4586961

Report and Financial Statements Period ended 31 March 2003

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Contents

Report of the Directors

The Directors present their report and the audited financial statements for the period ended 31 March 2003.

Incorporation
QinetiQ Holdings Ltd (QHL) was incorporated on 11 November 2002, under the registration number 4586941.

Principal activity
The company's principal activity is as the holding company of QinetiQ Group plc. The Group's principal activity is the supply of scientific and technical services.

Statement of Directors' responsibilities
Company law requires the Directors to prepare financial statements for each financial period which give a true and fair view of the state of affairs of the company and Group and of the profit or loss 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; 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 to enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Business review
The Group profit on ordinary activities after exceptionals and before tax amounted to £26.7m. This represents the final month of trading of the Group's annual results which historically have represented a disproportionate contribution to the level of trading activity.

On 28 February 2003 the company acquired QinetiQ Group Limited for a total investment value of £94.3m, this comprised £39.7m in cash, £78.1m of shares issued for non-cash consideration, less £34.2m of pension indemnity receivable from MOD and a further £10.7m of costs representing professional fees and other related acquisition costs. The fair value of net assets acquired on acquisition were £183.6m. Correspondingly negative goodwill of £89.3m has arisen, which is being released to the profit and loss account in the periods in which the fair values of the non-monetary assets acquired are recovered, through depreciation or sale.

The funding for the acquisition was achieved through the issue of new share capital and increased borrowings.

In economic interest terms, 62% of these shares were issued to the MOD, 34% to funds managed by The Carlyle Group ('Carlyle') and 4% to employees and the Directors. The voting rights attached to these shares varied by the class of shares issued. Carlyle obtained 51% of the voting rights of the company, with MOD obtaining 49%. Further details of share capital issued in the period is presented in note 17 of the financial statements.

On the date of the acquisition the company raised £165m in new borrowings from commercial banks, as well as a further £60m loan note which is repayable to the MOD on the disposal of certain, identified assets. The proceeds of these new borrowings were used to provide funding for the operations of the company as well as the repayment of £105.6m of loans which were payable to MOD, and £62.2m payable to commercial banks within the acquired group. Consequently as a result of the acquisition net debt within the Group has increased by £57.2m, before associated costs of the transaction.

Compliance regime
The compliance regime was created on 1 July 2001 and is intended to ensure that QinetiQ does not engage in any activity with a third party which could cause a conflict of interest which could not be managed to the MOD's satisfaction. It:
a) covers the provision of impartial advice and objective support to the MOD;
b) requires QinetiQ to seek permission wherever a potential conflict of interest could arise, including placing restrictions on defence manufacturing; and
c) forms part of QinetiQ's internal governance processes and is largely self-policing.

The Compliance committee has reported that:
"Where QinetiQ acts both in support of the MOD and as partner with industry, on the same MOD project, firewall arrangements are implemented to ensure that the interests of all parties are protected and safeguarded. At the end of the year, 25 firewalls were in place with one being established. Of the firewalls in existence at vesting, all are either closed or in the process of closing or are included in the 25 currently extant.

At 31 March 2002 there were 26 outstanding sought permissions, and all were cleared. During the year a total of 39 permissions were sought under the compliance regime, where potential conflicts of interest were identified. Of these requests 24 were approved, 4 did not require a permission (following discussion), 1 opportunity was not pursued and 10 were outstanding at the end of March 2003.

No breaches of the compliance regime have been noted during the year."

Proposed dividend
The Directors do not recommend the payment of a dividend.

Market value of land and buildings
Due to the specialised nature of the QinetiQ business, the valuation of buildings used in the business is based on depreciated replacement cost. The Directors have carried out a review to ensure that the depreciated replacement cost values are supported by business projections. Where this is not the case, asset values have been adjusted.

Surplus properties held for disposal are held at the lower of cost and open market value. At 31 March 2003 the surplus properties were shown at cost as this was lower than the open market value as determined by the Directors' valuation.

Policy and practice on payment of creditors
The policy of the Group is to agree terms of payment prior to commencing trade with a supplier and to abide by those terms based on the timely submission of satisfactory invoices.

Report of the Directors continued

Directors and Directors' interests
The Directors in office at the date of this report are listed in the Directors' remuneration report below.

The interests of the Directors in office at 31 March 2003 in the shares of QHL, all of which were acquired on 28 February 2003 and remain unchanged at 20 June 2003 were as follows:

	D Ordinary Shares of £1	Convertible Non-Voting A Ordinary Shares of £1	Convertible Non-Voting B Ordinary Shares of £1	Redeemable Cumulative Preference Shares of £1
Sir John Chisholm	129,500	920	80	9,000
Hal Kruth	69,375	–	–	–
Graham Love	106,375	920	80	9,000

Directors' remuneration
A full report of the Remuneration committee for the Directors including details of transfer values and accrued pension benefits of the highest paid Director are presented in the annual accounts for QinetiQ Group plc, copies of which are available from the company secretary at the address detailed below.

Directors' remuneration during the period was:

	Notes	Salary/Fees £	Bonus £	Benefits £	Total £
Executive Directors					
Sir John Chisholm	(a)	23,514	15,424	425(b)	39,363
Hal Kruth	(a)	15,833	8,833	833(c)	25,499
Graham Love	(a) (d)	19,028	9,280	4,639(e)	32,947
Non-executive Directors					
Dame Pauline Neville-Jones	(a)	9,651	–	–	9,651
Sir Denys Henderson	(f)	2,301	–	–	2,301
Jonathan Symonds	(a)	2,500	–	–	2,500
Colin Balmer	(a) (g)	–	–	–	–
Glenn Youngkin	(g) (h)	–	–	–	–
		72,827	**33,537**	**5,897**	**112,261**

(a) Appointed 28 February 2003
(b) Life insurance premium
(c) Cash car allowance
(d) Salary/fees include a salary supplement in lieu of pension arrangements
(e) Represents £833 cash car allowance and £3,806 in lieu of pension contribution
(f) Appointed 4 March 2003
(g) Do not receive fees for Non-executive Director appointment
(h) Appointed 11 November 2002

Pension benefits accrued to two Executive Directors. The accrued pension benefit of the highest paid Director was £95,028 at 31 March 2003.

Employees
The Group is an equal opportunities employer and has been granted use of the Employment Service's 'Two Ticks' symbol. Every possible consideration is given to applications for employment, regardless of gender, religion, disability or ethnic origin, having regard only to skills and competencies. This policy is extended to existing employees and any change which may affect their personal circumstances. The policy is supported by strategies for professional and career development.

QinetiQ seeks to utilise a range of communication channels to employees in order to involve them in the running of the organisation. This is done through a variety of methods, including regular in-house intranet, newsletters, bulletins, management briefings, trade union consultation and widespread training programmes.

Environment
The Group strives to manage its business in line with the voluntary international environmental management standard BS EN ISO14001:1996 and is committed to compliance with environmental legislation to prevent pollution and to maximise environmental efficiency.

During the period the Complex Managed Services (CMS) division of the Group has pursued accreditation of their environmental management systems and this has culminated in a series of audits by the accreditation body before the acquisition of QinetiQ Group Ltd and during March. Although we have yet to receive formal notification it is understood that the accreditation body will be recommending the award of an ISO 14001 certificate to CMS. Whilst this accreditation will be for CMS, all parts of the company have worked to improve management of environment impacts.

Political and charitable contributions
The Group made no political contributions during the period. Donations to UK charities amounted to £3,666.

Auditor
In accordance with section 384 of the Companies Act 1985, a resolution to re-appoint KPMG Audit Plc as auditor of the company is to be proposed at the Annual General Meeting.

By order of the Board

Lynton Boardman
Company Secretary
85 Buckingham Gate, London SW1E 6PD
20 June 2003

Independent auditors' report to the members of QinetiQ Holdings Ltd

We have audited the financial statements on pages 4 to 32.

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 auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the 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 are responsible for preparing the Directors' report and as described on page 1, this includes responsibility for preparing the financial statements in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, and by our profession's ethical guidance.

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 transactions with the Group is not disclosed.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards 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 judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group'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 of the state of affairs of the company and the Group as at 31 March 2003 and of the profit of the Group for the period then ended; and
- the financial statements have been properly prepared in accordance with the Companies Act 1985.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants
Registered Auditor
8 Salisbury Square
London
EC4Y 8BB
20 June 2003

Group profit and loss account

Notes		Period ended March 2003 £m
1	Turnover: Group and share of joint ventures	130.6
	less share of joint ventures	(0.1)
	Group turnover	**130.5**
	Cost of sales	(43.0)
	Group gross profit	**87.5**
	Operating expenses	(57.6)
	Group operating profit before exceptional items	31.2
3a	Exceptional operating expenses	(1.3)
2	**Group operating profit**	**29.9**
	Share of operating loss in joint ventures and associates	(0.5)
	Total operating profit: Group and share of joint ventures and associates	**29.4**
3b	Loss on disposal of fixed assets	(2.1)
	Profit on ordinary activities before interest and taxation	**27.3**
4	Net interest payable and other similar charges	(0.6)
1	**Profit on ordinary activities before taxation**	**26.7**
5	Tax on profit on ordinary activities	(8.0)
	Profit on ordinary activities after taxation	**18.7**
	Equity minority interest in subsidiary undertakings	0.1
19	**Retained profit for the financial period**	**18.8**

All operations are continuing.
There is no difference between the profit for the period and that prepared on an historic cost basis.

Balance sheets

Notes		Group 31 March 2003 £m	Company 31 March 2003 £m
	Fixed assets		
8	Intangible assets	(88.0)	–
9	Tangible assets	504.0	–
10a	Investment in subsidiary undertakings	–	94.3
		416.0	**94.3**
	Current assets		
11	Stocks and work in progress	23.5	–
12	Debtors	263.1	188.2
	Cash at bank and in hand	74.3	–
		360.9	**188.2**
13	Creditors: amounts falling due within one year	(239.2)	(15.7)
	Net current assets	**121.7**	**172.5**
	Total assets less current liabilities	**537.7**	**266.8**
14	Creditors: amounts falling due after more than one year	(192.3)	(141.8)
15	Provisions for liabilities and charges	(55.2)	–
	Provision for investment in joint ventures		
	Share of gross assets	8.6	–
	Share of gross liabilities	(11.6)	–
10b		(3.0)	–
10c	Provision for investment in associates	(0.1)	–
	Net assets excluding pension liabilities	**287.1**	**125.0**
25	Total of defined benefit pension scheme net liabilities	(147.1)	–
1	**Net assets**	**140.0**	**125.0**
	Capital and reserves		
17	Equity share capital	1.5	1.5
17	Non Equity preference shares	112.5	112.5
18	Share premium account	11.4	11.4
19	Profit and loss account	18.8	(0.4)
	Shareholders' funds	**144.2**	**125.0**
	Equity minority interest	(4.2)	–
		140.0	**125.0**

The accounting policies and notes on pages 8 to 32 form an integral part of these financial statements.
The financial statements on pages 4 to 32 were approved by the Board of Directors on 20 June 2003 and signed on its behalf by:

Sir John Chisholm
Chief Executive Officer

Graham Love
Chief Financial Officer

Group cash flow statement

Notes		Period ended March 2003 £m
20(a)	Cash inflow from operating activities	37.7
20(b)	Returns on investments and servicing of finance	(10.5)
	Taxation	–
20(c)	Capital expenditure and financial investment	10.6
20(d)	Acquisitions	(112.6)
	Cash outflow before financing	**(74.8)**
20(e)	Financing	149.1
	Increase in cash in the period	**74.3**

Reconciliation of net cash flow to movement in net debt

Notes		Period ended March 2003 £m	Period ended March 2003 £m
	Increase in cash in the period		74.3
7	Long term loans acquired	(105.7)	
20(e)	Loan notes issued	(60.0)	
20(e)	New loans	(157.3)	
	Less repayments	115.5	**(207.5)**
21	**Change in net debt resulting from cash flows and net debt at the end of the period**		**(133.2)**

Group statement of total recognised gains and losses

Notes		Period ended March 2003 £m
	Profit for the financial period excluding joint ventures and associates	19.3
	Share of joint ventures and associates losses for the period	(0.5)
	Profit for the period	**18.8**
10(b)	Gain arising on the refinancing of joint ventures and associates	0.1
25	Actuarial loss recognised in the defined benefit pension scheme	(0.1)
	Total recognised gains and losses for the period	**18.8**

Reconciliation of movements in shareholders' funds

Notes		Group Period ended March 2003 £m	Company Period ended March 2003 £m
	Profit/(loss) for the period	18.8	(0.4)
	Shares issued in the period	125.4	125.4
10(b)	Gain arising on the refinancing of joint ventures and associates	0.1	–
25	Actuarial loss recognised in the defined benefit pension scheme	(0.1)	–
	Shareholders' funds at 31 March 2003	**144.2**	**125.0**

Accounting policies

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the Group's financial statements except as noted below. The Group has adopted all relevant accounting and reporting standards up to and including FRS19 'Deferred Tax', including full adoption of FRS17 'Retirement Benefits', in these financial statements.

Basis of preparation
The accounts are prepared under the historical cost convention and in accordance with applicable UK accounting standards.

Basis of consolidation
The consolidated financial statements include the financial statements of the company and its subsidiary undertakings up to 31 March 2003. The acquisition method of accounting has been adopted. Under this method, the results of subsidiary undertakings acquired or disposed of in the period are included in the consolidated profit and loss account from the date of acquisition or up to the date of disposal.

An associate is an undertaking in which the Group has a long term interest, usually from 20% to 50% of the equity voting rights, and over which it exercises significant influence. The Group's share of the profits less losses of associates is included in the consolidated profit and loss account and its interest in their net assets is included in investments in the consolidated balance sheet.

A joint venture is an undertaking in which the Group has a long term interest and over which it exercises joint control. The Group's share of the profits less losses of joint ventures is included in the consolidated profit and loss account and its interest in their net assets is included in investments in the consolidated balance sheet.

As permitted by section 230(4) of the Companies Act 1985, a separate profit and loss account dealing with the results of the company has not been presented.

Acquisitions and disposals
On the acquisition of a business, or of an interest in a business, fair values, reflecting conditions at the date of acquisition, are attributed to the net assets. Where material, adjustments are also made to bring accounting policies into line with those of the Group.

Goodwill and other intangible assets
Purchased goodwill (representing the excess of the fair value of the consideration given and associated costs over the fair value of the separable net assets acquired) arising on consolidation is capitalised.

Positive goodwill and other intangible assets are amortised to nil by equal annual instalments over their estimated useful lives. On the subsequent disposal or termination of a business, the profit or loss on disposal or termination is calculated after charging the unamortised amount of any related goodwill. Impairment reviews are carried out to ensure that goodwill and intangible assets are not carried at above their recoverable amounts. Any amortisation or impairment write-downs are charged to the profit and loss account as operating items.

Negative Goodwill (representing the excess of the fair value of net assets acquired over the fair value of consideration given) arising in respect of acquisitions is included within fixed assets and released to the profit and loss account in the periods in which the fair values of the non-monetary assets purchased on the same acquisitions are recovered, whether through depreciation or sale.

In the company's financial statements, investments in subsidiary undertakings, associates and joint ventures are stated at cost less any impairment in value.

Turnover
Turnover represents the amounts invoiced to customers (net of value added tax) and, in the case of certain long term contracts, the value of work done in the year.

Tangible fixed assets and depreciation
Land and buildings are stated at cost less depreciation. Freehold land is not depreciated. Other tangible fixed assets are depreciated on a straight line basis over their useful economic lives to their estimated residual value within the following ranges:

Freehold buildings	20-25 years
Leasehold land and buildings	Over the unexpired term of the lease
Plant & machinery	10 years
Fixtures & fittings	5 years
Computers	3 years
Motor vehicles	3 years

All software costs, whether purchased or developed internally, are written off to the profit and loss account as incurred.

Surplus properties are stated at the lower of cost and open market valuation.

Assets in the course of construction are included in tangible fixed assets on the basis of expenditure incurred at the balance sheet date. In the case of assets constructed by QinetiQ, cost includes related works and directly attributed overheads.

Any gains or losses arising on the transfer of fixed assets between group companies are eliminated on consolidation.

Foreign currencies
Transactions in foreign currencies are recorded using the rate of exchange ruling at the date of the transaction unless designated forward foreign exchange contracts have been entered into in which case the rate specified in such contracts is used. Monetary assets and liabilities denominated in foreign currencies are translated using the rate of exchange ruling at the balance sheet date and the gains or losses on translation are included in the profit and loss account.

Leased assets
Assets held under finance leases, under which all the risks and rewards of ownership are transferred to QinetiQ, are capitalised and included in tangible fixed assets at fair value at the inception of the lease. Each asset is depreciated over the shorter of its lease term and its estimated useful life. The obligations relating to finance leases, net of finance charges in respect of future periods, are included under creditors. The interest element of the rental obligation is allocated to accounting periods during the lease term so as to produce a constant periodic charge on the balance outstanding.

Rentals payable under operating leases are charged to the profit and loss account evenly over the term of the lease.

Post-retirement benefits
QinetiQ operates a mixed benefit pension scheme, detailed in note 25. The first part is a defined benefit scheme, for which the charges to the profit and loss account are provided in accordance with the recommendation of independent qualified actuaries. The second part is a defined contribution scheme, for which the amount charged to the profit and loss account represents the contributions payable to the scheme in respect of the accounting period.

Research and development expenditure
Where research and development costs are incurred on behalf of a customer as part of a specific project, these costs are chargeable to the customer on whose behalf the work is undertaken. These costs and the related income are included in cost of sales and turnover respectively.

Internally funded development expenditure is capitalised in the balance sheet where there is a clearly defined project, the expenditures are separately identifiable, the project is technically and commercially feasible, all costs are recoverable by future revenue and the resources exist to complete the project. All other research and development costs are written off to the profit and loss account in the period in which they are incurred.

Stocks and work in progress
Stocks are stated at the lower of cost and net realisable value.

Work in progress represents costs incurred on specific contracts and is stated at the lower of cost (or net current replacement cost if materially different) and net realisable value. Cost represents direct materials and labour and other directly attributable overheads.

Loan issue costs
Costs associated with the issue of loans are capitalised and netted off against the loan liability presented in the balance sheets, in accordance with FRS4. Capitalised issue costs are released over the estimated life of the instrument to which they relate. If it becomes clear that the instrument will be redeemed early, the amortisation of the issue costs will be accelerated.

Share capital issue costs
Where allowable costs associated with the issue of share capital are netted off against Share Premium arising.

Long term contracts
Profits on long term contracts are calculated in accordance with accounting standards and industry practice and may not relate to turnover.

The principal estimation method used by the Group in attributing profit on contracts to a particular accounting period is the preparation of forecasts on a contract-by-contract basis. These focus on the costs to complete and enable an assessment to be made of the final outturn on each contract. Consistent contract review procedures are in place in respect of contract forecasting.

In preparing contract forecasts, claims receivable are recognised as income when received or certified for payment except that, in estimating the amount of foreseeable losses, a prudent and reasonable assessment of such claims is made.

The general principles for profit recognition are:

- Profit in respect of short term contracts is recognised when the contract is completed;
- Profit in respect of long term contracts is recognised on a percentage of completion basis when the contract's ultimate outcome can be foreseen with reasonable certainty;
- Provision is made for losses incurred or foreseen in bringing the contract to completion as soon as they become apparent.

Contract work in progress is stated at cost incurred, less amounts transferred to the profit and loss account, after deducting foreseeable losses and payments on account not matched with turnover.

Amounts recoverable on contracts are included in debtors and represent turnover recognised in excess of payments on account.

Taxation
The taxation charge is based on the profit for the period and takes into account taxation deferred because of timing differences between the treatment of certain items for taxation and accounting purposes.

Deferred tax is recognised, without discounting, in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date, except as otherwise required by FRS19.

Notes to the financial statements

1. Segmental analysis

		Profit/(loss) on ordinary activities before tax			
Period ending March 2003	Turnover £m	Before exceptional items £m	Exceptional items £m	Group total £m	Net assets £m
Solutions	88.3	24.9	–	24.9	88.9
Complex managed services	38.0	8.3	–	8.3	30.1
Corporate and other	4.2	(2.0)	(1.3)	(3.3)	24.0
Total	**130.5**	**31.2**	**(1.3)**	**29.9**	**143.0**
Joint ventures and associates	0.1	(0.5)	–	(0.5)	(3.0)
	130.6	**30.7**	**(1.3)**	**29.4**	**140.0**
Loss on disposal		–	(2.1)	(2.1)	
Net interest payable		(0.6)	–	(0.6)	
Group total	**130.6**	**30.1**	**(3.4)**	**26.7**	**140.0**

The Group's business is conducted principally in the UK. No other geographical market has contributed significantly to turnover. Sales between the Group's business segments have been eliminated.

Corporate and other net assets include: the Group's freehold land and buildings, net debt, provision for the deficit on the defined benefit pension scheme, deferred tax provision and other assets and liabilities which are not practical or appropriate to allocate across the segments.

2. Operating profit

Group operating profit has been arrived at after charging:

	Period ended March 2003 £m
Remuneration of the auditors and their associates, including expenses:	
audit fee – company	–
audit fee – Group	0.3
fees with respect to non-audit services	–
Depreciation and other amounts written off tangible and intangible fixed assets:	
depreciation and amortisation of owned assets	3.2
Operating lease rentals:	
land and buildings	0.3
plant and machinery	0.1

3. Exceptional operating costs

The following exceptional expenses were charged to the profit and loss account:

	Period ended March 2003 £m
a) Exceptional operating expenses	**1.3**

The exceptional operating expenses relate to costs incurred in respect of the restructuring that has taken place as part of the Public Private Partnership (PPP) transaction. There was £0.2m of tax relief in respect of this item and a total net cash outflow of £1.3m.

b) Loss on disposal of fixed assets	**2.1**

The Group has sold a site during the period incurring a loss of £2.1m on disposal. There was no tax relief in respect of this item and a total net cash inflow of £11.4m.

4. Net interest payable

		Period ended March 2003 £m
Interest payable on bank borrowings		0.7
Deferred finance fees written off		0.2
Net interest charge/(credit) on pension scheme under FRS17:		
Expected return on defined benefit scheme assets	(2.0)	
Interest on defined benefit scheme liabilities	1.7	(0.3)
		0.6

5. Taxation

Analysis of charge in period

	Period ended March 2003 £m
Current tax	
UK corporation tax at 30%	–
Deferred tax	
Deferred tax (note 15)	8.0
Tax on profit on ordinary activities	**8.0**

Factors affecting tax charge in period

	Period ended March 2003 £m
Profit before tax	26.7
Tax on ordinary activities at 30%	8.0
Expenses not deductible for tax purposes	(0.8)
Depreciation on non-qualifying assets	0.2
Goodwill impairment	0.1
Unprovided losses of overseas subsidiaries, joint ventures and associates	0.4
Depreciation in excess of capital allowances	0.9
Other timing differences	(0.1)
Utilisation of tax losses	(8.8)
Unprovided subsidiary and non-trade losses	0.1
UK corporation tax at 30%	**–**

Factors affecting future tax charges

Whilst no current UK corporation tax charge is anticipated for the immediate future, it is foreseen that there will continue to be a deferred tax charge as a result of the ongoing timing differences.

Notes to the financial statements

6. Employee information

The average number of persons employed by QinetiQ (including Directors) during the period, analysed by category, was as follows:

	Period ended March 2003 Number
Solutions	5,803
Complex managed services	2,896
Other	766
	9,465

The aggregate payroll costs of these persons were as follows:

	£m
Wages and salaries	18.1
Social security costs	7.9
Other pension costs	4.2
	30.2

7. Acquisition

On 28 February 2003, QinetiQ Holdings Limited acquired the whole of the share capital of QinetiQ Group Limited for a consideration of £94.3m.

The analysis of the combined net assets acquired is presented below.

Note		Book value total £m	Fair value adjustment total £m	Fair value at acquisition total £m
8	Intangible assets	0.9	–	0.9
10	Investments	(2.7)	–	(2.7)
9	Tangible fixed assets	527.8	(9.0)	518.8
	Current assets	237.7	–	237.7
	Current liabilities	(214.7)	–	(214.7)
21	Cash borrowings	(62.2)	–	(62.2)
21	Loans	(105.7)	–	(105.7)
15	Provisions for liabilities and charges	(45.5)	–	(45.5)
25	Defined benefit pension scheme net liabilities	(147.0)		(147.0)
	Minority interests	4.0	–	4.0
	Net assets acquired	**192.6**	**(9.0)**	**183.6**
8	Goodwill			(89.3)
				94.3
	Consideration satisfied by:			
	Cash			39.7
17	Shares issued for non-cash consideration			78.1
12	Pension indemnity			(34.2)
	Related costs of acquisition			10.7
	Total consideration			**94.3**

There was a fair value adjustment of £9.0m to write down tangible fixed assets to their recoverable amount.

8. Intangible fixed assets

	Other £m	Goodwill arising on QinetiQ Group acquisition £m	Total £m
Acquired in QinetiQ Group Limited	0.9	–	0.9
Additions	–	(89.3)	(89.3)
At 31 March 2003	**0.9**	**(89.3)**	**(88.4)**
Amortisation			
Release to the profit and loss account for the period	–	0.4	0.4
At 31 March 2003	**–**	**0.4**	**0.4**
Net book value at 31 March 2003	**0.9**	**(88.9)**	**(88.0)**

9. Tangible fixed assets

	Land and buildings £m	Surplus properties £m	Plant, machinery and vehicles £m	Computers and office equipment £m	Assets under construction £m	Total £m
Cost						
Acquired in QinetiQ Group Limited	352.2	84.3	62.3	10.0	10.0	518.8
Additions in period	–	–	0.3	–	0.4	0.7
Disposals	–	(12.0)	(1.4)	(0.5)	–	(13.9)
Transfers	1.3	0.4	0.8	1.6	(4.1)	–
At 31 March 2003	**353.5**	**72.7**	**62.0**	**11.1**	**6.3**	**505.6**
Depreciation						
Charge for the period	1.1	–	2.0	0.5	–	3.6
Disposals	–	(0.3)	(1.2)	(0.5)	–	(2.0)
Transfers	(0.4)	0.4	–	–	–	–
At 31 March 2003	**0.7**	**0.1**	**0.8**	**–**	**–**	**1.6**
Net book value:						
At 31 March 2003	**352.8**	**72.6**	**61.2**	**11.1**	**6.3**	**504.0**

Transfers of fixed assets shown above relate to assets constructed by QinetiQ. These are initially recorded within assets under construction and, on completion, transferred to the relevant asset category.

Under the terms of the Business Transfer Agreement with the MOD, certain restrictions have been placed on freehold land and buildings, surplus properties and certain plant and machinery related to them. These restrictions are detailed in note 23 'Transactions with related parties'.

Included within the net book value of land and buildings, at 31 March 2003, is £0.8m of leasehold properties. The remainder of the properties are freehold.

Notes to the financial statements

10. Investments

	Group March 2003 £m	Company March 2003 £m
(a) Subsidiary undertakings		
Additions	–	94.3
Net investment in subsidiary undertakings at 31 March 2003	**–**	**94.3**

	Group March 2003 £m	Company March 2003 £m
(b) Joint ventures		
Share of net assets in joint ventures		
Acquired from QinetiQ Group Limited	(2.6)	–
Increased value from refinancing (see note below)	0.1	–
Share of post-tax loss	(0.5)	–
Net investment in joint ventures at 31 March 2003	**(3.0)**	**–**

	Group March 2003 £m	Company March 2003 £m
(c) Associates		
Share of net assets in associates		
Acquired from QinetiQ Group Limited	(0.1)	–
Share of post-tax loss	–	–
Net investment in associates at 31 March 2003	**(0.1)**	**–**

The net gain on refinancing of joint ventures and associates, amounting to £0.1m, has been taken to reserves through the statement of total recognised gains and losses (page 7). Gains and losses arise when QinetiQ and/or its partners invest more cash or other assets into the joint ventures and associates and, as a result of the increased investment, the share of the net assets owned by QinetiQ changes in value.

11. Stocks and work in progress

	Group March 2003 £m	Company March 2003 £m
Raw materials and consumables	0.8	–
Work in progress	22.7	–
	23.5	**–**

12. Debtors

	Group March 2003 £m	Company March 2003 £m
Trade debtors	135.1	–
Due from subsidiary undertaking	–	152.2
Amounts recoverable under contracts	66.2	–
Other debtors	48.8	36.0
Prepayments	13.0	–
	263.1	**188.2**

Within other debtors there is a balance of £10.9m relating to rationalisation costs provided for which are recoverable from the MOD on future contracted work. It is estimated that £3.7m of this is recoverable in the next financial year with the remaining £7.2m recoverable within future years. In addition, there is a balance of £34.2m included in other debtors that relates to a recoverable amount in future years relating to a pension indemnity as described in note 25.

13. Creditors: amounts falling due within one year

Note		Group March 2003 £m	Company March 2003 £m
16	Bank loan	18.1	18.1
16	Deferred financing costs	(2.6)	(2.6)
		15.5	**15.5**
16	Loan notes	0.1	–
	Payments received on account	65.1	–
	Trade creditors	16.8	–
	Taxation and social security	33.4	–
	Other creditors	1.6	–
	Accruals and deferred income	106.7	0.2
		239.2	**15.7**

14. Creditors: amounts falling due after more than one year

Note		Group March 2003 £m	Company March 2003 £m
16	Bank Loans	146.9	146.9
16	Deferred financing costs	(5.1)	(5.1)
		141.8	**141.8**
16	Loan notes	50.1	–
	Accruals and deferred income	0.4	–
		192.3	**141.8**

Notes to the financial statements

15. Provisions for liabilities and charges

	Deferred taxation £m	Reorganisation £m	Other £m	Total £m
Acquired from QinetiQ Group Limited	10.7	18.5	16.3	45.5
Created in period	–	–	4.1	4.1
Utilised in period	–	(2.1)	(0.3)	(2.4)
Charged to the profit and loss account	8.0	–	–	8.0
At 31 March 2003	**18.7**	**16.4**	**20.1**	**55.2**

Other provisions comprise primarily of provisions for contract losses, costs related to the PPP process and systems developments.

Analysis of deferred tax balance:
The amounts provided for deferred taxation are set out below:

	March 2003 £m
Difference between accumulated depreciation, amortisation and capital allowances	27.0
Short term timing differences	0.3
Tax losses	(8.6)
Total deferred taxation liabilities provided	**18.7**

The amounts of deferred taxation not provided are set out below:

	March 2003 £m
Difference between accumulated depreciation, amortisation and capital allowances	–
FRS17 Pension Deficit	(43.1)
Tax losses	(9.1)
Total deferred taxation asset not provided	**(52.2)**

The unprovided deferred tax asset will be recovered in the event that there are sufficient future relevant taxable profits.

16. Financial instruments
The disclosures set out below exclude short term debtors and creditors and deferred tax as permitted under FRS13.

a) Currency risk
The majority of QinetiQ's trading activities are located in the United Kingdom. Accordingly the majority of QinetiQ's transactions are denominated in Sterling and do not give rise to a foreign currency exposure. For those transactions in non-Sterling currencies, forward foreign currency contracts are used to hedge material exposures.

At 31 March 2003, cash at bank and in hand was predominantly in Sterling. The Group held cash balances and deposits in other currencies of US$3.1m, €0.7m and ¥36.3m. All borrowings were in Sterling.

16. Financial instruments continued

b) Maturity of and interest on financial liabilities (excluding finance leases)

	Bank loans and loan notes £m	Deferred finance costs £m	Total £m
Due in one year or less	18.2	(2.6)	15.6
Due in more than one year but not more than two years	28.9	(2.6)	26.3
Due in more than two years but not more than five years	168.1	(2.5)	165.6
Due in more than five years	–	–	–
	215.2	**(7.7)**	**207.5**

In February 2003, as a part of the transaction whereby the company acquired all the issued ordinary share capital of QinetiQ Group Limited, new bank facilities were agreed by the company. The new facilities are structured into three tranches, reflecting their respective purposes. In addition, a subsidiary company issued a loan note ('the Aquila/Chertsey loan note') to the Secretary of State for Defence as part repayment of the term loan noted below.

Tranche A, a term loan for £165m, was available for drawdown on the completion date of the acquisition of QinetiQ Group Limited by the company and was fully drawn by QinetiQ Holdings Limited on that date. It bears interest at rates related to LIBOR for periods at the determination of the company. The facility will reduce in varying half yearly instalments commencing in September 2003 until maturity on 31 March 2008.

Tranche B, a term loan for £160m, became available on 1 April 2003 to fund expenditure under the LTPA. Drawings bear interest at rates related to LIBOR. The facility will reduce in varying half yearly instalments commencing in September 2008 until maturity on 28 February 2011.

Tranche C, for £130m, is available to finance the working capital requirements of the Group including guarantees and ancillary requirements. At 31 March 2003, the only amount drawn under this tranche was £1.1m by way of bank guarantees, see note 24. The facility expires on 28 February 2011.

All of the above loans are secured by way of a fixed and floating charge over the assets of the company.

On acquisition of QinetiQ Group Limited a subsidiary company issued the Aquila/Chertsey loan note referred to above, in the amount of £60m. The loan note is only repayable from the net proceeds of the disposal of certain, identified assets, against which the lender has a charge. £9.9m was repaid to MOD following the sale of one of the identified assets prior to 31 March 2003. The loan note is interest free to 30 June 2003, thereafter interest will be charged at rates relating to LIBOR until 28 August 2004.

QinetiQ Group plc (formerly QinetiQ Group Limited) holds loan notes totalling £0.1m. These are repayable in instalments, which commenced on 15 August 2002 and will be fully redeemed by February 2004. Interest is payable on the loan notes at 5% per annum.

On the acquisition of QinetiQ Group Limited loan notes totalling £5.6m, which were within QinetiQ Group Limited and payable to the Secretary of State for Defence, were fully repaid by the company.

On acquisition of QinetiQ Group Limited there was a term loan of £100m with the Secretary of State for Defence. On acquisition of the company by QinetiQ Holdings Limited this loan was fully repaid.

Notes to the financial statements

16. Financial instruments continued

c) Hedging

The Group's policy is to mitigate financial risk, both on interest rates and foreign exchange rates. The Group only hedges material foreign exchange exposures and at 31 March 2003, there were no hedges outstanding.

Interest rate hedges to lock in rates on debt have been transacted by a mix of interest rate swaps and collars. As at 31 March 2003, 64% of Group interest-bearing debt was hedged. Since 31 March 2003, further hedges have been transacted by way of interest rate swaps and collars, increasing the proportion of Group interest-bearing debt fixed to approximately 85%. The hedges have a maturity profile of between two and four years.

d) Maturity of finance lease commitments

At 31 March 2003, the Group had no finance lease commitments.

e) Fair value of financial assets and liabilities

Cash at bank and fixed asset investments

There is no significant difference between the fair value and the book value of cash at bank and fixed asset investments as at 31 March 2003.

Other creditors due after more than one year

Other creditors due after more than one year, which are not detailed in the above sections of this note, are recorded at monetary amount. The liabilities all exist in Sterling and fair value is deemed to approximate to monetary value as recorded at the balance sheet date.

f) Borrowing facilities

At 31 March 2003, the following committed facilities were available to QHL and other specific group companies:

	Total £m	Drawn £m	Undrawn £m	Facility expiry date
Tranche A – bank facility	165.0	165.0	–	See (b) above
Tranche B – bank facility	160.0	–	160.0	See (b) above
Tranche C – bank facility	130.0	1.1	128.9	See (b) above
Aquila/Chertsey loan note	50.1	50.1	–	See (b) above
Motionbase loan notes	0.1	0.1	–	See (b) above
Committed facilities March 2003	**505.2**	**216.3**	**288.9**	

The amount drawn under Tranche A was drawn by QHL and amounts surplus to the requirements of QHL were loaned to a Group company at interest rates related to LIBOR.

The amount of £1.1m disclosed as drawn under facility C represents a guarantee (see note 24).

17. Share capital

Number of shares authorised:	2003 Number	2003 Amount £
Attributable to equity interests:		
Convertible A Ordinary Shares of 1p each	11,533,367	115,534
Convertible B Ordinary Shares of 1p each	966,733	9,667
Convertible C Ordinary Shares of £1 each	450,489	450,489
D Ordinary Shares of £1 each	555,000	555,000
Convertible Non-Voting A Ordinary Shares of £1 each	425,960	425,960
Convertible Non-Voting B Ordinary Shares of £1 each	37,040	37,040
Convertible Preferred Shares of 1p each	3,752,686	37,527
	17,721,275	**1,631,217**
Attributable to non-equity interests:		
Redeemable Cumulative Preference Shares of £1 each	112,500,000	112,500,000
First Deferred Shares of 1p each	11,553,367	115,534
Second Deferred Shares of £1 each	450,489	450,489
Special Rights Redeemable Share of £1	1	1
	124,503,857	**113,066,024**
Total authorised share capital	**142,225,132**	**114,697,241**

Number of shares allotted, called up and fully paid:	Date of issue	Total amount paid £	Number	Amount £
Attributable to equity interests:				
Convertible A Ordinary Shares of 1p each	11 Nov. 2002	1	100	1
Convertible A Ordinary Shares of 1p each	28 Feb. 2003	7,700,981	7,700,981	77,010
Convertible B Ordinary Shares of 1p each	28 Feb. 2003	583,333	583,333	5,833
Convertible C Ordinary Shares of £1 each	28 Feb. 2003	416,635	416,635	416,635
D Ordinary Shares of £1 each	11 Nov. 2002	2	2	2
D Ordinary Shares of £1 each	28 Feb. 2003	527,248	527,248	527,248
Convertible Non-Voting A Ordinary Shares of £1 each	28 Feb. 2003	425,960	425,960	425,960
Convertible Non-Voting B Ordinary Shares of £1 each	28 Feb. 2003	37,040	37,040	37,040
Convertible Preferred Shares of 1p each	28 Feb. 2003	3,752,686	3,752,686	37,527
			13,443,985	**1,527,256**
Attributable to non-equity interests:				
Redeemable Cumulative Preference Shares of £1 each	28 Feb. 2003	112,500,000	112,500,000	112,500,000
Special Rights Redeemable Share of £1	28 Feb. 2003	1	1	1
			112,500,001	**112,500,001**
Total called up share capital			**125,943,986**	**114,027,257**

At the date of incorporation, 11 November 2002, the authorised share capital was £1,000, divided into 1,000 £1 Ordinary Shares. Three shares were issued and fully paid on that date, for total proceeds of £3. On 28 February 2003, by written resolution, two of the Ordinary Shares in issue were reclassified as 2 D Ordinary Shares. On the same date the third Ordinary Share in issue was converted into 100 Ordinary Shares of 1p each and then reclassified into 100 Convertible A Ordinary Shares. On the same date the remaining 997 authorised £1 Ordinary Shares were subdivided into 99,700 Ordinary Shares of 1p each, each of which was then reclassified as Convertible A Ordinary Shares of 1p each.

Except as noted below all shares rank pari passu in all respects. Of the amounts paid on issue of shares, £78,120,000 was settled by the MOD through the exchange of shares in QinetiQ Group Limited for shares in QinetiQ Holdings Limited.

Notes to the financial statements

17. Share capital continued

Rights attaching to the Redeemable Cumulative Preference Shares of £1 each

The Preference Shares carry the right to a fixed cumulative preferential dividend at the rate of 9% per annum excluding any associated tax credit. The preference dividend shall not be paid, but shall accrue until redemption of the shares. The right to the preference dividend has priority over the rights of the holders of any other class of shares to any dividend or other distribution of income.

The preference dividend accrues from day-to-day and compounds annually every 31 March in respect of the year, or in the case of the period to 31 March 2003 the period from date of issue to 31 March 2003.

In the event of a return of capital or liquidation of the company the assets available for distribution among the shareholders shall be applied, after repayment of the Special Rights Redeemable Share, firstly to repay the accrued preference dividends and secondly to repay the amount paid for the Redeemable Cumulative Preference Shares on issue.

Except as provided above, the Redeemable Cumulative Preference Shares carry no rights to any further participation in the profits or assets of the company.

The company shall redeem all the Redeemable Cumulative Preference Shares in the event of a sale, listing or a winding up of the company. The company may, with the written consent of the holders of a majority of the Redeemable Cumulative Preference Shares, redeem some or all of the shares at any time. In the event of only some of the shares being redeemed the redemption shall take place pro rata, as nearly as possible, to each shareholder's holding.

On redemption, the company shall pay a cash sum in respect of each redeemed share equal to the nominal amount of the share, plus any premium paid on issue, plus the preference dividend accrued to the date of redemption.

The holders of the Redeemable Cumulative Preference Shares are not entitled to receive notice of, nor to attend, speak or vote at, general meetings of the company, by virtue of their holdings of Redeemable Cumulative Preference Shares, unless the company is in default over payment on redemption or payments of dividends, or if the facilities under the Facilities Agreement become, or remain, repayable prior to their specified maturity or have been subject to a demand for repayment.

Rights attaching to the Convertible Preferred Shares of 1p each

The Convertible Preferred Shares, until conversion, have the right to participate in any ordinary dividend declared and paid by the company. Each Convertible Preferred Share in issue shall entitle the holder to the same dividend declared and paid by the company on each Convertible A Ordinary Share.

In the event of a sale, listing or winding up each Convertible Preferred Share shall convert by way of reclassification into 1 Convertible A Ordinary Share.

Rights attaching to the Ordinary Shares and the Special Rights Redeemable Share

Except as noted below the Convertible A Ordinary Shares of 1p each, the Convertible B Ordinary Shares of 1p each, the Convertible Non-Voting A Ordinary Shares of £1 each, the Convertible Non-Voting B Ordinary Shares of £1 each, the Convertible C Ordinary Shares of £1 each and the D Ordinary Shares of £1 each (together 'the Ordinary Shares' shall rank pari passu in all respects.

No dividend shall be declared or paid by the company on the Ordinary Shares unless the Cumulative Redeemable Preference Shares have been redeemed in full.

On a return of capital on a liquidation the Special Rights Redeemable Share will be repaid the amount paid on issue in priority to all other shares. The Special Rights Redeemable Share has no other right to share in the capital or profits of the company.

17. Share capital continued

Only the holders of the Convertible A Ordinary Shares and the Convertible B Ordinary Shares are entitled to receive notice of, attend, speak and vote at general meetings of the company. The holder of the Special Rights Redeemable Share is entitled to receive notice of any general meeting and any class meeting, and may attend and speak, but not vote, at such meetings.

In the event of a sale, a listing or a winding up of the company the Articles provide for certain of the Convertible A Ordinary Shares of 1p each, the Convertible B Ordinary Shares of 1p each, the Convertible Non-Voting A Ordinary Shares of £1 each, the Convertible Non-Voting B Ordinary Shares of £1 each and the Convertible C Ordinary Shares of £1 each to be converted into First Deferred Shares of 1p each or Second Deferred Shares of £1 each. The effect of this conversion will be to increase the return to the holders of the Convertible C Ordinary Shares of £1 each and the D Ordinary Shares of £1 each. The number of shares converted will be dependant on the meeting of certain investment performance criteria.

Rights attaching to the First Deferred Shares and the Second Deferred Shares (together the 'Deferred Shares')

Holders of the Deferred Shares shall not be entitled to receive notice of and shall not be entitled to attend or vote at general meetings of the company by virtue of their holding of Deferred Shares.

On a return of capital on liquidation the holders of the Deferred Shares shall be entitled to receive a distribution of 1p per share after £10,000,000 has been distributed on each of the Ordinary Shares, the Convertible Preferred Shares and the Redeemable Cumulative Preference Shares. Holders of the Deferred Shares are not entitled to any other participation in the profits or assets of the company.

Immediately prior to a sale, a Listing or a winding up of the company, the company shall redeem for cash for an aggregate amount of £1 (split pro rata between the holders of the Deferred Shares with a minimum payment of 1p to each holder) in total all the Deferred Shares.

Transfer restrictions

General restriction – a transferor may only transfer all or a proportion of shares of any one class held to a transferee if, at the same time, all or the same proportion of other classes of shares held are also transferred to the same transferee.

Convertible A Ordinary Shares and Convertible B Ordinary Shares may be transferred freely, unless the holders of 75% of the total of the Convertible A Ordinary Shares and the Convertible B Ordinary Shares agree otherwise; or on or after a Listing; or in acceptance of an offer which would reduce the Carlyle shareholding below 50% ('tag-along rights'); or when required to comply with a compulsory purchase notice issued by a transferee following the acquisition of more than 50% of the Convertible A Ordinary Shares owned by the MOD or Carlyle at 28 February 2003 ('bring-along rights'); or to any permitted transferee.

Convertible Non-Voting A Ordinary Shares and Convertible Non-Voting B Ordinary Shares may not be transferred except with the written consent of the Board; or to a replacement trustee of the Co-Invest trust; or on and after a Listing; or in accordance with the tag-along rights or bring-along rights described above.

Convertible C Ordinary Shares and D Ordinary Shares may not be transferred except with the written consent of the Board; or on or after Listing; or in accordance with the tag-along rights or bring-along rights described above; or by compulsory transfer after the holder ceases to be an employee or Director or consultant of the company or any of its subsidiary undertakings.

Convertible Preferred Shares may only be transferred to the same transferee and at the same time as Convertible A Ordinary Shares are transferred by the holder.

Redeemable Cumulative Preference Shares may only be transferred to the same transferee and at the same time as Convertible A Ordinary Shares, Convertible B Ordinary Shares, Convertible Non-Voting A Ordinary Shares and/or Convertible Non-Voting B Ordinary Shares are transferred by the holder.

Notes to the financial statements

17. Share capital continued
The Deferred Shares may not be transferred.

Special Rights Redeemable Share may only be transferred to the Crown, or as it directs.

Other rights attaching to the Special Rights Redeemable Share ('Special Share')
Following the acquisition of QinetiQ Group Limited on 28 February 2003 the nature of the work performed by the company is of strategic interest to the defence of the United Kingdom. As a result H.M. Government, acting through the MOD, retains ownership of the Special Share. The Special Share confers certain rights on the holder:
a) to require QinetiQ to implement and maintain the Compliance System (as defined in the Articles of Association) so as to make effective at all times the company's application of the Compliance Principles, in a manner acceptable to the Special Shareholder;
b) to refer matters to the Board or the compliance committee for its consideration in relation to the application of the Compliance Principles:
c) to veto any contract, transaction, arrangement or activity which the Special Shareholder considers:
- may result in circumstances which constitute unacceptable ownership, influence or control over the company contrary to the defence or security interests of the United Kingdom; or
- would not, or does not, ensure the effective application of the Compliance Principles or would be or is otherwise contrary to the defence or security interests of the United Kingdom;

d) to require the Board to take any action (including but not limited to amending the Compliance Principles or Compliance Guidelines), or rectify any omission in the application of the Compliance Principles, if the Special Shareholder is of the opinion that such steps are necessary to protect the defence or security interest of the United Kingdom;
e) to demand a poll at any of QinetiQ's meetings (even though it has no voting rights except those given to it as a Special Shareholder).

The Special Shareholder has an option to purchase defined Strategic Assets of the Group. The Special Shareholder has the right to purchase any defined Strategic Assets which the Group wishes to sell. Strategic Assets are normally testing and research facilities. See also note 23.

18. Share premium

	Total paid £	Number	Group March 2003 Premium amount £	Company March 2003 Premium amount £
Premium on shares issued:				
Convertible A Ordinary Shares of 1p each	7,700,982	7,701,081	7,623,971	7,623,971
Convertible B Ordinary Shares of 1p each	583,333	583,333	577,500	577,500
Convertible Preferred Shares of 1p each	3,752,686	3,752,686	3,715,159	3,715,159
Stamp duty on share issue charged to share premium			(586,990)	(586,990)
			11,329,640	**11,329,640**

19. Profit and loss account

	Group March 2003 £m	Company March 2003 £m
Profit/(loss) retained for the period	18.8	(0.4)
Gain arising on the refinancing of joint ventures and associates	0.1	–
Actuarial loss recognised in the defined benefit pension scheme	(0.1)	–
At 31 March 2003	**18.8**	**(0.4)**
Profit and loss reserve excluding defined benefit pension liability	18.9	(0.4)
Defined Benefit Pension Liability	(0.1)	–
Profit and loss reserve including defined benefit pension liability	**18.8**	**(0.4)**

20. Notes to the cash flow statement

(a) Reconciliation of operating profit to operating cash flows

Note		March 2003 £m
	Operating profit	27.3
	Depreciation	3.6
	Amortisation of goodwill	(0.4)
	Share of loss in joint ventures and associates	0.5
	Loss on disposal of fixed assets	2.1
	Decrease in stocks and work in progress	22.4
	Increase in debtors	(37.1)
	Increase in creditors	17.9
	Net movement in provisions	1.4
	Net cash inflow from operating activities	**37.7**

(b) Returns on investments and servicing of finance

Interest received	–
Interest paid	(10.5)
	(10.5)

Included in interest paid is £9.9m of interest relating to the MOD loans and included in the current liabilities of the acquired net assets (see note 7)

(c) Capital expenditure and financial investment

Purchase of tangible fixed assets	(0.7)
Sale of tangible fixed assets	11.4
Cash financing of investments	(0.1)
	10.6

(d) Acquisitions and disposals

Note		
	Acquisition of trade and assets of QinetiQ Group	
7	Net assets acquired	(183.6)
7	Net cash borrowings acquired	(62.2)
		(245.8)
	Less goodwill on acquisition	89.3
	Less shares issued for non-cash consideration	78.1
	Plus non-cash pension indemnity	(34.2)
	Cash outflow	**(112.6)**

Notes to the financial statements

20. Notes to the cash flow statement continued

(e) Financing

Repayment of MOD loans	(105.6)
Issue of Chertsey loan note	60.0
Partial repayment of Chertsey loan note	(9.9)
New long term loans	157.3
Proceeds from issue of share capital	47.3
	149.1

Long term loans are disclosed net of £7.7m of issue costs

21. Analysis of net debt

	Acquired £m	Shares issued £m	Cash flow £m	Non-cash movements £m	March 2003 £m
Bank and cash	(62.2)	125.4	11.1	–	74.3
Due within one year					
Bank Loans	–	–	(18.1)	2.6	(15.5)
MOD Loans	(5.6)	–	5.6	–	–
Other borrowings	(0.1)	–	–	–	(0.1)
	(5.7)	**–**	**(12.5)**	**2.6**	**(15.6)**
Due after one year					
Bank Loans	–	–	(146.9)	5.1	(141.8)
MOD Loans	(100.0)	–	100.0	–	–
Aquila/Chertsey loan note	–	–	(50.1)	–	(50.1)
	(100.0)	**–**	**(97.0)**	**5.1**	**(191.9)**
Total net debt	**(167.9)**	**125.4**	**(98.4)**	**7.7**	**(133.2)**

22. Commitments

(a) Capital commitments at 31 March 2003, for which no provision has been made, are as follows:

	March 2003 £m
Contracted	1.0

(b) Annual commitments under non-cancellable operating leases are as follows:

	Buildings March 2003 £m	Other March 2003 £m
Leases expiring within:		
– one year	1.8	–
– one to two years	0.4	–
– two to five years	0.3	0.5
– over five years	0.8	–
	3.3	**0.5**

(c) QinetiQ's share of capital commitments of joint ventures and associates as at 31 March 2003 was £nil.

23. Transactions with related parties
Excluding the special share (see below) the economic interest of QinetiQ Holdings Limited is 62% owned by the MOD, 34% owned by The Carlyle Group and 4% owned by QinetiQ employees and Directors.

Of the QinetiQ Holdings Limited voting equities issued Carlyle own 51%, with the MOD retaining 49%. Consequently management control and responsibility is held by The Carlyle Group, with the MOD retaining all benefits conventionally held by a major shareholder.

The MOD retains sole ownership of one special share in QinetiQ Holdings Limited, QinetiQ Group plc and QinetiQ Limited, the latter being a wholly owned subsidiary of QinetiQ Group plc.

Detailed below are the agreements that have been entered into and the trading that has taken place with the MOD.

Trading
The MOD is a major customer of QinetiQ. During the period under review sales of £99.7m were made to the MOD and at the period end the MOD had an outstanding trade debtor balance of £55.7m. The Group also purchased services of £0.6m from the MOD during the period under review and at the period end had an outstanding trade creditor of £2.8m.

Freehold land and buildings and surplus properties
Under the terms of the QinetiQ acquisition of part of the business and certain assets of DERA from the MOD on 1 July 2001, the MOD retained certain rights in respect of the freehold land and buildings and surplus properties transferred. These are:

(a) Restrictions on transfer of title
The property title deeds include a clause that prevents their transfer without the approval of the MOD;

(b) Property clawback agreement
The MOD retains an interest in future profits on disposal, or revaluation following a 'trigger event'. A 'trigger event' includes the granting of planning permission for development and/or change of use, and the disposition of any of the acquired land and buildings.

During the 12 years from 1 July 2001, following a 'trigger event', the MOD is entitled to clawback a proportion of the gain on each individual property transaction over and above a 30% gain over a July 2001 professional valuation. The proportion of the gain due to the MOD is based on a sliding scale which reduces over time from 50% to 9%. The July 2001 valuation was approximately 16% greater in aggregate than the consideration paid for the land and buildings on 1 July 2001.

Loans
QinetiQ Group plc retains the Aquila/Chertsey loan note, payable to MOD. At the year end the value repayable on this loan was £50.1m, and is repayable only from the net proceeds of the disposal of certain, identified assets. This loan is non-interest bearing to 30 June 2003, with interest relating to LIBOR until 28 August 2004 thereafter. Group financing arrangements are further detailed in note 16.

Notes to the financial statements

23. Transactions with related parties continued

Long Term Partnering Agreement

On February 28 2003, QinetiQ signed a Long Term Partnering Agreement (LTPA) with the MOD for the management and operation of 22 principal MOD Test and Evaluation sites throughout England, Scotland and Wales and at the Aircraft Test and Evaluation facility, Boscombe Down.

The new contract, which will take effect from 1 April 2003, replaces the short term Facilities Management Contract, which was put in place when QinetiQ was formed. The LTPA contract is worth up to £5.6bn to QinetiQ over its 25-year life.

Strategic assets

Under the Business Transfer Agreement with the MOD, the Group requires the written consent of the MOD, which will follow good faith negotiations between QinetiQ and the MOD on the commercial viability of the strategic assets to:
a) dispose of or destroy all or any part of a strategic asset; or
b) voluntarily undertake any closure of, or cease to provide a strategic capability by means of, all or any part of a strategic asset.

Where consent is not granted the MOD will reimburse the Group for the cost of maintaining the capability of the strategic assets.

The net book value of assets identified as being strategic assets as at 31 March 2003 was £35.8m, the principal items being plant and machinery of £26.8m and £8.3m for vehicles.

24. Contingent liabilities

The company is party to bank facilities, as described in note 16f. Under these facilities, all named borrowers cross guarantee all bank indebtedness under the facilities.

The subsidiary undertakings have given unsecured bank guarantees to third parties amounting to £1.1m.

The company is aware of claims and potential claims by or on behalf of current and former employees, including former employees of the MOD and DERA and contractors, in respect of intellectual property, wrongful dismissal and industrial illness and injury which involve or may involve legal proceedings against the Group. The Directors are of the opinion, having regard to legal advice received, the Group's insurance arrangements and provisions carried in the balance sheet, that it is unlikely that these matters will, in aggregate, have a material effect on the Group's financial position, results of operations and liquidity.

25. Post-retirement benefits

Introduction and background to FRS17

QinetiQ has elected to comply with Financial Reporting Standard FRS17 (Retirement Benefits). This standard requires QinetiQ to include in the balance sheet the surplus or deficit on the scheme calculated at the balance sheet date. It is therefore a snapshot view which can be significantly affected by short term market factors. The calculation of the surplus or deficit is significantly influenced by a number of factors which are beyond the control of QinetiQ – principally the value at the balance sheet date of equity shares in which the scheme has invested in and long term interest rates which are used to discount future liabilities. The funding of the scheme is based on long term trends and assumptions relating to market growth, as advised upon by qualified actuaries.

As part of the agreement on 28 February 2003 whereby QinetiQ Holdings Limited acquired QinetiQ Group Limited the MOD gave an indemnity to QinetiQ Holdings Limited to pay to QinetiQ Holdings Limited, on the earlier of a flotation or sale or 28 February 2008, a sum up to a maximum of £45m as a funding contribution to the pension scheme deficit. A discount rate of 5.65% has been applied to this amount, resulting in a discounted amount of £34.2m that is included in the 31 March 2003 balance sheet of QinetiQ Holdings Limited within debtors.

The QinetiQ Scheme

In the UK the Group operates the QinetiQ Pension Scheme, a mixed benefit scheme. The Defined Benefit (DB) section of the scheme provides future service pension benefits to transferring Civil Service employees. All Group employees who were members, or eligible to be members, of the Principal Civil Service Pension Scheme or the UKAEA principal Non-Industrial Superannuation Scheme were invited to join the DB section of the scheme from 1 July 2001, together with all new employees who were previously members of schemes who are part of the Public Sector Transfer Club. The Defined Contribution (DC) section of the scheme was set up for all employees who were not eligible or did not wish to join the DB section of the scheme.

Defined benefit section

The most recent full actuarial valuation of the DB scheme was undertaken as at 30 June 2002, with a further update as at 31 March 2003 for FRS17 purposes. On the basis of the 30 June 2002 full valuation the Trustees and the company agreed that the 17.5% employer contribution rate would continue and in addition a further £2m cash payment would be paid per annum until the next valuation to cover the past service deficit.

Notes to the financial statements

25. Post-retirement benefits continued

Assumptions

The major assumptions used in the year end valuation were:

	March 2003
Rate of increase in salaries	4.30%
Rate of increase in pensions in payment and deferred pensions	2.70%
Discount rate applied to scheme liabilities	5.60%
Inflation assumption	2.60%

The assumptions used by the actuary are the best estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily be borne out in practice.

Scheme assets

The fair value of the scheme's assets, which are not intended to be realised in the short term and may be subject to significant change before they are realised, and the present value of the scheme's liabilities, which are derived from cash flow projections over long periods and thus inherently uncertain, were:

	Value at March 2003 £m
Equities	167.5
Corporate bonds	20.3
Government bonds	88.5
Cash	5.4
Total market value of assets	**281.7**
Present value of scheme liabilities	(428.8)
Deficit in the scheme – Pension liability	**(147.1)**

	March 2003
Expected long term rate of return:	
Equities	7.50%
Corporate bonds	4.80%
Government bonds	4.50%
Cash	4.00%
Weighted average	**6.20%**

	Period ended March 2003 £m
Movement in deficit during the year:	
Deficit in scheme as acquired	(147.0)
Current service cost	(3.3)
Loss on curtailments	(0.3)
Contributions paid	3.3
Other finance income	0.3
Actuarial loss	(0.1)
Deficit in the scheme at 31 March 2003	**(147.1)**

25. Post-retirement benefits continued

Pension costs charged in arriving at operating profit were:

	Period ended March 2003 £m
Current service cost	**3.3**

Analysis of amounts included in other finance income/(costs):

	Period ended March 2003 £m
Expected return on pension scheme assets	2.0
Interest on pension scheme liabilities	(1.7)
	0.3

Analysis of amount recognised in statement of total recognised gains and losses:

	Period ended March 2003 £m
Actual return less expected return on scheme assets	(0.1)
Experience gains and losses arising on scheme liabilities	–
Changes in assumptions underlying the present value of scheme liabilities	–
Actuarial loss recognised in statement of total recognised gains and losses	**(0.1)**

History of experience gains and losses:

	Period ended March 2003 %	Period ended March 2003 £m
Difference between the expected and actual return on scheme assets:		
Amount		*(0.1)*
Percentage of period end scheme assets	–	
Experience gains and losses on scheme liabilities:		
Amount		–
Percentage of period end present value of scheme liabilities	–	
Total amount recognised in statement of total recognised gains and losses:		
Amount		(0.1)
Percentage of period end present value of scheme liabilities	–	

Payments to the defined contribution section totalled £0.2m in the period ended 31 March 2003. There were no outstanding or prepaid contributions at the period end.

Percentages have not been disclosed for the dates 28 February to 31 March as they would be distorted by the time period so as to be unrepresentative of the true nature of the scheme. Full disclosure of the scheme has been presented in the QinetiQ Group plc accounts, the actuarial loss recognised for the year in these accounts is presented below.

Notes to the financial statements

25. Post-retirement benefits continued

History of experience gains and losses:	Year ended March 2003 %	Year ended March 2003 £m
Difference between the expected and actual return on scheme assets:		
Amount		(96.8)
Percentage of period end scheme assets	(34.4)	
Experience gains and losses on scheme liabilities:		
Amount		(17.9)
Percentage of period end present value of scheme liabilities	(4.2)	
Total amount recognised in statement of total recognised gains and losses:		
Amount		(124.8)
Percentage of period end present value of scheme liabilities	(29.1)	

26. Investments

The principal subsidiary, associated undertakings and joint ventures at 31 March 2003, all of which are included in the consolidated financial statements, are shown below.

Name of company	Principal area of operation	Country of incorporation	Proportion of voting rights held(3)	Financial year end(1)	Nature of business
Subsidiary undertakings					
QinetiQ Group plc	Great Britain	England & Wales	100%		Holding company
QinetiQ Limited(2)	Great Britain	England & Wales	100%		Research and development
QinetiQ Overseas Holdings Limited(2)	Great Britain	England & Wales	100%		Holding company
QinetiQ North America Inc.	USA	USA	100%		Holding company
QinetiQ Inc.	USA	USA	100%		Holding company
QinetiQ Trusted Information Management Inc.	USA	USA	100%		Information systems security
QinetiQ Technology Extension Corporation	USA	USA	100%		Research and development
Science Enterprises Inc.	USA	USA	100%	31 Dec.	Holding company
QinetiQ Insurance PCC Limited(2)	Great Britain	Guernsey	100%		Insurance
QinetiQ Nanomaterials Limited(2)	Great Britain	England & Wales	100%		Research and development
QinetiQ Ventures Limited(2)	Great Britain	England & Wales	100%		Holding company
Motionbase (Holdings) Limited(2)	Great Britain	England & Wales	100%		Holding company
cueSim Limited (formerly Motionbase PLC)(2)	Great Britain	England & Wales	100%		Research and development
QinetiQ Estates Limited	Great Britain	England & Wales	100%		Holding company
QinetiQ Investment Company Limited	Great Britain	England & Wales	100%		Holding company
Precis (2188) Limited	Great Britain	England & Wales	100%		Holding company
Precis (2187) Limited	Great Britain	England & Wales	100%		Property investment company
Quintel Technology Limited(4)	Great Britain	England & Wales	45.7%		Research and development

Notes to the financial statements

26. Investments continued

Joint ventures and associates

Name of company	Principal area of operation	Country of incorporation	Proportion of voting rights held(3)	Financial year end(1)	Nature of business
ZBD Displays Limited	Great Britain	England & Wales	32%	31 July	Research and development
Holographic Imaging LLC	USA	USA	50%	31 Dec.	Research and development
20/20 Speech Limited	Great Britain	England & Wales	50%	30 June	Research and development
The Crystal Consortium Limited	Great Britain	England & Wales	54%		Research and development
pSiMedica Limited	Great Britain	England & Wales	44%		Research and development
Quintel Group Limited	Great Britain	England & Wales	45.7%	31 Dec.	Holding company
Quintel S4 Limited	Great Britain	England & Wales	45.7%		Research and development
Other investments					
British Titanium plc	Great Britain	England & Wales	5%		Manufacturing
Blazephotonics Ltd	Great Britain	England & Wales	6%		Research and development

(1) Accounting reference date is 31 March unless otherwise stated.
(2) Shares held directly by QinetiQ Group plc.
(3) Percentage of ordinary share capital unless otherwise stated.
(4) Disclosed as a subsidiary due to management control by QinetiQ.

Where the financial year of the entity is different to 31 March, the management accounts of that entity as at that date have been used for the purposes of the consolidation.