# 2004

Babcock International Group PLC

Annual report and accounts 2004

# Completing the transformation

Cover:

South West Regional Prime
Babcock, in a joint venture with Bovis Lend Lease, has been awarded a seven year contract to provide property maintenance and future capital works across the MoD estate in the South West. The value to Babcock is estimated at £480 million. The work will encompass Royal Navy, Army, Royal Airforce and DLO establishments. Babcock will provide a comprehensive building and infrastructure maintenance service.

# The transformation process is complete.

We are a service orientated company operating under two main business units. We supply support services, largely to the Ministry of Defence.

The strength of the business is underpinned by longer term order books, with good visibility of earnings.

**+16%**
Turnover for continuing businesses

**+£3.0m**
Group operating profit to **£21.9m**

**+21%**
Pre-goodwill operating profit to **£25.2m**

**+11%**
Pre-goodwill operating profit (for continuing businesses) to **£25.5m**

**+48%**
Profit before tax to **£19.8m**

**11.31p**
Earnings per share

**+11.7%**
Recommended dividend to **3.35p per share**

Ship refits at Rosyth:

# On time on budget

Heathrow T5 construction:

# Applying expertise to new sectors

# Chairman's statement

Previous pages:

**Performing beyond expectations at Rosyth**

Babcock continues to deliver high quality refit work on time and to budget for the Royal Navy. The partnership ethos at Rosyth and our ability to deliver high quality work has been consistently praised by both the Royal Navy and the Warship Support Agency.

**Babcock expertise adapted for the Heathrow T5 project**

The ability of Rosyth personnel to project manage and deliver complex warship refit work has been adapted to the provision of modules to be incorporated into Heathrow's Terminal 5 – the largest construction project in the UK.

The year ending March 2004 marked the completion of the first phase of Babcock's strategic transformation. Profit before tax increased by 48% and the operating profit of the Training and Support sector rose by 52% exceeding that of Technical Services for the first time.

These results amply vindicate the decision taken three years ago to transform Babcock from an engineering conglomerate to a support services business, with organic growth in these new businesses driving an increase in turnover of 16% in the continuing businesses and with the Training and Support sector growing by 41%, more than offsetting the decline in turnover at Rosyth. Ministry of Defence (MoD) contracts already won should enable growth to continue and we have good hopes of further contract wins to sustain this momentum.

We are now embarking on the second phase of the Babcock transformation, with our plans to expand into the civil support sector. We announced in March 2004 a recommended offer for Peterhouse Group plc. This business has similar characteristics to that of Babcock, in that it provides project management services to its customers, in operations which have a high technical content. It has, however, a different customer base to that of Babcock and as such the combined group would have a more balanced portfolio of customers. The offer, which comprises approximately 70% in Babcock's equity and 30% in cash, would increase Babcock's issued share capital by some 38%. Your Directors believe that this acquisition would be earnings enhancing pre-goodwill and exceptional items in the first full financial year following completion(*).

The MoD is a valued customer of Babcock and we have had notable successes in the last year in concluding contracts for South West Regional Prime and RAF Valley. We have also seen growth in the Single Living Accommodation Modernisation contract and the contract to manage Her Majesty's Naval Bases on the Clyde. These have more than offset the decline in turnover in Babcock Defence Services, as a consequence of the British Army's scale back in Kosovo. However, delays in converting the Royal School of Military Engineering contract from sole bidder to financial close and the lack of progress on the Armoured Vehicle Training System and Airside Support Project highlighted the frustrations experienced in concluding Ministry of Defence contracts, and reinforce the benefits of a broader customer base.

Equally, the delays in finalising the contract structure and the build programme on the new aircraft carrier project show how difficult long-term planning can be in the Defence sector. Discussions are continuing with the MoD on the extent of our participation in the new aircraft carrier programme and on the workload at Rosyth in the period to project start. We are optimistic as to the outcome of these discussions, which are likely to continue for sometime.

Earnings per share before goodwill and exceptional items in the year to 31 March 2004 increased by 53% to 13.60p per share and net debt was reduced from £37.2 million to £15.4 million. The Directors are recommending a final dividend of 2.1p per share giving a total dividend for the year of 3.35p per share an increase of 11.7% on the previous year. This final dividend would also be payable on the new equity issued to Peterhouse shareholders provided that the offer becomes unconditional before the record date for the final dividend.

The Report and Accounts show a high level of compliance with the Combined Code, which has of course been revised following the Higgs Report of last year. The revised code does not apply to our reporting year under review in the Report and Accounts and we will be considering carefully during the course of the current financial year the few areas in which we are not yet compliant. However, I should like to specifically thank Lord Hesketh for offering himself for re-election as a Director at this year's Annual General Meeting in accordance with the revised Combined Code as he has been on the Board for ten years. The executive Directors of Babcock are relatively new in their positions and Lord Hesketh's perspective of history and his knowledge of the Defence industry is extremely valuable. He maintains a considerable degree of independence and I have no hesitation in recommending his re-election and his identification as the Senior Independent Director. I can confirm, as required by the revised Combined Code, that following formal performance evaluation, Lord Hesketh's performance continues to be effective and to demonstrate commitment to the role, including commitment of time for Board and committee meetings and other duties.

I said at the beginning of this report that the performance of Babcock justifies the strategy laid out three years ago. However, a strategy is only as good as its implementation and the implementation is a function of the quality and dedication of our employees. The year ending 31 March 2004 has perhaps been more stable than the immediate previous years for Babcock, and we have seen the benefits of a consistent strategy and organic growth. Nevertheless this growth comes as a consequence of the hard work of everyone involved and I would like to thank all the Babcock people.

The successful implementation of a consistent strategy has produced an increase in shareholder value. Babcock's shares have outperformed the FTSE All-Share Index by 77% over the five years to 31 March 2004. We are committed to continued shareholder value creation and believe the prospective acquisition of Peterhouse would represent an important step in this direction.

G A Campbell
Chairman

*The statement that the acquisition will be earnings enhancing, pre-goodwill and exceptional items, in the first full financial year following completion does not constitute a profits forecast and should not be interpreted to mean that the earnings per share in the first full financial year following the acquisition, or in any subsequent period, would necessarily match or would be greater than those for the relevant preceding financial period.

Power distribution in South Africa:

# Growth in new areas

Navigation systems:

# Teaming-up to strengthen capabilities


Full support service provision:
Trusted
to deliver

# Chief Executive's operating statement

Previous pages:

**South Africa provided spectacular growth**
The Volvo construction equipment franchise and Eskom's expansion enabled Babcock Africa to grow sales by 63%.

**Working with Lockheed Martin to update the Royal Navy's warship navigation systems**
The Weymouth-based Babcock Design and Technology will be responsible for planning and installing the new Lockheed Martin designed navigational systems for the Royal Navy.

**Providing comprehensive support to RAF Valley**
RAF Valley is home of the Royal Airforce Fast Jet Training establishment. Babcock has been selected to provide a wide range of support services ranging from aircraft engineering to transportation. Babcock is now responsible for first line maintenance on virtually all of the Royal Airforce Hawks.

The past year has been a highly satisfactory one for Babcock. Sales in continuing businesses rose by 16% and continuing operating profit before goodwill and exceptional items by 11%. The last Materials Handling businesses were sold and we have secured a number of significant contract wins. The order book at 31 March 2004 stood at £1.0 billion (excluding Single Living Accommodation Modernisation – SLAM) compared to £0.6 billion at the end of the last financial year. The integration of the two businesses acquired last year (SGI and MEF) has been completed and both are exceeding our expectations.

The progress made can probably best be judged by looking back two years to 2001/02 when Training and Support sales were £98.7 million and operating profit before goodwill and exceptionals was £6.1 million. The combination of organic growth and acquisitions has resulted in sales for the current year of £252.9 million and operating profit before goodwill and exceptionals was £15.4 million, increases of 156% and 152% respectively. Further contract wins will continue to boost turnover and profits.

The decision to rebrand all the constituent parts of our support services businesses under the 'Babcock' name is paying real dividends with the MoD where recognition of the Babcock name is now significantly improved compared with the position of a year ago. This approach to branding has enabled us to build a common culture across our businesses, thus providing a platform to blend the skills and talents of our people with the corporate aim of delivering high quality service to our customers.

We continue to invest significant sums in pursuing contracts, particularly with the MoD. This is partly as a result of the complexity of the contracts for which we are bidding and partly a function of the time taken from initial discussions to award. It is essential that we continue to monitor carefully the expenditure required to achieve significant contract wins as the process can generally be measured in years rather than months.

We have also invested considerable effort during the year in building alliances to strengthen our total offering. We have formal alliance or partnership agreements with (amongst others) AT&T, Bovis Lend Lease, DynCorp International, Lockheed Martin and Thales.

## Training and Support

Babcock Naval Services (BNS) is included for a full year in the results, the start of the contract being in September 2002. The progress made is extremely encouraging. All key performance indicators which were in operation during the year were met or exceeded and cost savings are being achieved that are in line with those for which we are contracted over the initial five year period. There is still a significant management task ahead but the road map is clear and the customer is delighted with the progress. The success of the partnering concept and implementation was recognised by the winning of the Insider Magazine/Bank of Scotland Public Private Partnership of the Year award.

Babcock Infrastructure Services (BIS) has had an excellent year with the major contract win being South West Regional Prime (SWRP) which will lead to Babcock maintaining and upgrading a significant element of the Ministry Estate in the south west of England for the next seven years. This is the second of the regional primes to be let and there are three more to be awarded over the next two years. SLAM has had a somewhat slower start than we anticipated, but the programme for the 2004/05 year should accelerate the number of units being built.

In addition to the SWRP win BIS also won a contract for the maintenance management of the Metropolitan Police Estate in London and secured a two year extension to the contract to provide project management and design services to the London Borough of Ealing.

Babcock Defence Services (BDS), the business that largely provides operational support to the Armed Forces, declined in turnover and profit, as anticipated, with the withdrawal of the British Army from Kosovo. Our people based in the Balkans and Afghanistan have, however, done an excellent job in developing new business streams with NATO, the US military and the UN as well as the Ministry of Defence Estates. A small contract for aircraft technician training in the Gulf was secured during the year and is now being successfully operated.

The high point for BDS was the win of RAF Valley; a multi-activity contract which results in Babcock now being responsible for the operational maintenance of virtually all of the RAF Hawk Fast Jets – a position on which we will seek to build. Bids are under evaluation for the Armoured Vehicle Training System and the Airside Support Project – both have been significantly delayed. There has been gradual forward movement on the Royal School of Military Engineering (where a Babcock led consortium is sole bidder) during the year. A Babcock led consortium has been selected as one of the three bidders to submit formal bids on the core element of the Defence Training Review – a project which is currently valued at a sum of £5 billion over 25 years.

Babcock Africa had another successful year with significant growth in the construction equipment sales division and in the support business for energy generation. Volvo Construction Equipment awarded the 'Dealer of the Year' trophy to Babcock Africa in recognition of their continuing sales growth. Eskom, the South African power utility, as forecast, are planning to bring back on stream significant generation capacity and it is expected that a proportion of the work involved will be captured by Babcock Africa. In addition the successful completion of contracts in Libya should lead to further contract wins and the 'Mondi' cogeneration project is moving towards contract.

## Technical Services

The turnover of the Technical Services Division declined by 7% during the year as a result of a decline in the volume of Naval refit work and continuing difficulty in the fast ferry market. This was partially compensated by new business won by Babcock Design and Technology and the new Supply Chain Services business based at Rosyth. Nevertheless profitability, pre-pension costs, has been maintained during the year. Notable wins during the year included the manufacture of steel modules for Heathrow's Terminal 5, the Ministry of Defence 'Design Alliance' contract won by Babcock Design and Technology and a further Non Project Procurement Organisation (NPPO) contract won by Supply Chain Services. The 'SMIT' training boat contract was completed in the first half of the year, and the programme for the 16 landing craft for the Ministry of Defence was completed on time in the second half of the year. These vessels are now in service with the Royal Marines. The customer has expressed a high level of satisfaction with the quality and performance of the product.

During the period a total of six naval vessels have completed their refits at Rosyth to time and to budget. We have received a number of compliments from the Ministry of Defence about the quality of the work during the year and in particular in relation to the partnership ethos at Rosyth: which brings together customer and the supplier at all levels in an alliance to ensure successful refits. Following the refit of HMS ARK ROYAL and HMS INVINCIBLE, the third aircraft carrier HMS ILLUSTRIOUS is now well into its refit and is currently ahead of time and under budget. A number of minor war vessel refitting contracts were competitively secured, including HMS CATTISTOCK, GRIMSBY and RAMSAY.

Rosyth is the nominated site for the assembly and integration of the new carriers and is also expecting to participate extensively in the modular fabrication programme. However, the construction programme is unlikely to start before 2007/08. Discussions continue with the MoD as to the best solution for filling the work gap between the end of the allocated programme of naval refits during next year and the start of construction of the aircraft carriers. We are optimistic as to a successful outcome to these discussions.

The two smaller businesses in Technical Services both had difficult years with New Zealand failing to secure an extension to the current contract and the lack of activity in the US pipeline market resulting in Eagleton making a small loss for the year.

## Summary and Prospects

The transformation of Babcock into a support services business is now complete. We have built an effective relationship with the MoD and other public bodies, which was highlighted by the award of significant contracts. As the public sector budget issues are resolved, further contracts will be awarded and Babcock is well-placed to win additional business.

Peter Rogers
Chief Executive

Single living accomodation:

# Enhancing working lives

Support services on the Clyde:

# Building customer relationships

# Financial review

Previous pages:

## Single Living Accommodation Modernisation

The Debut joint venture between Babcock and Bovis Lend Lease is responsible for building and maintaining new single accommodation for the Armed Forces. The new accommodation is of a significantly higher standard than that which it is replacing and is expected to improve retention of personnel through an improvement in quality of life.

## Support and services on the Clyde

Babcock has almost completed the second year of a contract to provide a wide range of services to Royal Navy Submarine fleet and its people at Her Majesty's Naval Base Clyde. All key performance indications have been met or exceeded since the start of the contract leading to significant improvements in levels of customer satisfaction. This has been achieved at the same time as a continuing reduction in operational costs.

## Overview

I am pleased to report on the conclusion of another successful financial year, which saw group turnover increase by 7% to £452.0 million and profits before tax (before goodwill amortisation and exceptional items) by 28% to £23.1 million. Basic earnings per share (before exceptional items and goodwill) at 13.60p, was up 53% from 8.91p in the year 2002/03. After goodwill and exceptionals earnings per share grew from 5.72p to 11.31p. The group's cash flow performance was particularly strong, with group net debt ending the year at £15.4 million, down from £37.2 million at the end of the previous year. On the strength of this performance the Directors recommend a final dividend of 2.1p per share, making a total dividend payment for the year of 3.35p per share, an increase of 11.7% over 2002/03.

## Trading

### *Continuing businesses*

Turnover from continuing business increased by 16% to £438.0 million and generated operating profits before goodwill of £25.5 million, an increase of 11% from 2002/03. A number of milestone events in the year to 31 March 2004 contributed to the continuing financial progress of the group.

In Training and Support, the Babcock Naval Services (BNS) business saw the first full year of trading from the HM Naval Base Clyde contract and contributed turnover of £87.6 million and operating profit of £5.3 million (2002/03: £48.7 million, £1.2 million). Similarly, Babcock Infrastructure Services (acquired as SGI in 2002) completed its first full year in the group with turnover of £24.3 million and operating profit of £1.0 million (2002/03: £16.5 million and £0.9 million respectively).

Babcock Defence Services (BDS), which contributed turnover of £59.5 million and operating profits (including share of JV's) of £5.6 million (2002/03: £63.7 million, £6.7 million), were successful in their bid for a five year multi-activity contract at RAF Valley, expected to be worth £65.0 million over five years, and this will contribute to turnover from April 2004.

Technical Services, with turnover of £185.1 million and operating profit of £14.5 million, completed the refit of the second aircraft carrier, HMS INVINCIBLE and commenced work on the refit of the third carrier, HMS ILLUSTRIOUS, which is due to complete in November 2004.

Babcock Africa made significant progress in increasing its share of the heavy earth moving equipment market in South Africa through its Volvo franchise and also secured significant engineering contracts with Eskom and AECI. Africa increased turnover by 63% to £81.5 million and operating profit by 207% to £3.8 million.

### *Discontinued businesses*
The last remaining Materials Handling businesses were disposed of during the year, as set out in note 29 to the accounts, giving rise to a net exceptional loss on disposal of £2.5 million. These businesses, up to the date of disposal, generated turnover of £14.0 million and operating losses of £0.3 million.

### *Cash flow and net borrowings*
Cash flow from operating activities was £28.0 million (2002/03: £11.3 million). Working capital increased by only £2.1 million in the year and a reduced requirement for net fixed capital investment, which was £1.6 million (2002/03: £2.8 million) yielded an operating profit conversion rate after capital expenditure of 121% compared to 45% last year. As a consequence net borrowings decreased to £15.4 million from £37.2 million at the end of last year.

A major source of cash from operations remains the MoD and the size of individual cash receipts under these contracts can be very significant. As such, depending upon the timing of receipt relative to period ends, they may have a material effect on the reported working capital and cash position.

Last year I referred to certain contracts undertaken in the Rosyth dockyard containing profit sharing clauses. In the year under review, contrary to expectation, no material payments were made to the MoD under the shareline clauses applying to these contracts and it is now anticipated that these payments, which have been fully provided for in calculating the declared profits for the years in which they arose, will be made during 2004/05.

After taking into account payments for taxation of £1.6 million (2002/03: £3.0 million), interest on debt £0.4 million (2002/03: £2.5 million) and dividend payments of £4.5 million (2002/03: £4.2 million) as well as the net cash inflow from acquisitions and disposals totalling £1.4 million (2002/03: outflow £26.8 million) the net cash generated, before financing and management of liquid resources, in the 12 months to 31 March 2004 was £20.7 million compared to a net outflow in 2002/03 of £28.2 million. This outturn was the consequence of careful attention to the management of working and fixed capital investment as well as the strong operating result achieved in the year.

**+16%**
Continuing turnover

**+11%**
Continuing operating profit (pre-goodwill)

## Financial items

### *Interest*

The group net interest charge, before exceptional items, at £2.2 million was £0.4 million below the charge in 2002/03 as a result of a lower average cost of funds at 7.5% against 7.8% last year and lower average monthly net debt.

In addition, the group disposed of a financial asset during the year giving rise to an exceptional gain of £1.7 million, which is recorded on the interest and similar income line in the group's Profit and Loss statement.

### *Tax*

The group again benefited from the differential tax rates as between that of the UK and those of overseas jurisdictions as well as tax benefits arising on the utilisation of prior years' tax losses. As such, the underlying tax rate before goodwill and exceptionals for the group in 2003/04 was 15.7% (2002/03: 26.0%). The underlying rate next year is expected to be approximately 24.0%.

### *Returns to shareholders*

During the year Babcock's mid-market share price moved from a low of 88p to a high of 138.5p and ended the year at 116.5p. Compared to the FTSE All-Share index, this represented an out-performance of 3.5%.

Fully diluted earnings per share were 11.28p, an increase of 98% from 2002/03. Based on basic earnings pre-goodwill amortisation and exceptional items, earnings per share were 13.60p compared to 8.91p in 2002/03, an increase of 53%. The bases for the calculation of these statistics are set out in note 11 to the accounts.

The recommended final dividend of 2.1p per share, making a total for the year of 3.35p per share representing a net yield of 2.9% based on the mid-market price at the close of business on 31 March 2004.

Consolidated shareholders' funds stood at £101.1 million, an increase of £13.7 million since last year end.

### *Liquidity*

As reported last year, the group has access to loan funding totalling £77.5 million comprising a £17.5 million, three year, medium term loan facility, a £50.0 million short-term revolving credit facility and a £10.0 million overdraft facility. At the 31 March 2004 total utilisation of these facilities was £20.5 million.

*Treasury*

Foreign currency risk: It is group policy that operating businesses maintain forward cover for foreign exchange exposure in relation to transactions in as risk averse a way as possible. Speculation on future exchange rate movements is forbidden. When foreign currency options provide the most effective means of cover for transactions, for example where flows are uncertain, these instruments may be used with the express permission of the Group Finance Director. It is not group policy to hedge foreign currency exposure on translation of profits and net assets of overseas subsidiaries.

Management of net debt: Details of sources of debt, maturity and interest rates are set out in notes 20 and 21 to the accounts. Currency borrowings are taken out in relation to overseas businesses operational requirements and as such will provide a partial hedge against the effect of currency volatility on overseas net assets and income. Surplus cash is invested with prime rated counterparties.

Interest rate risk: All group borrowings are agreed by the Finance Committee of the Board prior to commitment and as a part of this process it is group policy that an appropriate balance of fixed and floating rate financing is in place such that the group mitigates the adverse risk of a rise in interest rates as well as enabling it to benefit from any decrease. In order to achieve this, the group has entered into an interest rate swap with one of its banking partners on its £20.0 million medium-term loan, capping the interest rate on this facility at 5.0%.

Many contracts for the provision of services entered into by the group require the provision of a parent company guarantee to underwrite the performance of the relevant operating subsidiaries. Such guarantees are subject to the approval of the group's executive Directors prior to commitment.

## Acquisitions and disposals

As noted above, the group completed the programme of disposals of the Materials Handling businesses in November 2003 with the sale of the BMH Marine and related business assets. Proceeds received were £2.0 million and the loss on disposal was £2.5 million. This was partially offset by a profit of £0.8 million, realised on the sale of a non-trading subsidiary.

On 22 March Babcock announced a recommended offer for Peterhouse Group Plc. At year end the group held £2.5 million of costs on its balance sheet, in debtors, representing costs incurred as at 31 March 2004 from the prospective acquisition. In the event of the acquisition failing, this value and further costs incurred post 31 March 2004 would be written off through the profit and loss account. In the event of the offer not being successful approximately £1.0 million of costs may be recoverable from Peterhouse Group Plc depending on the reasons for such failure.

**11.28p**
Earnings per share (from 5.69p)

**+11.7%**
Dividend growth

**£28.0m**
Cash generated from operations

## Pensions

The group maintains two principal defined benefit pension schemes as well as several money purchase schemes.

In calculating the accounting entries for its defined benefit pension funds the group applies SSAP24 in its consolidated accounts, using the latest actuarial valuation of the schemes. Since last year end, the valuation of the Rosyth Royal Dockyard defined benefit scheme, one of the two principal schemes, as at 31 March 2003 was completed. This showed an actuarial surplus of scheme assets over scheme liabilities. The SSAP24 surplus before deferred tax at 31 March 2004 based upon this and the latest valuation of the other schemes was £67.2 million (2002/03: £69.1 million). The net charge in the group profit and loss account in respect of all defined benefit schemes was £2.5 million (2002/03: £0.1 million).

The group applies the transitional rules of FRS17 in disclosing information on its defined benefit schemes in note 24 to the accounts. Under this standard, the net pension surplus of assets over liabilities before deferred tax was £2.0 million compared to a net surplus of £2.3 million last year end and the charge to profit and loss account would have been £7.6 million against a net credit of £8.3 million last year.

## International Financial Reporting Standards

The group is required under European legislation to adopt International Financial Reporting Standards also known as International Accounting Standards (IAS) from 1 April 2005.

The group has developed a transition plan to manage the conversion and the project is managed by the group's finance department. Divisional meetings have been held, attended by the divisional finance teams, group finance and the group's auditors. At these meetings plans for training, data gathering, timetable and resource requirements were established and certain initial differences identified. In common with many companies, the adoption of IFRS is likely to have a material impact on the group's financial statements, however it is too early to quantify the impact accurately.

The potential differences between UK GAAP and IFRS that may impact the group's financial statements are set out below:

### *Pensions*

Under UK GAAP, the cost of providing pensions is charged to the consolidated profit and loss account over employee service lives in accordance with SSAP 24. Any surplus or deficits arising on the valuation of the pension funds is recognised, in the main, over the average remaining service life of the active employees.

Under IFRS, pensions assets and liabilities are initially carried at their fair value at the balance sheet date. There are choices as to the treatment of subsequent movements.

*Deferred taxation*
There are differences between UK GAAP and IAS as to the treatment of overseas subsidiary remittable profits, which may result in some differences.

*Goodwill impairment*
Under UK GAAP, goodwill is carried on the balance sheet and amortised on a straight line basis over its estimated economic life, normally assumed to be no more than 20 years. Under IFRS goodwill will not be amortised but will be reviewed both annually and at any point where an indicator of impairment exists.

*Finance leases*
UK GAAP and IFRS have differing definitions particularly in relation to long leases on land and buildings where IFRS requires the property valuation to be split, with buildings to be normally treated as finance leases and the land element as operating leases.

*Foreign exchange hedging activities*
The group enters into foreign exchange future contracts to hedge the purchase of equipment and new material for resale. These contracts are accounted for as hedges, whereby gains and losses are deferred until the underlying transaction occurs. Under IFRS these contracts are recognised on the balance sheet at fair value. In order to achieve hedge accounting, certain criteria must be established regarding documentation and effectiveness of the hedge.

The adoption of IFRS will apply to the group's financial statements for the half year ending 30 September 2005.

Bill Tame
Group Finance Director

# Directors and Company Secretary

**Gordon Campbell** (Age 57), Chairman
Mr Campbell joined the Board as Group Chief Executive on 10 October 2000 and was appointed Executive Chairman on 1 January 2001. With effect from 1 August 2003 his responsibilities changed and he became part-time Chairman. Mr Campbell is currently non-executive Chairman of iti Scotland Limited, having been appointed as such following his change of status to part-time Chairman of the company. He is also a non-executive Director of Jupiter Split Trust plc, a Trustee Director of the British Heart Foundation and Vice President of the Royal Academy of Engineering. In April 2004, Mr Campbell was named as Chairman-designate of British Nuclear Fuels plc, of which he was already a non-executive Director. Mr Campbell was reappointed as a Director of the company at its Annual General Meeting in July 2001 and will, therefore, in accordance with the company's Articles of Association, be retiring at the company's forthcoming Annual General Meeting in July 2004 where, being eligible to do so, he will offer himself for re-election.

**The Rt Hon Lord Alexander Hesketh KBE** (Age 53), Non-Executive Deputy Chairman and Senior Independent Non-Executive Director; Chairman of the Remuneration Committee
Lord Hesketh joined the Board on 6 October 1993 becoming non-executive Deputy Chairman on 26 April 1996. He is a non-executive Director of BAE Systems PLC and Chairman of British Mediterranean Airways Limited. He was Government Chief Whip in the House of Lords from 1991 to 1993 and, prior to that, was Industry Minister at the Department of Trade and Industry. Lord Hesketh chairs the company's Remuneration Committee and is a member of its Audit and Risk Committee. He was reappointed as a Director of the company at its Annual General Meeting in July 2002. However, in accordance with the revised Combined Code on Corporate Governance, having served as a Director for more than nine years, he will be retiring and offering himself for re-election at the company's forthcoming Annual General Meeting in July 2004.

**Peter Rogers** (Age 56), Group Chief Executive Officer
Mr Rogers joined the Group as Chief Operating Officer on 1 June 2002 and was appointed to the Board on 13 June 2002. On 1 August 2003 he became Group Chief Executive. He is a former Director of Courtaulds plc and of Accordis plc. Mr Rogers was reappointed as a Director of the company at its Annual General Meeting in July 2002.

**William Tame** (Age 49), Group Finance Director
Mr Tame joined the Board as Group Finance Director on 25 January 2002. He is a former Finance Director of Scapa Group PLC. Mr Tame was reappointed as a Director of the company at its Annual General Meeting in July 2002.

**John Rennocks** (Age 58), Non-Executive Director; Chairman of the Audit and Risk Committee
Mr Rennocks joined the Board as a non-executive Director on 13 June 2002. He is a former Finance Director of Corus Group PLC and holds several other non-executive directorships, including of Diploma Plc, England Rugby Limited, Foreign & Colonial Investment Trust PLC, JP Fleming Overseas Investment Trust PLC, Wagon PLC, Nestor Healthcare Group PLC, and Xenova Group PLC. Mr Rennocks is Chairman of the company's Audit and Risk Committee and is a member of its Remuneration Committee. He was reappointed as a Director of the company at its Annual General Meeting in July 2002.

**Dipesh Shah** (Age 51), Non-Executive Director
Mr Shah joined the Board as a non-executive Director on 15 June 1999. He is the Chief Executive of the United Kingdom Atomic Energy Authority, and holds non-executive directorships of Viridian Group PLC and IT Power Limited. He was formerly Chief Executive Officer of various businesses within BP and was a member of the DTI's Renewable Energy Advisory Committee and UK Panel for European Environmental Awards. Mr Shah is a member of the company's Audit and Risk and Remuneration Committees. He was reappointed as a Director of the company at its Annual General Meeting in July 2002.

**Michael Turner CBE** (Age 55), Non-Executive Director
Mr Turner joined the Board as a non-executive Director on 5 June 1996. He is Chief Executive Officer of BAE Systems PLC and a member of the Supervisory Board of Airbus. He is President of the AeroSpace and Defence Industries of Europe (ASD). Mr Turner is a member of the company's Audit and Risk and Remuneration Committees. Mr Turner was reappointed as a Director of the company at its Annual General Meeting in July 2003.

**Sir Nigel Essenhigh GCB** (Age 59), Non-Executive Director
Sir Nigel Essenhigh joined the Board as a non-executive Director with effect from 4 March 2003. Until his retirement from the Royal Navy in late 2002, he was First Sea Lord and Chief of Naval Staff. He is non-executive Chairman of Defence Strategy & Solutions, a limited liability partnership. Sir Nigel is a member of the company's Audit and Risk and Remuneration Committees. Sir Nigel was reappointed as a Director of the company at its Annual General Meeting in July 2003.

Company Secretary
**Albert Dungate** (Age 47)
Mr Dungate was appointed as Group Company Secretary and General Counsel on 1 February 2002. A solicitor, he was formerly General Counsel and Company Secretary of Arjo Wiggins Appleton PLC. Mr Dungate is Secretary to the company's Audit and Risk and Remuneration Committees.

# Directors' report

The Directors present their Report and the audited Financial Statements of the group for the year ended 31 March 2004.

**Result and dividends**
The profit attributable to shareholders for the financial year was £16.4 million (2003: £8.3 million). An interim dividend of 1.25p per 60p ordinary share was declared in the year (2003: 1.15p per 60p ordinary share). The Directors propose to recommend the payment on 9 August 2004 of a final dividend of 2.1p (2003: 1.85p per 60p ordinary share) on each of the ordinary shares of 60p entitled thereto and in issue on 9 July 2004 or, in relation to ordinary shares of 60p issued after that date as consideration to shareholders in Peterhouse Group Plc who accept the offer made by Credit Suisse First Boston (Europe) Limited on behalf of the company to acquire the entire issued or to be issued share capital of Peterhouse Group Plc or whose shares are acquired after that date pursuant to the company's rights under sections 428 to 430F (inclusive) of the Companies Act 1985 (as amended), such later date as such ordinary shares of 60p are issued from time to time (in which case payment of the dividend to those shareholders will follow issue). The retained profit for the financial year was £11.5 million (2003: £3.9 million).

**Business review and group structure**
The Chief Executive's operating statement and the Financial review on pages 10 to 21 review the group's activities and future developments. Other matters material to an appreciation of the group's position are contained in the Chairman's statement on pages 4 and 5. The principal subsidiary and associated undertakings of the company are set out on page 68.

**Acquisitions and disposals**
Information regarding the group's acquisitions and disposals during the course of the year are set out in note 29 on page 65 and they are also referred to in the Chief Executive's operating statement, Financial review and Chairman's statement.

**Research and development**
The group commits resources to research and development where necessary for the evolution and growth of its business.

**Charitable and political donations**
During the year the group donated £38,230 (2003: £26,105) to charitable organisations. No donations were made during the year for political purposes.

**Supplier payments**
The group has a policy of making payments consistent with established practices agreed with suppliers. There is no universal code or standard on payment practices across the countries in which the group does business, but subsidiary companies are expected to establish terms of trade consistent with the above policy and with the markets in which they operate, to ensure that suppliers are made aware of the terms of payment and to abide by them. The company itself had no trade creditors at either 31 March 2004 or 31 March 2003.

**Directors**
Details of the present Directors are shown on page 22.

Mr G Campbell will retire at the company's forthcoming Annual General Meeting under the provisions of Article 92 of the company's Articles of Association, having last been reappointed as a Director at the company's Annual General Meeting in 2001. Being eligible, he offers himself for re-election at the forthcoming meeting. Lord Hesketh, having first been appointed as a Director in 1993 will, in accordance with the Combined Code, retire at the forthcoming Annual General Meeting and, being eligible, will offer himself for re-election. The Chairman recommends and explains in the Chairman's statement on page 5, in accordance with the Combined Code, why the Board believes that Lord Hesketh should be reappointed as a Director. Lord Hesketh will subsequently, in accordance with the Combined Code, offer himself for re-election on an annual basis at the company's Annual General Meetings. All other Directors have had their appointments voted on by shareholders at Annual General Meetings within the past three years.

**Directors' interests**
There is no contract or arrangement with the company or any of its subsidiaries subsisting at the date of this document in which any Director of the company is materially interested and which is significant in relation to the business of the company and its subsidiaries taken as a whole.

The interests of the Directors in the issued share capital of the company, including family interests, all of which were beneficial, were, at the dates shown, as follows:

| Director | At 31 March 2004 | At 1 April 2003 |
|---|---|---|
| G A Campbell | **49,685** | 49,685 |
| P L Rogers | **20,000** | 20,000 |
| The Rt Hon Lord Hesketh KBE | **8,249** | 8,249 |
| W Tame | **12,113** | 7,113 |
| D J Shah | **8,333** | 8,333 |
| M J Turner CBE | **16,666** | 16,666 |
| Sir Nigel Essenhigh GCB | **–** | – |
| J L Rennocks | **–** | – |

Holdings are all of ordinary shares of 60p each.

There were no changes in the Directors' interests in shares between 31 March 2004 and 19 May 2004.

Details of options and awards over shares in the company granted to Directors up to 19 May 2004 are given on pages 34 and 35. Each executive Director is also deemed to be interested, for the purposes of sections 324 to 328 of the Companies Act 1985, in the shares held by the Babcock Employees' Share Trust, being potential beneficiaries of that trust.

## Significant shareholdings

As at 18 May 2004, the company had been notified in accordance with sections 198 to 208 of the Companies Act 1985 of the following major interests in its ordinary shares (which represent interests in 3% or more of its issued ordinary share capital).

| Name | Number of 60p ordinary shares | % |
|---|---|---|
| Schroder Investment Management Limited | 25,162,927 | 16.73 |
| Fidelity International Limited | 16,085,228 | 10.69 |
| UBS Global Asset Management (UK) Limited and its associates in the UK | 5,656,961 | 3.76 |
| Legal & General Investment Management Limited | 4,844,632 | 3.22 |

## Employee share schemes

The company has employee share schemes and plans as follows:

*(i) Executive Share Option Schemes and Long-Term Incentive Plan*

The company has several executive share option schemes pursuant to which grants have been or may be made, at the discretion of the Remuneration Committee or as required by the terms of an individual's employment contract, to executive Directors and other senior managers of the group. The Babcock International Group PLC Approved Executive Share Option Scheme and the Babcock International Group PLC Unapproved Executive Share Option Scheme are schemes under which options were not performance-linked, and are no longer operated, although grants made under them continue to subsist. The Babcock 1999 Approved Executive Share Option Scheme and the Babcock 1999 Unapproved Executive Share Option Scheme ('the 1999 Schemes') do provide for option grants to be linked to company performance, and details of the performance criteria used are set out in the Remuneration Report on page 31.

Options granted under the executive share option schemes are not granted at a discount to market price, with the exercise price being determined by reference to the average of the mid-market quotation of a share as shown by the London Stock Exchange Daily Official List for the three dealing days immediately preceding the grant date. Options are normally exercisable only between the third and tenth anniversaries of their grant date, but may become exercisable earlier in certain events (for example on termination of employment or a change of control).

At the company's Annual General Meeting in 2003, shareholders approved the establishment of a share-based long-term incentive plan, The Babcock 2003 Long-Term Incentive Plan, pursuant to which performance-linked awards of shares (structured as nil-cost options) may be made to executive Directors and other senior executives. Share awards are normally exercisable only between the third and tenth anniversaries of their grant date, but may become exercisable earlier in certain events (for example on termination of employment or a change of control). Details of the performance criteria currently used for share awards are set out in the Remuneration Report on page 31.

*(ii) All Employee Share Ownership Plan ('AESOP')*

This plan allows participating employees to purchase 'partnership' shares in the company in the market out of pre-tax income, and could also be used by the company to award free and/or matching shares to participants. Shares are held on behalf of participants in a tax-approved employee trust, and must generally be kept in the trust for at least three years to obtain any tax advantages, and for five years to obtain maximum tax advantages. To date, employees have been given the opportunity to acquire partnership shares, but the company has not yet made an offer of matching or free shares. The AESOP is open to all UK employees (including executive Directors) who meet common service criteria.

*(iii) Babcock International Group PLC Sharesave Scheme*

This scheme was introduced in December 1997. It enables the grant of share options linked to save-as-you-earn contracts. Subject to meeting common service criteria, offers to participate in the scheme must be open to all UK employees (including executive Directors) of the group. There are, however, currently no outstanding options granted under this scheme. Options granted under the scheme could be granted at a discount of up to 20% off the market price of the shares at the time of the offer to participate.

## Employees

Further information concerning the company's approach to employee matters (including public interest disclosure and ethical standards, and its policy on disabled employees and employee involvement) is included in the company's Corporate and Social Responsibility Statement appearing on pages 25 and 26.

## Authority to purchase own shares

At the company's Annual General Meeting in July 2003, the shareholders authorised the company to make market purchases of up to 14,858,875 of its own ordinary shares of 60p each. That authority will expire at the forthcoming Annual General Meeting in July 2004. Although no ordinary shares have been purchased by the company during the period from 18 July 2003 (the date of the last Annual General Meeting) to the date of this report, a resolution will be put to shareholders at the forthcoming Annual General Meeting to renew the authority to make market purchases of the company's shares up to a maximum of no more than 10% of the company's issued share capital.

## Annual General Meeting

This year's Annual General Meeting will be held at The Berkeley Hotel, Wilton Place, Knightsbridge, London SW1X 7RL on Friday, 16 July 2004, at 11.30 am. The notice of meeting is on page 69 and a note on the resolution to be proposed at it as special business is set out on page 70.

## Auditors

PricewaterhouseCoopers LLP are willing to continue in office as Auditors, and resolutions to reappoint them will be proposed at the forthcoming Annual General Meeting.

## Approval of report

Approved by the Directors on 19 May 2004.

By Order of the Board

**A N Dungate** Company Secretary
19 May 2004

# Corporate and Social Responsibility Review

**Introduction**
In this review we explain our policies and the approach we take to demonstrate and continue to strengthen our commitment to health and safety, environmental, ethical and employee concerns. We acknowledge that understanding and continually seeking to improve our performance in these fields is an integral part of our development and benefits our workforce, commercial partners, customers and shareholders.

**Overview**
Our senior executive team receives and reviews monthly reports on safety and environmental matters, and the full Board receives and reviews full reports on these matters at least twice a year.

Our Group Chief Executive has management responsibility at Board level for health and safety, environmental and ethical matters, with Divisional Managing Directors having day-to-day responsibility at divisional level. Additionally, responsibility is assigned at business unit level to named individuals for the management of identified risks. Our risk management systems and risk registers directly or indirectly address issues affecting social responsibility and other matters, under the overall supervision of the Board's Audit & Risk Committee and the Group Risk Manager. Each of our business divisions has its own risk management, health and safety and environmental managers or access to external advisers as considered appropriate to their operations.

**Health and Safety**
The securing of the health, safety and welfare at work of the group's employees and others is recognised as a major responsibility of group management. The group's top level Health and Safety Policy is as follows:

'Babcock seeks to achieve the highest standards in the management of Health and Safety in all areas of its operations. These standards will apply not only to our own employees but also for the benefit of contractors, customers and the general public. Accreditation to the appropriate standard will be obtained and maintained for each operation.

The Chief Executive of Babcock is responsible to the Board for the overall implementation of the Health and Safety Policy and will report to the Board on a regular basis on the record of the company and on progress in achieving improvement.

Each operation within Babcock is required to develop, publish and display a statement on its Health and Safety Policy which must be consistent with the Babcock Policy but appropriate to its local environment. The Policy statement must be acceptable to the customer for each operation and must be formally agreed with the customer. The senior executive on each site will be responsible for the publication of the Policy and for its implementation.

Each operation within Babcock will record and report incidents and provide a mechanism for investigation and rectification of any unsafe conditions. Appropriate training will be provided by each operation for all personnel and for non-employees where appropriate.

While it is recognised by Babcock that Health and Safety is a line management responsibility, Divisional Managing Directors will ensure that sufficient professional expertise is available to advise Line Management on Health and Safety matters. Each executive is also responsible for the appropriate consultation processes with the workforce within his operational area.

This Policy statement should be displayed prominently on all operational sites.'

Group businesses are required to implement their own detailed policies, consistently with this overall policy, as appropriate for their individual operations.

Our commitment to Health and Safety can be seen in the many awards won and other recognition gained by our operations around the world, for example:

- Our BES operations at Rosyth were awarded the prestigious 'British Safety Council Sword of Honour' in 2003 and have received the British Safety Council Health and Safety Management 5 star rating for the last two years running, and prior to that received several British and Scottish safety awards.
- Our BIS operations have been awarded the Royal Society for the Prevention of Accidents ('RoSPA') President's Award for Health and Safety for three years running: this award is itself only given following 10 years of winning the RoSPA Golden Medal for Health and Safety.
- Outside the UK, our Africa operations have received awards from the National Occupational Safety Association, gaining a Gold Award in 2003 and have also been a recipient of safety awards from ESKOM, the nationalised power company that is its major customer for its power station services and BHP Billiton, the Australian-based resource company.

At HMNB Clyde, for which we acquired operational responsibility in September 2002, major strides have been taken in refocusing and reinvigorating the Health and Safety function that we took over and in enhancing those safety policies, practices and procedures for which we have responsibility. These programmes continue with the active support and engagement of our staff and their trade union representatives.

Our operations provide ongoing Health and Safety training to relevant staff and managers and we seek to share best practice around the group. Our Health and Safety functions continue to develop and implement policies on a wide range of matters relevant to their operations ranging from stress-related conditions to drug and alcohol use and AIDS awareness.

**The Environment**
We also recognise our responsibilities and obligations to be mindful of the environment and to seek always to minimise any avoidable unacceptable adverse impacts of our operations through positive environmental controls. Our top-level policy on environmental matters, as revised in 2003, is set out below:

'Babcock seeks to achieve the highest standards in the management of environmental matters. We recognise the impact our operations may have on the environment and will seek to minimise or eliminate adverse effects. Accreditation to the appropriate standard will be obtained and maintained by each operation.

It is the responsibility of operational managers to devise and implement a policy which is appropriate to their specific business and which is in conformity with the group policy. Such a policy should also be formally agreed with the owner or operator of the sites on which the business is present. The policy statement should be displayed at the site.

Divisional Managing Directors are responsible for ensuring that sufficient and appropriate expertise is available to operating managers to advise on the most effective methods of dealing with and minimising environmental impact.

The Chief Executive of Babcock International Group PLC will be responsible for preparing an annual report for the Babcock Board dealing with environmental matters.

This policy statement should be displayed prominently on all operational sites.'

Group businesses are required to implement this policy as applicable to their operations in respect of matters over which they have operational control. As a support services provider, many of our operations are carried out on sites belonging to our customers and for which customers retain, to varying degrees under the terms of the relevant contract, environmental responsibility, particularly for the management or rectification of historical environmental conditions. We also work to the service levels required by customers. Some customers may not require us, as part of the service level for which they are willing to pay, to go beyond compliance with minimum legal requirements. In other cases, customers may require us to manage operations in, or bring them into, compliance with the customer's own bespoke environmental management plans on timescales chosen by the customer. Nonetheless, our BIS division is accredited with ISO14001 and our BDS division will increasingly be seeking that accreditation for sites where this is agreed with the customer under the terms of the relevant contracts.

On those sites that we do effectively own and control, such as Rosyth, we have made significant advances in environmental management. For example, since taking over management of the Rosyth Dockyard (and later ownership) we have spearheaded an energy efficiency campaign resulting in a 40% reduction in electricity costs at the site, a reduction year-on-year of gas consumption costs of nearly 20% despite significant price rises and a reduction in water consumption of some 35%. In South Africa we are taking steps to be in a position to obtain OHSAS18000 (Occupational Health and Safety specification) together with ISO90001 (quality) and ISO14001 (Environmental) certificates, by the end of 2004.

**Ethical conduct**

We insist on the highest standards of honesty and integrity in all aspects of the group's business. This includes, but is not limited to, compliance with the laws and standards of conduct required in the countries in which the group operates and does business. A strict ethical policy, and guidance on business dealings, which we believe complies with international standards, has been issued to relevant group employees and is kept under review. Employees are required to avoid conflicts of interest regarding group business, to act lawfully and ethically, and to be responsible for communicating in good faith non-compliance issues of which they become aware.

To ensure compliance with the Public Interest Disclosure Act 1998 in the United Kingdom, the group has a procedure for employees to bring matters to the attention of the Company Secretary if they do not feel able to approach their line managers.

**Employees**

Group companies have hitherto followed policies and practices within their own operations as appropriate to ensure that talent is recognised and training and improvement encouraged. This involves training and development programmes for senior managers, managers, bid teams and project managers as well as apprentice training. We are currently engaged in a major review of training and staff development needs and programmes, having identified opportunities to bring a better structured and more focused group-wide approach. An implementation plan will roll this new approach out across our businesses.

We continue to use and develop a variety of means to improve communications with our employees. As well as using traditional cascade briefings, director/employee briefings and employee and union consultation forums and divisional newsletters, we have during the year under review significantly revamped and improved our group-wide publications to employees by the launch of our 'BIG Picture' magazine which looks at all aspects of the group's businesses and launched a group-wide intranet. Looking outwards, we have substantially enhanced our website for the benefit of customers, employees and shareholders alike.

As a group we have non-discriminatory employment policies. Full consideration is given to disabled applicants for employment, having regard to their particular aptitudes and abilities, and they share in the opportunities for training, career development and promotion. If an employee becomes disabled, our objective is, wherever possible, the continued provision of suitable employment either in the same or an alternative position, with appropriate training being given if necessary.

In the year ended 31 March 2004 Babcock International Group PLC employed an average of 6,356 staff worldwide, the majority being located in the United Kingdom.

**Babcock in the community**

Our business divisions and group headquarters support a range of charitable and community projects consistent with the company's interests.

**P L Rogers** Group Chief Executive
19 May 2004

# Statement on Corporate Governance

**Statement of compliance with the Combined Code**

During the year ended 31 March 2004 the company complied with the requirements of section 1 of the Principles of Good Governance and Code of Best Practice as it applied for reporting years commencing prior to 1 November 2003 (the 'Combined Code'). The Board has noted the changes made to the Combined Code following the Higgs Report and applicable for reporting years commencing on or after 1 November 2003, and to the extent that at the date of this document the company has not yet fully implemented the new recommendations that apply to the company from the current financial year the Board will be considering their implementation, having regard to the company's particular circumstances. To the extent that it should decide not fully to implement those recommendations, or to implement them in a particular way, it will explain the reasons in the company's annual report for the year ending 31 March 2005. This statement sets out how the principles of good governance in the Combined Code have been implemented.

**Board, Directors and independence**

*Chairman and Chief Executive functions; Senior Independent Director*

Until 31 July 2003 Mr Campbell held the post of Executive Chairman (when there was no Chief Executive Officer position), but with Mr Rogers, in his then capacity of Chief Operating Officer, having responsibility for the day-to-day operational matters of the group. On 1 August 2003, Mr Campbell's role changed when he became part-time Chairman and Mr Rogers was appointed as Group Chief Executive Officer. Lord Hesketh as Deputy Chairman is recognised by the Board as the Senior Independent Director to whom concerns may be conveyed by shareholders if they have concerns which have not been resolved through the normal channels of Chairman, Chief Executive or Finance Director.

*The Board*

It is a main principle of the Combined Code that Boards should be balanced between executives and non-executives (and in particular independent non-executives) such that no individual or small group of individuals can dominate the Board's decision taking, and also that there should be progressive refreshing of the Board. The Board considers that it complies with both principles. In the company's case there have been major changes to the Board since the 2000 AGM, with a completely new executive team, the retirement in 2002 of a long-serving non-executive Director and the appointment in each of 2002 and 2003 of new independent non-executive Directors, Mr Rennocks and Sir Nigel Essenhigh respectively. The Board now comprises of a part-time Chairman, two full-time executive Directors and five non-executive Directors. The Board believes that it has an appropriate balance of Directors with longer, medium and shorter term service. In addition, all Directors have been offered for election and re-election within the past two years with the exception of Mr Campbell who will be offering himself for re-election at the forthcoming Annual General Meeting. Lord Hesketh will also offer himself for re-election at that meeting even though he was last re-elected in July 2002. This complies with the revised Combined Code, as he has now served more than nine years on the Board. If re-elected, he will continue to offer himself for re-election annually as required by the Code. The Board recommends shareholders to vote in favour of Lord Hesketh's re-election for, in its view, he continues to bring valuable experience and insight for the benefit of the company, particularly on matters relating to Government, which is of course of major interest to the group's businesses. The Chairman confirms in his statement on page 5, as required by the revised Combined Code, that, having formally evaluated his performance, the Board is of the view that Lord Hesketh continues to be effective and to demonstrate commitment to his role, including commitment of time for Board and committee meetings and any other duties. The Directors (and, in particular, the other non-executive Directors) are of the view that Lord Hesketh continues to be independent notwithstanding that he has been on the Board for more than nine years, considering him to be a man of considerable and robust independence of thought and expression with no connections with the executive Directors. The Board also considers all its other non-executive Directors, Mr Turner, Mr Shah, Sir Nigel Essenhigh and John Rennocks, to be independent. Although Lord Hesketh and Mr Turner are both Directors of BAE Systems PLC, the Directors (and in particular the other non-executive Directors) do not consider this fact of a common directorship to in any way affect their independence in their capacity as non-executive Directors of the company.

All Directors have full and timely access to information.

The company's Articles of Association require that each Director must submit himself for re-election at least every three years.

The full Board formally met nine times in the financial year under review. Lord Hesketh was unable to attend on two occasions and each of Mr Turner, Mr Rogers, Sir Nigel Essenhigh and Mr Rennocks were unable to attend on one occasion, otherwise all Directors attended all the formal meetings. The Directors are aware of the principle in the revised Combined Code that the Board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors and will during the current financial year be considering the implementation of that principle.

*Board Committees – the Audit and Risk Committee*

For the year under review, the Board's Audit and Risk Committee consisted throughout the year, and currently consists, of all the non-executive Directors under the Chairmanship of Mr Rennocks, a former Finance Director of Corus Group PLC, namely:

**J L Rennocks (Committee Chairman)**
**The Rt Hon Lord Hesketh**
**D J Shah**
**M J Turner**
**Sir Nigel Essenhigh**

Biographical details of the members of the Committee are set out on page 22.

The Committee has formal terms of reference that have been updated, the Board having considered the recommendations made in the Smith Report. As recommended by the revised Combined Code, the Committee's terms of reference are available on the company's website. Committee meetings are attended, at the invitation of the Committee, by the Group Chairman, Group Chief Executive Officer and the Group Finance Director. The Company Secretary acts as secretary to the Committee. The Group Risk Manager is invited to attend meetings for discussion of group risk reports and related items. Ernst & Young LLP, who provide internal audit services to the company, attend for the part of the meetings relevant to their responsibilities and PricewaterhouseCoopers LLP, the group's external auditors, attend for the whole of the meetings. Committee members have the opportunity of meeting the auditors (internal and external) in the absence of executive Directors.

The Committee decided to appoint Ernst & Young LLP to provide internal audit services to the company with effect from May 2003; they are responsible to the Committee. This arrangement replaced the previous internally-provided audit service and followed a review by the company of its needs against the size and structure of the internal function that it could reasonably expect to sustain and utilise on a cost effective basis.

The Committee met formally twice in the year under review. The Committee is scheduled to meet formally three times in the current financial year. Mr Turner was unable to attend the meetings of the Committee held in the year under review and Mr Rennocks had, for personal reasons, to be absent on one occasion. All other Committee members were present at the meetings.

At its meetings in the year ended 31 March 2004, in addition to reviewing the preliminary and interim results and the proposed announcements relating to them, the Committee considered internal audit reports prepared by Ernst & Young LLP, the group risk standard and its implementation together with group risk reports, the draft statutory report and accounts of the company and external auditors' comments thereon, and the level of audit and non-audit fees. It also conducted a going concern review and determined priorities for the internal audit service.

The Committee will in the current financial year be reviewing arrangements by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The company's current arrangements in this regard are described in the Corporate and Social Responsibility Review on page 26.

In order to safeguard the objectivity and independence of the company's external auditors, the Committee Chairman must expressly authorise any engagement of those auditors on non-audit work that would entail their being paid fees in excess of 20% of the audit fee in any year. Careful consideration is given on each occasion as to potential conflicts and the possibility of actual or perceived threats to the independence of the external auditors before instructing them in connection with non-audit work. Instructions are given only when the company considers it to be in its best interests to use the external auditors other than in connection with pure audit services.

*Board Committees – the Remuneration (and Nomination) Committee*

Full details of the membership of this Committee (currently, all the non-executive Directors of the Board) and its report for the year under review are set out in the Remuneration report on page 30. The Committee met formally on four occasions in the year under review. Lord Hesketh, Mr Turner and Mr Rennocks were each unable to attend one meeting, but otherwise all Committee members were present at these meetings. The Remuneration Committee also performs the role of a Nomination Committee and its terms of reference (available on the company's website) are written accordingly. The Committee has during the year under review, performing the functions of a Nomination Committee, dealt with the change of roles of Mr Campbell and Mr Rogers and has also addressed other succession matters. Mr Rogers was recruited in 2002 as Chief Operating Officer but with the intention, of which he was aware on recruitment, of his becoming Group Chief Executive Officer subject to the Committee being satisfied with his performance. His performance was such that the Committee was able to confirm his appointment as Group Chief Executive Officer with effect from 1 August 2003.

*Contact with shareholders*

The company has regular contact with its shareholders, both institutional and individual, typically involving the Chairman and/or the Group Chief Executive Officer and the Group Finance Director. Reports on these meetings and general feedback from investors or the market are made to the Board. The Annual General Meeting is used as an important opportunity for communication with shareholders. All of the company's Directors attended the 2003 Annual General Meeting. The company's website is also available for shareholders to keep themselves advised of developments. It is regularly updated with press releases and analyst presentations. Shareholders can register on the website to be sent news releases automatically.

**Accountability and audit**

*Going concern*

The Financial Statements have been prepared on a going concern basis as the Directors have, after making enquiries, a reasonable expectation that the group will have adequate resources to continue in operational existence for the foreseeable future.

*Internal controls*

The Board of Directors has overall responsibility for the group's system of internal controls, and for monitoring its effectiveness. Whilst delegating certain of its day to day powers to executive management, the Board retains responsibility for major matters such as setting overall strategy, approving annual budgets, equity investments, business acquisitions and disposals, significant contracts outside the ordinary course of business and treasury policy. The retention of such powers is with a view to ensuring that the Board and/or its Committees maintain effective control over appropriate strategic, financial, organisational and compliance issues.

There has been a process for identifying, evaluating and managing significant risks throughout the period under review up to the date of the approval of the Financial Statements for the year ended 31 March 2004. This process is in accordance with Internal Controls: Guidance for Directors on the Combined Code published in September 1999. The group's systems are designed to manage rather than to eliminate the risk of failure to achieve business objectives, recognising that any system can only provide reasonable and not absolute assurance against material misstatement or loss. The key features of this system are described below.

**Control environment and procedures**

The group operates decentralised, profit-responsible units reporting through a Divisional management structure with clear delegated levels of authority and an established system of internal control.

Key controls and procedures are promulgated as formal group policies and authorities. Together, these controls include defined procedures for seeking approval for both significant commitments and organisational changes, and are updated as necessary.

### Identification and evaluation of risks and control objectives

The Board has the primary responsibility for identifying the major business risks facing the group and developing appropriate policies to manage those risks. The group has a Group Risk Manager, reporting directly to the Group Finance Director, who oversees a group Risk Standard that has been promulgated across the organisation requiring businesses and operations, in a consistent manner, to monitor, identify and clarify risks and the steps that can be taken to reduce, eliminate or manage them. Group risk registers are compiled from this information and are reviewed by the Audit and Risk Committee.

Given the nature of the group's business, the principal risks relate to out-turn on contracts and the success rate in bidding for contracts. All proposed and actual bids for significant contracts are subject to continuous monitoring and review by a 'Bid Executive', consisting of the Group Chief Executive Officer, Group Finance Director, Divisional Managing Directors and representatives from other central functions. It usually meets monthly. Its function is to ensure that group resources are properly focused on appropriate, realistic and remunerative bidding opportunities that are the most suitable having regard to the strengths of the group and its development objectives. The final submission of significant bids requires formal approval from one or more executive Directors to ensure that they meet group criteria. Progress on all significant contracts is continually monitored within the relevant Division and is reviewed quarterly by Group Head Office. In addition to the Bid Executive meetings, there are regular meetings of a Group Executive Committee consisting of the Group Chief Executive Officer, the Group Finance Director, Divisional Managing Directors, the Company Secretary and the Group Business Development Director. It considers the ongoing conduct and performance of the group's business and reviews key management matters, including health and safety.

### Information and communication

Comprehensive budgeting systems are in place to develop annual budgets covering the key aspects of each Division's business. The budgets are subject to review by central management prior to submission to the Board for approval. Updated forecasts for the year are prepared on a regular basis. Actual performance is compared each month with budgets, forecasts and the prior year, with written commentary on significant variances from approved plans.

### Monitoring

For the year under review, the internal control system was monitored and supported by an internal audit service provided by Ernst & Young LLP acting under the overall control of the Audit and Risk Committee that determines its areas of focus. These activities are supplemented by review visits by group management.

The Board of Directors has reviewed the effectiveness of the system of internal controls in place as part of the reviews conducted of the group risk register reports, internal audit reports and external audit reports to the Audit Committee.

### 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 the group and of the profit or loss of the group 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; and
- prepare the Financial Statements on a going concern basis unless it is inappropriate to presume that the company and the group will continue in business.

The Directors are responsible for maintaining proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and the group and to enable them to ensure that the Financial Statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

A copy of the Financial Statements of the company is placed on the company's website. The maintenance and integrity of this website is the responsibility of the Directors. The work carried out by the auditors does not include consideration of these matters, and accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# Remuneration report

## Remuneration Committee

This report sets out the company's policy on the remuneration of its Directors which it followed for the year under review and intends to follow for the current financial year and subsequent years. It also provides details of the Directors' remuneration packages and contracts. The report will be the subject of an advisory vote at the forthcoming Annual General Meeting of the company.

Responsibility for determining and approving the remuneration packages of the executive Directors and certain other senior group executives has been delegated by the Board to a Remuneration Committee ('the Committee') consisting solely of all the non-executive Directors of the company, each of whom the Board considers to be independent. Those Directors who served on the Committee during the last financial year (in each case they served for the whole year), and who are currently members of the Committee were and are as follows, namely:

**The Rt Hon Lord Hesketh (Committee Chairman)**
**D J Shah**
**M J Turner**
**J L Rennocks**
**Sir Nigel Essenhigh**

Biographical details of the members of the Committee are set out on page 22.

The Committee invites Mr Campbell and Mr Rogers to attend meetings in their capacities as Chairman and Group Chief Executive respectively, but neither is present when their own remuneration is under discussion. The Company Secretary attends as Secretary to the Committee. The Committee has access to market research on remuneration. Advice on matters affecting remuneration is sought by or on behalf of the Committee from Mr Campbell and Mr Rogers (other than in respect of their own remuneration), in connection with the structuring and operation of share awards and share schemes from Pinsents (solicitors with recognised expertise and experience in executive and employee share schemes) and, for advice on executive remuneration (including in relation to share options and long-term incentive plans) from Inbucon Limited (remuneration consultants). Pinsents also provide legal services to group companies. Inbucon Limited do not provide other services to group companies. Both firms have been appointed for these purposes, with the Committee's approval, by the company (acting through the Group Company Secretary).

The Committee also acts as the Nomination Committee in connection with the appointment of new Directors.

## Remuneration policy

*Basic policy*

The remuneration policy of the Committee is ordinarily to provide executive Directors and senior executives with basic remuneration packages that, looked at as a whole, are competitive having regard to the median for companies of a similar size in business sectors in which the group operates, with the opportunity to earn upper quartile rewards for upper quartile performance, and that are sufficient to recruit, retain and motivate executives in the light of the company's needs and development objectives.

Remuneration packages consist, to varying degrees as between individuals, of fixed elements – basic salary, pension entitlements and typical benefits in kind – and performance related elements – annual bonus schemes (linked to company and/or personal performance) and share-based or share-related longer term incentive schemes including grant of options under share option schemes and awards of shares under a long-term incentive plan (L-TIP) and this report describes the various elements of the packages for each of Mr Campbell, Mr Rogers and Mr Tame for the year under review. For that year, the performance related element consisted, for Mr Rogers and Mr Tame, of annual bonus schemes (the value of which was capped as described below) and, for each of Mr Campbell, Mr Rogers and Mr Tame, share awards under the L-TIP. Remuneration advice from Inbucon Limited indicates that our remuneration structure is consistent with mid market practice amongst UK companies of comparable size.

*Performance related rewards:*

*Annual bonus schemes:*

The Remuneration Committee determines a performance related annual bonus scheme for each executive Director at the beginning of each financial year. For the year ended 31 March 2004 the annual bonus payable to Mr Rogers and Mr Tame was dependent on the financial performance achieved by the group against budget and on the achievement of specific personal objectives. The maximum potential annual bonus for each of them is 50% of basic salary. Similar schemes are in place for Mr Rogers & Mr Tame for the current financial year. Annual bonuses are not pensionable. Since 1 August 2003, Mr Campbell has no contractual entitlement to an annual bonus.

*Long-term incentives:*

The Committee is firmly of the view that offering senior executives the opportunity to be awarded shares in the company, or cash awards linked to the value of the company's shares, is an important part of motivating and rewarding key employees so that they may participate in the future growth in value of the company. The company has both share option schemes and a share-based long-term incentive plan.

It is the policy of the Committee that, since 1 April 2003, share-related incentives to Directors will be made under the long-term incentive plan described below, and not under the company's executive share option schemes. Directors do, however, continue to hold share options granted prior to 2003. Grants of options under the executive share option schemes established in 1999 may continue to be made to senior employees but not, in any year, to recipients of an award under the long-term incentive plan in that year.

Further details of the company's executive share option schemes and long-term incentive plan are also set out in the Directors' Report on page 24. Details of executive share options and share awards under the long-term incentive plan already granted to Directors are set out in the tables on pages 34 and 35.

*Share options:*

Under the Babcock 1999 Approved Executive Share Option Scheme and the Babcock 1999 Unapproved Executive Share Option Scheme ('the 1999 Schemes'), performance criteria have been applied to the grant of options. The current executive Directors of the company hold options only under the 1999 Schemes or under option agreements (described further on page 35) that mirror those schemes as to performance criteria.

The performance criterion for the vesting of options granted before 2003 under the 1999 Schemes is based on comparative total shareholder return ('TSR'), with the company's performance over the three financial years beginning with the financial year in which the option was granted being assessed in relation to companies within the Engineering and Machinery section of the FTSE All-Share Index. In so far as the company's TSR performance is in the top quartile, share option awards will vest in full; if the company is ranked at the first position above median, 25% of the option shares will vest, with proportionate vesting for performance between those levels. In so far as the company's performance is at or below the median, no options will vest. This comparator group was chosen as being the appropriate comparator group at the time of the grants when the company was part of the Engineering section of the FTSE All-Share Index.

The performance criterion for grant of options made in 2003 under the 1999 share option schemes (which were made only to employees other than Directors of the company), and the intended criterion for grants made in the current financial year, is as stated above except that the comparator group was and will be the companies comprising the FTSE All-Share Index (excluding investment trusts).

No grants of share options were made to executive Directors in the year ended 31 March 2004 as they received awards under the long-term incentive plan referred to below.

*Long-Term Incentive Plan (L-TIP)*

At last year's Annual General Meeting of the company, shareholders approved the establishment of a long-term incentive plan (L-TIP) under which share-based awards may be made to executive Directors and other senior managers. As stated last year, it is the current policy of the Committee to make awards to executive Directors only under the L-TIP and not under the company's executive share option schemes.

Under the L-TIP, selected senior executives (including executive Directors) within the group may be awarded each year conditional entitlements to shares in the company ('Award Shares') or to a cash sum whose value is linked to a notional award of Award Shares. It is intended that such awards will be made only to the executive Directors of the company and a limited number of other senior executives in the group. The initial market value of the shares over which any such award is made in any year may not exceed 100% of the amount of the participant's basic annual salary at the date of grant (save in so far as a share award may be grossed up to compensate the award holder for the cost of employer's National Insurance Contributions if the Committee exercises its discretion to require the award holder to bear that cost). The number or proportion of Award Shares that vest will be determined by reference to the extent to which pre-set targets, relating to the performance of the company over the three financial years of the company beginning with that in which the award is made, are met or exceeded.

Performance targets are set by the Committee when an award is made, having regard to current market conditions. In relation to awards made under the L-TIP in the year under review, the target provides for no vesting unless the company is above the median ranking in a table of comparator companies ranked according to total shareholder return over the three years ending 31 March 2006 and the company's adjusted earnings per share pre-goodwill and exceptional items in the year ending 31 March 2006 are at least 9.27% (representing a 3% per annum compound growth rate) greater than the basic earnings per share pre-goodwill and exceptional items for the year ended 31 March 2003.
The rules of the L-TIP, in common with equivalent rules in the company's executive share option schemes, allow the remuneration committee a discretion to permit earlier vesting of all or part of awards (but normally no more than a time apportioned proportion), having regard to company performance, in the event of a director leaving the group or on a change of control before completion of the performance period. A ranking immediately above the median level in the comparator table would result in 25% of Award Shares vesting while a ranking in the top quartile would result in 100% vesting. Rankings between these threshold levels would result in proportionate vesting calculated on a straight-line basis between 25% and 100% respectively. The comparator companies used were all of the UK listed companies in the FTSE All-Share Index (excluding investment trusts).

The Committee intends to apply similar criteria to any share awards made in the current financial year, by reference to a performance period of the three financial years ending on 31 March 2007.

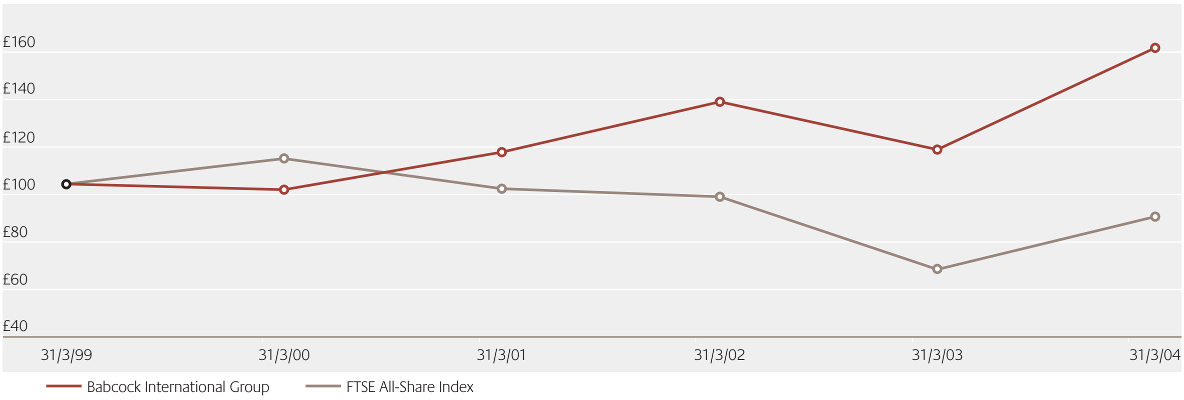
Awards made under the L-TIP have been made as rights to acquire shares granted by the trustee of The Babcock Employees' Share Trust ('the Trustee') acting on the recommendation of the Committee.

Companies comprising the FTSE All-Share Index (other than investment trusts) were selected as the currently appropriate comparator group for share-based awards or grants of options as reflecting the fact that shareholders can choose, instead of investing in shares of the company, to invest in any other listed shares.

*Performance graph*

The graph on page 32, compiled by Inbucon Limited shows the total shareholder return for a holding in the company's shares for the period from 31 March 1999 to 31 March 2004 relative to a holding of shares representing the FTSE All Share Index. This index has been selected as generally the companies forming part of it comprise the comparator group currently being used for share awards granted to directors. It is therefore considered as being a broad index representing alternative investment opportunities for shareholders. In last year's Remuneration report we also included a graph comparing performance to the Engineering and Machinery sector of the FTSE All Share Index as until then that had been the comparator group of companies used in respect of option grants.

**Total Shareholder Return Monitoring: Babcock International Group vs FTSE All-Share Index**
Cumulative Total Shareholder Return Value of £100 investment on 31 March 1999




*Directors' pensions*
UK based executive Directors of the company are eligible for membership, by invitation, of the company's defined benefit pension plan. This would entitle them, subject to Inland Revenue limits and period of service, to a retirement pension of up to two-thirds of their base salary in the 12 months prior to attaining age 60 and life assurance cover of up to four times base salary up to the earnings cap. For those eligible executive Directors invited to participate in the pension scheme whose earnings exceed the Inland Revenue earnings cap, the company will, on request, establish a Funded Unapproved Retirement Benefit Scheme (FURBS) and take out additional life assurance cover to provide additional retirement and life assurance benefits based on salary in excess of the earnings cap. The company may in lieu of membership of the defined benefit plan or a FURBS make a salary enhancement to reflect this, offer membership of a defined contribution scheme and/or make payments to a personal pension plan. Mr Tame is currently a member of the company's defined benefit scheme and benefits from a FURBS. Neither Mr Campbell nor Mr Rogers receive pensions benefits from the company, and their salaries take this into account.

A summary of Directors' pension entitlements is set out at page 33.

*Non-executive Directors*
It is currently company policy that non-executive Directors do not participate in any of the company's share, pension or bonus schemes. They are remunerated solely by fees that are reviewed against market practice at least every three years by the executive Directors, to whom the task has been delegated by the Board.

**Directors' emoluments and compensation (audited)**
The Directors' emoluments for the year ended 31 March 2004 are set out in the table below:

| Director | Salary or fee (Fixed) £'000 | Bonus (Performance related) £'000 | Benefits** (Fixed) £'000 | Total Year ended 31 March 2004 £'000 | Total Year ended 31 March 2003 £'000 |
|---|---|---|---|---|---|
| **Executive** | | | | | |
| G A Campbell (Chairman, part-time from 1 August 2003) | **288** | – | **1** | **289** | 622 |
| P L Rogers (Chief Executive Officer) | **340** | **170** | **16** | **526** | 373 |
| W Tame (Group Finance Director) | **219** | **98** | **26** | **343** | 319 |
| M Easton*† | – | – | – | – | 35 |
| Dr G Schäfer*† | – | – | – | – | 260 |
| **Non-executive** | | | | | |
| The Rt Hon Lord Hesketh KBE | **52** | – | – | **52** | 51 |
| J Rennocks† | **32** | – | – | **32** | 25 |
| D J Shah | **27** | – | – | **27** | 26 |
| M J Turner CBE | **27** | – | – | **27** | 26 |
| Sir Nigel Essenhigh† | **27** | – | **1** | **28** | 2 |
| A E Wheatley*† | – | – | – | – | 12 |
| Total | **1,012** | **268** | **44** | **1,324** | 1,751 |

*Former Director.
**Benefits comprised medical insurance, home to work expenses and accommodation expenses for Mr Rogers and for Mr Tame. In addition Mr Tame had contributions to FURBS. Mr Campbell only had home to work expenses reimbursed.
†The remuneration for the year ended 31 March 2003 relates to the part period of that year for which the Director held office.

The fees for Lord Hesketh reflect his additional duties as Deputy Chairman and Chairman of the Remuneration Committee. Mr Rennocks' fees reflect his additional duties as Chairman of the Audit and Risk Committee.

Bonus payments and benefits are not pensionable.

## Directors' pensions (audited)

*Babcock International Group Pension Scheme*

Mr W Tame is a member of the upper tier of the Babcock International Group Pension Scheme.

Details of the Directors' pension entitlements under the Babcock International Group Pension Scheme (defined benefit) are set out in the following table:

| Director | Accrued pension at 31 March 2004 £ pa | Increase in accrued benefits during the year ended 31 March 2004 £ pa | Change in accrued benefits after allowing for inflation £ | Transfer value at 1 April 2003 £ | Transfer value at 31 March 2004 £ | Increase in transfer value including inflation less director's contributions £ | Increase in transfer value excluding inflation less director's distributions £ |
|---|---|---|---|---|---|---|---|
| W Tame | **7,549** | **3,377** | 3,260 | 37,016 | **86,511** | 25,354 | 39,745 |

(1) Inflation has been taken as 2.8% for the purposes of calculating increases in transfer values and pension earned.

(2) The transfer value of the increase in pension accrued is calculated in accordance with Actuarial Guidance Note GN11, and is stated after deducting members' contributions.

(3) The figures in the above table make no allowance for the cost of death in service benefits under the Scheme.

(4) The figures in the above table make no allowance for any benefits in respect of earnings in excess of the Inland Revenue earnings cap.

(5) If any member has significant benefits retained in any pension scheme provided by previous employers then the pension entitlements shown above may be restricted to a lower amount and the figures may need to be reduced accordingly. In calculating the above figures for Mr W Tame no account has been taken of any retained benefits which he may have.

(6) No payments have been made to retired Directors in excess of the retirement benefit to which they were entitled on the date the benefits first became payable or, if later, 31 March 1997.

### Other pension arrangements

The amount of contributions made to the Directors' own pension plans or FURBS and former Directors' FURBS arrangements, including the cost of providing any additional life assurance cover, are set out in the table below:

| Director | 2004 £'000 | 2003 £'000 |
|---|---|---|
| Mr G A Campbell | – | 29 |
| Dr G Schäfer* | – | 33 |
| W Tame | **10** | 11 |
| M S Easton* | – | 2 |
| | **10** | 75 |

*Former Director.

Contributions to a FURBS for Mr Tame are fixed such that the total cost to the company, including tax and National Insurance, is 20% of basic salary over the earnings cap plus the cost of providing additional life assurance cover for earnings above the cap.

### Directors' share options (audited)

Details of Directors'/*former Directors' share options are set out in the table below and the notes beneath it:

| Director | Option scheme | Number of shares subject to options at 1 April 2003 | Granted during the year | Exercised during the year | Lapsed during the year | **Number of shares subject to options at 31 March 2004** | Exercise price (p) | Exercisable from | Expiry date |
|---|---|---|---|---|---|---|---|---|---|
| G A Campbell | e | 560,975 | | | | **560,975** | 123.00 | Nov 2003 | Nov 2010 |
| | c | 30,202 | | | | **30,202** | 99.33 | Jun 2004 | Jun 2011 |
| | d | 282,573 | | | | **282,573** | 99.33 | Jun 2004 | Jun 2011 |
| | d | 317,590 | | | | **317,590** | 124.50 | Jun 2005 | Jun 2012 |
| P L Rogers | e | 401,606 | | | | **401,606** | 124.50 | Jun 2005 | Jun 2012 |
| W Tame | c | 28,754 | | | | **28,754** | 104.33 | Jan 2005 | Jan 2012 |
| | d | 201,285 | | | | **201,285** | 104.33 | Jan 2005 | Jan 2012 |
| | d | 198,125 | | | | **198,125** | 124.50 | Jun 2005 | Jun 2012 |
| Dr G Schäfer*†† | b | 304,288 | | 304,288 | | – | 77.00 | | |
| | b | 340,017 | | 340,017 | | – | 82.00 | | |
| | b | 316,614 | | 316,614 | | – | 89.00 | | |
| | d | 180,020 | | 180,020 | | – | 118.00 | | |
| | d | 189,472 | | 189,472 | | – | 96.33 | | |
| M S Easton*†† | a | 35,502 | | 35,502 | | – | 84.50 | | |
| | b | 130,178 | | 130,178 | | – | 84.50 | | |
| | b | 56,909 | | 56,909 | | – | 82.00 | | |
| | b | 239,700 | | 239,700 | | – | 89.00 | | |
| | b | 179,591 | | | 179,591 | – | 122.50 | | |
| | d | 120,654 | | *120,654* | | – | 96.33 | | |
| | d | 23,287 | | | | **23,287** | 99.33 | Jun 2004 | Dec 2004 |

where:
a = Babcock International Group PLC Approved Executive Share Option Scheme
b = Babcock International Group PLC Unapproved Executive Share Option Scheme
c = Babcock 1999 Approved Executive Share Option Scheme
d = Babcock 1999 Unapproved Executive Share Option Scheme
e = Share Option Agreement
†† = Share options held at cessation of appointment as a Director which the Director was entitled or permitted to retain. The mid-market closing price for the shares on the date that Dr Schäfer exercised his retained options during the year was 126.5p. The mid-market closing price for the shares on the date that Mr Easton exercised retained options during the year was 107p save in the case of those shown in italics when the price was 120.5p.

There were no options exercised during the year by any of the continuing Directors.

The exercise prices of the options granted under the company's executive share options schemes were not set at a discount to the market value of the company's shares at the date of grant.

Directors may exercise their options between the third and tenth anniversary of the date of grant or, subject to the rules of the schemes, earlier in other circumstances such as on leaving the group or in the event of a change of control. There were no performance criteria attached to the right to exercise options under the Babcock International Group PLC Approved Executive Share Option Scheme and the Babcock International Group PLC Unapproved Executive Share Option Scheme. None of the current Directors hold or have held options granted under those schemes. There are performance criteria (as described on page 31) attaching to options granted under the Babcock 1999 Approved and Unapproved Executive Share Option Schemes.

Each of Mr Campbell and Mr Rogers were recruited on terms that provided for the issue, shortly after their respective appointments, of share option contracts with the Trustee of the Babcock Employees' Share Trust enabling them to purchase shares in the company equivalent in value (at the effective date of the contract) to twice their then rates of basic salary. These options (which are shown in the above table as being granted pursuant to a Share Option Agreement) take the form of bilateral contracts between the Trustee and Mr Campbell and the Trustee and Mr Rogers each on terms, including as to performance criteria, which mirror those governing options granted under The Babcock 1999 Unapproved Executive Share Option Scheme, save only that if the company comes under the control of another person or persons in consequence of a general takeover offer, these options granted pursuant to the option agreements become immediately exercisable in respect of all of the shares over which they are held. The performance criterion applicable under the option contracts is the TSR based criterion (comparator group: Engineering and Machinery section of the FTSE All-Share Index mentioned on page 31 above as applying to share options granted under the 1999 schemes before 2003). The provisions of the option contracts cannot be altered to the advantage of Mr Campbell or Mr Rogers without the prior approval of the company's shareholders in general meeting. The benefits under the option contracts are not pensionable.

### Directors' share awards under the L-TIP (audited)

Details of share awards made to Directors are set out in the table below:

| Director | Number of shares subject to award at 1 April 2003 | Granted during the year | Exercised during the year | Lapsed during the year | **Number of shares subject to award at 31 March 2004** | Market value of each share at date of award | Exercisable from | Expiry date |
|---|---|---|---|---|---|---|---|---|
| G A Campbell | – | 167,400 | – | – | **167,400** | 113.5p | Jul 2006 | Jul 2013 |
| P L Rogers | – | 255,506 | – | – | **255,506** | 113.5p | Jul 2006 | Jul 2013 |
| W Tame | – | 171,806 | – | – | **171,806** | 113.5p | Jul 2006 | Jul 2013 |

The awards were made, by the Trustee of the Babcock Employee Share Trust, as conditional rights to acquire shares (effectively nil cost options), and the number of shares awarded was based on the average of the mid-market closing price of the company's shares for the three dealing days preceding the date of the award. For each of Mr Rogers and Mr Tame the value of the award on grant was equivalent to his annual salary at the date of grant and for Mr Campbell was equivalent to his anticipated annual salary as part-time Chairman which took effect on 1 August 2003. Subject to satisfaction of the performance criteria (see page 31) attached on the grant of the awards, the Directors may call for the release to them of the shares subject to the award during the above shown exercise period. Subject to the rules of the plan, an earlier release of shares maybe allowed by the Remuneration Committee (for example, in the event of a cessation of employment or a change in control) but normally of not more than a time-apportioned proportion and then only having regard to the company's performance.

There were no changes in the current Directors' share options or share awards between 31 March 2004 and 19 May 2004.

The company's mid-market share price at close of business on 31 March 2004 was 116.5p. The highest and lowest mid-market share prices in the year ended 31 March 2004 were 138.5p and 88p respectively.

### Service contracts

The following table sets out a summary of the Directors' service contracts or terms of appointment.

### Executive Directors

| Name | Date of service contract | Unexpired term | Notice period |
|---|---|---|---|
| G A Campbell | 31 July 2003 | 12 months | 12 months from company, six months from Director |
| P L Rogers | 31 July 2003 | 12 months | 12 months from company, six months from Director |
| W Tame | 20 September 2001 | 12 months | 12 months from company, six months from Director |

The company's policy for executive Directors' service contracts is for them to be capable of being terminated by the company on not more than 12 months' notice, and for the company to reserve the right to terminate those contracts without full notice by payment of basic salary in lieu of notice. In the event of a change of control of the company, the executive Directors' contracts provide that within 90 days of the occurrence of the change of control the executive Director may terminate his employment forthwith. In that case, or if, following a change of control, the Director's appointment is terminated within 12 months, the Director is entitled to a termination payment equal to 100% of his annual salary (plus, in the case of Mr Rogers and Mr Tame, an additional 40% in lieu of bonus and all other benefits). If, however, the Director exercises his right to terminate his employment contract within 90 days of a change of control, he will only be entitled to be paid on a monthly basis, for up to a period of 12 months, his basic salary (plus, in the case of Mr Rogers and Mr Tame, 40% in lieu of bonus and all other contractual entitlements) but any amount that they receive by way of income from other sources within that 12 month period, if it exceeds 10% of their salary, and that they would not have been able to earn had they continued in employment with the company, is deductible from the amounts otherwise payable by the company. Directors' service contracts terminate automatically on the Director reaching the age of 60. In the event of the termination of a Director's service contract by the company (other than following a change of control or by the exercise of the company's option to pay salary in lieu of notice) the company will have regard to all the circumstances in determining the amount of compensation, if any, payable to him in connection with that termination. Save as mentioned above, the contracts do not contain provisions for contractual payments on termination.

**Non-executive Directors**

*Current Directors*

| Name | Date of letter of appointment | Date of appointment as a Director | Expiry of present term of appointment* |
|---|---|---|---|
| Lord Hesketh | 3 March 2004 | 6 October 1993 | AGM for 2005 |
| M J Turner | 7 June 1996 (extended 6 June 2003) | 5 June 1996 | 31 December 2004 |
| D J Shah | 15 June 1999 (extended 27 June 2002) | 15 June 1999 | 15 June 2006 |
| J L Rennocks | 27 June 2002 | 13 June 2002 | 12 June 2005 |
| Sir Nigel Essenhigh | 25 February 2003 | 4 March 2003 | 3 March 2006 |

* Subject in each case to re-election as required by the company's Articles of Association and/or the Combined Code.

For non-executive Directors the company's policy is to have written terms of appointment, with initial appointments being for a three-year term, and in all cases appointments being terminable at will. Non-executive Directors are free to resign at any time. The written terms of appointment are available for inspection at the company's registered office and at the company's Annual General Meeting. The expected time commitment of non-executive Directors is either set out in their current written terms of appointment (if they have recently been issued to them) or is known, by experience, to the Directors concerned. During the course of the current financial year non-executive Directors who do not currently have the newer form letters of appointment, as envisaged in the Higgs Report, will be issued with them.

**Outside directorships**

The company considers that it can often be of benefit to it if a Director, executive or non-executive, holds directorships in other companies outside the group, provided that any such appointment does not conflict with the Director's duties to the company or with the group's best interests. Before taking up any outside appointment after becoming a Director of the company, a Director must first seek the approval of the Board. Any fees earned by a Director for his outside appointment are ordinarily retainable by him. Neither Mr Rogers nor Mr Tame have been released by the company to work as non-executive Directors elsewhere. Mr Campbell is employed by the company in a part-time capacity only and his earnings from any non-executive directorships in other companies held by him are earned in time not committed to the company.

This report has been approved by the Board and signed on its behalf by

**Lord Hesketh** Chairman of the Remuneration Committee
19 May 2004

# Independent auditors' report to the members of Babcock International Group PLC

We have audited the Financial Statements of Babcock International Group PLC which comprise the Profit and loss account, Balance sheet, the Cash flow statement, the Statement of total recognised gains and losses and Reconciliation of movement in shareholders' funds and the related notes numbered 1 to 33, which have been prepared under the accounting policies as set out therein. We have also audited the disclosures required by Part 3 of Schedule 7A to the Companies Act 1985 contained in the Directors' remuneration report ('the auditable part').

**Respective responsibilities of Directors and auditors**

The Directors' responsibilities for preparing the annual report and the Financial Statements in accordance with applicable United Kingdom law and accounting standards are set out in the statement of Directors' responsibilities. The Directors are also responsible for preparing the Directors' remuneration report.

Our responsibility is to audit the Financial Statements and the auditable part of the Directors' remuneration report in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards issued by the Auditing Practices Board. This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

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 auditable part of the Directors' remuneration report 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 is not disclosed.

We read the other information contained in the annual report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Financial Statements. The other information comprises only the Chairman's report, the Operations review, the Financial review, the Directors' report, the Statement on corporate governance, the Remuneration report and the Five year financial record.

We review whether the corporate governance statement reflects the company's compliance with the seven provisions of the Combined Code issued in June 1998 specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

**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 the auditable part of the Directors' remuneration report. 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 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.

**Opinion**

In our opinion:

- the Financial Statements give a true and fair view of the affairs of the company and the group at 31 March 2004 and of its profit and cash flows for the year then ended;
- the Financial Statements have been properly prepared in accordance with the Companies Act 1985; and
- those parts of the Directors' remuneration report required by Part 3 of Schedule 7A to the Companies Act 1985 have been properly prepared in accordance with the Companies Act 1985.

**PricewaterhouseCoopers LLP**
Chartered accountants and registered auditors
Embankment Place
London WC2N 6RH

19 May 2004

# Group profit and loss account

For the year ended 31 March 2004

| | Notes | 2004 Before goodwill and exceptional items £m | 2004 Goodwill and exceptional items £m | 2004 Total £m | 2003 Before goodwill and exceptional items £m | 2003 Goodwill and exceptional items £m | 2003 Total £m |
|---|---|---|---|---|---|---|---|
| Continuing operations | 2 | 438.0 | – | 438.0 | 377.9 | – | 377.9 |
| Discontinued operations | 2 | 14.0 | – | 14.0 | 45.6 | – | 45.6 |
| **Group turnover** | 2 | 452.0 | – | 452.0 | 423.5 | – | 423.5 |
| Cost of sales | 3 | (385.0) | – | (385.0) | (357.8) | – | (357.8) |
| Gross profit | | 67.0 | – | 67.0 | 65.7 | – | 65.7 |
| Net operating expenses | 3 | (41.8) | (3.3) | (45.1) | (44.9) | (1.9) | (46.8) |
| Continuing operations | | 25.5 | (3.3) | 22.2 | 23.0 | (1.9) | 21.1 |
| Discontinued operations | | (0.3) | – | (0.3) | (2.2) | – | (2.2) |
| **Group operating profit** | 2 | 25.2 | (3.3) | 21.9 | 20.8 | (1.9) | 18.9 |
| Share of operating profit/(loss) of joint ventures | 2 | 0.1 | – | 0.1 | (0.2) | – | (0.2) |
| Loss on sale of operations | 5 | – | (1.7) | (1.7) | – | (2.7) | (2.7) |
| **Profit/(loss) on ordinary activities before interest** | | 25.3 | (5.0) | 20.3 | 20.6 | (4.6) | 16.0 |
| Net interest and similar (charges)/income | 6 | (2.2) | 1.7 | (0.5) | (2.6) | – | (2.6) |
| **Profit/(loss) on ordinary activities before taxation** | | 23.1 | (3.3) | 19.8 | 18.0 | (4.6) | 13.4 |
| Tax on profit on ordinary activities | 8 | | | (3.4) | | | (5.1) |
| **Profit for the financial year** | | | | 16.4 | | | 8.3 |
| Dividends paid and proposed | 10 | | | (4.9) | | | (4.4) |
| **Retained profit for the financial year** | 26 | | | 11.5 | | | 3.9 |
| Earnings per share | | | | | | | |
| – Basic | 11 | | | 11.31p | | | 5.72p |
| – Diluted | 11 | | | 11.28p | | | 5.69p |
| Earnings per share before exceptional items and goodwill | | | | | | | |
| – Basic | 11 | | | 13.60p | | | 8.91p |
| – Diluted | 11 | | | 13.57p | | | 8.87p |

The accompanying notes are an integral part of this group profit and loss account.

# Group balance sheet
As at 31 March 2004

| | Notes | 2004 £m | 2004 £m | 2003 £m | 2003 £m |
|---|---|---|---|---|---|
| **Fixed assets** | | | | | |
| **Intangible assets** | 12 | | | | |
| Development costs | | | **0.7** | | 1.0 |
| Goodwill | | | | | |
| – Goodwill | | **81.5** | | 84.0 | |
| – Negative goodwill | | **(4.7)** | | (6.5) | |
| | | | **76.8** | | 77.5 |
| | | | **77.5** | | 78.5 |
| **Tangible assets** | 13 | | **12.2** | | 16.5 |
| **Investments** | 15 | | | | |
| Investments in joint ventures | | | | | |
| Share of gross assets | | **2.4** | | 1.4 | |
| Share of gross liabilities | | **(2.7)** | | (1.8) | |
| Loans to joint ventures | | **0.9** | | 0.8 | |
| | | **0.6** | | 0.4 | |
| Other investments | | **4.1** | | 3.9 | |
| | | | **4.7** | | 4.3 |
| | | | **94.4** | | 99.3 |
| **Current assets** | | | | | |
| Stocks | 16 | | **29.7** | | 23.4 |
| Debtors – due within one year | 17 | **75.2** | | 88.7 | |
| Debtors – due after more than one year | 17 | **64.0** | | 69.6 | |
| | | | **139.2** | | 158.3 |
| Cash and bank balances | | | **17.5** | | 12.7 |
| | | | **186.4** | | 194.4 |
| **Creditors –** amounts due within one year | 18 | | **(134.7)** | | (159.9) |
| **Net current assets** | | | **51.7** | | 34.5 |
| **Total assets less current liabilities** | | | **146.1** | | 133.8 |
| **Creditors –** amounts due after more than one year | 19 | | **(16.0)** | | (19.0) |
| **Provisions for liabilities and charges** | 22 | | **(29.0)** | | (27.4) |
| **Net assets** | | | **101.1** | | 87.4 |
| **Capital and reserves** | | | | | |
| Called up equity share capital | 25 | | **90.1** | | 88.9 |
| Share premium account | 26 | | **38.6** | | 38.1 |
| Capital redemption reserve | 26 | | **30.6** | | 30.6 |
| Profit and loss account | 26 | | **(58.2)** | | (70.3) |
| **Equity interests** | | | **101.1** | | 87.3 |
| **Non-equity interests** | | | **–** | | – |
| Shareholders' funds | | | **101.1** | | 87.3 |
| Equity minority interests | 27 | | **–** | | 0.1 |
| | | | **101.1** | | 87.4 |

The accompanying notes are an integral part of this group balance sheet.

# Company balance sheet

As at 31 March 2004

| | Notes | 2004 £m | 2003 £m |
|---|---|---|---|
| **Fixed assets** | | | |
| Investment in subsidiary undertakings | 14 | **152.3** | 152.3 |
| Investment in own shares | 15 | **4.0** | 3.8 |
| | | **156.3** | 156.1 |
| **Current assets** | | | |
| Debtors | 17 | **20.7** | 10.9 |
| Cash and bank balances | | **42.0** | 56.2 |
| | | **62.7** | 67.1 |
| **Creditors –** amounts due within one year | 18 | **(30.5)** | (29.0) |
| **Net current assets** | | **32.2** | 38.1 |
| **Total assets less current liabilities** | | **188.5** | 194.2 |
| **Creditors –** amounts due after more than one year | 19 | **(15.0)** | (17.5) |
| **Provisions for liabilities and charges** | 22 | **–** | – |
| **Net assets** | | **173.5** | 176.7 |
| **Capital and reserves** | | | |
| Called up share capital | 25 | **90.1** | 88.9 |
| Share premium account | 26 | **38.6** | 38.1 |
| Capital redemption reserve | 26 | **30.6** | 30.6 |
| Profit and loss account | 26 | **14.2** | 19.1 |
| **Equity interests** | | **173.5** | 176.7 |
| **Non-equity interests** | | **–** | – |
| **Shareholders' funds** | | **173.5** | 176.7 |

The accompanying notes are an integral part of this company balance sheet.

The Financial Statements on pages 38 to 67 were approved by the Board on 19 May 2004 and signed on its behalf by:

**G A Campbell** Director
**W Tame** Director

# Group cash flow statement
For the year ended 31 March 2004

| | Notes | 2004 £m | 2004 £m | 2003 £m | 2003 £m |
|---|---|---|---|---|---|
| **Cash inflow from operating activities** | 28a | | **28.0** | | 11.3 |
| **Returns on investments and servicing of finance** | | | | | |
| Net interest and similar charges | | **(2.1)** | | (2.5) | |
| Exceptional finance income | 5 | **1.7** | | – | |
| **Net cash outflow from returns on investments and servicing of finance** | | | **(0.4)** | | (2.5) |
| **Taxation** | | | | | |
| UK corporation tax paid | | **(1.4)** | | (2.8) | |
| Overseas tax paid | | **(0.2)** | | (0.2) | |
| **Net cash outflow from taxation** | | | **(1.6)** | | (3.0) |
| **Capital expenditure and financial investment** | | | | | |
| Payments to acquire tangible fixed assets | | **(2.6)** | | (2.5) | |
| Payments to acquire own shares | | **(0.4)** | | (0.9) | |
| Loans to joint ventures | | **(0.3)** | | – | |
| Receipts from sale of tangible fixed assets | | **1.1** | | 0.4 | |
| **Net cash outflow from capital expenditure and financial investment** | | | **(2.2)** | | (3.0) |
| **Acquisitions and disposals** | | | | | |
| Receipts/(payments) to acquire subsidiary undertakings | 28d | **0.3** | | (24.2) | |
| Receipts/(payments) on sale of subsidiary undertakings | 28d | **1.1** | | (2.6) | |
| **Net cash inflow/(outflow) from acquisitions and disposals** | | | **1.4** | | (26.8) |
| **Equity dividends paid** | | | **(4.5)** | | (4.2) |
| **Cash inflow/(outflow) before management of liquid resources and financing** | | | **20.7** | | (28.2) |
| **Management of liquid resources** | | | | | |
| Cash movement on short-term deposits | | | **0.2** | | (0.2) |
| **Financing** | | | | | |
| Shares issued for cash | | **1.7** | | 0.5 | |
| (Decrease)/increase in borrowings | | **(20.1)** | | 20.7 | |
| Repayments of capital element of finance lease rentals | | **(0.4)** | | (0.5) | |
| **Net cash (outflow)/inflow from financing** | | | **(18.8)** | | 20.7 |
| **Increase/(decrease) in cash in the year** | 28b | | **2.1** | | (7.7) |

The accompanying notes are an integral part of this group cash flow statement.

## Group statement of total recognised gains and losses
For the year ended 31 March 2004

| | 2004 £m | 2003 £m |
|---|---|---|
| Group profit for the financial year | **16.4** | 8.5 |
| Profit/(loss) on joint ventures and associates | **–** | (0.2) |
| Profit for the financial year | **16.4** | 8.3 |
| Currency translation differences on foreign currency net investments and related loans | **0.6** | 2.0 |
| Total recognised gains and losses relating to the year | **17.0** | 10.3 |

## Reconciliation of movements in group shareholders' funds
For the year ended 31 March 2004

| | 2004 £m | 2003 £m |
|---|---|---|
| Shareholders' funds at start of year | **87.3** | 80.9 |
| Ordinary shares issued in the year | **1.7** | 0.5 |
| Total recognised gains and losses relating to the year | **17.0** | 10.3 |
| Dividends | **(4.9)** | (4.4) |
| Net movement in shareholders' funds | **13.8** | 6.4 |
| Shareholders' funds at end of year | **101.1** | 87.3 |

The accompanying notes are an integral part of this group statement of total recognised gains and losses and this reconciliation of movements in group shareholders' funds.

# Notes to the financial statements

**1. Accounting policies**
The principal accounting policies are summarised below. They have all been applied consistently throughout the year and the preceding year.

*Basis of accounting*
The Financial Statements have been prepared under the historical cost convention and in accordance with applicable United Kingdom Accounting Standards.

*Basis of consolidation*
The Group Financial Statements include the Financial Statements of the company and all of its subsidiary undertakings made up to 31 March. Acquisitions are included from the date of acquisition and the results of businesses disposed of or terminated are included in the results for the year up to the date of relinquishing control or closure and analysed as continuing or discontinued operations.

The Group Financial Statements include the appropriate share of the results and net assets of joint ventures and associated undertakings' results and net assets based on the latest available Financial Statements. Associated undertakings are those in which the group has a long-term investment in the voting equity and over which it exerts significant influence. Joint ventures are those entities in which the group has a long-term interest and shares control with another party or parties.

Acquisitions are accounted for using the acquisition method.

*Goodwill*
When the fair value of the consideration for an acquired undertaking exceeds the fair value of its separable net assets the difference is treated as purchased goodwill and is capitalised and amortised through the profit and loss account over its estimated economic life. The estimated economic life of goodwill is between 10 and 20 years.

Where the fair value of the separable net assets exceeds the fair value of the consideration for an acquired undertaking the difference is treated as negative goodwill and is capitalised and amortised through the profit and loss account in the period in which the non-monetary assets acquired are recovered. In the case of fixed assets this is the period over which they are depreciated, and in the case of current assets, the period over which they are sold or otherwise realised.

*Tangible fixed assets*
Tangible fixed assets are stated at cost less depreciation and any provision for impairment in value. Depreciation is provided on a straight-line basis to write off the cost of fixed assets over their estimated useful lives to their estimated residual value at the following annual rates:

| | |
|---|---|
| Freehold land | Nil |
| Freehold buildings | 2% to 10% |
| Short leasehold property | Over period of lease |
| Plant machinery and motor vehicles | 6.6% to 33.3% |

*Leases*
Assets acquired under finance leases are capitalised and the outstanding capital element of instalments is included in creditors. The interest element is charged against profits so as to produce a constant periodic rate of charge on the outstanding obligations. Depreciation is calculated to write the assets off over their expected useful lives or over the lease terms where these are shorter. Rentals under operating leases are charged to the profit and loss account on a straight-line basis. A provision is made where leases are deemed to be onerous.

*Investments*
Fixed asset investments are stated at cost less provision for impairment in value.

*Stocks and work in progress*
Stocks are valued at the lower of cost and net realisable value. In the case of finished goods and work in progress, cost comprises direct materials and labour and an appropriate proportion of overheads.

*Long-term contracts*
Long-term contracts are those which extend over more than one accounting period and are material in aggregate to the relevant subsidiary.

Management reviews are conducted at least quarterly to assess the progress of each significant contract, the costs to be incurred and the expected outcome of any disputes with customers or subcontractors. Where the ultimate profitability of a contract can be assessed with reasonable certainty having made prudent allowance for future risks and uncertainties, profit is recognised in proportion to the contract work completed. Immediate provision is made for all foreseeable losses.

Amounts recoverable on contracts represents recorded turnover on long-term contracts in excess of payments on account.

*Research and development*
Development expenditure on clearly defined projects, the commercial outcome of which can be assessed with reasonable certainty, is capitalised. Development expenditure on fast ferry designs is amortised over the shorter of the project life and seven years. Other capitalised development expenditure is amortised over the shorter of the project life and three years. All other research and development is written off in the period in which it is incurred.

**1. Accounting policies** (continued)

*Taxation*

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

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

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

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

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax is measured on a non-discounted basis.

*Foreign currencies*

Transactions denominated in foreign currencies are recorded in local currency at the rate of exchange ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the local currency at the year end exchange rates or at the rate at which they are hedged if appropriate.

Exchange gains and losses arising on foreign currency borrowings used to finance subsidiary undertakings are taken to reserves to the extent that they can be offset against the exchange differences arising on the equity investment. Except as disclosed below, assets and liabilities of foreign subsidiary undertakings are translated on consolidation into sterling at the rate of exchange ruling at the balance sheet date and the results are translated using the average exchange rate for the month of the applicable results. These consolidation differences on exchange are taken to reserves. All other exchange differences are dealt with in the profit and loss account.

*Turnover*

In respect of long-term contracts, turnover represents amounts transferred to cost of sales during the period plus attributed profit. Other turnover comprises the invoiced value of goods and services supplied by the group. Turnover excludes sales taxes and intra-group transactions.

*Pension costs*

The group operates various pension schemes established in accordance with local conditions and practices in the countries concerned. For those schemes that operate on a defined benefit basis, contributions are based on periodic actuarial calculations and are charged so as to spread the cost of pensions over the expected service lives of the employees who are members of the scheme.

The group has adopted the transitional disclosure requirements of Financial Reporting Standard 17: 'Retirement benefits'. FRS17 adopts a market value approach to the measurement of retirement benefits.

*Derivative financial instruments*

The group uses derivative financial instruments, principally forward foreign exchange contracts, to reduce exposure to foreign exchange risk. The group does not hold or issue derivative financial instruments for speculative purposes.

For a forward currency exchange contract to be treated as a hedge, the instrument must be related to actual foreign currency assets or liabilities or to a probable commitment. It must involve the same currency or similar currencies as the hedged items and must also reduce the risk of foreign currency exchange movements on the group's operations. Gains and losses on these contracts are deferred and recognised in the profit and loss account, or as adjustments to the carrying amount of fixed assets, only when the hedged transaction has itself been recognised in the Financial Statements.

If an instrument ceases to be accounted for as a hedge, for example because the underlying hedged position is eliminated, the instrument is marked to market and any resulting profit or loss is recognised at that time.

**2. Segmental information**

The segmental information reflects the current composition of the group.

| | 2004 Group turnover £m | 2004 Group operating profit/(loss) before goodwill £m | 2004 Goodwill £m | 2004 Group operating profit/(loss) £m |
|---|---|---|---|---|
| **Continuing operations** | | | | |
| Technical Services | 185.1 | 14.5 | – | 14.5 |
| Training and Support | 252.9 | 15.4 | – | 15.4 |
| Unallocated costs and other income | – | (4.4) | – | (4.4) |
| Goodwill amortisation | – | – | (3.3) | (3.3) |
| **Total continuing operations** | 438.0 | 25.5 | (3.3) | 22.2 |
| Discontinued operations | 14.0 | (0.3) | – | (0.3) |
| **Group total** | 452.0 | 25.2 | (3.3) | 21.9 |

## 2. Segmental information (continued)

| | 2003 Group turnover £m | 2003 Group operating profit/(loss) before goodwill £m | 2003 Goodwill £m | 2003 Group operating profit/(loss) £m |
|---|---|---|---|---|
| **Continuing operations** | | | | |
| Technical Services | 199.1 | 16.3 | – | 16.3 |
| Training and Support | 178.8 | 10.1 | – | 10.1 |
| Unallocated costs and other income | – | (3.4) | – | (3.4) |
| Goodwill amortisation | – | – | (1.9) | (1.9) |
| **Total continuing operations** | **377.9** | **23.0** | **(1.9)** | **21.1** |
| Discontinued operations | 45.6 | (2.2) | – | (2.2) |
| **Group total** | **423.5** | **20.8** | **(1.9)** | **18.9** |

The turnover, not included above, relating to joint ventures was £3.5 million (2003: £0.6 million). The share of operating profit of £0.1 million (2003: loss £0.2 million) from joint ventures represents a loss of £0.1 million with the Technical Services segment (2003: loss £0.2 million) and a profit within the Training and Support segment of £0.2 million (2003: nil).

The inter-segment sales in 2004 and 2003 were not material.

| **Group turnover By geographic area of origin** | **United Kingdom £m** | **Rest of Europe £m** | **North America £m** | **Africa £m** | **Rest of the World £m** | **Group Total £m** |
|---|---|---|---|---|---|---|
| **2004** | | | | | | |
| **Continuing operations** | **337.8** | **0.6** | **6.2** | **81.5** | **11.9** | **438.0** |
| **Discontinued operations** | **–** | **14.0** | **–** | **–** | **–** | **14.0** |
| **Group total** | **337.8** | **14.6** | **6.2** | **81.5** | **11.9** | **452.0** |
| 2003 | | | | | | |
| Continuing operations | 304.1 | 0.1 | 11.8 | 50.5 | 11.4 | 377.9 |
| Discontinued operations | 1.4 | 40.8 | 1.0 | 0.3 | 2.1 | 45.6 |
| Group total | 305.5 | 40.9 | 12.8 | 50.8 | 13.5 | 423.5 |

| **Group turnover By geographic area of destination** | **United Kingdom £m** | **Rest of Europe £m** | **North America £m** | **Africa £m** | **Rest of the World £m** | **Group Total £m** |
|---|---|---|---|---|---|---|
| **2004** | | | | | | |
| **Continuing operations** | **332.6** | **4.9** | **6.2** | **81.8** | **12.5** | **438.0** |
| **Discontinued operations** | **0.2** | **5.1** | **1.1** | **0.5** | **7.1** | **14.0** |
| **Group total** | **332.8** | **10.0** | **7.3** | **82.3** | **19.6** | **452.0** |
| 2003 | | | | | | |
| Continuing operations | 297.9 | 5.2 | 11.2 | 50.2 | 13.4 | 377.9 |
| Discontinued operations | 2.1 | 25.0 | 2.9 | 3.2 | 12.4 | 45.6 |
| Group total | 300.0 | 30.2 | 14.1 | 53.4 | 25.8 | 423.5 |

## 2. Segmental information (continued)

| Group operating profit/(loss)before goodwill by geographic origin | United Kingdom £m | Rest of Europe £m | North America £m | Africa £m | Rest of the World £m | Group Total £m |
|---|---|---|---|---|---|---|
| **2004** | | | | | | |
| **Continuing operations** | **22.1** | **(0.4)** | **(0.3)** | **3.8** | **0.3** | **25.5** |
| **Discontinued operations** | **–** | **(0.3)** | **–** | **–** | **–** | **(0.3)** |
| **Group total** | **22.1** | **(0.7)** | **(0.3)** | **3.8** | **0.3** | **25.2** |
| 2003 | | | | | | |
| Continuing operations | 21.0 | (0.3) | 0.7 | 1.3 | 0.3 | 23.0 |
| Discontinued operations | (0.7) | (0.6) | (1.0) | – | 0.1 | (2.2) |
| Group total | 20.3 | (0.9) | (0.3) | 1.3 | 0.4 | 20.8 |

The goodwill charge of £3.3 million in 2004 (2003: £1.9 million) relates to the UK £2.8 million (2003: £1.4 million) and North America £0.5 million (2003: £0.5 million).

| | 2004 £m | 2003 £m |
|---|---|---|
| **Operating net assets – by activity** | | |
| Technical Services | **22.2** | 26.5 |
| Training and Support | **7.0** | 9.7 |
| Discontinued | **–** | 3.5 |
| Unallocated | **27.8** | 22.6 |
| **Operating net assets** | **57.0** | 62.3 |
| **Operating net assets – by geographic area** | | |
| United Kingdom | **45.7** | 48.9 |
| Europe | **1.0** | 3.9 |
| North America | **(0.3)** | 0.1 |
| Africa | **10.2** | 8.6 |
| Rest of the World | **0.4** | 0.8 |
| **Operating net assets** | **57.0** | 62.3 |
| Investment in own shares | **4.0** | 3.8 |
| Net borrowings | **(14.3)** | (35.9) |
| Finance lease obligations | **(1.1)** | (1.3) |
| Taxation | **(18.2)** | (16.3) |
| Dividends | **(3.1)** | (2.7) |
| Net goodwill | **76.8** | 77.5 |
| Non-operating assets | **44.1** | 25.1 |
| **Net assets** | **101.1** | 87.4 |

Technical Services and the United Kingdom include no operating net assets in respect of associated undertakings (2003: £nil).

Technical Services and the Rest of the World includes operating net assets of £0.2 million (2003: £0.4 million) in respect of joint ventures.

Training and Support and Europe includes operating net assets of £0.4 million (2003: nil) in respect of joint ventures.

### 3. Net operating expenses

| | 2004 Cost of sales £m | 2004 Distribution expenses £m | 2004 Administration expenses £m | 2004 Net operating expenses £m |
|---|---|---|---|---|
| **Continuing operations** | **375.5** | **1.8** | **38.5** | **40.3** |
| **Discontinued operations** | **9.5** | **3.4** | **1.4** | **4.8** |
| **Group total** | **385.0** | **5.2** | **39.9** | **45.1** |

| | 2003 Cost of sales £m | 2003 Distribution expenses £m | 2003 Administration expenses £m | 2003 Net operating expenses £m |
|---|---|---|---|---|
| Continuing operations | 323.1 | 1.4 | 32.2 | 33.6 |
| Discontinued operations | 34.7 | 5.9 | 7.3 | 13.2 |
| Group total | 357.8 | 7.3 | 39.5 | 46.8 |

In 2004, administration expenses include a goodwill charge of £3.3 million in respect of continuing operations.

In 2003, administration expenses include a goodwill charge of £1.9 million in respect of continuing operations.

### 4. Operating profit

| | 2004 £m | 2003 £m |
|---|---|---|
| Operating profit is stated after charging/(crediting) | | |
| Depreciation on tangible fixed assets | | |
| – Owned | **4.4** | 8.5 |
| – Leased assets | **0.3** | 0.3 |
| Profit on the disposal and write-off of tangible fixed assets | **0.2** | – |
| Operating lease rentals | | |
| – Plant and machinery | **1.2** | 2.0 |
| – Land and buildings | **3.9** | 3.8 |
| – Short-term plant hire | **0.3** | 0.7 |
| – Other | **0.3** | 0.3 |
| Auditors' remuneration (audit services) | **0.4** | 0.4 |
| Research and development | | |
| – Expenditure | **0.2** | 0.5 |
| – Amortisation charge (note 12) | **0.3** | 0.3 |
| Net goodwill amortisation | **3.3** | 1.9 |

In addition to the amounts disclosed above, the group auditors and their associates were paid £333,000 (2003: £149,000) in relation to non audit services in the UK and £13,000 for services outside the UK. The UK non audit fees included £300,000 in respect of the Shareholder Circular for the Peterhouse offer, £26,000 in respect of tax advice and £7,000 in respect of other assurance.

### 5. Exceptional items

In 2004 there are no operating exceptional items (2003:nil).

In 2004 the non-operating exceptional charge of £1.7 million is made up of a loss on sale of Swedish Materials Handling businesses of £2.5 million, offset by a profit on the sale of a non trading subsidiary of £0.8 million. Net interest and similar income/(charges) includes an exceptional gain of £1.7 million arising on the disposal of a financial asset.

In 2003 the non-operating exceptional charge of £2.7 million for the loss on sale of operations represents the loss on disposal of the BMH Chronos Richardson Group.

### 6. Net interest and similar income/(charges)

| | 2004 £m | 2003 £m |
|---|---|---|
| Interest payable and similar charges | | |
| – Bank loans and overdrafts | **(2.3)** | (2.8) |
| – Finance lease interest | **(0.1)** | (0.1) |
| – Other | **(0.1)** | (0.1) |
| | **(2.5)** | (3.0) |
| Other interest receivable and similar income | **0.3** | 0.4 |
| Share of joint ventures | **–** | – |
| | **(2.2)** | (2.6) |
| Exceptional gain arising on disposal of financial asset | **1.7** | – |
| Total group interest charge | **(0.5)** | (2.6) |

### 7. Employee costs

| | 2004 £m | 2003 £m |
|---|---|---|
| Particulars of employees, including executive Directors, are as follows: | | |
| Employee costs | | |
| – Wages and salaries | **139.2** | 137.0 |
| – Social security costs | **12.3** | 11.2 |
| – Other pension costs (note 24) | **9.4** | 4.7 |
| | **160.9** | 152.9 |

The average number of people employed by the group in each of the following categories was as follows:

| | 2004 Number | 2003 Number |
|---|---|---|
| Operations | **5,767** | 6,133 |
| Administration and management | **589** | 779 |
| | **6,356** | 6,912 |

The number of people employed by the group at 31 March 2004 was 6,110 (2003: 7,070).

Information in respect of Directors' remuneration and share interests is contained within the Remuneration report on pages 30 to 36.

## 8. Tax on profit on ordinary activities

| | 2004 £m | 2003 £m |
|---|---|---|
| United Kingdom corporation tax charge at 30% | 3.1 | 5.5 |
| Double taxation relief | – | – |
| Adjustments in respect of previous periods | (0.8) | (0.9) |
| | 2.3 | 4.6 |
| Overseas taxation – current period | 1.4 | 0.5 |
| Adjustments in respect of previous periods | – | 0.1 |
| | 3.7 | 5.2 |
| Share of joint ventures | 0.1 | – |
| Total current tax | 3.8 | 5.2 |
| Deferred taxation: | | |
| Origination and reversal of timing differences | (0.4) | (0.1) |
| | 3.4 | 5.1 |

Excluding the net goodwill charge of £3.3 million, a loss in discontinued operations of £0.3 million, the non-operating exceptional loss of £1.7 million, and the exceptional interest credit of £1.7 million, the effective rate of 15.7% is lower than the standard UK rate of 30.0% due to the net effect of prior year items, the utilisation of overseas and other tax losses for which no deferred tax asset had been recognised and the difference between the UK rate and the effective overseas rate. There is no tax relief arising in respect of the exceptional loss. The tax charge includes £0.1 million (2003: £0.1 million) relating to discontinued operations.

The differences between the total current tax shown above and the amount calculated by applying the standard rate of UK corporation tax to the profit before tax is as follows:

| | 2004 £m | 2003 £m |
|---|---|---|
| **Profit on ordinary activities before tax** | 19.8 | 13.4 |
| Deduct: share of joint ventures and associates profit before tax | (0.1) | 0.2 |
| **Group profit on ordinary activities before taxation** | 19.7 | 13.6 |
| Tax on group profit on ordinary activities at standard UK corporation tax rate of 30% (2003: 30%) | 6.0 | 4.1 |
| Effects of: | | |
| Expenses (including exceptional items and goodwill) not deductible for tax purposes | 2.0 | 3.2 |
| Current year and prior year timing differences | 0.2 | 0.5 |
| Overseas timing differences not recognised and difference in rates on overseas earnings | (0.3) | (1.6) |
| Adjustments to current tax charge in respect of previous periods | (0.8) | (0.8) |
| Utilisation of brought forward tax assets not previously recognised | (3.3) | (0.2) |
| **Group current tax charge for period** | 3.8 | 5.2 |

The tax charge in future periods may be affected by results in overseas jurisdictions, together with overseas tax rates, permanent differences in the UK and elsewhere, and the utilisation of tax losses for which no deferred tax asset has been recognised.

## 9. Company profit

The company has taken advantage of the exemption granted by section 230 of the Companies Act 1985 whereby no individual profit and loss account of the company is disclosed. Included in the group profit for the financial year is a loss of £0.1 million (2003 profit: £2.6 million) dealt with in the Financial Statements of the company.

## 10. Dividends

| | 2004 £m | 2003 £m |
|---|---|---|
| **Ordinary shares** | | |
| – Interim dividend paid of 1.25p per 60p share (2003: 1.15p per 60p share) | 1.8 | 1.7 |
| – Final dividend proposed of 2.1p per 60p share (2003: 1.85p per 60p share) | 3.1 | 2.7 |
| | 4.9 | 4.4 |

### 11. Earnings per share
Earnings per ordinary share have been calculated by dividing the profit attributable to shareholders for the financial year by the weighted average number of ordinary shares in issue during the year.

| | 2004 Number | 2003 Number |
|---|---|---|
| Weighted average number of shares in issue for basic earnings per share | **145,022,090** | 144,812,194 |
| Dilutive effect of share options | **353,923** | 768,543 |
| Weighted average number of shares in issue for diluted earnings per share | **145,376,013** | 145,580,737 |

The weighted average number of shares excludes the weighted average number of shares held in the Babcock Employee Share Trust.

| | 2004 £m | 2004 Basic (pence) | 2004 Diluted (pence) | 2003 £m | 2003 Basic (pence) | 2003 Diluted (pence) |
|---|---|---|---|---|---|---|
| Profit attributable to shareholders | **16.4** | **11.31** | **11.28** | 8.3 | 5.72 | 5.69 |
| Add loss on sale or termination of a business | **1.7** | **1.20** | **1.20** | 2.7 | 1.89 | 1.88 |
| Exceptional interest | **(1.7)** | **(1.17)** | **(1.16)** | – | – | – |
| Profit before exceptional items | **16.4** | **11.34** | **11.32** | 11.0 | 7.61 | 7.57 |
| Add net goodwill amortisation | **3.3** | **2.26** | **2.25** | 1.9 | 1.30 | 1.30 |
| Profit before exceptional items and goodwill | **19.7** | **13.60** | **13.57** | 12.9 | 8.91 | 8.87 |

The earnings per share figures calculated above eliminate the effect of exceptional items and goodwill amortisation to give a more meaningful presentation of trading performance.

### 12. Fixed assets – intangible assets

| | Goodwill £m | Negative goodwill £m | Development costs £m | Total £m |
|---|---|---|---|---|
| **Group:** | | | | |
| **Cost** | | | | |
| At 1 April 2003 | 108.5 | (25.8) | 3.0 | **85.7** |
| On acquisition of subsidiaries | 2.5 | – | – | **2.5** |
| On disposal of subsidiaries (note 29) | (12.9) | – | – | **(12.9)** |
| **At 31 March 2004** | **98.1** | **(25.8)** | **3.0** | **75.3** |
| **Accumulated amortisation** | | | | |
| At 1 April 2003 | (24.5) | 19.3 | (2.0) | **(7.2)** |
| On disposal of subsidiaries (note 29) | 12.9 | – | – | **12.9** |
| (Charge)/credit for the year | (5.0) | 1.8 | (0.3) | **(3.5)** |
| **As at 31 March 2004** | **(16.6)** | **21.1** | **(2.3)** | **2.2** |
| **Net book value at 31 March 2004** | **81.5** | **(4.7)** | **0.7** | **77.5** |
| Net book value at 31 March 2003 | 84.0 | (6.5) | 1.0 | **78.5** |

### 13. Fixed assets – tangible assets

| | Freehold property £m | Leasehold property £m | Plant and machinery £m | **Total £m** |
|---|---|---|---|---|
| **Group:** | | | | |
| **Cost** | | | | |
| At 1 April 2003 | 15.4 | 0.9 | 51.1 | **67.4** |
| Exchange adjustments | (0.1) | – | 0.4 | **0.3** |
| On disposal of subsidiaries (note 29) | (1.6) | – | (3.8) | **(5.4)** |
| Additions | – | – | 2.6 | **2.6** |
| Disposals/assets written off | (1.1) | – | (9.0) | **(10.1)** |
| **At 31 March 2004** | **12.6** | **0.9** | **41.3** | **54.8** |
| **Accumulated depreciation** | | | | |
| At 1 April 2003 | (10.7) | (0.1) | (40.1) | **(50.9)** |
| Exchange adjustments | – | – | (0.1) | **(0.1)** |
| On disposal subsidiary (note 29) | 0.6 | – | 3.3 | **3.9** |
| Charge for the year | (0.7) | (0.1) | (3.9) | **(4.7)** |
| Disposals/assets written off | 0.7 | – | 8.5 | **9.2** |
| **At 31 March 2004** | **(10.1)** | **(0.2)** | **(32.3)** | **(42.6)** |
| **Net book value at 31 March 2004** | **2.5** | **0.7** | **9.0** | **12.2** |
| Net book value at 31 March 2003 | 4.7 | 0.8 | 11.0 | **16.5** |

The net book value of plant and machinery includes £2.1 million (2003: £2.2 million) in respect of assets held under finance leases or hire purchase contracts, comprising cost of £3.9 million (2003: £3.8 million) less depreciation of £1.8 million (2003: £1.6 million).

The net book value of freehold property includes land amounting to £0.4 million (2003: £0.9 million) which has not been depreciated.

### 14. Fixed assets – investments in subsidiary undertakings

| | Shares £m | Loans £m | **Total £m** |
|---|---|---|---|
| **Company cost** | | | |
| At 1 April 2003 and 31 March 2004 | 86.5 | 65.8 | **152.3** |

Information on the principal subsidiary undertakings is given on page 68.

### 15. Fixed assets – investments

| | Group | | | | Company |
|---|---|---|---|---|---|
| | Joint ventures £m | Investments in own shares £m | Other investments £m | **Total £m** | Investments in own shares £m |
| At 1 April 2003 | 0.4 | 3.8 | 0.1 | **4.3** | 3.8 |
| Exchange adjustment | – | – | – | **–** | – |
| Additions | 0.2 | 1.0 | – | **1.2** | 1.0 |
| Disposals | – | (0.6) | – | **(0.6)** | (0.6) |
| Share of profits | – | – | – | **–** | – |
| Provision movement | – | (0.2) | – | **(0.2)** | (0.2) |
| **At 31 March 2004** | **0.6** | **4.0** | **0.1** | **4.7** | **4.0** |

Information on associated undertakings is given on page 68.

During the year the company acquired 850,773 ordinary shares at a total cost of £966,054 through the Babcock Employee Share Trust (the 'Trust') in respect of its potential obligation under the Babcock 1999 Executive Share Option Schemes and the Babcock 2003 L-TIP. During the year ended 31 March 2004, 522,801 shares were disposed of resulting from options exercised. At 31 March 2004, the Trust held 3,767,967 ordinary shares at a total market value of £4,389,682 representing 2.53% of the issued share capital at that date. The company elected to pay dividends to the Trust at the rate of 0.001p per share during the year. All the Trust's shares are under option to employees. The company meets the operating expenses of the Trust. The provision represents an allowance for future L-TIP vesting.

### 15. Fixed assets – investments continued

The Trust enables shares in the company to be purchased and made available to employees principally through the grant and exercise of rights under the Babcock 1999 Executive Share Option Schemes and may be used to grant awards made under the long-term incentive plan referred to on page 31. The Trust is a discretionary settlement for the benefit of employees within the group. The company is excluded from benefiting under the Trust. The Trust is controlled and managed outside the UK and has a single corporate trustee which is an independent trustee services organisation. The right to remove the trustee and appoint a new trustee rests in the company. The trustee is required to waive both voting rights and dividends payable on any share in the company in excess of 0.001p, unless otherwise directed by the company. The Trust may not, without the approval by ordinary resolution of the members of the company, hold more than 5.0% of the issued ordinary shares of the company.

### 16. Stocks

| | Group 2004 £m | Group 2003 £m |
|---|---|---|
| Stocks and work in progress | | |
| – Raw materials and consumables | 3.2 | 6.7 |
| – Work in progress | 5.1 | 3.8 |
| – Finished goods and goods for resale | 24.7 | 13.9 |
| | 33.0 | 24.4 |
| Less : Progress payments | (0.6) | – |
| Provisions | (2.7) | (1.0) |
| | 29.7 | 23.4 |

### 17. Debtors

| | Group 2004 £m | Group 2003 £m | Company 2004 £m | Company 2003 £m |
|---|---|---|---|---|
| Due within one year: | | | | |
| Trade debtors | 32.1 | 40.0 | 0.1 | 0.6 |
| Amounts recoverable on contracts | 25.2 | 34.8 | – | – |
| Retentions | 0.1 | 0.6 | – | – |
| Amounts owed by subsidiary undertakings | – | – | 17.4 | 3.1 |
| Group dividends | – | – | – | 7.0 |
| Prepayments and accrued income | 8.3 | 7.0 | 2.5 | – |
| Pension scheme prepayments | 5.4 | 1.9 | – | – |
| Other debtors | 4.1 | 4.4 | 0.7 | 0.2 |
| | 75.2 | 88.7 | 20.7 | 10.9 |

| | Group 2004 £m | Group 2003 £m | Company 2004 £m | Company 2003 £m |
|---|---|---|---|---|
| Due after more than one year: | | | | |
| Pension scheme prepayments | 63.6 | 69.4 | – | – |
| Other debtors | 0.4 | 0.2 | – | – |
| | 64.0 | 69.6 | – | – |

## 18. Creditors – amounts due within one year

| | Group 2004 £m | Group 2003 £m | Company 2004 £m | Company 2003 £m |
|---|---|---|---|---|
| Bank overdraft (note 20) | **11.3** | 7.9 | **–** | – |
| Bank loans (note 20) | **5.5** | 23.1 | **5.5** | 21.5 |
| Obligations under finance leases (note 20) | **0.4** | 0.1 | **–** | – |
| Payments on account | **11.2** | 11.0 | **–** | – |
| Trade creditors | **36.6** | 36.5 | **–** | – |
| Contract accruals and provisions | **37.3** | 46.5 | **–** | – |
| Amounts owed to subsidiary undertakings | **–** | – | **19.9** | 4.5 |
| Other creditors | **8.0** | 5.2 | **2.0** | 0.3 |
| Corporation and overseas taxes | **6.1** | 4.2 | **–** | – |
| Other taxes and social security | **4.1** | 5.3 | **–** | – |
| Accruals and deferred income | **11.1** | 17.4 | **–** | – |
| Proposed dividend | **3.1** | 2.7 | **3.1** | 2.7 |
| | **134.7** | 159.9 | **30.5** | 29.0 |

## 19. Creditors – amounts due after more than one year

| | Group 2004 £m | Group 2003 £m | Company 2004 £m | Company 2003 £m |
|---|---|---|---|---|
| Bank loans (note 20) | **15.0** | 17.5 | **15.0** | 17.5 |
| Other loans (note 20) | **–** | 0.1 | **–** | – |
| Obligations under finance leases (note 20) | **0.7** | 1.2 | **–** | – |
| Other creditors | **0.1** | 0.1 | **–** | – |
| Corporation and overseas taxes | **0.2** | 0.1 | **–** | – |
| | **16.0** | 19.0 | **15.0** | 17.5 |

## 20. Borrowings

*Repayment details*

The total borrowings of the group at 31 March are repayable as follows:

| | 2004 Bank loans and overdrafts £m | 2004 Other loans £m | 2004 Finance lease obligations £m |
|---|---|---|---|
| Within one year | **16.8** | **–** | **0.4** |
| Between one and two years | **15.0** | **–** | **0.4** |
| Between two and five years | **–** | **–** | **0.3** |
| | **31.8** | **–** | **1.1** |

| | 2003 Bank loans and overdrafts £m | 2003 Other loans £m | 2003 Finance lease obligations £m |
|---|---|---|---|
| Within one year | 31.0 | – | 0.1 |
| Between one and two years | 2.5 | 0.1 | – |
| Between two and five years | 15.0 | – | 1.2 |
| | 48.5 | 0.1 | 1.3 |

**20. Borrowings** (continued)

| Security arrangements | Group 2004 £m | Group 2003 £m |
|---|---|---|
| **Loans and overdrafts** | | |
| Secured against fixed charge on freehold property of subsidiary undertaking | – | – |
| Unsecured borrowings | 31.8 | 48.6 |
| | 31.8 | 48.6 |

Finance lease obligations are secured against the assets to which they relate.

**21. Derivatives and other financial instruments**

The group's financial instruments, other than derivatives, comprise cash, liquid resources, some short-term borrowings and various items as trade debtors and trade creditors that arise directly from its operations. The main purpose of these financial instruments is to finance the group's operations.

The group controls credit risk by entering into financial derivatives only with prime rated and authorised counter-parties. Counter-party authorisations and positions are monitored on a regular basis.

The numerical disclosures in this note deal with financial assets and liabilities as defined in Financial Reporting Standard 13 – Derivatives and Other Financial Instruments: Disclosure (FRS13). Certain financial assets such as investments in subsidiary, joint venture and associate companies are excluded from the scope of these disclosures.

As permitted by FRS13, short-term debtors and creditors have been excluded from the disclosures, other than the currency disclosures.

*Interest rate profile*

The group's financial assets comprise cash deposits of £17.5 million (2003: £12.7 million). Cash deposits are placed on money markets at call, seven-day and monthly rates.

The interest rate profile of the group's financial assets and liabilities (excluding short-term debtors and creditors), after taking into account of the interest rate swaps used to manage the interest profile, is as follows:

| | 2004 Financial assets | 2004 Financial liabilities | | | |
|---|---|---|---|---|---|
| Currency | Total and floating rate £m | Total £m | Floating rate £m | Fixed rate £m | No interest paid £m |
| Sterling | 13.4 | 31.0 | 31.0 | – | – |
| Euro | 0.7 | – | – | – | – |
| US Dollar | 2.4 | – | – | – | – |
| South African Rand | – | 1.9 | 1.9 | – | – |
| Swedish Krona | 0.1 | – | – | – | – |
| Other currencies | 0.9 | – | – | – | – |
| | 17.5 | 32.9 | 32.9 | – | – |

## 21. Derivatives and other financial instruments (continued)

| Currency | 2003 Financial assets Total and floating rate £m | 2003 Financial liabilities Total £m | Floating rate £m | Fixed rate £m | No interest paid £m |
|---|---|---|---|---|---|
| Sterling | 4.2 | 47.0 | 46.9 | 0.1 | – |
| Euro | 1.5 | – | – | – | – |
| US Dollar | 3.6 | 0.1 | – | – | 0.1 |
| South African Rand | 1.4 | 2.8 | 1.2 | 1.6 | – |
| Swedish Krona | 1.2 | – | – | – | – |
| Other currencies | 0.8 | – | – | – | – |
| | 12.7 | 49.9 | 48.1 | 1.7 | 0.1 |

The above tables do not include onerous lease liabilities of £4.3 million (2003: £3.8 million). The discount rate on this liability is 6.0% (2003: 4.6%) and the maturity period is between seven and 15 years.

The discount rate on floating rate financial assets and liabilities is linked to LIBOR in the case of sterling and the prime rate in the case of South African rand.

The group has entered into an interest rate swap to cap the LIBOR component of interest to 5.0% per annum. This is in relation to £20.0 million of floating rate debt. The interest rate swap is effective for three years from 26 June 2003.

*Borrowing facilities*

The group had undrawn committed borrowing facilities at 31 March 2004, in respect of which all conditions precedent had been met, as follows:

| | **2004 £m** | 2003 £m |
|---|---|---|
| Expiring in less than one year | **–** | 2.1 |
| Expiring in more than one year but not more than two years | **47.0** | 21.0 |

*Currency exposures*

The Financial Review on page 19 explains that it is the group's policy not to hedge foreign currency exposures on the translation of its overseas profits and net assets to sterling. Such movements are dealt with through the group statement of total recognised gains and losses. It is group policy for subsidiaries to hedge transactional currency exposures against the currency in which their results are measured.

The table below shows the group's currency exposures; in other words, those transactional exposures that give rise to net currency gains or losses recognised in the profit and loss account. Such exposures comprise the monetary assets and monetary liabilities of the group that are not denominated in the operating (or 'functional') currency of the operating unit involved.

As at 31 March 2004, these exposures were as follows:

| | **Net foreign currency monetary assets/(liabilities)** | | | | | |
|---|---|---|---|---|---|---|
| **Functional currency of group operation** | **Sterling £m** | **US Dollars £m** | **Euro-zone currencies £m** | **Swedish Krona £m** | **Other £m** | **Total £m** |
| **Sterling** | **–** | **0.3** | **0.7** | **–** | **0.1** | **1.1** |
| **US Dollars** | **–** | **–** | **–** | **–** | **–** | **–** |
| **Euro** | **–** | **–** | **–** | **–** | **–** | **–** |
| **Swedish Krona** | **–** | **–** | **0.6** | **–** | **–** | **0.6** |
| **Other** | **–** | **–** | **–** | **–** | **–** | **–** |
| **Total** | **–** | **0.3** | **1.3** | **–** | **0.1** | **1.7** |

As at 31 March 2003, these exposures were as follows:

| | Net foreign currency monetary assets/(liabilities) | | | | | |
|---|---|---|---|---|---|---|
| **Functional currency of group operation** | Sterling £m | US Dollars £m | Euro-zone currencies £m | Swedish Krona £m | Other £m | Total £m |
| Sterling | – | 0.4 | 1.8 | – | – | 2.2 |
| US Dollars | – | – | – | – | – | – |
| Euro | – | – | – | – | – | – |
| Swedish Krona | – | – | (0.1) | – | – | (0.1) |
| Other | – | – | – | – | – | – |
| Total | – | 0.4 | 1.7 | – | – | 2.1 |

The amounts shown in the above table take into account the effect of forward foreign currency contracts entered in to manage these currency exposures.

As at 31 March 2004, the group also held open various forward foreign currency contracts that the group had taken out to hedge expected future foreign currency movements.

## 21. Derivatives and other financial instruments (continued)

*Fair values*

Set out below is a comparison of the book and fair values of derivative financial instruments held to manage the interest rate and currency profile of the group's operations. In all other cases, there is no material difference between the book value and the fair value of the group's financial assets/(liabilities).

| | 2004 Book value £m | 2004 Fair value £m | 2003 Book value £m | 2003 Fair value £m |
|---|---|---|---|---|
| Interest rate swap | **0.1** | **0.1** | 0.1 | 0.1 |
| Forward foreign currency contracts | **–** | **(5.0)** | – | (4.3) |

Changes in the value of the swap as a result of changes in interest rates are not included in the book value of the relevant asset or liability.

The book value and the fair value of the group's borrowings and cash at bank are the same and are therefore not reflected in the above table.

*Gains and losses on hedges*

The group enters into forward foreign currency contracts to hedge the currency exposures that arise on sales and purchases denominated in foreign currencies immediately the transaction occurs.

Changes in the fair value of instruments used as hedges are not recognised in the Financial Statements until the hedged position matures. An analysis of these unrecognised gains and losses is as follows:

| | Gains £m | Losses £m | Net £m |
|---|---|---|---|
| Unrecognised gains and losses on hedges at 1 April 2003 | 0.5 | (4.8) | (4.3) |
| Gains and losses arising in previous years that were recognised in the year ended 31 March 2004 | (0.5) | 4.8 | 4.3 |
| Gains and losses arising before 1 April 2003 that were not recognised in the year ended 31 March 2004 | – | – | – |
| Gains and losses arising that were not recognised in the year ended 31 March 2004 | 0.4 | (5.4) | (5.0) |
| Unrecognised gains and losses on hedges at 31 March 2004 | 0.4 | (5.4) | (5.0) |
| Of which: | | | |
| Gains and losses expected to be recognised in the year ending 31 March 2005 | 0.4 | (5.2) | (4.8) |
| Gains and losses expected to be recognised in the year ending 31 March 2006 or later | – | (0.2) | (0.2) |

There is no recognised or unrecognised gain or loss in respect of interest rate swaps. The above represents the gains and losses on the hedging instruments.

## 22. Provisions for liabilities and charges

| | Pensions and similar obligations (a) £m | Deferred taxation (note 23) £m | Acquisition/ deferred consideration (b) £m | Insurance provisions (c) £m | Closure or disposal of businesses (d) £m | Total £m |
|---|---|---|---|---|---|---|
| At 1 April 2003 | 2.1 | 12.6 | 1.0 | 6.4 | 5.3 | 27.4 |
| On acquisition of subsidiaries | 0.5 | – | 2.0 | – | – | 2.5 |
| On disposal of subsidiaries | – | – | – | – | 0.5 | 0.5 |
| Exchange adjustments | (0.1) | – | – | – | – | (0.1) |
| Provided in the year | 0.4 | – | – | – | – | 0.4 |
| Utilised in the year | (0.1) | – | (0.6) | (0.5) | (1.4) | (2.6) |
| Released | – | (0.3) | – | (0.2) | – | (0.5) |
| Transferred from current assets | – | – | 0.2 | – | 1.2 | 1.4 |
| **At 31 March 2004** | **2.8** | **12.3** | **2.6** | **5.7** | **5.6** | **29.0** |

(a) Provisions for pension liabilities.

(b) Deferred consideration relates to the contingent consideration for SGI which arose on the award of the South West Prime contract and is payable within one year. SGI was purchased on 19 June 2002.

(c) The insurance provisions arise in the group's captive insurance company, Chepstow Insurance Ltd. They relate to specific claims assessed in accordance with the advice of independent actuaries.

(d) Provisions for costs relating to the closure or disposal of businesses are principally for an onerous contract in respect of a partially vacant property which is not expected to become payable within the next two years.

The company had a provision for deferred tax of £2,000 as at 31 March 2004 (2003: £2,000).

### 23. Deferred taxation
The major components of the provision for deferred taxation and the potential liability are as follows:

| | 2004 Provided £m | 2003 Provided £m | 2004 Full potential £m | 2003 Full potential £m |
|---|---|---|---|---|
| Accelerated capital allowances | **(2.3)** | (2.9) | **(2.3)** | (2.9) |
| Pension surpluses | **20.7** | 21.4 | **20.7** | 21.4 |
| Other timing differences | **(1.6)** | (1.4) | **(1.6)** | (1.4) |
| Tax losses | **–** | – | **(21.4)** | (19.8) |
| | **16.8** | 17.1 | **(4.6)** | (2.7) |
| Recoverable advance corporation tax | **(4.5)** | (4.5) | **(4.5)** | (4.5) |
| | **12.3** | 12.6 | **(9.1)** | (7.2) |

There is no unprovided deferred tax liability in the company.

### 24. Pension arrangements
The group has continued to account for pension costs in accordance with SSAP 24. Full adoption of the requirements of FRS17 – Retirement Benefits has been deferred. The transitional disclosures required by FRS17 are set out in Part (b) of this note.

*(a) SSAP 24 disclosures*
The pension cost, calculated in accordance with SSAP 24, included as a charge in arriving at the group operating profit was as follows:

| | 2004 £m | 2003 £m |
|---|---|---|
| **Defined benefit schemes:** | | |
| Regular costs net of variation | **6.8** | 6.1 |
| Interest on pension scheme surpluses | **(4.3)** | (6.0) |
| | **2.5** | 0.1 |
| **Defined contribution schemes** | **6.9** | 4.6 |
| | **9.4** | 4.7 |

Of the above charge £8.0 million relates to the UK (2003: £3.3 million) and £1.4 million relates to overseas (2003: £1.4 million).

The group operates two principal defined benefit pension schemes for employees in the United Kingdom, the Babcock International Group Pension Scheme and the Rosyth Royal Dockyard Pension Scheme. Both schemes are funded by payments to separate trustee-administered funds and the level of the group's contributions to the schemes is assessed in accordance with the advice of independent, qualified actuaries. The details of the latest formal actuarial valuations of these two schemes are as follows:

| | Babcock International Group | Rosyth Royal Dockyard |
|---|---|---|
| Date of last formal actuarial valuation | 1 April 2001 | 31 March 2003 |
| Number of active members at 31 March 2004 | 441 | 1,774 |
| Actuarial valuation method | Projected unit | Projected unit |
| Results of last formal actuarial valuation: | | |
| Value of assets | £414 million | £355 million |
| Level of funding | 132% | 107% |
| Principal valuation assumptions: | | |
| Excess of investment returns over earnings increases | 2% to 2.5% | 2.5% |
| Excess of investment returns over pension increases | 3% to 3.5% | 3.5% |

As a result of the level of surplus the group's contributions to the Babcock International Group Pension Scheme are currently suspended until at least the next formal valuation. Contributions to the Rosyth Royal Dockyard Pension Scheme will resume in 2004/05 at a level of 7% of pensionable salary.

**24. Pension arrangements** (continued)
Prepayments of £69.0 million (2003: £71.2 million) are carried in the balance sheet in respect of the group's principal pension schemes.

*(b) FRS17 additional disclosures*
Under the transitional provisions of FRS17 certain additional disclosures are required on the basis of the valuation methodology adopted by FRS17 and the additional defined benefit schemes within the group.

In addition to the two principal defined benefit pension schemes referred to above, the group also operates a number of smaller defined benefit pension schemes:

The Babcock Holdings (USA), Inc. Pension Plan – for employees of US subsidiaries of Babcock Holdings (USA), Inc. A full actuarial valuation of the scheme was carried out at 31 December 2003. The company made a contribution of £0.1 million during the year to 31 March 2004. The plan was frozen as of 31 January 2003 and, therefore, no active members existed as at 31 March 2004. The minimum required contribution for the plan year 1 January 2004 to 31 December 2004 is £0.1 million.

The Unicorn Pension Scheme – for employees in the SGI business, acquired by the company on 19 June 2002. A full actuarial valuation of the scheme was carried out at 31 December 2000 and updated to 19 June 2002. The scheme was closed to new members from 30 November 2002 and there is no further accrual of benefits for future service. All scheme members are in the process of transferring to the Babcock International Group Pension Scheme. The company made no contribution to the scheme during the year to 31 March 2004.

For defined benefit schemes the fair values of pension scheme assets at 31 March 2004 are compared with the pension liabilities calculated under the projected unit method. The latest full actuarial valuations of the group's defined benefit pension schemes have been updated to 31 March 2004 by qualified independent actuaries using the following assumptions:

| | Babcock International Group Scheme % pa | | | Rosyth Royal Dockyard Scheme % pa | | | Other schemes (weighted average) % pa | | |
|---|---|---|---|---|---|---|---|---|---|
| | **2004** | 2003 | 2002 | **2004** | 2003 | 2002 | **2004** | 2003 | 2002 |
| Rate of increase of future earnings | **3.83** | 3.5 | 3.9 | **2.83-3.33** | 3.0 | 3.9 | **3.83** | 3.6 | 3.7 |
| Discount rate | **5.54** | 5.4 | 6.1 | **5.54** | 5.4 | 6.1 | **6.0** | 5.6 | 6.4 |
| Expected pension increases | **3.0** | 3.0 | 2.9 | **2.83** | 2.5 | 2.9 | **3.7** | 2.7 | 2.1 |
| Inflation rate | **2.83** | 2.5 | 2.9 | **2.83** | 2.5 | 2.9 | **3.7** | 2.7 | 2.8 |

The fair value of the assets, the present value of the liabilities and the expected rates of return of the Babcock International Group and Rosyth Royal Dockyard defined benefit schemes, together with the aggregated data for the other schemes in the Group at 31 March 2004 were as follows:

| | Babcock International Group Scheme | | Rosyth Royal Dockyard Scheme | | Other schemes | | Group |
|---|---|---|---|---|---|---|---|
| | Expected rate of return % | Fair value £'000 | Expected rate of return % | Fair value £'000 | Weighted average expected rate of return % | Fair value £'000 | Fair value £'000 |
| Equities | 7.5 | 85.3 | 7.5 | 229.9 | 7.5 | 1.8 | 317.0 |
| Property | – | – | 7.0 | 40.8 | – | – | 40.8 |
| Bonds | 4.8 | 313.6 | 4.8 | 72.6 | 6.4 | 3.4 | 389.6 |
| Cash | 4.0 | 2.7 | 4.0 | 1.2 | 4.0 | 0.1 | 4.0 |
| Fair value of assets | | 401.6 | | 344.5 | | 5.3 | 751.4 |
| Present value of scheme liabilities | | (356.3) | | (390.2) | | (2.9) | (749.4) |
| Recognised pension asset/ (liability) | | 45.3 | | (45.7) | | 2.4 | 2.0 |
| Deferred tax asset/(liability) | | (13.6) | | 13.7 | | (1.0) | (0.9) |
| Net pension asset/(liability) | | 31.7 | | (32.0) | | 1.4 | 1.1 |

**24. Pension arrangements** (continued)

The fair value of the assets, the present value of the liabilities and the expected rates of return of the Babcock International Group and Rosyth Royal Dockyard defined benefit schemes, together with the aggregated data for the other schemes in the group at 31 March 2003 were as follows:

| | Babcock International Group Scheme | | Rosyth Royal Dockyard Scheme | | Other schemes | | Group |
|---|---|---|---|---|---|---|---|
| | Expected rate of return % | Fair value £m | Expected rate of return % | Fair value £m | Weighted average expected rate of return % | Fair value £m | Fair value £m |
| Equities | 7.0 | 62.8 | 7.0 | 184.7 | 7.0 | 5.1 | 252.6 |
| Property | – | – | 7.0 | 38.8 | – | – | 38.8 |
| Bonds | 4.8 | 325.0 | 4.8 | 70.0 | 5.5 | 5.1 | 400.1 |
| Cash | 3.75 | 0.6 | 3.75 | 2.2 | 3.75 | 0.8 | 3.6 |
| Fair value of assets | | 388.4 | | 295.7 | | 11.0 | 695.1 |
| Present value of scheme liabilities | | (345.8) | | (331.3) | | (15.7) | (692.8) |
| Recognised pension asset/(liability) | | 42.6 | | (35.6) | | (4.7) | 2.3 |
| Deferred tax asset/(liability) | | (12.8) | | 10.7 | | 1.1 | (1.0) |
| Net pension asset/(liability) | | 29.8 | | (24.9) | | (3.6) | 1.3 |

The fair value of the assets and the expected rates of return of the Babcock International Group and Rosyth Royal Dockyard defined benefit schemes, together with the aggregated data for the other schemes in the group at 31 March 2002 were as follows:

| | Babcock International Group Scheme | | Rosyth Royal Dockyard Scheme | | Other schemes | | Group |
|---|---|---|---|---|---|---|---|
| | Expected rate of return % | Fair value £m | Expected rate of return % | Fair value £m | Weighted average expected rate of return % | Fair value £m | Fair value £m |
| Equities | 7.9 | 85.1 | 7.9 | 273.0 | 7.9 | 5.5 | 363.6 |
| Property | 7.9 | – | 7.9 | 41.0 | 7.9 | 0.2 | 41.2 |
| Bonds | 6.1 | 305.5 | 6.1 | 65.0 | 7.0 | 2.7 | 373.2 |
| Cash | 4.0 | 2.1 | 4.0 | – | 4.0 | 0.4 | 2.5 |
| Fair value of assets | | 392.7 | | 379.0 | | 8.8 | 780.5 |

If the defined benefit pension and post-retirement benefit schemes had been accounted for under FRS17, the following amounts would have been recorded in the profit and loss account and statement of total recognised gains and losses for the year ended 31 March 2004.

**24. Pension arrangements** (continued)

| | Babcock International Group Scheme £m | Rosyth Royal Dockyard Scheme £m | Other schemes £m | Group £m |
|---|---|---|---|---|
| **Amounts charged to operating profit** | | | | |
| Current service cost | (3.2) | (6.5) | – | (9.7) |
| Past service cost | – | – | (0.2) | (0.2) |
| Effect of settlement | (6.4) | – | 6.4 | – |
| Recognition of surplus | – | – | – | – |
| Curtailment gain | – | – | 0.2 | 0.2 |
| | (9.6) | (6.5) | 6.4 | (9.7) |
| **Amounts credited/(charged) to net interest** | | | | |
| Expected return on pension scheme assets | 19.5 | 18.7 | 0.6 | 38.8 |
| Interest on pension scheme liabilities | (18.2) | (17.7) | (0.8) | (36.7) |
| | 1.3 | 1.0 | (0.2) | 2.1 |
| **Amounts recorded in statement of total recognised gains and losses** | | | | |
| Actual return less expected return on pension scheme assets | 9.1 | 43.1 | 1.4 | 53.6 |
| Experience losses arising on scheme liabilities | (0.7) | (38.0) | – | (38.7) |
| Change in assumptions relating to present value of scheme liabilities | 2.6 | (9.7) | (0.7) | (7.8) |
| | 11.0 | (4.6) | 0.7 | 7.1 |
| **Movements in surplus/(deficit) during year** | | | | |
| Surplus/(deficits) in schemes at 1 April 2003 | 42.6 | (35.6) | (4.7) | 2.3 |
| Charged to operating profit | (9.6) | (6.5) | 6.4 | (9.7) |
| Employer contributions | – | – | 0.1 | 0.1 |
| Other finance income/(expense) | 1.3 | 1.0 | (0.2) | 2.1 |
| Actuarial gain/(loss) recognised in statement of total recognised gains and losses | 11.0 | (4.6) | 0.7 | 7.1 |
| Exchange adjustments | – | – | 0.1 | 0.1 |
| **Surplus/(deficits) in schemes as at 31 March 2004** | **45.3** | **(45.7)** | **2.4** | **2.0** |
| **History of experience gains and losses** | | | | |
| Difference between the expected and actual return on scheme assets | 9.1 | 43.1 | 1.4 | 53.6 |
| Percentage of scheme assets at 31 March 2004 | 2% | 12% | 27% | 7% |
| Experience gains/(losses) of scheme liabilities | (0.7) | (38.0) | – | (38.7) |
| Percentage of present value of scheme liabilities at 31 March 2004 | 0% | 10% | 0% | 5% |
| Total amount recognised in statement of total recognised gains and losses | 11.0 | (4.6) | 0.7 | 7.1 |
| Percentage of present value of scheme liabilities at 31 March 2004 | 3% | 1% | 24% | 1% |

**24. Pension arrangements** (continued)

If the defined benefit and post-retirement benefit schemes had been accounted for under FRS17, the following amounts would have been recorded in the profit and loss account and statement of recognised gains and losses for the year ended 31 March 2003.

| | Babcock International Group Scheme £m | Rosyth Royal Dockyard Scheme £m | Other schemes £m | Group £m |
|---|---|---|---|---|
| **Amounts charged to operating profit** | | | | |
| Current service cost | (1.9) | (5.9) | (0.6) | (8.4) |
| Effect of settlement | (1.2) | – | 1.2 | – |
| Recognition of surplus | 1.2 | – | – | 1.2 |
| Curtailment gain | – | – | 0.2 | 0.2 |
| | (1.9) | (5.9) | 0.8 | (7.0) |
| **Amounts credited/(charged) to net interest** | | | | |
| Expected return on pension scheme assets | 24.8 | 28.3 | 0.9 | 54.0 |
| Interest on pension scheme liabilities | (18.7) | (19.1) | (0.9) | (38.7) |
| | 6.1 | 9.2 | – | 15.3 |
| **Amounts recorded in statement of total recognised gains and losses** | | | | |
| Actual return less expected return on pension scheme assets | (12.6) | (99.9) | (4.1) | (116.6) |
| Experience gains/(losses) arising on scheme liabilities | 1.0 | 5.1 | (0.3) | 5.8 |
| Change in assumptions relating to present value of scheme liabilities | (23.9) | (7.1) | (1.5) | (32.5) |
| | (35.5) | (101.9) | (5.9) | (143.3) |
| **Movements in surplus/(deficit) during year** | | | | |
| Surplus/(deficit) in schemes at 1 April 2002 | 73.9 | 63.0 | (3.1) | 133.8 |
| Charged to operating profit | (1.9) | (5.9) | 0.8 | (7.0) |
| Employer contributions | – | – | 0.7 | 0.7 |
| Other finance income/(expense) | 6.1 | 9.2 | – | 15.3 |
| Actuarial gain/(loss) recognised in statement of total recognised gains and losses | (35.5) | (101.9) | (5.9) | (143.3) |
| Exceptional gain on disposal of business | – | – | 2.7 | 2.7 |
| Exchange adjustments | – | – | 0.1 | 0.1 |
| **Surplus/(deficits) in schemes as at 31 March 2003** | 42.6 | (35.6) | (4.7) | 2.3 |
| **History of experience gains and losses** | | | | |
| Difference between the expected and actual return on scheme assets | (12.6) | (99.9) | (4.1) | (116.6) |
| Percentage of scheme assets at 31 March 2003 | 3% | 34% | 37% | 17% |
| Experience gains/(losses) of scheme liabilities | 1.0 | 5.1 | (0.3) | 5.8 |
| Percentage of present value of scheme liabilities at 31 March 2003 | 0% | 2% | 2% | 1% |
| Total amount recognised in statement of total recognised gains and losses | (35.5) | (101.9) | (5.9) | (143.3) |
| Percentage of present value of scheme liabilities at 31 March 2003 | 10% | 31% | 38% | 21% |

**24. Pension arrangements** (continued)

If the valuation basis above had been applied in the accounts instead of the SSAP 24 valuation basis, the effect on the group's net assets and profit and loss account reserve after taking into account deferred tax, would have been as follows:

| | 2004 £m | 2003 £m |
|---|---|---|
| Net assets | | |
| As reported | 101.1 | 87.4 |
| Add back: | | |
| Pension prepayment under SSAP 24 | (69.0) | (71.2) |
| Provision for pension costs under SSAP 24 | 1.8 | 2.1 |
| Related deferred tax liability | 20.7 | 21.4 |
| Excluding pension assets | 54.6 | 39.7 |
| Net pension asset/(liability) under FRS17 | 1.1 | 1.3 |
| Including pension assets | 55.7 | 41.0 |

| | 2004 £m | 2003 £m |
|---|---|---|
| Profit and loss account reserve | | |
| As reported | (58.2) | (70.3) |
| Add back: | | |
| Pension prepayment under SSAP 24 | (69.0) | (71.2) |
| Provision for pension costs under SSAP 24 | 1.8 | 2.1 |
| Related deferred tax liability | 20.7 | 21.4 |
| Excluding pension assets | (104.7) | (118.0) |
| Net pension asset/(liability) under FRS17 | 1.1 | 1.3 |
| Including pension assets | (103.6) | (116.7) |

**25. Called up share capital**

| Authorised: | Ordinary shares of 60p Number | Unclassified shares of 30p Number | Ordinary shares of 60p £m | Unclassified shares of 30p £m |
|---|---|---|---|---|
| At 1 April 2003 | 249,166,666 | 1 | 150.0 | – |
| Authorised during the year | – | – | – | – |
| **At 31 March 2004** | **249,166,666** | **1** | **150.0** | **–** |

| Allotted, issued and fully paid: | Ordinary shares of 60p Number | Company and Group total £m |
|---|---|---|
| At 1 April 2003 | 148,126,466 | 88.9 |
| Ordinary 60p shares issued on exercise of options | 2,122,563 | 1.2 |
| **As at 31 March 2004** | **150,249,029** | **90.1** |

## 25. Called up share capital (continued)

*Outstanding share options*

The table below shows options existing over the company's shares as at 31 March 2004. They represent outstanding options granted under all of the company's Executive Share Options Schemes. Of the total number of shares shown, 3,462,621 are in respect of options granted by the trustee of the Babcock Employee Share Trust ('the trustee') and are options to acquire shares already purchased or intended to be purchased in the market by the trustee. The balance of 3,097,873 shares is in respect of options granted by the company to subscribe for newly issued shares.

| Scheme | Number of shares under option | Subscription price per share | Exercise period |
|---|---|---|---|
| Executive share option schemes | 27,000 | 132.50p | 16.12.1997 to 15.12.2004 |
| | 50,000 | 151.00p | 03.01.1999 to 02.01.2006 |
| | 40,000 | 74.50p | 19.12.1999 to 18.12.2006 |
| | 542,384 | 89.00p | 20.07.2001 to 19.07.2008 |
| | 218,465 | 122.50p | 08.07.2002 to 07.07.2009 |
| | 336,900 | 118.00p | 09.09.2002 to 08.09.2009 |
| | 391,104 | 96.33p | 23.06.2003 to 22.06.2010 |
| | 560,975 | 123.00p | 22.11.2003 to 21.11.2010 |
| | 1,123,090 | 99.33p | 25.06.2004 to 24.06.2011 |
| | 52,978 | 79.50p | 28.11.2004 to 27.11.2011 |
| | 230,039 | 104.33p | 31.01.2005 to 30.01.2012 |
| | 134,615 | 104.00p | 20.02.2005 to 19.02.2012 |
| | 1,932,944 | 124.50p | 24.06.2005 to 23.06.2012 |
| | 120,000 | 106.33p | 27.11.2005 to 26.11.2012 |
| | 800,000 | 115.66p | 30.06.2006 to 29.06.2013 |
| Total outstanding share options | 6,560,494 | | |

Options granted to Directors are summarised in the Remuneration report on pages 30 to 36 and are included in the outstanding options set out above.

## 26. Reserves

| | Group share premium account £m | Group capital redemption reserve £m | Group profit and loss account £m |
|---|---|---|---|
| At 1 April 2003 | 38.1 | 30.6 | (70.3) |
| Shares issued on exercise of options | 0.5 | – | – |
| Currency translation differences on foreign currency net investments and related loans | – | – | 0.6 |
| Retained profit for the financial year | – | – | 11.5 |
| **At 31 March 2004** | **38.6** | **30.6** | **(58.2)** |

| | Company share premium account £m | Company capital redemption reserve £m | Company profit and loss account £m |
|---|---|---|---|
| At 1 April 2003 | 38.1 | 30.6 | 19.1 |
| Shares issued on exercise of options | 0.5 | – | – |
| Retained loss for the financial year | – | – | (4.9) |
| **At 31 March 2004** | **38.6** | **30.6** | **14.2** |

## 27. Equity minority interests

| | £m |
|---|---|
| As at 1 April 2003 | 0.1 |
| Sold | (0.1) |
| **At 31 March 2004** | **–** |

## 28. Group cash flow statement

*(a) Reconciliation of group operating profit to net cash flow from operating activities:*

| | 2004 £m | 2003 £m |
|---|---|---|
| **Group operating profit** | **21.9** | 18.9 |
| Depreciation and amortisation charges | **8.2** | 11.0 |
| Increase in stocks | **(8.5)** | (8.8) |
| Decrease/(increase) in debtors | **13.7** | (20.3) |
| (Decrease)/increase in creditors | **(7.1)** | 9.4 |
| (Decrease)/increase in provisions | **(0.1)** | 1.1 |
| Other items | **(0.1)** | – |
| **Net cash inflow from operating activities** | **28.0** | 11.3 |
| Net cash inflow from operating activities comprises: | | |
| Continuing operating activities | **27.9** | 15.5 |
| Discontinued operating activities | **0.1** | (4.2) |
| | **28.0** | 11.3 |

*(b) Movement in net debt:*

| | 2004 £m | 2003 £m |
|---|---|---|
| **Increase/(decrease) in cash in the year** | **2.1** | (7.7) |
| (Decrease)/increase in liquid resources in the year | **(0.2)** | 0.2 |
| Cash flow from decrease/(increase) in debt and lease financing | **20.5** | (20.2) |
| Change in net funds resulting from cash flows | **22.4** | (27.7) |
| Loans and finance leases acquired with subsidiary | **–** | (0.1) |
| New finance leases | **(0.1)** | (0.7) |
| Translation differences | **(0.5)** | (0.3) |
| Movement in net debt in the year | **21.8** | (28.8) |
| Net debt at 1 April | **(37.2)** | (8.4) |
| Net debt at 31 March | **(15.4)** | (37.2) |

*(c) Changes in net debt*

| | At 1 April 2003 £m | Cash flow £m | New finance leases £m | Subsidiaries disposed/ acquired £m | Exchange movement £m | At 31 March 2004 £m |
|---|---|---|---|---|---|---|
| Cash in hand and at bank | 9.6 | 5.4 | – | – | (0.4) | **14.6** |
| Overdrafts | (7.9) | (3.3) | – | – | (0.1) | **(11.3)** |
| | 1.7 | 2.1 | – | – | (0.5) | **3.3** |
| Debt | (40.7) | 20.1 | – | – | 0.1 | **(20.5)** |
| Finance leases | (1.3) | 0.4 | (0.1) | – | (0.1) | **(1.1)** |
| | (42.0) | 20.5 | (0.1) | – | – | **(21.6)** |
| Liquid resources | 3.1 | (0.2) | – | – | – | **2.9** |
| Total | (37.2) | 22.4 | (0.1) | – | (0.5) | **(15.4)** |

## 28. Group cash flow statement (continued)

*(d) Analysis of the net cash flow in respect of acquisitions and disposals of subsidiaries:*

| | 2004 Disposals £m | 2004 Acquisitions £m | 2003 Disposals £m | 2003 Acquisitions £m |
|---|---|---|---|---|
| Net cash consideration | **2.6** | **0.6** | 1.0 | (23.5) |
| Net cash (disposed) of/acquired | – | – | (0.7) | 0.2 |
| Other payments and receipts | **(1.5)** | **(0.3)** | (2.9) | (0.9) |
| Net cash flow | **1.1** | **0.3** | (2.6) | (24.2) |

*(i) Disposals* The cash inflow from the sale of the Swedish Materials Handling group comprised consideration of £2.0 million and other costs of £1.6 million. The disposal of a non-trading subsidiary containing financial assets comprised consideration of £0.9 million and costs of £0.1 million. A payment of £0.3 million was also made on the previously disposed of Claudius Peters group. Also included in other payments and receipts are cash flows relating to previously disposed of businesses.

*(ii) Acquisitions* The cash inflow in respect of acquisitions comprises a repayment of consideration of £0.9 million received in respect of SGI purchased on 19 June 2002 and costs of £0.3 million. A final payment of £0.3 million was made in respect of the purchase of Air Power International in January 2001.

## 29. Acquisitions and disposals

*(a) Acquisitions*

The net assets acquired and the related costs were as follows:

Adjustments were made to the fair value of the assets acquired on the purchase of SGI. This related to the valuation of the Unicorn Pension Scheme. Also contingent consideration of £2.0 million became probable. The additional deferred consideration becomes payable on the signature of the South West Prime contract. This results in an increase of goodwill by £2.5 million. Dependent on future contract gains there is additional contingent consideration due of £3.0m.

| | | | SGI £'000 |
|---|---|---|---|
| | Fair value as stated in the 2003 accounts | Adjustments | Fair value as now reinstated |
| Tangible fixed assets | 0.3 | – | 0.3 |
| **Current assets** | | | |
| Debtors | 4.4 | – | 4.4 |
| Creditors | (3.2) | 0.2 | (3.0) |
| Finance lease | (0.1) | – | (0.1) |
| Provisions for liabilities and charges | (1.0) | (0.7) | (1.7) |
| **Net assets** | **0.4** | **(0.5)** | **(0.1)** |
| **Fair value of consideration:** | | | |
| Cash | 21.3 | – | 21.3 |
| Price adjustment | (0.9) | – | (0.9) |
| Deferred consideration | – | 2.0 | 2.0 |
| Costs | 0.6 | – | 0.6 |
| | 21.0 | 2.0 | 23.0 |
| Goodwill arising | 20.6 | 2.5 | 23.1 |

There were no changes to the fair value of the assets acquired for MEF (purchased 2 August 2002).

## 29. Acquisitions and disposals (continued)

*(b) Disposals*

The group sold the Swedish Materials Handling businesses on 30 November 2003.

The profits attributable to these businesses are included within discontinued operations in the profit and loss account and in the notes to the accounts.

The net assets disposed of and the related sale proceeds were as follows:

| | Swedish Materials Handling business |
|---|---|
| Tangible fixed assets | 1.5 |
| **Current assets** | |
| Stocks and work in progress | 3.7 |
| Debtors | 5.3 |
| Creditors | (7.9) |
| Deferred tax | (0.1) |
| **Net assets** | **2.5** |
| **Loss on sale** | **(2.5)** |
| **Net sale proceeds** | **–** |
| **Satisfied by:** | |
| Cash | 2.0 |
| Costs | (1.6) |
| Accrued costs | (0.4) |
| | – |

In addition a non trading subsidiary was sold on 31 March 2004 for net proceeds of £0.8 million after costs of £0.1 million.

## 30. Financial commitments

*Capital commitments*

| | **2004 £m** | 2003 £m |
|---|---|---|
| Authorised future capital expenditure of the group at 31 March that was contracted for but not provided for in the Financial Statements | **0.1** | 0.1 |

The company had no capital expenditure contracted for at 31 March 2004 (2003: £nil).

*Operating lease commitments*

*Group* The annual commitment of the group under non-cancellable operating leases was as follows:

| | **2004 Land and buildings £m** | **2004 Plant machinery and vehicles £m** | 2003 Land and buildings £m | 2003 Plant machinery and vehicles £m |
|---|---|---|---|---|
| Leases expiring: | | | | |
| Within one year | **0.4** | **0.2** | 0.2 | 0.7 |
| Within two to five years | **1.0** | **0.6** | 1.4 | 0.5 |
| Thereafter | **2.5** | **–** | 2.3 | – |
| | **3.9** | **0.8** | 3.9 | 1.2 |

*Company* The company has an operating lease commitment for land and buildings as at 31 March 2004 with an annual commitment expiring after more than five years of £1.7 million (2003: £1.7 million).

**31. Contingent liabilities**

*(a)* The company has guaranteed or has joint and several liability for bank facilities of £88.5 million (2003: £83.4 million) provided to certain group companies.

*(b)* Throughout the group, guarantees exist in respect of performance bonds and indemnities issued on behalf of group companies by banks and insurance companies in the ordinary course of business. At 31 March 2004 these amounted to £6.5 million (2003: £22.5 million), of which the company had counter-indemnified £6.0 million (2003: £22.5 million).

*(c)* The company has given guarantees on behalf of group companies in connection with the completion of contracts within specification.

*(d)* Pursuant to the Rosyth Dockyard privatisation agreement, the MoD will share in the net proceeds of sale or development of the Dockyard following planning enhancement, on terms set out in the asset purchase agreement between the RRDL and the MoD dated 30 January 1997. By way of security for the MoD's rights to such share, the company has granted a fixed charge (standard security) over the Dockyard in favour of the Authority.

*(e)* The company has given certain indemnities and warranties in the course of disposing of businesses and companies. The company believes that any liability in respect of these is unlikely to have a material effect on the group's financial position.

*(f)* The group is involved in disputes and litigation which have arisen in the course of normal trading. The Directors do not believe that the outcome of these matters will result in any material adverse change to the group's financial position.

**32. Related party transactions**

Details of transactions with related parties in accordance with the requirements of FRS8 Related Party Disclosures, are set out below:

*(a) Transactions with joint ventures*

*(i)* During the year a group subsidiary purchased goods from, and sold goods to, its joint venture FBMA Babcock Marine Inc. for £nil and £53,000 respectively (2003: £939,000 and £nil). The amounts outstanding at year end on these purchases and sales were £nil and £37,000 respectively (2003: £nil and £6,000). A group subsidiary also made loans to the joint venture. The amount outstanding at year end was £667,000 (2003: £775,000). All transactions with the joint venture arise in the normal course of business.

*(ii)* During the year a group subsidiary sold goods to its joint venture DynCorp-Hiberna Limited for £305,000 (2003: £nil). The amount outstanding at year end was £56,000 (2003: £nil). A group subsidiary also made loans to the joint venture. The amount outstanding at year end was £267,000 (2003: £nil). All transactions with the joint venture arise in the normal course of business.

*(iii)* During the year a group subsidiary sold services to its joint venture JBFM Babcock Pty Limited for £13,000 (2003: £nil). The amount outstanding at year end was £nil (2003: £nil). During the year a group subsidiary received a dividend from the joint venture for £6,000 (2003: £nil). All transactions with the joint venture arise in the normal course of business.

*(b) Transactions with BAE Systems PLC*

During the year group subsidiaries purchased goods from, and sold goods to BAE Systems PLC for £122,000 and £470,000 respectively (2003: £262,000 and £2,440,000). The amounts outstanding at year end on these purchases and sales were £117,000 and £370,000 respectively (2003: £15,000 and £538,000). Mr M J Turner, Chief Executive Officer of BAE Systems PLC, and the Rt Hon Lord Hesketh, a non-executive Director of BAE Systems PLC, are non-executive Directors of Babcock International Group PLC. All transactions between group subsidiaries and BAE Systems PLC arise in the normal course of business, and on arm's length terms.

*(c) Babcock Employee Share Trust*

During the year the company acquired ordinary shares through the Babcock Employee Share Trust. Further information is given in note 15 on page 51.

**33. Subsequent events**

There are no material events subsequent to 31 March 2004 that are required to be disclosed.

# Principal subsidiary and associated undertakings

**Technical Services**
Technical services and secure facilities management for the MoD and related markets:

| |
|---|
| Babcock Eagleton Inc. (USA) |
| Babcock Support Services Limited |
| Babcock Design & Technology Limited |
| FBM Babcock Marine Holdings (UK) Limited |
| FBM Babcock Marine Limited |
| FBMA Babcock Marine Inc. (50%) (Philippines)* |
| Marine Engineering & Fabrications Limited |
| Rosyth Royal Dockyard Limited |

**Training and Support**
Training, operating and maintenance services primarily for the MoD:

| |
|---|
| Acetech Personnel Limited |
| CMR Consultants Limited |
| Hiberna FM Limited |
| Babcock Africa (Pty) Limited (South Africa) |
| Babcock Africa Services (Pty) Limited (South Africa) |
| Babcock Naval Services Limited |
| Air Power International Limited |

**Others**

| |
|---|
| Babcock Holdings Limited |
| Babcock International Holdings BV (Netherlands) |
| Babcock International Limited |
| Babcock Investments Limited |
| Babcock Management Limited |
| Babcock Overseas Investments Limited |
| Chepstow Insurance Limited (Guernsey) |
| Babcock Support Services (Investments) Limited |
| Babcock Holdings (USA) Inc. (USA) |

All undertakings are wholly-owned unless otherwise stated. With the exception of Babcock Holdings Limited and Babcock Investments Limited which are owned by the company, all group undertakings are owned by subsidiary undertakings.

Except as otherwise stated, all shares held comprise share capital.

All undertakings are incorporated and operated in Great Britain unless otherwise stated. Undertakings located overseas operate principally in the country of incorporation.

*Denotes undertakings recognised and accounted for as joint ventures.

# Notice of meeting

Notice is hereby given that the fifteenth Annual General Meeting of the members of Babcock International Group PLC ('the company') will be held at The Berkeley Hotel, Wilton Place, Knightsbridge, London SW1X 7RL, on Friday, 16 July 2004, at 11.30 am for the transaction of the following business:

**As Ordinary Business:**

*(1)* To receive the Directors' and Auditors' reports and the audited Financial Statements of the company for the year ended 31 March 2004.

*(2)* To declare a final dividend for the year ended 31 March 2004 as recommended by the Directors.

*(3)* To re-elect Mr Campbell as a Director of the company.

*(4)* To re-elect Lord Hesketh as a Director of the company.

*(5)* To approve the Remuneration Report of the Directors for the year ended 31 March 2004.

*(6)* To reappoint PricewaterhouseCoopers LLP as Auditors.

*(7)* To authorise the Directors to set the remuneration of the Auditors, as they shall in their discretion see fit.

**As Special Business, to consider and, if thought fit, to pass the following special resolution:**

*(8)* That the company is hereby generally and unconditionally authorised to make market purchases (within the meaning of section 163 of the Companies Act 1985) of ordinary shares of 60p each ('ordinary shares') in the capital of the company provided that:

- *(a)* the maximum number of ordinary shares hereby authorised to be purchased shall be 15,000,000;
- *(b)* the minimum price which may be paid for each ordinary share is not less than the nominal value thereof exclusive of the expenses of purchase;
- *(c)* the maximum price which may be paid for each ordinary share (exclusive of the expenses of purchase) shall not exceed 105% of the average middle market quotation for an ordinary share as derived from the London Stock Exchange Daily Official List for the five business days preceding the day of purchase;
- *(d)* the authority hereby conferred shall expire on 31 December 2005 or at the conclusion of the next Annual General Meeting of the company (whichever is the earlier) unless such authority is renewed prior to such time; and
- *(e)* the company may make a contract to purchase ordinary shares under the authority hereby conferred prior to the expiry of such authority which will or may be executed wholly or partly after the expiry of such authority and may make purchases of ordinary shares in pursuance of any such contract.

By order of the Board.

**A N Dungate** Secretary
11 June 2004
Registered Office:
2 Cavendish Square
London W1G 0PX

**Notes:**

*(1)* An explanation of the special business resolution is given on page 70.

*(2)* A holder of ordinary shares is entitled to attend and vote at the meeting and may appoint a proxy to attend and, on a poll, vote on his or her behalf. The proxy need not be a member of the company.

*(3)* A holder of ordinary shares must be entered on the relevant register of securities in respect of such shareholding not later than 48 hours before the time appointed for the meeting in order to have the right to attend and vote at the meeting.

*(4)* A form of proxy is enclosed and, to be effective, must be completed in accordance with the instructions printed thereon and returned so as to be received by the Registrars of the company not less than 48 hours before the time appointed for the meeting. Completion of a form of proxy will not affect the right of a member to attend and vote in person at the meeting.

*(5)* The register of Directors' interests in the share capital of the company, together with copies of service agreements or terms of appointment under which Directors of the company are engaged, are available for inspection at the company's registered office during normal business hours until the date of the Annual General Meeting and will be available for inspection at the place of the Annual General Meeting for at least 15 minutes prior to and during the meeting.

# Explanatory notes

*Resolution (8)* set out in the notice of Annual General Meeting on page 69 constitutes special business.

It will be proposed as a Special Resolution. If passed, it will renew the general authority for the company to make market purchases of its own ordinary shares. The renewed authority, in respect of just under 10% of the company's issued share capital as at 2 June 2004, would be exercisable with a minimum purchase price of 60p per share and a maximum price of not more than 105% of the average middle market quotation for an ordinary share as derived from the London Stock Exchange Daily Official List for the five business days preceding the day of purchase.

If granted, the authority will expire on 31 December 2005 or, if earlier, at the conclusion of the Annual General Meeting of the company to be held in 2005. Shares purchased under the authority would either be cancelled or held by the company as treasury shares. The Directors have no present intention of using this power, and would only exercise the power if they were satisfied at any time that it was in the best interests of shareholders generally to do so, and that (except in the case of a purchase of own shares to be held as treasury shares to fulfil obligations under the company's employee share schemes) any purchase would be likely to result in an increase in earnings per share. The company has no warrants outstanding and the total number of options to subscribe for equity shares outstanding on 2 June 2004 (being the latest practicable date before publication of the notice of meeting) was 2,938,903 representing 1.95% of issued share capital as at 2 June 2004. If the full authority to buy back shares were to be used, and the Shares cancelled, these outstanding options would represent 2.17% of issued share capital.

# Five year financial record

| | 2004 £m | 2003 £m | 2002 £m | 2001 £m | 2000 £m |
|---|---|---|---|---|---|
| Group turnover | **452.0** | 423.5 | 423.0 | 441.0 | 470.7 |
| Operating profit/(loss)* | **22.0** | 18.7 | 0.9 | (4.8) | 20.8 |
| Exceptional items | **(1.7)** | (2.7) | (13.8) | (6.2) | 1.0 |
| Profit/(loss) on ordinary activities before interest | **20.3** | 16.0 | (12.9) | (11.0) | 21.8 |
| Net interest and similar charges | **(0.5)** | (2.6) | (1.0) | 3.7 | 4.2 |
| Profit/(loss) on ordinary activities before taxation | **19.8** | 13.4 | (13.9) | (7.3) | 26.0 |
| Tax on ordinary activities | **(3.4)** | (5.1) | (3.1) | (1.2) | (4.5) |
| Profit/(loss) on ordinary activities after taxation | **16.4** | 8.3 | (17.0) | (8.5) | 21.5 |
| Minority interests | **–** | – | (0.1) | 3.2 | 1.0 |
| Profit/(loss) attributable to shareholders | **16.4** | 8.3 | (17.1) | (5.3) | 22.5 |
| Fixed assets | **94.4** | 99.3 | 85.1 | 114.7 | 58.7 |
| Net current assets | **51.7** | 34.5 | 25.6 | 33.9 | 129.1 |
| Non-current liabilities and provisions | **(45.0)** | (46.4) | (29.7) | (39.7) | (36.0) |
| Total net assets | **101.1** | 87.4 | 81.0 | 108.9 | 151.8 |
| Shareholders' funds | **101.1** | 87.3 | 81.0 | 105.7 | 143.9 |
| Minority interests | **–** | 0.1 | – | 3.2 | 7.9 |
| | **101.1** | 87.4 | 81.0 | 108.9 | 151.8 |
| Earnings/(loss) per share – basic | **11.31p** | 5.72p | (11.86)p | (3.34)p | 13.26p |
| Dividends per share | **3.35p** | 3.00p | 2.85p | 2.65p | 2.55p |

*Includes operating loss/profit of joint ventures and associates. Years prior to 2001 have not been restated following adoption of FRS19.

# Shareholder information

**Financial calendar**

| | |
|---|---|
| Financial year end | 31 March 2004 |
| 2003/04 preliminary results announced | 20 May 2004 |
| Annual General Meeting | 16 July 2004 |
| Final dividend payment date (record date 9 July 2004) | 9 August 2004* |

*See also 'Results and Dividends' on page 23

**Registered office and company number**
2 Cavendish Square
London W1G 0PX

Registered in England
Company number 2342138

**Registrars**
Computershare Investor Services PLC
PO Box No 82
The Pavilions
Bridgwater Road
Bristol BS99 7NH

Shareholder enquiries relating to shareholding, dividend payments, change of address, loss of share certificate etc. should be addressed to Computershare Investor Services PLC at their address given above.

**Auditors**
PricewaterhouseCoopers LLP
1 Embankment Place
London WC2N 6RH

**Principal UK bankers**
The Royal Bank of Scotland plc
135 Bishopsgate
London EC2M 3UR

HSBC Bank plc
8 Canada Square
London E14 4QJ

**Investment bankers**
Credit Suisse First Boston (Europe) Limited
1 Cabot Square
London E14 4OJ

**Stockbrokers**
Cazenove Group PLC
20 Moorgate
London EC2R 6DA

**Share dealing service**
The company, through National Westminster Bank Plc, offers a special share dealing service to shareholders either by post or through NatWest branches. Shareholders who wish to use either of these facilities are asked to telephone 0870 600 2050 or alternatively, to write to NatWest Stockbrokers Limited, Babcock International Group Information, FREEPOST, London E1 8BR or email contactces@natwest.com, please quote 'Babcock'.

**Taxation**
A return of capital to ordinary shareholders by way of a bonus issue of redeemable 'B' shares of 18p each, out of the company's share premium account, was approved at an Extraordinary General Meeting of the company held on 10 October 2000. A guide to the general tax position of United Kingdom shareholders under the return of capital is given in Part IV of the circular to shareholders dated 15 September 2000. Copies of the Part IV guide are available, on request, from the Company Secretary, at Babcock International Group PLC's Registered Office (see back cover).

Market values of Babcock International Group PLC new ordinary shares of 60p and 'B' Shares for the purpose of taxation of chargeable capital gains (CGT) are as follows:

| | New ordinary shares | 'B' shares |
|---|---|---|
| 23 October 2000** | 112.5p | 17.75p |

The market values stated above are used to allocate the base cost of the existing ordinary shares, between the new ordinary shares and 'B' shares in calculating any CGT liability.

**Being the first day of trading of the new ordinary shares and the 'B' shares.

Design and production: Radley Yeldar
Main photography: Richard Learoyd

Babcock International Group PLC
2 Cavendish Square
London W1G 0PX
Telephone +44 (0)20 7291 5000
Fax +44 (0)20 7291 5055
www.babcock.co.uk