign Exchange Differences	IFRS2 Share based Payments	Year ended 31 st March 2005 Restated Under IFRS
	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Revenue	23,459				(2)		23,457
Cost of sales	(9,685)			1,071	17		(8,597)
Gross profit	13,774						14,860
Distribution & admin costs	(12,256)		96	(332)	(15)		(12,507)
	1,518						2,353
Other operating income	583				(2)		581
Operating profit before adjustment	2,101						2,934
Amortisation of goodwill	(1,561)			1,561			-
Restructuring costs	(420)						(420)
Share Based payment	-					(79)	(79)
Operating profit after adjustments	120						2,435
Finance cost	(235)		(14)				(249)
Finance income	118				1		119
Profit before tax	3						2,305
Taxation	416		(25)	(227)	(6)	23	181
Profit for the period	419						2,486
Dividend proposed/paid	(1,564)	1,564					-
Profit for the period attributable to equity shareholders	(1,145)						2,486

Reconciliation of statement of recognised income and expenditure

Profit for the period attributable to equity shareholders	(1,145)						2,486
Foreign exchange differences	(63)				23		(40)
Actuarial losses	-		(493)				(493)
Deferred tax	-		148				148
Recognised gains and losses relating to the period	(1,208)						2,101

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Reconciliation of the group's consolidated income statement for the 6 months ended 30th September 2004

	6 months ended 30 th September 2004 Under UK GAAP	IAS10 Dividend	IAS38 Intangible Assets	Foreign Exchange Differences	IFRS2 Share based Payments	6 months ended 30 th September 2004 Restated Under IFRS
	£'000	£'000	£'000	£'000	£'000	£'000
Revenue	11,559			(119)		11,440
Cost of sales	(4,500)			65		(4,435)
Gross profit	7,059					7,005
Distribution & admin costs	(6,139)		278	42		(5,819)
	920					1,186
Other operating income	278			(2)		276
Operating profit before adjustments	1,198					1,462
Amortisation of goodwill	(781)		781			-
Share Based payment	-				(39)	(39)
Operating profit after adjustments	417					1,423
Finance cost	(118)					(118)
Finance income	47					47
Profit before tax	346					1,352
Taxation	(305)		(89)	1	12	(381)
Profit for the period attributable to equity shareholders	41					971

Reconciliation of statement of recognised income and expenditure

Profit for the period attributable to equity shareholders	41					971
Foreign exchange differences	48			29		77
Actuarial losses	-					-
Recognised gains and losses relating to the period	89					1,048

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Reconciliation of the group's consolidated balance sheet as at 31st March 2004 (the "opening" IFRS balance sheet)

	31 st March 2004 Under UK GAAP	IAS10 Dividend	IAS19 Employee Benefits	IAS38 Intangible Assets	IAS12 Investment Property	IFRS2 Share based Payments	31 st March 2004 Restated Under IFRS
	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Assets							
Non current assets							
Property, plant and equipment	6,522						6,522
Investment properties	3,150						3,150
Intangible assets - R & D	-			4,333			4,333
Intangible assets - Goodwill	3,512						3,512
Deferred tax asset	153		928			1	1,082
	<u>13,337</u>						<u>18,599</u>
Current assets							
Inventories	1,784						1,784
Trade receivables and prepayments	3,388						3,388
Cash and cash equivalents	8,413						8,413
	<u>13,585</u>						<u>13,585</u>
Total assets	<u>26,922</u>						<u>32,184</u>
Liabilities							
Current liabilities							
Bank loans and overdrafts	4,546						4,546
Trade and other liabilities	4,687	(1,554)					3,133
Current tax liabilities	252						252
	<u>9,485</u>						<u>7,931</u>
Non current liabilities							
Deferred tax liabilities	737			1,300	296		2,333
Long term liabilities	-		3,093				3,093
	<u>737</u>						<u>5,426</u>
Total liabilities	<u>10,222</u>						<u>13,357</u>
Net assets	<u>16,700</u>						<u>18,827</u>
Equity							
Share capital	740						740
Convertible warrants	240						240
Share premium	3,590						3,590
Share based payments	-					3	3
Capital redemption reserve	255						255
Revaluation reserve	986				(986)		-
Retained earnings	10,889	1,554	(2,165)	3,033	690	(2)	13,999
Shareholders' equity	<u>16,700</u>						<u>18,827</u>

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Reconciliation of the group's consolidated balance sheet as at 31st March 2005

	31 st March 2005 Under UK GAAP £'000	IAS10 Dividend £'000	IAS19 Employee Benefits £'000	IAS38 Intangible Assets £'000	Foreign Exchange Differences £'000	IAS12 Investment Property £'000	IFRS2 Share based Payments £'000	31 st March 2005 Restated Under IFRS £'000
Assets								
Non current assets								
Property, plant and equipment	7,195			(2)				7,193
Investment properties	3,150							3,150
Intangible assets - R & D	-			5,089				5,089
Intangible assets - Goodwill	1,951			1,561				3,512
Deferred tax asset	497		1,051				25	1,573
	<u>12,793</u>							<u>20,517</u>
Current assets								
Inventories	1,723							1,723
Trade receivables and prepayments	4,093							4,093
Cash and cash equivalents	8,449							8,449
	<u>14,265</u>							<u>14,265</u>
Total assets	<u>27,058</u>							<u>34,782</u>
Liabilities								
Current liabilities								
Bank loans and overdrafts	4,378							4,378
Trade and other liabilities	5,649	(1,563)						4,086
Current tax liabilities	272							272
	<u>10,299</u>							<u>8,736</u>
Non current liabilities								
Deferred tax liabilities	801			1,527		296		2,624
Provisions	420							420
Long term liabilities	-		3,504					3,504
	<u>1,221</u>							<u>6,548</u>
Total liabilities	<u>11,520</u>							<u>15,284</u>
Net assets	<u>15,538</u>							<u>19,498</u>
Equity								
Share capital	744							744
Convertible warrants	120							120
Share premium	3,752							3,752
Share based payments	-						83	83
Capital redemption reserve	255							255
Revaluation reserve	986					(986)		-
Foreign exchange differences	-				(40)			(40)
Retained earnings	9,681	1,563	(2,453)	5,121	40	690	(58)	14,584
Shareholders' equity	<u>15,538</u>							<u>19,498</u>

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Reconciliation of the group's consolidated balance sheet as at 30th September 2004

	30 th September 2004 Under UK GAAP £'000	IAS10 Dividend £'000	IAS19 Employee Benefits £'000	IAS38 Intangible Assets £'000	Foreign Exchange Differences £'000	IAS12 Investment Property £'000	IFRS2 Share based Payments £'000	30 th September 2004 Restated Under IFRS £'000
Assets								
Non current assets								
Property, plant and equipment	6,828							6,828
Investment properties	3,150							3,150
Intangible assets - R & D	-			4,629				4,629
Intangible assets - Goodwill	2,732			780				3,512
Deferred tax asset	126		928				12	1,066
	<u>12,836</u>							<u>19,185</u>
Current assets								
Inventories	1,991							1,991
Trade receivables and prepayments	3,837							3,837
Cash and cash equivalents	8,471							8,471
	<u>14,299</u>							<u>14,299</u>
Total assets	<u>27,135</u>							<u>33,484</u>
Liabilities								
Current liabilities								
Bank loans and overdrafts	4,378							4,378
Trade and other liabilities	4,786	2						4,788
Current tax liabilities	418							418
	<u>9,582</u>							<u>9,584</u>
Non current liabilities								
Deferred tax liabilities	723			1,389		296		2,408
Provisions	-							-
Long term liabilities	-		3,093					3,093
	<u>723</u>							<u>5,501</u>
Total liabilities	<u>10,305</u>							<u>15,085</u>
Net assets	<u>16,830</u>							<u>18,399</u>
Equity								
Share capital	741							741
Convertible warrants	240							240
Share premium	3,630							3,630
Share based payments	-						42	42
Capital redemption reserve	255							255
Revaluation reserve	986					(986)		-
Foreign exchange differences	-				77			77
Retained earnings	10,978	(2)	(2,165)	4,020	(77)	690	(30)	13,414
Shareholders' equity	<u>16,830</u>							<u>18,399</u>

CML Microsystems Plc

Accounting Policies

Basis of accounting

The financial statements have been prepared in accordance with IAS and IFRS issued by the IASB. The accounting policies applied assume that all existing standards in issue from the IASB will be fully endorsed by the EU. These are subject to amendment by the IASB and subsequent endorsement by the EU and are therefore subject to possible change.

The financial statements have been prepared under the historical cost convention with the exception of investment properties, which are carried at valuation.

The consolidated financial statements for the year ended 31st March 2006 will be the Group's first full IFRS financial statements. Comparative information at 31st March 2005 and for the year then ended has been restated under IFRS.

The Group has elected to take certain optional exemptions contained in IFRS 1 "First time Adoption of IFRS" in preparing the Group's balance sheet on transition to IFRS. These exemptions apply to accounting under IFRS 2 "Share based payments", IAS 19 "Employee Benefits" and IAS 21 "Cumulative Translation Differences".

Basis of consolidation

The financial statements incorporate the financial statements of the Company and its subsidiary undertakings using the acquisition method of accounting. The results of acquired subsidiary undertakings are included from the date of acquisition.

Segmental reporting

The Group's primary reporting format is in two segments being Semi-conductor Components and Equipment. These individual segments are engaged in separate business sectors and are subject to different risks and returns.

Revenue

Revenue represents the total amount receivable by the Group for the sale of its product or services to third parties in respect of deliveries of goods and services rendered during the year, excluding local sales tax.

Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at the rates of exchange ruling at the balance sheet date. Transactions in foreign currencies are recorded at the rates ruling at the date of the transactions. All differences are taken to the profit and loss account.

The income statements of overseas subsidiaries are translated into sterling at the average rate for the period. Translation differences are dealt with through the Foreign Exchange differences reserve in shareholders funds.

The Group has elected to deem the cumulative amount of exchange differences arising on consolidation of the net investments in subsidiaries at 1st April 2004 to be zero.

Tangible Fixed Assets

All tangible fixed assets, other than investment properties, are stated at historic cost.

Depreciation is provided on all tangible fixed assets other than freehold land and investment properties at rates calculated to write each asset down to its estimated residual value evenly over its expected useful life as follows:

Freehold and long leasehold premises	2% straight line
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Short leasehold premises		period of lease
Plant and equipment:	Fixtures and fittings	20% reducing balance
	Other equipment	20% & 25% straight line
Motor Vehicles		25% straight line

Investment Properties

Investment properties comprise freehold and long leasehold land and buildings. Investment properties are carried at fair value in accordance with IAS 40 'Investment Properties'. Properties are recognised as investment properties when held for long-term rental yields, and after consideration has been given to a number of factors including length of lease, quality of tenant and covenant, value of lease, management intention for future use of property, planning consents and percentage of property leased. Investment properties are revalued annually by the directors and every third year by professional external surveyors and included in the balance sheet at their fair value. Gains or losses arising from changes in the fair values of assets are recognised in the consolidated income statement. In accordance with IAS 40, investment properties are not depreciated.

Intangible Assets – Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Historically the Group's policy for goodwill arising on acquisition of a subsidiary undertaking was to write it off directly against reserves but following the introduction of Financial Reporting Standard 10 goodwill arising on the acquisition of a subsidiary undertaking was capitalised, classified as an asset and amortised over its economic useful life. Under IFRS 1 the Group has elected to adopt the 31st March 2004 balance sheet amortised value prepared under UK GAAP for goodwill and carry out annual impairment reviews as required under IAS 38.

Intangible Assets – Research and Development

Research and development assets that fall within the scope of IAS 38 are shown at historical cost less accumulated amortisation since research and development has a definite useful life. Amortisation is calculated using the straight line method to allocate the cost of the research and development over its estimated useful life of between 2 and 4 years.

Research and development expenditure that falls outside the scope of IAS 38 is charged to the income statement when it is incurred.

Inventories

Inventories are valued on a first in, first out basis and are stated at the lower of cost and net realisable value. In respect of work in progress and finished goods, cost comprises direct materials, direct labour and a proportion of overhead expenses appropriate to the business.

Cash and Cash Equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts where there is a set off arrangement with the bank. Other bank overdrafts are shown within borrowings in current liabilities on the balance sheet.

Income tax

The charge for current income tax is based on the results for the year as adjusted for items which are not taxed or disallowed. It is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred income tax is accounted for using the liability method in respect of temporary differences arising from differences between the tax bases of assets and liabilities and their carrying amounts in the financial statements.

In principle, deferred tax liabilities are recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference is due to goodwill arising on a business combination or from an asset or liability, the initial recognition of which does not affect either taxable or accounting income.

In respect of the deferred tax on the revaluation surplus, this is calculated on the basis of the chargeable gains that would crystallise on the sale of the investment portfolio as at the reporting date. The calculation takes account of indexation on the historic cost of the properties and any available capital losses.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is calculated at the tax rates that are expected to apply to the period when the asset is realised or liability is settled. Deferred tax is charged or credited in the income statement, except when it relates to items credited or charged directly to shareholders' equity, in which case the deferred tax is also dealt with in shareholders' equity.

Investments

Fixed asset investments are stated at cost less any provision for diminution on value. Investments held as current assets are stated at the lower of cost and net realisable value.

Employee Benefits – Pension Obligations

Group companies operate both defined benefit and defined contribution pension schemes. The schemes are funded through payments to funds administered by trustees and these are determined by periodic actuarial calculations in respect of the defined benefit pension schemes.

The Group has elected to recognise all cumulative actuarial gains and losses in relation to employee defined benefit schemes at the date of transition.

The liability recognised in the balance sheet in respect of the defined benefit pension schemes is the present value of the defined benefit obligation at the balance sheet date less the fair value of the scheme assets. Independent actuaries using the projected unit method calculate the defined benefit obligation annually.

Past service costs are included where the benefits have vested, otherwise they are amortised on a straight line basis over the vesting period. The expected return on assets of the defined benefit pension plan and the imputed interest on the pension plan liabilities comprise the pension element of the net finance cost/income in the income statement.

Differences between the actual and expected return on assets, changes to the retirement benefit obligation due to experience and changes in actuarial assumptions are included in the statement of recognised income and expense in full in the period in which they arise.

For defined contribution schemes, contributions are recognised as an employee benefit expense when they are due.

Employee Benefits – Share Based Payments

The Group has taken advantage of the transitional provisions that allows it to apply IFRS 2 to share option awards granted after 7th November 2002 that had not vested on or before 31st March 2005.

Share options are valued using the Black Scholes model. This fair value is charged to the income statement over the vesting period of the share based payment scheme. The value of the charge is adjusted to reflect expected and actual levels of options vesting.

EU Grants

EU grants receivable to assist the Group with costs in respect of development work are credited to the income statement so as to match them with the expenditure to which they relate.

Leases

Leases of property, plant and equipment where the Group has substantially all the risk and rewards of ownership are classified as finance leases. The Group has no such leases. Leases in which a significant number of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Rental payments under operating leases are charged to the income statement on a straight-line basis.

Dividends

Final dividends proposed by the Board of Directors and unpaid at the year end are not recognised in the financial statements until they have been approved by the shareholders at the Annual General Meeting. Interim dividends, which do not require shareholder approval are recognised when they are approved by the Board of Directors.