



2006

FINANCIAL STATEMENTS



Chemring

Contents

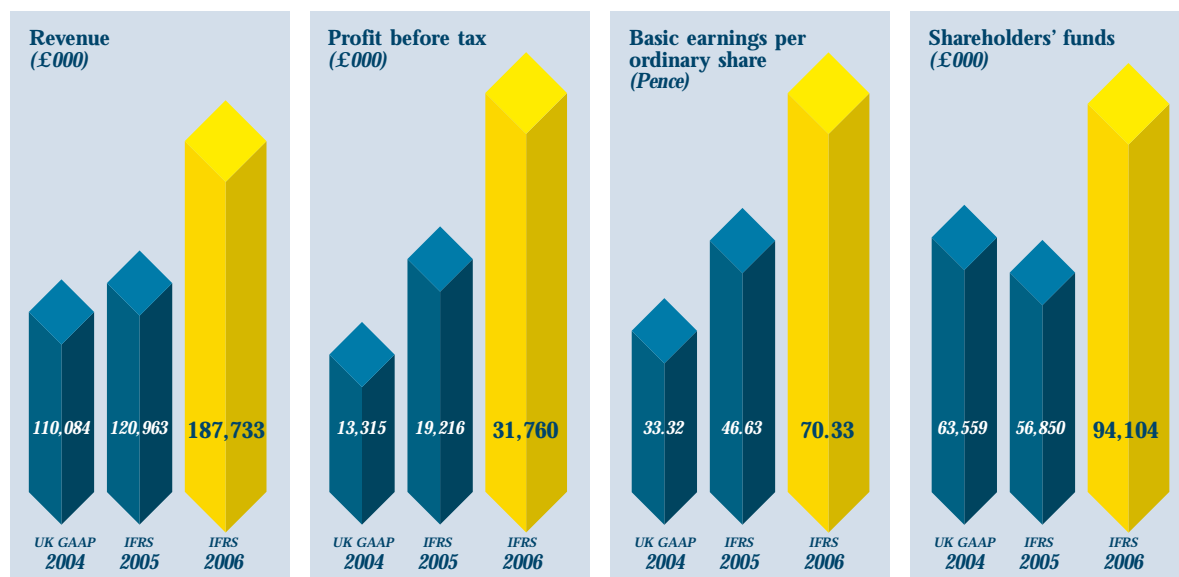
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Summary Financial Information

| Continuing Operations | IFRS 2006 £000 | IFRS 2005 £000 | UK GAAP 2004 £000 |
|--|----------------------|----------------------|-------------------------|
| Revenue | | | |
| Countermeasures total | 118,384 | 90,768 | 78,724 |
| Energetics -continuing operations | 42,058 | 30,195 | 31,360 |
| -acquired | 27,291 | - | - |
| Energetics total | 69,349 | 30,195 | 31,360 |
| Total revenue | 187,733 | 120,963 | 110,084 |
| Operating profit | | | |
| -continuing operations | 33,433 | 22,908 | 16,927 |
| -acquired | 4,346 | - | - |
| Total operating profit | 37,779 | 22,908 | 16,927 |
| Profit before tax | 31,760 | 19,216 | 13,315 |
| Dividend per ordinary share | 16.00p | 10.50p | 9.00p |
| Basic earnings per ordinary share | 70.33p | 46.63p | 33.32p |
| Diluted earnings per ordinary share | 69.87p | 46.39p | 33.14p |
| Net debt (£000) | 70,554 | 52,774 | 30,008 |
| Shareholders' funds (£000) | 94,104 | 56,850 | 63,559 |

Financial Highlights



Results

| | <i>2006</i> | <i>2005</i> |
|--|---------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Operating profit | | |
| - continuing operations | 33,433 | 22,908 |
| - acquired | 4,346 | - |
| Total operating profit | 37,779 | 22,908 |
| Profit before tax | 31,760 | 19,216 |
| Dividend per ordinary share | 16.00p | 10.50p |
| Basic earnings per ordinary share | 70.33p | 46.63p |



Statement by the Chairman

“A year of dynamic progress and outstanding performance”



2006 has been a year of dynamic progress and outstanding performance, as anticipated in my closing comments in last year's annual report. Operating profit and profit before tax both increased by over 65% to £37.8 million (2005: £22.9 million) and £31.8 million (2005: £19.2 million) respectively, with basic earnings per share (on continuing operations), on the enlarged share capital following the vendor placing in March 2006, rising by 51% to 70.33p (2005: 46.63p). In view of the excellent performance of the Group this year, the Board is recommending a final dividend of 11.20p per ordinary share, a 53% increase on the final dividend for 2005.

Both the Countermeasures and Energetics divisions contributed strongly in the year, and there was a welcome improvement in Energetics' margins which increased to 15% (2005: 8%).

Our acquisitions completed in the latter part of 2005 and during 2006 - Nobel Energetics in Scotland, Comet in Germany, Technical Ordnance in the US and Leaffield Engineering in England - all contributed as anticipated. In 2007 we will enjoy a full year's profits from the businesses acquired in 2006.

Balance Sheet and Cash Flow

In 2006 the Group delivered a very strong operating cash flow of £45.6 million. Approximately 60% of our acquisitions were debt-funded, which increased net debt to £70.6 million - a satisfactory debt/equity ratio of 75%. Historically, British companies have tended to be geared more conservatively, using balance sheet ratios rather than the interest cover approach which is now predominant in the US and which is a strong feature of venture capital funding - a competitive force in our search for suitable acquisitions. With the strength of the Group's cash generation from our growing earnings, the Board has determined that, in the short term, the Group can afford to continue debt funding acquisitions, recognising the speed at which such debt can be repaid. The Group will however, as deemed prudent and as it did in 2006, continue to raise equity, as appropriate, as part of its acquisition strategy.

Acquisitions

Since I last reported at the half year, the Group has acquired B.D.L. Systems in England for approximately £10 million

(including costs). This business, which operates in the energetics industry, is complementary to Nobel Energetics and Leaffield Engineering.

Throughout the year, the Group has continued its search for further suitable acquisition opportunities in energetics, particularly, but not exclusively, in the US. Some targets, after careful examination, were found not to meet our criteria, and in others we refused to meet the vendors' expectations on price. Our activities in this area continue.

Disposals

As indicated in last year's annual report, the Marine division was determined to be non-core. The Marine Lights business was sold during the year, and since the year end, we have reached conditional agreement on the sale of all but one small part of the Marine Electronics business. This eliminates the losses from the Group and, once we have completed the sale of the Marine Electronics business, over £7 million of cash will have been received. The cash will be reinvested in our two core divisions. The residual Marine Electronics business is being carried in the Group's accounts at minimal value, giving the prospect of a small recovery when sold.

Countermeasures

As the world's largest manufacturer of countermeasure decoys, with over 50% market share, and the leading supplier to the US military, the Group's three countermeasure businesses have all been operating at full stretch to meet the increasing demands of armed forces involved in conflicts around the globe, particularly in the protection of helicopters and transport aircraft.

All three businesses had a record year in 2006, resulting in a 37% increase in the operating profits of this division to £33.9 million.

The requirements for Iraq and Afghanistan inevitably had a significant impact on demand but major orders were also received for future years for new aircraft not linked to these conflicts.

Production commenced in the extension to Alloy Surfaces' second plant in June 2006, and the third plant is currently being commissioned, providing valuable additional capacity.

Statement by the Chairman

- continued

Kilgore installed additional manufacturing facilities for two new products, and has received multi-year orders for a flare developed by the company to protect the new F-22 Raptor. Chemring Countermeasures in the UK had particular success during the year with demand for its new spectral decoy, developed through its own research and development activity, requiring the establishment of an additional production line.

Energetics

Despite this division not benefiting from a full year's contribution from the newly-acquired businesses, revenue still increased to £69.3 million (2005: £30.2 million). A notional full twelve months' performance, including all businesses, would have produced revenue of approximately £90 million. Divisional profitability increased to £10.4 million (2005: £2.3 million) and, as referred to above, an encouraging improvement in profit margins to 15% was also achieved.

The main objectives during the year have been the development of an effective organisational structure to maximise the performance of the businesses in the division; the establishment of a customer-facing, worldwide, marketing and selling strategy and sales force; and the rationalisation of production plants to optimise manufacturing efficiencies.

This division now has plants in Germany, Spain, Australia, the US, and four plants in the UK.

Group Strategy

In last year's annual report I outlined the Board's strategy of concentrating on our two divisions of Countermeasures and Energetics. This strategy remains unchanged. In Countermeasures we are capitalising on our industry strengths, developing new decoys and new military uses for our specialised pyrophoric material, and investing in plant, equipment and new production processes to reduce manufacturing costs and improve quality. In Energetics we continue our search for suitable acquisitions to make us a consolidating force in a fragmented industry.

As a Group with a worldwide capability, we have been developing a strategy to increase our presence and marketing activities in the Middle East and in the major and growing economies east to Japan. B.D.L. Systems brought with it an office in Dubai, which we intend to use to develop further our existing and extensive relationships in this part of the world. Our tactics for the other major territories in Asia and the Far East, where we already enjoy substantial business, are being established on a country by country basis.

Health and Safety

In the majority of our plants throughout the world, the Group is heavily involved in the handling of energetic and volatile materials which can, if not stringently controlled, prove hazardous. The Board has determined that, as part of its future strategy, the Group will expand its operations in this area. It is incumbent upon us therefore to be at the forefront in whatever methods can be developed to minimise health and safety risks in our manufacturing facilities. Consequently, a major investment programme is underway, which will result in increased automation to remove employees from sensitive processes; additional physical barriers to provide protection for employees; and manufacturing processes that minimise the risk of incidents. These processes will be supported by a continuous programme of employee training and education.

Health and safety issues are reviewed by the Executive Committee and the Board every month. The Board recognises that the highest standards are required in this area if we are to achieve our desired growth and maintain leadership in the Group's chosen markets.

The Board of Directors and Senior Executive Management

During the year I was delighted to welcome The Rt Hon Lord Freeman to the Board. Roger Freeman has a wealth of experience, having enjoyed senior roles in the financial and defence industry sectors, and was formerly a Government minister in the Ministry of Defence. He has assumed the position of Chairman of the Audit Committee.

We also appointed two senior executives to strengthen our operational management during the year. Mike Helme joined the Group in January 2006 as Managing Director of the Energetics division, outside of the US, and Dan McKenrick, a US national, joined us in September 2006 as President of our US operations.

Insurance Claim

The Group has now commenced legal action against its former insurance broker Willis, for the recovery of additional amounts in excess of the \$17 million paid out by Royal & Sun Alliance in respect of the 2001 incident at Kilgore. Our claim is valued at over \$8 million. Willis has yet to serve its defence and no date has been set for a Court hearing. The Group continues to carry forward in its balance sheet the debtor established previously. Costs incurred in the meantime have been expensed.

Corporate Governance

The Group has made significant progress in recent years in meeting the corporate governance standards which are now



expected of us. However, the demands on public companies and their directors continue to grow every year, although possibly now at a slower rate as it is generally recognised that “enough is enough”. It should be recognised that, for any other than the very largest companies, the administration of these increased requirements incurs significant cost and absorbs management time, with little or no perceived benefit to the company or its shareholders. We continue to strive however to meet the varying demands of the different self-appointed regulators in this area, and last year generally received a clean bill of health, which I trust we will repeat this year.

The new and substantial Companies Act 2006 will bring further new challenges and difficult responsibilities for directors, with the prospect of considerable confusion in many areas if it is as badly drafted as much recent legislation. Unfortunately, none of these “initiatives” help British companies in a global competitive environment.

Employees

The Group now has more than 2,100 employees around the world. We strive to be an employer of choice, providing competitive terms and conditions wherever we are located, with a favourable working environment (recognising that companies working with volatile materials obviously have limitations in this area). To those who have years of service with the Group, I convey our thanks once again for your efforts which have produced another outstanding year's results. To those who have just joined or been assumed through acquisition, I hope you will find working for the Group an enjoyable and constructive experience.

Pensions

The Board has spent a considerable amount of time analysing and debating this complex subject, with regard to both the Group's existing obligations and future pension provision for employees in the constantly-changing pension world. The Board currently intends to retain the Group's defined benefit pension scheme in the UK for existing members but with restricted entry on a discretionary basis for new employees. In line with many other companies, the Board has had to recognise the significantly increasing costs, arising from factors such as increased longevity, of maintaining such a scheme. The scheme's triennial actuarial valuation is currently being undertaken and whereas I remain confident, on normal commercial investment criteria, that no deficit should arise, the basis of valuation stipulated by current pensions regulations may produce a theoretical deficit. It is hoped that, should this occur, a “recovery plan” as permitted by the Pension Regulator can be constructed which is satisfactory to all parties.

The Board is considering the introduction of a new defined contribution scheme for the considerable number of our UK employees who currently choose not to participate in the defined benefit scheme. This will provide an alternative to the new National Pensions Saving Scheme being introduced by the Government but will offer better benefits for employees. The UK-based Chemring Group Executive Pension Scheme was closed to new entrants some years ago.

Dividends

The Board is recommending a final dividend of 11.20p per ordinary share, a 53% increase on the final dividend for 2005. This, together with the interim dividend of 4.80p paid in August 2006, gives a total dividend for the year of 16.00p, a 52% increase over 2005. The dividend is over four times covered on net profits of the continuing operations. The shares will be marked “ex dividend” on 28 March 2007 and the dividend is payable on 20 April 2007 to shareholders on the register at the close of business on 30 March 2007.

Prospects

In the year under review basic earnings per share from continuing operations increased by 51% to 70.33p, the share price reached over £16 from £6.60, and the Group was admitted to the FTSE 250 Index. Whilst it would be unrealistic to believe that such outstanding performance could be repeated continuously in the longer term, the Board believes that with the current record order book, a full twelve months' earnings from each of the companies now in the Group, and the opportunities for our product range at a time of political and military uncertainty, not just in the Middle East, further significant growth is achievable in 2007.

K C Scobie
Chairman

23 January 2007

Review by the Chief Executive

“Operating profit rose dramatically by 65% to £37.8 million”



Group Results

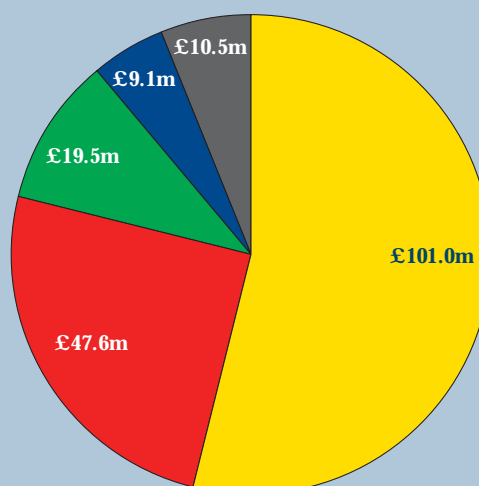
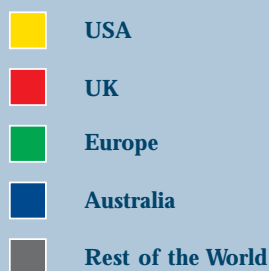
The Group performed strongly throughout the year and revenue from the core businesses increased by 55% to £187.7 million. This was an excellent result, with 23% of the growth achieved organically and 32% from the first contribution of our new acquisitions. Good growth was achieved by all the businesses but it was particularly pleasing to see Kilgore meet all of its targets and increase its turnover by 19% during the year.

Operating margins for the Group continued to improve and by the year end reached 20%. Margins were considerably enhanced by the second half contributions of the newly acquired businesses in the Energetics division. Profitability improvements, through enhanced automation, process efficiencies as well as manufacturing rationalisation, were achieved across the Group. Consequently, operating profit rose dramatically by 65% to £37.8 million, with 38% of this growth generated by the new acquisitions. Since many of the newly acquired businesses did not contribute for the full twelve months, it is expected that similar levels of operating margin to the second half of the year will be achieved in 2007.

The focus on operational cash flow remained strong throughout the year and all the newly acquired businesses demonstrated good cash management. The operating cash inflow was £45.6 million, equivalent to a cash conversion rate of 121%. Investment in research and development (R&D) and capital expenditure increased 40% to £15.3 million, which represents only 8% of Group revenue. The Board has decided to increase this level of investment to over £23 million in 2007, with planned increases in both the R&D and capital expenditure.

The order intake in the year was £268.8 million, up 119% on 2005, with only £40.0 million attributable to the acquired businesses. Consequently, the order book at the year end was £214.6 million, which was 75% higher than the previous year. This record level of order cover underpins the expected growth in 2007. I am also delighted to report that the final order book for the Countermeasures division was 45% higher than in 2005, providing a strong foundation for further growth in this sector over the year to come.

Revenue by Destination





Countermeasures

- Orders: £173.7 million → up 87%
- Revenue: £118.4 million → up 30%
- Operating profit: £33.9 million → up 37%
- Operating margin: 29% (2005: 27%)

The global expendable countermeasures market continued to grow in 2006 and now stands at about £215 million, an increase over the year of nearly 20%. The turnover of the Countermeasures division grew by 30% year-on-year, increasing our market share to over 55%. However, our order intake during the year increased significantly more (up 87%) during the year, with sales limited by the speed with which increased production capacity and new products could be safely introduced. The strong demand for our decoys has continued to be driven principally by the threat from shoulder-launched missiles to the helicopters and transport aircraft used in peacekeeping operations by the US, UK and other coalition forces in Iraq and Afghanistan.

Alloy Surfaces had another excellent year, generating \$114.6 million of sales, with strong demand for its special material decoys, particularly for the protection of US Army helicopters. The ramp-up of production capacity, by extending plant two by 18,000 ft² and building a third production facility of 40,000 ft², was delivered to schedule. The monthly production target of 60,000 M211 decoys was achieved in September, in line with the customer's requirements. With a total of \$108 million of orders for the M211 decoy from the US Army alone, order cover is already in place for production at this rate throughout 2007 and 2008.

Kilgore performed exceptionally well in 2006, achieving consistent high volume production with daily production rates regularly 100% above that achieved in the previous year. Record volumes of nearly 1.9 million M206 and MJU-7A/B decoy flares were produced and delivered to the US Air Force customer. A strong focus was also placed on process improvements during the year and this provided a considerable improvement in the margin achieved.

A significant enhancement to our production capability at Kilgore was achieved with the completion of the new Large Flare Facility, built with a capital investment of \$2.7 million. This automated facility was designed to manufacture two new decoy products, the MJU-10 flare for the F-15 aircraft and the ALA-17 flare for the B-52 aircraft. A three year production contract for MJU-10s was received from the US Air Force during the year, and acceptance of the first

production lots has just been achieved. Qualification testing of the ALA-17 is still underway, but the first production order was received earlier in the year. Production of both flares will ramp-up during the second half of 2007.

The US Air Force also awarded Kilgore a first production contract for the MJU-53A/B flare for the protection of the C-17 transport aircraft. Production will begin in 2007, after qualification and first article acceptance has been achieved. The capture of this programme, in the face of strong competition, was an important success.



Review by the Chief Executive

- continued

The first production order for the F-22 Raptor aircraft advanced flare suite was also awarded to Kilgore by the US Air Force. The suite consists of two flares, designed to defeat air-to-air guided missiles. The total contract, which is worth \$18.5 million, covers the final qualification of the flares and the first production lots for delivery in June 2008. A new advanced material facility, to manufacture these flares and those required for the Joint Strike Fighter programme, will be built during 2007.

Chemring Countermeasures, our UK business, also had an excellent year, with strong demand for its latest airborne decoy products to support UK operations in Afghanistan. A series of orders for aerodynamic and dual spectral flares have been placed by the UK Ministry of Defence over the last twelve months. Production start-up of the aerodynamic flares was achieved rapidly and consistent volume production continues to take place. Development and qualification of the spectral flare took place during the first half of the year and production ramp-up towards 20,000 units per month is underway. A new spectral flare production facility is nearing completion, to provide the additional production capacity needed to meet the rapid growth in volumes demanded by the customer.

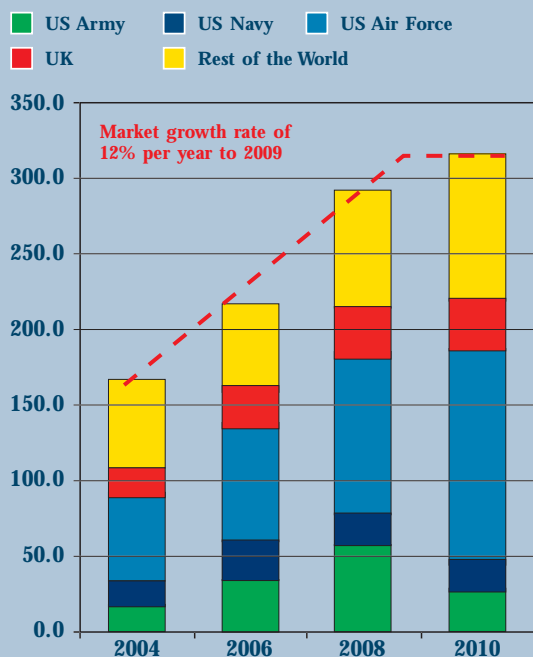
The global market in anti-radar decoys has become extremely competitive, and a decision was therefore taken to close our

Portsmouth chaff manufacturing facility after forty years of continuous production. Manufacturing was successfully transferred to our Salisbury facility, and the consolidation onto a single site has reduced our overhead costs and significantly improved the operational efficiency.

The first production contract for the flares to protect the Typhoon aircraft was also received from the UK Ministry of Defence during the year. These flares are to a proprietary design and initial production is sole source to the Group. Substantial production orders from the UK and its European partners are expected over the next few years, and early deployment of the Typhoon to peacekeeping roles is likely to accelerate the demand. Similarly, the recent confirmation by Saudi Arabia of its intention to purchase up to seventy two Typhoon aircraft should lead to considerable export potential from 2008 onwards.

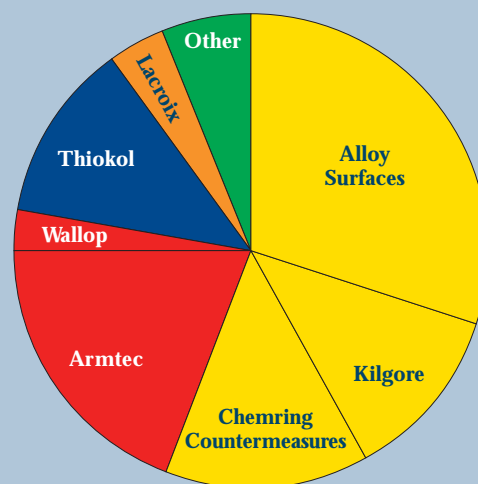
The UK requirement for decoys to support both its helicopter and fixed wing aircraft deployments in Iraq and Afghanistan is placing increasing demands on our manufacturing capability and making it harder to fully support all our export customers. Consequently, the Group intends to construct a new flexible flare facility in Salisbury during 2007 to provide a 100% increase in our maximum production capacity.

Global Market for Countermeasures (£m)¹



¹ All figures based on program funding plans and estimates of key export markets

Countermeasures Market Shares (2006)²



Total Market £215m

² Management estimates



Energetics

- Orders: £95.2 million → up 222%
- Revenue: £69.3 million → up 129%
- Operating profit: £10.4 million → up 352%
- Operating margin: 15% (2005: 8%)

During 2006, the Group successfully acquired four new companies in the Energetics sector. All of these companies have made a positive start and, together with Nobel Energetics, acquired in September 2005, contributed excellent profits and cash flow.

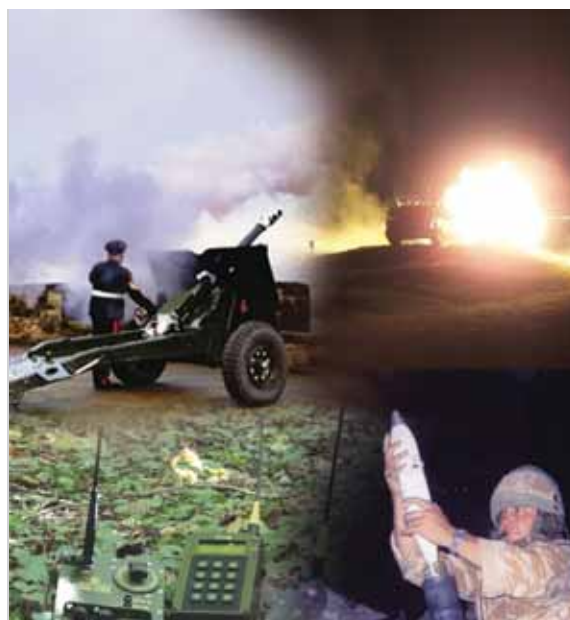
The revenue of our Energetics division grew by 129% year-on-year, principally driven by our newly acquired businesses. Organic growth became more significant in the latter half of the year, and our order intake in the continuing operations increased by over 100% compared with 2005. Most of these orders were received too late in the year to transition into sales but will generate further growth in 2007.

The profitability of the enlarged Energetics division grew to £10.4 million, a very satisfying result, which represents a 15% operating margin for the year. However, the second half of the year, bolstered by the presence of the new higher margin acquisitions, generated an impressive operating margin of 20%, and provided a better insight into the future profitability expected from this division.

PW Defence had a strong year and continued to develop its product range to meet the current market conditions. A multi-spectral hand thrown screening smoke for use in urban environments was developed during the year, and a substantial order for the product was received from a NATO country. A novel composition for IR illumination ("blacklight") was also developed, and this is now being used by another NATO country. The business also had a major international success by securing a substantial prime contract from a Middle Eastern country to supply an extensive range of third party military products over the next three years.

Record sales levels were achieved at Nobel Energetics, driven by strong demand for metron actuators, detonators, propellants and rocket motors. Sales of actuators grew by 35%, driven by demand from fire suppression systems, cash security and automotive bonnet release systems. There was also strong demand (up 20%) for ejector seat propellant from Martin Baker. The business completed development of the rocket motor for the NLAW missile and started to build-up volume production.

Kilgore made good progress on several of its key energetic product programmes. The redesign of the Mk58 marine



location marker was completed, with successful flight qualification trials on both helicopter and F/A-18 platforms. The US Air Force placed a record production order and volume production of nearly 19,000 markers (worth \$6 million) is now underway. The development of a new air-launched illumination flare was also completed during the year. A new ignition train is now being fitted to improve its insensitive munitions (IM) performance and qualification on several aircraft platforms will take place in early 2007.

Comet also had a good year, with strong interest shown in both its mine clearance and battlefield simulation products. France, Spain and Australia placed orders for the PEMBS mine clearance system, and the UK Ministry of Defence selected the system for its next generation Dismounted Counter-Mine Capability (DCMC). The US Army placed a five year contract for the MECS battlefield simulation ammunition, and strategic partnerships have been signed with several US/European training prime contractors for the supply of micro/macro pyrotechnic devices for urban warfare and IED training systems.

Technical Ordnance performed extremely well during its first seven months under our new ownership. Over 7.7 million impulse cartridges were manufactured for the US Air Force, its principal customer. Detonator and booster pellets were also manufactured in very large quantities for assembly into munition fuzing systems manufactured by ATK, KDI and Kaman Aerospace. Access to the Group's global sales network also brought a major success, with the award of an important prime contract from another substantial Middle East customer.

Review by the Chief Executive

- continued

In September, we announced the acquisition of B.D.L. Systems Limited, an explosive ordnance disposal (EOD) company located in Poole, UK. BDL is a world leader in RF initiation products, and has just completed a number of upgrades to its mini-RABS system used globally for military engineering/demolition purposes. New secure coding techniques and secure firing mechanisms have been incorporated. BDL has also secured a number of key prime contracts for EOD equipment, including the supply and support of a wide range of equipment for both the Iraqi forces (through the US programme office) and an important customer in the Far East.

The integration of the newly acquired businesses has been an important priority. New processes, investment in automation and rationalisation of manufacturing have been implemented to improve efficiency. During the year, we transferred the manufacture of all marine pyrotechnic products to Bremerhaven, Germany, and instigated a rolling programme of automation to upgrade the manufacturing facilities to cope with increased volumes. We have completed the transfer to Nobel Energetics of the manufacture of all explosive primers used in the ceremonial ammunition supplied to the UK Ministry of Defence by Leafield Engineering. Other high explosive cutting charges used by Leafield Engineering in break-up units for European munitions are also now being transferred. Consolidation of European pyrotechnics has also started to take place, with the gradual establishment of a centre-of-excellence for pyrotechnic flare products in Germany and another one for smoke products in the UK. To improve efficiency further, we have also successfully transferred the manufacture of some of our lower technology, labour-intensive products to a partner in Estonia and worked with them to successfully deliver the first production contract to a NATO customer.

Strategy

The Group strategy remains focussed on our two core sectors of operations, Countermeasures and Energetics.

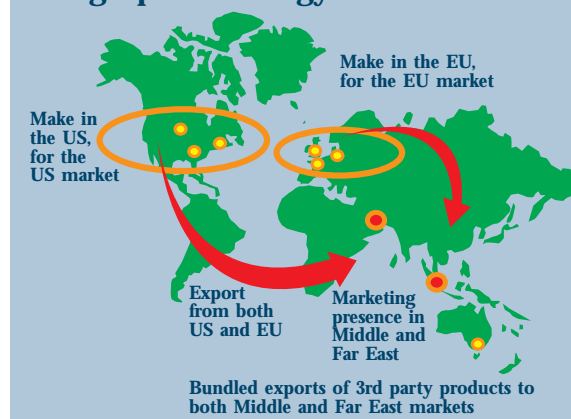
The core strategy for the Countermeasures business is to maintain and improve our market share, and carefully exploit the continuing market growth over the next few years. We intend to increase our investment in new products and to build on our leadership in both special material and spectral decoys. We also intend to invest in new automated production facilities, to drive further manufacturing efficiencies and to maintain our lead role in the development of new products for the next generation of fixed wing and rotary aircraft.

We intend to continue the expansion of our Energetics division, with new acquisitions in both the US and Europe.

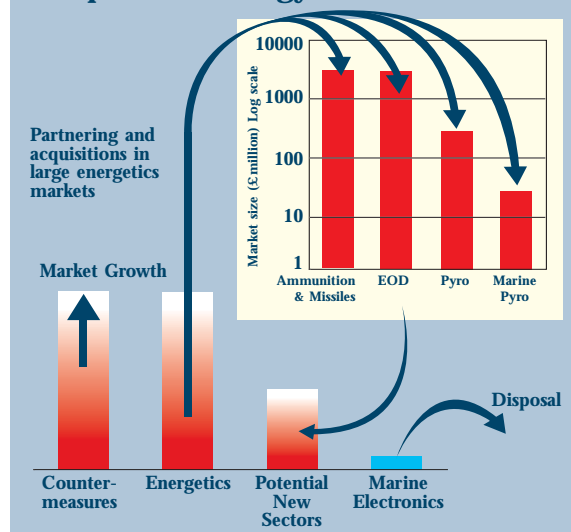
We will focus on becoming a key supplier of energetic materials to the major prime contractors for munitions. We intend to build on our expertise in explosive ordnance disposal and develop the capability to become a specialist prime contractor. We also plan to invest in new products to expand our pyrotechnic business and develop clear leadership in both the detonator and cartridge activated device markets.

Our geographic strategy also remains unchanged. We intend to manufacture in the US for the US market and in Europe for the European market. We will then use our excellent worldwide sales network to export from both the US and Europe. We will also develop our capabilities to bundle third party products and offer a broader supply chain management service to our export customers.

Geographic Strategy



Corporate Strategy





Future Prospects

Countermeasures

The market outlook for our Countermeasures businesses continues to be positive. Over the next three years, we believe that the global market will expand by around 12% each year. The short term growth is driven by a number of major factors. The peacekeeping activities in Afghanistan have grown in importance over the last twelve months and senior UK and US military have consistently indicated the long term nature of the deployment. Both the US and the UK are considering further increases in the number of troops deployed. The UK has recently increased the number of helicopters used in operations and its demand for decoys has continued to grow strongly.

UN peacekeeping activities outside Iraq and Afghanistan are expected to involve in excess of 140,000 troops during 2007. This represents significant growth over the last few years, and although many of these troops are involved in small scale operations, most will also involve helicopter or transport aircraft deployment.

Shoulder-launched missiles continue to be a major threat to low level helicopter and transport aircraft missions. New helicopters, such as the Tiger and NH90 platforms, have Defence Aids Suites (DAS) fitted as standard, and DAS systems are now being fitted as upgrades to most Apache fleets. These DAS systems contain sophisticated missile approach detectors and programmable decoy dispensers to cope with the myriad of threats. Demand for decoys will expand as growing numbers of these platforms become operational and are deployed in peacekeeping roles.

A number of important aircraft will enter into service over the next five to ten years. The Typhoon and Raptor decoy suites have entered production this year, and the decoy requirements will increase steadily as the production numbers increase and the aircraft start to be deployed in combat or peacekeeping operations. Similarly, the Joint Strike Fighter is now undergoing qualification and is expected to enter service with the US Air Force in the next six to eight years. Chemring is responsible for the development of the advanced technology flares for all three next generation aircraft and is well placed to secure all the initial production contracts.



Review by the Chief Executive

- continued

Energetics

Energetics can be sub-divided into munitions, EOD and pyrotechnic segments. The global market for energetic materials used in munitions is substantial, amounting to some £2 billion each year. At present, our activities amount to only £15 million of sales per annum, and there are significant opportunities to expand our product range of primers, detonators, propellants, tracers and pyrotechnic payloads. The combined capabilities of our two acquired businesses, Nobel Energetics and Leaffield Engineering, have significantly enhanced our capabilities in this area, and our planned product investment will extend our range of products and provide opportunities to penetrate the market further. In addition, the combined capabilities of Technical Ordnance and Kilgore have given us a similar capability in the US and tremendous opportunity for the cross-transfer of products and technology.

The formation of centres-of-excellence for the production of energetic materials has generated considerable interest from the major prime contractors in both the US and Europe, who are looking for strategic partners. Discussions on the manufacture of primers, detonators and fuze components are at an advanced stage, and we believe that there is considerable scope for further collaboration over the next few years.



The global ordnance disposal market is also large at just over £2 billion per annum. This market is quite fragmented and involves a broad range of technologies, including detection systems, robots, protective clothing and explosives. The acquisition of BDL has enhanced our profile in this market and our developing ability to offer a one-stop EOD supply service should offer good opportunities for growth.

The pyrotechnic market is an order of magnitude smaller at about £300 million and remains fragmented with many small players. We have developed an excellent relationship with Martin Baker on ejector seat propellant, pyromechanisms and canopy cutting charges. We have also made good progress in the development of battlefield simulation, mine clearance and cartridge activated devices. In these areas, there remains good scope for improving our market share in both the US and Europe.

At the year end, the Group had a strong order book of £214.6 million, up 75% since the previous year. This has grown a further 15%, and today stands at a record level of £246 million. We are confident that the market outlook over the next few years will remain strong and the prospects for the Group in 2007 continue to be excellent.

Dr David Price
Chief Executive

23 January 2007



Review by the Finance Director

*“Operating cash flow was £45.6 million,
an increase of 116% on 2005”*



Results

Revenue from continuing operations increased 33% to £160.4 million (2005: £121.0 million). Net operating profits from continuing operations increased 46% to £33.4 million (2005: £22.9 million). Net operating margins from continuing operations were 21% (2005: 19%).

Revenue from acquired businesses was £27.3 million and £4.3 million of operating profit was generated at a margin of 16%.

Total revenue was £187.7 million (2005: £121.0 million), an increase of 55%. Total operating profit was £37.8 million (2005: £22.9 million), an increase of 65%.

An analysis of total revenue and operating profit by business segment is set out below:

The revenue of the Countermeasures division grew 30% and the operating profit grew 37%. The revenue of the Energetics division grew 129% and the operating profit grew nearly five times.

The interest charge for the year was £6.1 million (2005: £3.8 million). Interest was covered 6.2 times (2005: 6.0 times) by operating profits.

Profit before tax was £31.8 million (2005: £19.2 million), an increase of 66%.

The tax charge of £9.9 million (2005: £5.7 million) represents a rate of 31% (2005: 29%) on profits.

Profit after tax was £21.9 million (2005: £13.6 million), an increase of 61%.

| Segment | 2006 | | | 2005 | | |
|--------------------------------------|---------------|---------------------------|------------|---------------|---------------------------|------------|
| | Revenue £m | Operating profit £m | Margin | Revenue £m | Operating profit £m | Margin |
| Countermeasures | 118.4 | 33.9 | 29% | 90.8 | 24.8 | 27% |
| Energetics | 69.3 | 10.4 | 15% | 30.2 | 2.3 | 8% |
| Amortisation of acquired intangibles | - | (0.8) | | - | (0.1) | |
| Share-based payments | - | (2.2) | | - | (0.9) | |
| Unallocated head office costs | - | (3.5) | | - | (3.2) | |
| Total | 187.7 | 37.8 | 20% | 121.0 | 22.9 | 19% |

Review by the Finance Director

- continued

Discontinued Operations

The results of the discontinued operations represent those of the Marine division. In June 2006 the Lights business of McMurdo was sold, and in December 2006, a conditional agreement was entered into to sell McMurdo's Electronics business to Signature Industries Limited. The agreement provides for an earn out of up to £1.5 million, if certain sales targets are achieved. The earn out proceeds will be cash accounted for as the proceeds are received. ICS Electronics remained unsold at the year end, and a decision was taken to fully impair the goodwill associated with this company, leaving net assets of approximately £0.1 million.

A summary of the results of the discontinued operations follows:

| | 2006 £m | 2005 £m |
|----------------------|--------------|------------|
| Revenue | 11.3 | 11.5 |
| Pre-tax loss | (8.9) | (5.6) |
| Tax | 0.8 | 0.8 |
| Post-tax loss | (8.1) | (4.8) |

The pre-tax loss includes £1.0 million of trading losses (2005: £2.6 million), and £7.9 million of impairment and loss on disposal charges (2005: £3.0 million).

The net carrying value of the discontinued operations is £4.2 million (2005: £12.9 million), which is disclosed under assets for sale. Approximately £2.8 million is collectable when the sale to Signature Industries Limited completes, anticipated in Spring 2007, with the balance receivable from collection of working capital balances.

Shareholder Returns

Basic earnings per ordinary share from continuing operations were 70.33p (2005: 46.63p), an increase of 51%. Basic earnings per ordinary share were 44.33p (2005: 30.16p), an increase of 47%.

The dividend per ordinary share of 16.00p (2005: 10.50p) is covered 4.4 times (2005: 4.4 times) by the post-tax profits of the continuing operations.

The total shareholder return for the Group over the five years to 31 October 2006 has outperformed the FTSE 250 Index for the same period by 122%.

Shareholders' funds at the year end were £94.1 million (2005: £56.8 million).

Pensions

The Group's pension deficit before associated tax credits, as defined by IAS19 *Accounting for Pension Costs*, was £16.3 million (2005: £20.2 million), a decrease of 19%. The two UK final salary schemes are currently undergoing their triennial actuarial valuations, with results expected to be finalised in the first half of 2007.

Research and Development

Research and development expenditure totalled £5.3 million (2005: £4.2 million), an analysis of which is set out below:

| | 2006 £m | 2005 £m |
|---|------------|------------|
| Customer funded research and development | 2.1 | 2.5 |
| Internally funded research and development | 2.5 | 1.4 |
| Capitalised development costs | 0.7 | 0.3 |
| Total research and development expenditure | 5.3 | 4.2 |

The Group's policy is to write-off capitalised development costs over a three year period. Amortisation of development costs was £0.4 million (2005: £0.2 million).

Acquisitions

During the year the Group acquired the following businesses:

| | Date acquired | Consideration (including costs) £m |
|----------------------------|------------------|--|
| Comet GmbH | 30 Nov 2005 | 7.2 |
| Leaffield Engineering Ltd | 31 Jan 2006 | 5.2 |
| Technical Ordnance, Inc. | 13 Mar 2006 | 42.6 |
| B.D.L. Systems Ltd | 30 Sep 2006 | 10.2 |
| Total consideration | | 65.2 |

Of the total consideration, £39.0 million was funded by the draw down of medium term debt, with the balance of £26.2 million funded by a vendor placing.



A summary of the fair value of assets acquired and the goodwill arising on acquisitions is as follows:

| | 2006 £m |
|--------------------------------------|-------------|
| Intangible assets | 9.2 |
| Fixed assets | 5.3 |
| Working capital | 9.3 |
| Tax | (1.3) |
| Cash | 10.8 |
| Fair value of assets acquired | 24.3 |
| Consideration (including costs) | 65.2 |
| Goodwill arising | 40.9 |

Cash Flow

Operating cash flow was £45.6 million (2005: £21.1 million), which represents a conversion rate of operating profit to operating cash of 121% (2005: 92%). Working capital balances were well controlled in the year and were kept below increases in Group revenues.

Group fixed asset expenditure was £11.9 million (2005: £8.0 million). The principal expenditure was in support of Alloy Surfaces' second and third facilities, and a large flare facility at Kilgore Flares.

A summary of Group cash flow is set out below:

| | 2006 £m |
|--|-------------|
| Operating cash flow | 45.6 |
| Capital expenditure | (11.9) |
| Tax | (10.6) |
| Free cash flow | 23.1 |
| Interest | (5.3) |
| Dividends | (3.7) |
| Net cash inflow before acquisitions and disposals | 14.1 |

Net Debt

Net debt movements are summarised below:

| | 2006 £m |
|--|---------------|
| Opening net debt | (52.8) |
| Net cash inflow before acquisitions and disposals | 14.1 |
| Acquisitions and disposals (net of share placings) | (34.1) |
| Foreign exchange movements | 2.2 |
| Closing net debt | (70.6) |

Gearing at the year end was 75% (2005: 93%).

Share Capital

During the year 2,900,000 5p ordinary shares were issued as part of a vendor placing to fund the acquisition of Technical Ordnance, Inc. After costs, £26.2 million was raised.

157,500 5p ordinary shares were issued during the year, on the exercise of employee share awards. The proceeds of these share issues were £0.2 million.

International Financial Reporting Standards

International Financial Reporting Standards (IFRS) came into effect on 1 January 2005. The Group adopted IFRS at its 2006 interim results and has consequently restated the prior year financial statements. Full details of the restatements upon adoption of IFRS are contained in Note 36.

Foreign Exchange

The Group's principal foreign exchange exposure is to the US dollar. Foreign exchange contracts have been entered into for the next two financial years to reduce the Group's exposure to further depreciation of the US dollar against sterling.

P A Rayner
Finance Director

23 January 2007

Business Review

This Business Review, together with the Statement by the Chairman, the Review by the Chief Executive and the Review by the Finance Director set out on pages 3 to 15, provides a fair review of the Group's business development, performance and position at the end of the financial year; its strategy and likely future developments; key performance indicators; and a description of the principal risks and uncertainties facing the business.

Group Operations

Chemring Group PLC is an international leader in expendable countermeasures and energetics, with manufacturing operations in the UK, the US, Europe and Australia.

Countermeasures

The Group is the world's leading producer of expendable decoy countermeasures for protecting air, sea and land platforms against guided missile threats. Our countermeasures products can be categorised as follows:

Air Countermeasures

- Conventional MTV Flares
- Special Material Decoys
- Chaff

Naval Countermeasures

- RF Decoys
- IR Decoys





Energetics

The Group is a centre-of-excellence for the design, development and production of energetic materials and sub-systems for military, OEM and safety customers. Our energetics products can be categorised as follows:

Military Pyrotechnics

- Smokes and Flares
- Distraction and Screening Grenades
- Markers
- Smoke Payloads
- Battlefield Simulation Products
- Impulse Cartridges and Cartridge Activated Devices



Demolition Stores

- RF and Hard-wired Electrical Initiators
- Percussion Initiators
- Detonators
- Charges
- Minefield Clearance Systems



Energetics Sub-Systems

- Propellants and Rockets
- Fuze and Safe/Arm Units
- Flight Termination Systems
- Pyro-mechanisms and Actuators
- Warheads and Charges
- Primers
- Detonators and Explosive Chains



Marine Pyrotechnics

- Smokes and Flares
- Rockets
- Line Throwers



Business Review

- continued

Strategy

Group strategy

The Group strategy remains focused on our two core sectors of operations - Countermeasures and Energetics.

“Our vision is to be the leading producer of countermeasures and energetic materials for the global defence market.”

Countermeasures strategy

The core strategy for the Countermeasures business is to maintain and improve our market share, and carefully exploit the continuing market growth over the next few years. We intend to increase our investment in new products and to build on our leadership in both special material and spectral decoys. We also intend to invest in new automated production facilities, to further drive manufacturing efficiencies and to maintain our lead role in the development of new products for the next generation of fixed wing and rotary aircraft.

Energetics strategy

We intend to continue the expansion of our Energetics division, with new acquisitions in both the US and Europe. We will focus on becoming a key supplier of energetic materials to the major prime contractors for munitions. We intend to build on our expertise in explosive ordnance disposal (EOD) and develop the capability to become a specialist prime contractor. We also plan to invest in new products to expand our pyrotechnic business and develop clear leadership in both the detonator and cartridge activated device market.

Our geographic strategy also remains unchanged. We intend to manufacture in the US for the US market and in Europe for the European market. We will then use our excellent worldwide sales network to export from both the US and Europe. We will also develop our capabilities to bundle third party products and offer a broader supply chain management service to our export customers.

Strengths and Resources

The Group has core competencies in the design and manufacture of energetic materials; the development of highly reliable and safe products; and volume manufacturing.

Market position and reputation

The Group is the world's leading manufacturer of countermeasure decoys, with over 50% market share. The special material decoys manufactured by our US countermeasures business are unique to the Group, and we are currently leading the field in the development and manufacture of spectral decoys.

In our growing Energetics division, we are developing a prominent position in several niche market areas, and building on the Group's reputation as an expert manufacturer of products containing energetic materials.

Customer relationships

The Group has an extensive customer base, comprising governments, armed forces, prime contractors and OEMs across the globe. The US Department of Defense is our largest single customer. We have an extensive distribution network and, with worldwide market access, our businesses currently supply to over seventy countries.

Manufacturing operations

The Group continues to benefit from significant efficiency improvements achieved through enhanced automation and rationalisation of manufacturing capabilities across the Group, and we have an ongoing investment plan for new plants and technologies. Our operational structure is now geared to benefit strongly from future sales growth.

Solid financial base

The Group enjoys healthy operating margins across its businesses. Our focus on working capital management in recent years has manifested itself in excellent cash conversion and produced a sound balance sheet for the Group.

Management

Management resource and expertise has been strengthened at all levels across the Group during the last two years, and we continue to develop our operational skills to ensure that we remain a world class manufacturer. We have an experienced team working on business development and acquisitions, and we are focusing heavily on our post-acquisition plans to ensure that we achieve maximum value from our growth strategy.



Operating Performance and Key Performance Indicators

Operating performance during the year

| Continuing Operations | 2006 £000 | 2005 £000 |
|--|----------------|----------------|
| Revenue | | |
| Countermeasures | 118,384 | 90,768 |
| Energetics | | |
| -continuing operations | 42,058 | 30,195 |
| -acquired | 27,291 | - |
| -total | 69,349 | 30,195 |
| Total revenue | 187,733 | 120,963 |
| Operating profit | | |
| -continuing operations | 33,433 | 22,908 |
| -acquired | 4,346 | - |
| Total operating profit | 37,779 | 22,908 |
| Profit before tax | 31,760 | 19,216 |
| Basic earnings per ordinary share | 70.33p | 46.63p |

Key performance indicators

The Group's strategy is underpinned by focusing on a number of key financial performance indicators. The key indicators that the Board utilises to assess Group performance are set out below. Similar indicators are used to review performance in the two divisions.

Orders received and order book

| | Orders received | | Order book | |
|-----------------------|-----------------|----------------|----------------|----------------|
| Continuing Operations | 2006 £000 | 2005 £000 | 2006 £000 | 2005 £000 |
| Countermeasures | 173,663 | 93,112 | 130,431 | 89,734 |
| Energetics | 95,166 | 29,599 | 84,185 | 32,442 |
| Total | 268,829 | 122,711 | 214,616 | 122,176 |

The closing order book at the year end of £214.6 million represents a 75% increase on the previous year end. This reflects the significant increase in demand for the Group's products during the year, and provides a solid base for performance in the current financial year.

Business Review

- continued

Operating profit

| | Operating profit before unallocated head office costs | |
|-----------------------|---|---------------|
| Continuing Operations | 2006 £000 | 2005 £000 |
| Countermeasures | 33,876 | 24,808 |
| Energetics | 10,361 | 2,331 |
| Total | 44,237 | 27,139 |

The operating profit on continuing operations before unallocated head office costs increased by 63% during the year, reflecting the strong operating performance of both divisions.

Return on sales

| | Return on sales | |
|-----------------------|-----------------|-----------|
| Continuing Operations | 2006 % | 2005 % |
| Countermeasures | 29 | 27 |
| Energetics | 15 | 8 |
| Total | 24 | 22 |

The return on sales increased by 9% during the year. This growth is driven by improved automation, increased process efficiencies, and rationalisation of manufacturing facilities.

Interest cover

| | Interest cover | |
|--------------|------------------|----------------|
| | 2006 | 2005 |
| Total | 6.2 times | 6 times |

Interest was covered 6.2 times by operating profits at the year end. The Board aims to keep interest cover at a prudent level.

Operating cash flow

| | Operating cash flow | |
|--------------|---------------------|---------------|
| | 2006 £000 | 2005 £000 |
| Total | 45,629 | 21,141 |

Group operating cash flow increased by 116% to £45.6 million during the year. This represents a conversion rate of operating profit to operating cash of 121%.

Principal Risks and Uncertainties

As described on page 38, the Board is responsible for the Group's systems of internal control and its risk management systems. The Board has constituted a Risk Management Committee, which meets quarterly, to review the key risks associated with the achievement of the annual budget and the five year plan for each business, and the risk control procedures implemented. The Committee reports biannually to the Board, and through this process, the Board has identified the following principal risks currently facing the Group. The Group mitigates its risk exposure through an insurance programme that covers property and liability risks, where it is appropriate and cost-effective to do so.

Health and safety risks

The nature of the Group's operations, involving energetic materials, is such that the Board considers health and safety to be a key area of focus in managing risk. Accordingly, health and safety is included on the agenda at every Board meeting and is an important area of discussion at the monthly Group Executive Committee meeting. The Board believes that responsibility for the delivery of world class safety standards is an integral part of the operational management accountability. Accordingly, quarterly health and safety meetings are held in Europe and the US, chaired by the Managing Director of the Energetics division and the President of the US operations respectively. These supplement the regular health and safety meetings held at site level, which are chaired by the President or Managing Director of each site. A review of the top five manufacturing process risks at each business is undertaken by the Group Executive Committee at its monthly meetings, and our stated aim is to achieve zero injuries and to reduce health and safety risks, where they cannot be eliminated altogether, to a level which is "as low as reasonably practicable". Our planned automation of production facilities at all sites, to include remote operations where possible, is assisting this process, and will feature significantly in our future capital investment projects. Continual training of employees is also a key priority.

During the year, a white illuminating hand flare manufactured by the Group caused serious injury to a member of the public when fired. A detailed investigation concluded that the flare involved had deflagrated due to a rare production fault, and all of these types of flares were therefore recalled in May 2006. A provision of £0.5 million was made in the Group's accounts to cover the costs of this product recall, which is now substantially complete. Extensive tests established that the fault would not affect any other product manufactured by the Group. However, the incident did lead to a review of production control procedures across the Group, aimed at mitigating the risk of an incident such as this reoccurring in the future.



Further details on the Group's approach to health and safety are set out below.

Introduction of new products

The Group's innovative approach and continued research and development activity ensure that we are continually adding new products to the range. Over the last year, our position has been further strengthened in this area by the demand for our countermeasures on a range of new platforms. However, in order to satisfy these requirements, we need to ensure that new product development is completed to a standard which allows us to undertake volume manufacturing, and to produce products against high reliability and safety criteria. In a number of cases, new manufacturing facilities need to be built to accommodate the production of these new products, and in other areas, there is a need to provide significantly increased capacity on our existing production lines. This necessitates careful management of contractors - where construction work is being undertaken, suppliers - where new components have to be qualified for use in our products, and employees - where training in new skills is required. The management resource within the Group has been strengthened during the year to facilitate this. In addition, Six Sigma techniques are being introduced as appropriate within the organisation to improve our manufacturing capabilities.

Product design changes

Many of the Group's products are required to be modified and updated on a regular basis to meet our customers' changing requirements. There is inevitably risk associated with the implementation of product design changes, and whilst a review of the design change and product modification process in operation at each site has been undertaken during the year, further process improvements will continue to be driven by the Group management.

Technology transfers

The formation by the Group of centres-of-excellence for the production of energetic materials has generated considerable interest from major prime contractors in both the US and Europe, who are looking for strategic partners. Progressing the development of these relationships and securing the transfer of technologies from these large prime contractors is a key objective for the Group over the next five years. Accordingly, the Group is recruiting new personnel to manage these activities, and reviewing manufacturing capabilities and investing capital where necessary, to ensure that we mitigate the risk associated with the technology transfers and maximise the opportunities that are presented.

Management of prime contracts

The Energetics division secured several substantial prime contracts during the year from Middle Eastern and Far

Eastern countries. These contracts provide for the supply of an extensive range of our own and third party military products over the next three years, and require a particular type of programme management expertise. Dedicated programme managers have been appointed during the year, with a reporting chain through to the Group Executive Committee, which undertakes a regular high level review of programme status and supply chain issues.

Disaster recovery and crisis management

The Board recognises that a significant incident at one of its sites could result in that business being inoperable for a sustained period of time. New crisis management procedures have been adopted in the Group's European operations during the year, and these will be replicated in the US businesses over the next six months. A review of the business continuity plans in operation at each site is planned for the forthcoming year, and a best practice process will be adopted across the Group. This risk is also being mitigated as we increase the number of manufacturing sites in the Group, and build in flexibility to transfer production from one site to another.

Corporate Responsibility

Corporate responsibility management and accountability

The Board fully acknowledges its obligation to ensure the responsible operation of the Group's businesses at all times with due regard to the interests of shareholders, customers, employees and the wider community. The Board has overall responsibility for establishing and maintaining the Group's policies in this area, and the Chief Executive is accountable to the Board for ensuring that the Group's businesses adhere to these policies.

Business conduct

The Group has adopted a Code of Business Conduct, which requires our employees and our businesses to comply with applicable laws and regulations in all of the countries in which we operate. The Managing Directors of each business are required to report to the Chief Executive on compliance with the Code of Business Conduct on an annual basis.

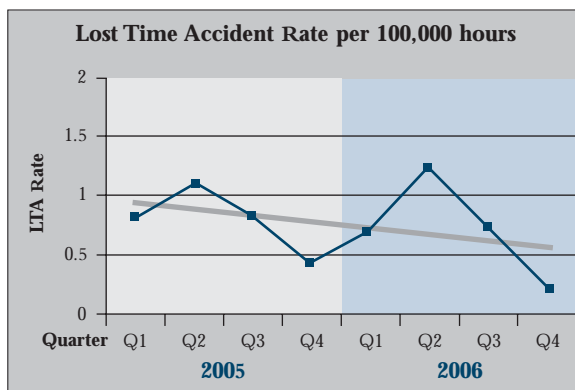
Arrangements exist by which employees may, in confidence, raise concerns about possible improprieties.

Health, safety and environment

The Board recognises that the highest levels of safety are required in order to achieve growth and maintain leadership in the Group's chosen markets. The Board believes that all injuries are preventable, and management systems and a long term strategy have been adopted to ensure that we continually improve our performance and reduce risk within the constraints of what is reasonably achievable. All accidents

Business Review

- continued



and near misses are investigated, steps taken to prevent recurrence, and “lessons learnt” shared across the Group’s businesses. During the year under review, the Group achieved a 21% reduction in lost time accidents from 0.96 per 100,000 hours in 2005 to 0.76 in 2006, as illustrated in the graph above.

The Board believes that environmental protection will help to secure the long term future of our businesses. The Group’s Health, Safety and Environment Policy states that we will control pollution, minimise the quantity of material burnt at each site, consume resources efficiently, and use materials that minimise the environmental impact of our operations where practicable. The Group recycled approximately 76% of its waste during the year, and our businesses are currently considering how to further increase their recycling proportion. All operations are working towards achieving ISO14001 standards, and we are aiming for the majority to be certified by the end of 2007.

The Board requires that all businesses systematically manage their health, safety and environment hazards; set objectives; monitor progress by regular measurement, audit and review; and take additional action when necessary. Each Managing Director is responsible for the management of health, safety and environmental issues within their business, and for providing adequate resources to satisfy the Board’s requirements. The Group management and all business heads have regular meetings to ensure that these requirements are being met. Audits and inspections are carried out annually by the Group at all operating sites to check that delivery is effective. The Group increased the number of dedicated health, safety and environment professionals employed at its operational sites by more than 50% during 2006.

The Board emphasises the importance of individual responsibility for health, safety and environment at all levels of our organisation. We expect managers to enforce procedures and to provide leadership and commitment that promote and embrace a positive culture in this area.

We expect employees to report potential hazards, to be involved in implementing solutions, and to adhere to rules and procedures. Employee attitude surveys have been carried out at one site during the year, and were followed up with workshops aimed at identifying opportunities to improve. We intend to carry out similar surveys in most other businesses in 2007.

The Group’s health, safety and environment performance is reported monthly to the Board. A number of key performance indicators, including lost time accident rates and recycling rates, are reported to the Board quarterly. We continue to liaise closely with regulators in order to ensure legislation is fully implemented at all operating sites.

Employees

The Board recognises the valuable contribution that the Group’s employees make to its success, and aims to provide a working environment that reflects this.

The Group pursues a policy of employee communication through meetings (including team briefings and works councils) and in-house magazines by which employees are made aware of the progress of the Group and the companies in which they work.

The Group employs disabled persons wherever circumstances permit, and full and fair consideration is given to applications for employment by disabled persons having regard to their particular aptitudes and disabilities. Disabled persons in employment receive equal treatment to that afforded to other employees, in line with the Group’s philosophy of equal opportunities for all employees, irrespective of race, nationality, gender, disability or age. The Group is committed to meeting, at a minimum, the labour rights and legislation requirements in each country in which it operates, and in practice, often exceeds these.

Community

The Board recognises that each of the Group’s businesses has an important role to play in its local community.

At locations where our operations may inconvenience neighbours through product proofing, we liaise with local residents to minimise any impact.

The Group supports charitable fund-raising activities through cash donations and allowing employees to undertake voluntary work in the local community where appropriate. In addition to local initiatives, the Group also supports selected national charitable causes with a focus on the armed services.



Directors and Professional Advisers

Non-Executive Chairman

Kenneth C Scobie^{***}

Joined the Group as Non-Executive Chairman in June 1997. Former Chairman of Allied Leisure plc. Chairman, Chief Executive and non-executive director of a wide range of industrial companies since 1972. Aged 68.

Executive Directors

Dr David J Price

Chief Executive

Joined the Group in April 2005 as Chief Executive. Formerly Managing Director, Naval Marine at Rolls-Royce plc. Previous appointments in the aerospace sector include Managing Director of Thomson (UK) Holdings Ltd and Chief Executive of Thomson-Thorn Missile Electronics Ltd (both now part of the Thales Group). Fellow of the Institute of Electrical Engineers and the Institute of Marine Engineering, Science & Technology. Aged 51.

Paul A Rayner FCA

Finance Director

Joined the Group in June 1994 and acted as Finance Director to several Group companies before being appointed to the Board in August 1999. Formerly a Senior Audit Manager with Deloitte & Touche. Aged 45.

Non-Executive Directors

David R Evans

Joined the Group in 1987 as Managing Director of the Countermeasures business and appointed to the Board in 1988. He took up his current position as a non-executive director in April 2005, after stepping down as Chief Executive, a position he had held since January 1999. Managing Director of the Marconi torpedo business prior to joining the Group. Currently a non-executive director of Whatman PLC. Aged 60.

The Rt Hon Lord Freeman^{***}

Joined the Group as a non-executive director in May 2006. Chairman of the Audit Committee. Currently a Consultant (formerly Partner) to PricewaterhouseCoopers and Chairman of Thales UK plc. He is also on the main Board of Thales S.A., France. Chairman of Cambridge University Board -Technology Transfer Office. Partner with Lehman Brothers Investment Bankers between 1969 and 1985. Member of Parliament from 1983 to 1997. Made a Privy Councillor in 1993. Aged 64.

Ian F R Much^{***}

Joined the Group as a non-executive director in December 2004. Chairman of the Remuneration Committee. Previous appointments include Chief Executive of De La Rue plc and T&N plc, and non-executive director of Admiral plc, Camelot plc and Manchester United plc. Currently a non-executive director of Senior plc and Simplyhealth Group Ltd. Aged 62.

Air Marshal Sir Peter Norriss KBE CB AFC MA FRAeS^{***}

Joined the Group as a non-executive director in May 2004. Currently Chairman of Microturbo Limited, Senior Military Adviser of VEGA Group PLC and consultant within the aerospace and defence sectors. Formerly Deputy Chief of Defence Procurement (Operations) and Controller Aircraft. Past President of the Royal Aeronautical Society. Aged 62.

Secretary

Sarah Ellard FCIS

Professional Advisers

Auditors

Deloitte & Touche LLP, Southampton

Solicitors

Ashurst, London
Seyfarth Shaw, Washington

Bankers

Bank of Scotland, Southampton

Stockbrokers

Investec Henderson Crosthwaite, London

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Registration Number

86662

Registrars

Computershare Investor Services PLC
The Pavilions
Bridgwater Road
Bristol BS13 8AE

Membership of Board committees during year:

*Audit –Remuneration + Nomination

Directors' Report

for the year ended 31 October 2006

The directors present their annual report, together with the audited financial statements of the Group and the Company, for the year ended 31 October 2006.

Principal Activities

The principal activities of the Group are the design, manufacture and sale of countermeasures and energetic materials.

Business Review

The Statement by the Chairman, the Review by the Chief Executive and the Review by the Finance Director on pages 3 to 15, together with the Business Review on pages 16 to 22, provide a review of the Group's business development, performance and position during and at the end of the financial year; its strategy and likely future developments; key performance indicators; and a description of the principal risks and uncertainties facing the business. Further information regarding financial risk management policies and financial instruments is given in Notes 19 and 23 of the financial statements.

Results and Dividends

The profit attributable to the Group's shareholders for the year was £13.8 million (2005: £8.8 million). The directors recommend a final dividend of 11.20p per ordinary share, which together with the interim dividend of 4.80p per ordinary share paid in August 2006, gives a total for the year of 16.00p (2005: 10.50p). The final dividend is subject to approval by shareholders at the Annual General Meeting on 22 March 2007, and accordingly has not been included as a liability in these financial statements.

Directors and their Interests

The present directors are shown on page 23.

The Rt Hon Lord Freeman was appointed as a director on 26 May 2006. He will be seeking re-appointment under Article 87.1 of the Company's Articles of Association at the forthcoming Annual General Meeting on 22 March 2007. He does not have a service contract with the Company.

Mr K C Scobie will be retiring by rotation at the Annual General Meeting and will be offering himself for re-election. Details of Mr Scobie's service contract with the Company are set out in the Directors' Remuneration Report on page 31.

None of the directors had a beneficial interest in any contract of significance to which the Group was a party during the year to 31 October 2006.

Information required as to directors' shareholdings is set out in the Directors' Remuneration Report.

Substantial Shareholdings

At 22 January 2007 the following interests in the ordinary share capital of the Company exceeding 3% had been notified to the Company under the provisions of section 198 of the Companies Act 1985:

| <i>Name</i> | <i>% Interest</i> |
|---|-----------------------|
| Prudential Corporation PLC | 4.83 |
| Legal and General Investment Management | 4.01 |
| Barclays PLC | 3.94 |
| Standard Life Group | 3.92 |

Employees

Details of the Group's employment policies are set out in the Business Review on page 22.

Charitable and Political Donations

Charitable donations amounting to £18,000 (2005: £9,620) were made during the year. No political donations were made during the year (2005: £nil).

Policy on Payment of Suppliers

It is the policy of the Group that each of the Group companies should agree appropriate terms and conditions for its transactions with suppliers. These will range from standard written terms to individually negotiated contracts. Creditor days of the Group as at 31 October 2006 amounted to 59 days (2005: 66 days).



The Chemring Group Performance Share Plan (the “PSP”)

The following conditional awards were made under the PSP during the year:

| <i>Date of award</i> | <i>Total number of shares awarded</i> | <i>Number of participants receiving awards</i> |
|----------------------|---------------------------------------|--|
| 23 March 2006 | 121,420 | 19 |
| 27 September 2006 | <u>7,256</u> | <u>1</u> |
| Total | <u>128,676</u> | <u>20</u> |

The Chemring 1998 Executive Share Option Scheme (the “1998 ESOS”)

On 1 February 2006, options were granted over 50,000 ordinary shares. During the year options over 95,000 ordinary shares were exercised. Additional information is set out in Note 30.

The Chemring Group PLC Share Based Incentive Scheme (the “ESOP”)

No options were granted during the year and there were no options outstanding under the ESOP at 31 October 2006.

Share Capital

Under the provisions of section 80 of the Companies Act 1985 (“the Act”) the Board is prevented from exercising its powers under the Articles of Association (“the Articles”) to allot shares without an authority in terms of the Act contained either in the Articles or in a resolution of the shareholders in general meeting. The authority, when given, can last for a maximum period of five years, but the Board proposes that renewal should be sought at each Annual General Meeting. Such proposal is set out as resolution 7 in the Notice of Annual General Meeting.

Section 89 of the Act requires that an allotment of shares for cash may not be made unless the shares are first offered to existing shareholders on a pre-emptive basis in accordance with the terms of the Act. In accordance with general practice, to ensure that small issues of shares can be made without the necessity of convening a general meeting, the Board proposes that advantage be taken of the provisions of section 95 of the Act to not apply the Act’s pre-emptive requirements. Accordingly, a special resolution (set out as resolution 8 in the Notice of Annual General Meeting) will be proposed which, if passed, will have the effect of granting the directors the power to allot not more than

5% of the present issued ordinary share capital free of the requirements of section 89 of the Act. No issue of these shares will be made which would effectively alter the control of the Company without prior approval of the shareholders in general meeting.

Statement of Directors’ Responsibilities

The directors are responsible for preparing the annual report and the financial statements. The directors have chosen to prepare accounts for the Group in accordance with International Financial Reporting Standards (IFRSs). Company law requires the directors to prepare such financial statements in accordance with International Financial Reporting Standards, the Companies Act 1985 and Article 4 of the IAS Regulation. 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:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- 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;
- for the Company financial statements, state whether applicable UK accounting standards have been followed; and
- prepare the accounts on a going concern basis unless, having assessed the ability of the Company to continue as a going concern, management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

Directors' Report

- *continued*

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 which comply with the requirements of the Companies Act 1985.

The directors are responsible for the maintenance and integrity of the Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements differs from legislation in other jurisdictions.

The directors confirm that suitable accounting policies, consistently applied and supported by reasonable and prudent judgments and estimates, have been used in the preparation of the financial statements, and that applicable accounting standards have been followed.

Provision of Information to Auditors

Each of the directors at the date of approval of this report confirms that:

- so far as the director is aware, there is no relevant audit information of which the Company's auditors are unaware; and
- the 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 confirmation is given and should be interpreted in accordance with the provisions of s234ZA of the Companies Act 1985.

Close Company Provisions

As far as the directors are aware, the close company provisions of the Taxes Acts do not apply to the Group nor has there been any change in that respect since 31 October 2006.

Auditors

A resolution to re-appoint Deloitte & Touche LLP as auditors will be proposed at the Annual General Meeting

Annual General Meeting

The resolutions to be proposed at the Annual General Meeting to be held on 22 March 2007, together with explanatory notes, appear in the separate Notice of Annual General Meeting sent to all shareholders.

Approved by the Board of Directors on 23 January 2007.

Signed on behalf of the Board

S L Ellard - Secretary



Directors' Remuneration Report

This report sets out the information required by the Directors' Remuneration Report Regulations 2002 ("the Regulations"). As required by the Regulations, the Directors' Remuneration Report will be submitted to shareholders for approval at the Annual General Meeting on 22 March 2007.

Unaudited Information

Remuneration Committee

During the year under review the Remuneration Committee comprised:

- **Mr I F R Much** (Committee Chairman)
- **Air Marshal Sir Peter Norriss**
- **The Rt Hon Lord Freeman** (appointed 26 May 2006)
- **Mr K C Scobie** (re-appointed 3 August 2006)

Mr Scobie was re-appointed as a member of the Committee following publication by the Financial Reporting Council of the amended Combined Code on Corporate Governance in June 2006, in which it was deemed permissible for the Chairman to be a member of the Remuneration Committee (so long as he was considered independent upon his appointment as Chairman).

The Committee's principal responsibilities are:

- determining, agreeing with the Board and reviewing from time to time the overall policy for the remuneration of the Chairman, the executive directors, the Company Secretary and certain other senior executives in the Group, and their individual remuneration packages and any changes thereto;
- approving the terms and conditions of employment, and any changes thereto, of the executive directors;
- approving any compensation payments for executive directors;
- approving the design of, and determining targets for, any performance-related pay schemes operated by the Group;
- reviewing the design of all share incentive plans for approval by the Board and the Company's shareholders;
- overseeing any major changes in employee benefits structures across the Group.

None of the Committee members has any personal financial interest in the matters reserved for the Committee (other than the Chairman in respect of his own remuneration; accordingly, he will not be present during any discussions relating to this matter), nor do they have any conflicts of interest arising from cross-directorships, and they are not involved in the day to day running of the Group's business. Therefore, they are regarded by the Board as independent.

The Committee met five times during the year. The Chief Executive attends meetings by invitation but is not present during any discussions relating to his own remuneration.

The terms of reference of the Committee are available on the Company's website or on request from the Company Secretary.

Advisers

During the year the Committee received advice on remuneration matters from New Bridge Street Consultants LLP and Aon Consulting. Aon Consulting also provided investment consultancy services for the Group's UK pension schemes during the year.

The Committee also consults internally with the Chief Executive and the Company Secretary.

Remuneration Policy for Executive Directors

The Committee's policy is to provide executive remuneration packages which are competitive, but not excessive, by reference to market rates across comparator companies, reflect the performance of the business against financial objectives, and which take into account the individual contribution and performance of each executive director. Remuneration packages comprise the following elements:

- (i) basic salary and benefits, including pensions;
- (ii) annual bonuses linked to the Group's financial performance; and
- (iii) awards of share-based incentives linked to the long term growth of the Group.

The Committee aims to align the interests of executive directors with those of shareholders, by ensuring that a significant proportion of remuneration is performance-related. This is achieved through the performance-related elements of annual bonuses and share-based incentives.

Directors' Remuneration Report

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Basic Salaries and Benefits

The executive directors' basic salaries are reviewed annually by the Committee, and adjustments made, if appropriate, taking into account individual performance and comparable salary levels in manufacturing companies of a similar size and in other companies within the aerospace and defence sector. The Committee refers to published salary surveys and data provided by its remuneration advisers, New Bridge Street Consultants, and also reviews the remuneration information presented in the annual reports of companies in the reference group. Currently, Dr Price's basic salary is £300,000 per annum and Mr Rayner's basic salary is £190,000 per annum.

The main taxable benefits for executive directors are company cars, fuel for private motoring and private medical insurance.

Annual Bonuses

The Company operates an annual performance-related bonus plan for the executive directors, with key characteristics as follows:

- the maximum bonus potential for the executive directors is unchanged at 60% of basic salary, with an unchanged on-target bonus of 30% of basic salary;
- three quarters of the bonus potential is linked to two separate financial conditions, namely earnings per share and cash flow (with equal weighting). The conditions, which are set by the Committee, take into account a number of factors including budget, market expectations, long term growth prospects and the previous year's out-turn. No bonus is payable for achievement of less than 90% of target, with bonuses being earned thereafter on a straight-line basis up to the maximum for 110% or better achievement of target;
- one quarter of the bonus potential may be achieved in connection with the satisfaction of personal objective criteria set at the beginning of the financial year. No part of this element of bonus is payable unless threshold performance of both the financial conditions described above is achieved;
- one quarter of any bonus payable is deferred as a conditional award of the Company's shares, with vesting subject to continued employment (save in good leaver scenarios) three years from the award of bonus; and
- the payment of any bonus remains ultimately at the discretion of the Committee.

Bonuses are non-pensionable.

Long Term Incentive Schemes

Performance Share Plan

Following an independent review of remuneration last year, a new long term incentive plan (the Chemring Group Performance Share Plan) was approved by the shareholders at the Annual General Meeting on 23 March 2006. The plan has the following key features:

- conditional awards can be made of the Company's shares worth no more than 100% of basic salary each year;
- awards will vest three years after grant subject to the extent to which a demanding performance condition has been achieved over a single three year performance period (with no ability to re-test the performance condition). The performance condition is based on the growth of the Company's earnings per share in excess of RPI over three consecutive financial years. The Committee considers an earnings per share condition to most closely align the interests of participants with those of the Company's shareholders;
- the following vesting schedule applies:

| Total earnings per share growth per annum (not compounded) over three financial years | Percentage of the total number of shares under an award that vest |
|---|---|
| Less than RPI + 5% | Nil |
| RPI + 5% | 33% |
| RPI + 15% or more | 100% |
| Between RPI + 5% and RPI + 15% | Between 33%-100% on a straight-line basis |

- earnings per share is calculated on a fully diluted and normalised basis, as specified by the Committee prior to grant; and
- market purchase shares or new issue shares (including treasury shares) may be used to satisfy awards. To the extent that new issue shares or treasury shares are used, these will count towards the usual share usage dilution limits (10% in ten years for all schemes and 5% in ten years for discretionary (executive) schemes).



Participation in the plan is extended at the discretion of the Committee to the executive directors and senior management of the Group, both in the UK and overseas. The following awards were made under the plan during the year:

| <i>Date of award</i> | <i>Total number of shares awarded</i> | <i>Number of participants receiving awards</i> |
|----------------------|---------------------------------------|--|
| 23 March 2006 | 121,420 | 19 |
| 27 September 2006 | <u>7,256</u> | <u>1</u> |
| Total | <u>128,676</u> | <u>20</u> |

Details of the awards made to executive directors during the year are set out on page 33.

Other Schemes

Between 1998 and 2005 the Company operated the Chemring 1998 Executive Share Option Scheme. Following the introduction of the Chemring Group Performance Share

Plan, no further grants will be made under the option scheme, save in exceptional circumstances such as on recruitment, and the conditions applying to any such grants will accord with current corporate governance best practice.

The Company previously operated a long term incentive scheme known as the Chemring Group PLC Share Based Incentive Scheme. This scheme is not being utilised at present.

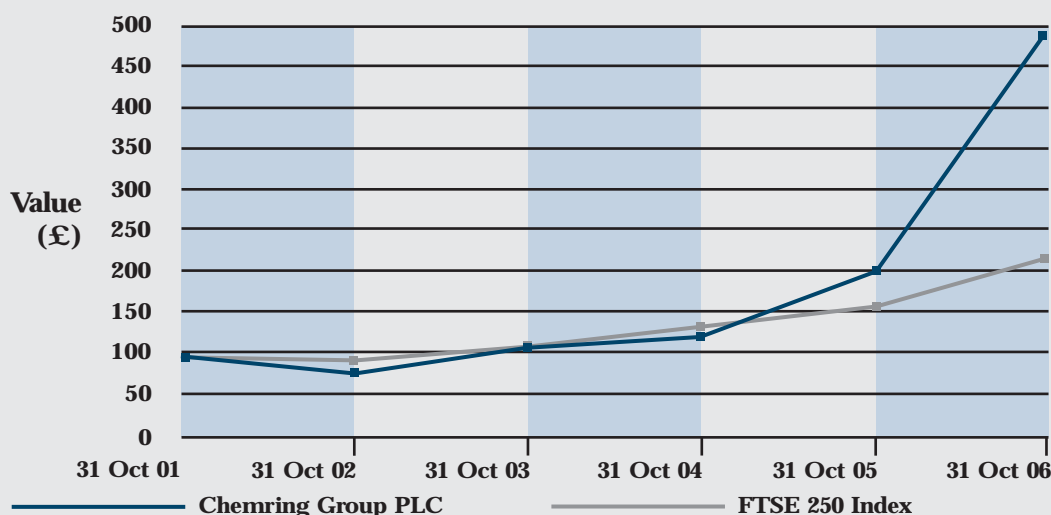
As referred to in previous Remuneration Reports, the Company also made a one-off award of restricted shares to Dr Price shortly after he took up his appointment as Chief Executive in 2005.

Performance Graph

The graph below shows a comparison of the Company's total shareholder return (TSR) over the last five financial years against a "broad equity market index", as required by the Regulations. The FTSE 250 Index has been selected by the Committee for this comparison because it provides the most appropriate measure of performance of listed companies of a similar size to the Company.

Total shareholder return

Source: Thomson Financial



This graph shows the value, by 31 October 2006, of £100 invested in Chemring Group PLC on 31 October 2001 compared with the value of £100 invested in the FTSE 250 Index. The other points plotted are the values at intervening financial year ends.

Directors' Remuneration Report

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Pensions

Dr Price is a member of the Chemring Group Staff Pension Scheme (the "Staff Scheme"). This is an approved final salary scheme, which is contracted out of the State Second Pension, and which provides, at retirement, a pension of up to two-thirds of salary, subject to Inland Revenue limits. The Staff Scheme also provides life assurance cover, dependants' pensions and lump sum payments on death-in-service. Members of the Staff Scheme are required to make monthly contributions to the scheme at the rate of 8% of pensionable salary.

Dr Price's pension under the Staff Scheme accrues at 1/80th of final pensionable salary for each year of membership, and he also accrues a cash lump sum at 3/80ths of final pensionable salary for each year of membership. A two-thirds spouses' pension is payable in respect of service accrued to 31 January 2004, reducing to 50% for service accrued thereafter, and on death-in-service, Dr Price's dependants would receive a lump sum payment of two times basic salary and, in addition a spouses' pension would be payable, as calculated above. Dr Price is subject to an earnings cap (equivalent to the cap applied by HM Revenue and Customs prior to April 2006) in respect of his membership of the Staff Scheme.

Mr Rayner is a member of the Chemring Group Executive Pension Scheme (the "Executive Scheme"). The Executive Scheme is also an approved final salary scheme but is not contracted out of the State Second Pension. Members of the Executive Scheme are required to make monthly contributions to the scheme at the rate of 8% of pensionable salary. Mr Rayner's benefits under the Executive Scheme accrue in an identical manner to that in which Dr Price accrues benefits under the Staff Scheme, as set out above. Mr Rayner is also subject to an earnings cap.

Mr Evans also participated in the Executive Scheme up until 31 March 2006. His benefit accrual was based on a pension of two-thirds final pensionable salary with no cash commutation, and a 50% spouses' pension, in respect of his membership of the scheme from 10 August 1987 to 5 April 1993. For service thereafter, his benefit accrual was based on a pension of 50% final pensionable salary plus one and a half times final pensionable salary as cash, and a two-thirds spouses' pension. For service accrued from 1 February 2004, the spouses' pension reduced to 50%.

Mr Evans started drawing benefits under the Executive Scheme on reaching the age of 60 in October 2006.

Both Dr Price and Mr Rayner have a normal retirement age of 65.

The Committee undertook a review of the impact of changes in pension legislation during the year. Steps have been taken to ensure that any changes in benefits accruing have been broadly cost neutral from the Company's perspective; in particular, an earnings cap (equivalent to the cap applied by HM Revenue and Customs prior to April 2006) has been retained.

Service Contracts

Dr Price has a rolling service contract dated 4 April 2005. This provides for termination by either party on twelve months' notice. The Company may however terminate without notice, and make a payment in lieu of notice equal to the sum of the salary due for the unexpired notice period plus the fair value of any contractual benefits. Any such sum may be paid in instalments, and in these circumstances there is a requirement to mitigate loss.

Mr Rayner has a rolling service contract dated 27 August 1999. This provides for termination by either party on twelve months' notice. The Company may however terminate without notice and make a payment in lieu of notice equal to the sum of twelve months' salary plus the value of any contractual benefits. There are no other provisions relating to compensation on early termination.

It is the Committee's general policy that all new executive directors appointed in the future will have service contracts with the Company which are terminable on a maximum of twelve months' notice. The service contracts will contain provisions permitting the Company to make any termination payments by instalments, and will require directors to mitigate their loss in such circumstances.



Policy on Outside Appointments

With the specific approval of the Board in each case, executive directors may accept external appointments as non-executive directors of other companies, provided that they do not detract from their responsibilities to the Group, and may retain any related fees paid to them. None of the executive directors currently holds any external appointments.

Non-Executive Directors

Mr Scobie has a rolling service contract with the Company terminable on twelve months' notice by either party. His remuneration under the contract, part of which is paid to his company for consultancy services, is £88,000 per annum. His time commitment under the contract is two to four days per month, not to exceed a total of fifty days per year. Additional services are paid for at the rate of £1,000 per day.

Mr Evans was previously employed by the Company as Chief Executive under a service contract, dated 10 December 1991, which was due to expire on Mr Evans' 60th birthday on 27 October 2006. The contract was terminated early by the Company on 31 March 2006, and all amounts due to Mr Evans for the balance of the contract were paid over the four month period to 31 July 2006. Mr Evans now has a letter of appointment covering his terms of appointment as a non-executive director and expected time commitment. This letter of appointment provides for a three year appointment, unless terminated earlier by and at the discretion of either party upon three months' written notice. The basic fee payable to Mr Evans is £30,000 per annum.

The Rt Hon Lord Freeman, Mr Much and Air Marshal Sir Peter Norriss also have letters of appointment covering, amongst other items, their terms of appointment and expected time commitment. These letters of appointment provide for an initial three year appointment, unless terminated earlier by and at the discretion of either party upon three months' written notice, and anticipate that, subject to satisfactory performance and re-election by the shareholders, two three-year terms will be served as a non-executive director. The basic fee payable to each of these three non-executive directors is £30,000 per annum. The Rt Hon Lord Freeman and Mr Much each receive an additional fee of £4,500 per annum, in respect of their Chairmanship of the Audit Committee and Remuneration Committee respectively.

Fees for the non-executive directors are determined annually by the Board, having regard to the practice of other companies and the particular demands of the Group.

The Company provides private medical insurance for Mr Scobie, Mr Evans and Air Marshal Sir Peter Norriss, and their respective spouses.

With the exception of Mr Evans, whose pension arrangements are set out above, the non-executive directors do not participate in the Company's pension, bonus or share-based incentive schemes. However, a long term incentive scheme, known as The Chemring Group Phantom Share Option Scheme, was established in 1997 to secure the appointment of Mr Scobie as Chairman at a difficult time when the Group was undergoing a fundamental reorganisation. Mr Scobie, who is the only participant in the scheme, acquired a contractual entitlement on his appointment in 1997 to the grant of phantom options over 141,025 ordinary shares in the Company at a notional exercise price of 78p per share. On exercise of the phantom options at least three years after the date of grant, Mr Scobie will be entitled to a cash payment from the Company equivalent to the difference between the then current market value of the ordinary shares less the total exercise price. The options have met the performance condition linked to growth in earnings per share. No further awards will be made under this scheme.

Directors' Remuneration Report

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Audited Information

Directors' Emoluments

The emoluments of all the directors who served during the year are shown below:

| | <i>Salaries and fees</i> | | <i>Bonuses (cash and deferred shares)</i> | | <i>Taxable benefits</i> | | <i>Total</i> | |
|--|------------------------------|----------------------|---|----------------------|-----------------------------|----------------------|----------------------|----------------------|
| | <i>2006 £000</i> | <i>2005 £000</i> | <i>2006 £000</i> | <i>2005 £000</i> | <i>2006 £000</i> | <i>2005 £000</i> | <i>2006 £000</i> | <i>2005 £000</i> |
| Executives | | | | | | | | |
| D J Price (appointed 4 Apr 2005) | 279 | 144 | 176 | 54 | 31 | 18 | 486 | 216 |
| P A Rayner | 177 | 156 | 111 | 70 | 17 | 16 | 305 | 242 |
| Non-executives | | | | | | | | |
| D R Evans | 198 | 200 | - | 41 | 28 | 30 | 226 | 271 |
| R N Freeman (appointed 26 May 2006) | 12 | - | - | - | - | - | 12 | - |
| I F R Much | 34 | 21 | - | - | - | - | 34 | 21 |
| P C Norriss | 30 | 25 | - | - | 1 | 1 | 31 | 26 |
| K C Scobie | 88 | 80 | - | - | 2 | 2 | 90 | 82 |
| Total remuneration | 818 | 626 | 287 | 165 | 79 | 67 | 1,184 | 858 |

Amounts shown above in the salaries and fees column relate to basic salary in the case of executive directors and fees in the case of non-executive directors.

Mr Scobie's remuneration includes payments to his company, K C Scobie Limited, in respect of his consultancy services. In addition to the remuneration shown above, Mr Scobie has a long term incentive scheme, details of which are given on page 31, in respect of which the Group had accrued £2,122,000 (2005: £810,000) as at 31 October 2006. £1,312,000 (2005: charge of £369,000) was charged to the profit and loss account during the year in respect of Mr Scobie's long term incentive scheme, reflecting the increase in the Group's share price during the year and the increase in the cash amount to be paid to Mr Scobie on exercise of his phantom options.

Mr Evans' remuneration includes payments due to him under his service contract with the Company, which was terminated early on 31 March 2006 (as explained more fully on page 31).

The bonuses paid to Dr Price and Mr Rayner for the year were linked to the achievement of pre-agreed targets for earnings per share and operating cash flow. The Group performed exceptionally well during the year, and the reported earnings per share of 70.33p, an increase of 51% over last year, and operating cash flow of £45.6 million, an increase of 116% over last year, were both in excess of 110% of the bonus scheme targets. Accordingly, Dr Price and Mr Rayner both earned bonuses for the year equating to 58.5% of basic salary. One quarter of the value of the 2006 bonus payable has been deferred as a conditional award of the Company's shares, with vesting usually subject to continued employment three years from the award of bonus.



Directors' Share Interests

The interests of the directors in the ordinary shares of the Company at 1 November 2005 (or date of appointment if later) and 31 October 2006 are shown below. All are beneficial holdings.

| | <i>2006 Number</i> | <i>2005 Number</i> |
|-------------|------------------------|------------------------|
| D R Evans | 80,348 | 87,497 |
| R N Freeman | - | - |
| I F R Much | 3,000 | - |
| P C Norriss | 3,600 | - |
| D J Price | 36,400 | 1,000 |
| P A Rayner | 21,000 | 20,000 |
| K C Scobie | 149,864 | 144,864 |

No movements have taken place between 31 October 2006 and 22 January 2007.

In addition to the interests detailed above, by the virtue of section 324 of the Companies Act 1985, the executive directors are technically deemed to be interested in all of the shares held by the trustees of the Chemring Group PLC Share Based Incentive Scheme. 43,274 ordinary shares were held by the trustees at 31 October 2006.

Performance Share Plan

Details of awards made to the executive directors under the Chemring Group Performance Share Plan during the year are shown below.

| | <i>Number of shares</i> | | | | | |
|------------|------------------------------|--|---------------------------------------|--|-------------------------------|------------------------|
| | <i>At 1 Nov 2005</i> | <i>Granted during the year</i> | <i>Lapsed during the year</i> | <i>Exercised during the year</i> | <i>At 31 Oct 2006</i> | <i>Date of vesting</i> |
| D J Price | - | 22,321 | - | - | 22,321 | 23 March 2009 |
| P A Rayner | - | 14,285 | - | - | 14,285 | 23 March 2009 |

Awards were granted during the year on 23 March 2006 when the Company's share price was 1136p. 33% of the shares under award will vest if earnings per share growth is RPI+5% p.a. over the three year performance period, rising on a straight-line basis to full vesting for growth of at least RPI+15% p.a.

Share Options

The holdings by the directors of share options granted under the Chemring 1998 Executive Share Option Scheme at 1 November 2005 and 31 October 2006 are shown below.

| | <i>Number of share options</i> | | | | | | | | |
|------------|--------------------------------|--|---------------------------------------|--|-------------------------------|-------------------------------|---|--|------------------------|
| | <i>At 1 Nov 2005</i> | <i>Granted during the year</i> | <i>Lapsed during the year</i> | <i>Exercised during the year</i> | <i>At 31 Oct 2006</i> | <i>Exercise price (p)</i> | <i>Market price at date of exercise (p)</i> | <i>Date from which exercisable</i> | <i>Expiry date</i> |
| D J Price | 52,798 | - | - | - | 52,798 | 473.5 | - | 7 Apr 2008 | 6 Apr 2015 |
| P A Rayner | 25,000 | - | - | - | 25,000 | 436.5 | - | 8 Jul 2007 | 7 Jul 2014 |

The exercise of outstanding share options is subject to the Company meeting pre-set performance targets.

Directors' Remuneration Report

- continued

- For options first exercisable in 2007, the target requires the Company's average annual earnings per share to increase by at least 5% over the period of three, four or five years following grant.
- For options first exercisable in 2008, 50% of the options granted will vest after three years if the growth in the Company's earnings per share over the period exceeds RPI+3% per annum, increasing (on a straight-line basis) to 100% of the options vesting if earnings per share growth over the period exceeds RPI+6% per annum. No re-testing is permitted.

Restricted Shares

As described in previous Remuneration Reports, Dr Price received a one-time award of 125,000 restricted ordinary shares shortly after he took up his appointment as Chief Executive in 2005 (when the Company's share price was 450p). 50% of these shares vested in March 2006 (when the Company's share price was 1184p) and, subject to him remaining in the post, the remaining 50% will vest in March 2007. There are no other performance conditions. This award was necessary in order to secure the appointment of Dr Price, and compensates him for the loss of the options and performance shares he held in his previous employment.

The market price of the ordinary shares at 31 October 2006 was 1583p. During the year, the ordinary shares traded within the range 660p to 1630p.

Pensions

The following table sets out the pension benefits accrued by the directors during the year.

| | Total benefit accrued at 31 Oct 2005 | | Transfer value of accrued benefit at 31 Oct 2005 | Increase in accrued benefit during year before inflation | | Total benefit accrued at 31 Oct 2006 | | Transfer value of accrued benefit at 31 Oct 2006 | Increase in accrued benefit during year after inflation | | Transfer value of increase in accrued benefit after inflation (less members' contributions) | Increase in transfer value during year (less members' contributions) |
|------------|--------------------------------------|----------|--|--|----------|--------------------------------------|----------|--|---|----------|---|--|
| | Pension (£p.a.) | Cash (£) | (£) | Pension (£p.a.) | Cash (£) | Pension (£p.a.) | Cash (£) | (£) | Pension (£p.a.) | Cash (£) | (£) | (£) |
| D J Price | 660 | 1,980 | - | 1,376 | 4,129 | 2,036 | 6,109 | 23,905 | 1,352 | 4,056 | 7,306 | 15,337 |
| P A Rayner | 15,070 | 45,210 | 201,844 | 1,786 | 5,357 | 16,856 | 50,567 | 223,487 | 1,232 | 3,696 | 2,687 | 13,075 |
| D R Evans | 109,437 | 137,624 | 2,092,271 | 5,890 | 7,576 | 115,327 | 145,200 | 2,403,568 | 1,870 | 2,521 | 17,557 | 295,297 |

- i) Mr Evans retired on 27 October 2006. The increase in accrued benefit and benefits accrued as at 31 October 2006 have been based on the pension before commutation. The transfer value is based on the cash sum and pension actually received by Mr Evans.
- ii) Transfer values represent liabilities of the applicable scheme, and do not represent sums paid to the individuals.
- iii) Transfer values have been calculated on the basis of actuarial advice in accordance with actuarial professional guidance.

Approval of the Directors' Remuneration Report

The Directors' Remuneration Report was approved by the Board on 23 January 2007.

Signed on behalf of the Board

I F R Much - Chairman of the Remuneration Committee



Statement on Corporate Governance

This statement sets out how the Company has applied the main and supporting principles of good governance set out in Section 1 of the revised Combined Code on Corporate Governance, and whether or not the Company has complied throughout its accounting period with the provisions of Section 1 of the revised Combined Code.

The Board

The Board currently comprises the Chairman, the Chief Executive, the Finance Director and four non-executive directors. The Board considers that three of the current non-executive directors, The Rt Hon Lord Freeman, Mr Much and Air Marshal Sir Peter Norriss, are independent in character and judgment, and meet the criteria for independence set out in the revised Combined Code. The directors' biographical details are set out on page 23.

The Board, which meets at least ten times a year, approves the Group's long-term goals and strategies and provides overall financial and organisational control. The Board has a formal schedule of matters specifically reserved to it for consideration and approval, including: approval of the Group's corporate plan; approval of the annual operating budgets; acquisitions, disposals and major capital expenditure; financing and treasury; pensions; reviewing the Group's systems of financial control and risk management; approving appointments to the Board and approving policies relating to directors' remuneration; and maintaining an effective dialogue with shareholders. All directors take decisions objectively in the interests of the Company.

The Board delegates certain responsibilities to the Executive Committee, including: implementation of the Group's strategies and policies as determined by the Board; monitoring of operational and financial results against budget; allocation of resources across the Group within the overall plan approved by the Board; capital expenditure within limits imposed by the Board; and developing and implementing risk management systems. Further details of the Executive Committee are set out in the section of this report covering Board Committees.

Procedures are in place covering the content, presentation and timely delivery of papers to the Board for each Board meeting, to ensure that directors have sufficient information to make expedient and considered decisions in fulfilment of their fiduciary duties. Where directors have concerns which cannot be resolved about the running of the Company or a proposed action, such concerns are recorded in the Board minutes.

Each director has full access to the advice and services of the Company Secretary who, under the direction of the Chairman, is responsible for maintaining good information flows within the Board and its committees, assisting with induction and keeping

the directors informed about changes to their duties and responsibilities, and advising the Board on all governance matters. The appointment and removal of the Company Secretary is a matter for the Board as a whole.

All directors are entitled to take independent professional advice in furtherance of their duties at the Company's expense, if the need should arise.

An internal induction programme on the Group's operations and its strategic and business plans is provided for newly-appointed directors. The Company Secretary also provides detailed information on directors' legal duties and responsibilities on appointment, and updates the Board on a regular basis with regards to regulatory changes affecting the directors and the Group's operations generally. Directors are continually updated on the Group's businesses and the matters affecting the market in which they operate. The Company meets the cost of appropriate external training for directors, the requirement for which is kept under review by the Chairman.

The Company separates the roles of Chairman and Chief Executive in accordance with the recommendations of the revised Combined Code. The division of responsibilities between the Chairman and the Chief Executive, and their respective job descriptions, are set out in writing and agreed by the Board.

In addition to chairing the Board, the Chairman is responsible for: ensuring that the Board is kept properly informed and is consulted on all decisions reserved to it; promoting constructive relations between the executive and non-executive directors; ensuring that the development needs of directors are identified and the performance of the Board evaluated on a regular basis; and ensuring effective communication with shareholders and acting as a conduit to ensure that the views of shareholders are communicated to the Board. The Chairman has no significant business commitments other than his chairmanship of the Company.

The non-executive directors perform an essential role in safeguarding shareholders' interests. They actively participate in the development of strategic objectives and monitor the performance of executive management in achieving these objectives. The non-executive directors also review financial performance, and consider the integrity of the financial information produced by the Group and whether the financial controls and risk management systems are robust and defensible. They meet regularly with the management of the Group's operating companies. In addition to participating in Board meetings, the three independent non-executive directors are the members of the standing committees set up to deal with audit and the remuneration of executive directors and senior

Statement on Corporate Governance

- continued

management. The Board considers that the current balance of executive and non-executive influence which exists is appropriate for the Company, taking into account its size and status.

The Board has not appointed a senior independent director, as it does not consider this to be appropriate at the present time in view of the size of the Board.

During the financial year, the Chairman met regularly with the non-executive directors without the executives present.

Mr Evans, The Rt Hon Lord Freeman, Mr Much and Air Marshal Sir Peter Norriss all have letters of appointment covering, amongst other items, their terms of appointment and expected time commitment. These letters of appointment provide for an initial three year appointment, unless terminated earlier by and at the discretion of either party upon three months' written notice. The non-executive directors' letters of appointment are available for inspection on request to the Company Secretary.

In accordance with the revised Combined Code and the Company's Articles of Association, all directors submit themselves for re-election every three years. The papers accompanying the Notice of Annual General Meeting include a statement from the Chairman confirming that the performance of each non-executive director seeking re-election at the meeting continues to be effective and that each such director continues to demonstrate commitment to their role.

A formal evaluation of the performance of the Board and its committees was undertaken during the year. This was facilitated by the Chairman and the Company Secretary, using a questionnaire-based approach. The process identified that minor improvements to succession planning in the Group would be beneficial and this is now being addressed.

The Company maintains directors and officers liability insurance in respect of legal action against its directors.

Board Committees

The terms of reference of the Audit Committee, the Nomination Committee and the Remuneration Committee are posted on the Company's website and are available on request from the Company Secretary.

Audit Committee

During the year Mr Scobie, The Rt Hon Lord Freeman, Mr Much and Air Marshal Sir Peter Norriss all served as members of the Audit Committee. Mr Scobie initially acted as Chairman of the Committee on an interim basis, pending the appointment of a new non-executive director, but resigned as a member following the appointment of The Rt Hon Lord Freeman as Chairman of the Committee on 1 July 2006. The Committee meets not less than twice a year and operates within formal written terms of reference. As referred to above, the terms of reference are available on the Company's website. Meetings of the Committee are attended, at the invitation of the Committee,

Meetings Attendance

The following table shows the attendance of directors, who served during the year, at meetings of the Board, the Audit Committee, the Nomination Committee and the Remuneration Committee:

| | <i>Board</i> <i>(12 meetings)</i> | <i>Audit Committee</i> <i>(2 meetings)</i> | <i>Nomination Committee</i> <i>(0 meetings)</i> | <i>Remuneration Committee</i> <i>(5 meetings)</i> |
|-------------------------------|--------------------------------------|---|--|--|
| K C Scobie | 12 (12) | 2 (2) | - | 0 (0) |
| D R Evans | 11 (12) | - | - | - |
| The Rt Hon Lord Freeman | 3 (4) | 1 (1) | - | 0 (0) |
| I F R Much | 12 (12) | 2 (2) | - | 5 (5) |
| Air Marshal Sir Peter Norriss | 12 (12) | 2 (2) | - | 5 (5) |
| D J Price | 12 (12) | - | - | - |
| P A Rayner | 12 (12) | - | - | - |

The maximum number of meetings which each director could have attended is shown in brackets.



by the external auditors, the Chairman, the Finance Director and representatives from the Group finance function. The Committee meets with the auditors on a regular basis without executive directors present. The Company Secretary acts as secretary to the Committee and minutes of meetings are circulated to all Board members.

The Committee is authorised to seek any information it requires from any employee of the Company in order to perform its duties, and to obtain any outside legal or other professional advice it requires at the Company's expense.

The Committee monitors the integrity of the Group's financial statements and the effectiveness of the external audit process. It is responsible for ensuring that an appropriate relationship between the Group and the external auditors is maintained, including reviewing non-audit services and fees. The Committee keeps under review the effectiveness of the Group's internal controls and financial risk management systems, and on an annual basis, considers the need for a dedicated internal audit function. The Committee reviews annually its terms of reference and its effectiveness, and recommends to the Board any changes required as the result of such review.

During the year, the Committee, operating under its terms of reference, discharged its responsibilities by:

- reviewing the Group's draft 2005 financial statements and 2006 interim results statement prior to Board approval and reviewing the external auditors' detailed reports thereon;
- reviewing the appropriateness of the Group's accounting policies, and reviewing various accounting matters raised by management and the external auditors in the context of financial disclosures;
- reviewing the potential impact in the Group's financial statements of certain matters such as impairments of fixed asset values and International Financial Reporting Standards;
- reviewing the external auditors' plan for the 2005 financial statements and 2006 interim results, including key risks on the accounts, confirmation of auditor independence and the proposed audit fee, and approving the terms of engagement for the audit;
- reviewing the requirement for a dedicated internal audit function.

The Committee also reviewed the arrangements by which employees may, in confidence, raise concerns about possible improprieties in financial reporting or other matters during the year.

During the year under review, the Group did not have a dedicated internal audit function. Despite this, it is felt that the financial record keeping in the Group is robust and capable of highlighting significant departures from procedures. Other areas of risk which might normally be carried out by an internal audit function have been in the main covered by the Board as a whole or by the activities of other committees reporting in to the Board. The Group will establish an internal audit function during 2007.

The Board has accepted the Committee's recommendation that Deloitte & Touche LLP be proposed for re-appointment as auditors at the forthcoming Annual General Meeting.

The Committee keeps under review the level of non-audit services which are provided by the external auditors, to ensure that this does not impair their independence and objectivity. The Committee, in conjunction with the Finance Director, also ensures that the Group maintains a sufficient choice of appropriately qualified audit firms. During the year, work on corporate finance matters was sourced from the external auditors only where there was no direct conflict with their role as external auditors and where there were clear efficiencies and value added benefits for the Company. Details of the amounts paid to the external auditors during the year for audit and other services are set out in the Notes to the Financial Statements on page 56.

Nomination Committee

Mr Scobie, Mr Much and Air Marshal Sir Peter Norriss all served on the Nomination Committee during the year. Mr Scobie is Chairman of the Committee but, in accordance with the Committee's terms of reference, is not permitted to chair meetings when the Committee is dealing with the appointment of his successor. As referred to above, the Committee's terms of reference are available on the Company's website.

With regards to the recruitment and appointment of new directors to the Board, the Committee considers the specific knowledge and expertise which would be of benefit to the Group's current operations and future strategy, and provides a brief to external search agents based upon its conclusions. The search agents put forward a short list of candidates for the Committee to interview before making its recommendations to the Board. The Board interviews preferred candidates prior to making any formal offers of appointment. These procedures were adopted for the appointment during the year of The Rt Hon Lord Freeman.

Remuneration Committee

The Rt Hon Lord Freeman, Mr Much and Air Marshal Sir Peter Norriss all served on the Remuneration Committee during the year. Mr Much is Chairman of the Committee. The Committee

Statement on Corporate Governance

- continued

met five times during the year. Mr Scobie was re-appointed on 3 August 2006 as a member of the Committee, following publication by the Financial Reporting Council of the amended Combined Code on Corporate Governance, in which it was deemed permissible for the Chairman to be a member of the Remuneration Committee. Further details on the Committee and the Company's policy on directors' remuneration are included within the Directors' Remuneration Report.

Executive Committee

The Chief Executive, Dr Price, chairs the Executive Committee, which meets monthly. The other members are the Finance Director, the Company Secretary, the Business Development Director, the Managing Director of the Energetics division and the President of the Group's US operations. The Executive Committee is responsible for the executive day-to-day running of the Company, submission to the Board of strategic plans and budgets for the Group's operations, and monitoring the day-to-day performance of the Group as a whole.

Relations with Shareholders

The Company maintains an active dialogue with institutional shareholders through regular briefing meetings and formal presentations following the release of interim and annual results. Meetings are usually attended by the Chairman, the Chief Executive and the Finance Director. However, the non-executive directors are offered the opportunity to meet with major shareholders and attend meetings if so requested by major shareholders. No such requests were received during the year. Communication with private investors is achieved largely through the medium of the interim report and the financial statements.

The Company's website (www.chemring.co.uk) provides financial and business information on the Group.

The directors are provided with reports and other written briefings from the Company's principal shareholders and analysts, and are regularly informed by the Company Secretary about changes to significant shareholdings.

It is the Company's policy that all directors should attend and make themselves available to take questions from shareholders or address any concerns at the Annual General Meeting. At other times of the year, the directors can be contacted via the Company's head office.

All substantial issues, including the adoption of the annual report and financial statements, are proposed on separate resolutions at the Annual General Meeting. The number of proxy votes received for and against each resolution, together with the number of abstentions, are indicated after votes have been dealt with on a show of hands. The Notice of the Annual General Meeting is sent to shareholders at least twenty working days before the meeting.

Financial Reporting

The Statement of Directors' Responsibilities in respect of the financial statements and accounting records maintained by the Company is set out on page 25.

Internal Control and Risk Management

The Board has continued to review the effectiveness of the Group's systems of internal control, including financial, operational and compliance controls, and risk management systems.

The Board acknowledges its responsibility for the Group's systems of internal control and attaches considerable importance to these systems, which are designed to meet the Group's particular needs and identify those risks to which it is exposed. However, the systems can only provide reasonable, not absolute, assurance against material misstatement, loss or mismanagement of the Group's assets.

In carrying out its review of the effectiveness of the Group's systems of internal control, the Board has taken into consideration the following key features of the Group's risk management systems and control procedures which operated during the year:

- The Board assesses the key risks associated with achievement of the Group's business objectives as part of the annual strategic planning process. Out of this process, each business establishes a five year plan and annual budget, which are subject to approval by the Board. The performance of each business against budget and prior years is reviewed on a monthly basis at both operational level and by the Board. Achievement of strategic business objectives and the associated risks are monitored by the Board on an ongoing basis.
- All businesses hold monthly operating meetings, which are attended by at least one main Board director, either in person or, in the case of the overseas companies, by video conference. In the case of the US businesses, formal Board meetings are held quarterly and these are attended by main Board directors and external non-executive directors appointed in the US. The US non-executive directors are available to provide guidance and monitor governance in the US businesses throughout the year.
- Each business is required to comply with the Group's accounting policy manual, which sets out formal procedures for incurring certain types of expenditure and making contractual commitments. Compliance with the accounting policy manual is reviewed by both the Audit Committee and the full Board.



- The Board retains primary responsibility for acquisitions and disposals, and financing arrangements for the Group. Treasury management, IT strategy, insurance and significant legal matters are dealt with centrally from the Group head office, and the Board receives regular reports on each of these items. Reviews of the Group's pensions, insurance and risk management arrangements are carried out by external advisors on a regular basis.

- A dedicated Group Health, Safety and Environment Manager, supported by a Group Health and Safety Management Committee, co-ordinates and controls the activities of each business in relation to health and safety and environmental matters, which are a key focus for the Board in view of the nature of the Group's operations. The Chief Executive is the Board member nominated with specific responsibility for health and safety, and a sub-committee of the main Board also focuses specifically on safety at the Group sites where energetic materials are handled.

The Group's Risk Management Committee was reconstituted during the year and new terms of reference agreed. The Chief Executive, the Finance Director, the Company Secretary, the Business Development Director, the Managing Director of the Energetics division and the President of the Group's US operations now serve on the Committee, which meets quarterly. The Committee reviews the key risks associated with the achievement of the annual budget and the five year plan for each business, and the risk control procedures implemented. It reports biannually to the Board on the top ten risks from a Group perspective, and monitors the actions being taken to mitigate these.

The Board confirms that it has reviewed the effectiveness of the Group's systems of internal control and risk management which were in place during the financial year ended 31 October 2006, and it confirms that systems of internal control and risk management compliant with the revised Combined Code and the Turnbull Guidance were in place throughout the year and have remained in place up to the date of approval of these financial statements. Notwithstanding this, the Board will continue to take steps to embed internal control and risk management further into the operations of the Group and to deal with any areas of improvement which come to the attention of management and the Board.

Compliance with the Provisions of the Revised Combined Code

Throughout the year ended 31 October 2006, the Company has been in compliance with the code provisions set out in Section 1 of the revised Combined Code on Corporate Governance issued by the Financial Reporting Council in July 2003, with the following exceptions (references to the relevant sections of the revised Combined Code are given in brackets):

- The non-executive directors did not meet without the Chairman present to formally appraise the Chairman's performance during the year, as the Board considers that this is against the spirit of the concept of a unitary Board (A.1.3).
- The Board has not nominated a non-executive director as the senior independent director as it does not consider this to be appropriate at the present time in view of the size of the Board. This requirement will be kept under review (A.3.3).
- A formal evaluation of the performance of the Board and its committees was undertaken during the year but this did not extend to a formal evaluation of individual directors, which the Chairman undertakes informally on a continual basis (A.6.1).
- Mr Scobie's appointment as Non-Executive Chairman is not for a specified term; however, he is subject to retirement by rotation (A.7.2).
- Following the unexpected retirement of Mr Peter Molony as a non-executive director in July 2005, it was necessary for Mr Scobie to be re-appointed as Chairman of the Audit Committee on an interim basis. Mr Scobie therefore initially acted as Chairman of the Audit Committee but resigned on 1 July 2006 following the appointment of The Rt Hon Lord Freeman (C.3.1).

Going Concern

The directors have acknowledged the latest guidance on going concern and, after making appropriate enquiries, have formed a judgment at the time of approving the financial statements that there is a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the financial statements.

Approved by the Board of Directors on 23 January 2007.

S L Ellard
Secretary

Independent Auditors' Report to the Members of Chemring Group PLC

for the year ended 31 October 2006

We have audited the Group financial statements of Chemring Group PLC for the year ended 31 October 2006 which comprise the Consolidated Income Statement, the Consolidated Statement of Recognised Income and Expense, the Consolidated Balance Sheet, the Consolidated Cash Flow Statement, the Notes to the Consolidated Cash Flow Statement and the related Notes 1 to 36. These Group financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

We have reported separately on the individual company financial statements of Chemring Group PLC for the year ended 31 October 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 Directors' Remuneration Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Group financial statements and the part of the Directors' Remuneration Report described as having been 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 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 Directors' Remuneration Report described as having been audited have 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 includes that specific information presented in the Statement by the Chairman, the Review by the Chief Executive and the Review by the Finance Director that is cross referred from the review of the year and results section of the Directors' Report.

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 Statement on Corporate Governance 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 statement on internal control covers 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 including the unaudited part of the Directors' Remuneration Report 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 Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Group 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 Group financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated



the overall adequacy of the presentation of information in the Group financial statements and the part of the Directors' Remuneration Report to be audited.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 October 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 Directors' Remuneration Report 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.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
Southampton, United Kingdom

23 January 2007

Consolidated Income Statement

for the year ended 31 October 2006

| | Note | 2006 £000 | 2005 £000 |
|--|-----------|----------------|----------------|
| Continuing operations | | | |
| Revenue | | | |
| -continuing | | 160,442 | 120,963 |
| -acquired | | 27,291 | - |
| Total revenue | 3 | 187,733 | 120,963 |
| Operating profit | | | |
| -continuing | | 33,433 | 22,908 |
| -acquired | | 4,346 | - |
| Total operating profit | 5 | 37,779 | 22,908 |
| Share of post-tax results of associate | | 84 | 130 |
| Finance expense | 7 | (6,103) | (3,822) |
| Profit before tax for the year from continuing operations | | 31,760 | 19,216 |
| Tax | 8 | (9,873) | (5,657) |
| Profit after tax for the year from continuing operations | | 21,887 | 13,559 |
| Discontinued operations | | | |
| Loss after tax from discontinued operations | 32 | (8,090) | (4,790) |
| Profit after tax for the year | 27 | 13,797 | 8,769 |
| Attributable to: | | | |
| Equity holders of the parent | | 13,795 | 8,756 |
| Minority interests | | 2 | 13 |
| Earnings per ordinary share | | | |
| From continuing operations: | 10 | | |
| Basic | | 70.33p | 46.63p |
| Diluted | | 69.87p | 46.39p |
| From continuing and discontinued operations: | 10 | | |
| Basic | | 44.33p | 30.16p |
| Diluted | | 44.04p | 29.99p |



Consolidated Statement of Recognised Income and Expense

for the year ended 31 October 2006

| | Note | 2006 £000 | 2005 £000 |
|---|-----------|----------------------|---------------------|
| Gains on cash flow hedges | | 340 | - |
| Movement on deferred tax relating to cash flow hedges | | (98) | - |
| Exchange differences on translation of foreign operations | | (5,230) | 67 |
| Actuarial gains/(losses) on defined benefit pension schemes | 33 | 4,685 | (4,074) |
| Movement on deferred tax relating to pension schemes | | (1,406) | 1,222 |
| Tax on items taken directly to equity | | <u>1,868</u> | <u>119</u> |
| Net income/(expense) recognised directly in equity | | 159 | (2,666) |
| Profit after tax for the year | | <u>13,797</u> | <u>8,769</u> |
| Total recognised income and expense for the year | 28 | <u>13,956</u> | <u>6,103</u> |
| Attributable to: | | | |
| Equity holders of the parent | | 13,954 | 6,090 |
| Minority interests | | <u>2</u> | <u>13</u> |

Consolidated Balance Sheet

as at 31 October 2006

| | Note | £000 | 2006 £000 | £000 | 2005 £000 |
|---|------|----------|--------------|----------|--------------|
| Non-current assets | | | | | |
| Goodwill | 11 | 72,664 | | 34,680 | |
| Other intangible assets | 12 | 11,863 | | 3,470 | |
| Property, plant and equipment | 13 | 57,681 | | 50,698 | |
| Investments | 15 | 1,033 | | 1,068 | |
| Deferred tax | 25 | 9,649 | | 7,440 | |
| | | | 152,890 | | 97,356 |
| Current assets | | | | | |
| Inventories | 16 | 36,252 | | 27,821 | |
| Trade and other receivables | 17 | 39,015 | | 27,168 | |
| Cash and cash equivalents | 18 | 13,411 | | 7,774 | |
| Derivative financial instruments | 23 | 178 | | - | |
| | | | 88,856 | | 62,763 |
| Assets held for sale | 32 | | 6,516 | | 14,646 |
| Total assets | | | 248,262 | | 174,765 |
| Current liabilities | | | | | |
| Bank loans and overdrafts | 20 | (11,523) | | (12,701) | |
| Obligations under finance leases | 21 | (435) | | (925) | |
| Trade and other payables | 22 | (39,538) | | (24,899) | |
| Provisions | 24 | (286) | | (170) | |
| Current tax liabilities | | (1,928) | | (1,150) | |
| Liabilities held for sale | 32 | (2,338) | | (1,776) | |
| | | | (56,048) | | (41,621) |
| Non-current liabilities | | | | | |
| Bank loans | 20 | (71,698) | | (46,320) | |
| Obligations under finance leases | 21 | (309) | | (602) | |
| Other payables | 22 | (210) | | (163) | |
| Deferred tax | 25 | (9,486) | | (8,958) | |
| Preference shares | | (62) | | (62) | |
| Retirement benefit obligations | 33 | (16,345) | | (20,189) | |
| | | | (98,110) | | (76,294) |
| Total liabilities | | | (154,158) | | (117,915) |
| Net assets | | | 94,104 | | 56,850 |
| Equity | | | | | |
| Share capital | 26 | | 1,612 | | 1,459 |
| Share premium account | 27 | | 53,540 | | 27,274 |
| Special capital reserve | 27 | | 12,939 | | 12,939 |
| Hedging reserve | 27 | | 230 | | - |
| Revaluation reserve | 27 | | 1,604 | | 1,640 |
| Retained earnings | 27 | | 23,900 | | 13,261 |
| | | | | | |
| Equity attributable to equity holders of the parent | | | 93,825 | | 56,573 |
| Minority interests | | | 279 | | 277 |
| Total equity | | | 94,104 | | 56,850 |

These financial statements were approved by the Board of Directors on 23 January 2007.
Signed on behalf of the Board

D J Price

P A Rayner



Consolidated Cash Flow Statement

for the year ended 31 October 2006

| | Note | 2006 £000 | 2005 £000 |
|--|------|-----------------|-----------------|
| Cash flows from operating activities | | | |
| Cash generated from operations | A | 45,629 | 21,141 |
| Tax paid | | (10,588) | (7,612) |
| Net cash inflow from operating activities | | 35,041 | 13,529 |
| Cash flows from investing activities | | | |
| Dividends received from associate | | 107 | 108 |
| Purchases of property, plant and equipment | | (10,148) | (6,898) |
| Purchases of intangible assets | | (1,798) | (1,063) |
| Proceeds on disposal of subsidiary undertaking/division | | 2,570 | 242 |
| Proceeds on disposal of property, plant and equipment | | 98 | 8 |
| Acquisition of subsidiaries (net of cash acquired) | 31 | (62,808) | (22,009) |
| Net cash outflow from investing activities | | (71,979) | (29,612) |
| Cash flows from financing activities | | | |
| Dividends paid | | (3,695) | (2,736) |
| Interest paid | | (5,261) | (3,237) |
| Proceeds on issue of shares | | 26,419 | 572 |
| New borrowings | | 38,112 | 30,097 |
| Repayment of borrowings | | (5,983) | (4,130) |
| Net cash inflow from financing activities | | 49,592 | 20,566 |
| Increase in cash and cash equivalents during the year | | | |
| Cash and cash equivalents at start of the year | | (2,970) | (7,530) |
| Effect of foreign exchange rate changes | | (689) | 77 |
| Cash and cash equivalents at end of the year | | 8,995 | (2,970) |

Notes to the Consolidated Cash Flow Statement

for the year ended 31 October 2006

| A. Cash generated from operations | 2006 £000 | 2005 £000 | | | |
|---|-----------------------------|----------------------|-----------------------------|------------------------------|------------------------------|
| Operating profit from continuing operations | 33,433 | 22,908 | | | |
| Operating profit from acquired operations | 4,346 | - | | | |
| Operating loss from discontinued operations | (646) | (2,557) | | | |
| Loss on disposal/impairment of discontinued operations | (7,970) | (3,000) | | | |
| Adjustment for: | | | | | |
| Depreciation of property, plant and equipment | 5,776 | 4,103 | | | |
| Amortisation of intangible assets | 2,044 | 1,678 | | | |
| Impairment of goodwill | 4,890 | 3,000 | | | |
| Impairment of intangible assets | 782 | - | | | |
| Difference between pension contributions paid and amount recognised in income statement | (939) | (875) | | | |
| Profit on disposal of property, plant and equipment | - | 8 | | | |
| Decrease in provisions | (170) | (456) | | | |
| Operating cash flows before movements in working capital | 41,546 | 24,809 | | | |
| Increase in inventories | (1,362) | (5,696) | | | |
| Increase in trade and other receivables | (693) | (1,073) | | | |
| Increase in trade and other payables | 6,138 | 3,101 | | | |
| Cash generated from operations | 45,629 | 21,141 | | | |
| Reconciliation of net cash flow to movement in net debt | | | | | |
| Increase in cash and cash equivalents during the year | 12,654 | 4,483 | | | |
| Cash inflow from increase in debt and lease financing | (32,129) | (25,967) | | | |
| Change in net debt resulting from cash flows | (19,475) | (21,484) | | | |
| New finance leases | (247) | (103) | | | |
| Translation difference | 2,252 | (1,109) | | | |
| Amortisation of debt finance costs | (310) | (70) | | | |
| Movement in net debt in the year | (17,780) | (22,766) | | | |
| Net debt at start of the year | (52,774) | (30,008) | | | |
| Net debt at end of the year | (70,554) | (52,774) | | | |
| Analysis of net debt | | | | | |
| | As at 1 Nov 2005 £000 | Cash flow £000 | Non-cash changes £000 | Exchange movement £000 | As at 31 Oct 2006 £000 |
| Cash at bank and in hand | 7,774 | 6,119 | - | (482) | 13,411 |
| Overdrafts | (10,744) | 6,535 | - | (207) | (4,416) |
| | (2,970) | 12,654 | - | (689) | 8,995 |
| Debt due within one year | (1,957) | 5,104 | (10,469) | 215 | (7,107) |
| Debt due after one year | (46,320) | (38,112) | 10,159 | 2,575 | (71,698) |
| Finance leases | (1,527) | 879 | (247) | 151 | (744) |
| | (52,774) | (19,475) | (557) | 2,252 | (70,554) |



Notes to the Group Financial Statements

for the year ended 31 October 2006

1. GENERAL INFORMATION

Chemring Group PLC is a company incorporated in England and Wales under registration number 86662. The address of the registered office is Chemring House, 1500 Parkway, Whiteley, Fareham, Hampshire PO15 7AF. The nature of the Group's operations and its principal activities are set out in Note 4 and in the Directors' Report on pages 24 to 26. These financial statements are the consolidated financial statements of Chemring Group PLC and its subsidiaries ("the Group").

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 policy set out in Note 2 "Accounting Policies".

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

- IFRS7 *Financial Instruments: Disclosures* and the related amendment to IAS1 on capital disclosures (effective from 1 January 2007).

IFRS7 and this amendment to IAS1 introduce new disclosures of information about financial instruments and capital management. The impact of these changes to the Group is that additional disclosures will be required concerning the sensitivity analysis to market risk and the management of capital. These will be applied for the year ending 31 October 2008.

- IFRIC4 *Determining Whether an Arrangement Contains a Lease* (effective from 1 January 2007).

IFRIC4 requires determination of whether an arrangement is or contains a lease to be based on the substance of the arrangement. Management is currently assessing the impact of IFRIC4 on the Group's operations.

- IFRIC6 *Liabilities Arising from Participating in a Specific Market: Waste Electrical and Electronic Equipment* (effective from 1 December 2005).

Management is currently assessing the impact of IFRIC6 on the Group's operations.

- IFRIC11 *IFRS2-Group and Treasury Share Transactions*.

IFRIC11 provides guidance on whether share-based payment arrangements, in which suppliers of goods or services of an entity are provided with equity instruments of the entity's parent should be accounted for as cash-settled or equity-settled in the entity's financial statements. These interpretations will be applied for the period ending 31 October 2008.

2. ACCOUNTING POLICIES

Basis of preparation

These financial statements have been prepared in accordance with IFRS adopted for use in the European Union. These will be those IAS, IFRS and related Interpretations (Standing Interpretations Committee (SIC)/International Financial Reporting Interpretations Committee (IFRIC) interpretations), subsequent amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB) that have been endorsed by the European Commission (collectively referred to as IFRS). These are subject to ongoing review and endorsement by the European Commission or possible amendment by interpretive guidance from the IASB and the IFRIC and are therefore still subject to change.

Comparative data for 2005 has been restated to conform to the new accounting policies and where appropriate these new policies reflect the exemptions from restating certain financial information as permitted under IFRS1 *First Time Adoption of International Financial Reporting Standards*. Note 36 "Explanation of Transition to IFRS" details the exemptions taken by the Group.

Basis of accounting

The financial statements have been prepared in accordance with IFRS. The disclosures required by IFRS1 concerning the transition from previously reported UK GAAP to IFRS are given in Note 36.

Accounting convention

The financial statements are prepared under the historical cost convention, except for the revaluation of certain properties and financial instruments.

Notes to the Group Financial Statements

- continued

2. ACCOUNTING POLICIES - continued

Basis of consolidation

The Group financial statements consolidate those of the Company and all of its subsidiaries. A subsidiary is an entity over which the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The results of subsidiaries acquired are consolidated from the date on which control passes to the Group and the results of disposed subsidiaries are consolidated up to the date on which control passes from the Group.

All companies within the Group make up their financial statements to the same date. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Operating profit

Operating profit is stated before the share of results of associates and before finance expense. Operating profit excludes the results of discontinued operations.

Revenue recognition

Sales comprise the fair value of the consideration received or receivable for deliveries made, work completed or services rendered during the year, net of discounts, VAT and other sales related taxes. Sales are recognised when title passes, or when the right to consideration, in exchange for performance, has been completed. For bill and hold arrangements revenue is recognised when the risks and rewards are transferred to the customer, typically on formal acceptance. An appropriate proportion of total long term contract value, based on the fair value of work performed, is included in revenue and an appropriate level of profit is taken based the percentage completion method when the final outcome can be reliably assessed. Provision is made in full for foreseeable losses as soon as they are identified.

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

Acquisitions

On acquisition of a subsidiary, the cost is measured as the fair value of the consideration given plus any directly attributable costs. The assets, liabilities and contingent liabilities of a subsidiary that meet the IFRS3 *Business Combinations* recognition criteria are measured at the fair value at the date of acquisition. Where cost exceeds fair value of the net assets acquired the difference is recorded as goodwill.

Where the fair value of the net assets exceeds the cost, the difference is recorded directly in the income statement. The accounting policies of subsidiaries are changed where necessary to be consistent with those of the Group.

Intangible assets

Goodwill

The purchased goodwill of the Group is regarded as having an indefinite useful economic life and, in accordance with IAS36 *Impairment of Assets*, is not amortised but is subject to annual tests for impairment. In reviewing the carrying value of goodwill of the various businesses the Board has considered the separate plans and cash flows of these businesses consistent with the requirements of IAS36 and is satisfied that these demonstrate that no impairment has occurred. Goodwill arising on acquisition 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. 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.

For acquisitions after 1 November 2004 the Group recognises separately from goodwill intangible assets that are separable or arise from contractual or other legal rights and whose fair value can be measured reliably. These intangible assets have finite lives and are amortised on a straight-line basis over those lives, averaging ten years.

Research and development expenditure

Expenditure on research activities is recognised as an expense in the period in which it is incurred. Development expenditure, where it meets certain criteria given below, is capitalised on a straight line basis over typically three years from the date commercial production commences. Development costs not meeting the criteria for capitalisation are expensed as incurred.



An intangible asset is recognised only if all of the following conditions are met:

- the development costs are separately identifiable;
- the development costs can be measured reliably;
- management are satisfied as to the ultimate technical and commercial viability of the project; and
- it is probable that the asset will generate future economic benefits.

Patents and trademarks

Patents and trademarks are measured initially at purchase cost and are amortised on a straight-line basis over their estimated useful lives.

Property, plant and equipment

Other than revalued land and buildings, property, plant and equipment are held at cost less accumulated depreciation and any recognised impairment loss. No depreciation is provided on freehold land. On other assets depreciation is provided at rates calculated to write down their cost or valuation to their estimated residual values by equal instalments over their estimated useful economic lives, which are considered to be:

- Freehold buildings - up to 50 years
- Leasehold buildings - the period of the lease
- Plant and equipment - 10 years

Impairment of non-current assets

Assets that have indefinite lives are tested for impairment annually. Assets that are subject to depreciation or amortisation are reviewed for impairment whenever changes in circumstances indicate that the carrying value may not be recoverable. To the extent that the carrying value exceeds the recoverable amount an impairment loss is recorded for the difference as an expense in the income statement. The recoverable amount used for impairment testing is the higher of the value in use and its fair value less costs of disposal. For the purpose of impairment testing assets are grouped at the lowest levels for which there are separately identifiable cash flows.

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. These items are so classified if their carrying amount will be recovered through a sale transaction rather than through continuing use.

Inventories

Inventories are recorded at the lower of cost and net realisable value. Cost represents materials, direct labour, other direct costs and related production overheads and is determined using the first-in first-out (FIFO) method. Net realisable value is based on estimated selling price, less further costs expected to be incurred to completion and disposal.

Provision is made for slow moving, obsolete and defective items where appropriate.

Tax

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 of income 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 at the balance sheet date.

Deferred tax is 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 taxable profits will be available against which deductible temporary

Notes to the Group Financial Statements

- *continued*

2. ACCOUNTING POLICIES - *continued*

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.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

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 where it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Special capital reserve

The special capital reserve was created as part of a capital reduction scheme involving the cancellation of the share premium account which was approved by the Court in 1986 and is in accordance with the requirements of the Companies Act 1985.

Foreign currencies

The individual financial statements of each Group company are presented in the currency of the primary economic environment in which it operates (its functional currency). For the purpose of the consolidated financial statements, the results and financial position of each Group company are expressed in pounds sterling, which is the functional currency of the Company, and the presentation currency for the consolidated financial statements.

In preparing the financial statements of the individual companies, transactions in currencies other than the entity's functional currency (foreign currencies) 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. Non-monetary items carried at fair value that are denominated in foreign currencies are translated at the rates prevailing at the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences arising on the settlement of monetary items, and on the retranslation of monetary items, are included in the profit or loss for the period.

In order to hedge its exposure to certain foreign exchange risks, the Group enters into forward contracts and options which are accounted for as derivative financial instruments (see below for details of the Group's accounting policies in respect of such derivative financial instruments).

For the purpose of presenting consolidated financial statements, the assets and liabilities of the Group's foreign 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.

Financial instruments

Financial assets and 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.

Financial liabilities and equity instruments

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 accruals basis to the Income Statement using the 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.

Derivative financial instruments

The Group's activities expose it primarily to the financial risks of interest rate and foreign currency transactions, and it uses derivative financial instruments to hedge its exposure to these transactional risks. The Group uses interest rate swap contracts and foreign exchange forward contracts to reduce these exposures and does not use derivative financial instruments for speculative purposes. As IAS32 and IAS39 are only applied from 1 November 2005, as permitted, the comparative information to 31 October 2005 for derivative financial instruments is presented under UK GAAP FRS13. Under UK GAAP changes in the fair value of forward foreign exchange contracts were recognised through the Income Statement. However, the difference between fair value and book value of the Group's interest rate swaps was not recognised.

From 1 November 2005, under IFRS, derivative financial instruments are recognised at fair value at the date the derivative contract is entered into and are revalued at fair value at each balance sheet date. The method by which any gain or loss is recognised depends on whether the instrument is designated a hedging instrument or not. To be designated as a hedging instrument the instrument must be documented as such at inception and must be assessed at inception and on an ongoing basis to be highly effective in offsetting changes in fair values or cash flows of hedged items.

Hedge accounting principles are used for interest rate swaps and net investment hedges where movements in fair value are held in equity until such time as the underlying amounts of the contract mature. At maturity the amounts held in equity will be recycled to the Income Statement. Changes in fair value of any ineffective portion of net investment hedges and interest rate swaps are recognised in the Income Statement immediately.

Where derivatives do not meet the criteria for hedge accounting the changes in fair value are immediately recognised in the Income Statement. The Group does not apply hedge accounting to the foreign currency forward contracts to mitigate against currency fluctuations. Accordingly, gains and losses arising from measuring the contracts at fair value are recognised immediately in the Income Statement.

Embedded derivatives that are not closely related to the host contract are treated as separate derivatives, with unrealised gains and losses reported in the Income Statement.

Retirement benefit costs

Payments to defined contribution retirement benefit schemes are charged as an expense as they fall due. For defined 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 of the profit or loss and presented in the Statement of Recognised Income and Expense (SORIE).

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 adjusted for unrecognised past service cost, and as reduced by the fair value of scheme assets. Any asset resulting from this calculation is limited to past service cost, plus the present value of available refunds and reductions in future contributions to the scheme.

Leased assets

Where the Group enters into a lease which entails taking substantially all the risks and rewards of ownership of an asset, the lease is treated as a finance lease. The asset is recorded in the Balance Sheet as property, plant and equipment and is depreciated over the shorter of the estimated useful economic life and the lease term. Future instalments under such leases, net of finance charges, are

Notes to the Group Financial Statements

- *continued*

2. ACCOUNTING POLICIES - *continued*

included in creditors. The finance element of the instalments is charged to the Income Statement at a constant rate of charge on the remaining balance of the obligation.

All other leases are operating leases and the rental charges are taken to the Income Statement on a straight-line basis over the life of the lease.

Share-based compensation

The Group operates equity settled and cash settled share-based compensation schemes.

For grants made under the Group's share-based compensation schemes, the fair value is remeasured at each balance sheet date with changes in the fair value recognised in the Income Statement on a straight-line basis over the vesting period, based on the Group's estimate of the shares that will eventually vest. The valuation of the options utilises a methodology based on the Black-Scholes model.

For equity settled share-based grants, the total amount recognised is based on the fair value of the equity instrument measured at the date the award is made. At each balance sheet date the impact of any revision to vesting estimates is recognised in the Income Statement over the vesting period. Proceeds received, net of any directly attributable transaction costs, are credited to share capital and share premium.

For cash settled share-based grants, the total amount recognised is based on the fair value of the liability incurred. The fair value of the liability is remeasured at each balance sheet date with changes in the fair value recognised in the income statement for the period.

Critical accounting judgements and key sources of estimation uncertainty

When applying the Group's accounting policies, management must make assumptions and estimates concerning the future that affect the carrying amounts of assets and liabilities at the balance sheet date and the amounts of revenue and expenses recognised during the accounting period. Such assumptions and estimates are based upon factors such as historical experience, the observance of trends in the industries in which the Group operates, and information available from the Group's customers and other outside sources.

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 include:

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.

Intangible assets acquired in business combinations

Under IFRS3 *Business Combinations*, it is necessary to separately identify and value any acquired intangible assets. In order to ascertain the values of the separate assets it is necessary for management to estimate the future cash flows attributable to the assets and estimate their useful economic lives.

Pensions

The liability recognised in relation to retirement benefit obligations is dependent on a number of assumptions, including discount rate, mortality rate, salary increases and inflation. Any change in these assumptions would change the amount recognised on the Balance Sheet (see Note 33).

Insurance claim

The Group is pursuing a claim against its former insurance brokers, concerning the insurance cover for Kilgore Flares Company LLC and the brokers' subsequent handling of a claim following a manufacturing incident at Kilgore Flares Company LLC on 18 April 2001. During the year the Group incurred costs of £121,000 (2005: £147,000) in relation to the claim, which were written off.

The balance of the claim that had not been recovered from the Group's insurance brokers at the year end was £2,595,000 (2005: £2,796,000), which has been included within other debtors. Foreign exchange movements of £201,000 (2005: £107,000) have been recognised through the Statement of Recognised Income and Expense.



3. REVENUE

An analysis of the Group's revenue is as follows:

| | <i>2006</i> | <i>2005</i> |
|------------------------------|----------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Continuing operations | | |
| Sale of goods | | |
| - continuing | 160,442 | 120,963 |
| - acquired | 27,291 | - |
| | 187,733 | 120,963 |

The following table provides an analysis of the Group's revenue by geographical market irrespective of the origin of the goods.

| | <i>Continuing operations</i> | <i>Acquisitions</i> | <i>Total</i> | <i>Total</i> |
|-------------------------------|----------------------------------|---------------------|----------------|--------------|
| | <i>2006</i> | <i>2006</i> | <i>2006</i> | <i>2005</i> |
| Revenue by destination | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| UK | 43,031 | 4,518 | 47,549 | 19,734 |
| USA | 87,429 | 13,644 | 101,073 | 60,156 |
| Australia | 8,825 | 257 | 9,082 | 8,018 |
| Europe | 12,724 | 6,755 | 19,479 | 12,045 |
| Rest of the world | 8,433 | 2,117 | 10,550 | 21,010 |
| Total | 160,442 | 27,291 | 187,733 | 120,963 |

Discontinued revenue of £11,348,000 (2005: £11,495,000) is disclosed in Note 32, giving total revenue of £199,081,000 (2005: £132,458,000).

4. BUSINESS AND GEOGRAPHICAL SEGMENTS

For management purposes the Group has two operating divisions – Countermeasures and Energetics. These divisions are the basis on which it reports its primary segment information.

Principal activities are as follows:

Countermeasures: Expendable countermeasure equipment

Energetics: Propellants, pyrotechnics, battlefield simulation, minefield clearance systems, flares

The Group classified its Marine Lights and Electronics division as discontinued with effect from 31 October 2005. See Note 32 for discontinued segmental analysis.

Notes to the Group Financial Statements

- continued

4. BUSINESS AND GEOGRAPHICAL SEGMENTS - continued

A segmental analysis of revenue and profit is set out below:

Business segments

| | <i>Countermeasures</i> | | <i>Energetics</i> | | <i>Total</i> | |
|--------------------------------------|------------------------|-------------|-------------------|-------------|----------------|-------------|
| | <i>2006</i> | <i>2005</i> | <i>2006</i> | <i>2005</i> | <i>2006</i> | <i>2005</i> |
| | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| Revenue: | | | | | | |
| Total revenue from third parties | 118,384 | 90,768 | 69,349 | 30,195 | 187,733 | 120,963 |
| Result: | | | | | | |
| Operating profit | 33,876 | 24,808 | 10,361 | 2,331 | 44,237 | 27,139 |
| Charge for share-based payments | | | | | (2,215) | (924) |
| Amortisation of acquired intangibles | | | | | (723) | (71) |
| Unallocated head office costs | | | | | (3,520) | (3,236) |
| Total operating profit | | | | | 37,779 | 22,908 |

Included within the charge for share-based payments is net costs of £586,000 (2005: £311,000) for equity settled share-based payments.

| Balance sheet: | <i>Countermeasures</i> | | <i>Energetics</i> | | <i>Total</i> | |
|---------------------------------------|------------------------|-------------|-------------------|-------------|------------------|-------------|
| | <i>2006</i> | <i>2005</i> | <i>2006</i> | <i>2005</i> | <i>2006</i> | <i>2005</i> |
| | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| Assets | | | | | | |
| Segment assets | 102,833 | 92,166 | 127,169 | 50,063 | 230,002 | 142,229 |
| Interest in associate | | | | | 1,023 | 1,058 |
| Unallocated assets | | | | | 10,721 | 16,832 |
| Consolidated total assets | | | | | 241,746 | 160,119 |
| Liabilities | | | | | | |
| Segment liabilities | (56,351) | (53,980) | (77,669) | (36,691) | (134,020) | (90,671) |
| Unallocated liabilities | | | | | (17,800) | (25,468) |
| Consolidated total liabilities | | | | | (151,820) | (116,139) |
| Net assets - continuing operations | | | | | 89,926 | 43,980 |
| Net assets held for sale | | | | | 4,178 | 12,870 |
| Group net assets | | | | | 94,104 | 56,850 |
| Other information: | | | | | | |
| Capital additions | 9,023 | 6,037 | 1,705 | 1,012 | 10,728 | 7,049 |
| Depreciation and amortisation | 3,565 | 3,091 | 2,920 | 487 | 6,485 | 3,584 |



Geographical segments

The Group's operations in the Countermeasures division are located in the UK and the USA. The Group's Energetics division operates in the UK, EU countries, Australia and the USA.

An analysis of geographical segmental information is shown in Note 3.

The following is an analysis of the carrying amount of net segment assets and additions to property, plant and equipment and intangible assets, analysed by the geographical area in which the assets are located. Net segment assets includes continuing operations with associates and unallocated segment assets and liabilities (shown within the UK).

| | <i>Carrying amount of net segment assets</i> | | <i>Additions to property, plant and equipment and intangible assets</i> | |
|-------|--|-------------|---|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| | £000 | £000 | £000 | £000 |
| UK | 25,558 | 15,729 | 3,240 | 1,994 |
| USA | 61,235 | 25,244 | 7,089 | 4,819 |
| Other | 3,133 | 3,007 | 399 | 236 |
| | 89,926 | 43,980 | 10,728 | 7,049 |

5. OPERATING PROFIT

Operating profit is stated after charging:

| | 2006 | 2005 |
|---|---------------|-------------|
| | £000 | £000 |
| Research and development costs | 5,320 | 4,188 |
| Depreciation | 4,940 | 3,506 |
| - property, plant and equipment | | |
| - leased assets | 367 | 597 |
| Amortisation | 1,178 | 261 |
| - other intangible assets | | |
| Operating lease rentals | 490 | 428 |
| - other | | |
| - plant and machinery | 919 | 607 |
| Loss on disposal of property, plant and equipment | - | 8 |
| Staff costs (see Note 6) | 59,906 | 39,713 |
| Cost of inventories recognised as an expense | 53,831 | 43,801 |
| Auditors' remuneration for audit services (see over page) | 170 | 126 |

Notes to the Group Financial Statements

- continued

5. OPERATING PROFIT - continued

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

| | 2006 £000 | 2005 £000 |
|---|--------------|--------------|
| Audit fees | 170 | 126 |
| Other services: | | |
| Auditing accounts of subsidiary companies | 53 | 42 |
| Other audit services to Group company | 15 | 11 |
| Tax services – compliance | 129 | 93 |
| Tax services – advisory | 106 | 100 |
| Corporate finance services | 497 | 242 |
| All other services | 65 | - |
| | 1,035 | 614 |

Included within the above are £497,000 (2005:£242,000) of tax advisory and corporate finance fees relating to acquisitions and disposals. Also included in the Group audit fees is an amount of £33,000 (2005:£33,000) paid in respect of the parent company.

A description of the work of the Audit Committee is set out in the Statement on Corporate Governance on pages 36 and 37 and includes an explanation of how auditor objectivity and independence is safeguarded when non-audit services are provided by the auditors.

6. STAFF COSTS

The average monthly number of employees within each category (including executive directors) was:

| | 2006 Number | 2005 Number |
|---------------------|----------------|----------------|
| Production | 1,742 | 1,343 |
| Sales and marketing | 411 | 190 |
| | 2,153 | 1,533 |

The costs incurred in respect of these employees were:

| | £000 | £000 |
|-----------------------|---------------|---------------|
| Wages and salaries | 49,273 | 33,058 |
| Social security costs | 7,519 | 4,186 |
| Other pension costs | 3,114 | 2,469 |
| | 59,906 | 39,713 |



7. FINANCE EXPENSE

| | <i>2006</i> | <i>2005</i> |
|---|---------------------|---------------------|
| | <i>£000</i> | <i>£000</i> |
| Bank overdraft and loans interest | 1,130 | 1,282 |
| Loan stock interest | - | 1 |
| Medium term loan interest | 3,813 | 1,487 |
| Finance lease interest | 64 | 120 |
| Amortisation of debt finance costs | 310 | 70 |
| Preference shares | 4 | 4 |
| Interest cost of retirement benefit obligations (see Note 33) | 782 | 858 |
| | <u>6,103</u> | <u>3,822</u> |

8. TAX

| | <i>2006</i> | <i>2005</i> |
|--------------------------------------|-----------------------|-----------------------|
| | <i>£000</i> | <i>£000</i> |
| Current tax charge | (12,751) | (5,727) |
| Deferred tax credit | 2,878 | 70 |
| Total current year tax charge | <u>(9,873)</u> | <u>(5,657)</u> |

Income tax in the UK is calculated at 30% (2005: 30%) of the estimated assessable profit for the year. Tax for other jurisdictions is calculated at the rates prevailing in the respective jurisdictions.

The total charge for the year can be reconciled to the income statement as follows:

| | <i>2006</i> | <i>2005</i> |
|--|-----------------------|-----------------------|
| | <i>£000</i> | <i>£000</i> |
| Profit before tax from continuing operations | <u>31,760</u> | <u>19,216</u> |
| Tax at the UK corporation tax rate of 30% (2005: 30%) | (9,527) | (5,765) |
| Expenses not deductible for tax purposes net of tax credits | 119 | 702 |
| Utilisation of tax losses | 951 | 96 |
| Other | 200 | 164 |
| Prior year adjustments | (20) | 124 |
| Overseas profits taxed at rates different to the standard rate | <u>(1,596)</u> | <u>(978)</u> |
| Total current year tax charge | <u>(9,873)</u> | <u>(5,657)</u> |

In addition to the income tax expense charged to the Income Statement, a tax credit of £364,000 (2005: £1,341,000) has been recognised in equity in the year and is included in the Statement of Recognised Income and Expense.

Notes to the Group Financial Statements

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9. DIVIDENDS

| | 2006 £000 | 2005 £000 |
|---|--------------|--------------|
| Dividends on ordinary shares of 5p each | | |
| Final dividend for the year ended 31 October 2005 7.30p (2004: 6.20p) | 2,130 | 1,797 |
| Interim dividend for the year ended 31 October 2006 4.80p (2005: 3.20p) | 1,565 | 933 |
| Under provided in previous year | - | 6 |
| Total dividends | 3,695 | 2,736 |

The proposed final dividend in respect of the year ended 31 October 2006 of 11.20p per share will, if approved, absorb approximately £3.6 million of shareholders' funds. The dividend is subject to approval by shareholders at the Annual General Meeting and accordingly has not been included as a liability in these financial statements.

10. EARNINGS PER ORDINARY SHARE

The earnings and shares used in the calculations are as follows:

| From continuing and discontinued operations | 2006 | | | 2005 | | |
|---|-------------------------|---|---------------------|-------------------------|---|---------------------|
| | <i>Earnings</i> £000 | <i>Ordinary shares Number</i> 000s | <i>EPS</i> Pence | <i>Earnings</i> £000 | <i>Ordinary shares Number</i> 000s | <i>EPS</i> Pence |
| Basic EPS from continuing operations | 21,887 | 31,119 | 70.33 | 13,559 | 29,075 | 46.63 |
| Basic EPS from discontinued operations | (8,090) | - | (26.00) | (4,790) | - | (16.47) |
| Basic EPS | 13,797 | 31,119 | 44.33 | 8,769 | 29,075 | 30.16 |
| Diluted EPS from continuing operations | 21,887 | 31,323 | 69.87 | 13,559 | 29,200 | 46.39 |
| Diluted EPS from discontinued operations | (8,090) | - | (25.83) | (4,790) | - | (16.40) |
| Diluted EPS | 13,797 | 31,323 | 44.04 | 8,769 | 29,200 | 29.99 |

Ordinary shares are calculated by reference to the weighted average number of shares in issue in the year.



11. GOODWILL

| | <i>£000</i> |
|--|---------------|
| Cost | |
| At 1 November 2004 | 27,984 |
| Recognised on acquisition of subsidiary undertakings | 14,590 |
| Classified as held for sale | (7,894) |
| At 1 November 2005 | <u>34,680</u> |
| Recognised on acquisition of subsidiary undertakings | 40,928 |
| Foreign exchange adjustments | (2,944) |
| At 31 October 2006 | <u>72,664</u> |
| Accumulated impairment losses | |
| At 1 November 2004 | - |
| Impairment charge for the year | 3,000 |
| Classified as held for sale | (3,000) |
| At 1 November 2005 and at 31 October 2006 | <u>-</u> |
| Carrying amount | |
| At 31 October 2006 | <u>72,664</u> |
| At 31 October 2005 | <u>34,680</u> |

The additions to goodwill arose on the acquisition of Nobel Energetics Limited in 2005 and on the acquisitions of Comet GmbH, Leaffield Engineering Limited, Technical Ordnance, Inc. and B.D.L. Systems Limited in 2006 (see Note 31). The impairment charge in the year ended 31 October 2005 relates to a write-down of goodwill in respect of the discontinued Marine Lights and Electronics division.

Goodwill acquired in a business combination is allocated at acquisition to the cash generating units ("CGU") that are expected to benefit from that business combination. Before recognition of impairment losses the carrying amount of goodwill had been allocated as follows:

| | <i>£000</i> |
|-------------------------------|---------------|
| Energetics | |
| Nobel Energetics Limited | 14,590 |
| At 31 October 2005 | <u>14,590</u> |
| Comet GmbH | 1,748 |
| Leaffield Engineering Limited | 3,445 |
| Technical Ordnance, Inc. | 29,323 |
| B.D.L. Systems Limited | <u>6,412</u> |
| At 31 October 2006 | <u>40,928</u> |

Notes to the Group Financial Statements

- *continued*

11. GOODWILL - *continued*

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

The recoverable amounts of the CGU are determined from value in use calculations. The key assumptions for the value in use calculations are those regarding the discount rates, the growth rates and expected changes to selling prices and direct costs during the period for which management have detailed plans. Management estimates discount rates using pre-tax rates that reflect current market assessments of the time value of money and the risks specific to the CGU being measured (the weighted average cost of capital "WACC"). The discount rate used is 10.0% (2005:10.0%). The growth rates are based on a prudent view of industry growth forecasts adjusted for a premium associated with the high technological nature of the businesses. A growth assumption of 2.5% (2005: 2.5%) has been used. Changes in selling price and direct costs are based on past practices and expectations of future changes in the market. The Group prepares cash flow forecasts derived from the most recent financial budgets approved by management for the next five years and extrapolates cash flows after that period based on growth as described above.

Following a detailed review, no impairment losses for continuing operations have been recognised in the year and no prior impairment losses reversed.



12. OTHER INTANGIBLE ASSETS

| | <i>Development costs £000</i> | <i>Other* £000</i> | <i>Total £000</i> |
|--|---------------------------------------|------------------------|-----------------------|
| Cost | | | |
| At 1 November 2004 | 5,842 | - | 5,842 |
| Additions | 1,063 | - | 1,063 |
| Recognised on acquisition of subsidiary undertakings | - | 3,000 | 3,000 |
| Classified as held for sale | (5,563) | - | (5,563) |
| Foreign exchange adjustments | 17 | - | 17 |
| At 1 November 2005 | 1,359 | 3,000 | 4,359 |
| Additions | 733 | - | 733 |
| Recognised on acquisition of subsidiary undertakings | 27 | 9,221 | 9,248 |
| Transfers from property, plant and equipment | 588 | - | 588 |
| Foreign exchange adjustments | (34) | (639) | (673) |
| At 31 October 2006 | 2,673 | 11,582 | 14,255 |
| Amortisation | | | |
| At 1 November 2004 | 3,001 | - | 3,001 |
| Charge for the year | 1,607 | 71 | 1,678 |
| Classified as held for sale | (3,807) | - | (3,807) |
| Foreign exchange adjustments | 17 | - | 17 |
| At 1 November 2005 | 818 | 71 | 889 |
| Transfers from property, plant and equipment | 382 | - | 382 |
| Charge for the year | 455 | 723 | 1,178 |
| Foreign exchange adjustments | (31) | (26) | (57) |
| At 31 October 2006 | 1,624 | 768 | 2,392 |
| Carrying amount | | | |
| At 31 October 2006 | 1,049 | 10,814 | 11,863 |
| At 31 October 2005 | 541 | 2,929 | 3,470 |

All of these assets are recognised at fair value to acquire and are amortised over their estimated useful lives. Fair values for acquired intangible assets are assessed by reference to future estimated cash flows discounted at an appropriate rate to present value, or by reference to the amount that would have been paid in an arm's length transaction between two knowledgeable and willing parties.

* Other intangibles comprise intangible assets recognised on acquisition of subsidiary undertakings, of which the most significant are customer relationships assets.

Notes to the Group Financial Statements

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13. PROPERTY, PLANT AND EQUIPMENT

| Cost or valuation | <i>Freehold land and buildings £000</i> | <i>Plant and equipment £000</i> | <i>Total £000</i> |
|--|---|---|-----------------------|
| At 1 November 2004 | 19,888 | 39,301 | 59,189 |
| Additions | 1,164 | 5,837 | 7,001 |
| Acquired on acquisition of subsidiary undertakings | 5,740 | 976 | 6,716 |
| Reclassified as held for sale (see Note 32) | (656) | (4,375) | (5,031) |
| Disposals | - | (32) | (32) |
| Foreign exchange adjustments | 441 | 958 | 1,399 |
| At 1 November 2005 | 26,577 | 42,665 | 69,242 |
| Transfer to intangible assets | - | (588) | (588) |
| Additions | 415 | 9,580 | 9,995 |
| Acquired on acquisition of subsidiary undertakings | 2,455 | 2,864 | 5,319 |
| Reclassified as held for sale (see Note 32) | (543) | - | (543) |
| Disposals | (10) | (428) | (438) |
| Foreign exchange adjustments | (863) | (2,438) | (3,301) |
| At 31 October 2006 | 28,031 | 51,655 | 79,686 |
| Accumulated depreciation | | | |
| At 1 November 2004 | 1,994 | 15,385 | 17,379 |
| Charge for the year | 408 | 3,695 | 4,103 |
| Acquired on acquisition of subsidiary undertakings | - | 219 | 219 |
| Reclassified as held for sale (see Note 32) | (245) | (3,323) | (3,568) |
| Disposals | - | (16) | (16) |
| Foreign exchange adjustments | 35 | 392 | 427 |
| At 1 November 2005 | 2,192 | 16,352 | 18,544 |
| Transfer to intangible assets | - | (382) | (382) |
| Charge for the year | 1,223 | 4,084 | 5,307 |
| Reclassified as held for sale (see Note 32) | (139) | - | (139) |
| Disposals | (10) | (330) | (340) |
| Foreign exchange adjustments | (75) | (910) | (985) |
| At 31 October 2006 | 3,191 | 18,814 | 22,005 |
| Carrying amount | | | |
| At 31 October 2006 | 24,840 | 32,841 | 57,681 |
| At 31 October 2005 | 24,385 | 26,313 | 50,698 |

The carrying amount of the Group's plant and equipment includes an amount of £2,567,000 (2005: £2,687,000) in respect of assets held under finance leases.

Land and buildings were revalued at 30 September 1997 by Chestertons Chartered Surveyors, independent valuers not connected with the Group, on the basis of depreciated replacement cost for the two pyrotechnic sites, and on open market for the remainder.

| | 2006 £000 | 2005 £000 |
|--|----------------------|----------------------|
| 30 September 1997 depreciated replacement cost | 5,820 | 5,820 |
| Freehold at cost | 22,211 | 20,757 |
| | 28,031 | 26,577 |



If stated under historical cost principles the comparable amounts for the total of land and buildings would be:

| | 2006 | 2005 |
|--------------------------|----------------|-------------|
| | £000 | £000 |
| Cost | 25,957 | 24,503 |
| Accumulated depreciation | (3,458) | (2,495) |
| Historical cost value | 22,499 | 22,008 |

All other tangible fixed assets are stated at historical cost.

At 31 October 2006 the Group had entered into contractual commitments for the acquisition of property, plant and equipment amounting to £885,000 (2005: £634,000).

14. SUBSIDIARY UNDERTAKINGS

All subsidiary undertakings have been included in the consolidation. The undertakings held at 31 October 2006 which, in the opinion of the directors, principally affected the results for the year or the net assets of the Group are shown below.

| Subsidiary undertaking | Country of incorporation (or registration) and operation | % of issued ordinary share capital controlled by Chemring Group PLC | Activity |
|-------------------------------|---|--|--------------------------------|
| Pains Wessex Ltd | England | 100 | Countermeasures |
| PW Defence Ltd | England | 100 | Energetics |
| Leaffield Engineering Ltd | England | 100 | Energetics |
| Chemring Marine Ltd | England | 100 | Energetics |
| B.D.L. Systems Ltd | England | 100 | Energetics |
| Nobel Energetics Ltd | Scotland | 100 | Energetics |
| Comet GmbH | Germany | 100 | Energetics |
| Alloy Surfaces Company, Inc. | USA | 100 | Countermeasures |
| Kilgore Flares Company LLC | USA | 100 | Countermeasures and energetics |
| Technical Ordnance, Inc. | USA | 100 | Energetics |
| Chemring Australia Pty Ltd | Australia | 100 | Countermeasures and energetics |
| Pirotécnia Oroquieta S.L. | Spain | 51 | Energetics |
| Associated undertaking | | | |
| CIRRA S.A. | France | 49 | Countermeasures |

Details of the discontinued operations of McMurdo Limited and I.C.S. Electronics Limited are included in Note 32. Both subsidiary undertakings are incorporated in England, 100% controlled by Chemring Group PLC and involved in marine electronics.

Notes to the Group Financial Statements

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15. INVESTMENTS

| | 2006 £000 | 2005 £000 |
|---|--------------|--------------|
| Trading investments | 10 | 10 |
| Interest in associate (including goodwill of £520,000 (2005: £520,000)) | <u>1,023</u> | <u>1,058</u> |
| | <u>1,033</u> | <u>1,068</u> |

Results of the associated undertaking relate to the Group's share of CIRRA S.A.

16. INVENTORIES

| | 2006 £000 | 2005 £000 |
|------------------|---------------|---------------|
| Raw materials | 18,949 | 13,567 |
| Work in progress | 7,807 | 6,474 |
| Finished goods | <u>9,496</u> | <u>7,780</u> |
| | <u>36,252</u> | <u>27,821</u> |

There are no significant differences between the replacement costs and the fair values shown above.

17. TRADE AND OTHER RECEIVABLES

| | 2006 £000 | 2005 £000 |
|--------------------------------|---------------|---------------|
| Current | | |
| Trade debtors | 33,373 | 20,204 |
| Prepayments and accrued income | 774 | 744 |
| Other debtors | <u>4,868</u> | <u>6,220</u> |
| | <u>39,015</u> | <u>27,168</u> |

Included within other debtors is £2,595,000 (2005: £2,796,000) recoverable under an insurance claim relating to an incident at Kilgore Flares Company LLC (see Note 2). Included within other debtors is £170,000 (2005: £170,000) of advance corporation tax recoverable.

All amounts shown above are due within one year.

The average credit period taken on sales of goods, adjusted for Group revenue had the acquisitions taken place on the first day of the financial year, is 60 days (2005: 64 days). No interest is charged on the receivables from the date of invoice to payment.

There is no provision for irrecoverable amounts from the sale of goods (2005: nil).

The directors consider that the carrying amount of trade and other receivables approximates to their fair values.



18. CASH AND CASH EQUIVALENTS

Bank balances and cash comprise cash held by the Group and short term deposits with an original maturity of three months or less. The carrying amount of these assets approximates to their fair value.

19. CREDIT AND PRICE RISK

The Group's principal financial assets are bank balances and cash, and trade and other receivables, which represent the Group's maximum exposure to credit risk in relation to financial assets.

The Group's credit risk is primarily attributable to its trade receivables. The amounts presented in the Balance Sheet are net of allowances for doubtful receivables, based on prior experience and an assessment of the current economic environment.

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 has no significant concentration of credit risk with exposure spread over a large number of counterparties and customers.

The Group's price risk is principally in relation to the cost of raw materials and is not considered significant. Price risk is managed through negotiations with suppliers and where appropriate the agreement of fixed price supply contracts.

20. BANK LOANS AND OVERDRAFTS

| | <i>2006</i> <i>£000</i> | <i>2005</i> <i>£000</i> |
|---|----------------------------|----------------------------|
| Bank loans and overdrafts | 11,523 | 12,701 |
| UK medium term loans | | |
| - sterling denominated | 39,751 | 29,282 |
| - US dollar denominated | 21,410 | 14,745 |
| - Euro denominated | 6,693 | - |
| Overseas medium term loans | 3,844 | 2,293 |
| | 83,221 | 59,021 |
| Borrowings falling due within: | | |
| One year | 11,523 | 12,701 |
| One to two years | 11,181 | 5,838 |
| Two to five years | 45,754 | 27,562 |
| After five years | 14,763 | 12,920 |
| | 83,221 | 59,021 |
| Analysis of borrowings by currency: | | |
| Sterling | 46,615 | 34,086 |
| US dollar | 29,913 | 24,935 |
| Euro | 6,693 | - |
| | 83,221 | 59,021 |
| The weighted average interest rates paid were as follows: | | |
| Bank overdrafts | 6.0% | 5.5% |
| UK medium term loans | | |
| - sterling denominated | 6.4% | 6.7% |
| - US dollar denominated | 6.5% | 5.4% |
| - Euro denominated | 5.1% | - |
| Overseas medium term loans | 3.1% | 2.8% |

Notes to the Group Financial Statements

- continued

20. BANK OVERDRAFTS AND LOANS - continued

Bank loans and overdrafts held with Bank of Scotland are secured by a full debenture over the assets of all of the Group's subsidiaries and are also subject to cross guarantees between all subsidiaries. Bank loans held with Citizens Bank of Pennsylvania (USA) are secured on the related assets purchased with these loans by Alloy Surfaces Company, Inc. Finance lease obligations are secured on the related assets.

The overseas medium term loan is secured on the assets of certain of the overseas businesses.

The directors do not believe the fair value of the Group's borrowings to be materially different to the book values.

The Group has the following undrawn borrowing facilities in various currencies available in respect of which all conditions precedent had been met. These facilities are at floating interest rates.

| | <i>2006</i> | <i>2005</i> |
|-------------------------------------|---------------|---------------|
| | <i>£000</i> | <i>£000</i> |
| Undrawn borrowings | | |
| Expiring between one and five years | <u>20,423</u> | <u>39,438</u> |

21. OBLIGATIONS UNDER FINANCE LEASES

| | <i>Minimum lease payments</i> | | <i>Present value of minimum lease payments</i> | |
|---|-------------------------------|-------------|--|--------------|
| | <i>2006</i> | <i>2005</i> | <i>2006</i> | <i>2005</i> |
| | <i>£000</i> | <i>£000</i> | <i>£000</i> | <i>£000</i> |
| Amounts payable under finance leases: | | | | |
| Within one year | 455 | 961 | 435 | 925 |
| In the second to fifth years | 324 | 619 | 309 | 602 |
| Less future finance charges | <u>(35)</u> | <u>(53)</u> | <u>-</u> | <u>-</u> |
| Present value of lease obligations | 744 | 1,527 | 744 | 1,527 |
| Less amounts due within twelve months shown under current liabilities | | | <u>(435)</u> | <u>(925)</u> |
| Amount due for settlement after twelve months | | | <u>309</u> | <u>602</u> |

It is the Group's policy to lease certain of its fixtures and equipment under finance leases. Finance lease obligations attract interest rates of between 2% and 3% above base rate. Lease obligations are denominated in sterling, US dollars and Australian dollars.

The fair value of the Group's leases approximates to their carrying amounts.

The Group's obligations under finance leases are secured by the lessors' title to the underlying leased assets.



22. TRADE AND OTHER PAYABLES

| | <i>2006</i> | <i>2005</i> |
|-------------------------------|---------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Current | | |
| Trade creditors | 20,416 | 17,079 |
| Other creditors | 5,772 | 2,279 |
| Other tax and Social Security | 1,972 | 1,560 |
| Accruals and deferred income | 11,378 | 3,981 |
| | 39,538 | 24,899 |
| Non-current | 210 | 163 |

Trade creditors and accruals principally comprise amounts outstanding for trade purchases and ongoing costs. The directors consider that the carrying amount of trade payables approximates to their fair value.

Notes to the Group Financial Statements

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23. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

The Group uses financial instruments to manage financial and commercial risk wherever it is appropriate to do so.

The main risks addressed by the financial instruments of the Group are interest rate risk, foreign exchange risk and liquidity risk. The Group's policies in respect of the management of these risks, which remained unchanged throughout the year, were as follows:

| | |
|------------------------|---|
| Interest rate risk: | The Group finances its operations through a mixture of retained profits, bank borrowings and leasing lines of credit. The UK borrowings are denominated in sterling and US dollar and are subject to fixed rates of interest through an amortising LIBOR swap and floating rates of interest linked to Bank of Scotland base rate to provide flexibility. The overseas borrowings are denominated in local currency and are predominantly subject to fixed rates of interest. |
| Foreign exchange risk: | Foreign exchange risk can be subdivided into two components, transactional risk and translation risk: Transactional risk – The Group policy is to hedge significant transactional currency exposures via the use of forward foreign exchange contracts. The measurement and control of this risk is closely monitored on a Group-wide basis. Translation risk – The Group translates overseas results and net assets in accordance with the accounting policy in Note 2. The translation risk on net assets is controlled by the transfer of currencies between Group companies and the appropriate use of foreign currency borrowings. |
| Liquidity risk: | Details of the maturity profiles of the Group's funding can be found in Note 20. |

The profile of the Group's financial assets and liabilities is as follows:

| Financial assets | 2006 | 2005 |
|--------------------------|-----------------|--------------|
| | Total | Total |
| | £000 | £000 |
| Sterling | 6,593 | 4,518 |
| US dollar | 25,804 | 10,979 |
| Australian dollar | 573 | 1,158 |
| Euro | 1,736 | 985 |
| Other currencies | - | 8 |
| | 34,706 | 17,648 |
| Offset in the UK | (21,295) | (9,874) |
| Cash at bank and in hand | 13,411 | 7,774 |

Financial assets held in the UK enjoy a right of interest offset against overdraft balances. Overseas financial assets have a weighted average interest rate of 3.8% (2005: 1%). The financial assets for both years are at floating rate.



Financial liabilities

| | 2006 | | | 2005 | | |
|----------------------------------|-----------------------------------|--------------------------------|-----------------------|-----------------------------------|--------------------------------|-----------------------|
| | <i>Floating rate £000</i> | <i>Fixed rate £000</i> | <i>Total £000</i> | <i>Floating rate £000</i> | <i>Fixed rate £000</i> | <i>Total £000</i> |
| Sterling | (48,415) | (20,239) | (68,654) | (34,398) | (10,191) | (44,589) |
| US dollar | (11,226) | (18,687) | (29,913) | (15,009) | (10,824) | (25,833) |
| Euro | - | (6,693) | (6,693) | - | - | - |
| | <u>(59,641)</u> | <u>(45,619)</u> | <u>(105,260)</u> | <u>(49,407)</u> | <u>(21,015)</u> | <u>(70,422)</u> |
| Offset in the UK | | | <u>21,295</u> | | | <u>9,874</u> |
| | | | <u>(83,965)</u> | | | <u>(60,548)</u> |
| Bank loans and overdrafts | | | (11,523) | | | (12,701) |
| Medium term loans UK | | | (67,854) | | | (44,027) |
| Medium term loans overseas | | | (3,844) | | | (2,293) |
| Obligations under finance leases | | | <u>(744)</u> | | | <u>(1,527)</u> |
| | | | <u>(83,965)</u> | | | <u>(60,548)</u> |

A right of offset exists for currency amounts held within the UK by Bank of Scotland. These are used to offset the interest charged on the UK overdraft which bears interest at 1.25% above LIBOR. Cash at bank and in hand consists primarily of overseas funds which are used as short term intra-group financing as well as an internal exchange rate hedge.

The weighted average interest rate of fixed rate financial liabilities at 31 October 2006 was 5.8% (2005: 5.2%) and the weighted average period of funding was five years (2005: three years).

The Group has three amortising interest rate swaps, from floating to fixed rate, one that expires in 2012 at a rate of 6.53% (sterling), one that expires in 2011 at a rate of 6.27% (US dollars) and one that expires in 2011 at a rate of 5.13% (Euro). The fair value of interest rate swaps recognised on the Balance Sheet at 31 October 2006 was £328,000 (2005: £nil).

24. PROVISIONS

| | £000 | |
|---------------------------------|-------------|-------------|
| At 1 November 2005 | | 170 |
| Provided in the year | | 500 |
| Utilised in the year | | (384) |
| At 31 October 2006 | | <u>286</u> |
| Analysed as: | 2006 | 2005 |
| | £000 | £000 |
| Included in current liabilities | <u>286</u> | <u>170</u> |

The provision at 31 October 2006 is held in respect of ongoing legal costs and insurance costs associated with a product recall. Management considers that completion of the recall process and associated costs will be finalised within one year.

The provision at 31 October 2005 was held in respect of amounts payable to the Group's pension schemes following the disposal of Kembrey Wiring Systems Limited. Payment was made in full in November 2005.

Notes to the Group Financial Statements

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25. DEFERRED TAX

The following are the major deferred tax liabilities/(assets) recognised by the Group and movements thereon during the year.

| | <i>Accelerated tax depreciation £000</i> | <i>Retirement benefit obligation £000</i> | <i>Tax losses £000</i> | <i>Other £000</i> | <i>Total £000</i> |
|---|--|---|----------------------------|-----------------------|-----------------------|
| At 1 November 2004 | 2,096 | (4,835) | (480) | 2,483 | (736) |
| Charge/(credit) to income | 1,411 | - | 412 | (871) | 952 |
| Credit to equity | - | (1,222) | - | (119) | (1,341) |
| Amounts arising on acquisition of subsidiary undertakings | 2,743 | - | - | - | 2,743 |
| Foreign exchange movements | (79) | - | - | (11) | (90) |
| Other movements | - | - | - | (10) | (10) |
| At 1 November 2005 | 6,171 | (6,057) | (68) | 1,472 | 1,518 |
| Charge/(credit) to income | 1,180 | - | (1,113) | (3,159) | (3,092) |
| Charge/(credit) to equity | - | 1,406 | - | (475) | 931 |
| Amounts arising on acquisition of subsidiary undertakings | (652) | - | - | 1,311 | 659 |
| Foreign exchange movements | (151) | - | 14 | (37) | (174) |
| Other movements | - | - | - | (5) | (5) |
| At 31 October 2006 | 6,548 | (4,651) | (1,167) | (893) | (163) |

Certain deferred tax assets and liabilities have been offset in accordance with the Group's accounting policy. Deferred tax balances after offset, for balance sheet purposes are analysed as follows:

| | 2006 £000 | 2005 £000 |
|--------------------------|----------------------|----------------------|
| Deferred tax liabilities | 9,486 | 8,958 |
| Deferred tax assets | (9,649) | (7,440) |
| | (163) | 1,518 |

At the balance sheet date the Group has unused tax losses of £16 million (2005: £7 million) potentially available for offset against future profits in certain circumstances. £13 million of tax losses were acquired with Comet GmbH. No deferred tax asset has been recognised in respect of this amount because of the unpredictability of future qualifying profit streams. These losses can be carried forward indefinitely.



26. SHARE CAPITAL

| | 2006 £000 | 2005 £000 |
|--|--------------|--------------|
| Authorised | | |
| 43,000,000 (2005: 33,000,000) ordinary shares of 5p each | <u>2,150</u> | <u>1,650</u> |
| Issued and fully paid | | |
| 32,235,076 (2005: 29,177,576) ordinary shares of 5p each | <u>1,612</u> | <u>1,459</u> |

During the year 2,900,000 ordinary shares were issued to partially fund the acquisition of Technical Ordnance, Inc. Net proceeds after issue costs were £26,213,000. A further 157,500 ordinary shares were issued for a cash consideration of £206,000 under the Group's share schemes.

The Company's authorised share capital also includes 62,500 7% cumulative preference shares of £1 each, which are all issued and fully paid-up.

27. RESERVES

| | Share premium account £000 | Special capital reserve £000 | Hedging reserve £000 | Revaluation reserve £000 | Retained earnings £000 | Total £000 |
|---|-------------------------------------|---------------------------------------|----------------------------|--------------------------------|------------------------------|---------------|
| At 1 November 2004 | 26,710 | 12,939 | - | 1,687 | 9,549 | 50,885 |
| Ordinary shares issued | 564 | - | - | - | - | 564 |
| Profit after tax for the year | - | - | - | - | 8,769 | 8,769 |
| Minority interest | - | - | - | - | (13) | (13) |
| Dividends paid | - | - | - | - | (2,736) | (2,736) |
| Net cost of share-based payments | - | - | - | - | 311 | 311 |
| Actuarial loss net of tax | - | - | - | - | (2,852) | (2,852) |
| Foreign exchange translation gains | - | - | - | - | 67 | 67 |
| Recognition of deferred tax on revaluation | - | - | - | (11) | 11 | - |
| Transfers between reserves | - | - | - | (36) | 36 | - |
| Tax credits on items taken direct to reserves | - | - | - | - | 119 | 119 |
| At 31 October 2005 | <u>27,274</u> | <u>12,939</u> | <u>-</u> | <u>1,640</u> | <u>13,261</u> | <u>55,114</u> |
| Adoption of IAS32 and 39 | - | - | (12) | - | - | (12) |
| At 1 November 2005 – restated | <u>27,274</u> | <u>12,939</u> | <u>(12)</u> | <u>1,640</u> | <u>13,261</u> | <u>55,102</u> |
| Ordinary shares issued | 26,266 | - | - | - | - | 26,266 |
| Profit after tax for the year | - | - | - | - | 13,797 | 13,797 |
| Minority interest | - | - | - | - | (2) | (2) |
| Dividends paid | - | - | - | - | (3,695) | (3,695) |
| Net cost of share-based payments | - | - | - | - | 586 | 586 |
| Actuarial gain net of tax | - | - | - | - | 3,279 | 3,279 |
| Increase in fair value of cash flow hedging derivatives | - | - | 242 | - | - | 242 |
| Foreign exchange translation losses | - | - | - | - | (5,230) | (5,230) |
| Transfers between reserves | - | - | - | (36) | 36 | - |
| Tax credits on items taken direct to reserves | - | - | - | - | 1,868 | 1,868 |
| At 31 October 2006 | <u>53,540</u> | <u>12,939</u> | <u>230</u> | <u>1,604</u> | <u>23,900</u> | <u>92,213</u> |

The share premium account, the special capital reserve and the revaluation reserve are not distributable.

Included within retained earnings is £1,022,000 of retained profits (2005: £1,045,000) relating to the associated undertaking and £145,000 (2005: £145,000) of own shares held by the Group's ESOP trustees.

Notes to the Group Financial Statements

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28. STATEMENT OF CHANGES IN EQUITY

| | 2006 £000 | 2005 £000 |
|--|----------------------|----------------------|
| Total recognised income and expense for the year (see page 43) | 13,956 | 6,103 |
| Dividends | (3,695) | (2,736) |
| | <u>10,261</u> | <u>3,367</u> |
| Ordinary shares issued | 153 | 10 |
| Share premium arising | 26,266 | 564 |
| Cost of share-based payments | 586 | 311 |
| Net addition to shareholders' funds | <u>37,266</u> | <u>4,252</u> |
| Opening shareholders' funds | 56,850 | 52,598 |
| Adoption of IAS32 and 39 | (12) | - |
| Closing shareholders' funds | <u>94,104</u> | <u>56,850</u> |

Equity comprises share capital, share premium and retained earnings.

29. OBLIGATIONS UNDER NON-CANCELLABLE OPERATING LEASES

| | 2006 £000 | 2005 £000 |
|----------------------|---------------------|---------------------|
| Within one year | 713 | 575 |
| Two to five years | 1,583 | 1,111 |
| More than five years | <u>2,914</u> | <u>-</u> |
| | <u>5,210</u> | <u>1,686</u> |

30. SHARE-BASED PAYMENTS

The Group operates share-based compensation arrangements to provide incentives to the Group's senior management and other eligible employees.

Details of the three schemes which operated during the year are as follows:

The Chemring Group Performance Share Plan (the "PSP")

Under the PSP conditional awards of ordinary shares are made at nil cost. Awards ordinarily vest on the third anniversary of the award date. The scheme commenced in March 2006.

| | 2006 Number of conditional shares awarded |
|---|--|
| Awarded during the year | 128,676 |
| Outstanding at the end of the year | <u>128,676</u> |
| Subject to vesting at the end of the year | <u>-</u> |

The Group assumes that all the conditions of the PSP will be met.

As there is no option element the share price is discounted based on the following assumptions:

- Dividend growth at 1.5p per annum;
- weighted average cost of capital 10%.

The weighted average fair value of awards made during the year was 1115.7p (2005: nil)



Restricted Share Award

A one-time award of 125,000 restricted ordinary shares at nil cost was made to Dr Price on 4 April 2005, on taking up his appointment as Chief Executive. 50% of the award vested in March 2006 and the remaining 50% will vest in March 2007.

| | <i>2006</i> |
|--|---|
| | <i>Number of conditional shares awarded</i> |
| Outstanding at the beginning of the year | 125,000 |
| Awards vesting during the year | (62,500) |
| Outstanding at the end of the year | <u>62,500</u> |
| Subject to vesting at end of year | <u>-</u> |

As there is no option element the share price is discounted based on the following assumptions:

- Dividend growth at 1.5p per annum;
- weighted average cost of capital 10%.

There were no awards made during the year ended 31 October 2006. The weighted average fair value of awards made during the year ended 31 October 2005 was 447.5p.

The Chemring 1998 Executive Share Option Scheme (the "1998 ESOS")

Under the 1998 ESOS options are granted at a price not less than the market value of the Group's ordinary shares on the date the options are granted.

| | <i>2006</i> | | <i>2005</i> |
|----------------------------------|----------------------|-----------------------|-----------------------|
| | <i>Number of</i> | <i>Weighted</i> | <i>Number of</i> |
| | <i>share options</i> | <i>average</i> | <i>share options</i> |
| | | <i>exercise price</i> | <i>exercise price</i> |
| | | <i>Pence</i> | <i>Pence</i> |
| Outstanding at beginning of year | 242,798 | 356.0 | 379,000 |
| Granted during the year | 50,000 | 1,059.0 | 52,798 |
| Exercised during the year | <u>(95,000)</u> | 228.5 | <u>(189,000)</u> |
| Outstanding at end of year | <u>197,798</u> | 512.0 | <u>242,798</u> |
| Exercisable at end of year | <u>5,000</u> | 228.5 | <u>-</u> |

Share options were exercised throughout the year and the average share price was 1,115.0p (2005: 494.4p). The options outstanding at the end of the year have exercise prices ranging from 228.5p to 1,059.0p.

The compensation expense recognised in respect of share options is based on their fair value at the grant date calculated using the Black-Scholes option pricing model.

Notes to the Group Financial Statements

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30. SHARE-BASED PAYMENTS - continued

Assumptions made in calculating the fair values of options granted during the year were as follows:

| | 2006 | 2005 |
|---|---------|---------|
| Options granted | 50,000 | 52,798 |
| Weighted average fair value (pence) | 222.0 | 94.0 |
| Weighted average share price (pence) | 1,059.0 | 473.5 |
| Weighted average exercise price (pence) | 1,059.0 | 473.5 |
| Expected volatility | 31% | 27% |
| Expected life | 3 years | 3 years |
| Risk free interest rate | 4.58% | 4.71% |
| Expected dividend yield | 1.96% | 2.32% |

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous years. The expected life 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 £2,215,000 (2005: £924,000) in respect of share-based payment transactions during the year.

31. ACQUISITIONS

The following acquisitions have taken place during the year to 31 October 2006:

| Name of business acquired | Activity | Date of acquisition | Proportion of shares acquired % | Cost of acquisition £000 |
|---------------------------|------------|---------------------|---------------------------------------|-----------------------------|
| Comet GmbH | Energetics | 30 November 2005 | 100 | 7,230 |
| Leaffield Engineering Ltd | Energetics | 31 January 2006 | 100 | 5,160 |
| Technical Ordnance, Inc. | Energetics | 13 March 2006 | 100 | 42,630 |
| B.D.L. Systems Ltd | Energetics | 30 September 2006 | 100 | 10,204 |
| | | | | <u>65,224</u> |

Satisfied by:

| | |
|------------------------|---------------|
| | £000 |
| Cash | 64,324 |
| Deferred consideration | <u>900</u> |
| | <u>65,224</u> |

Reconciliation to cash flow statement:

| | |
|---|---------------|
| | £000 |
| Cash outflow on subsidiaries acquired in current year | 64,324 |
| Cash acquired | (1,789) |
| Deferred consideration on subsidiaries acquired in prior year | <u>273</u> |
| Net cash outflow | <u>62,808</u> |



An analysis of the assets acquired with Technical Ordnance, Inc. is shown below:

| | <i>Book value</i> | <i>Fair value</i> | <i>Fair value</i> |
|-------------------------------|-------------------|--------------------|-------------------|
| | <i>£000</i> | <i>adjustments</i> | <i>£000</i> |
| | | <i>£000</i> | <i>£000</i> |
| Intangible assets | - | 6,721 | 6,721 |
| Property, plant and equipment | 885 | - | 885 |
| Deferred tax asset | - | 646 | 646 |
| Inventories | 3,747 | (284) | 3,463 |
| Trade receivables | 1,888 | (24) | 1,864 |
| Bank and cash balances | 290 | - | 290 |
| Trade and other payables | (554) | (8) | (562) |
| Net assets acquired | 6,256 | 7,051 | 13,307 |
| Goodwill on acquisition | - | 29,323 | 29,323 |
| Total | <u>6,256</u> | <u>36,374</u> | <u>42,630</u> |

| | |
|------------------------|---------------|
| | <i>£000</i> |
| Consideration | |
| Cash | 40,556 |
| Deferred consideration | 927 |
| Costs | 1,147 |
| Total | <u>42,630</u> |

The other acquisitions had a net asset book value of £8,051,000 and were acquired for a consideration of £22,594,000 (cash £21,412,000 and costs of £1,182,000). Goodwill of £11,605,000 arose after fair value adjustments of £2,938,000.

Adjustments from book value to fair value arise principally from the application of Group accounting policies and the recognition of intangible assets under IFRS3 *Business Combinations and Fair Value Adjustments to Inventories, Receivables, Property, Plant and Equipment*. Intangible assets relate principally to customer relationships (see Note 12). Fair values relating to the acquisition of B.D.L. Systems Limited are provisional and will be finalised within one year of the acquisition date.

Costs include those legal and accounting costs incurred in developing the acquisition contracts and performing due diligence activities.

All intangible assets were recognised at their respective fair values. The residual excess of total cost over the fair value of net assets acquired is recognised as goodwill in the financial statements. Goodwill represents the value of synergies and assembled workforces acquired.

If the acquisitions had been completed on the first day of the financial year, Group revenues and profits before tax for continuing activities for the year would have been approximately £210 million and £36 million respectively. This information is not necessarily indicative of the results of operations that would have occurred had the operations been acquired at the start of the year, nor of the future results of the combined operations.

Notes to the Group Financial Statements

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32. DISCONTINUED OPERATIONS

The results of the discontinued operations for the year, or to the date of disposal, which have been included in the Consolidated Income Statement, were as follows:

| | 2006 £000 | 2005 £000 |
|------------------------------------|----------------|--------------|
| Revenue | 11,348 | 11,495 |
| Trading loss | (984) | (2,557) |
| Loss on disposal/impairment | (7,970) | (3,000) |
| Loss before tax | (8,954) | (5,557) |
| Tax | 864 | 767 |
| Loss after tax for the year | (8,090) | (4,790) |

On 31 October 2005, the Board concluded that the Marine Lights and Electronics business should become a discontinued operation and resolved to dispose of the operation. Accordingly the operations of McMurdo Limited and I.C.S. Electronics Limited have been treated as discontinued.

On 30 June 2006, the Group sold its McMurdo Lights business to Daniamant Limited for the sum of £2.8 million; £0.2 million of the consideration is payable in July 2007.

On 15 December 2006, the Group announced the conditional sale of its McMurdo Marine Electronics business to Signature Industries Limited. Following receipt of a cash deposit of £0.25 million, £2.8 million will be paid in cash at completion and deferred contingent consideration of up to £1.5 million will be paid in December 2007.

At the end of the year I.C.S. Electronics Limited remained unsold and a decision was taken to impair the goodwill attributable to the company. A charge of £1.1 million arose.

The loss after tax includes £4.9 million (2005: £3 million) impairment charge of goodwill and £3.1 million loss on disposal of the Marine Lights and Electronics businesses.

The tax credit for the year of £864,000 (2005: £767,000) was lower (2005: lower) than the standard rate of 30% (2005: 30%), primarily as a result of the impairment of goodwill which is not deductible for tax purposes.

| | | |
|--|--------------|--------------|
| Cash flows from discontinued operations | 2006 £000 | 2005 £000 |
| Net cash used on operating activities | (824) | (1,040) |
| Net cash received/(used) on investing activities | 1,168 | (950) |
| Total | 344 | (1,990) |



The major classes of assets and liabilities classified as held for sale are as follows:

| | <i>2006</i> | <i>2005</i> |
|---|----------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Goodwill | - | 4,890 |
| Other tangible assets | 1,000 | 1,756 |
| Property, plant and equipment | 904 | 1,049 |
| Inventories | 2,031 | 4,453 |
| Trade and other receivables | 2,581 | 2,498 |
| Total assets classified as held for sale | 6,516 | 14,646 |
| Trade and other payables | (2,338) | (1,776) |
| Net assets of disposal group | 4,178 | 12,870 |

Notes to the Group Financial Statements

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33. PENSIONS

Within the UK the Group operates two defined benefit schemes, the Chemring Group Staff Pension Scheme (the "Staff Scheme") and the Chemring Group Executive Pension Scheme (the "Executive Scheme"), as detailed below. In Germany, Comet GmbH operates a defined benefit scheme (the "Comet Scheme"). The other overseas arrangements are all defined contribution schemes. The total pension costs for the Group for the year ended 31 October 2006, including defined contribution schemes, was £3,114,000 (2005: £2,469,000).

The Staff Scheme and Executive Scheme are funded schemes and the assets of the schemes are held in separate trustee administered funds. Full actuarial valuations for the Staff Scheme and the Executive Scheme as at 6 April 2003 have been prepared and updated to 31 October 2006 by a qualified actuary, using the projected unit credit method.

The Comet Scheme is a new scheme in the year and is an unfunded scheme. The actuarial liability has been calculated at 31 October 2006 by a qualified actuary using the projected unit credit method. The main assumptions used were a discount rate of 4.5%, inflation rate of 1.8% and rate of increase in deferred pensions of 0%. The net deficit of the Comet Scheme was £927,000 at 31 October 2006.

The amount recognised in the Balance Sheet in respect of the Group's defined benefit schemes is as follows:

| | 2006 £000 | 2005 £000 |
|---|-----------------|-----------------|
| Present value of funded obligations | (48,577) | (47,606) |
| Fair value of scheme assets | 32,232 | 27,417 |
| Net liability recognised in the Balance Sheet | <u>(16,345)</u> | <u>(20,189)</u> |

Amounts recognised in income in respect of the defined benefit schemes are as follows:

| | 2006 £000 | 2005 £000 |
|--|----------------|----------------|
| Amounts included within operating profit: | | |
| Current service cost | <u>(995)</u> | <u>(724)</u> |
| Amounts included as other finance costs: | | |
| Expected return on scheme assets | 1,667 | 1,440 |
| Discount on scheme liabilities | <u>(2,449)</u> | <u>(2,298)</u> |
| | <u>(782)</u> | <u>(858)</u> |
| Net charge | <u>(1,777)</u> | <u>(1,582)</u> |

Amounts recognised in the Statement of Recognised Income and Expense (SORIE) are as follows:

- (i) scheme assets at the balance sheet date;
- (ii) present value of the scheme liabilities at the balance sheet date.

| | 2006 £000 | 2005 £000 |
|--|----------------|----------------|
| Actual return less expected return on pension scheme assets (i) | 2,226 | 2,187 |
| Experience gains/(losses) arising on scheme liabilities (ii) | 5,464 | (327) |
| Changes in assumptions underlying the present value of the scheme liabilities (ii) | <u>(3,005)</u> | <u>(5,934)</u> |
| Actuarial gain/(loss) recognised in SORIE | <u>4,685</u> | <u>(4,074)</u> |



Changes in the present value of the defined benefit obligation are as follows:

| | <i>2006</i> | <i>2005</i> |
|------------------------------------|-----------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Opening defined benefit obligation | (47,606) | (38,821) |
| Arising from business combinations | (922) | - |
| Service cost | (995) | (724) |
| Interest cost | (2,449) | (2,298) |
| Contributions from scheme members | (543) | (509) |
| Actuarial gains and losses | 2,459 | (6,261) |
| Benefits paid | 1,479 | 1,007 |
| Closing defined benefit obligation | (48,577) | (47,606) |

Movements in the fair value of the scheme assets were as follows:

| | <i>2006</i> | <i>2005</i> |
|---|----------------|-------------|
| | <i>£000</i> | <i>£000</i> |
| Opening fair value of scheme assets | 27,417 | 22,706 |
| Expected return on scheme assets | 1,667 | 1,440 |
| Actuarial gains and losses | 2,226 | 2,187 |
| Contributions from scheme members | 543 | 509 |
| Contributions from sponsoring companies | 1,858 | 1,582 |
| Benefits paid | (1,479) | (1,007) |
| | 32,232 | 27,417 |

The total scheme assets of the Staff Scheme and the Executive Scheme updated to 31 October along with the expected rates of return on assets were as follows:

| | | <i>2006</i> | | <i>2005</i> |
|----------------------------|--------------------------|---------------|--------------------------|-------------|
| | <i>Long term rate of</i> | | <i>Long term rate of</i> | |
| | <i>return expected</i> | <i>£000</i> | <i>return expected</i> | <i>£000</i> |
| Equities | 6.3% | 19,062 | 6.4% | 15,499 |
| Bonds | 5.1% | 12,848 | 5.0% | 11,440 |
| Other assets | 4.3% | 322 | 4.4% | 478 |
| Total fair value of assets | | 32,232 | | 27,417 |

The expected rates of return are determined by reference to relevant published indices. The overall expected rate of return is calculated by weighting the individual rates in accordance with the anticipated balance in the scheme's investment portfolio.

Notes to the Group Financial Statements

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33. PENSIONS - continued

History of experience gains and losses:

| | <i>IFRS</i> 2006 <i>£000</i> | <i>IFRS</i> 2005 <i>£000</i> | <i>UK GAAP</i> 2004 <i>£000</i> | <i>UK GAAP</i> 2003 <i>£000</i> | <i>UK GAAP</i> 2002 <i>£000</i> |
|---|---|------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
| Present value of funded obligations | (48,577) | (47,606) | (38,821) | (34,450) | (31,748) |
| Fair value of scheme assets | 32,232 | 27,417 | 22,744 | 20,321 | 18,281 |
| Deficit in the schemes | (16,345) | (20,189) | (16,077) | (14,129) | (13,467) |
| Experience gains/(losses) on scheme liabilities | 5,464 | (327) | (902) | 2,517 | (217) |
| Percentage of scheme liabilities | 11.2% | 0.7% | 2.3% | 7.3% | 0.7% |
| Experience gains/(losses) on scheme assets | 2,226 | 2,187 | (372) | 455 | (4,333) |
| Percentage of scheme assets | 6.9% | 8.0% | 1.6% | 2.2% | 23.7% |

Analysis of movement in the deficit in the schemes during the year:

| | 2006 <i>£000</i> | 2005 <i>£000</i> |
|------------------------------------|----------------------------|---------------------|
| Opening deficit in scheme | (20,189) | (16,115) |
| Arising from business combinations | (922) | - |
| Current service cost | (995) | (724) |
| Contributions | 1,858 | 1,582 |
| Other finance costs | (782) | (858) |
| Actuarial gain/(loss) | 4,685 | (4,074) |
| Closing deficit in the schemes | (16,345) | (20,189) |

The principal assumptions used in the actuarial valuations were as follows:

| | 2006 | 2005 |
|--|-------------------|------------|
| Discount rate | 5.05% | 5.1% |
| Rate of increase in salaries | 3.8 – 4.3% | 3.7 – 4.2% |
| Rate of increase in deferred pensions | 2.8% | 2.7% |
| Rate of increase in pensions in payment (where applicable) | 2.9% | 2.8% |
| Inflation assumption | 2.8% | 2.7% |
| Expected return on scheme assets | 5.7% | 6.0% |

In determining the pension liabilities the Group uses mortality assumptions which are based on published mortality tables. For both the Staff and Executive Schemes the actuarial table used is PA92(YOB)MC+2.

The assumption considered to be the most significant is the discount rate adopted. If the discount rate in the schemes were to change by 0.1% then it is predicted that the deficit in the schemes would change by approximately £1 million.



34. SELF INSURANCE

The Group is self insured through its captive insurance company CHG Insurance Limited, based in Guernsey. The Group has been self insured for the first £2.5 million of material damage and business interruption cover, subject to a maximum liability of £3.5 million in any one year, since 31 October 2001. Insurance cover in respect of this risk at a level over that disclosed here is placed with external insurers.

35. 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.

Trading transactions

There are no trading activities between the Group and its associate.

Remuneration of key management personnel

The remuneration of the directors, who are the key management personnel of the Group, is set out below in aggregate for each of the categories specified in IAS24 *Related Party Disclosures*. Further information on the remuneration of individual directors is provided in the audited part of the Directors' Remuneration Report on pages 27 to 34.

The directors of Chemring Group PLC had no material transactions with the Company during the year other than as a result of service agreements.

The remuneration of directors is determined by the Remuneration Committee having regard to the performance of individuals and the market trends.

| | 2006 | 2005 |
|----------------------|--------------|-------------|
| | £000 | £000 |
| Remuneration | 616 | 800 |
| Termination benefits | 116 | 185 |
| Share-based payments | 280 | 202 |
| Total | 1,012 | 1,187 |

36. EXPLANATION OF TRANSITION TO IFRS

This is the first year that the Group has presented its consolidated financial statements under IFRS. The last financial statements under UK GAAP were for the year ended 31 October 2005. As the date for transition to IFRS was 1 November 2004, comparative financial information presented in these financial statements has been re-presented under IFRS.

The Group has taken advantage of the following exemptions as permitted under IFRS1 *First Time Adoption of IFRS*:

- Business combinations occurring before the date of transition on 1 November 2004 have not been restated.
- Only equity instruments granted after 7 November 2002 that vest after the effective date of IFRS2 on 1 January 2005 have been valued.
- The actuarial gains and losses approach to valuation of the defined benefit plans has not been applied retrospectively. The initial recognition of the defined benefit schemes' deficits is recorded on the face of the Group Balance Sheet as at 1 November 2004 (date of transition).
- The Group has not separately disclosed the amount of cumulative translation differences for its overseas operations included within retained earnings at 1 November 2004.
- Tangible assets have continued to be reported on the basis of depreciated historical cost, as under UK GAAP.
- Comparative information for financial instruments remain under UK GAAP (IAS39 exemption not to restate comparatives).

Notes to the Group Financial Statements

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36. EXPLANATION OF TRANSITION TO IFRS - continued

Notes to the reconciliation of equity at 1 November 2004 and 31 October 2005

Significant changes to previously reported UK GAAP figures have been made in the following areas to comply with IFRS:

A) IFRS3 - Business Combinations

Under IFRS3 there is a specific requirement to recognise separately identifiable intangible assets that meet the IFRS3 criteria (principally customer relationships) at fair value on acquisition and to amortise these over an appropriate period. This reduces the amount of residual goodwill recognised.

As stated above, under IFRS1, business combinations prior to the date of transition are not required to be restated. The adjustment is therefore limited to the five acquisitions completed since 1 November 2004. In the year ended 31 October 2005 specific intangibles were identified, on acquisition, with a fair value of £3,000,000 and amortisation of £71,000 was charged.

B) IFRS2 - Share-Based Payment

Under IFRS2 charges are required for all share-based remuneration schemes. These charges reflect the fair value of the shares at the date of the grant. The operating profit charge for the year to 31 October 2005 for all relevant schemes under this standard was £477,000. The opening IFRS balance sheet net assets are reduced by £76,000. Net assets at 31 October 2005 are reduced by £328,000.

C) IAS19 - Employee Benefits and Retirement Benefit Schemes

Under IAS19 there is a requirement to recognise the monetary value of employee benefits accruing to employees but not yet settled; typically holiday pay. There is a requirement to present the value of the liability for employee benefits to be paid in the future for services provided up to the reporting date. A review of employee benefits across the Group identified an opening balance sheet adjustment of £518,000.

Under UK GAAP the Group accounted for defined benefit pension schemes in accordance with SSAP24, with disclosure as required under FRS17. Under IAS19 there is a requirement to value defined benefit scheme assets at bid price rather than mid market price, and to disclose the retirement benefit asset/obligation on the face of the balance sheet, with movement in the valuation of actuarial gains and losses through the Statement of Recognised Income and Expenditure (SORIE). At the date of transition, 1 November 2004, the initial increase in non-current liabilities is £16,115,000, with a corresponding deferred tax asset of £4,835,000 reported in non-current assets. In addition, the previous SSAP24 prepayment of £252,000 has been reversed. The charge to the Income Statement under IAS19 for retirement benefits includes three components, a service cost, the expected return on pension scheme assets and the unwinding cost of interest on the pension scheme liabilities.

D) IAS10 - Events after the Balance Sheet Date

There is a requirement under IFRS to only recognise the liability for dividends that have been proposed and approved at the balance sheet date.

E) IAS21 - The Effects of Changes in Foreign Exchange Rates

Under IAS21 all foreign currency transactions and balances must be converted to the reporting entity currency at the rate applicable on the last day of the reporting period, i.e. at the spot rate. UK GAAP permitted the use of an applicable forward currency contract rate instead of the spot rate.

F) IAS12 - Income Tax

Under UK GAAP deferred tax liabilities were discounted; under IFRS discounting is not permitted. The impact as at 1 November 2004 was to increase deferred tax liabilities by £824,000. The tax in the income statement for the year ended 31 October 2005 is £61,000 higher than it would have been under UK GAAP.

Under UK GAAP deferred tax liabilities on revaluation reserves were not provided for unless the Group entered into a binding contract to sell the revalued assets. Under IAS12 deferred tax must be provided for. The impact is to increase deferred tax liabilities as at 1 November 2004 by £1,081,000. The Group has available capital losses to offset against any potential gain arising on these assets. The impact as at 1 November 2004 is to recognise a deferred tax asset of £1,081,000. Netting-off of assets and liabilities is not permitted under IAS12.



The reconciliation of equity at 1 November 2004 (date of transition to IFRS) and at 31 October 2005 (date of last UK GAAP financial statements) and the reconciliation of profit for the year ended 31 October 2005, as required by IFRS1, are given below. There are no significant differences in cash flow between UK GAAP and IFRS consequently there is no cash flow statement reconciliation.

Reconciliation of equity at 1 November 2004 (date of transition to IFRS)

| | Note | UK GAAP as restated £000 | Share-based payments £000 | Employee benefits £000 | Income tax £000 | Other £000 | IFRS £000 |
|---|---------|--------------------------------|---------------------------------|------------------------------|-----------------------|---------------|---------------|
| Non-current assets | | | | | | | |
| Development costs | | 2,841 | - | - | - | - | 2,841 |
| Goodwill | | 27,984 | - | - | - | - | 27,984 |
| Tangible assets | | 41,810 | - | - | - | - | 41,810 |
| Investment in associate | | 1,073 | - | - | - | - | 1,073 |
| Deferred tax asset | B,C,F | - | 30 | 4,893 | 1,081 | - | 6,004 |
| Total non-current assets | | 73,708 | 30 | 4,893 | 1,081 | - | 79,712 |
| Current assets | | | | | | | |
| Inventories | | 25,090 | - | - | - | - | 25,090 |
| Trade and other receivables | C | 27,036 | - | (252) | - | - | 26,784 |
| Cash and cash equivalents | | 9,933 | - | - | - | - | 9,933 |
| Total current assets | | 62,059 | - | (252) | - | - | 61,807 |
| Current liabilities | | | | | | | |
| Loans | | (3,070) | - | - | - | - | (3,070) |
| Obligations under finance leases | | (1,234) | - | - | - | - | (1,234) |
| Bank overdrafts | | (17,463) | - | - | - | - | (17,463) |
| Trade and other payables | B,C,D,E | (25,208) | - | (518) | - | 1,825 | (23,901) |
| Corporation tax | | (2,940) | - | - | - | - | (2,940) |
| | | (49,915) | - | (518) | - | 1,825 | (48,608) |
| Non-current liabilities | | | | | | | |
| Loans | | (17,055) | - | - | - | - | (17,055) |
| Obligations under finance leases | | (1,119) | - | - | - | - | (1,119) |
| Other payables | B | - | (68) | - | - | - | (68) |
| Deferred tax liabilities | C,E,F | (3,431) | - | 76 | (1,905) | (8) | (5,268) |
| Long term provisions | | (626) | - | - | - | - | (626) |
| Preference shares | | (62) | - | - | - | - | (62) |
| Retirement benefit obligations | C | - | - | (16,115) | - | - | (16,115) |
| | | (22,293) | (68) | (16,039) | (1,905) | (8) | (40,313) |
| Net assets | | 63,559 | (38) | (11,916) | (824) | 1,817 | 52,598 |
| Equity | | | | | | | |
| Share capital | | 1,449 | - | - | - | - | 1,449 |
| Share premium account | | 26,710 | - | - | - | - | 26,710 |
| Special capital reserve | | 12,939 | - | - | - | - | 12,939 |
| Revaluation reserve | F | 2,410 | - | - | (723) | - | 1,687 |
| Retained earnings | | 19,787 | (38) | (11,916) | (101) | 1,817 | 9,549 |
| Equity attributable to equity holders of the parent | | 63,295 | (38) | (11,916) | (824) | 1,817 | 52,334 |
| Equity attributable to minority interests | | 264 | - | - | - | - | 264 |
| Total equity | | 63,559 | (38) | (11,916) | (824) | 1,817 | 52,598 |

Notes to the Group Financial Statements

- continued

36. EXPLANATION OF TRANSITION TO IFRS - continued

Reconciliation of equity at 31 October 2005 (date of last UK GAAP financial statements)

| | Note | UK GAAP as restated £000 | 2004 IFRS transition adjustments £000 | Share- based payments £000 | Employee benefits £000 | Income tax £000 | Other £000 | IFRS £000 |
|---|---------|-----------------------------------|--|-------------------------------------|------------------------------|-----------------------|---------------|---------------|
| Non-current assets | | | | | | | | |
| Intangible assets | A | - | - | - | - | - | 2,929 | 2,929 |
| Development costs | | 541 | - | - | - | - | - | 541 |
| Goodwill | A | 35,058 | - | - | - | - | (378) | 34,680 |
| Tangible assets | | 50,698 | - | - | - | - | - | 50,698 |
| Investment in associate | | 1,068 | - | - | - | - | - | 1,068 |
| Deferred tax assets | B,C,F | - | 6,004 | 225 | 1,222 | (11) | - | 7,440 |
| Total non-current assets | | 87,365 | 6,004 | 225 | 1,222 | (11) | 2,551 | 97,356 |
| Current assets | | | | | | | | |
| Inventories | | 27,821 | - | - | - | - | - | 27,821 |
| Trade and other receivables | C,E | 27,450 | (252) | - | 18 | - | (48) | 27,168 |
| Cash and cash equivalents | | 7,774 | - | - | - | - | - | 7,774 |
| Assets held for sale | | 14,646 | - | - | - | - | - | 14,646 |
| Total current assets | | 77,691 | (252) | - | 18 | - | (48) | 77,409 |
| Current liabilities | | | | | | | | |
| Loans | | (1,957) | - | - | - | - | - | (1,957) |
| Obligations under finance leases | | (925) | - | - | - | - | - | (925) |
| Overdrafts | | (10,744) | - | - | - | - | - | (10,744) |
| Trade and other payables | B,C,D,E | (26,474) | 1,307 | (71) | 6 | - | 333 | (24,899) |
| Corporation tax | | (1,150) | - | - | - | - | - | (1,150) |
| Liabilities held for sale | | (1,776) | - | - | - | - | - | (1,776) |
| | | (43,026) | 1,307 | (71) | 6 | - | 333 | (41,451) |
| Non-current liabilities | | | | | | | | |
| Loans | | (46,320) | - | - | - | - | - | (46,320) |
| Obligations under finance leases | | (602) | - | - | - | - | - | (602) |
| Other payables | B | - | (68) | (95) | - | - | - | (163) |
| Deferred tax liabilities | A,C,E,F | (4,457) | (1,837) | - | (6) | (50) | (2,608) | (8,958) |
| Long term provisions | | (170) | - | - | - | - | - | (170) |
| Preference shares | | (62) | - | - | - | - | - | (62) |
| Retirement benefit obligations | C | - | (16,115) | - | (4,074) | - | - | (20,189) |
| | | (51,611) | (18,020) | (95) | (4,080) | (50) | (2,608) | (76,464) |
| Net assets | | 70,419 | (10,961) | 59 | (2,834) | (61) | 228 | 56,850 |
| Equity | | | | | | | | |
| Share capital | | 1,459 | - | - | - | - | - | 1,459 |
| Share premium account | | 27,274 | - | - | - | - | - | 27,274 |
| Special capital reserve | | 12,939 | - | - | - | - | - | 12,939 |
| Revaluation reserve | F | 2,374 | (723) | - | - | (11) | - | 1,640 |
| Retained earnings | | 26,096 | (10,238) | 59 | (2,834) | (50) | 228 | 13,261 |
| Equity attributable to equity holders of the parent | | 70,142 | (10,961) | 59 | (2,834) | (61) | 228 | 56,573 |
| Equity minority interest | | 277 | - | - | - | - | - | 277 |
| Total equity | | 70,419 | (10,961) | 59 | (2,834) | (61) | 228 | 56,850 |



Reconciliation of profit for the year ended 31 October 2005

| | Note | UK GAAP as restated £000 | Share-based payments £000 | Employee benefits £000 | Income tax £000 | Business combi- nations £000 | Other £000 | IFRS £000 |
|--|-------|-----------------------------------|---------------------------------|------------------------------|-----------------------|---------------------------------------|---------------|--------------|
| Continuing operations: | | | | | | | | |
| Revenue | | 120,963 | - | - | - | - | - | 120,963 |
| Operating profit | A,B,C | 22,623 | (477) | 881 | - | (71) | (48) | 22,908 |
| Share of results of associate | | 130 | - | - | - | - | - | 130 |
| Finance expense | C | (2,964) | - | (858) | - | - | - | (3,822) |
| Profit before taxation | | 19,789 | (477) | 23 | - | (71) | (48) | 19,216 |
| Tax | F | (5,711) | 95 | (5) | (50) | - | 14 | (5,657) |
| Profit for the year from continuing operations | | 14,078 | (382) | 18 | (50) | (71) | (34) | 13,559 |
| Discontinued operations: | | | | | | | | |
| Loss for the year from discontinued operations | | (4,790) | - | - | - | - | - | (4,790) |
| Net profit for the year | | 9,288 | (382) | 18 | (50) | (71) | (34) | 8,769 |

Independent Auditors' Report on the Parent Company Financial Statements

for the year ended 31 October 2006

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF CHEMRING GROUP PLC

We have audited the parent company financial statements of Chemring Group PLC for the year ended 31 October 2006 which comprise the Balance Sheet, the Statement of Total Recognised Gains and Losses, the Reconciliation of Movements in Shareholders' Funds and the related Notes 1 to 11. 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 Chemring Group PLC for the year ended 31 October 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 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 Directors' Remuneration Report 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 Directors' Remuneration Report 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 includes that specific information presented in the Statement by the Chairman, the Review by the Chief Executive and the Review by the Finance Director that is cross referred from the Review of the year and results section of the Directors' Report.

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 individual company financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the individual 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.



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 October 2006;
- the parent company financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the parent company financial statements.

Deloitte & Touche LLP

Chartered Accountants and Registered Auditors

Southampton, United Kingdom

23 January 2007

Parent Company Accounting Policies

for the year ended 31 October 2006

CHEMRING GROUP PLC ACCOUNTING POLICIES

The financial statements have been prepared in accordance with applicable United Kingdom accounting standards. The particular accounting policies adopted are described below. All accounting policies have been applied consistently throughout the year.

Accounting convention

The financial statements are prepared under the historical cost convention as modified by the revaluation of property in accordance with the Companies Act 1985 and applicable accounting standards (UK GAAP).

Changes in accounting policies

The Company has adopted FRS17 *Retirement Benefits*, FRS20 *Share-based Payment*, FRS21 *Events after the Balance Sheet Date* and FRS26 *Financial Instruments (Measurement)*. The adoption of these standards represents a change in accounting policy and the comparative figures have been restated accordingly, except where the exemption to restate comparatives has been taken. Details of the effect of the prior year's adjustments are given in Note 9.

Revenue recognition

Sales comprise the fair value of the consideration received or receivable for deliveries made, work completed or services rendered during the year, net of discounts, VAT and other sales related taxes. Sales are recognised when title passes, or when the right to consideration, in exchange for performance, has been completed. For bill and hold arrangements revenue is recognised when the risks and rewards are transferred to the customer, typically on formal acceptance. An appropriate proportion of total long term contract value, based on the fair value of work performed, is included in revenue and an appropriate level of profit is taken based on the percentage completion method when the final outcome can be reliably assessed. Provision is made in full for foreseeable losses as soon as they are identified.

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 its net carrying amount.

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

Tangible fixed assets

Other than revalued land and buildings, property, plant and equipment are held at cost less accumulated depreciation and any recognised impairment loss. No depreciation is provided on freehold land. On other assets depreciation is provided at rates calculated to write down their cost or valuation to their estimated residual values by equal instalments over their estimated economic useful lives, which are considered to be:

- Freehold buildings - up to 50 years
- Leasehold buildings - the period of the lease
- Plant and equipment - 10 years

Investment in Group undertakings

Investments are stated at cost less any provision for impairment in value.

Operating leases

Operating lease rental charges are taken to the profit and loss account on a straight-line basis over the life of the lease.

Provisions

A provision is recognised when the Company has a present legal or constructive obligation as a result of a past event and it is probable that settlement will be required of an amount that can be reliably estimated. Long-term liabilities and provisions are discounted when the impact is material.

Current tax

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



Deferred tax

Deferred tax is provided in full at the anticipated tax rates on differences arising from the inclusion of items of income and expenditure in tax computations in periods different from those in which they are included in the financial statements. Deferred tax is not provided on timing differences arising from the revaluation of fixed assets where there is no commitment to sell the asset. Deferred tax assets and liabilities are discounted.

Special capital reserve

The special capital reserve was created as part of a capital reduction scheme involving the cancellation of the share premium account which was approved by the Court in 1986 and is in accordance with the requirements of the Companies Act 1985.

Foreign currencies

The functional currency of the Company is sterling. Transactions in foreign currencies are translated into sterling at the rates ruling at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the rates ruling at that date. These translation differences are dealt with in the profit and loss account.

Pensions

The Company operates defined benefit pension schemes. The defined benefit schemes are multi-employer schemes including employees of other Group companies. It is not considered possible to allocate scheme assets and liabilities between various companies and accordingly schemes are accounted for as though they were defined contribution schemes. The amount charged to the profit and loss account is the contribution payable in the year. Differences between amounts payable and actually paid are shown as accruals or prepayments in the Balance Sheet.

The directors do not believe the FRS17 deficit for the Group is significantly different from the IAS19 deficit reported in Note 33 to the Chemring Group PLC accounts.

Share-based compensation

For grants made under the Company's share-based remuneration schemes, amounts which reflect the fair value of options awarded at the time of grant are charged to the profit and loss account. The valuation of the options utilises a methodology based on the Black-Scholes model.

Parent Company Balance Sheet (under UK GAAP)

as at 31 October 2006

| | | 2006 | 2005 |
|--|------|-----------------|---------------------|
| | Note | £000 | As restated £000 |
| Fixed assets | | | |
| Tangible assets | 1 | 25 | 456 |
| Investments | 2 | 57,410 | 62,636 |
| | | <u>57,435</u> | <u>63,092</u> |
| Current assets | | | |
| Debtors | 4 | 109,609 | 55,599 |
| Creditors due within one year | 5 | <u>(32,107)</u> | <u>(29,704)</u> |
| Net current assets | | <u>77,502</u> | <u>25,895</u> |
| Total assets less current liabilities | | <u>134,937</u> | <u>88,987</u> |
| Creditors due after more than one year | 6 | (67,916) | (44,089) |
| Provisions for liabilities and charges | 7 | - | (170) |
| | | <u>67,021</u> | <u>44,728</u> |
| Capital and reserves | | | |
| Called-up share capital | 8 | 1,612 | 1,459 |
| Reserves | | | |
| Share premium account | 9 | 53,540 | 27,274 |
| Special capital reserve | 9 | 12,939 | 12,939 |
| Revenue reserves | 9 | (1,300) | 3,056 |
| Hedging reserve | 9 | <u>230</u> | <u>-</u> |
| | | <u>65,409</u> | <u>43,269</u> |
| Shareholders' funds | | <u>67,021</u> | <u>44,728</u> |

These financial statements were approved by the Board of Directors on 23 January 2007.

Signed on behalf of the Board

D J Price

P A Rayner

Registered number in England: 86662



Parent Company Statement of Total Recognised Gains and Losses

for the year ended 31 October 2006

| | | 2006 | 2005 |
|---|------|----------------|--------------------|
| | | | <i>As restated</i> |
| | Note | £000 | £000 |
| Profit for the financial year | 9 | 877 | 2,315 |
| Currency translation differences | 9 | (2,124) | (740) |
| Increase in fair value of hedging reserve | 9 | 242 | - |
| Total recognised gains and losses for the year | | (1,005) | 1,575 |

Reconciliation of Movements in Shareholders' Funds

| | | | |
|---|---|---------------|---------------|
| Profit for the financial year | | 877 | 2,315 |
| Dividends | | (3,695) | (2,736) |
| Loss for the year | | (2,818) | (421) |
| Other recognised losses | | (1,882) | (740) |
| Ordinary shares issued | 8 | 153 | 10 |
| Share premium arising | 9 | 26,266 | 564 |
| Share-based payments | 8 | 586 | 311 |
| Net addition to /(reduction in) shareholders' funds | | 22,305 | (276) |
| Opening shareholders' funds | | 43,009 | 43,518 |
| Prior year adjustment | | 1,719 | 1,486 |
| Opening shareholders' funds as restated | | 44,728 | 45,004 |
| Impact of adopting FRS26 | | (12) | - |
| Closing shareholders' funds | | 67,021 | 44,728 |

Profit attributable to shareholders

In accordance with the concession granted under the Companies Act 1985, section 230(1), the profit and loss account of Chemring Group PLC has not been presented separately in these financial statements. There is no material difference between the results disclosed and the results on an unmodified historical cost basis.

Cash flow statement

In accordance with the exemption under FRS1 the Company's cash flow statement has not been presented separately in these financial statements.

Notes to the Parent Company Financial Statements

for the year ended 31 October 2006

1. TANGIBLE FIXED ASSETS

| | <i>Land and buildings £000</i> | <i>Plant and equipment £000</i> | <i>Total £000</i> |
|------------------------------------|--|---|-----------------------|
| Cost | | | |
| At 1 November 2005 | 535 | 561 | 1,096 |
| Additions | - | 14 | 14 |
| Transfer to subsidiary undertaking | (535) | - | (535) |
| Disposal | - | (85) | (85) |
| At 31 October 2006 | - | 490 | 490 |
| Depreciation | | | |
| At 1 November 2005 | 111 | 529 | 640 |
| Charge for the year | 27 | 21 | 48 |
| Transfer to subsidiary undertaking | (138) | - | (138) |
| Disposal | - | (85) | (85) |
| At 31 October 2006 | - | 465 | 465 |
| Net book value | | | |
| At 31 October 2006 | - | 25 | 25 |
| At 31 October 2005 | 424 | 32 | 456 |

The Company had no capital commitments at 31 October 2006 (2005: nil).



2. FIXED ASSET INVESTMENTS

| | <i>Shares in subsidiary undertakings £000</i> | <i>Shares in associated undertakings £000</i> | <i>Loans to subsidiary undertakings £000</i> | <i>Trade investments £000</i> | <i>Total £000</i> |
|---|---|---|--|---------------------------------------|-----------------------|
| Cost | | | | | |
| At 1 November 2005 | 63,299 | 13 | 6,250 | 10 | 69,572 |
| Additions | 7 | - | - | - | 7 |
| Acquisitions of subsidiary undertakings | 5,160 | - | - | - | 5,160 |
| At 31 October 2006 | 68,466 | 13 | 6,250 | 10 | 74,739 |
| Provision for impairment | | | | | |
| At 1 November 2005 | 6,936 | - | - | - | 6,936 |
| Charge for the year | 10,393 | - | - | - | 10,393 |
| At 31 October 2006 | 17,329 | - | - | - | 17,329 |
| Net book value | | | | | |
| At 31 October 2006 | 51,137 | 13 | 6,250 | 10 | 57,410 |
| At 31 October 2005 | 56,363 | 13 | 6,250 | 10 | 62,636 |

During the year the Company acquired the entire share capital of Leaffield Engineering Limited for a consideration of £5,160,000 (including costs). A list of the Company's material subsidiary undertakings is given in Note 3.

3. INVESTMENT IN GROUP UNDERTAKINGS

| Subsidiary undertaking | Country of incorporation (or registration) and operation | % of issued ordinary share capital controlled by Chemring Group PLC | Activity |
|-------------------------------|---|--|--------------------------------|
| Pains Wessex Ltd | England | 100 | Countermeasures |
| PW Defence Ltd | England | 100 | Energetics |
| McMurdo Ltd | England | 100 | Marine electronics |
| I.C.S. Electronics Ltd | England | 100 | Marine electronics |
| Leaffield Engineering Ltd | England | 100 | Energetics |
| Chemring Marine Ltd | England | 100 | Energetics |
| *B.D.L. Systems Ltd | England | 100 | Energetics |
| Nobel Energetics Ltd | Scotland | 100 | Energetics |
| *Comet GmbH | Germany | 100 | Energetics |
| *Alloy Surfaces Company, Inc. | USA | 100 | Countermeasures |
| *Kilgore Flares Company LLC | USA | 100 | Countermeasures and energetics |
| *Technical Ordnance, Inc. | USA | 100 | Energetics |
| *Chemring Australia Pty Ltd | Australia | 100 | Countermeasures and energetics |
| *Pirotecnia Oroquieta S.L. | Spain | 51 | Energetics |
| Associated undertaking | | | |
| CIRRA S.A. | France | 49 | Countermeasures |

*Investments held by a subsidiary company

The directors consider that the carrying value of the investments approximates to their fair value.

Notes to the Parent Company Financial Statements

- continued

4. DEBTORS

| | 2006 | 2005 |
|---|----------------|---------------------|
| | £000 | As restated £000 |
| Trade debtors | - | 12 |
| Amounts owed by subsidiary undertakings | 103,951 | 51,342 |
| Group relief recoverable | 3,174 | 1,942 |
| Advance corporation tax recoverable | 170 | 170 |
| Corporation tax recoverable | 217 | - |
| Deferred tax asset (see Note 10) | 900 | 248 |
| Assets for resale | - | 414 |
| Other debtors | 651 | 1,417 |
| Financial instruments | 328 | - |
| Prepayments and accrued income | 218 | 54 |
| | <u>109,609</u> | <u>55,599</u> |

Financial instruments of £328,000 (2005: £nil) recognised on the Balance Sheet is in respect of the fair value of interest rate swaps (see Note 23 of the Group financial statements). The directors consider that the carrying value of the debtors approximates to their fair value.

5. CREDITORS DUE WITHIN ONE YEAR

| | 2006 | 2005 |
|---|---------------|---------------|
| | £000 | £000 |
| Bank overdrafts | 12,206 | 15,408 |
| Bank loans | 6,134 | 1,957 |
| Trade creditors | 916 | 507 |
| Amounts owed to subsidiary undertakings | 8,102 | 9,787 |
| Other creditors | 271 | 270 |
| Other tax and Social Security | 55 | 43 |
| Accruals and deferred income | 4,423 | 1,732 |
| | <u>32,107</u> | <u>29,704</u> |



6. CREDITORS DUE AFTER MORE THAN ONE YEAR

| | <i>2006</i> | <i>2005</i> |
|--|----------------------|---------------|
| | <i>£000</i> | <i>£000</i> |
| Medium term loan – UK | 67,854 | 44,027 |
| Preference shares (62,500 shares of £1 each) | 62 | 62 |
| | <u>67,916</u> | <u>44,089</u> |

The cumulative preference shares carry an entitlement to a dividend at the rate of 7 pence per share per annum, payable in equal instalments on 30 April and 31 October each year. Holders of the preference shares have the right on winding-up to receive, in priority to any other classes of shares, the sum of £1 per share together with any arrears of dividends.

| | <i>2006</i> | <i>2005</i> |
|--------------------------------|----------------------|---------------|
| | <i>£000</i> | <i>£000</i> |
| Borrowings falling due within: | | |
| One year | 18,340 | 17,365 |
| One to two years | 9,907 | 4,921 |
| Two to five years | 43,429 | 26,453 |
| After five years | 14,518 | 12,653 |
| | <u>86,194</u> | <u>61,392</u> |

7. PROVISIONS

| | <i>£000</i> |
|----------------------|--------------|
| At 1 November 2005 | 170 |
| Utilised in the year | <u>(170)</u> |
| At 31 October 2006 | <u>-</u> |

Notes to the Parent Company Financial Statements

- continued

8. CALLED-UP SHARE CAPITAL

| | <i>2006</i> | <i>2005</i> |
|--|--------------|--------------|
| | <i>£000</i> | <i>£000</i> |
| Authorised | | |
| 43,000,000 (2005: 33,000,000) ordinary shares of 5p each | <u>2,150</u> | <u>1,650</u> |
| Issued, allotted and fully paid | | |
| 32,235,076 (2005: 29,177,576) ordinary shares of 5p each | <u>1,612</u> | <u>1,459</u> |

The preference shares are presented as a liability (see Note 6) and accordingly are excluded from called-up share capital in the Balance Sheet.

Share-based incentive schemes

The following options to subscribe for the Company's ordinary shares granted under the Group's share-based incentive schemes were outstanding at 31 October 2006.

The Chemring 1998 Executive Share Option Scheme

| <i>Date of grant</i> | <i>Number of ordinary shares under option</i> | <i>Exercise price per share</i> £ | <i>Dates between which options may be exercised</i> |
|----------------------|---|--------------------------------------|---|
| 5 Feb 2003 | 5,000 | 2.285 | 5 Feb 2006 – 4 Feb 2013 |
| 8 Jul 2004 | 90,000 | 4.365 | 8 Jul 2007 – 7 Jul 2014 |
| 7 Apr 2005 | 52,798 | 4.735 | 7 Apr 2008 – 6 Apr 2015 |
| 1 Feb 2006 | 50,000 | 10.590 | 1 Feb 2009 – 31 Jan 2016 |

The Chemring Group Performance Share Plan

| <i>Date of grant</i> | <i>Number of ordinary shares awarded</i> | <i>Date of vesting</i> |
|----------------------|--|------------------------|
| 23 Mar 2006 | 121,420 | 23 Mar 2009 |
| 27 Sept 2006 | 7,256 | 27 Sept 2009 |

Full details of the schemes are disclosed in Note 30 of the Group financial statements.



9. RESERVES

| | <i>Share premium account £000</i> | <i>Special capital reserve £000</i> | <i>Hedging reserve £000</i> | <i>Revenue reserves £000</i> | <i>Total £000</i> |
|---|---|---|-------------------------------------|--------------------------------------|-----------------------|
| At 31 October 2005 as reported | 27,274 | 12,939 | - | 1,337 | 41,550 |
| Prior year adjustment | - | - | - | 1,719 | 1,719 |
| At 31 October 2005 as restated | 27,274 | 12,939 | - | 3,056 | 43,269 |
| Impact of adopting FRS26 | - | - | (12) | - | (12) |
| At 1 November 2005 | 27,274 | 12,939 | (12) | 3,056 | 43,257 |
| Ordinary shares issued | 26,266 | - | - | - | 26,266 |
| Profit for the financial year | - | - | - | 877 | 877 |
| Foreign exchange differences | - | - | - | (2,124) | (2,124) |
| Increase in fair value of hedge reserve | - | - | 242 | - | 242 |
| Dividends paid | - | - | - | (3,695) | (3,695) |
| Net cost of share-based payments | - | - | - | 586 | 586 |
| At 31 October 2006 | 53,540 | 12,939 | 230 | (1,300) | 65,409 |

Included within revenue reserves is £145,000 (2005:£145,000) of own shares held by the Group's ESOP trustees.

The share premium account and special capital reserve are not distributable. A profit after tax of £877,000 (2005: £2,315,000) was recognised in the year. Dividends of £12,608,000 (2005: £7,361,000) were received in the year.

After the year end, subsidiary undertakings declared dividends of £5 million to the Company. The directors consider the Company will have sufficient distributable reserves to meet its proposed dividend payment in April 2007.

Prior year adjustments and impact of new standards

The prior year adjustments relate to the implementation of FRS17 *Retirement Benefits*, FRS20 *Share-based Payment* and FRS21 *Post Balance Sheet Events* while FRS26 *Financial Instruments* does not affect comparatives and is only applied to the current period.

Notes to the Parent Company Financial Statements

- continued

9. RESERVES - continued

| | 31 Oct 2005 as previously reported £000 | FRS20 Share- based payment £000 | FRS21 Events after the balance sheet date £000 | FRS26 Financial instruments £000 | FRS17 Retirement benefits £000 | Total effect of restatement £000 | 31 Oct 2005 As restated £000 |
|-----------------------------------|---|---|---|---|---|---|---------------------------------------|
| Year ended 31 October 2005 | | | | | | | |
| Profit for the year | 2,792 | (477) | - | - | - | (583) | 2,315 |
| As at 31 October 2005 | | | | | | | |
| Property, plant and equipment | 456 | - | - | - | - | - | 456 |
| Investments | 62,636 | - | - | - | - | - | 62,636 |
| Current debtors | 55,776 | - | - | - | (253) | (253) | 55,523 |
| Deferred tax asset | - | - | - | - | 76 | 76 | 76 |
| Current liabilities | (31,600) | (234) | 2,130 | - | - | 1,896 | (29,704) |
| Non-current liabilities | (44,027) | - | - | (62) | - | (62) | (44,089) |
| Provisions | (170) | - | - | - | - | - | (170) |
| | <u>43,071</u> | <u>(234)</u> | <u>2,130</u> | <u>(62)</u> | <u>(177)</u> | <u>1,657</u> | <u>44,728</u> |
| Share capital | 1,521 | - | - | (62) | - | (62) | 1,459 |
| Profit and loss account reserve | 1,337 | (234) | 2,130 | - | (177) | 1,719 | 3,056 |
| Share premium | 27,274 | - | - | - | - | - | 27,274 |
| Capital reserve | 12,939 | - | - | - | - | - | 12,939 |
| | <u>43,071</u> | <u>(234)</u> | <u>2,130</u> | <u>(62)</u> | <u>(177)</u> | <u>1,657</u> | <u>44,728</u> |



10. DEFERRED TAX

| | <i>2006</i> <i>£000</i> | <i>2005</i> <i>£000</i> |
|--|----------------------------|----------------------------|
| Movement in deferred tax liabilities/(assets) are as follows: | | |
| At 1 November 2005 | (248) | (102) |
| Prior year adjustments | - | (76) |
| At 1 November 2005 as restated | (248) | (178) |
| Charge to profit and loss account | (750) | (70) |
| Credit to statement of total recognised gains and losses | 98 | - |
| At 31 October 2006 | (900) | (248) |
| The amount provided represents: | | |
| Accelerated capital allowances | (25) | 41 |
| Other timing differences | (875) | (39) |
| Discount | - | (250) |
| Net deferred tax assets | (900) | (248) |

11. STAFF COSTS

| | <i>2006</i> <i>Number</i> | <i>2005</i> <i>Number</i> |
|--|------------------------------|------------------------------|
| The average monthly number of employees (including executive directors) was: | | |
| Total | 17 | 14 |
| The costs incurred in respect of these employees were: | <i>£000</i> | <i>£000</i> |
| Wages and salaries | 2,186 | 1,488 |
| Social security costs | 262 | 218 |
| Other pension costs | 348 | 495 |
| | 2,796 | 2,201 |

Disclosure in respect of directors' emoluments can be found in the Directors' Remuneration Report on pages 27 to 34 of the Group financial statements.

Disclosure in respect of key management employees can be found in Note 35 of the Group financial statements.



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