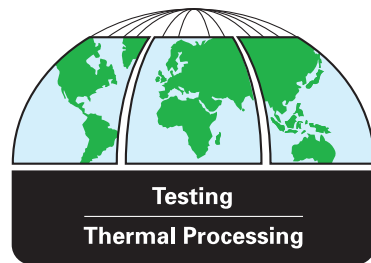


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annual report 2006

Bodycote International plc  
annual report 2006



outsourcing for industry

Bodycote International plc  
Hulley Road  
Macclesfield  
Cheshire  
SK10 2SG

Tel: +44 (0)1625 505300  
Fax: +44 (0)1625 505313  
Email: [info@bodycote.com](mailto:info@bodycote.com)

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The logo for Bodycote, featuring a red square to the left of the word 'Bodycote' in a bold, black, sans-serif font.

# Bodycote wins the 'Manchester Evening News' Business of the Year Award



Bodycote won the premier award in the large business category organised by the UK North West daily newspaper and sponsored by Barclays Bank, Greater Manchester Chamber of Commerce, Hammonds law firm and PricewaterhouseCoopers. "Entrepreneurial skills exhibited throughout Bodycote" and "highly regarded customer service" were particularly praised.

## At a glance

### Bodycote Thermal Processing

Operating 184 plants in 21 countries; an unrivalled strategically located network, experienced in supporting large multi-national customers and their supply chains, as well as local niche specialists and providing a vital link in the manufacturing process for the automotive, aerospace, construction, power generation, electronics, consumer products and general engineering industries.

### Heat Treatments and Metal Joining

Vacuum and sealed quench and induction heat treatment, carburising, carbonitriding, gas and plasma nitriding, nickel, copper, silver and gold brazing, hardening, tempering, kolsterising, low pressure carburising and electron beam welding. Expanding in Eastern Europe, Asia and other developing economies and developing low pressure carburising technology in Europe and the USA.

### Hot Isostatic Pressing

Applying the unique product enhancement and novel material production benefits of this advanced technology to an increasing number of customers in precision foundry, power generation, aerospace, automotive, medical, precision tooling, and electronic engineering. Managing the western world's largest HIP capacity at 11 locations across 6 countries. Developing the Densa® process and other new materials and manufacturing techniques by collaborative projects with market-leading OEMs.

### Surface Engineering

Improving the performance, durability and appearance of components and tools by the application of functional and decorative coatings utilising sherardizing, mechanical cladding, plasma spray, organic, anodizing, HVOF and specialist ceramic coatings processes.

### Bodycote Testing

Offering a fully accredited group of 107 testing laboratories in 18 countries for producers and other users, serving international customers and providing a beneficial outsource option for advanced businesses. Measuring, inspecting and certifying the quality and reliability of materials and products for many clients in the fields of civil engineering, food and household goods, pharmaceutical, energy and transportation. Bodycote Testing also provides services to protect the environment and workplace. Consultancy, expert witness and advisory services are also provided.

### Materials Testing/Engineering and Technology

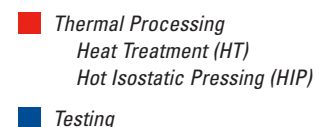
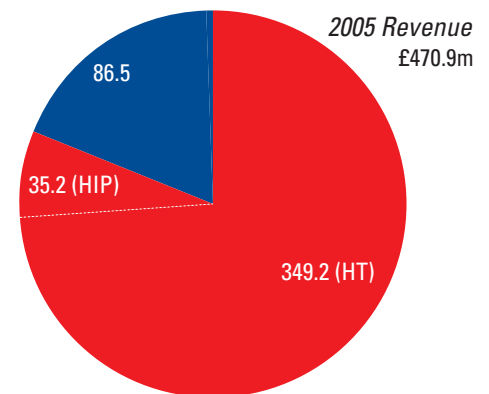
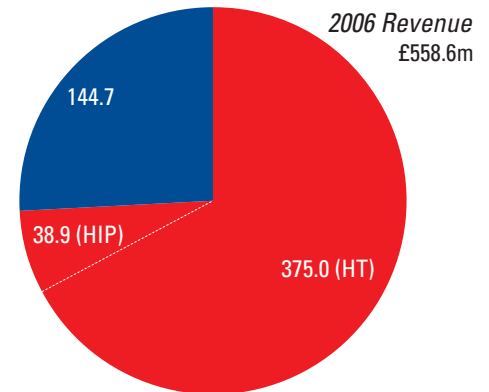
Testing ferrous and non-ferrous alloys, building products, composites and plastics, oils (wear and high voltage) applying mechanical, metallurgical, physical, radiographic and chemical methods. Also providing advanced airframe and engine testing for component integration as well as oilfield, erosion testing, automotive engine development and production testing. Bodycote MTET delivers advanced solutions in a cost effective outsource environment.

### Health Sciences/Environmental

Testing, evaluation, research and development for food, pharmaceutical and consumer products. Also the sampling and testing for hazardous materials including asbestos, eco-toxicity, stack emission sampling and testing of soils and water. Bodycote HSE brings scientific measurement to facilitate environmental studies and management, and supports a multi-national client base in a highly regulated laboratory environment.

### Measurement Solutions

Offering complete services within metrology and measurement of instrumentation for the electronic, telecom, medical, electrical and mechanical engineering industries. Bodycote Measurement Solutions provides a complete and cost effective service with the aim of enabling customers to reduce test and measurement costs and focus upon their core business.



[www.bodycote.com/audiocast](http://www.bodycote.com/audiocast)

Bodycote continually improves the website offerings for both customers and investors. The most recent is the addition of an audio webcast of Bodycote's 2006 results presentation in the Investor Relation section of the website. We invite you to view and to listen by visiting [www.bodycote.com/audiocast](http://www.bodycote.com/audiocast)

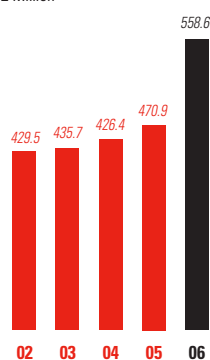
|  | 2006          | 2005    | Change % |
|--|---------------|---------|----------|
| Revenue - Continuing Operations              | <b>558.6m</b> | £470.9m | +18.6    |
| Headline Operating Profit <sup>1,2</sup>     | <b>£79.7m</b> | £67.8m  | +17.6    |
| Operating Profit                             | <b>£58.8m</b> | £61.0m  | -3.6     |
| Headline Profit Before Taxation <sup>1</sup> | <b>£70.0m</b> | £58.8m  | +19.0    |
| Profit Before Taxation                       | <b>£46.6m</b> | £52.7m  | -11.6    |
| Headline Earnings Per Share <sup>3</sup>     | <b>17.3p</b>  | 14.6p   | +18.5    |
| Basic Earnings Per Share                     | <b>13.4p</b>  | 12.7p   | +5.5     |
| Dividend Per Share                           | <b>7.0p</b>   | 6.4p    | +9.4     |

<sup>1</sup> Expressed pre impairment of goodwill (£6.0m: 2005 £5.8m), amortisation of acquired intangibles (£1.0m: 2005: £0.2m), share of associates interest and tax (£0.6m: 2005 £0.8m), impairment of equity investment in associate (£8.3m: 2005 nil) and major facility closure costs (£5.0m: 2005 nil)

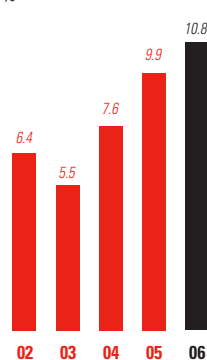
<sup>2</sup> Expressed pre impairment of goodwill (£6.0m : 2005 £5.8m), amortisation of acquired intangibles (£1.0m: 2005 £0.2m), impairment of equity investment in associate (£8.3m: 2005 nil), major facility closure costs (£5.0m: 2005 nil) and the cost of early settlement of US \$ private placement debt (£3.1m: 2005 nil)

<sup>3</sup> A detailed reconciliation is provided in note 10 page 40.

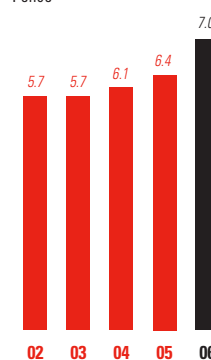
Revenue - Continuing Operations  
£ Million



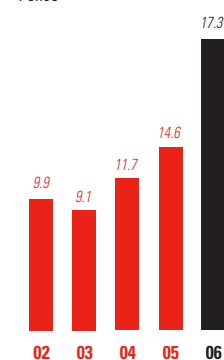
Return on capital employed  
%



Dividend Per Share  
Pence



Headline Earnings Per Share<sup>3</sup>  
Pence



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## Chairman's Statement

Bodycote has had another year of successful trading with good growth in sales (up 18.6%) and headline\* operating profits (ahead 17.6%), as well as completing 17 bolt-on acquisitions with 52 facilities. Our return on invested capital has increased to 10.8%. We are expanding into new geographies, and broadening the range of services that we have to offer our customers.

The Board is recommending a final dividend of 4.5p (2005: 4.05p), an increase of 11.1%, to be paid on 5 July 2007 to all shareholders on the register at the close of business on 8 June 2007. The total proposed dividend for 2006 is therefore up by 9.4% at 7.0p per share (2005: 6.4p) of which 2.5p per share (2005: 2.35p) was recognised in the 2006 results and is covered 2.5 times by headline\*\* earnings.

Acquisition growth in Testing has been significant and we have consolidated and integrated systematically. We clearly appreciate that we must maintain high standards in our existing businesses and we are determined that there should be balanced and controlled growth. Consequently, there will be an increased emphasis on organic growth and garnering synergy benefits from recent acquisitions.

Thermal Processing has benefited from good organic growth and an expansion into new geographies, both through acquisition in Brazil and Turkey and investment in new facilities in China, Mexico and Singapore. This initiative will continue in 2007 as we enter India and maintain our investment in supporting newer technologies and processes.

Towards the end of the year we decided to close four plants and write-down the equity investment in our associated company, SSCP Coatings. These measures demonstrate our commitment to act decisively with the Group's best long term interests in mind but as a result statutory operating profit fell by £2.2m compared to 2005. We also saw a reversal in the second half of the currency translation gains that we had seen in the first half.

Bodycote now employs over 10,000 people and operates from 291 sites in 28 countries. In order to manage such growth it is important that we invest in our people and our systems. A significant amount of work has been done on enhancing safety systems and the training and development of our people throughout the Group. These are now an integral part of our management systems.

The current board has been unchanged since January 2003. We have decided to increase the membership from seven to nine directors, with four executives and four independent non executives under a non executive chairman. The expanded and enhanced Board will reflect the changing requirements of the business going forward and will be in line with the provisions of the Combined Code. Richard Scholes will be retiring by rotation at the AGM having served for nine years. We had selected a replacement for him as chairman of the Audit Committee but in January we were informed that he could not join the Board. As a result Mr Scholes will be proposed for re election. He will, however, step down as a director upon the later of our interim results being announced and a replacement Audit Committee Chairman being appointed. We thank him for agreeing to stay beyond his current term. The search for his replacement is well underway. Also following the 2007 AGM Hans Vogelsang has agreed to take on the role of Senior Independent Non-Executive Director. In 2008, I will have served 14 years on the Board, 6 of them as Chairman and I will be retiring at the 2008 AGM. You can be assured, however, that I remain fully committed to the continued success of Bodycote and ensuring that it has a Board with the right balance of skills and experience. A search for a successor has commenced.

After a strategic review in early 2005, we set ourselves ambitious 5 year targets. New five year targets are set annually on a rolling basis (see table on page 5 in the group business review). Management incentives are geared to value creation for shareholders based on this plan and stretch targets established each year by the Board's Remuneration Committee.

Bodycote has a strong platform on which to develop the business and we are confident for the Group's prospects in 2007. We have high quality committed people and a clear understanding of our markets and the drivers for profitable growth. Our balance sheet is strong, with an appropriate level of gearing taking into account the cyclical characteristics of some of our businesses, our need for capital expenditure and our plans for growth, both organically and by acquisition.

The Business Review which follows gives a comprehensive summary of our activities in the year and enables shareholders to appreciate more fully how we have performed in our own business environment and how we meet the challenges. I commend it to you.



**James Wallace**  
27 February 2007

\* For reconciliation of headline operating profit to statutory operating profit please refer to page 5 of the Group Business Review

\*\* For reconciliation of headline earnings to basic earnings please refer to Note 10 on page 40

### OPERATIONS

Bodycote provides Thermal Processing and Testing services to manufacturers in virtually every sector of the world economy. From 291 facilities in 28 countries, more than 10,000 employees provide high quality services to over 60,000 customers. In line with our strategy to grow the Testing Strategic Business Unit (SBU) rapidly, this business delivered 26% of Group sales compared to 18% in 2005. A continued increase in this proportion is expected in 2007. The SBU is organised into two Divisions: Materials, Engineering & Technology and Measurement (METM) and Health Sciences/Environmental (HSE). The Thermal Processing SBU delivered 74% of Group sales compared to 82% in 2005 and is organised into two Divisions: Heat Treatment and Hot Isostatic Pressing (HIP).

### COMPETITIVE ENVIRONMENT

In the western hemisphere we are the clear leader in Thermal Processing and have a unique multi-disciplinary presence in the Testing market. In both Thermal Processing and Testing, Bodycote predominantly competes with local, privately owned companies and manufacturers' captive facilities. Both supply and demand are very fragmented with hundreds of providers servicing thousands of customers. We have developed a competitive advantage over local entrepreneurs through our quality systems, extensive knowledge base, breadth of technology, flexible capacity and broad range of services. Our proven track record of supplying Thermal Processing and Testing services to many of the world's most respected manufacturers is testament to our success in outsourcing and subcontracting for manufacturers, who need to reduce costs, whilst at the same time being confident that their critical components are processed to specification. Our HIP business operates in a much smaller total market. We have about 60% of western hemisphere capacity and few manufacturers invest in this technology, principally because of its high capital cost and the cyclical nature of demand. The competitors we have vary from smaller private companies to large corporations.

### REGULATORY ENVIRONMENT

As a service provider to virtually all market sectors and operating in many countries, we are subject to a multitude of quality, safety, environmental and regulatory requirements. We continuously monitor changes in laws, regulations and standards, adopting systems and policies to remain compliant. Although this effort is costly it clearly differentiates us in the market place. Customers have confidence in our quality and the sustainability of our services.

### MACRO-ECONOMIC ENVIRONMENT

The countries we operate in are generally experiencing positive economic conditions, with inflation largely under control. Energy prices increased to record highs during 2006. Recently we have seen some reduction in natural gas prices but they remain at historically high levels, whilst electricity prices have continued to rise and are not expected to moderate before the second half of 2007. Materials such as nickel, chrome and molybdenum used in the baskets and fixtures, have significantly increased in price but we have successfully recovered these costs. As a service provider to manufacturers we are subject to the cyclical nature of our customers' demand. Currently the only significant sector we serve that is exhibiting softness is automotive in North America and some parts of Europe. However, we are being successful in offsetting its impact by winning new business in our traditional territories and expanding into new geographies. Aerospace, power generation, oil & gas and health sciences demand continues to be robust. We have, as part of our strategic plan, been increasing the contribution from our Testing business, as we believe it will give an improved return on capital employed and be less cyclical than Thermal Processing.

### LONG TERM STRATEGY AND BUSINESS OBJECTIVES

After a thorough review in early 2005, we adopted a strategy which incorporates three key initiatives, each aiming to enhance shareholder value and accelerate growth:

- Increase Testing to about half of the Group sales
- Expand the Group into developing manufacturing geographies
- Intensify Outsourcing initiatives

We measure our performance against this strategy using the following financial and non financial indicators (see table on page 5).

Our most important indicator is the improvement in return on capital employed (ROCE) and further progress has been made in 2006 towards our 5 year target. The HIP division and Testing SBU both continue to be above this target and hence our primary focus for improvement is in Heat Treatment. Overall return on sales saw a modest reduction despite increases in both Heat Treatment (+0.6%) and HIP (+5.9%). As anticipated, mix changes and additional infrastructure costs have resulted in a reduction of margins in the Testing SBU. Organic sales growth was again in our target range. People costs are the Group's largest expense. Pleasingly Thermal Processing saw a reduction in these costs to 40.7% of sales and is within sight of our target of 40%. Testing, however, deteriorated slightly due to the impact of acquisitions. Capital expenditure was within our target range but was above the level of depreciation, reflecting the Group's establishment of new facilities in emerging markets and our commitment to additional HIP capacity in the US and Germany, to support growing aerospace and automotive demand. We expect to benefit from this investment in future years. The key metric to improve profitability in heat treatment is capacity utilisation and 2006 saw further progress towards our goal of >80%. Significant progress has been made during 2006 towards our target of having all the Group's facilities meet environmental standard ISO 14001 or ISO 17025 with 63% of sites now accredited. This is the third year that Bodycote has been collecting statistics on accidents in all parts of the Group. Although significant improvements have been made over three years, the ultimate target of having zero accidents has not yet been met. Further initiatives to reduce the number of accidents were put in place during 2006 and it is expected that the results of these will begin to feed through to the statistics in 2007.

## 2006 Group Business Review

### FINANCIAL RESULTS FOR 2006

Bodycote has continued to show strong growth in 2006 with sales increasing by 18.6% to £558.6m (2005: 10.4%, £470.9m). Organic sales accounted for 5.5% of this improvement (2005: 5.3%) and acquisitions for 13.1% (2005: 4.6%). Movement in exchange rates on translation of overseas sales was less than 1% this year (2005: 1.0%).

We have seen increasing demand in several key markets, most notably aerospace, power generation, oil & gas and health sciences. Outsourcing (Strategic Partnerships and Long Term Agreements) provided £8m of additional sales, resulting in a total of £105m in 2006 (2005: £97m). Some notable outsourcing agreements concluded in the year were with Land Rover, SNECMA, Honeywell, TRW, ZF, American Axle, Haering Polska, SKF, Michelin, and GM. Outsourcing sales continue to account for approximately 20% of Group sales.

Headline\* operating profit increased by 17.6% to £79.7m in 2006 (2005: 22.2%, £67.8m). The impact of exchange rates on translation of overseas profits was less than 1% this year (2005: 1.1%).

Although headline\* operating profit improved by £11.9m, operating profit fell by £2.2m largely due to the impact of the cost of major facility closures (£5.0m) and the write down of the Group's investment in SSCP (£8.3m).

Overall, our headline\* operating margin decreased slightly from 14.4% in 2005 to 14.3% in 2006. Whilst the Heat Treatment business saw its headline\* margin increase to 13.4% (2005: 12.8%) and HIP to 32.9% (2005: 27.0%), Testing saw its margin fall to 14.7% (2005: 18.8%). This is largely attributable to the recent acquisitions in the environmental and measurement solutions segments, which operate at a lower margin than the Testing SBU average, although with a return on capital within our target range. In addition, the SBU saw substantial investment in its infrastructure to support the rapid growth.

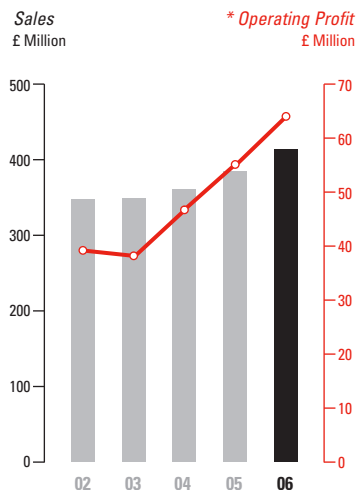
A charge of £1.0m has been accrued in head office for a share-based long term incentive plan (LTIP) for senior managers designed to incentivise growth in profit and return on capital employed. The LTIP was approved by shareholders at the 2006 AGM.

The amount charged reflects the expected fair value, spread over the three year vesting period, based on current progress towards plan targets.

As part of our plans to increase activity in Asia, we have put in place a senior management team to develop our business there. The increased expenditure, included in head office costs, was £0.5m.

During the year we acquired seventeen businesses at a cost of £86.3m. Twelve businesses were acquired by the Testing SBU, in line with our strategy to increase its size both geographically and in terms of service offering. Four of the acquired businesses were in the Thermal Processing SBU, and one was a small IS service provider (the Group already being its major customer) to strengthen our in-house IS and IT capability. Much effort has been put into developing our integration approach to allow us to bring newly acquired companies into our network quickly and maximise synergies.

### Thermal Processing Sales and Operating Profit



### REVIEW BY STRATEGIC BUSINESS UNIT (SBU)

#### Thermal Processing SBU

Thermal Processing delivered sales of £413.9m, an increase of 7.6%. This was split 5.2% organic, 2.7% acquired and a reduction of 0.3% in respect of foreign exchange movements. ROCE improved to 9.9% (2005: 8.4%). Margins improved to 15.2% (2005: 14.1%). We acquired four businesses representing 14 facilities at a net cost of £20.4m. Two of these acquisitions moved us into the important developing economies of Brazil and Turkey.

The impact of rapid energy price rises has abated. As expected we have been able to recover almost all of the associated cost increases, although there is a time lag and therefore margins are impacted. As part of our continuous review of operations, we sold our loss making anodising plant in Espoo, Finland and our St Louis heat treatment business. A further seven heat treatment facilities have been closed, with a proportion of the work and much of the equipment transferred to other locations. Four of these, two in the USA and two in UK, are major in nature and for which a closure provision of £5.0m has been established. Asset realisations are expected to exceed cash closure costs.

#### Heat Treatment Division

The division delivered 7.4% growth with sales of £375.0m, which accounts for 67% of the group revenues (2005: 74%). ROCE was 8.5% (2005: 7.4%). Margins increased to 13.4% (2005: 12.8%).

The UK continued to see strong demand from power generation, aerospace and oil & gas customers resulting in 6.5% organic growth. The rationalisation of facilities (Aldridge, Walsall, Sittingbourne and Gosport) into other sites is expected to be completed in early 2007 and deliver improved customer service and financial results. The acquisition of Ceramet has facilitated the start up of a Thermal Spray/Slurry Coating facility in Singapore in support of our oil & gas and aerospace customers. This technology transfer will start production in the first half of 2007 along with a new Testing laboratory at the same location. Our Nordic group continues to perform well and organic sales growth was 5.6%. In Central Europe our facilities delivered mixed results, with improvements in the German/Dutch markets but deterioration in the Alpine countries. Organic sales growth was a creditable 5.9%, overall. Our position in the Ruhr region was enhanced by the acquisition of SGB in Solingen. Our Eastern European facilities continue to grow, but margins have been reduced as we introduce Bodycote's quality, safety and business systems to meet the expectations of western manufacturers moving into the region in search of low cost products. We expect a solid first full year in the group from the acquisition of 60% of Istas in Turkey.

## Key performance indicators

|   | 2006         | 2005  | Target                     |
|---|--------------|-------|----------------------------|
| <b>Financial</b>                                    |              |       |                            |
| Return on capital employed <sup>1</sup>             | <b>10.8%</b> | 9.9%  | Mid teens %                |
| Return on sales <sup>2</sup>                        | <b>14.3%</b> | 14.4% | High teens %               |
| Organic sales growth <sup>3</sup>                   | <b>5.5%</b>  | 5.3%  | Mid to high single digit % |
| People costs as a percentage of sales <sup>4</sup>  |              |       |                            |
| Thermal Processing                                  | <b>40.7%</b> | 41.8% | 40%                        |
| Testing   | <b>51.8%</b> | 50.7% | 50%                        |
| Capital expenditure/depreciation ratio <sup>5</sup> | <b>1.2x</b>  | 1.1x  | 0.8 – 1.3x                 |
| <b>Non financial</b>                                |              |       |                            |
| Utilisation (Heat Treatment only) <sup>6</sup>      | <b>72%</b>   | 71%   | >80%                       |
| ISO 14001/17025 compliant facilities <sup>7</sup>   | <b>184</b>   | 134   | All facilities             |
| Accident frequency <sup>8</sup>                     | <b>2.2</b>   | 2.1   | Zero                       |

## Definitions

<sup>1</sup> Headline<sup>\*</sup> operating profit as a percentage of average capital employed. Capital employed includes tangible and intangible assets including all previously amortised/impaired goodwill and all non-interest bearing assets and liabilities.

<sup>2</sup> Headline<sup>\*</sup> operating profit as a percentage of revenue from continuing operations.

<sup>3</sup> Year on year increase in revenue from continuing operations excluding revenue from acquisitions made within the prior twelve months.

<sup>4</sup> The salary and benefit costs of all employees as a percentage of revenue from continuing operations.

<sup>5</sup> Net capital expenditure divided by depreciation.

<sup>6</sup> Actual revenues expressed as a percentage of theoretical maximum revenue assuming that heat treatment facilities operate 24 hours per day, 365 days per year.

<sup>7</sup> The number of facilities holding registrations for ISO 14001 or ISO 17025.

<sup>8</sup> Accident frequency - the number of accidents x 200,000 (approximating 100 man years), divided by the total hours worked.

## Financial results for 2006

|                    | Revenue <sup>***</sup> |       | Headline operating profit <sup>*</sup> |       | Margin      |      |
|--------------------|------------------------|-------|--|-------|-------------|------|
|                    | 2006                   | 2005  | 2006                                   | 2005  | 2006        | 2005 |
|                    | £m                     | £m    | £m                                     | £m    | %           | %    |
| Heat Treatment     | <b>375.0</b>           | 349.2 | <b>50.3</b>                            | 44.8  | <b>13.4</b> | 12.8 |
| HIP                | <b>38.9</b>            | 35.2  | <b>12.8</b>                            | 9.5   | <b>32.9</b> | 27.0 |
| Thermal Processing | <b>413.9</b>           | 384.4 | <b>63.1</b>                            | 54.3  | <b>15.2</b> | 14.1 |
| Testing            | <b>144.7</b>           | 86.5  | <b>21.3</b>                            | 16.3  | <b>14.7</b> | 18.8 |
| Head office costs  | -                      | -     | <b>(4.7)</b>                           | (2.8) | -           | -    |
| Group Total        | <b>558.6</b>           | 470.9 | <b>79.7</b>                            | 67.8  | <b>14.3</b> | 14.4 |

## Notes

<sup>\*</sup> Headline operating profit is derived as shown in the second half of the table to the left.

<sup>\*\*</sup> A reconciliation of headline earnings is given in Note 10 on page 40.

<sup>\*\*\*</sup> Revenue from continuing operations after deducting inter-segment sales.

|  | 2006         | 2005  |
|--|--------------|-------|
|  | £m           | £m    |
| Headline operating profit  | <b>79.7</b>  | 67.8  |
| Share of associates' interest and tax                                | <b>(0.6)</b> | (0.8) |
| Amortisation of acquired intangibles                                 | <b>(1.0)</b> | (0.2) |
| Goodwill impairment  | <b>(6.0)</b> | (5.8) |
| Impairment of equity investment in associate                         | <b>(8.3)</b> | -     |
| Major facility closure costs   | <b>(5.0)</b> | -     |
| Operating profit from continuing operations per financial statements | <b>58.8</b>  | 61.0  |

## 2006 Group Business Review

France/Belgium continued to show improved sales (4.0% organic growth) and margins (an increase of 2.1% points) despite modest automotive demand. We expect these challenging automotive conditions to lead to increased outsourcing opportunities in 2007. Buoyant aerospace demand is also generating outsourcing opportunities.

North America saw organic sales grow 3.4% and margins improved by 0.6% points. Efforts to turn around two automotive focused facilities (Maple Heights, Ohio and Lansing, Michigan) proved fruitless and we decided to close these. In addition, we sold our St Louis facility, which was profitable, but was in a shrinking market and required significant investment. We will continue to review our various locations in light of our strategy to provide value added services with growth potential. In that vein, our investment in low pressure carburizing capability in Livonia, Michigan (used particularly for new generation automotive transmission gears) commenced production at the end of 2006 as forecast. Our success in meeting GM quality and service expectations has led to the award of two more contracts for a similar facility in Mexico and increased capacity in Livonia, both of which will come on line in early 2008. The latter part of the year saw us enter, for the first time, South America with the acquisition of Brasimet, Brazil's largest and most respected heat treatment group (six locations). The integration programme is going very well as they already had sophisticated quality, IS and management systems similar to those in use in Bodycote. We have found the Brazilian customer base to be highly complementary to that of the rest of our international base. We will also be commercialising a materials testing laboratory which Brasimet recently established and which creates an entry point into South America for our Testing SBU.

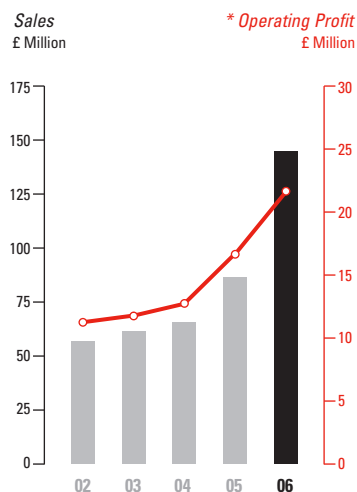
Our greenfield facility in Wuxi, China started generating sales in December. We anticipate our first year in production will generate a modest operating profit.

### HIP Division

The division achieved 11.2% organic growth on the back of strong demand from aerospace, power generation and oil & gas customers, with sales of £38.9m which amounted to 7% of the Group (2005: 7%).

ROCE increased from 19.7% in 2005 to 28.0% and this balances the disappointing performance experienced when end markets were at a cyclical low in 2002/2003. Margins were 32.9% (2005: 27.0%). Additional capacity from moth-balled units has been added in Princeton, Kentucky and Haag, Germany. Aerospace led the growth in North America while power generation demand was the key driver of European growth. Densal® has been gaining new market applications in Europe and North America, but growth was modest in 2006 due to capacity constraints which will be addressed by the availability of an additional unit by mid 2007.

### Testing Sales and Operating Profit



### Testing SBU

Testing delivered sales of £144.7m, an increase of 67.3%. This was split 6.6% organic, 59.0% acquisition and 1.8% due to foreign exchange movements. ROCE eroded slightly to 20.0% although margins slipped to 14.7% (2005: 18.8%) due to a change in business mix as a result of the various acquisitions and the cost of additional infrastructure to support the much larger business.

We acquired 12 Testing businesses representing 38 laboratories and a small IS service provider for a net cost of £65.9m. These acquisitions took us into several new geographies (Eire, Hong Kong and Australia) and increased our presence in fire testing and certification as well as adding a new service, Measurement Solutions.

The ROCE of these businesses is in line with our expectations. Several of the acquisitions are in sectors with lower margins, although they are at an equivalent level to similar activities already in the Group. This change in mix has led to a lower blended margin in the SBU. Based on our historical performance, we anticipate that we will be able to increase the margins of the newly acquired businesses by bringing operational systems to bear and by leveraging the synergies of the Group. We expect to see the benefits in 2007. In line with our strategy to grow Testing relative to the size of Thermal Processing, the SBU now represents 26% of the Group's increased revenue (2005: 18%).

Testing is a single SBU but to provide enhanced information in this review we have split its activities into two core divisions.

### Materials, Engineering & Technology and Measurement Division (METM)

The division delivered 55.5% growth, with sales at £99.6m, which accounts for 18% of group sales (2005: 14%) with a ROCE of 20.1%. Margins were 14.3% (2005: 20.5%). Oil & gas, aerospace and construction demand was robust across all regions, with North America and Middle East particularly strong, posting growth of 39% and 53% respectively. We invested in a number of key market segments to strengthen our leadership, e.g. two fatigue testing laboratories (Canada and UK) and two advanced high temperature & corrosion laboratories (Czech Republic and US). The purchase of Staveley laboratories in December, with four sites, has strengthened our market coverage in the US. Our Middle East laboratories are benefiting from the major government backed civil infrastructure investment taking place in the region. The acquisition of the Warrington Fire business (seven sites in four countries) significantly expands our existing capabilities in this market segment. Similarly, our North American automotive position was expanded by the addition of ACT Laboratories with two locations in Michigan. We continued our investment in engine testing and development for trucks and automotive compliance, where demand is driven by ever tightening environmental standards. Sales for our first year of operation in Asia Pacific were £1.2m.



In addition to the laboratories joining the Group with the Warrington Fire acquisition (Hong Kong and Australia), we have created a business development team based in Singapore to intensify our effort to enter this important market in support of migrating global manufacturers and local companies. During the year, Measurement Solutions was added to the division, based initially on a business acquired from Saab Aerospace and delivered sales of £11m. The business currently includes eleven laboratories in four countries (Germany, Denmark, Sweden and Finland) with a plan to create a pan-European value added service for our existing customer base, particularly in the aerospace, defence, telecoms and pharmaceutical sectors. The business won a €1m per annum outsourcing contract, starting in 2007, from a large Danish pharmaceutical business.

#### Health Sciences/Environmental (HSE) Division

The division delivered 101% growth, with sales at £45.2m, which accounts for 8% of the group (2005: 5%) and ROCE was 20.0%. Margins were 15.6% (2005: 14.1%).

The UK pharmaceutical and food markets progressed well. We acquired six businesses in the UK and Eire at multiples which met our demanding acquisition criteria (SEAL Land & Water, Norpath, Foodscan, Tetra and Prova R&D all in the UK and Consult-US in Eire) thus establishing a strong network of facilities in support of both UK pharmaceutical manufacturers and food retailers. Our combination of food testing and advisory enables a unique service offering in the market. Our North American operations performed well in Ontario and Oregon but were disappointing in Quebec. The acquisition of Norwest in Canada and West Coast Analytical in California substantially expanded our network, opening up cross-selling opportunities. North American markets were buoyant in the civil sector while UK asbestos testing demand was soft. The acquisition of Norwest added services in key market segments, including environmental impact studies for the Albian oil sands development projects.

#### Associated Company SSCP Coatings Sarl (SSCP)

We have been participating in the consolidation of the Physical Vapour Deposition (PVD) market by way of our investment in SSCP following the sale of our own PVD interests to them in 2004. From a customer perspective SSCP continues to provide high quality coatings with excellent service and technical knowledge. However, it was decided that we should write off our equity investment (£8.3m) in SSCP at year end following SSCP's poor trading performance and subsequent refinancing. The consequent infusion of funds allows SSCP to continue normal operations, but comes at a cost and could dilute the minority equity shareholders if we do not subscribe for warrants to be issued in March. If Bodycote elects not to buy warrants, the Group's holding would be diluted to 9.25% in the event of a full exercise. We remain hopeful that, over time, the company will recover. Bodycote and SSCP continue to jointly market their synergistic heat treatment and PVD services.

#### FINANCIAL REVIEW

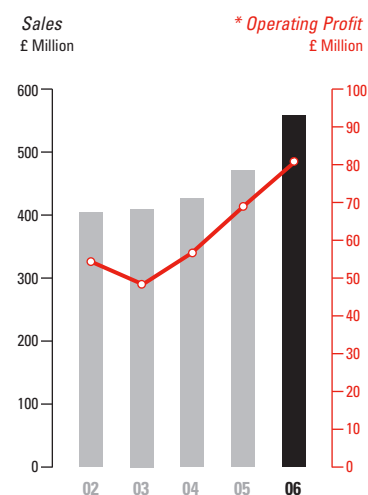
##### Revenue

Group revenue from continuing operations, as reported for the year, was £558.6m, an increase of £87.7m (18.6%) on 2005 (£470.9m). Revenue growth for Heat Treatment was £25.8m (up 7.4% on 2005), for HIP £3.7m (up 10.5%) and for Testing £58.2m (67.3% on 2005). Organic growth accounted for £25.9m (30% of total growth) of the increase and acquisitions for £61.6m (70% of total growth). The net impact of foreign currency movements on revenues were negligible, with foreign currency losses in Euros and US Dollar being offset by gains in the Canadian Dollar.

##### Operating Profit and Margins

Demand was robust in most of our markets in 2006 with the notable exception of automotive in North America and France. On the other hand, energy and commodity prices rose considerably and had a significant impact on our ability to improve margins, particularly in heat treatment, notwithstanding the fact that these increased costs were essentially completely recovered via higher selling prices. Consequently, headline\* operating profit increased 17.6%. In Heat Treatment, margins improved from 12.8% to 13.4% with headline\* operating profits up 12.3%.

#### Group Sales and Operating Profit



HIP continued to benefit from robust aerospace and power generation demand and is much less energy intensive than heat treatment. Consequently margins moved ahead from 27.0% to 32.9% and headline\* operating profit increased by 34.7%. Testing headline\* operating profit increased 30.7% but margins fell back from 18.8% to 14.7% due to a combination of the mix of businesses acquired and additional infrastructure costs. Consequently the overall Group operating margin was slightly lower at 14.3% (2005:14.4%).

##### Interest

The net finance charge for the Group was £12.2m compared to £8.3m in 2005. The increase was primarily due to a one-off make whole payment of £3.1m as a result of the early settlement of \$80m of privately placed senior notes at 7.79% which were originally due in December 2009 and, in addition, higher average net debt levels resulting from the 2006 acquisitions.

##### Profit before tax

Headline\* profit before tax was £66.9m compared to £58.7m in 2005. Profit before tax was £46.6m compared to £52.7m in 2005.

## 2006 Group Business Review

### Taxation

Taxation was £2.7m for the year, £9.1m lower than in 2005. The effective tax rate for the Group, before impairment of goodwill and amortisation of acquired intangibles (which are generally not allowed for tax) and before non recurring items was 7.7% (2005: 20.2%). In the year, the Group was able to reassess the tax effectiveness of treasury management in 2003 and 2004 and has also benefited from a settlement with the relevant tax authority in respect of the Lindberg acquisition in 2001. These items have reduced the tax liability by £11.2m. Excluding these two items, the adjusted underlying effective tax rate would be 19.9%.

### Earnings per share

Basic earnings per share for the year were 13.4p (2005: 12.7p) and diluted earnings per share were 13.4p (2005: 12.7p). Headline earnings per share, after adding back the post-tax effect of goodwill impairment, amortisation of acquired intangibles, major facility closure costs, impairment of equity investment in an associate and prior year tax benefits, rose by 18.5% to 17.3p (2005: 14.6p).

### Dividend

The Board has recommended a final dividend of 4.5p bringing the total dividend in 2006 to 7.0p (2005: 6.4p) an increase of 9.4%. The dividend is covered 2.5 times by headline earnings (2005: 2.3 times).

### CAPITAL STRUCTURE

Our balance sheet at 31 December 2006 can be summarised as set out in the table below:

Net assets increased by 4.7% to £453.9m (2005: £433.5m) and net assets per share by 4.4% to £1.41 (2005: £1.35). The main movements in the balance sheet were an increase in goodwill and intangible assets of £54.4m arising from the acquisitions completed during the year, an increase in net current assets of £9.1m and an increase in net borrowings of £52.4m.

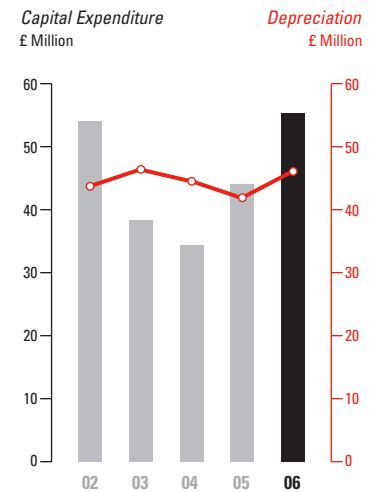
### Net debt

Group net debt was £160.9m (2005: £108.5m). During the year additional loans of £13.4m were drawn down under committed facilities and \$80m of senior notes were repaid early. The Group continues to be able to borrow at competitive rates and therefore currently deems this to be the most effective means of funding. In 2006, a seven year committed loan facility of €125m was completed.

### Cash flow

After allowing for capital expenditure, interest and tax the Group generated free cash flow of £41.0m compared to £42.1m in 2005 and cash flow from operating activities was £109.2m compared to £95.7m in 2005. The reduction in free cash flow was primarily due to increased capital expenditure. There has been continued focus on cash collection although debtor days increased by one to 70. Acquisitions resulted in net cash outgoings of £86.3m.

### Capital Expenditure and Depreciation



### Capital Expenditure

Net capital expenditure for the year was £55.4m compared to £44.1m in 2005. The multiple of net capital expenditure to depreciation was 1.2 times as the Group expands into emerging markets and continues to take advantage of outsourcing opportunities. With buoyant demand in a number of the Group's markets, strong growth expected in Testing and the major investment in HIP capacity in the USA, the Group anticipates a ratio of 1.3 times in the coming year.

Major projects undertaken during the year included the establishment of a combined Thermal Spray and Testing facility in Singapore, expansion of the HIP facility in Surahammar, Sweden, additional Kolsterising capacity in southern Germany and France, ground breaking for a greenfield heat treatment plant in Silao, Mexico, additional aerospace focused vacuum heat treatment capacity in France, establishment of new laboratories in Dubai, Saudi Arabia, Manchester, UK and Monterrey, Mexico along with additional heavy duty engine testing cells in Canada and new fatigue testing equipment in North America and the UK.

### Balance sheet at 31 December 2006

|  | Assets<br>£m | Liabilities<br>£m | Net assts<br>£m |
|--|--------------|-------------------|-----------------|
| Property plant and equipment             | 448.4        | -                 | 448.4           |
| Goodwill and intangible assets           | 212.3        | -                 | 212.3           |
| Current assets and liabilities           | 154.0        | (128.5)           | 25.5            |
| Other non-current assets and liabilities | 16.8         | (9.9)             | 6.9             |
| Post retirement obligations              | -            | (32.8)            | (32.8)          |
| Deferred tax                             | 23.2         | (68.7)            | (45.5)          |
| Total before net debt                    | 854.7        | (239.9)           | 614.8           |
| Net debt                                 | 34.7         | (195.6)           | (160.9)         |
| <b>Total as at 31 December 2006</b>      | <b>889.4</b> | <b>(435.5)</b>    | <b>453.9</b>    |
| Total as at 31 December 2005             | 893.4        | (459.9)           | 433.5           |

### Liquidity and investments

Bodycote is financed by a mix of cash flows from operations, short-term borrowings, longer-term loans and finance leases. Bodycote's funding policy is to ensure continuity of finance at reasonable cost, based on committed facilities from several sources, arranged for a spread of maturities. At 31 December 2006 Bodycote had £125.8m of unutilised committed facilities with average remaining life of 4.4 years. The Group's principal committed facility of £225m (£84.7m of which was unutilised at 31 December 2006) has a maturity of 3.6 years. During the year the Group completed a €125m loan facility committed until July 2013 (£41.1m of which was unutilised at 31 December 2006). Part of these proceeds have been used to repay US \$80m of senior notes.

Bodycote also has access to uncommitted and short-term facilities, used principally to manage day-to-day liquidity and working capital requirements. In addition pooling, netting and concentration techniques are used to minimise borrowings.

### TREASURY POLICY

Treasury activities have the objective of minimising risk and are centralised in the Group's head office. Group Treasury is responsible for management of liquidity and interest and foreign exchange risks, operating within policies and authority limits approved by the Board. The use of financial instruments including derivatives is permitted when approved by the Board, where the effect is to minimise risk to the Group. Speculative trading of derivatives or other financial instruments is not permitted.

Bodycote has operations in 28 countries. Assets are hedged where appropriate, by matching the currency of borrowings to the net assets. The Group principally borrows in US Dollars, Euro and Swedish Krona, consistent with the location of the Group's non-sterling assets. These borrowings are at both fixed and floating interest rates and the Group will use derivatives where appropriate, to generate the desired effective currency and interest rate exposure.

Interest rate fluctuations on indebtedness are managed by using a combination of fixed and floating rates. Consideration is given to entering into interest rate swaps and forward rate agreements. The policy objective is to have a target proportion of net borrowings hedged at all times.

At the end of December 2006 4% of borrowings were at fixed rates for an average period of 4.6 years.

It is Group policy to hedge exposure to cash transactions in foreign currencies when a commitment arises, usually through the use of foreign exchange forward contracts but not to hedge exposure for the translation of reported profits.

### DEFINED BENEFIT PENSION ARRANGEMENTS

The Group has defined benefit pension obligations in the UK, France, Germany, Sweden, USA and Brazil which are all reflected in the Group balance sheet. In the UK the Group has a final salary scheme, which was closed to new members in April 2001 but continues to accrue benefits for current employee members, a total of just over 300 people. The deficit as calculated by the scheme actuary at 31 December 2006 using the principles of IAS 19 is £23.3m. In France we operate a plan which pays a cash lump sum on retirement and also for long service. The plan is open to new employees but by its nature is not mortality dependent. It is unfunded and the IAS 19 liability at 31 December 2006 was £4.1m. The Group's heat treatment business in Germany has inherited several defined benefit arrangements. They are all unfunded and are closed to new members but existing members continue to accrue benefits. The IAS 19 liability at 31 December 2006 was £2.6m. In Sweden, the Group has three defined benefit arrangements. One is funded and two are unfunded and each is open to new employees. The IAS 19 liability at 31 December 2006 was £2.4m. The company sponsors five defined benefit pension arrangements in the USA which were inherited with the acquisition of Lindberg and had a total IAS 19 deficit at 31 December 2006 of £0.5m.

Following the sale of the St Louis facility and closure of Lansing, there are no further accruals on any of these plans. Brasimet operates a defined benefit plan for three senior members of staff. It is fully funded and the members continue to accrue benefits. At 31 December 2006 it had a surplus of £0.1m.

### POST BALANCE SHEET EVENTS

After the year end the Group purchased Techmeta SA, a French Electron Beam Welding business, for cash consideration of €6.0m (£4.0m) of which €2.7m (£1.8m) is deferred.

### CHANGE IN ACCOUNTING POLICIES

During the year there were no material changes to accounting policies.

### GOING CONCERN

After making enquiries, the Directors have formed the opinion that at the time of approving the financial statements, that there is a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason the Directors continue to adopt the going concern basis in preparing the financial statements.

### PRINCIPAL RISKS AND UNCERTAINTIES

#### Markets

A reduction in end market demand is the key risk we face, but with the exception of the automotive sector, forecast demand in the near term appears robust.

#### Commercial relationships

The Group benefits from many long term and partnership arrangements with key customers. Although we believe it is highly unlikely, damage to or loss of any of these relationships may be detrimental to Group results. Given that our top ten customers account for only c.10% of sales, with the balance made up by many thousands of customers, we have low revenue concentration risk. The Group has no significant supplier dependency.

## 2006 Group Business Review

### Competitors

The fragmentation of the markets we operate in, with the exception of HIP, means that typically the actions of competitors are felt locally rather than across the Group. The small market and concentrated supply of HIP means that there is a greater risk of material impact on this division should competitors add significant capacity.

### Human Resources

People are the Group's greatest asset but also form the largest cost. We work hard at maintaining a respectful and trusting relationship with all employees. However, we are mindful that there must be strong control on these costs, which can be flexed more easily in North America, the UK and emerging economies, but much less so in Western Europe where we strive to keep about 15% of our workforce flexible against a background of more restrictive employment laws.

### Safety and Health

Our work environment has numerous and varied risks which we strive to mitigate by providing systems, equipment, training and supervision. Risk is evaluated by internal and external resources so that it is continuously managed and mitigated.

### Brand and Reputation

Bodycote is a valuable and well-known business to business brand. Any damage to the brand because of the breakdown of commercial relationships, non-compliance with laws and regulations, misuse of human or other resources in breach of our corporate ethos could have an adverse impact on the Group as a whole. For these reasons Bodycote has instituted an effective programme under which employees can and do use the Group's open door policy to report legitimate concerns about business conduct to the most senior executives.

### Energy

An increase in energy cost is a risk which to date we have been able to mitigate, although with some time lag, through price adjustments or surcharges and we expect to be able to continue this practice.

### Operations

Our stringent quality systems, our internal and external auditing as well as our customers verification of our results, minimise the risk of releasing faulty parts into use, which could arise as a result of system or human failure.

### Environmental

Our heat treatment plants in some cases use solvents and other hazardous chemicals in comparatively small quantities. There is therefore the potential for ground contamination at our facilities. Past exposures are remediated as and when required. The likelihood of future problems is mitigated by our procedures, typically under the auspices of ISO 14001 environmental systems.

### Foreign exchange

Although the Group has all but 17% of its sales generated outside the UK, the overwhelming majority of those sales are supplied locally to customers buying in the currency of our input costs. Consequently transaction risk is low. We are, however, exposed to fluctuation in exchange rates in respect of the translation of non-sterling denominated results. In common with the majority of UK listed companies we do not hedge this exposure. We do, however, partially hedge our balance sheet assets and liabilities through a mixture of local currency loans and cross currency swaps.

### RESOURCES

The Group has key resources which are critical to its continued success: People, Technology, Approvals and Systems.

#### People

The strength of our Group primarily rests in our people, however, one of the key challenges for management is to ensure availability of appropriately qualified people to support our continued growth. We are fortunate to have a competent and committed international team that is well respected in technical and business circles. Most of our acquisitions are based on historical relationships with Bodycote personnel; this is a testament to the integrity of our people. The Board has established a remuneration policy which rewards performance while offering competitive base packages.

In line with our policy of continuous improvement we have established a talent development programme to improve the succession pipeline for our future business leadership. With the opportunity for career development we believe we can continue to sustain and grow the Group into the future.

#### Technology

The technology we apply in delivering our services is mostly generic. The differentiator is in our know-how in applying that technology, the quality standards we adhere to, the depth of technical knowledge we are able to deliver and the consistency of service. In those instances where we have unique technology, we have principally relied upon confidentiality with patent protection for niche areas.

#### Approvals

We have 49 facilities registered to Nadcap, the international aerospace quality standard. All Thermal Processing facilities are certified to at least one quality standard (e.g. ISO 9001, TS 16949, Nadcap) and by the end of 2007, we intend that all will be certified to ISO 14001 environmental standards. Testing has 97 of its facilities accredited to the laboratory management standard ISO 17025. Our reputation for strong compliance differentiates us in the market place and assures customers of our ability to deliver consistent quality. This makes their decision to outsource critical components easier.

#### Systems

IS provides the systems to allow us to successfully operate a large distributed network. It is critical that we continue to advance our systems so we have the most efficient information processes for ourselves, our customers and the ability to identify and control costs across the whole of the Group. We utilise computer and internet technology to provide secure real time job status as well as technical support to our customers.

## CORPORATE ETHOS

In achieving Bodycote's aim to be globally recognised as the leading provider of Thermal Processing and Testing services, the Board has, over time, developed several principles which will apply in its dealings with stakeholders and the wider community.

### Safety, health and the environment

Bodycote has a proactive approach to Safety, Health and the Environment and is committed to the highest practicable standards of safety and health management and to the minimisation of adverse environmental impacts.

### Human Resources

Bodycote's employment policies are non-discriminatory, complying with all current legislation to engender equal opportunity, irrespective of race, gender, religion, disability, sexual orientation or nationality. Harassment is not tolerated.

### Ethical standards

All Bodycote personnel are expected to apply a high ethical standard, consistent with an international UK-listed company.

### Compliance with laws

Bodycote has systems in place designed to ensure compliance with all applicable laws and regulations and conformity with all relevant codes of business practice.

### Competition

Bodycote aims to win business in a differentiated high value manner, does not employ unfair trading methods and competes vigorously but fairly within the requirements of the applicable laws. Employees are prohibited from either giving or receiving any inducements.

### Conflicts of interest

Employees are expected to ensure that their personal interests do not at any time conflict with those of Bodycote. Shareholder employees are advised of and comply with share trading codes.

### Politics

Bodycote does not make political donations.

As a result of these principles, some key areas of focus have emerged, namely in respect of people, safety, health and the environment.

## KEY AREAS OF FOCUS

### Training and Education

The Group sponsors The Bodycote Educational Foundation, a registered charity, whose aim is to fund relevant educational and training opportunities. These aims are fulfilled by supporting short term student placements at Bodycote facilities to work on specific projects of benefit to the Group. Since 1996, the Foundation has sponsored over 250 students from 10 countries. The Foundation also supports the annual Prize Paper Competition. In its eleventh year, the competition has become one of the most highly regarded in its field. Numerous entries from universities and materials science institutes worldwide follow a rigorous selection process, with five entrants reaching the final presentation judged by management and engineering academics. Winners receive a cash prize, publication in a peer reviewed journal and potential for career development within the Group.

### Safety & Health

Appropriate safety and health policies and procedures are in force in both Strategic Business Units. In 2004 the Group commenced reporting its performance internally in terms of lost time, frequency and severity of accidents in a uniform manner. As a result, each Strategic Business Unit is now able to benchmark its safety and health performance and formulate criteria for improvements. Bonus payments to Directors and senior executives are in part dependent on achievement of these targets.

### Environment

Bodycote has for many years contributed to the reduction of the environmental impact of industry. By adopting the latest technologies as they have become available, Bodycote has provided its customers with environmentally friendly solutions to their heat treatment requirements. The replacement, where possible, of harmful materials has reduced the need for disposal of waste products. At the same time the adoption of high efficiency heating systems has reduced energy consumption and reduced emissions.

The success of Bodycote's processes in addressing these issues is key to our environmental credentials. We do not simply aim to minimise our own energy consumption, but also to effect substantial reductions in our customers' energy use.

Bodycote operates modern, efficient heat treatment furnaces around the clock. We aggregate demand from a wide range of customers to maximise efficiency and minimise energy costs. By replacing under-utilised, in-house thermal processing operations with Bodycote's state of the art equipment, the overall amount of energy used can be dramatically reduced.

The range of services offered across the Group is designed to enhance the operational lifetime of components whilst maintaining their suitability for re-cycling at the end of their working lives. This increase in the working life of components has a major effect on the amount of raw materials that are processed. Modern treatments also allow new technologies, such as common rail diesel systems, to be introduced within acceptable financial constraints. This, in turn, reduces the environmental impact of motor vehicles by improving fuel consumption and reducing emissions. So, at every stage where Bodycote is involved in the manufacturing cycle, our operations aim to lessen the overall impact on the environment.

## CURRENT TRADING AND PROSPECTS

The forecasts we have seen for the aerospace, oil & gas, power generation, health sciences and environmental sectors are all positive in the near term. Automotive is experiencing over-capacity in North America and Western Europe, however, demand is increasing in Asia and other emerging economies. Our sales continue to grow as western manufacturers outsource their thermal processing and testing requirements to Bodycote. High efficiency, high equipment utilisation and adding support and value beyond the basic service are the tools by which we combat price competition.

## 2006 Group Business Review

In addition, our growing presence in developing countries is providing us with the opportunities to assist western manufacturers who are establishing new facilities in these low cost countries.

Two greenfield facilities are being built in Mexico. A heat treatment facility in Silao will initially be focused on supporting GM with low pressure carburizing and a testing laboratory in Monterey will be supporting a major aerospace supplier. We are also in the process of building a greenfield heat treatment plant in Pune, India and anticipate it will go into production in early 2008. A joint greenfield thermal spray and testing facility in Singapore will commence production by mid-2007. Other developments include plans for greenfield laboratories in Bahrain, Saudi Arabia, Kazakhstan and Croatia as well as several transient laboratories in support of large scale infrastructure projects in the Middle East including the Dubai Light Railway project.

An additional 'mega' HIP unit is scheduled to be in production by the end of 2007 at our Camas, Washington facility and an additional Densal® unit will go into production in Haag, Germany in the first half of the year. Our Surahammar, Sweden facility is being expanded to improve efficiency of can making/powder filling which gives us additional work for the HIP unit which will improve ROCE. The International Thermo Nuclear Experimental Reactor (ITER) is continuing to move forward with funding now committed by an international consortium. We expect high value HIP opportunities over the medium term as we saw from the CERN project on which we completed work in 2006.

In line with our strategy, we will continue to seek bolt-on acquisitions which are either in Testing, developing markets or have technical niches which are value enhancing. Strict investment criteria and disciplined operations will continue to aid our growth and performance improvement. Overall, the Group anticipates about £60m will be spent on acquisitions in 2007, of which approximately two thirds will be in Testing.

The Thermal Processing SBU acquired Techmeta SA in France at the beginning of February. Techmeta is an Electron Beam (EB) service provider and a global supplier of EB equipment which produced c.£6m of sales in 2006.

This expands our current technical capabilities in servicing the aerospace, power generation and nuclear industries. We estimate about £70m will be invested in capital expenditure which will be approximately 1.3 times depreciation (2006: 1.2 times) and reflects the high level of investment in greenfield facilities in emerging markets and the Camas HIP facility in 2007. About half of the capital expenditure will be for additional capacity to grow the business in new technologies (e.g. low pressure carburizing) or enter new geographies and the remainder will be to replace equipment for cost saving projects or infrastructure.

Since the start of the current financial year, trading has been above the levels in the same period in 2006, with a strong performance in Europe and steady results in North America. Organic growth has been robust with 2006 acquisitions contributing as expected. Notably, we entered 2007 with annualised revenue for the Testing SBU at approximately £170m.

We enter 2007 confident that we will deliver another successful performance.



**J D Hubbard**  
Chief Executive  
27 February 2007



**D F Landless**  
Finance Director  
27 February 2007

The Directors are pleased to submit their report and the audited financial statements for the year ended 31 December 2006. The Chairman's Statement, the Group Business Review, the Audit Committee Report, the board report on remuneration and the details of the Board of Directors and Advisers on pages 2 to 24 together comprise the Directors' Report for the year ended 31 December 2006.

### PRINCIPAL ACTIVITIES

The Company is a holding company with subsidiaries carrying on business in the fields of materials technology and testing services. The activities and locations of the principal subsidiary undertakings are set out on pages 77 to 79. The Group Business Review contains a survey of the Group's activities, significant acquisitions and disposals during the year together with an outline of future developments.

### GROUP BUSINESS REVIEW

The enhanced business review for the Group, entitled Group Business Review, is provided on pages 3 to 12 of this annual report. This is a review of the development of the businesses of the Group, including the financial performance during the year ended 31 December 2006, key performance indicators (KPIs) and a description of the principal risks and uncertainties facing the Group. The Group Business Review has been prepared solely to assist the shareholders in assessing the Group's strategies and the potential of those strategies. It should not be relied on by any other party for any other purpose. Forward-looking statements have been made by the Directors in good faith using information available up to the date of this report and such statements should be regarded with caution because of the inherent uncertainties in economic trends and business risks. Since the end of the financial year no important events affecting the business of the Group have occurred.

### TRADING RESULTS

The profit of the Group before taxation was £46.6m (2005: £52.7m). Profit attributable to shareholders amounted to £43.1m (2005: £40.7 m) and, after providing for dividends of £21.0m (2005: £19.8m) and other items of recognised income and expense, the balance of £20.0m (2005: £17.4 million) has been transferred to reserves.

### DIVIDENDS

The Board is recommending a final dividend of 4.5p per share making a total for the year of 7.0p per share (2005: 6.4p). The final dividend, if approved, will be paid on 5 July 2007 to shareholders on the register at the close of business on 8 June 2007.

### SHARE CAPITAL

The Company's issued share capital as at 31 December 2006 was £32.2m and during the year was increased by the issue of 1,013,202 shares of 10p each between 1 March and 6 December 2006 for a total consideration of £1,872,594 pursuant to options granted under the Company's executive share option schemes. The shareholders have authorised the Company to purchase up to 32,115,486 of its own shares, although no purchases have been made. This authority expires at the conclusion of the forthcoming Annual General Meeting to be held on 23 May 2007, at which time a further authority will be sought from shareholders.

### DIRECTORS

The current Directors are listed on page 24 and all served throughout the year. Messrs R.T. Scholes and D.F. Landless are retiring by rotation and, in accordance with the articles of association and each being eligible, offer themselves for re-election at the forthcoming Annual General Meeting. The service agreement for Mr Landless is terminable by one year's notice. Mr Scholes does not have a service agreement with the Company.

### DIRECTORS' INTERESTS IN CONTRACTS & SHARES

Details of the Executive Directors' service contracts and details of the Directors' interests in the Company's shares, share option schemes and plans are shown in the Board Report on Remuneration on pages 18 to 23. No Director has had any dealings in any shares or options in the Company since 31 December 2006. Qualifying third party indemnity provision (as defined by section 309C of the Companies Act 1985) has remained in force for the Directors for the year ended 31 December 2006 and, as the date of the report, remains in force for the benefit of the current Directors in relation to certain losses and liabilities which they may incur (or have incurred) to third parties in the course of their duties. Apart from these exceptions, none of the Directors had a material interest in any contract of significance in relation to the Company and its subsidiaries at any time during the financial year.

### CORPORATE GOVERNANCE

The Group's mission is:

- *To provide world class companies with metallurgical and testing services that make a positive contribution to the success of their businesses.*
- *To earn sustainable profits which attract shareholder interest.*
- *To engage, develop and retain competent people, harness their enthusiasm and inspire them to excel.*
- *To act as a good corporate citizen.*

The Group's aim in terms of corporate governance is, therefore, to sustain and support these objectives over the longer term.

### Compliance with 2003 FRC Combined Code

The Bodycote Board oversaw substantial changes in its board and committee membership in the years 2001-2004. All these changes were appropriate to the Company, in accordance with the principles of good corporate governance, and comply with the provisions of The Combined Code on Corporate Governance published by the UK Financial Reporting Council in July 2003 ('the 2003 Code'), save in two areas where the reasons for the variance throughout the year are:

#### (1) Performance evaluation (code provision A.6)

The Board believes a rolling programme of assessments is the most practical and effective method of evaluating Bodycote's control structures. Informal evaluation of Bodycote's actions, control structures and personnel also takes place regularly as part of a continuous momentum for improvement. Bodycote aims to carry out and report on assessments of all relevant personnel, committees and the Board itself within a three-year cycle, notwithstanding that the 2003 Code lays down an annual frequency for each.

## Directors' Report

### (2) Investor Relations (code provision D.1.1)

Bodycote believes that generally it is the responsibility of the Chief Executive and the Finance Director to manage relationships with institutional investors. The Chairman is available to meet and has met institutional investors to discuss overall strategy, governance and any concerns that shareholders may have. Only where these more usual channels of communication have failed would the Company expect the Senior Independent or other Non-Executive Directors to become involved, notwithstanding that the 2003 Code specifies attendance of the Senior Independent Non-Executive Director at meetings with major shareholders. Regular feedback by the Company's advisers on investor meetings and results presentations are circulated to all Directors. Non-Executive Directors are also encouraged to attend one of the results presentations each year. On specific issues the Chairman will seek the views of Bodycote's leading investors.

Apart from these distinct areas, Bodycote was in compliance with the provisions of the 2003 Code throughout 2006.

### Operation of the 2003 Code

Taken together with the Audit Committee Report and the Board Report on Remuneration presented on pages 17 to 23, this statement explains how Bodycote has applied the principles of good corporate governance set out in the 2003 Code.

### Leadership

The Board of Directors comprises seven members, of whom three are independent Non-Executive Directors and three are Executive Directors led by the Company's part-time Non-Executive Chairman, Mr J.A.S. Wallace, who also chairs the Nomination Committee. The Chief Executive is Mr J.D. Hubbard and the Senior Independent Non-Executive Director is Mr R.T. Scholes, who also chairs the Audit Committee. The Remuneration Committee is chaired by Mr J. Vogelsang. Brief biographical details of all Directors are given on page 24. The Board meets at least nine times a year and visits are made to UK and overseas facilities. Certain defined issues are reserved for the Board to decide, inter alia:

- Approval of financial statements and circulars
- Capital projects, acquisitions and disposals
- Annual budgets
- Strategy
- Directors' appointments, service agreements and remuneration
- Policies for financial statements, treasury, safety, health and environment, donations
- Committees' terms of reference
- Board and committee membership
- Investments
- Equity and bank financing
- Internal control and risk management
- Corporate governance
- Key external and internal appointments
- Pensions and employee incentives

In advance of board meetings Directors are supplied with up-to-date information about the trading performance of each operating location, the Group's overall financial position and its achievement against prior year, budgets and forecasts. They are also supplied with the latest available information on Safety, Health and Environmental and risk management issues and details of the safety and health performance of the Group, and each strategic business unit in terms of severity and frequency rates for accidents at work. Where required, a Director may seek independent professional advice at the expense of the Company, all Directors have access to the Company Secretary and they may also address specific issues to the Senior Independent Non-Executive Director.

In accordance with the articles of association all newly appointed Directors and any who have not stood for re-election at the two previous Annual General Meetings, if eligible, must submit themselves for re-election. Non-Executive Directors, including the Chairman, are appointed for fixed terms not exceeding three years, after which the appointment may be extended by mutual agreement. A statement of the Directors' responsibilities is set out on page 16. The Board also operates three committees. These are the Nomination Committee, the Remuneration Committee and the Audit Committee.

### Independence of Non-Executive Directors

The Board considers that Messrs R.T. Scholes, J. Vogelsang and L.P. Bermejo are all independent for the purposes of the 2003 Code.

### Commitment

The Directors recorded 100% attendance at the ten regular scheduled Board meetings held in the year, including visits to facilities in England and The Czech Republic. Apart from the absence of Mr L.P. Bermejo from one audit committee planning meeting in November 2006 due to business commitments elsewhere, 100% attendance was also recorded for all regular scheduled meetings of the Audit, Remuneration and Nomination Committees.

### Performance Evaluation

All Executive Directors were appraised internally during 2006. In October 2006 the Board carried out its own evaluation of the Board as a whole. The Audit, Remuneration and Nomination Committees reviewed their own performance in November 2006. The Chairman assessed the performance of Mr L.P. Bermejo in December 2006.

### Nomination Committee

Mr J.A.S. Wallace chairs the Nomination Committee which also comprises Messrs R.T. Scholes, J. Vogelsang, L.P. Bermejo and J.D. Hubbard. All members attended the four committee meetings in 2006, when it proposed the nominations for re-election at the 2006 and 2007 Annual General Meetings, and discussed general succession planning and specific positions.

### Proposals for Re-election

Mr Scholes has served as an independent non-executive director since 1998 and was last evaluated for the purposes of the Code in November 2003. The board proposes his re-election as a Director to cover the interim period until his successor as audit committee chairman can be appointed, and as explained by the Chairman on page 2 of this report. Following a performance evaluation by the Chief Executive in February 2007, the Board also proposes the re-election of Mr D.F. Landless as a Director.



### Internal Control

The Board is responsible for the Group's system of internal control and for reviewing its effectiveness. Such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss. The Board has applied Principle C.2 of the 2003 Code by establishing a continuous process for identifying, evaluating and managing the Group's significant risks, including risks arising out of Bodycote's corporate and social engagement.

The Board continuously and regularly reviews the process, which has been in place from the start of 2000 to the date of approval of this report and which is in accordance with Internal Control: Guidance for Directors on the Combined Code published in September 1999. The Board's monitoring covers all controls, including financial, operational and compliance controls and risk management. It is based principally on reviewing reports from management and from internal audit to consider whether any significant weaknesses are promptly remedied and indicate a need for more extensive monitoring. The Audit Committee assists the Board in discharging these review responsibilities. During 2006, in compliance with provision C.2.1, the Board also performed a specific assessment for the purpose of this annual report. The assessment considered all significant aspects of internal control arising during the period covered by the report including the work of Internal Audit. In addition, the Managing Director of each of the Group's Strategic Business Units reported on the existing internal control procedure and any failings or weaknesses. They identified and made an assessment of the risks affecting the businesses they control, in each case with the assistance of input from those reporting directly to them. Such risks were measured against their own stated objectives, and actions for any improvements were scheduled against a timetable for later verification by Internal Audit. No significant previously unidentified risks were uncovered as part of this process, and the necessary actions have been or are being taken to remedy any significant failings or weaknesses identified as part of the review.

### Investor relations

The Chief Executive and Finance Director regularly talk with and meet institutional investors, both individually and collectively, and this has enabled institutional investors to increase their understanding of the Group's strategy. The business of the Annual General Meeting now comprises a review of the Group's operations for the benefit of shareholders attending. In addition, since 1998, internet users have been able to view up-to-date news on the Group and its share price via the Bodycote website at [www.bodycote.com](http://www.bodycote.com). Users of the website can also enrol free for a service that automatically notifies them of results announcements and recent significant Group events. Bodycote's financial advisers, corporate brokers and financial public relations consultants provide Directors with opinion surveys from analysts and investing institutions following visits and meetings with the Chief Executive and Finance Director. Non-Executive Directors are themselves invited to attend analysts' presentations at the time of the regular results announcements. As stated on page 14 the Chairman and Senior Independent Non-Executive Director are available to discuss any issues not resolved by the Chief Executive and Finance Director. On specific issues, as with the introduction in 2003 of the share option scheme, in 2005 with the stock bonus plan and in 2006 with the introduction of long term incentive and share matching schemes, the Company will seek the views of leading investors.

During the year the Company appointed Credit-Suisse Securities (Europe) Limited and Lehman Brothers Europe Limited as joint brokers.

### EMPLOYMENT

The Group recognises the value that can be added to its future profitability and strength by the efforts of employees. The commitment of employees to excel is key to the Group's continued success. Through their attendance at, or participation in, production, safety and health meetings at site level, employees are kept up to date with the performance and progress of the Group, the contribution to the Group made by their site and are advised of safety and health issues. During 2006 the Group published, via the Group extranet, two ten language editions of 'EveryBody Extra' an electronic magazine for all staff detailing the Group's activities, performance and some of its personalities. Approximately 2,000 Bodycote employees are connected to the Bodycote extranet, which will improve knowledge of Group activities, and assist greatly with technology exchange and co-ordination. The winter 2005 edition of 'EveryBody Extra' featured the Group's open door policy under which employee concerns can be voiced on a confidential basis.

It is the Group's policy to give full and fair consideration to applications for employment from disabled persons, having regard to their particular aptitudes and abilities, and to encourage the training and career development of all personnel employed by the Group, including disabled persons. Should an employee become disabled the Group, where practicable, will seek to continue the employment and arrange appropriate training. An equal opportunities policy is in operation in the Group.

### RESEARCH AND DEVELOPMENT

Product development and quality improvement at all Group companies is a continuous process. The Group has a policy of deploying the best technology available and actively seeking improvements. It also conducts research programmes with its customers.

### DONATIONS

Charitable donations during the year net of income tax amounted to £16,600 (2005: £12,000). There were no political contributions.

### CREDITORS POLICY

Group operating companies are responsible for agreeing the terms and conditions under which business transactions are conducted. It is Group policy that payments to suppliers are made in accordance with the terms agreed, provided that these suppliers have also complied with applicable terms and conditions. Creditor days at the year end for the Company were 45 days (2005: 45 days).

### SHAREHOLDERS

An analysis of the Company's shareholders and the shares in issue at 19 February 2007 and details of major shareholders' interests appearing in the register maintained pursuant to Section 211 of the Companies Act 1985 are given on page 80.

## Directors' Report

### AUDITORS

In accordance with the provisions of section 384 of the Companies Act 1985, a resolution for the reappointment of Deloitte & Touche LLP as auditors is to be proposed at the forthcoming Annual General Meeting.

Each Director of the Company states that, in accordance with and as defined by the Companies Act 1985:-

- (1) so far as each Director is aware, there is no relevant audit information of which the Company's auditors are unaware, and
- (2) 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.

This statement is given and should be interpreted in accordance with the provisions of section 234ZA of the Companies Act 1985.

### DIRECTORS' RESPONSIBILITIES

The Directors are responsible for preparing the Annual Report and the financial statements. The Directors are required to prepare accounts for the Group in accordance with International Financial Reporting Standards (IFRS) and have chosen to prepare company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (UK GAAP). In the case of UK GAAP accounts, the Directors are required to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the Directors are required to:

- (1) select suitable accounting policies and then apply them consistently;
- (2) make judgments and estimates that are reasonable and prudent; and
- (3) state whether applicable accounting standards have been followed.

In the case of IFRS accounts, International Accounting Standard 1 requires that financial statements present fairly for each financial year the Company's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements'. In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable International Financial Reporting Standards.

Directors are also required to:

- (1) properly select and apply accounting policies;
- (2) present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and
- (3) provide additional disclosures when compliance with the specific requirements in International Financial Reporting Standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a Directors' Report and the Board Report on Remuneration which comply with the requirements of the Companies Act 1985. The Directors are responsible for the maintenance and integrity of the Company website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

### ANNUAL GENERAL MEETING

The 2007 Annual General Meeting will be held on 23 May 2007 in accordance with the notice being sent to Shareholders.

By order of the Board.



**J.R. Grime**  
Secretary  
27 February 2007

Hulley Road  
Hurdsfield  
Macclesfield  
Cheshire  
SK10 2SG

The members of the Audit Committee during 2006 were Messrs R.T. Scholes (appointed 1998; Chairman from 2002), J. Vogelsang (2003) and L.P. Bermejo (2003). Appointments to the Committee are made by the Board at the same time as appointment to the main Board of Bodycote. In the cases of Messrs Vogelsang and Bermejo, appointments were made following a recommendation of the Nomination Committee. All members of the Committee are independent for the purposes of the 2003 Code.

Mr Scholes is considered to have recent and relevant financial experience having been an investment banker, and also as a Chartered Accountant. Greater detail on the qualifications and experience of all Directors is given on page 24 and their remuneration on page 21. The Committee Chairman's additional responsibilities are reflected by fees of £9,000 per annum for that role. The Committee met four times during 2006 and has the assistance of the Company Secretary, who serves as committee secretary. 100% attendance at committee meetings was achieved by all committee members who served in the year, apart from the absence of Mr L.P. Bermejo from one audit planning meeting in November 2006 due to business commitments elsewhere. The Committee (and its chairman) held meetings with both the external and internal auditors without management in attendance. The Head of Internal Audit has a direct reporting line to the Chairman of the Audit Committee. Those attending meetings include the Finance Director and Head of Internal Audit.

In reporting financial results to shareholders, the Committee depends on the skill, objectivity and independence of the auditors. In the year ended 31 December 2006 the Committee obtained confirmation of the auditor's independence and objectivity. Further it is the policy of the Company not to use the auditors for non-audit services, save for tax compliance, matters where the fee is unlikely to exceed £20,000, or with the prior approval of the Audit Committee. Details of amounts paid to the external auditors for audit and non-audit services in 2006 is analysed in note 3 on page 37.

The Committee's areas of activity during 2006 included:

- Assessment of independence of auditors
- Approval of auditors' re-appointment and fees
- Approval of scope of internal and external audits
- Approval of accounting policies
- Approval of management representations and internal representations
- Review of financial statements and results announcements
- Review of management improvement letters and audit process
- Review of arrangements for reporting and investigation of employee concerns
- Review of Bodycote's business principles
- Review of internal audit findings and monitoring of effectiveness of internal audit
- Review of effectiveness of Board's internal controls and risk management process
- Assessment of internal and external audit effectiveness
- Assessment of the Committee's own effectiveness
- Review of the terms of reference for committee
- Approval of the appointment of a new Head of Internal Audit and plan for enlargement of the Internal Audit department

Having reviewed and expressed satisfaction with the level of fees, objectivity, independence, expertise, resources and general effectiveness of Deloitte & Touche LLP, the Committee recommends (and the Board agrees to propose) their re-appointment as auditors of the Company in accordance with the notice of meeting being sent to shareholders.

Approved by the Board.



**R.T. Scholes**  
Audit Committee Chairman  
27 February 2007

## Board Report on Remuneration

The Remuneration Committee is responsible for remuneration policies that create value for shareholders.

Remuneration structures and packages therefore include moderate base salaries, a high potential for variable pay but clearly linked with absolute value delivered in the business, with key business value drivers used as a basis for measuring performance and a significant proportion of variable pay in restricted conditional shares.

This report has been prepared in accordance with the Directors' Remuneration Report Regulations 2002 and describes how the Board has applied the principles of the Combined Code on Corporate Governance in relation to the remuneration of the Directors.

As required by the Remuneration Report Regulations, a resolution to approve the Board Report on Remuneration will be proposed at the Annual General Meeting of the Company. The Chairman of the Remuneration Committee will be available at the Annual General Meeting to answer questions about Directors' remuneration.

The sections of this report dealing with Directors' emoluments paid, pensions and share options and incentives have been audited. The remaining sections are not subject to audit.

### THE REMUNERATION COMMITTEE

The Committee is responsible for recommending to the Board the remuneration of Executive Directors and senior executives (in all its forms), and the terms of the service contracts and all other terms and conditions of employment of the Executive Directors. The Committee's full terms of reference are available on the Group's website.

The members of the Remuneration Committee during 2006 were J. Vogelsang (Chairman), R.T. Scholes and L.P Bermejo.

The Committee has taken advice from Ernst & Young LLP (appointed by the Remuneration Committee in 2006) to provide independent advice in determining appropriate levels of remuneration. In addition, the Company received actuarial and other pensions advice from JLT Benefit Consultants Limited (appointed in 1995) and from KPMG LLP (appointed in 2005) in relation to the management of risk arising from the UK final salary pension scheme.

### REMUNERATION POLICY

The Committee aims to provide a remuneration policy consistent with the Group's overall business objectives and thereby attract and retain high calibre executives, align executives rewards with the creation of shareholder value and motivate executives to achieve and maintain challenging levels of company and individual performance. Market rates are determined by reference to other companies of similar size, activities and complexity. At the same time, policy in this area is sensitive to the remuneration structure within the Group.

The Committee keeps both the fixed and variable elements of each Executive Director's and senior executive's overall package under review. In recent years, the Committee has progressively increased the proportion of variable as against fixed element of pay.

The changes introduced include:

- Performance related annual bonus potential increased for all executives for 2006;
- The 2003 share option scheme being replaced in 2006 by a long-term incentive plan known as the Bodycote Incentive Plan; and
- The introduction of the Bodycote Share Match Plan.

The Committee considers the targets set for the variable element of Executive Directors' and senior executives' remuneration and has sought to encourage and incentivise "stretch" or exceptional and sustainable financial performances, as measured against the Group's strategic plans.

### FIXED ELEMENTS OF PAY

The fixed elements of remuneration are salaries, pensions and other benefits.

#### Base salary

The base salaries for each Executive Director and senior executives are reviewed annually and are determined by taking into account the responsibilities and performance of the individual, having regard to current market practice.

In line with the remuneration policy the Committee has, since 2002, only made inflationary (and where appropriate market) adjustments following benchmarking. The Committee has used UK engineering businesses and FTSE 250 companies, as well as other North American or European companies in similar trades, as comparables. This resulted in the following salaries being set with effect from 1 January 2007:

|                 |          |
|-----------------|----------|
| Mr J D Hubbard  | £390,000 |
| Mr D F Landless | £250,000 |
| Mr D R Sleight  | £190,000 |

#### Pension

Pensions for current UK domiciled Executive Directors are, up to the UK Government salary cap, provided for under the Group's UK contributory final salary pension scheme which has a normal retirement age of 65 and which is closed to new members.

The main features, in respect of the Executive Directors are:

- a) Pensions from age 65 of 1/60th highest average salary of any consecutive three years out of the last ten years prior to retirement (restricted to the earnings cap where it applies) for each year of pensionable service, and with increases in pensionable salary after 31 December 2003 restricted to 4.25% each year ('the Salary Limit');
- b) A cash death-in-service benefit of four times basic salary at date of death;
- c) Spouse or dependant's pension on member's death equal to half member's prospective retirement pension (restricted as before) at 65 on death in service, or half member's pension entitlement on death in retirement;
- d) Member's contributions are 7% of basic salary;
- e) For Executive Directors with basic salaries above the Salary Limit or the earnings cap the Group will contribute 14% (between 14% and 16% from 5 April 2007) of the excess to a defined contribution arrangement.

An analysis of accrued pension entitlements for the two Directors with accruing benefits under the scheme during 2006 is given on page 23.

The Group proposes to amend the scheme further so that increases in pensionable salary after 5 April 2007 are capped at 3% per annum and so that member's contributions will increase to 8% of pensionable salary.

Arrangements for Mr Hubbard are for a contribution to a defined contribution arrangement of between 14% and 16% of his basic salary (including any payments being made by the Group into the Group's US 401k retirement plan) from January 2004 onwards.

Mr Hubbard is a member of the Group's US 401K retirement plan to which the Group contributed £8,491 (2005: £24,362). Pension contributions for Mr Landless' salary above the earnings cap amounted to £16,156 (2005: £15,540).

#### **Other fixed elements**

The Company provides other benefits in line with market practices. These include the provision of a company car, private medical insurance for the Executive Directors and their families, and long-term disability insurance.

#### **VARIABLE ELEMENTS OF PAY**

There are essentially four variable elements of pay.

##### **Annual Bonuses**

For 2006 an annual bonus is payable to all Executive Directors and senior executives, based on the Group and individual performance. For those senior executives with Strategic Business Unit (SBU) responsibilities, part of the performance-related bonus is based on their relevant sphere of responsibility.

Payment of the maximum cash bonus for 2006 required Executive Directors and senior executives to achieve challenging target increases over 2005 performance in Economic Profit (40% of target achieved), ROCE (Group return on capital employed) (42.9% achieved), organic sales (61.1% achieved) and quantitative improvements in safety and health (although accident severity rates improved by 8.6% the frequency and overall targets were not achieved). As a result, Executive Directors received a cash bonus of 21.7% of basic salary (against a maximum of 60%) and senior executives' cash bonuses ranged from 18.5% to 37.4% depending upon individual SBU performances (again compared to maximum of 60%).

##### **Share Awards**

In 2006, the Company introduced the Bodycote Incentive Plan (BIP) under which Executive Directors and senior executives are rewarded for the delivery of the Company's Strategic Plan and in particular enhanced Economic Profit. Economic Profit for these purposes is defined as adjusted earnings before interest and tax (EBIT), less a 15% charge per annum for the aggregate average of shareholders' funds, net borrowings and goodwill previously written off to reserves, amortised or impaired. To achieve the improvement in Economic Profit both pre-tax ROCE as well as EBIT improvements have to be made.

The Strategic Plan targets ROCE improvement by approximately one percentage point each year until a mid-teens pre-tax ROCE performance has been achieved. In addition significant growth in EBIT is targeted. Based on the Group's typical capital requirements in the initial three year performance period 2006 to 2008, maximum vesting under the BIP will require a compound annual growth of EBIT of approximately 30%. Minimum vesting will be made for compound annual growth in EBIT of approximately 15%. Below this level no vesting will be made. A sliding scale will be applied to performance between the maximum, target and minimum. Based upon the Group's Economic Profit Performance in 2006 the Committee expects final vesting of awards for performance in the three-year period 2006 to 2008 to be in the mid-range of possible outcomes. As a result Executive Directors' awards made in 2006 and that would vest in 2009 could equate to around 100% of their basic 2005 salaries using the share price at the date of the award. Details of the awards under the BIP are noted on page 23.

##### **Deferred Share Awards**

In addition to the BIP, a new deferred share-matching element, which received shareholder approval at the annual general meeting in 2006 has been introduced to provide a link between the Company's short and long term incentive arrangements. This plan, the Bodycote Share Match Plan ("BSMP"), allows the grant of awards of matching shares to participants on an annual basis. This will be based on the number of shares purchased by participants with monies deferred under their annual bonus arrangements.

This plan will first operate in 2007 by reference to the 2006 financial year bonus. Every year, annual bonus up to the value of 20% of base salary may be deferred into Company shares for three years. The maximum level of matching shall be up to one share for each share deferred based upon the achievement of a robust and challenging ROCE target.

The BSMP replaces the Deferred Restricted Stock Bonus Plan ("DRSBP") which permitted Executive Directors and senior executives to defer up to one-third of their cash bonus payable in 2003 and 2004 for shares to be held for three years and which the Company would then match. It also replaces the Bodycote Short Term Stock Bonus Plan ("STSBP") which was introduced in 2005 as a temporary measure until the BIP and BSMP could be presented to shareholders for approval. Under the STSBP, Executive Directors and senior executives received the maximum awards as a consequence of Bodycote being in the upper quartile of TSR achieved by companies within the FTSE 350 Engineering & Machinery Index and certain other comparator companies.

The shares will vest in 2009 and at the end of the holding period, the awards will be enhanced by an amount reflecting dividends paid on the award shares over the three-year period.

No further awards will be made under the STSBP or DRSBP following adoption of the BIP and BSMP. Details of shares held by Directors pursuant to the schemes noted are given on page 23.

## Board Report on Remuneration

### Option Arrangements

The Committee also reviews and manages share incentive schemes established between 1994 and 2003. Following adoption of the BIP no further share options will be granted to Executive Directors and staff pursuant to the 2003 executive share option scheme, but share options granted before this decision will continue to be capable of exercise. At the time each scheme was approved by shareholders, institutional guidelines were followed and latterly leading investors were consulted.

All outstanding share options have now qualified for exercise. Options granted since 1998 have all qualified on the basis of the increase in headline earnings per share (EPS) since 2002 using the UK GAAP headline EPS data for 2002 to 2004 and the IFRS headline EPS figure for 2005. Having received and reviewed a reconciliation between the two accounting standards (the calculations for which have been approved by the Audit Committee), the Committee were satisfied that each performance criterion had been met by a wide margin.

Share options granted under the 1994 and 1996 share option schemes were only exercisable if, over any rolling period of three years from the date of the awarded, the growth in the Group's headline EPS exceeds United Kingdom retail inflation by 6% (10% in respect of those options granted in September 2002).

Under the 2003 scheme the value of shares over which options may be granted to an executive in any one year may not normally exceed 1.5 times basic salary. The extent to which options may be exercised will depend on the Companies growth in pre-tax EPS exceeding the growth in the retail price index (RPI) in the three or five year period following grant. Options over shares worth up to 0.5 times salary may be exercised if the growth in EPS exceeds the growth in RPI by 3% per annum.

The Committee believed that the use of growth in pre-tax EPS was at the time the most appropriate measure of the Company's financial performance and was consistent with market practice, when adopted.

The market price of Bodycote's ordinary shares at 31 December 2006 was 228.25p, the range during 2006 was 218p to 299.25p and the average was 246.54p. The aggregate gains made by Executive Directors in 2006 before the impact of tax and national insurance were £123,220 for Mr Landless and £115,447 for Mr Sleight (2005: nil in each case). An analysis of all Executive Directors' share options is given on page 22.

### TOTAL SHAREHOLDER RETURN (TSR)

The graph on page 22 illustrates the Company's TSR performance since 2001 relative to the FTSE All Share Industrial Index of which the Company is a component part. This sector is considered the most appropriate comparator group over the five year period to December 2006

The index classifications changed on 2 January 2006 and with effect from that date the Company is included in the Industrial Machinery sub-sector. In line with market practice the calculation for TSR assumes reinvestment of dividends and is based on data provided by Datastream.

### SERVICE CONTRACTS

It is the Company's policy that Executive Directors have service contracts with a one year notice period. All the Executive Directors have service agreements which are terminable by one year's notice by either party at any time, and by one year's remuneration in lieu of notice by the employer, and by one year's remuneration in the event of a change in control of the Company. Legally appropriate factors would be taken into account to mitigate any compensation payment, covering basic salary, annual and long term incentives and benefits, which may arise on the termination of employment of any Executive Director, other than payments made on a change in control or for payments in lieu of notice. Mr Hubbard's contract is dated 5 February 2002 and those for Messrs Landless and Sleight are each dated 26 September 2001.

### EXTERNAL APPOINTMENTS

The Company believes that there are benefits to the individual and the Company for Executive Directors holding one non-executive directorship in other organisations, provided that they do not conflict with the Company's interests and that, provided the Executive Director's performance is not impaired, he could retain the fees earned in connection with such an appointment. There have been no appointments covered by this policy.

### NON-EXECUTIVE DIRECTORS

The remuneration of Non-Executive Directors is determined by the Chairman and the Executive Directors. Remuneration for the Chairman is determined by the whole board (excluding the Chairman). Remuneration for the Chairman and Non-Executive Directors takes into account the time commitments and duties and responsibilities involved. The Chairman and each Non-Executive Director hold letters of appointment for terms of three years. Each is terminable under the Company's articles of association, the Companies Act 1985, the Director's resignation or otherwise on six months' notice (twelve months in the case of the Chairman) if termination occurs before expiry of the term.

To determine the fees it pays to Non-Executive Directors, the Board takes into account the need to attract individuals of appropriate calibre and expertise, the fees paid to Non-Executive Directors by other companies of a similar size and the time commitment attached to each appointment. The Board keeps fees under review.

The Chairman and Non-Executive Directors are not entitled to any pension or other employment benefits or to participate in any incentive scheme.

Approved by the Board



**J. Vogelsang**  
Chairman of the Remuneration Committee  
27 February 2007

### Directors' emoluments – audited

|                      |                                  |                  |                         | 2006          | 2005          |
|----------------------|----------------------------------|------------------|-------------------------|---------------|---------------|
|                      | Basic salary<br>and fees<br>£000 | Benefits<br>£000 | Annual<br>Bonus<br>£000 | Total<br>£000 | Total<br>£000 |
| <b>Executive</b>     |                                  |                  |                         |               |               |
| J. D. Hubbard        | 325                              | 20               | 71                      | 416           | 465           |
| D. F. Landless       | 226                              | 18               | 49                      | 293           | 314           |
| D. R. Sleight        | 168                              | 11               | 36                      | 215           | 234           |
|                      | <u>719</u>                       | <u>49</u>        | <u>156</u>              | <u>924</u>    | <u>1,013</u>  |
| <b>Non-Executive</b> |                                  |                  |                         |               |               |
| J. A. S. Wallace     | 120                              | –                | –                       | 120           | 110           |
| R. T. Scholes        | 44                               | –                | –                       | 44            | 36            |
| J. Vogelsang         | 39                               | –                | –                       | 39            | 33            |
| L. P. Bermejo        | 34                               | –                | –                       | 34            | 30            |
|                      | <u>956</u>                       | <u>49</u>        | <u>156</u>              | <u>1,161</u>  | <u>1,222</u>  |

### Directors' share interests – audited

The beneficial interest of the directors and their families in the ordinary shares of the Company are detailed below.

| Ordinary Shareholdings | 31 December 2006<br>Number of shares | 31 December 2005<br>Number of shares |
|------------------------|--------------------------------------|--------------------------------------|
| J.D Hubbard            | 949,103                              | 949,103                              |
| D.F Landless           | 30,520                               | 6,875                                |
| D.R Sleight            | 87,500                               | 87,500                               |
| J.A.S Wallace          | 57,287                               | 57,287                               |
| R.T Scholes            | 18,750                               | 18,750                               |
| J.Vogelsang            | -                                    | -                                    |
| L.P Bermejo            | -                                    | -                                    |

None of the directors has a beneficial interest in the shares of any other Group Company, or non-beneficial interest in the Company or any other Group Company.

### Executive Directors' Shareholding Retention Policy

The Committee introduced in 2005 a shareholding retention policy under which Executive Directors and other senior executives will be required, within five years, to build up a shareholding in the Company. In respect of Executive Directors the requirement will be for their Directors' interests in shares to be worth at least 100% of basic salary.

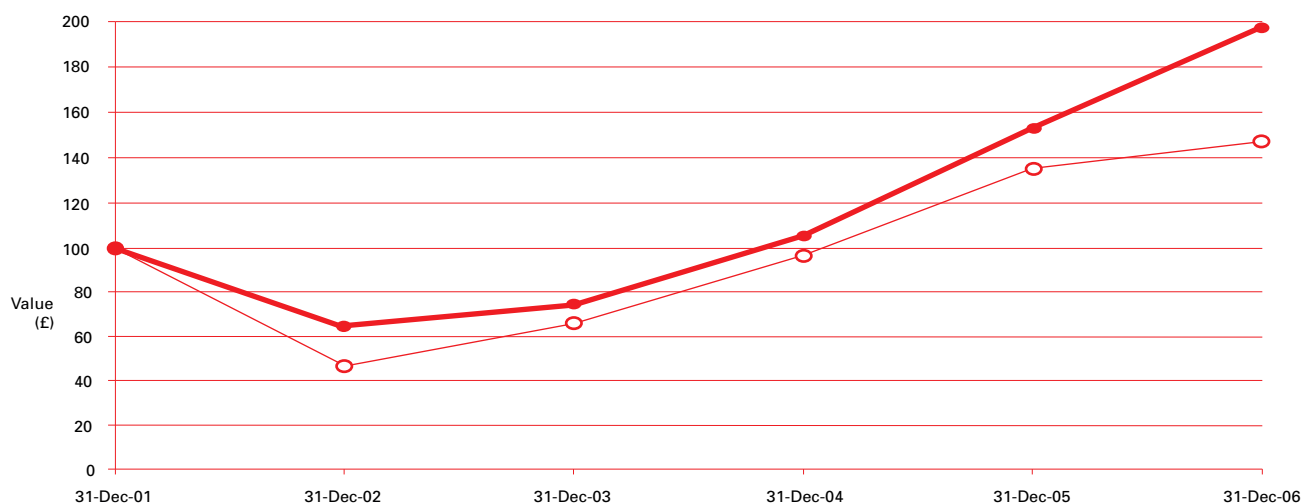
## Board Report on Remuneration

### Share Options – audited

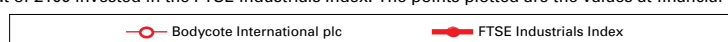
| Director     | Options as at 1 January 2006 | Lapsed   | Exercised in year | Options at 31 December 2006 | Option prices (pence) at date of grant | Prices (pence) at date of exercise | Dates from which exercisable | Expiry date |
|--------------|------------------------------|----------|-------------------|-----------------------------|--|------------------------------------|------------------------------|-------------|
| J.D Hubbard  | 44,178                       | –        | –                 | 44,178                      | 315.43                                 | –                                  | 03/12/2000                   | 03/12/2007  |
|              | 40,107                       | –        | –                 | 40,107                      | 370.26                                 | –                                  | 26/04/2002                   | 26/04/2009  |
|              | 26,738                       | –        | –                 | 26,738                      | 292.19                                 | –                                  | 14/12/2002                   | 14/12/2009  |
|              | 12,834                       | –        | –                 | 12,834                      | 231.42                                 | –                                  | 02/05/2003                   | 02/05/2010  |
|              | 16,042                       | –        | –                 | 16,042                      | 203.37                                 | –                                  | 24/04/2004                   | 24/04/2011  |
|              | 64,170                       | –        | –                 | 64,170                      | 125.76                                 | –                                  | 16/09/2005                   | 16/09/2012  |
|              | 84,882                       | –        | –                 | 84,882                      | 147.27                                 | –                                  | 15/09/2006                   | 15/09/2013  |
| D.F Landless | 53,475                       | (45,454) | –                 | 8,021                       | 370.26                                 | –                                  | 26/04/2002                   | 26/04/2009  |
|              | 53,476                       | (53,476) | –                 | –                           | 292.19                                 | –                                  | 14/12/2002                   | 14/12/2006  |
|              | 16,042                       | –        | –                 | 16,042                      | 231.42                                 | –                                  | 02/05/2003                   | 02/05/2007  |
|              | 21,390                       | –        | –                 | 21,390                      | 203.37                                 | –                                  | 24/04/2004                   | 24/04/2008  |
|              | 53,475                       | –        | –                 | 53,475                      | 370.26                                 | –                                  | 26/04/2002                   | 26/04/2009  |
|              | 42,780                       | –        | (42,780)          | –                           | 125.76                                 | 278.25                             | 16/09/2005                   | 16/09/2009  |
|              | 57,719                       | –        | (57,719)          | –                           | 147.27                                 | 247.73                             | 15/09/2006                   | 15/09/2013  |
| D.R Sleight  | 40,106                       | (32,085) | –                 | 8,021                       | 370.26                                 | –                                  | 26/04/2002                   | 26/04/2009  |
|              | 32,085                       | (32,085) | –                 | –                           | 292.19                                 | –                                  | 14/12/2002                   | 14/12/2006  |
|              | 16,042                       | –        | (16,042)          | –                           | 231.42                                 | 247.73                             | 02/05/2003                   | 02/05/2007  |
|              | 21,390                       | –        | (21,390)          | –                           | 203.37                                 | 247.73                             | 24/04/2004                   | 24/04/2008  |
|              | 42,780                       | –        | (42,780)          | –                           | 125.76                                 | 247.73                             | 16/09/2005                   | 16/09/2009  |
|              | 50,929                       | –        | (50,929)          | –                           | 147.27                                 | 247.73                             | 15/09/2006                   | 15/09/2013  |

The Performance Criteria are set out in the Option Arrangements section on page 20.

### Total Shareholder Return (TSR)



This graph looks at the value, by 31/12/06, of £100 invested in Bodycote International plc on 31/12/01 compared with that of £100 invested in the FTSE Industrials Index. The points plotted are the values at financial year-ends.



Source: Datastream



### Directors' share interests - Deferred Restricted Stock Bonus Scheme – audited

| Director     | At 1 January<br>2006 | Awarded<br>in year <sup>1</sup> | Vested<br>in year | At 31 December<br>2006 | Earliest<br>vesting date |
|--------------|----------------------|---------------------------------|-------------------|------------------------|--------------------------|
| J.D Hubbard  | 36,697               | 994                             | -                 | 37,691                 | March 2008               |
| D.F Landless | 24,464               | 662                             | -                 | 25,126                 | March 2008               |
| D.R Sleight  | 18,899               | 512                             | -                 | 19,411                 | March 2008               |

<sup>1</sup>These additional awards take into account the interim and final dividend for the financial year ended 31 December 2005.

### Directors' share interests - Short Term Stock Bonus Plan – audited

| Director     | At 1 January<br>2006 | Awarded<br>in year | At 31 December<br>2006 | Market price<br>at award date | Earliest<br>vesting date |
|--------------|----------------------|--------------------|------------------------|-------------------------------|--------------------------|
| J.D Hubbard  | -                    | 63,106             | 63,106                 | £2.58                         | March 2009               |
| D.F Landless | -                    | 41,747             | 41,747                 | £2.58                         | March 2009               |
| D.R Sleight  | -                    | 31,262             | 31,262                 | £2.58                         | March 2009               |

### Directors' share interests under the Bodycote Incentive Plan – audited

| Director     | At 1 January<br>2006 | Awarded<br>in year | At 31 December<br>2006 | Market price<br>at award date | Earliest<br>vesting date |
|--------------|----------------------|--------------------|------------------------|-------------------------------|--------------------------|
| J.D Hubbard  | -                    | 125,322            | 125,322                | £2.59                         | March 2009               |
| D.F Landless | -                    | 82,905             | 82,905                 | £2.59                         | March 2009               |
| D.R Sleight  | -                    | 62,083             | 62,083                 | £2.59                         | March 2009               |

### Directors' pensions – audited

| Director      | Accrued<br>annual<br>pension at<br>01/01/06<br>£000 | Transfer<br>value at<br>01/01/06<br>£000 | Real increase<br>in accrued<br>annual<br>pension<br>£000 | Inflation<br>£000 | Increase in<br>accrued<br>annual<br>pension<br>£000 | Transfer<br>value of real<br>increase in<br>accrued<br>annual<br>pension (less<br>members'<br>contributions)<br>£000 | Real<br>increase<br>in transfer<br>value less<br>members'<br>contributions<br>£000 | Members'<br>contributions<br>£000 | Accrued<br>annual<br>pension at<br>31/12/06<br>£000 | Transfer<br>value at<br>31/12/06<br>£000 |
|---------------|---|--|--|-------------------|---|--|--|-----------------------------------|---|--|
| D.F. Landless | 11  | 105                                      | 2  | -                 | 2   | 7  | 1  | 8                                 | 13  | 117                                      |
| D.R. Sleight  | 61  | 854                                      | 3  | 2                 | 5   | 24   | (10)   | 12                                | 66  | 887                                      |

## Board of Directors

### EXECUTIVE DIRECTORS

**J. D. Hubbard** Chief Executive (59) United States

Appointed Chief Executive in January 2002; joined the Board in 2001. Previously served as President of Bodycote's North American Heat Treatment operations from 1996 to 2001. A licensed professional Metallurgical Engineer.

**D. F. Landless** Finance Director (47)

Appointed Finance Director and joined the Group in 1999. From 1989 to 1997 served as Finance Director in UK and US divisions of Courtaulds Plc. Finance Director of Courtaulds Coatings (Holdings) Limited from 1997 to 1999. A Chartered Management Accountant.

**D. R. Sleight** Corporate Development Director (57)

Appointed Corporate Development Director in 2002 having joined the Board in 1996, and served previously as Finance Director (1990 to 1995) and Joint Managing Director (1995 to 2001) of Bodycote's Testing operations. A Chartered Accountant.

### NON-EXECUTIVE DIRECTORS

**J. A. S. Wallace** Chairman (63)

Appointed a Director in 1994. Non-Executive Director of Holidaybreak Plc (2002), NCC Group PLC (2004) and The Sanctuary Group PLC (2006). Deputy Chairman of Pifco Holdings plc from 1994 to 2001. Chairman of the Nomination Committee. A Chartered Accountant.

**R. T. Scholes** Senior Independent Non-executive Director (61)

Appointed in 1998. Non-Executive Director of Keller Group PLC (2002) Chaucer Holdings PLC, Crest Nicholson Plc and Marshalls PLC (2003) and of British Vita plc (1993 to 2003). Investment banker with Dresdner Kleinwort Wasserstein (1986 to 2001). Chairman of the Audit Committee and member of the Remuneration and Nomination Committees. A Chartered Accountant.

**J. Vogelsang** (64) Netherlands

Appointed in 2003. President of Technology at Basell Polyolefins (2001 to 2002), President of Montell Polyolefins Europe (1999 to 2001), Vice-President Shell Chemical Europe and Africa (1994 to 1999) and Chief Executive of the Shell Companies in Sweden (1992 to 1994). Chairman of the Remuneration Committee and member of the Audit and Nomination Committees. A Chemical Engineer.

**L. P. Bermejo** (47) France

Appointed in 2003. Executive Vice-President Industry & Facilities Northern & Eastern Europe at Bureau Veritas from 2006, Director for Northern Europe at Dalkia International from 2004, Chief Executive Dalkia Plc (UK and Ireland subsidiary of Veolia Environment) 1999 to 2004, Chief Executive of Dalkia in the Czech and Slovak Republics (1995 to 1999) and DEKRA-Veritas Automobile (1993 to 1995). Member of the Audit, Remuneration and Nomination Committees. A Structural Engineer.

### SECRETARY AND REGISTERED OFFICE

**J. R. Grime**

Hulley Road, Hurdsfield, Macclesfield, Cheshire SK10 2SG. Tel: 01625 505300 Fax: 01625 505313. Registered Number 519057 England and Wales.

## Advisers

### AUDITORS

Deloitte & Touche LLP

### PRINCIPAL BANKERS

HSBC Bank plc, Barclays Bank PLC, The Royal Bank of Scotland plc, Svenska Handelsbanken AB, Lloyds TSB Bank plc, Bayerische Hypo und Vereinsbank AG, ING Bank NV and Scotiabank Europe plc

### SOLICITORS

Eversheds LLP

### BROKERS & FINANCIAL ADVISERS

Credit-Suisse Securities (Europe) Limited and Lehman Brothers Europe Limited

### REGISTRARS

Capita Registrars Limited, Huddersfield

# Independent Auditors' Report To The Members Of Bodycote International Plc

We have audited the Group financial statements of Bodycote International plc for the year ended 31 December 2006, which comprise the Consolidated Income Statement, the Consolidated Balance Sheet, the Consolidated Cash Flow Statement, the Consolidated Statement of Recognised Income and Expense and the related notes 1 to 33. These Group financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Board Report on Remuneration that is described as having been audited.

We have reported separately on the parent company financial statements of Bodycote International plc for the year ended 31 December 2006.

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

## RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The directors' responsibilities for preparing the Annual Report, the Board Report on Remuneration and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Group 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 Group financial statements give a true and fair view, whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation and whether the part of the Board Report on Remuneration described as having been audited has been 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 group financial statements. The information given in the Directors' Report specifically includes that information presented in the Group Business Review.

In addition we report to you if, in our opinion, 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 review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

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

## 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 group financial statements and the part of the Board Report on Remuneration to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the group financial statements and of whether the accounting policies are appropriate to the group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the group financial statements and the part of the Board Report on Remuneration 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 Group financial statements and the part of the Board Report on Remuneration to be audited.

## OPINION

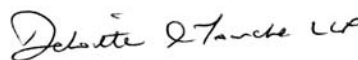
In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the group's affairs as at 31 December 2006 and of its profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation;
- the part of the Board Report on Remuneration described as having been audited has been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the Group financial statements.

## SEPARATE OPINION IN RELATION TO IFRS

As explained in the statement of accounting policies, the Group in addition to complying with its legal obligation to comply with IFRS as adopted by the European Union, has also complied with the IFRS as issued by the International Accounting Standards Board.

In our opinion the Group financial statements give a true and fair view, in accordance with IFRSs, of the state of the Group's affairs as at 31 December 2006 and of its profit for the year then ended.



**Deloitte & Touche LLP**  
Chartered Accountants and  
Registered Auditors

Manchester  
27 February 2007

## Consolidated Income Statement

for the year ended 31 December 2006

|   | 2006<br>£m   | 2005<br>£m   | Note |
|---|--------------|--------------|------|
| <b>Revenue</b>  |              |              |      |
| Existing operations   | 510.3        | 453.7        |      |
| Acquisitions  | 48.3         | 17.2         |      |
| <b>Revenue - continuing operations</b>  | <b>558.6</b> | <b>470.9</b> | 1    |
| <b>Operating profit</b>   |              |              | 3    |
| Existing operations   | 51.3         | 57.0         |      |
| Acquisitions  | 7.2          | 3.3          |      |
| Share of results of associates  | 0.3          | 0.7          | 14   |
| <b>Operating profit - continuing operations</b>   | <b>58.8</b>  | <b>61.0</b>  |      |
| Operating profit prior to amortisation, impairment charges and major facility closure costs | 79.1         | 67.0         |      |
| Amortisation/impairment of acquired intangible fixed assets                                 | (1.0)        | (0.2)        | 12   |
| Impairment of goodwill  | (6.0)        | (5.8)        | 11   |
| Impairment of investment in associate   | (8.3)        | -            |      |
| Major facility closure costs  | (5.0)        | -            |      |
| <b>Operating profit - continuing operations</b>   | <b>58.8</b>  | <b>61.0</b>  |      |
| Investment income   | 3.4          | 5.2          | 5    |
| Finance costs   | (15.6)       | (13.5)       | 6    |
| <b>Profit before taxation</b>   | <b>46.6</b>  | <b>52.7</b>  |      |
| Taxation  | (2.7)        | (11.8)       | 7    |
| <b>Profit for the year</b>  | <b>43.9</b>  | <b>40.9</b>  |      |
| Attributable to:  |              |              |      |
| Equity holders of the parent  | 43.1         | 40.7         |      |
| Minority interest   | 0.8          | 0.2          |      |
|   | <b>43.9</b>  | <b>40.9</b>  |      |
|   | <b>Pence</b> | Pence        |      |
| <b>Earnings per share</b>   |              |              | 10   |
| From continuing operations:   |              |              |      |
| Basic   | 13.4         | 12.7         |      |
| Basic-diluted   | 13.4         | 12.7         |      |

The accompanying notes and statement of accounting policies are an integral part of these financial statements.

**Consolidated Balance Sheet**  
at 31 December 2006



|  | 2006<br>£m   | 2005<br>£m   | Note |
|--|--------------|--------------|------|
| <b>Non-current assets</b>                                  |              |              |      |
| Goodwill   | 201.9        | 154.2        | 11   |
| Other intangible assets                                    | 10.4         | 3.7          | 12   |
| Property, plant and equipment                              | 448.4        | 442.9        | 13   |
| Interests in associates                                    | 1.2          | 9.2          | 14   |
| Finance lease receivables                                  | 1.4          | 1.9          | 16   |
| Deferred tax asset   | 23.2         | 22.7         | 20   |
| Derivative financial instruments                           | 0.6          | –            | 19   |
| Trade and other receivables                                | 11.3         | 6.1          | 17   |
|  | <b>698.4</b> | <b>640.7</b> |      |
| <b>Current assets</b>                                      |              |              |      |
| Inventories  | 13.7         | 11.9         | 15   |
| Finance lease receivables                                  | 0.3          | 0.3          | 16   |
| Derivative financial instruments                           | 1.9          | –            | 19   |
| Trade and other receivables                                | 138.1        | 114.5        | 17   |
| Cash and cash equivalents                                  | 34.7         | 124.8        | 17   |
|  | <b>188.7</b> | <b>251.5</b> |      |
| Non-current assets classified as held for sale             | 2.3          | 1.2          |      |
| <b>Total assets</b>  | <b>889.4</b> | <b>893.4</b> |      |
| <b>Current liabilities</b>                                 |              |              |      |
| Trade and other payables                                   | 111.1        | 97.2         | 22   |
| Dividends payable  | 8.0          | 7.5          | 9    |
| Current tax liabilities                                    | 6.7          | 3.3          | 7    |
| Obligations under finance leases                           | 1.4          | 1.4          | 21   |
| Bank overdrafts and loans                                  | 4.4          | 6.4          | 18   |
| Derivative financial instruments                           | 0.2          | –            | 19   |
| Short-term provisions                                      | 2.5          | 2.3          | 23   |
|  | <b>134.3</b> | <b>118.1</b> |      |
| <b>Net current assets</b>                                  | <b>54.4</b>  | <b>133.4</b> |      |
| <b>Non-current liabilities</b>                             |              |              |      |
| Bank loans   | 186.5        | 221.6        | 18   |
| Retirement benefit obligation                              | 32.8         | 29.9         | 30   |
| Deferred tax liabilities                                   | 68.7         | 79.9         | 20   |
| Obligations under finance leases                           | 3.3          | 3.9          | 21   |
| Derivative financial instruments                           | 0.1          | –            | 19   |
| Long-term provisions                                       | 4.1          | 4.7          | 23   |
| Other payables   | 5.7          | 1.8          | 22   |
|  | <b>301.2</b> | <b>341.8</b> |      |
| <b>Total liabilities</b>                                   | <b>435.5</b> | <b>459.9</b> |      |
| <b>Net assets</b>  | <b>453.9</b> | <b>433.5</b> |      |
| Share capital  | 32.2         | 32.1         | 24   |
| Share premium account                                      | 302.1        | 300.3        | 25   |
| Own shares   | (2.4)        | (2.5)        | 25   |
| Other reserves   | 3.8          | 1.7          | 25   |
| Hedging and translation reserves                           | 4.4          | 11.1         | 25   |
| Retained earnings  | 109.4        | 89.4         | 25   |
| <b>Equity attributable to equity holders of the parent</b> | <b>449.5</b> | <b>432.1</b> |      |
| <b>Minority interest</b>                                   | <b>4.4</b>   | <b>1.4</b>   |      |
| <b>Total equity</b>  | <b>453.9</b> | <b>433.5</b> |      |

Approved by the Board of Directors on 27 February 2007 and signed on its behalf by:

J. D. Hubbard }  
D. F. Landless } Directors

The accompanying notes and statement of accounting policies are an integral part of these financial statements.

## Consolidated Cash Flow Statement

for the year ended 31 December 2006

|   | 2006<br>£m     | 2005<br>£m | Note |
|---|----------------|------------|------|
| <b>Net cash from operating activities</b>                                   | <b>109.2</b>   | 95.7       | 27   |
| <b>Investing activities</b>   |                |            |      |
| Purchases of property, plant and equipment                                  | (59.5)         | (51.8)     |      |
| Proceeds on disposal of property, plant and equipment and intangible assets | 4.8            | 8.6        |      |
| Purchases of intangible fixed assets  | (0.7)          | (0.9)      |      |
| Acquisition of investment in an associate                                   | –              | (2.3)      |      |
| Acquisition of subsidiaries   | (86.3)         | (31.8)     |      |
| Disposal of subsidiaries  | 0.1            | 5.8        |      |
| <b>Net cash used in investing activities</b>                                | <b>(141.6)</b> | (72.4)     |      |
| <b>Financing activities</b>   |                |            |      |
| Interest received   | 2.9            | 5.4        |      |
| Interest paid   | (15.7)         | (14.9)     |      |
| Dividends paid  | (20.5)         | (19.5)     |      |
| Dividends paid to a minority shareholder                                    | (0.1)          | (0.1)      |      |
| Repayments of bank loans  | (65.5)         | (10.1)     |      |
| Repayments of obligations under finance leases                              | (1.8)          | (1.6)      |      |
| New bank loans raised   | 46.0           | 0.1        |      |
| New obligations under finance leases  | 0.5            | 0.1        |      |
| Proceeds on issue of ordinary share capital                                 | 1.9            | 0.3        |      |
| Settlement of share options/own shares purchased                            | 0.1            | (1.7)      |      |
| <b>Net cash used in financing activities</b>                                | <b>(52.2)</b>  | (42.0)     |      |
| <b>Net decrease in cash and cash equivalents</b>                            | <b>(84.6)</b>  | (18.7)     |      |
| <b>Cash and cash equivalents at beginning of year</b>                       | <b>120.7</b>   | 138.7      |      |
| Effect of foreign exchange rate changes                                     | (2.7)          | 0.7        |      |
| <b>Cash and cash equivalents at end of year</b>                             | <b>33.4</b>    | 120.7      |      |

## Consolidated Statement of Recognised Income and Expense

for the year ended 31 December 2006

|   | 2006<br>£m   | 2005<br>£m |
|---|--------------|------------|
| Exchange differences on translation of foreign operations | (6.7)        | (5.1)      |
| Actuarial losses on defined benefit pension schemes       | (3.7)        | (3.7)      |
| Tax on items taken directly to equity                     | 1.6          | 0.2        |
| <b>Net loss recognised directly in equity</b>             | <b>(8.8)</b> | (8.6)      |
| <b>Profit for the year</b>                                | <b>43.9</b>  | 40.9       |
| <b>Recognised income and expense for the year</b>         | <b>35.1</b>  | 32.3       |
| Attributable to:  |              |            |
| Equity holders of the parent                              | 34.3         | 32.1       |
| Minority interests  | 0.8          | 0.2        |
|   | <b>35.1</b>  | 32.3       |

The accompanying notes and statement of accounting policies are an integral part of these financial statements.

### BASIS OF ACCOUNTING

The financial statements of the Group have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted for use in the EU.

The Group has adopted Standards and Interpretations issued by the International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee of the IASB. Individual standards and interpretations have to be adopted by the European Commission (EC) and the process leads to a delay between the issue and adoption of new standards and in some cases amendment by the EC.

International Financial Reporting Standards are subject to ongoing amendment by the IASB and subsequent endorsement by the EC and are therefore subject to change.

In addition to complying with its legal obligation to comply with IFRS as adopted for use in the EU, the Group has also complied with IFRS as issued by the IASB.

The financial statements have been prepared on the historic cost convention, with the exception of accounting for share-based payments and certain financial instruments. The principal accounting policies adopted are set out below.

### BASIS OF CONSOLIDATION

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company (its subsidiaries) made up to 31 December each year. Control is achieved where the Company has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities.

On acquisition, the assets and liabilities and contingent liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired (i.e. discount on acquisition) is credited to the income statement in the period of acquisition. The interest of minority shareholders is stated at the minority's proportion of the fair values of the assets and liabilities recognised. Subsequently, any losses applicable to the minority interest in excess of the minority interest are allocated against the interests of the parent.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by the Group.

All intra-group transactions, balances, income and expenses are eliminated on consolidation.

### INVESTMENTS IN ASSOCIATES

An associate is an entity over which the Group is in a position to exercise significant influence, but not control or joint control, through participation in the financial and operating policy decisions of the investee.

The results and assets and liabilities of associates are incorporated in these financial statements using the equity method of accounting. Investments in associates are carried in the balance sheet at cost as adjusted by post-acquisition changes in the Group's share of the net assets of the associate, less any impairment in the value of individual investments. Losses of the associates in excess of the Group's interest in those associates are not recognised.

Any excess of the cost of acquisition over the Group's share of the fair values of the identifiable net assets of the associate at the date of acquisition is recognised as goodwill. Any deficiency of the cost of acquisition below the Group's share of the fair values of the identifiable net assets of the associate at the date of acquisition (i.e. discount on acquisition) is credited in profit and loss in the period of acquisition.

Where a group company transacts with an associate of the Group, profits and losses are eliminated to the extent of the Group's interest in the relevant associate. Losses may provide evidence of an impairment of the asset transferred, in which case appropriate provision is made for impairment.

### NON-CURRENT ASSETS HELD FOR SALE

Non-current assets (and disposal groups) classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Non-current assets and disposal groups are classified as held for sale if their carrying amount will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the asset (or disposal group) is available for immediate sale in its present condition. Management must be committed to the sale which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

### GOODWILL

Goodwill arising on consolidation represents the excess of the cost of acquisition over the Group's interest in the fair value of the identifiable assets and liabilities of a subsidiary, associate or jointly controlled entity at the date of acquisition.

Goodwill is recognised as an asset and reviewed for impairment at least annually. Any impairment is recognised immediately in profit or loss and is not subsequently reversed.

On disposal of a subsidiary, associate or jointly controlled entity, the attributable amount of goodwill is included in the determination of the profit or loss on disposal.

Goodwill arising on acquisitions before the date of transition to IFRS has been retained at the previous UK GAAP amounts, subject to being tested for impairment at that date. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and is not included in determining any subsequent profit or loss on disposal.

### REVENUE RECOGNITION

Revenue is measured at the fair value of the consideration received or receivable and represents amounts receivable for goods and services provided in the normal course of business, net of discounts, VAT and other sales-related taxes.

Interest income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount.

Dividend income from investments is recognised when the shareholder's rights to receive payment have been established.

## Accounting Policies

### THE GROUP AS LESSEE

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

Assets held under finance leases are recognised as assets of the Group at their fair value or, if lower, at the present value of the minimum lease payments, each determined at the inception of the lease. The corresponding liability to the lessor is included in the balance sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income.

Rentals payable under operating leases are charged to income on a straight-line basis over the term of the relevant lease.

Benefits received and receivable as an incentive to enter into an operating lease are also spread on a straight-line basis over the lease term.

### THE GROUP AS LESSOR

Amounts due from lessees under finance leases are recorded as receivables at the amount of the group's net investment in the leases. Finance lease income is allocated to accounting periods so as to reflect a constant periodic rate of return on the Group's net investment outstanding in respect of the leases.

### FOREIGN CURRENCIES

Transactions in currencies other than pounds sterling are recorded at the rates of exchange prevailing on the dates of the transactions. At each balance sheet date, monetary assets and liabilities that are denominated in foreign currencies are retranslated at the rates prevailing on the balance sheet date. Gains and losses arising on retranslation are included in net profit or loss for the period.

On consolidation, the assets and liabilities of the Group's overseas operations are translated at exchange rates prevailing on the balance sheet date. Income and expense items are translated at the average exchange rates for the period unless exchange rates fluctuate significantly. Exchange differences arising, if any, are classified as equity and transferred to the Group's translation reserve. Such translation differences are recognised as income or as expenses in the period in which the operation is disposed of.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate. The Group has elected to treat goodwill and fair value adjustments arising on acquisitions before the date of transition to IFRS as sterling-denominated assets and liabilities.

### BORROWING COSTS

Borrowing costs are recognised in profit or loss in the period in which they are incurred.

### GOVERNMENT GRANTS

Government grants relating to property, plant and equipment are treated as deferred income and released to profit and loss over the expected useful lives of the assets concerned.

### INCOME STATEMENT

Operating profit is stated after charging restructuring costs, goodwill impairment, amortisation of acquired intangible assets and after the post-tax share of results of associates but before investment income and finance costs. Amounts presented in the income statement for acquisitions relate to businesses acquired during the current or prior year.

### RETIREMENT BENEFIT COSTS

Payments to defined contribution retirement benefit schemes are charged as an expense as they fall due. Payments made to state-managed retirement benefit schemes are dealt with as payments to defined contribution schemes where the Group's obligations under the schemes are equivalent to those arising in a defined contribution retirement benefit scheme.

For defined benefit retirement benefit schemes, the cost of providing benefits is determined using the Projected Unit Credit Method, with actuarial valuations being carried out at each balance sheet date. Actuarial gains and losses are recognised in full in the period in which they occur. They are recognised outside profit or loss and presented in the statement of recognised income and expense.

Past service cost is recognised immediately to the extent that the benefits are already vested, and otherwise is amortised on a straight-line basis over the average period until the benefits become vested.

The retirement benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligation, as reduced by the fair value of scheme assets.

### TAXATION

The tax expense represents the sum of the tax currently payable and deferred tax.

The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the tax profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates, and interests in joint ventures, except where the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.



## PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment are stated at cost less accumulated depreciation and any recognised impairment loss.

Depreciation is charged so as to write off the cost of assets, other than land and properties under construction, over their estimated useful lives, using the straight-line method, on the following bases:

|                       |                              |
|-----------------------|------------------------------|
| Freehold buildings    | 2%                           |
| Leasehold property    | over the period of the lease |
| Fixtures and fittings | 10% - 20%                    |
| Plant and machinery   | 5% - 20%                     |
| Motor vehicles        | 20% - 33%                    |

Assets held under finance leases are depreciated over their expected useful lives on the same basis as owned assets or, where shorter, over the term of the relevant lease.

The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in income.

## IMPAIRMENT OF TANGIBLE AND INTANGIBLE ASSETS EXCLUDING GOODWILL

At each balance sheet date, the Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where the asset does not generate cash flows that are independent from other assets, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised as an expense immediately.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognised as income immediately.

## INVENTORIES

Inventories are stated at the lower of cost and net realisable value. Cost comprises direct materials and, where applicable, direct labour costs and those overheads that have been incurred in bringing the inventories to their present location and condition. Net realisable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

## FINANCIAL INSTRUMENTS

Financial assets and financial liabilities are recognised on the Group's balance sheet when the Group becomes a party to the contractual provisions of the instrument.

### Trade Receivables

Trade receivables do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

### Cash and Cash Equivalents

Cash and cash equivalents comprise cash in hand and demand deposits and other short-term highly liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

### Financial Liabilities and Equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities.

### Bank Borrowings

Interest-bearing bank loans and overdrafts are recorded at the proceeds received, net of direct issue costs. Finance charges, including premiums payable on settlement or redemption and direct issue costs, are accounted for on an accrual basis to the profit and loss account using effective interest method and are added to the carrying amount of the instrument to the extent that they are not settled in the period in which they arise.

### Trade Payables

Trade payables are not interest-bearing and are stated at their nominal value.

### Equity Instruments

Equity instruments issued by the Company are recorded at the proceeds received, net of direct issue costs.

## PROVISIONS

Provisions for restructuring costs are recognised when the Group has a detailed formal plan for the restructuring that has been communicated to affected parties.

## DERIVATIVE FINANCIAL INSTRUMENTS

The Group uses derivative financial instruments, in particular interest rate swaps, foreign currency swaps and forward exchange contracts to manage the financial risks arising from the business activities and the financing of those activities. The Group does not use derivative financial instruments for speculative purposes.

The use of financial derivatives is governed by the Group's policies approved by the Board of Directors, which provide written principles on the use of financial derivatives.

Derivative financial instruments are recognised as assets and liabilities measured at their fair value on the balance sheet date. Changes in the fair value of any derivative instruments that do not fulfil the criteria for hedge accounting contained in IAS 39 are recognised immediately in the income statement.

## Accounting Policies

### HEDGE ACCOUNTING

The Group uses foreign currency debt and cross currency swaps to hedge its exposure to changes in the underlying net assets of overseas operations arising from foreign exchange rate movements.

The Group maintains documentation of the relationship between the hedged item and the hedging instrument at the inception of a hedging transaction together with the risk management objective and the strategy underlying the designated hedge. The Group also documents its assessment, both at the inception of the hedging relationship and subsequently on an ongoing basis, of the effectiveness of the hedge in offsetting movements in the fair values or cash flows of the hedged items.

When hedge accounting is used, the relevant hedging relationships are classified as fair value hedges, cash flow hedges or net investment hedges.

#### Fair Value Hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

#### Cash Flow Hedge

Cash flow hedging matches the cash flows of hedged items against the corresponding cash flow of the derivative. The effective part of any gain or loss on the derivative is recognised directly in equity and the hedged item is accounted for in accordance with the policy for that financial instrument. Any ineffective part of any gain or loss is recognised immediately in the income statement.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting. At that time, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to net profit or loss for the period.

#### Net Investment Hedge

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. To the extent the hedge is effective, changes in the fair value of the hedging instrument arising from the hedged risk are recognised directly in equity rather than in the income statement.

Gains and losses accumulated in equity are included in the income statement in the event that the foreign operation is disposed of.

### SHARE-BASED PAYMENTS

The Group has applied the requirements of IFRS 2 Share-based Payments. In accordance with the transitional provisions, IFRS 2 has been applied to all grants of equity instruments after 7 November 2002 that were unvested as of 1 January 2005.

The Group issues equity-settled share-based payments to certain employees. Equity-settled share-based payments are measured at fair value at the date of grant. The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the group's estimate of shares that will eventually vest. Fair value is measured by use of a Black-Scholes model.

### CRITICAL JUDGEMENTS IN APPLYING THE GROUP'S ACCOUNTING POLICIES

In the process of applying the Group's accounting policies, which are described above, management has made the following judgements that have the most significant effect on the amounts recognised in the financial statements (apart from those involving estimations, which are dealt with below).

#### Provisions for environmental liabilities

The Group provides for the costs of environmental remediation that have been identified, either as part of acquisition due diligence, or in other circumstances where remediation by the Group is required. The provision is reviewed annually.

### KEY SOURCES OF ESTIMATION UNCERTAINTY

The key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are discussed below.

#### Impairment of Goodwill

Determining whether goodwill is impaired requires an estimation of the value in use of the cash-generating units to which goodwill has been allocated. The value in use calculation requires the entity to estimate the future cash flows expected to arise from the cash-generating unit and a suitable discount rate in order to calculate present value.

### GENERAL INFORMATION

Bodycote International plc is a company incorporated in the United Kingdom under the Companies Acts 1948 to 1980. The address of the registered office is given on page 24. The nature of the group's operations and its principal activities are set out on page 13 of the directors' report.

These financial statements are presented in pounds sterling because that is the currency of the primary economic environment in which the group operates. Foreign operations are included in accordance with the policies set out in the Foreign Currencies accounting policy above.

At the date of authorisation of these financial statements, the following Standards, which have not been applied in these financial statements, were in issue but not yet effective:

- IFRS 7 Financial instruments: Disclosures; and the related amendment to IAS 1 on capital disclosures
- IFRS 8 Operating Segments

The directors anticipate that the adoption of these Standards in future periods will have no material impact on the financial statements of the Group except for additional disclosures on capital and financial instruments and operating segments when the relevant standards come into effect for periods commencing on or after 1 January 2007 and 1 January 2008 respectively.

The impact of all other standards and interpretations not yet adopted is not expected to be material.

**Notes to the Consolidated Financial Statements**  
Year ended 31 December 2006



**1. Revenue**

|   | 2006<br>£m          | 2005<br>£m          |
|---|---------------------|---------------------|
| <b>Continuing operations</b>                                |                     |                     |
| Heat treatment, hot isostatic pressing and testing services | <u>558.6</u>        | <u>470.9</u>        |
| Other operating income                                      | 2.8                 | 2.6                 |
| Investment income (see note 5)                              | <u>3.4</u>          | <u>5.2</u>          |
|   | <b>564.8</b>        | <b>478.7</b>        |
| <b>Discontinued operations</b>                              |                     |                     |
| Revenue (see note 8)  | -                   | <u>1.5</u>          |
| <b>Total Revenue</b>  | <u><b>564.8</b></u> | <u><b>480.2</b></u> |

**2. Business and geographical segments**

|   | Heat<br>Treatment | Hot<br>Isostatic<br>Pressing | Testing      | Electro<br>plating<br>(discontinued) | Head<br>Office and<br>Eliminations | Continuing<br>operations |
|---|-------------------|------------------------------|--------------|--------------------------------------|------------------------------------|--------------------------|
|   | 2006<br>£m        | 2006<br>£m                   | 2006<br>£m   | 2006<br>£m                           | 2006<br>£m                         | 2006<br>£m               |
| <b>Revenue</b>  |                   |                              |              |                                      |                                    |                          |
| External sales  | 375.0             | 38.9                         | 144.7        | -                                    | -                                  | 558.6                    |
| Inter-segment sales   | -                 | -                            | 0.6          | -                                    | (0.6)                              | -                        |
| Total revenue   | <u>375.0</u>      | <u>38.9</u>                  | <u>145.3</u> | <u>-</u>                             | <u>(0.6)</u>                       | <u>558.6</u>             |
| <b>Result</b>   |                   |                              |              |                                      |                                    |                          |
| Segment result prior to amortisation of acquired intangible assets, impairment of goodwill and major facility closure costs | 49.5              | 12.7                         | 21.3         | -                                    | -                                  | 83.5                     |
| Share of associates' operating profit   | 0.8               | 0.1                          | -            | -                                    | -                                  | 0.9                      |
| Unallocated corporate expenses  | -                 | -                            | -            | -                                    | (4.7)                              | (4.7)                    |
|   | <u>50.3</u>       | <u>12.8</u>                  | <u>21.3</u>  | <u>-</u>                             | <u>(4.7)</u>                       | <u>79.7</u>              |
| Amortisation/Impairment of acquired intangible assets, impairment of goodwill and investment in associate                   | (10.7)            | -                            | (4.6)        | -                                    | -                                  | (15.3)                   |
| Major facility closure costs  | (5.0)             | -                            | -            | -                                    | -                                  | (5.0)                    |
| Segment result  | <u>34.6</u>       | <u>12.8</u>                  | <u>16.7</u>  | <u>-</u>                             | <u>(4.7)</u>                       | <u>59.4</u>              |
| Share of associates' interest and tax   | <u>(0.6)</u>      |                              |              |                                      |                                    | <u>(0.6)</u>             |
| Operating profit - continuing operations  |                   |                              |              |                                      |                                    | <b>58.8</b>              |
| Investment revenues   |                   |                              |              |                                      |                                    | <b>3.4</b>               |
| Finance costs   |                   |                              |              |                                      |                                    | <u>(15.6)</u>            |
| Profit before tax   |                   |                              |              |                                      |                                    | <b>46.6</b>              |
| Tax   |                   |                              |              |                                      |                                    | <u>(2.7)</u>             |
| Profit for the year   |                   |                              |              |                                      |                                    | <u><b>43.9</b></u>       |

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 2. Business and geographical segments continued

|   | Heat<br>Treatment | Hot<br>Isostatic<br>Pressing | Testing     | Electro<br>plating<br>(discontinued) | Head<br>Office and<br>Eliminations | Continuing<br>operations |
|---|-------------------|------------------------------|-------------|--------------------------------------|------------------------------------|--------------------------|
|   | 2005<br>£m        | 2005<br>£m                   | 2005<br>£m  | 2005<br>£m                           | 2005<br>£m                         | 2005<br>£m               |
| <b>Revenue</b>  |                   |                              |             |                                      |                                    |                          |
| External sales  | 349.2             | 35.2                         | 86.5        | 1.5                                  | (1.5)                              | 470.9                    |
| Inter-segment sales   | –                 | –                            | 0.6         | –                                    | (0.6)                              | –                        |
| Total revenue   | <u>349.2</u>      | <u>35.2</u>                  | <u>87.1</u> | <u>1.5</u>                           | <u>(2.1)</u>                       | <u>470.9</u>             |
| <b>Result</b>   |                   |                              |             |                                      |                                    |                          |
| Segment result prior to amortisation of acquired intangible assets and impairment of goodwill | 43.3              | 9.5                          | 16.3        | –                                    | –                                  | 69.1                     |
| Share of associates' operating profit   | 1.5               | –                            | –           | –                                    | –                                  | 1.5                      |
| Unallocated corporate expenses  | –                 | –                            | –           | –                                    | (2.8)                              | (2.8)                    |
|   | <u>44.8</u>       | <u>9.5</u>                   | <u>16.3</u> | <u>–</u>                             | <u>(2.8)</u>                       | <u>67.8</u>              |
| Amortisation of acquired intangible assets and impairment of goodwill                         | (5.8)             | –                            | (0.2)       | –                                    | –                                  | (6.0)                    |
| Segment result  | <u>39.0</u>       | <u>9.5</u>                   | <u>16.1</u> | <u>–</u>                             | <u>(2.8)</u>                       | <u>61.8</u>              |
| Share of associates' interest and tax   | <u>(0.8)</u>      |                              |             |                                      |                                    | <u>(0.8)</u>             |
| Operating profit - continuing operations  |                   |                              |             |                                      |                                    | 61.0                     |
| Investment revenues   |                   |                              |             |                                      |                                    | 5.2                      |
| Finance costs   |                   |                              |             |                                      |                                    | (13.5)                   |
| Profit before tax   |                   |                              |             |                                      |                                    | 52.7                     |
| Tax   |                   |                              |             |                                      |                                    | (11.8)                   |
| Profit for the year   |                   |                              |             |                                      |                                    | <u>40.9</u>              |

Inter-segment sales are charged at prevailing market prices.

### Other information

|  | Heat<br>Treatment | Hot<br>Isostatic<br>Pressing | Testing      | Head<br>Office and<br>Eliminations | Consolidated |
|--|-------------------|------------------------------|--------------|------------------------------------|--------------|
|  | 2006<br>£m        | 2006<br>£m                   | 2006<br>£m   | 2006<br>£m                         | 2006<br>£m   |
| Capital additions                      | 38.8              | 6.6                          | 14.5         | 0.3                                | 60.2         |
| Depreciation and amortisation          | 33.1              | 4.3                          | 8.6          | 0.2                                | 46.2         |
| Impairment losses recognised in income | 13.9              | –                            | 3.9          | –                                  | 17.8         |
| Balance sheet                          |                   |                              |              |                                    |              |
| Assets:                                |                   |                              |              |                                    |              |
| Segment assets                         | 772.6             | 87.2                         | 196.5        | (168.1)                            | 888.2        |
| Interests in associates                | 1.2               | –                            | –            | –                                  | 1.2          |
| Consolidated total assets              | <u>773.8</u>      | <u>87.2</u>                  | <u>196.5</u> | <u>(168.1)</u>                     | <u>889.4</u> |
| Liabilities:                           |                   |                              |              |                                    |              |
| Segment liabilities                    | 445.7             | 36.1                         | 168.0        | (214.3)                            | 435.5        |
| Segment net assets                     | <u>328.1</u>      | <u>51.1</u>                  | <u>28.5</u>  | <u>46.2</u>                        | <u>453.9</u> |

## 2. Business and geographical segments continued

|  | Heat<br>Treatment<br>2005<br>£m | Hot<br>Isostatic<br>Pressing<br>2005<br>£m | Testing<br>2005<br>£m | Head<br>Office and<br>Eliminations<br>2005<br>£m | Consolidated<br>2005<br>£m |
|--|---------------------------------|--|-----------------------|--|----------------------------|
| Capital additions                      | 37.6                            | 5.2  | 9.9                   | –  | 52.7                       |
| Depreciation and amortisation          | 32.2                            | 4.3  | 4.9                   | –  | 41.4                       |
| Impairment losses recognised in income | 5.8                             | –  | –                     | –  | 5.8                        |
| Balance sheet                          |                                 |  |                       |  |                            |
| Assets:                                |                                 |  |                       |  |                            |
| Segment assets                         | 726.8                           | 86.5                                       | 117.6                 | (46.7)   | 884.2                      |
| Interests in associates                | 9.2                             | –  | –                     | –  | 9.2                        |
| Consolidated total assets              | <u>736.0</u>                    | <u>86.5</u>                                | <u>117.6</u>          | <u>(46.7)</u>                                    | <u>893.4</u>               |
| Liabilities:                           |                                 |  |                       |  |                            |
| Segment liabilities                    | 399.1                           | 28.0                                       | 69.3                  | (36.5)   | 459.9                      |
| Segment net assets                     | <u>336.9</u>                    | <u>58.5</u>                                | <u>48.3</u>           | <u>(10.2)</u>                                    | <u>433.5</u>               |

### Discontinued operations

During 2004 the Group sold the majority of the Electroplating plants. The remaining electroplating plants were sold during 2005. Details can be found in note 8.

### By geographical market

|              | Sales revenue |              |
|--------------|---------------|--------------|
|              | 2006<br>£m    | 2005<br>£m   |
| EMEA         | 356.8         | 304.2        |
| Americas     | 200.6         | 166.7        |
| Asia Pacific | 1.2           | –            |
|              | <u>558.6</u>  | <u>470.9</u> |

Revenue from the Group's discontinued operations was derived principally from EMEA (2006: £nil, 2005: £1.5m).

|              | Carrying amount of segment assets |              | Additions to property, plant and equipment and intangible assets |             |
|--------------|-----------------------------------|--------------|--|-------------|
|              | 2006<br>£m                        | 2005<br>£m   | 2006<br>£m   | 2005<br>£m  |
| EMEA         | 321.5                             | 305.6        | 37.3   | 31.5        |
| Americas     | 129.8                             | 126.9        | 19.6   | 21.0        |
| Asia Pacific | 2.6                               | 1.0          | 3.3  | 0.2         |
|              | <u>453.9</u>                      | <u>433.5</u> | <u>60.2</u>  | <u>52.7</u> |

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 3. Operating profit

|  | 2006           |               |                |            | 2005       |
|--|----------------|---------------|----------------|------------|------------|
|  | £m             | £m            | £m             | £m         | £m         |
|  | Existing       | Acquisitions  | Continuing     | Existing   | Continuing |
|  | operations     |               | operations     | operations | operations |
| Revenue  | <b>510.3</b>   | <b>48.3</b>   | <b>558.6</b>   | 453.7      | 470.9      |
| Cost of sales  | <b>(334.7)</b> | <b>(31.3)</b> | <b>(366.0)</b> | (301.4)    | (312.1)    |
| Gross profit   | <b>175.6</b>   | <b>17.0</b>   | <b>192.6</b>   | 152.3      | 158.8      |
| Other operating income                                       | <b>2.8</b>     | –             | <b>2.8</b>     | 2.5        | 2.6        |
| Distribution costs   | <b>(16.5)</b>  | <b>(2.1)</b>  | <b>(18.6)</b>  | (14.3)     | (14.7)     |
| Administration expenses                                      | <b>(90.7)</b>  | <b>(7.1)</b>  | <b>(97.8)</b>  | (77.7)     | (80.4)     |
| Other operating expenses                                     | <b>(0.2)</b>   | –             | <b>(0.2)</b>   | –          | –          |
| Amortisation/impairment of acquired intangible fixed assets* | <b>(0.4)</b>   | <b>(0.6)</b>  | <b>(1.0)</b>   | –          | (0.2)      |
| Impairment of goodwill*                                      | <b>(6.0)</b>   | –             | <b>(6.0)</b>   | (5.8)      | (5.8)      |
| Impairment of investment in associate*                       | <b>(8.3)</b>   | –             | <b>(8.3)</b>   | –          | –          |
| Major facility closure costs*                                | <b>(5.0)</b>   | –             | <b>(5.0)</b>   | –          | –          |
| Operating profit before income from associates               | <b>51.3</b>    | <b>7.2</b>    | <b>58.5</b>    | 57.0       | 60.3       |
| Income from associates after interest and tax                |                |               | <b>0.3</b>     |            | 0.7        |
| Operating profit   |                |               | <b>58.8</b>    |            | 61.0       |

\*Administration expenses (total £118.1m, 2005: £86.4m)

Profit for the year has been arrived at after charging/(crediting):

|   | 2006         | 2005  |
|---|--------------|-------|
|   | £m           | £m    |
| Net foreign exchange losses/(gains)                         | <b>0.2</b>   | (0.2) |
| Depreciation of property, plant and equipment               | <b>44.8</b>  | 40.5  |
| Impairment of investment in associate                       | <b>8.3</b>   | –     |
| Amortisation/impairment of acquired intangible fixed assets | <b>1.0</b>   | 0.2   |
| Impairment of goodwill                                      | <b>6.0</b>   | 5.8   |
| Loss/(profit) on disposal of property, plant and equipment  | <b>0.3</b>   | (0.6) |
| Staff costs (see note 4)                                    | <b>249.4</b> | 208.5 |
| Auditors' remuneration for audit services (see page 37)     | <b>0.7</b>   | 0.6   |

### 3. Operating Profit continued

A more detailed analysis of auditors' remuneration on a worldwide basis is provided below:

|   | <b>2006</b>       | 2005       |
|---|-------------------|------------|
|   | <b>£m</b>         | £m         |
| Fees payable to the Company's auditors for the audit of the Company's annual accounts | <b>0.1</b>        | 0.1        |
| Fees payable to the Company's auditors and their associates for other services:       |                   |            |
| The audit of the Company's subsidiaries pursuant to legislation                       | <b>0.6</b>        | 0.5        |
| Tax Services  | <b>0.4</b>        | 0.5        |
| All other services  | <b>-</b>          | 0.1        |
|   | <b><u>1.1</u></b> | <u>1.2</u> |

Fees paid to the Company's auditors, Deloitte & Touche LLP, and their associates for services other than the statutory audit of the company are not disclosed in subsidiaries' accounts since the consolidated accounts of the subsidiaries' parent, Bodycote International plc, are required to disclose non-audit fees on a consolidated basis.

In addition to the amounts shown above, the auditors received fees of £9,000 (2005: £8,000) for the audit of the Group pension schemes.

A description of the work of the Audit Committee is set out in the Audit Committee Report and includes an explanation of how auditor objectivity and independence is safeguarded when non-audit services are provided by the auditors.

### 4. Staff costs

The average monthly number of employees (including Executive Directors) was:

|                        | <b>2006</b>          | <b>2006</b>          | 2005         | 2005         |
|------------------------|----------------------|----------------------|--------------|--------------|
|                        | <b>Year-end</b>      | <b>Average</b>       | Year-end     | Average      |
| Heat treatment         | <b>6,375</b>         | <b>6,418</b>         | 5,335        | 5,279        |
| Hot isostatic pressing | <b>343</b>           | <b>328</b>           | 314          | 307          |
| Testing                | <b>3,528</b>         | <b>3,320</b>         | 2,120        | 1,843        |
|                        | <b><u>10,246</u></b> | <b><u>10,066</u></b> | <u>7,769</u> | <u>7,429</u> |

Their aggregate remuneration comprised:

|                                   | <b>£m</b>           | £m           |
|-----------------------------------|---------------------|--------------|
| Wages and salaries                | <b>211.4</b>        | 174.9        |
| Social security costs             | <b>30.0</b>         | 26.6         |
| Other pension costs (see note 30) | <b>8.0</b>          | 7.0          |
|                                   | <b><u>249.4</u></b> | <u>208.5</u> |

Disclosure of individual Director's remuneration, share interests, share options, long term incentive schemes, pension consideration and pension entitlements required by the Companies Act 1985 and those specified for audit by the Financial Services Authority are shown in the tables in the Board Report on Remuneration on pages 21 to 23 and form part of these financial statements.

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 5. Investment revenue

|                           | 2006<br>£m | 2005<br>£m |
|---------------------------|------------|------------|
| Interest on bank deposits | 2.4        | 5.0        |
| Other interest receivable | 1.0        | 0.2        |
|                           | <u>3.4</u> | <u>5.2</u> |

### 6. Finance costs

|  | 2006<br>£m  | 2005<br>£m  |
|--|-------------|-------------|
| Interest on bank overdrafts and loans                        | 10.0        | 11.3        |
| Cost of early settlement of US Dollar private placement debt | 3.1         | –           |
| Interest on obligations under finance leases                 | 0.4         | 0.4         |
| Interest on pension scheme liabilities                       | 3.3         | 3.1         |
| Return on pension assets                                     | (2.4)       | (2.1)       |
| Other finance charges  | 1.2         | 0.8         |
| Total finance costs  | <u>15.6</u> | <u>13.5</u> |

### 7. Tax

|  | 2006<br>£m | 2005<br>£m  |
|--|------------|-------------|
| Current tax - charge for the year                          | 10.5       | 9.5         |
| Current taxation - adjustment in respect of previous years | 1.6        | (0.1)       |
| Deferred tax (see note 20)                                 | (9.4)      | 2.4         |
|  | <u>2.7</u> | <u>11.8</u> |

UK corporation tax is calculated at 30% (2005: 30%) of the estimated assessable profit for the year. Taxation for other jurisdictions is calculated at the rates prevailing in the respective jurisdictions. The charge for the year can be reconciled to the profit per the income statement as follows:

|  | 2006<br>£m  | 2005<br>£m  |
|--|-------------|-------------|
| Profit before tax  | <u>46.6</u> | <u>52.7</u> |
| Tax at the UK corporation tax rate of 30% (2005: 30%)                          | 14.0        | 15.8        |
| Tax effect of share of results of associates                                   | –           | (0.2)       |
| Tax effect of expenses that are not deductible in determining taxable profit   | 8.0         | 0.9         |
| Tax effect of utilisation of tax losses not previously recognised              | (0.9)       | (1.5)       |
| Tax settlements in respect of prior years                                      | (11.2)      | –           |
| Tax effect of other adjustments in respect of previous periods                 | (3.5)       | (2.3)       |
| Effect of different tax rates of subsidiaries operating in other jurisdictions | (3.7)       | (0.9)       |
| Tax expense for the year   | <u>2.7</u>  | <u>11.8</u> |

Tax credit on items taken directly to equity is £1.6m (2005: £0.2m).



## 8. Discontinued operations

At the end of 2003 following more than 2 years of very poor performance the Group decided to exit the electroplating business. Activity was conducted at 17 sites in 3 countries. The business was sold piecemeal in 14 transactions with the final transactions being completed in 2005.

The results of the discontinued operations, which have been included in the consolidated income statement, were as follows:

|                   | <b>2006</b> | 2005     |
|-------------------|-------------|----------|
|                   | <b>£m</b>   | £m       |
| Revenue           | –           | 1.5      |
| Expenses          | –           | (1.5)    |
| Profit before tax | <u>–</u>    | <u>–</u> |

As a result of a continued review of the Group's network 8 sites of former heat treatment facilities are held for sale, with a book value of £2.3m. It is expected that all of the sites will be sold within the next 12 months. Impairment losses of £0.7m have been recognised in 2006. Non-current assets held for sale comprise property, plant and equipment.

## 9. Dividends

|   | <b>2006</b>        | 2005        |
|---|--------------------|-------------|
|   | <b>£m</b>          | £m          |
| Amounts recognised as distributions to equity holders in the period:                        |                    |             |
| Final dividend for the year ended 31 December 2005 of 4.05p (2004: 3.85p) per share         | <b>13.0</b>        | 12.3        |
| Interim dividend for the year ended 31 December 2006 of 2.50p (2005: 2.35p) per share       | <b>8.0</b>         | 7.5         |
|   | <u><b>21.0</b></u> | <u>19.8</u> |
| Proposed final dividend for the year ended 31 December 2006 of 4.5p (2005: 4.05p) per share | <b>14.5</b>        | 13.0        |

The proposed final dividend is subject to approval by shareholders at the Annual General Meeting and has not been included as a liability in these financial statements.

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 10. Earnings per share

The calculation of the basic and diluted earnings per share is based on the following data:

|   | <b>2006</b>               | 2005               |
|---|---------------------------|--------------------|
|   | <b>£m</b>                 | £m                 |
| <b>Earnings</b>   |                           |                    |
| Earnings for the purposes of basic earnings per share being net profit attributable to equity holders of the parent | <u><b>43.1</b></u>        | <u>40.7</u>        |
|   |                           |                    |
|   | <b>2006</b>               | 2005               |
|   | <b>Number</b>             | Number             |
| <b>Number of shares</b>   |                           |                    |
| Weighted average number of ordinary shares for the purposes of basic earnings per share                             | <b>320,462,772</b>        | 319,719,955        |
| Effect of dilutive potential ordinary shares:   |                           |                    |
| Share options   | <u><b>880,065</b></u>     | <u>546,590</u>     |
| Weighted average number of ordinary shares for the purposes of diluted earnings per share                           | <u><b>321,342,837</b></u> | <u>320,266,545</u> |
|   |                           |                    |
|   | <b>Pence</b>              | Pence              |
| Basic   | <u><b>13.4</b></u>        | <u>12.7</u>        |
| Diluted   | <u><b>13.4</b></u>        | <u>12.7</u>        |
|   |                           |                    |
|   | <b>2006</b>               | 2005               |
|   | <b>£m</b>                 | £m                 |
| <b>Headline earnings</b>  |                           |                    |
| Net profit attributable to equity holders of the parent   | <b>43.1</b>               | 40.7               |
| Add back:   |                           |                    |
| Impairment of goodwill  | <b>6.0</b>                | 5.8                |
| Amortisation/Impairment of acquired intangible fixed assets   | <b>1.0</b>                | 0.2                |
| Impairment of investment in associate   | <b>8.3</b>                | –                  |
| Major facility closure costs  | <b>5.0</b>                | –                  |
| Cost of early settlement of US Dollar private placement debt  | <b>3.1</b>                | –                  |
| Tax settlements in respect of prior years   | <u><b>(11.2)</b></u>      | <u>–</u>           |
| <b>Headline earnings</b>  | <u><b>55.3</b></u>        | <u>46.7</u>        |
|   |                           |                    |
|   | <b>Pence</b>              | Pence              |
| <b>Earnings per share from headline earnings:</b>   |                           |                    |
| Basic   | <u><b>17.3</b></u>        | <u>14.6</u>        |
| Diluted   | <u><b>17.2</b></u>        | <u>14.6</u>        |

## 11. Goodwill

|   | 2006<br>£m   | 2005<br>£m   |
|---|--------------|--------------|
| <b>Cost</b>                               |              |              |
| At 1 January                              | 160.0        | 139.7        |
| Exchange differences                      | (2.1)        | –            |
| Recognised on acquisition of subsidiaries | 55.9         | 20.3         |
| Derecognised on disposal of subsidiaries  | (2.1)        | –            |
| At 31 December                            | <u>211.7</u> | <u>160.0</u> |
| <b>Accumulated impairment losses</b>      |              |              |
| At 1 January                              | (5.8)        | –            |
| Impairment losses for the year            | (6.0)        | (5.8)        |
| Eliminated on disposal of subsidiaries    | 2.0          | –            |
| At 31 December                            | <u>(9.8)</u> | <u>(5.8)</u> |
| <b>Carrying amount</b>                    | <u>201.9</u> | <u>154.2</u> |

Goodwill acquired in a business combination is allocated, at acquisition, to the business units that are expected to benefit from that business combination. After recognition of impairment losses, the carrying amount of goodwill had been allocated as follows:

|                | 2006<br>£m   | 2005<br>£m   |
|----------------|--------------|--------------|
| Heat Treatment | 133.3        | 126.2        |
| Testing        | 68.6         | 28.0         |
|                | <u>201.9</u> | <u>154.2</u> |

The Group tests goodwill annually for impairment, or more frequently if there are indications that goodwill might be impaired.

The recoverable amounts of the Business Units are determined from value in use calculations. The key assumptions for the value in use calculations are those regarding the discount rates, growth rates and expected changes to selling prices and direct costs during the period. Management estimates discount rates using rates that reflect current market assessments of the time value of money and the risks specific to the Business Units. The rate used to discount the forecast cash flows from all Business Units is 8.7%. Changes in selling prices and direct costs are based on management forecasts.

The Group prepares cash flow forecasts derived from the most recent financial budgets and forecasts approved by management for the next five years and extrapolates cash flows thereafter based on an estimated growth rate of 3.3% being the historical weighted average growth in GDP in the markets that the Group operates in. This rate does not exceed the average long-term growth rate for the relevant markets.

Goodwill written off in the year includes to the impairment of two North American heat treatment plants (£2.0m), the impairment of one North American testing facility (£3.8m) and the disposal of a Swedish testing facility (£0.2m).

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 12. Other intangible assets

|   | Software<br>£m | Other intangibles<br>acquired through<br>business combinations<br>£m | Total<br>£m |
|---|----------------|--|-------------|
| <b>Cost</b>                             |                |  |             |
| At 1 January 2005                       | 5.3            | –  | 5.3         |
| Exchange differences                    | 0.1            | –  | 0.1         |
| Additions                               | 0.9            | –  | 0.9         |
| Acquired on acquisition of subsidiaries | 0.2            | 2.0  | 2.2         |
| Disposals                               | (0.2)          | –  | (0.2)       |
| At 1 January 2006                       | 6.3            | 2.0  | 8.3         |
| Exchange differences                    | (0.2)          | –  | (0.2)       |
| Additions                               | 0.7            | –  | 0.7         |
| Acquired on acquisition of subsidiaries | 0.7            | 7.4  | 8.1         |
| Disposals                               | (1.4)          | –  | (1.4)       |
| <b>At 31 December 2006</b>              | <b>6.1</b>     | <b>9.4</b>   | <b>15.5</b> |
| <b>Amortisation</b>                     |                |  |             |
| At 1 January 2005                       | 3.9            | –  | 3.9         |
| Charge for the year                     | 0.7            | 0.2  | 0.9         |
| Disposals                               | (0.2)          | –  | (0.2)       |
| At 1 January 2006                       | 4.4            | 0.2  | 4.6         |
| Charge for the year                     | 0.6            | 0.8  | 1.4         |
| Impairment loss                         | –              | 0.2  | 0.2         |
| Acquired on acquisition of subsidiaries | 0.3            | –  | 0.3         |
| Disposals                               | (1.4)          | –  | (1.4)       |
| <b>At 31 December 2006</b>              | <b>3.9</b>     | <b>1.2</b>   | <b>5.1</b>  |
| <b>Carrying amount</b>                  |                |  |             |
| <b>At 31 December 2006</b>              | <b>2.2</b>     | <b>8.2</b>   | <b>10.4</b> |
| At 31 December 2005                     | 1.9            | 1.8  | 3.7         |

The amortisation periods for intangible assets are:

|                          | Years    |
|--------------------------|----------|
| Software                 | 3 to 5   |
| Customer relationships   | 10 to 15 |
| Membership lists         | 15       |
| Non-compete arrangements | 2 to 5   |
| Trade names              | 3        |

### 13. Property, plant and equipment

|  | Land and buildings |                         |                          |                              |                                | Total<br>£m  |
|--|--------------------|-------------------------|--------------------------|------------------------------|--------------------------------|--------------|
|  | Freehold<br>£m     | Long<br>leasehold<br>£m | Short<br>leasehold<br>£m | Plant and<br>machinery<br>£m | Fixtures<br>and fittings<br>£m |              |
| <b>Cost or valuation</b>                       |                    |                         |                          |                              |                                |              |
| At 1 January 2005                              | 147.2              | 11.8                    | 7.0                      | 494.7                        | 33.8                           | 694.5        |
| Additions                                      | 2.3                | 0.3                     | 0.4                      | 46.7                         | 2.1                            | 51.8         |
| Acquisition of subsidiaries                    | 1.5                | 1.1                     | 0.1                      | 12.7                         | 1.8                            | 17.2         |
| Exchange differences                           | 0.7                | (0.2)                   | 0.3                      | 3.9                          | (0.1)                          | 4.6          |
| Reclassified as held for sale                  | (0.3)              | –                       | –                        | (0.4)                        | –                              | (0.7)        |
| Recategorisation                               | 2.2                | 0.5                     | –                        | 1.2                          | (1.7)                          | 2.2          |
| Disposals                                      | (2.4)              | –                       | (0.1)                    | (15.5)                       | (3.1)                          | (21.1)       |
| At 1 January 2006                              | 151.2              | 13.5                    | 7.7                      | 543.3                        | 32.8                           | 748.5        |
| Additions                                      | 4.4                | 0.2                     | 0.8                      | 51.8                         | 2.3                            | 59.5         |
| Acquisition of subsidiaries                    | 0.3                | 2.4                     | 0.3                      | 37.9                         | 2.6                            | 43.5         |
| Exchange differences                           | (6.1)              | (0.5)                   | (0.3)                    | (23.7)                       | (1.1)                          | (31.7)       |
| Reclassified as held for sale                  | (2.0)              | –                       | –                        | (0.7)                        | –                              | (2.7)        |
| Recategorisation                               | 2.1                | 0.3                     | (0.2)                    | (5.2)                        | 0.9                            | (2.1)        |
| Disposals                                      | (1.6)              | (0.3)                   | –                        | (13.3)                       | (2.0)                          | (17.2)       |
| <b>At 31 December 2006</b>                     | <b>148.3</b>       | <b>15.6</b>             | <b>8.3</b>               | <b>590.1</b>                 | <b>35.5</b>                    | <b>797.8</b> |
| <b>Accumulated depreciation and impairment</b> |                    |                         |                          |                              |                                |              |
| At 1 January 2005                              | 22.1               | 7.0                     | 2.4                      | 211.2                        | 25.9                           | 268.6        |
| Charge for the year                            | 3.7                | 0.3                     | 0.3                      | 33.9                         | 2.3                            | 40.5         |
| Acquisition of subsidiaries                    | 0.1                | 0.1                     | –                        | 6.3                          | 1.4                            | 7.9          |
| Exchange differences                           | (0.2)              | (0.1)                   | 0.1                      | 0.5                          | –                              | 0.3          |
| On assets reclassified as held for sale        | (0.1)              | –                       | –                        | –                            | –                              | (0.1)        |
| Recategorisation                               | 1.3                | –                       | –                        | 2.5                          | (1.6)                          | 2.2          |
| Eliminated on disposals                        | (0.6)              | –                       | –                        | (10.3)                       | (2.9)                          | (13.8)       |
| At 1 January 2006                              | 26.3               | 7.3                     | 2.8                      | 244.1                        | 25.1                           | 305.6        |
| Charge for the year                            | 3.8                | 0.4                     | 0.4                      | 37.6                         | 2.6                            | 44.8         |
| Acquisition of subsidiaries                    | –                  | 0.7                     | –                        | 20.7                         | 1.0                            | 22.4         |
| Impairment loss                                | 0.6                | –                       | –                        | 2.7                          | –                              | 3.3          |
| Exchange differences                           | (0.9)              | (0.2)                   | (0.1)                    | (9.2)                        | (0.7)                          | (11.1)       |
| On assets reclassified as held for sale        | (0.6)              | –                       | –                        | (0.4)                        | –                              | (1.0)        |
| Recategorisation                               | 0.2                | (0.2)                   | –                        | (2.5)                        | 0.5                            | (2.0)        |
| Eliminated on disposals                        | (0.8)              | –                       | –                        | (10.0)                       | (1.8)                          | (12.6)       |
| <b>At 31 December 2006</b>                     | <b>28.6</b>        | <b>8.0</b>              | <b>3.1</b>               | <b>283.0</b>                 | <b>26.7</b>                    | <b>349.4</b> |
| <b>Carrying amount</b>                         |                    |                         |                          |                              |                                |              |
| <b>At 31 December 2006</b>                     | <b>119.7</b>       | <b>7.6</b>              | <b>5.2</b>               | <b>307.1</b>                 | <b>8.8</b>                     | <b>448.4</b> |
| At 31 December 2005                            | 124.9              | 6.2                     | 4.9                      | 299.2                        | 7.7                            | 442.9        |

The net book value of leased assets is £1.0m (2005: £1.0m).

Included within plant and machinery are assets under construction with a cost of £25.2m (2005: £21.8m).

The Group has pledged land and buildings having a carrying amount of approximately £9.1m (2005: £10.8m) to secure banking facilities granted to the Group.

At 31 December 2006 the Group had entered into contractual commitments for the acquisition of property, plant and equipment amounting to £13.8m (2005: £16.1m).

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 14. Subsidiaries and Associates

A list of the significant investments in subsidiaries, including the name, country of incorporation and proportion of ownership interest is given on pages 77 to 79. A list of the significant investments in associates, including the name, country of incorporation and proportion of ownership interest is given in note 3 to the company's separate financial statements on page 73.

|  | <b>2006</b>   | 2005  |
|--|---------------|-------|
|  | <b>£m</b>     | £m    |
| <b>Aggregated amounts relating to associates</b> |               |       |
| Total assets                                     | <b>137.8</b>  | 104.3 |
| Total liabilities                                | <b>112.1</b>  | 91.3  |
| Revenues   | <b>67.0</b>   | 67.1  |
| (Loss)/profit                                    | <b>(14.8)</b> | 4.1   |

Amounts recognised in the income statement and in the balance sheet for associates are as follows:

|  | <b>2006</b>  | 2005  |
|--|--------------|-------|
|  | <b>£m</b>    | £m    |
| Operating profit                                     | <b>0.9</b>   | 1.5   |
| Less: Interest                                       | <b>(0.6)</b> | (0.7) |
| Less: Tax  | -            | (0.1) |
| Share of results of associates (prior to impairment) | <b>0.3</b>   | 0.7   |
| Interest in associates                               | <b>1.2</b>   | 9.2   |

During the year the Group impaired its investment in SSCP Coatings (see note 3).

#### 15. Inventories

|                                     | <b>2006</b> | 2005 |
|-------------------------------------|-------------|------|
|                                     | <b>£m</b>   | £m   |
| Raw materials                       | <b>8.7</b>  | 7.0  |
| Work-in-progress                    | <b>4.9</b>  | 4.7  |
| Finished goods and goods for resale | <b>0.1</b>  | 0.2  |
|                                     | <b>13.7</b> | 11.9 |

## 16. Finance lease receivables

|   | Minimum lease payments |            | Present value of minimum lease payments |            |
|---|------------------------|------------|---|------------|
|   | 2006<br>£m             | 2005<br>£m | 2006<br>£m                              | 2005<br>£m |
| <b>Amounts receivable under finance leases:</b>   |                        |            |   |            |
| Within one year   | <b>0.4</b>             | 0.4        | <b>0.3</b>                              | 0.3        |
| In the second to fifth years inclusive  | <b>1.5</b>             | 1.7        | <b>1.4</b>                              | 1.5        |
| After five years  | <b>-</b>               | 0.4        | <b>-</b>                                | 0.4        |
|   | <b>1.9</b>             | 2.5        | <b>1.7</b>                              | 2.2        |
| Less: unearned finance income   | <b>(0.2)</b>           | (0.3)      |   |            |
| Present value of minimum lease payments receivable  | <b>1.7</b>             | 2.2        |   |            |
| <b>Analysed as:</b>   |                        |            |   |            |
| Non-current finance lease receivables (recoverable after 12 months)                       |                        |            | <b>1.4</b>                              | 1.9        |
| Current finance lease receivables (recoverable within 12 months)                          |                        |            | <b>0.3</b>                              | 0.3        |
|   |                        |            | <b>1.7</b>                              | 2.2        |
| The present value of minimum lease payments were denominated in the following currencies: |                        |            |   |            |
| Euro  |                        |            | <b>1.0</b>                              | 1.3        |
| US Dollar   |                        |            | <b>0.7</b>                              | 0.9        |
|   |                        |            | <b>1.7</b>                              | 2.2        |

The Group has entered into finance leasing arrangements with SSCP Coating Sàrl, an associate company, for 3 PVD machines. The average term of finance leases entered into is 7 years. Unguaranteed residual values of assets leased under finance leases at the balance sheet date are £1.7m (2005: £2.1m). The interest rate inherent in the leases is fixed at the contract date for the entire lease term. The average effective interest rate contracted approximates to 4.4%. The fair value of the Group's finance lease receivables at 31 December 2006 is estimated at £1.9m (2005: £2.4m).

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 17. Other financial assets

|  | 2006<br>£m   | 2005<br>£m   |
|--|--------------|--------------|
| <b>Trade and other receivables</b>                   |              |              |
| <b>Amounts falling due within one year:</b>          |              |              |
| Amount receivable for the supply of services         | 117.5        | 98.3         |
| Other debtors and prepayments                        | <u>20.6</u>  | <u>16.2</u>  |
|  | <b>138.1</b> | <b>114.5</b> |
| <b>Amounts falling due after more than one year:</b> | <u>11.3</u>  | <u>6.1</u>   |

The average credit period given to customers for the supply of services is 70 days (2005: 69 days). An allowance has been made for estimated irrecoverable amounts from the supply of services of £6.9m (2005: £6.3m). This allowance has been determined by reference to past default experience. The Directors consider that the carrying amount of trade and other receivables approximates their fair value.

#### Credit risk

The Group's principal financial assets are bank balances and cash, trade and other receivables, finance lease receivables and investments.

The Group's credit risk is primarily attributable to its trade and finance lease receivables. The amounts presented in the balance sheet are net of allowances for doubtful receivables. An allowance for impairment is made where there is an identified loss event which, based on previous experience, is evidence of a reduction in the recoverability of cash flows.

The credit risk on liquid funds and derivative financial instruments is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies.

The Group had no significant concentration of credit risk, with exposure spread over a large number of counterparties and customers.

#### Bank and cash balances

Bank and cash balances comprise cash held by the Group and short-term bank deposits with an original maturity of three months or less. The carrying amount of these assets approximates their fair value. A breakdown of significant bank and cash balances by currency is as follows:

|                              | 2006<br>£m  | 2005<br>£m   |
|------------------------------|-------------|--------------|
| Sterling                     | 4.3         | 50.9         |
| US Dollar                    | 5.1         | 19.6         |
| Euro                         | 13.2        | 38.5         |
| Swedish Krona                | 2.2         | 4.8          |
| Other                        | <u>9.9</u>  | <u>11.0</u>  |
| Total bank and cash balances | <b>34.7</b> | <b>124.8</b> |



## 18. Bank overdrafts and loans

|                 | <b>2006</b>  | 2005  |
|-----------------|--------------|-------|
|                 | <b>£m</b>    | £m    |
| Bank overdrafts | <b>1.3</b>   | 4.1   |
| Bank loans      | <b>189.6</b> | 223.9 |
|                 | <b>190.9</b> | 228.0 |

The borrowings are repayable as follows:

|  |              |       |
|--|--------------|-------|
| On demand or within one year   | <b>4.4</b>   | 6.4   |
| In the second year   | <b>0.8</b>   | 1.9   |
| In the third to fifth years  | <b>140.8</b> | 217.8 |
| After five years   | <b>44.9</b>  | 1.9   |
|  | <b>190.9</b> | 228.0 |
| Less: Amount due for settlement within 12 months (shown under current liabilities) | <b>(4.4)</b> | (6.4) |
| Amount due for settlement after 12 months  | <b>186.5</b> | 221.6 |

Analysis of borrowings by currency:

|                     | Sterling<br>£m | Euro<br>£m  | US\$<br>£m  | Swedish<br>Krona<br>£m | Other<br>currencies<br>£m | Total<br>£m  |
|---------------------|----------------|-------------|-------------|------------------------|---------------------------|--------------|
| At 31 December 2006 |                |             |             |                        |                           |              |
| Bank overdrafts     | <b>0.3</b>     | <b>0.3</b>  | <b>0.1</b>  | –                      | <b>0.6</b>                | <b>1.3</b>   |
| Bank loans          | <b>0.6</b>     | <b>81.6</b> | <b>85.4</b> | <b>17.2</b>            | <b>4.8</b>                | <b>189.6</b> |
|                     | <b>0.9</b>     | <b>81.9</b> | <b>85.5</b> | <b>17.2</b>            | <b>5.4</b>                | <b>190.9</b> |
| At 31 December 2005 |                |             |             |                        |                           |              |
| Bank overdrafts     | 0.8            | 2.1         | 0.1         | 0.1                    | 1.0                       | 4.1          |
| Bank loans          | –              | 64.3        | 138.0       | 12.4                   | 9.2                       | 223.9        |
|                     | 0.8            | 66.4        | 138.1       | 12.5                   | 10.2                      | 228.0        |

|   | <b>2006</b> | 2005 |
|---|-------------|------|
|   | <b>%</b>    | %    |
| The weighted average interest rates paid were as follows: |             |      |
| Bank overdrafts   | <b>2.9</b>  | 4.2  |
| Bank loans  | <b>5.1</b>  | 4.4  |

Loans and finance leases of £6.1m (2005: £56.5m) were arranged at fixed interest rates and expose the Group to fair value interest rate risk. The remaining borrowings are arranged at floating rates, thus exposing the Group to cash flow interest rate risk.

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 18. Bank overdrafts and loans continued

The Directors estimate the fair value of the Group's borrowings as follows:

|                 | <b>2006</b>  | 2005  |
|-----------------|--------------|-------|
|                 | <b>£m</b>    | £m    |
| Bank overdrafts | <b>1.3</b>   | 4.1   |
| Bank loans      | <b>189.6</b> | 226.5 |

The other principal features of the Group's borrowings are as follows:

- (i) Bank overdrafts are repayable on demand. No overdrafts are secured. The average effective interest rate approximates 2.9% (2005: 4.2%).
- (ii) The group has two principal loans which are secure by upstream guarantees provided by subsidiaries:
  - (a) Drawings of £140.3m (2005: £170.0m) under a Revolving Credit Facility of £225m. This unsecured facility commenced on 29th July 2005 for a period of five years. The multi currency drawings under this facility carry an interest rate of between 0.50% and 0.75% above LIBOR (the margin at 31 December 2006 was 0.50%).
  - (b) Drawings of £43.1m (2005: £nil) under a Revolving Credit Facility of €125m. This unsecured facility commenced on 31st July 2006 for a period of seven years. The Euro drawings under this facility carry an interest rate of between 0.80% and 1.10% above LIBOR (the margin at 31 December 2006 was 0.80%).

At 31 December 2006 the group had available £125.8m (2005: £72.1m) of undrawn committed borrowing facilities.

## 19. Derivative financial instruments

### Currency derivatives

|  | Nominal<br>value<br>2006<br>£m | Fair<br>value<br>2006<br>£m |
|--|--------------------------------|-----------------------------|
| Net asset                                |                                |                             |
| <b>Current</b>                           |                                |                             |
| Forward foreign exchange contracts       | 0.3                            | –                           |
| Cross currency swaps - fixed/fixed       | 20.2                           | 0.1                         |
| Cross currency swaps - floating/floating | 51.2                           | 1.6                         |
|  | <u>71.7</u>                    | <u>1.7</u>                  |
| <b>Non-current</b>                       |                                |                             |
| Cross currency swaps - fixed/fixed       | 10.1                           | –                           |
| Cross currency swaps - floating/floating | 31.3                           | 0.5                         |
|  | <u>41.4</u>                    | <u>0.5</u>                  |
| <b>Total</b>                             |                                |                             |
| Forward foreign exchange contracts       | 0.3                            | –                           |
| Cross currency swaps - fixed/fixed       | 30.3                           | 0.1                         |
| Cross currency swaps - floating/floating | 82.5                           | 2.1                         |
|  | <u>113.1</u>                   | <u>2.2</u>                  |

The Group utilises currency derivatives to hedge material future transactions and cash flows. The Group uses foreign currency forward contracts in the management of its exchange rate exposures. The contracts are primarily denominated in the currencies of the Group's principal markets. The unrecognised gains and losses were not material either in 2006 or 2005.

At the balance sheet date the Group had entered into foreign currency denominated cross currency swaps that were designated as a hedging instrument for the purposes of hedging the translation of its foreign operations. The contracts are entered into either with both currencies at floating interest rates (generally based on 3 month LIBOR interest rates) or both currencies at fixed interest rates. The details are as follows:

|                              | Sterling<br>2006<br>£m | Euro<br>2006<br>£m | Swedish<br>Krona<br>2006<br>£m | Danish<br>Krone<br>2006<br>£m | Canadian<br>Dollar<br>2006<br>£m | Swiss<br>Franc<br>2006<br>£m | Total<br>fair value<br>2006<br>£m |
|------------------------------|------------------------|--------------------|--------------------------------|-------------------------------|----------------------------------|------------------------------|-----------------------------------|
| Asset/(liability)            |                        |                    |                                |                               |                                  |                              |                                   |
| Fixed/fixed                  | 30.4                   | (30.3)             | –                              | –                             | –                                | –                            | 0.1                               |
| Floating/floating            | 84.5                   | (40.4)             | (17.5)                         | (4.5)                         | (13.8)                           | (6.2)                        | 2.1                               |
| Total                        | <u>114.9</u>           | <u>(70.7)</u>      | <u>(17.5)</u>                  | <u>(4.5)</u>                  | <u>(13.8)</u>                    | <u>(6.2)</u>                 | <u>2.2</u>                        |
| On demand or within one year | 73.0                   | (40.4)             | (10.4)                         | (4.5)                         | (11.4)                           | (4.6)                        | 1.7                               |
| In the second year           | 41.9                   | (30.3)             | (7.1)                          | –                             | (2.4)                            | (1.6)                        | 0.5                               |
|                              | <u>114.9</u>           | <u>(70.7)</u>      | <u>(17.5)</u>                  | <u>(4.5)</u>                  | <u>(13.8)</u>                    | <u>(6.2)</u>                 | <u>2.2</u>                        |

The Group's interest rate risk is primarily in relation to its fixed rate borrowings (fair value risk) and floating rate borrowings (cash flow risk). From time to time the Group will use interest rate derivative contracts to manage its exposure to interest rate movements within Group policy. However at the balance sheet date the Group had no interest rate derivative contracts.

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 20. Deferred tax

The following are the major deferred tax liabilities and assets recognised by the Group and movements thereon during the current and prior reporting periods.

|                               | Accelerated<br>tax<br>depreciation | Tax losses | Retirement<br>benefit<br>obligations | Other        | Total       |
|-------------------------------|------------------------------------|------------|--------------------------------------|--------------|-------------|
|                               | £m                                 | £m         | £m                                   | £m           | £m          |
| At 1 January 2005             | 59.6                               | (5.3)      | (6.5)                                | 5.4          | 53.2        |
| Charge/(credit) to income     | 5.1                                | 0.8        | –                                    | (2.8)        | 3.1         |
| Charge to equity              | 2.0                                | –          | (2.2)                                | –            | (0.2)       |
| Acquisition of subsidiaries   | 0.4                                | –          | –                                    | (0.1)        | 0.3         |
| Exchange differences          | 1.3                                | –          | –                                    | 0.2          | 1.5         |
| Effect of change in tax rate: |                                    |            |                                      |              |             |
| Income statement              | (0.6)                              | –          | –                                    | (0.1)        | (0.7)       |
| At 1 January 2006             | 67.8                               | (4.5)      | (8.7)                                | 2.6          | 57.2        |
| Charge/(credit) to income     | (4.1)                              | 2.4        | (0.1)                                | (7.6)        | (9.4)       |
| Charge to equity              | –                                  | –          | (1.6)                                | –            | (1.6)       |
| Acquisition of subsidiaries   | 0.3                                | (0.2)      | (0.1)                                | 0.1          | 0.1         |
| Exchange differences          | (2.0)                              | 2.5        | 1.4                                  | (2.7)        | (0.8)       |
| <b>At 31 December 2006</b>    | <b>62.0</b>                        | <b>0.2</b> | <b>(9.1)</b>                         | <b>(7.6)</b> | <b>45.5</b> |

Certain deferred tax assets and liabilities have been offset. The following is the analysis of the deferred tax balances (after offset) for financial reporting purposes:

|                          | 2006<br>£m  | 2005<br>£m  |
|--------------------------|-------------|-------------|
| Deferred tax liabilities | 68.7        | 79.9        |
| Deferred tax assets      | (23.2)      | (22.7)      |
|                          | <b>45.5</b> | <b>57.2</b> |

At the balance sheet date, the Group has unused tax losses of £17.2m (2005: £42.8m) available for offset against future profits. A deferred tax asset has been recognised in respect of £15.4m (2005: £37.5m) of such losses. No deferred tax asset has been recognised in respect of the remaining £1.8m (2005: £5.3m) of such losses. All losses may be carried forward indefinitely.

At the balance sheet date, the aggregate amount of undistributed earnings of subsidiaries for which deferred tax liabilities have not been recognised was £348.0m (2005: £290.7m). No liability has been recognised in respect of these differences because the Group is in a position to control the timing of the reversal of the temporary differences and it is probable that such differences will not reverse in the foreseeable future. Temporary differences arising in connection with interests in associates and joint ventures are insignificant.

## 21. Obligations under finance leases

|   | Minimum lease payments |            | Present value of minimum lease payments |            |
|---|------------------------|------------|---|------------|
|   | 2006<br>£m             | 2005<br>£m | 2006<br>£m                              | 2005<br>£m |
| <b>Amounts payable under finance leases:</b>                              |                        |            |   |            |
| Within one year   | 1.7                    | 1.7        | 1.4                                     | 1.4        |
| In the second to fifth years inclusive                                    | 3.1                    | 3.4        | 2.5                                     | 2.8        |
| After five years  | 0.8                    | 1.2        | 0.8                                     | 1.1        |
|   | <u>5.6</u>             | <u>6.3</u> | <u>4.7</u>                              | <u>5.3</u> |
| Less: future finance charges  | (0.9)                  | (1.0)      |   |            |
| Present value of lease obligations  | <u>4.7</u>             | <u>5.3</u> |   |            |
| <b>Analysed as:</b>   |                        |            |   |            |
| Amount due for settlement after 12 months                                 |                        |            | 3.3                                     | 3.9        |
| Amount due for settlement within 12 months (shown as current liabilities) |                        |            | 1.4                                     | 1.4        |
|   |                        |            | <u>4.7</u>                              | <u>5.3</u> |

The present value of minimum lease payments were denominated in the following currencies:

|              |            |            |
|--------------|------------|------------|
| Euro         | 1.7        | 2.4        |
| Sterling     | 0.9        | 0.9        |
| Danish Krone | 0.8        | 0.9        |
| US Dollar    | 0.7        | 0.9        |
| Other        | 0.6        | 0.2        |
|              | <u>4.7</u> | <u>5.3</u> |

It is the Group's policy to lease certain of its fixtures and equipment under finance leases. The average lease term is 5.2 years. For the year ended 31 December 2006, the average effective borrowing rate was 7.2% (2005: 5.4%). Interest rates are fixed at the contract date. All leases are on a fixed repayment basis and no arrangements have been entered into for contingent rental payments. The fair value of the Group's lease obligations approximates to their carrying amount. The Group's obligations under finance leases are secured by the lessors' rights over the leased assets.

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 22. Other financial liabilities

|  | 2006<br>£m   | 2005<br>£m  |
|--|--------------|-------------|
| <b>Trade and other payables</b>                      |              |             |
| <b>Amounts falling due within one year:</b>          |              |             |
| Trade creditors                                      | 43.7         | 33.4        |
| Other taxes and social security                      | 17.1         | 14.4        |
| Other creditors                                      | 8.8          | 12.7        |
| Accruals and deferred income                         | 41.5         | 36.7        |
|  | <u>111.1</u> | <u>97.2</u> |
| <b>Amounts falling due after more than one year:</b> |              |             |
| Other creditors                                      | 5.7          | 1.8         |

Trade creditors and accruals principally comprise amounts outstanding for trade purchases and ongoing costs. The average credit period taken for trade purchases is 69 days (2005: 59 days). The Directors consider that the carrying amount of trade payables approximates to their fair value.

#### 23. Provisions

|                                     | Restructuring<br>provision<br>£m | Environ-<br>mental<br>£m | Total<br>£m |
|-------------------------------------|----------------------------------|--------------------------|-------------|
| At 1 January 2006                   | 2.8                              | 5.4                      | 8.2         |
| Utilisation of provision            | (1.2)                            | –                        | (1.2)       |
| At 1 January 2005                   | 1.6                              | 5.4                      | 7.0         |
| Increase of provision               | 0.8                              | 2.2                      | 3.0         |
| Release of provision                | (0.3)                            | –                        | (0.3)       |
| Utilisation of provision            | (1.2)                            | (1.4)                    | (2.6)       |
| Exchange difference                 | (0.1)                            | (0.4)                    | (0.5)       |
| <b>At 31 December 2006</b>          | <u>0.8</u>                       | <u>5.8</u>               | <u>6.6</u>  |
| Included in current liabilities     |                                  |                          | 2.5         |
| Included in non-current liabilities |                                  |                          | 4.1         |
|                                     |                                  |                          | <u>6.6</u>  |

The restructuring provision relates to the remaining costs associated with the closure of various heat treatment and electroplating sites.

The Group provides for the costs of environmental remediation that have been identified, either as part of acquisition due diligence, or in other circumstances where remediation by the Group is required. This provision is reviewed annually.

Cash outflows in respect of these liabilities are expected to occur within five years.

## 24. Share capital

|   | 2006<br>£m  | 2005<br>£m |
|---|-------------|------------|
| Authorised 430,000,000 (2005: 430,000,000) ordinary shares of 10p each            | <b>43.0</b> | 43.0       |
| Issued and fully paid 322,168,062 (2005: 321,154,860) ordinary shares of 10p each | <b>32.2</b> | 32.1       |

The Company has one class of ordinary shares which carry no right to fixed income. Movements in share capital during the year relate to the exercise of share options.

## 25. Reserves

|  | Share<br>premium<br>£m | Own<br>shares<br>£m | Hedging and<br>translation<br>reserves<br>£m | Other<br>reserves<br>£m | Retained<br>earnings<br>£m | Total<br>£m  |
|--|------------------------|---------------------|--|-------------------------|----------------------------|--------------|
| At 1 January 2005  | 300.0                  | (0.8)               | 16.2   | 1.5                     | 72.0                       | 388.9        |
| Premium arising on issue of equity shares                  | 0.3                    | –                   | –  | –                       | –                          | 0.3          |
| Acquired in the year                                       | –                      | (1.7)               | –  | –                       | –                          | (1.7)        |
| Share based payments                                       | –                      | –                   | –  | 0.2                     | –                          | 0.2          |
| Exchange differences on translation of overseas operations | –                      | –                   | (5.1)  | –                       | –                          | (5.1)        |
| Dividends paid   | –                      | –                   | –  | –                       | (19.8)                     | (19.8)       |
| Net profit for the year                                    | –                      | –                   | –  | –                       | 40.7                       | 40.7         |
| Items taken directly to equity                             | –                      | –                   | –  | –                       | (3.5)                      | (3.5)        |
|  | <u>300.3</u>           | <u>(2.5)</u>        | <u>11.1</u>                                  | <u>1.7</u>              | <u>89.4</u>                | <u>400.0</u> |
| At 1 January 2006  | 300.3                  | (2.5)               | 11.1   | 1.7                     | 89.4                       | 400.0        |
| Premium arising on issue of equity shares                  | 1.8                    | –                   | –  | –                       | –                          | 1.8          |
| Settlement of share options                                | –                      | 0.1                 | –  | –                       | –                          | 0.1          |
| Share based payments                                       | –                      | –                   | –  | 2.1                     | –                          | 2.1          |
| Exchange differences on translation of overseas operations | –                      | –                   | (6.7)  | –                       | –                          | (6.7)        |
| Dividends paid   | –                      | –                   | –  | –                       | (21.0)                     | (21.0)       |
| Net profit for the year                                    | –                      | –                   | –  | –                       | 43.1                       | 43.1         |
| Items taken directly to equity                             | –                      | –                   | –  | –                       | (2.1)                      | (2.1)        |
|  | <u>302.1</u>           | <u>(2.4)</u>        | <u>4.4</u>                                   | <u>3.8</u>              | <u>109.4</u>               | <u>417.3</u> |
| <b>At 31 December 2006</b>                                 | <b>302.1</b>           | <b>(2.4)</b>        | <b>4.4</b>                                   | <b>3.8</b>              | <b>109.4</b>               | <b>417.3</b> |

The own shares reserve represents the cost of shares in Bodycote International plc purchased in the market and held by the Bodycote International Employee Benefit Trust to satisfy share-based payments under the Group's incentive schemes (see note 29).

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 26. Acquisition of subsidiaries

The Group acquired the following subsidiaries during the year:

| Interest  | Date of acquisition | Principal activity |
|---|---------------------|--------------------|
| Coalescence Limited                                 | 05 Jan 2006         | IS for Testing     |
| West Coast Analytical Services Inc                  | 31 Jan 2006         | Testing            |
| Norwest Soil Research Limited                       | 03 Feb 2006         | Testing            |
| Warrington Fire Research Group Ltd and subsidiaries | 25 Mar 2006         | Testing            |
| Saab Metech AB and subsidiaries                     | 26 Apr 2006         | Testing            |
| Ceramet Plasma Coatings Limited                     | 28 Apr 2006         | Plasma Coatings    |
| Norpath Laboratories Limited                        | 10 Jul 2006         | Testing            |
| ISTAS (60%)   | 18 Aug 2006         | Heat Treatments    |
| Foodsan Laboratories Limited                        | 31 Aug 2006         | Testing            |
| Prova (R&D) Limited                                 | 12 Sept 2006        | Testing            |
| Brasimet Comercio e Industria SA                    | 26 Oct 2006         | Heat Treatments    |
| MDA Berth Limited (trading as Consult-Us)           | 31 Oct 2006         | Testing            |

In addition the Group acquired the following businesses during the period:

| Interest  | Date of acquisition | Principal activity |
|---|---------------------|--------------------|
| SGB Härterei GmbH & Co KG                                     | 04 Jan 2006         | Heat Treatments    |
| Tetra-Labs Ltd  | 04 Jan 2006         | Testing            |
| ACT Laboratories Inc, Testing & Engineering Services Division | 20 Feb 2006         | Testing            |
| Stanger Environmental Analysis Ltd - Land and Water Division  | 05 Jun 2006         | Testing            |
| Staveley Services Materials Testing                           | 12 Dec 2006         | Testing            |

All transactions have been accounted for by the purchase method of accounting and are summarised below. The data for these acquisitions have been aggregated as they are considered individually immaterial to the Group's results and, save where stated, the Group acquired 100% of the issued share capital of these businesses.



**26. Acquisition of subsidiaries** continued

|   | Heat<br>Treatments<br>£m | Testing<br>£m | Total<br>Group<br>£m |
|---|--------------------------|---------------|----------------------|
| Book value and fair value of net assets acquired: |                          |               |                      |
| Intangible assets:                                |                          |               |                      |
| At book value                                     | 0.3                      | 0.1           | 0.4                  |
| Fair value adjustment                             | 3.9                      | 3.5           | 7.4                  |
| At fair value                                     | 4.2                      | 3.6           | 7.8                  |
| Property, plant and equipment                     | 8.2                      | 12.9          | 21.1                 |
| Inventories                                       | 0.4                      | 1.4           | 1.8                  |
| Trade and other receivables                       | 5.9                      | 12.4          | 18.3                 |
| Cash and cash equivalents                         | 0.8                      | 4.0           | 4.8                  |
| Trade and other payables                          | (5.5)                    | (8.5)         | (14.0)               |
| Current tax asset/(liability)                     | 0.6                      | (0.6)         | –                    |
| Bank loans  | (0.9)                    | (0.2)         | (1.1)                |
| Finance leases                                    | –                        | (0.8)         | (0.8)                |
| Deferred tax assets/(liabilities)                 | 0.1                      | (0.2)         | (0.1)                |
| Retirement benefit obligations                    | –                        | (0.4)         | (0.4)                |
|   | 13.8                     | 23.6          | 37.4                 |
| Minority interest                                 | (2.2)                    | –             | (2.2)                |
| Goodwill  | 9.6                      | 46.3          | 55.9                 |
| Total consideration                               | 21.2                     | 69.9          | 91.1                 |
| Satisfied by:                                     |                          |               |                      |
| Cash  | 20.1                     | 69.3          | 89.4                 |
| Directly attributable costs                       | 1.1                      | 0.6           | 1.7                  |
|   | 21.2                     | 69.9          | 91.1                 |
| Net cash outflow arising on acquisition:          |                          |               |                      |
| Cash consideration                                | 21.2                     | 69.9          | 91.1                 |
| Cash and cash equivalents acquired                | (0.8)                    | (4.0)         | (4.8)                |
|   | 20.4                     | 65.9          | 86.3                 |

The goodwill arising on the acquisitions is attributable to the anticipated profitability of the distribution of the Group's services and the anticipated future operating synergies from the combination. The acquired businesses contributed £48.3m revenue and £4.8m to the Group's profit before tax for the period between the date of acquisition and the balance sheet date. If the acquisition of all the businesses had been completed on the first day of the financial year, Group revenues for continuing operations for the year would have been £595.7m and Group profit attributable to equity holders of the parent would have been £45.7m.

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 27. Notes to the cash flow statement

|  | 2006<br>£m    | 2005<br>£m |
|--|---------------|------------|
| Operating profit   | <b>58.8</b>   | 61.0       |
| Share of associates' interest and tax                    | <b>0.6</b>    | 0.8        |
| Depreciation of property, plant and equipment            | <b>44.8</b>   | 40.5       |
| Amortisation/impairment of intangible assets             | <b>1.6</b>    | 0.9        |
| Impairment of goodwill                                   | <b>6.0</b>    | 5.8        |
| Impairment of investment in associate                    | <b>8.3</b>    | –          |
| Major facility closure costs                             | <b>5.0</b>    | –          |
| EBITDA*  | <b>125.1</b>  | 109.0      |
| Loss/(gain) on disposal of property, plant and equipment | <b>0.3</b>    | (0.6)      |
| Income from associates                                   | <b>(0.9)</b>  | (1.6)      |
| Share-based payments                                     | <b>2.1</b>    | 0.2        |
| Operating cash flows before movements in working capital | <b>126.6</b>  | 107.0      |
| Increase in inventories                                  | <b>(0.4)</b>  | (2.1)      |
| Increase in receivables                                  | <b>(15.5)</b> | (8.4)      |
| Increase in payables                                     | <b>9.5</b>    | 2.8        |
| (Decrease)/increase in provisions                        | <b>(2.6)</b>  | 4.7        |
| Cash generated by operations                             | <b>117.6</b>  | 104.0      |
| Income taxes paid  | <b>(8.4)</b>  | (8.3)      |
| Net cash from operating activities                       | <b>109.2</b>  | 95.7       |

\*Earnings before interest, tax, depreciation and amortisation.

Cash and cash equivalents (which are presented as a single class of assets on the face of the balance sheet) comprise cash at bank and other short-term highly liquid investments with a maturity of three months or less.

## 28. Operating lease arrangements - the Group as lessee

|   | 2006<br>£m  | 2005<br>£m |
|---|-------------|------------|
| Minimum lease payments under operating leases recognised in income for the year | <u>12.5</u> | <u>4.5</u> |

At the balance sheet date, the Group had outstanding commitments for future minimum lease payments under non-cancellable operating leases, which fall due as follows:

|  | 2006<br>£m  | 2005<br>£m  |
|--|-------------|-------------|
| Within one year                        | 11.9        | 6.2         |
| In the second to fifth years inclusive | 24.5        | 13.1        |
| After five years                       | 7.6         | 8.2         |
|  | <u>44.0</u> | <u>27.5</u> |

Operating lease payments represent rentals payable by the Group for certain of its land and buildings, fixtures and fittings and motor vehicles.

## 29. Share based payments - Equity-settled share option scheme

The company operates 3 share option schemes in relation to Group employees. Options are exercisable at the middle market closing price for the working day prior to the date of grant and are exercisable 3 years from the date of grant if stated performance criteria have been met. Options lapse if not exercised within ten years (7 years for the 1996 scheme) of the date of grant or if the participant leaves Group employment. Details of the share options outstanding at 31 December 2006 are as follows.

| Date of grant | Option price<br>in pence | Exercise<br>period | 2006             | No of options outstanding<br>2005 |
|---------------|--------------------------|--------------------|------------------|-----------------------------------|
| Dec-96        | 253.46                   | 1999-2006          | -                | 334,256                           |
| May-97        | 241.92                   | 2000-2007          | 434,398          | 655,278                           |
| Dec-97        | 315.43                   | 2000-2007          | 502,119          | 531,567                           |
| Jan-98        | 353.06                   | 2001-2008          | 187,121          | 227,222                           |
| May-98        | 475.92                   | 2001-2008          | 33,688           | 33,688                            |
| Oct-98        | 285.18                   | 2001-2008          | 233,137          | 257,200                           |
| Apr-99        | 370.26                   | 2002-2009          | 181,813          | 478,465                           |
| May-99        | 329.12                   | 2002-2009          | 16,042           | 16,042                            |
| Dec-99        | 292.19                   | 2002-2009          | 58,823           | 197,859                           |
| May-00        | 231.42                   | 2003-2010          | 726,117          | 952,191                           |
| Apr-01        | 203.37                   | 2004-2011          | 873,752          | 1,090,309                         |
| Apr-01        | 203.37                   | 2004-2008*         | 21,390           | 45,926                            |
| Sep-02        | 125.76                   | 2005-2012          | 555,729          | 808,210                           |
| Sep-02        | 125.76                   | 2005-2009*         | 31,231           | 90,158                            |
| Sep-03        | 147.27                   | 2006-2013          | 998,736          | 1,214,331                         |
|               |                          |                    | <u>4,854,096</u> | <u>6,932,702</u>                  |

Shares under option marked\* have been purchased in the market from previously issued share capital and are held by the trustees of the Bodycote International Employee Benefit Trust.

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 29. Share based payments - Equity-settled share option scheme continued

Movements in share options are summarised as follows:

|                                      | <b>2006</b>             | <b>2006</b>             | 2005             | 2005             |
|--------------------------------------|-------------------------|-------------------------|------------------|------------------|
|                                      | <b>Number of</b>        | <b>Weighted average</b> | Number of        | Weighted average |
|                                      | <b>share options</b>    | <b>exercise price</b>   | share options    | exercise price   |
|                                      |                         | <b>pence</b>            |                  | pence            |
| Outstanding at beginning of period   | <b>6,932,702</b>        | <b>226.00</b>           | 7,457,381        | 223.86           |
| Exercised during the period          | <b>(1,013,202)</b>      | <b>184.82</b>           | (186,094)        | 145.16           |
| Expired during the period            | <b>(1,065,404)</b>      | <b>292.37</b>           | (338,585)        | 210.46           |
| Outstanding at the end of the period | <b><u>4,854,096</u></b> | <b><u>219.98</u></b>    | <u>6,932,702</u> | <u>226.00</u>    |
| Exercisable at the end of the period | <b><u>4,854,096</u></b> | <b><u>219.98</u></b>    | <u>2,053,378</u> | <u>285.00</u>    |

The weighted average share price at the date of exercise for share options exercised during the period was 246.54 pence. The options outstanding at 31 December 2006 had a weighted average exercise price of 219.98 pence, and a weighted average remaining contractual life of 3.0 years.

The inputs into the Black-Scholes model are as follows:

|                                 |       | <b>2006</b>  | 2005  |
|---------------------------------|-------|--------------|-------|
| Weighted average share price    | pence | <b>157.5</b> | 157.5 |
| Weighted average exercise price | pence | <b>157.5</b> | 157.5 |
| Expected volatility             |       | <b>0.4</b>   | 0.4   |
| Expected life                   | years | <b>3.0</b>   | 3.0   |
| Risk-free rate                  | %     | <b>4.0</b>   | 4.0   |
| Expected dividends              | pence | <b>4.3</b>   | 4.3   |

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous 3 years. The expected life used in the model has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioural considerations.

The Group recognised total expenses of £2.1m and (2005: £0.2m) related to equity-settled share-based payment transactions.

### 30. Pension schemes

The Group operated a number of pension schemes during the year. The defined benefit obligation less fair value of assets at the end of the year and total expense recognised in the income statement are summarised as follows:

#### Defined benefit obligation less fair value of assets at the end of the year

|                  | Year ended<br>31 Dec 2006<br>£m | Year ended<br>31 Dec 2005<br>£m |
|------------------|---------------------------------|---------------------------------|
| UK Scheme        | 23.3                            | 21.8                            |
| American Schemes | 0.4                             | 1.0                             |
| European Schemes | 9.1                             | 7.1                             |
|                  | <u>32.8</u>                     | <u>29.9</u>                     |

#### Total expense recognised in income statement

|                  | Year ended<br>31 Dec 2006<br>£m | Year ended<br>31 Dec 2005<br>£m |
|------------------|---------------------------------|---------------------------------|
| UK Scheme        | 2.1                             | 2.0                             |
| American Schemes | 0.2                             | 0.2                             |
| European Schemes | 0.7                             | 0.3                             |
|                  | <u>3.0</u>                      | <u>2.5</u>                      |

#### UK Scheme

The company sponsors the Bodycote International UK Pension Scheme which is a funded defined benefit arrangement for UK employees. The last full actuarial valuation of this scheme was carried out by a qualified independent actuary as at 6 April 2005 and updated on an approximate basis to 31 December 2006.

The contributions made by the employer over the financial year have been £1.1m, equivalent to approximately 14% of pensionable pay plus a special contribution of £2.2m. This level of contribution has been reviewed following the triennial valuation of the scheme completed as at 6 April 2005 and it is expected that the deficit will be extinguished in no more than ten years.

It is the policy of the Group to recognise all actuarial gains and losses in the year in which they occur outside the profit and loss account and in the statement of recognised income and expense.

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 30. Pension schemes continued

##### Reconciliation of opening and closing balances of the present value of the defined benefit obligation

|   | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|---|---------------------------|---------------------------|
|   | £m                        | £m                        |
| Defined benefit obligation at start of year                     | 59.5                      | 50.7                      |
| Current service cost  | 1.5                       | 1.3                       |
| Interest cost   | 2.9                       | 2.7                       |
| Contributions by plan participants                              | 0.6                       | 0.5                       |
| Actuarial loss  | 3.8                       | 5.6                       |
| Benefits paid, death in service insurance premiums and expenses | <u>(1.1)</u>              | <u>(1.3)</u>              |
| Defined benefit obligation at end of year                       | <u>67.2</u>               | <u>59.5</u>               |

##### Reconciliation of opening and closing balances of the fair value of plan assets

|   | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|---|---------------------------|---------------------------|
|   | £m                        | £m                        |
| Fair value of assets at start of year                           | 37.7                      | 30.0                      |
| Expected return on assets                                       | 2.3                       | 2.0                       |
| Actuarial gains   | 0.7                       | 4.5                       |
| Contributions by employer                                       | 3.7                       | 2.0                       |
| Contributions by plan participants                              | 0.6                       | 0.5                       |
| Benefits paid, death in service insurance premiums and expenses | <u>(1.1)</u>              | <u>(1.3)</u>              |
| Fair value of assets at end of year                             | <u>43.9</u>               | <u>37.7</u>               |

##### Total expense recognised in the income statement

|  | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|--|---------------------------|---------------------------|
|  | £m                        | £m                        |
| Current service cost                     | 1.5                       | 1.3                       |
| Interest on pension scheme liabilities   | 2.9                       | 2.7                       |
| Expected return on pension scheme assets | <u>(2.3)</u>              | <u>(2.0)</u>              |
| Total expense                            | <u>2.1</u>                | <u>2.0</u>                |

The cumulative amount of actuarial losses recognised in the statement of recognised income and expenses since adoption of IAS 19 is £4.3m.

### 30. Pension schemes continued

#### Assets

|                             | <b>At 31 Dec 2006</b> | At 31 Dec 2005 | At 31 Dec 2004 |
|-----------------------------|-----------------------|----------------|----------------|
|                             | <b>£m</b>             | £m             | £m             |
| Equities                    | <b>28.1</b>           | 25.1           | 20.2           |
| Bonds                       | <b>9.6</b>            | 7.0            | 5.2            |
| Cash                        | <b>3.2</b>            | –              | –              |
| With profits insured policy | <b>3.0</b>            | 5.6            | 4.6            |
|                             | <b><u>43.9</u></b>    | <u>37.7</u>    | <u>30.0</u>    |

None of the fair values of the assets shown above include any of the Company's own financial instruments or any property occupied by, or other assets used by the Company.

#### Expected long-term rates of return

The expected long-term return on cash is equal to bank base rates at the balance sheet date. The expected return on bonds is determined by reference to UK long dated gilt and bond yields at the balance sheet date. The expected rate of return on equities and property have been determined by setting an appropriate risk premium above gilt/bond yields having regard to market conditions at the balance sheet date.

The expected long-term rates of return are as follows:

|                    | <b>At 31 Dec 2006</b> | At 31 Dec 2005 | At 31 Dec 2004 |
|--------------------|-----------------------|----------------|----------------|
|                    | <b>% per annum</b>    | % per annum    | % per annum    |
| Equities           | <b>7.5</b>            | 7.5            | 7.6            |
| Bonds              | <b>4.8</b>            | 4.3            | 4.5            |
| Insurance Policy   | <b>4.6</b>            | 4.1            | 4.5            |
| Cash               | <b>5.0</b>            | 4.5            | 4.75           |
| Overall for scheme | <b>6.3</b>            | 6.4            | 6.6            |

#### Actual return on plan assets

The actual return on the plan assets over the year ended 31 December 2006 was 8.0%.

#### Assumptions

|  | <b>2006</b>         | 2005        | 2004        |
|--|---------------------|-------------|-------------|
|  | <b>% per annum</b>  | % per annum | % per annum |
| Inflation  | <b>3.0</b>          | 3.0         | 3.0         |
| Salary increases   | <b>4.25</b>         | 4.25        | 4.25        |
| Rate of discount   | <b>5.0</b>          | 4.8         | 5.3         |
| Allowance for pension in payment increases of RPI or 5% p.a. if less     | <b>3.0</b>          | 3.0         | 3.0         |
| Allowance for revaluation of deferred pensions of RPI or 5% p.a. if less | <b>3.0</b>          | 3.0         | 3.0         |
| Mortality - current pensioners   |                     |             |             |
| Actuarial tables used  | <b>pa 92 YOB MC</b> | pa 92c 2010 |             |
| Life expectancy for members currently aged 65                            | <b>21.8</b>         | 19.0        |             |
| Mortality - future pensioners  |                     |             |             |
| Actuarial tables used  | <b>pa 92 YOB MC</b> | pa 92c 2010 |             |
| Life expectancy at age 65 for members currently aged 40                  | <b>23.2</b>         | 19.8        |             |

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 30. Pension schemes continued

##### Present values of defined benefit obligations, fair value of assets and deficit

|   | At 31 Dec 2006 | At 31 Dec 2005 | At 31 Dec 2004 |
|---|----------------|----------------|----------------|
|   | £m             | £m             | £m             |
| Present value of defined benefit obligation | (67.2)         | (59.5)         | (50.7)         |
| Fair value of plan assets                   | <u>43.9</u>    | <u>37.7</u>    | <u>30.0</u>    |
| Deficit in the scheme                       | <u>(23.3)</u>  | <u>(21.8)</u>  | <u>(20.7)</u>  |

As all actuarial gains and losses are recognised, the deficit shown above at 31 December 2006 is that recognised in the balance sheet.

The best estimate of contributions to be paid into the plan for the year ending 31 December 2007 is £3.3m.

##### Amounts for the current and previous four years

|  | 2006          | 2005          | 2004          | 2003          | 2002          |
|--|---------------|---------------|---------------|---------------|---------------|
|  | £m            | £m            | £m            | £m            | £m            |
| Fair value of assets   | 43.9          | 37.7          | 30.0          | 26.1          | 22.7          |
| Defined benefit obligation   | <u>(67.2)</u> | <u>(59.5)</u> | <u>(50.7)</u> | <u>(38.6)</u> | <u>(36.1)</u> |
| Deficit in the plan  | <u>(23.3)</u> | <u>(21.8)</u> | <u>(20.7)</u> | <u>(12.5)</u> | <u>(13.4)</u> |
| Experience adjustment on plan liabilities  | –             | 0.4           | 0.1           | 0.1           | (0.6)         |
| Experience adjustment on plan assets   | 0.7           | 4.5           | 0.9           | 2.4           | (6.4)         |
| Effects of changes in the demographic and financial assumptions underlying the present value of the plan liabilities | (3.8)         | (6.0)         | (9.4)         | (1.9)         | (2.0)         |

##### Combined American disclosures

The Group sponsors five defined benefit pension arrangements in the USA. These are Metallurgical Inc Pension Plan, Lakeside Heat Treating, Lansing (UAW), St Louis Hourly and the Supplemental Retirement Plan. The last full actuarial valuation of these schemes was carried out by a qualified independent actuary as at 1 January 2004 (1 September 2004 for the Metallurgical Plan) and updated on an approximate basis to 31 December 2006. The contributions made by the employer over the financial year were \$0.2m. The Group also operates a defined benefits scheme, acquired on 26 October 2006, for 3 employees in Brazil.

##### Reconciliation of opening and closing balances of the present value of the defined benefit obligation

|   | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|---|---------------------------|---------------------------|
|   | £m                        | £m                        |
| Defined benefit obligation at start of year                     | 2.9                       | 2.6                       |
| Current service cost  | 0.1                       | 0.1                       |
| Interest cost   | 0.2                       | 0.2                       |
| Actuarial gain  | (0.3)                     | –                         |
| Acquisition   | 0.2                       | –                         |
| Benefits paid, death in service insurance premiums and expenses | (0.2)                     | (0.2)                     |
| Exchange rate gain  | <u>(0.3)</u>              | <u>0.2</u>                |
| Defined benefit obligation at end of year                       | <u>2.6</u>                | <u>2.9</u>                |



### 30. Pension schemes continued

#### Reconciliation of opening and closing balances of the fair value of plan assets

|   | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|---|---------------------------|---------------------------|
|   | £m                        | £m                        |
| Fair value of assets at start of year                           | 1.9                       | 1.7                       |
| Expected return on assets                                       | 0.1                       | 0.1                       |
| Actuarial gains   | 0.3                       | –                         |
| Contributions by employer                                       | 0.2                       | 0.1                       |
| Benefits paid, death in service insurance premiums and expenses | (0.2)                     | (0.2)                     |
| Acquisition   | 0.2                       | –                         |
| Exchange rate (loss)/gain                                       | (0.3)                     | 0.2                       |
|   | <u>2.2</u>                | <u>1.9</u>                |

#### Total expense recognised in the income statement

|  | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|--|---------------------------|---------------------------|
|  | £m                        | £m                        |
| Current service cost                     | 0.1                       | 0.1                       |
| Interest on pension scheme liabilities   | 0.2                       | 0.2                       |
| Expected return on pension scheme assets | (0.1)                     | (0.1)                     |
|  | <u>0.2</u>                | <u>0.2</u>                |

The cumulative amount of actuarial gains and (losses) recognised in the statement of recognised income and expenses since adoption of IAS 19 is £0.6m.

#### Assets

|                     | At 31 Dec 2006 | At 31 Dec 2005 | At 31 Dec 2004 |
|---------------------|----------------|----------------|----------------|
|                     | £m             | £m             | £m             |
| Equities            | 1.3            | 1.2            | 0.9            |
| Bonds               | 0.3            | 0.5            | 0.4            |
| Cash                | 0.3            | 0.2            | 0.4            |
| Insurance contracts | 0.3            | –              | –              |
|                     | <u>2.2</u>     | <u>1.9</u>     | <u>1.7</u>     |

None of the fair values of the assets shown above include any of the Company's own financial instruments or any property occupied by, or other assets used by, the Company.

#### Expected long-term rates of return

The expected long-term return on cash and bonds is equal to an expected real rate of return of 2.5%. The expected rate of return on equities is a weighted average of 8.5% real return on US large caps, 9.5% real return on US small caps, 8.5% real return on international, and 10.5% real returns on emerging markets. These returns were then adjusted to reflect a rebalancing/diversification adjustment and an active management adjustment. The expected rate of return on insurance contracts has been calculated based on 10.24% per annum in line with the expected return on the policies held in Brazil.

## Notes to the Consolidated Financial Statements

### Year ended 31 December 2006

#### 30. Pension schemes continued

The expected long-term rates of return are as follows:

|                    | <b>At 31 Dec 2006</b><br>% per annum | At 31 Dec 2005<br>% per annum | At 31 Dec 2004<br>% per annum |
|--------------------|--------------------------------------|-------------------------------|-------------------------------|
| Equities           | <b>9.1</b>                           | 7.0                           | 7.0                           |
| Bonds              | <b>5.0</b>                           | 5.0                           | 5.0                           |
| Cash               | <b>5.0</b>                           | 2.25                          | 2.25                          |
| Insurance policy   | <b>10.2</b>                          | –                             | –                             |
| Overall for scheme | <b>8.1</b>                           | 5.9                           | 5.5                           |

#### Actual return on plan assets

The actual return on the plan assets over the year ending 31 December 2006 was 16%.

#### Assumptions

|                  | <b>USA</b><br>At 31 Dec 2006<br>% per annum | <b>Brazil</b><br>At 31 Dec 2006<br>% per annum |
|------------------|---|--|
| Salary increases | –   | <b>6.08</b>                                    |
| Rate of discount | <b>6.0</b>                                  | <b>10.24</b>                                   |
| Price inflation  | <b>2.5</b>                                  | <b>4.00</b>                                    |

#### Present values of defined benefit obligations, fair value of assets and deficit

|                            | <b>At 31 Dec 2006</b><br>£m | At 31 Dec 2005<br>£m | At 31 Dec 2004<br>£m |
|----------------------------|-----------------------------|----------------------|----------------------|
| Defined benefit obligation | <b>(2.6)</b>                | (2.9)                | (2.6)                |
| Fair value of plan assets  | <b>2.2</b>                  | 1.9                  | 1.7                  |
| Deficit in scheme          | <b>(0.4)</b>                | (1.0)                | (0.9)                |

As all actuarial gains and losses are recognised, the deficit shown above at 31 December 2006 is that recognised in the balance sheet.

The best estimate of contributions to be paid into the plan for the year ending 31 December 2007 is £0.2m.

#### Amounts for the current and previous four years

|  | <b>2006</b><br>£m | 2005<br>£m | 2004<br>£m | 2003<br>£m | 2002<br>£m |
|--|-------------------|------------|------------|------------|------------|
| Fair value of assets   | <b>2.2</b>        | 1.9        | 1.7        | 1.8        | 12.9       |
| Defined benefit obligation   | <b>(2.6)</b>      | (2.9)      | (2.6)      | (3.0)      | (16.0)     |
| Deficit in plan  | <b>(0.4)</b>      | (1.0)      | (0.9)      | (1.2)      | (3.1)      |
| Experience adjustment on plan liabilities  | –                 | –          | 0.2        | (0.1)      | –          |
| Experience adjustment on plan assets   | <b>0.3</b>        | –          | 0.1        | 0.1        | (0.3)      |
| Effects of changes in the demographic and financial assumptions underlying the present value of the plan liabilities | <b>0.3</b>        | –          | –          | –          | (2.5)      |

As all actuarial gains and losses are recognised, the deficit shown above at 31 December 2006 is that recognised in the balance sheet.

### 30. Pension schemes continued

#### Continental European Schemes

The Group operates schemes for employees in France, Germany and Sweden. With the exception of the scheme for Bodycote Metech AB all schemes are unfunded.

#### Reconciliation of opening and closing balances of the present value of the defined benefit obligation

|   | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|---|---------------------------|---------------------------|
|   | £m                        | £m                        |
| Defined benefit obligation at start of year | 7.1                       | 5.3                       |
| Current service cost                        | 0.3                       | 0.1                       |
| Interest cost                               | 0.4                       | 0.2                       |
| Actuarial loss (gain)                       | 1.2                       | 1.6                       |
| Benefits paid                               | (0.2)                     | (0.1)                     |
| Acquisition                                 | 1.9                       | –                         |
| Exchange rate gain                          | (0.1)                     | –                         |
| Defined benefit obligation at end of year   | <u>10.6</u>               | <u>7.1</u>                |

#### Reconciliation of opening and closing balances of the fair value of plan assets

|                                       |            |          |
|---------------------------------------|------------|----------|
| Fair value of assets at start of year | –          | –        |
| Acquisition                           | 1.5        | –        |
| Fair value of assets at end of year   | <u>1.5</u> | <u>–</u> |

#### Total expense recognised in the income statement

|  | Year ended<br>31 Dec 2006 | Year ended<br>31 Dec 2005 |
|--|---------------------------|---------------------------|
|  | £m                        | £m                        |
| Current service cost                   | 0.3                       | 0.1                       |
| Interest on pension scheme liabilities | 0.4                       | 0.2                       |
| Expected return on plan assets         | –                         | –                         |
| Total expense                          | <u>0.7</u>                | <u>0.3</u>                |

The cumulative amount of actuarial losses recognised in the statement of recognised income and expenses since adoption of IAS 19 is £0.2m. All assets are held in an insured contract. The expected long-term return of this contract is 2.0% per annum.

#### Assumptions

|                    | France<br>At 31 Dec 2006<br>% per annum | Germany<br>At 31 Dec 2006<br>% per annum | Sweden<br>At 31 Dec 2006<br>% per annum |
|--------------------|---|--|---|
| Salary increases   | –                                       | 2.5                                      | 3.0                                     |
| Rate of discount   | 4.5                                     | 4.5                                      | 4.0                                     |
| Price inflation    | 2.0                                     | –  | 2.0                                     |
| Pensions increases | –                                       | 1.75                                     | –                                       |

## Notes to the Consolidated Financial Statements

Year ended 31 December 2006

### 30. Pension schemes continued

#### Present values of defined benefit obligations, fair value of assets and deficit

|   | At 31 Dec 2006 | At 31 Dec 2005 | At 31 Dec 2004 |
|---|----------------|----------------|----------------|
|   | £m             | £m             | £m             |
| Defined benefit obligation                    | (10.6)         | (7.1)          | (5.3)          |
| Fair value of plan assets                     | <u>1.5</u>     | <u>–</u>       | <u>–</u>       |
| Deficit in scheme                             | <u>(9.1)</u>   | <u>(7.1)</u>   | <u>(5.3)</u>   |
| Experience gains/(losses) on plan liabilities | 0.6            | (1.6)          | 0.1            |
| Gain on acquisition                           | 0.4            | –              | –              |

As all actuarial gains and losses are recognised, the deficit shown above at 31 December 2006 is that recognised in the balance sheet.

As the scheme is unfunded the best estimate of contributions to be paid into the plans for the year ending 31 December 2007 are nil.

#### Note on plan assets

There are assets held in trust for pension purposes within Bodycote Metech AB (acquired on 26 April 2006). The opening and closing balances 2006 for these assets, £1.5m in each case, is reflected in the balance sheet above.

### 31. Related party transactions

Transactions between the Company and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note. Transactions between the Group and its associates are disclosed below. Transactions between the Company and its subsidiaries and associates are disclosed in the Company's separate financial statements.

#### Trading transactions

During the year, group companies entered into the following transactions with related parties who are not members of the Group:

|            | Sale of goods and services |            | Purchase of goods and services |            | Amounts owed by related parties |            | Amounts owed to related parties |            |
|------------|----------------------------|------------|--------------------------------|------------|---------------------------------|------------|---------------------------------|------------|
|            | 2006                       | 2005       | 2006                           | 2005       | 2006                            | 2005       | 2006                            | 2005       |
|            | £m                         | £m         | £m                             | £m         | £m                              | £m         | £m                              | £m         |
| Associates | <u>2.1</u>                 | <u>3.6</u> | <u>0.7</u>                     | <u>0.2</u> | <u>9.3</u>                      | <u>5.7</u> | <u>0.7</u>                      | <u>0.2</u> |

Sales of goods and services include the sale of property, payments received from finance leases (see note 16) and the provision of management services. All transactions were made at arms length.

The amounts outstanding are unsecured and will be settled in cash. No guarantees have been given or received. No provisions have been made for doubtful debts in respect of the amounts owed by related parties.

### 32. Contingent liabilities

Under the terms of the transfer of the Group's assets into the SSCP Coating ("SSCP") associated undertaking, SSCP has a commitment to purchase equipment from a third party supplier in 2006 to the value of €1.4m (£0.9m). If SSCP does not meet this commitment, Bodycote International plc is required to reimburse the supplier at a rate of 35% of any shortfall resulting in a maximum contingent liability of €0.5m (£0.3m).

### 33. Events after the balance sheet date

After the year end the Group purchased Techmeta SA, a French electron beam welding business for a cash consideration of €7.2m (£5.0m).

|  | <b>IFRS<br/>2006<br/>£m</b> | IFRS<br>2005<br>£m | IFRS<br>2004<br>£m | UK GAAP<br>2003<br>£m | UK GAAP<br>2002<br>£m |
|--|-----------------------------|--------------------|--------------------|-----------------------|-----------------------|
| <b>Revenue</b>   |                             |                    |                    |                       |                       |
| Existing operations  | <b>558.6</b>                | 470.9              | 426.4              | 435.7                 | 429.5                 |
| Discontinued operations  | –                           | 1.5                | 30.8               | 12.7                  | 10.6                  |
| <b>Revenue - continuing and discontinued operations</b>  | <b>558.6</b>                | <b>472.4</b>       | <b>457.2</b>       | <b>448.4</b>          | <b>440.1</b>          |
| <b>Profit/(losses) for continuing and discontinued operations:</b>                                   |                             |                    |                    |                       |                       |
| Headline operating profit  | <b>79.7</b>                 | 67.8               | 53.1               | 41.7                  | 49.4                  |
| Share of results of associates: Interest and tax   | <b>(0.6)</b>                | (0.8)              | –                  | –                     | –                     |
| Loss/(gain) on disposal of tangible and intangible fixed assets                                      | <b>0.3</b>                  | (0.6)              | 0.5                | –                     | –                     |
| Amortisation and impairment of goodwill and intangibles  | <b>(7.0)</b>                | (6.0)              | –                  | (9.1)                 | (8.7)                 |
| Impairment of investment in associate  | <b>(8.3)</b>                | –                  | –                  | –                     | –                     |
| Major facility closure costs   | <b>(5.0)</b>                | –                  | –                  | –                     | –                     |
| Operating exceptional items  | –                           | –                  | –                  | (7.5)                 | (18.3)                |
| <b>Operating profit before restructuring and disposals of operations and fixed assets</b>            | <b>59.1</b>                 | 60.4               | 53.6               | 25.1                  | 22.4                  |
| (Loss)/profit on disposal of operations  | –                           | –                  | (3.8)              | 3.5                   | –                     |
| Restructuring costs  | –                           | –                  | (7.4)              | (30.0)                | –                     |
| Loss/(gain) on disposal of fixed assets  | <b>(0.3)</b>                | 0.6                | (0.5)              | –                     | –                     |
| <b>Profit/(loss) before interest and tax</b>   | <b>58.8</b>                 | 61.0               | 41.9               | (1.4)                 | 22.4                  |
| Net interest payable   | <b>(12.2)</b>               | (8.3)              | (8.8)              | (9.7)                 | (11.2)                |
| <b>Profit/(loss) before taxation</b>   | <b>46.6</b>                 | 52.7               | 33.1               | (11.1)                | 11.2                  |
| Taxation   | <b>(2.7)</b>                | (11.8)             | (4.6)              | (6.2)                 | (4.8)                 |
| <b>Profit/(loss) after taxation</b>  | <b>43.9</b>                 | 40.9               | 28.5               | (17.3)                | 6.4                   |
| Minority interests   | <b>(0.8)</b>                | (0.2)              | (0.2)              | (0.1)                 | (0.1)                 |
| <b>Profit/(loss) attributable to the equity holders of the parent</b>                                | <b>43.1</b>                 | 40.7               | 28.3               | (17.4)                | 6.3                   |
| <b>Headline earnings per share (pence)</b>   | <b>17.3</b>                 | 14.6               | 11.7               | 9.1                   | 9.9                   |
| <b>Dividends per share (pence)</b>   | <b>7.0</b>                  | 6.4                | 6.1                | 5.7                   | 5.7                   |
| <b>Assets employed</b>   |                             |                    |                    |                       |                       |
| Intangible fixed assets  | <b>212.3</b>                | 157.9              | 141.1              | 137.5                 | 155.5                 |
| Tangible fixed assets  | <b>448.4</b>                | 442.9              | 425.9              | 478.7                 | 498.4                 |
| Other current assets and liabilities   | <b>(45.9)</b>               | (58.7)             | (54.7)             | (34.1)                | (30.3)                |
|  | <b>614.8</b>                | <b>542.1</b>       | <b>512.3</b>       | <b>582.1</b>          | <b>623.6</b>          |
| <b>Financed by</b>   |                             |                    |                    |                       |                       |
| Share capital  | <b>32.2</b>                 | 32.1               | 32.1               | 25.7                  | 25.6                  |
| Reserves   | <b>417.3</b>                | 400.0              | 388.9              | 345.2                 | 363.6                 |
| <b>Shareholders' funds</b>   | <b>449.5</b>                | 432.1              | 421.0              | 370.9                 | 389.2                 |
| Minority interests   | <b>4.4</b>                  | 1.4                | 1.0                | 0.9                   | 0.2                   |
| Net borrowings   | <b>160.9</b>                | 108.6              | 90.3               | 210.3                 | 234.2                 |
|  | <b>614.8</b>                | <b>542.1</b>       | <b>512.3</b>       | <b>582.1</b>          | <b>623.6</b>          |
| <b>Net assets per share (pence)</b>  | <b>139.5</b>                | 134.5              | 131.2              | 144.5                 | 151.8                 |
| <b>Return on capital employed:</b>   |                             |                    |                    |                       |                       |
| Headline operating profit before amortisation of acquired intangibles and impairment of goodwill (%) | <b>13.8</b>                 | 12.9               | 9.7                | 6.9                   | 7.9                   |
| Profit before interest and tax (%)   | <b>10.2</b>                 | 11.6               | 7.7                | (0.2)                 | 3.6                   |
| <b>Return on capital employed (including cumulative goodwill written back to reserves):</b>          |                             |                    |                    |                       |                       |
| Headline operating profit before amortisation of acquired intangibles and impairment of goodwill (%) | <b>10.8</b>                 | 9.9                | 7.6                | 5.5                   | 6.4                   |

## Company Balance Sheet

as at 31 December 2006

|  | 2006<br>£m     | 2005<br>£m     | Note |
|--|----------------|----------------|------|
| <b>Fixed assets</b>                          |                |                |      |
| Tangible fixed assets                        | 0.6            | 0.7            | 2    |
| Investments                                  | <u>849.4</u>   | <u>680.3</u>   | 3    |
|  | <u>850.0</u>   | <u>681.0</u>   |      |
| <b>Current assets</b>                        |                |                |      |
| Debtors                                      | 27.2           | 15.9           | 4    |
| Cash at bank and in hand                     | <u>0.1</u>     | <u>47.1</u>    |      |
|  | <u>27.3</u>    | <u>63.0</u>    |      |
| <b>Creditors</b>                             |                |                |      |
| Amounts falling due within one year          | <u>(18.7)</u>  | <u>(20.7)</u>  | 5    |
| <b>Net current assets</b>                    | <u>8.6</u>     | <u>42.3</u>    |      |
| <br>   |                |                |      |
| Total assets less current liabilities        | <u>858.6</u>   | <u>723.3</u>   |      |
| <br>   |                |                |      |
| <b>Non-current liabilities</b>               |                |                |      |
| <b>Creditors</b>                             |                |                |      |
| Amounts falling due after more than one year | <u>(473.5)</u> | <u>(376.6)</u> | 5    |
| <b>Net assets</b>                            | <u>385.1</u>   | <u>346.7</u>   |      |
| <br>   |                |                |      |
| <b>Capital and reserves</b>                  |                |                |      |
| Called-up share capital                      | 32.2           | 32.1           | 7    |
| Share premium account                        | 302.1          | 300.3          | 7    |
| Currency and other reserves                  | 4.5            | –              | 7    |
| Profit and loss account                      | <u>46.3</u>    | <u>14.3</u>    | 7    |
| <b>Equity shareholders' funds</b>            | <u>385.1</u>   | <u>346.7</u>   |      |

Approved by the Board of Directors on 27 February 2007 and signed on its behalf by:

J. D. Hubbard }  
D. F. Landless } Directors




*The accompanying notes and statement of accounting policies are an integral part of these financial statements.*

## Independent auditors' report to the members of Bodycote International plc

We have audited the parent company financial statements of Bodycote International plc for the year ended 31 December 2006, which comprise the Balance Sheet and the related notes 1 to 10. These parent company financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the group financial statements of Bodycote International plc for the year ended 31 December 2006 and on 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 in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body for our audit work, for this report, or for the opinions we have formed.

### RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The directors' responsibilities for preparing the Annual Report, the Board Report on Remuneration and the parent company 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 parent company financial statements and the part of the Board Report on Remuneration to be audited 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 parent company financial statements give a true and fair view and whether the parent company financial statements have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the Directors' Report is consistent with the parent company financial statements. The information given in the Directors' Report specifically includes the information presented in the Group Business Review.

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

### BASIS OF AUDIT OPINION

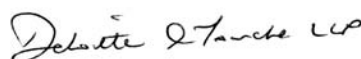
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the parent company financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the parent company 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 parent company 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 parent company financial statements.

### OPINION

In our opinion:

- the parent company 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;
- the parent company financial have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the parent company financial statements.



### Deloitte & Touche LLP

Chartered Accountants and  
Registered Auditors

Manchester  
27 February 2007

## Accounting Policies

### ACCOUNTING CONVENTION

The financial statements have been prepared under the historical cost convention and in accordance with applicable United Kingdom accounting standards. The accounting policies have been applied consistently throughout the year and the preceding year in dealing with items that are considered material in relation to the Company's financial statements.

In accordance with Section 230 of the Companies Act 1985 a separate profit and loss account dealing with the results of the Company has not been presented.

### INVESTMENTS

Investments are held at cost less provision for impairment.

### STOCK

Stock is valued at the lower of cost and net realisable value. In the case of manufactured products, cost includes the attributable proportion of manufacturing overhead costs. Net realisable value comprises the estimated selling price less all further costs to completion and all costs to be incurred in selling and distribution.

### PENSION COSTS

For defined benefit schemes, the amount charged to the profit and loss account in respect of pension costs is the contributions payable in the year.

### LEASES

Assets held under finance leases and other similar contracts, which confer rights and obligations similar to those attached to owned assets, are capitalised as tangible fixed assets and are depreciated over the shorter of the lease terms and their useful lives. The capital elements of future lease obligations are recorded as liabilities, while the interest elements are charged to the profit and loss account over the period of the lease to produce a constant rate of charge on the balance of capital repayments outstanding. Hire purchase transactions are dealt with similarly, except that assets are depreciated over their useful lives. Rental costs under operating leases are charged to the profit and loss account over the period of the lease.

### THE COMPANY AS LESSOR

Amounts due from lessees under finance leases are recorded as receivables at the amount of the Company's net investment in the leases. Finance lease income is allocated to accounting periods so as to reflect a constant periodic rate of return on the Company's net investment outstanding in respect of the leases.

### TANGIBLE FIXED ASSETS

Tangible fixed assets are stated at cost or valuation. Depreciation is provided on a straight line basis, to reduce the carrying value to the estimated residual value at the point of sale, at the following annual rates:

|                       |                              |
|-----------------------|------------------------------|
| Land                  | nil                          |
| Fixtures and fittings | 10% to 20%                   |
| Plant and machinery   | 5% to 20%                    |
| Leasehold property    | over the period of the lease |
| Buildings             | 2%                           |
| Motor vehicles        | 20% to 33%                   |

Residual value is calculated on prices prevailing at the date of acquisition.

### TAXATION

Current UK corporation tax and foreign tax is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more tax in the future or a right to pay less tax in the future have occurred at the balance sheet date. Timing differences are differences between the Company's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the financial statements.

A net deferred tax asset is regarded as recoverable and therefore recognised only when, on the basis of all available evidence, it can be regarded as more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

Deferred tax is recognised in respect of the retained earnings of overseas subsidiaries only to the extent that, at the balance sheet date, dividends have been accrued as receivable or a binding agreement to distribute past earnings in future has been entered into by the subsidiary.

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax is measured on a discounted basis to reflect the time value of money over the period between the balance sheet date and the dates on which it is estimated that the underlying timing differences will reverse. The discount rates used reflect the post-tax yields to maturity that can be obtained on government bonds with similar maturity dates and currencies to those of the deferred tax assets or liabilities.

### DEBT

Debt is initially stated at the amount of the net proceeds after deduction of issue costs. The carrying amount is increased by the finance cost in respect of the accounting period and reduced by payments made in the period. Finance costs of debt are recognised in the profit and loss account over the term of such instruments at a constant rate on the carrying amount.

### DERIVATIVE FINANCIAL INSTRUMENTS

The Company may enter into derivative financial instruments, in particular interest rate swaps, foreign currency swaps and forward exchange contracts to manage the financial risks arising from the business activities and the financing of the group's activities. The Company does not use derivative financial instruments for speculative purposes.

The use of financial derivatives is governed by group policies approved by the board of directors, which provide written principles on the use of financial derivatives.

Derivative financial instruments are recognised as assets or liabilities measured at their fair value on the balance sheet date. Changes in the fair value of any derivative instruments that do not fulfil the criteria for hedge accounting contained in FRS 26 are recognised immediately in the income statement.



## **HEDGE ACCOUNTING**

The Company maintains documentation of the relationship between the hedged item and the hedging instrument at the inception of a hedging transaction together with the risk management objective and the strategy underlying the designated hedge. The Company also documents its assessment, both at the inception of the hedging relationship and subsequently on an ongoing basis, of the effectiveness of the hedge in offsetting movements in the fair values or cash flows of the hedged items.

When hedge accounting is used, the relevant hedging relationships are classified as fair value hedges or cash flow hedges:

### **Fair Value Hedge**

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

### **Cash Flow Hedge**

Cash flow hedging matched the cash flows of hedged items against the corresponding cash flow of the derivative. The effective part of any gain or loss on the derivative is recognised directly in equity and the hedged item is accounted for in accordance with the policy for that financial instrument. Any ineffective part of any gain or loss is recognised immediately in the income statement.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, or exercised, or no longer qualifies for hedge accounting. At that time, any cumulative gain or loss on the hedging instrument recognised in equity is retained in equity until the forecasted transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to net profit or loss for the period.

## Notes to the Company Financial Statements

### 1. Profit for the year

As permitted by section 230 of the Companies Act 1985 the Company has elected not to present its own profit and loss account for the year. Bodycote International plc reported a profit for the financial year ended 31 December 2006 of £53.0m (2005: loss £9.2m).

The auditors' remuneration for audit services to the Company was £0.1m (2005: £0.1m).

Total employee costs (including Executive Directors) were:

|                       | <b>2006</b>       | 2005       |
|-----------------------|-------------------|------------|
|                       | <b>£m</b>         | £m         |
| Wages and salaries    | <b>4.5</b>        | 2.3        |
| Social security costs | <b>0.4</b>        | 0.2        |
| Other pension costs   | <b>0.2</b>        | 0.2        |
|                       | <b><u>5.1</u></b> | <u>2.7</u> |

### 2. Tangible Fixed Assets

|                       | Fixtures<br>and fittings<br>£m |
|-----------------------|--------------------------------|
| <b>Cost</b>           |                                |
| At 1 January 2006     | 1.0                            |
| Additions             | 0.3                            |
| Disposals             | (0.3)                          |
| At 31 December 2006   | <u>1.0</u>                     |
| <b>Depreciation</b>   |                                |
| At 1 January 2006     | 0.3                            |
| Charge for the year   | 0.1                            |
| Disposals             | -                              |
| At 31 December 2006   | <u>0.4</u>                     |
| <b>Net book value</b> |                                |
| At 31 December 2006   | <u>0.6</u>                     |
| At 31 December 2005   | <u>0.7</u>                     |

### 3. Investments

|                           | Shares<br>£m | Shares in<br>associates<br>£m | Loans<br>£m  | Total<br>£m  |
|---------------------------|--------------|-------------------------------|--------------|--------------|
| <b>Cost</b>               |              |                               |              |              |
| 1 January 2006            | 397.5        | 7.3                           | 283.7        | 688.5        |
| Acquisitions and advances | 3.5          | –                             | 439.4        | 442.9        |
| Disposals and repayments  | –            | –                             | (244.9)      | (244.9)      |
| Currency adjustments      | –            | –                             | (21.2)       | (21.2)       |
| At 31 December 2006       | <u>401.0</u> | <u>7.3</u>                    | <u>457.0</u> | <u>865.3</u> |
| <b>Provision</b>          |              |                               |              |              |
| 1 January 2006            | 8.2          | –                             | –            | 8.2          |
| Provision in the year     | 0.4          | 7.3                           | –            | 7.7          |
| At 31 December 2006       | <u>8.6</u>   | <u>7.3</u>                    | <u>–</u>     | <u>15.9</u>  |
| <b>Net book value</b>     |              |                               |              |              |
| At 31 December 2006       | <u>392.4</u> | <u>–</u>                      | <u>457.0</u> | <u>849.4</u> |
| At 31 December 2005       | <u>389.3</u> | <u>7.3</u>                    | <u>283.7</u> | <u>680.3</u> |

Shares in associates comprise:

| Name of company                    | Nature of<br>business  | Country of<br>incorporation | % Holding of<br>ordinary shares |
|------------------------------------|------------------------|-----------------------------|---------------------------------|
| Traitement Compression Services SA | Hot Isostatic Pressing | France                      | 49                              |
| SSCP Coating S.à.r.l.              | PVD Coatings           | Luxembourg                  | 24                              |
| Bio Vision Research Limited        | Testing                | Canada                      | 45                              |
| Pacific Rim Laboratories Inc       | Testing                | Canada                      | 30                              |

### 4. Debtors

|  | 2006<br>£m  | 2005<br>£m  |
|--|-------------|-------------|
| <b>Amounts falling due within one year:</b>          |             |             |
| Amounts owed by subsidiary undertakings              | 10.4        | 4.4         |
| Corporation tax recoverable                          | 2.6         | 4.5         |
| Deferred taxation                                    | 1.2         | 0.4         |
| Finance lease receivables                            | 0.4         | 0.3         |
| Derivative financial instruments                     | 1.9         | –           |
| Other debtors and prepayments                        | 2.8         | 2.7         |
|  | <u>19.3</u> | <u>12.3</u> |
| <b>Amounts falling due after more than one year:</b> |             |             |
| Finance lease receivables                            | 1.5         | 1.9         |
| Derivative financial instruments                     | 0.6         | –           |
| Other debtors  | 5.8         | 1.7         |
|  | <u>7.9</u>  | <u>3.6</u>  |
|  | <u>27.2</u> | <u>15.9</u> |

## Notes to the Company Financial Statements

### 5. Creditors

|  | 2006<br>£m   | 2005<br>£m   |
|--|--------------|--------------|
| <b>Amounts falling due within one year:</b>          |              |              |
| Bank loans   | 2.0          | –            |
| Bank overdrafts                                      | 5.0          | 8.3          |
| Trade creditors                                      | 1.1          | 0.5          |
| Amounts owed to subsidiary undertakings              | 0.5          | 3.1          |
| Proposed dividends                                   | 8.0          | 7.5          |
| Other taxes and social security                      | 0.2          | 0.1          |
| Derivative financial instruments                     | 0.2          | –            |
| Other creditors                                      | 0.7          | 0.6          |
| Accruals and deferred income                         | 1.0          | 0.6          |
|  | <b>18.7</b>  | <b>20.7</b>  |
| <b>Amounts falling due after more than one year:</b> |              |              |
| Bank loans   | 183.4        | 216.6        |
| Amounts owed to subsidiary undertakings              | 289.8        | 160.0        |
| Derivative financial instruments                     | 0.1          | –            |
| Other creditors                                      | 0.2          | –            |
|  | <b>473.5</b> | <b>376.6</b> |
| <b>Bank loans are repayable:</b>                     |              |              |
| After 5 years  | 43.1         | –            |
| Between 2 and 5 years                                | 140.3        | 216.6        |
| Between 1 and 2 years                                | –            | –            |
|  | <b>183.4</b> | <b>216.6</b> |
| On demand or within 12 months                        | 2.0          | –            |
|  | <b>185.4</b> | <b>216.6</b> |

The Company's principal loans are secured by upstream guarantees from principal subsidiaries.

### 6. Deferred Taxation

|   | Deferred tax<br>£m |                    |
|---|--------------------|--------------------|
| At 1 January 2006                                 |                    | 0.4                |
| Profit and loss credit                            |                    | 0.8                |
| <b>At 31 December 2006</b>                        |                    | <b>1.2</b>         |
| <b>Deferred tax</b>                               |                    |                    |
|   | <b>2006<br/>£m</b> | <b>2005<br/>£m</b> |
| Deferred tax is provided/(recognised) as follows: |                    |                    |
| Accelerated capital allowances                    | 0.1                | (0.4)              |
| Other timing differences                          | (1.3)              | –                  |
| Deferred tax asset                                | <b>(1.2)</b>       | <b>(0.4)</b>       |

## 7. Share Capital and reserves

### Share capital:

|  | <b>2006</b> | 2005 |
|--|-------------|------|
|  | <b>£m</b>   | £m   |
| Authorised 430,000,000 (2005: 430,000,000) Ordinary shares of 10p each)                        | <b>43.0</b> | 43.0 |
| Allotted, called-up and fully paid 322,168,062 (2005: 321,154,860) ordinary shares of 10p each | <b>32.2</b> | 32.1 |

Details of share options in issue on the Company's share capital and share-based payments are set out in note 29 to the Group Financial Statements.

### Reserves:

|  | Share<br>premium<br>account<br>£m | Other<br>reserves<br>£m | Profit<br>and loss<br>account<br>£m | Total<br>£m  |
|--|-----------------------------------|-------------------------|-------------------------------------|--------------|
| At 1 January 2006                                  | 300.3                             | –                       | 14.3                                | 314.6        |
| Retained profit for the year                       | –                                 | –                       | 32.0                                | 32.0         |
| Premium on shares issues (net of expenses)         | 1.8                               | –                       | –                                   | 1.8          |
| Share based payments and acquisition of own shares | –                                 | 4.5                     | –                                   | 4.5          |
| <b>At 31 December 2006</b>                         | <b>302.1</b>                      | <b>4.5</b>              | <b>46.3</b>                         | <b>352.9</b> |

The currency and other reserve is stated after deducting £2.4m (2005: £2.5m) relating to shares held in the Bodycote International Employee Benefit Trust. The trust holds Bodycote International plc shares and satisfies awards made under various employee incentive schemes when issuance of new shares is not appropriate.

At 31 December 2006 1,235,110 (2005: 1,321,823) shares were held by the trust and following recommendations by the employer are provisionally allocated to satisfy awards under employee incentive schemes. The trust waives payment of dividend. The market value of these was £2.8m (2005: £2.9m).

## 8. Contingent liabilities

The Company has guaranteed bank overdrafts and loans of certain subsidiary undertakings amounting to £3.1m (2005: £3.0m).

## 9. Pension commitments

The Company participates in a group defined benefit scheme, the details of which are disclosed in note 30 to the Group financial statements. However, the Company is unable to identify its share of the underlying assets and liabilities and has therefore accounted for the scheme as if it were a defined contribution scheme. Full disclosures concerning the scheme as required by IAS 19 are set out in note 30 to the Group Financial Statements.

## Notes to the Company Financial Statements

### 10. Derivative financial instruments

#### Forward foreign exchange derivative contracts

The Company utilises forward foreign exchange derivatives to hedge material future transactions and cash flow. The Group uses foreign currency forward contracts in the management of its exchange rate exposures. The contracts are primarily denominated in the currencies of the group's principal market and currency interest flows. The recognised gains and losses were not material in either 2006 or 2005.

#### Cross currency swaps

At the balance sheet date the Company had entered into foreign currency denominational cross currency swaps that were designated as a hedging instrument for the purposes of hedging the translation of its foreign operations. The contracts are entered into either with both currencies at floating interest rates (generally based on 3 month LIBOR interest rates) or both currencies at fixed interest rates.

#### Interest rate derivatives

The Company's interest rate risk is primarily in relation to its fixed rate borrowings (fair value risk) and floating rate borrowings (cash flow risk). From time to time the Company will use interest rate derivative contracts to manage its exposure to interest rate movements within Group policy. However at the balance sheet date the Company had no interest rate derivative contracts.

Full disclosure of the fair value of derivative financial instruments are set out in note 19 to the Group Financial Statements.

### Thermal Processing - Heat Treatment & Metal Joining

|   |   | Country of incorporation<br>or registration |
|---|---|---|
| *Bodycote Heat Treatments Limited                           | Cambridge, Chard, Cheltenham, Coventry, Derby, Gillingham, Great Barr, Hazel Grove, Macclesfield, Morden, Rotherham, Skelmersdale, Stillington and Woodford   | England                                     |
| Bodycote Värmebehandling AB                                 | Anderstorp, Göteborg, Karlskoga, Koping, Malmö, Mora, Stockholm, Värnamo and Västerås   | Sweden                                      |
| Bodycote Lämpökäsittely Oy                                  | Hameelina, Pieksämäki, Tampere, Vaasa and Vantaa  | Finland                                     |
| Bodycote Värmebehandling A/S                                | Herlev  | Denmark                                     |
| Bodycote Hastrup Haerderiet A/S                             | Ejby  | Denmark                                     |
| Bodycote Wärmebehandlung GmbH                               | Ebersbach, Eching, Essen, Esslingen, Karben, Köln, Korntal, Landsberg, Langenselbold, Lüdenscheid, Menden, Nürnberg, Remscheid, Sömmerda, Sprockhövel and Wehingen  | Germany                                     |
| Bodycote Hardingscentrum BV                                 | Diemen, Hengelo, Tilburg and Venlo  | Netherlands                                 |
| Bodycote Hardiff BV   | Apeldoorn   | Netherlands                                 |
| Bodycote Rheintal Wärmebehandlung AG                        | Schaan  | Liechtenstein                               |
| Bodycote Austria Wärmebehandlung GmbH                       | Kapfenberg, Marchtrenck and Vienna  | Austria                                     |
| Bodycote Switzerland Wärmebehandlung AG                     | Fallenden and Urdorf  | Switzerland                                 |
| Bodycote Czech Republic Heat Treatment S.r.o.               | Modrice, Pilzen and Prague  | Czech Republic                              |
| Bodycote Pribram S.r.o.                                     | Pribram   | Czech Republic                              |
| Bodycote HT S.r.o.  | Brno and Liberec  | Czech Republic                              |
| Bodycote Polska Sp z o.o.                                   | Warsaw  | Poland                                      |
| Bodycote Obróbka Ciepina Sp z o.o.                          | Czestochowa, Chelmno, Grodzisk Mazowiecki and Zabrze  | Poland                                      |
| Bodycote Hokezelo KFT                                       | Budapest  | Hungary                                     |
| Bodycote Tratamente Termice SRL (75% owned)‡                | Brasov, Bucharest and Cugir   | Romania                                     |
| Bodycote IMT Inc.   | London OH and Camas WA  | USA   |
| Istas Isil Islem Sanayi ve Ticaret AS (60% owned)‡          | Adana, Ankara, Bursa, Istanbul and Izmir  | Turkey                                      |
| Bodycote Thermal Processing, Inc.                           | Fremont, San Diego, Santa Fe Springs, Santa Ana, Gardena, Huntington Park, Rancho Dominguez, Vernon, Walnut, Westminster and Tarzana CA, Berlin, Waterbury, South Windsor and Suffield CT, Ipswich and Worcester MA, Canton and Livonia MI, Cincinnati and Cleveland OH, Oklahoma City and Tulsa OK, Dallas, Houston and Fort Worth TX, Laconia NH, Melrose Park IL, Indianapolis IN, Eden Prairie MN, Rochester NY, Lexington TN, Sturtevant and New Berlin WI | USA   |
| Bodycote Thermal Processing Canada, Inc.                    | Newmarket and Kitchener ON  | Canada                                      |
| Brasimet Comercio e Industria SA                            | Campinas, Contagem, Guarulhos, Joinville, Sao Leopoldo and Sao Paulo  | Brazil                                      |
| Bodycote Wuxi Technology Co. Limited                        | Wuxi  | China                                       |
| Bodycote Metallurgical Services India Pte Limited           | Pune  | India                                       |
| Bodycote SAS  | Ambazac, Amiens, Beaugency, Brétigny sur Orge, Billy-Berclau, Cernay, Chanteloup les Vignes, Charleville Mézières, Chassieu, Condé sur Noireau, Gemenos, Gennevilliers, Lagny sur Marne, La Monnerie Le Montel, La Talaudière, Le Subdray, Neuilly sur Marne, Neuilly en Thelle, Nogent, Pusignan, Serres Castet, St Aubin les Elbeuf, St Dié, St Nicolas d'Aliermont, St Rémy en Mauges, Theyez and Voreppe  | France                                      |
| Applications du Brasage des Matériaux et des Traitements SA | Charvonnex and Villaz   | France                                      |
| Techmeta SA   | Metz-Tessy  | France                                      |
| Bodycote Italia Srl   | Gorgonzola  | Italy                                       |
| Bodycote Trattamenti Termici SPA                            | Flero, Madone and Rodengo   | Italy                                       |
| Bodycote Belgium  | Brussels and Nivelles   | Belgium                                     |

Vacuum and sealed quench and induction heat treatment, carburising, carbonitriding, gas and plasma nitriding, nickel, copper, silver and gold brazing, hardening, tempering, kolsterising, low pressure carburising and electron beam welding.

## Principal Subsidiary Undertakings

### Thermal Processing - Hot Isostatic Pressing

|   |  |         |
|---|--|---------|
| *Bodycote H.I.P. Limited                  | Chesterfield and Hereford                        | England |
| Bodycote IMT Inc.                         | Andover MA, London OH, Princeton KT and Camas WA | USA     |
| Bodycote Heiss-Isostatisches Pressen GmbH | Haag   | German  |
| Bodycote IMT NV                           | Sint-Niklaas                                     | Belgium |
| Bodycote Hot Isostatic Pressing AB        | Surahammar                                       | Sweden  |

Application of the hot isostatic process and the manufacture of specialist steels and products using hot isostatic pressing technology.

### Thermal Processing - Surface Engineering

|  |  | Country of incorporation<br>or registration |
|--|--|---|
| *Bodycote Metallurgical Coatings Limited | Knowsley, Macclesfield, Stonehouse and Wolverhampton | England                                     |
| Bodycote K-Tech, Inc                     | Hot Springs AR                                       | USA   |
| Bodycote Ytbehandling AB                 | Katrineholm, Karlstad and Västra Frölunda            | Sweden                                      |
| Bodycote Nussbaum GmbH & Co KG.          | Kaufbeuren   | Germany                                     |
| Bodycote Singapore Pte Limited           | Singapore  | Singapore                                   |

Surface engineering for product improvement including sherardizing, mechanical cladding, organic, plasma spray, anodising and ceramic coating.

### Testing

|  |   |             |
|--|---|-------------|
| Bodycote Testing Limited   | Arundel, Birmingham, Bridgwater, Burton-on-Trent, Camberley, Daventry, Doncaster, Droitwich, Dudley, Glasgow, Greenford, Greenock, Grimsby, Hillington, Huddersfield, Lancaster, London, Middlesbrough, Newcastle, Newbridge, Nuneaton, Runcorn, Salford, Seaham, Shotton, Sittingbourne, Sutton Coldfield, Warrington, Washington, Willenhall and Windsor. | Scotland    |
| MDA Berth Limited (trading as Consult-Us)                              | Cork  | Eire        |
| Bodycote Materials Testing BV  | Emmen and Spijkensisse  | Netherlands |
| Bodycote Materials Testing A/S   | Sandnes   | Norway      |
| Bodycote Materials Testing Srl   | Milan   | Italy       |
| Bodycote CTR Srl   | Padua   | Italy       |
| Bodycote Materials Testing Services Limited                            | Abu Dhabi   | Guernsey    |
| Al Futtaim Bodycote Materials Testing Services LLC (49% owned)‡        | Dubai   | Dubai       |
| Bodycote Materials Testing Services Limited Company & LLC (70% owned)‡ | Muscat and Sohar  | Oman        |
| Bodycote Materials Testing Services LLC (24.5% owned)‡                 | Doha  | Qatar       |
| Bodycote Materials Testing Inc.  | Chicago, Glendale Heights and Melrose Park IL, Houston TX, Los Angeles and Santa Fe Springs CA, Hillsdale, Wixom, and Detroit MI, Gary and Rockport IN, and Rockport IN.  | USA         |



## Testing continued

|  |   |                |
|--|---|----------------|
| Bodycote Materials Testing Canada Inc. | Burlington, Cambridge and Mississauga ON, Ste Foy, St Bruno and Pointe Claire QC, Calgary, Edmonton, Lethbridge, Grande Prairie and Fort McMurray AB, Surrey and Fort St John BC and Winnipeg MB, Mount Pleasant TN (USA) and Saltillo (Mexico) | Canada         |
| Bodycote Polymer AB                    | Nyköping  | Sweden         |
| Bodycote CMK AB                        | Karlskoga   | Sweden         |
| Bodycote Materials Testing AB          | Stockholm, Tannefors, Linköping and Malmslätt   | Sweden         |
| Bodycote Metech AB                     | Arboga, Stockholm, Goteborg, Ludvika, Linköping and Jonköping (Sweden), Oulu and Nummela (Finland), Hamburg (Germany) and Karup and Taastrup (Denmark)  | Sweden         |
| Bodycote Materials Testing s.r.o.      | Pilzen  | Czech Republic |
| Bodycote Singapore Pte Limited         | Singapore   | Singapore      |
| Warrington Fire Research Group Limited | Singapore, Hong Kong and Melbourne (Vict.)  | England        |

Testing, calibration and consultancy services for producers and users. Mechanical, metallurgical corrosion, physical, radiographic and chemical testing of ferrous and non-ferrous alloys, building products, ceramics, composites and plastics, oils (wear and high voltage) and lifetime assessment of polymers. Healthcare testing, microbiological assessment, water analysis, fire, drug, pharmaceutical, asbestos and food product testing. Automotive engine structural and environmental exposure testing. Calibration and maintenance of instruments and devices. Fire safety engineering consultancy services.

## Group Services

|  |         |         |
|--|---------|---------|
| *Thomas Cook & Son Insurance Brokers Limited (75% owned) | Burnley | England |
|--|---------|---------|

Insurance broking, industrial and commercial risk management, independent financial advisers.

|                      |           |          |
|----------------------|-----------|----------|
| *Coalescence Limited | Edinburgh | Scotland |
|----------------------|-----------|----------|

Information Services for Testing.

|                                 |                |        |
|---------------------------------|----------------|--------|
| Bodycote Property Holdings Inc. | Mississauga ON | Canada |
|---------------------------------|----------------|--------|

Managers of the Group's property interests.

Except where stated, these companies are wholly owned subsidiaries and have only one class of issued shares. Subsidiaries marked with an asterisk\* are held directly by Bodycote International plc. Entities marked ‡ have been treated as subsidiary undertakings in the financial statements because the Group exercises a dominant influence over these entities.

## Financial Calendar

|                                  |               |
|----------------------------------|---------------|
| <b>Annual general meeting</b>    | 23 May 2007   |
| <b>Final dividend for 2006</b>   | 5 July 2007   |
| <b>Interim results for 2007</b>  | July 2007     |
| <b>Interim dividend for 2007</b> | January 2008  |
| <b>Results for 2007</b>          | February 2008 |

## Shareholder Enquiries

Enquiries on the following administrative matters can be addressed to the Company's registrars, Capita Registrars, Northern House, Woodsome Park, Fenay Bridge, Huddersfield HD8 0LA. Telephone: 0870 1623131 or +44(0)208 639 2157; Fax: +44(0)1484 600911; and email: [shareholder.services@capitaregistrars.com](mailto:shareholder.services@capitaregistrars.com)

- Change of address
- Lost share certificates or dividend cheques
- Dividend mandates
- Amalgamation of holdings

Forms for these matters can be downloaded from the registrars' website at [www.capitaregistrars.com](http://www.capitaregistrars.com), where shareholders can also check their holdings and details.

## Share Dealing Service

Information on a low cost share dealing service offered by our registrar is available from Capita on 0870 458 4577 or at [www.capitadeal.com](http://www.capitadeal.com)

## Shareholder Analysis

Analysis of share register as at 18 February 2007

| Holding range:     | Number of shareholders | %            | Number of Shares   | %             |
|--------------------|------------------------|--------------|--------------------|---------------|
| 1 to 1,000         | 859                    | 29.8         | 428,841            | 0.13          |
| 1,001 to 10,000    | 1,403                  | 48.6         | 5,106,568          | 1.59          |
| 10,001 to 100,000  | 397                    | 13.7         | 12,809,689         | 3.98          |
| 100,001 to 500,000 | 110                    | 3.8          | 23,827,746         | 7.39          |
| 500,001 and over   | 118                    | 4.1          | 279,995,218        | 86.91         |
|                    | <u>2,887</u>           | <u>100.0</u> | <u>322,168,062</u> | <u>100.00</u> |

| Types of shareholders:                     | % of shareholders | % of total shares |
|--|-------------------|-------------------|
| Directors' interests                       | 0.1               | 0.7               |
| Major institutional and corporate holdings | 9.2               | 92.7              |
| Other shareholdings                        | <u>90.7</u>       | <u>6.6</u>        |
|  | <u>100.0</u>      | <u>100.0</u>      |

As at 27 February 2007 the following interests of 3% or more in the issued share capital of the Company appeared in the register maintained under the provisions of Section 211 of the Companies Act 1985:

|   | Number of shares | %    |
|---|------------------|------|
| Standard Life plc                             | 32,293,670       | 10.0 |
| Legal & General Investment Management Limited | 25,791,810       | 8.0  |
| Sprucegrove Investment Management Limited     | 22,798,161       | 7.1  |
| Franklin Resources Inc.                       | 12,830,800       | 4.0  |
| UBS AG  | 12,286,493       | 3.8  |
| Atlantic Investment Management Inc.           | 10,150,821       | 3.2  |
| LD Pensions                                   | 10,073,738       | 3.1  |