



Surface Transforms plc

Annual Report and Financial Statements

Registered number 3769702

31 May 2005

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Highlights

- Turnover of £258,336 (2004: £428,608)
- Losses before taxation of £675,185 (2004: £249,209)
- Strong cash position of £2,728,052 (2004: £2,707,839)
- Agreed two-year supply programme to Roxel, Europe's largest manufacturer of rocket and missile propulsion systems
- Awarded a new US-based ceramic aircraft brake development programme in January 2005
- Enhanced the management and engineering teams, and invested in next generation CFRC technology
- Commenced development test programmes with two British high-performance car manufacturers using the SystemST ceramic brake

Chairman's statement

In the year under review, following the raising of £2.7 million net of expenses in May 2004, we were able to accelerate the investment in Surface Transforms' operating facilities; the proprietary ceramic transformation processes; management and staffing, as we pursued the faster commercialisation of our unique carbon fibre reinforced ceramics (CFRCs) technology.

Despite the unexpected, short-term revenue reduction in the second half, after the loss of the wide-bodied aircraft brake contract, the board remains confident that there are excellent market opportunities to exploit our world-class technology by creating commercial applications for the global automotive, aircraft and rocket motor components industries.

The management team has been strengthened over the past 12 months and we have recruited additional senior technicians and engineers. Since January 2005, under the leadership of non-executive director Peter Holland, we have begun the integration of a new, more experienced management team. The management team has been set challenging new operating targets in aircraft and automotive brake development. It has also been tasked with developing additional intellectual property, including the next generation of carbon ceramics technology.

Financial Review

Despite the progress made by the Company in automotive brake development and the award of a second, US-based aircraft brake development programme in mid January 2005, revenues for the year ending 31 May 2005 were less than the prior year at £258,336 (2004: £428,608). This reflects the impact of the loss of the aircraft brake contract associated with Dunlop Aerospace announced on 13 January 2005. The loss of this contract, combined with the strategic decision to increase development costs and strengthen management, resulted in the Company delivering a pre tax loss of £675,185 (2004: £249,209). Losses after tax were higher at £616,623 (2004: £129,524).

Capital expenditure for the year amounted to £63,775 and these levels are scheduled to increase materially next year as a result of investment in the Company's processes and technologies.

The Company's cash and working capital position remain healthy demonstrating the strong financial structures within the Company. At 31 May 2005, the Company held cash and deposits amounting to £2,728,052 (2004: £2,707,839) representing approximately 20 pence per share. Surface Transforms continues to have no bank borrowings.

Management

Dr. Kevin Johnson BSc, PhD, MBA was appointed Managing Director on 1 August 2005. Kevin is a chemist and has been Operations Director since joining the Company in July last year. This strengthening of the management team allows Julio Faria, who jointly founded the business in 1992, to bring his considerable focus to all aspects of the technical platform of the Company. Continuous development of the Company's proprietary technology is viewed as one of the key drivers for the improvement of shareholder value and Julio's experience and knowledge will be instrumental in ensuring that this is achieved. We would like to thank him for the years of valuable work he has already contributed to the Company as MD. He takes up his new appointment as Technical Director with immediate effect.

We wish Kevin Johnson and his management team every success in the coming months. His promotion reflects the board's intent to promote outstanding executives with energy and talent, irrespective of age. We recognise that creating a successful market-driven business is very dependent on the energy and drive of its employees.

Science & Technology Group

Good progress has been made by the Science & Technology Group headed by Julio Faria. The first design phase of the new carbon siliconisation plant (*ST-Tech 2*) was completed within budget in June 2005. The next two phases comprising

plant assembly and commissioning are scheduled for completion in early 2006.

This next generation *ST-Tech 2* plant is a key part of delivering the Company's business model. Once brake applications have been developed and commercialised, the business model incorporates the sale and commissioning of Surface Transforms' technology at the client's production site. Surface Transforms will then base its licence fee on the number of each brake unit produced. When completed, the new plant should cost less than half the capital cost of the current technology and it is expected to reduce the current unit cost of an automotive ceramic brake disc significantly.

Patent applications for *ST-Tech 2* have been filed during July 2005. Further patent applications are being processed and these cover most of the chemical processes relating to the manufacture of a carbon ceramic brake disc. The Company's goal is to ensure that it has a robust platform of proprietary intellectual property that can produce revenues either under licence or as separate joint venture contracts.

Automotive Braking Systems

The high-performance road car market is one of the Company's two main markets for the commercial use of carbon ceramic brake discs and pads. The main product is SystemST, a carbon ceramic brake disc and pad which can be used on a variety of high-performance cars. The principal advantages of SystemST are:

- it is 70 per cent lighter than the equivalent steel disc. This weight reduction leads to improved handling and better fuel efficiency
- enhanced braking characteristics, reducing stopping distances and providing constant and responsive performance in all weather conditions
- the wear rate is approximately 50 per cent better than the equivalent steel disc. It can withstand high temperatures and does not rust

In 2004, the number of high-performance cars sold in the EU was 150,000 and the total number of such cars on the road is approximately 1,000,000. The board estimates that within five years the majority of high-performance car manufacturers will provide carbon ceramic brakes as an alternative option to steel brake discs. This represents substantial market potential and at an estimated five to 10 per cent market penetration on new cars, the European market could account for approximately 50,000-100,000 ceramic brake discs annually.

The Company's market entry strategy is threefold:

- sale of ceramic brake systems to the automotive Original Equipment Manufacturer (OEM) market for high volume performance cars
- sale of ceramic brake systems to the automotive OEM market for low volume performance cars
- sale of ceramic brake systems into the automotive after market for high-performance cars

Our operation at Ince, Cheshire has capacity to produce around 3,000 automotive brake discs per annum, representing approximately £2 million of annual revenues. The Company's business model allows the production of brake discs and pads to supply small OEM automotive companies while larger volumes, when approvals are achieved, will be supplied under licence contracts whereby the customer acquires the plant and other equipment.

Both the low volume, high-performance OEM car brake market and the equivalent brake after market are attractive to Surface Transforms and represent the best opportunity for early sales. We are pleased to report that a number of British car manufacturers are testing the SystemST brake system and shareholders will be updated once material progress has been made.

In parallel, the Company is now able to offer an after market SystemST ceramic brake system on a number of specialist, high-performance cars in the UK. Car owners can contact Surface Transforms to purchase SystemST and enquiries will be directed to our specialist contract-brake fitting partners. Cars suitable for these brakes currently include the Ferrari F48, the BMW M3 and the Jaguar C Class.

Aircraft Brake Systems

The Company maintains two separate brake development programmes for UK-based Dunlop Aeropace and a US-based, global aircraft brake system supplier. Preliminary development work with a third global supplier commenced in May 2005. Dunlop's Master Licence Agreement was signed in November 2003 and is still in operation. Currently, new disc evaluation protocols have been agreed and testing is underway. At present the board understands that Dunlop has no further aircraft brake contracts onto which it could introduce carbon ceramic brake systems.

The US aircraft brake manufacturer development contract was signed in January 2005. This client is seeking to substantially improve brake wear characteristics from carbon ceramic brake discs. Improved aircraft brake wear reduces time lost on the ground to maintenance and increases the financial and operating efficiency of the aircraft owner. The positive revenue impact from this new aircraft development project will be seen in 2005/6. The intention in 2006, if the initial two phases of the development programme are completed successfully, is to enter into a third phase programme to qualify the carbon ceramic discs for selected new and existing aircraft models.

Aerospace Components

The Company recently announced a two-year supply programme to deliver rocket motor components to Roxel (UK Rocket Motors) Ltd., Europe's largest

manufacturer of rocket and missile propulsion systems.

Previously, Surface Transforms supplied Roxel with finished components for its thrust modulation research programme on a select-supplier commercial basis. This technology has now matured to the extent that it is being used on motor demonstrator programmes, including live motor firings. Separate work is also well underway at both companies to generate specific engineering design data for Surface Transforms' material for use in rocket motors and related components. The combined total value of the Roxel collaborations is expected to be in the region of £100,000.

Should the new project be successful, and once quality and commercial aspects have been validated, the CFRC materials are a potential candidate for future production of rocket motor nozzle components, gas valve systems, and other components.

Outlook

Despite the weaker sales and financial performance in the year ending May 2005, considerable change has been implemented within the business. The May 2004 fundraising allowed changes to be made to reduce the business risk and to improve the Company's capability of successfully implementing its business strategy.

The new and larger team at Surface Transforms is capable of driving success in its chosen markets. Experienced new managers have joined to work alongside

the original directors and managers and the results are an accelerated penetration of both aircraft and automotive brake markets, investment in and improvement of the technological platform and an improved operational base.

During this 2005/6 financial year, the board expects to demonstrate the success of its business development activities in the automotive brake market and build upon its existing development and supply programmes in aircraft braking and rocket engine components. The cost base of the Company was systematically increased last year but remains under tight financial control with the ultimate target of achieving break even and positive cash generation once there is success in the supply of high-performance automotive brake discs.

Finally, we are optimistic about the progress we will make over the next five years. This growth necessitates the selection and training of an innovative and entrepreneurial management team. All employees require an environment of trust, recognition and professional growth. If we can maintain this, we will continue to attract and retain talented people to create a dynamic growth company.

Kevin D'Silva
Chairman

2 August 2005

Directors' report

The directors present their annual report and the audited financial statements for the year ended 31 May 2005.

Principal activity

The principal activity of the company during the year was the development and manufacture of carbon fibre reinforced ceramic products (CFRC).

Business review

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

Future developments

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

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

Research and development

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

Proposed dividend and transfer to reserves

The loss for the year after taxation amounted to £616,623. The directors do not recommend the payment of a dividend.

Policy and practice on payment of creditors

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

At the year end, there were 68 days (2004: 56 days) purchases in trade creditors.

Political and charitable donations

The company made no political or charitable donations during the year (2004: £nil).

Directors and directors' interests

The directors who held office during the year were as follows:

- K D'Silva* (Chairman)
- JJ Faria
- Professor DT Clark*
- Dr G Gould
- PJ Holland*
- K Johnson (appointed 12 January 2005)

* denotes non-executive Director.

Kevin Johnson, who was appointed a director since the last annual general meeting, retires in accordance with the articles of association and, being eligible, offers himself for re-election.

The directors retiring by rotation are Kevin D'Silva and Peter Holland who, being eligible, offer themselves for re-election.

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

	Number of £0.01 ordinary shares		
	% of issued share capital	Interest at end of year	Interest at start of year
JJ Faria	16.58	2,326,845	2,326,845
Professor DT Clark	6.98	979,661	994,661
PJ Holland	1.22	170,515	170,515
K D'Silva	1.12	156,986	151,486
Dr G Gould	0.03	4,350	4,350
K Johnson	-	-	-

According to the register of directors' interests, no rights to subscribe for shares in or debentures of the company were granted to any of the directors or their immediate families, or exercised by them during the financial year, except as disclosed in the report on directors' remuneration on pages 9 and 10.

Registered holding

JM Finn Nominees Limited
Artemis Investments Management Limited
Bank of New York Nominees Limited
Securities Services Nominees Limited

**Number of
ordinary
shares**

1,530,110
807,143
720,000
478,571

**% of issued
share
capital**

10.91
5.75
5.13
3.41

Corporate governance

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

The Board has appointed an Audit Committee whose primary role is to review the company's interim and annual financial statements before submission to the Board for approval. The Board has also appointed a Remuneration Committee, which is responsible for reviewing executive remuneration and performance. The Audit Committee is made up of two non-executive directors,

Substantial shareholders

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

Peter Holland and Kevin D'Silva. The Remuneration Committee currently comprises three non-executive directors. Details of the Remuneration Committee are disclosed in the report on directors' remuneration on pages 9 and 10.

Auditors

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

By order of the board

2 August 2005

K D'Silva
Chairman

Surface Transforms plc
April House, Tarvin Road
Frodsham, Cheshire WA6 6XN

Report on directors' remuneration

Policy on executive directors' remuneration

The Remuneration Committee comprises Kevin D'Silva, Peter Holland and David Clark.

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

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

Fees for non-executive directors

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

Directors' remuneration - audited

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

	2005 £	2004 £
<i>Executive directors</i>		
JJ Faria	52,899	46,359
Dr G Gould	45,318	36,124
K Johnson (appointed 12 January 2005)	25,054	-
	<hr/>	<hr/>
	123,271	82,483
<i>Non-executive directors</i>		
K D'Silva	18,000	12,020
PJ Holland	31,500	21,030
Professor DT Clark	19,485	13,366
	<hr/>	<hr/>
	68,985	46,416
	<hr/>	<hr/>
	192,256	128,899
	<hr/> <hr/>	<hr/> <hr/>

The non-executive directors each receive fees of £1,500 per month, for two days consultancy plus fees for any additional days. During the year, P J Holland has provided additional consultancy services co-ordinating the integration of the new management team and this is reflected in the level of his fees shown above.

With the exception of Kevin Johnson, none of the directors received pension contributions in respect of their office. In addition to the emoluments received, as stated above, Kevin Johnson received £1,300 (2004: £Nil) in respect of pension contributions.

Directors' interests

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

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

Share options – audited

The company operates a share incentive scheme. All options are granted at the discretion of the Board. The options granted, date of grant, exercise price and exercise periods under the scheme are set out below. During the year options to the directors and selected employees to purchase ordinary shares were granted at an exercise price of £0.50.

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

Enterprise Management Incentive Scheme

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

The market price of the shares at 31 May 2005 was £0.35 and during the period varied from £0.765 to £0.325. The market price of the shares from the date share options were granted has varied from £0.12 to £0.885.

K D'Silva
 Chairman
 Surface Transforms plc
 April House, Tarvin Road
 Frodsham, Cheshire WA6 6XN

By order of the board 2 August 2005

Statement of directors' responsibilities

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss for that period. In preparing those financial statements, the directors are required to:

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

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

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

Report of the independent auditors to the members of Surface Transforms plc

We have audited the financial statements on pages 14 to 32. In addition to our audit of the financial statements, the directors have engaged us to audit the information in the directors' remuneration report that is described as having been audited, which the directors have decided to prepare (in addition to that required to be prepared) as if the company were required to comply with the requirements under Schedule 7A to the Companies Act 1985.

This report is made solely to the company's members, as a body, in accordance with section 235 of the Companies Act 1985 and our terms of our engagement. 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 our 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 are responsible for preparing the annual report and the directors' remuneration report. As described on page 11 this includes responsibility for preparing the financial statements in accordance with applicable United Kingdom law and accounting standards. Our responsibilities, as independent auditors, are established in the United Kingdom by statute, the Auditing Practices Board, and by our profession's ethical guidance.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the directors' report is not consistent with the financial statements, if 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 transactions with the company is not disclosed.

We read the other information contained in the annual report, including the unaudited part of the directors' remuneration report, and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements.

Basis of audit opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and 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 financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion

- the financial statements give a true and fair view of the state of affairs of the company as at 31 May 2005 and of its loss for the year then ended and have been properly prepared in accordance with the Companies Act 1985;
- the part of the directors' remuneration report which we were engaged to audit has been properly prepared in accordance with the requirements of Schedule 7A to the Companies Act 1985, as if the company were required to comply with the requirements of that Schedule.

KPMG Audit Plc
Chartered Accountants
Registered Auditor

2 August 2005

Profit and loss account
for the year ended 31 May 2005

	<i>Note</i>	2005 £	2004 £
Turnover	2	258,336	428,608
Cost of sales		(93,846)	(117,461)
		<hr/>	<hr/>
Gross profit		164,490	311,147
Distribution costs		(1,348)	(1,261)
Administrative expenses:			
Before development costs		(500,574)	(473,479)
Development costs		(472,978)	(123,349)
		<hr/>	<hr/>
Total administrative expenses		(973,552)	(596,828)
Other operating income	3	4,980	29,970
		<hr/>	<hr/>
Operating loss		(805,430)	(256,972)
Interest receivable	6	131,480	7,763
Interest payable	7	(1,235)	-
		<hr/>	<hr/>
Loss on ordinary activities			
before taxation	2-7	(675,185)	(249,209)
Tax on loss on ordinary activities	8	58,562	119,685
		<hr/>	<hr/>
Loss on ordinary activities			
after taxation and retained	16	(616,623)	(129,524)
for the financial year		<hr/> <hr/>	<hr/> <hr/>
Loss per ordinary share			
Basic and diluted	22	(4.47p)	(1.36p)
		<hr/> <hr/>	<hr/> <hr/>

All amounts relate to continuing activities.

Balance sheet
at 31 May 2005

	<i>Note</i>	2005		2004	
		£	£	£	£
Fixed assets					
Intangible assets	<i>9</i>		6,322		8,540
Tangible assets	<i>10</i>		73,877		56,037
			<u>80,199</u>		<u>64,577</u>
Current assets					
Stocks	<i>11</i>	67,522		88,683	
Debtors	<i>12</i>	80,991		506,011	
Cash at bank and in hand		2,728,052		2,707,839	
		<u>2,876,565</u>		<u>3,302,533</u>	
Creditors: amounts falling due within one year	<i>13</i>	<u>(147,789)</u>		<u>(97,075)</u>	
Net current assets			<u>2,728,776</u>		3,205,458
Net assets			<u>2,808,975</u>		<u>3,270,035</u>
Capital and reserves					
Called up share capital	<i>15</i>		140,308		132,158
Share capital to be issued	<i>15</i>		-		4,750
Share premium account	<i>16</i>		4,902,715		4,750,552
Other reserves	<i>16</i>		463,885		520,399
Profit and loss account	<i>16</i>		(2,697,933)		(2,137,824)
Equity shareholders' funds			<u>2,808,975</u>		<u>3,270,035</u>

These financial statements were approved by the board of directors on 2 August 2005 and were signed on its behalf by:

K D'Silva
Director

JJ Faria
Director

Cash flow statement
for the year ended 31 May 2005

	<i>Note</i>	2005	2004
		£	£
Reconciliation of operating loss to net cash flow from operating activities			
Operating loss		(805,430)	(256,972)
Depreciation charge		45,935	42,674
Amortisation charge		2,218	2,218
Decrease/(increase) in stocks		21,161	(18,615)
Decrease/(increase) in debtors		103,847	(37,974)
Increase in creditors		50,714	19,467
Net cash outflow from operating activities		(581,555)	(249,202)

		2005	2004
		£	£
Cash flow statement			
Cash flow from operating activities		(581,555)	(249,202)
Return on investments and servicing of finance	<i>19</i>	118,918	7,763
Taxation		58,562	278,535
Capital expenditure	<i>19</i>	(63,775)	(818)
Cash (outflow)/inflow before management of liquid resources and financing		(467,850)	36,278
Management of liquid resources	<i>19</i>	3,000	(2,635,000)
Financing	<i>19</i>	488,063	2,493,386
Increase/(decrease) in cash in the year		23,213	(105,336)

	<i>Note</i>	2005	2004
		£	£
Reconciliation of net cash flow to movement in net funds			
Increase/(decrease) in cash in the year		23,213	(105,336)
Cash (outflow)/inflow from liquid resources		(3,000)	2,635,000
		<hr/>	<hr/>
Movement in net funds in the year		20,213	2,529,664
Net funds at the start of the year	20	2,707,839	178,175
		<hr/>	<hr/>
Net funds at the end of the year	20	2,728,052	2,707,839
		<hr/> <hr/>	<hr/> <hr/>

Statement of total recognised gains and losses
for the year ended 31 May 2005

		2005	2004
		£	£
Loss for the financial year		(616,623)	(129,524)
Unrealised gain on the lapse of warrants		56,514	-
		<hr/>	<hr/>
Total recognised gains and losses relating to the financial year		(560,109)	(129,524)
		<hr/> <hr/>	<hr/> <hr/>

Reconciliation of movements in shareholders' funds
for the year ended 31 May 2005

		2005	2004
		£	£
Loss for the financial year		(616,623)	(129,524)
New share capital subscribed (net of issue costs)		155,563	2,825,886
		<hr/>	<hr/>
Net (reduction in)/addition to shareholders' funds		(461,060)	2,696,362
Opening shareholders' funds		3,270,035	573,673
		<hr/>	<hr/>
Closing shareholders' funds		2,808,975	3,270,035
		<hr/> <hr/>	<hr/> <hr/>

Notes

(forming part of the financial statements)

1 Accounting policies

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the company's financial statements.

Basis of preparation

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

Intangible fixed assets and amortisation

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

Tangible fixed assets and depreciation

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

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

Foreign currencies

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

Leases

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

Government grants

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

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

Post retirement benefits

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

Employee share schemes

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

Research and development expenditure

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

Stocks

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

Taxation

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

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

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

Cash

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

Liquid resources

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

Turnover

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

Derivatives and other financial instruments

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

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

Interest rate risk

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

Liquidity risk

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

2 Analysis of turnover and loss on ordinary activities before taxation

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

Turnover by destination is analysed as follows:

	2005	2004
	£	£
<i>By geographical market:</i>		
United Kingdom	251,432	407,931
Rest of European Community	6,904	15,177
United States of America	-	5,500
	258,336	428,608
	258,336	428,608

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

3 Loss on ordinary activities before taxation

	2005	2004
	£	£
Loss on ordinary activities before taxation is stated		
<i>after charging</i>		
Auditors' remuneration:		
- audit	14,500	14,000
- other	11,431	21,500
Depreciation of owned tangible fixed assets	45,935	42,674
Research and development expenditure	472,978	123,349
Amortisation of patents and licences	2,218	2,218
Rentals payable under operating leases		
- land and buildings	47,739	42,756
Exchange losses	876	1,660
<i>after crediting</i>		
Exchange gains	22	-
Government grants	4,980	29,970
	4,980	29,970
	4,980	29,970

4 Remuneration of directors

Full disclosure of directors' emoluments, share options and directors' pension entitlements which form part of the package as well as remuneration, interests and transactions is given in the Report on directors' remuneration on pages 9 and 10.

5 Staff numbers and costs

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

	Number of employees	
	2005	2004
Directors	6	5
Other employees	10	10
	<u>16</u>	<u>15</u>

The aggregate payroll costs of these persons were as follows:

	2005	2004
	£	£
Wages and salaries	348,590	292,058
Social security costs	34,887	25,662
Other pension costs (see note 18)	6,740	2,960
	<u>390,217</u>	<u>320,680</u>

6 Interest receivable

	2005	2004
	£	£
Bank interest receivable	131,480	7,763

7 Interest payable

	2005	2004
	£	£
Other interest payable	1,235	-

8 Taxation

Analysis of credit in year

	2005	2004
	£	£
<i>UK corporation tax</i>		
Current tax on income for the year	-	
Research and development tax repayment	(58,562)	(119,685)
)	<hr/>	<hr/>
Tax on loss on ordinary activities	(58,562)	(119,685)
	<hr/> <hr/>	<hr/> <hr/>

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

Factors affecting the tax credit for the current period

The current tax credit for the year is higher (*2004: lower*) than the standard rate of corporation tax in the UK of 30%. The differences are explained below:

	2005	2004
	£	£
<i>Current tax reconciliation</i>		
Loss on ordinary activities before tax	(675,185)	(249,209)
	<hr/>	<hr/>
Current tax at standard rate of 30%	(202,556)	(74,763)
<i>Effects of:</i>		
Expenses not deductible for tax purposes	1,036	665
Capital allowances for period in excess of depreciation	15,008	5,257
Tax losses incurred in the period	186,512	68,841
Research and development tax repayment	(58,562)	(119,685)
	<hr/>	<hr/>
Total current tax credit (see above)	(58,562)	(119,685)
	<hr/> <hr/>	<hr/> <hr/>

Factors that may affect future tax charges

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

9 Intangible fixed assets

	Patents and licences £
<i>Cost</i>	
At beginning and end of year	16,637

<i>Amortisation</i>	
At beginning of year	8,097
Charge for year	2,218

At end of year	10,315

<i>Net book value</i>	
At 31 May 2005	6,322
	=====
At 31 May 2004	8,540
	=====

Patent costs are amortised over seven and a half years.

10	Tangible fixed assets				
	Assets in the course of construction	Plant and machinery	Fixtures and fittings	Motor vehicles	Total
	£	£	£	£	£
	<i>Cost</i>				
At beginning of year	-	203,514	7,333	-	210,847
Additions	22,030	22,038	1,855	17,852	63,775
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
At end of year	22,030	225,552	9,188	17,852	274,622
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	<i>Depreciation</i>				
At beginning of year	-	148,490	6,320	-	154,810
Charge for year	-	41,304	2,028	2,603	45,935
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
At end of year	-	189,794	8,348	2,603	200,745
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
	<i>Net book value</i>				
At 31 May 2005	22,030	35,758	840	15,249	73,877
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
At 31 May 2004	-	55,024	1,013	-	56,037
	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

11	Stocks	
	2005	2004
	£	£
Raw materials and consumables	1,303	1,176
Work in progress	66,219	87,507
	<hr/>	<hr/>
	67,522	88,683
	<hr/> <hr/>	<hr/> <hr/>

12	Debtors	2005	2004
		£	£
	Trade debtors	15,993	155,157
	Share capital unpaid	-	332,500
	Other debtors	37,266	519
	Prepayments	27,732	17,835
		80,991	506,011
		<hr/> <hr/>	<hr/> <hr/>
	All debtors fall due within one year.		
13	Creditors: amounts falling due within one year	2005	2004
		£	£
	Trade creditors	106,702	52,703
	Taxation and social security	13,000	12,058
	Accruals and deferred income	28,087	32,314
		147,789	97,075
		<hr/> <hr/>	<hr/> <hr/>
14	Provisions for liabilities and charges		
	The elements of deferred taxation are as follows:		
		2005	2004
		£	£
	Difference between accumulated depreciation and amortisation and capital allowances	(21,511)	(6,504)
	Tax losses	(570,327)	(423,392)
		(591,838)	(429,896)
		<hr/> <hr/>	<hr/> <hr/>

The company has an unrecognised deferred tax asset at 31 May 2005 of £591,838 (2004: £429,896) relating to tax losses which the company can offset against future taxable profits from the same trade. An element of historical losses brought forward at 1 June 2004 has been surrendered for tax credit relief to allow the submission of a research and development tax claim. The claim has resulted in the surrender of some historical losses carried forward and a £109,204 reduction in the unrecognised deferred tax asset at 31 May 2004 which was previously disclosed in the 2004 accounts as £429,896.

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

15 Called up share capital

	2005	2004
	£	£
<i>Authorised</i>		
20,000,000 ordinary shares of £0.01 each	200,000	200,000
	<hr style="border-top: 3px double #000;"/>	<hr style="border-top: 3px double #000;"/>
<i>Allotted, called up and fully paid</i>		
14,030,748 shares of £0.01 each	140,308	132,158
(2004: 13,215,748 shares of £0.01 each)	<hr style="border-top: 3px double #000;"/>	<hr style="border-top: 3px double #000;"/>

On 3 August 2004 the directors resolved to allot 475,000 ordinary shares of £0.01 each. These shares were issued on 3 August and 4 August 2004.

The allotment was pursuant to a placing of shares to institutional and other investors. The total consideration in respect of the above was £332,500.

The funds raised will be applied to the company's capital investment programme, the expansion of its management and technical team and to provide working capital generally.

In addition, 340,000 shares were issued on the exercise of warrants as referred to below.

The new shares issued rank pari passu in all respects with the ordinary shares in issue including the same voting rights, rights to dividends, and their priority and amounts receivable on a winding up.

Warrants

On 4 December 2000, the date of admission to OFEX, 566,667 Offer Warrants and 615,799 Financial Arranger Warrants were granted to the purchasers of the ordinary shares and the financial adviser respectively. One Offer Warrant was issued with every three ordinary shares purchased. The Financial Arranger Warrants were issued to the financial adviser in lieu of consultancy fees.

The fair value attributable to the Offer and Financial Arranger Warrants were calculated on the date of issue as £212,500 and £307,899 respectively. When the warrants were granted, adjustments were made to reduce the share premium account and increase the warrant reserve in respect of both amounts. The Offer Warrant reserve, relates to the reduction in consideration received for the shares and the Financial Arranger Warrant reserve relates to issue costs that would have been set off against the share premium account.

When the warrants are exercised the fair value of the warrants is transferred from the warrant reserve to the capital reserve and the premium credited to the share premium account in accordance with Financial Reporting Standard 4.

None of the warrants held voting rights.

The Financial Arranger Warrants have been exercised as follows:

	Arranger warrants Number
At 31 May 2004	340,000
Warrants exercised in the year	(340,000)
	<hr/>
At 31 May 2005	-
	<hr/> <hr/>

The Financial Arranger Warrants exercised during the year were priced at £0.50. The consideration received was £170,000.

The offer warrants were exercisable until 3 December 2003 and the Financial Arranger Warrants until 3 December 2004. All warrants not exercised have now therefore expired.

Enterprise Management Incentive Scheme

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

The options granted to directors, date of grant and exercise price and exercise periods under scheme are set out in the report on directors' remuneration on page 10. In addition to the directors' share options, certain employees have been granted the following options:

Date of grant	Number of share options granted	Number of share options expired	Exercise price	Exercise period
19/12/02	149,233	(90,931)	£0.70	19/12/05-19/12/12
08/12/03	34,091	(34,091)	£0.88	19/12/06-19/12/13
08/03/04	120,000	-	£0.665	08/03/07-08/03/14
04/04/05	35,000	-	£0.50	04/04/08-04/04/15

16 Share premium and reserves

	Share premium account	Warrant reserve	Capital reserve	Profit and loss account
	£	£	£	£
At beginning of year	4,750,552	226,514	293,885	(2,137,824)
Premium on exercise of warrants	166,600	-	-	-
Transfer on exercise of warrants	-	(170,000)	170,000	-
Gain on lapse of warrants	-	(56,514)	-	56,514
Issue costs	(14,437)	-	-	-
Retained loss for the year	-	-	-	(616,623)
At end of year	4,902,715	-	463,885	(2,697,933)

17 Commitments

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

	Land and buildings 2005 £	Land and buildings 2004 £
Operating leases which expire: In the second to fifth years inclusive	33,000	30,662
	<u> </u>	<u> </u>

18 Pension scheme

The company contributes to specific employees personal pension schemes. The pension cost charge for the year represents contributions payable by the company to the scheme and amounted to £6,740 (2004: £2,960).

There were no outstanding or prepaid contributions either at the beginning or end of the financial year.

19 Analysis of cash flows

	2005 £	2004 £
Returns on investments and servicing of finance		
Interest received	120,153	7,763
Interest paid	(1,235)	-
	<u>118,918</u>	<u>7,763</u>
	<u> </u>	<u> </u>
Capital expenditure and financial investment		
Purchase of tangible fixed assets	(63,775)	(818)
	<u> </u>	<u> </u>
Management of liquid resources		
Cash transferred from/(placed) on treasury deposit	3,000	(2,635,000)
	<u> </u>	<u> </u>
Financing		
Issue of ordinary share capital	8,150	38,359
Premium from issue of ordinary share capital (net of issue costs)	327,750	2,393,851
Premium on exercise of warrants	152,163	61,176
	<u>488,063</u>	<u>2,493,386</u>
	<u> </u>	<u> </u>

20 Analysis of net funds

	At beginning of year £	Cash flow £	At end of year £
Cash at bank and in hand	72,839	23,213	96,052
Liquid resources	2,635,000	(3,000)	2,632,000
	2,707,839	20,213	2,728,052
	2,707,839	20,213	2,728,052

21 Related party disclosures

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

Company/entity	Relationship	Purchase	2005 £	2004 £
April Training Executive Ltd	JJ Faria is a director and has a controlling interest	Administrative services	9,480	10,200
April Property Partnership	JJ Faria is a director and has a controlling interest	Rent	6,000	6,000
			9,480	16,200
			9,480	16,200

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

At the year end £1,998 was owing to April Training Executive Limited (2004: £2,045) and £587 to April Property Partnership (2004: £587).

22 Loss on ordinary shares

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

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

Basic	2005	2004
	£	£
Loss after tax	(616,623)	(129,524)
Weighted average number of shares	13,805,406	9,506,297
Loss per share	(4.47p)	(1.36p)

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

23 Derivatives and other financial instruments

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

Financial assets

The company has £2,728,052 (2004: £2,707,839) held in cash and deposits as financial assets as well as short term debtors.

Financial liabilities

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

Fair values of the company's financial assets and liabilities

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

Company information and advisors

Website	www.surface-transforms.com	
Registered Number	03769702	
Directors	Kevin D'Silva (<i>Non-executive Chairman</i>) Julio Joseph Faria (<i>Managing Director</i>) Geoffrey Gould (<i>Sales and Marketing Director</i>) Kevin Johnson (<i>Operations Director</i>) Professor David Thomas Clark (<i>Non-executive Director</i>) Peter Holland (<i>Non-executive Director</i>)	
Locations	Registered office	Research and manufacturing site
	April House Tarvin Road Frodsham Cheshire WA6 6XN	Cheshire Innovation Park, Unit 306 Pool Lane Ince Cheshire CH2 4NU
	Tel: 01928 735498	Tel: 0151 373 7130
Nominated adviser	John East & Partners Limited Crystal Gate, 28-30 Worship Street, London EC2A 2AH	
Broker	Teather & Greenwood Limited Beaufort House, 15 St Botolph Street, London EC3A 7QR	
Auditors	KPMG Audit Plc St James' Square, Manchester M2 6DS	
Solicitors to the Company	Halliwells LLP St James' Court, Brown Street, Manchester M2 2JF	
Bankers	Barclays Bank plc 125 Main Street, Frodsham, Cheshire WA6 7AD	
Registrars	Capita IRG plc Bourne House, 34 Beckenham Road, Beckenham, Kent BR3 4TU	