

Chairman's Report

2469592

I am pleased to report to our shareholders another year of substantial progress for Xaar. Important commercial and technical milestones have been met, and a successful private placing of shares raised approximately £4 million net of expenses in July 1996.

Financial Results

Revenue for the year was £2.48 million (1995 - £3.25 million) producing a loss before tax of £510,000 (1995 - £377,000 profit before tax). These figures reflect licence fees close to plan but a delay in the commencement of royalty income. Two more major licensing agreements with international corporations were completed, bringing the total number to eight. Although at modest levels, I am pleased to report the first royalty revenues from two of our existing licensees.

The Company had cash balances of just under £5.6 million at 31 December 1996.

Technology Developments

The research and development team has successfully completed trials of its first wide printhead, for which they are to be congratulated. During 1997 these printheads will be further developed for a range of colour and greyscale applications.

Development work involves close co-operation with strategic partners. Continuing collaboration with Zeneca has resulted in new ink formulations, suitable for printing on a variety of materials, and a joint development agreed with NEC, which will result in driver chips for the next generation of greyscale printheads, is progressing smoothly.

Future Prospects

1997 holds as many opportunities and challenges as 1996 and, we expect, will be another exciting year for Xaar. A number of further licences are in the early stages of negotiation and we hope to add to our list of licensees in 1997. We are also anticipating further licensee product launches in 1997, which should lead to growth in the royalty stream.

Plans are well underway for a printhead sales operation which will focus its marketing strategy on niche commercial and industrial applications where we believe the demands of speed and quality will be satisfied by Xaar technology. To resource this and an expanded development team, we expect the company to grow from just over 50 to about 70 people.

Commensurate with the development of the business, we are continuing with our plans to seek a listing on a recognised stock exchange.

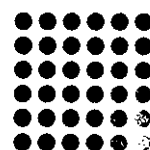
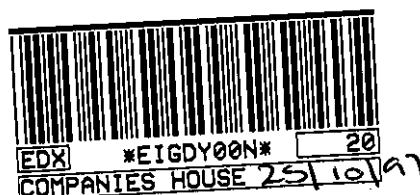
People

I would like to thank Graham Wylie, his executive team, and all the staff for their hard work over the last year. Xaar is a company which always impresses with its dedication and enthusiasm, in no small part the result of its leadership.

Jonathan Lowe joined as Finance Director in November 1996, further strengthening the executive team, and Arie Rosenfeld joined the Board as a non-executive director in February 1997. Having spent much of his career with Scitex Corporation, latterly as President and CEO, Arie brings wide knowledge and experience of a global player in the high technology end of the printing industry. I welcome them both and look forward to their contribution to Xaar's further development.



Robert Hook
Chairman



Xaar Limited Director's Report

The directors present their annual report on the affairs of the company together with the financial statements and auditors' report for the year ended 31 December 1996.

Principal activity and business review

The principal activity of the company continues to be the development and commercial exploitation of a patented ink jet printing technology. The directors are of the opinion that turnover will increase and that retained earnings will improve in the next year.

Research and development

The majority of the company's employees are involved in research and development and most of its operating costs relate to this function.

Results and dividends

Turnover for the year was £2,477,833 (1995 - £3,250,498) and principally comprises licence fees, the sale of evaluation kits and technical consultancy fees. The retained loss for the year was £726,885 (1995 - profit £135,093). As the company has an accumulated deficit, it has no reserves available for dividend distribution.

Directors and their interests

The directors who served during the year were as follows:

Dr. R C Hook (Non-executive Chairman)

G T Wylie (Managing Director)

S Temple (Technical Director)

M R Shepherd (Business Development Director)

J A Lowe (Finance Director appointed 14 November 1996)

R A King (Non-executive)

M J Geary (Non-executive appointed 14 November 1996)

Euroventures (UK) BV (Resigned 14 November 1996)

C A J Taysom (Resigned 4 June 1996)

A Rosenfeld was appointed a non-executive director on 11 February 1997.

The directors who held office at 31 December 1996 had no interests, other than those shown below, in the shares of the company.

Director	Class of Share	31 December 1996	31 December 1995
G T Wylie	£1 A ordinary shares	12,284	11,242
S Temple	£1 A ordinary shares	10,514	9,680
M R Shepherd	£1 A ordinary shares	6,939	6,314
R A King	£1 A ordinary shares	5,873	4,831

Details of options held by directors can be found in note 12 of the financial statements.

Directors' responsibilities

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss of the company for the period. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Supplier Payment Policy

The company's policy is to settle terms of payment with suppliers when agreeing the terms of each transaction, ensure that suppliers are made aware of the terms of payment and abide by the terms of payment.

Auditors

The directors will place a resolution before the Annual General Meeting to reappoint Arthur Andersen as auditors for the ensuing year.

Science Park
Cambridge
CB4 4FD

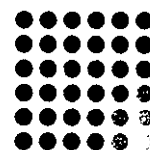
By order of the Board

18 March 1997



W Hepburn
Secretary

Registered no. 2469592



Xaar Limited Auditor's Report

To the Shareholders of Xaar Limited:

We have audited the financial statements on pages 5 to 13 which have been prepared under the historical cost convention and the accounting policies set out on page 8.

Respective responsibilities of directors and auditors

As described on page 3, the company's directors are responsible for the preparation of the financial statements.

It is our responsibility to form an independent opinion, based on our audit, of those statements and to report our opinion to you.

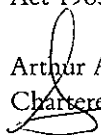
Basis of opinion

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

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

Opinion

In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 1996 and of its loss and cash flows for the year then ended and have been properly prepared in accordance with the Companies Act 1985.


Arthur Andersen

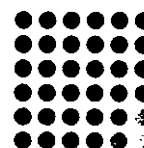
Chartered Accountants and Registered Auditors

Betjeman House
104 Hills Road
Cambridge
CB2 1LH

18 March 1997

Xaar Limited Profit and loss account

For the year ended 31 December 1996	Notes	1996 £	1995 £
Turnover	2	2,477,833	3,250,498
Operating expenses (net)		<u>(3,096,787)</u>	<u>(2,911,259)</u>
Operating (loss)/profit		(618,954)	339,239
Investment income	3	159,717	74,566
Interest payable and similar charges	4	<u>(50,648)</u>	<u>(36,123)</u>
(Loss)/profit on ordinary activities before taxation	5	(509,885)	377,682
Tax on (loss)/profit on ordinary activities	7	<u>(217,000)</u>	<u>(242,589)</u>
Retained (loss)/ profit for the year		(726,885)	135,093
Accumulated deficit, beginning of year		(1,739,419)	(1,874,512)
Accumulated deficit, end of year		<u>(2,466,304)</u>	<u>(1,739,419)</u>



There were no recognised gains and losses except for the retained loss for the year and therefore no statement of total recognised gains and losses has been provided.

A statement of movements on reserves is given in note 13.

The accompanying notes are an integral part of this statement.

Xaar Limited Balance sheet

31 December 1996	Notes	1996 £	1995 £
Fixed assets			
Tangible assets	8a	1,110,612	970,902
Investments	8b	10,727	10,727
		<u>1,121,339</u>	<u>981,629</u>
Current assets			
Debtors	9	134,831	2,106,877
Cash at bank and in hand		5,574,885	528,348
		<u>5,709,716</u>	<u>2,635,225</u>
Creditors: Amounts falling due within one year	10	(901,887)	(943,700)
Net current assets		<u>4,807,829</u>	<u>1,691,525</u>
Total assets less current liabilities		5,929,168	2,673,154
Creditors: Amounts falling due after more than one year	11	(269,029)	(185,514)
Net assets		<u>5,660,139</u>	<u>2,487,640</u>
Capital and reserves			
Called-up share capital	12	3,985,053	3,119,953
Share premium account	13	4,141,390	1,107,106
Profit and loss account	13	(2,466,304)	(1,739,419)
Shareholders' funds - all equity		<u>5,660,139</u>	<u>2,487,640</u>

Signed on behalf of the Board

G T Wylie
Managing Director

J A Lowe
Finance Director

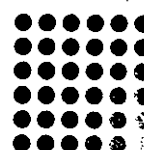
18 March 1997

The accompanying notes are an integral part of this statement.

Xaar Limited Cash flow statement

For the year ended 31 December 1996	Notes	1996 £	1995 £
Net cash inflow from operating activities	15	<u>1,559,058</u>	<u>370,446</u>
Returns on investments and servicing of finance			
Interest received		159,717	74,566
Interest paid		(25,947)	(22,822)
Interest element of finance lease rentals		<u>(24,701)</u>	<u>(13,301)</u>
Net cash inflow from returns on investment and servicing of finance		<u>109,069</u>	<u>38,443</u>
Taxation			
Overseas withholding tax paid		<u>(217,000)</u>	<u>(277,555)</u>
Investing activities			
Purchase of tangible fixed assets		(197,196)	(177,303)
Sale of tangible fixed assets		9,025	25,695
Net cash outflow from investing activities		<u>(188,171)</u>	<u>(151,608)</u>
Net cash inflow/(outflow) before financing		<u>1,262,956</u>	<u>(20,274)</u>
Financing			
Issue of ordinary share capital		3,899,384	-
Capital element of finance lease rental payments	16	(115,803)	(101,106)
		<u>3,783,581</u>	<u>(101,106)</u>
Increase/(Decrease) in cash and cash equivalents	17	<u>5,046,537</u>	<u>(121,380)</u>

The accompanying notes are an integral part of this statement.



1. Accounting policies

The principal accounting policies, all of which have been applied consistently throughout the year and with the prior year are set out below:

a) Basis of accounting

The financial statements are prepared under the historical cost convention and in accordance with applicable accounting standards.

b) Tangible fixed assets

All fixed assets are shown at original historical cost net of depreciation.

Depreciation is provided at rates calculated to write off the cost, less estimated residual value, of each asset on a straight-line basis over its estimated useful life, as follows:

Improvements to leasehold property	The term of the lease
Plant and machinery, furniture and fittings	3 - 5 years
Motor vehicles	3 years

c) Investments

Fixed asset investments are shown at cost less any amounts written off representing a permanent diminution in value.

d) Foreign currency

Transactions denominated in foreign currencies are recorded in the local currency at actual exchange rates as of the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the year end are reported at the rates of exchange prevailing at the year end. Gains or losses arising from a change in exchange rates subsequent to the date of the transactions are included as exchange gains or losses in the profit and loss account.

e) Research and development

Research and development costs including the costs associated with the acquisition, registration and development of patents and know-how are written off to the profit and loss account as incurred.

f) Pension costs

Amounts charged in the profit and loss account comprise employer's contributions payable to the company's defined contribution pension scheme in respect of pensionable payroll costs for the accounting period.

g) Turnover

Turnover, all of which arises from continuing activities, comprises licence fees receivable under agreements (gross of any tax withheld), royalties receivable, sales of evaluation kits to potential licensees and project consultancy fees.

h) Leases

Assets held under finance leases are initially reported at the fair value of the asset with an equivalent liability categorised as appropriate under creditors due within or after one year. The asset is depreciated over the shorter of the lease term and its useful economic life. Finance charges are allocated to accounting periods over the period of the lease to produce a constant rate of charge on the outstanding balance. Rentals are apportioned between finance charges and reduction of the liability, and allocated to operating expenses.

Rentals under operating leases are charged on a straight-line basis over the lease term, even if the payments are not made on such a basis. Further information on charges in the year and future commitments is given in note 18b.

i) Taxation

Corporation tax payable is provided on taxable profits at the current rate.

Foreign tax payable in the year is written off, except when recoverability against corporation tax payable is considered to be reasonably assured.

Deferred taxation (which arises from differences in the timing of the recognition of items, principally depreciation, in the accounts and by the tax authorities) is calculated on the liability method. Deferred tax is provided on timing differences, which will probably reverse at the rates of tax likely to be in force at the time of reversal. Deferred tax is not provided on timing differences which, in the opinion of the directors, will probably not reverse.

2. Segment information

The analysis of turnover by geographical market and by activity has been omitted.

Xaar Limited Notes to financial statements (continued)

3. Investment income	1996 £	1995 £
Income from short term deposits	<u>159,717</u>	<u>74,566</u>

4. Interest payable and similar charges	1996 £	1995 £
On bank loans and overdrafts:		
- repayable within five years, not by instalments	4,095	42
Finance lease interest	24,701	13,301
On all other loans	21,852	22,780
	<u>50,648</u>	<u>36,123</u>

5. (Loss)/profit on ordinary activities before taxation	1996 £	1995 £
The (loss)/profit on ordinary activities before taxation is stated after charging:		
Auditors' remuneration		
- audit	8,000	7,650
- non audit	21,848	10,030
Depreciation		
- on assets owned	255,430	190,103
- on assets held under finance leases	82,662	56,123
Staff costs (see note 6)	1,358,469	1,314,837
Hire of fixtures and fittings and lease of premises under operating leases	<u>128,515</u>	<u>127,321</u>

6. Staff costs	1996 £	1995 £
Particulars of employees (including executive directors) are shown below:		
Employee costs during the year amounted to:		
Wages and salaries	1,158,098	1,110,175
Social security costs	115,293	110,813
Other pension costs	85,078	93,849
	<u>1,358,469</u>	<u>1,314,837</u>

The average monthly number of persons employed by the company was as follows:

	1996 Number	1995 Number
Research and development	32	32
Sales and marketing	6	3
Administration	7	8
	<u>45</u>	<u>43</u>

Directors' remuneration

Remuneration was paid in respect of directors of the company as follows:

	1996 £	1995 £
Directors' emoluments (including pension contributions)	309,125	340,872
Fees to third parties in respect of directors' services	46,100	37,775
Compensation for loss of office	-	7,664
	<u>355,225</u>	<u>386,311</u>

The above figures for emoluments do not include any amount for the value of directors' share options since the directors have concluded that it is impractical to estimate the value of such options with reasonable certainty.

Details of the options are given in note 12.

Xaar Limited Notes to financial statements (continued)

6 Staff costs (continued)

The directors' remuneration shown above (excluding pension contributions) included:

	1996 £	1995 £
Chairman	20,300	25,660
Highest paid director	97,881	98,334

Directors received emoluments (excluding pensions and pensions contributions) in the following ranges:

	1996 Number	1995 Number
£0 to £3,000	-	1
£3,001 to £10,000	-	1
£10,001 to £15,000	3	2
£15,001 to £25,000	1	1
£25,001 to £45,000	1	-
£45,001 to £65,000	1	2
£65,001 to £75,000	1	1
£75,001 to £100,000	1	1
	8	9

7. Tax on (loss)/profit on ordinary activities

The tax charge is based on the (loss)/profit for the year and comprises:

	1996 £	1995 £
Foreign withholding taxation	217,000	277,555
Over-provision for corporation tax in respect of prior years	-	(34,966)
	217,000	242,589

No deferred tax has been provided due to the availability of tax losses carried forward of approximately £2,000,000 (1995 £1,400,000).

8a. Tangible fixed assets

The movement in the year was as follows:

	Leasehold Property £	Plant & Machinery £	Furniture & Fittings £	Motor Vehicles £	Total £
Cost					
At 31 December 1995	166,910	1,211,102	102,565	139,284	1,619,861
Additions	-	356,580	35,636	85,586	477,802
Disposals	-	-	-	(38,823)	(38,823)
At 31 December 1996	166,910	1,567,682	138,201	186,047	2,058,840
Depreciation					
At 31 December 1995	78,935	433,796	60,465	75,763	648,959
Charge for the year	45,570	244,400	18,378	29,744	338,092
Disposals	-	-	-	(38,823)	(38,823)
At 31 December 1996	124,505	678,196	78,843	66,684	948,228
Net book value					
At 31 December 1996	42,405	889,486	59,358	119,363	1,110,612
At 31 December 1995	87,975	777,306	42,100	63,521	970,902
Leased assets included in the above					
Net book value 1996	-	472,384	-	67,605	539,989
Net book value 1995	-	284,838	-	63,521	348,359

Xaar Limited Notes to financial statements (continued)

8b. Investment in own shares.

An Employee Benefit Trust was established in 1995 to hold shares for the benefit of the employees of the company. Xaar Trustee Limited was formed during 1995 to act as trustee to the Trust. At 31 December 1996 there were 7,150 A ordinary shares (1995 - 7150) held as nominee by Xaar Trustee Limited at a cost of £1.50 per share.

9. Debtors

The following are included in the net book value of debtors and fall due within one year:

	1996	1995
	£	£
Trade debtors	28,362	2,031,556
VAT	17,726	16,700
Other debtors	19,400	12,166
Prepayments	69,343	46,455
	<u>134,831</u>	<u>2,106,877</u>

10. Creditors: Amounts falling due within one year

	1996	1995
	£	£
Convertible unsecured loan stock	390,376	401,808
Obligations under finance leases and HP contracts	190,246	108,958
Trade creditors	206,359	233,498
Social security and PAYE	61,564	30,151
Amount due to pension scheme	11,472	8,715
Accruals	41,870	160,570
	<u>901,887</u>	<u>943,700</u>

The convertible unsecured loan stock has interest compounded annually on 6 March and is denominated in US dollars. The figure shown above is the principal amount (US\$ 454,545) plus interest accrued to 31 December 1996 (US \$202,262) converted to sterling at the prevailing exchange rate on 31 December 1996. Conversion to 'B' ordinary shares may take place at the option of the loan stock holder. The conversion price shall be the higher of the par value of an 'A' ordinary share and an amount equal to the fair value of an 'A' ordinary share at the conversion rate.

11. Creditors: Amounts falling due after more than one year

The following amounts are included in creditors falling due after more than one year:

	1996	1995
	£	£
Obligations under finance leases and HP contracts, due within 2 to 5 years	<u>269,029</u>	<u>185,514</u>

12. Called-up share capital

	1996	1995
	£	£
Authorised:		
'A' Ordinary shares of £1 each	4,847,072	3,581,656
'B' Ordinary shares of £1 each	285,000	213,866
Cumulative redeemable preference shares of £1 each	430,000	330,033
	<u>5,562,072</u>	<u>4,125,555</u>
Allotted, called-up and fully paid:		
'A' Ordinary shares of £1 each	3,965,858	3,100,758
'B' Ordinary shares of £1 each	19,195	19,195
	<u>3,985,053</u>	<u>3,119,953</u>

In July 1996 the company allotted 865,000 'A' Ordinary Shares with a nominal value of £865,000 and at a premium of £3,287,000 pursuant to a private placing.

Xaar Limited Notes to financial statements (continued)

12. Called-up share capital (continued)

Options have been granted to certain employees to subscribe for 'A' ordinary shares of £1 each. At 31 December 1996 a total of 510,269 options were outstanding and exercisable on the following terms:

	At 1/1/96	No of options granted	No of options exercised	No of options lapsed	At 31/12/96	Option price £
Directors						
G T Wylie	20,000	-	-	-	20,000	£1.00
	78,859	70,000	-	-	148,859	£1.50
S Temple	20,000	-	-	-	20,000	£1.00
	53,428	17,000	-	-	70,428	£1.50
M R Shepherd	10,000	-	-	-	10,000	£1.00
	44,777	12,000	-	-	56,777	£1.50
R A King	20,000	-	-	-	20,000	£1.00
	10,985	-	-	-	10,985	£1.50
Employees	10,000	-	-	-	10,000	£1.00
	171,172	-	(100)	(27,852)	143,220	£1.50
	<u>439,221</u>	<u>99,000</u>	<u>(100)</u>	<u>(27,852)</u>	<u>510,269</u>	

Options are exercisable between three and ten years after the date of grant in the case of options at £1.00 and between three and seven years for those granted at £1.50.

On 28 January 1997 R A King exercised 20,000 options at £1 and 1,099 options at £1.50. In February 1997 a further 133,511 options were granted, of which 50,000 were to A Rosenfeld and 40,000 were to J A Lowe. The Board has also approved a further 60,000 options which will be granted in the course of 1997; of these 50,000 will be granted to A Rosenfeld and 10,000 to J A Lowe.

13. Reserves

The movement on reserves for the year is as follows:

	Share premium account £	Profit & loss account £	Total £
At 1 January 1996	1,107,106	(1,739,419)	(632,313)
Retained loss for the year	-	(726,885)	(726,885)
Share issues	3,287,050	-	3,287,050
Cost of share issue	(252,766)	-	(252,766)
At 31 December 1996	<u>4,141,390</u>	<u>(2,466,304)</u>	<u>1,675,086</u>

The share premium account is not distributable.

14. Reconciliation of movements in shareholders' funds

	1996 £	1995 £
Retained (loss)/profit for the year	(726,885)	135,093
Opening shareholders' funds	2,487,640	2,352,547
New shares issued (net of costs)	3,899,384	-
Closing shareholders' funds	<u>5,660,139</u>	<u>2,487,640</u>

15. Reconciliation of operating (loss)/profit to net cash inflow from operating activities

	1996 £	1995 £
Operating (loss)/profit	(618,954)	339,239
Depreciation charge	338,092	246,226
(Profit)/loss on disposal of tangible fixed assets	(9,025)	465
Investment in own shares	-	(10,727)
Decrease/(increase) in debtors	1,972,046	(109,027)
Decrease in creditors	(123,101)	(45,730)
Decrease in provisions for liabilities and charges	-	(50,000)
Net cash inflow from operating activities	<u>1,559,058</u>	<u>370,446</u>

Xaar Limited Notes to financial statements (continued)

16. Analysis of changes in financing during the year

	Share capital & share premium		Finance lease obligations	
	1996 £	1995 £	1996 £	1995 £
At 1 January	4,227,059	4,227,059	294,472	68,721
Net cash inflow from financing	3,899,384	-	-	-
Capital repayments of finance leases	-	-	(115,803)	(101,106)
Inception of finance lease contracts	-	-	280,606	326,857
At 31 December	<u>8,126,443</u>	<u>4,227,059</u>	<u>459,275</u>	<u>294,472</u>

17. Analysis of changes in cash and cash equivalents during the year

	1996 £	1995 £
At 1 January	528,348	649,728
Net cash inflow/(outflow)	5,046,537	(121,380)
At 31 December	<u>5,574,885</u>	<u>528,348</u>

18. Guarantees and other financial commitments

a) Capital commitments

At the end of the year, capital commitments were:

	1996 £	1995 £
Contracted for but not provided for	<u>76,000</u>	<u>-</u>

b) Lease commitments

The company has entered into non-cancellable leases in respect of fixtures and fittings, the payments for which extend over a period of up to 3 years. The total rental for the year was £8,515 (1995 £7,321).

In addition, the company leases land and buildings. The rental for the year was £120,000 (1995 £120,000). The earliest expiry date is 25 December 1997.

The minimum annual rentals under the foregoing leases are as follows:

	Property		Fixtures & fittings	
	1996 £	1995 £	1996 £	1995 £
Operating leases which expire:				
- within 1 year	120,000	-	1,909	-
- within 2 - 5 years	<u>-</u>	<u>120,000</u>	<u>6,606</u>	<u>7,321</u>