Financial review

Introduction

During 2005, Spectris adopted International Financial Reporting Standards (IFRS) in common with other companies that are listed in the European Union. This has required a restatement of the 2004 results reported previously under UK GAAP. In certain respects, IFRS has introduced more complexity to Spectris' financial statements through the use of fair value accounting rules. The section headed 'Adoption of IFRS' below describes the principal impact on Spectris from adopting IFRS.

Spectris uses adjusted figures as key performance measures in addition to those reported under IFRS. Adjusted figures are stated before amortisation of acquisition-related intangible assets, goodwill charges, profits or losses on the termination or disposal of businesses or major fixed assets, unrealised changes in the fair value of financial instruments, related tax effects and other tax items which do not form part of the underlying tax rate. Unless otherwise stated all profit and earnings figures referred to below are adjusted measures.

Operating performance

	2005	2004
Turnover (£m)	**655.9**	614.1
Operating profit (£m)	**73.5**	64.6
Operating margin (%)	**11.2**	10.5

Sales increased by 7% overall, driven largely by increased demand from customers in Asia.

Adjusted operating profit rose by 14% overall with the operating margin improving from 10.5% to 11.2%. Aside from the impact of sales growth, operating profits benefited from the constraint exercised on overheads and the return to profitability of the Beta LaserMike and Spectrum businesses.

Interest costs, including IAS 19 pension charges, reduced from £14.1 million to £13.0 million, reflecting both the consistent reduction in the level of net debt during the year and more efficient use of surplus cash balances. After taking account of lower interest costs, adjusted profits before tax increased by 20% from £50.5 million to £60.5 million.

Bolt-on acquisitions and currency movements had a broadly neutral overall effect on the profits for the year.

Operating profits, after including goodwill charges of £7.4 million (2004: £12.2 million) and acquisition-related intangible asset amortisation of £1.2 million (2004: £1.2 million), increased by 27% from £51.2 million to £64.9 million.

Unadjusted profits before tax increased by 42% from £35.9 million to £50.8 million. In addition to goodwill charges and acquisition-related intangible asset amortisation charges, the 2005 result includes a £1.7 million profit on the disposal of the group's remaining interest in the Luxtron business. This result also includes unrealised losses of £2.8 million on the group's cross-currency interest rate swaps and average rate options as a consequence of the adoption of IAS 39 with effect from 1 January 2005. These items are explained in more detail in the 'Adoption of IFRS' section below.

Acquisitions and disposals

During the year, one small bolt-on acquisition was made for which the total consideration, including acquisition expenses and debt acquired, was £2.5 million.

In February 2006, Spectris entered into an option agreement to sell the Arcom business to Eurotech S.p.A. Since the year end, Eurotech has paid US$2 million to Spectris in consideration for the option which gives Eurotech 60 days to acquire Arcom on a cash and debt-free basis. Should the acquisition complete, the total consideration will be US$26 million (including the US$2 million option payment already received). As a consequence of this agreement, the Arcom business' assets and liabilities are presented separately in the group balance sheet as 'held for sale'.

Taxation

The effective tax rate on profits was 26.9% (2004: 24.4%). The effective tax rate continues to be below the weighted average statutory tax rate of 32.8% (2004: 32.6%) as a consequence of the utilisation of unrecognised tax losses in Germany, tax-efficient financing, and prior year tax credits. As anticipated, the increase in the tax rate in 2005 was due to

a reduction in the effect of tax planning and brought forward loss utilisation. The underlying tax charge is expected to increase further towards the weighted average statutory tax rate over the next few years.

Earnings per share

Adjusted earnings per share increased by 15% from 31.6p to 36.2p. This increase is lower than the growth in profit before tax due to a higher effective tax rate.

Basic earnings per share increased by 48% from 19.5p to 28.8p. The differences between the two measures are shown in the table below.

	2005 Pence	2004 Pence
Basic earnings per share	**28.8**	19.5
Goodwill charges and acquisition-related intangible asset amortisation	**7.0**	11.1
Loss on termination of businesses	**–**	1.0
Income from disposal of Luxtron	**(1.4)**	–
Unrealised changes in fair value of financial instruments	**2.3**	–
Tax effect of the above and other tax items that do not form part of the underlying tax rate	**(0.5)**	–
Adjusted earnings per share	**36.2**	31.6

The weighted average number of shares outstanding during the year increased from 120.9 million to 122.1 million. This increase arose principally as a result of the disposal of a proportion of the own shares held by the Spectris Employee Benefit Trust for cash proceeds of £10.7 million.

Cash flow

Operating cash flow	2005 £m	2004 £m
Adjusted operating profit	**73.5**	64.6
Add back: depreciation	**12.6**	13.4
Working capital movement/other	**4.5**	(13.7)
Net cash flow from operating activities before capex	**90.6**	64.3
Capex	**(12.2)**	(15.6)
Operating cash flow	**78.4**	48.7
Cash conversion	**107%**	75%
Non-operating cash flow		
Tax paid	**(15.8)**	(7.7)
Interest paid	**(12.7)**	(13.9)
Dividends paid	**(18.1)**	(16.3)
Acquisitions	**(3.0)**	(10.5)
Shares issued	**1.3**	0.7
Sale of own shares by Employee Benefit Trust	**10.7**	–
Financial income	**1.8**	0.1
Finance leases	**(0.5)**	–
Exchange/other	**(3.1)**	3.4
Total non-operating cash flow	**(39.4)**	(44.2)
Operating cash flow	**78.4**	48.7
Movement in net debt	**39.0**	4.5

Cash conversion of operating profit to operating cash was 107% (2004: 75%). The improvement in cash conversion was chiefly due to a turnaround of £18.2 million in the working capital movements which improved from a cash outflow in 2004 of £13.7 million to a cash inflow of £4.5 million in 2005. Inventory turns improved from 2.9 times at December 2004 to 3.3 times at the end of 2005. Debtor days outstanding increased very slightly, rising from 59 days at December 2004 to 60 days at the end of 2005. Over the same period, trade working capital expressed as a percentage of sales remained constant at 16%.

Capital expenditure reduced during the year and equated to 1.9% of sales and, at £12.2 million, was 97% of depreciation.

The level of tax paid in 2005 was higher than in 2004 due primarily to the acceleration of payments on account in Germany and an increase in the current tax on profits.

Overall, net debt fell by £39.0 million. Interest cost, excluding the financing charge arising from IAS 19, was covered by operating profits 5.8 times (2004: 4.7 times), providing headroom over the banking covenants which require a minimum of 3 times cover.

Financing and treasury

The group finances its operations from both retained earnings and third-party borrowings, the majority of which are currently at fixed rates of interest.

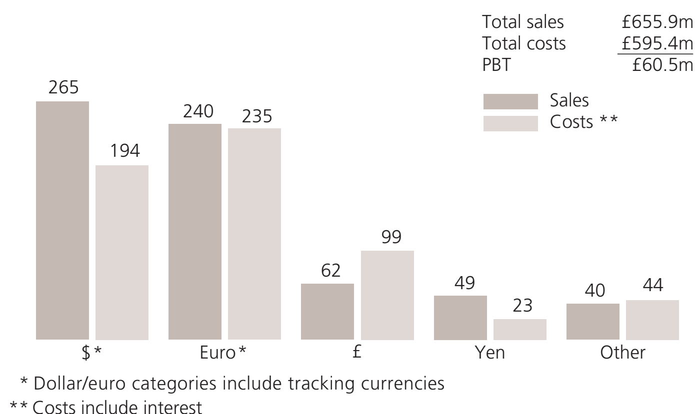
During 2004, no significant new loan borrowings were taken out and the majority of third-party borrowings continue to be comprised of US dollar private placement loans which have been partly swapped into euros to provide a hedge against euro-denominated net assets in the group's balance sheet.

30% of debt is due to mature within one year (2004: 0%), 29% of debt is due to mature in between one and five years (2004: 27%) and the remaining 41% in more than five years (2004: 73%). During July 2006, the $100 million 1996 Private Placement loan notes will become due for repayment. New committed facilities have already been negotiated which, together with the free cash flow generated by the group, will provide sufficient funds to repay these loans.

Currency

The group has both translational and transactional currency exposures. Translational exposures arise on the consolidation of overseas company results into sterling. Transactional exposures arise where the currency of sale or purchase invoices differs from the functional currency in which each company prepares its local accounts. The transactional exposures include situations where foreign currency denominated trade debtor, trade creditor and cash balances are held.

To demonstrate the currency exposures faced by the group, the chart opposite shows the differences between the group's consolidated revenues and costs for each of the major currencies.



* Dollar/euro categories include tracking currencies
** Costs include interest

The largest transactional exposures are to the US dollar and, to a lesser extent, the Japanese yen. The largest translational exposures are to the US dollar and euro (and also the Danish krone which has tended to track the euro quite closely). The table below shows the average exchange rates during 2004 and 2005 which are quite similar and there was therefore a modest currency effect on the results when compared year-on-year.

The key exchange rates were as follows:

	2004 (average)	2005 (average)	2005 (year-end rate)
US$	1.83	1.82	1.72
Euro	1.47	1.46	1.45
Yen	197	200	203

In the past, the group's currency exposures have been hedged using zero cost average rate options. The group's US dollar, euro and Japanese yen exposures were hedged in 2004 through zero cost average rate options which, in aggregate, generated net gains of £3.2 million. In 2005, whilst the group had zero cost average rate options in place, no gain or loss arose. Going forward, the group does not intend to use zero cost average rate options to hedge currency exposures and no options were outstanding as at 31 December 2005.

Translational currency exposures are not hedged. Forward exchange contracts are used to hedge forecast sale transactions where there is reasonable certainty of an exposure.

Defined benefit pension schemes

Operating profit includes a defined benefit pension scheme current service charge of £0.7 million (2004: £0.8 million). The net pension liability in the balance sheet (before taking account of the related deferred tax asset) has increased to £22.6 million (2004: £20.7 million), largely as a consequence of a reduced discount rate. During 2005, the group increased its cash contributions into the defined benefit pension schemes to £3.2 million (2004: £1.5 million).

Adoption of IFRS

In most respects, there was a minimal impact on Spectris from the adoption of IFRS. However, IFRS has introduced more complexity into the group's financial statements, particularly the requirement to fair value derivative financial instruments (following the adoption of accounting standard IAS 39 with effect from 1 January 2005). The detailed transitional reconciliations from the group's reported UK GAAP results in 2004 to the restated IFRS results for 2004 are presented in Note 36 of the financial statements. However, the most significant adjustments arising on adoption of IFRS are summarised below.

Presentational matters

IFRS has different presentation and disclosure requirements to UK GAAP and has involved significant changes to the presentation of the financial statements. Wherever possible, the group has attempted to present the financial statements in a consistent manner with those presented in the past. The changes in accounting rules have meant that the group's adjusted measures of profits and earnings have been changed, and the new measures are described in the introduction to the financial review.

Deferred tax

The single largest adjustment arising on the transition to IFRS relates to deferred tax. Deferred tax accounting under UK GAAP is based on the concept of 'timing' differences which focuses on the differences in timing between when profits are recognised for accounting and tax purposes. In contrast, IFRS has a concept of 'temporary' differences which is more balance sheet focused, comparing the carrying value of assets and liabilities for both tax and accounting purposes. Goodwill arising on the acquisition of the group's US businesses which was previously written off to reserves is deductible for tax purposes. Under UK GAAP, the current tax deduction obtained each year gave rise to a deferred tax liability because it was perceived that there was a timing difference which could reverse (for example on disposal of a business). Under IFRS, the tax balance carried forward at each balance sheet date instead gives rise to a deferred tax asset since the accounting asset has been written off to reserves and is not recognised on the balance sheet, whilst a tax asset exists by virtue of the ability to claim future deductions.

At 31 December 2004, the deferred tax liability under UK GAAP was £17.6 million. Under IFRS, this liability has been eliminated and replaced with a deferred tax asset of £11.0 million, a combined adjustment of £28.6 million. There was an impact of £0.2 million on the tax charge in the income statement in 2004 from this change.

Goodwill

There are a number of differences in the way goodwill is treated between IFRS and UK GAAP:

1. Under UK GAAP, goodwill was amortised over its estimated useful life. Under IFRS, goodwill is not amortised but is

instead subject to an annual impairment test. As a consequence of this, goodwill amortisation included in the 2004 UK GAAP accounts of £13.0 million has been reversed.

2. Under UK GAAP, no distinction was made between the various components of any intangible asset arising on acquisitions where the price paid exceeds the fair market value of the tangible assets and liabilities acquired. Under UK GAAP all such intangibles were disclosed as goodwill and amortised over an appropriate economic life. IFRS requires separate identification of these intangibles, and amortisation where appropriate, with any residue being classified as goodwill. As a consequence, £5.8 million of the goodwill reported at 31 December 2004 under UK GAAP has been reclassified under IFRS as intangible assets, and amortisation of £1.2 million was charged on these assets in 2004.
3. Where an acquisition occurs and the conditions for recognition of a deferred tax asset are not met at that time, but are met at a later date, IFRS requires that an equal and opposite adjustment to goodwill is made. In 2004 under UK GAAP, the group recognised a deferred tax asset of £12.2 million relating to an earlier acquisition and as a consequence, under IFRS, an additional goodwill charge of £12.2 million has been made in 2004.

Dividends

Under UK GAAP, dividends payable to shareholders were recognised in the profit and loss account in the period to which they related. On this basis the 2004 UK GAAP accounts included an accrual for the final dividend approved at the Annual General Meeting in May 2005.

IFRS requires that dividends are not recognised until they are declared. As a consequence, the net assets reported by the group on a UK GAAP basis at 31 December 2004 have been increased on adoption of IFRS by £12.4 million to reverse the accrual for the final dividend declared in 2005 in respect of the year ended 31 December 2004.

Other adjustments impacting the transition to IFRS in the 2004 comparative period

There were three other types of adjustment made to the 2004 comparative results in the transition to IFRS which had a less significant impact than those items already described above:

1. Share options – a charge to the profit and loss account is recognised under IFRS where previously no such charge existed under UK GAAP. The charge applies to options issued after November 2002. This requirement resulted in a charge to the income statement in the year ended 31 December 2004 of £0.4 million. However there is no overall impact on the balance sheet since there is also a corresponding adjustment to equity through reserves.
2. Revenue recognition – IFRS is similar to UK GAAP but contains specific additional guidance on accounting for contracts that include installation elements. Following a review of existing policies, this gives rise to some subtle differences in the timing of accounting for certain transactions. This led to a reduction in profits before tax of £0.2 million in the income statement for the year ended 31 December 2004. The net deferral of revenue and associated costs in the balance sheet at 31 December 2004 was £2.3 million.
3. Holiday pay – IFRS requires short-term accumulating benefits such as holiday and sick pay entitlements to be accrued over the period in which the entitlement is earned. There was no impact on the income statement in 2004 but an additional liability of £1.1 million was recognised in the balance sheet as at 31 December 2004.

Adoption of IAS 39 from 1 January 2005 (derivatives and hedge accounting)

As permitted by the IFRS transitional accounting rules, the group elected to adopt IAS 39 with effect from 1 January 2005 and consequently the comparative period for 2004 has not been restated to comply with IAS 39. IAS 39 has impacted on the group in 2005 in three main areas:

1. Average rate options – the group has historically used average rate options to provide a hedge against the group's currency exposures. Under UK GAAP, the value of the options was recognised in the profit and loss account in a way that matched the gains or losses arising with the period the options were intended to hedge. IFRS requires that the fair value of such derivative financial instruments is recognised on the balance sheet at all times. Since the options did not meet IAS 39's strict hedge accounting criteria, all changes in the fair value were recognised in the income statement. As at 1 January 2005, the fair value of the average rate options was £1.7 million, reducing to a value of £nil at 31 December 2005. This gives rise to a charge in the income statement in 2005 of £1.7 million. This charge is excluded from the group's adjusted measure of profits and earnings since it is an unrealised loss.
2. Cross-currency interest rate swaps – the group uses cross-currency interest rate swaps to convert some of its fixed interest US dollar private placement loan note borrowings into fixed interest euro-denominated borrowings. This is done so as to provide a natural hedge of the group's European investments. Under UK GAAP, the combined instruments were accounted for as if they were a single financial instrument whilst IFRS requires that the instruments are recognised in the balance sheet separately and the swaps are required to be carried at their fair value.

   The fair value of the cross-currency swaps can effectively be split into two components: a currency portion that converts a US dollar borrowing obligation into one denominated in euros; and an interest portion that changes a stream of US dollar fixed interest payments into euro fixed interest payments. Under UK GAAP, the currency

portion of the swaps was included within the carrying value of the group's borrowings in the balance sheet. However, the interest portion of the swap was not previously recognised in the group balance sheet. Aside from the change to the way these financial instruments are presented in the balance sheet, the move to IFRS has required the interest portion of the swap to be carried in the group balance sheet for the first time. Since it is considered to be ineffective in any hedging relationship, all changes in the fair value of the interest portion of the swap are recognised in the income statement. At 1 January 2005, the fair value of the interest portion of the swap was a liability of £7.6 million, increasing to a liability of £8.7 million at 31 December 2005. This gives rise to a charge in the income statement of £1.1 million in 2005.

Over time, as the group continues to make the fixed interest payments due under the swap arrangement, the value of the interest portion of the swap will decrease to nil. On this basis, changes in its value are considered to be unrealised gains or losses and so are excluded from the group's adjusted measures of profits and earnings.

3. Forward currency contracts – the group uses forward exchange contracts to hedge highly probable forecast future cash flows. Under UK GAAP, the value of these contracts was recognised at the time when the sale transactions to which they related were recognised. Under IFRS, the fair value of the forward exchange contracts is required to be recognised on the balance sheet at all times. Provided the hedges are considered to remain fully effective, the change in the fair value of the forward exchange contracts is recognised in a hedging reserve until the point in time when the sale transactions occur. At this point, the fair value of the contracts is recognised in the income statement.

   This change from UK GAAP to IFRS has not had any impact on the income statement in 2005 but there is an impact on the group balance sheet. The fair value of the forward exchange contracts at 1 January 2005 of an asset of £0.8 million was recognised in the group balance sheet, reducing to a liability of £0.6 million at 31 December 2005. £1.3 million of this movement was recognised in the hedging reserve and £0.1 million of the movement has been recognised in the income statement in 2005.

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