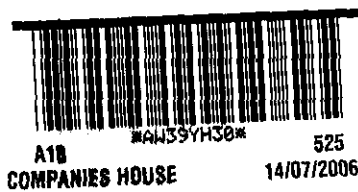


QinetiQ

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TRANSFORMING TECHNOLOGY INTO SOLUTIONS



ANNUAL REPORT
& ACCOUNTS 2006

QinetiQ is a leading international defence and security technology company. The QinetiQ Group delivers innovative technology solutions and support services to governmental organisations including the UK Ministry of Defence (MOD), UK national intelligence and security agencies, the US Department of Defense (DoD), the US Department of Homeland Security (DHS) and other US intelligence and security agencies. Additionally, it services leading aerospace, defence and security original equipment manufacturers (OEMs) and blue-chip commercial customers around the world.

Over the past 50 years, QinetiQ and its predecessor organisations have built up significant intellectual capital being a leading supplier of defence research to the UK Government. In 1993, the UK Government transferred its non-nuclear defence research establishments to a separate trading fund (originally as the Defence Research Agency (DRA) and subsequently as the enlarged Defence Evaluation and Research Agency (DERA)). In 2001, the majority of DERA was transferred into QinetiQ Limited and, to date, the UK is the only advanced nation to permit, on this scale, its national defence laboratories to be transformed into a separate entity as an arm's length commercial enterprise and to operate as a private sector entity.

QinetiQ has over 11,400 talented employees who contribute to the development of its intellectual capital base by winning customer-funded research assignments and exploiting QinetiQ's strengths in technology research by selling systems solutions, products and licences into a broad spectrum of defence, security, technology and related commercial markets.

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QINETIQ AT A GLANCE

STRATEGY

DEFENCE & TECHNOLOGY

The Defence & Technology sector (D&T) forms the core of QinetiQ's UK defence business, providing technology and services to support the armed forces of the UK and its allies.

Its success depends on maintaining and expanding its relationship with the UK Ministry of Defence (MOD) and continuing to apply its unique intellectual property in line with the UK government's defence and spending policy. In addition to its MOD work, D&T addresses other defence markets by offering solutions and services to allied governments and forming partnerships with defence contractors in the UK and elsewhere.

SECURITY & DUAL USE

The Security & Dual Use sector (S&DU) takes technologies and services developed for the MOD and other defence customers and applies them in new ways to create high-value solutions for civilian use.

Combining its technological advantages with a deep understanding of the commercial marketplace, it works mainly – though not exclusively – for customers in adjacent sectors such as security and counter-terrorism. There is a continual demand for its expertise and S&DU intends to grow in non-defence markets where its capabilities offer competitive advantage.

NORTH AMERICA

Our fast-developing North American sector (QNA) links the world-class technology developed in the UK with the world's largest defence and security market – the US. Still in its formative stages, the business offers significant potential for growth.

QinetiQ established a US bridgehead by setting up QinetiQ Inc in 2002 and has since acquired six US companies. The aim is to achieve strong organic growth in the region while strengthening US capabilities and introducing more UK technologies and services into the North American market.

CAPABILITIES

MOD RESEARCH

With its defence industry heritage and innovative expertise across a range of advanced technologies, D&T is the leading supplier of research to the MOD.

TECHNOLOGY SUPPLY

Since QinetiQ's transition to the private sector, D&T has had growing opportunities to inject its technology into the defence equipment supply chain. In this way, it increasingly supports prime contractors in upgrading the UK's defence capability.

PROCUREMENT & CAPABILITY SUPPORT

D&T provides expert support to the MOD in terms of assessing the technology offered by prime contractors, both at the procurement stage and throughout the lifetime of the system.

MANAGED SERVICES

This part of D&T covers the long-term supply of technology and training-based services. The main component is the Long Term Partnering Agreement (LTPA) under which D&T manages the MOD's test and evaluation ranges.

SECURITY

S&DU offers world-class research, advice, consultancy and technology-based products and services to government and civilian customers in the security and counter-terrorism markets.

SPACE

S&DU's work for space sector customers like the European Space Agency (ESA) includes research and technology for individual space missions and for services such as GPS (global positioning systems) and small satellites.

TECHNOLOGY DEVELOPMENT & EXPLOITATION

This business provides research and development services in optronics and materials for the MOD and other customers. It also helps to exploit QinetiQ's technology through product development, royalties, licence fees, partnerships and joint ventures.

MANAGED SERVICES

S&DU offers its clients a portfolio of managed services in areas such as fuel and lubricant testing and analysis, instrument calibration and supporting technical services. It also provides real estate, procurement, facilities and asset management services.

TECHNOLOGY

Offering high-technology research for defence and security customers. The combined capabilities, including robotics, provide advanced products across a range of technologies.

SYSTEMS ENGINEERING & TECHNOLOGY ASSISTANCE

Providing independent systems engineering and support services for major military programmes and equipment in North America.

IT SERVICES

This business serves the fast-growing demand for advanced IT services, particularly on the part of the Department of Defense and the Department of Homeland Security.

HIGHLIGHTS

ACHIEVEMENTS

- 22.9% increase in turnover to £1.1bn (2005: £0.9bn)
- Underlying operating margin improved to 8.6% (2005: 7.6%) (excluding profit on disposal of interest in pSiMedica Limited)
- Underlying operating cash conversion of 84.4% (2005: 27.2%)
- Execution of US strategy continued with three further acquisitions in year
- Successful IPO on the London Stock Exchange raising net proceeds of £132.7m
- Underlying earnings per share growth of 16.3%
- Maiden dividend proposed of 2.25p per share

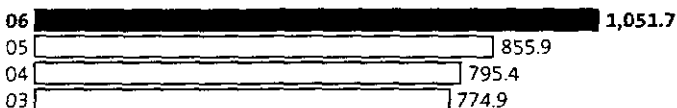
FINANCIAL SUMMARY

	2006	2005
Group turnover	£1,051.7m	£855.9m
Underlying operating profit	£90.7m	£82.3m
Underlying operating profit (excluding profit on disposal of interest in pSiMedica Limited)	£90.7m	£65.2m
Underlying operating margin (excluding profit on disposal of interest in pSiMedica Limited)	8.6%	7.6%
Underlying profit before tax	£80.1m	£58.2m
Underlying earnings per share	10.2p	8.8p
Basic earnings per share	10.0p	12.0p
Net debt	£233.0m	£176.6m
Free cash flow	£141.3m	£55.7m
Backlog	£608.4m	£572.0m
Underlying effective tax rate	22.7%	16.2%
Dividend per ordinary share	2.25p	Nil

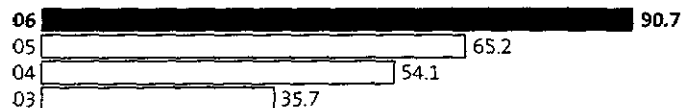
See Glossary on p115 for definition of Non-GAAP terms used throughout the Annual Report.

FOUR-YEAR SUMMARY

TURNOVER £m

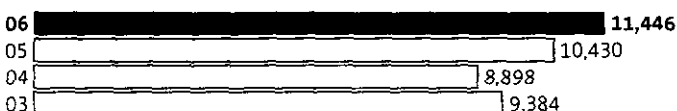


UNDERLYING OPERATING PROFIT* £m

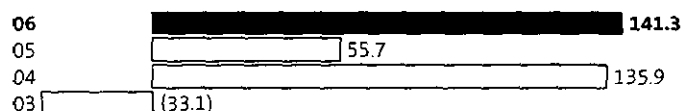


*Excluding profit on disposal of interest in pSiMedica Limited in 2005

EMPLOYEES AT 31 MARCH



FREE CASH FLOW £m



36.5%

Compound annual growth in
underlying operating profit
since 2003

CHAIRMAN'S STATEMENT

This year QinetiQ reports on a major milestone in our development. The vision of creating an international world class defence and security technology company out of the defence laboratories of the British Government was born more than a decade ago. With the successful listing on the London Stock Exchange, the value of this strategy has been more widely recognised.

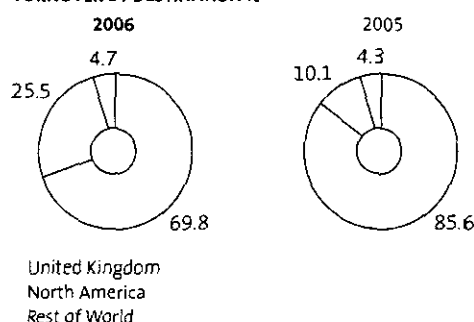
I am pleased to report that QinetiQ has continued to perform strongly in 2005/06 and is able to show a 22.9% growth in turnover and a 100 basis point improvement in underlying operating margin to 8.6%. These good results are driven by our three pronged thrusts, each of which is making good progress – the UK defence market, the commercialisation of our defence technology into adjacent commercial markets and the building of our platform in the US.

Our positioning in these markets remains well chosen to capture some of the best opportunities that they present. The need for nations to invest in defence and security is as clear now as ever but it is becoming less predictable where and how their forces will be deployed. The UK Government's recent Defence Industrial Strategy paper, for instance, highlighted the paramount need for agility and flexibility. This Government White Paper made clear that it sees Research and Technology as playing a key role in providing an enabler for this objective.

QinetiQ has a unique position as a researcher and provider of technology into the supply chain and, separately, as an expert adviser and technology service provider to the ultimate customer. In the UK, our constitution provides a compliance regime which gives MOD customers for our advisory services the right to decide whether to agree to QinetiQ providing a related technology supply activity if they are completely satisfied by the firewalls we put in place to separate the two activities. The 28.2% growth in our Technology Supply business this year is a testament both to the importance of technology supply in meeting the customers' agility and flexibility agenda and also their confidence in our firewalls.

In the US, the Quadrennial Defense Review emphasised many similar issues to the UK and the President's 2007 budget submission has proposed a 3% increase in real terms in the Science & Technology budget despite having to find significant savings in major defence programmes.

TURNOVER BY DESTINATION %



This underlines the strength of our chosen positions in the US in three sub sectors mirroring our UK position. Our advisory business, known as Systems Engineering & Technical Assistance in the US, had a particularly good year growing organically by 10.9% in the second half of the year. Overall we grew the turnover of our US business 254.4% on a year-on-year basis through organic and acquisition led growth.

Innovation remains the strongest driver for economic development in first world nations. Much of the rationale for the creation by the UK Government of QinetiQ from its defence research laboratories was to release the powerhouse represented by its defence scientists to create vibrant new businesses in related commercial markets. While the maturation of business from early stage technology never provides a quick win, QinetiQ's Security and Dual Use (S&DU) Sector has had a strong year and is well placed to fulfil the promise of this key strategy.

In preparing QinetiQ for its listing we undertook a number of changes to the Board. Dame Pauline Neville-Jones (Chairman), Sir Denys Henderson, Richard Gillingwater and Trevor Woolley all retired having steered QinetiQ through our private equity phase and provided us with excellent guidance and support. We are in considerable debt to each of them and I would like to thank them for the enormous contribution they made. The new Board aimed to enact best practice as advocated by the Combined Code consistent with the particular needs of QinetiQ as a unique company.

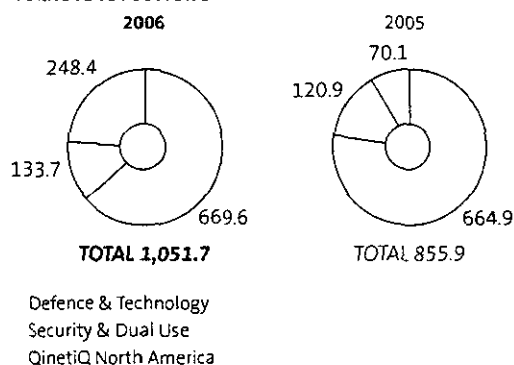
The Board proposed that I succeeded Dame Pauline as Chairman and Sir David Lees joined the Board as Deputy Chairman and Senior Independent Director. Noreen Doyle joined us as our fourth independent Non-executive Director (NED) alongside Peter Fellner and Nick Luff. Glenn Youngkin and Colin Balmer continue as NEDs nominated by Carlyle and the MOD respectively. Graham Love became Chief Executive Officer, Doug Webb succeeded him as Chief

Financial Officer and Hal Kruth stood down from the Board but continues as Managing Director of S&DU. As reported in our Prospectus, it is our intention that we recruit one further independent NED with strong US experience.

The launch of the Company on the London Stock Exchange is the beginning of a new phase in our growth and provides us with the ability to execute our strategy and deliver on our ambitious vision. Many of our staff have come a long way since their days in Government and all are absolutely committed to providing excellent service to customers. I would like to pay tribute to all our staff for the magnificent way they have responded to the challenges and opportunities we face and we all look forward with confidence to continuing to grow our business in the stimulating future that is now before us.

SIR JOHN CHISHOLM
CHAIRMAN
QinetiQ Group plc
7 June 2006

TURNOVER BY SECTOR £m



CHIEF EXECUTIVE OFFICER'S STATEMENT

This was clearly a very significant year for QinetiQ from many points of view. We continued to reposition the Group into growth markets within Ministry of Defence (MOD) programmes, achieved significant progress in commercialising our defence technologies into adjacent markets and substantially expanded our presence in our key North American market. We addressed senior management succession issues as Sir John Chisholm, for so long the principal architect of and driver behind QinetiQ, moved up to Chairman of the Board, I moved into the Chief Executive role, and Doug Webb took over from me as Chief Financial Officer. Last, but clearly not least, we took QinetiQ public through an Initial Public Offering on the London Stock Exchange.

DELIVERING ON OUR STRATEGY

We have continued to build upon the opportunities afforded by our three market facing sectors, each of which reflects a particular strategic thrust. In our Defence & Technology sector, addressing our core UK defence market, we have continued to grow our technology supply business and consolidated our position in the provision of advisory services. In our Security & Dual Use sector, we have seen *excellent progress in our service businesses and passed some important milestones in developing our commercial ventures*. In North America, we have substantially increased our footprint, both through acquisition and through direct sales from the UK.

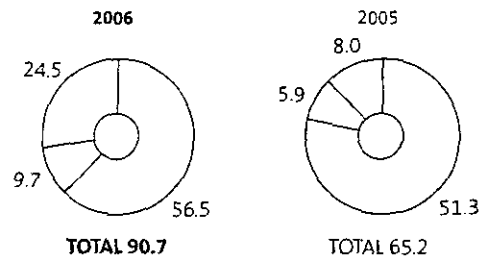
OUR MARKETPLACE

In our principal defence markets in the UK and US there are significant challenges, as scarce resources continue to be heavily focused on operational deployments, particularly in Iraq and Afghanistan. Significant supplemental budgets have been approved to support these campaigns, and there are *encouraging signs of QinetiQ being successful in meeting these needs, particularly as the rapid insertion of technology is used to upgrade systems and platforms more quickly than would be possible using conventional new platform procurement processes*. US spending on IT services, by both the Department of Defense (DoD) and the Department of Homeland Security (DHS), has also been a particular feature of the 2006 budget, and we are well placed to benefit from this.

FINANCIAL PERFORMANCE

Overall, our turnover grew by 22.9% to £1,051.7m, and underlying operating profit, excluding profit on disposal of our interest in pSiMedica Limited in 2005, grew 39.1% to £90.7m. Whilst this growth was in part attributable to acquisitions, all sectors of our business also showed organic turnover growth during the year and our UK sectors also further improved their profit margins. Our underlying operating margin now stands at 8.6%, up 100bps from last year. Significant restructuring was required to achieve this profit margin, and restructuring costs totalling £9.4m have been charged in arriving at operating profit. Net cash flow from operating activities was also strong at £83.3m, 253.0% up on last year.

UNDERLYING OPERATING PROFIT BY SECTOR £m



Defence & Technology
Security & Dual Use
QinetiQ North America

DEFENCE & TECHNOLOGY SECTOR

Turnover increased 0.7% to £669.6m and underlying operating profit 10.1% to £56.5m. In our UK defence business we continue to adjust to the introduction of competition into the MOD's research programme, which affects all of our technology businesses to a degree, but, because it is combined with a reshaping of MOD's investment priorities, can affect certain technology areas more dramatically than others. This led to the need to restructure certain of our technology divisions during the year. Our advice and managed services business with the MOD remained broadly stable during the year, whilst our Technology Supply turnover increased 28.2%.

Key wins in the year included leading the Haldane-Spearman consortium to success in the 'Preparing people for operations' research assignment and being part of the successful BAE Systems team which won the US Future Combat Systems tracked vehicle demonstrator programme. We have also been appointed preferred bidder for the 20-year managed service contract for the Combined Aerial Targets Service.

SECURITY & DUAL USE SECTOR

Turnover increased 10.6% to £133.7m, with underlying operating profit, excluding the gain on disposal of our interest in pSiMedica in 2005, increasing by 64.1% to £9.7m. Although our Optronics and Materials divisions had a tough year due to unexpectedly severe reductions in MOD research funding in these areas, necessitating restructuring during the year, they both did an excellent job of finding new sources of funding in order to sustain the important world-class capabilities we have in these areas. We have continued to make good progress in developing our Security and Space businesses, whilst our estates function made a significant contribution to cash flow by realising proceeds of £110.2m through the sale of surplus property assets.

Key wins included the first sales of Tarsier®, those of our Quintel joint venture, a research contract from the US Defense Advanced Research Projects Agency into optical tagging, and a number of significant new government and commercial customers for our IT security practice.

QINETIQ NORTH AMERICA SECTOR

Turnover grew 254.4% to £248.4m, and underlying operating profit 206.3% to £24.5m. This includes the

contribution for part of the year from two new acquisitions. The first of these, Planning Systems Inc. is a technology company working primarily for the DoD, which had a turnover in its last full year prior to acquisition (December 2004) of \$44.6m (£24.3m). The other is Apogen Technologies Inc., an IT services company, working mainly for the DoD and the DHS, which in its last complete year prior to acquisition (December 2004) had turnover of \$199.9m (£109.0m). Our previous acquisitions put in a solid performance all round, despite some reduction in Foster-Miller's research business due to difficult market conditions. We also successfully established the first projects to exploit technology synergies between the UK and the US, in order to increase overall sales into the US market. QinetiQ's staff numbers in North America had grown to 2,640 by 31 March 2006, and our North American group is now making a very substantial contribution to our overall performance.

Key wins included the Man Transportable Robotic System (the major procurement contract for Improvised Explosive Device (IED) robots), significant extensions of our systems engineering work with the US Army and our IT services to the Department of Homeland Security. Just before the end of the year, we announced the acquisition of Ocean Systems Engineering Corp, which will strengthen our position with the US Navy and our US capabilities in mission critical systems.

MANAGEMENT AND ORGANISATION

The three sector structure we put in place in late 2004 continues to serve us well. We have been most fortunate in securing the services of Phil Odeen, a widely respected US defence industry executive, to run our enlarged North American group. Phil joined us with our acquisition of Apogen, where he was Chairman, and will continue to act as part-time CEO until a full-time appointment is made during 2006.

We have an outstandingly talented group of people at all levels in QinetiQ – our challenge as leaders is to provide an environment in which our people can deliver maximum value for our customers and shareholders. Our IPO has allowed us to make equity incentives available to all staff – in particular, we have been able to introduce a targeted share option plan.

EMPLOYEES BY SECTOR AT 31 MARCH



DEFENCE & TECHNOLOGY

06  6,791
 05  6,905



SECURITY & DUAL USE

06  1,643
 05  1,790

QINETIQ NORTH AMERICA

06  2,640
 05  1,374

CORPORATE

06  372
 05  361

CHIEF EXECUTIVE OFFICER'S STATEMENT CONTINUED

THE FUTURE

The evidence of the past year supports the strategy we are pursuing and so our emphasis will continue to be on executing as effectively as possible.

In Defence & Technology, this means continuing to build on our many critical customer relationships, ensuring that we are providing the UK armed forces with the services and solutions they need to meet increasingly asymmetric threats. In particular, it means continuing to insert our technology into the systems and equipment which are urgently required, thereby pulling through the benefits of the MOD's research programme into the field. Our order performance in year positions us well to continue with this growth in technology insertions. Typically we will operate on the supplier side of the market through partners, although, where appropriate, we may act as prime contractor, with the approval of our MOD customers. This reflects our unique constitutional ability in the UK to act as both advisor and technology supplier, where our customers approve this through our compliance regime.

We will also continue to work hard on developing our managed services business. In particular we are pursuing our bid for the Defence Training Rationalisation Programme, through Metrix, where we are a 50% co-sponsor along with Land Securities Trillium. We are seeking to make our vast experience in successfully managing the Long Term Partnering Agreement, the MOD's largest outsourcing contract to date, available to support the MOD in its ambitious plans to improve the delivery of technical training to all of the armed services.

In Security & Dual Use, this means continued exploitation of defence capabilities into adjacent markets, building particularly on our strong security positioning, continuing to build our space business through the pursuit of key bidding opportunities and selected acquisitions, and delivering on our business plans in our ventures portfolio.

In North America, conditions are expected to remain challenging for parts of our business as the government balances budget demands due to the combined effects of the Iraq war and Hurricane Katrina. However, we look

forward to seeing the first integration benefits as we begin to combine certain back office functions, and to generate new business opportunities. Our US companies are starting to work more closely together and with the UK on bidding for major programmes and developing our growing network of US customers and partners. We will also continue to pursue tactical acquisitions of the type we have already made, provided this can be done at sensible prices.

Overall, the past year has laid a firm foundation for our company, and although there are many challenges ahead, I look forward to the coming year, confident in our ability to make further progress. We have developed a robust business model and a management team capable of delivering it.

GRAHAM LOVE
CHIEF EXECUTIVE OFFICER
 QinetiQ Group plc
 7 June 2006

EXPERT SOLUTIONS IN KEY MARKETS

With its unique background, QinetiQ offers a breadth and depth of technology beyond the range of most commercial providers. We also have an enviable record of turning our technology into innovative solutions, both for government defence purposes and in related sectors of the civilian market where demand for our skills is growing rapidly.

QinetiQ is about clever people, well managed in the service of our customers. Because we know our markets so well, we can make sure our technology precisely meets their needs. We can also direct that technology towards the best commercial opportunities so the business itself develops and prospers.

The following pages show some of the ways in which we have succeeded.

EMPLOYEES BY SECTOR AT 31 MARCH

DEFENCE & TECHNOLOGY		QINETIQ NORTH AMERICA	
06	6,791	06	2,640
05	6,905	05	1,374
SECURITY & DUAL USE		CORPORATE	
06	1,643	06	372
05	1,790	05	361

CHIEF EXECUTIVE OFFICER'S STATEMENT CONTINUED

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GRAHAM LOVE
CHIEF EXECUTIVE OFFICER
 QinetiQ Group plc
 7 June 2006

PROVEN DEFENCE EXPERTISE

The largest of QinetiQ's business sectors, Defence & Technology (D&T), is a major supplier of innovative technology and managed services to the UK's armed forces and those of its allies.

With its historic links to the Ministry of Defence, D&T has been at the forefront of British defence research for over 60 years. Its expertise, intellectual property and knowledge of the defence marketplace are therefore unique and provide a powerful competitive advantage.

FRES – A NEW GENERATION OF ARMoured FIGHTING VEHICLES

Today's British army needs to be able to respond rapidly to new situations, move troops quickly into position and carry out joint operations with allies or other UK forces.

This, added to a need to replace obsolete vehicles, is the impetus behind the Army's first transformational programme – the Future Rapid Effect System (FRES).

The aim of the programme is to develop a new generation of medium-weight armoured fighting vehicles that are network-enabled and transportable by air. The new vehicles will complement the existing fleet, offering enhanced tactical (and strategic) mobility and greater protection.

In March 2006, QinetiQ was awarded contracts in excess of £5m by the prime contractor, Atkins, as part of the FRES – Initial Assessment Phase Technical Demonstrator Programmes. The purpose of these is to help inform decisions on which technologies will be used and to demonstrate the readiness of the chosen technologies. With its long record in defence research and its knowledge of MOD requirements, QinetiQ is well-placed to inject innovative technology into many elements of this programme.

QinetiQ has been named as preferred bidder for the Combined Aerial Target Service (CATS) contract which will provide a fully mobile target service to the UK armed forces on air defence training and test and evaluation for the next 20 years.

As part of its offering, QinetiQ will provide all of the MOD's aerial target requirements worldwide. CATS will include target services currently delivered under the 25-year Long Term Partnering Agreement with the MOD.

Additionally, QinetiQ will provide aerial target services for ground-based air defence training, a service for the Royal Navy and an air-to-air service for the RAF.

QinetiQ's aerial target systems will also be used for the training of US aircrews in Europe, which will involve several of the ranges operated by the Group.

MAINTAINING SONAR EFFECTIVENESS

The sonar system in the UK's four Vanguard-class submarines was built in the 1980s and will eventually become obsolete. QinetiQ has been involved in innovation research for a replacement system, the key to which is an open architecture that allows the incorporation of commercial off-the-shelf (or COTS) components.

Unlike a bespoke sonar system, the COTS approach sources major sub-systems from commercial suppliers. The resulting integrated solutions are flexible, cost-effective and easier to upgrade than their predecessors. QinetiQ's DeRSCI (Delivery of Rapid Sonar COTS Insertion) programme has led the world in this particular field and is proving crucial in managing obsolescence.

AElGT

A UK STRATEGY FOR AEROSPACE TECHNOLOGY

Government and Industry launched the Aerospace Innovation and Growth Team (AElGT) in 2002, with the aim that by 2022: "The UK will offer a global Aerospace Industry the world's most innovative and productive location".

In 2005, QinetiQ provided key input into the AElGT's National Aerospace Technology Strategy. In the AElGT technology validation programmes, now underway, QinetiQ's joint efforts with world-class partners such as Airbus, BAE Systems, Bombardier, and Thales will deliver cutting-edge aerospace innovation to the UK.

LAUNCHING A HEAVIER HARRIER

After identifying the needs of several stakeholders from the MOD, QinetiQ carried out work to enable the Harrier GR7A variant to take off from 'ski jump' equipped RN ships at increased weights.

The aims were two-fold. Firstly to increase the all-up weight clearance of the Harrier for ship ski-jump operations. Secondly to provide operating clearances following a QinetiQ led modification programme to HMS *Illustrious's* third mast.

Carried out in 2006, the trials were entirely successful and brings the launching capability to the same as is currently cleared for land operations. This will enhance the power projection from the sea of Britain's front-line Harrier force.

PROVEN DEFENCE EXPERTISE

JSF SUPPORT BREAKTHROUGH IN AUTOMATIC LANDING

In a major milestone for the Joint Strike Fighter (JSF) programme, QinetiQ has achieved the world's first automatic landing of a short take-off vertical landing (STOVL) aircraft on a moving ship.

Using relative GPS technology, QinetiQ's Autoland system calculates the relative position of aircraft and ship and transmits steering instructions to the autopilot to enable it to bring the aircraft down without intervention from the pilot. As a result, JSF pilots will be able to operate at night and in weather that would previously have made flying very difficult. It also reduces risk in that the pilot no longer has to make complicated manoeuvres at the end of a mission when fatigue is most likely.

Carried out on HMS Invincible in May 2005, the landing is the latest advance in a long line of research by QinetiQ and its predecessors. The project itself is jointly funded by the US JSF Program Office, as part of QinetiQ's \$10m of work to de-risk the JSF's flight control system and by the MOD's Joint Combat Aircraft Integrated Project Team.

ADVISING ON THE JSF

In September 2005 the Joint Combat Aircraft (JCA) Integrated Project Team (IPT) placed a follow-on contract with QinetiQ to provide technical and acceptance advice.

Under the three-year £10.3m support package, QinetiQ helps the IPT meet its aims to deliver JCA with an acceptable level of capability at minimum cost, influences the JSF Programme to meet the UK requirement and minimises UK-specific testing and acceptance activity.

The QinetiQ support includes test and acceptance experts deployed throughout the Joint Strike Fighter programme in the US along with a multi-faceted technical support team in the UK.

RAPID SET UP FOR SECURE COMMUNICATIONS

QinetiQ has won in open competition a £2.5m contract from the MOD to develop a mobile command and control system, able to be rapidly deployed in the field wherever and whenever the need arises.

The system uses off-the-shelf components such as servers, laptops, telephones and printers. Once the integrated technology is installed into military vehicles, the operators can set up the system in a matter of minutes as soon as they reach the location. This enables them to communicate securely with a central base. For swifter decision-making, the MOD system will be compatible with other government departments.

This shows QinetiQ once again using its systems integration skills to meet the operational needs of the MOD.

NETWORK ENABLED CAPABILITY

QinetiQ plays a major role in contributing to the MOD's Network Enabled Capability (NEC) initiatives.

Our recent Combat ID trial showed how the future NEC battlespace might look: linking coalition C4ISR (Command, Control, Communications, Computers, Intelligence, Surveillance and Reconnaissance) assets to deliver a precise military effect. As co-founding partners on NITEworks, the MOD's NEC experimentation and simulation initiative, QinetiQ has also provided significant resources and capabilities into many military themed experiments. QinetiQ's co-prime role on research activities, such

as Dabinett, also places the company at the forefront of the acquisition of future C4ISR capability for the next 20 years.

Other programmes where QinetiQ supports the MOD, the research programme and the wider defence industry, demonstrate our highly regarded domain knowledge, communications solutions, information management and systems integration capabilities. This positions QinetiQ as a company which truly understands how to deliver timely intelligence to decision makers for improved military effect.

ALL MEASURED UP FOR BACK TO SCHOOL

The shoe company, Clarks, needed a new way of measuring feet. For the best fit, and to mark them out from their competitors, Clarks wanted to be able to define not just the outline of the foot but its 3D shape.

At the same time, QinetiQ had been pioneering a 3D camera, a technology with roots in identifying unexploded ordnance for the MOD. The need and the technology came together in a revolutionary foot gauge for Clarks.

The concept uses a camera sensor and bespoke software to generate a 3D image. A prototype was developed and successfully trialled in two Midlands stores. Volume manufacture is now underway and Clarks will have units in approximately 50 of its leading shops in time for the 2006 'back to school' season and has ordered 800 units from QinetiQ.

SAFER HIGHWAYS

TRAINING AND ACCREDITING TRAFFIC OFFICERS

The Highways Agency has contracted QinetiQ to provide elements of training, tutoring and competence assessment for the 1,200 new Traffic Officers and Control Room Operators, now being introduced to take over some of the tasks previously carried out by the police on England's roads.

By assessing Traffic Officers and Operators on the job, QinetiQ will help them demonstrate their competence and work towards a new qualification, the Certificate in Traffic Management. In conjunction with providing training on all the Control Centre systems, and support with vehicle procurement, QinetiQ is helping to ensure high and consistent standards of traffic management across the country.

SPEEDING UP

COMPUTER CHIPS

QinetiQ, in collaboration with Intel, the world leader in microchip manufacture, has carried out research into new transistor technology.

This has meant using a material called indium antimonide in a new way. The material was pioneered by scientists in QinetiQ and enables the devices to operate at very high speed and also at very low power to reduce chip temperatures.

This could revolutionise the manufacture and development of the transistors in computer, networking and communications products.

ROUTES TO MARKET

MANAGED SERVICES	PRODUCTS	LICENSING	SPIN OUT	REALISATION
PITO The recognised security expertise of QinetiQ has led to provision of high level services to the Police Information Technology Organisation (PITO) to host, develop and manage the UK National Police Portal. The web portal provides a one-stop shop for police appeals and force resources and demonstrates QinetiQ's skills in the Digital Security and Managed Services arenas.	GPS QinetiQ has developed Orellius, a ground-breaking compact Global Positioning System that requires no visible antenna and can be fitted to any portable object. The system can report location and movement and can be used to track equipment, machines and people in environments where conventional GPS fails to produce a location fix or is not in real-time.	FUNTI™ QinetiQ's FUNTI™ thermal imaging technology is used to produce very low cost thermal cameras (as low as \$20 each) in high volume, compared to competitor offerings at nearly \$1,000 per unit. It has been licensed for various applications, including automotive airbag safety, industrial process monitoring and building sensors.	STINGRAY A venture with a consortium led by Energy Ventures established to develop a commercial fibre optic seismic monitoring system on the seabed providing high quality data on offshore hydrocarbon reservoirs to maximise oil and gas productivity. This is targeted at increasing recovery of reserves from 35% to 50%, generating significant extra value and maintaining the world's supplies.	FRIENDS REUNITED Sale of the 1901 Census online business to Friends Reunited. This site has played a key role in the increasing popularity of genealogy as people use the internet to research their roots. Following the installation of systems to ensure uninterrupted service for users, the team oversaw the migration of the website from QinetiQ servers to Friends Reunited offices.

EXCELLENCE IN COMMERCIAL INNOVATION

QinetiQ is seeking to grow in markets where its expertise and technologies offer competitive advantage and where it can provide high-value solutions for its customers.

Within these markets, it aims to add value through innovation that is informed by a deep understanding of the trends that influence customers' needs. QinetiQ works across a range of commercial sectors in areas such as security, counter-terrorism, aviation, space and communication.

TARSIER® SEES CLEAR RUNWAYS

In 2005, QinetiQ sold its first Tarsier® runway debris detection system to Vancouver International Airport in Canada.

Whether it is aircraft parts, litter or dead birds, debris on runways costs an estimated \$4 billion a year in terms of damaged aircraft and delayed flights. A busy airport typically inspects its runways from a moving vehicle four times a day – a challenging task on a 4km

stretch of tarmac with aircraft taking off or landing every 60 seconds. QinetiQ's remote detection system provides the answer. Developed after the Concorde crash in Paris in 2000, Tarsier® constantly scans the runway and can detect a 5cm metal bolt at over 1.5kms distance, even at night and in bad weather.

Tarsier® has been trialled with great success at major airports in the UK and North America. At Vancouver, debris was detected and removed within five minutes while a trial system at New York functioned perfectly in -20°C and through blizzard conditions.

EXCELLENCE IN COMMERCIAL INNOVATION

SHARING MOBILE TECHNOLOGY

Quintel Technology Limited, a QinetiQ joint venture, has successfully installed its first multi-operator, independent variable tilt 3G shared antenna solution, which enabled three mobile phone operators to share the same site.

The installation at the Trentham site was significantly faster than traditional site tower re-development timescales and has enabled Vodafone and 3 to improve network coverage in the area.

The Quintel product allows up to five mobile phone operators to share a single antenna whilst maintaining independent control of tilt, a key function for 3G network optimisation. In addition to enabling multi-operator site sharing, Quintel Technology Limited is developing a range of solutions intended to significantly enhance mobile radio performance, through tilt optimisation freedoms.

TECHNOLOGY SOLUTION FOR RETAILERS

Liquid crystal display (LCD) technology developed in QinetiQ and commercialised by ZBD, has been trialled by Tesco to enable it to automate price and product information on shelf labels from the back office. This heralds a first in UK supermarkets.

Using wireless technology to update promotional offers and price changes instantly gives a number of benefits. Pricing can be updated easily and wastage in perishable items can be minimised by reducing prices automatically when they get close to consumption date.

The display uses zero power, except for updates, making the ZBD wireless display very economical to run.

SECURING THE DIGITAL ECONOMY

QinetiQ's heritage of securing classified networks and its proven independence means that it is well-placed at the centre of the UK's cyber security industry. This has led to its selection for the management of the UK's new Cyber Security Knowledge Transfer Network.

Funded by the DTI, this new initiative will bring together experts from industry, academia and government to look at threats and solutions in the field of digital security, including identity management and biometrics.

The network will be instrumental in helping UK enterprises develop innovative products and services that address the challenges posed by the need for improved digital security.

LOW COST ACCESS TO SPACE

TopSat, a micro-satellite developed by a British consortium led by QinetiQ, sent its first high quality images through on 7 December 2005, proving the success of the technology and representing a major step forward in affordability of space missions.

The launch, from Plesetsk in Northern Russia on 27 October, attracted a lot of attention and was hailed as a British success story by Lord Sainsbury, Parliamentary Under-Secretary of State for Science and Innovation. The first images were downloaded to the QinetiQ ground station.

TopSat offers a less expensive option for future missions – current image-generating satellites cost more than five times the cost of TopSat. The 2.8 metre resolution imagery will have a number of uses, from disaster relief and environmental monitoring to border control and security use.

SUSTAINED GROWTH IN THE UNITED STATES

QinetiQ North America has leading positions in its core market sectors in the North American defence and security market with particular focus on technology, systems engineering & technical assistance and IT services.

Having entered the US in 2001, QinetiQ has since acquired a number of US companies with complementary skills and close relationships with government and military institutions. The combination of UK research and technology with the strong market positions of QinetiQ's acquired companies is proving highly successful in the US marketplace.

US-VISIT PROGRAM

US-VISIT has been deployed in airports across the US to keep records of foreign visitors entering the country. Apogen was involved in the initial roll out of the system, providing installation of the IT systems.

Apogen continues its involvement in the programme through day-to-day support of the Local Area Network and hardware at each site.

SAFER STREETS

SECURES® is an acoustic gunshot detection tool from Planning Systems to aid law enforcement. A gunshot can be detected in just three seconds and its location triangulated within ten feet of its origin.

The technology means that the precise time and location, quicker reporting, dispatch and field response is achieved. SECURES® has been successfully deployed in several cities in the US in both overt and covert missions. Through its use, police have been able to recover evidence, come to the aid of victims, intervene in criminal activity and directly make arrests.

As a technology tool, SECURES® has become an integral component in the operations and response to gun-related crime.

INCREASING AIRDROP ACCURACY

A Precision Air Drop System (PADS), developed by Planning Systems, is now being supplied to the US Army, US Air Force, US Marine Corps and Special Operations Forces.

This system enables precision drops of material and personnel from high altitudes with the accuracy necessary for current and future high mobility operations. It works directly with unguided delivery systems and with steerable systems now being developed.

PROTECTION THROUGH SIMULATION

In response to the growing demand for safe and cost effective air travel, FlightViz® and FlightAnalyst™, two aviation systems analysis products, have been developed by Westar.

These in-flight data visualisation and simulation technologies help customers to improve maintenance, operations, training and safety and are used by the US Navy, US Army and other aviation industry leaders.

SUCCESSFUL STRATEGY

QinetiQ has a world scale technology innovation engine within its UK operations.

A growing presence within the US markets provides the opportunity to introduce that technology and innovation to the world's largest defence and security market.

SUSTAINED GROWTH IN THE UNITED STATES

HURRICANE HEROES

When Hurricane Katrina hit in October 2005, Apogen provided infrastructure support to the US Space and Naval Warfare (SPAWAR) Center in New Orleans.

Apogen, which already provided IT and programme management support to the Center, enabled the Navy to carry out its operations plan after the devastation of the hurricane made its facilities uninhabitable.

These efforts meant that the programmes proceeded on schedule, including the Defense Integrated Military Human Resources system (DIMHRS), a project that will combine the personnel and pay systems of all of the military branches into a consolidated system.

REMOTE FIREPOWER

Foster-Miller has reconfigured its highly-successful TALON™ robot as a small mobile weapons system for the US Army.

This version, named SWORDS (Special Weapons Observation Reconnaissance Direct-action System), will provide extra firepower to troops and can be used remotely to help preserve life.

TALON™ is used extensively on Explosive Ordnance Disposal (EOD) missions in Iraq and Afghanistan with great success and works in all terrains and all weathers with both day and night capability. It has alternative mounts for a 40mm grenade launcher and an M202 anti-tank rocket system.

PREPARING THE ARMY FOR COMBAT

A multi-year contract with the US Army Combat Readiness Center will see Westar provide comprehensive safety engineering, loss prevention, composite risk management, research analysis and information technology programme support. This work will be carried out both in the US and at field locations around the world.

SUPPORTING ARMY SOFTWARE

A contract with the US Army's Programme Manager to provide Enterprise Resource Management and technology support means that Westar will be responsible for the fielding, training and post-deployment software support of the aviation Unit-Level Logistics System for all Army, Reserve and National Guard units around the world and for all armed helicopters.

EXPERTISE CROSSING BORDER SECURITY PROJECTS

Apogen plays a critical role in the US Customs and Border Protection's (CBP) Container Security Initiative (CSI), a preemptive effort against terrorist attempts to smuggle persons and weapons of mass destruction set up after 9/11.

Providing critical support to fulfil the CSI mission, Apogen's team ensures access to the Automated Manifest System and the Automated Targeting System. These databases provide CBP Inspectors at port locations with the data they need to pre-screen containers.

In the Free and Secure Trade Initiative (FAST), an allied project, Apogen designed and implemented a radio frequency identity (RFID) system at six initial border locations. FAST uses RFID technology to create a more advanced form of a pass system for trusted, certified truckers.

Another part of the US drive to secure its borders, the Port Radiation Inspection, Detection & Evaluation (PRIDE) programme, saw Apogen develop the data warehouse to process the vast amounts of data generated by the PRIDE initiative efficiently.

ENVIRONMENTAL TECHNOLOGY SOLUTIONS

Corporate Responsibility (CR) for QinetiQ is a fundamental prerequisite for ensuring business sustainability.

Only by demonstrating to key stakeholders accountability for environmental, social and ethical impacts can QinetiQ claim to be managing the risks that define its reputation as a responsible business.

The Group is also committed to using technology to help solve critical problems facing society, including the challenge of environmental sustainability.

REDUCING THE IMPACT OF AIRCRAFT EMISSIONS

Emissions from aircraft are increasingly associated with climate change and are likely to be subject to tougher legislation in the future.

QinetiQ is well-placed to help the aerospace sector become more environmentally acceptable. It is helping the aerospace industry to design cleaner, quieter engines and lighter, more fuel-efficient aircraft. It is also helping

air traffic controllers to plan fuel-efficient flight paths and develop better methods for understanding the impact of emissions.

Responsibility for emissions policy in the UK lies to a large extent with the UK Department for Transport (DfT). As a result, the Department needs sound technical information on all aspects of aircraft emissions from engine combustion and

airline operations to the effect on climate and air quality. QinetiQ contributes key information and provides expert advice to the DfT on engine, aircraft and air transport system performance and the impact on the environment. Its contribution has ranged from improving the assessment of emissions at Heathrow Airport to researching the formation of vapour trails and advising on global regulations.

GREEN WARSHIPS

Even warships must keep ahead of environmental laws. The Green Warrior 2030 programme is funded by the MOD and looks at the environmental aspects of operating a warship – everything from recycling to the management of weapons – in order to implement sustainable solutions by 2030.

As part of the programme, QinetiQ has developed ELAN (Environmental Legislation Analysis – Naval). This tool will allow the MOD to assess the way that environmental legislation, both current and planned, will affect naval operations in terms of cost, time and military constraints.

USING TECHNOLOGY TO TACKLE CLIMATE CHANGE

Tackling climate change is central to QinetiQ's work as a responsible corporate citizen. Just as science and technology have exposed the dangers of climate change, they also provide the means for mitigating its effects.

Much of the Group's work in this area involves helping customers to keep ahead of tougher environmental legislation, to use energy and resources more efficiently and to enhance their environmental reputations. QinetiQ also recognises that its credibility as a provider of environmental solutions depends on managing its own environmental impact.

FUEL CELLS POWER SOURCE OF THE FUTURE

In the drive for cleaner energy, there is growing interest in fuel cells. These convert chemical energy directly into electrical energy and are less damaging to the environment than conventional primary batteries.

To advance the technology, which is in early stage development, Olympus Corporation has commissioned QinetiQ to develop a hydrogen generator for fuel cells. The key in this instance is QinetiQ's ammonia borane technology that provides the hydrogen fuel source which in turn combines with oxygen from the air in a fuel cell to generate electrical power.

This new technology has been initially developed for high power portable systems and so is typically carried as part of a back-pack. This work aims to miniaturise the technology to the size of a small battery. Olympus plans to use this new generation of fuel cells to power portable devices such as cameras and small sensors.

APPLYING CREATIVE THINKING

The QinetiQ Fellowship Scheme provides a formal recognition of the achievement of world-class scientific, technological and intellectual status.

QinetiQ Fellowship is awarded to individuals who have achieved exceptional technical standing and can show that their work has had real impact and significance for QinetiQ and its customers. Fellows are enabled and funded to pursue speculative technical topics which may become the foundation of future valuable innovations.

Following rigorous internal and external review, new Fellows are appointed by the Chairman and receive their award from a leading figure in the UK's scientific community at an annual ceremony. In March 2006 QinetiQ had 91 Fellows and 16 Senior Fellows.

NEW SENIOR FELLOWS AND FELLOWS IN 2005

BACK ROW LEFT TO RIGHT Dr Andrew Scott, Tim Rabbets, Dr Sam Kaddour, John Doherty, Dr David Hutber, Dr Nigel Davies, Peter Sumner. FRONT ROW LEFT TO RIGHT Dr Simon Richards, Dr Neil Salmon, Dr Tim Ashley, Dr Eoin O'Keefe, Dr Stephen Hayward, Mike Curnow

Senior Fellows and Fellows received their awards from Professor Roy Anderson, Chief Scientific Adviser to the Ministry of Defence. The selection process reports in the Spring and two Senior Fellows and eleven Fellows have been added to the cadre.

SENIOR FELLOWS

DR TIM ASHLEY

For international distinction in research on narrow band-gap semiconductors and their applications to infra-red sources and detectors, to ultra-fast transistors, and in CMT focal plane arrays grown on silicon substrates.

DR ANDREW SCOTT

For international distinction in non-linear optics and laser physics, particularly in phase conjugation, Brillouin scattering, adaptive optics, in steerable high power lasers, dynamic optical tags and template tracking.

FELLOWS

MIKE CURNOW

For outstanding technical leadership, innovation and expertise in aircraft test and evaluation, particularly for the Merlin helicopter, where he is an internationally-recognised authority.

DR NIGEL DAVIES

For his outstanding contributions and international distinction in the field of high-frequency communications, combining deep understanding of principles with exceptional practical engineering and successful exploitation.

JOHN DOHERTY

For distinguished research in design optimisation and multi-disciplinary design, including his innovation of practical tools for aerodynamic design, which have made QinetiQ the European leader in this field.

DR STEPHEN HAYWARD

For outstanding achievements in adaptive signal processing, developing solutions to important problems, which have had a substantial impact and contributed greatly to QinetiQ's world reputation in the field.

DR DAVID HUTBER

For outstanding contributions to the exploitation of systems science in command and control and ISTAR systems, and particularly for his pioneering work in concepts and simulation for network enabled capability.

DR SAM KADDOUR

For major contributions in the design and analysis of composite structures, notably in the creation of international standards and failure criteria for fibre-reinforced polymer composites.

DR EOIN O'KEEFE

For many outstanding and highly innovative contributions in the field of low-observable and camouflage materials and paints.

TIM RABBETS

For distinguished work in systems engineering, notably in naval combat systems and in methods for non-functional requirements, and for linking design and life cycle processes to reduce whole life cost.

DR SIMON RICHARDS

For important fundamental contributions in underwater acoustics, particularly for turbid coastal waters, through his work on the acoustical properties of marine suspensions and sediments.

DR NEIL SALMON

For outstanding contributions in the field of millimetre-wave imaging, particularly combining research on passive imaging systems with profound expertise in millimetre-wave interactions and in simulation and modelling.

PETER SUMNER

For his outstanding technical leadership and expertise in Electromagnetic (EMC) testing of aircraft, and for his innovation in related methods and instrumentation and in minimising the biological hazards of EMC testing.

OPERATING AND FINANCIAL REVIEW

MARKET OVERVIEW

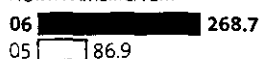
The Group conducts the majority of its business in the UK and US defence and security markets.

TURNOVER BY DESTINATION

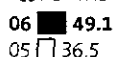
UNITED KINGDOM £m



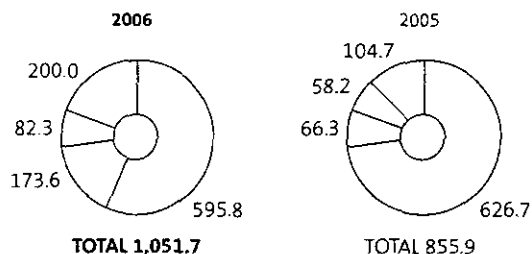
NORTH AMERICA £m



REST OF THE WORLD £m



TURNOVER BY CUSTOMER TYPE £m



MOD
DOD
Commercial Defence
Civil and Other Government Agencies

DEFENCE

Policymakers in the UK and the US have responded to the new, more diverse and unpredictable threats faced by these nations by reconsidering the needs of modern armed forces. The experience of conflicts in Afghanistan and Iraq have reinforced the emphasis placed on armed forces being capable of rapid and global deployment, on being mobile, interoperable with allies and equipped with the most effective technology.

These changes have placed a premium on innovation and agility in upgrading existing platforms and in the supply of novel and timely solutions to rapidly emerging defence needs. In both the US and the UK, developments in defence policy have focused on more rapid and flexible equipment acquisition approaches. The US Government published "Transforming the Defense Industrial Base: A Roadmap" in December 2004, and the Defence Industrial Strategy White

Paper (DIS) was published by the MOD in December 2005. Both recognised the importance of the defence industry in meeting these new and evolving defence needs, and the growing role for industry in whole life management of defence equipment and service provision.

The DIS places emphasis on a strong UK defence industry and recognises 'the need to improve the earned profit margins available to industry based on good performance if we are to attract global investment capital into the UK defence industry'. The MOD is also expected to publish a separate Research and Technology paper during 2006 to address the technology strategy for UK defence procurement.

The effects of these policies can be seen in the procurement strategies being employed in major projects such as FRES in the UK and FCS in the US, which play to the importance of designing for flexibility and innovation. They can also be seen in the many smaller purchasing decisions where advanced technology is taken rapidly into operational use and evolved alongside practical experience. With its long experience of supporting urgent customer needs and its deep base of technical excellence, QinetiQ is well positioned to benefit from these evolving policy trends through its well established businesses in defence funded research and development, technology supply, advice and managed services.

SECURITY AND COUNTER-TERRORISM

With continued uncertainty in the world and new threats regularly emerging, global spending by governments on homeland security and counter-terrorism continues to rise, with particular emphasis on the deployment of technical solutions to counter the new threats. QinetiQ's heritage in the defence market leaves it well positioned to support its customers through the provision of innovative products and services. In particular, the US Department of Homeland Security (DHS) budget and the counter-terrorism/resilience budget in the UK are key areas of focus for QinetiQ.

Additionally the infrastructure, physical security and information assurance markets, both government and commercial, in which QinetiQ participates are fast growing segments of the security and counter-terrorism market. This Sector focuses on technologies that provide tracking, detection and surveillance that have capabilities to secure borders and protect high value or iconic buildings and events. The information assurance sector focuses on fundamental requirements for the secure hosting of information and information systems penetration testing and assurance.

NICHE CIVIL MARKETS

QinetiQ operates in niche sectors of large and growing commercial markets by leveraging technology and capabilities originally developed for defence customers. QinetiQ delivers funded research and development contracts, consultancy and support services, specialised products and intellectual property licensing to solve important problems in markets as diverse as civil aviation, oil and gas exploration and production, small space satellite systems, telecommunications, electronics and healthcare.

KEY CUSTOMERS

As the Group has further expanded during the course of the year the customer base has become more diverse and the market mix has changed accordingly. In the UK market the MOD remains the Group's largest customer accounting for direct sales of £595.8m (2005: £626.7m). Sales made into the commercial defence market in the UK, where the MOD is generally the ultimate customer, have grown by 38.9% to £71.0m.

Direct revenues from the MOD have decreased from 73.2% to 56.7% of Group turnover largely due to the increase in revenues in North America as the Group has expanded into the US market place over the last two years.

Principal customers in the US are the DoD and DHS which contributed 64.6% and 11.3% of North American revenues in the year.

Across the Group Civil and Other government agency revenues have grown by 91.0% in the year to £200.0m. This growth comes from a combination of the new customer profiles from acquisitions in the year such as DHS contracts with Apogen and ESA contracts with Verhaert together with the continued execution of QinetiQ's strategy to increase the commercialisation of its intellectual capital into non-defence markets.

OPERATING AND FINANCIAL REVIEW

GROUP TRADING PERFORMANCE

SUMMARY

	2006	2005	INCREASE
Group turnover	£1,051.7m	£855.9m	22.9%
Underlying operating profit	£90.7m	£82.3m	10.2%
Profit on disposal of interest in pSiMedica Limited	–	£17.1m	
Underlying operating profit (excluding profit on disposal of interest in pSiMedica Limited)	£90.7m	£65.2m	39.1%
Underlying operating margin (excluding profit on disposal of interest in pSiMedica Limited)	8.6%	7.6%	100bps
Underlying profit before tax	£80.1m	£58.2m	37.6%
Underlying earnings per share	10.2p	8.8p	16.3%
Net debt	£233.0m	£176.6m	31.9%
Free cash flow	£141.3m	£55.7m	153.7%
Backlog	£608.4m	£572.0m	6.4%
Underlying Effective Tax Rate	22.7%	16.2%	
Dividend per ordinary share	2.25p	Nil	

QinetiQ is organised into three operating sectors:

- **Defence & Technology (D&T)** – D&T represents the core of QinetiQ's UK-based defence business, delivering research-based technology solutions, advice and managed services that support the UK's armed forces and those of its allies.
- **Security & Dual Use (S&DU)** – S&DU draws from QinetiQ's broad inventory of defence-related intellectual property and leading scientists to develop commercially viable products and services in selected adjacent commercial markets.
- **QinetiQ North America (QNA)** – QNA delivers technology services, systems engineering & technical assistance and IT services into the North American defence and security marketplace from its US-based operations.

TURNOVER

DEFENCE & TECHNOLOGY £m

06	669.6
05	664.9

SECURITY & DUAL USE £m

06	133.7
05	120.9

QINETIQ NORTH AMERICA £m

06	248.4
05	70.1

Turnover in the year to 31 March 2006 has increased by 22.9% over 2005 as the Group continued to execute its strategy to expand into the key North American defence and security markets. The growth reflects the inclusion of a full year's results from the acquisitions of Westar (acquired October 2004) and Foster Miller (acquired November 2004) together with a first time contribution from the acquisitions of Apogen and Planning Systems (both acquired September 2005). UK-based sector turnover grew by 2.2% with the impact of £14.0m of non-recurring LTPA revenue in 2005 partly offset by the first time contribution from Verhaert Design and Development NV (Verhaert) of Belgium (acquired September 2005). Underlying organic growth in the UK sectors was 2.3%.

ORDERS AND BACKLOG

ORDERS

DEFENCE & TECHNOLOGY £m

06	420.7
05	472.6

SECURITY & DUAL USE £m

06	168.1
05	127.8

QINETIQ NORTH AMERICA £m

06	227.9
05	67.9

BACKLOG

DEFENCE & TECHNOLOGY £m

06	366.6
05	410.0

SECURITY & DUAL USE £m

06	112.6
05	93.4

QINETIQ NORTH AMERICA £m

06	129.2
05	68.6

Orders won in year increased by 22.2% to £816.7m in 2006. Orders do not include a value for the revenues from the £5.6bn core service contract for the LTPA included in the D&T sector each year as this contract was awarded for a 25 year period at inception. Growth in orders was driven by the QNA acquisitions in 2005 and 2006 and strong organic growth in S&DU. At a Group level this was offset in D&T where the previous year included several awards of significant multi-year research and procurement & capability contracts that, as expected, were not repeated in 2006.

Backlog is also stated excluding the £5.0bn value of the remaining 22 years of the LTPA contract. The growth in backlog is generally driven by the same factors underlying the growth in orders. Compared to the UK, backlog in the US businesses is generally lower as the nature of the contract awards is more centred around larger multi-year 'enabling' contracts that become funded and then utilised in smaller segments during the course of each fiscal budget cycle. An example of this is the enabling order for Talon™ robots that Foster-Miller holds which in total indicates an intention to buy \$257m worth of equipment over a number of years with the specific funding for each year being decided as part of each US Government annual budget cycle.

OPERATING PROFIT

Underlying operating profit (excluding profit on disposal of interest in pSiMedica Limited in 2005) has grown by 39.1% from £65.2m to £90.7m, with margin improving from 7.6% to 8.6%. Underlying operating profit growth from the two UK-based sectors was 15.7% reflecting continued margin enhancement and focus on delivery from core trading activities together with the contribution from the acquisitions of HVR Consulting in August 2004 and Verhaert Design & Development NV in September 2005. This profit growth in the UK-based sectors is complemented by profit growth in QNA largely arising from acquisitions made in the year and the consolidation of prior year acquisitions for a full year.

Within the Group, S&DU crystallises value from intellectual property through a variety of different methods such as royalties, licence fees, equity realisations, sale of IP joint ventures and technology transfer based transactions, which can lead to volatility in the year to year trend. In 2006 licence revenue from now expired LCD patents contributed £13.0m of turnover (2005: £14.7m) of which £9.0m arose in the first half of the year. In 2005, Underlying Operating Profit included a £17.1m gain on disposal of the investment in pSiMedica Limited. Underlying Operating Profit, inclusive of the gain on disposal of the investment in pSiMedica, has grown 10.2% from £82.3m in 2005 to £90.7m in 2006.

Within the UK the business continues to respond to changes in the profile of demand for its services from customers and actively seeks to redeploy people from declining areas of the business to areas of growth. Due to the particular specialised capabilities the ever increasing rate of technological change and shift in market demands, redeployment is not always possible and the Group recognises that a degree of ongoing restructuring and repositioning is an integral part of the progression of the business. The current year costs of such repositioning are borne within the underlying operating profits of the Group. In the year to 31 March 2006 an amount of £9.4m has been charged to the income statement, within employee costs and further costs of at least £8.0m are anticipated in the first half of the year ending 31 March 2007.

Consistent with the historical trends in our UK business, 58.9% of the Group's Underlying Operating Profit was delivered in the second half of the year. In light of the strong LCD royalties in the first half of 2006 and the restructuring costs already committed in 2007, it is anticipated that an even greater proportion of UK profits will be generated in the second half of the coming year than in 2006.

NET CASH FLOW FROM OPERATING ACTIVITIES

GROUP £m

06	83.3
05	23.6

Net cash flow from operating activities improved by 253.0% to £83.3m. The UK sectors were the drivers of this performance contributing strong operating cash flow conversion due to diligent working capital management and a consequent reduction in MOD-related working capital at the year end. The benefit in the UK sectors was mitigated in part by an absorption of working capital in QNA due to the timing of contract funding awards from the DoD and DHS around the year end following the delayed finalisation of the US Government budget in February 2006.

During 2006 the Group completed the UK restructuring programme announced in 2005 resulting in an associated cash outflow during 2006 of £22.8m. Excluding the impact of these cash payments the Underlying Operating Cash Conversion ratio improved from 27.2% to 84.4%.

OUTLOOK

The UK government's Defence Industrial Strategy and the US government's Quadrennial Defense Review will shape QinetiQ's markets to a considerable degree into the medium term future. It is positive for QinetiQ that both documents emphasise the imperative for agility in military procurement and the key role for advance technology in delivering that agility. While budgets will remain constricted on each side of the Atlantic, QinetiQ will maintain its pace of transformation through investment, rationalisation and the creation of more product-based offerings to realise the significant potential provided by its chosen markets. The successes of the 2006 year have laid a solid foundation for delivering on these opportunities.

The coming year will see QinetiQ continuing to execute its repositioning strategy. In the UK defence business, this means continuing requirements to rapidly insert technology into new and existing systems and equipment. In the commercialisation business, this means building particularly on a strong security positioning, continuing to develop the space business through key bidding opportunities and selected acquisitions, and further investment to develop the ventures portfolio business plans. In North America, new business opportunities are anticipated as the US companies work more closely together and with the UK, and the disciplined approach to acquisitions continues to be pursued.

OPERATING AND FINANCIAL REVIEW

SECTOR ANALYSIS

DEFENCE AND TECHNOLOGY

D&T generates revenue through four business streams:

- **MOD Research:** customer-funded defence research to the MOD;
- **Technology Supply:** using intellectual property from customer-funded defence research to provide technology-based solutions to OEMs, defence prime contractors, MOD and other UK Government agencies, US DoD and a number of technology-driven civil industries;
- **Procurement & Capability Support:** advice to the MOD in relation to the acquisition, effective sustainment and use of defence equipment together with systems engineering, integration and other support services along with tasking services under the LTPA; and
- **Managed Services:** provision of long-term managed services to the MOD. Currently this is principally through the LTPA whereby QinetiQ provides the UK's test and evaluation capabilities to MOD. The LTPA is QinetiQ's single largest current contract and is expected to provide revenues of up to £5.6bn (for the non-tasking services only) over 25 years from its commencement in 2003.

for the contribution from the HVR Consulting acquisition in August 2004.

Since the formation of QinetiQ in 2001, the MOD has introduced competition into its research programme and is progressively phasing down the amount of such work that is assured to QinetiQ such that by 2008 those elements of the MOD Research programme available to industry will be fully opened to competition. QinetiQ has maintained market leadership in this domain, through success in winning competed contracts or as a subcontractor where QinetiQ is equipped to provide the requisite solution. During the year QinetiQ continued to win more than 50% of the MOD research bids in which it competed.

The overall level of MOD research undertaken by the Group, in both D&T and S&DU, has reduced in line with expectations from £227.1m in 2005 to £193.1m in 2006. This trend is expected to continue in the coming year as further areas of the research budget are opened to competition and the volume of assured work for QinetiQ reduces. QinetiQ has been able to offset the impact of competition in the research programme by increasing its penetration of the defence technology supply chain as a partner or subcontractor to other primes, leading to 28.2% growth in the Technology Supply stream offsetting the reduction in MOD research revenue within the D&T sector.

	2006 £m	2005 £m	% GROWTH	% UNDER- LYING GROWTH ⁽¹⁾
Turnover				
MOD Research	164.3	188.8	(13.0%)	(13.0%)
Technology Supply	124.2	96.9	28.2%	28.2%
Procurement & Capability Support	197.3	182.3	8.2%	6.5%
Managed Services	183.8	196.9	(6.7%)	0.5%
	669.6	664.9	0.7%	2.4%
Underlying operating profit	56.5	51.3	10.1%	8.9%
Underlying operating margin	8.4%	7.7%		

Orders

MOD Research	99.8	202.5
Technology Supply	137.3	98.3
Procurement & Capability Support	177.1	171.8
Managed Services	6.5	–
	420.7	472.6

⁽¹⁾ Underlying growth in turnover excludes the impact of acquisitions and £14.0m non-recurring rationalisation revenues under the LTPA in 2005.

D&T turnover increased by £4.7m to £669.6m in the year to 31 March 2006. Underlying turnover growth was 2.4% after excluding non-recurring rationalisation income of £14.0m in 2005 under the LTPA within Managed Services and allowing

Procurement and Capability Support turnover grew by 8.2% largely due to particularly high levels of demand for Tasking Services within the LTPA in year. Within Managed Services the core provision of test and evaluation services under the LTPA remained broadly consistent excluding the reduction year-on-year due to non-recurring rationalisation revenues in 2005 of approximately £14.0m.

Underlying Operating Profit has risen £5.2m primarily due to core operational performance and improved margins driven from a continued focus on cost control, strong project delivery across the sector in year and ongoing rationalisation of sector overhead functions. The sector incurred £4.4m in restructuring costs in year as part of the continual process of aligning technical capabilities and back office infrastructure to evolving market needs.

As discussed above the profile of work won on the 'supply side' of D&T's business is transitioning to higher levels of Technology Supply work away from a historic dependence on MOD Research. The orders profile indicates that this trend will continue where the book to bill ratio for Technology Supply was 1.1:1 in the year. The overall decrease in D&T orders in the year is due largely to the non-recurrence of a number of multi-year contract awards that were won in 2005 in the Research and Procurement & Capability Support streams.

In March 2006 the Group was named preferred bidder, after a long and detailed competitive tender process, to provide a Combined Aerial Target Service (CATS) for air defence training and test and evaluation for the UK's armed forces over the next 20 years. This selection demonstrates the Group's credentials to win and operate long-term managed services contracts in a highly competitive environment. The largest element of this opportunity is work already undertaken by QinetiQ under the LTPA to deliver the aerial target service. In addition QinetiQ will provide a service for ground-based air defence training, aerial target services for the Royal Navy, and an air-to-air service for the RAF. The service will be capable of operating from any suitable range worldwide.

Looking forward, QinetiQ is a 50% co-sponsor of Metrix, a planned joint venture with Land Securities Trillium, currently bidding for two large 25-year contracts to provide training to the UK armed forces as part of the MOD's Defence Training Rationalisation (DTR) Programme. Metrix is bidding against one other entity for each of the contracts and MOD has stated that it will announce its preferred bidder in October 2006.

SECURITY & DUAL USE

S&DU provides contract R&D and other technology services, and supplies products to customers in security, defence and commercial markets. In addition, it earns royalty revenues, licence fees and equity realisations from the broad intellectual capital generated by the Group's funded R&D activities. The sector organises its business under four streams:

- **Security:** delivers world-class capabilities in information security and assurance, physical security including runway monitoring systems, people screening and specialised hardware and software solutions.
- **Space:** a leading European player in the development of ion engines, small low-cost, fast-to-launch satellites, mission design and geospatial information systems.
- **Technology Development & Exploitation:** delivers R&D offerings from its leading Optronics, Materials and Energy technical capabilities. In addition, it facilitates the transition of intellectual capital generated from QinetiQ's funded technology research and development work into a viable range of products and solutions for the commercial marketplace. Applications include optical devices, nanomaterials and portable power units.
- **Managed Services:** offers a portfolio of managed services in areas such as fuel and lubricant testing and analysis, instrument calibration and supporting technical services together with real estate, facilities and equipment management services.

	2006 £m	2005 £m	GROWTH %	UNDER- LYING GROWTH ⁽¹⁾ %
Turnover				
Security	32.1	24.6	30.5%	30.5%
Space	25.5	17.9	42.5%	(15.1%)
Technology Development & Exploitation	50.3	56.0	(10.2%)	(10.2%)
Managed Services	25.8	22.4	15.2%	15.2%
	133.7	120.9	10.6%	2.1%

Underlying operating profit (excluding profit on disposal of interest in pSiMedica Limited)	9.7	5.9	64.4%	54.2%
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Underlying operating margin (excluding profit on disposal of interest in pSiMedica Limited)	7.3%	4.9%
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Profit on disposal of interest in pSiMedica Limited	–	17.1
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Underlying operating profit	9.7	23.0
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Orders

Security	48.3	28.2
Space	18.7	12.5
Technology Development & Exploitation	63.1	56.0
Managed Services	38.0	31.1
	168.1	127.8

⁽¹⁾ Underlying growth in turnover excludes the impact of acquisitions in 2006.

OPERATING AND FINANCIAL REVIEW

SECTOR ANALYSIS CONTINUED

Security and Dual Use (S&DU) turnover increased 10.6% in the year. The organic growth of 2.1% reflects strong performance in the Security stream with continued penetration of both government and commercial markets, including a contract to deliver the replacement information portal system for the UK police forces and a rise in IT security managed services turnover allowing investment to be initiated in a second secure operating centre. These increases were partly offset by a reduction in turnover from Technology Development & Exploitation (TD&E) as the Optronics and Materials businesses continued their transition away from a traditional MOD-funded research base towards US defence and commercial revenues from contracts such as the optical foot measuring system being designed and implemented for Clarks, the shoe retailer. TD&E includes £13.0m (2005: £14.7m) of royalty revenue from enforcement actions on LCD patents which expired in 2004. The Space stream saw an underlying decline in its UK business due to lower levels of UK Government funding directed to Space research in year, more than offset by a strong initial contribution from the acquisition of Verhaert which delivered £10.3m of revenue, well ahead of expectations due to an unusually high level of pass-through work on ESA projects.

Underlying Operating Profit increased 64.4% (excluding the £17.1m gain on the sale of the Group's interest in pSiMedica in 2005) due to strong operational focus within the core business and a first time contribution of £0.6m from Verhaert. The sector incurred £5.0m of restructuring costs in the year as it continues to align the business to market opportunities beyond the defence sector and to improve operational efficiency.

S&DU orders rose 31.5% resulting in a book to bill ratio of 1.26:1 in the year. This was driven by strong performance in the Security stream which secured a four and a half year contract to provide and manage a replacement for the UK National Police Portal System, received funding from the DTI to form, manage and facilitate the UK's Cyber Security and Biometrics Knowledge Transfer Network and secured the first commercial order for the Tarsier® runway debris detection radar system from Vancouver Airport. Managed Services secured a two-year contract to continue to provide support to the Defence Diversification Agency (DDA) and also negotiated specific consultancy contracts to provide planning support, site remediation and integration services and property consultancy services, while TD&E saw some important wins in its Optronics business, including further research contracts from the DoD.

QINETIQ NORTH AMERICA

QinetiQ North America is the world's largest defence and security market and is targeted as a major area of potential strategic growth for QinetiQ. QinetiQ established its presence in North America in 2001 through QinetiQ Inc., which served as the principal route to market for the supply of QinetiQ's UK research and technology into the North American defence and security markets.

QinetiQ has accelerated its expansion into the North American market through the creation of a dedicated North America sector which comprises a number of strategic acquisitions focused on growth markets which are complementary to, and draw upon, QinetiQ's UK technology and expertise. QinetiQ faces the North American market through three business streams:

- **Technology:** provides high technology research services and development of defence and security related products to the US DoD, other government agencies and commercial customers in North America through the Group's subsidiaries Foster-Miller and Planning Systems.
- **Systems Engineering & Technical Assistance:** principally engaged through Westar in providing independent support for the procurement, development, modification, fielding and sustainment of major army and missile defence equipment in North America.
- **IT Services:** Apogen provides information technology services to US Government agencies, particularly to the DoD and DHS.

	2006 £m	2005 £m	2006 \$m	2005 \$m
Turnover				
Technology	82.9	26.6	146.8	50.6
Systems Engineering & Technical Assistance	105.3	43.5	187.5	82.4
IT Services	60.2	–	105.5	–
	248.4	70.1	439.8	133.0

Underlying operating profit	24.5	8.0
Underlying operating margin	9.9%	11.4%

Orders				
Technology	73.2	25.3	129.6	48.2
Systems Engineering & Technical Assistance	97.4	42.6	172.6	80.8
IT Services	57.3	–	100.3	–
	227.9	67.9	402.5	129.0

QinetiQ North America turnover has increased by £178.3m in 2006 as the Group has made a number of acquisitions over the past two years to establish a platform to access this important market. The majority of growth in 2006 has been due to the acquisitions of Planning Systems and Apogen and the consolidation of a full year of results for Westar and Foster-Miller which were acquired in 2005. Within the operating units, the Technology stream led by Foster-Miller was adversely impacted during the year by a number of factors, noticeably the lack of shipments of Talon™ robots from September to November 2005 due to component issues, an accelerated decline in Last® Armor sales and the cancellation of all external contractor work by Pfizer as it reshaped its own business. Shipments of the Talon™ product resumed in full in December 2005. Foster-Miller is completing the testing of SWORDS, a new armed variant of the Talon™ platform, which commenced sales in 2006 and continues to pursue new opportunities to use the Talon™ robotic platform in other innovative applications. Planning Systems has traded in line with expectations since its acquisition and has recovered well from the impact of Hurricane Katrina which caused the temporary closure of its four offices in the New Orleans area.

The SETA stream driven by Westar performed strongly in the year with organic growth of 10.9% in the second half of 2006 when compared with the same period in 2005. In particular the high demand for desert kits from its Air Filtration Systems business, as the US Army in Iraq equipped their Blackhawk helicopter fleet, created a strong level of demand for these products in the first half of the year, although this is unlikely to be repeated as the product matures. Westar is now targeting its Air Filters business development towards commercial helicopter applications and is actively pursuing a wide range of commercial models, through civil aviation approval processes, in order to bring these products to market. Its engineering services divisions continued to perform strongly during the year. Westar's performance has exceeded expectations at the time of acquisition and the contingent consideration has accordingly been settled in full.

Within IT Services, Apogen has performed broadly in line with expectations since joining the Group in September 2005, although overall performance was adversely impacted by two external factors. In September, Hurricane Katrina resulted in over 150 employees and 100 contractors being displaced from a key customer site for several weeks due to the disruption caused by the hurricane. In the subsequent weeks after the hurricane struck, Apogen was praised by its customers for its speed and resilience in getting staff back to work on key tasks for customers and has won additional work later in the year to re-instate customers' systems and networks disrupted as a result of the hurricane. Additionally, across the second half of the year, Apogen has suffered delays in generating revenue from recently won contracts with the DHS due to the lengthy process in obtaining security clearances for new staff as the DHS expands its own staff and contractor base.

Underlying Operating Profit increased by 206.3% to £24.5m primarily due to the acquisitions in the year and full consolidation of prior year acquisitions. The underlying operating profit margin decrease is due to the changing mix of products and services as a result of the acquisitions in the year and the delayed Talon™ shipments.

OPERATING AND FINANCIAL REVIEW

OTHER GROUP ACTIVITIES AND PERFORMANCE

ACQUISITIONS

Since 1 April 2005 the Group has made the following principal acquisitions.

US ACQUISITIONS

On 2 September 2005, the Group acquired the whole of the share capital of Planning Systems Inc., a technology development company, for an initial cash consideration, before acquisition costs, of £24.3m (\$44.4m), including £1.6m (\$2.8m) for Planning Systems' cash and surplus working capital. Contingent consideration of £0.9m is payable for the achievement of certain performance criteria in the year ended 31 December 2005 and up to a further £1.6m is potentially payable dependent on the performance of the company for the year ended 31 December 2006.

On 9 September 2005, the Group acquired the whole of the share capital of Apogen Technologies Inc. for a cash consideration, before acquisition costs, of £130.3m (\$238.5m) and assumed debt of £29.2m (\$53.5m). This included £1.7m (\$3.2m) for Apogen's cash and surplus working capital. Apogen is one of the United States' leading providers of information technology services to the US federal government.

On 1 March 2006 the Group acquired the whole of the share capital of SimAuthor Inc. for £4.6m (\$8.0m), through Westar, in an all-cash transaction. SimAuthor is a software and services company that specialises in flight data visualisation and simulation technology.

On 4 April 2006 Apogen signed an agreement to acquire, subject to US Government approval, San Diego-based Ocean Systems Engineering Corporation (OSEC) for a cash consideration of £30.3m (\$53m). The approvals were subsequently received and the transaction was completed on 15 May 2006. OSEC is a leading provider of research design, development and integration of advanced information technology systems to key defence agencies. OSEC reported (under US GAAP) revenues of £27.9m (\$48.2m), EBITDA of £2.8m (\$4.8m) and earnings of £1.6m (\$2.7m) in the year to 31 December 2005.

OTHER ACQUISITIONS

On 1 September 2005, the Group acquired 90% of the share capital of Verhaert Design and Development NV, the leading Belgian space systems integrator, for an initial cash consideration, before acquisition costs, of £4.1m (Euro 5.9m), including £0.2m (Euro 0.3m) for Verhaert's cash and surplus working capital. Contingent consideration of £0.8m was paid in May 2006 for the achievement of certain performance criteria in the year ended 31 December 2005 and up to a further £0.8m is payable dependent on the performance of the company for the year ending 31 December 2006.

FIXED ASSET DISPOSALS

The Group recognised a net £8.9m profit on disposal of non-current assets and assets held for sale. The principal gains in the year were £13.8m on the sale and partial leaseback of a long leasehold interest in the Fort Halstead site which was disposed of for gross proceeds of £40.0m in September 2005; £3.4m of contingent consideration received in respect of the 2003 sale of the Aquila site; and £7.5m of contingent consideration received following the disposal of the Chertsey site in 2003. These gains were partially offset by £2.7m of losses on sundry other asset disposals and, in March 2006, two surplus properties at the Group's Farnborough site were sold for gross proceeds of £24.7m generating a loss on disposal of £13.1m.

The property disposals completed during the year mark the conclusion of the current programme to dispose of the larger surplus properties in the estates portfolio. The strategy going forward is to continue to pursue opportunities to release capital through the disposal of smaller surplus sites.

IPO

On 15 February 2006 the Company successfully completed an initial public offering (IPO) and a listing on the London Stock Exchange raising net proceeds for the Company of £132.7m.

Costs associated with the IPO have been charged to the share premium account or the income statement as appropriate. IPO costs totalling £8.9m are disclosed separately in the Income Statement as they represent significant one-off expenses relating to the transaction. The cost includes £5.8m arising on the gift of £500 worth (including associated tax costs) of ordinary shares to each eligible employee at the date of IPO.

The Company's principal shareholders, the MOD and Carlyle Group, reduced their stakes in QinetiQ immediately following the IPO and at 31 March 2006 held 19.2% and 10.4% respectively of the issued capital.

PENSIONS

The Group provides both defined contribution and defined benefit pension arrangements. The principal defined benefit scheme is the QinetiQ Pension Scheme.

At 31 March 2006 the QinetiQ Pension Scheme had gross assets of £716.0m and gross liabilities of £884.4m resulting in a gross deficit of £168.4m. After deducting the deferred tax asset associated with the scheme the net pension deficit at the year end stood at £118.0m compared to £76.2m at the start of the year (net of MOD indemnity).

Of the increase in the gross deficit in the year £40m relates to the application of the latest mortality rates, which resulted in a weighted average increase of one year in the life expectancy of scheme members, and £112m to a 0.5 percentage point reduction in 15 year AA bond yields increasing the present value of the liabilities. 15 year AA Bond yields declined significantly during the year from 5.4% at 1 April 2005 to 4.9% at 31 March 2006. The impact of the changes in bond yields has been to disproportionately increase the present value of the future liabilities in the scheme compared to the present value of the scheme assets resulting in a net increase in the scheme deficit before additional funding contributions.

The current investment policy of the QinetiQ Pension Scheme is weighted towards equity investments. The trustees believe this to be appropriate at the current time due to the relative youth of the scheme, which is expected to be cashflow positive for approximately the next ten years.

As part of the agreement in 2003 whereby QinetiQ Group plc acquired QinetiQ Holdings Limited, the MOD gave an indemnity to pay to the Group, on the earlier of a flotation, sale or winding up and 28 February 2008, a sum of up to £45m dependent on the size of the pension scheme deficit. The IPO was a trigger event for this payment and the Group received an amount of £45.3m (including interest from the date of IPO) on 24 March 2006. The Group has no further indemnities from the Government in respect of the scheme. The Group made an equivalent contribution into the QinetiQ Pension Scheme on 30 March 2006.

As part of the plan agreed with the trustees of the QinetiQ Pension Scheme to reduce the deficit following the March 2005 actuarial valuation, the Group committed to make additional contributions of £10m pa over six years, payable monthly from October 2005. On 30 March 2006 the Group prepaid the remainder of the first five years of these additional contributions by way of a payment of £45.0m into the QinetiQ Pension Scheme from the proceeds received from the IPO.

In June 2005 the Group made an additional past service deficit contribution of £10m to the scheme. This contribution was made as part of an agreement whereby employee contributions to the scheme are being progressively increased from 1.5% prior to June 2005 to 5% from June 2007.

As a result of these and other minor supplemental contributions, the total past service deficit contributions made by the Group in year totalled £106.4m.

The key assumptions used in the IAS 19 valuation are detailed in note 42 to the financial statements. The principal sensitivities regarding these assumptions are shown below.

ASSUMPTION	CHANGE IN ASSUMPTION	INDICATIVE EFFECT ON THE SCHEME'S GROSS LIABILITIES
Discount rate	Increase/decrease by 0.1%	Decrease/increase by 2.5%
Rate of inflation	Increase/decrease by 0.1%	Increase/decrease by 2.5%
Real rate of increase in salaries	Increase/decrease by 0.1%	Increase/decrease by 0.6%
Mortality	Increase by 1 year	Increase by 4.5%

TAX

The Group's statutory effective tax rate for the year was 16.7% compared to 7.3% in the year to 31 March 2005 while the underlying effective tax rate was 22.7% (2005: 16.2%). The effective rate of taxation continues to be below the standard UK rate, mainly due to the availability of research and development relief from HM Revenue and Customs and the utilisation of tax losses not previously recognised. The increase in the effective rate is primarily due to the increasing contribution to Group profits from QNA operations as the effective rate for those businesses broadly tracks the US statutory rate together with a lower level of utilisation of unprovided tax losses. The effective tax rate is expected to continue to rise with the evolving mix of the Group's business.

From a cash tax perspective, the impact of the research and development relief available, the utilisation of tax losses and the benefit of the additional pension contributions is expected to result in the UK business not being in a tax payable position for at least the next two years. The taxable profits from QNA operations are expected to result in cash tax payments on these businesses broadly following the US statutory rate.

OPERATING AND FINANCIAL REVIEW

OTHER GROUP ACTIVITIES AND PERFORMANCE CONTINUED

CASH FLOW AND NET DEBT

Cash flow from operations has increased to £107.6m (2005: £36.9m) primarily due to the growth in operating profit and the prior year cash flow being adversely affected by a £40.0m build up in short-term MOD-related working capital at the previous year end. Improved working capital management in the UK sectors has contributed to strong operational cash flows in the UK in 2006, partly offset by an increase in working capital in QNA as a result of the late funding of contracts following the delayed agreement of the DoD budget.

Net interest paid increased to £9.4m from £1.6m as the Group increased its borrowings to fund acquisitions this year. The Group's policy has been to fund significant US acquisitions with US dollar denominated debt to provide a hedge against the investment in the subsidiary operations.

Additional material cash flows include proceeds from the sale of the Fort Halstead, Chertsey and Pyestock South sites, which generated net cash inflows of £111.5m, and additional payments to the QinetiQ Pension Scheme of £61.1m (net of MOD indemnity receipt).

As part of the preparation for the Group's IPO QinetiQ redeemed the £37.5m of outstanding cumulative preference shares for £48.0m inclusive of accrued preference dividends. The Group received net cash proceeds of £136.2m from its IPO in February 2006 of which £45.0m was used to reduce the deficit in the defined benefit section of the QinetiQ Pension Scheme, with the balance of the IPO proceeds utilised to reduce net debt. A further £3.5m of IPO costs will be settled post year end.

The Group's net debt increased by £56.4m to £233.0m at 31 March 2006 (2005: £176.6m) principally due to the acquisitions made in the year and additional pension contributions, partly offset by IPO proceeds and strong operating cash flows.

Net debt at 31 March 2006 comprised net US dollar denominated debt of £281.0m and Euro denominated debt of £4.9m offset by sterling denominated net financial assets of £52.9m which were principally represented by cash balances. The US dollar : sterling exchange rate prevailing at the year end was \$1.73 : £1.

During the year the Group's primary borrowing facility was renegotiated and now comprises a £500m multicurrency revolving facility of which £291.4m has been drawn.

CAPITAL EXPENDITURE

Capital expenditure on property, plant and equipment totalled £45.0m (2005: £16.0m). Of this amount £23.5m (2005: £5.9m) was in respect of contractually committed amounts recoverable through annual charges under managed services contracts (principally the LTPA). The Group has future capital commitments of £26.2m of which £24.7m is under the LTPA and as such these commitments are also customer funded.

RESEARCH AND DEVELOPMENT

A large proportion of the Group's activity is focused on research and development, the majority of which is fully funded by customers as part of the Group's core business. In most cases the Group retains the rights to any intellectual property created in the course of research and development for customers. In addition to customer funded research and development the Group also undertakes limited research and development at its own expense, primarily focused on the later stage development of commercial products out of the funded research base. In the year to 31 March 2006 research and development costs totalled £504.7m (2005: £502.6m).

The Group capitalised £6.3m (2005: £1.8m) of development costs in the year. These sums were incurred on late stage development of new products, principally Tarsier®, ZephIR™ and GPS.

EMPLOYEES

DEFENCE & TECHNOLOGY

06	6,791
05	6,905

SECURITY & DUAL USE

06	1,643
05	1,790

QINETIQ NORTH AMERICA

06	2,640
05	1,374

CORPORATE

06	372
05	361

Year end employee numbers have risen by 9.7% to 11,446 primarily driven by the US acquisitions. UK staff numbers have reduced by 2.8% primarily as a result of the rationalisation programmes announced at the end of the last financial year.

FINANCIAL RISKS

The QinetiQ Group Treasury Department operates within a framework of policies and procedures approved by the Audit Committee, which include strict controls on the use of financial instruments in managing the Group's risk in order to maintain shareholder value. The Audit Committee receives regular reports on the activities of the Treasury Department. The Group does not undertake any speculative trading activity in financial instruments. The principal areas of activity are as follows.

INTEREST RATE RISK MANAGEMENT

A significant portion of the Group's debt is floating rate debt and, therefore, is exposed to movements in interest rates. At 31 March 2006, the Group had entered into swaps to convert 89 per cent. (31 March 2005: 86 per cent) of the bank debt to fixed or capped rates.

FOREIGN EXCHANGE RISK MANAGEMENT

US dollar: sterling exchange rates applicable to the Group

	1 APRIL	AVERAGE	31 MARCH
2006	\$1.89 : £1	\$1.78 : £1	\$1.73 : £1
2005	\$1.84 : £1	\$1.85 : £1	\$1.89 : £1

The majority of the Group's income and expenditure is settled in the functional currency of the relevant Group entity, principally sterling or US dollar. The Group's policy is to hedge all material transaction exposure at the point of commitment to the underlying transaction. The Group does not typically hedge uncommitted future transactions, although transaction risks are fully considered and appropriately mitigated when bidding for new work. The Group does not currently hedge income statement translation exposure.

INSURANCE

QinetiQ continually assesses the balance of risk arising from the operations undertaken against the insurance cover available for such activities and the associated premiums payable for such cover. The Group is currently self insured through its captive insurance company against specific risks up to limited level of liabilities with insurance cover above these levels placed with third party insurers in the external insurance market.

IFRS

The Group has adopted International Financial Reporting Standards (IFRS) for the year ended 31 March 2006. Comparative data has also been presented using IFRS.

The effect of transition to IFRS at 31 March 2005 on profit attributable to ordinary shareholders and net assets is analysed below:

Reconciliation of profit attributable to ordinary shareholders

	2005 £m
UK GAAP	75.6
Goodwill and intangibles	(3.3)
Tax	1.4
Leases	0.5
Employee benefits – pension	(0.3)
IFRS	73.9

Reconciliation of net assets

	2005 £m
UK GAAP	214.1
Goodwill and intangibles	98.4
Tax	(11.8)
Leases	1.0
Employee benefits – pension	(0.5)
Employee benefits – holiday pay	(7.1)
IFRS	294.1

The full effect of the Group's transition to IFRS is analysed in note 46 to the financial statements.

OPERATING AND FINANCIAL REVIEW

OTHER GROUP ACTIVITIES AND PERFORMANCE CONTINUED

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Group's critical accounting policies and estimates are disclosed in full in note 1 to the financial statements. The following commentary is intended to highlight those policies that are critical to the business based on the level of management judgement required in their application, their complexity and potential impact on the results and financial position reported for the Group. The level of management judgement required includes assumptions and estimates about future events which are uncertain, the actual outcome of which may result in a materially different outcome from that anticipated.

REVENUE AND PROFIT RECOGNITION

Turnover from fixed-price contracts is recognised in proportion to the value of the work performed and includes attributable profit. Depending on the nature of the contract, revenue is recognised as contractually agreed-upon milestones are reached, as units are delivered or as the work progresses. Royalty revenue is recognised on the earlier of the date on which the income is earned and measurable with reasonable certainty or cash is received. Turnover from sales of products is recognised on acceptance by the customer and when the amount of revenue can be measured reliably.

Profit on the supply of professional services on cost plus or time and materials contracts is recognised as the work is performed. Profit on fixed-price contracts is recognised on a percentage of completion basis once the contract's ultimate outcome can be foreseen with reasonable certainty. Losses on completion are recognised in full as soon as they are foreseen.

The estimation process required to evaluate the potential outcome on contracts and projects requires skill, knowledge and experience from a variety of sources within the business to assess the status of the contract, costs to complete, internal and external labour resources required and other factors. This process is carried out continuously throughout the business to ensure that project and contract assessments reflect the latest status of such work.

BUSINESS COMBINATIONS

Business combinations are accounted for under the purchase accounting method. All identifiable assets acquired and liabilities and contingent liabilities incurred or assumed are recorded at fair value at the date control is transferred to QinetiQ. The cost of a business combination is measured at the fair value of assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Any excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised is capitalised as goodwill. IFRS 3 requires that as part of this process intangible assets are identified. Intangible assets recognised on acquisitions have been valued using established methods and models to determine estimated value and useful economic life, with input, where appropriate, from external valuation consultants. Such methods require the use of estimates which may produce results that are different from actual future outcomes.

The Group tests annually whether goodwill and identified intangible assets have suffered any impairment. This process is reliant on the use of estimates of the future profitability and cash flows of the acquired business which may differ from the actual results delivered.

POST-RETIREMENT BENEFITS

The Group provides both defined contribution and funded defined benefit pension arrangements. The liabilities of the Group arising from defined benefit obligations, and the related current service cost, are determined by external actuaries using the projected unit credit method. For the funded defined benefit plans, the excess or deficit of the fair value of plan assets over the present value of the defined benefit obligation is recognised as an asset or a liability respectively.

For defined benefit plans, the actuarial cost charged to the income statement consists of current service cost, interest cost, and expected return on plan assets and past service cost. Other actuarial gains and losses are recognised in full immediately through the statement of changes in equity.

The Group's defined benefit pension obligations and net income statement costs are based on key assumptions including return on plan assets, discount rates, mortality, inflation and future salary and pension increases. Management exercise their best judgement, in consultation with actuarial advisers, in selecting the values for these assumptions that are the most appropriate to the Group. Small changes in these assumptions, individually or collectively, may result in significant changes in the size of the deficit or the net income statement costs.

RESEARCH AND DEVELOPMENT EXPENDITURE

Research and development costs incurred on behalf of a customer as part of a specific project are chargeable to the customer on whose behalf the work is undertaken. The costs and the related income are included in their relevant income statement cost category and turnover respectively.

Internally-funded development expenditure is capitalised when criteria are met and is written off over the forecast period of sales resulting from the development. Management decides upon the adequacy of future demand and market for such new products in order to justify capitalisation of internally funded development expenditure, which can be difficult to determine when dealing with such innovative technologies. Actual product sales may differ from these estimates.

PROFIT FOR THE PERIOD

The underlying performance of the Group, after allowing for non-recurring events and amortisation of acquired intangible assets, is shown below:

	2006 £m	2005 £m
Profit for the year	60.4	72.3
Minority interests	(2.3)	1.6
Profit for the year attributable to equity shareholders of the parent company	58.1	73.9
Preference Share dividend	—	(5.2)
IPO-related items	4.2	—
Restructuring costs	—	25.9
Profit on disposal of non current assets	(8.9)	(29.1)
Profit on disposal of interest in <i>psiMedica Limited</i>	—	(17.1)
Amortisation of intangible assets arising from acquisitions and impairment of goodwill and current asset investments	12.3	5.7
Tax impact of above items	(0.7)	1.0
Brought forward tax losses utilised	(5.4)	(4.7)
Underlying profit for the year attributable to equity shareholders of the parent company	59.6	50.4

In arriving at the underlying profit for the year, the Group has adjusted for a number of items which are considered non-recurring including the costs associated with the Group's IPO, profit on disposal of surplus property and the cost of restructuring the UK business into two market facing sectors. The Group has also restated the 2005 preference share dividend as if it had been treated as interest expense, to align with the 2006 presentation following adoption of IFRS.

During the year the Group restructured the funding arrangements with its co-investors in Quintel Technology Limited and QS4 Limited of which part of this agreement removed any funding obligations from its venture partner in Quintel Technology Limited (see note 36 to the financial statements). This resulted in a credit to minority interests of £4.1m representing the reversal of the cumulative losses previously attributable to minority interests. Prior to the restructuring the loss attributable to minority interest in the year was £1.8m (2005: £1.6m) resulting in a net overall credit to the minority interest position of £2.3m in the year.

DIVIDENDS

The Board recommends a final dividend for the year of 2.25 pence per ordinary share in respect of the year ending 31 March 2006. The Group anticipates that its final dividend will normally represent approximately two-thirds of the full annual dividend. No interim dividend was paid this year. The Group's dividend policy allows for a progressive approach.

In January 2006 the Company paid a dividend of 28 pence per preference share (including cumulative accrued dividends from prior periods) on the redemption of cumulative preference shares. Under IFRS the dividend charge for the year is shown as a component of finance expense rather than as a distribution of profits as in previous years.

OPERATING AND FINANCIAL REVIEW

CORPORATE RESPONSIBILITY

QinetiQ remains committed to the principle of Corporate Responsibility (CR) across all of its business activities.

This year it has sought to glean a clearer understanding of the social, environmental and ethical context in which it operates and has introduced a more structured management of impacts in a number of key areas.

The business case for CR – as a mechanism for managing risk and reputation – is now firmly embedded within the UK businesses of QinetiQ and is enabling the Group to *build on its heritage as an organisation committed to the socially responsible application of technology*. Recently acquired businesses are assessed against this framework as part of their integration into the Group.

ENVIRONMENTAL RESPONSIBILITY

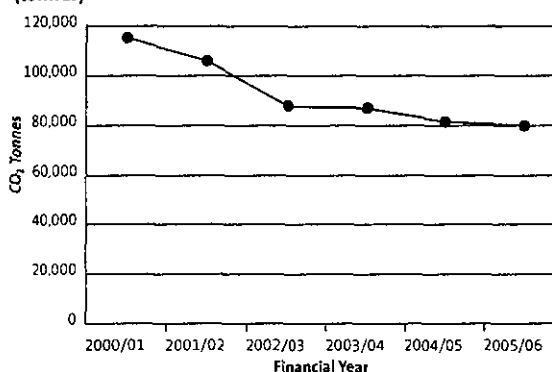
Managing the Group in a sound environmental manner is important both in saving costs and in maintaining QinetiQ's credibility as a provider of environmental solutions.

This year the Group has gained a better understanding of its environmental impact across the UK by gathering extensive data on its performance in three critical areas – energy, waste and travel. This information will now provide the baseline for measuring progress across the Group in the future.

An internal campaign during the year has emphasised the need for employees to behave responsibly in these areas. The results have been positive. In the past 12 months the UK businesses have reduced their annual CO₂ emissions by 1,500 tonnes and recycled 488.7 tonnes of waste across its three biggest sites compared with 454.5 tonnes last year.

On the conservation front, QinetiQ has continued to manage 13 sites of special scientific interest including Eelmoor Marsh in Farnborough which celebrated its 30th anniversary in 2005.

QINETIQ UK CO₂ EMISSIONS FROM ENERGY CONSUMPTION (tonnes)



LOCAL COMMUNITIES

QinetiQ recognises its responsibility to manage its impact on local communities in respect of the 54 sites on which it operates across the UK.

This year it has continued to work in partnership with local stakeholders in helping to address sensitive and important local issues. Highlights this year include:

- working alongside the National Trust for Scotland to help secure St Kilda's dual World Heritage Status
- the establishment of the QinetiQ Boscombe Down Fund through the Community Foundation for Wiltshire & Swindon, designed to improve the lives of disadvantaged people through education and science
- providing funding for the St Richard's Hospice in Malvern.

EDUCATION

An emphasis has been placed on supporting science and technology in education including through:

- the piloting of QinetiQ's use of 'Lab in a Lorry' in Boscombe Down to increase awareness of science and technology in local schools
- support for two schools – St Augustine's in Malvern and Cove in Farnborough – in attaining specialist science status
- strengthening the Group's links with academia with the launch of QinetiQ's University Partnership programme
- sponsorship of the Schools Aerospace Challenge, the Stockholm Prize at the BA Crest Science Fair, the Cheltenham Science Festival, Generation Science as part of the Edinburgh Science Festival, and the Engineering Education Scheme.

CHARITIES

QinetiQ has focused its corporate giving around a number of priority charities. A particular emphasis has been placed on investigating ways to make a contribution through technology support for the Royal National Lifeboat Institute (RNLI) and Cancer Research UK.

As well as organising pan-QinetiQ fundraising initiatives such as 'Pub Quizzes', the Group has also provided over £15,000 of match-funding to any member of staff raising money for priority charities and funded a payroll giving service.

QinetiQ donated a total of £136,000 to registered charities, of which £54,000 was to UK registered charities.

TECHNOLOGY SOLUTIONS FOR SOCIAL PROBLEMS

QinetiQ continues to develop technology solutions to significant social problems facing communities, from finding better ways to treat cancer patients through to providing greater security against terrorist threats.

This year attention has been focused on the application of QinetiQ technology to disaster relief and humanitarian affairs. For example, the Group has conducted a study to identify the equipment capabilities required to enable the Royal Navy to undertake Humanitarian Disaster Relief Operations.

EMPLOYEES

QinetiQ continues to invest in its most powerful asset – its people. Achievements in the UK this year include:

- £6.3m invested in training, equating to 48,886 working days (5.5 working days per employee)
- 56 employees becoming chartered members of professions
- 121 students recruited through QinetiQ's award-winning graduate recruitment programme and 255 registered to its Core Graduate Development Programme
- 73 students given work experience through the 'Year in Industry' scheme alongside support for Women in Science & Engineering – examples of the Group's commitment to promote education and careers in science, engineering and technology.
- the introduction of QinetiQ Currency including flexible benefits and share schemes for employees.

PURCHASING

This year QinetiQ has developed a CR Purchasing policy that includes the following commitments:

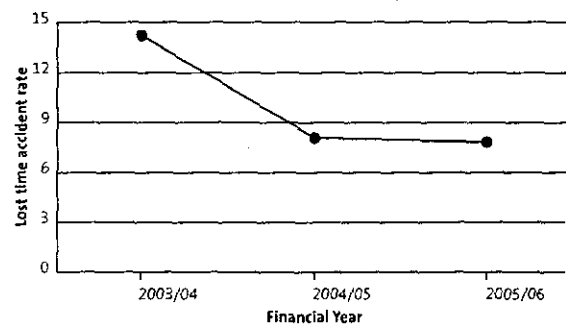
- adoption and promotion of the Ethical Code of the Chartered Institute of Purchasing and Supply
- elimination of waste in the supply chain to deliver both economy and a responsible and sustainable approach to consumption of resources
- partnerships with key suppliers in identifying and managing mutual responsibilities and achieving continuous improvement across the supply chain.

HEALTH AND SAFETY

QinetiQ recognises that it has a duty of care to employees and those affected by its activities. This is particularly important since many of its operations are inherently hazardous and could cause significant damage to people and property.

The Group's health and safety policies and practices are designed to mitigate the risks associated with all of its activities to a level that is as low as reasonably practicable. QinetiQ continues to demonstrate improved performance in this area and has achieved a 5.84% improvement on its Lost Time Accident rate compared to last year in the UK.

UK ACCIDENTS AT WORK (per 1,000 employees)



A Hazardous Trials Board, led by an independent chairman, continues to give an additional level of rigour in the application of health and safety practices.

QinetiQ also continues to research ways in which human performance can be enhanced to match the performance of the equipment. Any trial that involves human volunteers is conducted only with the approval of an Ethics Committee, constituted and operated according to the principles outlined in the Declaration of Helsinki (1962) and guidelines published by the Royal College of Physicians.

Further, any clinical trials require the approval of an independent Phase 1 Ethics Committee in accordance with the EU Clinical Trials Directive.


DOUG WEBB
 CHIEF FINANCIAL OFFICER
 QinetiQ Group plc
 7 June 2006

BOARD OF DIRECTORS

1 SIR JOHN CHISHOLM

CHAIRMAN (EXECUTIVE DIRECTOR)

Sir John Chisholm (59), the Chairman of QinetiQ, was Chief Executive of QinetiQ (previously DERA) from 1991, transforming it into a successful trading fund and developing its commercial business. Previously he was UK Managing Director of Sema Group plc and prior to that he was a director of Cap Group plc. In 1979 he founded and became Managing Director of CAP Scientific Ltd. After a degree at Cambridge in Mechanical Sciences, Sir John's work experience has included periods at General Motors and Scicon Ltd, part of BP. Sir John is currently a Trustee and President of the Institution of Engineering and Technology and it was recently announced that he will become Chairman of the Medical Research Council later this year. He is also a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institute of Physics.

2 GRAHAM LOVE

CHIEF EXECUTIVE OFFICER (EXECUTIVE DIRECTOR)

Graham Love (52) is the Chief Executive Officer of QinetiQ, having previously been Chief Financial Officer for four years. Prior to rejoining DERA in 2001, he was Chief Executive of Comax Secure Business Services Ltd, leading it through its privatisation in 1997 before its sale to Amey plc in 1999. Before that, Graham was Finance Director of DERA from 1992 to 1996. After a degree in English at Cambridge, his work experience included management roles with Ernst & Young, KPMG and Shandwick plc, as well as several years in international consulting. He is a Fellow of the Institute of Chartered Accountants in England and Wales.

3 DOUG WEBB

CHIEF FINANCIAL OFFICER (EXECUTIVE DIRECTOR)

Doug Webb (45) is the Chief Financial Officer of QinetiQ, having previously been Group Financial Controller. He joined QinetiQ in June 2003 from Logica CMG, where he had most recently been the Regional Finance Director for Continental Europe. During his eight years with Logica, Doug spent the period from 1995 to 2000 in the US in various management roles at its US subsidiary, including Chief Operating Officer, Chief Financial Officer and Executive Vice President, Telecoms Division. He trained as an accountant with Price Waterhouse where, as a senior audit manager, he focused on IT companies and stock

exchange listed clients. Doug graduated in Geography and Management Sciences from Fitzwilliam College, Cambridge and is a Fellow of the Institute of Chartered Accountants in England and Wales.

4 SIR DAVID LEES

DEPUTY CHAIRMAN

(SENIOR INDEPENDENT NON-EXECUTIVE DIRECTOR)

Sir David Lees (69) is currently Chairman of Tale & Lyle plc and Non-executive Joint Deputy Chairman of Brambles Industries plc and Brambles Industries Limited. He has been a member of the UK Panel on Takeovers and Mergers since June 2001. Sir David joined GKN plc in 1970 as an accountant and became Group Finance Director in 1982. He was appointed Group Managing Director in 1987, and Chairman and Chief Executive in 1988 before becoming Non-executive Chairman in 1997 until his retirement in May 2004. Other notable roles include being a member of the National Defence Industries Council between 1995 and 2004, Chairman of Courtaulds plc from 1996 to 1998, a Non-executive Director of the Bank of England between 1991 and 1999 and Chairman of the CBI Economic Affairs Committee from 1988 until 1994 as well as being a member of the CBI President's Committee from 1988 to 1996. Sir David is currently a Non-executive Director of the Royal Opera House and Chairman of the governing body of Shrewsbury School. He is also a Fellow of the Institute of Chartered Accountants in England and Wales.

5 NICK LUFF

NON-EXECUTIVE DIRECTOR

Nick Luff (39) joined the Board of QinetiQ in June 2004. Until April 2006, Nick was Chief Financial Officer of P&O Group. He trained as a chartered accountant with KPMG and is a member of the Institute of Chartered Accountants in England and Wales. He joined P&O in 1991 and held various finance roles before joining the board as Finance Director in 1999. In October 2000 he became Chief Financial Officer of P&O Princess Cruises plc on its demerger from the P&O Group and returned as a Director of P&O in May 2003. Nick has served as a Non-executive Director on the board of Royal P&O Nedlloyd NV, the Dutch-listed international container shipping company, and he is a trustee of the Merchant Navy Officers Pension Fund.

6 DR PETER FELLNER**NON-EXECUTIVE DIRECTOR**

Dr Peter Fellner (62) joined the Board of QinetiQ in September 2004. He is Executive Chairman of Vernalis plc, and also Chairman of the privately held biotechnology company, Astex Therapeutics Limited. In addition, he serves as a Director of two European biotechnology companies, UCB SA and Evotec AG and is also a Director of Bepak plc, Acambis plc and Isis Innovation Limited. He is also a member of the Medical Research Council. Peter previously served as Chairman of Celltech Group plc from 2003 to July 2004, having been Chief Executive Officer from 1990 onwards. Before joining Celltech, he was Chief Executive of Roche UK from 1986 to 1990, having previously been a Director of Roche UK Research Centre.

7 NOREEN DOYLE**NON-EXECUTIVE DIRECTOR**

Noreen Doyle (57) was appointed to the Board of QinetiQ in October 2005 and serves as an independent Non-executive Director. She also sits on the Risk Committee of Credit Suisse Group (Zurich) and is a Non-executive Director of Newmont Mining Corporation (Denver) and Rexam PLC. In August 2005, Noreen completed her four-year term as First Vice President of the European Bank for Reconstruction and Development (EBRD), where she chaired the EBRD's Operations Committee and was a member of the Executive Committee. Prior to her appointment as First Vice President, Noreen was firm-wide head of Risk Management. She joined the EBRD in 1992 to establish its syndications functions. Before joining the EBRD, Noreen had a distinguished career at Bankers Trust Company (now Deutsche Bank) in corporate finance and leveraged financing with a concentration in oil, gas and mining. Noreen has a BA from the College of Mount Saint Vincent, Riverdale, New York and an MBA from Tuck School at Dartmouth College.

8 GLENN YOUNGKIN**NON-EXECUTIVE DIRECTOR**

Glenn Youngkin (39) is a Managing Director of The Carlyle Group and is head of the Global Industrial Team. Prior to joining the Carlyle Group in 1995, Glenn was a management consultant with McKinsey & Co. Prior to joining McKinsey, he was with Credit Suisse First Boston, where he structured

and executed both merger and acquisition transactions and capital market financings. Glenn is an engineering graduate of Rice University and received his MBA from Harvard Business School where he was a Baker Scholar. He currently serves on the boards of directors of Kuhlman Electric Corporation, Forgings International Holdings Limited (Firth Rixson), Dr Pepper Seven-Up Bottling Group Inc., Britax Childcare Holdings Limited and RIVR Acquisitions BV (Petroplus).

9 COLIN BALMER**NON-EXECUTIVE DIRECTOR**

Colin Balmer (59) was Managing Director of the Cabinet Office from 2003 until his retirement in early 2006. Previously, Colin was Finance Director of the MOD, with responsibility for QinetiQ's privatisation and the subsequent investment by Carlyle as part of the PPP Transaction. He has extensive experience across the MOD including periods as Private Secretary of two Ministers for Defence Procurement, a secondment to the UK Delegation to the North Atlantic Treaty Organisation (NATO) and as a Minister for Defence Materiel in Washington DC, United States. Colin was formerly a member of the Independent Financial Reporting Advisory Board and the Advisory Council of Partnerships UK and is currently a member of the Foreign and Commonwealth Office's Audit and Risk Committee.

REPORT OF THE DIRECTORS

The Directors present their report and the audited financial statements for the year to 31 March 2006.

PRINCIPAL ACTIVITY

The Group's principal activity is the supply of scientific and technical solutions and services.

BUSINESS REVIEW

The profit of the Group before tax was £72.5m (2005: £78.0m).

A description of the Group's performance during the year and the likely future developments is contained in the reports of the Chairman and Chief Executive Officer on pages 2 to 6 and in the Operating and Financial Review on pages 24 to 39.

PRINCIPAL CHANGES TO THE GROUP AND THE COMPANY

The Group made a number of acquisitions in the year which are disclosed in detail in note 14.

On 8 December 2005 the Company changed its name from QinetiQ Holdings Limited to QinetiQ Group Limited. On 11 January 2006 the Company re-registered as a public limited company in anticipation of the IPO on the LSE in February 2006.

RESEARCH AND DEVELOPMENT

One of the Group's principal business streams is the provision of funded research and development for customers. The Group also invests in the commercialisation of promising technologies across all areas of business. Further description of the Group's research and development activity is contained in the Operating and Financial Review on pages 24 to 39.

PROPOSED DIVIDEND

The Directors recommend the payment of a final dividend of 2.25p per ordinary share (2005: nil). During the year the Group paid a Preference Share dividend of £10.5m (2005: £8.9m) on the redemption of the outstanding Cumulative Preference Shares.

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 upon depreciated replacement cost. The Directors have carried out a review to ensure that these values are supported by business projections.

POLICY AND PRACTICE ON PAYMENT OF SUPPLIERS

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. At 31 March 2006 the trade creditors of the Group represented 31 days of annual purchases (2005: 33 days).

PRINCIPAL FINANCIAL INSTRUMENT RISKS AND UNCERTAINTY

The Group's principal risks in relation to the use of financial instruments arise on contracting with customers in foreign currencies and through the use of interest rate swaps and caps to manage interest rate exposure on the Group's borrowings. A more detailed description of the Group's principal risks and uncertainties and policies related to the use of

financial instruments is contained in the Operating and Financial Review on pages 24 to 39.

DIRECTORS AND DIRECTORS' INTERESTS

The Directors in office at the date of this report are detailed on pages 40 and 41. The dates of Director appointments and details of the Board committees on which they sit are given on pages 45 to 48. Details of the Directors' emoluments and interests are shown in the Report of the Remuneration Committee on pages 50 to 54.

EMPLOYEES

The Group is an equal opportunities employer, upholds the principles of the UK Employment Service's 'Two Ticks' symbol and is accredited by Investors in People. 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 using various media including in-house magazines, intranet, regular newsletters, bulletins, management briefings, trade union consultation and widespread training programmes.

ENVIRONMENT

Details of the Group's policy and practice in relation to the environment is detailed in the Corporate Responsibility report on pages 38 and 39.

POLITICAL AND CHARITABLE CONTRIBUTIONS

The Group made no political contributions during the year or in the prior year. The Group made donations to UK charities of £54,000 (2005: £57,000) in the year.

CORPORATE GOVERNANCE

The Company's application of the principles of good governance in respect of the Combined Code, as revised by the Financial Reporting Council in July 2003, is described in the Statement of Corporate Governance on pages 44 to 49.

SHARE CAPITAL

At 5 June 2006, being the latest practicable date prior to the issuance of this report, the Group had been notified of the following shareholdings of at least 3% in the ordinary share capital of the Group:

UK Ministry of Defence	19.2%
Carlyle Group	10.4%
Lansdowne	7.4%

POST BALANCE SHEET EVENT

On 15 May 2006 the Group completed the acquisition of San Diego-based Ocean Systems Engineering Corp (OSEC) through its subsidiary Apogen Technologies Inc. for a cash consideration of £30.3m (\$53m).

STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT AND THE FINANCIAL STATEMENTS

The Directors are responsible for preparing the Annual Report and the Group and parent company financial statements, in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and parent company financial statements for each financial year. Under that law the Directors are required to prepare the Group financial statements in accordance with IFRS as adopted by the EU and have elected to prepare the parent company financial statements in accordance with UK Accounting Standards.

The Group financial statements are required by law and IFRS as adopted by the EU to present fairly the financial position and performance of the Group; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

The parent company financial statements are required by law to give a true and fair view of the state of affairs of the parent company. In preparing each of the Group and parent company financial statements, the Directors are required:

- to select suitable accounting policies and then apply them consistently;
- to make judgements and estimates that are reasonable and prudent;
- to state for the group financial statements, whether they have been prepared in accordance with IFRS as adopted by the EU; and
- to state for the parent company financial statements, whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its 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.

Under applicable law and regulations, the Directors are also responsible for preparing a Directors' Report, Directors' Remuneration Report and Corporate Governance Statement that comply with that law and those regulations.

STATEMENT OF DISCLOSURE OF INFORMATION TO AUDITORS

So far as the Directors are aware, there is no relevant audit information of which the Company's auditors are unaware, and the Directors have taken all the steps they ought to have taken as Directors to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

ANNUAL GENERAL MEETING

The Company's annual general meeting will be held on 28 July 2006.

AUDITOR

In accordance with Section 385 of the Companies Act 1985, a resolution to reappoint KPMG Audit Plc as auditor of the Company is to be proposed at the forthcoming annual general meeting.

By order of the Board



LYNTON BOARDMAN
COMPANY SECRETARY
 85 Buckingham Gate
 London SW1E 6PD
 7 June 2006

STATEMENT OF CORPORATE GOVERNANCE

COMPLIANCE WITH THE COMBINED CODE

QinetiQ is committed to the highest standards of corporate governance. Since its creation in July 2001, QinetiQ has been guided by the letter and spirit of the Combined Code on Corporate Governance ('the Combined Code'), even before its Initial Public Offering (IPO) on the London Stock Exchange in February 2006. Save as stated below, QinetiQ has continued to comply with the Combined Code following its IPO and is committed to doing so in the future. Account is also taken of institutional shareholder and governance rules, together with guidance on disclosure and shareholder authorisation, in discharging QinetiQ's corporate governance responsibilities.

QinetiQ also complies with a code of securities dealings in relation to its ordinary shares which is consistent with the Model Code published in the UKLA's Listing Rules. The Model Code applies to the Company's Directors and certain employees of the QinetiQ Group.

This Corporate Governance statement, together with the report of the Remuneration Committee, explains how the Group has applied the governance principles and achieved compliance since its IPO.

COMPOSITION OF THE BOARD AND DIRECTORS' INDEPENDENCE

Sir John Chisholm is the executive Chairman of the Board of Directors and Graham Love is the Chief Executive Officer. The roles of Chairman and Chief Executive Officer are separate, with responsibilities divided between them and agreed by the Board in writing. Sir David Lees is the Deputy Chairman and the Company's Senior Independent Director.

The Board comprises an executive Chairman, six Non-executive Directors (including one Carlyle representative and one MOD representative) and two additional Executive Directors, namely the Chief Executive Officer and the Chief Financial Officer, with the objective of achieving a balance of Executive and Non-executive Directors. The Board considers its overall size and composition to be appropriate, having regard in particular to the independence of character and integrity of all the Directors and the experience and skills which they bring to their duties, which prevents any individual or small group from dominating the Board's decision-making.

Currently, half the Board (excluding the Chairman) are independent Non-executive Directors. In addition, QinetiQ intends to appoint a further independent Non-executive Director before the end of 2006. In assessing Director independence, the Board considers Sir David Lees, Nick Luff, Dr Peter Fellner and Noreen Doyle to be Non-executive Directors who are independent of QinetiQ's executive management and free from any business or other relationship that could materially interfere with the exercise of their independent judgement. The Board considers the following Non-executive Directors not to be independent: Glenn Youngkin, as he is a nominee of Carlyle, which continues to be a significant shareholder in QinetiQ; and Colin Balmer, as he is a nominee of the MOD, and the MOD is the largest shareholder on QinetiQ's register.

On his appointment as Chairman, Sir John Chisholm was not independent for Combined Code purposes as he was formerly QinetiQ's Chief Executive Officer. The Combined Code recommends that a company's Chairman be independent on appointment, and that its Chief Executive Officer should not become Chairman of the same company. The Board considers that departure from the Combined Code in this area is appropriate, and firmly believes that Sir John is the most appropriate person to lead the Board during QinetiQ's transition to a

publicly listed company. The Board considers Sir John's extensive knowledge and experience of QinetiQ's businesses, gained whilst Chief Executive Officer, to be a valuable asset available to the Board, which should enhance the Board's decision-making and understanding of strategic issues. In addition, Sir David Lees has been appointed Deputy Chairman to assist in maintaining appropriate independence within the Board.

Each member of the Board is elected to a three-year term by ordinary resolution of QinetiQ's shareholders at a general meeting, with approximately one-third, and at least one, of the Board members being elected or re-elected each year. The Shareholder Relationship Agreement entered into between the Company, MOD and Carlyle on 15 February 2006 includes a commitment from the Company that the Chairman will be put forward for re-election at the annual general meeting of the Company in 2007. The Shareholder Relationship Agreement also entitles the MOD and Carlyle to each nominate one Non-executive Director to the Board, for so long as they do not dispose of any further ordinary shares in the Company, and thereafter for so long as they each hold at least 10% of QinetiQ's issued ordinary share capital.

Details of Executive Directors' service contracts and the Non-executive Directors' letters of appointment are set out in the report of the Remuneration Committee.

In October 2005, the Chairman, Sir John Chisholm, was appointed President of the Institution of Engineering and Technology (IET), which is a 12-month term of office for which no fee is received. Sir John has agreed to commit two days per month to carrying out the role of President of the IET. It was also recently announced that Sir John will become Chairman of the Medical Research Council later in 2006.

OPERATION OF THE BOARD

The Board is responsible for managing the Group and in this capacity determines the Group's strategic and investment policies and monitors the performance of the Group's senior management team. The Board operates through a comprehensive set of processes, which define the schedule of matters to be considered by the Board and its Committees during the yearly business cycle, the level of delegated authorities (both financial and non-financial) available to the Executive Directors and other layers of management within the business, and QinetiQ's Business Ethics, Risk Management and Health, Safety and Environmental processes. The Board also has a clearly articulated set of matters which are specifically reserved to it for consideration, which include reviewing the annual budgets, raising indebtedness, granting security over Group assets, approving Group strategy and the corporate plan, approval of the annual and interim report and accounts, approval of significant investment and bid, acquisition and divestment transactions, approval of HR policies (including pension arrangements), reviewing material litigation and monitoring the overall system of internal controls, including risk management.

The Chairman is responsible for the effective working of the Board and works with the Chief Executive Officer in addressing significant strategic issues facing the Group and the formulation of strategic proposals for consideration by the Board. The Chief Executive Officer reports to the Board and is responsible for the day-to-day management of the Group and the implementation of Board policies. It is the Board's intention that the Chairman's executive responsibilities will be transferred to the

Chief Executive Officer and that this process will be completed by October 2006.

The Board meets regularly throughout the year, and in the past financial year met on 11 separate occasions. A committee of the Board met on a number of occasions during the past financial year to address issues arising out of QinetiQ's IPO process.

PERFORMANCE OF THE BOARD

During the period commencing 1 April 2005 through to completion of the IPO on 15 February 2006, the Carlyle Group exercised control over the majority of the Company's voting shares and also had the right to remove and replace any member of the QinetiQ Board, with the exception of the two Directors nominated by the MOD. As a consequence, the Company has not had in place in the last financial year a formal process for evaluating the performance of the Board, its Committees and individual Directors (with the exception of the executive Directors, who are appraised as part of the annual salary review process overseen by the Remuneration Committee). The Board is currently in the process of introducing a formal evaluation policy, both for the Board and its Committees, which will be in place in the second half of the financial year commencing 1 April 2006. As part of this process the Non-executive Directors, led by the Senior Independent Director, will conduct a performance evaluation of the Chairman, taking into account the views of the Executive Directors. It is also proposed as part of this process that the Chairman will meet at least once a year with the Non-executive Directors, without the Executive Directors present, in order to review the operation of the Board and that in addition, the Chairman will have an annual meeting with each Non-executive Director to review their contribution to the Board.

DIRECTORS' INDUCTION, TRAINING AND INFORMATION

All newly appointed Directors participate in an induction programme, which is tailored to meet their needs in relation to information on the Group. This induction programme includes an induction pack, which is refreshed to ensure it contains the most up-to-date information available on the Group. All Directors are encouraged to visit QinetiQ's principal sites and to meet a wide cross section of QinetiQ's employee base. By way of example, during the past financial year, the Board held one of its meetings in Boston, Massachusetts in order to allow members of the Board to better appreciate the business dynamics of Foster-Miller and have increased exposure to the QinetiQ North America management team.

Training is also available to the Board on key business issues or developments in policy, regulation or legislation on an 'as needed' basis. Each of the Directors has access to the services of the Company Secretary, and there is also an agreed procedure for the Directors to seek independent advice at the Company's expense.

COMMITTEES OF DIRECTORS

The Board has established four principal committees, being the Audit Committee, the Remuneration Committee, the Nominations Committee and the Compliance Committee, each of which operates within written terms of reference approved by the Board. Details of each of these Committees are summarised below.

AUDIT COMMITTEE

Each member of the Audit Committee is an independent Non-executive Director. The Committee is chaired by Nick Luff. Nick has been a member of the Institute of Chartered Accountants in England and Wales since 1991 and the Board considers him to have recent and relevant financial experience. The other members of the Committee are Dr Peter Fellner and Noreen Doyle. The Audit Committee meets as necessary and at least four times a year. During the financial year ended 31 March 2006, the Committee met on six occasions. The external auditors may also request the Audit Committee to meet. At least once a year the Committee meets with QinetiQ's external auditors and the internal audit function without Executive Directors present. Except where not permitted to attend, the Chairman, Chief Executive Officer, Chief Financial Officer, Group Financial Controller, Head of Internal Audit and a representative of the external auditors normally attend Committee meetings.

The principal functions of the Audit Committee are:

- to consider the appointment/re-appointment of the external auditor, the audit fee, and any questions of resignation or dismissal of the external auditors and to make recommendations to the Board in relation to those matters;
- to discuss and agree with the external auditor before the annual audit cycle the nature and scope of the audit and whether appropriate planning is in place for the audit;
- to review annually the cost effectiveness of the audit and assess the qualifications, skills and resources, effectiveness and independence of the external auditors;
- to assess the procedures in place to ensure the independence and objectivity of the external auditor annually and to develop and recommend to the Board appropriate policies in relation to the provision of non-audit services by the external auditors;
- to review the significant financial reporting issues and judgements, and the completeness of disclosures made, in connection with the preparation of the Group's financial statements, interim reports and formal statements, focusing particularly on:
 - any changes in accounting policies and practice;
 - areas of major judgement;
 - significant adjustments resulting from the audit;
 - the going concern assumption;
 - compliance with accounting standards; and
 - compliance with the Listing Rules and other legal requirements;
- to discuss any problems and reservations arising from the interim and final audits, and any matters the auditors may wish to discuss (in the absence of management where necessary) and at the end of the audit cycle, assess the effectiveness of the audit process;
- to review the external auditors' management letter and management's response;
- to monitor the integrity of the Group's systems of internal controls (including financial, operational compliance and risk management), assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non-financial risks and make recommendations to the Board;

STATEMENT OF CORPORATE GOVERNANCE CONTINUED

- to review the proposed statement on the Directors' review of the Group's systems of internal controls (including financial, operational compliance and risk management) prior to endorsement by the Board;
- to review, from time to time, the Group's internal audit programme, approve the appointment/ termination of appointment of the Head of Internal Audit, ensure co-ordination between the internal and external auditors and ensure that the internal audit function has adequate resources and maintains an appropriate standing within the Group;
- to review annually the appropriateness of the process for reporting and investigating allegations of malpractice pursuant to QinetiQ's whistle blowing policies;
- to consider the major findings of internal investigations and management's response;
- to review the Group's operating, financial and accounting policies and practices;
- to consider other matters as defined by the Board; and
- to review on an annual basis the Audit Committee's effectiveness and recommend to the Board any necessary changes.

In order to safeguard auditor independence, the Committee ensures that any other advisory/consulting services provided by the auditors do not conflict with their statutory audit responsibilities and are normally conducted through entirely separate working teams, with such advisory/consulting services only generally covering other regulatory reporting, tax, mergers and acquisitions work, and, in the financial year ended 31 March 2006, IPO-related activities. Any non-audit services conducted by the auditors require the consent of the Chief Financial Officer before being initiated, with any such services exceeding £50,000 in value requiring the consent of the Audit Committee. Throughout the year, the Committee reviews the cost of non-audit work undertaken by the auditors and is therefore in a position to take corrective action if it believes that there is a risk of the auditors' independence being undermined through the award of such work.

REMUNERATION COMMITTEE

Each member of the Remuneration Committee is an independent Non-executive Director. The Committee is chaired by Dr Peter Fellner. The other members of the Remuneration Committee are Sir David Lees and Noreen Doyle. The Committee meets as necessary although normally not less than three times a year. During the financial year ended 31 March 2006, the Remuneration Committee met on six occasions. Although not members of the Committee, the Chairman, the Chief Executive Officer, the Group Head of Human Resources and the Head of Performance and Reward normally attend Committee meetings. Executive Directors are not present when their own remuneration is being discussed.

The principal duties of the Remuneration Committee are:

- to make recommendations to the Board as to the framework and broad policy for remuneration provided to the Chairman and Executive Directors and its cost;

- to design and oversee all elements of Executive Directors' remuneration, including base salary, bonus, long-term incentive plans, compensation in the event of early termination and pensions;
- to procure such information as it may consider necessary to compare remuneration provided to QinetiQ's Executive Directors against the remuneration provided by comparable companies to executive directors;
- to monitor and be sensitive to pay and employment conditions elsewhere in the Group;
- to ensure that QinetiQ complies with any legal requirements governing disclosure of remuneration and pensions, including the Directors' Remuneration Report Regulations 2002 and the Combined Code;
- to review the remuneration packages and terms and conditions of employment of the Group's senior management; and
- to approve the scheme rules and launch of any QinetiQ executive share-based incentive scheme and oversee the administration and operation of any such scheme.

During the course of the year ended 31 March 2006, the Company engaged Deloitte & Touche as remuneration consultants, to assist the Remuneration Committee and the Board in framing the remuneration and benefits policies for the Executive Directors, members of the senior management team and employees throughout the Group. Deloitte & Touche have also provided consultancy services to the Company during the course of the past financial year in areas such as taxation, through entirely separate teams of advisors, none of whom have any other connection with the Company.

NOMINATIONS COMMITTEE

The Nominations Committee consists of the Chairman and two independent Non-executive Directors. A majority of the Committee are Non-executive Directors. The Nominations Committee is chaired by Sir David Lees. The other members of the Committee are Dr Peter Fellner and Sir John Chisholm. The Committee meets as necessary and when called by its chair. During the financial year ended 31 March 2006, the Committee met on two separate occasions.

The principal duties of the Nominations Committee are:

- to review the structure, size and composition (including the skills, knowledge and experience) of the Board and make recommendations to the Board with regard to any changes;
- to be responsible for identifying and nominating, for the approval of the Board, appropriate individuals to fill Board vacancies as and when they arise;
- to evaluate the balance of skills, knowledge and experience on the Board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment;
- in identifying suitable candidates, where appropriate, to review internal candidates through a process of succession planning and/or: (i) use open advertising or the services of external advisors to facilitate the search; (ii) consider candidates from a wide range of backgrounds; and (iii) consider candidates on merit and against

objective criteria, taking care that appointees have enough time available to devote to the position;

- to review annually the time required from a Non-executive Director and use performance evaluation to assess whether the Non-executive Director is giving sufficient commitment to the role;
- to give full consideration to succession planning in the course of its work, taking into account the challenges and opportunities facing the Group and the skills and expertise that are therefore needed on the Board in the future; and
- to ensure that on appointment to the Board, Non-executive Directors receive a formal letter of appointment setting out clearly what is expected of them in terms of commitment, committee service and involvement outside Board meetings.

The principal focus of the Committee's activity during the financial year ended 31 March 2006 was to select two new independent Non-executive Directors to allow the Company to meet the requirements of the Combined Code on its IPO. Given the corporate structure of QinetiQ prior to IPO, the process of making appointments in the case of the Chairman, Chief Executive Officer, Chief Financial Officer and Deputy Chairman/Senior Independent Director positions was principally the responsibility of the Board as a whole and QinetiQ's major shareholders (MOD and Carlyle), rather than the Nominations Committee. Each of the two independent Non-executive Directors appointed to the Board during the financial year ended 31 March 2006 was appointed following a rigorous review process involving a number of members of the Board, a process which was overseen by the Nominations Committee.

MOD COMPLIANCE REGIME

QinetiQ's position in the supply chain allows QinetiQ to partner with a range of 'Original Equipment Manufacturers', thereby providing a potential exploitation route for defence research. However, MOD customers involved in the procurement, testing and evaluation of defence related equipment also place importance on their ability to use QinetiQ as a source of impartial advice. To give MOD customers confidence that QinetiQ is able to perform these distinct activities, QinetiQ is required by its Articles of Association to implement a Compliance Regime, a framework which was established on its creation out of DERA to facilitate this process. Central to the Compliance Regime is the requirement for QinetiQ to request permission from the MOD prior to providing commercial defence services to others where there is potential for a conflict of interest with the services that QinetiQ provides to the MOD. Since the inception of the Compliance Regime, over 97% of all applications to the MOD to supply defence research to the commercial defence market have been approved.

The Compliance Regime includes a prohibition preventing QinetiQ from engaging in certain categories of defence manufacturing without the explicit approval of the MOD. In February 2006, the MOD agreed that this restriction will be removed with effect from 1 April 2008. QinetiQ will, however, continue to be required to seek the MOD's approval to engage in defence manufacturing where such manufacturing activity could create a conflict of interest.

In designing the Compliance Regime, the MOD and QinetiQ sought to achieve a balance between meeting the needs of the procurement

customers within the MOD (principally the DPA and the DLO) and the need to allow QinetiQ flexibility to exploit research into the supply chain and pursue its planned commercial activities, without compromising the defence or security interests of the UK. The Compliance Regime is largely self-policing, in that it is applied by QinetiQ in respect of its activities without extensive intervention or oversight by the MOD.

The Compliance Committee is chaired by Sir David Lees. The other Non-executive member of the Committee is Colin Balmer. The Chairman, Chief Executive Officer and Compliance Audit Director are also members of the Compliance Committee. The Board nominates two senior executives to act as Compliance Implementation Director and Compliance Audit Director respectively. The current Compliance Audit Director is Dr Graham Coley. The current Compliance Implementation Director is Dr Michael Goodfellow.

QinetiQ's Compliance Committee meets on four occasions each year to monitor the operation of the Regime. It receives a report from the Company's Compliance Implementation Director which describes the permissions which have been sought and granted since the last meeting of the Committee, and the status of projects where the potential conflicts of interest are being managed. The Committee also receives, from the Compliance Audit Director, a report on the effectiveness of the controls that are in place to ensure that the Regime is operated correctly. The Committee reviews the systems that support the Compliance Regime and those that may impact it, directing changes if appropriate. The Committee is the forum that would address any issues arising out of QinetiQ's failure to comply with the requirements of the Regime.

The MOD reviews the operation and effectiveness of the Compliance Regime, through its right to have an observer on the Compliance Committee.

During the year, a total of 15 new permissions were sought from the MOD under the Compliance Regime where potential conflicts of interest were identified by QinetiQ, with a further four permission requests outstanding from the previous year. Of these 19 requests nine were approved, five were not pursued, one was rejected and four were outstanding at the end of March 2006.

At the end of the year, 29 firewalls were in place with three being established and four being closed down during the year. Since vesting in 2001, a total of 87 firewalls have operated with 51 now closed.

No breaches of the MOD Compliance Regime have been noted during the year.

SENIOR INDEPENDENT DIRECTOR

The senior independent Non-executive Director is Sir David Lees. Sir David is also Deputy Chairman of the Board and serves as an additional contact point for shareholders should they feel that their concerns are not being addressed through the normal channels. Sir David is, furthermore, available to fellow Non-executive Directors, either individually or collectively, should they wish to discuss matters of concern in a forum that does not include Executive Directors or the senior management of QinetiQ.

STATEMENT OF CORPORATE GOVERNANCE CONTINUED

DIRECTORS' RESPONSIBILITIES

Statements explaining the Directors' responsibilities for preparing the Group's financial statements and the auditors' responsibilities for reporting on those statements are set out on pages 43 and 55 respectively.

GOING CONCERN

The Directors are of the opinion that the Group has adequate resources to continue to operate for the foreseeable future and have prepared the accounts on a going concern basis.

ATTENDANCE AT BOARD AND COMMITTEE MEETINGS APRIL 2005 – MARCH 2006

	BOARD	REMUNERATION COMMITTEE	AUDIT COMMITTEE	COMPLIANCE COMMITTEE	NOMINATIONS COMMITTEE
Colin Balmer ⁶	11/11	6/6	5/5	1/1	
Sir John Chisholm ⁹	11/11			1/1	2/2
Noreen Doyle ^{1,7}	3/3	1/1	1/1		
Dr Peter Fellner ⁸	11/11	4/4	2/3		2/2
Richard Gillingwater ²	7/9		4/5		
Sir Denys Henderson ³	5/6	3/3		2/2	
Hal Kruth ³	6/6				
Sir David Lees ^{4,8}	6/6	4/4		2/2	2/2
Graham Love ⁹	11/11			1/1	
Nick Luff	10/11		6/6		
Dame Pauline Neville-Jones ³	6/6	3/3		2/2	
Doug Webb ⁵	5/5				
Trevor Woolley ²	9/9			2/3	
Glenn Youngkin ⁶	11/11	5/6	4/5		2/2

1 Noreen Doyle was appointed to the Board on 26 October 2005

2 Richard Gillingwater and Trevor Woolley resigned from the Board and its Committees on 18 January 2006

3 Sir Denys Henderson, Hal Kruth and Dame Pauline Neville-Jones resigned from the Board and its Committees on 12 September 2005

4 Sir David Lees was appointed to the Board on 1 August 2005

5 Doug Webb was appointed to the Board on 12 September 2005

6 Colin Balmer ceased to be a member of the Remuneration Committee and the Audit Committee on 25 January 2006 and was appointed to the Compliance Committee on the same date; Glenn Youngkin ceased to be

a member of the Remuneration Committee, the Audit Committee and the Nominations Committee on 25 January 2006

7 Noreen Doyle became a member of the Remuneration Committee and the Audit Committee on 25 January 2006

8 Dr Peter Fellner became a member of the Remuneration Committee, the Audit Committee and the Nominations Committee on 27 September 2006; Sir David Lees became a member of the Remuneration Committee, the Compliance Committee and the Nominations Committee on 27 September 2005

9 Sir John Chisholm and Graham Love became members of the Compliance Committee on 25 January 2006

COMMUNICATION WITH SHAREHOLDERS

The Company attaches importance to the effectiveness of its communications with shareholders. Since the IPO, the Company has initiated regular dialogue with institutional shareholders and the financial community. Going forward, this will include presentations of the preliminary and interim results, regular meetings with major shareholders and industry analysts, participation in stockbrokers' seminars and opportunities for shareholder site visits. All shareholders and potential shareholders can gain access to the Annual Report and other significant information about the QinetiQ Group on the Company's website at www.QinetiQ.com.

Holders of ordinary shares may attend the Company's AGM at which the Company highlights key business developments during the year and at which the shareholders have an opportunity to ask questions. The chairmen of the Audit, Remuneration, Nominations and Compliance

Committees will be available to answer any questions on the work of the Committees. The Company confirms that it will send the AGM notice and relevant documentation to all shareholders at least 20 working days before the date of the AGM. For those shareholders who have elected to receive communications electronically, notice is given of the availability of documents on the Investor Relations section of the Groups' website. All shareholders will be entitled to vote on the resolutions put to the AGM and, to ensure that all votes are counted, a poll will be taken on all the resolutions in the Notice of Meeting. The results of the votes on the resolutions will be published on the Company's website.

Responsibility for maintaining regular communications with shareholders rests with the Executive Team, led by the Chief Executive Officer, assisted by an investor relations function which reports to the

Chief Financial Officer. The Board is informed on a regular basis of key shareholder issues, including share price performance, the composition of the shareholder register and City expectations. The Chairman, the senior independent Director and Non-executive Directors make themselves available to meet with shareholders as required.

MANAGEMENT AND CONTROL OF US SUBSIDIARIES

QinetiQ's US subsidiaries, Apogen, Foster Miller, Planning Systems and Westar are currently required by the US National Industrial Security Program to maintain facility security clearances and to be insulated from foreign ownership, control or influence. To comply with these requirements, QinetiQ North America Operations, LLP (a wholly-owned subsidiary of QinetiQ in the US) and the US DoD have entered into a proxy agreement that regulates the ownership, management and operation of these companies. Pursuant to this proxy arrangement, QinetiQ appointed three US citizens holding requisite US security clearances as proxy holders to exercise the voting rights of QinetiQ North America Operations, LLP's shares in the US subsidiaries. The proxy holders are also appointed as Directors of the relevant US subsidiaries and, in addition to their powers as Directors, have power under the proxy arrangements to exercise all prerogatives of share ownership of QinetiQ North America Operations, LLP. The proxy holders agree to perform their role in the best interests of QinetiQ North America Operations, LLP and consistent with the national security concerns of the United States. QinetiQ does not have any representation on the boards of Apogen, Foster Miller, Planning Systems or Westar and does not have the right to attend board meetings. QinetiQ may not remove the proxy holders except for acts of gross negligence or wilful misconduct or for breach of the proxy agreements (with the consent of the US Defense Security Service).

INTERNAL CONTROLS

The Board is ultimately responsible for the Group's system of internal control and for reviewing its effectiveness in safeguarding the shareholders' interests and the Company's assets. However, such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can provide only reasonable and not absolute assurance against material misstatement or loss. QinetiQ managers are responsible for the identification and evaluation of significant risks applicable to their areas of business together with the design and operation of suitable internal controls to ensure effective mitigation. These risks, which are related to achievement of business objectives, are assessed on a continual basis and may be associated with a variety of internal and external events, including control breakdowns, competition, disruption, regulatory requirements and natural and other catastrophes.

A process of hierarchical self-certification has been established within the organisation which provides a documented and auditable trail of accountability for the operation of the system of internal control. This process is informed by a rigorous and structured self-assessment that addresses all of the guidance cited in the Combined Code. The

process provides for successive assurances to be given at increasingly higher levels of management and, finally, to the Board. The process is informed by the Internal Audit function, which also provides a degree of assurance as to the operation and validity of the system of internal control. Planned corrective actions are independently monitored for their timely completion.

The managers report regularly on risks (which are recorded at corporate, sector and divisional level of profit and loss as well as within all customer-facing projects) and how these are managed to the QinetiQ Executive Team and the Board, formally, on a quarterly basis.

The QinetiQ Executive Team reviews on a monthly basis the risk management and control process and considers:

- the authority, resources and co-ordination of those involved in the identification, assessment and management of significant risks faced by the organisation;
- the response to the significant risks which have been identified by management and others;
- the monitoring of reports from Group management;
- the maintenance of a control environment directed towards the proper management of risk.

The centrally provided internal audit programme is structured to address the risks identified by the Company and is integrated across all business and functional dimensions, thereby reducing issues of overlap or gaps in coverage. These risks are identified dynamically and the Board is involved in this process as well as the QinetiQ Executive Team.

The Chief Financial Officer provides to the Board monthly information that includes key performance and risk indicators. Where areas for improvement in the system of internal control are identified, the Board considers the recommendations made by the QinetiQ Executive Team, the Audit Committee and the Compliance Committee. The Audit Committee reviews, on behalf of the Board, the key risks inherent in the business and the system of internal control necessary to manage such risks and presents its findings to the Board. Internal Audit independently reviews the risk identification and control processes implemented by management and reports to the Audit Committee.

The Audit Committee also reviews the assurance process, ensuring that an appropriate mix of techniques is used to obtain the level of assurance required by the Board. It presents its findings to the Board on a regular basis. The Board has reviewed the effectiveness of the system of internal control that has been in operation during the financial year ended 31 March 2006. In particular, it has reviewed and updated the process for the identification and evaluation of significant risks affecting the business and the processes by which these are managed. However, the Board routinely challenges the management to ensure that the systems of internal control are constantly improving to maintain their continuing effectiveness.

REPORT OF THE REMUNERATION COMMITTEE

This report sets out the current policy and disclosures in relation to Directors' remuneration. This report has been produced in accordance with the Directors' Remuneration Report Regulations 2002. The report has been prepared by the Remuneration Committee, and has been approved by the Board for submission to shareholders.

ROLE OF THE REMUNERATION COMMITTEE

The Terms of Reference of the Committee are described in the Statement of Corporate Governance on page 46.

COMMITTEE MEMBERSHIP

The Committee is composed of the following independent Non-executive Directors:

- Dr Peter Fellner (Committee Chairman);
- Sir David Lees; and
- Noreen Doyle.

The Committee met six times during the year.

ADVISORS TO THE COMMITTEE

Deloitte & Touche LLP ('Deloitte') were appointed by the Committee to advise on matters relating to executive remuneration. Towers Perrin and Monks Partnership provide market data.

Sir John Chisholm (Chairman), Graham Love (CEO), Stephen Luckhurst (Group Human Resources Director) and John Leighton-Jones (Group Head of Reward & Performance) provided guidance to the Committee, other than for their own remuneration.

DIRECTORS' REMUNERATION POLICY

The Committee recommends to the Board a remuneration framework for Executive Directors and determines the remuneration arrangements for individual Executive Directors. The Committee aims to maintain a remuneration policy, consistent with the Company's business objectives, which:

- attracts, retains and motivates individuals of high calibre;
- is responsive to both Company and personal performance;
- is based on information from independent remuneration sources and other publicly available information for companies of a comparable size (based on turnover and market capitalisation);
- is compatible with the principles for establishing remuneration for the Company as a whole (based on market median and individual performance).

The remuneration policy is built on the following philosophy:

- remuneration packages will be structured in order to support business strategy whilst conforming to current best practice;
- constituent elements of each Executive Director's remuneration package will be evaluated on the basis of total rewards;

- total rewards are achieved through the attainment of stretching performance targets based around measures which are consistent with the short, medium and long-term interests of shareholders;
- a significant element of the executive's remuneration package will be performance-related.

EXECUTIVE DIRECTORS' REMUNERATION

The components of the remuneration packages for Executive Directors are as follows. They are reviewed annually by the Committee:

BASIC SALARY

Basic salary for each Director is determined by assessment of the Director's performance, experience and responsibility, and relevant benchmarks. Salaries are reviewed annually (although not necessarily increased) in the context of all other remuneration elements. Factors taken into account are performance, personal contribution, responsibilities and market pressures. For market comparison purposes account is taken of company type, sector and measures of company size in terms of both market capitalisation and turnover.

ANNUAL BONUS

Executive Directors have annual cash bonus arrangements, which are non-pensionable. Bonuses are linked to Group and personal targets. The maximum annual bonus opportunity for the Executive Directors is 100% of salary.

The 2005/06 bonus scheme was structured around an 'on target' annual bonus of 50% of basic salary. The bonuses for all three Executive Directors were measured against the same four key performance indicators (KPIs): turnover, earnings before interest, tax and amortisation (EBITA), orders and cash generation. An entry level is defined for each KPI and no payment will be made against that KPI unless the entry level performance is achieved. The entry level is always set to represent incremental growth over the prior year performance. Performance against the KPIs is measured independently. However, if the underlying EBITA is not satisfied, the Committee has the discretion to reduce any bonus.

For performance in excess of the entry threshold, bonus elements for each KPI accrue on a straight line up to the target level at which a bonus equal to 12.5% of salary can be earned if the target is achieved for a KPI. If there is over-achievement against one or more KPIs, then the proportion of bonus increases linearly such that twice the 'on target' bonus is payable if 125% or more of the target is achieved.

Each Executive Director also has personal supporting objectives which may be used to moderate the financial element up or down. The Committee considers annually the choice of performance measures and approves bonus targets.

BENEFITS

Benefits include a pension or contribution in lieu, as appropriate, plus car allowance and health insurance, none of which are pensionable. The Company also pays an insurance premium in respect of death in service cover.

In response to the new UK pensions legislation which took effect on 6 April 2006, it was determined to permit executives whose benefits are likely to exceed the Lifetime Allowance to opt out of the QinetiQ Pension Plan. In such cases, the individual will be paid a salary supplement in lieu of pension contributions.

LONG-TERM INCENTIVES

The Company currently provides long-term incentives in the form of share options. Their objective is to align the rewards of executives with the returns to shareholders in providing a focus on increasing the share price over the medium to longer term. Under the scheme, annual share option awards with a face value up to 300% of salary can be made.

The Committee determined that the equity arrangements currently in place for Sir John Chisholm, the Chairman, and Graham Love, the CEO, did not warrant a separate grant of long-term incentives in the year ended 31 March 2006. Doug Webb was the only Executive Director to receive a grant of share options under the QinetiQ Share Option Scheme in the year ended 31 March 2006. The 2006 award is subject to two performance measures which have equal weighting: earnings per share ('EPS') and total shareholder return ('TSR') measured against the FTSE250 index. Performance is measured over three years and there is no retesting of performance.

The EPS measure was selected to ensure that the scheme includes a performance measure which is in a clear line of sight for the participants, reflecting the business strategy. For the EPS proportion of the award to start to vest, EPS growth of at least 22.5% must be achieved over the performance period. 25% of the award vests at that level of performance with full vesting for achieving 52% EPS growth. For EPS performance between these two points straight-line vesting applies.

Under the TSR element, there is no vesting for performance below the median with full vesting for achieving TSR performance which positions the Company in the upper quartile of the FTSE250. At median, 30% of the award vests with straight-line vesting between median and the upper quartile.

Due to the recent IPO of QinetiQ (February 2006), a TSR performance graph has not been included within this Report at this stage.

The Committee has commissioned its advisers, Deloitte, to conduct a review of the Structure of QinetiQ's long-term incentivisation arrangements during the coming year.

SHAREHOLDING REQUIREMENT

Executives are encouraged to maintain equity interests in the Group. Given the current levels of executive equity interests, coupled with the current lock-in arrangements which control the Executive Directors' ability to sell shares over a three-year period, the Committee does not consider it appropriate to introduce a formal shareholding requirement for the Executive Directors and other executives at this stage.

DILUTION LIMITS

In the year ended 31 March 2006, all outstanding awards under the QinetiQ Group Share Option Scheme represented 0.06% of the issued share capital.

In July 2003, all employees were granted share options under the QinetiQ Share Option Plan. Dilution limits do not include rights to shares relating to options granted prior to the IPO.

NON-EXECUTIVE DIRECTORS' TERMS, CONDITIONS AND FEES

The Chairman reviews the fees of the Non-executive Directors and makes recommendations to the Board. Directors receive additional fees as agreed by the Board for the chairmanship of Board committees. The fees take account of responsibilities of the role. The level of fees paid in UK organisations of a similar size and complexity to QinetiQ are considered in setting remuneration policy for Non-executive Directors. The fees are neither performance-related nor pensionable. Non-executive Directors are not eligible to participate in bonus, profit sharing or employee share schemes. The annual fees are listed below, and became effective on 1 February 2006:

Board membership	£35,000
Committee Chairmanship	£5,000 per committee
Additional fee for Senior Independent Non-executive Director responsibility	£5,000

REPORT OF THE REMUNERATION COMMITTEE CONTINUED

SERVICE AGREEMENTS

The Chairman's contract as an executive Director continues until 30 September 2006 after which he will become non-executive. Further detail on this is provided in the Governance section of the report.

	TERM OF APPOINTMENT	DATE OF SERVICE AGREEMENT/APPOINTMENT
Sir John Chisholm**	Agreement terminates 30 September 2006*	1 December 2005
Graham Love**	12 months rolling	1 December 2005
Doug Webb**	12 months rolling	1 October 2005

* Sir John will continue as Chairman in a non-executive capacity from 1 October 2006.

** Notice period of 12 months from the individual and the Company.

Sir David Lees, Nick Luff, Dr Peter Fellner, Noreen Doyle, Colin Balmer and Glenn Youngkin were appointed for a 36 month term commencing 16 February 2006. These appointments are terminable without notice or compensation from the Company or the individual.

The service agreements/letters of appointment were reviewed and updated in preparation for IPO and the Board received advice on current best practice from Herbert Smith LLP. Consequently, the Board believes that the current contracts are generally in line with best practice.

EXTERNAL APPOINTMENTS

QinetiQ recognises that in order to broaden their knowledge and experience, executives may be invited to become Non-executive Directors of other companies. Fees are normally retained by the individual Directors.

During the period, Sir John Chisholm was a Non-executive Director of Bepak plc (resigned September 2005).

AUDITED INFORMATION

The following information on Directors' remuneration and Directors' interests on pages 52 and 54 has been audited. Where Executive Directors were appointed or resigned during the year, but have been employees of QinetiQ for the whole year, the sums shown reflect the elements of their remuneration over the full year.

	NOTES	SALARY/FEES £	BONUS (a) £	BENEFITS (b) £	TOTAL 2006 £	TOTAL 2005 £
EXECUTIVE DIRECTORS						
Sir John Chisholm		295,000	228,445	37,570 ^(a)	561,015	662,121
Graham Love		267,500	228,445	65,167 ^(b)	561,112	452,900
Doug Webb	(c)	207,500 ^(a)	195,605	14,210 ^(m)	417,315	—
NON-EXECUTIVE DIRECTORS						
Sir David Lees	(e)	28,333	—	—	28,333	—
Nick Luff		35,833	—	—	35,833	26,346
Peter Fellner		33,593	—	—	33,593	17,500
Noreen Doyle	(f)	13,826	—	—	13,826	—
Colin Balmer	(g)	2,917	—	—	2,917	—
Glenn Youngkin	(h)	—	—	—	—	—

	NOTES	SALARY/FEES £	BONUS (a) £	BENEFITS (b) £	TOTAL 2006 £	TOTAL 2005 £
FORMER DIRECTORS						
Dame Pauline Neville-Jones	(i)	60,375	—	—	60,375 ^(a)	135,000
Sir Denys Henderson	(i)	17,500	—	—	17,500	35,000
Trevor Woolley	(j)	—	—	—	—	—
Richard Gillingwater	(j)	—	—	—	—	—
Hal Kruth	(i)	214,167	116,186	21,750 ^(m)	352,103	374,265
Jonathan Symonds	(o)	—	—	—	—	14,583
		1,176,544	768,681	138,697	2,083,922	1,717,715

(a) Includes performance bonuses relating to but not paid in the financial period

(b) Benefits apart from pensions

(c) Appointed 12 September 2005

(d) Before deductions to basic salary for SMART Pensions (salary sacrifice arrangement)

(e) Appointed 1 August 2005

(f) Appointed 26 October 2005

(g) Did not receive fees for Non-executive Director appointment until 1 March 2006

(h) Does not receive fees for Non-executive Director appointment

(i) Resigned 12 September 2005

(j) Resigned 18 January 2006

(k) Includes life insurance, health insurance and company car benefits; also an amount equal to the tax on the pension contributions of £28,383 in respect of the current year and the period 6 April 2006 – 27 August 2006

(l) Includes cash car allowance of £11,667 and £53,500 in lieu of pension contribution

(m) Includes car allowance, life insurance and health insurance benefits

(n) Dame Pauline also received consultancy fees of £74,625 relating to services provided between 13 September 2005 and 31 March 2006

(o) Resigned 30 June 2004

PENSIONS

The Group's policy is to offer all UK employees membership of the QinetiQ Pension Scheme, as described in note 42 to the financial statements. This scheme contains both defined benefit and defined contribution sections. Sir John Chisholm is a member of the defined benefit section. Hal Kruth and Doug Webb are members of the defined contribution section of the QinetiQ Pension Scheme.

DISCLOSURES IN RESPECT OF SIR JOHN CHISHOLM

DISCLOSURE IN RELATION TO DEFINED BENEFIT PENSION ARRANGEMENTS

Details of the value of individual pension entitlements and information relating to defined benefits available to Sir John Chisholm under the QinetiQ Pension Scheme, as required under Schedule 7A section 12(2) of the Companies Act 1985 are shown below:

	ADDITIONAL ACCRUED PENSION EARNED IN THE YEAR (INCLUDING INFLATION) £ P.A.	ADDITIONAL ACCRUED LUMP SUM EARNED IN THE YEAR (INCLUDING INFLATION) £	ACCRUED PENSION ENTITLEMENT AT 31 MARCH 2006 £ P.A.	ACCRUED LUMP SUM ENTITLEMENT AT 31 MARCH 2006 £	TRANSFER VALUE AT 31 MARCH 2006 £	TRANSFER VALUE AT 31 MARCH 2005 £	INCREASE IN TRANSFER VALUE LESS DIRECTOR'S CONTRIBUTIONS £
Sir John Chisholm	1,588	4,764	6,689	20,068	155,628	109,682	38,439

The additional information required under LR 9.8.8 (11) of the FSA's Listing Rules is given below:

	ADDITIONAL ACCRUED PENSION EARNED IN THE YEAR (EXCLUDING INFLATION) £ P.A.	ADDITIONAL ACCRUED LUMP SUM EARNED IN THE YEAR (EXCLUDING INFLATION) £	TRANSFER VALUE OF INCREASE IN ACCRUED BENEFITS (EXCLUDING INFLATION) AT 31 MARCH 2006 LESS DIRECTOR'S CONTRIBUTIONS £
Sir John Chisholm	1,450	4,351	26,236

Notes to pension benefits

1. The pension entitlement shown is that which would be paid annually on retirement based on service to the end of the period.
2. The transfer values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11.
3. Members of the scheme have the option to pay Additional Voluntary Contributions: neither the contributions nor the resulting benefits are included in the above table.

The value of individual pension entitlements relating to defined benefits available to Sir John Chisholm under the QinetiQ Pension Scheme, less member contributions, valued on the IAS 19 basis for the year to 31 March 2006 were £28,779.

DISCLOSURE IN RELATION TO DEFINED CONTRIBUTION PENSION ARRANGEMENTS

Details of the contributions payable to the Sir John Chisholm Retirement Benefits Scheme, as required under Schedule 7A section 12(3) of the Companies Act 1985 and LR 9.8.8 (11) of the FSA's Listing Rules are shown below:

The Company contributions payable in respect of the year to 31 March 2006 were £11,064.

REPORT OF THE REMUNERATION COMMITTEE CONTINUED

DISCLOSURES IN RESPECT OF HAL KRUTH AND DOUG WEBB

Details of the contributions payable to the Defined Contribution section of QinetiQ Pension Scheme, as required under Schedule 7A Section 12(3) of the Companies Act 1985 and 9.8.8 (11) of the FSA's Listing Rules are shown below:

HAL KRUTH

The Company contributions payable in respect of the 12 months to 31 March 2006 were £43,083.

In addition, contributions of £8,370 were paid to QinetiQ Pension Scheme in March 2006 in respect of the period from 1 April 2006 to 30 June 2006.

DOUG WEBB

The Company contributions payable in respect of the 12 months to 31 March 2006 were £18,909, these represent notional payments before SMART pension arrangements.

DIRECTORS' INTERESTS

The interests of the Directors in office at 31 March 2006 in the shares of QinetiQ Group plc at that date were as follows. There have been no changes in the interests of the Directors between 31 March 2006 and 7 June 2006 with the exception of Doug Webb who has acquired on 9 May 2006 82 shares under the QinetiQ Share Incentive Plan (QSIP). This comprised of 62 Partnership Shares and 20 Matching Shares. All shares were acquired at 199 pence.

NAME	NUMBER OF £1 ORDINARY SHARES HELD AT 1 APRIL 2004 AND 2005	SHARE RESTRUCTURING ON IPO AT 15 FEBRUARY 2006	DISPOSAL IN YEAR	ACQUIRED IN YEAR SHARE INCENTIVE PLAN – FREE SHARE ELEMENT	ACQUIRED IN YEAR	NO OF ORDINARY IP SHARES HELD AT 31 MARCH 2006
Sir John Chisholm *	130,500	12,858,548	–	250	–	12,989,298
Graham Love *	107,375	10,569,173	–	250	–	10,676,798
Doug Webb	10,000	714,900	(108,735)	250	–	616,415
Sir David Tees	–	–	–	–	17,000	17,000
Nick Luff	–	–	–	–	17,000	17,000
Peter Fellner	–	–	–	–	17,000	17,000
Noreen Doyle	–	–	–	–	17,000	17,000
Glenn Youngkin	–	–	–	–	47,067	47,067
Colin Balmer	–	–	–	–	–	–

Note

* Ordinary shares held on 1 April 2005 included 920 convertible, non-voting A shares and 80 convertible, non-voting B shares, the balance being in D ordinary shares.

Vested share options held during the year ended 31 March 2006*

NAME	25 JULY 2003 OPTIONS HELD ON 1 APRIL 2005	SHARE RESTRUCTURING ON IPO AT 15 FEBRUARY 2006	NUMBER OF SHARE OPTIONS HELD AT 31 MARCH 2006	GRANT PRICE	DATE FROM WHICH EXERCISABLE	EXPIRY DATE
Sir John Chisholm	40	1,662	1,702	2.35p	15 Feb 2006	24 July 2013
Graham Love	40	1,662	1,702	2.35p	15 Feb 2006	24 July 2013
Doug Webb	40	1,662	1,702	2.35p	15 Feb 2006	24 July 2013
Hal Kruth	40	1,662	1,702	2.35p	15 Feb 2006	24 July 2013

Note

* Options vested under the all employee share option plan.

Unvested share options held during the year ended 31 March 2006**

NAME	UN-VESTED APPROVED OPTION 22 FEBRUARY 2006	UN-VESTED UNAPPROVED OPTION 22 FEBRUARY 2006	GRANT PRICE	DATE FROM WHICH EXERCISABLE	EXPIRY DATE
Doug Webb**	14,403	230,789	£2.08	23 Feb 2009	23 Aug 2009

** Options granted under the Group Share Option Scheme.

By order of the Board

DR PETER FELLNER

CHAIRMAN OF THE REMUNERATION COMMITTEE

QinetiQ Group plc

7 June 2006

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF QINETIQ GROUP PLC

We have audited the Group and parent company financial statements (the "financial statements") of QinetiQ Group plc for the year ended 31 March 2006 which comprise the Group Income Statement, the Group and Parent Company Balance Sheets, the Group Cash Flow Statement, Group Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

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' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the EU, and for preparing the parent company financial statements and the Directors' Remuneration Report in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities on page 43.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross referenced from the Business Review section of the Directors' Report. We also report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

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

BASIS OF AUDIT OPINION

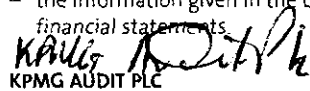
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration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

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited 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 and the part of the Directors' Remuneration Report to be audited.

OPINION

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the EU, of the state of the Group's affairs as at 31 March 2006 and of its profit for the year then ended;
- the parent company financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the parent company's affairs as at 31 March 2006;
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and, as regards the Group financial statements, Article 4 of the IAS Regulation; and
- the information given in the Directors' Report is consistent with the financial statements.


KPMG AUDIT PLC
CHARTERED ACCOUNTANTS
REGISTERED AUDITOR

London
7 June 2006

CONSOLIDATED INCOME STATEMENT

FOR THE YEAR ENDED 31 MARCH

	NOTES	2006 BEFORE NON- RECURRING ITEMS AND ACQUISITION AMORTISATION £m	2006 NON- RECURRING ITEMS AND ACQUISITION AMORTISATION £m	2006 TOTAL £m	2005 BEFORE NON- RECURRING ITEMS AND ACQUISITION AMORTISATION £m	2005 NON- RECURRING ITEMS AND ACQUISITION AMORTISATION £m	2005 TOTAL £m
GROUP TURNOVER		1,053.1	–	1,053.1	858.9	–	858.9
Less equity method accounted joint ventures and associates		(1.4)	–	(1.4)	(3.0)	–	(3.0)
TURNOVER	2, 3	1,051.7	–	1,051.7	855.9	–	855.9
Employee costs	10	(492.0)	(6.8)	(498.8)	(394.8)	(25.9)	(420.7)
Third-party project costs		(230.8)	–	(230.8)	(160.0)	–	(160.0)
Other operating costs excluding depreciation and amortisation		(217.5)	(2.1)	(219.6)	(207.8)	–	(207.8)
Share of post-tax loss of equity accounted joint ventures and associates	19	(0.4)	–	(0.4)	(2.5)	–	(2.5)
Profit on disposal of interest in equity accounted associate	19	–	–	–	17.1	–	17.1
Other income	2	13.5	–	13.5	13.5	–	13.5
EBITDA (EARNINGS BEFORE INTEREST, TAX, DEPRECIATION AND AMORTISATION)		124.5	(8.9)	115.6	121.4	(25.9)	95.5
Depreciation of property, plant and equipment	15	(32.7)	–	(32.7)	(38.9)	–	(38.9)
Amortisation of intangible assets and impairment of goodwill and current asset investments	4	(1.1)	(12.3)	(13.4)	(0.2)	(5.7)	(5.9)
GROUP OPERATING PROFIT	3	90.7	(21.2)	69.5	82.3	(31.6)	50.7
Profit on disposal of non-current assets	6	8.9	–	8.9	29.1	–	29.1
Finance income	7	8.4	4.7	13.1	8.1	–	8.1
Finance expense	7	(19.0)	–	(19.0)	(9.9)	–	(9.9)
PROFIT BEFORE TAX	4	89.0	(16.5)	72.5	109.6	(31.6)	78.0
Taxation expense	8	(16.6)	4.5	(12.1)	(4.7)	(1.0)	(5.7)
PROFIT FOR THE YEAR		72.4	(12.0)	60.4	104.9	(32.6)	72.3
PROFIT ATTRIBUTABLE TO:							
Equity shareholders of the parent company	36	70.1	(12.0)	58.1	106.5	(32.6)	73.9
Minority interest	36	2.3	–	2.3	(1.6)	–	(1.6)
		72.4	(12.0)	60.4	104.9	(32.6)	72.3
EARNINGS PER SHARE							
Basic	11			10.0p			12.0p
Diluted	11			9.8p			11.7p
Underlying	11			10.2p			8.8p

CONSOLIDATED BALANCE SHEET

AS AT 31 MARCH

	NOTES	2006 £m	2005 £m
NON-CURRENT ASSETS			
Goodwill	12	315.0	131.5
Intangible assets	13	56.4	37.3
Property, plant and equipment	15	340.3	367.9
Investment property	16	5.8	6.6
Financial assets	17	22.1	15.6
Investments	18	1.3	0.5
Investments accounted for using the equity method	19	0.6	—
Deferred tax asset	28	12.4	15.1
		753.9	574.5
CURRENT ASSETS			
Inventories	20	25.4	17.8
Financial assets	17	3.0	3.0
Trade and other receivables	21	332.6	371.6
Cash and cash equivalents	22	58.9	12.3
Investments	23	11.2	12.8
Non-current assets classified as held for sale	24	3.6	—
		434.7	417.5
TOTAL ASSETS		1,188.6	992.0
CURRENT LIABILITIES			
Trade and other payables	25	(302.7)	(309.3)
Provisions	27	(17.3)	(33.5)
Financial liabilities	29	(6.6)	(54.5)
		(326.6)	(397.3)
NON-CURRENT LIABILITIES			
Retirement benefit obligation (gross of deferred tax)	42	(168.4)	(125.0)
Deferred tax liability	28	(8.2)	(10.1)
Provisions	27	(9.2)	(10.8)
Financial liabilities	30	(310.4)	(153.0)
Other payables	26	(2.9)	(1.7)
		(499.1)	(300.6)
TOTAL LIABILITIES		(825.7)	(697.9)
NET ASSETS		362.9	294.1
CAPITAL AND RESERVES			
Ordinary Shares	35	6.5	1.6
Preference Shares	35	—	37.5
Capital redemption reserve	36	39.9	1.9
Share premium account	36	147.5	11.4
Hedging and translation reserve	36	4.9	—
Retained earnings	36	164.7	244.5
CAPITAL AND RESERVES ATTRIBUTABLE TO SHAREHOLDERS OF THE PARENT COMPANY		363.5	296.9
MINORITY INTEREST	36	(0.6)	(2.8)
	36	362.9	294.1
CAPITAL AND RESERVES ANALYSED AS:			
Equity shareholders' funds		362.9	256.6
Non-equity shareholders' funds		—	37.5
Total shareholders' funds		362.9	294.1

The financial statements were approved by the Board of Directors and authorised for issue on 7 June 2006. They were signed on its behalf by:



GRAHAM LOVE



DOUG WEBB

CHIEF FINANCIAL OFFICER

CONSOLIDATED CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 MARCH

	NOTES	2006 £m	2005 £m
PROFIT FOR THE YEAR		60.4	72.3
Taxation expense		12.1	5.7
Net finance costs		5.9	1.8
IPO costs		8.9	–
Profit on disposal of non-current assets and impairment of asset held for sale		(8.9)	(29.1)
Profit on disposal of interest in equity accounted associate		–	(17.1)
Depreciation of property, plant and equipment		32.7	38.9
Amortisation of intangible assets and impairment of goodwill and current asset investments		13.4	5.9
Share of post-tax loss of equity accounted joint ventures and associates		0.4	2.5
Increase in inventories		(9.9)	(16.7)
Decrease/(increase) in receivables		42.2	(49.6)
Decrease in payables		(31.8)	(0.6)
(Decrease)/increase in provisions		(17.8)	22.9
CASH FLOW FROM OPERATIONS		107.6	36.9
Tax paid		(4.4)	(2.8)
Interest received		3.4	3.8
Interest paid		(12.8)	(5.4)
Preference Share interest paid		(10.5)	(8.9)
NET CASH FLOW FROM OPERATING ACTIVITIES		83.3	23.6
Purchase of intangible assets		(8.5)	(2.5)
Purchase of property, plant and equipment		(45.0)	(16.0)
Sale of property, plant and equipment		111.5	50.6
Investments in associate undertaking		(1.2)	(2.5)
Purchase of subsidiary undertakings		(202.5)	(166.9)
Sale of interest in equity accounted associate		–	1.7
NET CASH FLOW FROM INVESTING ACTIVITIES		(145.7)	(135.6)
Net proceeds from IPO	45	136.2	–
Cash outflow from repayment of loans		(75.4)	(116.6)
Cash outflow from repayment of loan note		(45.9)	–
Cash inflow from loans received		198.9	151.7
Preference Share repayment		(37.5)	(75.0)
Receipt of MOD indemnity		45.3	–
Additional pension contributions		(106.4)	–
Capital element of finance lease rental payments		(2.2)	(0.7)
Capital element of finance lease rental receipts		3.0	3.0
NET CASH FLOW FROM FINANCING ACTIVITIES		116.0	(37.6)
Increase/(decrease) in cash and cash equivalents	32	53.6	(149.6)
Cash and cash equivalents at beginning of year		5.0	154.6
CASH AND CASH EQUIVALENTS AT END OF YEAR		58.6	5.0
Cash and cash equivalents	22	58.9	12.3
Overdrafts	33	(0.3)	(7.3)
CASH AND CASH EQUIVALENTS AT END OF YEAR		58.6	5.0

CONSOLIDATED STATEMENT OF RECOGNISED INCOME AND EXPENSE

FOR THE YEAR ENDED 31 MARCH

	NOTES	2006 £m	2005 £m
Net loss on hedge of net investment in foreign subsidiary	36	(2.0)	(0.4)
Increase in fair value of hedging derivatives	36	4.9	—
Movement in deferred tax on hedging derivatives	36	(1.5)	—
Loss on available for sale assets	36	(1.6)	—
Gain arising on the refinancing of joint ventures and associates	36	—	0.6
Actuarial loss recognised in the defined benefit pension schemes	36	(105.4)	(9.9)
Deferred tax asset on pension deficit	36	8.7	15.9
NET INCOME RECOGNISED DIRECTLY IN EQUITY		(96.9)	6.2
Prior period restatement on adoption of IAS 32 and 39 (see note 1)	36	1.3	—
		(95.6)	6.2
Profit for the year		60.4	72.3
TOTAL RECOGNISED INCOME AND EXPENSE FOR THE YEAR		(35.2)	78.5
Attributable to:			
Equity shareholders of the parent company		(37.5)	80.1
Minority interest		2.3	(1.6)
		(35.2)	78.5

NOTES TO THE FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES

ACCOUNTING POLICIES

The following accounting policies have been applied consistently to all periods presented in dealing with items which are considered material in relation to the Group's financial statements with the exception of certain policies subject to the transition arrangements of IFRS 1 as detailed in the following paragraph.

BASIS OF PREPARATION

The Group financial statements have been prepared and approved by the Directors in accordance with International Financial Reporting Standards as adopted by the EU ('IFRS'). The Company has elected to prepare its parent company financial statements in accordance with UK GAAP; these are presented on pages 111 to 113.

The accounts have been prepared under the historical cost convention, except that the following assets and liabilities are stated at their fair values: derivative financial instruments, available-for-sale investments and recognised assets and liabilities subject to fair value hedges and non-current assets held for sale are held at the lower of historic cost and fair value. The Group is domiciled in the United Kingdom. The Group's functional currency is sterling and unless otherwise stated the financial statements are rounded to the nearest hundred thousand. The Group's transition date to IFRS is 1 April 2004 and disclosures required by IFRS 1 relating to the transition from UK GAAP to IFRS are presented in note 46. The Group has taken the following exemptions available under IFRS 1:

- IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* has been applied from 1 April 2005 onward.
- IFRS 3 *Business Combinations* has not been applied to acquisitions completed prior to transition to IFRS; and
- IAS 21 *The Effects of Changes in Foreign Exchange Rates* has been applied prospectively from the date of transition to IFRS in respect of consolidated cumulative translation differences on foreign operations.

BASIS OF CONSOLIDATION

The consolidated financial statements comprise the financial statements of the Company and its subsidiary undertakings up to 31 March 2006. The purchase 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 income statement account from the date control is obtained to the date that control is lost (usually on acquisition and disposal respectively).

A subsidiary is an entity over which the Group has the power to govern financial and operating policies in order to obtain benefits. An associate is an undertaking in which the Group has a long-term interest and over which it exercises significant influence (usually from 20% to 50% of the equity voting rights). A joint venture is an undertaking in which the Group has a long-term interest and over which it exercises joint control. Associates and joint ventures are accounted for using the equity method from the date of acquisition up to the date of disposal. Where an associate or joint venture has net liabilities full provision is made for the Group's share of liabilities where there is a constructive or legal obligation to provide additional funding to the associate or joint venture.

REVENUE

Turnover (net of value added and other sales taxes) represents the value of work performed for customers, measured on the following basis.

- turnover from fixed price contracts is recognised in proportion to the value of the work performed and includes attributable profit. Depending on the nature of the contract, revenue is recognised as contractually agreed-upon milestones are reached, as units are delivered or as the work progresses;
- turnover on cost plus and time and materials contracts is recognised as work is performed;
- royalty revenue is recognised on the earlier of the date on which the income is earned and measurable with reasonable certainty or cash is received;
- turnover from sales of products and licensing of technology is recognised on acceptance by the customer and when the amount of revenue can be measured reliably.

THIRD-PARTY PROJECT COSTS

Third-party project costs primarily consist of subcontracted research and development costs and purchased materials incurred on behalf of customers as part of funded projects, together with direct materials costs used in product manufacture.

PROFIT RECOGNITION

Profit on the supply of professional services on cost plus or time and materials contracts is recognised as the work is performed. Profit on fixed-price contracts is recognised on a percentage of completion basis once the contract's ultimate outcome can be foreseen with reasonable certainty. 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 most likely final out-turn of each contract. Consistent contract review procedures are in place in respect of contract forecasting. Losses on completion are recognised in full as soon as they are foreseen.

SEGMENTAL INFORMATION

Segmental information is presented in two formats: the primary format reflects the Group's management structure and markets in which the Group operates, whereas the secondary format is based on geography (ie location of customers). The principal activities of the Group are managed through three sectors organised according to the distinct markets the Group operates in:

- Defence & Technology which primarily delivers technology solutions and managed services that support the armed forces of the UK;
- Security & Dual Use which primarily delivers security and technology solutions and consultancy to civil and government customers; and
- QinetiQ North America which primarily provides technology to the US Government and US prime-contractors.

Segment results represent the contribution of the different segments to the profit of the Group. Corporate expenses are allocated to the corresponding segments. Unallocated items comprise mainly profit on disposal of surplus assets, one-off restructuring costs and financing costs. Eliminations represent inter-company trading between the different segments.

Segment assets comprise property, plant and equipment, goodwill and other intangible assets, trade and other receivables, inventories and

prepayments and accrued income. Unallocated assets represent mainly corporate assets, including property, cash and cash equivalents and deferred tax asset balances. Segment liabilities comprise trade and other payables, accruals and deferred income and debt specifically used to finance activities and acquisitions. Unallocated liabilities represent mainly corporate liabilities, including retirement benefit obligations, current and deferred tax liabilities and bank and other borrowings. Segment assets and liabilities represent the situation at the end of the financial year.

RESEARCH AND DEVELOPMENT EXPENDITURE

Research and development costs incurred on behalf of a customer as part of a specific project are chargeable to the customer on whose behalf the work is undertaken. The costs and the related income are included in their relevant income statement cost category 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. Such capitalised costs are written off over the forecast period of sales resulting from the development. All other research and development costs are written off to the income statement in the period in which they are incurred. If the research phase cannot be clearly distinguished from the development phase, the respective project-related costs are treated as if they were incurred in the research phase only and expensed.

FINANCING

Financing represents the financial expense on borrowings accounted for using the effective rate method and the financial income earned on funds invested. Exchange differences on financial assets and liabilities and the results on interest hedging instruments that are recognised in the income statement are included within interest income and expense in financing.

TAXATION

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

Deferred taxation is the tax attributable to the temporary differences that appear when taxation authorities recognise and measure assets and liabilities with rules that differ from those of the consolidated accounts. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using rates enacted or substantively enacted at the balance sheet date. Any change in the tax rates are recognised in the income statement unless related to items directly recognised in equity. Deferred tax liabilities are recognised on all taxable temporary differences excluding non-deductible goodwill. Deferred tax assets are recognised on all deductible temporary differences provided that it is probable that future taxable income will be available against which the asset can be utilised. Deferred tax assets and liabilities are only offset where there is a legally enforceable right to offset and there is an intention to settle balances net.

GOODWILL

Business combinations since 1 April 2004 are accounted for under the purchase accounting method. All identifiable assets acquired and

liabilities and contingent liabilities incurred or assumed are recorded at fair value at the date control is transferred to QinetiQ, irrespective of the extent of any minority interest. The cost of a business combination is measured at the fair value of assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Any excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised is capitalised as goodwill. Goodwill is subject to annual impairment reviews (see below). If the cost of an acquisition is less than the fair value of the net assets acquired, the difference is immediately recognised in the Consolidated Income Statement.

INTANGIBLE ASSETS

Intangible assets recognised on acquisition are at fair value, which is calculated as the present value of future cash flows expected to be derived from those assets. Internally generated intangible assets are recorded at cost, including labour, attributable overhead and any third-party expenses. Purchased intangible assets are recognised at cost less amortisation.

Intangible assets are amortised over their respective useful lives on a straight line basis as follows:

Intellectual property rights	2-8 years
Development costs	Forecast period of sales resulting from development
Other	1-5 years

PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost less depreciation. Freehold land is not depreciated. Other tangible non-current assets are depreciated on a straight line basis over their useful economic lives to their estimated residual value as follows:

Freehold buildings	20-25 years
Leasehold land and buildings	Shorter of useful economic life and the period of the lease
Plant and machinery	3-10 years
Fixtures and fittings	5-10 years
Computers	3-5 years
Motor vehicles	3-5 years

Assets under construction are included in property, plant and equipment on the basis of expenditure incurred at the balance sheet date. In the case of assets constructed by the Group, the value includes the cost of own work completed, including directly attributed overheads but excluding interest.

The useful lives and depreciation methods applied to property, plant and equipment are reviewed annually and if they change significantly, depreciation charges for current and future periods are adjusted accordingly. If the carrying amount of any asset exceeds its recoverable amount an impairment loss is recognised immediately in the income statement.

INVESTMENT PROPERTY

The Group accounts for investment property using the cost model. Investment property is recorded on balance sheet at book value, that is at cost less any accumulated depreciation and any accumulated impairment losses. The fair value of investment property is reviewed annually by management or expert valuers where appropriate.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

IMPAIRMENT OF TANGIBLE, INTANGIBLE AND HELD FOR SALE ASSETS

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. In addition, goodwill is tested for impairment annually irrespective of any indication of impairment. If the carrying amount exceeds the recoverable amount, the respective asset or the assets in the cash-generating unit are written down to their recoverable amounts. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use. The value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. Impairment losses are expensed to the income statement.

INVENTORIES

Inventory and work in progress (including contract costs) are stated at the lower of cost and net realisable value. Work in progress and manufactured finished goods are valued at production cost. Production cost includes direct production costs and an appropriate proportion of production overheads. A provision is established when the net realisable value of any inventory item is lower than its cost.

AMOUNTS RECOVERABLE ON CONTRACTS AND PAYMENTS RECEIVED ON ACCOUNT

Amounts recoverable on contracts are included in trade and other receivables and represent turnover recognised in excess of amounts invoiced. Payments received on account are included in trade and other payables and represent amounts invoiced in excess of turnover recognised.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents comprise cash at bank and short-term deposits that are readily convertible into cash.

CURRENT AND NON-CURRENT LIABILITIES

Current liabilities include amounts due within the normal operating cycle of the Group. Interest-bearing current and non-current liabilities are recognised at fair value and then stated at amortised cost with any difference between the cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest rate basis.

PROVISIONS

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected cash flows at the Group's weighted average cost of capital.

FINANCIAL INSTRUMENTS

Financial assets and financial liabilities are recognised on the Group's balance sheet when the Group becomes a party to the contractual provisions of the instrument. The derecognition of a financial instrument takes place when the Group no longer controls the contractual rights that comprise the financial instrument, which is normally the case when the instrument expires or is sold, terminated or exercised.

LEASED ASSETS

Assets held under finance leases are capitalised and included in property, plant and equipment at the lower of the present value of minimum lease payments and fair value at the inception of the lease.

Assets are then depreciated over the shorter of their useful economic lives or the lease term. Obligations relating to finance leases, net of finance charges arising in future periods, are included under creditors. Rentals payable under operating leases are charged to the income statement on a straight line basis over the term of the lease.

NON-CURRENT ASSETS HELD FOR SALE

Where the carrying value of an asset will be recovered principally through a sale transaction rather than continuing use, the asset is classified as held for sale. Held for sale assets are held at the lower of net book value and net realisable value. Depreciation is not charged on assets classified as held for sale.

PREFERENCE SHARES

During the year the Group had in issue Redeemable Cumulative Preference Shares of £1 each which carried the right to a fixed cumulative preferential dividend at the rate of 9% per annum excluding any associated tax credit. The Group redeemed all the Redeemable Cumulative Preference Shares during the year. The Group has adopted the transition arrangements under IFRS 1 and applied IAS 32 *Financial Instruments: Disclosure and Presentation* to the current year by reclassifying the Preference Shares as a liability and the associated dividend as a component of finance expense. Accordingly the comparative periods continue to show the Preference Shares as part of the Group's capital and reserves, and associated dividend within dividends.

INVESTMENTS IN DEBT AND EQUITY SECURITIES

Investments held by the Group are classified as either a current asset or as a non-current asset, being available for sale and are stated at fair value, with any resultant gain or loss being recognised directly in equity, except for impairment losses. When these investments are derecognised, the cumulative gain or loss previously recognised directly in equity is recognised in the income statement.

The fair value of financial instruments is their quoted bid price at the balance sheet date where available. Unquoted equity investments are measured using discounted cash flows based upon forecast performance.

Prior to the adoption of IAS 39, current asset investments were held at the lower of cost and net realisable value with impairments recorded in the profit and loss account. Fixed asset investments were held at cost.

DERIVATIVE FINANCIAL INSTRUMENTS

The Group primarily uses derivative financial instruments to manage operational exposures to foreign exchange and interest rate risks. The Group does not use derivative financial instruments for speculative purposes. Derivative financial instruments are initially recognised at cost and thereafter held at fair value, being the market value for quoted instruments or valuation based on models and discounted cash flow calculations for unlisted instruments.

Prior to the adoption of IAS 39 on 1 April 2005, no adjustment was made in respect of the market value of derivative financial instruments unless the instruments were judged to be in excess of current or future hedging requirements.

HEDGING – FAIR VALUE

Changes in the fair value of fair value hedges of currency risk or the interest price risk are recognised in the income statement. The hedged item is held at fair value with any gain or loss recognised in the income statement.

HEDGING – CASH FLOW

Changes in the fair value of derivatives designated as a cash flow hedge that are regarded as highly effective are recognised in equity. The ineffective portion is recognised immediately in the income statement. Where a hedged item results in an asset or in a liability, gains and losses previously recognised in equity are included in the cost of the asset or of the liability. Gains and losses previously recognised in equity are removed and recognised in the income statement at the same time as the hedged transaction.

HEDGING – NET INVESTMENT

The changes in fair value of derivatives used to hedge the net investment in a foreign entity are recognised in equity until the net investment is sold or disposed. Any ineffective portion is recognised directly in the income statement.

LOAN ISSUE COSTS

Costs associated with the arrangement of bank facilities or the issue of loans are capitalised and deducted from against the associated liability presented in the balance sheet. Capitalised issue costs are released over the estimated life of the facility or instrument to which they relate using the effective interest rate method. If it becomes clear that the facility or instrument will be redeemed early, the amortisation of the issue costs will be accelerated.

ACCOUNTING POLICIES PRIOR TO THE ADOPTION OF IAS 32 AND 39

For the period up to the adoption of IAS 32 and IAS 39 on 1 April 2005 the following policies for derivative financial instruments, interest rate swaps, foreign exchange swaps and forwards and debt instruments, consistent with UK GAAP, were followed for financial instruments:

INTEREST RATE SWAPS

Interest rate swaps, caps and collars are revalued to fair value for disclosure in the notes to the accounts. They are not shown on the consolidated balance sheet. Interest payments and receipts are accrued and included in net interest payable as an adjustment of the interest expense of the designated liability. Realised gains and losses that occur from the early termination of such instruments designated as a hedge are deferred and are amortised to interest expense over the period of the hedged position, to the extent that the originally designated liability remains outstanding.

FOREIGN EXCHANGE SWAPS AND FORWARDS

Where foreign exchange swaps and forwards are used to adjust the currency profile of net borrowings which are matched to overseas net investments, realised and unrealised gains and losses are taken directly to reserves. Where foreign exchange swaps and forwards are used to hedge foreign currency trade debtors and creditors, realised gains and losses are recognised in the income statement. Where foreign exchange contracts are used to hedge a committed future transaction, gains and losses are deferred until the transaction occurs.

DEBT INSTRUMENTS

New borrowings are stated at net proceeds received after deduction of issue costs. The issue costs are charged to the income statement over the life of the instrument.

FOREIGN CURRENCIES

Transactions in foreign currencies are recorded using the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities in foreign currencies are translated at period-end rates. Any resulting exchange differences are taken to the income statement. Gains and losses on designated forward foreign exchange hedging contracts are matched against the foreign exchange movements on the underlying transaction.

Assets and liabilities of overseas subsidiaries and associated undertakings and joint ventures, including any related goodwill, are translated to sterling at the rate of exchange at the balance sheet date. The results and cash flows of overseas subsidiaries and associated undertakings and joint ventures are translated to sterling using the average rates of exchange during the period. Exchange adjustments arising from the retranslation of the opening net investment and the results for the period to the period-end rate are taken directly to equity and reported in the statement of Recognised Income and Expense.

POST-RETIREMENT BENEFITS

The Group provides both defined contribution and defined benefit pension arrangements. The liabilities of the Group arising from defined benefit obligations, and the related current service cost, are determined using the projected unit credit method. Valuations for accounting purposes are carried out half yearly for the largest plans and on a regular basis for other plans. Actuarial advice is provided by external consultants. For the funded defined benefit plans, the deficit or excess of the fair value of plan assets less the present value of the defined benefit obligation are recognised as an asset or a liability respectively, taking into account any unrecognised actuarial gains or losses and past service cost.

For defined benefit plans the actuarial cost charged to the income statement consists of current service cost, interest cost, expected return on plan assets and past service cost.

Actuarial gains and losses are recognised in full immediately through the Statement of Recognised Income and Expense.

Contributions to defined contribution plans are charged to the income statement as incurred.

SHARE-BASED PAYMENTS

The Group operates share-based payment arrangements with employees. The fair value of equity settled options for share-based payments is determined on grant and expensed straight line over the period from grant to the date of earliest unconditional exercise. The fair value of cash settled options for share-based payments is determined each period-end until exercised or they lapse. The value is expensed straight line over the period from grant to the date of earliest unconditional exercise. The fair value of both equity settled and cash settled share options is calculated by a binomial option pricing model. The charges for both equity and cash settled share-based payments are updated annually for non-market based vesting conditions.

CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

A description and consideration of the critical accounting estimates and judgements made in preparing these financial statements is set out in the Operating and Financial Review on pages 36 to 37.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

2. TURNOVER

Turnover and other income is analysed as follows:

	2006 £m	2005 £m
Sales of goods	73.2	31.4
Services	962.2	809.4
Royalties	16.3	15.1
TURNOVER	1,051.7	855.9
PROPERTY RENTAL INCOME	13.5	13.5

3. SEGMENTAL ANALYSIS

BUSINESS SEGMENTS

Year ended 31 March 2006

	DEFENCE & TECHNOLOGY £m	SECURITY & DUAL USE £m	QINETIQ NORTH AMERICA £m	ELIMINATIONS £m	CONSOLIDATED £m
TURNOVER					
External sales	669.6	133.7	248.4	–	1,051.7
Internal sales ⁽¹⁾	9.8	11.3	–	(21.1)	–
	679.4	145.0	248.4	(21.1)	1,051.7

OTHER INFORMATION

EBITDA before IPO costs and share of equity accounted joint ventures and associates and profit on disposal of equity accounted associate	79.0	18.8	27.1		124.9
Share of loss of equity accounted joint ventures and associates	–	(0.4)	–		(0.4)
EBITDA BEFORE IPO COSTS	79.0	18.4	27.1		124.5
Depreciation of property, plant and equipment – own equipment	(13.2)	(8.2)	(2.5)		(23.9)
Depreciation of property, plant and equipment – LTPA funded	(8.8)	–	–		(8.8)
Amortisation of purchased or internally developed intangible assets	(0.5)	(0.5)	(0.1)		(1.1)
GROUP OPERATING PROFIT BEFORE IPO COSTS AND AMORTISATION ⁽¹⁾	56.5	9.7	24.5		90.7
Amortisation of intangible assets arising from acquisitions	(2.0)	(0.7)	(9.6)		(12.3)
GROUP OPERATING PROFIT BEFORE IPO COSTS	54.5	9.0	14.9		78.4
IPO costs					(8.9)
GROUP OPERATING PROFIT					69.5
Profit on disposal of non-current assets					8.9
Net finance expense					(5.9)
PROFIT BEFORE TAX					72.5
Taxation expense					(12.1)
PROFIT FOR THE YEAR					60.4

⁽¹⁾ Inter segment sales are priced at fair value and treated as an arm's length transaction.

⁽²⁾ Group operating profit before IPO costs and amortisation of intangible assets arising from acquisitions and impairment of goodwill and current asset investment.

3. SEGMENTAL ANALYSIS CONTINUED

Year ended 31 March 2005

	DEFENCE & TECHNOLOGY £m	SECURITY & DUAL USE £m	QINETIQ NORTH AMERICA £m	ELIMINATIONS £m	CONSOLIDATED £m
TURNOVER					
External sales	664.9	120.9	70.1	–	855.9
Internal sales ⁽¹⁾	9.9	12.4	–	(22.3)	–
	674.8	133.3	70.1	(22.3)	855.9
OTHER INFORMATION					
EBITDA before restructuring costs and share of equity accounted joint ventures and associates and profit on disposal of equity accounted associate	78.0	19.9	8.9		106.8
Share of loss of equity accounted joint ventures and associates	–	(2.5)	–		(2.5)
Profit on disposal of interest in equity accounted associate	–	17.1	–		17.1
EBITDA BEFORE RESTRUCTURING COSTS	78.0	34.5	8.9		121.4
Depreciation of property, plant and equipment – own equipment	(13.5)	(11.3)	(0.9)		(25.7)
Depreciation of property, plant and equipment – LTPA funded	(13.2)	–	–		(13.2)
Amortisation of purchased intangible assets	–	(0.2)	–		(0.2)
GROUP OPERATING PROFIT BEFORE RESTRUCTURING COSTS AND AMORTISATION ⁽²⁾	51.3	23.0	8.0		82.3
Amortisation of intangible assets arising from acquisitions and impairment of goodwill and current asset investments	(1.8)	(1.4)	(2.5)		(5.7)
GROUP OPERATING PROFIT BEFORE RESTRUCTURING COSTS	49.5	21.6	5.5		76.6
Restructuring costs					(25.9)
GROUP OPERATING PROFIT					50.7
Profit on disposal of non-current assets					29.1
Net finance expense					(1.8)
PROFIT BEFORE TAX					78.0
Taxation expense					(5.7)
PROFIT FOR THE YEAR					72.3

⁽¹⁾ Inter segment sales are priced at fair value and treated as an arm's length transaction.⁽²⁾ Group operating profit before restructuring costs and amortisation of intangible assets arising from acquisitions and impairment of goodwill and current asset investment.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

3. SEGMENTAL ANALYSIS CONTINUED

Year ended 31 March 2006

	DEFENCE & TECHNOLOGY £m	SECURITY & DUAL USE £m	QINETIQ NORTH AMERICA £m	UNALLOCATED £m	CONSOLIDATED £m
ASSETS AND LIABILITIES					
Segment assets	463.5	157.2	449.8	118.1	1,188.6
TOTAL ASSETS	463.5	157.2	449.8	118.1	1,188.6
Segment liabilities	(143.7)	(75.6)	(53.4)	(151.6)	(424.3)
Unallocated net debt				(233.0)	(233.0)
Unallocated retirement benefit obligation				(168.4)	(168.4)
TOTAL LIABILITIES	(143.7)	(75.6)	(53.4)	(553.0)	(825.7)
NET ASSETS	319.8	81.6	396.4	(434.9)	362.9
OTHER INFORMATION					
Capital expenditure – own equipment*	8.3	17.4	4.3	–	30.0
Capital expenditure – LTPA funded*	23.5	–	–	–	23.5
Impairment losses recognised in income statement or equity	–	(0.5)	–	–	(0.5)

Year ended 31 March 2005

	DEFENCE & TECHNOLOGY £m	SECURITY & DUAL USE £m	QINETIQ NORTH AMERICA £m	UNALLOCATED £m	CONSOLIDATED £m
ASSETS AND LIABILITIES					
Segment assets	543.2	150.2	178.3	120.3	992.0
TOTAL ASSETS	543.2	150.2	178.3	120.3	992.0
Segment liabilities	(168.9)	(53.2)	(15.4)	(162.1)	(399.6)
Unallocated net debt	–	–	–	(173.3)	(173.3)
Unallocated retirement benefit obligation	–	–	–	(125.0)	(125.0)
TOTAL LIABILITIES	(168.9)	(53.2)	(15.4)	(460.4)	(697.9)
NET ASSETS	374.3	97.0	162.9	(340.1)	294.1
OTHER INFORMATION					
Capital expenditure – own equipment*	6.5	4.7	1.4	–	12.6
Capital expenditure – LTPA funded*	5.9	–	–	–	5.9
Impairment losses recognised in income statement or equity	(0.5)	–	–	(2.3)	(2.8)

* Capital expenditure is defined as cash paid for property, plant and equipment additions and purchased intangible assets.

3. SEGMENTAL ANALYSIS CONTINUED

GEOGRAPHICAL SEGMENTS

Turnover by destination	TURNOVER	
	2006 £m	2005 £m
United Kingdom	733.9	732.5
North America	268.7	86.9
Other	49.1	36.5
TOTAL	1,051.7	855.9

Assets/liabilities by location	GROSS ASSETS		GROSS LIABILITIES	
	2006 £m	2005 £m	2006 £m	2005 £m
United Kingdom	733.5	813.5	(767.9)	(682.4)
North America	449.8	178.3	(53.4)	(15.4)
Other	5.3	0.2	(4.4)	(0.1)
TOTAL	1,188.6	992.0	(825.7)	(697.9)

Capital expenditure by location	2006 £m	2005 £m
United Kingdom	49.2	17.1
North America	4.3	1.4
TOTAL	53.5	18.5

4. PROFIT BEFORE TAX

The following items have been charged/(credited) in arriving at profit before tax:

	NOTES	2006 £m	2005 £m
Audit services:			
– Statutory audit		0.6	0.5
Further assurance services			
– Fees in respect of pension schemes		0.1	0.1
– Tax advisory services		0.1	0.2
– Other		0.1	0.2
Total auditors' remuneration*		0.9	1.0
Inventories recognised as an expense		33.5	14.6
Depreciation of property, plant and equipment:			
– Owned assets		29.8	37.9
– Under finance lease		2.9	1.0
Research and development expenditure including costs under customer funded contracts		504.7	502.6
Amortisation of intangible assets and impairment of goodwill and current asset investments:			
– Goodwill impairment	12	–	0.5
– Intangible asset amortisation	13	13.4	4.4
– Negative goodwill	14	–	(1.3)
– Current asset investment impairment		–	2.3
		13.4	5.9

* The Group has additionally incurred £3.7m for reporting accountant's and due diligence services from its auditor related to the IPO for reporting accountants' and due diligence services. This amount has not been charged in arriving at profit for the period as it has been charged to the share premium account.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

5. RESTRUCTURING COSTS

	2006 £m	2005 £m
RESTRUCTURING COSTS	—	25.9

In the year to 31 March 2005 restructuring costs resulted from the restructuring of the UK business into two market-facing sectors and the consequent release of approximately 260 staff from the business. The restructuring cost resulted in a tax credit of £7.8m with nil cash flow in the year.

6. PROFIT ON DISPOSAL OF NON-CURRENT ASSETS

	2006 £m	2005 £m
PROFIT ON DISPOSAL OF NON-CURRENT ASSETS	8.9	29.1

On 30 September 2005 the Group sold the Fort Halstead freehold site for cash proceeds of £40.0m, resulting in a profit on disposal costs of £13.8m.

On 31 March 2006 the Group sold two buildings in Farnborough for £24.7m, resulting in a loss on disposal of £13.1m. A total of £6.0m of the gross proceeds is due in instalments with £1.0m due by 30 September 2006 and a further £5.0m due on 31 March 2007.

Cash proceeds of £48.1m were received in the year relating to a prior year disposal (Chertsey) giving a profit on disposal of £7.5m on consideration contingent on certain planning approvals being granted. Additionally cash proceeds and profit of £3.4m has been recognised on the satisfaction of performance criteria relating to the Aquila disposal.

Other fixed asset disposals generated net cash proceeds of £5.4m and a related loss on disposal of £2.7m.

On 21 June 2004 the Group sold the Pyestock North freehold site for £47.9m net of costs, resulting in a profit on disposal of £30.7m. The cash consideration was £54.0m and disposal costs and associated works totalled £6.1m. There was an £8.7m tax charge in respect of this disposal. Other fixed asset disposals in the financial year to 31 March 2005 generated net cash proceeds of £2.7m and a related loss on disposal of £1.6m.

7. FINANCE INCOME AND EXPENSE

	2006 £m	2005 £m
Receivable on bank deposits	3.8	3.6
Finance lease income	2.4	2.6
Release of discount on MOD indemnity	2.2	1.9
FINANCE INCOME	8.4	8.1
Amortisation of recapitalisation fee	(1.6)	(4.5)
Payable on bank loans and overdrafts	(13.3)	(4.1)
Payable on Aquila/Chertsey Loan Note	—	(1.1)
Finance lease expense	(1.0)	—
Other loan interest	—	(0.2)
Preference Share interest	(3.1)	—
Interest payable	(17.4)	(5.4)
FINANCE EXPENSE	(19.0)	(9.9)
NET FINANCE COSTS BEFORE IPO RELATED ITEMS	(10.6)	(1.8)
Release of remaining discount on MOD indemnity (see note 45)	4.7	—
NET FINANCE EXPENSE	(5.9)	(1.8)

8. TAXATION EXPENSE

	2006 £m	2005 £m
(A) ANALYSIS OF CHARGE		
UK corporation tax at 30%	—	—
Overseas corporation tax	7.4	1.0
Overseas corporation tax in respect of previous periods	—	(0.1)
TOTAL CORPORATION TAX	7.4	0.9
Overseas withholding tax	2.4	1.3
Deferred tax	7.7	3.5
Deferred tax in respect of prior years	(5.4)	—
TAXATION EXPENSE	12.1	5.7

(B) FACTORS AFFECTING THE TAX CHARGE IN YEAR

The principal factors reducing the Group's current year tax charge below the UK statutory rate are explained below:

Profit before tax	72.5	78.0
Tax on Profit before tax at 30%	21.8	23.4
Effect of:		
Expenses not deductible for tax purposes, tax relief and non-taxable items arising on consolidation	(8.4)	(19.0)
Unprovided tax losses of overseas subsidiaries	1.3	—
Overseas withholding tax	2.4	1.3
Deferred tax in respect of prior years	(5.4)	—
Effect of different rates in overseas jurisdictions	0.4	—
TAXATION EXPENSE	12.1	5.7

(C) FACTORS AFFECTING FUTURE TAX CHARGES

It is anticipated that the Group will continue to benefit from a low effective tax rate in future years. Research and development relief in the UK will continue to be a major contributory factor in reducing the future tax charge.

9. DIVIDENDS

During the year to 31 March 2006 the Group has not declared or paid equity dividends (year to 31 March 2005: £nil). On 7 June 2006 the Directors proposed a dividend of 2.25 pence per ordinary share payable on 23 August 2006.

As discussed in note 1 the accounting treatment under IAS 32 *Financial Instruments: Disclosure and Presentation* requires the Preferences Shares dividends to be classified as a finance expense. The Group has adopted this standard with effect from 1 April 2005 and accordingly only the Preference Share dividend for the current year is reflected in note 7 'Finance Income and Expense'.

Preference Share dividends accrued and paid are as follows:

	2006 £m	2005 £m
At 1 April	7.4	11.1
Preference Share dividend accrued in year	3.1	5.2
Preference Share dividend paid in year	(10.5)	(8.9)
At 31 March	—	7.4

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

10. ANALYSIS OF EMPLOYEE COSTS

The largest component of operating expenses is employee costs. The year-end and average monthly number of persons employed by the Group including Directors analysed by business segment, was:

	YEAR END		MONTHLY AVERAGE	
	2006 NUMBER	2005 NUMBER	2006 NUMBER	2005 NUMBER
Defence & Technology	6,791	6,905	6,883	6,899
Security & Dual Use	1,643	1,790	1,695	1,715
QinetiQ North America	2,640	1,374	2,083	669
Corporate	372	361	363	349
TOTAL	11,446	10,430	11,024	9,632

The aggregate payroll costs of these persons were as follows:

	2006 £m	2005 £m
Wages and salaries	408.4	315.8
Social security costs	35.2	28.3
Other pension costs	48.3	50.7
Cost of share based payments (see note 37)	0.1	—
Employee costs before IPO and restructuring costs	492.0	394.8
IPO costs (see note 45)	6.8	—
Restructuring costs (see note 5)	—	25.9
TOTAL EMPLOYEE COSTS	498.8	420.7

11. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year on an adjusted basis to reflect the share restructuring that took place at IPO. For diluted earnings per share the weighted average number of shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares arising from share options granted. Underlying earnings per share figures presented below reflect adjustments for the impact of non-recurring and other items on basic earnings per share.

YEAR ENDED 31 MARCH 2006	EARNINGS £m	WEIGHTED AVERAGE NUMBER OF SHARES MILLION	PER SHARE AMOUNT PENCE
BASIC	58.1	582.4	9.98
Effect of dilutive securities – options	—	12.4	—
DILUTED	58.1	594.8	9.77

UNDERLYING EARNINGS PER SHARE	EARNINGS £m	WEIGHTED AVERAGE NUMBER OF SHARES MILLION	PER SHARE AMOUNT PENCE
Basic	58.1	582.4	9.98
IPO related items (see note 45)	4.2		
Amortisation of intangible assets arising from acquisitions	12.3		
Profit on disposal on non-current assets	(8.9)		
Tax impact of items above	(0.7)		
Brought forward unprovided tax losses utilised in year	(5.4)		
UNDERLYING	59.6	582.4	10.23

11. EARNINGS PER SHARE CONTINUED

YEAR ENDED 31 MARCH 2005	EARNINGS £m	WEIGHTED AVERAGE NUMBER OF SHARES MILLION	PER SHARE AMOUNT PENCE
<i>Profit for the period</i>	73.9	573.0	
Net profit attributable to preference shareholders	(5.2)		
BASIC	68.7	573.0	11.99
Effect of dilutive securities – options	–	12.8	
DILUTED	68.7	585.8	11.73

UNDERLYING EARNINGS PER SHARE	EARNINGS £m	WEIGHTED AVERAGE NUMBER OF SHARES MILLION	PER SHARE AMOUNT PENCE
Basic	68.7	573.0	11.99
Restructuring costs	25.9		
Profit on disposal on non-current assets and interest in equity accounted associate	(46.2)		
Amortisation of intangible assets arising from acquisitions and impairment of goodwill and current asset investments	5.7		
Tax impact of items above	1.0		
Brought forward unprovided tax losses utilised in year	(4.7)		
UNDERLYING	50.4	573.0	8.80

12. GOODWILL

	2006 £m	2005 £m
COST		
At 1 April	132.0	0.5
Acquisitions (note 14)	163.9	135.1
Foreign exchange	19.6	(3.6)
At 31 March	315.5	132.0
IMPAIRMENT		
At 1 April	0.5	–
Impairment losses for the year	–	0.5
At 31 March	0.5	0.5
NET BOOK VALUE AT 31 MARCH	315.0	131.5

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

13. INTANGIBLE ASSETS

YEAR ENDED 31 MARCH 2006	ACQUIRED INTANGIBLE ASSETS £m	DEVELOPMENT COSTS £m	OTHER INTANGIBLE ASSETS £m	TOTAL £m
COST				
At 1 April 2005	38.7	2.3	0.7	41.7
Additions – Internally Developed	–	6.3	–	6.3
Additions – Purchased	–	–	2.2	2.2
Additions – Recognised on acquisitions (note 14)	21.0	–	–	21.0
Foreign exchange	3.3	–	–	3.3
At 31 March 2006	63.0	8.6	2.9	74.5
AMORTISATION AND IMPAIRMENT				
At 1 April 2005	4.2	–	0.2	4.4
Amortisation charge for the year	12.3	0.5	0.6	13.4
Foreign exchange	0.3	–	–	0.3
At 31 March 2006	16.8	0.5	0.8	18.1
NET BOOK VALUE AT 31 MARCH 2006	46.2	8.1	2.1	56.4

YEAR ENDED MARCH 2005	ACQUIRED INTANGIBLE ASSETS £m	DEVELOPMENT COSTS £m	OTHER INTANGIBLE ASSETS £m	TOTAL £m
COST				
At 1 April 2004	–	0.5	–	0.5
Additions – Internally developed	–	1.8	–	1.8
Additions – Purchased	–	–	0.7	0.7
Additions – Recognised on acquisitions (note 14)	39.9	–	–	39.9
Foreign exchange	(1.2)	–	–	(1.2)
At 31 March 2005	38.7	2.3	0.7	41.7
AMORTISATION AND IMPAIRMENT				
At 1 April 2004	–	–	–	–
Amortisation charge for the year	4.2	–	0.2	4.4
At 31 March 2005	4.2	–	0.2	4.4
NET BOOK VALUE AT 31 MARCH 2005	34.5	2.3	0.5	37.3
NET BOOK VALUE AT 31 March 2004	–	0.5	–	0.5

14. BUSINESS COMBINATIONS

In the financial year to 31 March 2006 the Group made three acquisitions in North America, Planning Systems Inc (Planning Systems), Apogen Technologies Inc. (Apogen) and Sim Author Inc (Sim Author), one in Continental Europe, Verhaert Design and Development NV (Verhaert), and two in the UK, Graphics Research Corporation Limited (GRC) and Broadreach Networks Limited (Broadreach). If these acquisitions had been completed at 1 April 2005 Group turnover for the year ended 31 March 2006 would have been £1,120.2m and Group profit before tax would have been £76.4m.

PRINCIPAL US ACQUISITIONS

Summary profit and loss accounts for the two principal acquisitions in the year, Planning Systems and Apogen prior to acquisition are shown below. These results are extracted from the audited financial statements for the relevant periods, which were prepared under US GAAP. The results have been converted into sterling at the exchange rates ruling at that time and have not been adjusted to IFRS.

14. BUSINESS COMBINATIONS CONTINUED

	PERIOD FROM 1 JANUARY 2005 TO 1 SEPTEMBER 2005 £m	YEAR FROM 1 JANUARY 2004 TO 31 DECEMBER 2004 £m	PERIOD 1 AUGUST 2003 TO 31 DECEMBER 2003 £m
PLANNING SYSTEMS			
INCOME STATEMENT			
Revenue	19.7	24.3	10.0
Income from operations	0.9	1.1	0.5
Profit before taxation	0.8	1.2	0.5
Taxation expense	(0.1)	—	—
Profit after tax	0.7	1.2	0.5

	PERIOD FROM 1 JANUARY 2005 TO 8 SEPTEMBER 2005 £m	YEAR FROM 1 JANUARY 2004 TO 31 DECEMBER 2004 £m	YEAR FROM 1 JANUARY 2003 TO 31 DECEMBER 2003 £m
APOGEN			
INCOME STATEMENT			
Revenue	68.7	109.0	36.3
Income from operations	7.3	9.6	1.3
Profit before taxation	5.5	7.7	0.6
Taxation expense	(2.5)	(3.2)	(0.2)
Profit after tax	3.0	4.5	0.4

On 2 September 2005 the Group acquired the whole of the share capital of Planning Systems for an initial cash consideration, before acquisition costs, of £24.3m (\$44.4m), including £1.6m (\$2.8m) for Planning Systems' cash and surplus working capital. A further £0.9m of additional consideration was payable on the achievement of certain performance criteria in the 12 months ended 31 December 2005. In addition, an estimate of £0.8m (\$1.5m) has been provided for the additional consideration of up to £1.6m (\$3.0m) which is payable dependent on the performance of the Company for the year ending 31 December 2006.

On 9 September 2005 the Group acquired the whole of the share capital of Apogen for a cash consideration, before acquisition costs, of £130.3m (\$238.5m) and assumed debt of £29.2m (\$53.5m). This included £1.7m (\$3.2m) for Apogen's cash and surplus working capital.

Set out below are the preliminary allocations of purchase consideration, assets and liabilities of the North America acquisitions made in the period and the provisional adjustments required to the book values of the assets and liabilities of the businesses acquired in order to present the net assets of these businesses at fair values and in accordance with Group accounting principles.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

14. BUSINESS COMBINATIONS CONTINUED

	NOTE	BOOK VALUE £m	APOGEN FAIR VALUE ADJUSTMENT £m	FAIR VALUE AT ACQUISITION £m	PLANNING SYSTEMS		
					BOOK VALUE £m	FAIR VALUE ADJUSTMENT £m	FAIR VALUE AT ACQUISITION £m
Intangible assets		61.6	(50.3)	11.3	1.4	4.8	6.2
Property, plant and equipment		0.9	(0.1)	0.8	0.5	–	0.5
Investments		–	–	–	1.0	(1.0)	–
Trade and other receivables		22.3	9.5	31.8	5.2	–	5.2
Trade and other payables		(15.6)	–	(15.6)	(3.7)	(2.1)	(5.8)
Cash and cash equivalents		2.8	–	2.8	3.4	–	3.4
Debt and other borrowings		(29.2)	–	(29.2)	–	–	–
Deferred taxation	28	(0.8)	(2.9)	(3.7)	–	–	–
NET ASSETS/(LIABILITIES) ACQUIRED		42.0	(43.8)	(1.8)	7.8	1.7	9.5
Goodwill				132.7			17.0
				130.9			26.5
Consideration satisfied by:							
Cash				131.5			24.3
Deferred consideration				–			1.7
Recoverable amount				(1.2)			–
TOTAL CONSIDERATION				130.3			26.0
Related costs of acquisition				0.6			0.5
				130.9			26.5

The Apogen fair value adjustment of £43.8m primarily relates to the reversal of goodwill of £61.6m recognised on previous acquisitions made by Apogen, the recognition of acquired intangible assets of £11.3m, the impairment of £0.5m of debt issue costs, the recognition of £10.0m of taxes recoverable and the recognition of a deferred tax liability of £2.9m in relation to the acquired intangible assets. From the date of acquisition to 31 March 2006 Apogen has contributed turnover of £60.2m and operating profit of £6.9m.

The Planning Systems fair value adjustment of £1.7m relates to a £1.0m adjustment to the value of an investment in a subsidiary, a £2.1m tax liability in relation to the change in tax status of the Company at the time of the acquisition and the recognition of £6.1m of acquired intangible assets less a £1.3m adjustment to pre-acquisition goodwill and intangibles. From the date of acquisition to 31 March 2006 Planning Systems has contributed turnover of £17.0m and an operating profit of £0.8m.

OTHER ACQUISITIONS

On 1 September 2005 the Group acquired 90% of the share capital of Verhaert for an initial cash consideration, before acquisition costs, of £4.1m (£5.9m), including £0.2m (£0.3m) for Verhaert's cash and surplus working capital. A further £1.6m (£2.3m) of contingent consideration is payable dependent on the performance of the company for the years ending 31 December 2005 and 2006. Net assets of £3.8m (£5.4m) were acquired which together with acquisition costs of £0.2m (£0.3m) resulted in £3.9m (£5.6m) of provisional goodwill arising on this acquisition. From the date of acquisition to 31 March 2006 Verhaert has contributed turnover of £10.3m and an operating profit of £0.6m.

On 23 September 2005 the Group acquired the business and certain assets of Broadreach through its 100% owned subsidiary QinetiQ Rail Limited, for £0.3m. There was nil goodwill arising on this acquisition.

On 1 March 2006 the Group acquired the whole of the share capital of SimAuthor for a cash consideration, before acquisition costs, of £4.6m (\$8.0m). Net assets of £0.9m (\$1.6m) were acquired which together with acquisition costs of £0.2m (\$0.3m) resulted in a provisional value of goodwill of £3.9m (\$6.8m), pending the completion of the valuation exercise to quantify the level of identifiable intangible assets.

On 2 March 06 the Group acquired 100% of the share capital of Graphic Research Corporation Ltd (GRC) for an initial cash consideration of £1.0m. In addition there is a deferred payment of £0.6m for cash and surplus working capital which was settled in May 2006. There was £0.5m of goodwill arising on this acquisition.

Set out below are the preliminary allocations of purchase consideration, assets and liabilities of the other acquisitions made in the year and the provisional adjustments required to the book values of the assets and liabilities of the businesses acquired in order to present the net assets of these businesses at fair value and in accordance with Group accounting principles.

14. BUSINESS COMBINATIONS CONTINUED

	NOTE	BOOK VALUE £m	ADJUSTMENTS £m	FAIR VALUE AT ACQUISITION £m
<i>Intangible assets</i>		0.6	2.9	3.5
Property, plant and equipment		0.6	–	0.6
Trade and other receivables		3.7	–	3.7
Trade and other payables		(4.0)	–	(4.0)
Cash and cash equivalents		1.2	–	1.2
Deferred taxation	28	–	(0.8)	(0.8)
NET ASSETS ACQUIRED		2.1	2.1	4.2
Minority interest				0.1
Goodwill				8.3
				12.6
Consideration satisfied by:				
Cash				10.0
Deferred consideration				0.6
Contingent consideration				1.6
TOTAL CONSIDERATION				12.2
Related costs of acquisition				0.4
				12.6

The fair value adjustments in the year to 31 March 2006 consist of fair value adjustments of £2.0m relating to the recognition of acquired intangible assets in relation to Verhaert, £0.6m in relation to SimAuthor, £0.3m in relation to GRC and the recognition of a deferred tax liability of £0.8m in relation to the acquired intangible assets of Verhaert.

YEAR TO 31 MARCH 2005

US acquisitions

On 8 October 2004 the Group acquired the whole of the share capital of Westar for an initial consideration, before acquisition costs, of £75.4m (\$136.5m), including £3.0m (\$5.5m) for Westar's cash and surplus working capital. In the year ended 31 March 2006, provision has been made for additional consideration of £5.1m (\$9.0m), which is payable dependent on the profits of the company for the year ending 31 December 2005, which had not previously been recognised due to uncertainty as to attainment of the underlying performance targets.

On 5 November 2004 the Group acquired the whole of the share capital of Foster-Miller Inc (Foster-Miller) for an initial consideration, before acquisition costs, of £104.0m (\$191.4m), including £10.5m (\$19.3m) for Foster-Miller's cash and surplus working capital.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

14. BUSINESS COMBINATIONS CONTINUED

Set out below are the allocations of purchase consideration, assets and liabilities of the acquisitions of Westar and Foster-Miller made in the year and the adjustments required to the book values of the assets and liabilities of the businesses acquired in order to present the net assets of these businesses at fair values and in accordance with Group accounting principles.

12 MONTHS TO 31 MARCH 2005

NOTE	WESTAR			FOSTER-MILLER		
	BOOK VALUE £m	FAIR VALUE ADJUSTMENT £m	FAIR VALUE AT ACQUISITION £m	BOOK VALUE £m	FAIR VALUE ADJUSTMENT £m	FAIR VALUE AT ACQUISITION £m
Intangible assets	7.9	(5.8)	2.1	—	32.2	32.2
Property, plant and equipment	1.0	—	1.0	3.3	—	3.3
Trade and other receivables	25.4	—	25.4	21.3	—	21.3
Trade and other payables	(19.9)	—	(19.9)	(10.5)	—	(10.5)
Cash and cash equivalents	3.5	—	3.5	8.2	—	8.2
Provisions for liabilities and charges	—	—	—	(0.2)	—	(0.2)
Deferred taxation	28	—	(0.8)	3.2	(12.9)	(9.7)
NET ASSETS ACQUIRED	17.9	(6.6)	11.3	25.3	19.3	44.6
Goodwill			65.2			60.5
			76.5			105.1
Consideration satisfied by:						
Cash			71.5			98.3
Deferred consideration			3.9			5.7
TOTAL CONSIDERATION			75.4			104.0
Related costs of acquisition			1.1			1.1
			76.5			105.1

The Westar fair value adjustment of £6.6m relates to the reversal of goodwill of £7.9m recognised on a previous acquisition made by Westar, the recognition of acquired intangible assets of £2.1m and the recognition of a deferred tax liability of £0.8m in relation to the acquired intangible assets. From the date of acquisition to 31 March 2005 Westar contributed turnover of £43.5m and operating profit of £5.8m.

The Foster-Miller fair value adjustment of £19.3m relates to the recognition of acquired intangible assets of £32.2m and the recognition of a deferred tax liability of £12.9m in relation to the acquired intangible assets. From the date of acquisition to 31 March 2005 Foster-Miller contributed turnover of £25.8m and operating profit of £3.4m.

OTHER ACQUISITIONS

On 5 August 2004 the Group acquired HVR Group Limited for a consideration, before acquisition costs, of £13.6m. The provisional fair value of net assets at this date was £4.4m, resulting in goodwill on acquisition of £9.4m, after £0.2m of acquisition costs. Included in the acquisition cost is £3.9m of deferred consideration settled through the issue of loan notes which are redeemable from six months after issue until 31 July 2009. The deferred consideration was recognised in the second half of the year to 31 March 2005 once the underlying performance criteria had been satisfied.

On 1 September 2004 the Group took control of Aurix Limited, with the transfer of shares to QinetiQ from its joint venture partner for nil consideration. This resulted in QinetiQ owning 80.1% of the share capital. Negative goodwill of £1.3m, which was recognised immediately in the income statement, and a minority interest of £0.3m were recorded on completion.

On 20 September 2004 the Group purchased the remaining 55% that it did not previously own of ASAP Calibration Limited, making this a wholly-owned subsidiary. The consideration of £1.0m was identical to the fair value of net assets acquired.

14. BUSINESS COMBINATIONS CONTINUED

Set out below are the preliminary allocations of purchase consideration, assets and liabilities of the other acquisitions made in the year ended 31 March 2005 and the provisional adjustments required to the book values of the assets and liabilities of the businesses acquired in order to present the net assets of these businesses at fair value and in accordance with Group accounting principles.

12 MONTHS TO 31 MARCH 2005

	NOTE	BOOK VALUE £m	ADJUSTMENTS £m	FAIR VALUE AT ACQUISITION £m
Intangible assets		1.6	4.0	5.6
Property, plant and equipment		0.8	—	0.8
Trade and other receivables		3.0	—	3.0
Trade and other payables		(3.9)	—	(3.9)
Cash and cash equivalents		3.4	—	3.4
Loans		(0.5)	—	(0.5)
Defined benefit pension scheme net liabilities	42	—	(0.4)	(0.4)
Deferred taxation	28	—	(1.6)	(1.6)
NET ASSETS ACQUIRED		4.4	2.0	6.4
Minority interest				0.3
Negative goodwill recognised in income statement				(1.3)
Goodwill				9.4
				14.8
Consideration satisfied by:				
Cash				9.8
Loan Notes				0.9
Deferred consideration				3.9
TOTAL CONSIDERATION				14.6
Related costs of acquisition				0.2
				14.8

The fair value adjustments in the year ended 31 March 2005 relate to the elimination of QinetiQ developed intellectual property rights of £1.6m held by Aurix Ltd, the recognition of acquired intangible assets of £5.6m and an associated deferred tax liability of £1.6m. Additionally an accounting policy adjustment was made to recognise Aurix Ltd's pension liability of £0.4m in accordance with Group accounting policy.

UPDATE TO PRELIMINARY FAIR VALUES OF ACQUISITIONS MADE IN THE YEAR ENDED 31 MARCH 2005

In relation to the acquisitions of Westar and Foster-Miller in 2004 the following adjustments have been made to the preliminary fair values of consideration due to the satisfaction of the performance criteria in the 12 months ended 31 December 2005 and the provision of deferred consideration for the payments due on the performance for the 12 months ended 31 December 2006. An adjustment has been made to the preliminary fair value of net assets acquired on acquisition of Foster-Miller for a tax liability:

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

14. BUSINESS COMBINATIONS CONTINUED

	WESTAR			FOSTER-MILLER		
	FAIR VALUE AS PREVIOUSLY STATED £m	FAIR VALUE ADJUSTMENT £m	FAIR VALUE AS RESTATEd £m	FAIR VALUE AS PREVIOUSLY STATED £m	FAIR VALUE ADJUSTMENT £m	FAIR VALUE AS RESTATEd £m
Net assets acquired	11.3	—	11.3	44.6	(0.9)	43.7
Goodwill	65.2	5.1	70.3	60.5	0.8	61.3
	76.5	5.1	81.6	105.1	(0.1)	105.0
Consideration satisfied by:						
Cash	71.5	3.9	75.4	98.3	5.6	103.9
Deferred consideration	3.9	(3.9)	—	5.7	(5.7)	—
Deferred consideration recognised in the year to 31 March 2006	—	5.1	5.1	—	—	—
TOTAL CONSIDERATION	75.4	5.1	80.5	104.0	(0.1)	103.9
Related costs of acquisition	1.1	—	1.1	1.1	—	1.1
	76.5	5.1	81.6	105.1	(0.1)	105.0

During the year there was a £3.9m payment of deferred consideration in relation to the acquisition of HVR that had been provided at 31 March 2005.

15. PROPERTY, PLANT AND EQUIPMENT

YEAR ENDED 31 MARCH 2006

	LAND AND BUILDINGS £m	PLANT, MACHINERY AND VEHICLES £m	COMPUTERS AND OFFICE EQUIPMENT £m	ASSETS UNDER CONSTRUCTION £m	TOTAL £m
COST					
At 1 April 2005	341.0	67.2	19.6	10.3	438.1
Additions	2.4	3.2	4.6	34.8	45.0
Acquisitions	—	0.4	1.5	—	1.9
Disposals	(40.2)	(2.3)	—	(0.2)	(42.7)
Transfers **	—	18.7	0.5	(19.2)	—
Transfer to disposal group*	(3.9)	—	—	—	(3.9)
Foreign exchange	0.1	0.1	0.2	—	0.4
AT 31 MARCH 2006	299.4	87.3	26.4	25.7	438.8
DEPRECIATION					
At 1 April 2005	24.9	39.1	6.2	—	70.2
Charge for the year	12.6	13.2	6.9	—	32.7
Disposals	(3.7)	(0.5)	—	—	(4.2)
Transfer to disposal group*	(0.3)	—	—	—	(0.3)
Foreign exchange	—	0.1	—	—	0.1
AT 31 MARCH 2006	33.5	51.9	13.1	—	98.5
NET BOOK VALUE AT 31 MARCH 2006	265.9	35.4	13.3	25.7	340.3

15. PROPERTY, PLANT AND EQUIPMENT CONTINUED

YEAR ENDED 31 MARCH 2005	LAND AND BUILDINGS £m	PLANT, MACHINERY AND VEHICLES £m	COMPUTERS AND OFFICE EQUIPMENT £m	ASSETS UNDER CONSTRUCTION £m	TOTAL £m
At 1 April 2004	355.4	67.5	12.5	9.3	444.7
Additions	0.7	1.5	8.7	10.9	21.8
Acquisitions	1.3	1.4	2.2	0.2	5.1
Disposals	(17.7)	(8.8)	(6.1)	(0.9)	(33.5)
Transfers**	1.3	5.6	2.3	(9.2)	—
AT 31 MARCH 2005	341.0	67.2	19.6	10.3	438.1
DEPRECIATION					
At 1 April 2004	12.8	22.5	6.3	—	41.6
Charge for the year	12.1	20.8	6.0	—	38.9
Disposals	—	(4.2)	(6.1)	—	(10.3)
AT 31 MARCH 2005	24.9	39.1	6.2	—	70.2
NET BOOK VALUE AT 31 MARCH 2005	316.1	28.1	13.4	10.3	367.9
NET BOOK VALUE AT 31 MARCH 2004	342.6	45.0	6.2	9.3	403.1

* At 31 March 2006 certain property has been presented as held for sale and transferred to a disposal group (see note 24).

** Other transfers of property, plant and equipment relate to assets constructed by the Group. These are initially recorded within assets under construction and, on commencement of use, transferred to the relevant asset category.

Assets held under finance leases, capitalised and included in computers and equipment, have:

- a cost of £5.2m (31 March 2005: £5.2m);
- aggregate depreciation of £2.9m (31 March 2005: £1.0m); and
- a net book value of £2.3m (31 March 2005: £4.2m).

Under the terms of the Business Transfer Agreement with the MOD, certain restrictions have been placed on freehold land and buildings, and certain plant and machinery related to them. These restrictions are detailed in note 39 'Transactions with the MOD'.

16. INVESTMENT PROPERTY

	2006 £m	2005 £m
COST AND NET BOOK VALUE		
Brought forward	6.6	6.6
Disposals	(0.8)	—
CARRIED FORWARD	5.8	6.6

The Group considers the fair value of investment property to be greater than or equal to net book value.

	2006 £m	2005 £m
THE FOLLOWING AMOUNTS HAVE BEEN CREDITED/(CHARGED) IN ARRIVING AT GROUP OPERATING PROFIT:		
Rental income from investment property	0.7	0.5
Direct operating expenses arising on investment property generating rental income	(0.2)	(0.3)

All investment property generated income in the year.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

17. FINANCIAL ASSETS

	2006 £m	2005 £m
Net investment in finance lease	15.0	15.6
Derivative financial instruments	7.1	–
TOTAL NON-CURRENT FINANCIAL ASSET	22.1	15.6
Total current financial assets – net investment in finance lease	3.0	3.0
TOTAL FINANCIAL ASSETS	25.1	18.6

18. NON-CURRENT ASSET INVESTMENTS

	2006 £m	2005 £m
AVAILABLE FOR SALE INVESTMENTS	1.3	0.5

On 30 June 2005 the Group acquired a 1.7% interest in Last Mile Communications Limited for £0.2m. The investment is held at £0.2m at 31 March 2006.

On 14 December 2005 the Group sold certain intellectual property to Metalysis Limited and received settlement for the sale in the form of a 10.0% interest in the ordinary share capital of the Company. The investment is held at fair value of £0.8m.

On 23 March 2006 the Group sold certain intellectual property to Stingray Geophysical and received a 19.9% interest in Stingray Geophysical. The investment is held at £0.3m which represents the value of the Group's holding based upon investments in Stingray Geophysical by third parties. The Group's interest in Stingray Geophysical may increase upon satisfaction of certain performance criteria to the extent that the Group will receive 30% of the proceeds of a sale or disposal.

At 31 March 2006 and 31 March 2005 the Group held a 10.8% interest in Sciemus Limited which was acquired on 14 September 2004. The net book value of the investment was written down to nil in the year ended 31 March 2006 due to the uncertainty of future cashflows.

19. EQUITY ACCOUNTED INVESTMENTS

YEAR ENDED 31 MARCH 2006

	ASSOCIATES' FINANCIAL RESULTS £m	GROUP GROSS SHARE OF ASSOCIATES £m	RESTRUCTURING OF GROUP'S FUNDING OF ASSOCIATES £m	GROUP NET SHARE OF ASSOCIATES £m
TURNOVER	4.2	1.4	–	1.4
LOSS AFTER TAX	(4.1)	(1.5)	1.1	(0.4)
Non-current assets	1.2	0.3	–	0.3
Current assets	1.8	0.7	(0.2)	0.5
	3.0	1.0	(0.2)	0.8
Current liabilities	(2.7)	(1.2)	1.0	(0.2)
Non-current liabilities	(0.7)	(0.3)	0.3	–
	(3.4)	(1.5)	1.3	(0.2)
NET ASSETS	(0.4)	(0.5)	1.1	0.6

19. EQUITY ACCOUNTED INVESTMENTS CONTINUED

YEAR ENDED 31 MARCH 2005

	ASSOCIATES' FINANCIAL RESULTS £m	GROUP SHARE OF ASSOCIATES £m	GROUP SHARE OF JOINT VENTURES £m	GROUP SHARE TOTAL £m
TURNOVER	5.8	2.1	0.9	3.0
Cost of sales			(0.2)	
Operating expenses			(1.1)	
Finance costs			(0.1)	
Loss before tax			(0.5)	
Tax			0.1	
LOSS AFTER TAX	(5.8)	(2.1)	(0.4)	(2.5)
Non-current assets	0.2	0.1	—	0.1
Current assets	3.0	1.4	—	1.4
	3.2	1.5	—	1.5
Current liabilities	(3.2)	(1.5)	—	(1.5)
	(3.2)	(1.5)	—	(1.5)
NET ASSETS	—	—	—	—

Details of the Group's associates are set out in note 47.

On 4 August 2004 the Group sold its 42.7% interest in pSiMedica Limited to pSivida Limited for £16.7m. The consideration was settled by £1.7m in cash and £15.0m by way of the issue of new pSivida Limited shares, representing 16.3% of its issued share capital. The Group recorded a profit on disposal of £17.1m. The shares are held as current asset investments (see note 23).

The unrecognised share of losses of associates at 31 March 2006 was £1.1m (31 March 2005: nil) representing associate losses the Group has no obligation to fund following the restructuring of the funding arrangements for QS4 Limited (see note 36).

During the year ended 31 March 2006 sales of £1.2m (year ended 31 March 2005: £1.5m) were made to associates and joint ventures and at 31 March 2006 associates and joint ventures had an outstanding debtor balance of £1.0m (31 March 2005: £2.7m).

20. INVENTORIES

	2006 £m	2005 £m
Raw materials	3.6	1.1
Work in progress	5.6	5.5
Finished goods	16.2	11.2
	25.4	17.8

21. TRADE AND OTHER RECEIVABLES

	2006 £m	2005 £m
Trade debtors	194.8	219.1
Amounts recoverable under contracts	94.7	89.6
Current tax	3.6	4.0
Other debtors	17.8	48.1
Prepayments	21.7	10.8
	332.6	371.6

Included within amounts recoverable under contracts is £7.8m (31 March 2005: £23.5m) due after one year.

Trade debtors include a provision for doubtful debts of £4.2m (31 March 2005: £3.2m).

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

22. CASH AND CASH EQUIVALENTS

	2006 £m	2005 £m
CASH	58.9	12.3

At 31 March 2006 £10.6m (31 March 2005: £8.8m) of cash is held by the Group's captive insurance subsidiary. The amount is included above but can only be used for insurance purposes or utilised by the Group with prior approval by the subsidiary board and relevant insurance regulator.

23. CURRENT ASSET INVESTMENTS

	2006 £m	2005 £m
LISTED INVESTMENTS	11.2	12.8

At 31 March 2006 the Group held 35.7 million shares in pSivida Limited (31 March 2005: 35.7 million) a company listed on the Australian Stock Exchange. The investment is held at fair value using the closing share price at 31 March 2006 of A\$0.75 per share (31 March 2005: A\$0.88).

During the year a loss of £1.6m has been recognised directly in reserves.

24. NON-CURRENT ASSETS IDENTIFIED AS HELD FOR SALE

	2006 £m	2005 £m
ASSETS HELD FOR SALE	3.6	—

At 31 March 2006 certain property has been presented as held for sale.

25. TRADE AND OTHER PAYABLES – CURRENT

	2006 £m	2005 £m
Payments received on account	64.3	103.1
Trade creditors	37.3	20.1
Current tax	2.6	—
Other tax and social security	42.2	40.0
Other creditors	22.9	25.5
Accruals and deferred income	133.4	120.6
	302.7	309.3

26. OTHER PAYABLES – NON-CURRENT

	2006 £m	2005 £m
OTHER CREDITORS	2.9	1.7

27. PROVISIONS FOR LIABILITIES AND CHARGES

YEAR ENDED 31 MARCH 2006	REORGANISATION £m	OTHER £m	TOTAL £m
At 1 April 2005	28.2	16.1	44.3
Utilised in year	(26.3)	(0.6)	(26.9)
Released in year	(1.9)	(3.8)	(5.7)
Created in year	9.4	5.4	14.8
AT 31 MARCH 2006	9.4	17.1	26.5
Current liability	9.4	7.9	17.3
Non-current liability	–	9.2	9.2
AT 31 MARCH 2006	9.4	17.1	26.5

YEAR ENDED 31 MARCH 2005	REORGANISATION £m	OTHER £m	TOTAL £m
At 1 April 2004	3.6	17.6	21.2
Acquired in year	–	0.2	0.2
Utilised in year	(5.7)	(3.1)	(8.8)
Released in year	(0.6)	(3.2)	(3.8)
Created in year	30.9	4.6	35.5
AT 31 MARCH 2005	28.2	16.1	44.3
Current liability	28.2	5.3	33.5
Non-current liability	–	10.8	10.8
AT 31 MARCH 2005	28.2	16.1	44.3

Reorganisation provisions relate to current year and prior year restructuring of the Group. Other provisions comprise legal, environmental, statutory property and other liabilities.

28. DEFERRED TAX

Deferred tax assets and liabilities are only offset where there is a legally enforceable right to offset and there is an intention to settle the balances net.

Movements on the deferred tax assets and liabilities are shown below:

YEAR ENDED 31 MARCH 2006	PENSION LIABILITY £m	OTHER £m	TOTAL £m
DEFERRED TAX ASSET			
At 1 April 2005	48.8	6.1	54.9
Created	1.6	–	1.6
Released	–	(7.7)	(7.7)
Transferred to deferred tax liabilities	–	1.6	1.6
GROSS DEFERRED TAX ASSET AT 31 MARCH 2006	50.4	–	50.4
Less asset available for offset			(38.0)
NET DEFERRED TAX ASSET AT 31 MARCH 2006			12.4

The net deferred tax asset created in the year relating to the pension liability includes £8.7m created in equity.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

28. DEFERRED TAX CONTINUED

DEFERRED TAX LIABILITY	ACCELERATED TAX DEPRECIATION AND AMORTISATION £m	OTHER £m	HEDGING £m	TOTAL £m
At 1 April 2005	(49.9)	—	—	(49.9)
Acquisitions	(4.5)	—	—	(4.5)
Created	—	—	(1.5)	(1.5)
Released	12.5	—	—	12.5
Transferred from deferred tax assets	—	(1.6)	—	(1.6)
Foreign exchange	(0.7)	—	—	(0.7)
Created on adoption of IAS 32 & 39	—	—	(0.5)	(0.5)
GROSS DEFERRED TAX LIABILITY AT 31 MARCH 2006	(42.6)	(1.6)	(2.0)	(46.2)
Less asset available for offset				38.0
NET DEFERRED TAX LIABILITY AT 31 MARCH 2006				(8.2)

Deferred tax movements on hedging have been recognised in equity.

YEAR ENDED 31 MARCH 2005

DEFERRED TAX ASSET	PENSION LIABILITY £m	OTHER £m	TOTAL £m
At 1 April 2004	30.2	4.3	34.5
Acquisitions	—	1.7	1.7
Created	21.3	0.1	21.4
Credit in respect of tax on additional payment to pension scheme	(2.7)	—	(2.7)
GROSS DEFERRED TAX ASSET AT 31 MARCH 2005	48.8	6.1	54.9
Less asset available for offset			(39.8)
NET DEFERRED TAX ASSET AT 31 MARCH 2005			15.1

£18.6m of the deferred tax asset recognised in the year relating to the pension liability was created in equity. The £2.7m credit in respect of tax on additional payment to pension scheme was recognised in equity.

DEFERRED TAX LIABILITY	ACCELERATED TAX DEPRECIATION AND AMORTISATION £m	TOTAL £m
At 1 April 2004	(29.8)	(29.8)
Acquisitions	(13.8)	(13.8)
Created	(7.9)	(7.9)
Released	1.6	1.6
GROSS DEFERRED TAX LIABILITY AT 31 MARCH 2005	(49.9)	(49.9)
Less asset available for offset		39.8
NET DEFERRED TAX LIABILITY AT 31 MARCH 2005		(10.1)

At the balance sheet date, the Group had unused tax losses of £40.2m potentially available for offset against future profits. No deferred tax asset has been recognised in respect of this amount. These losses can be carried forward indefinitely.

29. FINANCIAL LIABILITIES – CURRENT

	2006 £m	2005 £m
Aquila/Chertsey loan note	—	45.9
Other loan notes	1.5	—
Deferred financing costs	(0.1)	(0.3)
Finance lease creditor	4.9	1.6
Other bank borrowings	0.3	7.3
	6.6	54.5

Further analysis of the terms and maturity dates for financial liabilities are set out in note 31.

30. FINANCIAL LIABILITIES – NON-CURRENT

	2006 £m	2005 £m
Bank loan	291.4	150.8
Deferred financing costs	(0.5)	(1.2)
	290.9	149.6
Loan notes	3.8	0.9
Derivative financial instruments	0.5	—
Finance lease creditor	15.2	2.5
	310.4	153.0

Further analysis of the terms and maturity dates for financial liabilities are set out in note 31.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

31. FINANCIAL INSTRUMENTS

TREASURY POLICIES

The QinetiQ Group Treasury Department operates within a framework of policies and procedures approved by the Audit Committee, which include strict controls on the use of financial instruments in managing the Group's risk. The Audit Committee receives regular reports on the activities of the Treasury Department. The Group does not undertake any speculative trading activity in financial instruments. The Treasury Department is responsible for treasury strategy, funding requirements, cash management, banking relationships, the management of financial risk including interest rate, currency exposures and covenant compliance, and other treasury issues throughout the Group. All treasury interfaces with banks and third parties are governed by dealing mandates, facility letters and other agreements.

The disclosures below exclude short-term debtors and creditors and deferred tax, except for the analysis of net currency exposure.

(A) FAIR VALUES OF FINANCIAL INSTRUMENTS

All financial assets and liabilities, with the exception of derivative financial instruments at 31 March 2005, have a fair value identical to book value at 31 March 2006 and 31 March 2005.

Following adoption of IAS32 and IAS39 in the year ended 31 March 2006, the Group has recognised derivative financial instruments at their fair values in the financial statements. Prior to adoption of IAS32 and IAS39, derivative financial instruments were not recognised until expiry or sale.

	BOOK VALUE		FAIR VALUE	
	2006 £m	2005 £m	2006 £m	2005 £m
DERIVATIVE FINANCIAL INSTRUMENTS				
Interest rate swaps and similar instruments	7.1	—	7.1	1.9
Forward currency contracts	(0.5)	—	(0.5)	(0.1)

Market values, where available, have been used to determine fair values. Where market values are not available, fair values have been calculated by discounting cashflows at prevailing interest rates, except for unlisted fixed asset investments which are given a fair value equal to book value.

(B) INTEREST RATE RISK

31 MARCH 2006

FINANCIAL ASSETS

	FIXED OR CAPPED £m	FLOATING £m	NON-INTEREST BEARING £m	TOTAL £m
Sterling	18.0	53.1	—	71.1
US Dollar	—	5.8	7.1	12.9
Other	—	—	10.9	10.9
	18.0	58.9	18.0	94.9

Floating rate financial assets attract interest based on the relevant national LIBID equivalent.

FINANCIAL LIABILITIES

	FIXED OR CAPPED £m	FLOATING £m	NON-INTEREST BEARING £m	TOTAL £m
Sterling	(23.9)	(0.9)	(0.5)	(25.3)
US Dollar	(253.7)	(33.1)	—	(286.8)
Other	—	(4.9)	—	(4.9)
	(277.6)	(38.9)	(0.5)	(317.0)

Floating rate financial assets attract interest based on the relevant national LIBOR equivalent.

	FINANCIAL ASSETS £m	FINANCIAL LIABILITIES £m	NET £m
Of which:			
Cash and cash equivalents	58.9	—	58.9
Bank borrowings, loans and loan notes	—	(296.4)	(296.4)
Finance leases	18.0	(20.1)	(2.1)
Investments	10.9	—	10.9
Derivative financial instruments	7.1	(0.5)	6.6
	94.9	(317.0)	(222.1)

31. FINANCIAL INSTRUMENTS CONTINUED**31 MARCH 2005****FINANCIAL ASSETS**

	FIXED OR CAPPED £m	FLOATING £m	NON-INTEREST BEARING £m	TOTAL £m
Sterling	18.6	10.7	0.5	29.8
US Dollar	—	0.9	—	0.9
Other	—	0.7	12.8	13.5
	18.6	12.3	13.3	44.2

Floating rate financial assets attract interest based on the relevant national LIBID equivalent.

FINANCIAL LIABILITIES

	FIXED OR CAPPED £m	FLOATING £m	NON-INTEREST BEARING £m	TOTAL £m
Sterling	(4.1)	(6.7)	(45.9)	(56.7)
US Dollar	(121.7)	(29.1)	—	(150.8)
	(125.8)	(35.8)	(45.9)	(207.5)

Floating rate financial assets attract interest based on the relevant national LIBOR equivalent.

	FINANCIAL ASSETS £m	FINANCIAL LIABILITIES £m	NET £m
Of which:			
Cash and cash equivalents	12.3	—	12.3
Bank borrowings, loans and loan notes	—	(203.4)	(203.4)
Finance leases	18.6	(4.1)	14.5
Investments	13.3	—	13.3
	44.2	(207.5)	(163.3)

For the fixed or capped rate financial assets and liabilities, the average interest rates and the average period for which the rates are fixed are:

	FIXED OR CAPPED £m 2006	WEIGHTED AVERAGE INTEREST RATE % 2006	WEIGHTED AVERAGE YEARS TO MATURITY 2006	FIXED OR CAPPED £m 2005	WEIGHTED AVERAGE INTEREST RATE % 2005	WEIGHTED AVERAGE YEARS TO MATURITY 2005
Financial assets:						
Sterling	18.0	13.4	9.0	18.6	13.4	10.0
Financial liabilities:						
Sterling	(23.9)	11.0	7.6	(4.1)	6.7	2.3
US Dollar	(253.7)	4.3	3.2	(121.7)	4.4	3.7
	(277.6)	5.0	3.6	(125.8)	4.5	3.6

Sterling assets and liabilities consist primarily of finance leases with the weighted average interest rate reflecting the internal rate of return of those leases.

INTEREST RATE RISK MANAGEMENT

A significant portion of the Group's debt is floating rate debt and, therefore, is exposed to movements in interest rates. At 31 March 2006, the Group held swaps to convert 89% (31 March 2005: 86%) of the bank debt to fixed or capped rates.

(C) CURRENCY RISK

The table below shows the Group's currency exposures, being exposures on currency transactions that give rise to net currency gains and losses recognised in the income statement. Such exposures comprise the monetary assets and liabilities of the Group that are not denominated in the functional currency of the operating company involved, other than certain non-sterling borrowings treated as hedges of net investments in overseas entities.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

31. FINANCIAL INSTRUMENTS CONTINUED

Functional currency of the operating company:

	NET FOREIGN CURRENCY US DOLLAR £m	MONETARY ASSETS EURO £m	OTHER £m	TOTAL £m
31 March 2006 – Sterling	1.2	0.4	0.3	1.9
31 March 2005 – Sterling	2.0	3.9	0.4	6.3

The amounts shown in the table take into account the effect of the forward contracts entered into to manage these currency exposures.

FOREIGN EXCHANGE RISK MANAGEMENT

During the year ended 31 March 2006 the majority of the Group's income and expenditure was settled in the functional currency of the relevant Group entity, principally sterling or US Dollar. The most significant foreign currencies to which the Group is exposed are the US Dollar and Euro. The Audit Committee has approved policies dealing with transaction exposures (typically being trading cash flows which impact the income statement) and translation exposure (the investment in, and underlying assets and liabilities of, overseas subsidiaries). The Group's policy is to hedge all material transaction exposure at the point of commitment to the underlying transaction. The Group does not typically hedge uncommitted future transactions, although transaction risks are fully considered and appropriately mitigated when bidding for new work. The Group does not hedge income statement translation exposure.

(D) MATURITY OF FINANCIAL LIABILITIES

	BANK BORROWINGS AND LOAN NOTES £m	FINANCE LEASES AND DERIVATIVE FINANCIAL INSTRUMENTS £m	TOTAL £m
AT 31 MARCH 2006			
Due in one year or less	1.7	4.9	6.6
Due in more than one year but not more than two years	–	2.7	2.7
Due in more than two years but not more than five years	294.7	6.6	301.3
Due in more than five years	–	6.4	6.4
	296.4	20.6	317.0

	BANK BORROWINGS AND LOAN NOTES £m	FINANCE LEASES £m	TOTAL £m
AT 31 MARCH 2005			
Due in one year or less	52.9	1.6	54.5
Due in more than one year but not more than two years	–	2.2	2.2
Due in more than two years but not more than five years	150.5	0.3	150.8
	203.4	4.1	207.5

(E) BORROWING FACILITIES

At 31 March 2006, the following committed facilities were available to the Group:

	INTEREST RATE %	TOTAL £m	DRAWN £m	UNDRAWN £m
Multicurrency revolving facility	LIBOR plus 0.375%	500.0	291.4	208.6
HVR loan notes	Base minus 1.0%	1.5	1.5	–
Damega Corporation loan note	7.5%	3.8	3.8	–
US Dollar revolving facilities	LIBOR plus 1.5 to plus 2.05%	18.9	–	18.9
COMMITTED FACILITIES 31 MARCH 2006		524.2	296.7	227.5
Committed facilities 31 March 2005		356.3	197.6	158.7

Loans drawn under the £500m multi-currency revolving facility are repayable within twelve months, but have been classified as due in more than two years as the relevant committed facilities are available until 19 August 2010, with the banks' option at the Group's request to extend for a further two years. The loans bear interest at a variable margin over LIBOR of between 0.35% and 0.725% dependent on the ratio of EBITDA to Net Debt and the level of utilisation.

31. FINANCIAL INSTRUMENTS CONTINUED

The HVR loan notes were issued in connection with the acquisition of HVR Consulting Ltd. They are repayable on request of the holders, but no later than 31 July 2009 and they bear interest at a discount to Lloyds TSB Base Rate.

The Damega Corporation loan note relates to funding from the minority shareholder of Quintel Technology Limited. The loan notes are repayable on request by Damega Corporation, but no later than 17 May 2007.

CREDIT RISK MANAGEMENT

Credit risk arises because a counterparty may fail to perform its obligations. The Group is exposed to credit risks on financial instruments such as liquid assets, derivative assets and trade receivables. Credit risk is managed by investing liquid assets and acquiring derivatives with high credit quality financial institutions in accordance with the Group's Treasury Management Guidelines. The Group is not exposed to concentrations of credit risk on its liquid assets as these are spread over several financial institutions. Trade receivables are subject to credit limits, control and approval procedures across the Group. The nature of the Group's operations leads to concentrations of credit risk on its trade receivables. The majority of the Group's credit risk is with the UK and US Governments.

32. RECONCILIATION OF NET CASH FLOW TO MOVEMENT IN NET DEBT

NOTE	YEAR ENDED 31 MARCH 2006		YEAR ENDED 31 MARCH 2005	
	£m	£m	£m	£m
Increase/(decrease) in cash in the year		53.6		(149.6)
New loans		(191.3)		(150.8)
New loan notes		(7.6)		(0.9)
Bank loan repayments		72.2		116.6
Loan note repayments		45.9		-
Repayment of other borrowings		3.2		-
Preference Share and associated interest repayment		48.0		-
		(29.6)		(35.1)
Capital element of finance lease payments		2.2		0.7
Capital element of finance lease receipts		(3.0)		(3.0)
CHANGE IN NET DEBT RESULTING FROM CASH FLOWS		23.2		(187.0)
Addition of deferred financing costs		0.7		1.7
Amortisation of deferred financing costs		(1.6)		(4.5)
Foreign exchange movements		(21.5)		-
Preference Share redemption and associated interest		(48.0)		-
Finance lease receivables		2.4		2.6
Finance lease payables		(18.2)		(4.8)
Adoption of IAS32 and IAS39		1.8		-
Movement on derivatives		4.8		-
Net debt at the start of the year		(176.6)		15.4
NET DEBT AT THE END OF THE YEAR	33	(233.0)		(176.6)

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

33. ANALYSIS OF NET DEBT

	YEAR ENDED 31 MARCH 2005 £m	CASH FLOW £m	NON CASH MOVEMENTS £m	YEAR ENDED 31 MARCH 2006 £m
DUE WITHIN ONE YEAR				
Bank and cash	12.3	46.6	–	58.9
Bank overdraft	(7.3)	7.0	–	(0.3)
Recapitalisation fee	0.3	–	(0.2)	0.1
Aquila/Chertsey Loan Note	(45.9)	45.9	–	–
Other loan notes	–	(0.6)	(0.9)	(1.5)
Finance lease creditor	(1.6)	–	(3.3)	(4.9)
Finance lease debtor	3.0	–	–	3.0
Preference Shares	–	48.0	(48.0)	–
	(39.2)	146.9	(52.4)	55.3
DUE AFTER ONE YEAR				
Bank loan	(150.8)	(119.1)	(21.5)	(291.4)
Recapitalisation fee	1.2	–	(0.7)	0.5
Finance lease creditor	(2.5)	2.2	(14.9)	(15.2)
Finance lease debtor	15.6	(3.0)	2.4	15.0
Loan notes	(0.9)	(3.8)	0.9	(3.8)
Derivative financial assets	–	–	7.1	7.1
Derivative financial liabilities	–	–	(0.5)	(0.5)
	(137.4)	(123.7)	(27.2)	(288.3)
TOTAL NET DEBT	(176.6)	23.2	(79.6)	(233.0)

Non cash movements principally consist of movements arising on transition to IFRS and foreign exchange.

34. FINANCE LEASES

GROUP AS A LESSOR

The minimum lease receivables under finance leases fall as follows:

	MINIMUM LEASE PAYMENTS		PRESENT VALUE OF MINIMUM LEASE PAYMENTS	
	2006 £m	2005 £m	2006 £m	2005 £m
Amounts payable under finance leases				
Within one year	3.0	3.0	3.0	3.0
In the second to fifth years inclusive	12.0	12.0	8.9	8.9
Greater than five years	13.5	18.0	6.1	6.7
	28.5	33.0		
Less unearned finance income	(10.5)	(14.4)		
Present value of minimum lease payments	18.0	18.6	18.0	18.6

Classified as follows:

Financial asset – current	3.0	3.0
Financial asset – non-current	15.0	15.6
	18.0	18.6

The Group leases out certain buildings under finance leases over a twelve-year term expiring in 2015.

34. FINANCE LEASES CONTINUED**GROUP AS A LESSEE**

The minimum lease payments under finance leases fall due as follows:

	MINIMUM LEASE PAYMENTS		PRESENT VALUE OF MINIMUM LEASE PAYMENTS	
	2006 £m	2005 £m	2006 £m	2005 £m
Amounts payable under finance leases				
Within one year	4.9	1.6	4.9	1.6
In the second to fifth years inclusive	11.6	2.6	8.8	2.5
Greater than five years	12.8	–	6.4	–
	29.3	4.2		
Less future finance charges	(9.2)	(0.1)		
Present value of minimum lease payments	20.1	4.1	20.1	4.1
Classified as follows:				
Financial liability – current			4.9	1.6
Financial liability – non-current			15.2	2.5
			20.1	4.1

The Group utilises certain buildings and computer equipment under finance leases. Average lease terms are typically between two and ten years (31 March 2005: two years).

35. SHARE CAPITAL

Authorised share capital at 31 March 2006:

	£	NUMBER
AUTHORISED SHARE CAPITAL:		
Attributable to equity interests:		
Ordinary Shares of 1p each	14,000,000	1,400,000,000
Attributable to non-equity interests:		
Special Share of £1	1	1
TOTAL AUTHORISED SHARE CAPITAL	14,000,001	1,400,000,001

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

35. SHARE CAPITAL CONTINUED

Authorised share capital at 31 March 2005:

AUTHORISED SHARE CAPITAL:	£	NUMBER
Attributable to equity interests:		
Convertible A Ordinary Shares of 1p each	115,534	11,553,367
Convertible B Ordinary Shares of 1p each	9,667	966,733
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	37,527	3,752,686
	1,631,217	17,741,275
Attributable to non-equity interests:		
Redeemable Cumulative Preference Shares of £1 each	112,500,000	112,500,000
First Deferred Shares of 1p each	115,534	11,553,367
Second Deferred Shares of £1 each	450,489	450,489
Special Share of £1	1	1
	113,066,024	124,503,857
TOTAL AUTHORISED SHARE CAPITAL	114,697,241	142,245,132

35. SHARE CAPITAL CONTINUED

SHARES ALLOTTED, CALLED UP AND FULLY PAID:

	1 APRIL 2005 £	SHARE RESTRUCTURING ON IPO £	ISSUED/ (REDEEMED) IN YEAR £	31 MARCH 2006 £	NUMBER
Attributable to equity interests:					
Ordinary Shares of 1p each*	—	5,729,918	775,732	6,505,650	650,565,024
Convertible A Ordinary Shares of 1p each	77,010	(77,010)	—	—	—
Convertible B Ordinary Shares of 1p each	5,833	(5,833)	—	—	—
Convertible C Ordinary Shares of £1 each	450,135	(450,135)	—	—	—
D Ordinary Shares of £1 each	537,250	(537,250)	—	—	—
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	37,527	(37,527)	—	—	—
	1,570,755	4,159,163	775,732	6,505,650	650,565,024
Attributable to non-equity interests:					
Redeemable Cumulative Preference Shares of £1 each	37,500,000	—	(37,500,000)	—	—
Special Share of £1	1	—	—	1	1
	37,500,001	—	(37,500,000)	1	1
TOTAL CALLED UP SHARE CAPITAL	39,070,756	4,159,163	(36,724,268)	6,505,651	650,565,025

* On 15 February 2006, the Group allotted 75,000,000 Ordinary Shares of 1p each (aggregate nominal value £750,000) as part of the Group's IPO. On IPO the market value of the Group's Ordinary Shares was £2.00. On 15 February 2006 the Group allotted 2,573,224 Ordinary Shares of 1p each (aggregate nominal value of £25,732). 2,169,250 Ordinary Shares were allotted to Hill Samuel ESOP Trustees Limited and 403,974 Ordinary Shares were allotted to Hill Samuel Offshore Trust Company Limited together representing the free shares gifted to employees on IPO (see note 45).

	1 APRIL 2004 £	ISSUED/ (REDEEMED) IN YEAR* £	31 MARCH 2005 £	NUMBER
YEAR ENDED 31 MARCH 2005				
Attributable to equity interests:				
Convertible A Ordinary Shares of 1p each	77,010	—	77,010	7,700,981
Convertible B Ordinary Shares of 1p each	5,833	—	5,833	583,333
Convertible C Ordinary Shares of £1 each*	448,335	1,800	450,135	450,135
D Ordinary Shares of £1 each*	527,250	10,000	537,250	537,250
Convertible Non-Voting A Ordinary Shares of £1 each	425,960	—	425,960	425,960
Convertible Non-Voting B Ordinary Shares of £1 each	37,040	—	37,040	37,040
Convertible Preferred Shares of 1p each	37,527	—	37,527	3,752,686
	1,558,955	11,800	1,570,755	13,487,385
Attributable to non-equity interests:				
Redeemable Cumulative Preference Shares of £1 each**	112,500,000	(75,000,000)	37,500,000	37,500,000
Special Share of £1	1	—	1	1
	112,500,001	(75,000,000)	37,500,001	37,500,001
TOTAL CALLED UP SHARE CAPITAL	114,058,956	(74,988,200)	39,070,756	50,987,386

* 1,800 £1 C Ordinary Shares were issued on 8 June 2004 at £4.90 per share resulting in a share premium of £7,020 and 10,000 £1 D Ordinary Shares were issued on 30 November 2004 at £4.90 per share, resulting in a share premium of £39,000.

** 75,000,000 £1 Redeemable Cumulative Preference Shares were redeemed on 14 June 2004 at par. Interest of £8,898,468 payable on these shares was also paid on that date.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

35. SHARE CAPITAL CONTINUED

On the Company's IPO, resolutions were passed which authorised the Company to purchase its own Ordinary Shares on the following terms:

- a) up to 10% of the Ordinary Share capital
- b) a minimum price of 1p per Ordinary Share
- c) a maximum price of 105% of the average mid market price for the preceding five business days prior to the purchase
- d) authority will expire at the next AGM
- e) the Company may contract prior to an AGM for shares to be purchased after an AGM.

Except as noted below all shares at 31 March 2006 rank *pari passu* in all respects.

RIGHTS ATTACHING TO THE SPECIAL SHARE

QinetiQ carries out activities which are important to UK defence and security interests. To protect these interests in the context of the ongoing commercial relationship between the MOD and QinetiQ, and to promote and reinforce the principles of the Compliance Regime ('the Compliance Principles'), the MOD holds a Special Share in QinetiQ. The Special Share confers certain rights on the holder:

- a) to require the Group to implement and maintain the Compliance System (as defined in the Articles of Association) so as to make at all times effective its and each member of QinetiQ Controlled Group'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:
 - i) may result in circumstances which constitute unacceptable ownership, influence or control over QinetiQ or any other member of the QinetiQ consolidated Group contrary to the defence or security interests of the United Kingdom; or
 - ii) would not, or does not, ensure the effective application of the Compliance Principles to and/or by all members of the QinetiQ Controlled Group 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 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 exercise any of the powers contained in the Articles of Association in relation to the Compliance Committee; and
- f) to demand a poll at any of QinetiQ's meetings (even though it may have no voting rights except those specifically set out in the Articles of Association).

The Special Shareholder has an option to purchase defined Strategic Assets of the Group in certain circumstances. The Special Shareholder has, *inter alia*, the right to purchase any Strategic Assets which the Group wishes to sell. Strategic Assets are normally testing and research facilities (see note 39).

The Special Share may only be issued to, held by and transferred to H.M. Government (or as it directs). At any time the Special Shareholder may require QinetiQ to redeem the Special Share at par. If QinetiQ is wound up the Special Shareholder will be entitled to be repaid the capital paid up on the Special Share before other shareholders receive any payment. The Special Shareholder has no other right to share in the capital or profits of QinetiQ.

The Special Shareholder must give consent to a general meeting held on short notice.

The Special Share entitles the Special Shareholder to require certain persons who hold (together with any person acting in concert with them) a material interest in QinetiQ to dispose of some or all of their Ordinary Shares in special circumstances.

The Special Share may only be transferred to the Crown, or as it directs. The Directors must register any transfer of the Special Share within seven days.

RIGHTS ATTACHING TO THE REDEEMABLE CUMULATIVE PREFERENCE SHARES OF £1 EACH

The Redeemable Cumulative Preference Shares were redeemed by the Company on 4 January 2006.

The Redeemable Cumulative Preference Shares carried the right to a fixed cumulative preferential dividend at the rate of 9% per annum excluding any associated tax credit. The preference dividend was not paid, but accrued until redemption of the shares. The right to the preference dividend had priority over the rights of the holders of any other class of shares to any dividend or other distribution of income. The preference dividend accrued from day to day and compounded annually on 31 March. Cumulative dividends were repaid in full on redemption of the Preference Shares.

36. CHANGES IN EQUITY

	ISSUED SHARE CAPITAL £m	PREFERENCE SHARES £m	CAPITAL REDEMPTION RESERVE £m	SHARE PREMIUM £m	HEDGE RESERVE £m	TRANSLATION RESERVE £m	RETAINED EARNINGS £m	TOTAL £m	MINORITY INTEREST £m	TOTAL EQUITY £m
At 1 April 2004	1.5	112.5	—	11.4	—	—	182.6	308.0	(1.0)	307.0
Exchange loss	—	—	—	—	—	—	(0.4)	(0.4)	—	(0.4)
Equity shares issued	0.1	—	—	—	—	—	—	0.1	—	0.1
Profit	—	—	—	—	—	—	73.9	73.9	(1.6)	72.3
Preference Share dividends	—	—	—	—	—	—	(16.3)	(16.3)	—	(16.3)
Preference Shares redeemed in year	—	(75.0)	1.9	—	—	—	(1.9)	(75.0)	—	(75.0)
Minority interest arising on acquisition	—	—	—	—	—	—	—	—	(0.2)	(0.2)
Gain arising on the refinancing of joint ventures and associates	—	—	—	—	—	—	0.6	0.6	—	0.6
Actuarial (loss)/gain recognised in the defined benefit pension schemes	—	—	—	—	—	—	(9.9)	(9.9)	—	(9.9)
Deferred tax asset on pension deficit	—	—	—	—	—	—	15.9	15.9	—	15.9
AT 31 MARCH 2005	1.6	37.5	1.9	11.4	—	—	244.5	296.9	(2.8)	294.1
Adoption of IAS 32 and IAS 39 (net of deferred tax)	—	(37.5)	—	—	1.3	—	—	(36.2)	—	(36.2)
AT 1 APRIL 2005 RESTATED	1.6	—	1.9	11.4	1.3	—	244.5	260.7	(2.8)	257.9
Exchange gain/(loss)	—	—	—	—	—	0.2	(2.2)	(2.0)	—	(2.0)
Profit	—	—	—	—	—	—	58.1	58.1	2.3	60.4
Bonus issue	—	—	0.5	(4.6)	—	—	—	(4.1)	—	(4.1)
Issue of new shares	4.9	—	—	154.3	—	—	—	159.2	—	159.2
IPO costs	—	—	—	(13.6)	—	—	—	(13.6)	—	(13.6)
Share-based payments	—	—	—	—	—	—	0.1	0.1	—	0.1
Net loss on available for sale financial assets	—	—	—	—	—	—	(1.6)	(1.6)	—	(1.6)
Increase in fair value of hedging derivatives	—	—	—	—	4.9	—	—	4.9	—	4.9
Deferred tax on hedging derivatives	—	—	—	—	(1.5)	—	—	(1.5)	—	(1.5)
Preference Shares redeemed in year	—	—	37.5	—	—	—	(37.5)	—	—	—
Arising on acquisition	—	—	—	—	—	—	—	—	(0.1)	(0.1)
Actuarial (loss)/gain recognised in the defined benefit pension schemes	—	—	—	—	—	—	(105.4)	(105.4)	—	(105.4)
Deferred tax asset on pension deficit	—	—	—	—	—	—	8.7	8.7	—	8.7
AT 31 MARCH 2006	6.5	—	39.9	147.5	4.7	0.2	164.7	363.5	(0.6)	362.9

The translation reserve consists of the cumulative foreign exchange difference arising on translation since the Group transitioned to IFRS. Movements on hedge instruments and hedged items, where the hedge is effective, are recorded in the hedge reserve until the hedge ceases.

The capital redemption reserve is not distributable and was created following redemption of preference share capital and the bonus issue of shares.

During the year the Group restructured its funding commitments to Quintel Technology Limited and QS4 Limited. The Group recognised a gain of £1.1m on equity accounted investments on the removal of any funding obligations in respect of QS4 Limited (see note 19). The Group no longer receives funding from its joint venture partner in respect of Quintel Technology Limited resulting in a credit to minority interest of £4.1m representing the reversal of the cumulative losses previously attributable to minority interests. Prior to the restructuring the loss attributable to minority interests in the year was £1.8m (2005: £1.6m) resulting in a net overall credit to the minority interest position of £2.3m in the year.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

37. SHARE-BASED PAYMENTS

The Group operates a share-based payment plan for employees

2003 EMPLOYEE SHARE OPTION PLAN

Under the ESOS, all employees as at 25 July 2003 received share options which vested when the Group completed its IPO and which must be exercised within ten years of grant. The options are settled by shares.

	2006		2005	
	NUMBER	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding at start of year	295,880	100.0p	325,040	100.0p
Forfeited in year before bonus issue	(5,200)	100.0p	(29,160)	100.0p
Bonus issue in year (42.55 new shares for each 1 share)	12,077,754	—	—	100.0p
Forfeited in year after bonus issue	(11,914)	2.3p	—	100.0p
Exercised in year after bonus issue	(234,876)	2.3p	—	100.0p
Outstanding and exercisable at end of year	12,121,644	2.3p	295,880	100.0p

Options outstanding at 31 March 2006 had an average remaining life of 7.3 years (31 March 2005: 8.3 years).

QINETIQ SHARE INCENTIVE PLAN

All employees of the Group received £500 worth of shares at the date of the Group's admission to the London Stock Exchange. In the case of US employees, the actual number of Ordinary Shares received by eligible employees is on a net of tax basis. There was no vesting period or conditions over the shares and employees were not required to pay any consideration. A cost of £5.8m has been recognised in the income statement in respect of the value of these shares and associated tax incurred by the Group.

Post 31 March 2006, under the QinetiQ Share Incentive Plan, the Group has commenced offering UK employees the option of purchasing up to £125 worth of shares per month at the prevailing market rate. The Group will make a matching contribution of a third of the employee's payment. The Group's matching contribution may be forfeited if the employee ceases to be employed by QinetiQ within three years of the award of the shares.

GROUP SHARE OPTION SCHEME

In the last financial year the Group granted options to certain employees under the Group Share Option Scheme. The exercise price of the options is the average market price of the Group's shares over the five days prior to grant. The options vest after three years. For 217,805 of the options the number that will vest is dependent upon the growth of earnings per share (EPS) over the vesting period. 25% of options will vest if EPS growth is 22.5% for the period and 100% will vest if growth is at least 52%. No options will vest if EPS growth is below 22.5%. Options will vest on a straight line basis if EPS growth is between 22.5% and 52%. For the remaining 160,112 options the EPS growth target is replaced by a performance target based on QinetiQ's ranking by reference to total shareholder return ('TSR') against a comparator group comprising the FTSE 250 companies over a three-year performance period, such that a below median ranking will result in nil shares vesting, at the median level 30 per cent of the options would vest and the amount vested will increase on a straight line basis such that 100% would vest if TSR reaches the upper quartile of the ranking over a three-year period.

	2006		2005
	NUMBER	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE SHARE PRICE
Granted in year and outstanding at end of year	377,917	£2.08	£1.98

Options outstanding at 31 March 2006 had an average remaining life of 4.9 years.

On 10 April 2006 the Company granted to certain employees at an exercise price of 195p a further 12.7m options with EPS growth vesting criteria as noted above.

OPTION PRICING

Share based payments have been valued using a binomial option pricing model. Assumptions used within the model include expected volatility of 35%, an expected life of three years and a risk free rate of return of 3.78% and for the 2003 Employee Share Option Plan options a pre bonus issue weighted average share price of £1 and a weighted average exercise price of £1 based on third-party transactions in the Company's shares in the period immediately prior to the issue of the share options.

Prior to IPO there was no active market for the Company's shares, therefore expected volatility was determined using the average volatility for a comparable selection of businesses.

The Group had no established pattern of dividend payments therefore no dividends were assumed in this model.

The total share based payment expense in the period was £0.1m (year to 31 March 2005: nil).

38. OPERATING LEASES**GROUP AS A LESSOR**

The Group receives rental income on certain properties. The Group had contracted with tenants for the following future minimum lease payments:

	2006 £m	2005 £m
Within one year	4.3	4.3
In the second to fifth years inclusive	2.5	2.9
Greater than five years	2.6	3.2
	9.4	10.4

GROUP AS A LESSEE

	2006 £m	2005 £m
Lease and sublease income statement expense		
MINIMUM LEASE PAYMENTS	10.9	4.6

The Group had the following future minimum lease payment commitments:

	2006 £m	2005 £m
Within one year	9.6	7.2
In the second to fifth years inclusive	19.0	15.2
Greater than five years	10.0	8.8
	38.6	31.2

Operating lease payments represent rentals payable by the Group on certain office property and plant. Leases are negotiated for an average of three to ten years.

39. TRANSACTIONS WITH THE MOD

The MOD is a 19.2% (2005: 49% in voting terms) shareholder in the Group. 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 the Group. An analysis of trading with the MOD is presented below:

	2006 £m	2005 £m
Sales to MOD excluding property rental income	595.8	626.7
Property rental income	13.0	10.9
TOTAL INCOME FROM THE MOD	608.8	637.6
PURCHASED SERVICES FROM THE MOD	17.8	17.4

	2006 £m	2005 £m
Trade debtors	72.6	123.0
Trade creditors	0.3	0.3

FREEHOLD LAND AND BUILDINGS AND SURPLUS PROPERTIES

Under the terms of the Group's 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 transferred. These are:

(i) Restrictions on transfer of title

The title deeds of those properties with strategic assets (see below) or properties where strategic assets are in the course of being downgraded to becoming non-strategic include a clause that prevents their transfer without the approval of MOD. The MOD also has the right to purchase any Strategic Assets in certain circumstances.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

39. TRANSACTIONS WITH THE MOD CONTINUED

(ii) Property clawback agreement

The MOD retains an interest in future profits on disposal of certain property assets 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 in excess of a 30% gain on a July 2001 professional valuation. The proportion of the excess gain due to the MOD is based on a sliding scale which reduces over time from 50% to 9% and at 31 March 2006 stands at 44%. The July 2001 valuation was approximately 16% greater in aggregate than the consideration paid for the land and buildings on 1 July 2001.

COMPLIANCE REGIME

The Compliance Committee monitors the effective application of the Compliance Regime required by the MOD to maintain the position of QinetiQ as a supplier of independent and impartial scientific/technical advice to the MOD and ensures that the required standards are met in trials involving human volunteers and trials where an incident may result in serious injury.

STRATEGIC ASSETS

Under the Principal Agreement with the MOD, the QinetiQ controlled Group is not permitted without the written consent of the MOD, to:

- (i) dispose of or destroy all or any part of a Strategic Asset; or
- (ii) voluntarily undertake any closure of, or cease to provide a strategic capability by means of, all or any part of a Strategic Asset.

The net book value of assets identified as being Strategic Assets as at 31 March 2006 was £35.1m (31 March 2005: £17.2m), the principal items being £28.1m of plant and machinery (31 March 2005: £9.1m) and £3.8m of vehicles (31 March 2005: £3.0m).

LONG TERM PARTNERING AGREEMENT

On 27 February 2003 QinetiQ Limited entered into a Long Term Partnering Agreement to provide the Test and Evaluation facilities and training support services to the MOD. This is a 25-year contract with a total turnover value of up to £5.6bn, dependent on the level of usage by MOD, under which QinetiQ Limited is committed to providing the T&E services with increasing efficiencies through cost saving and innovative service delivery.

40. DIRECTORS AND OTHER SENIOR MANAGEMENT PERSONNEL

The current Board consists of: Colin Balmer, Sir John Chisholm, Noreen Doyle, Dr Peter Fellner, Sir David Lees, Graham Love, Nick Luff, Doug Webb and Glenn Youngkin. Other Directors (who resigned in year) were: Richard Gillingwater, Sir Denys Hendersen, Hal Kruth, Dame Pauline Neville-Jones and Trevor Woolley. Senior Management personnel are: Hal Kruth, Andrew Sleigh, Phil Odeen and Lynton Boardman.

	2006 £000's	2005 £000's
DIRECTORS		
Short-term employee benefits	1,699	1,703
Post-employment benefits	79	133
TOTAL	1,778	1,836
OTHER SENIOR MANAGEMENT PERSONNEL		
Short-term employee benefits	904	535
Post-employment benefits	102	57
TOTAL	1,006	592

41. CONTINGENT LIABILITIES AND ASSETS

Subsidiary undertakings within the Group have given unsecured guarantees of £2.8m at 31 March 2006 (31 March 2005: £0.9m) in the ordinary course of business.

The Group 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, employment rights 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.

The Group has not recognised contingent amounts receivable relating to the Chertsey property which was disposed of during 2004 or the Fort Halstead property disposed of in September 2005. Additional consideration, subject to clawback to the MOD pursuant to the arrangements referred to in note 39, is potentially due upon the purchasers obtaining additional planning consents, with the quantum dependent on the scope of the consent achieved.

In January 2006, QinetiQ received the first in a series of letters from the advisers of British Titanium plc ("BTi") alleging specific claims in relation to the termination of a sub-licence to BTi from QinetiQ for a titanium manufacturing process. The Group intends to defend vigorously the legal action commenced by BTi. The Directors believe that this matter will not have a material adverse effect on QinetiQ's financial position or results of operations.

42. POST-RETIREMENT BENEFITS

INTRODUCTION AND BACKGROUND TO IAS 19

International Accounting Standard 19 (Employee Benefits) requires the Group to include in the balance sheet the surplus or deficit on the scheme calculated as at the balance sheet date. It is a snapshot view which can be significantly influenced by short-term market factors. The calculation of the surplus or deficit is, therefore, dependent on factors which are beyond the control of the Group – principally the value at the balance sheet date of equity shares in which the scheme has invested 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 by qualified actuaries.

THE QINETIQ PENSION SCHEME

In the UK the Group operates the QinetiQ Pension Scheme for the majority of its UK employees, 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.

The most recent full actuarial valuation of the DB section was undertaken as at 31 March 2005 and resulted in an actuarially assessed deficit of £106.5m. On the basis of the 31 March 2005 full valuation, the Trustees and the Company agreed that the 17.5% employer contribution rate would continue and in addition a further £10.0 million per annum cash payment would be paid in monthly instalments for six years from October 2005, subject to review at the next valuation, due in March 2008, to cover the past service deficit. Subsequently, the Company agreed that part of the IPO proceeds would be used to prepay the balance of the first five years of the additional funding and a £45m payment was made into the scheme on 30 March 2006. The Company also made a further £45.3m payment into the scheme on the same date following the receipt of the payment from the MOD of the same value that was received in March 2006 in accordance with the indemnity given by the MOD to the Company as part of the agreement dated 3 December 2002, whereby QinetiQ Group plc acquired QinetiQ Holdings Limited.

OTHER UK SCHEMES

In the UK, the Group operates a further three small defined benefit schemes, QinetiQ Prudential Platinum Scheme and schemes for the subsidiary companies ASAP Calibration Limited and Aurix Limited. The net pension deficits of these schemes at 31 March 2006 amounted to £0.3m (31 March 2005: £0.4m).

There were no outstanding or prepaid contributions at the balance sheet date (March 2005: £nil). Set out below is a summary of the overall IAS 19 defined benefit pension schemes' liabilities. The fair value of the schemes' 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 schemes' liabilities, which are derived from cash flow projections over long periods, and thus inherently uncertain, were as follows:

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

42. POST-RETIREMENT BENEFITS CONTINUED

	2006 £m	2005 £m
Equities	551.1	361.6
Corporate bonds	85.2	44.4
Government bonds	74.8	45.7
Cash	4.9	2.4
TOTAL MARKET VALUE OF ASSETS	716.0	454.1
Present value of scheme liabilities	(884.4)	(617.2)
RETIREMENT BENEFIT OBLIGATION	(168.4)	(163.1)
MOD pension indemnity	–	38.1
NET PENSION LIABILITY BEFORE DEFERRED TAX	(168.4)	(125.0)
Deferred tax asset	50.4	48.8
NET PENSION LIABILITY	(118.0)	(76.2)

ASSUMPTIONS

The major assumptions (weighted to reflect individual scheme differences) were:

	2006	2005
Rate of increase in salaries	4.40%	4.30%
Rate of increase in pensions in payment	2.90%	2.90%
Rate of increase in pensions in deferment	2.90%	2.80%
Discount rate applied to scheme liabilities	4.90%	5.40%
Inflation assumption	2.90%	2.80%

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. It is important to note that these assumptions are long term and, in the case of the discount rate and the inflation rate, are measured by external market indicators. Of the pension liability increase in the year to 31 March 2006, £40m relates to the application of the latest mortality rates which resulted from a weighted average increase of one year in the life expectancy of pre-retirement defined benefit scheme members, as summarised below:

	2006	2005
Mortality assumption in years		
Future male pensioners	86	85
Future female pensioners	89	88

SCHEME ASSETS

Expected long-term rates of return on scheme assets (weighted to reflect individual scheme differences) were:

	2006	2005
Equities	7.70%	7.70%
Corporate bonds	4.70%	5.00%
Government bonds	4.10%	4.70%
Cash	4.50%	4.20%
WEIGHTED AVERAGE	6.90%	7.00%

	2006 £m	2005 £m
Actual return on plan assets:		
Expected return on scheme assets	34.1	27.7
Actuarial gain on scheme assets	85.8	12.0
ACTUAL RETURN ON SCHEME ASSETS	119.9	39.7

42. POST-RETIREMENT BENEFITS CONTINUED

	2006 £m	2005 £m
Changes to the fair value of scheme assets:		
Opening fair value of scheme assets	454.1	379.4
New schemes acquired in the year	–	1.3
Expected return on assets	34.1	27.7
Actuarial gains on scheme assets	85.8	12.0
Contributions by the employer	149.2	37.8
Contributions by plan participants	4.6	3.0
Net benefits paid out	(11.8)	(7.1)
CLOSING FAIR VALUE OF SCHEME ASSETS	716.0	454.1

	2006 £m	2005 £m
Changes to the present value of the defined benefit obligation:		
Opening defined benefit obligation	617.2	525.3
New schemes acquired in the year	–	1.7
Current service cost	40.1	41.7
Interest cost	34.4	30.0
Contributions by plan participants	4.6	3.0
Actuarial losses on scheme liabilities	193.5	21.9
Net benefits paid out	(11.8)	(7.2)
Curtailments	6.4	0.8
CLOSING DEFINED BENEFIT OBLIGATION	884.4	617.2

	2006 £m	2005 £m
Pension costs charged to the income statement:		
Current service cost	40.1	41.7
Interest cost	34.4	30.0
Expected return on plan assets	(34.1)	(27.7)
Curtailment cost	–	0.8
TOTAL EXPENSE RECOGNISED IN THE INCOME STATEMENT (GROSS OF DEFERRED TAX)	40.4	44.8

£6.4m of curtailment cost for the year to 31 March 2006 was provided for in the year to 31 March 2005 as part of the Group's restructuring costs.

	2006 £m	2005 £m
Analysis of amounts recognised in statement of recognised income and expenses:		
Total actuarial losses (gross of deferred tax)	(105.4)	(9.9)
Cumulative total actuarial losses recognised in the SORIE	(248.8)	(143.4)

	2006 £m	2005 £m
History of scheme experience gains and losses		
Experience gains on scheme assets	85.8	12.0
Experience losses on scheme liabilities	(193.5)	(21.9)

The expected employer cash contribution to the defined benefit scheme for the year ending 31 March 2007 is £34.8m.

DEFINED CONTRIBUTION SCHEMES

Payments to the DC schemes totalled £7.9m (March 2005: £5.9m).

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

43. IMPACT OF FUTURE ACCOUNTING STANDARDS

The International Financial Reporting Interpretations Committee (IFRIC) has issued draft interpretations relating to service concession arrangements. Service concession arrangements typically arise where a government grants a concession to a third party to operate a service for the public sector. Often the service concession operator is required to build associated assets as part of the grant arrangement. The drafts, IFRIC D12, IFRIC D13 and IFRIC D14, propose service concession arrangements are accounted for as either a financial asset or intangible asset. The Group has reviewed the impact of these draft interpretations but does not expect them to have any material effect in their current form.

Additional standards have been issued but were not effective during the year and are not expected to have any material effect on the results of the Group.

44. CAPITAL COMMITMENTS

The Group had the following capital commitments for which no provision has been made:

	2006 £m	2005 £m
Contracted	26.2	5.0

Capital commitments at 31 March 2006 include £24.7m in relation to property, plant and equipment that will be wholly funded by a third party customer under long-term contract arrangements.

45. INITIAL PUBLIC OFFERING

On 15 February 2006 the Group listed on the London Stock Exchange. The transactions relating to the Group's IPO are analysed below:

	2006 £m
Proceeds received on IPO:	
Gross proceeds	150.0
Costs paid in year	(13.8)
Net proceeds received in year	136.2
Accrued costs	(3.5)
Net proceeds	132.7

In addition to the cash costs noted above, the Company gifted £500 worth of free shares to all employees at the date of the IPO (see note 37). The value of these shares at the admission price of £2.00 per share amounts to £5.2m.

The total costs of the IPO, inclusive of the value of the gift of shares, have been charged to the income statement or the share premium account as follows:

	2006 £m
Income statement	(8.9)
Share premium account	(13.6)
Total costs	(22.5)

Income statement income/(costs) before corporation tax:

Employee shares (including associated tax costs)	(6.8)
Other IPO costs	(2.1)
Total	(8.9)
Release of remaining discount on MOD indemnity triggered by IPO	4.7
Net IPO related items	(4.2)

As part of the agreement dated 3 December 2002 whereby QinetiQ Group plc acquired QinetiQ Holdings Limited, the MOD gave an indemnity to the Company to pay to the Company on the earlier of a flotation, sale or winding up and 28 February 2008, an amount up to £45.0m dependent on the size of the deficit on the QinetiQ Pension Scheme. At 31 March 2005 the amount included in the balance sheet of £38.1m represented the discounted amount payable based on the longest date to maturity being 28 February 2008. The IPO represented a trigger event for the payment of the indemnity which resulted in the remaining balance of the discount on the carrying value of the indemnity at the date of the IPO of £4.7m being released and classified as finance income in the year (see note 7).

45. INITIAL PUBLIC OFFERING CONTINUED

The net proceeds received from the IPO as at 31 March 2006 have been applied as follows:

	2006 £m
Contribution to defined benefit pension scheme (see note 42)	45.0
Reduction in net debt	91.2
Net proceeds	136.2

46. TRANSITION TO IFRS

The Group has adopted International Financial Reporting Standards (IFRS) for the year ended 31 March 2006. Comparative data has also been presented using IFRS. Reconciliations between UK GAAP and IFRS of net assets and balance sheets at 31 March 2004 and 31 March 2005 and profit attributable to ordinary shareholders and income statements for the year to 31 March 2005 are included below:

RECONCILIATION OF NET ASSETS

	31 MARCH 2005 £m	1 APRIL 2004 £m
UK GAAP	214.1	225.2
Goodwill and intangibles	98.4	86.3
Tax	(11.8)	2.2
Leases	1.0	0.5
Employee benefits – pension	(0.5)	(0.4)
Employee benefits – holiday pay	(7.1)	(6.8)
IFRS	294.1	307.0

RECONCILIATION OF PROFIT ATTRIBUTABLE TO ORDINARY SHAREHOLDERS

	YEAR ENDED 31 MARCH 2005 £m
UK GAAP	75.6
Goodwill and intangibles	(3.3)
Tax	1.4
Leases	0.5
Holiday pay	(0.3)
IFRS	73.9

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

46. TRANSITION TO IFRS CONTINUED

RECONCILIATION OF INCOME STATEMENT FOR YEAR ENDED 31 MARCH 2005

	NOTE	UK GAAP £m	IFRS ADJUSTMENTS £m	IFRS RECLASSI- FICATION £m	IFRS £m
GROUP TURNOVER		873.3	2.1	(16.5)	858.9
Less equity method accounted joint ventures and associates		(0.9)	(2.1)	—	(3.0)
TURNOVER		872.4	—	(16.5)	855.9
Employee benefit costs	E		(0.3)	(420.4)	(420.7)
Third-party project costs		(160.0)	—	—	(160.0)
Other operating costs excluding depreciation and amortisation		(668.3)	0.7	459.8	(207.8)
Share of loss of equity accounted joint ventures and associates		—	—	(2.5)	(2.5)
Profit on disposal of interest in equity accounted associate		—	—	17.1	17.1
Other income		—	(3.0)	16.5	13.5
EBITDA		44.1	(2.6)	54.0	95.5
Depreciation of property, plant and equipment		—	0.9	(39.8)	(38.9)
Amortisation of intangible assets and impairment of goodwill and current asset investments	A,B	—	(4.0)	(1.9)	(5.9)
GROUP OPERATING PROFIT		44.1	(5.7)	12.3	50.7
Share of operating loss in joint ventures and associates		(2.6)	—	2.6	—
Total operating profit before restructuring costs and impairment		69.2	—	—	—
Restructuring costs		(28.2)	—	—	—
Impairment		0.5	—	—	—
GROUP OPERATING PROFIT		41.5	(5.7)	14.9	50.7
Group profit on disposal of non-current assets		46.2	—	(17.1)	29.1
PROFIT BEFORE INTEREST		87.7	(5.7)	(2.2)	79.8
Finance income		—	2.6	5.5	8.1
Finance expense		(6.7)	—	(3.2)	(9.9)
PROFIT BEFORE TAX		81.0	(3.1)	0.1	78.0
Taxation expense	G	(7.0)	1.4	(0.1)	(5.7)
PROFIT FOR THE PERIOD FROM CONTINUING OPERATIONS		74.0	(1.7)	—	72.3
Minority interest		1.6	—	—	1.6
PROFIT ATTRIBUTABLE TO ORDINARY SHAREHOLDERS		75.6	(1.7)	—	73.9

46. TRANSITION TO IFRS CONTINUED

RECONCILIATION OF EQUITY AT 31 MARCH 2005

	NOTE	UK GAAP £m	IFRS ADJUSTMENTS £m	IFRS RECLASSI- FICATION £m	IFRS £m
NON-CURRENT ASSETS					
Goodwill	A	68.1	63.4	—	131.5
Intangible assets	B	2.3	35.0	—	37.3
Property, plant and equipment	C,D	392.1	(17.6)	(6.6)	367.9
Investment property	C	—	—	6.6	6.6
Financial asset		—	15.6	—	15.6
Investments		0.5	—	—	0.5
Deferred tax asset	F,G	—	1.9	13.2	15.1
		463.0	98.3	13.2	574.5
CURRENT ASSETS					
Inventories		17.8	—	—	17.8
Financial assets		—	3.0	—	3.0
Trade and other receivables		409.7	—	(38.1)	371.6
Cash and cash equivalents		12.3	—	—	12.3
Investments		12.8	—	—	12.8
		452.6	3.0	(38.1)	417.5
TOTAL ASSETS		915.6	101.3	(24.9)	992.0
CURRENT LIABILITIES					
Trade and other payables	E	(356.7)	(7.1)	54.5	(309.3)
Provisions		—	—	(33.5)	(33.5)
Financial liabilities		—	—	(54.5)	(54.5)
		(356.7)	(7.1)	(33.5)	(397.3)
NON-CURRENT LIABILITIES					
Retirement benefit obligation	F	(113.9)	(0.5)	(10.6)	(125.0)
Deferred tax liability	G	—	(13.7)	3.6	(10.1)
Provisions		(76.2)	—	65.4	(10.8)
Financial liabilities		(150.5)	—	(2.5)	(153.0)
Other payables		(4.2)	—	2.5	(1.7)
		(344.8)	(14.2)	58.4	(300.6)
TOTAL LIABILITIES		(701.5)	(21.3)	24.9	(697.9)
NET ASSETS		214.1	80.0	—	294.1
CAPITAL AND RESERVES					
Share capital		1.6	—	—	1.6
Preference Shares		37.5	—	—	37.5
Capital redemption reserve		—	—	1.9	1.9
Share premium account		11.4	—	—	11.4
Retained earnings		166.4	80.0	(1.9)	244.5
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT		216.9	80.0	—	296.9
MINORITY INTEREST		(2.8)	—	—	(2.8)
TOTAL EQUITY		214.1	80.0	—	294.1

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

46. TRANSITION TO IFRS CONTINUED

RECONCILIATION OF EQUITY AT 1 APRIL 2004

	NOTE	UK GAAP £m	IFRS ADJUSTMENTS £m	IFRS RECLASSI- FICATION £m	IFRS £m
NON-CURRENT ASSETS					
Goodwill	A	(85.8)	86.3	—	0.5
Intangible assets	B	0.5	—	—	0.5
Property, plant and equipment	C,D	428.2	(18.5)	(6.6)	403.1
Investment property	C	—	—	6.6	6.6
Financial assets		—	16.0	—	16.0
Investments accounted for using the equity method		0.4	—	(0.4)	—
Deferred tax asset	E,G	—	2.2	2.5	4.7
		343.3	86.0	2.1	431.4
CURRENT ASSETS					
Inventories		1.1	—	—	1.1
Financial assets		—	3.0	—	3.0
Trade and other receivables		310.4	—	(36.1)	274.3
Cash and cash equivalents		154.6	—	—	154.6
		466.1	3.0	(36.1)	433.0
TOTAL ASSETS		809.4	89.0	(34.0)	864.4
CURRENT LIABILITIES					
Trade and other payables	E	(277.0)	(6.8)	16.5	(267.3)
Provisions		—	—	(7.8)	(7.8)
Financial liabilities		—	—	(16.5)	(16.5)
		(277.0)	(6.8)	(7.8)	(291.6)
NON-CURRENT LIABILITIES					
Retirement benefit obligation	F	(115.3)	(0.4)	6.0	(109.7)
Provisions		(48.8)	—	35.4	(13.4)
Provisions for joint venture deficit		(1.0)	—	1.0	—
Investments accounted for using the equity method		—	—	(0.6)	(0.6)
Financial liabilities		(142.1)	—	—	(142.1)
		(307.2)	(0.4)	41.8	(265.8)
TOTAL LIABILITIES		(584.2)	(7.2)	34.0	(557.4)
NET ASSETS		225.2	81.8	—	307.0
CAPITAL AND RESERVES					
Share capital		1.5	—	—	1.5
Preference Shares		112.5	—	—	112.5
Share premium account		11.4	—	—	11.4
Retained earnings		100.8	81.8	—	182.6
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT		226.2	81.8	—	308.0
MINORITY INTEREST		(1.0)	—	—	(1.0)
TOTAL EQUITY		225.2	81.8	—	307.0

46. TRANSITION TO IFRS CONTINUED

The effect of transition to IFRS is analysed below.

A – GOODWILL

Under IFRS 3 *Business combinations*, goodwill arising on acquisition is no longer amortised on a straight line basis but is instead subject to an annual impairment review. Accordingly, goodwill has not been amortised since transition to IFRS on 1 April 2004. Negative goodwill is recognised immediately in the income statement on acquisition.

The non-amortisation of goodwill has resulted in a decrease of £0.9m in profit for the year ended 31 March 2005 as the Group had considerable negative goodwill. Negative goodwill relating to Aurix Limited recognised in the income statement increased profit by £1.3m for the year to 31 March 2005. An additional goodwill impairment of £0.1m has been recognised under IFRS for the year to 31 March 2005. The total increase in profit in relation to goodwill adjustments was £0.3m for the year to 31 March 2005. Negative goodwill on transition to IFRS of £86.3m was removed and opening shareholders' funds increased accordingly.

B – INTANGIBLE ASSETS

IAS 38 *Intangible Assets* requires certain software and development costs to be capitalised within intangible assets. IFRS 3 *Business combinations* requires the recognition of intangible assets and goodwill on acquisition rather than just goodwill as was the case under UK GAAP. Previously, intangible assets have not been recognised on acquisition of a business under UK GAAP.

Intangible assets totalling £39.9m have been recognised on the acquisitions of Westar Aerospace & Defense Group, Inc., Foster-Miller, Inc., HVR Group Limited and ASAP Calibration Limited at 31 March 2005. These assets are being amortised over their useful economic lives. In the year to 31 March 2005 £4.2m of amortisation has been charged to the income statement of these intangibles assets. A £1.2m exchange loss on translation has been recorded on intangible assets recognised on acquisition at 31 March 2005. The loss has been recognised within equity. The exchange loss had previously been recognised within UK GAAP goodwill. At 31 March 2005 the net book value of capitalised intangible assets acquired on acquisition was £35.4m.

Software costs of £0.7m in the year to 31 March 2005 that were expensed under UK GAAP have been capitalised and are being amortised over 3-5 years. An additional £0.1m has been charged to the income statement in the year to 31 March 2005 under IFRS as amortisation of capitalised software. This has increased intangible assets by £0.6m at 31 March 2005.

The majority of the Group's development expenditure is performed under contract for third parties and will continue to be accounted for under contract accounting.

C – INVESTMENT PROPERTY

IAS 40 *Investment Property* requires certain of the Group's properties, those primarily held for rental income or capital appreciation, to be classified as investment property instead of tangible fixed assets under UK GAAP.

At 31 March 2005 and 1 April 2004, land with a net book value of £6.6m has been reclassified from tangible fixed assets to investment property.

D – LEASING

IAS 17 requires property leases to be considered as separate components for land and buildings. This resulted in an element of a UK GAAP operating lease granted by the Group being reclassified as a finance lease.

At 31 March 2005, the Group derecognised property assets with a net book value of £17.6m (1 April 2004: £18.6m) and instead recognised a finance lease debtor of £18.6m (1 April 2004: £19.0m). For the year ended 31 March 2005, depreciation was decreased by £0.9m. Other income was reduced by £3.0m for the year to 31 March 2005. Finance income of £2.6m has been recognised in the year to 31 March 2005.

E – EMPLOYEE BENEFITS – HOLIDAY PAY

Previously under UK GAAP it was not accepted practice to provide for holiday pay. Under IFRS the Group has recognised the full liability for accrued holiday. An additional liability of £7.1m has been recognised at 31 March 2005 (1 April 2004: £6.8m). Opening shareholders' funds at 1 April 2004 have been reduced by £6.8m to reflect the increased liability. Subsequent movements have been through the income statement.

F – EMPLOYEE BENEFITS – PENSION LIABILITY

The Group's pension liability has increased £0.5m at 31 March 2005 (1 April 2004: £0.4m) as equities held by the fund are valued at bid price under IFRS rather than mid price under UK GAAP.

Under IFRS the deferred tax asset of £48.7m (1 April 2004: £30.1m) relating to the pension liability is presented within deferred tax assets as opposed to being offset with the IFRS 17 pension liability as was the practice under UK GAAP.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

46. TRANSITION TO IFRS CONTINUED

The MOD defined benefit pension indemnity of £38.1m (1 April 2005: £36.1m) is offset with the pension liability rather than being included within trade and other receivables as was the case under UK GAAP.

G – TAX

Under IFRS deferred tax is recognised on all temporary differences at the balance sheet date. The effect at 31 March 2005 was a reduction in net assets of £11.8m (1 April 2004: £2.2m increase) and profit for the year to 31 March 2005 was increased by £1.4m.

SHARE-BASED PAYMENTS

The Group has reviewed its share-based payments on transition to IFRS resulting in no material adjustment.

CASH FLOW

There are no changes in the Group's underlying cash flows as a result of transition to IFRS; however, presentation categorises cash flows as operating activities, investing activities and financing activities.

47. SUBSIDIARIES AND ASSOCIATES

The principal subsidiary, associated undertakings and joint ventures at 31 March 2006, all of which are included in the consolidated financial statements, are shown below.

NAME OF COMPANY	NOTE	PRINCIPAL AREA OF OPERATION	COUNTRY OF INCORPORATION	PROPORTION OF VOTING RIGHTS HELD ⁽¹⁾	FINANCIAL YEAR END ⁽²⁾	NATURE OF BUSINESS
SUBSIDIARY UNDERTAKINGS						
QinetiQ Holdings Limited	(2)	UK	England & Wales	100%		Holding company
QinetiQ Limited		UK	England & Wales	100%		Research and development
ASAP Calibration Services Limited		UK	England & Wales	100%		Calibration and Engineering
Aurix Limited	(5)	UK	England & Wales	80.1%		Research and development
cueSim Limited		UK	England & Wales	100%		Research and development
Graphic Research Corporation Limited		UK	England & Wales	100%		Research and development
HVR Consulting Services Limited		UK	England & Wales	100%		Research and development
QinetiQ Nanomaterials Limited		UK	England & Wales	100%		Research and development
Quintel Technology Limited	(4) (6)	UK	England & Wales	50.0%		Research and development
Trusted Experts Limited		UK	England & Wales	100%		Resource Management
QinetiQ Insurance PCC Limited		UK	Guernsey	100%		Insurance
QinetiQ Overseas Holdings Limited		UK	England & Wales	100%		Holding company
QinetiQ Rail Limited		UK	England & Wales	100%		Research and development
Apogen Technologies, Inc.		USA	USA	100%	31 December	Research and development
Aerospace Filtration Systems, Inc.		USA	USA	100%		Research and development
Foster-Miller, Inc.		USA	USA	100%		Research and development
Planning Systems Inc.		USA	USA	100%	31 December	Research and development
QinetiQ Inc.		USA	USA	100%		Research and development
QinetiQ Technology Extension Corporation		USA	USA	100%		Research and development
SimAuthor, Inc.		USA	USA	100%		Research and development
Westar Aerospace & Defense Group, Inc.		USA	USA	100%	31 December	Research and development
Westar Display Technologies, Inc.		USA	USA	100%	31 December	Research and development
QinetiQ North America Operations, LLC		USA	USA	100%		Holding Company
QinetiQ North America Inc.		USA	USA	100%		Holding company
Verhaert Design and Development NV		Belgium	Belgium	90%	31 December	Research and development
QinetiQ Philippines Company Inc.		Philippines	Philippines	100%		Research
ASSOCIATES						
QS4 Group Limited	(6)	UK	England & Wales	50.0%	31 December	Holding company
QS4 Limited	(6)	UK	England & Wales	50.0%	31 December	Research and development
Quintel (UK) Limited	(6)	UK	England & Wales	50.0%	31 December	Research and development
ZBD Displays Limited		UK	England & Wales	30.4%	31 July	Research and development
Infoscitex Inc.		USA	USA	27.8%		Research and development

(1) Accounting reference date is 31 March unless otherwise stated.

(2) QinetiQ Holdings Limited was formerly known as QinetiQ Group plc. Shares are held directly by QinetiQ Group plc, formerly known as QinetiQ Holdings Limited.

(3) Percentage of ordinary share capital unless otherwise stated.

(4) Disclosed as a subsidiary due to management control by QinetiQ.

(5) Post 31 March 2006 the Group has acquired the remaining 19.9% of Aurix Limited it did not own.

(6) Employee warrants if exercised would dilute the Group's interest to 45.1%.

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.

On 8 December 2005 the Company changed its name from QinetiQ Holdings Limited to QinetiQ Group Limited. On 11 January 2006, the Company was re-registered as a public limited company under section 43 of the Companies Act 1985 and changed its name to QinetiQ Group plc.

NOTES TO THE FINANCIAL STATEMENTS CONTINUED

48. POST-BALANCE SHEET EVENT

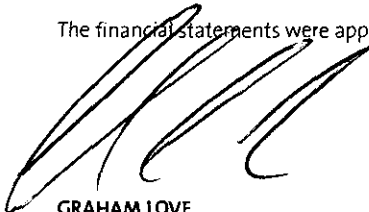
On 4 April 2006 Apogen Technologies, one of QinetiQ's principal US subsidiaries, signed an agreement to acquire, subject to US Government approval, San Diego-based Ocean Systems Engineering Corp (OSEC) for cash consideration of £30.3m (\$53.0m). The approvals were subsequently received and the acquisition completed on 15 May 2006. OSEC reported revenues of \$48.2m, EBITDA of \$4.8m and earnings of \$2.7m in the year to 31 December 2005.

COMPANY BALANCE SHEET

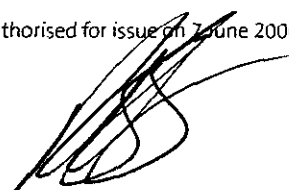
AS AT 31 MARCH

	NOTES	2006 £m	2005 £m
FIXED ASSETS			
Investments in subsidiary undertaking	2	92.3	92.3
		92.3	92.3
CURRENT ASSETS			
Debtors	3	153.5	40.0
		153.5	40.0
CURRENT LIABILITIES			
Creditors amounts falling due within one year	4	(0.3)	(79.9)
		(0.3)	(79.9)
NET CURRENT ASSETS/(LIABILITIES)		153.2	(39.9)
NET ASSETS		245.5	52.4
CAPITAL AND RESERVES			
Equity share capital	5, 6	6.5	1.6
Preference Shares	5, 6	–	37.5
Capital redemption reserve	6	39.9	1.9
Share premium account	6	147.5	11.4
Profit and loss account	6	51.6	–
CAPITAL AND RESERVES ATTRIBUTABLE TO SHAREHOLDERS		245.5	52.4
<i>Capital and reserves analysed as:</i>			
Equity shareholders' funds		245.5	14.9
Non-equity shareholders' funds		–	37.5
Total shareholders' funds		245.5	52.4

The financial statements were approved by the Board of Directors and authorised for issue on 7 June 2006. They were signed on its behalf by:



GRAHAM LOVE
CHIEF EXECUTIVE OFFICER



DOUG WEBB
CHIEF FINANCIAL OFFICER

There are no other recognised gains and losses.

NOTES TO THE COMPANY FINANCIAL STATEMENTS

1. ACCOUNTING POLICIES

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the Company's financial statements.

BASIS OF PREPARATION

The financial statements have been prepared under the historical cost convention and in accordance with applicable UK accounting standards. 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.

CASH FLOW STATEMENT

Under FRS 1 *Cash Flow Statements* the Company is exempt from the requirement to prepare a cash flow statement on the grounds that it is consolidated within the consolidated financial statements of the Group.

INVESTMENTS

In the Company's financial statements, investments in subsidiary undertakings are stated at cost less any impairment in value.

FOREIGN CURRENCIES

Transactions in foreign currencies are recorded using the rate of exchange ruling at the date of the transaction and gains and losses on translation are included in the profit and loss account. If designated forward foreign exchange hedging contracts have been entered into, gains and losses are matched against the foreign exchange movements on the underlying transaction.

SHARE-BASED PAYMENTS

FRS 20 *Share-Based Payments* became effective for accounting periods beginning on or after 1 January 2005. The fair value of equity settled options for share-based payments is determined on grant and expensed on a straight-line basis over the period from grant to the date of earliest exercise. The fair value of cash settled options for share-based payments is determined each period end until exercised or they lapse. The value is expensed straight line over the period from grant to the date of earliest exercise. The fair value of both equity settled and cash settled share options is calculated by a binomial option pricing model. The cost of share-based payments is charged to subsidiary undertakings.

PREFERENCE SHARES

During the year the Company had in issue Redeemable Cumulative Preference Shares of £1 each which carry the right to a fixed cumulative preferential dividend at the rate of 9% per annum excluding any associated tax credit. The Company redeemed all the Redeemable Cumulative Preference Shares on IPO. The Company adopted FRS 25 *Financial Instruments: Disclosure and Presentation* for the year commencing 1 April 2005 however as permitted by FRS 25 the comparative period continues to show the Preference Shares as part of the Company's capital and reserves and associated dividend within dividends.

2. INVESTMENT IN SUBSIDIARY UNDERTAKINGS

	2006 £m	2005 £m
Subsidiary undertakings – 100% of ordinary share capital of QinetiQ Holdings Limited	92.3	92.3

3. DEBTORS

	2006 £m	2005 £m
Amounts owed by Group undertakings	152.8	1.9
Tax and social security	0.6	—
Other debtors	0.1	38.1
	153.5	40.0

4. CREDITOR AMOUNTS DUE WITHIN ONE YEAR

	2006 £m	2005 £m
Bank overdrafts	0.3	–
Amounts due to Group undertakings	–	72.4
Accruals and deferred income	–	7.5
	0.3	79.9

5. SHARE CAPITAL

The Company's share capital is disclosed in note 35 to the Group financial statements.

6. RESERVES

	ISSUED SHARE CAPITAL £m	PREFERENCE SHARES £m	CAPITAL REDEMPTION RESERVE £m	SHARE PREMIUM £m	PROFIT AND LOSS £m	TOTAL EQUITY £m
At 1 April 2004	1.5	112.5	–	11.4	(3.4)	122.0
Equity shares issued	0.1	–	–	–	–	0.1
Profit	–	–	–	–	16.4	16.4
Preference Share dividend accrual charged to the profit and loss account	–	–	–	–	(11.1)	(11.1)
Preference Shares redeemed in year	–	(75.0)	1.9	–	(1.9)	(75.0)
AT 31 MARCH 2005	1.6	37.5	1.9	11.4	–	52.4
Adoption of FRS 25	–	(37.5)	–	–	–	(37.5)
AT 1 APRIL 2005 RESTATED	1.6	–	1.9	11.4	–	14.9
Profit	–	–	–	–	88.9	88.9
Preference Shares redeemed in year	–	–	37.5	–	(37.5)	–
Share options	–	–	–	–	0.2	0.2
IPO costs	–	–	–	(13.6)	–	(13.6)
Bonus issue	–	–	0.5	(4.6)	–	(4.1)
Issue of new shares	4.9	–	–	154.3	–	159.2
AT 31 MARCH 2006	6.5	–	39.9	147.5	51.6	245.5

The capital redemption reserve is not distributable and was created following redemption of Preference Share capital and the bonus issue of shares.

7. SHARE-BASED PAYMENTS

The Company's share-based payments are as those detailed in note 37 to the Group financial statements, however the total share-based payment expense has been dispersed to other Group undertakings (2005: £nil).

8. INITIAL PUBLIC OFFERING

On 15 February 2006 the Company listed on the London Stock Exchange. The transactions relating to the Company's IPO are analysed in note 45 to the Group financial statements.

9. OTHER INFORMATION

The Company had no employees during the year. Directors emoluments, excluding Company pension contributions were £2.1m (2005: £1.7m). These emoluments were all in relation to services provided on behalf of the QinetiQ Group with no amount specifically relating to their work for the Company.

The remuneration of the Company's auditors for the year to 31 March 2006 was £5,000 (2005: £5,000).

FOUR-YEAR REVIEW

FOR THE YEAR ENDED 31 MARCH

	UK GAAP		IFRS	
	2003 £m	2004 £m	2005 £m	2006 £m
Defence & Technology	631.4	657.7	664.9	669.6
Security & Dual Use	128.8	134.5	120.9	133.7
QinetiQ North America	1.6	0.3	70.1	248.4
Central	13.1	2.9	—	—
TURNOVER	774.9	795.4	855.9	1,051.7
Defence & Technology	48.8	50.7	51.3	56.5
Security & Dual Use	(12.2)	2.0	23.0	9.7
QinetiQ North America	(5.6)	(0.6)	8.0	24.5
Central	4.7	2.0	—	—
OPERATING PROFIT BEFORE AMORTISATION AND IMPAIRMENT OF INTANGIBLES ARISING FROM ACQUISITIONS, RESTRUCTURING COSTS AND IPO COSTS	35.7	54.1	82.3	90.7
Operating profit margin before amortisation and impairment of intangibles, restructuring costs and IPO costs	4.6%	6.8%	9.6%	8.6%
Profit before tax	10.7	51.3	78.0	72.5
Profit after tax	7.1	41.2	72.3	60.4
Average number of employees	9,384	8,898	9,632	11,024
Cash flow from operations	(4.4)	142.7	36.9	107.6
Free cash flow	(33.1)	135.9	55.7	141.3
Net debt	133.2	3.6	176.6	233.0

The combined and consolidated financial information has been prepared as set out below to show the results and financial position of the Company as if it has existed as a discrete operation from 1 April 2002:

- for the year ended 31 March 2003, the consolidated financial statements of QinetiQ Holdings Limited for the period from 1 April 2002 to 28 February 2003 aggregated with the consolidated financial statements of QinetiQ Group plc for the period to 31 March 2003; and
- for the years ended 31 March 2004 and 31 March 2005, the consolidated financial statements of QinetiQ Group plc.

The capital structure of the Group and its interest charges and goodwill amortisation up to 28 February 2003 are significantly different from those that have existed since the acquisition of QinetiQ Holdings Limited by QinetiQ Group plc on 28 February 2003.

Note 46 to the Group financial statements details the principal differences between UK GAAP and IFRS relevant to the Group's financial statements.

GLOSSARY

AGM	– Annual General Meeting	LCD	– Liquid Crystal Display
Backlog	– <i>the expected future value of turnover from contractually-committed and funded customer orders (excluding £5.0bn value of remaining 22 years of LTPA contract)</i>	LSE	– London Stock Exchange
Bn	– billion	LTPA	– Long Term Partnering Agreement – 25-year contract established in 2003 to manage the MOD's test and evaluation ranges
Book to bill ratio	– ratio of orders in year to turnover in year	m	– million
BPS	– Basis points	MOD	– Ministry of Defence
CATS	– Combined Aerial Target Service	Non-recurring items and acquisition amortisation	– IPO costs, major restructuring costs, disposals of property, plant and equipment, amortisation of intangible assets arising from acquisitions and impairment of goodwill and current assets (2005 only)
COTS	– Commercial off the Shelf	OEM	– Original Equipment Manufacturer
CR	– Corporate Responsibility	OSEC	– Ocean Systems Engineering Corporation
D&T	– QinetiQ's Defence & Technology Sector	QNA	– QinetiQ's North America Sector
DARPA	– US Defense Advanced Research Projects Agency	R&D	– Research and development
DDA	– Defence Diversification Agency	S&DU	– QinetiQ's Security & Dual Use Sector
DERA	– Defence Evaluation and Research Agency, a QinetiQ predecessor organisation	SETA	– Systems Engineering and Technology Assistance
DHS	– US Department of Homeland Security	UK GAAP	– UK Generally Accepted Accounting Principles
DoD	– US Department of Defense	Underlying effective tax rate	– the tax charge for the year excluding the tax impact of non-recurring items and acquisition amortisation expressed as a percentage of underlying profit before tax
DRA	– Defence Research Agency, a QinetiQ predecessor organisation	Underlying operating cash conversion	– the ratio of cash flow from operations (excluding cash spend on major restructuring items), less cash outflows on the purchase of intangible assets and property, plant and equipment and before additional pension contributions to underlying operating profit excluding share of post-tax loss of equity accounted joint ventures and associates
DTI	– Department of Trade and Industry	Underlying operating margin	– underlying operating profit expressed as a percentage of turnover
DTR	– MOD's Defence Training Rationalisation Programme	Underlying operating profit	– earnings before interest, tax and sale of investment in equity accounted associate in 2005 (excluding IPO costs, major restructuring costs, property, plant and equipment disposals, amortisation of intangible assets arising on acquisitions)
EBITDA	– earnings before interest, tax, depreciation and amortisation	Underlying profit before tax	– profit before tax excluding IPO costs, major restructuring costs, property, plant and equipment disposals, sale of interest in equity accounted associate, amortisation of intangible assets arising from acquisitions and impairment of goodwill and current asset investments and including 2005 preference share dividend
ESA	– European Space Agency		
EU	– European Union		
FCS	– Future Combat System		
Free cash flow	– net cash flow from operating activities less the net cash flow from the purchase of intangible assets and the purchase and sale of plant, property and equipment		
FRES	– Future Rapid Effect System		
GPS	– Global Positioning System		
IAS	– International Accounting Standard		
IFRS	– International Financial Reporting Standard		
IP	– Intellectual property		
IPO	– Initial Public Offering		

FINANCIAL CALENDAR

28 JULY 2006	ANNUAL GENERAL MEETING
2 AUGUST 2006	EX-DIVIDEND DATE
23 AUGUST 2006	FINAL ORDINARY DIVIDEND PAYABLE
30 SEPTEMBER 2006	INTERIM FINANCIAL PERIOD END
30 NOVEMBER 2006	INTERIM RESULTS ANNOUNCEMENT
31 MARCH 2007	FINANCIAL YEAR END
MAY 2007	PRELIMINARY RESULTS ANNOUNCEMENT

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