Surface Transforms plc

Annual Report and Financial Statements

Registered number 3769702

31 May 2006

Contents

Highlights

- Turnover £155,177 (2005: £258,336) and loss after tax of £811,870 (2005: £616,623). Increase in losses largely due to the loss of development contract in year ended 31 May 2005

- Turnover in the second half of the year is ahead of that achieved in the first six months

- Cash at 31 May 2006 approximately £1.75 million, equivalent to 12.4 pence per share

- Outstanding order bank at the year end of £147,400

- Intellectual Property Portfolio enhanced through 3 new patent applications

- Initial sales of ceramic brakes made under a 12 month contract with Koenigsegg Automotive

- Additionally working with three, small UK based automotive OEMs who build high performance cars and Weber Sportcars in Switzerland. Considerable interest in the System ST brake system being shown

- Management team strengthened during the year and further non-executives to be appointed to assist in targeting the range of activities undertaken by the Company

Chairman's statement

In the year under review, Dr Kevin Johnson, Managing Director, and his new management team have progressed plans within the Company's operations and my statement is designed to bring shareholders up to date with progress in the year to 31 May 2006 and since the year end. The principal areas the Board has and continues to focus on are:

- strengthening the Intellectual Property portfolio;
- the Company's next generation production process for carbon ceramic brake discs;
- development of a carbon ceramic disc brake for commercial aircraft; and
- commercialisation of the Company's SystemST carbon ceramic brake systems for high performance cars.

Financial review

In the year to 31 May 2006, turnover was £155,177 (*2005: £258,336*). Despite the fall in turnover for the full year compared with the prior year the sales performance in the second half of the year was better than that achieved in the first six months of the year. The outstanding order bank at the year end was £147,400.

Revenues in this period include development fees from a US aircraft brake system supplier, sales of ceramic rocket components to Roxel and initial sales of ceramic brake discs to Koenigsegg Automotive, the Company's first significant automotive client, and to prospective clients who are testing automotive brake discs.

Losses after tax in the period were £811,870 (*2005: £616,623*). The increase in losses relates almost entirely to the first half of the year, where the corresponding period in 2004/05 included development income from a contract which was terminated later that year. Furthermore, the losses also reflect the Board's decision to strengthen the management team and invest in the Company's proprietary technology.

Shareholders funds as at 31 May 2006 were £1,997,105 (*2005: £2,808,975*) which included cash deposits of £1,743,389 (*2005: £2,728,052*). At the year end cash represented 12.4 pence per share.

Capital expenditure in the year amounted to £129,690 (2005: £63,775).

Operating activities

Science & technology

During the period the Company made three new patent applications which, once approved, are expected to supplement the existing patent portfolio.

The Company is making good progress with the new ST Tech 2 production system which is designed to improve productivity and reduce the costs of manufacturing automotive carbon ceramic brake discs.

Capital expenditure in the current year is expected to be mainly within the CVIST and MIST sub-processes. The majority of the CVIST expenditure planned for the current year falls within the criteria of the £200,000 grant awarded by the Northwest Development Agency.

The Board have decided to temporarily delay expenditure on the MIST process until the Company receives confirmation of a second automotive contract alongside the Koenigsegg agreement. We have conducted preliminary work on the MIST process and at present we are confident that the technology delivers the productivity and cost savings targeted. The new production system is expected to generate a 50 per cent. reduction in the unit cost of disc brakes compared with those currently being produced.

Aircraft brake systems

The Company is currently engaged in brake development programmes with three global aircraft brake suppliers. These development programmes derive low levels of revenue but they are expected to continue for at least the next twelve months. It is difficult to forecast the timing of the eventual acceptance of the first ceramic brake disc for aircraft use, although two of our clients are very keen to continue to evaluate the suitability of our technology as a replacement for the current carbon carbon brakes that are used on most commercial aircraft.

The development contracts are profitable and the Board's view is that it should maintain its position in this market and continue to target increased revenues from aircraft brake development programmes.

Automotive braking systems

In March this year Koenigsegg Automotive of Sweden agreed a supply contract for carbon ceramic brakes for 24 car systems with a value of up to £145,000 over twelve months. The carbon ceramic brakes are being sold as a factory fitted option on the new Koenigsegg CCX, a 860 bhp supercar that was launched this year.

The Company continues to work with three, small UK based automotive OEMs who build high performance cars and it is also working with Weber Sportcars in Switzerland. It is never easy to predict customer uptake on the introduction of a new, high technology product but there is little doubt that there is considerable interest in the System ST brake system.

People

Our success depends on fostering a strong entrepreneurial culture within which our young management team can develop professionally. We have been active in incentivising our staff with share options to ensure their rewards are the same as other shareholders and that the business is managed with an 'owner's eye'. Share options, although granted this year, have been priced at levels higher than the current share prices and we have selected our share price as a key performance indicator for remuneration. I would like to thank all my colleagues for their hard work and dedication over the past year.

Outlook
We have two main challenges ahead of us in the coming year.

The first is that we have to gain at least one other significant automotive brake contract and once this has been achieved it will provide clear evidence of customer acceptance of the Company's brake disc technology for high performance cars. In the aircraft brake market our technology is actively being evaluated by several system suppliers but it will take time before our product is accepted for use on a commercial aircraft.

The second challenge is the completion of our ST Tech 2 production process so that it delivers products at greater efficiency and at lower cost than the current process. The Company is relocating to new facilities approximately 10 miles from the current site and the move should be completed by the end of the year.

The Board currently has two non-executive directors including Professor David Clark who is a founder and has been a director since the Company's incorporation. To support the current range of activities undertaken by the Company and to assist it in targeting its automotive and aerospace markets more effectively, it is the Board's intention to appoint additional non-executive directors and we hope to make such announcements in the current year.

Kevin D'Silva
Chairman
17 August 2006

Directors' report

The directors present their annual report and the audited financial statements for the year ended 31 May 2006.

Principal activity
The principal activity of the company during the year was the development and manufacture of carbon fibre reinforced ceramic products (CFRC) for aircraft brake, automotive brake and rocket component applications.

Business review
A review of the company's activities during the year is dealt with in the Chairman's statement.

Future developments
The Board aims to continue with its corporate strategy which is to exploit its technologies in carbon fibre reinforced ceramics by:

- establishing contract development opportunities and collaborations with national and multi-national customers in the aerospace and automotive industries; and
- expanding commercial sales of CFRC products.

Research and development
The majority of the company's staff are employed in research and development activities which are concentrated on the ongoing development of carbon fibre reinforced ceramic friction and non-friction materials for new products and applications.

Proposed dividend and transfer to reserves
The loss for the year after taxation amounted to £811,870. The directors do not recommend the payment of a dividend.

Policy and practice on payment of creditors
It is the company's policy that payments to suppliers are made in accordance with the terms and conditions agreed between the company and its suppliers, providing that all trading terms and conditions have been complied with. The company does not follow any code or standard on payment practice.

At the year end, there were 37 days *(2005: 68 days)* purchases in trade creditors.

Political and charitable donations
The company made no political or charitable donations during the year *(2005: £nil)*.

Directors and directors' interests
The directors who held office during the year were as follows:

K D'Silva* (Chairman)
Dr K Johnson (Managing Director)
JJ Faria
Professor DT Clark*
Dr G Gould
PJ Holland* (resigned 13 December 2005)
* denotes non-executive Director.

The directors retiring by rotation are Dr K Johnson and JJ Faria who, being eligible, offer themselves for re-election.

The directors who held office at the end of the financial year had the following interests in the ordinary shares of the company according to the register of directors' interests:

		Number of £0.01 ordinary shares	
	% of issued share capital	**Interest at end of year**	Interest at start of year
JJ Faria	**16.8**	**2,357,845**	2,326,845
Professor DT Clark	**6.98**	**979,661**	979,661
K D'Silva	**1.12**	**156,986**	156,986
Dr K Johnson	**0.41**	**57,250**	-
Dr G Gould	**0.03**	**4,350**	4,350

According to the register of directors' interests, no rights to subscribe for shares in or debentures of the company were granted to any of the directors or their immediate families, or exercised by them during the financial year, except as disclosed in the report on directors' remuneration on pages 7 and 8.

The directors benefited from qualifying third party indemnity provisions in place during the financial year and at the date of this report.

Substantial shareholders

In addition to the directors' interests noted above, the directors are aware of the following who were interested in 3% or more of the company's equity at the end of the year:

Registered holding	Number of ordinary shares	% of issued share capital
JM Finn Nominees Limited	**1,595,860**	11.37
Artemis Investments Management Limited	**807,143**	5.75
Bank of New York Nominees Limited	**720,000**	5.13
Barclayshare Nominees Limited	**648,205**	4.62
Securities Services Nominees Limited	**468,571**	3.34
Giltspur Nominees Limited	**455,400**	3.25

Corporate governance

Surface Transforms plc is committed to maintaining high standards of corporate governance. The company complies with the Combined Code as modified by the recommendations of the Quoted Companies Alliance to the extent the directors consider appropriate, given the size of the company, its current stage of development and the constitution of the Board.

The Board has appointed an Audit Committee whose primary role is to review the company's interim and annual financial statements before submission to the Board for approval. The Board has also appointed a Remuneration Committee, which is responsible for reviewing executive remuneration and performance. The Remuneration and Audit Committees are made up of two non-executive directors, David Clark and Kevin D'Silva. Details of the Remuneration Committee are disclosed in the report on directors' remuneration on page 7 and 8.

Disclosure of information to auditors

The directors who held office at the date of approval of this directors' report confirm that, so far as they are each aware, there is no relevant audit information of which the Company's auditors are unaware; and each director has taken all the steps that he ought to have taken as a director to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Auditors

In accordance with Section 384 of the Companies Act 1985, a resolution for the re-appointment of KPMG Audit Plc as auditors of the company is proposed at the forthcoming Annual General Meeting.

By order of the board

K D'Silva
Chairman

Surface Transforms plc
Cheshire Innovation Park
Unit 306, Pool Lane
Ince, Cheshire CH2 4NU

Report on directors' remuneration

Policy on executive directors' remuneration
The Remuneration Committee comprises Kevin D'Silva and David Clark.

The Remuneration Committee is responsible for reviewing and determining the company's policy on executive remuneration (including the grant of options under the Share Option Scheme) and ensuring compliance with and implementation by the company, as far as reasonably practicable, the recommendations and guidelines of the Combined Code.

Executive remuneration packages are designed to ensure the company's executive directors and senior executives are fairly rewarded for their individual contributions to the company.

Fees for non-executive directors
The fees for non-executive directors are determined by the Board. The non-executive directors are not involved in the decisions about their own remuneration.

Directors' remuneration - audited
Set out below is a summary of the fees and emoluments received by all directors for the year or, where applicable, period of office:

	2006	2005
	£	£
Executive directors		
Dr K Johnson	**71,683**	25,054
JJ Faria	**57,966**	52,899
Dr G Gould	**52,890**	45,318
	182,539	123,271
Non-executive directors		
K D'Silva	**19,900**	18,000
Professor DT Clark	**19,544**	19,485
PJ Holland	**11,687**	31,500
	51,131	68,985
	233,670	192,256

With the exception of Kevin Johnson, none of the directors received pension contributions in respect of their office. In addition to the emoluments received, as stated above, Kevin Johnson received £3,847 (*2005: £1,300*) in respect of pension contributions.

Directors' interests
Details of any contracts in which a director has a material interest are disclosed in note 21.

None of the directors received any remuneration or benefits under long term incentive schemes.

Share options – audited
The company operates a share incentive scheme. All options are granted at the discretion of the Board. The options granted, date of grant, exercise price and exercise periods under the scheme are set out below. During the year options to the directors and selected employees to purchase ordinary shares were granted at an exercise price of £0.40.

None of the directors exercised options during the year. Directors' options outstanding and the options which were granted and expired during the year are as follows:

Enterprise Management Incentive Scheme

Director	**Date of Grant**	**Number of Share options granted**	**Number of Share options expired**	**Exercise Price**	**Exercise Period**	**Expiry Date**
JJ Faria	19/12/02	64,286	-	£0.70	19/12/05-19/12/12	19/12/12
Dr G Gould	19/12/02	64,286	-	£0.70	19/12/05-19/12/12	19/12/12
Dr G Gould	08/12/03	34,091	-	£0.88	08/12/06-08/12/13	08/12/13
Dr G Gould	08/03/04	20,000	-	£0.665	08/03/07-08/03/14	08/03/14
Dr G Gould	14/09/05	29,000	-	£0.40	14/09/08-14/09/15	14/09/15
Dr K Johnson	04/04/05	50,000	-	£0.50	04/04/08-04/04/15	04/04/15
Dr K Johnson	14/09/05	180,000	-	£0.40	14/09/08-14/09/15	14/09/15
		441,663				

The market price of the shares at 31 May 2006 was £0.145 and during the period varied from £0.36 to £0.145. The market price of the shares from the date share options were granted has varied from £0.12 to £0.885.

By order of the board

K D'Silva
Chairman

Surface Transforms plc
Cheshire Innovation Park
Unit 306, Pool Lane
Ince, Cheshire CH2 4NU

Statement of directors' responsibilities in respect of the directors' report and the financial statements

The directors are responsible for preparing the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards.

The financial statements are required by law to 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.

In preparing these financial statements, the directors are required to:

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

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

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

KPMG Audit Plc
St James' Square
Manchester M2 6DS
United Kingdom

Independent auditors' report to the members of Surface Transforms plc

We have audited the financial statements of Surface Transforms plc for the year ended 31 May 2006 which comprise the Profit and Loss Account, the Balance Sheet, the Cash Flow Statement, the Statement of Total Recognised Gains and Losses, the Reconciliation of Shareholders' Funds and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities on page 9.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

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

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

Basis of audit opinion

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

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

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with UK Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 May 2006 and of its loss 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; and
- the information given in the Directors' Report is consistent with the financial statements.

KPMG Audit Plc 17 August 2006
Chartered Accountants
Registered Auditor

Profit and loss account
for the year ended 31 May 2006

	Note	**2006**	2005
		£	£
Turnover	*2*	**155,177**	258,336
Cost of sales		**(101,706)**	(93,846)
Gross profit		**53,471**	164,490
Distribution costs		**(1,613)**	(1,348)
Administrative expenses:			
Before development costs		**(511,186)**	(500,574)
Development costs		**(583,936)**	(472,978)
Total administrative expenses		**(1,095,122)**	(973,552)
Other operating income	*3*	**27,155**	4,980
Operating loss		**(1,016,109)**	(805,430)
Interest receivable	*6*	**92,662**	131,480
Interest payable	*7*	**-**	(1,235)
Loss on ordinary activities before taxation	*2-7*	**(923,447)**	(675,185)
Tax on loss on ordinary activities	*8*	**111,577**	58,562
Loss on ordinary activities after taxation and retained for the financial year	*16*	**(811,870)**	(616,623)
Loss per ordinary share Basic and diluted	*22*	**(5.79p)**	(4.47p)

All amounts relate to continuing activities.

Balance sheet
at 31 May 2006

	Note	2006		2005	
		£	**£**	£	£
Fixed assets					
Intangible assets	*9*		**4,104**		6,322
Tangible assets	*10*		**170,156**		73,877
			174,260		80,199
Current assets					
Stocks	*11*	**124,335**		67,522	
Debtors	*12*	**84,135**		80,991	
Cash at bank and in hand		**1,743,389**		2,728,052	
		1,951,859		2,876,565	
Creditors: amounts falling due within one year	*13*	**(129,014)**		(147,789)	
Net current assets			**1,822,845**		2,728,776
Net assets			**1,997,105**		2,808,975
Capital and reserves					
Called up share capital	*15*		**140,308**		140,308
Share premium account	*16*		**4,902,715**		4,902,715
Other reserves	*16*		**463,885**		463,885
Profit and loss account	*16*		**(3,509,803)**		(2,697,933)
Shareholders' funds			**1,997,105**		2,808,975

These financial statements were approved by the board of directors on 17 August 2006 and were signed on its behalf by:

K D'Silva
Director

Dr K Johnson
Director

Cash flow statement
for the year ended 31 May 2006

Reconciliation of operating loss to net cash flow from operating activities

	Note	2006 £	2005 £
Operating loss		**(1,016,109)**	(805,430)
Depreciation charge		**33,411**	45,935
Amortisation charge		**2,218**	2,218
(Increase)/decrease in stocks		**(56,813)**	21,161
(Increase)/decrease in debtors		**(14,471)**	103,847
(Decrease)/increase in creditors		**(18,775)**	50,714
Net cash outflow from operating activities		**(1,070,539)**	(581,555)

Cash flow statement

	Note	2006 £	2005 £
Cash flow from operating activities		**(1,070,539)**	(581,555)
Return on investments and servicing of finance	*19*	**103,989**	118,918
Taxation		**111,577**	58,562
Capital expenditure	*19*	**(129,690)**	(63,775)
Cash outflow before management of liquid resources and financing		**(984,663)**	(467,850)
Management of liquid resources	*19*	**987,500**	3,000
Financing	*19*	**-**	488,063
Increase in cash in the year		**2,837**	23,213

Reconciliation of net cash flow to movement in net funds

	Note	**2006** **£**	2005
Increase in cash in the year		**2,837**	23,213
Cash outflow from liquid resources		**(987,500)**	(3,000)
Movement in net funds in the year		**(984,663)**	20,213
Net funds at the start of the year	*20*	**2,728,052**	2,707,839
Net funds at the end of the year	*20*	**1,743,389**	2,728,052

Statement of total recognised gains and losses
for the year ended 31 May 2006

	2006 **£**	2005 £
Loss for the financial year	**(811,870)**	(616,623)
Unrealised gain on the lapse of warrants	**-**	56,514
Total recognised gains and losses relating to the financial year	**(811,870)**	(560,109)

Reconciliation of movements in shareholders' funds
for the year ended 31 May 2006

	2006 **£**	2005 £
Loss for the financial year	**(811,870)**	(616,623)
New share capital subscribed (net of issue costs)	**-**	155,563
Net reduction in shareholders' funds	**(811,870)**	(461,060)
Opening shareholders' funds	**2,808,975**	3,270,035
Closing shareholders' funds	**1,997,105**	2,808,975

Notes
(forming part of the financial statements)

1 Accounting policies

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the financial statements, except as noted below.

In these financial statements FRS 28 "Corresponding amounts" has been adopted for the first time. This has had no material effect as it imposes the same requirements for comparatives as hitherto required by the Companies Act 1985.

Basis of preparation

The financial statements have been prepared in accordance with applicable accounting standards and under the historical cost accounting rules.

Intangible fixed assets and amortisation

Expenditure on patents is capitalised and amortised to nil by equal annual instalments over the useful economic life of seven and a half years.

Tangible fixed assets and depreciation

Depreciation is provided to write off the cost less the estimated residual value of tangible fixed assets by equal instalments over their estimated useful economic lives as follows:

Plant and machinery	-	12.5% - 20% per annum
Fixtures and fittings	-	25% per annum
Motor vehicles	-	25% per annum

Foreign currencies

Transactions in foreign currencies are recorded using the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated using the contracted rate or the rate of exchange ruling at the balance sheet date and the gains or losses on translation are included in the profit and loss account.

Leases

Operating lease rentals are charged to the profit and loss account on a straight line basis over the period of the lease.

Government grants
Revenue grants are credited to the profit and loss account, and included within other operating income, so as to match them with expenditure to which they relate.

Capital based government grants are included within accruals and deferred income tax in the balance sheet and credited to the profit and loss account over the estimated useful economic lives of the assets to which they relate.

Post retirement benefits
The company contributes to specific employees' personal pension schemes. The amount charged to the profit and loss account represents the contributions payable to employees personal pension schemes during the accounting year.

Employee share schemes
The cost of awards to employees that take the form of shares or rights to shares are recognised over the period of the employees related performance. Where there are no performance criteria the cost is recognised when the employee becomes unconditionally entitled to shares.

Research and development expenditure
Expenditure on research and development is written off to the profit and loss account in the year in which it is incurred.

Stocks
Stocks are stated at the lower of cost and net realisable value. In determining the cost of raw materials and consumables the standard purchase price is used. For work in progress, cost is taken as production cost, which includes an appropriate proportion of attributable overheads.

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

Deferred tax liabilities are recognised without discounting in respect of all timing differences between the treatment of certain items for taxation and accounting purposes which have arisen but not reversed by the balance sheet date, except as otherwise required by Financial Reporting Standard 19.

Deferred tax assets are only recognised when it is possible to assess whether there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted. Any potential tax reclaim in relation to Research and Development tax credits are recognised when it is probable that such amounts will be received.

Cash
Cash, for the purpose of the cash flow statement, comprises cash in hand and deposits repayable on demand, less overdrafts payable on demand.

Liquid resources
Liquid resources are current asset investments which are disposable without curtailing or disrupting the business and are either readily convertible into known amounts of cash at or close to their carrying values or traded in an active market. Liquid resources comprise term deposits of less than one year.

Turnover
Turnover comprises income derived from research and development agreements and other related services and the supply of carbon fibre structures and carbon fibre reinforced ceramic products. Turnover excludes value added taxes.

Derivatives and other financial instruments
The company's financial instruments comprise cash and liquid resources, and various items, such as trade debtors and trade creditors, that arise directly from its operations. The main purpose of these financial instruments is to raise finance for the company's operations.

The main risks arising from the company's financial instruments are interest rate risk and liquidity risk. The board reviews and agrees policies for managing each of these risks and they are summarised below. These policies have remained unchanged.

Interest rate risk
The company finances its operations through cash. Cash resources are invested to attract the highest rates for periods that do not limit access to these resources.

Liquidity risk
With regard to liquidity, the company's policy has throughout the year been to ensure that the company is able at all times to meet its financial liabilities as and when they fall due.

2 Analysis of turnover and loss on ordinary activities before taxation

Turnover and loss on ordinary activities before taxation is wholly attributable to the principal activity of the company.

Turnover by destination is analysed as follows:

	2006	2005
	£	£
By geographical market:		
United Kingdom	**88,288**	251,432
Rest of Europe	**16,281**	6,904
United States of America	**44,229**	-
Rest of World	**6,379**	-
	155,177	258,336

Turnover by origin, net assets and profit before interest and tax all relate to the UK.

3 Loss on ordinary activities before taxation

	2006	2005
	£	£
Loss on ordinary activities before taxation is stated		
after charging		
Auditors' remuneration:		
- audit	**14,750**	14,500
- other	**14,875**	11,431
Depreciation of owned tangible fixed assets	**33,411**	45,935
Research and development expenditure	**583,986**	472,978
Amortisation of patents and licences	**2,218**	2,218
Rentals payable under operating leases		
- land and buildings	**41,354**	47,739
Exchange losses	**700**	876
after crediting		
Exchange gains	**553**	22
Government grants	**27,155**	4,980

4 Remuneration of directors

Full disclosure of directors' emoluments, share options and directors' pension entitlements which form part of the package as well as remuneration, interests and transactions is given in the Report on directors' remuneration on pages 7 and 8.

5 Staff numbers and costs

The average number of persons employed by the company (including directors) during the year, analysed by category, was as follows:

	Number of employees 2006	2005
Directors	**5**	6
Other employees	**10**	10
	15	16

The aggregate payroll costs of these persons were as follows:

	2006	2005 £
Wages and salaries	**433,263**	348,590
Social security costs	**46,968**	34,887
Other pension costs (see note 18)	**11,341**	6,740
	491,572	390,217

6 Interest receivable

	2006 £	2005 £
Bank interest receivable	**92,662**	131,480

7 Interest payable

	2006 £	2005 £
Other interest payable	**-**	1,235

8 Taxation

Analysis of credit in year

	2006	2005
	£	£
UK corporation tax		
Current tax on income for the year	**-**	-
Research and development tax repayment	**(111,577)**	(58,562)
Tax on loss on ordinary activities	**(111,577)**	(58,562)

Details of the unrecognised deferred tax asset are included in note 14.

Factors affecting the tax credit for the current period

The current tax credit for the year is lower *(2005:lower)* than the standard rate of corporation tax in the UK of 30%. The differences are explained below:

	2006	2005
	£	£
Current tax reconciliation		
Loss on ordinary activities before tax	**(923,447)**	(675,185)
Current tax at standard rate of 30%	**(277,034)**	(202,556)
Effects of:		
Expenses not deductible for tax purposes	**715**	1,036
Short-term timing differences	**2,905**	-
Depreciation for period in excess of capital allowances	**10,461**	15,008
Tax losses incurred in the period	**262,953**	186,512
Research and development tax repayment	**(111,577)**	(58,562)
Total current tax credit (see above)	**(111,577)**	(58,562)

Factors that may affect future tax charges

The effective tax rate in future years is expected to be below the standard rate of corporation tax in the UK due principally to historical losses which have been carried forward.

9 Intangible fixed assets

	Patents and licences £
Cost	
At beginning and end of year	16,637
Amortisation	
At beginning of year	10,315
Charge for year	2,218
At end of year	12,533
Net book value	
At 31 May 2006	**4,104**
At 31 May 2005	6,322

10 Tangible fixed assets

	Assets in the course of construction	Plant and machinery	Fixtures and fittings	Motor vehicles	Total
	£	**£**	**£**	**£**	£
Cost					
At beginning of year	22,030	225,552	9,188	17,852	274,622
Additions	22,186	95,414	1,282	10,808	129,690
At end of year	44,216	320,966	10,470	28,660	404,312
Depreciation					
At beginning of year	-	189,794	8,348	2,603	200,745
Charge for year	-	25,592	1,104	6,715	33,411
At end of year	-	215,386	9,452	9,318	234,156
Net book value					
At 31 May 2006	**44,216**	**105,580**	**1,018**	**19,342**	170,156
At 31 May 2005	22,030	35,758	840	15,249	73,877

11 Stocks

	2006	2005
	£	£
Raw materials and consumables	**68,572**	1,303
Work in progress	**55,763**	66,219
	124,335	67,522

12 Debtors

	2006	2005
	£	£
Trade debtors	**17,982**	15,993
Other debtors	**50,028**	37,266
Prepayments	**16,125**	27,732
	84,135	80,991

All debtors fall due within one year.

13 Creditors: amounts falling due within one year

	2006	2005
	£	£
Trade creditors	**66,347**	106,702
Taxation and social security	**15,916**	13,000
Accruals and deferred income	**46,751**	28,087
	129,014	147,789

14 Provisions for liabilities and charges

The elements of deferred taxation are as follows:

	2006	2005
	£	£
Difference between accumulated depreciation and amortisation and capital allowances	**(31,972)**	(21,511)
Other short term timing differences	**(2,946)**	-
Tax losses	**(713,152)**	(570,327)
Unrecognised deferred tax asset	**(748,070)**	(591,838)

The company has an unrecognised deferred tax asset at 31 May 2006 of £748,089 *(2005: £591,838)* relating principally to tax losses which the company can offset against future taxable profits from the same trade. An element of historical losses brought forward at 1 June 2005 has been surrendered for tax credit relief to allow the submission of a research and development tax claim. The claim has resulted in the surrender of some historical losses carried forward and a £209,207 reduction in the unrecognised deferred tax asset at 31 May 2005 which was previously disclosed in the 2005 accounts as £591,838.

The deferred tax asset has not been recognised in the accounts because it is not possible to assess whether there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

15 Called up share capital

	2006	2005
	£	£
Authorised		
20,000,000 ordinary shares of £0.01 each	**200,000**	200,000
Allotted, called up and fully paid		
14,030,748 shares of £0.01 each	**140,308**	140,308

Enterprise Management Incentive Scheme

The company operates a share incentive scheme for the benefit of the directors and certain employees. All options are granted at the discretion of the Board. The scheme grants options to purchase ordinary shares of £0.01 each. No options were exercised in the period.

The options granted to directors, date of grant and exercise price and exercise periods under the scheme are set out in the report on directors' remuneration on page 8. In addition to the directors' share options, certain employees have been granted the following options:

Date of grant	Number of share options granted	Number of share options expired	Exercise price	Exercise period
19/12/02	149,233	(106,789)	£0.70	19/12/05-19/12/12
08/12/03	34,091	(34,091)	£0.88	08/12/06-08/12/13
08/03/04	140,000	(20,000)	£0.665	08/03/07-08/03/14
04/04/05	35,000	-	£0.50	04/04/08-04/04/15
14/09/05	275,000	(20,000)	£0.40	14/09/08-14/09/15

There are a total of 452,444 unexpired options held by employees and a total of 441,663 unexpired options held by directors.

16 Share premium and reserves

	Share premium account	**Capital reserve**	**Profit and loss account**
	£	**£**	**£**
At beginning of year	4,902,715	463,885	(2,697,933)
Retained loss for the year	-	-	(811,870)
At end of year	**4,902,715**	**463,885**	**(3,509,803)**

17 Commitments

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

	Land and buildings 2006	Land and buildings 2005
	£	£
Operating leases which expire:		
Within one year	**8,500**	-
In the second to fifth years inclusive	**-**	33,000
	8,500	33,000

18 Pension scheme

The company contributes to specific employees personal pension schemes. The pension cost charge for the year represents contributions payable by the company to the scheme and amounted to £11,341 *(2005: £6,740)*.

There were outstanding contributions of £1,818 at the end of the financial year.

19 Analysis of cash flows

	2006	2005
	£	£
Returns on investments and servicing of finance		
Interest received	**103,989**	120,153
Interest paid	**-**	(1,235)
	103,989	118,918
Capital expenditure and financial investment		
Purchase of tangible fixed assets	**(129,690)**	(63,775)
Management of liquid resources		
Cash transferred from treasury deposit	**987,500**	3,000
Financing		
Issue of ordinary share capital	**-**	8,150
Premium from issue of ordinary share capital (net of issue costs)	**-**	327,750
Premium on exercise of warrants	**-**	152,163
	-	488,063

20 Analysis of net funds

	At beginning of year	**Cash flow**	**At end of year**
	£	**£**	**£**
Cash at bank and in hand	96,052	2,837	**98,889**
Liquid resources	2,632,000	(987,500)	**1,644,500**
	2,728,052	(984,663)	**1,743,389**

21 Related party disclosures

The results of the company include the following transactions with related parties:

Company/entity	Relationship	Purchase	2006 £	2005 £
April Training Executive Ltd	JJ Faria is a director and has a controlling interest	Administrative services	**3,660**	9,480
April Property Partnership	JJ Faria is a director and has a controlling interest	Rent	**2,000**	6,000

All purchases from related parties are conducted on an arms length basis under normal commercial trading terms.

At the year end £nil was owing to April Training Executive Limited *(2005: £1,998)* and £nil to April Property Partnership *(2005: £587)*.

22 Loss on ordinary shares

The calculation of basic loss per ordinary share is based on the loss for the financial year divided by the weighted average number of shares in issue during the year.

Losses and number of shares used in the calculations of loss per ordinary share are set out below:

Basic

	2006 £	2005 £
Loss after tax	**(811,870)**	(616,623)
Weighted average number of shares	**14,030,748**	13,805,406
Loss per share	**(5.79p)**	(4.47p)

The calculation of diluted loss per ordinary share is identical to that used for the basic loss per ordinary share. This is because the exercise of options would have the effect of reducing the loss per ordinary share and is therefore not dilutive under the terms of Financial Reporting Standard 14.

23 Derivatives and other financial instruments

The company's policies with regard to financial instruments are set out within the accounting policies note. Short term debtors and creditors have been omitted from all disclosures.

Financial assets

The company has £1,743,389 (*2005: £2,728,052*) held in cash and deposits as financial assets as well as short term debtors.

Financial liabilities

The company has no financial liabilities except for short term creditors.

Fair values of the company's financial assets and liabilities

There is no material difference between the fair value and the book value of the company's financial assets and liabilities.

Company information and advisors

Websites	www.surface-transforms.com and www.systemST.com
Registered Number	03769702
Directors	Kevin D'Silva *(Non-executive Chairman)* Dr Kevin Johnson *(Managing Director)* Julio Joseph Faria *(Technical Director)* Geoffrey Gould *(Sales and Marketing Director)* Professor David Thomas Clark *(Non-executive Director)*
Address	Cheshire Innovation Park, Unit 306 Pool Lane Ince Cheshire CH2 4NU Tel: 0151 472 3733
Nominated adviser	John East & Partners Limited Crystal Gate, 28-30 Worship Street, London EC2A 2AH
Broker	Teather & Greenwood Limited Beaufort House, 15 St Botolph Street, London EC3A 7QR
Auditors	KPMG Audit plc St James' Square, Manchester M2 6DS
Solicitors to the Company	Halliwells LLP St James' Court, Brown Street, Manchester M2 2JF
Bankers	Barclays Bank plc 125 Main Street, Frodsham, Cheshire WA6 7AD
Registrars	Capita IRG plc Bourne House, 34 Beckenham Road, Beckenham, Kent BR3 4TU