QinetiQ

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FROM SCIENCE TO SOLUTIONS

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ANNUAL REPORT AND ACCOUNTS 2005

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QinetiQ is one of the world's leading defence technology and security companies. In today's world the challenges faced by governments to detect, identify and respond to both defence and homeland security threats requires the most advanced technical capabilities science can offer.

QinetiQ is the world's first top flight national defence laboratory to transition to the private sector. It gives customers access to the output of 50 years of national investment at the forefront of technology. QinetiQ has developed rapidly into a commercial organisation present in the UK and North America with a breadth and depth of innovative technologies, services, customers, contracts and geographies.

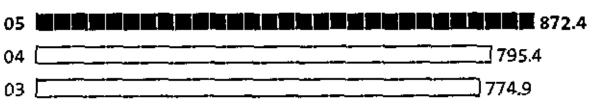
Our technology plays an important role in enabling more effective and efficient use to be made of existing manpower and platforms in a world where agility, flexibility and adaptability have become the watchwords of defence and security provision.

From integrating legacy weapons systems with state-of-the-art sensors and software for the British MOD, to fielding advanced robotic systems for the US Department of Defense; providing port security products for the US Department of Homeland Security, or designing advanced security systems for many of the City's computer systems, QinetiQ is committed to delivering Brilliant Solutions to Important Problems.

FINANCIAL HIGHLIGHTS

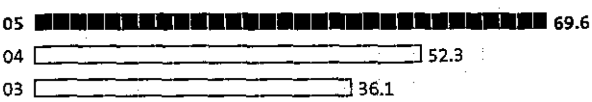
- Turnover increase of 9.7% to £872.4m (2004: £795.4m)
- Two US acquisitions completed and integrated successfully
- Continued improvement in operating margin* to 8.0% (2004: 6.6%)
- Cash generation remains a real strength of the business, with a cash inflow before financing acquisitions, disposal of businesses and dividends paid of £68.2m (2004: £131.2m) despite an increase of £40m in short-term MOD-related working capital

Turnover (£m)



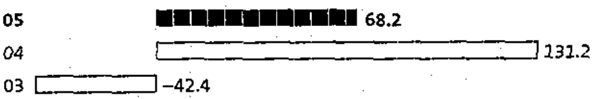
£77.0m (9.7%) increase

Operating profit before exceptional items, amortisation and impairment (£m)



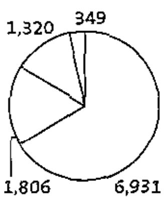
£17.3m (33.1%) increase

Cash flow before financing acquisitions, disposals of businesses and dividends paid (£m)

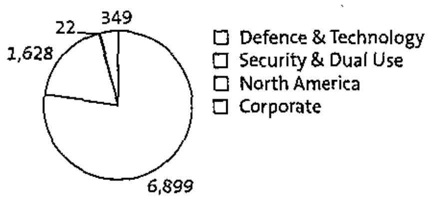


£63.0m decrease

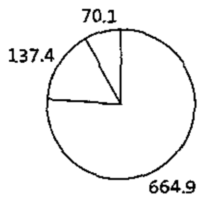
Headcount 2005



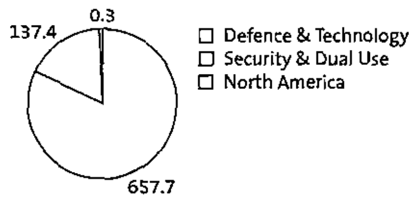
Headcount 2004



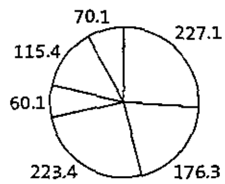
Turnover by Sector 2005 (£m)



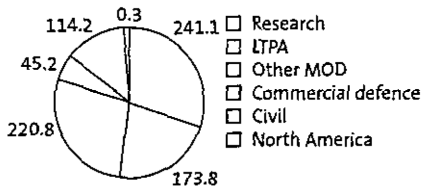
Turnover by Sector 2004 (£m)



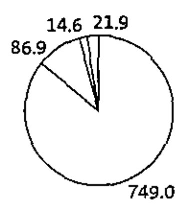
Turnover by channel 2005 (£m)



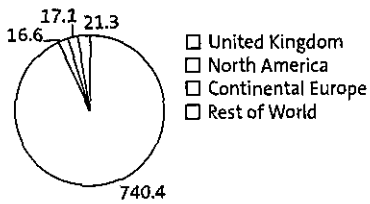
Turnover by channel 2004 (£m)



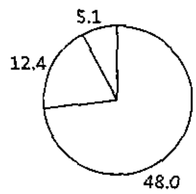
Turnover by geographic market 2005 (£m)



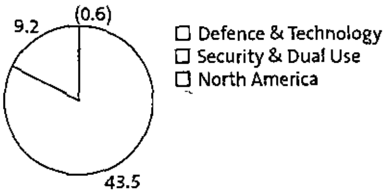
Turnover by geographic market 2004 (£m)



Sector operating profit* before exceptionals 2005 (£m)



Sector operating profit* before exceptionals 2004 (£m)



*Operating profit before exceptionals and intangible amortisation and impairment as a percentage of group turnover.

QINETIQ AT A GLANCE

SECTOR

SUCCESSES

DEFENCE & TECHNOLOGY

Andrew Sleigh
Managing Director
Defence &
Technology Sector

"We sit at the heart of innovation in defence, supporting customers across the UK MOD and the defence industry. We are well matched to today's defence priorities of agility, flexibility and adaptability."

- Research: QinetiQ continues its heritage as the MOD's premier supplier of critical technology research and has created a significant inventory of world-class technology.
- QinetiQ benefits from the MOD's 25-year £5.6bn Long Term Partnering Agreement to supply, test and evaluate and provide support services.
- Procurement support: QinetiQ delivers a growing amount of the DPA's annual needs in providing independent support to defence equipment projects.
- Commercial: QinetiQ has developed a new market injecting knowledge and technology into the UK defence equipment supply chain.

– assembling advanced technology mast for HMS Ark Royal (p10)

– researching inflatable technology to cross obstacles on the battlefield (p14)

SECURITY & DUAL USE

Hal Kruth
Managing Director
Security & Dual
Use Sector

"The Security & Dual Use sector draws from the Company's significant inventory of intellectual property and world-leading technology, leveraging these assets into high growth, non-defence adjacent markets."

- QinetiQ possesses leading technology products in the high growth security and counter-terrorism markets.
- We are one of Europe's foremost technology providers to the space industry.
- We have developed our technology into leading commercial products with multiple routes to market.
- We leverage our technology through licensing agreements and the creation of focused partnerships and joint venture businesses.

– development of National X-ray Certification Test to monitor and train security screeners (p18)

NORTH AMERICA

Graham Love
CEO
North America Sector

"We have continued to progress our strategic plan of building a complementary platform and culture in North America and are rapidly becoming a leading independent defence technology and security company in the highest growth region."

- The world's largest market for QinetiQ's core offerings.
- Three-legged approach to the market, closely aligned to traditional skills and seeking cross-selling opportunities:
  - technology: similar to heritage research competencies
  - systems engineering: similar to UK MOD advisory work
  - Federal IT services: extending QinetiQ's world-class capabilities.

– TALON™ robots remove operators from danger in a number of situations, including Explosive Ordnance Disposal (p22)

CAPABILITIES

MOD Research
Playing a key role in the defence supply chain by using research to prove the ability of technology to meet defence requirements in both the short and long term.

Long Term Partnering Agreement
QinetiQ continues to provide test and evaluation services to the MOD across more than 20 range sites, meeting the requirements of the contract.

Other MOD
Providing acquisition support to integrated project teams in the Defence Procurement Agency (DPA) and the Defence Logistics Organisation (DLO), parts of the MOD.

Commercial Defence and Civil
Providing independent technology solutions to defence and security problems, exploiting advances in research.

Transport Security
Using advanced technology to enhance security for airports, ports and the transport industry.

Security & Intelligence
One of the leading organisations in information assurance and security technology exploiting key offerings to become a leader in international security matters.

Business Security
Delivering both physical and digital security services, creating fully integrated solutions.

National Security & Resilience
Contingency planning including business continuity, crisis management and exercising and training continuity teams.

Space
A UK leader in electric propulsion and high altitude unmanned aerial vehicles. Advanced technology in spacecraft payloads, mission design and data exploitation.

Technology & Products
Promoting the value of scientific research to key customers and translating results into commercial solutions.

Managed Services
Bringing together QinetiQ's expertise in facilities and asset management to expand in specialist managed services areas.

Technology
Provision of leading-edge technology services to the US defence market from our US and UK capabilities.

- Foster-Miller Inc. (FMI)
- QinetiQ Inc.
- QinetiQ Technology Extension Corporation

Systems Engineering
Systems Engineering and Technical Assistance (SETA) companies in the US support defence and security customers.

- Westar Aerospace & Defense Group (Westar)

Dame Pauline Neville-Jones
Chairman

CHAIRMAN'S STATEMENT

This has been a landmark year for QinetiQ, registering solid growth, increased profitability and positive cash flow from operating activities. We have made strides towards our strategic goals of maintaining our strong relationship with the UK MOD, growing our commercial defence business, establishing a substantial presence in the United States (US) – the world's largest defence market – and leveraging our technology and expertise into the non-defence arena. Successful commercialisation of our technology in new defence and related security and dual use markets has accelerated. The purchase and integration of two thriving defence companies in the US, Foster-Miller and Westar, has diversified QinetiQ's earnings base, provided a scale entry point into, and contributed to significant growth in, the critical American market. It has also laid the base for QinetiQ's long-term development as a global solutions company with a continuing focus on defence and security but also with significant business in civilian applications. QinetiQ is realising its huge potential and our brand is achieving recognition.

QinetiQ's unique position
The incoming government has recommitted to maintain Britain's position as a world leader in defence technology. In the debate on the Queen's Speech, Lord Drayson, Minister of State for Procurement in the MOD, said: "Our defence scientists and engineers are at the cutting edge of research in order to provide the best kit for our armed forces". In his address to the CBI Annual Conference this year, the Chancellor of the Exchequer proposed that industry and government should form a partnership to agree on long-term investment in British science and technology, asserting that, in an open global economy, the greatest added value in society comes from innovation which is a driver of economic growth. As I set out in my statement last year, QinetiQ shares this vision, which is central to our strategy as a company.

As a provider of technology solutions to problems in both the defence and civilian spheres, QinetiQ is uniquely placed to contribute to the realisation of both national priorities. In our view, defence Research and Development (R&D), in which continuing government investment is vital, will remain an important component of technological advance with significant benefits to the economy as a whole. The funded research QinetiQ does for the MOD lies at the core of our business model. Its global quality is demonstrated by the progress we have made in the last year in winning research contracts with the US Government Defense Advanced Research Projects Agency (DARPA). To disseminate QinetiQ-owned technologies derived from defence research more effectively into the wider economy, we have developed processes to fast-track them to market, thus releasing value more rapidly into the economy as a whole. Defence partners are also engaging us to help commercialise their own technologies and we believe that others will follow suit.

Many of the important problems we are asked to solve are of direct interest to government, business and society now and in the future: the development of waste management systems; improved cancer diagnosis methods; enhanced safety mechanisms in cars; advanced security for air travellers are but a few examples. We will work to ensure that the research bedrock on which our technologies are based continues to be resourced.

Past year
This past year, the defence and security markets have confirmed their strengths in the UK and the US. We have capitalised on this. In Britain,

our technological expertise is increasingly sought by the Defence Procurement Agency (DPA) and the Defence Logistics Organisation (DLO) of the MOD, while our commercial defence business has grown by a third. In the US, the Department of Defense (DoD) is now the Group's second largest customer – testimony to the strategic importance of our US acquisitions. The market for security technology is maturing globally, with increasing emphasis on threat analysis and the appropriate application of technology, both of which are among QinetiQ's core strengths. We have made progress in focusing our ability to exploit our intellectual property to win business in non-defence sectors, better understanding these markets, developing techniques to exploit them and building important long-term relationships.

Improving performance
We continue to focus on improving our financial and operational performance. We have simplified the structure of our business to focus on the three main markets of defence, security and civil applications, and the US. We have further developed our corporate governance structures to ensure compliance with the Combined Code. During the course of the year, Richard Gillingwater, Head of the Government's Shareholder Executive, joined the QinetiQ Board as did Dr Peter Fellner, Executive Chairman of Vernalis. Effective from 1 August 2005, Sir David Lees, Chairman of Tate & Lyle, will also join. Taken together, these appointments constitute a major strengthening of our Board and I am delighted to welcome all three members.

Our major shareholders, The Carlyle Group and the MOD, have continued to work closely with us to support our business strategies at this important time. At QinetiQ's Public Private Partnership transaction in February 2003, the MOD stated its intention of selling its remaining shareholding interest some three to five years later, probably through UK flotation. This remains the position in principle, although no decisions have been taken about the timing or structure of any sale. We and our shareholders continue to share the same vision, that a flotation would be an important milestone in the long-term development of the Group as a strong, vibrant and international defence technology business.

Corporate responsibility
At QinetiQ, we take our responsibility as a corporate citizen seriously. We recognise that we have an impact on the world around us: socially, environmentally and ethically. We have used our business strengths in environmental issues to make a special contribution to the wider community. We look after a number of valuable conservation areas including 13 Sites of Special Scientific Interest (SSSIs), we have secured accreditation with the National Energy Foundation for our energy efficiency and have maintained our ISO14001 registration. We are strongly supported in our determination to act with integrity in all our business dealings by our highly accountable staff.

A workforce of which to be proud
I have commented before on the brilliance of our 10,400 people. In QinetiQ's case, this is no platitude. It is literally true in the extent and quality of their professional qualifications. The Company's success is predicated on their achievements – on their passion, commitment and effectiveness. We aim to recruit, retain and develop the best – a necessity for retaining our vibrancy and productivity – and to treat our staff with the respect they deserve. At a time of transition and restructuring, an inevitably unsettling process, we rely on our staff's loyalty and commitment more than ever. We are grateful for the certitude shown by employees during this time, ensuring that we are in a strong position to accelerate the growth of the business.

A bright future
The Board looks to the future with well-placed confidence. We are positioned to capitalise further on the continued strength of our core markets, defence and security. Our expansion into the US, through carefully targeted acquisitions, has been successful in terms of revenue and profitability and provides a model to develop further. Our ability to work productively on both sides of the Atlantic with government agencies and their contractors puts us in a strong position to generate further business in these quarters. And, while the commercialisation of technology is complex, our 'fast-track' process has the potential to bring step-change technologies rapidly to market, capable of delivering high returns both to ourselves and our customers.

Pauline Neville-Jones

Dame Pauline Neville-Jones
Chairman QinetiQ Group
28 June 2005

Sir John Chisholm
Chief Executive Officer

CHIEF EXECUTIVE OFFICER'S STATEMENT

This has been a year of real progress for QinetiQ but also one of transition. We have now had two years following investment by The Carlyle Group, which took the Company into the private sector. The first year was devoted to sound performance, demonstration of cash generation and examination of the strategic choices that our new freedoms offered. This second year has started to progress the strategy we formulated. This is leading the Company into areas of significantly greater growth potential and our people are responding magnificently to the opportunities now before us.

Execution on strategy

In all our markets our strongest differentiator is that QinetiQ contains within it the integrated result of 50 years of investment by one of the most sophisticated defence nations in the world. No other similarly advanced country has transitioned its national laboratories into the private sector with the intention of giving them the opportunity of fulfilling their potential to serve a broader range of customers, bringing their technology through to market leading products and services, and growing and creating a new internationally-based defence technology Group.

Last year, we announced that our strategic review had concluded that the unparalleled capabilities that our newly private company had inherited could best be exploited in the Defence and Security markets and the greatest opportunities for expansion were in the US. This year, we have been executing that strategy beginning with a major restructuring of the Group into three Sectors: the Defence & Technology Sector, serving primarily the defence market in the UK; the Security & Dual Use Sector, which contains those technology capabilities drawn from our Defence core markets as well as their defence customers; and the North America Sector, focused primarily on serving Defence and Security customers in the US.

North America is the world's largest market for QinetiQ's core offerings, representing the most exciting growth arena and we have executed our strategy to replicate the success of our UK model and expand our presence significantly in the market. We will continue to look for opportunities and new ways in which best to leverage our core skills and expertise in this exciting area in the future.

Financial review

Turnover for the year rose 9.7% to £872.4m due mainly to our investments in the US defence market. Continued attention to superior operational management moved margins faster than turnover resulting in total operating profit (before exceptionals, intangible amortisation and impairment) expanding 33.1% to £69.6m. Cash flow before financing, dividends, acquisitions and disposals was also strong at £68.2m although less than last year's figure due primarily to an increase of some £40m in short-term MOD-related working capital.

In all our markets our strongest differentiator is that QinetiQ contains within it the integrated result of 50 years of investment by one of the most sophisticated defence nations in the world

We have more than 700 contracts valued between £100,000 and £5m that QinetiQ has undertaken for customers in the MOD including 370 research contracts, 91 test and evaluation contracts and 242 technical services contracts. Our field of activities ranges from a key role in developing the MOD's thinking with respect to Networked Enabled Capabilities, to research into new Electronic Warfare sensors, to proving our technology for automatic landing of Short Take-Off and Vertical Landing (STOVL) aircraft at sea, to procurement and integration of new generation aerial targets, and on to extending the shelf life of munitions – providing the opportunity for enormous savings.

Responding to the defence and security environments
All major nations, including the UK, are faced with the challenge of equipping their armed forces in an environment where sophisticated modern defence systems take a decade or more to develop while the missions they have to undertake emerge with little warning in a matter of months. The resolution of this discrepancy in timing is creating a seismic change in the international defence equipment marketplace. QinetiQ, given its distinctive heritage, is well equipped to help customers respond to this challenge. Our core business in funded research work ensures our laboratories have available demonstrations of leading-edge technology, while our practical understanding of existing in-service equipment enables us to expedite the insertion of new relevant capability into legacy platforms.

The US armed forces face the same issues but on an even greater scale. Being part of a Group with such a range of solutions to offer customers was the key to persuading two very capable US defence technology companies to join this year. Foster-Miller and Westar Aerospace & Defense are two highly respected companies with strong, but different, customer positions.

In QinetiQ North America, Westar works predominantly directly for the Department of Defense (DoD) providing systems engineering and technology services in the army aviation and missile defence fields. In its last complete year (to December 2004) it had a turnover of $155.5m (£85.4m) and recorded an operating profit of $18.0m (£9.9m). Foster-Miller is a longer-established company which had its origins in a spin-out from Massachusetts Institute of Technology (MIT). Today it is engaged in advanced research for the DoD and the application of its technologies, particularly in the automation, materials and power engineering fields, into products for military and commercial customers. It is particularly well known for its TALON™ and SWORDS military robots, of which more than 250 have been sold, and its LAST® appliqué armour which has been bought by 11 nations. In its last full year (to July 2004) Foster-Miller reported turnover of $121.0m (£68.9m) and operating profit of $20.1m (£11.4m).

With these acquisitions, QinetiQ's staff numbers in the US have risen to 1,320 out of a Group total of 10,406 at March 2005. The opportunities we are now pursuing are likely to mean that the US will make an even larger percentage contribution to the Group by the end of the current financial year.

Positioned for growth
Our leading position in understanding research markets for the MOD provides insight and positioning at the very birth of nascent defence programmes. As the MOD's partner for test and evaluation, through the £5.6bn LTPA contract, we provide a technical advisory service to new programmes and equipment updates. The intellectual property and technical insight which these activities provide makes us attractive technology partners for Original Equipment Manufacturers (OEMs) bidding for major equipment supply roles and this is resulting in a business in commercial defence which grew 33% this year.

Our defence technology has numerous applications outside the strictly defined defence market and many of these are the focus of our Security & Dual Use (S&DU) Sector. The creation of this Sector, which remains founded squarely on funded technologies drawn from our defence capability and tested against the demands of our defence customers, provides the Group with a critical mass of expertise in taking technology products to commercial customers.

Its Security Division expanded work for intelligence customers by 50% during the year and also continued to grow our business in Information Security which has now reached £20.0m. The Space Division, which focuses on low-cost access to space, also had a good year, growing 12% through programmes such as the low-cost Earth observation platform TopSat, our 'near space' unmanned autonomous vehicle (UAV) Zephyr, and the Maps-on-Tap programme we won for the Office of the Deputy Prime Minister.

The opportunities we are now pursuing in the US are likely to mean that the US will make an even larger percentage contribution to the Group by the end of the current financial year

The UK Technology and Products Division houses some of QinetiQ's very best scientists and most advanced technology. This is reflected in our customers and the assignments they choose us to do. Intel selected us to develop an indium antimonide transistor as a candidate solution to the end of the 'Moore's law' era on silicon. We are working with DARPA on a low-cost means of monitoring units in a battlespace. US customers have bought early versions of our passive millimetre screening systems able to detect bomb and gun threats at stand-off distances.

One of the principal purposes in forming S&DU was to gather together in a single part of the organisation the wealth of experience we have developed in commercialising technology. Our capabilities in these much sought-after skills are apparent both from the fact that other major corporations seek our assistance, and also by the success of the ventures we have launched.

This year several of our early ventures have reached important goals. We were able to recognise the value in pSiMedica, our venture based on our invention of porous silicon, when we accepted an offer from the Australian company pSiVida which resulted in an overall gain for the year of £14.8m represented in cash and listed stock. Quintel Technology has now begun to take orders for its multi-network 3G antenna following the start of serious build out of 3G networks in the UK. The problem of maximising coverage, while minimising the proliferation of unpopular masts, is a worldwide issue and at the current time we have the only proven solution.

Looking forward

QinetiQ occupies a unique place at the crossroads of three powerful demand drivers:

- First, active deployment of UK and US military forces drives the need to develop, integrate and field new technologies to meet emerging threats.
- Second, security and terrorist challenges place an urgency behind discovering new means to prevent and protect society.
- Third, the recognition by UK, European and American businesses that rapid technology innovation is the primary means to compete successfully in the global economy which drives the resulting demand for innovation-led solutions.

Our strategy is to grow in each of three target sectors. In Defence and Technology (D&T), we will build on our core franchise in research and test and evaluation to transition our technology into equipment and services programmes through partnerships with the OEMs. In S&DU, we will exploit our differentiated technologies into niche markets by way of product and service offerings, partnerships, ventures and licensing. In the US, we will continue our rapid growth leveraging the Group's incomparable technology strengths and selectively adding to our chosen sub-sectors of technology, systems engineering, and federal IT services.

Our unique heritage gives us capabilities to meet these demands, creating loyal customers with expanding relationships. This organic growth opportunity, combined with our proven ability to grow through strategic acquisitions, will offer our customers an even larger and more comprehensive set of technologies and services.

The private equity transaction with Carlyle in 2003 created the opportunity for QinetiQ to start to fulfil its potential. The past year has reshaped and repositioned the Company to address these opportunities. The world we now occupy is altogether more challenging than the public sector environment from which many of our staff came, but all our staff, from whatever background, have risen magnificently to the challenges. They have embraced the changes and are focused on our core mission of delivering brilliant solutions to important problems. Given the wealth of key issues in both the military and commercial fields for which our science and technology can provide effective solutions, I am confident that this Company has a strong future before it.

Sir John Chisholm
Chief Executive Officer QinetiQ Group
28 June 2005

QinetiQ's business is all about innovation and solution. Its heritage is well-founded in developing intellectual property and applying it, providing a wealth of available expertise. This position gives the organisation a unique angle to take on important problems for its customers, providing them with tailored solutions.

From using weapons expertise to facilitate border patrols for an overseas navy to using human science expertise in the provision of more secure travel environments, the science and skills offered by QinetiQ is put to task to solve a wide range of real problems.

FROM ADVANCED COMPOSITE MATERIALS

QinetiQ is merging its expertise in materials, radar and communications to assemble a new advanced technology mast for HMS Ark Royal.

The mast encloses radio frequency transmitters and receivers ranging from essential systems such as radar through to those carried for purely entertainment purposes such as televisions and radios. This means that they are shielded from both electromagnetic interference and the elements, two problems experienced with the placement of equipment on traditional masts. The innovative material from which the mast is made allows the signals to penetrate.

Despite their smart nature, the skins of the mast are designed so that they can be built using standard shipyard techniques and their ease of maintenance means that they represent a considerable cost saving in both the short and long term.

The advanced mast on Ark Royal is due to enter service later this year.

TO PLAIN SAILING WHATEVER THE WEATHER

FROM TESTING AND EVALUATION TO INTEROPERABILITY

QinetiQ will be delivering key support for the MOD's Tornado F3 sustainability programme.

We work on delivering technical aspects of the programme and managing core elements of the avionic integration, including the latest standards of air defence missiles onto the aircraft. The high speed, air-to-air missiles provide significant enhancements to both the Tornado F3's Beyond Visual Range capability and to the infra-red engagement capability.

As part of the Tornado Integrated Project Team's 'Capability Lean' initiative, the programme uses innovation to deliver more than 30% savings compared to traditional approaches.

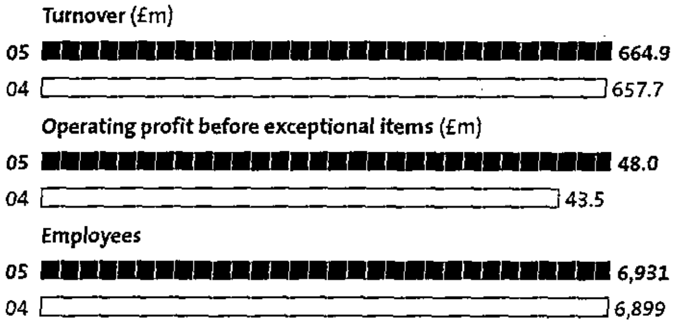
DEFENCE & TECHNOLOGY: BUSINESS REVIEW

Introduction
The Defence & Technology Sector (D&T) forms the core of QinetiQ's UK defence business, delivering technology solutions and managed services that support the armed forces of the UK and our allies. The Sector comprises over 6,900 people, working to discover real time solutions to urgent military and security issues and selling its expertise and technology across all of the MOD's defence equipment and service procurement programmes. We have two complementary positions in the market:

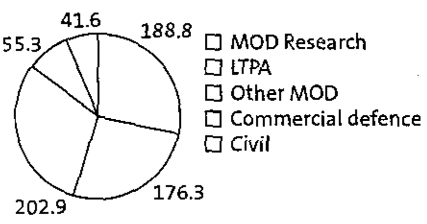
- as a technology supplier, we generate technology solutions feeding into the defence manufacturing supply chain, drawing from the global science base as well as the applied research we conduct for our customers
- as an expert and objective advisor, we provide acquisition support to the MOD throughout the lifecycle of defence equipment, drawing upon the know-how generated through research funded by MOD and other civil and military agencies.

These two roles are regulated through a compliance regime that forms part of our governance, whereby we agree with the MOD on a case-by-case basis measures to avoid conflicts of interest.

We do not undertake the role of a prime system integrator for mainstream UK defence equipment, thereby avoiding the cyclical exposure in our earnings seen by many of the original equipment manufacturers (OEMs), rather we partner with manufacturers to take science and technology through to realisable defence capability. An important part of our business is creating technology opportunities that are ready 'on the research shelf', able to be rapidly inserted into current platforms or new designs. We also lead the delivery of major managed services, the most significant being a 25-year contract to operate the MOD's test and evaluation services, currently its largest single contract.



Turnover by channel (£m)



The D&T Sector has four channels, each focused on a key area of the defence domain – MOD research, Long Term Partnering Agreement (LTPA), Other MOD and Commercial Defence and Civil.

MOD research
QinetiQ plays a key role in the defence supply chain by drawing knowledge from the science base and developing solutions to meet near-term and long-term defence needs. Often we will work with MOD stakeholders to develop new concepts for achieving defence capability, networking with teams in academia to incorporate advanced science and supporting defence prime contractors to include winning technology in their proposals to supply high quality and affordable defence equipment.

FROM WEAPONS SYSTEMS TO DEFENDED COASTLINES

QinetiQ has won the first phase of a multi-million pound contract to upgrade three Jacinto Class patrol vessels for the Philippine Navy.

The contract demonstrates QinetiQ's expertise in complex project management gained by previous military projects.

Extensive upgrades include supply, installation and testing of a new weapons system, including a 25mm cannon and a 75mm gun. Each refit is expected to take 10-12 months.

The vessels are used to patrol the vast stretch of coastline around the Philippines and form a central capability in the country's national security. The upgrades will allow them to meet their operational requirements over the next 15-20 years.

Although the volume of our non-competed research funded by the MOD has decreased as the industry element is opened to competition, we are being compensated by the opening up of revenue generation potential from projects on which QinetiQ was previously prohibited to compete. Our success in UK research competitions, coupled with growing revenue from other research customers, eg US Department of Defense (DoD), means that overall the volume of our defence research business was sustained during 2004/05. Alongside this we have secured strong positions with the defence prime contractors by exploiting research into their equipment solutions, this strand of business grew by 33% on 2003/04.

Notable successes:

- QinetiQ has undertaken a linked series of research projects to help the MOD develop its approach to achieving Network Enabled Capability (NEC), forging new concepts in ways to deliver the right effect at the right time making use of the latest communications and information technology. In addition, as co-founder with BAE Systems of the NITEworks Experimentation facility, QinetiQ has supported the 'themes' that have been addressed to answer specific NEC-related questions posed by the MOD.
- The Integrated Waste Management System (IWMS) is a total waste management procedure that will see Royal Navy ships achieve early compliance with new environmental laws and significant resource savings, transforming vessels into self-contained units with considerably less environmental impact.
- The Ground-Based Air Defence (GBAD) Synthetic Environment is a multi-million pound contract which has been awarded to QinetiQ that will enable the first Synthetic Environment (SE) based acquisition to be conducted by the MOD.
- QinetiQ is working on an MOD contract to improve and enhance sensor technology for the Royal Navy. Phase one of the contract, which will focus on development and testing of the techniques and algorithms to be used, is worth around £5m and will cover a period of three years.
- QinetiQ technologists have developed a unique onboard decision aid computer software tool to help Royal Navy bridge officers operate their ships safely in extreme weather conditions. ORPHEUS (Onboard Risk Performance Hazard Evaluation System) is a dedicated and flexible operator guidance system providing clear and concise information on how a ship will perform in all types of bad weather.
- QinetiQ has designed and delivered an urgent minesweeping capability to support clearing the KAA waterway in southern Iraq.
- QinetiQ is developing a hybrid electric drive demonstrator for a 6x6 vehicle for the MOD.

Long Term Partnering Agreement (LTPA)

The LTPA for test, evaluation and training support services forms a large part of our UK business with the MOD. At £5.6bn over 25 years, the LTPA is the largest single contract by cost currently let by the MOD, with the contract contemplating savings of at least £700m compared to the historical baseline, as well as benefiting from private finance of £150m to be invested in rationalisation and modernisation. Work associated with the LTPA helps to ensure the safe operational performance for both platforms and weapons – a vital precursor to release into service of both new and upgraded equipment. This Test & Evaluation service can be in particular demand in times of conflict, when equipment is often used in ways not envisaged in the original requirement.

The first two major QinetiQ investments, costing £45m, successfully progressed during 2004/05. These were complex, hybrid projects involving estate and personnel transformations as well as the procurement, adaptation and setting to work of a fleet of aerial targets (unmanned jet aircraft). The LTPA has an innovative pricing structure that has stimulated customer usage, with a 30% increase in demand.

D&T also supports non-equipment Lines of Development (such as training, infrastructure and logistics) and such work is likely to become increasingly important in the future. D&T draws heavily on its defence technology know-how, protected from any potential conflicts of interest by a firewall agreed with the MOD. The combination of deep technological expertise, long-standing understanding of the defence domain and tailored tools and facilities combine to produce a comprehensive set of offerings across the MOD. In 2004/05 we extended our range of capabilities in this area by acquiring HVR Consulting Services (HVR), specialists in defence analysis and project assurance.

FROM INFLATABLE MATERIALS

QinetiQ is carrying out a study for the US Army's Tank-Automotive Research and Development Establishment Center (TARDEC) to study Gap Defeat Technology for the Future Combat System.

The Gap Defeat Technology will determine the width of a 'gap', assess that it can be crossed and then deploy a solution. The QinetiQ Gap Defeat Solution utilises patented 'inflatable fascine' technology that offers the potential to allow vehicles to cross obstacles like ditches and climb steps.

The technology offers a significant gap defeat ability from a small stowed volume, removing the need for a specialist vehicle as currently used. QinetiQ expects that the inflatable fascine will give a stowed volume reduction of eight times, and be half the weight of, an equivalent current pipe fascine system.

The study is in two phases to provide an outline system solution and bench test the relevant elements. The QinetiQ study will include the manufacture and testing of fascine tubes and field testing of several candidate gap width sensing technologies.

TO BRIDGING THE GAP

FROM NUTRITIONAL ANALYSIS TO HIGH PERFORMANCE TROOPS

Research carried out on armed forces ration packs to heighten performance and morale indicated the need for more healthy eating and highlighted improvements to deliver energy and critical nutrients to the troops.

The team analysed guidelines and legislation governing ration packs, their chemical composition and energy requirements of operational scenarios.

They conducted a survey of military personnel on consuming ration packs, including their likes and dislikes.

The research provided the UK Defence Catering Group with important information to enable it to improve ration packs. QinetiQ authored new guidelines on ration packs that became MOD policy in March 2005.

DEFENCE & TECHNOLOGY: BUSINESS REVIEW CONTINUED

Notable successes:

- QinetiQ carries out the majority of aircraft release advice in the UK for military aircraft including the advanced jet trainer and Eurofighter.
- QinetiQ is working on the upgrading of GR7A Harriers into the Harrier GR9 programme which should save the MOD up to £5m over the next two years.
- The Mirach aerial target, introduced by QinetiQ within two years at Aberporth Range, is now fully operational with the option to operate at the Hebrides Range being considered.
- QinetiQ continues to provide the MOD with independent advice for its acquisition of future soldier technology on its Future Infantry Soldier Technology (FIST) programme.
- Over the last year, QinetiQ has delivered independent technical advice on in-service trials of the BOWMAN communications system for the armed forces.

Other MOD

Equally important is the wide-ranging acquisition support we provide to Integrated Project Teams (IPT) in the DPA and DLO, where our advice helps define requirements and assess bids, set out standards and architectures, understand and mitigate risk.

We deliver a growing number of the DPA's annual needs in providing independent test and evaluation to defence equipment projects from initial conception through to entering service. We are also involved as part of the IPT to help prime contractors overcome critical technology-related problems.

QinetiQ has been working closely with the MOD in delivering UK Network Enabled Capability (NEC) as part of a wider Defence Transformation. Important milestones achieved in the last 12 months include: supporting the successful business case approval of Acquisition for NEC (AfNEC), delivering a series of AfNEC pilots in areas such as Urban ISTAR and Cursor-on-Target, co-founding NITEworks, with support to the recent information note, establishing the MOD Joint Capabilities Board strategy for delivering NEC, together with engagement across many IPTs and the Director's Equipment Capability.

Notable successes:

- Our research into the ageing of explosive materials has enabled the DLO to save hundreds of millions of pounds by safely extending the life between refurbishment or disposal of missiles and our advice has changed logistics practices to further extend the life of munitions.
- QinetiQ is reducing risk and cost for the MOD on its Gatekeeper programme for utility vehicles.

Commercial Defence and Civil

Technology innovation requires access to deep expertise across a range of subjects. It is in the bringing together of science to solve real problems by which new opportunities are created.

As one of Europe's largest technology suppliers, QinetiQ is well placed to deliver agile and cutting-edge solutions using the best science and technology, exploiting advances widely into the defence and civil supply chains, without constraints from being 'locked-in' to a single manufacturer, market or product line. This is emphasised by the impact our defence-funded research has had in providing the foundations for civil products. This flexibility in forming multi-disciplinary teams and multiple market linkages lies at the heart of our ethos and enables the Company to create gearing in the value from technology for QinetiQ, for our partners and for the community overall.

Notable successes:

- QinetiQ developed Agile C2, a new command and control product that allows the planning, co-ordination and management of joint air operations. The system provides a flexible and cost-effective suite of planning tools and is particularly beneficial in multinational environments, allowing the armed forces of different countries to plan and execute joint operations effectively and safely.
- As part of its work for the Joint Strike Fighter programme, QinetiQ has reached a significant milestone demonstrating the first automatic landing of a Short Take off and Vertical Landing (STOVL) aircraft aboard an aircraft carrier. QinetiQ's VAAC (Vectored-thrust Aircraft Advanced Control) Harrier successfully landed on the UK's aircraft carrier HMS Invincible.

FROM SONAR TECHNOLOGIES TO A PROTECTED NAVY

QinetiQ's acoustic expertise will be protecting Norwegian ships by supplying torpedo countermeasures for the Royal Norwegian Navy to be used on its new Fridtjof Nansen class frigates. The 'Loki' countermeasure system was designed as a defence mechanism against acoustic-homing torpedoes. It operates in two modes; jammer mode, which allows the transmission of high-power pseudo random noise and confuser mode, which counters the threat of active, narrow-band sonar weapons. Loki is one of a unique family of high performance, next generation underwater countermeasures that provide a layered defence capability for both surface ships and submarines.

- QinetiQ's high performance swimmer detection system, Cerberus, is currently being evaluated by the US Navy under a contract issued by the US DoD.
- QinetiQ has signed a Memorandum of Understanding (MoU) with Trelleborg AB to allow the two companies to offer acoustic stealth cladding solutions to shipbuilders and navies throughout the world.
- QinetiQ has developed and demonstrated an open architecture for all inboard processing of sonar which enables capability enhancement and new approaches to procurement, in-service support and third party technology insertion.
- QinetiQ's Aerodynamics & Aeromechanical Systems team has a world-class capability for aerodynamic shape optimisation which is gaining an ever-widening customer base. Recently, Constrained Optimisation Design of Aerodynamic Shapes (CODAS) has been adopted by Airbus for wing aerodynamic design and by Formula 1 designers.
- In March 2005, QinetiQ signed a contract to provide its fast satellite acquisition Global Positioning System (GPS) to the US Joint Advanced Missile Instrumentation (JAMI) programme.

FROM UNDERSTANDING HUMAN BEHAVIOUR

QinetiQ has developed the National X-ray Certification Test for the Department for Transport. Every screener in the UK is required to complete this test before they are able to screen and must repeat the test every 13 months.

The software consists of image libraries and questions and allows screeners to sit the test repeatedly. This is in order to train operatives and to keep the standards of screening at a certain level.

The software was designed by experts in QinetiQ's Centre for Human Sciences, where research into how people learn and how best to evaluate performance has been applied in a variety of commercial ways.

TO TRAVELLING WITH PEACE OF MIND

FROM HIGH SENSITIVITY GPS TECHNOLOGY TO SAFER POLICE OFFICERS

QinetiQ's enhanced GPS technology has been integrated into a hand-portable radio to support police personnel on the job.

The award-winning High sensitivity GPS module, which is manufactured for Sepura, one of the world's largest TETRA (Terrestrial Trunked Radio) suppliers, makes it possible to determine position within the built up areas of city centres and even inside buildings and car parks.

This ability enables police forces, like West Yorkshire Police, to develop services that significantly enhance officer safety and enables all emergency services to deploy resources quickly and efficiently.

SECURITY & DUAL USE: BUSINESS REVIEW

The S&DU Sector, with over 1,800 staff, contains the largest share of QinetiQ's growing security and other commercial business. The S&DU team of scientists, engineers, consultants and analysts is focused on maintaining strong relationships with traditional defence and government security customers. It leverages the technology assets and capabilities developed from that work into new technology-enabled solutions for customers in defence, security and other government and commercial markets to give them a competitive advantage.

We engage with our customers through research and development contracts, consultancy services, technology licensing, specialised products, support services, and in some cases, spinning-out new businesses. A major and growing share of S&DU's revenues comes from consulting, analysis and advisory services in secure information management and other aspects of business security.

The Sector includes five key business areas: Security & Intelligence, Space, Technology & Products, Managed Services and Ventures.

S&DU teams work very closely with the D&T and North America Sectors to help them deliver dual use solutions to their customers.

Security & Intelligence
Decades-long experience in providing advice and security solutions to defence and other UK public sector customers has provided QinetiQ with capabilities in information and physical security. The range of offerings is extremely broad and has been well received by the marketplace. We provide advisory services to assist customers in identifying and mitigating risks regarding the security of their facilities and information systems. We also develop, license and sell technology product solutions addressing specific security vulnerabilities.

QinetiQ Trusted Information Management is a rapidly growing information assurance business offering consulting, software assurance, secure hosting, vulnerability scanning, penetration testing, digital forensics and managed services for a diverse range of public and private sector customers.

Notable successes:
- Helping Barclaycard to assess threats to their online business via an independent audit and a detailed Security Health Check.
- Tarsier® is a runway debris detection radar system developed in the wake of the 2000 Paris Concorde incident which was successfully trialled at Heathrow, JFK and Vancouver International airports.

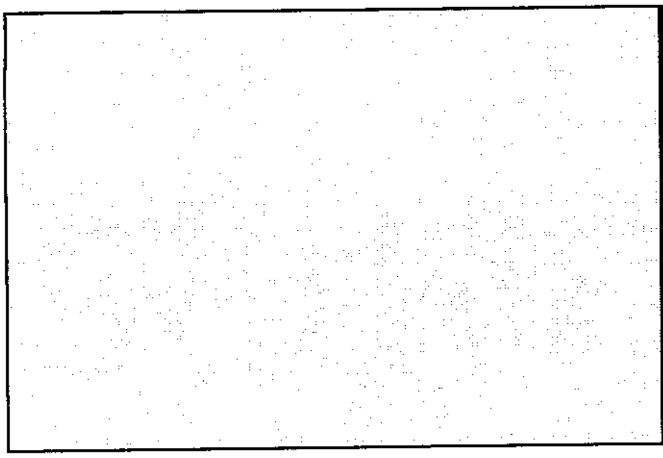
Turnover (£m)	
05	137.4
04	137.4
Operating profit before exceptional items (£m)	
05	12.4
04	9.2
Employees	
05	1,806
04	1,628

Space
QinetiQ is one of Europe's foremost space technology providers, leading the way in the development of ion engines with strong capabilities in small satellites, advanced payloads, high altitude unmanned autonomous vehicles (UAVs), mission design and Geospatial Information Systems. Ion engine technology is already seen as a critical technology to several future European Space Agency (ESA) missions, while our 'near space' UAVs, small satellites, groundstation processing capabilities and secure data distribution networks are key to providing customers with low-cost access to space-based data.

QinetiQ's space experts contribute to a number of ESA missions (the Mars Express orbiter, the Gravity field and steady-state Ocean Circulation Explorer (GOCE) mission and lead of the TopSat programmes).

After a two-year programme of investment and research, the Zephyr high altitude long endurance UAV flew several prototypes in early 2005. These large, lightweight and low-cost platforms will provide a unique capability for applications such as environmental monitoring and border surveillance.

Notable successes:
- The Maps-on-Tap programme is a QinetiQ-led consortium providing government departments with access to high quality, up-to-date digital mapping information and decision support tools under a contract awarded by the Office of the Deputy Prime Minister.
- The first version of the Space Risk Analysis Tool was completed for Sciemus Ltd, providing scientifically-based analysis on the risk of



FROM IT SECURITY TO PATIENT PRIVACY

QinetiQ's expertise in information security will be helping to secure patient records throughout the UK for the NHS.

Accenture, which provides information solutions for the NHS, looked to QinetiQ Trusted Information Management to provide security threat assessment, monitoring and alerting for the NHS LSP project.

QinetiQ's Monitoring Services combines our research capability, people, processes, tools, security intelligence and experience, offering to clients a more holistic security solution. The Monitoring Services solution provides to the NHS, through Accenture, a visible, fully-operational comprehensive security service that operate 24 hours a day. This system is fully auditable, compliant to government guidelines and run by security professionals.

spacecraft failure, targeted at insurers wanting better analysis of premiums and satellite operators wanting better ways to manage their risks.

Technology & Products

The Technology & Products (T&P) Division brings together QinetiQ's expertise and laboratory facilities in energy technologies, materials, microelectronics and optical devices to provide research and development, technology licensing, analysis and advisory services, as well as limited volume specialised products and materials for defence, public sector and commercial customers. The Division plays a key role in the transition of technology research and development into viable commercial solutions. Located within T&P, QinetiQ Nanomaterials Limited manufactures a broad range of nanopowders and is recognised as one of the leading nanotechnology businesses in Europe. GPS Enabled Telematics, another T&P business, exploits QinetiQ's leading expertise in GPS technology to offer chipsets and design services in developing hardware for the most difficult location-based applications.

Notable successes:

- Working with the North America Sector on a significant joint research programme with Intel on the use of indium antimonide as a new transistor technology.
- Working with D&T on a licence agreement with Oxford NewTech, a clinical and pharmaceutical device and diagnostics company, to commercialise two healthcare technologies – Pathscore™ – an automated breast cancer diagnostic system and MEA BioSensor, promoting more efficient, safer drugs testing.
- Working with the North America Sector on providing the SatID system that identifies and locates the source of satellite interference to the US DoD.
- QinetiQ successfully completed two programmes to develop stand-off people screening systems. The SPO-20 and SPO-30 passive millimetre wave screening systems allow security personnel to locate concealed weapons and other threats under the clothing of suspects at ranges of at least 20 metres.

Managed Services

The Managed Services Division offers a mix of services spanning calibration and supporting technical services, real estate, facilities and asset management. On 1 September 2004, QinetiQ acquired the remaining 55% of ASAP Calibration Limited, one of the UK's leading providers of offsite calibration services. Recognised as one of the most successful online family history websites, QinetiQ's 1901 Census site has delivered over 112 million searches and downloads and has generated £8.5m in revenue since its launch.

The Estates Division manages around 58 sites to promote continuous improvement in QinetiQ business results through affordable facilities and competitive support services.

Ventures

QinetiQ prides itself on the creation and management of its intellectual property and this has continued to generate considerable revenue this year. In some cases, due to the dynamics of particular markets or financing needs, the creation of a separate spin-out venture offers the best route to extracting value from QinetiQ technologies. The Ventures activity provides focused investment and active, hands-on guidance to businesses in the ventures portfolio.

Notable successes:

- Quintel has developed an antenna sharing technology that will allow multiple wireless operators to share the same antenna with independent operator control. The technology has been successfully trialled with mobile operators and initial units are now being deployed.
- ZBD is developing novel liquid crystal displays (LCD) using 'bistable' LCD technology. ZBD offers displays with low power consumption yet high readability, well-suited to the growing market for electronic point-of-display product labelling.
- Aurix – offering high accuracy speech recognition software products, the Aurix technology platform is especially well-suited to audio data mining. Aurix solutions help customers manage and 'mine' the speech data they have recorded.
- pSivida Limited has commercialised QinetiQ's porous silicon material as BioSilicon™, used for multiple applications in healthcare, focusing on drug delivery.

S&DU's customer base

Major customers include the UK armed forces, the DoD, FTSE 100 companies, large multinationals and critical national infrastructure companies. Additionally, major projects are undertaken with the UK and US Government security and other public sector organisations, and agencies and offices of the European Union.

FROM ADVANCED ROBOTICS

TALON™ robots are powerful, durable, lightweight tracked vehicles that are widely used for Explosive Ordnance Disposal (EOD), reconnaissance, communications, sensing, security, defence and rescue. They have been in active military service since 2000 when they were successfully used in Bosnia for the safe movement and disposal of live grenades. TALON™ robots were the only US robots used at Ground Zero in search and recovery efforts after the September 11 attack.

A variety of TALON™ systems are in production as well as further development. The latest, which was developed with and delivered to the US Army Armament Research, Development and Engineering Center (ARDEC) for evaluation, is the Special Weapons Observation, Reconnaissance Direct-action System (SWORDS) robot for armed reconnaissance that *Time* magazine recognised as "one of the most amazing inventions of 2004". The SWORDS version is just 30 inches high, can carry a variety of weapons including the 7.62mm M240 automatic and is manually operated remotely using a visual display screen.

In 2004, TALON™ became the first robot equipped with off-the-shelf chemical, gas, temperature and radiation sensors that can be read simultaneously, remotely and in real time via an integrated hand-held display unit. These are the only robots on the market that offer crucial sensing capability to civilian first responders and the military.

TO SAFETY AT A DISTANCE

The Australian fire beetle *(Acanthocnemus Nigricans)* has an ability to detect forest fires at distances of up to several kilometres using receptor organs located on its thorax. As an example of one area of work funded by DARPA, QinetiQ has investigated some of the characteristics of these organs using laser vibrometry to help understand whether enhanced infra-red sensors could be developed exploiting silicon micro-systems technology.

This could have a major impact on the next generation of uncooled infra-red sensors and QinetiQ has been exploring some potentially disruptive approaches separately under MOD funding. Early results indicate that a high performance solution is feasible, which could lead to the evolution of a new generation of low-cost camera systems. Such devices could find application both in the military arena (eg rifle-mounted sights, unmanned air vehicles) and in civilian markets (eg security surveillance).

NORTH AMERICA: BUSINESS REVIEW

Introduction

In last year's Annual Report we stated that our plan was to develop the US market as a major strategic avenue for growth in our core businesses of defence and security. This year, we can report significant progress in delivering this plan.

As an independent technology developer we have three principal ways to leverage QinetiQ's technology strength in the US market. We can:

- *source technology and technology development services to US* Government research and development (R&D) organisations
- provide technology to US prime-contractor managed defence programmes in order to earn both direct and licensing revenue
- source UK technology to our direct US holdings so they rapidly meet customer requirements and can grow more quickly.

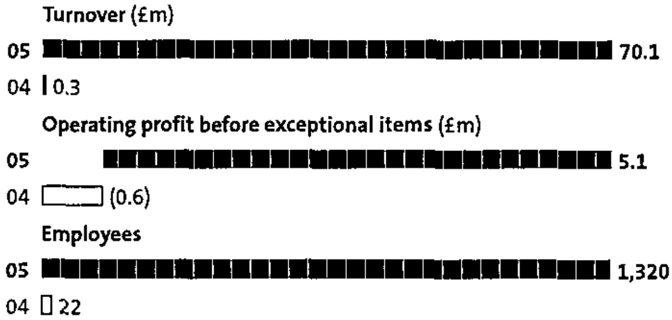
The US defence and security markets are the largest in the world. The first phase of QinetiQ's strategy has been to access these markets directly, through QinetiQ Inc, our business development company based in Washington DC.

During the year revenues from the North American market increased from \$27.0m (£16.6m) to \$163.8m (£86.9m) of which \$131.6m (£69.3m) was derived from acquisitions in the year. QinetiQ Inc. had sales orders of \$68.5m (£37.0m) and was also notified by customers of their intention to award contracts totalling an additional \$10.0m (£5.4m), with these negotiations continuing into the new financial year.

The second phase has been to reinvest the cash being generated from our more mature UK businesses into the higher growth US market by making selected acquisitions.

During the year we made an excellent start on this programme by acquiring two outstanding companies. One was Westar Aerospace & Defense Group, a provider of systems engineering and technical advice (sales for the year to December 2004 of \$155.5m (£85.4m)) principally to the US Army, Missile Defense Agency and National Aeronautics & Space Administration (NASA), employing around 1,000 staff at several locations including St. Louis, Huntsville and Washington DC.

Another was Foster-Miller, Inc., a technology company (sales for the year to July 2004 \$121.0m (£68.9m)) providing advanced products



and services to the US DoD, to other US government departments, and to private industry, particularly in the pharmaceuticals and medical devices sectors.

In order to obtain US regulatory approval for these acquisitions we have put in place separate proxy boards of directors to run our US companies. These boards include three highly experienced proxy holders who act on our behalf and who are security cleared US citizens approved by the DoD.

QinetiQ Inc.

The primary role of QinetiQ Inc. is to build relationships with key customers and partners in government and industry, and to raise awareness within the US of the rich source of technology and ideas within QinetiQ. Through these relationships, QinetiQ Inc. is identifying new business opportunities whereby QinetiQ technology can bring decisive advantage to a US customer or partner, subject always to the UK export and MOD regulatory regimes under which QinetiQ operates.

QinetiQ's customer base in the US includes both government agencies and defence and security suppliers. As a technology-based company it is important to QinetiQ that it is successful in winning R&D contracts from organisations such as Defence Advanced Research Projects Agency (DARPA), the Services research labs: the Army Research Laboratory, the Naval Research Laboratory and the Air Force Research Laboratory, and the equivalent R&D agency in the Department of Homeland Security: the Homeland Security Advanced Research Projects Agency (HSARPA).

TALON™

Foster-Miller's TALON™ robots are powerful, durable, lightweight tracked vehicles that are widely used for explosive ordinance disposal, reconnaissance, communications, sensing, security, defence and rescue. They have been in active military service since 2000 when they were successfully used in Bosnia for the safe movement and disposal of live grenades. TALON™ robots were the only US robots used at Ground Zero in search and recovery efforts after the September 11 attack.

A variety of TALON™ systems are in production as well as further development. The latest, which was developed with and delivered to the US Army Armament Research, Development and Engineering Center (ARDEC) for evaluation, is the SWORDS robot for armed reconnaissance that *Time* magazine recognised as "one of the most amazing inventions of 2004".

Significant progress has been made during this past year in building QinetiQ's reputation and volume of business with these organisations. However, QinetiQ's main strength lies in using its technical breadth and depth to develop novel solutions for its customers.

In the defence field, QinetiQ is active in developing hardware and software systems for a number of agencies including: the Tank-automotive and Armaments Command, the Armament Research Development Engineering Center, the Technical Support Working Group, the Night Vision Lab, the National Renewable Energy Laboratory, the United States Marine Corp. and the Joint Non-lethal Weapons Directorate.

An important goal for QinetiQ in the US is to get QinetiQ technology into major new acquisition programmes. A strong relationship has already been established with Lockheed Martin on the Joint Strike Fighter programme, and QinetiQ is currently partnered with United Defense LP in offering its hybrid electric drive design into the Future Combat System. Partnering and teaming agreements have been put in place with most of the key players in the US defence supply chain. With Boeing, this process has been taken a stage further with the signing of an MoU to facilitate closer technical co-operation between the companies in defence and civil applications.

During the year, QinetiQ was awarded over 180 contracts in North America that covered the breadth of the technology range and addressed defence, security, civil, health, energy and environmental market segments. The contracts provided for consultancy, advanced R&D, simple products and complex systems. Over 25% of the contracts were direct with US Government agencies.

Recent contract wins:

- Intel Corp. awarded QinetiQ a contract to help develop a next generation advanced processor based on QinetiQ's patented ultra fast indium antimonide technology.
- Boeing awarded QinetiQ a contract to provide acoustics modelling for composites on its next generation 7E7 DreamLiner aircraft.
- Initial orders were placed for SatID, QinetiQ's tri-band satellite Geolocation System, opening the door for multiple applications in both military and civil markets.
- The US Navy and DRS Technologies awarded contracts for Cerberus, a swimmer detection sonar system that will be used for shipboard, port and coastal waterway protection.

Foster-Miller, Inc.

QinetiQ announced its first US acquisition, Foster-Miller, Inc., the Boston-based engineering and technology development company, on 8 September 2004 for a net cash consideration of $167.2m (£90.9m), excluding Foster-Miller's cash and surplus working capital. The acquisition will enable Foster-Miller to introduce QinetiQ's technologies into US markets alongside its own, particularly in areas such as robotics and homeland security.

Foster-Miller was founded around 50 years ago by three graduates of the Massachusetts Institute of Technology, who believed that there was a need for a company that could solve clients' difficult technical problems through first-class analysis and design. Today, Foster-Miller is a recognised leader in providing innovative engineering solutions in fields such as robotics, advanced materials technology and medical devices.

The company employs around 350 engineers, scientists and support staff and was recently named as one of the most innovative businesses in America by *Inc* magazine. With annual revenues for the year ended July 2004 of $121.0m (£68.9m), Foster-Miller has enjoyed compound growth of around 30% p.a. over the last four years.

High profile examples of turning defence research into commercial technology applications include Foster-Miller's Robotics and Armour products.

Foster-Miller is a major manufacturer of military and industrial robots. The company has extensive experience in all aspects of mobile and fixed robotic technologies. Applications range from laboratory automation to bomb squad operations. Foster-Miller's robots have saved lives, reduced labour costs on critical production lines, and have enabled workers to perform critical operations while in hostile and hazardous environments. QinetiQ is a world leader in the field of ground robotics and its technology is now being integrated into the next generation of military robots being developed by Foster-Miller. Originally using research funding from DARPA, Foster-Miller prototyped and developed TALON™ robots which have now completed over 20,000 explosive ordinance disposal (EOD) missions in Afghanistan and Iraq.

LAST®

LAST® Armor is a unique armour appliqué system for tactical ground vehicles and aircraft that is installed without any cutting, welding or drilling on the base vehicle.

LAST® Armor was originally developed internally at Foster-Miller and then prototyped under funding from DARPA. The first product was a wholly ceramic add-on hard face for Light Armoured Vehicles. The primary product line, which was later developed for aircraft applications, is a ceramic/composite laminate which provides both the hard face and spall liner for unarmoured vehicles.

Over the past ten years, LAST® Armor has been used on light armoured vehicles and transport planes in Bosnia, Kosovo, Afghanistan and Iraq.

NORTH AMERICA: BUSINESS REVIEW CONTINUED

LAST® Armor, a division of Foster-Miller, produces a unique armour appliqué system for tactical ground vehicles and aircraft. LAST® armor was originally developed internally at Foster-Miller and then demonstrated and first fielded under funding from the Defence Advanced Research Projects Agency (DARPA). Over the past ten years, LAST® Armor has been used on light armoured vehicles and transport planes in Bosnia, Kosovo, Afghanistan and Iraq.

Recent contract wins:

- November 2004, Foster-Miller began shipping a $20m order for TALON™ robots to be used in Iraq, bringing the total number of TALON™ robots in use in Iraq to nearly 200.
- February 2005, Foster Miller was awarded a $5m contract by the US Naval Sea System Command for TALON™IIIB explosive device disposal products and spare parts.
- February 2005, Foster-Miller received a $1m order from the RAF for L-1011 armour kits.
- March 2005, Foster-Miller received a $1.7m order from Renault for ground vehicle armour kits.
- March 2005, Foster-Miller won an $8.5m contract from the Naval Air Systems Command as a key member of the team developing the next-generation Advanced Arresting Gear system for US Navy aircraft carriers.

Westar Aerospace & Defense Group

On 14 September 2004, QinetiQ announced its second US acquisition, Westar Aerospace & Defense Group, which it purchased for an initial net cash consideration of $131.0m (£72.4m), excluding Westar's cash and surplus working capital.

Westar is a leading systems engineering company with key expertise in global and theatre defence architecture, defence systems interoperability, systems engineering, integration and test, sense and respond logistics, and programmatic services.

The company, with revenues of $155.5m (£85.4m) in the year ended 31 December 2004, has grown at a compound rate of 38% during the last five years.

The company comprises a number of divisions and subsidiaries including Aerospace Filtration Systems, Inc. and Westar Display Technologies, Inc.

Aerospace Filtration Systems, Inc. (AFS), is an industry leader in the design, development and manufacturing of high performance engine inlet barrier filtration systems used in commercial and military propulsion systems. AFS systems have been proven in combat during operation 'Iraqi Freedom' under the most severe conditions.

Westar Display Technologies, Inc. (WDT) is a leading worldwide supplier of electro-optical performance measurement systems, instrumentation and devices used in the flat-panel display industry. With over 150 systems installed worldwide that ensure the quality of military flat-panel displays, commercial monitors and flat-panel TV's, Westar improves efficiency by minimising production, qualification, display integration and repair pipeline costs.

AIR FILTRATION

More than 1,000 helicopters are currently protected with Air Filtration Services' patented system that remove 99.8% of all sand and dust, before they damage engines.

In the last two years alone the US Army has ordered over $60 million in products to protect its engines, reduce operations and maintenance cost, and increase readiness. Special Operations customers actually increased their top-speed as a result of a substantial power increase attributable to AFS's filtration inlet design. This has saved the Army and US taxpayers millions of dollars, since protected engines now remain operable and at rated power throughout their life, even in the harshest desert environments.

Recent contract wins:

- The Expedited Professional Engineering Services Support (EXPRESS) contract awarded by the US Army's Aviation and Missile Command, which has a ceiling value of over $1bn. Westar has been awarded four out of four follow-on orders under this contract, including, among others, a $42m multi-year award for electronic mission equipment systems engineering.
- The award of a $28m contract to AFS to supply turbine engine life extension filtration systems to the US Army for the UH-60 Blackhawk helicopter.
- The selection of AFS by Bell Helicopter as its OEM supplier of engine barrier filtration systems for its 407 series of aircraft.
- Dell Computer Corporation's selection of WDT for implementing its worldwide Vendor Self-Qualification standard.
- The selection of WDT by the world's number two cell phone producer for display assurance test systems used throughout its supply chain.

QinetiQ Technology Extension Corporation

QinetiQ Technology Extension Corporation (QTEC) is headquartered in Norco, California. The company provides obsolescence management services to US Government agencies including: the DoD, the Federal Aviation Administration, NASA, Department of Energy, and the Department of Transportation, as well as to prime contractors such as Boeing, General Dynamics, Lockheed Martin, Northrop Grumman and Raytheon.

Many industries such as defence, aerospace, medical, power generation and telecommunications can benefit from improved obsolescence management since they all feature ageing systems or applications. Being able to sustain production and spares support means that any organisation can reduce the cost of design, production and operational support, particularly for electronic systems applications.

Integration

Both Westar and FMI were selected, in part, for their complementarity with QinetiQ's UK technology businesses. An important part of QinetiQ Inc's role is to identify and prosecute joint business opportunities between the UK and the US – in particular to identify opportunities for Westar and Foster-Miller to enhance their offerings to US customers by adding in QinetiQ UK technology. Developing this new aspect of our business will inevitably take some time to get off the ground, but in the short period we have owned these two outstanding US companies, we have already identified a significant number of additional joint opportunities which we are now taking forward energetically.

Recruiting, retaining and developing world-class scientists and engineers is fundamental to QinetiQ's business survival. An award-winning graduate recruitment programme has ensured recruitment of around 250 of the brightest and best graduates in the UK. Last year QinetiQ staff benefited from £8 million's worth of training investment including more than 40,000 working days of training, helping the organisation to gain re-accreditation as an Investor in People (IiP). QinetiQ also boasts an award-winning Initial Professional Development (IPD) Scheme, accredited by 13 Professional Bodies and with around 360 scientists and engineers registered – making it the largest scheme of its type in the UK.

CORPORATE RESPONSIBILITY

Corporate Responsibility (CR) shapes our values and defines the way we do business. QinetiQ recognises that CR is fundamental to its long-term sustainability – a principle that is embedded at every level of the business.

This year QinetiQ has identified its core impacts – environmental, social and ethical – enabling us to systematically improve on our CR performance.

QinetiQ is a complex business, both in terms of technologies and people. The knowledge and expertise gained from our work in the defence sector is applied successfully to important problems facing global businesses. This gives an insight into the type of value QinetiQ can bring to society.

Environment

QinetiQ owns or manages 58 sites across the UK which generate a host of environmental challenges. QinetiQ sees this as an opportunity to demonstrate commitment to sound environmental stewardship, examples of which include:

- Continuing registration to ISO14001, the international standard for environmental management compliance.
- Energy efficiency accreditation with the National Energy Foundation having reduced our CO_2 emissions by around 10,000 tonnes since 1999/2000.
- On-line e-shop across test and evaluation sites to recycle surplus equipment, generating a database of over 1,500 items across 20 QinetiQ sites.
- £265,000 spent on the remediation and clean-up of the Pershore site.

There are also a number of Sites of Special Scientific Interest (SSSIs) located on QinetiQ sites which provide an invaluable opportunity to show our commitment to environmental best practice and illustrates how business and environmental objectives can be complementary. In many cases, our maintenance of these sites has ensured the conservation of some extremely rare species of plants and wildlife. One example of this is the Eelmoor Marsh SSSI in Farnborough which celebrates its 30th Anniversary in 2005.

Communities

QinetiQ is an integral part of many local communities across the UK and accepts its responsibility to local stakeholders to contribute to community sustainability wherever possible.

When, for example, ferocious storms hit the Western Isles of Scotland in January devastating Balivanich primary school, our Benbecula office provided premises while repairs were carried out. Equally, plans to develop our Malvern site in collaboration with various local and regional bodies, including Advantage West Midlands, should deliver several million pounds worth of vital investment into essential infrastructure in Malvern.

As scientists, engineers and innovators, QinetiQ people are well-placed to promote science-related subjects among young people. Our Year in Industry scheme has one of the largest intakes in the UK and provides many A-level students with work experience in a scientific environment. This year QinetiQ provided financial support to two local schools – Crofton and Winchcombe – pursuing the Government's Special Science in Schools status and has continued its sponsorship of the Stockholm International Youth Science Seminar Prize.

A series of formal partnering agreements with UK universities is enabling interaction between QinetiQ and the academic community. This provides university staff and students with the opportunity to work with business and ensures that they work together in order to deliver maximum value from science and technology to the UK economy.

QinetiQ has identified a series of charitable priorities and has implemented a match-funding arrangement for employees. Charitable concerns that resonate with local communities are important to QinetiQ and it has chosen to support, among others, the Royal National Lifeboat Institute (RNLI) and the Malvern-based St Richard's Hospice. Cancer Research UK will receive direct support through our technologies and expertise.

QinetiQ is developing products that contribute to the health, safety and security of communities across the UK including the world's first

QinetiQ has developed a number of technology solutions to environmental problems. This includes technologies designed to help tackle the threat of climate change including for example, the ZephIR remote wind sensing tool (see above) that enables the optimal siting of wind farms, a suite of technologies designed to tackle aviation emissions and fuel-cell powered automotive vehicles. Equally, QinetiQ is using its knowledge of specific physical environments to address a number of sensitive environmental issues: from technologies for waste segregation and management to providing advice to the MOD and industry on how it can minimise its environmental impact.

automated breast cancer diagnostic system, Pathscore™, enabling the consistent grading of breast cancer cells; a low-cost thermal camera system, designed to increase the safety and reliability of vehicle airbags; and data analysis software for improving baggage screening performance, now used in around 20 airports in the UK. Technologies like this demonstrate how QinetiQ can make a considerable difference in everyday life.

Ethics

Integrity, transparency and accountability are priority values that QinetiQ promotes through its CR profile. These are fundamental to our corporate code of conduct and provide the principles by which our business is managed. The culture and heritage of the organisation give it strong credentials for corporate governance.

In addressing ethical impacts, QinetiQ considers issues and risks associated with its core business: defence. Our defence heritage and the role of protecting society is a source of pride in the organisation and allows us to solve important problems in the civil sector. However, QinetiQ is involved with sensitive technologies and accepts the necessity for tight regulations across the UK defence sector.

As a company that is uniquely placed to provide technologies to the UK's armed forces, QinetiQ's need for transparency and a strict compliance regime is key to business operations. For example, it must show that potential conflicts of interest which might arise from providing advice to the MOD while working with other companies are properly managed.

QinetiQ's business orientation could pose a problem for those who are uncomfortable with the defence industry. Understanding and engaging with these views enables QinetiQ to grow as a business. Since CR cuts to the core of the organisation's defence operations there is a broad willingness to undertake dialogue.

Health and safety

Like all companies, QinetiQ has a duty of care to its employees and those affected by its activities. Unlike most others, QinetiQ's operations include activities that are inherently hazardous and could cause significant damage to people and property. These include test flying aircraft, the firing of guns and missiles and the disposal of outdated ammunition.

QinetiQ's sound 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. Although QinetiQ is making year-on-year improvements – this year saw a 16% reduction in a RIDDOR rate that already compared favourably with the HSE's benchmark – further progress can be made.

QinetiQ has introduced a Hazardous Trials Board, led by an independent chairman, to give an additional level of rigour in the application of health and safety practices. Its remit is to establish protocols defining the criteria for the safe conduct of each of the many types of hazardous trial and then to review each proposed plan against those criteria.

Trials involving human volunteers

A large majority of the products created using QinetiQ's technologies have an impact on people. QinetiQ is researching ways in which human performance can be enhanced to match the performance of the equipment. For example, in the case of the Eurofighter, QinetiQ is continually looking to improve the protective equipment for pilots, allowing them to manoeuvre with the aircraft at high rates of turn without being compromised by the high G-forces.

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. Additionally, any clinical trials require the approval of an independent Phase 1 Ethics Committee in accordance with the EU Clinical Trials Directive. This robust committee structure ensures that every trial undertaken by QinetiQ involving human subjects, including armed forces personnel, is carried out with the objective of protecting volunteers from possible harm.

OPERATING AND FINANCIAL REVIEW

Results
The results for the year reflect the further development of the Group, with continued successful delivery in the core UK defence business, realisation of benefits from the commercialisation of intellectual property and growth in the key North American market through two successful acquisitions.

Group turnover for the year grew 9.7% to £872.4m (2004: £795.4m), with acquisitions contributing £78.4m of turnover in the year. 10.0% of Group turnover was derived from customers in North America (2004: 2.1%). Operating margin* increased from 6.6% to 8.0%, reflecting strong delivery performance from the growing volume of fixed price contracts in the UK business and the addition of higher margin product business in North America. As a result the operating profit* grew 33.1% to £69.6m (2004: £52.3m), with the acquisitions contributing £9.1m in the year.

Earnings before interest, tax, depreciation and amortisation (EBITDA) pre-exceptional items and profit on disposal of fixed assets grew 16.0% to £109.4m (2004: £94.3m). The profit before tax (PBT) was £82.3m (2004: £47.6m). The PBT includes a profit of £17.1m (2004: nil) from Intellectual Property (IP) Realisation on the disposal of the Group's interest in pSiMedica Limited, partially offset by an unrealised holding loss of £2.3m (2004: nil) in the listed pSivida Limited shares received as part consideration, a profit of £29.1m (2004: £7.4m) from fixed asset disposals and an exceptional charge of £25.9m (2004: nil) for the restructuring of the UK business.

The Group's operating cash inflow was £40.4m (2004: £139.2m), resulting in free cash flow, before financing acquisitions and disposals of businesses and dividends, of £68.2m (2004: £131.2m) after taking into account an increase of £40m in short-term MOD-related working capital. A dividend of £27.0m has been paid to the Group's parent company, QinetiQ Holdings Limited, in respect of the current year to fund that company's repayment of its bank debt (2004: nil).

	2005 £m	2004 £m
Turnover	872.4	795.4
Operating profit*	69.6	52.3
Profit before tax	82.3	47.6
Profit after tax	75.3	37.5
(Net debt)/cash	(124.7)	2.6
Net assets	335.7	281.7

Market sector review
The Group's largest customer remains the UK Ministry of Defence (MOD) with turnover for the year of £637.6m (2004: £643.7m). As expected, the mix of business with the MOD is gradually changing as the Research programme is opened to competition and the cost reduction programmes under the Long Term Partnering Agreement (LTPA) are successfully completed. These anticipated reductions have been partly offset by increased business through the Defence Procurement Agency (DPA) and the Defence Logistics Organisation (DLO).

The UK businesses continue to make progress in the commercial defence market, with full year growth of 33%. We are well placed in teams bidding for future major procurement contracts, although uncertainty over government plans for the UK defence budget earlier in the year has resulted in some slippage in the start-up of new projects.

The civil market continues to show longer term promise but with continued uncertainty about the speed of take off. The results of the IP Realisation activities were very strong in year, with some £16.2m (2004: £16.7m) of royalty revenue recognised and a gain of £17.1m on the sale of our shares in pSiMedica Limited for a 16.3% interest in our joint venture partner, pSivida Limited, plus £1.7m in cash. Conversely, progress was slower in the Transport and Public Sector markets with new revenue streams taking longer than expected to be developed.

Following the acquisitions of Westar Aerospace & Defense Inc. (Westar) and Foster-Miller, Inc. (Foster-Miller), our business for North American customers has increased significantly to £86.9m (2004: £16.6m). The US Department of Defense (DoD) is now the Group's second largest customer.

Review of operations
During the year, the Group undertook a major restructuring of its business into three new Sectors. Accordingly, the segmental analysis of the Group's results and this review of operations have been restated to align with the new management structure.

Defence and Technology (D&T)
The D&T Sector leads the Group's UK defence business, with responsibility for delivery to our principal customer, the MOD, together with the broader defence market in the UK, allied countries and, through the North American Sector's sales operations, into the US. Through this work, new technology is developed for exploitation in all our markets.

The Sector is responsible for the Group's largest single contract, the 25-year LTPA through which QinetiQ delivers test and evaluation services for the MOD based on the facilities at MOD-owned sites. The Company earns revenue for managing the facilities, delivering trials services and undertaking modernisation projects. The modernisation spend was again behind original expectations although there has been a noticeable increase in the volume of projects agreed with the customer this year which will begin to deliver during the coming year. One highlight during the year was very positive progress with the £34.0m Air Rationalisation project, which has resulted in a new air target operation commencing at Aberporth, allowing the closure of the Llanbedr facility to be completed.

Turnover from the core LTPA was £176.3m (2004: £173.8m). Delivery of trials services continued above the original planned volume while turnover from rationalisation projects under the LTPA declined as expected from £23.7m to £14.1m as these projects were successfully delivered in year.

Apart from the LTPA, the Sector comprises a number of Divisions operating across the defence space delivering value to their customers through the MOD Research programme, through direct contracts with the DPA and DLO and as members of teams with, or as subcontractors to, other major defence suppliers. The year saw strong performances in areas such as Spectrum Solutions, Command & Intelligence Systems and Communications where the Group's technology plays a major role in MOD programmes. Performance was more mixed in areas such as Weapons and Sea Systems, where delays in contracting for the Research programme resulted in operational staff deployment challenges that could be only partially offset in the second half of the year once the work was confirmed.

Overall, the Sector has managed well the transitions caused by the two major trends of increased competition in the Research programme and the move to fixed price contracting. As the revenue from the Research programme declines (down 5.8% in year to £227.1m for the Group overall), focused marketing efforts are achieving compensating growth in the DPA, DLO and commercial defence areas.

As a result, overall Sector revenue increased by 1.1% to £664.9m (2004: £657.7m). The trend to greater fixed price contracting has been beneficial to the Sector as our risk management capabilities have been brought to bear on project delivery, resulting in Sector margins* increasing to 7.2% (2004: 6.6%).

Security and Dual Use (S&DU)
S&DU leads our UK business activities in the commercial markets, including our businesses in security and intelligence, space, energy, materials and optronics. The Sector also covers our managed services activities in the areas of equipment calibration and estates management.

OPERATING AND FINANCIAL REVIEW CONTINUED

Turnover in S&DU was unchanged in the year at £137.4m (2004: £137.4m). The operating profit improved from £9.2m in 2004 to £12.4m in 2005, representing a margin of 9.0% (2004: 6.7%). The higher margin in this Sector reflects the strong royalty flows and high margin managed estates business, partly offset by investment in new product development, such as Quintel antennas and Tarsier™ runway debris detection radar, and bid costs for major programmes that have not yet been decided.

The growth was driven by strong performances in Trusted Information Management (TIM), Space and Managed Services. TIM, one of the cornerstones of our Security business, grew 26.6% to £17.6m (2004: £13.9m) as demand continued to increase for our services in areas such as secure hosting, penetration testing and digital forensics. The Space Division continued its development as a broader based business working both for the European Space Agency and commercial customers.

S&DU also leads the drive to realise value from the Group's technology portfolio. The Sector delivered £14.8m (2004: £15.4m) of revenue from royalties, principally related to our LCD technology. In addition, a gain of £17.1m was recognised as the Group's interest in the porous silicon joint venture, pSiMedica Limited, was exchanged for a 16.3% interest in our listed partner, pSivida Limited. The Sector further developed ventures in areas as diverse as speech recognition, battery technology and 3G wireless antennas, where our Quintel subsidiary has now begun earning customer revenue.

In Optronics and Materials the year was more challenging. These businesses contain many of our best scientists and have been responsible for a number of our most distinguished scientific inventions. With customer emphasis switching to shorter term goals, their concentration has become technology exploitation in both military and commercial markets. The reduced demand for innovative research has had to be accommodated through headcount reductions as part of the UK restructuring programme.

North America (NA)

The North America Sector comprises Westar and Foster-Miller, companies acquired during the year, together with QinetiQ Inc, the Group's US-focused sales and marketing operation and QinetiQ Technology Extension Corporation, which provides obsolescence management services to US Government agencies.

The acquisitions of Westar and Foster-Miller have made a step-change in the Group's presence in North America, the largest defence and security market available to the Group. As a result, the Group now has 1,320 (2004: 22) employees based in North America, primarily in Boston, St Louis and Huntsville and the North America Sector contributed £70.1m (2004: £0.3m) of turnover in the year. This represents 8.0% of Group turnover and the proportion will grow further in the coming year as we include a full 12 months of results from the acquired businesses.

In addition to their access to the North American market, Westar and Foster-Miller bring to the Group a more product-oriented business. In the current year, 28% of their turnover came from product sales, primarily TALON™ robots and LAST® Armor in Foster-Miller and air filtration systems in Westar. These product sales contribute positively to the operating margins of these businesses, although they do add some volatility to the timing of turnover recognition which is dependent on customer delivery schedules.

Acquisitions

On 5 August 2004 the acquisition of HVR Group Limited (HVR) was completed for a total consideration, including costs, of £13.8m, of which £8.9m was paid in cash and £0.9m in loan notes, with the balance to be settled by way of loan notes exercisable at the holder's option no later than 31 July 2009. Goodwill of £12.9m arises on the acquisition.

The Group completed the acquisition of Westar on 8 October 2004 for net cash consideration of £72.4m ($131.0m) excluding Westar's cash and surplus working capital and excluding £4.8m ($9.0m) of deferred consideration payable dependent on the performance of Westar for year ending 31 December 2005. Total consideration to date of £76.5m ($138.5m), including payment for surplus cash and working capital and acquisition costs, results in preliminary goodwill of £66.5m, which will be increased by the final amount of the deferred consideration payable.

The acquisition of Foster-Miller was completed on 5 November 2004 for net cash consideration of £90.9m ($167.2m) excluding Foster-Miller's cash and surplus working capital. Total consideration of £105.1m ($193.3m), including payment for surplus cash and working capital and acquisition costs, results in goodwill of £79.8m.

Fixed asset disposals
An exceptional profit of £30.7m (2004: nil) arose on the disposal of the Pyestock North property for a gross consideration of £54.0m. A net profit of £15.5m (2004: profit of £7.4m) was booked on the sale of other fixed assets, including £17.1m (2004: nil) on disposal of the Group's interest in pSiMedica Limited.

Pensions
The Group has adopted FRS17, which provides a snapshot valuation of the Group's defined benefit pension schemes. During the year, the increase in the value of the assets of the Group's principal scheme broadly matched the increase in the associated liability resulting from salary and pension increases and additional accrued service. The overall FRS17 liability (net of deferred tax) decreased by £1.4m to £113.9m (2004: £115.3m), with the adverse impact of a 0.1% reduction in the bond rates used to determine the discount rate applied to the liabilities offset by an increase in the deferred tax asset related to the FRS17 liability.

Funding levels are set after full actuarial valuations, the latest of which was performed as at 30 June 2002 and identified a deficit of £29.0m. The next valuation is currently in progress and will be as at 31 March 2005. Following the 2002 valuation, the Group increased its contributions by £2.0m per annum. During 2005, the Group has agreed with employee representatives to increase, over a three-year period, employee contributions to the Group's main defined benefit scheme from the current 1.5% of salary to 5% of salary to help fund increases in future service costs. In addition, in June 2005, the Group made a further one-off contribution of £10.0m against the past service deficit in the scheme.

During the year the Group inherited two small defined benefit pension schemes as a result of business acquisitions. The FRS17 deficit for these schemes is £0.4m.

The MOD has indemnified the Group's parent undertaking, QinetiQ Holdings Limited (QHL), up to a maximum deficit of £45.0m in the Group's main scheme, of which £38.1m has been recognised in the QHL accounts. Accordingly, the overall QHL FRS17 pension liability net of tax was £75.8m (2004: £79.2m) at 31 March 2005.

Taxation
The Group tax charge of £7.0m (2004: £10.1m) represents an effective tax rate of 8.5% (2004: 21.2%). The effective rate is below the statutory UK rate due primarily to the availability of research and development relief and accelerated capital allowances in the UK and the utilisation of brought forward tax losses not previously recognised in the US.

Restructuring costs
An exceptional charge of £25.9m (2004: £nil) has been included in the profit and loss account resulting from the fourth quarter restructuring of the UK business from four technology Divisions into two market-facing Sectors. £24.5m of the charge relates to 260 staff leaving the business from the elimination of duplicate overhead positions and the rationalisation of business units. In addition, impairment provisions totalling £1.4m have been made against fixed assets that will no longer be used in the business.

Ownership structure
The Group is a wholly owned subsidiary of QHL, a company controlled by funds managed by The Carlyle Group, but in which the MOD retains a majority economic interest.

Cash flow
The Group's cash inflow from operating activities was £40.4m (2004: £139.2m). The reduction from 2004 reflects mainly the timing of MOD contracts resulting in an increase of £40.0m in working capital at the year end.

Free cash flow after interest, taxation and capital expenditure but before acquisitions and disposals of businesses and dividends was £68.2m (2004: £131.2m). £166.9m was reinvested in the acquisition of businesses, principally Westar and Foster-Miller. £192.7m was remitted to the Group's parent company, QHL, through loans and dividends to fund the repayment of £75.0m of QHL's preference share capital, together with the payment of accrued dividends of £8.9m, and to repay QHL's remaining bank debt.

OPERATING AND FINANCIAL REVIEW CONTINUED

The strong cash flow of the Company over the last two years, and consequent debt repayment (before acquisition financing), results in net interest payable substantially lower at £1.2m (2004: £11.9m). The current period includes a one-time benefit of £0.6m from the cancellation of surplus interest rate hedges, with a further £1.8m gain recognised by QHL.

Foreign exchange risk management
During the year ended 31 March 2005 the majority of the Group's income and expenditure was settled in the local functional currencies of sterling and US dollar. The most significant currencies to which the Group is exposed are the US dollar and euro.

The Audit Committee has approved policies for hedging the following: transactions in currencies other than the functional currency of the relevant business; translation of the net assets of overseas businesses; and translation of foreign currency financial assets and liabilities.

The Group's policy is to hedge transaction exposures at the point of commitment to the underlying transaction using forward foreign exchange contracts or options. The Group does not typically hedge uncommitted future transactions, although foreign exchange risks are fully considered and appropriately mitigated when bidding for new work.

The currency risk arising on translation of the results of overseas businesses is not hedged. The Group's policy is to hedge the currency risk on the balance sheets of overseas subsidiaries by maintaining a high ratio of borrowings to net assets (including goodwill) for each currency.

Interest rate risk management
With the exception of the Aquila/Chertsey Loan Note reported in sterling at fixed rates of interest, the Group's gross debt is substantially denominated in US dollars at floating rates of 0.6% above LIBOR. The Group's policy is to use interest rate swaps, collars and caps to manage its interest rate exposure. As at 31 March 2005, 81% of the Group's US dollar denominated debt was either fixed or capped at rates in the range 3.95% to 4.95%.

Group funding
The Group's policy towards funding is to ensure that the Group has sufficient facilities available for its ongoing operations. During the year the Group's primary bank facility was renegotiated to improve flexibility in its use and to reduce the cost of borrowing. The new agreement is a £300.0m unsecured revolving multi-currency credit facility, available for all normal corporate uses including acquisitions.

At 31 March 2005, the Group had £150.8m of US dollar debt (2004: nil) drawn to fund the acquisitions of Westar and Foster-Miller. The Group's total net debt was £124.7m (2004: £2.6m net cash).

The Group monitors the identity of the counterparties with whom it deposits cash and transacts other financial instruments so as to control exposure to any territory or institution. Surplus funds are placed for short periods with highly rated institutions in investments which are readily realisable.

International Financial Reporting Standards (IFRS)
IFRS becomes mandatory for listed companies in the European Union in 2005. Although their adoption is optional for unlisted companies in the UK from that date, the Group is making preparations such that it is in a position to adopt IFRS for its year ending 31 March 2006.

The Group has completed its initial assessment of the impact of IFRS on its accounting policies, although it continues to monitor new pronouncements and the development of best practice which may give rise to further changes. The principal differences identified to date between IFRS and the Group's current accounting policies are goodwill accounting and the recognition of intangible assets under acquisition accounting, capitalisation of development costs, marking to market of interest rate and currency derivatives, balance sheet disclosure of preference share capital, accounting for holiday pay and accounting for deferred taxation.

Outlook

The restructuring of the UK business leaves the Group well placed to grow its commercial defence and civil business while continuing to deliver value to its primary customer, the MOD. The acquisitions of Westar and Foster-Miller provide a springboard for further expansion in the North American markets.

Graham Love
Chief Financial Officer
28 June 2005

* Before exceptional charges and amortisation and impairment of goodwill, including share of losses in joint ventures and associates.

1. Dame Pauline Neville-Jones
Member of:
- Remuneration Committee
- Nominations Committee (Chair of the committee)
- Compliance Committee (Chair of the Committee)

2. Sir John Chisholm
Member of:
- Nominations Committee
- Investment Committee

3. Graham Love
Member of:
- Investment Committee

7. Glenn Youngkin
Member of:
- Remuneration Committee
- Audit Committee
- Investment Committee (Chair of the Committee)
- Nominations Committee

8. Trevor Woolley
Member of:
- Compliance Committee
- Nominations Committee

9. Nick Luff
Member of:
- Audit Committee (Chair of the Committee)

BOARD OF DIRECTORS

1. Dame Pauline Neville-Jones
Chairman (Non-executive Director)
Dame Pauline (65) has worked extensively in the Foreign and Commonwealth Office where she was Political Director. She has been Deputy Under Secretary in the Cabinet Office and Chairman of the Joint Intelligence Committee, as well as advisor to the Prime Minister on all foreign, defence and intelligence issues. After leaving government service she was a Managing Director at NatWest Markets and Vice-chairman of Hawkpoint Partners. She has been the BBC International Governor, with special responsibility for all BBC external broadcasting services. Dame Pauline is currently Chairman of the Information Assurance Advisory Council, a member of the Councils of Oxford University, of the Royal United Services Institute (RUSI), the International Institute for Strategic Studies (IISS) and Honorary Treasurer of the charity Refuge.

2. Sir John Chisholm
Chief Executive Officer (Executive Director)
Sir John (58), the Chief Executive of QinetiQ, was Chief Executive of DERA (previously DRA) 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 Director of Cap Group plc. In 1979 he founded and became MD 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 Non-executive Director of Bespak plc and a Trustee and Deputy President of the Institute of Electrical Engineers. He is also a Fellow of the Royal Academy of Engineering, the Royal Aeronautical Society and the Institute of Physics.

3. Graham Love
Chief Financial Officer (Executive Director)
Graham (51) is the Chief Financial Officer of QinetiQ and CEO of QinetiQ's US operations. Prior to rejoining DERA in 2001, he was Chief Executive of Comax Limited, leading it through its privatisation in 1997 before sale to Amey plc in 1999. Before that, Graham was Finance Director of DERA from 1992 to 1996. After a degree at Cambridge in English, Graham's work experience has 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.

4. Colin Balmer
(Non-executive Director)
Colin (58) has been the Managing Director of the Cabinet Office since July 2003. Prior to that he was the MOD's Finance Director and was responsible for the vesting of QinetiQ and the subsequent PPP Transaction with Carlyle. His main responsibility at the MOD was the planning and management of the defence programme with an annual budget of £32bn. He had extensive experience across the Department including periods as Private Secretary to two Ministers for Defence Procurement, a secondment to the UK Delegation to NATO and as Minister for Defence Materiel in Washington. Colin is also a member of the Foreign and Commonwealth Office's Audit and Risk Committee.

5. Hal Kruth
Group Commercial Director (Executive Director)
Hal (55) is Group Commercial Director of QinetiQ and head of QinetiQ's Security and Dual Use Division. Hal joined QinetiQ in 2001 as CEO of QinetiQ Ventures and prior to that worked for almost a decade at SRI International, one of the world's leading independent research organisations. As SRI's Senior Vice-president, Ventures and Licensing, Hal managed major transactions involving start-up companies, licensing, sponsored research, joint ventures and technology spin-offs. Hal has a degree in Law (Juris Doctor) and AB with distinction (phi Beta Kappa) in Economics from the University of California, Berkeley.

6. Sir Denys Henderson
(Non-executive Director)
Sir Denys (72) joined the Board of QinetiQ as a Non-executive Director in March 2003 and is also a Senior Advisor to The Carlyle Group. He was previously Chairman of ICI (1987-95); Zeneca (1993-95); The Rank Group (1995-2001); Dalgety plc (1996-98) and the Crown Estate (1995-2002). Sir Denys was also a Non-executive Director of Barclays Bank plc (1983-97); RTZ plc (1990-96); Schlumberger Corporation (1995-2001), and MORI. Sir Denys was also Chairman of Spencer Stuart's Advisory Board and an advisor to Bain & Co, as well as serving on several Government Committees. Sir Denys has also served as a Trustee of the Natural History Museum (1989-98) and was Chancellor of Bath University (1994-2000).

4. Colin Balmer

Member of:
- Remuneration Committee
- Audit Committee

5. Hal Kruth

Member of:
- Investment Committee

6. Sir Denys Henderson

Member of:
- Remuneration Committee (Chair of the Committee)
- Compliance Committee

10. Peter Fellner

Member of:
- Investment Committee
- Nominations Committee

11. Richard Gillingwater

Member of:
- Audit Committee

7. Glenn Youngkin
(Non-executive Director)
Glenn (38) is a Managing Director of The Carlyle Group. Prior to joining Carlyle in 1995, Glenn was a management consultant with McKinsey & Company, where he worked on a variety of strategic and operating issues in the energy, consumer product and healthcare industries. Prior to joining McKinsey, Glenn was with Credit Suisse First Boston, where he structured and executed both M&A transactions and capital market financings. Glenn is an engineering graduate of Rice University and received his MBA from the Harvard Business School where he was a Baker Scholar. Glenn serves on the Boards of Directors of Kuhlman Electric Company, Imagitas Inc and Firth Rixson. Since his relocation to Carlyle's London office in January 2000, he has led the London office buy-out efforts with Carlyle's Europe Partners.

8. Trevor Woolley
(Non-executive Director)
Trevor (50) is Finance Director of the MOD, following his appointment in 2003. His main responsibility is the planning and management of the defence programme. Trevor has worked extensively in the MOD in a career spanning almost 30 years. During the 1980s, Trevor spent three years as Private Secretary to Secretary of the Cabinet and, subsequently, Director of Procurement Policy. More recently, senior management positions have included Head of Resources and Programmes (Army), Director General Resources and Plans and, in the last two years, Command Secretary, Land. Trevor holds a Master of Arts Degree in History from Peterhouse, Cambridge.

9. Nick Luff
(Non-executive Director)
Nick (38) joined the Board of QinetiQ as a Non-executive Director in June 2004 and is currently the Chief Financial Officer of The Peninsular and Oriental Steam Navigation Company (P&O). Until May 2005, he was also a Non-executive Director, as a representative of P&O, on the board of Royal P&O Nedlloyd NV, the Dutch-listed international container shipping company. Nick trained as a chartered accountant with KPMG before joining the Corporate Finance department of P&O in 1991. He then moved to the Treasury department in 1993, becoming Group Treasurer of P&O in 1994 and then combined this role with Head of Corporate Finance from 1996, before joining the P&O Board in 1999 as Finance Director. 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 2003 following the successful merger of P&O Princess Cruises plc with Carnival Corporation.

10. Peter Fellner
(Non-executive Director)
Peter (61) joined the Board of QinetiQ as a Non-executive Director in September 2004. He is Executive Chairman of Vernalis plc, and also Chairman of the privately held UK biotechnology company, Astex Therapeutics Limited. In addition, he serves as a Director of two European biotechnology companies, UCB SA and Evotec AG, and is a Director of Isis Innovation Limited. He is 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, Peter was Chief Executive of Roche UK, 1986 to 1990, having previously been Director of the Roche UK Research Centre.

11. Richard Gillingwater
(Non-executive Director)
Richard (48) joined the Board of QinetiQ as a Non-executive Director in September 2004. Richard is currently the Chief Executive of the Shareholder Executive (ultimately reporting to the Cabinet Office), a position he has held since its creation in 2003. He is also the Non-executive Chairman of Faber Music, and a Non-executive Director of Rights Worldwide Limited, and serves on the Advisory Board of St Edmund Hall, Oxford. A law graduate from Oxford University, with an MBA from IMD Lausanne, he qualified as a solicitor before joining Kleinwort Benson, where he became a director in Corporate Finance. He then moved to BZW and became joint head of Global Corporate Finance, before moving to CSFB, where he was ultimately promoted to Chairman of European Investment Banking.

REPORT OF THE DIRECTORS

The Directors present their report and the audited financial statements for the year to 31 March 2005.

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

Business review
The profit on ordinary activities of the Group before tax was £82.3m (2004: £47.6m).

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 4 to 8 and in the Operating and Financial Review on pages 30 to 35.

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.

Proposed dividend
An interim dividend of 7.8p per ordinary share, totalling £27.0m (2004: nil) was paid to QinetiQ Holdings Limited on 11 March 2005. The Directors do not recommend the payment of a final dividend.

Market value of land and buildings
Due to the specialised nature of the QinetiQ business the valuation of buildings used in the business is based 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 2005 the trade creditors of the Group represented 33 days of annual purchases (2004: 35 days).

Directors and Directors' interests
The Directors in office at the date of this report are detailed on pages 36 and 37. The dates of Director appointments can be found on pages 36 and 37. Details of the Board committees are given on pages 39 and 40. Details of the Directors' emoluments and interests are shown in the Report of the Remuneration Committee on pages 42 to 45.

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 page 28.

Political and charitable contributions
The Group made no political contributions during the year or in the prior year. Donations to UK charities amounted to £57,000 (2004: £32,000).

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.

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
28 June 2005

STATEMENT OF CORPORATE GOVERNANCE

QinetiQ is committed to the highest standards of corporate governance. This is demonstrated by the fact that, although not listed, the Company has nevertheless complied with the best practice provisions of Section 1 of the revised Combined Code on Corporate Governance, where relevant, throughout the last financial year and up to the point of approval of the Report and Accounts. This Corporate Governance statement, together with the report of the Remuneration Committee, explains how the Group has applied the governance principles and achieved compliance throughout this period.

Board structure
The Board comprises a Non-executive Chairman, seven additional Non-executive Directors (including two Carlyle representatives and two MOD representatives) and three Executive Directors, including the Chief Executive Officer, the Chief Financial Officer and the Group Commercial Director, with the objective of achieving a balance of Executive and Non-executive Directors. Each of Carlyle and the MOD have the right to appoint two observers each, who may attend (but not participate in) meetings of the Board. The roles of Chairman and Chief Executive Officer are separate. The Chairman is responsible for the effective working of the Board and for ensuring that all Directors are properly informed of matters affecting the Company. The Chief Executive is responsible for all operational matters.

The Board considers three of the Non-executive Directors, Dame Pauline Neville-Jones (the Chairman), Nick Luff (Chairman of the Audit Committee) and Dr Peter Fellner, to be independent, as they are independent of the Company's executive management and free from any business or other relationship that could materially interfere with the exercise of their Non-executive duties.

The Board meets regularly throughout the year, and in the last financial year met on ten separate occasions. The Board has agreed a schedule of matters that are reserved to it for decision. The Board has also agreed a number of policies and procedures to help it to operate effectively, covering amongst other matters, access to the Company Secretary and independent professional advice, as well as the provision of effective induction training and company information.

The Board does not currently have a formal process in place to evaluate the performance of the Board, its committees and individual Directors (with the exception of the Executive Directors).

In addition to the main Board, there are five committees of the Board (each having its own terms of reference) which are empowered to give detailed consideration to various aspects of the Company's operations. These committees, together with a brief description of their remit, are as follows:

- **Nominations Committee** – recommends to the Board individuals for appointment to the Board and its committees.

- **Remuneration Committee** – makes recommendations to the Board on the remuneration and benefits packages for the Executive Directors and senior executives, reviews bonus arrangements, terms and conditions of employment and compensation terms for loss of office for the Executive Directors and senior executives, recommends awards under executive share plans and (following the recommendation of the CEO) recommends Non-executive Directors' fees.

- **Audit Committee** – oversees on behalf of the Board the financial and internal/external audit functions and reviews all controls (both financial and operational) and risk management processes operating in the business. The Audit Committee meets at least four times a year to carry out the following tasks:
  - to consider the appointment/re-appointment of the external auditors and to set their fees
  - to agree the scope of the audit prior to its commencement
  - to review the cost-effectiveness of the audit on an annual basis
  - to assess the qualifications, skills and resources and independence of the auditors
  - to assess current procedures to ensure independence and objectivity
  - to develop company policy with regard to non-audit services provided by the auditors
  - to review significant financial reporting issues and judgements made in connection with the financial statements and reports
  - to monitor the effectiveness of the internal audit function
  - to monitor the integrity of the Group's system of internal control (including risk management) and make recommendations to the Board.

- **Investment Committee** – reviews all proposed investments exceeding the delegated authority of the Chief Executive Officer, including major acquisitions and divestments, major bids, significant capital expenditure and material contracts.

- **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. The Committee meets four times a year to carry out the following tasks:
  - to review the operation of the MOD Compliance Regime
  - to monitor the activities of the QinetiQ Ethics Committee in ensuring that trials involving human volunteers are conducted in accordance with the requirements of the declaration of Helsinki (1962)
  - to monitor the activities of QinetiQ's Hazardous Trials Board in assuring trials safety
  - to review other compliance issues of note.

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 46 and 47.

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

Attendance at all Board and committee meetings April 2004-March 2005

Board

	Meetings attended
Dame Pauline Neville-Jones	10/10
Colin Balmer	9/10
Dr Peter Fellner **	4/5
Richard Gillingwater **	5/5
Sir Denys Henderson	8/10
Nick Luff *	5/7
Jonathan Symonds †	1/2
Trevor Woolley	10/10
Glenn Youngkin	9/10
Sir John Chisholm	10/10
Graham Love	10/10
Hal Kruth	10/10

Remuneration Committee

	Meetings attended
Dame Pauline Neville-Jones	4/4
Colin Balmer	4/4
Sir Denys Henderson	4/4
Glenn Youngkin	4/4

Audit Committee

	Meetings attended
Colin Balmer	2/5
Richard Gillingwater **	1/1
Nick Luff *	2/2
Jonathan Symonds †	3/3
Glenn Youngkin	5/5

Investment Committee

	Meetings attended
Jonathan Symonds †	1/2
Glenn Youngkin	2/2
Sir John Chisholm	2/2
Graham Love	2/2
Hal Kruth	2/2

Compliance Committee

	Meetings attended
Dame Pauline Neville-Jones	4/4
Sir Denys Henderson	4/4
Trevor Woolley	4/4

Nominations Committee

	Meetings attended
Dame Pauline Neville-Jones	2/2
Trevor Woolley	2/2
Glenn Youngkin	2/2
Sir John Chisholm	2/2

*Nick Luff was appointed to the Board on 30 June 2004.
**Dr Peter Fellner and Richard Gillingwater were both appointed to the Board on 29 September 2004.
†Jonathan Symonds resigned from the Board on 30 June 2004.

Relationship with auditors
The Audit Committee oversees the relationship with the Group's auditors, including their appointment and remuneration. In particular the Audit Committee has introduced guidelines to ensure that the independence and objectivity of the external auditors is safeguarded when carrying out non-audit work.

The principal features of these guidelines include the fact that all non-audit fees in excess of £50,000 are to be approved in advance by the Audit Committee and that the CFO must approve all contracts for non-audit work with the external auditor and the appointment of any of the auditor's employees into any senior role within QinetiQ. The policy expressly prohibits the auditors from valuing real estate or other material assets of the Group, from advising on potential corporate structures for accounting purposes, and from implementing or advising on financial and reporting systems. Furthermore, the policy prohibits the use of the external auditor for any non-audit work on which they may be asked to express an audit opinion.

US acquired companies
As part of the regulatory approval process for the acquisition of Foster-Miller, Inc. ('Foster-Miller') and Westar Aerospace and Defense Group, Inc. ('Westar'), both Foster-Miller and Westar were required to adopt a proxy regime as part of their respective corporate governance structures. The proxy regime requires each company to appoint at least three proxy directors to their respective boards, each of whom must be a cleared US citizen, with no previous experience of employment with either QinetiQ or Foster-Miller/Westar, and each having been approved by the US Department of Defense. The principal function of the proxy directors is to represent the shareholder interests of QinetiQ on the Foster-Miller and Westar boards, given the fact that under the proxy regime, QinetiQ is not entitled to appoint QinetiQ representatives as directors of Foster-Miller/Westar. The creation of proxy boards within Foster-Miller and Westar allows both companies to continue to perform existing classified contracts on US defense programmes and bid for new classified work. The review of internal controls at Foster-Miller and Westar is conducted by the same self-certification process as is applicable for the rest of the business, which is described in more detail below.

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 internal audit, 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, divisional and the next significant level of profit and loss as well as within all customer-facing projects) and how these are managed to both the QinetiQ Executive Team and the Audit Committee.

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 year ended 31 March 2005. 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.

The remuneration report covers all Directors, both Executive and Non-executive. This report sets out the current policy and disclosures in relation to Directors' remuneration.

The Remuneration Committee
('the Committee')

The Committee comprises exclusively Non-executive Directors and met on four occasions during the year.

The current members are:

Sir Denys Henderson (Chairman)
Dame Pauline Neville-Jones
Glenn Youngkin
Colin Balmer.

Sir John Chisholm, CEO, Stephen Luckhurst, Group Head of HR, and John Leighton-Jones, Head of Performance and Reward, attend meetings by invitation and provide advice and services to the Committee to enable it to make informed decisions. No Executive Directors are present when their own remuneration is being discussed.

The Committee's main responsibilities are:

- Setting, reviewing and approving remuneration packages for Executive Directors including terms and conditions of employment and changes to their packages.
- Reviewing the remuneration packages and terms and conditions of employment of other Group Executives along with the Company Secretary.
- Approving the scheme rules and launch of any QinetiQ share-based incentive scheme. Approving the grant, allocation or issue of shares or payment under an equity-based scheme.
- Reviewing proposals for significant changes to QinetiQ's remuneration strategies.

Hewitt Bacon & Woodrow provide actuarial, pensions and remuneration advice to the Committee who draw additional data from a number of independent sources.

This report has been produced in accordance with schedule 7A of the Companies Act 1985 and the Directors' Remuneration Report Regulations 2002. The following sections have been audited: Directors' Remuneration; Directors' Share Interests; and the Pension Section of the Report.

QinetiQ needs to employ, retain and motivate employees of the highest calibre with the capabilities, skills and experience in order to deliver its business strategy. The catchment areas for recruitment of this finite resource are scarce and increasingly so in the UK and outside.

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 personal and company performance;
- is based on information from independent remuneration sources and other large companies of a comparable size (turnover and market capitalisation);
- is compatible with the principles for establishing remuneration for the Company as a whole.

The cornerstone of the remuneration policy is that – whilst remuneration levels should reflect the market – competitive, performance-related incentives rather than fixed remuneration will be utilised to provide above market median levels of reward. Performance-related schemes form a significant proportion of the total reward packages for executives and are designed to align their interests with those of shareholders, establishing a clear link between performance and reward. However, the CEO, Sir John Chisholm, has personally chosen to accept only a graduated increase to his market-based salary during the transition from Civil Service conditions. The Remuneration Committee recognise that, in due course, this will need to be increased. Additionally, he should, in due course, benefit from a stock purchase incentivisation scheme.

Remuneration policy
QinetiQ aims to reward all performing employees competitively, taking into account individual performance, company performance, market comparisons and the competitive pressure in the industry. External comparisons are made on the basis of comparable roles in similar organisations in terms of size, market sector and business complexity in the UK. The Committee considers that it is important to link a significant proportion of the total executive package to individual, corporate and Sector performance. Remuneration packages and performance targets are reviewed annually to achieve this. The means of determining individual remuneration levels is consistent throughout the Company.

Since the creation of QinetiQ Ltd in July 2001, there has been a significant movement in salaries of all performing employees in order to better reflect the market. We will continue to benchmark our salaries in line with the market median. Exceptional levels of performance will continue to attract reward levels above market median.

Components of remuneration
The components of the remuneration packages for Executive Directors are as follows:

Basic salary
Salaries are reviewed annually with changes, if any, taking effect from 1 June. Basic salary for each Director is determined taking into account assessments of the Director's performance, experience and responsibility, together with market factors. For market comparison purposes account is taken of company type, sector and measures of company size in terms of both market capitalisation and turnover.

In line with our remuneration policy, the Committee benchmarks Executive salaries against a comparator group. In addition, salaries are referenced against the median of the FTSE 250.

Benefits
Benefits include a pension or contribution in lieu, as appropriate, plus car allowance and health insurance, neither of which is pensionable. The Company also pays an insurance premium in respect of death in service cover.

Annual bonus
Executive Directors have 'in year' cash bonus arrangements, which are non-pensionable, linked to Group and personal performance. The annual bonus arrangements for 2004/05 are summarised below. The 2004/05 bonus scheme was structured around a nominal annual bonus of 50% of basic salary. All three Executive Directors were measured against the same four key performance indicators (KPIs): turnover, management earnings before interest and taxes (EBIT), non-MOD orders and a cash generation target. An entry level is defined for each KPI and no payment will be made against that KPI unless the entry level performance is achieved. If the Company fails to achieve the entry level for management EBIT, then all bonus payments become discretionary. Assuming that this criterion is met, then each of the objectives is weighted and each has an entry threshold, above which the bonus payable increases linearly up to the target level, with bonus greater than 50% of salary (capped at 100%) available if performance over-achieves against the KPIs.

Each Executive Director also has personal supporting objectives which may be used to moderate the award. The Committee considers annually the choice of performance measures and the targets to be met.

Service contracts
Service contracts for Executive Directors are on a 12 months' rolling basis. The current retirement age for both Sir John Chisholm and Graham Love is 60, which is subject to review. Hal Kruth is an employee of QinetiQ Inc. registered in the USA and has no predetermined retirement age.

Three Non-executive Directors (Dame Pauline Neville-Jones, Nick Luff and Peter Fellner) have rolling service agreements, none of which has a notice period in excess of one year in duration. The remaining Directors have been appointed by the MOD and The Carlyle Group respectively, and are likely to remain in post until an 'exit' event takes place (such as the flotation of the Company or a sale). The appointment and removal of shareholder appointees is solely at shareholder discretion.

Current long-term incentives
Hal Kruth received a participatory interest in the QinetiQ Venture Fund. In April 2004, the Company agreed with Hal Kruth that this interest would be ended, and that he would be paid the sum of £100,000 in compensation. This event was reported in the 2004 Annual Report, but is included again in these accounts for completeness. Long-term incentive for the executive team is derived from participation in the equity of the parent undertaking – QinetiQ Holdings Limited.

Option scheme in shares of QHL
A share option scheme open to all employees was approved by the Board in July 2003 and Options were granted to all permanent UK employees in August 2003. Each Option is over 40 shares (per employee) and the price was set at £1 per share.

Directors' remuneration
The following information on Directors' remuneration and Directors' interests on pages 43 to 45 has been audited.

	Notes	Salary/fees £	Bonus (a) £	Benefits (f) £	Benefits in respect of prior periods £	Total 2005 £	Total 2004 £
Executive Directors							
Sir John Chisholm		295,000	147,500	49,641(g,j)	169,980(j)	662,121	466,541
Hal Kruth		204,167	61,500	108,598(h)	–	374,265	315,996
Graham Love		242,000	152,500	58,400(i)	–	452,900	416,001
Non-executive Directors							
Dame Pauline Neville-Jones		135,000				135,000	133,334
Sir Denys Henderson		35,000				35,000	34,167
Nick Luff	(c)	26,346				26,346	
Peter Fellner	(d)	17,500				17,500	
Colin Balmer	(b)	–				–	–
Trevor Woolley	(b)	–				–	–
Richard Gillingwater	(b) (d)	–				–	–
Glenn Youngkin	(b)	–				–	–
Former Directors							
Jonathan Symonds	(e)	14,583				14,583	34,167
Total		**969,596**	**361,500**	**216,639**	**169,980**	**1,717,715**	**1,400,206**

(a) Includes performance bonuses approved but not paid in the financial period
(b) Do not receive fees for Non-executive Director appointment
(c) Appointed 30 June 2004
(d) Appointed 29 September 2004
(e) Resigned 30 June 2004
(f) Benefits apart from pensions
(g) Includes life insurance, health insurance, car and chauffeur benefits
(h) Payment includes a one-off payment of £100,000 in compensation for relinquishing his carried interest in the Venture Fund; also payments for life insurance, health insurance and tax return fees
(i) Includes cash car allowance of £10,000 and £48,400 in lieu of pension contribution
(j) The year ended March 2005 includes an amount equal to the tax on the pension contribution of £28,335 in respect of the year ended March 2005 and £169,980 relating to the years ended March 2004 and March 2003. These payments, whilst made in the year ended March 2005, cover benefits applicable for the three years ended 31 March 2005.

Pensions
The Group's policy is to offer all UK employees membership of the QinetiQ Pension Scheme, as described in note 26. This scheme contains both defined benefit and defined contribution sections. Sir John Chisholm is a member of the defined benefit section. Hal Kruth is a member of the defined contribution section of the QinetiQ Pension Scheme.

Disclosures in respect of Sir John Chisholm
Disclosure in relation to defined benefits
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:

Executive Director	Additional accrued pension earned in the year (including inflation) £	Additional accrued lump sum earned in the year (including inflation) £	Accrued pension entitlement at 31 March 2005 £pa	Accrued lump sum entitlement at 31 March 2005 £	Transfer value at 31 March 2004 £	Transfer value at 31 March 2005 £	Increase in transfer value less Director's contributions £
Sir John Chisholm	1,470	4,410	5,101	15,303	74,916	109,682	28,410

The additional information required under LR 12.43A (c)(ix) of the FSA's Listing Rules is given below:

Executive Director	Additional accrued pension earned in the year (excluding inflation) £	Additional accrued lump sum earned in the year (excluding inflation) £	Transfer value of increase in accrued benefits (excluding inflation) at 31 March 2005 less Director's contributions £
Sir John Chisholm	1,358	4,073	22,834

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 year.
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.

Disclosure in relation to defined contributions
Sir John Chisholm was a member of QinetiQ Pension Scheme throughout the year. The benefits provided under the scheme are subject to the current earnings cap, which is a restriction on the amount of pay that can be used to calculate pensionable pay from a UK tax approved pension scheme. However, contractually Sir John was entitled to broad comparability under the Civil Service scheme to which he belonged. In view of the earnings cap, that can only be achieved under an unapproved arrangement and for the 2004/05 financial year Sir John Chisholm's benefits include a single payment of £198,315 representing three years of contributions in respect of his right of membership of the unapproved scheme.

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 12.43A (c)(x) of the FSA's Listing Rules are shown below:

The Company contribution payable in respect of the year to 31 March 2005 was £40,780 (2004: £80,736). In addition, a contribution of £244,605 (2004: £163,562) which was in respect of the period from 1 July 2001 to 31 March 2004 was paid on 8 April 2004.

Disclosures in respect of Hal Kruth
Details of the contributions payable to QinetiQ Pension Scheme, as required under Schedule 7A Section 12(3) of the Companies Act 1985 and LR 12.43A (c)(x) of the FSA's Listing Rules are shown below:

During the year, contributions of £40,833 (2004: £8,903) were paid into the QinetiQ Pension Scheme as per the contributions payable in respect of the year to 31 March 2005. There is US$119,000 accumulated in respect of Hal Kruth's 401(k) Safe Harbour Plan (in which he ceased to participate in 2003/04).

Directors' interests
The interests of the Directors in office at 31 March 2004 in the shares of QinetiQ Holdings Ltd (QHL), all of which were purchased on 28 February 2003 and remain unchanged at 31 March 2005, were as follows:

	D ordinary shares of £1	Convertible non-voting A ordinary shares of £1	Convertible non-voting B ordinary shares of £1	Redeemable cumulative preference shares of £1
Executive Directors				
Sir John Chisholm	129,500	920	80	9,000
Hal Kruth	69,375	–	–	–
Graham Love	106,375	920	80	9,000

Non-executive Directors
The following Non-executive Directors indirectly hold beneficial interests in QHL (all of which are fully paid up) which expressed as a percentage of the called-up share capital of the Company are: Dame Pauline Neville-Jones (0.04%); Sir Denys Henderson (0.08%); Glenn Youngkin (0.06%).

Share options
The Executive Directors, as detailed above, have all been granted 40 £1 B ordinary share options in QHL. These were granted on 25 July 2003. Options are exercisable at or after an exit (i.e. flotation of the Company or a sale) and must be exercised before the tenth anniversary of the date granted. If an option is not exercised within the dates, it will lapse.

Non-executive Directors
The Chief Executive reviews the fees of the Non-executive Directors and makes recommendations to the Committee and the Board.

The responsibilities of the role and the level of fees paid in UK organisations of similar size and complexity to QinetiQ are considered in setting remuneration policy for Non-executive Directors.

Non-executive Directors are not eligible to participate in bonus, profit sharing or employee share schemes, nor do they receive pension contributions from the Company.

Sir Denys Henderson
Chairman, Remuneration Committee
28 June 2005

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

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

The Directors are responsible for keeping proper accounting records which disclose, with reasonable accuracy at any time, the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF QINETIQ GROUP PLC

We have audited the financial statements on pages 48 to 72. 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 auditors' report and for no other purpose.

To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditors
The Directors are responsible for preparing the Annual Report and the Directors' remuneration report. As described on page 46, this includes responsibility for preparing the financial statements in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, the Listing Rules of the Financial Services Authority and by our profession's ethical guidance.

We report to you our opinion as to whether the financial statements give a true and fair view and 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. We also report to you if, in our opinion, the Directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions with the Group is not disclosed.

We review whether the corporate governance statement on page 39 to 41 reflects the Company's compliance with the nine provisions of the 2003 FRC Code specified for our review by the Listing Rules, 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, including the corporate governance statement and the unaudited part of the Directors' remuneration 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 mis-statements or material inconsistencies with the financial statements.

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

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' remuneration report to be audited are free from material mis-statement, 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 financial statements give a true and fair view of the state of affairs of the Company and the Group as at 31 March 2005 and of the profit of the Group for the year then ended; and
- 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.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
8 Salisbury Square
London
EC4Y 8BB
28 June 2005

GROUP PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31 MARCH

	Notes	2005 Before exceptional items £m	2005 Exceptional items £m	**2005 Total £m**	2004 Total £m
Turnover:					
Group and share of joint ventures before acquisitions		794.9	–	794.9	796.2
Acquisitions		78.4	–	78.4	–
Continuing operations		873.3	–	873.3	796.2
Less share of joint ventures		(0.9)	–	(0.9)	(0.8)
Group turnover	1	**872.4**	–	**872.4**	**795.4**
Cost of sales		(160.0)	–	(160.0)	(149.1)
Gross profit		**712.4**	–	**712.4**	**646.3**
Operating expenses		(644.3)	(28.2)	(672.5)	(589.6)
Group operating profit before acquisitions		59.0	(28.2)	30.8	56.7
Acquisitions		9.1	–	9.1	–
Group operating profit	2(a)	**68.1**	**(28.2)**	**39.9**	**56.7**
Share of operating loss in joint ventures and associates		(2.6)	–	(2.6)	(4.6)
Total operating profit before exceptional items and intangible assets amortisation and impairment		60.5	–	60.5	52.3
Exceptional restructuring costs and investment impairment	2(b)	–	(28.2)	(28.2)	–
Intangible assets amortisation and impairment		(4.1)	–	(4.1)	(0.2)
Total operating profit before acquisitions		**56.4**	**(28.2)**	**28.2**	**52.1**
Acquisitions		9.1	–	9.1	–
Total operating profit		**65.5**	**(28.2)**	**37.3**	**52.1**
Profit on disposal of fixed assets	3	15.5	30.7	46.2	7.4
Profit on ordinary activities before interest and taxation		**81.0**	**2.5**	**83.5**	**59.5**
Net interest payable and other similar charges	4	(1.2)	–	(1.2)	(11.9)
Profit on ordinary activities before taxation	1	**79.8**	**2.5**	**82.3**	**47.6**
Tax on profit on ordinary activities	5	(6.1)	(0.9)	(7.0)	(10.1)
Profit on ordinary activities after taxation		**73.7**	**1.6**	**75.3**	**37.5**
Equity minority interest in subsidiary undertakings				1.6	1.5
Profit attributable to ordinary shareholders				**76.9**	**39.0**
Dividends paid	6			(27.0)	–
Retained profit for the financial year	20			**49.9**	**39.0**

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

BALANCE SHEET
AS AT 31 MARCH

	Notes	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Fixed assets					
Intangible assets	9	152.2	1.0	–	–
Tangible assets	10	392.1	428.2	–	–
Investment in subsidiary undertakings	11(a)	–	–	205.5	205.5
Investment in associates	11(b)	–	0.4	–	–
Other investments	11(b)	0.5	–	–	–
		544.8	**429.6**	**205.5**	**205.5**
Current assets					
Stocks and work in progress	12	17.8	1.1	–	–
Debtors	13	442.1	274.3	137.6	140.9
Current asset investments	14	12.8	–	3.6	–
Cash at bank and in hand		12.3	154.5	–	–
		485.0	**429.9**	**141.2**	**140.9**
Creditors: amounts falling due within one year	15	(349.3)	(355.6)	(0.1)	(0.1)
Net current assets		**135.7**	**74.3**	**141.1**	**140.8**
Total assets less current liabilities		**680.5**	**503.9**	**346.6**	**346.3**
Creditors: amounts falling due after more than one year	16	(154.7)	(57.1)	–	(0.4)
Provisions for liabilities and charges	17	(76.2)	(48.8)	–	–
Provision for joint venture deficit:					
– Share of gross assets		–	2.4	–	–
– Share of gross liabilities		–	(3.4)	–	–
	11(b)	–	(1.0)	–	–
Net assets excluding pension liabilities		**449.6**	**397.0**	**346.6**	**345.9**
Defined benefit pension scheme net liabilities	26	(113.9)	(115.3)	–	–
Net assets	1	**335.7**	**281.7**	**346.6**	**345.9**
Capital and reserves					
Called up share capital	19	345.8	345.8	345.8	345.8
Profit and loss account	20	(7.3)	(63.1)	0.8	0.1
Equity shareholders' funds		**338.5**	**282.7**	**346.6**	**345.9**
Equity minority interest		(2.8)	(1.0)	–	–
		335.7	**281.7**	**346.6**	**345.9**

The accounting policies and notes on pages 52 to 72 form an integral part of these financial statements.
The financial statements on pages 48 to 72 were approved by the Board of Directors on 28 June 2005 and signed on its behalf by:

Sir John Chisholm
Chief Executive Officer

Graham Love
Chief Financial Officer

GROUP CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 MARCH

	Notes	2005 £m	2004 £m
Cash inflow from operating activities	21(a)	40.4	139.2
Returns on investments and servicing of finance	21(b)	(1.4)	(4.9)
Tax paid		(2.8)	(1.5)
Capital expenditure and financial investment	21(c)	32.0	(1.6)
Acquisitions and disposals	21(d)	(165.2)	(0.5)
Equity dividend paid		(27.0)	–
Cash (outflow)/inflow before financing		**(124.0)**	**130.7**
Financing	21(e)	(18.2)	(50.5)
(Decrease)/increase in cash in the year		**(142.2)**	**80.2**

RECONCILIATION OF NET CASH FLOW TO MOVEMENT IN NET (DEBT)/CASH
FOR THE YEAR ENDED 31 MARCH

	Note	2005 £m	2005 £m	2004 £m	2004 £m
(Decrease)/increase in cash in the year			(142.2)		80.2
New loans and overdrafts		(158.1)		(10.8)	
New loan notes		(0.9)		–	
Loan to parent undertaking		70.5		–	
Loan repayment to parent undertaking		95.2		57.0	
Loan repayments		10.8		4.3	
			17.5		50.5
Capital element of finance lease payments			0.7		–
Change in net (debt)/cash resulting from cash flows			**(124.0)**		**130.7**
Recapitalisation fee			1.5		–
New finance leases			(4.8)		–
Net cash/(debt) at the start of the year			2.6		(128.1)
Net (debt)/cash at the end of the year	22		**(124.7)**		**2.6**

GROUP STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

FOR THE YEAR ENDED 31 MARCH

	Notes	2005 £m	2004 £m
Profit attributable to ordinary shareholders excluding joint ventures and associates		79.3	43.4
Share of losses of joint ventures and associates		(2.4)	(4.4)
Profit attributable to ordinary shareholders		**76.9**	**39.0**
Gain/(loss) arising on the refinancing of joint ventures and associates	11(b)	0.6	(0.6)
Exchange loss		(0.8)	(0.4)
Actuarial (loss)/gain recognised in the defined benefit pension schemes	26	(9.8)	10.1
Movement in deferred tax asset on pension deficit	26	15.9	30.1
Total recognised gains and losses for the year		**82.8**	**78.2**

RECONCILIATION OF MOVEMENTS IN EQUITY SHAREHOLDERS' FUNDS

FOR THE YEAR ENDED 31 MARCH

	Notes	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Equity shareholders' funds at 1 April		282.7	204.5	345.9	345.8
Retained profit for the year		49.9	39.0	0.7	0.1
Exchange loss		(0.8)	(0.4)	–	–
Gain/(loss) arising on the refinancing of joint ventures and associates	11(b)	0.6	(0.6)	–	–
Actuarial (loss)/gain recognised in the defined benefit pension schemes	26	(9.8)	10.1	–	–
Movement in deferred tax asset on pension deficit	26	15.9	30.1	–	–
Equity shareholders' funds at 31 March		**338.5**	**282.7**	**346.6**	**345.9**

ACCOUNTING POLICIES

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the Group's financial statements.

Basis of preparation
The financial statements have been prepared under the historical cost convention and in accordance with applicable UK accounting standards.

Basis of consolidation
The consolidated financial statements comprise the financial statements of the Company and its subsidiary undertakings up to 31 March 2005. The acquisition method of accounting has been adopted. Under this method, the results of subsidiary undertakings acquired or disposed of in the period are included in the consolidated profit and loss account from the date of acquisition or up to the date of disposal.

On the acquisition of a business, or of an interest in a business, fair values, reflecting conditions at the date of acquisition, are attributed to the net assets. Where material, adjustments are also made to bring accounting policies into line with those of the Group. Deferred consideration is recognised once any underlying performance targets have been achieved.

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

Where an associate or joint venture has net liabilities full provision is made for the Group's share of liabilities even where there is no obligation to provide additional funding to the associate or joint venture.

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.

Turnover
Turnover represents the value of work performed for customers (net of value added tax and other sales taxes) including attributable profit and after adjusting for foreseeable losses.

Turnover from fixed price contracts is recognised in proportion to the value of the work performed and includes attributable profit. 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.

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 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.

Amounts recoverable on contracts
Amounts recoverable on contracts are included in debtors and represent turnover recognised in excess of amounts invoiced.

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

Goodwill
Purchased goodwill (representing the excess of the fair value of the consideration paid and associated costs over the fair value of the separable net assets acquired) arising on consolidation is capitalised. Goodwill is amortised to nil by equal annual instalments over its estimated useful economic life (of up to 20 years). On the subsequent disposal or termination of a business, the profit or loss on disposal or termination is calculated after charging the unamortised amount of any related goodwill. Impairment reviews are carried out to ensure that goodwill is not carried at above its recoverable amount. Any amortisation or impairment write-downs are charged to the profit and loss account as operating items.

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

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

Current asset investments are carried at the lower of cost and market value.

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

Freehold buildings	20-25 years
Leasehold land and buildings	Over the unexpired term 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 tangible fixed assets 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.

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.

Assets and liabilities of overseas subsidiary 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 subsidiary and associated undertakings and joint ventures are translated to sterling using the average rates of exchange during the period. Exchange adjustments arising from the re-translation of the opening net investment and the results for the period to the year end rate are taken directly to reserves and reported in the statement of total recognised gains and losses.

Leased assets
Assets held under finance leases are capitalised and included in tangible fixed assets at 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 profit and loss account evenly over the term of the lease.

Post-retirement benefits
The Group provides both defined contribution and defined benefit pension arrangements.

Costs associated with the provision of defined benefit pension schemes are recognised in accordance with advice received from independent qualified actuaries. Costs associated with the provision of defined contribution schemes reflect the contributions payable by the Group in the period.

The balance sheet valuation of defined benefit schemes is calculated by independent, qualified actuaries in accordance with FRS17, and represents the market valuation of scheme assets at the balance sheet date less the present value of long-term liabilities discounted at a rate determined by the market return on corporate bonds.

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 cost of sales and turnover respectively.

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

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

Deferred tax is provided, without discounting, in respect of all timing differences that have arisen but not reversed by the balance sheet date. Deferred tax assets are only provided to the extent that they are regarded as recoverable.

NOTES TO THE FINANCIAL STATEMENTS

1. Segmental analysis

Classes of business

Year ended March 2005

	Turnover £m	Operating profit before exceptional items £m	Exceptional items £m	Profit on disposal of fixed assets £m	Interest £m	Profit before tax £m	Net assets £m
Defence & Technology	664.9	48.0	–	(1.5)	–	46.5	378.8
Security & Dual Use	137.4	12.4	–	47.7	–	60.1	99.6
North America	70.1	5.1	–	–	–	5.1	163.3
Corporate	–	–	(28.2)	–	(1.2)	(29.4)	(181.3)
Total	**872.4**	**65.5**	**(28.2)**	**46.2**	**(1.2)**	**82.3**	**460.4**
Net debt*							(124.7)
Group total	**872.4**	**65.5**	**(28.2)**	**46.2**	**(1.2)**	**82.3**	**335.7**

Year ended March 2004**

	Turnover £m	Operating profit before exceptional items £m	Exceptional items £m	Profit on disposal of fixed assets £m	Interest £m	Profit before tax £m	Net assets £m
Defence & Technology	657.7	43.5	–	–	–	43.5	345.9
Security & Dual Use	137.4	9.2	–	7.4	–	16.6	101.9
North America	0.3	(0.6)	–	–	–	(0.6)	1.7
Corporate	–	–	–	–	(11.9)	(11.9)	(170.4)
Total	**795.4**	**52.1**	**–**	**7.4**	**(11.9)**	**47.6**	**279.1**
Net cash*							2.6
Group total	**795.4**	**52.1**	**–**	**7.4**	**(11.9)**	**47.6**	**281.7**

*Net debt/cash includes £45.9m (2004: £45.9m) in respect of the Aquila/Chertsey Loan Note which is repayable only from the net proceeds of certain identifiable assets.
**The prior year figures have been restated to be on a basis comparable with the current year.

Geographic markets

The table below shows turnover by geographic area:

	Turnover by destination		Turnover by origin	
	2005 £m	2004 £m	**2005 £m**	2004 £m
United Kingdom	749.0	740.4	802.3	795.1
North America	86.9	16.6	70.1	0.3
Continental Europe	14.6	17.1	–	–
Rest of world	21.9	21.3	–	–
	872.4	**795.4**	**872.4**	**795.4**

The table below shows profit before tax and net assets by geographic area:

	Profit before tax by origin		Net assets by origin	
	2005 £m	2004 £m	**2005 £m**	2004 £m
United Kingdom	77.2	48.2	172.4	280.0
North America	5.1	(0.6)	163.3	1.7
	82.3	**47.6**	**335.7**	**281.7**

2. Operating profit

a) Group operating profit has been stated after charging:

	2005 £m	2004 £m
Auditors' remuneration:		
Group – audit	0.5	0.3
Group – other attestation	0.3	0.1
Group – taxation	0.2	0.2
Depreciation and other amounts written off tangible and intangible fixed assets:		
depreciation and impairment of tangible fixed assets	39.8	42.0
amortisation and impairment of goodwill	4.1	0.2
Operating lease rentals:		
land and buildings	5.1	9.8
plant and machinery	0.4	0.5
Foreign exchange loss	–	0.2

The Company audit fee was £5,000 (2004: £5,000).

b) Exceptional operating items

The following exceptional items were included in the profit and loss account:

	2005 £m	2004 £m
Exceptional restructuring costs	25.9	–
Exceptional investment impairment	2.3	–
	28.2	**–**

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

The impairment of the investment results from an unrealised reduction in the value of the investment in pSivida Limited (see note 14). There was nil tax and cash effect.

3. Profit on disposal of fixed assets

	2005 £m	2004 £m
Profit on disposal of fixed assets	**46.2**	**7.4**

On 21 June 2004 the Group sold the Pyestock North freehold site for £47.9m net of costs, resulting in an exceptional profit on disposal of £30.7m. The cash consideration was £54.0m and disposal costs and associated works totalled £6.1m of which £4.4m had been spent by year end. There was an £8.7m tax charge in respect of this disposal.

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. Since the date of the disposal the value of the pSivida shares has declined and a £2.3m impairment in the investment carrying value of these shares has been charged to operating profit.

Other fixed asset disposals in the year generated net cash proceeds of £2.7m and a related loss on disposal of £1.6m.

In the prior year the Group disposed of the Chertsey property for £48.5m generating a profit on disposal of £4.1m. Additional consideration is due upon the purchaser obtaining additional planning consents, with the quantum dependent on the scope of consent achieved. Additional profits on disposal of £3.3m were recognised from other fixed asset sales.

4. Net interest payable

		2005 £m		2004 £m
Receivable on bank deposits		(3.6)		(5.7)
Payable on bank loans and overdrafts	3.1		2.2	
Payable on Aquila/Chertsey Loan Note	1.1		2.0	
Other loan interest	0.3		0.1	
Interest (receivable from)/payable to parent undertaking	(2.0)		7.2	
Interest payable		2.5		11.5
Net interest on pension scheme under FRS17:				
Expected return on defined benefit scheme assets	(27.7)		(19.2)	
Interest on defined benefit scheme liabilities	30.0		25.3	
		2.3		6.1
		1.2		**11.9**

5. Taxation

a) Analysis of charge

	2005 £m	2004 £m
Current tax:		
UK corporation tax at 30%	–	–
Overseas corporation tax	1.0	–
Overseas corporation tax in respect of previous periods	(0.1)	–
Overseas withholding tax	1.3	1.5
Share of joint ventures' and associates' tax credit	(0.1)	(0.3)
Total current tax	**2.1**	**1.2**
Deferred tax (note 17)	4.9	8.9
Tax on profit on ordinary activities	**7.0**	**10.1**

b) Factors affecting the tax charge

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

Profit before tax	82.3	47.6
Tax on ordinary activities at 30%	24.7	14.3
Effect of:		
Expenses not deductible for tax purposes, tax relief and non-taxable items arising on consolidation	(14.2)	(7.5)
Capital allowances in excess of depreciation	(6.5)	(2.8)
Utilisation of UK tax losses	(2.1)	(8.6)
Unprovided tax losses of UK subsidiaries, joint ventures, associates and non-trade losses	–	1.3
(Utilisation of)/unprovided tax losses of overseas subsidiaries	(2.6)	0.8
Overseas withholding tax	1.3	1.5
Share of joint ventures and associates tax credit	(0.1)	(0.3)
Other timing differences	1.6	2.5
Current tax charge for the year	**2.1**	**1.2**

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 will continue to be a major contributory factor in reducing the future tax charge.

6. Dividends

During the year the Group declared and paid a dividend of 7.8p per share, totalling £27.0m (2004: £nil).

7. Employee information

The average number of persons employed by the Group including Directors analysed by class of business, was:

	2005 Number	2004 Number*
Defence & Technology	6,931	6,899
Security & Dual Use	1,806	1,628
North America	1,320	22
Corporate	349	349
	10,406	**8,898**

The aggregate payroll costs of these persons were as follows:

	£m	£m
Wages and salaries	315.8	280.1
Social security costs	28.3	25.0
Other pension costs	45.7	43.8
	389.8	**348.9**

*The prior year figures have been restated on a comparable basis with the current year.

The Company had no employees (2004: nil).

8. Acquisitions and disposals

US Acquisitions

On 8 October 2004 QinetiQ Group acquired the whole of the share capital of Westar Aerospace & Defence Group, Inc. (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. No provision has been made for additional consideration of up to £4.8m ($9.0m) payable dependent on the profits of Westar for the year ending 31 December 2005.

On 5 November 2004 QinetiQ Group acquired the whole of the share capital of Foster-Miller, Inc. (Foster-Miller) for a consideration, before acquisition costs, of £104.0m ($191.3m), including £13.1m ($24.1m) for Foster-Miller's cash and surplus working capital.

Summary profit and loss accounts and statements of total recognised gains and losses for Foster-Miller and Westar prior to acquisition are:

	Westar period from 1/1/04 to 8/10/04 £m	Foster-Miller period from 1/8/04 to 5/11/04 £m
Profit and loss		
Turnover	65.2	18.6
Operating profit	8.1	2.2
Profit before taxation	8.0	2.2
Taxation	(3.0)	(0.9)
Profit for the period	**5.0**	**1.3**

There were no recognised gains and losses in the periods other than the reported profit after taxation.

In the year to 31 December 2003 Westar recorded a profit after taxation of £1.3m ($2.4m). In the year to 31 July 2004 Foster-Miller recorded a profit after taxation of £5.5m ($10.3m).

The provisional analysis of the net assets acquired is:

	Westar			Foster-Miller		
	Book value Total £m	Fair value adjustment Total £m	Fair value at acquisition Total £m	Book value Total £m	Fair value adjustment Total £m	Fair value at acquisition Total £m
Intangible fixed assets	7.9	(7.9)	–	–	–	–
Tangible fixed assets	1.0	–	1.0	3.3	–	3.3
Current assets	25.4	–	25.4	21.3	–	21.3
Current liabilities:	(19.9)	–	(19.9)	(10.6)	–	(10.6)
Cash	3.5	–	3.5	8.2	–	8.2
Provisions for liabilities and charges	–	–	–	(0.2)	–	(0.2)
Deferred taxation	–	–	–	3.3	–	3.3
Net assets acquired	**17.9**	**(7.9)**	**10.0**	**25.3**	**–**	**25.3**
Goodwill			66.5			79.8
			76.5			**105.1**
Consideration satisfied by:						
Cash			71.5			98.3
Deferred consideration			3.9			5.7
Related costs of acquisition			1.1			1.1
Total consideration			**76.5**			**105.1**

The fair value adjustment of £7.9m relates to the elimination of goodwill recorded on a previous acquisition in Westar. Since acquisition Westar contributed turnover of £43.5m and operating profit of £5.8m.

Since acquisition Foster-Miller contributed turnover of £25.8m and operating profit of £3.4m.

UK acquisitions

On 5 August 2004 QinetiQ acquired HVR Group Limited for a consideration, including costs, of £13.8m. The provisional fair value of net assets at this date was £0.9m, resulting in goodwill on acquisition of £12.9m. Included in the acquisition cost is £3.9m of deferred consideration which will be settled through the issue of loan notes which are redeemable from six months after issue until 31 July 2009.

8. Acquisitions and disposals (continued)

On 1 September 2004 QinetiQ 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 and a minority interest of £0.3m were recorded on completion.

On 20 September 2004 QinetiQ purchased the remaining 55% of its associate ASAP Calibration Limited, making this a wholly-owned subsidiary. The consideration was £1.0m, resulting in goodwill on acquisition of £0.5m.

The provisional analysis of the net assets acquired is:

	Total UK acquisitions		
	Book value Total £m	Fair value adjustments Total £m	Fair value at acquisition Total £m
Intangible fixed assets	1.6	(1.6)	–
Tangible fixed assets	0.8	–	0.8
Current assets	3.0	–	3.0
Current liabilities	(3.9)	–	(3.9)
Cash	3.4	–	3.4
Loans	(0.5)		(0.5)
Defined benefit pension scheme net liabilities	–	(0.4)	(0.4)
Net assets acquired	**4.4**	**(2.0)**	**2.4**
Minority interest			0.3
Goodwill			12.1
			14.8
Consideration satisfied by:			
Cash			9.8
Loan Notes			0.9
Deferred consideration			3.9
Related costs of acquisition			0.2
Total consideration			**14.8**

The fair value adjustments relate to the elimination of QinetiQ developed intellectual property rights (£1.6m) held by Aurix Ltd and the FRS17 recognition of Aurix Ltd's pension liability (£0.4m) in accordance with Group accounting policy.

The resulting goodwill of the US and UK acquisitions, totalling £158.4m was capitalised and is being amortised over a 20-year period.

9. Intangible fixed assets

	Goodwill £m	Intellectual property and development costs £m	Total £m
Cost			
At 1 April 2004	5.7	0.5	6.2
Fully written down	(5.1)	–	(5.1)
Additions	–	1.8	1.8
Acquisitions	158.4	–	158.4
Foreign exchange	(4.9)	–	(4.9)
At 31 March 2005	154.1	2.3	156.4
Amortisation			
At 1 April 2004	5.2	–	5.2
Fully written down	(5.1)	–	(5.1)
Charge for the year	3.7	–	3.7
Impairments in the year	0.4	–	0.4
At 31 March 2005	4.2	–	4.2
Net book value			
At 31 March 2005	**149.9**	**2.3**	**152.2**
At 31 March 2004	0.5	0.5	1.0

10. Tangible fixed assets

	Land and buildings £m	Plant, machinery and vehicles £m	Computers and office equipment £m	Assets under construction £m	Total £m
Cost					
At 1 April 2004	410.3	110.4	19.4	9.3	549.4
Additions	0.7	1.2	8.4	10.9	21.2
Acquisitions	1.3	1.7	2.5	0.2	5.7
Disposals	(17.7)	(8.8)	(6.1)	(0.9)	(33.5)
Transfers	1.3	5.6	2.3	(9.2)	–
At 31 March 2005	395.9	110.1	26.5	10.3	542.8
Depreciation					
At 1 April 2004	42.6	65.4	13.2	–	121.2
Charge for the year	13.1	20.8	5.9	–	39.8
Disposals	–	(4.3)	(6.0)	–	(10.3)
At 31 March 2005	55.7	81.9	13.1	–	150.7
Net book value					
At 31 March 2005	**340.2**	**28.2**	**13.4**	**10.3**	**392.1**
At 31 March 2004	367.7	45.0	6.2	9.3	428.2

Transfers of fixed assets 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.

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 24 'Relationship with related party'.

Assets held under finance leases, capitalised and included in computers and office equipment have a cost of £5.2m (2004: nil), aggregate depreciation of £1.0m (2004: nil), and a net book value of £4.2m. Included within the net book value of land and buildings is £0.9m (2004: £0.9m) of leasehold properties, the remainder of the properties are freehold.

11. Investments

	Company 2005 £m
a) Subsidiary undertakings	
At 1 April and 31 March	**205.5**

	Joint ventures £m	Associates £m	Other investments £m	Group Total £m
b) Fixed asset investments				
At 1 April 2004	(1.0)	0.4	–	(0.6)
Reclassified	(0.2)	0.2	–	–
Additions	0.4	1.6	0.5	2.5
Share of post-tax losses	(0.3)	(2.1)	–	(2.4)
Reclassification on change to subsidiary status	–	(1.1)	–	(1.1)
Increase in value from refinancing (see note below)	–	0.6	–	0.6
Disposals	1.1	0.4		1.5
Net book value at 31 March 2005	**–**	**–**	**0.5**	**0.5**

The net increase in value from refinancing of the associates has been taken to reserves through the statement of recognised gains and losses. Gains and losses arise when the Group and/or its partners invest differing amounts of cash or other assets into the joint ventures and associates and, as a result of the increased investment, the share of the net assets owned by the Group changes in value.

Other investments represents the Group's 10.8% interest in Sciemus Limited, acquired for cash consideration of £0.5m on 14 September 2004.

12. Stocks and work in progress

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Raw materials and consumables	12.3	0.8	–	–
Work in progress	5.5	0.3	–	–
	17.8	**1.1**	–	–

13. Debtors

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Trade debtors	219.1	150.4	–	–
Amounts recoverable under contracts	89.6	61.7	–	–
Amounts owed by Group undertakings	–	–	120.1	140.9
Amounts due from immediate parent undertaking	70.5	–	–	–
Other debtors	52.1	48.4	17.5	–
Prepayments	10.8	13.8	–	–
	442.1	**274.3**	**137.6**	**140.9**

Included within amounts recoverable under contracts is £11.6m (2004: £11.8m) due after one year, and within other debtors is an amount of £nil due after one year (2004: £45.8m).

14. Current asset investments

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Cost	15.1	–	4.2	–
Impairment	(2.3)	–	(0.6)	–
Net book value	**12.8**	–	**3.6**	–

At 31 March 2005 the Group held 35.7 million shares in pSivida Limited (2004: nil). The Group's carrying value of this listed investment was impaired by £2.3m during the year to reflect its market value at 31 March 2005 of A$0.88 per share.

15. Creditors: amounts falling due within one year

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Aquila/Chertsey Loan Note	45.9	–	–	–
Bank overdraft	7.3	–	–	–
Deferred financing costs	(0.3)	–	–	–
Finance lease creditor	1.6	–	–	–
Payments received on account	103.1	83.3	–	–
Trade creditors	20.1	17.7	–	–
Due to immediate parent undertaking	–	95.2	–	–
Taxation and social security	40.0	41.2	–	0.1
Other creditors	25.5	15.9	0.1	–
Accruals and deferred income	106.1	102.3	–	–
	349.3	**355.6**	**0.1**	**0.1**

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

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Bank loan	150.8	10.8	–	–
Aquila/Chertsey Loan Note	–	45.9	–	–
Loan notes	0.9	–	–	–
Deferred financing costs	(1.2)	–	–	–
Finance lease creditor	2.5	–	–	–
Other creditors	1.7	0.4	–	0.4
	154.7	**57.1**	–	**0.4**

17. Provisions for liabilities and charges

	Deferred taxation £m	Reorganisation £m	Other £m	Total £m
At 1 April 2004	27.6	7.6	13.6	48.8
Utilised	–	(5.7)	(3.1)	(8.8)
Acquisitions	(3.3)	–	–	(3.3)
Released	–	(0.6)	(3.2)	(3.8)
Credit in respect of tax on additional payment to pension scheme	2.7	–	–	2.7
Created	4.9	30.9	4.8	40.6
At 31 March 2005	**31.9**	**32.2**	**12.1**	**76.2**

Other provisions include legal and statutory and environmental and insurance commitments. Reorganisation provisions relate to the costs associated with the restructuring of the UK business.

The amounts provided for deferred taxation are set out below:	**Group 2005 £m**	Group 2004 £m
Difference between accumulated depreciation, amortisation and capital allowances	35.8	29.8
Short-term timing differences	(3.9)	(2.2)
Total deferred taxation liability provided	**31.9**	**27.6**

In addition a deferred tax asset of £48.7m (2004: £30.1m) is offset directly against the pension deficit (note 26).

The amounts of deferred taxation not provided are set out below:	**Group 2005 £m**	Group 2004 £m
Tax losses	(6.6)	(11.2)
Total deferred taxation asset not provided	**(6.6)**	**(11.2)**

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

18. Financial instruments

The disclosures set out below exclude short-term debtors and creditors and deferred tax, except for the analysis of net currency exposure. Disclosures on financial risk management and treasury policies are also included in the Operating and Financial Review.

a) Fair values of financial instruments at 31 March

	Book value 2005 £m	**Fair value 2005 £m**	Book value 2004 £m	Fair value 2004 £m
Primary financial instruments held or issued to finance the Group's operations				
Cash and deposits	12.3	12.3	154.5	154.5
Amounts due from/(to) immediate parent undertaking	70.5	70.5	(95.2)	(95.2)
Borrowings due within one year	(54.5)	(54.5)	–	–
Borrowings due after more than one year	(153.0)	(153.0)	(56.7)	(56.7)
Derivative financial instruments held to manage interest rate and currency exposure				
Interest rate swaps and similar instruments	–	1.9	–	2.6
Forward currency contracts	–	(0.1)	–	0.1
Other financial assets				
Trade investments	0.5	0.5	–	–
Current asset investments	12.8	12.8	–	–
Other assets	–	–	45.8	45.8

Market values, where available, have been used to determine fair values. Where market values are not available, fair values have been calculated by discounting cash flows at prevailing interest rates, except for unlisted fixed asset investments which are given a fair value equal to book value. The book value of unlisted fixed asset investments at 31 March 2005 is £0.5m (2004: £nil).

18. Financial instruments (continued)

b) Interest rate risk

After taking into account the various interest rate swaps and forward foreign exchange contracts entered into by the Group, the currency and interest rate profile of the Group's financial assets and liabilities at 31 March 2005 is:

Financial assets

	Floating £m	Non-interest bearing £m	Total £m
Sterling	81.2	7.5	88.7
US Dollar	0.9	–	0.9
Other	0.7	5.8	6.5
	82.8	**13.3**	**96.1**

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)**

Net financial assets and liabilities

	Fixed or capped £m	Floating £m	Non-interest bearing £m	Total £m
Sterling	(4.1)	74.5	(38.4)	32.0
US Dollar	(121.7)	(28.2)	–	(149.9)
Other	–	0.7	5.8	6.5
	(125.8)	**47.0**	**(32.6)**	**(111.4)**

	Financial assets 2005 £m	**Financial liabilities 2005 £m**	Total £m
Of which:			
Cash and deposits	12.3	(7.3)	5.0
Amounts due from immediate parent undertaking	70.5	–	70.5
Bank loans and loan notes	–	(196.1)	(196.1)
Finance leases	–	(4.1)	(4.1)
Investments	13.3	–	13.3
	96.1	**(207.5)**	**(111.4)**

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

	Weighted average interest rate % 2005	**Weighted average years to maturity 2005**	Weighted average interest rate % 2004	Weighted average years to maturity 2004
Sterling	6.7%	2.3	5.6%	2.7
US Dollar	4.4%	3.7	–	–
	4.5%	**3.6**	**5.6%**	**2.7**

c) Currency risk

The table below shows the Group's currency exposures at 31 March 2005, being exposures on currency transactions that give rise to net currency gains and losses recognised in the profit and loss account. 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.

Functional currency of the operating company	Net foreign currency monetary assets US Dollar £m	Euro £m	Australian Dollar £m	Other £m	Total £m
Sterling	2.0	3.9	5.3	0.4	11.6

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

Comparative figures are not provided in respect of currency risk as the Group's monetary assets and liabilities were substantially denominated in the functional currency of the operating unit involved.

d) Maturity of financial liabilities

	Bank borrowings and loan notes 2005 £m	**Finance leases 2005 £m**	**Total 2005 £m**	Bank borrowings and loan notes 2004 £m	Other liabilities 2004 £m	Total 2004 £m
Due in one year or less	52.9	1.6	54.5	–	95.2	95.2
Due in more than one year but not more than two years	–	2.2	2.2	45.9	–	45.9
Due in more than two years but not more than five years	150.5	0.3	150.8	10.8	–	10.8
	203.4	**4.1**	**207.5**	**56.7**	**95.2**	**151.9**

e) Borrowing facilities

At 31 March 2005, the following committed facilities were available to the Group:

	Expiry	Interest rate %	Total £m	Drawn £m	Undrawn £m
Multicurrency revolving facility	24/08/09	LIBOR plus 0.60%	300.0	150.8	149.2
HVR Loan Notes	31/07/09	Base minus 1.0%	0.9	0.9	–
Aquila/Chertsey Loan Note		Interest free	45.9	45.9	–
US Dollar revolving facility	2/12/07	Price minus 0.50%	6.9	–	6.9
US Dollar revolving facility	25/07/05	LIBOR plus 2.0%	2.6	–	2.6
Committed facilities March 2005			**356.3**	**197.6**	**158.7**
Committed facilities March 2004			441.7	162.5	279.2

Loans drawn under the £300m multi-currency revolving facility are repayable within 12 months, but have been classified as due in more than two years as the relevant committed facilities are available until 24 August 2009.

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

A subsidiary company has issued the 'Aquila/Chertsey Loan Note' to the MOD. The original capital sum of £60m is repayable only from the net proceeds of the sale of certain identified assets. As at the balance sheet date £14.1m had been repaid to MOD.

Under the terms of the US Dollar revolving facility expiring 2 December 2007, the Lender has been granted a security interest in and lien on all assets and personal property of Westar Aerospace and Defense Group, Inc.

19. Share capital

	Ordinary shares Number	Special share Number
Number of shares authorised		
Shares of £1 each	345,880,038	1
Number of shares allotted, called up and fully paid		
At 31 March 2005 and 31 March 2004	345,830,039	1
	£m	£m
Nominal value of shares allotted at 31 March 2005 and 31 March 2004	**345.8**	**–**

Special share – the nature of the work performed by the Group is of strategic interest to the defence of the United Kingdom. As a result HM Government, acting through the MOD, retains ownership of the Special Share. The Special Share gives certain rights to 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 effective at all times the 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 the Company 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 or would be or is otherwise contrary to the defence or security interests of the United Kingdom;

d) to require the Board to take any action (including but not limited to amending the Compliance Principles or Compliance Guidelines), or rectify any omission in the application of the Compliance Principles, if the Special Shareholder is of the opinion that such steps are necessary to protect the defence or security interests of the United Kingdom;

e) to demand a poll at any of the Group's meetings (even though it has no voting rights except those given to it as a Special Shareholder).

The Special Shareholder has an option to purchase defined Strategic Assets of the Group. The Special Shareholder has the right to purchase any defined Strategic Assets which the Group wishes to sell. Strategic Assets are normally testing and research facilities (see also note 24).

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 the Group to redeem the Special Share at par.

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

20. Profit and loss account

	Group 2005 £m	Company 2005 £m
At 1 April	**(63.1)**	**0.1**
Retained profit for the year	49.9	0.7
Exchange loss	(0.8)	–
Gain arising on the disposal of joint ventures and associates	0.6	–
Actuarial loss recognised in the defined benefit pension scheme	(9.8)	–
Movement in deferred tax asset recognised on defined pension scheme liability	15.9	–
At 31 March	**(7.3)**	**0.8**
Profit and loss reserve excluding defined benefit pension liability	103.1	0.8
Post 1 July 2001 actuarial losses recognised in the defined benefit pension scheme	(110.4)	–
Profit and loss reserve including defined benefit pension liability	**(7.3)**	**0.8**

21. Notes to the cash flow statement

a) Reconciliation of operating profit to operating cash flows

	Notes	2005 £m	2004 £m
Operating profit		37.3	52.1
Depreciation and impairment of tangible fixed assets		39.8	42.0
Amortisation and impairment of intangible fixed assets		4.1	0.2
Share of loss in joint ventures and associates		2.6	4.6
(Increase)/decrease in stocks and work in progress		(16.7)	1.6
(Increase)/decrease in debtors		(47.6)	16.4
(Decrease)/increase in creditors		(2.0)	37.6
Net movement in provisions		22.9	(15.3)
Net cash inflow from operating activities		**40.4**	**139.2**

b) Returns on investments and servicing of finance

Interest received		3.8	5.8
Interest paid		(4.3)	(3.5)
Interest paid to parent company		(0.9)	(7.2)
		(1.4)	**(4.9)**

c) Capital expenditure and financial investment

Purchase of intangible fixed assets	9	(1.8)	–
Purchase of tangible fixed assets		(16.0)	(13.4)
Sale of tangible fixed assets		52.3	14.2
Cash investments	11(b)	(2.5)	(2.4)
		32.0	**(1.6)**

d) Acquisitions and disposals

Purchase of businesses

Net assets acquired		(37.7)	–
Minority interest		(0.3)	–
Cash and cash equivalents acquired/(disposed)		15.1	(0.5)
		(22.9)	**(0.5)**
Goodwill on acquisition		(158.4)	–
Less: deferred consideration and loan notes		14.4	–
Cash outflow on purchase of businesses		**(166.9)**	**(0.5)**
Sale of investment in associate	3	1.7	–
Total acquisitions and disposals		**(165.2)**	**(0.5)**

e) Financing

Repayment of term and other loans		(10.8)	(4.3)
New bank overdraft		7.3	–
New long-term loan		150.8	10.8
New loan note		0.9	–
Loan to parent undertaking		(70.5)	–
Loan repayments to parent undertaking		(95.2)	(57.0)
Capital payments under finance leases		(0.7)	–
		(18.2)	**(50.5)**

22. Analysis of net (debt)/cash

	2004 £m	Cash flow £m	**2005 £m**
Bank and cash	154.5	(142.2)	12.3
Due within one year			
Bank borrowings	–	(7.3)	(7.3)
Recapitalisation fee	–	0.3	0.3
Acquila/Chertsey Loan Note	–	(45.9)	(45.9)
Finance leases	–	(1.6)	(1.6)
Loan to/(from) parent undertaking	(95.2)	165.7	70.5
	(95.2)	**111.2**	**16.0**
Due after one year			
Bank loan	(10.8)	(140.0)	(150.8)
Recapitalisation fee	–	1.2	1.2
Aquila/Chertsey Loan Note	(45.9)	45.9	–
Finance leases	–	(2.5)	(2.5)
Loan notes	–	(0.9)	(0.9)
	(56.7)	**(96.3)**	**(153.0)**
Total net cash/(debt)	**2.6**	**(127.3)**	**(124.7)**

23. Commitments

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

	2005 £m	2004 £m
Contracted	**5.0**	**6.4**

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

Leases expiring within:	**Buildings 2005 £m**	**Other 2005 £m**	Buildings 2004 £m	Other 2004 £m
– one year	2.1	0.5	2.0	0.6
– two to five years	3.8	0.7	0.8	0.3
– over five years	1.4	–	0.5	–
	7.3	**1.2**	**3.3**	**0.9**

c) The Group's share of capital commitments of joint ventures and associates as at 31 March 2005 was £0.5m (2004: £nil).

24. Relationship with related party

Detailed below are the agreements that have been entered into and the trading that has taken place with the MOD and other HM Government related parties.

Trading

The MOD is a major customer of the Group. During the financial year sales of £637.6m included property rental income of £10.9m (2004: £643.7m including property rental income of £10.4m) were made to the MOD and at 31 March 2005 the MOD had an outstanding trade debtor balance of £123.0m (2004: £102.9m). The Group also purchased services of £17.4m (2004: £14.9m) from the MOD during the year and at the year end had an outstanding trade creditor of £0.3m (2004: £0.8m).

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:

a) Restrictions on transfer of title

The property title deeds include a clause that prevents their transfer without the approval of the MOD.

b) Property clawback agreement

The MOD retains an interest in future profits on disposal, or revaluation, following a 'trigger event'. A 'trigger event' includes the granting of planning permission for development and/or change of use, and the disposition of any of the acquired land and buildings. During the 12 years from 1 July 2001, following a 'trigger event', the MOD is entitled to clawback a proportion of the gain on each individual property transaction 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%. The July 2001 valuation was approximately 16% greater in aggregate than the consideration paid for the land and buildings on 1 July 2001.

Loans

The Aquila/Chertsey Loan Note payable to the MOD is repayable only from the net proceeds of the disposal of the Chertsey and Aquila properties. At the year end the amount repayable on this loan was £45.9m (2004: £45.9m). This loan was non-interest bearing to 30 June 2003, with interest relating to LIBOR until 28 August 2004 from when it became non-interest bearing in perpetuity.

Compliance Regime

Information on the Compliance Regime, set up on 1 July 2001, is included in the Compliance Committee section of the Statement of Corporate Governance.

Strategic assets

Under the Business Transfer Agreement with the MOD, the Group is not permitted without the written consent of the MOD, to:

a) dispose of or destroy all or any part of a strategic asset; or
b) voluntarily undertake any closure of, or cease to provide a strategic capability by means of, all or any part of a strategic asset.

The net book value of assets identified as being strategic assets as at 31 March 2005 was £16.6m (2004: £28.7m), the principal items being £9.1m of plant and machinery (2004: £19.7m) and £3.0m of vehicles (2004: £5.3m).

Long Term Partnering Agreement

On 27 February 2003 the Group entered into a Long Term Partnering Agreement to provide the Test and Evaluation (T&E) facilities and training support services to the MOD. This is a 25-year contract with a total value of £5.6bn under which the Group is committed to providing the T&E services with increasing efficiencies through cost saving and innovative service delivery.

25. Contingent liabilities

Fellow subsidiary undertakings have given unsecured guarantees of £0.9m (2004: £1.0m).

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.

26. Post-retirement benefits

Introduction and background to FRS17

Financial Reporting Standard 17 (Retirement 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, therefore, 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.

As part of the agreement of 28 February 2003 whereby QinetiQ Holdings Limited (QHL) acquired the Group, the MOD gave an indemnity to QHL to pay to QHL, on the earlier of a flotation or sale or on 28 February 2008, a sum up to a maximum of £45m as a funding contribution to the pension scheme deficit. The anticipated net amount of £38.1m (2004: £36.1m) is included in the 31 March 2005 balance sheet of QHL as a long-term debtor.

The QinetiQ Scheme

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

The most recent full actuarial valuation of the DB section was undertaken as at 30 June 2002 and resulted in an actuarially assessed deficit of £29.0m. On the basis of the 30 June 2002 full valuation, the Trustees and the Company agreed that the 17.5% employer contribution rate would continue and in addition a further £2.0m cash payment would be paid per annum until the next valuation, due in June 2005, to cover the past service deficit.

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

Set out below is a summary of the overall FRS17 defined benefit pension schemes' liabilities:

	31 March 2005 £m	31 March 2004 £m
FRS17 calculated liability	(162.6)	(145.4)
Deferred tax asset	48.7	30.1
QinetiQ Group plc net pension liability (disclosed below)	**(113.9)**	**(115.3)**
MOD pension indemnity	38.1	36.1
QHL net pension liability	**(75.8)**	**(79.2)**

Assumptions

The major assumptions (weighted to reflect individual scheme differences) used by the actuaries as at 31 March were as follows:

	2005	2004	2003
Rate of increase in salaries	4.30%	4.30%	4.30%
Rate of increase in pensions in payment	2.90%	2.90%	2.70%
Rate of increase in pensions in deferment	2.80%	2.80%	2.60%
Discount rate applied to scheme liabilities	5.40%	5.50%	5.60%
Inflation assumption	2.80%	2.80%	2.60%

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

26. Post-retirement benefits (continued)

Scheme assets

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

	QinetiQ Scheme value at 2005 £m	Other UK Schemes' value at 2005 £m	Total 2005 £m	2004 £m	2003 £m
Equities	361.2	0.9	362.1	286.7	167.5
Corporate bonds	44.2	0.2	44.4	38.6	20.3
Government bonds	45.7	–	45.7	50.2	88.5
Cash	2.0	0.4	2.4	4.4	5.4
Total market value of assets	**453.1**	**1.5**	**454.6**	**379.9**	**281.7**
Present value of scheme liabilities	(615.3)	(1.9)	(617.2)	(525.3)	(428.8)
Deferred taxation attributable to pension liability	48.7	–	48.7	30.1	–
Deficit in the schemes – pension liability	**(113.5)**	**(0.4)**	**(113.9)**	**(115.3)**	**(147.1)**

Expected long-term rates of return (weighted to reflect individual scheme differences) were:

	2005	2004	2003
Equities	7.70%	7.70%	7.50%
Corporate bonds	5.10%	5.00%	4.80%
Government bonds	4.70%	4.70%	4.50%
Cash	4.70%	4.20%	4.00%
Weighted average	**7.13%**	**7.00%**	**6.20%**

Movement in deficit during the year:

	2005 £m	2004 £m
Deficit in QinetiQ Scheme brought forward	(115.3)	(147.1)
Deficit on acquisitions of other UK schemes	(0.4)	–
Current service cost	(41.7)	(40.0)
Loss on curtailments	(0.8)	(5.3)
Contributions paid	37.8	43.0
Other finance costs	(2.3)	(6.1)
Actuarial (loss)/gain	(9.8)	10.1
Deferred tax current year timing difference	2.7	–
Deferred tax on actuarial change recognised in statement of total recognised gains and losses	15.9	30.1
Deficit in the schemes at 31 March	**(113.9)**	**(115.3)**

Pension costs charged in arriving at operating profit were:

	2005 £m	2004 £m
Current service cost	**41.7**	**40.0**

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

	2005 £m	2004 £m
Expected return on pension scheme assets	27.7	19.2
Interest on pension scheme liabilities	(30.0)	(25.3)
	(2.3)	**(6.1)**

26. Post-retirement benefits (continued)

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

	2005 £m	2004 £m
Actual return less expected return on scheme assets	12.1	42.0
Experience gains and losses arising on scheme liabilities	(8.3)	(8.4)
Changes in assumptions underlying the present value of scheme liabilities	(13.6)	(23.5)
Actuarial (loss)/gain recognised in statement of total recognised gains and losses	**(9.8)**	**10.1**

History of experience gains and losses:

	2005 £m	2004 £m	2003 £m
Difference between the expected and actual return on scheme assets:			
Amount	12.1	42.0	(96.8)
Percentage of period end scheme assets	2.7%	11.1%	(34.4)%
Experience gains and losses on scheme liabilities:			
Amount	(8.3)	(8.4)	(17.9)
Percentage of period end present value of scheme liabilities	(1.3)%	(1.6)%	(4.2)%
Total amount recognised in statement of total recognised gains and losses:			
Amount	(9.8)	10.1	(124.8)
Percentage of period end present value of scheme liabilities	(1.6)%	1.9%	(29.1)%

There were no outstanding or prepaid pension contributions to any Group pension scheme at the balance sheet date (2004: £nil).

Defined contribution section

Payments to the DC section of the QinetiQ Scheme totalled £5.9m (2004: £3.8m).

27. Ultimate parent undertaking

The ultimate parent undertaking of the Group is QinetiQ Holdings Limited (QHL) a company incorporated in the UK.

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

Set out below is a reconciliation of the net assets of the Group to those of the QHL Group. The figures for QHL have been extracted from that company's audited accounts on which the auditors have issued an unqualified audit opinion.

	2005 £m	2004 £m
Net assets of the Group	335.7	281.7
Negative goodwill arising on acquisition of the Group by QHL	(81.8)	(86.3)
MOD pension indemnity	38.1	36.1
Inter-company balance between QHL and the Group	(70.5)	95.2
Bank loans and deferred financing costs	(0.2)	(101.5)
Preference share dividend creditor	(7.2)	–
Net assets of QHL Group	**214.1**	**225.2**

Net debt of the QHL Group is:

	2005 £m	2004 £m
Cash at bank and in hand	12.3	154.6
Short-term debt	(53.2)	(20.8)
Debt due after more than one year	(151.7)	(141.7)
Deferred financing costs	1.5	4.3
Finance leases	(4.1)	–
Net debt of QHL Group	**(195.2)**	**(3.6)**

The consolidated accounts of QinetiQ Holdings Limited include the results of QinetiQ Group plc and are available from the Company's registered office.

28. Investments

The principal subsidiary undertakings, associated undertakings and joint ventures at 31 March 2005, all of which are included in the consolidated financial statements, are shown below:

Name of company		Principal area of operation	Country of incorporation	Proportion of voting rights held[3]	Financial year end[1]	Nature of business
Subsidiary undertakings						
QinetiQ Limited	(2)	Great Britain	England & Wales	100%		Research and development
Aurix Limited	(5)	Great Britain	England & Wales	80.1%	30 Mar	Research and development
cueSim Limited	(2)	Great Britain	England & Wales	100%		Research and development
HVR Consulting Services Limited		Great Britain	England & Wales	100%	31 Jan	Research and development
HVR Group Limited		Great Britain	England & Wales	100%	31 Jan	Research and development
QinetiQ Nanomaterials Limited	(2)	Great Britain	England & Wales	100%		Research and development
QinetiQ Survey and Surveillance Limited		Great Britain	England & Wales	100%		Research and development
Quintel Technology Limited	(4)	Great Britain	England & Wales	50.0%	31 Dec	Research and development
ASAP Calibration Services Limited		Great Britain	England & Wales	100%		Calibration and engineering
Precis (2187) Limited		Great Britain	England & Wales	100%		Property holding company
Trusted Experts Limited	(2)	Great Britain	England & Wales	100%		Resource management
QinetiQ Insurance PCC Limited	(2)	Great Britain	Guernsey	100%		Insurance
Precis (2188) Limited		Great Britain	England & Wales	100%		Holding company
QinetiQ Corporate Finance Limited		Great Britain	England & Wales	100%		Holding company
QinetiQ Estates Limited		Great Britain	England & Wales	100%		Holding company
QinetiQ Investments Limited	(2)	Great Britain	England & Wales	100%		Holding company
QinetiQ Overseas Holdings Limited	(2)	Great Britain	England & Wales	100%		Holding company
QinetiQ Partnership Finance Limited		Great Britain	England & Wales	100%		Holding company
QinetiQ Ventures Limited	(2)	Great Britain	England & Wales	100%		Holding company
Aerospace Filtration Systems, Inc.		USA	USA	100%	31 Dec	Research and development
Foster-Miller Canada Limited		Canada	Canada	100%		Research and development
Foster-Miller, Inc.		USA	USA	100%		Research and development
Pimsol, LLC		USA	USA	100%	31 Dec	Research and development
QinetiQ Inc.		USA	USA	100%		Research and development
QinetiQ Technology Extension Corporation		USA	USA	100%		Research and development
Rapidex, Inc.		USA	USA	100%		Research and development
Westar Aerospace & Defense Group, Inc.		USA	USA	100%	31 Dec	Research and development
Westar Display Technologies, Inc.		USA	USA	100%	31 Dec	Research and development
QinetiQ Philippines Company Inc.		Philippines	Philippines	100%		Research
QinetiQ Trusted Information Management, Inc.		USA	USA	100%		Information systems security
QinetiQ North America Inc.		USA	USA	100%		Holding company
QinetiQ USA Partnership		USA	USA	100%	31 Dec	Holding company
Science Enterprises LLC		USA	USA	100%	31 Dec.	Holding company
Joint ventures and associates						
QS4 Group Limited		Great Britain	England & Wales	50%	31 Dec	Holding company
QS4 Limited		Great Britain	England & Wales	50%	31 Dec	Research and development
Quintel (UK) Limited		Great Britain	England & Wales	50%	31 Dec	Research and development
ZBD Displays Limited		Great Britain	England & Wales	30.4%	31 July	Research and development
Infoscitex, Inc.		USA	USA	27.8%	31 Dec	Research and development

(1) Accounting reference date is 31 March unless otherwise stated.
(2) Shares held directly by QinetiQ Group plc.
(3) Percentage of ordinary share capital unless otherwise stated.
(4) Disclosed as a subsidiary due to management control by QinetiQ.
(5) Name changed during the year from 20/20 Speech Limited.

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.

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