

Company Registration No. 04441386 (England and Wales)

**SOLARFLARE COMMUNICATIONS LIMITED**  
**(formerly Level 5 Networks Limited)**

**DIRECTORS' REPORT AND FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED 31 DECEMBER 2006**

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# SOLARFLARE COMMUNICATIONS LIMITED

## COMPANY INFORMATION

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Directors	C W A Cotton D E Roberts S T Hughes
Secretary	D E Roberts
Company Number	04441386
Registered Office	Block 2, Second Floor Westbrook Centre Milton Road Cambridge CB4 1YG
Auditors	PricewaterhouseCoopers LLP Abacus House Castle Park Cambridge CB3 0AN
Accountants	Haslers Chartered Accountants and Registered Auditors Old Station Road Loughton Essex IG10 4PL
Bankers	Barclays Bank plc 28 Chesterton Road Cambridge CB4 3AZ

# SOLARFLARE COMMUNICATIONS LIMITED

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# **SOLARFLARE COMMUNICATIONS LIMITED**

## **DIRECTORS' REPORT FOR THE YEAR ENDED 31 DECEMBER 2006**

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The Directors present their report and the audited financial statements of the company for the year ended 31 December 2006.

### **Principal activities and review of business**

The principal activity of the company is the research and development of ethernet based network technology.

The company is the wholly owned subsidiary of Level 5 Networks, Inc. In April 2006 Level 5 Networks Inc, merged with Solarflare Communications Inc in a merger of equals. Both companies raised additional funds to set the capitalisation substantially equal, with the combined entity holding a cash balance of over \$50m. The company changed its name from Level 5 Networks Ltd to Solarflare Communications Ltd on 17<sup>th</sup> August 2007.

The company receives commissions from Level 5 Networks Inc., equal to its operating costs plus a percentage of net revenues generated by Level 5 Networks Inc. through the research and development and administrative support provided by the company. The company undertakes research and development exclusively for the parent company. The principal risk and uncertainty for the company therefore relates to the possibility of a discontinuation of that relationship.

The company continues to be dependent on the support of its ultimate parent company, Solarflare Communications Inc., to be able to continue in operation for the foreseeable future. Solarflare Communications Inc has committed to provide such financial support as is necessary for the company to meet its obligations on an ongoing basis, and at least for the next twelve months, and accordingly the directors believe that it is appropriate to prepare the financial statements on a going concern basis.

The company's operations as a Research and Development centre ensure that it has no exposure to price risk. The company also has no exposure to equity securities price risk as it holds no listed or other equity investments. The company is financed solely by the Parent Company and as such faces no major credit or liquidity risk. The company has interest bearing assets in the form of cash balances and holds no interest bearing liabilities.

The Key Performance Indicators for the business include:  
Developmental milestones – the Cambridge team successfully completed verification of silicon prior to the tape-out of a new chip.

Design of new and innovative hardware – In the year to 31<sup>st</sup> December 2006, the group completed 4 major board designs, including the world's first 10 Gigabit Base-T (copper) network adapter

The results for the year to 31 December 2006 are set out in the profit and loss account on page 6.

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# **SOLARFLARE COMMUNICATIONS LIMITED**

## **DIRECTORS' REPORT (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006**

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### **Research and development**

The company incurred research and development costs of £1,959,079 during the year (year ended 31 December 2005: £1,741,787), all of which has been written off to the profit and loss account during the year.

### **Results and Dividends**

The company's profit for the financial year is £148,036 (2005: £140,605 restated). The directors do not recommend payment of a dividend (year ended 31 December 2005: £nil).

### **Directors and their interests**

The following directors have held office during the period:

C W A Cotton	
A Hopper	Resigned 2 May 07
J Golden	Resigned 10 May 07
H Hauser	Resigned 2 May 07
B Carano	Resigned 27 April 07
Derek Roberts	Appointed 6 June 2007
Scott Hughes	Appointed 6 June 2007

None of the directors had any interest in the shares of the company at the beginning or end of the year.

The company is a wholly owned subsidiary of a company incorporated outside Great Britain and, as permitted by Statutory Instrument 85/802, the register kept in accordance with Section 235 of the Companies Act 1985 does not disclose the interest of directors in shares in foreign registered group companies.

# SOLARFLARE COMMUNICATIONS LIMITED

## DIRECTORS' REPORT (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

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### Statement of directors' responsibilities

Company law requires the directors to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. The directors are required to prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the company will continue in business.

The directors confirm that suitable accounting policies have been used and applied consistently in the preparation of the financial statements. They also confirm that reasonable and prudent judgements and estimates have been made in preparing the financial statements for the year ended 31 December 2006 and that applicable accounting standards have been followed.

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

### Auditors and disclosure of information to auditors

So far as each director is aware, there is no relevant audit information of which the company's auditors are unaware and each director has taken all steps that they ought to have taken as a director in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

### Auditors

The auditors, PricewaterhouseCoopers LLP, have indicated their willingness to continue in office, and a resolution concerning their reappointment will be proposed at the next Annual General Meeting.

By order of the board

Director



Date

30/10/07

# SOLARFLARE COMMUNICATIONS LIMITED

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## INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF SOLARFLARE COMMUNICATIONS LIMITED

We have audited the financial statements of Solarflare Communications Limited for the year ended 31 December 2006 which comprise the Profit and Loss Account, the Balance Sheet, the Statement of Total Recognised Gains and Losses and the related notes. These financial statements have been prepared under the accounting policies set out therein.

### Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition, we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

### Basis of audit opinion

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

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

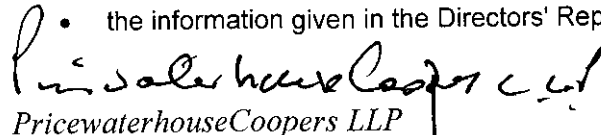
## SOLARFLARE COMMUNICATIONS LIMITED

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### Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 2006 and of its profit for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

  
PricewaterhouseCoopers LLP  
Chartered Accountants and Registered Auditors  
Cambridge

30 October 2007



# SOLARFLARE COMMUNICATIONS LIMITED

## PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2006

		2006	2005
	Notes	£	(as restated) £
<b>Turnover</b>		2,520,474	2,437,661
<b>Gross profit</b>		2,520,474	2,437,661
Net operating expenses	2	(2,330,259)	(2,240,211)
<b>Operating profit</b>	5	190,215	197,450
Other interest receivable and similar income		7,009	6,733
<b>Profit on ordinary activities before taxation</b>		197,224	204,183
Taxation	6	(49,188)	(63,578)
<b>Profit on ordinary activities after taxation</b>	12,13	148,036	140,605

The above results relate to continuing operations of the company.

There is no material difference between the profit on ordinary activities before taxation and the profit for the year stated above and their historical cost equivalents.

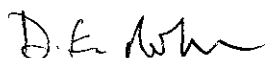
The notes on pages 9 to 20 form part of these financial statements.

# SOLARFLARE COMMUNICATIONS LIMITED

## BALANCE SHEET AS AT 31 DECEMBER 2006

			2006	2005 (as restated)
	Notes	£	£	£
<b>Fixed assets</b>				
Tangible assets	7		134,276	156,114
<b>Current assets</b>				
Debtors	8	420,104	194,165	
Cash at bank and in hand		110,886	156,383	
		530,990	350,548	
<b>Creditors - Amounts falling due within one year</b>	9	(245,772)	(235,803)	
<b>Provisions for liabilities and charges</b>	6	(15,523)	(46,834)	
<b>Net current assets</b>			269,695	67,912
<b>Net asset</b>			403,971	224,025
<b>Capital and reserves</b>				
Called up share capital	11	10,500	10,500	
Share premium account	12	147,370	147,370	
Profit and loss account	12, 13	246,101	66,155	
<b>Total shareholders' funds</b>	13		403,971	224,025

The financial statements on pages 6 to 20 were approved by the Board of Directors on 30/10/07 and signed on its behalf by:



D Roberts  
Director

# SOLARFLARE COMMUNICATIONS LIMITED

## STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES AS AT 31 DECEMBER 2006

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	2006 £	2005 (as restated) £
Profit for the financial year	148,036	140,604
Total recognised profit for the year	<u>148,036</u>	<u>140,604</u>
Prior year adjustment - share based payments charge	14,596	
Total recognised profit since last financial statement	<u>162,632</u>	

# **SOLARFLARE COMMUNICATIONS LIMITED**

## **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2006**

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### **1 Accounting policies**

#### **1.1 Basis of preparation of financial statements**

These financial statements are prepared on the going concern basis, under the historical cost convention, and in accordance with the Companies Act 1985 and applicable accounting standards in the United Kingdom. The principal accounting policies, which are set out below, have been applied consistently throughout the year.

#### **1.2 Going concern**

Solarflare Communications Limited (formally Level 5 Networks Limited) is a private company, which became a wholly owned subsidiary of Level 5 Networks Inc on 26 November 2003.

In April 2006 Level 5 Networks Inc merged with Solarflare Communications Inc in a merger of equals. Both companies raised additional funds to set the capitalisation substantially equal, with the combined entity holding a cash balance in excess of over \$50m.

The company receives commissions from Level 5 Networks Inc., equal to its operating costs plus a percentage of net revenues generated by Level 5 Networks Inc. through the research and development and administrative support provided by the company.

The company receives settlement of these commissions from its ultimate parent company, Solarflare Communications Inc. The company will continue to be dependent on the support of Solarflare, to be able to continue in operation for the foreseeable future. Solarflare Communications Inc has committed to provide such financial support as is necessary for the company to meet its obligations on an ongoing basis, and at least for the next 12 months, and accordingly the directors believe that it is appropriate to prepare the financial statements on a going concern basis.

#### **1.3 Turnover**

Turnover, represents amounts recharged to Level 5 Networks Inc. in respect of operating costs and commissions earned on net revenues generated by Solarflare Communications Inc. through the efforts of the company.

# **SOLARFLARE COMMUNICATIONS LIMITED**

## **NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2006**

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### **1.4 Tangible fixed assets and depreciation**

The cost of tangible fixed assets is their purchase cost, together with any incidental costs of acquisition.

Depreciation is calculated so as to write off the cost of tangible fixed assets, less their estimated residual values, on a straight line basis over the expected useful economic lives of the assets concerned. The principle annual rates used for this purpose are:

Computer and laboratory equipment	33.33%
Equipment	25.00%
Leasehold Improvements	over the term of the lease

### **1.5 Foreign currencies**

Assets and liabilities denominated in foreign currencies are expressed in sterling at the rates of exchange ruling at the balance sheet date. Exchange differences are dealt with in the profit and loss account.

### **1.6 Finance and operating leases**

Costs in respect of operating leases are charged on a straight line basis over the lease term. Leasing agreements which transfer to the company substantially all the benefits and risks of ownership of an asset are treated as if the asset had been purchased outright.

### **1.7 Deferred taxation**

*Provision is made for deferred taxation, in accordance with FRS 19 "Deferred tax", on all material timing differences. Deferred tax assets are recognised to the extent that they are regarded as recoverable. Deferred tax assets and liabilities are not discounted.*

### **1.8 Cash flow statement**

The company has taken advantage of the exemption in Financial Reporting Standard No. 1 from the requirement to produce a cash flow statement on the grounds that it is a small company.

### **1.9 Research and development**

Research and development costs are written off in the period in which they are incurred.

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

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### 1.10 Financial Instruments

The financial instruments are held at historical cost.

The financial asset and the financial liability are offset and the net amount presented in the balance sheet, as Solarflare Communications Limited intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

### 1.11 Pension scheme arrangements

The company operates a defined contribution pension scheme. Contributions are charged to the profit and loss account as incurred and have no impact on the account. Contributions are based on the pensionable salaries of the scheme members. Contribution to the Solarflare Communications Ltd Group Personal Pension Plan is made on a monthly basis, contributions of £66,219 were made during the year to 31 December 2006 (31 December 2005: £43,384). Contributions of £811 were outstanding at the year end (31 December 2005: £1,236). The company provides no other post retirement benefits to its employees.

### 1.12 Changes in accounting policy

The entity has adopted FRS 20, 'Share-based Payment'. In accordance with the transitional provision of FRS 20, the entity is required to recognise an expense in respect of options granted after 7 November 2002 that were unvested as of 1 January 2006. This expense, which is calculated by reference to the fair value of the options granted, is recognised on a straight-line basis over the vesting period based on the entity's estimate of options that will eventually vest. The charge is then credited back to reserves.

The adoption of FRS 20 constitutes a change in accounting policy. The previous policy was to apply the provisions of Urgent Issues Task Force ('UITF') Abstract 17 'Employee Share Schemes' whereby the entity made charges to the profit and loss account when options in the parent Company were granted to employees of the entity, the charge being the estimated market value of the shares at the date of grant less the exercise price of the options. Where options were granted with no performance conditions the charge was recognised immediately. Where options were granted with performance conditions the charge was recognised over the performance period and was then reversed through reserves.

The effect of this change in accounting policy was to increase the share-based payments charge from £nil to £31,910 for the year ended 31 December 2006 and from £nil to £8,280 for the year ended 31 December 2005. This charge will not affect the entity's net assets in the year.

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

<b>2</b>	<b>Net operating expenses</b>	<b>2006</b>	<b>2005</b> (as restated)
		£	£
	Research and development expenses	1,959,079	1,741,787
	Sales and marketing expenses	23,666	109,822
	Administrative expenses	315,604	380,322
	Share options charge	31,910	8,280
		<u>2,330,259</u>	<u>2,240,211</u>
<b>3</b>	<b>Directors' emoluments</b>	<b>2006</b>	<b>2005</b>
		£	£
	Aggregate emoluments	<u>73,007</u>	<u>107,850</u>
<b>4</b>	<b>Employees</b>		
	The average monthly number of persons (including executive directors) employed by the company during the year was:	<b>2006</b>	<b>2005</b>
	<b>By activity</b>		
	Research and Development	29	24
	Sales and Marketing		1
	Administration	7	8
		<u>36</u>	<u>33</u>
	<b>Staff costs (for the above persons)</b>	<b>2006</b>	<b>2005</b> (as restated)
		£	£
	Wages and salaries	1,411,219	1,216,370
	Social security costs	162,519	144,607
	Other pension costs	67,030	43,384
	Other costs	27,031	28,071
	Share options charge	31,910	8,280
		<u>1,699,709</u>	<u>1,440,712</u>

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

5	Operating profit	2006 £	2005 (as restated) £
	Operating profit is stated after charging:		
	Depreciation of tangible fixed assets	74,271	48,476
	Accelerated depreciation of tangible fixed assets		
	Auditors' remuneration		
	- Audit services	11,500	8,000
	Operating lease charges:		
	Land and building	67,783	61,899
	Staff costs	1,699,709	1,440,712
6	Taxation	2006 £	2005 £
	Current tax		
	UK Corporation Tax on profits of the period	73,268	16,728
	Adjustment in respect of previous period	7,231	16
	Total current tax	80,499	16,744
	Deferred tax	(31,311)	46,834
	Tax on profit on ordinary activities	49,188	63,578
	Factors affecting the tax credit for the year	2006 £	2005 (as restated) £
	Profit on ordinary activities before taxation	197,224	204,183
	Tax on profit on ordinary activities multiplied by the research and development tax credit rate of 30% (2005: 19%)	59,167	38,795



# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

### Tax effect of reconciling items:

Expenses not deductible for tax purposes	4,801	4,529
Carried forward losses		
Differences between capital allowances and depreciation	16,381	(26,596)
Marginal relief	(7,081)	-
Adjustments to tax charge in respect of previous period	7,231	16
	<u>80,499</u>	<u>16,744</u>
Current tax		

### Deferred taxation

Deferred tax liabilities (assets) are comprised as follows:

	Provided 2006 £	Provided 2005 £
Accelerated capital allowances	29,475	46,834
Other short term timing differences	(13,952)	-
	<u>15,523</u>	<u>46,834</u>

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

7	Tangible fixed assets	Computer and laboratory equipment	Equipment	Leasehold improvements	Total
	Cost	£	£	£	£
	At 1 January 2006	174,646	15,840	37,739	228,225
	Additions	52,433	-	-	52,433
	At 31 December 2006	227,079	15,840	37,739	280,658
	<b>Accumulated depreciation</b>				
	At 1 January 2006	68,300	1,114	2,697	72,111
	Charge for the year	60,530	9,210	4,531	74,271
	At 31 December 2006	128,830	10,324	7,228	146,382
	<b>Net book value</b>				
	At 31 December 2006	98,249	5,516	30,511	134,276
	At 31 December 2005	106,346	14,726	35,042	156,114
8	<b>Debtors</b>		<b>2006</b>	<b>2005</b>	
			£	£	
	Prepayments		31,981	32,385	
	Other Debtors		64,684	55,608	
	Amounts owed by parent undertaking		323,439	106,172	
			420,104	194,165	

Amounts owed by the parent undertaking are unsecured, interest-free and have no fixed repayment date.

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

9	<b>Creditors: amounts falling due within one year</b>	<b>2006</b>	<b>2005</b>
		£	£
	Trade Creditors	37,777	66,831
	Other taxation and social security	59,067	73,072
	Accruals	75,659	72,578
	Other Creditors	-	6,578
	Corporation tax payable	73,269	16,744
		<u>245,772</u>	<u>235,803</u>
10	<b>Provisions for liabilities and charges</b>		<b>Total</b>
			£
	1 January 2006		46,834
	Charged to the profit and loss account		(31,311)
			<u>15,523</u>
	<b>31 December 2006</b>		
11	<b>Share Capital</b>	<b>2006</b>	<b>2005</b>
		£	£
	<b>Authorised</b>		
	20,000,000 ordinary shares of 0.125p each	25,000	25,000
		<u>25,000</u>	<u>25,000</u>
	<b>Allotted, called up and fully paid</b>		
	8,400,264 ordinary shares of 0.125p each	10,500	10,500
		<u>10,500</u>	<u>10,500</u>

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

### 12 Statement of movement on reserves

	Share Premium	Profit and loss account (as restated)
	£	£
At 1 January 2005 before restatement	147,370	(82,730)
Restated profit for 2005	-	140,605
Share options reserve	-	8,280
Balance as at 31 December 2005	147,370	66,155
Profit for 2006	-	148,036
Share options reserve for 2006	-	31,910
Balance as at 31 December 2006	147,370	246,101

### 13 Reconciliation of movement in shareholders' funds

	2006	2005 (as restated)
	£	£
Opening shareholders' funds	224,025	75,140
Share options reserve	31,910	8,280
Profit for the financial year	148,036	140,605
Closing shareholders' funds	403,971	224,025

### 15 Financial commitments

At 31 December 2006, the company had annual commitments under non-cancellable operating leases as follows:

	2006	2005
	£	£
Land and buildings		
Expiring within 1 year	73,035	73,035
Expiring within 2-5 years	107,044	180,079
	180,079	253,114

## SOLARFLARE COMMUNICATIONS LIMITED

### NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

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#### 16 Share based payments

The Enterprise Management Incentive Share Option Scheme (EMI Plan) was introduced in 2003. Under the EMI the Board of Directors can grant options over shares in the company to employees of the group. Options are granted with a fixed exercise price equal to the market price of the shares under option at the date of grant. Options are granted in US Dollars and for reporting purposes have been converted to Sterling using the spot rate on the last calendar day of each year. The contractual life of an option is 10 years. All permanent employees are eligible for Awards under the EMI. The company has made regular option grants in 2004, 2005 and 2006, with the majority of shares granted on each employee's hire date. Most options granted under the EMI scheme will become exercisable 25% after the first year and pro rata monthly thereafter for the next 36 months. Vesting of an option is subject to continued employment, with exercises allowed for up to 90 days after termination of employment. The company merged with Solarflare Communications in April 2006. The share option grants detailed below are the original grants, they were subsequently converted into options to purchase shares in Solarflare and therefore a merger fraction of 0.70699108 applied to the calculations. Options were valued using the Black-Scholes option-pricing model. No performance conditions were included in the fair value calculations. The fair value per option granted and the assumptions used in the calculation are as follows:

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

### 16 Share based payments (continued)

#### Grant Dates 2004

	29/04/2004	03/05/2004	15/07/2004	09/09/2004	20/09/2004	02/11/2004	02/12/2004
Exercise Price	£ 0.024	£ 0.024	£ 0.024	£ 0.024	£ 0.024	£ 0.024	£ 0.024
# of employees	3	11	1	1	1	1	3
Shares Under Option	192,000	1,575,000	10,000	40,000	175,000	40,000	155,000
Vesting Period	4 Years	4 Years	4 Years	4 Years	4 Years	4 Years	4 Years
Volatility	100.30%	93.40%	93.70%	93.60%	93.50%	92.90%	92.30%
Option Life	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years
Expected Life	6.08 Years	6.08 Years	6.08 Years	6.08 Years	6.08 Years	6.08 Years	6.08 Years
Risk Free Rate	3.98%	3.96%	3.98%	3.69%	3.55%	3.60%	3.98%
Dividend Yield	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Fair Value	£ 0.019	£ 0.019	£ 0.019	£ 0.019	£ 0.019	£ 0.019	£ 0.019

#### Grant Dates 2005 and 2006

	21/02/2005	27/04/2005	27/07/2005	09/09/2005	02/11/2005	13/01/2006
Exercise Price	£ 0.052	£ 0.052	£ 0.052	£ 0.052	£ 0.052	£ 0.046
# of employees	6	23	2	2	3	3
Shares Under Option	260,000	2,062,612	150,000	150,000	150,000	417,500
Vesting Period	4 Years	4 Years	4 Years	4 Years	4 Years	4 Years
Volatility	100.50%	103.50%	93.00%	102.30%	102.10%	101.40%
Option Life	10 Years	10 Years	10 Years	10 Years	10 Years	10 Years
Expected Life	6.08 Years	6.08 Years	6.08 Years	6.08 Years	6.08 Years	6.08 Years
Risk Free Rate	3.98%	3.99%	4.13%	4.17%	4.56%	4.31%
Dividend Yield	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Fair Value	£ 0.041	£ 0.041	£ 0.041	£ 0.041	£ 0.041	£ 0.036

As Solarflare is not a publicly traded company, the expected volatility is based on companies that directly deemed comparable to Solarflare. The expected life is the average expected period to exercise. The risk-free rate is based on the spot rates for U.S. treasury strips with maturities similar to the options. A reconciliation of option movements over the year to 31 December 2006 is shown below:

	No of options	Price		No of options	Price
Outstanding Jan 1, 2005	1,523,000	£ 0.027	Outstanding Jan 1, 2006	4,295,612	£ 0.038
Granted	2,772,612.00	£ 0.052	Granted	417,500	£ 0.046
Forfeited	-		Forfeited	76,146	£ 0.033
Exercised	-		Exercised	38,854	£ 0.025
Outstanding Dec 31, 2005	4,295,612	£ 0.043	Outstanding Dec 31, 2006	4,598,112	£ 0.036
Exercisable Dec 31, 2005	738,211	£ 0.028	Exercisable Dec 31, 2006	2,484,646	£ 0.031

# SOLARFLARE COMMUNICATIONS LIMITED

## NOTES TO THE FINANCIAL STATEMENTS (CONTINUED) FOR THE YEAR ENDED 31 DECEMBER 2006

### 16 Share based payments (continued)

The weighted average fair value of options granted in the year was £14,925 (2005: £112,813)

The Weighted Average Exercise Price and Weighted Average Expected and Contractual Lives for 2005 and 2006 are:

	2005	2006
Weighted Average Exercise Price	£ 0.052	£ 0.046
Number Of Shares	2,772,612	417,500
Weighted Average Contractual Life	8.37	9.04
Weighted Average Expected Life Life	4.45	5.12

The weighted average exercise price of shares exercised in 2006 was £0.023 (2005: no exercises). The total charge for the year relating to employee share based payment plans was £31,910 (2005: £8,280), all of which related to equity-settled share based payment transactions.

### 17 Related party disclosures

During the period the company entered into a number of transactions with Level 5 Networks Inc., the immediate parent company and Solarflare Communications Inc, the ultimate parent company.

During the period, the company lent funds to Level 5 Networks Inc. for working capital purposes whilst it obtained funds from Solarflare Communications Inc of £535,976 (2005: £nil). The company has the right to net the payable and receivable amounts and as such the net balance owed to the company was £323,439 (2005: £106,172). This balance is unsecured, interest free and has no fixed payment date.

The company's turnover is derived principally from sales to its parent company. The company's turnover for the year amounted to £2,520,474 (2005: £2,437,661)

There were no companies other than Solarflare Communications Inc, Level 5 Networks Inc. and Solarflare Communications Limited within the group at 31 December 2006.

### 18 Ultimate parent undertaking

The directors regard Solarflare Communications Inc, a company incorporated in the USA to be the ultimate parent company. Solarflare Communications Inc has a 100% interest in the issued share capital of Level 5 Networks Inc, Level 5 Networks Inc holds a 100% interest in Solarflare Communications Ltd.