Bringing service to life

Annual review and accounts 2005

Serco Group plc Annual review and accounts 2005

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Serco is an international service company which combines commercial know-how with a deep public service ethos.

We improve services by managing people, processes, technology and assets more effectively. We advise policy makers, design innovative solutions, integrate systems and – most of all – deliver to the public.

Serco supports governments, agencies and companies who seek a trusted partner with a solid track-record of providing assured service excellence. Our people offer operational, management and consulting expertise in the aerospace, defence, education, health, home affairs, local government, science, technology, transport and the commercial sectors.

We improve patient care with our health services; we rehabilitate offenders in our prisons; we protect borders through technology; we provide swift, safe travel with our trains and transport systems; we help young people learn in the schools and training centres we manage; we enable trade by the precise measurements undertaken by our scientists. We bring service to life.

Our five foundation stones

The five foundation stones define the way we will run and grow Serco. They set out the services we wish to provide, our behaviours and the way we manage. They ensure we are all working from a commonly understood base that can be consistently applied across our organisation.

Our governing principles
The behaviours we expect to see in the organisation
- We foster an entrepreneurial culture
- We enable our people to excel
- We deliver our promises
- We build trust and respect

Our business model
The way we wish to build the business
- Long term relationships in which there is opportunity for continuous improvement, organic growth and value creation

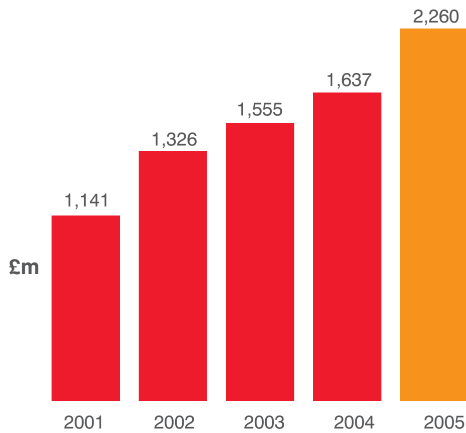
Our business offering
The services we wish to provide
- Assured delivery of services, innovation and organisational change to help our clients in achieving their ambitions

Our organisational model
How Group, Divisions and Business Services interact
- Group focuses on external stakeholder relationships, setting the strategic direction for the Group and maintaining the appropriate controls on the underlying business
- Divisions focus on delivering value and growth
- Business Services focuses on helping the Divisions achieve the right returns at the most cost effective rate

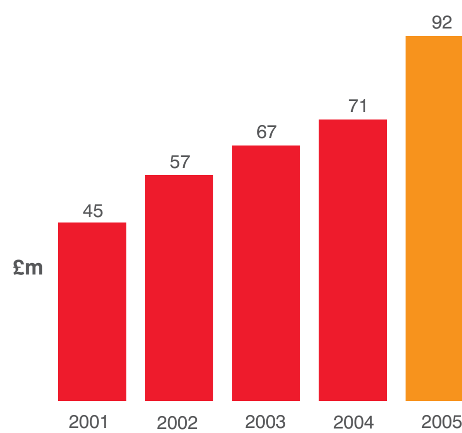
Our operating principles
The principles by which we will manage the company
- We have a simple and efficient organisation
- We operate an effective governance framework
- We encourage strong and capable leaders

Highlights

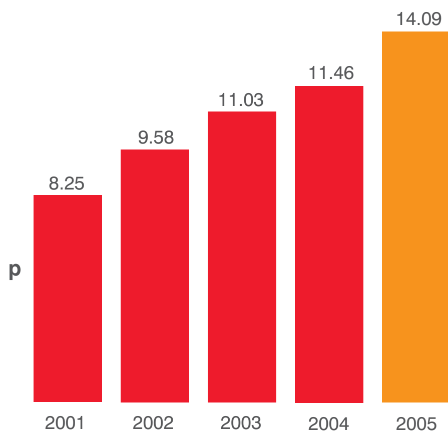
Revenue
including share of joint ventures



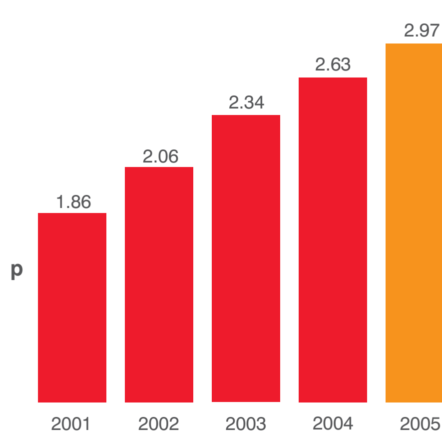
Profit
before tax
and intangible amortisation



Basic earnings per share
before intangible amortisation



Dividend per share



Note: 2001 to 2003 under UK GAAP. 2004 restated under IFRS.

	2005	2004	
Revenue	**£2,260.3m**	£1,636.9m	**up 38.1%**
Profit before tax and amortisation	**£91.5m**	£71.2m	**up 28.5%**
Earnings per share before amortisation	**14.09p**	11.46p	**up 22.9%**
Profit before tax	**£77.9m**	£64.0m	**up 21.7%**
Earnings per share	**11.66p**	10.11p	**up 15.3%**
Dividend per share	**2.97p**	2.63p	**up 12.9%**

Further strong growth

- Organic revenue growth of 19.4% and organic PBTA growth of 13.1%
- In 2005, contract wins and extensions of £2.6bn secured and appointed preferred bidder on contracts valued at a further £2.4bn
- Continued win rates of over 90% of rebids and over 50% of new bids
- Acquisitions of ITNET and RCI added £333.9m to revenue and £23.6m to PBTA (£10.3m after funding costs)
- Group EBITDA to cash conversion of 90% contributing to Group free cash flow of £73.8m (2004: £55.8m)

Rapidly developing capabilities and markets

- ITNET and RCI have added new skills and capabilities and taken us into new and growing markets
- Leveraging Group-wide capabilities to win large and technical contracts – Cyclamen (£100m) and Small Business Service (£125m)
- Increasing range of drivers expanding our markets around the world

High visibility of future revenue

- Forward order book at a record £13.4bn at 31 December 2005
- 91% of planned revenue for 2006, 77% for 2007, 64% for 2008
- None of our ten largest contracts due for rebid before end of 2010
- Encouraging start to 2006 – appointed preferred bidder for £1.0bn Marine Services rebid

Continuing positive outlook

- Unprecedented range of market opportunities
- In excess of £21bn of opportunities identified across our markets
- Selective bidding, portfolio management and efficiency will contribute to increasing margins
- Confident of double-digit growth for the foreseeable future

Note: Organic growth excludes the impact of acquisitions and disposals as included in the Finance review. PBTA is profit before tax and intangible amortisation. Group EBITDA is earnings from subsidiaries before interest, tax, depreciation and intangible amortisation. Cash conversion is the ratio of Group operating cash flow to Group EBITDA. Group free cash flow is from subsidiaries and is reconciled in Section 4 of the Finance review.

Our business

Civil government

We have over 25 years' experience in delivering essential public services. In home affairs, our activities range from managing prisons and court escort services to electronic monitoring of offenders and developing intelligence systems. We also have a growing civil resilience capability.

We provide education services to children in Walsall and Bradford and have an expanding school software operation. In health we provide support services to hospitals, strategic consulting to health services and out-of-hours doctor services to 1m people. In local government we are a leading provider of IT services and business process outsourcing and deliver environmental, streetscene and other direct services.

More generally, governments are increasingly using us in a consulting capacity as they seek answers to their public service issues.

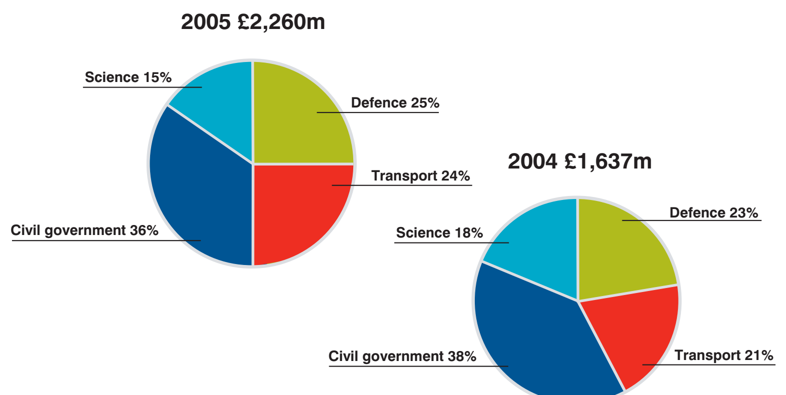
Transport

We have a strong position in transport. In UK rail we run Merseyrail – one of the best performing franchises – and Northern Rail, the largest network. In Australia we run the Great Southern Railway, including its iconic service The Ghan. Our urban transportation business operates the award-winning Docklands Light Railway and light rail systems in Manchester and Copenhagen, and is a UK market leader in traffic management systems. In air, we are a leading provider of air traffic control services in the Middle East and US.

Defence

Since winning our first contract in the 1960s, we have developed a broad business of more than 100 defence contracts in the UK, ranging from supporting secure military communication's systems to managing training colleges. We are a leading service supplier to the Australian armed forces and have a growing portfolio in Germany. We have built critical mass in the key North American market, with particular strength in providing human resources services to the military.

Revenue: market sector analysis



2005 private sector revenue of £192m (2004: £125m) included within the four segments above

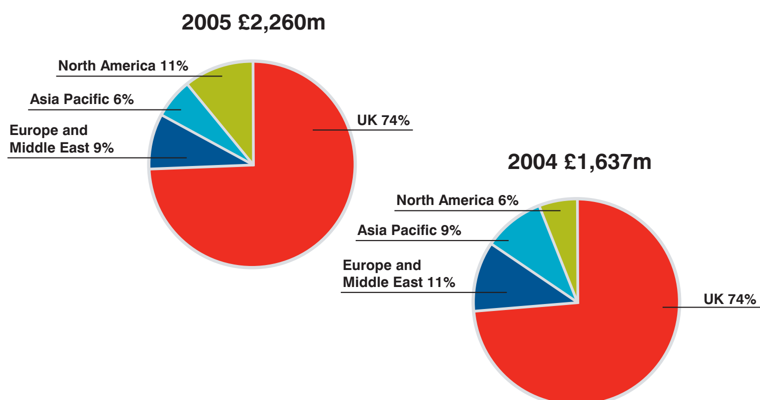
Science

Our science business began in the 1970s with our work for the European Space Agency and we are now a sector leader. We run the UK's National Physical Laboratory – one of the world's major scientific establishments. With our partners, we operate the UK's Atomic Weapons Establishment. We provide safety advice to the Royal Navy's nuclear submarines and deliver technical support services to CERN – the world's largest particle physics laboratory.

Private sector

Our work with the private sector includes multi-service facilities management for blue-chip clients. For example, we provide a shared services centre for Microsoft's European subsidiaries, and deliver integrated services to Airbus UK. We also provide IT services to major companies, including Cadbury Schweppes and Coca-Cola Enterprises. In North America we have a strong position in fleet maintenance for utilities. In the Middle East, we perform facilities management and maintenance tasks for local businesses.

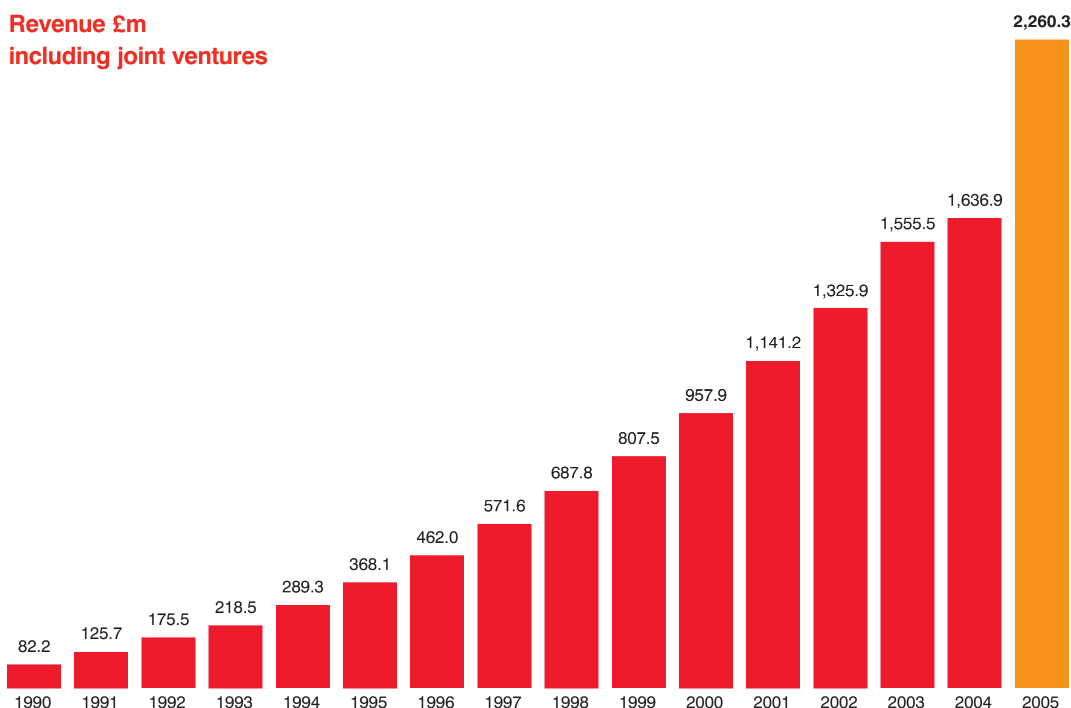
Revenue: geographical analysis



Chairman's statement

Kevin Beeston
Executive Chairman

"2005 was an outstanding year for Serco. Markets continue to grow, primarily driven by governments' needs to control spending and improve the quality of public services. Our public service ethos and commitment to partnership enable us to win more than 90% of rebids and 50% of new bids. This success is built on a firm foundation: consistent, high quality service to satisfied customers. Our balanced portfolio, spread across our chosen sectors and international markets, allows us to target the best opportunities. The forward order book stands at a record level and none of our ten highest revenue contracts are due for rebid before the end of 2010. We remain confident of continuing double-digit growth and increasing margins."



2005 was an outstanding year for Serco. We grew revenue by 38.1% to £2,260m, with organic growth of 19.4%. Profit before tax and intangible amortisation (PBTA) also increased strongly, by 28.5% to £91.5m, with organic PBTA growth of 13.1%. Earnings per share before intangible amortisation grew 22.9% to 14.09p. After intangible amortisation, profit before tax grew 21.7% to £77.9m and earnings per share increased by 15.3% to 11.66p.

The recommended final dividend of 2.06p per share gives a total for the year of 2.97p, an increase of 12.9%.

Our cash performance remains strong, with Group EBITDA to cash conversion of 90% (2004: 93%) contributing to a Group free cash flow of £73.8m for the year (2004: £55.8m).

In total during 2005, we signed contracts and extensions valued at £2.6bn and we were appointed preferred bidder for contracts totalling £2.4bn.

We have maintained our win rate of more than 90% on rebids, demonstrating the quality of service we deliver to satisfied customers. The highest profile re-competition during 2005 was the Docklands Light Railway contract, valued at around £400m over up to nine years. Additionally, in February 2006 we became preferred bidder for a 15-year contract valued at around £1bn to provide marine services to the UK Ministry of Defence (MoD). With these rebids now signed or at preferred bidder stage, none of our ten largest contracts by annual revenue are due for renewal before the end of 2010.

Our record of winning new contracts was also excellent. As in previous years, we won more than 50% of new bids in 2005, underlining the strength of our reputation, our ability to be selective in targeting new work and continuing innovative solutions. Amongst many notable wins, we were appointed preferred bidder for a 35-year contract valued at around £1.2bn to provide support services to three hospitals in Leicester, and we signed a 23-year contract valued at around £400m to support the MoD's Defence Academy.

Our two largest acquisitions – ITNET (now Serco Solutions) and RCI (now part of Serco Inc) – had the anticipated positive impact, adding £333.9m to revenue and £23.6m (£10.3m after funding costs) to PBTA.

The new skills and capabilities they have brought to the Group are already delivering benefits. For example, Serco Solutions was instrumental in winning a £125m Small Business Service contract from the UK Department of Trade and Industry. Serco Inc is enjoying strong growth and will provide a platform for expanding our North American presence into other sectors such as transport.

We are leveraging the benefits of our increasing scale and achieving efficiencies by centralising the purchasing of materials and developing a shared services facility for our back office functions such as finance and administration. We have streamlined our management structure, removed unnecessary bureaucracy and begun the implementation of a SAP financial system. These initiatives – together with selective bidding and continued management of our business portfolio – will benefit our PBTA margins in 2006 and beyond.

Visibility of future revenue remains excellent. At 31 December 2005, our forward order book stood at a record £13.4bn and we had visibility of 91% of our planned revenue for 2006, 77% for 2007 and 64% for 2008.

At the same date, we had contracts valued at £2.6bn at preferred bidder and a further £2.7bn of bids where we have been shortlisted to the final two or three bidders.

Favourable drivers worldwide

Our opportunities for growth are created by two principal drivers: the necessity for central and local governments to control their spending and their need to respond to social pressures for improved public services.

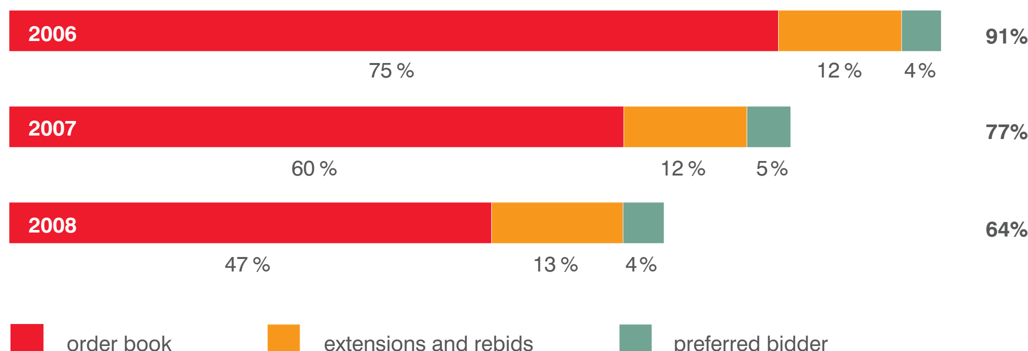
Our business portfolio, spread across different sectors and around the world, allows us to target our resources towards the best opportunities.

In the UK, the home affairs market is driven by the change in government focus from implementing initiatives to the delivery of outcomes - reducing crime and the fear of crime. We estimate that this market is worth £2.5bn per annum and growing fast. We have created a new position in healthcare, which is among the largest and fastest growing areas of UK Government spending – some £89bn in 2005/6. The Government continues to invest some £70bn per annum in education and we see opportunities in children's services and information and communications technology emerging from the recent Education Bill. In science, the formation of the UK's Nuclear Decommissioning Authority has created a market worth around £2bn per annum. Most areas of the public sector are seeing budgetary pressure and in response are changing the way they work. In UK defence, we expect our addressable market to double to £8bn per annum by 2010 as the MoD focuses resources, continues to civilianise and seeks cost savings.

A similar pattern is emerging in North America, the largest services market in the world. The market is estimated at $2,000bn per annum, of which around one third is at the federal level and the remainder with state and local governments. The annual US defence budget is nearly $400bn and rising. Some market segments are looking at private sector service provision for the first time and more established markets such as municipal services and transportation are moving to more sophisticated, performance-based contracting as the emphasis shifts from lowest cost to best value, a trend which plays to our strengths.

We also see exciting prospects in parts of Europe – notably Germany, where economic and political conditions are accelerating the trend towards public private partnerships – and the Middle East, in particular the United Arab Emirates. In Asia Pacific, the Australian defence and transport

Visibility of planned revenue



markets continue to offer good potential, while the opening of our Shanghai, China office positions us to explore opportunities as the regional government pursues its ambitious public service objectives.

Dedicated professionals

People are at the heart of our business. Throughout 2005, the dedication, expertise and professionalism of Serco colleagues around the world were critical to our performance. Notwithstanding their daily achievements in bringing service to life, their wholehearted response to the tsunami in south-east Asia, the London bombings, the hurricanes in the Gulf of Mexico and the Pakistan earthquake, epitomised the spirit that defines Serco.

Board

Since his appointment as a Non-Executive Director in April 2000, Ralph Hodge has played a vital role in shaping the direction of our business. As he prepares to step down from the Board, we would like to place on record our gratitude for his contribution. We wish him a long and healthy retirement.

The Board has approved the appointment of Leonard V. Broese van Groenou as a Non-Executive Director, effective from 3 April 2006. We are delighted to welcome him to Serco.

Continuing positive outlook

Governments around the world are continuing to face significant pressures to provide better public services at lower cost and our market opportunities are unprecedented. In the UK, our growth is being fuelled by the development of a mixed economy, which incorporates the private sector in the delivery of public services, and our ability to deliver customers' desired outcomes, which enable us to develop long term relationships which in turn drive our organic growth.

The Group has identified in excess of £21bn of opportunities across our markets. The breadth of these opportunities, together with our approach to selective bidding, portfolio management and efficiency will contribute to increasing margins. We are confident of achieving double-digit growth for the foreseeable future.

Business review

Christopher Hyman
Chief Executive

"We are proud to combine a strong public service ethos with commercial know-how. We work hard to protect that culture by living our governing principles."

Vision, strategy and values

Vision

Our vision is to be the leading service company in our chosen markets. We aim to be the best partner to work with, the company people aspire to work for and a company that delivers superior returns to its shareholders.

Strategy

Serco's strategy is to build a balanced contract portfolio, spread across different sectors and geographic markets around the world. We do this through organic growth, achieved by delivering excellent service and building long term relationships with our customers.

Balanced contract portfolio

A balanced portfolio brings three benefits: broader exposure to growth opportunities, better diversification of risk and the opportunity to share good practice honed by wide experience. Even if one market sector or region slows down, we will still be able to deliver strong growth. None of our contracts accounts for more than 10% of our revenue. We are able to transfer our skills and capabilities from one sector to another and to other countries as their markets develop.

Organic growth

Organic growth – both new contracts and expanding the scale and scope of contracts with existing customers – is fundamental to Serco. It is enabled by our structure, which devolves responsibility as far as practicable so we can be more responsive, customer focused and entrepreneurial. We only make acquisitions to bring new skills into the Group or to open up new markets – either geographically or in new business areas.

Delivering excellent service and building long term relationships

We support governments, agencies and companies who seek a trusted partner with a solid track-record of providing assured service excellence. Delivering our customers' required outcomes enables us to develop long term relationships with them, which in turn drives our organic growth as we expand the scale and scope of our contracts.

Values

Our values are captured within our Governing Principles, which define the way we behave.

We foster an entrepreneurial culture
We are passionate about building innovative and successful businesses.

This means we succeed by encouraging and generating new ideas. We trust our people to deliver. We embrace change and by taking measured risks encourage creative thinking.

We enable our people to excel
Our success comes from our commitment and energy to go the extra mile.

This means we are responsible to each other and can expect support when we need it most. We expect our people to achieve more by recognising and harnessing the power of individuals. We value people for their knowledge, ideas and potential to contribute.

We deliver our promises
We do what we say we will do to meet expectations.

This means we only promise what we can deliver. If we make mistakes we put them right. We are clear about what we need to achieve and we expect to make a fair profit.

We build trust and respect
We build trust and respect by operating in a safe, socially responsible, consistent and honest manner.

This means we never compromise on safety. We listen. We treat others as we would wish to be treated and challenge when we see something is wrong.

All Serco employees are expected to adhere to the highest standards in dealings with colleagues, customers, suppliers or shareholders. By setting these standards and by supporting each other, we aim to get the best out of our people and subsequently the best service for our customers. This is vital to our ongoing business.

The role of culture and reputation

To prosper in a service market it is essential to have the right culture and the right reputation.

Serco's culture has developed over many years. We are proud to combine a strong public service ethos with commercial know-how. We work hard to protect that culture by living our Governing Principles.

The Serco Institute, our public policy think tank, is now internationally recognised as a centre of insight into public private partnerships. It recently conducted an anonymous research programme with more than 100 of our contract managers who have moved from the public to the private sector. Overwhelmingly, they reported that contracting public services to the private sector made it easier to deliver high quality, better value public services and made them feel more accountable for delivering outcomes, rather than just managing processes.

Our reputation for delivering excellent service and our ability to build long term relationships is behind the consistent success Serco has enjoyed to date.

As we move deeper into markets and extend into new markets, we require our reputation to precede us. The Serco name is becoming better known among commercial and political audiences and we continue to strengthen our brand through the services we provide, our contribution to policy debates and the provision of tangible and topical examples of service improvement.

Operating environment

Our opportunities for growth in our public sector markets are created by two principal drivers: the necessity for central and local governments to control their spending and their need to respond to social pressures for improved public services.

More governments are recognising the value of private sector partnership in the delivery of essential public services. We focus our efforts on those sectors and countries with the greatest potential.

The climate in the UK, North America and parts of Europe is working strongly in our favour and we see longer term potential in selected countries in the Middle East and Asia Pacific, including China.

The UK Government spends hundreds of billions of pounds every year on public services. The proportion that is competitively sourced is relatively small but growing rapidly. Issues such as improving civil resilience, reducing re-offending, enhancing people's health, helping children's education, and more efficient use of transport infrastructure are high on the political agenda. We see substantial opportunities for us to be part of the range of public, private and voluntary organisations contributing to the reform programme. This move to involve a broad church of organisations demonstrates how government is shifting its role from implementing initiatives to defining the outcomes needed from public services.

In the UK home affairs market, the Government's focus is on reducing crime and the fear of crime. We estimate that this market is worth £2.5bn per annum and growing fast. We have created a new position in healthcare, which is among the largest and fastest growing areas of UK Government spending – some £89bn in 2005/6.

The Government spends £70bn on education and we see opportunities in children's services and information and communications technology emerging from the recent Education Bill. In science, the formation of the Nuclear Decommissioning Authority has created a market worth around £2bn per year.

Most areas of the UK public sector are seeing budgetary pressure and in response are changing the way they work. In UK defence, for example, we expect our addressable market to double to £8bn per annum by 2010, as the Ministry of Defence focuses resources, continues to civilianise and seeks cost savings.

A similar pattern is emerging in North America, the world's largest services market. The market is estimated at $2,000bn a year, of which around one third is at the federal level and the remainder with state and local governments. The annual US defence budget is nearly $400bn and rising. New military challenges and ongoing conflict in the Middle East has put our biggest US customer, the Department of Defense, under pressure to focus resources on its frontline operations. The shift of personnel from the back office into active duty creates an opportunity that we can fill. Some market segments in North America are looking at private sector service provision for the first time and more established markets, such as municipal services and transportation, are moving to more sophisticated, performance-based contracting as the emphasis shifts from lowest cost to best value, a trend which plays to Serco's strengths.

We have focused our European strategy onto opportunities in two key areas: the European scientific agency network and the German public sector.

In Germany, economic and political conditions are accelerating the trend towards public private partnerships. There is a widening gap between the supply of public funds and demand for investment in the country's essential infrastructure and services. These pressures are felt at federal, state and local government levels, resulting in a broad range of opportunities emerging for Serco. Our primary focus is in the defence and justice markets, with transport also likely to provide exciting opportunities.

We see prospects in the Middle East, in particular the United Arab Emirates. In Asia Pacific, the Australian defence and transport markets continue to offer good potential, while the opening of our Shanghai, China office positions us to explore opportunities as the regional government pursues its ambitious public service objectives.

Our ‘Lads n Dads’ scheme helps to develop parenting skills and responsibility in young people at Ashfield

Civil government

Reducing re-offending is a priority for the UK Government and Serco plays an important part in this complex and challenging area. Under a 25-year PFI contract we operate HMP & YOI Ashfield, the only privately-run prison solely responsible for the care of young people. It currently houses 360 males aged between 15 and 18, either on remand or serving custodial sentences.

We are responsible for all services at Ashfield, from employing the custody officers to providing education, training, health, personal development and drug rehabilitation. Our ethos at Ashfield – as with the four adult prisons we run – is based on holding the young people in our care safely and securely, while treating them with dignity and respect.

We aim to help the young men who pass through Ashfield live stable, healthy and law-abiding lives after release by providing support and training to tackle the issues they face – issues often originating in difficult social circumstances, poor educational attainment and drug or alcohol problems.

High on our agenda is helping them maintain or re-establish contact with their families. Danuta Hinde, community and family liaison officer, carries out this vital role. She visits every new arrival to offer support and is always looking for new ways to help the young people she works with.

One innovative scheme that Danuta introduced is 'Lads n Dads'.

"Many of the lads in here are fathers or have girlfriends who are pregnant. Most have little or no parenting skills – many have never even pushed a pram or given a bottle," she explains.

'Lads n Dads' allows young fathers to spend quality time with their partners and children during special visiting hours.

"Having a relationship with their children totally changes their outlook on offending behaviour," says Danuta. "They want to be a father, to go out to work and provide for their families. And it's working – we've only had one lad come back here since the scheme started two years ago."

The scheme has received considerable recognition: in 2005, Danuta was awarded the Butler's Trust Award for her Outstanding Contribution to the Effective Care of Prisoners. A 2004 HM Inspectorate of Prisons report also praised it as a significant development in the curriculum.

And the young people at Ashfield appreciate Danuta's efforts. As one said recently: "I feel more responsible and have lots more confidence with my son... I've realised that my family is more important than crime."

Civil government remains our largest market. During 2005, revenue grew by 28% to £803.6m, representing 36% of our total revenue.

Civil government encompasses many of the largest and fastest growing markets, including home affairs, education, health, regional and local government, and consulting.

Home affairs

Home affairs is at the top of the UK's political agenda, and has become a strong source of new business for us. At the start of 2005, we combined our Premier Custodial Group and Justice divisions to create one business focused on four key areas: civil resilience, offender management, law enforcement, and immigration control. With the ability to draw on complementary strands of expertise from across the Group, such as science and defence, Serco has emerged as one of the few businesses that can deliver the integrated solutions our customers demand.

Civil resilience

Our compelling offering secured our first major civil resilience win - a ten-year contract valued at around £100m to provide solutions that detect the illicit importation of radiological substances at UK borders. Managed by the Home Office, the Cyclamen programme is central to the UK Government's counter-terrorism strategy. This success has attracted interest from abroad and we are confident that we can transfer the model to other countries.

We have also supported efforts to reinforce the UK's national crisis management capability, working with the Office of the Deputy Prime Minister (ODPM) to deliver the New Dimension programme, designed to improve the UK's fire and rescue services' response to a catastrophic incident.

As a result of our work at the ODPM, we have been awarded new work with the Home Office chemical, biological, radiological and nuclear resilience programme which deals with the police response to catastrophic incidents.

Offender management

We run four adult prisons in the UK, a young offenders institute and a secure training centre for juveniles. We also provide prison escort and custody services across London and the south east of England, and electronic monitoring of offenders.

In October 2005, we secured an important win: a five-year contract valued at around £30m to provide electronic monitoring of offenders across Scotland. This award, made by the Scottish Executive, means that we now manage three of the six electronic monitoring contracts in the UK.

The UK Government is committed to encouraging a 'contestable and plural market', where private sector companies will be able to bid to run public sector prisons. We anticipate announcements during 2006 outlining government policy on this issue, and we will pursue attractive opportunities that arise from it. In addition, we are looking to

leverage our abilities in other parts of the Group in the reskilling, education and aftercare of released inmates.

Our efforts to extend our home affairs capability internationally are producing results. By the end of the year, our team in Germany's first partly-privatised prison, at Hünfeld in Hessen, were ready to begin work. Over the next six years, they will deliver all the facility's non-custodial services, including psychological, medical and educational care, rehabilitation services, catering and facilities management.

This gives our German team an excellent platform from which to bid for the second partly-privatised prison, at Burg, in the state of Sachsen-Anhalt. This opportunity will come up for tender during 2006.

Law enforcement

Globalisation of communications, technological advances and the opening up of borders mean that serious crime is becoming more sophisticated and highly-organised.

Since 2000, we have had a strategic partnership with the UK's National Crime Squad (NCS). Owing to the new crime threats faced today, the NCS, the National Criminal Intelligence Service, parts of HM Revenue & Customs and the Home Office's Immigration and Nationality Directorate are amalgamating into the Serious and Organised Crime Agency. We will continue to build on our relationship with this important new organisation.

Central to our relationship with the NCS has been the development of the Athena software, which provides the organisation with a holistic intelligence, operations and evidence management system. Our track record means that there are opportunities to sell Athena to police forces and crime prevention organisations outside the UK.

We also see new opportunities arising from the proposed merger of UK police forces, including improving the efficiency of back office systems that allow the police to fight crime rather than carry out administration.

Immigration control

Our management record at Colnbrook Immigration Removal Centre and Short-Term Holding Facility near Heathrow Airport and the Dungavel Immigration Removal Centre in Scotland has secured us a strong reputation in this demanding area. We have grown revenue by bringing into service a number of additional places at Colnbrook and work is under way to convert unused areas of the centre into a further 35 places. We are also examining opportunities to bid for the operation of other immigration removal centres.

The UK Government is investing heavily in services and infrastructure that will protect citizens from a range of evolving threats and challenges. Our four-member consortium has now been shortlisted for the e-borders project. We are bidding to provide the Warnings Index, a secure database used by the Home Office to identify potentially high-risk people trying to enter the UK. We also believe we are well-positioned for the forthcoming ID card programme.

Our technology business streams continue to grow steadily with a balanced portfolio of opportunities. Notably, we are focussing our efforts on cross-border and airport security technology.

Education

Serco is one of the leading private sector partners in the UK education and children's services sectors. A number of government initiatives, not least the Every Child Matters agenda and Building Schools for the Future programme, plus continuing pressure on schools to improve performance, make the education sector fast-moving.

We run two local education authorities in the UK - Walsall and Bradford. In January 2005 the Office for Standards in Education (Ofsted) reported that the performance of Bradford's services was 'satisfactory', a significant turnaround for what was once one of the poorest performing authorities in the country.

In 2005 Ofsted published a report declaring Education Walsall's services to be 'highly satisfactory'. This transformation was achieved just two years after the service was condemned as being 'very poor' and put out to competition.

While there is still a considerable amount of work to be done, both Walsall and Bradford have continued to improve at rates faster than national trends in all indicators.

We are exploring other education opportunities. Our school management information software is gaining market share based on the ability it gives schools to monitor and hence improve their performance. Numerous schools have improved attendance and assessment using our products.

We provide consultancy and project management support to children's services departments for a growing number of local authorities. The Government's move to align education and children's social care, and place schools at the heart of their communities, will provide us with a number of opportunities in the provision of integrated services.

The implementation of policies contained in the Education Bill and the continuing push towards central and local government becoming commissioning organisations rather than delivery organisations will create further opportunities.

Middle East

In 2005, Serco completed an advisory facilities management service during the master planning stage of the proposed design and construction of the United Arab Emirates University in Al Ain, a 19,000-student campus. Negotiations are continuing to form a joint venture company to provide the campus with facilities management and operational maintenance.

Health

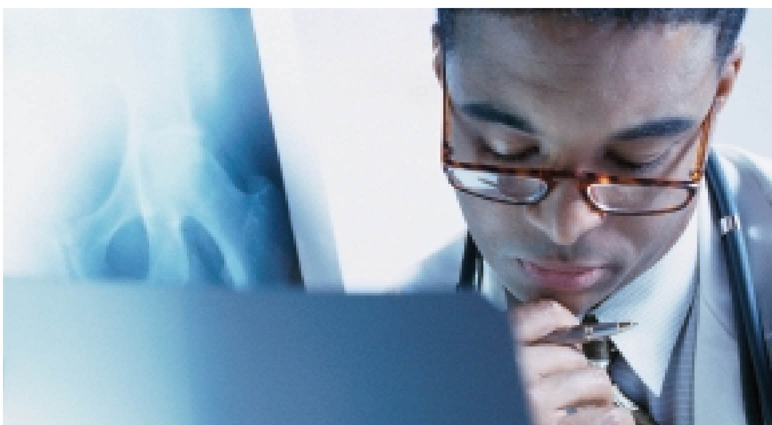
Health is an emerging market for Serco and our focus is on managed healthcare and providing services to new hospitals built under Private Finance Initiatives (PFIs).

Among notable developments, our joint venture with Equion Ltd, a division of John Laing plc, was appointed preferred bidder for a major PFI programme to improve health services in Leicester. The Pathway project, commissioned by the University Hospitals of Leicester NHS Trust, involves extensively refurbishing, modernising and supporting the Trust's hospitals. The associated support services contract will be valued at around £1.2bn to Serco over 35 years.

In managed healthcare, Serco now provides NHS 'out of hours' cover for one million people. We acquired a doctors 'out of hours' business in Cardiff during 2005. Building on this acquisition, we now have a confirmed order book in excess of £50m through contract wins in Oxford and a further contract covering the whole of Cornwall.

From this platform we have won other contracts. At Feltham Young Offenders Institute & Remand Centre, we provide all nurses and deploy doctors and other health professionals to care for the young people at the facility. The contract is valued at around £4m over three years with provision for a two-year extension. Similarly, we won a three-year contract with Cardiff Local Health Board. In conjunction with local doctors, we will provide medical services to HMP Cardiff from April 2006.

Our win with the Newham Primary Care NHS Trust is an example of how we are using our skills to offer an integrated, managed healthcare package. Serco has been appointed to improve care for patients with long term illnesses and will manage patients' conditions through community matrons, who will analyse patients' needs and arrange home-based support. We will also train community matrons and develop supporting information to help devise the best care for each patient.



As our health business continues to grow, we are presented with opportunities where we can bring to bear the range and depth of skills across the Group. For example, we will be able to provide healthcare services to facilities that we operate, such as immigration removal centres.

We are also seeking to expand our hospital PFI portfolio and have a pipeline of further opportunities, including a current bid for the Forth Valley PFI.

Regional and local government

The regional and local government market is one where we see significant opportunities for growth. We have a strong reputation as a provider of IT services, business management and environmental services to UK local authorities. Our position in the local authority market was significantly strengthened by the acquisition of ITNET (now Serco Solutions) in February 2005.

The expertise we have gained in our long term strategic contracts, including Winchester and Canterbury City Councils and Woking Borough Council, led to further wins in 2005. We were awarded a contract by Restormel Borough Council in Cornwall, valued at around £45m over ten years, to provide streetscene services including recycling, street cleaning and refuse collection. We also won a contract to provide a range of environmental services to Welwyn Hatfield Council.

Serco is a leading supplier of IT and IT-enabled services to local government. In June 2005, we were chosen by IBM as a sub-contractor to implement Bradford Council's IT platforms and services. The programme of transformation will take ten years and is valued at £158m to the consortium.

Over the last year, we have seen contract extensions with councils in Southwark, Ealing, Bedfordshire and Cotswold. We have also delivered additional services and projects to a number of councils including Coventry, Enfield and Hertfordshire, a contract which is an innovative response to the Government's requirement that local councils adopt shared services as a way of increasing efficiency.

One of the key opportunities in this area is the outsourcing of UK local and central government shared services. This has been slower than anticipated in coming to market. We have invested in enhanced capacity and capability to prepare for the rapid expansion in this market.

Central government services

In November, we had a significant win when we were selected to provide the UK Government with web-based information services to support the nation's growing small businesses. The contract with the Department of Trade and Industry will run for five years with up to four additional one-year renewals, and could be valued at more than £125m over this extended period.

The successful bid, originating in Serco Solutions, draws on skills and experience from across the Group to deliver the contract requirements. Under the contract, Serco will be responsible for developing and delivering the 'business.gov' programme, including the www.businesslink.gov.uk portal, which provides advice and guidance to small businesses from across local, regional and national government.

Consulting

Since its formation in 2003, our consulting business has grown rapidly and now employs around 80 consultants. It aims to raise awareness of and enhance Serco's reputation with potential and existing customers by providing high-value advisory services. Our presence was substantially increased by the addition of French Thornton, the consulting arm of ITNET.

Our consulting business draws on subject experts from the wider organisation to provide clients with a unique proposition – high-level consultancy backed up by deep operational experience.

In the public sector, we have started work with new customers at the Department of Health, the Home Office and the Environment Agency.

At the BBC, we are supporting the procurement of a cost-effective, over-the-counter solution for licence fee collection. We are assisting BBC Property as it transitions to a new operating model and new suppliers.

We are managing projects at a major retail bank as part of a wider programme to migrate high-net-worth customers from a legacy banking system to a new strategic solution. At a global investment bank, we are assisting the development of a software lifecycle model, reviewing credit-risk approval systems solutions and helping the bank provide technical and project management support to client engagement solutions.

We provide a world-class service that passengers can rely on and build their lives around

Transport

When you rebid for a contract as significant as the Docklands Light Railway (DLR), nothing can be taken for granted. However, our outstanding performance and inspired vision for the future led to our customer, Transport for London, renewing our contract to operate and maintain the DLR for up to a further nine years.

Serco runs the whole of the complex DLR system, including operating the driverless trains and maintaining the rolling stock, track, signalling, control systems and stations.

Since we started running DLR in 1997 we have consistently met or exceeded performance targets and delivered record reliability scores year on year. For five months in 2005, our reliability exceeded 98% against a target of 95%. This is even more remarkable considering that the number of passengers has almost trebled from 18m a year at the start of the franchise.

The rail industry has recognised the strength of our performance. For six consecutive years we have been honoured in the National Rail Awards including twice winning Rail Operator of the Year and in 2005, the prestigious award for Outstanding Achievement.

Under the new contract, we will continue delivering these levels of service while looking forward to exciting developments. The DLR is set to keep growing, with planned extensions to Woolwich Arsenal, opening in 2009, and Stratford International, set for 2010.

As the network expands, we will phase in new services that will benefit customers and enhance their travel experience. These include on-train screens that give up-to-date travel information and a team of 'Travelsafe' officers who will patrol the network in darkness hours. And we will manage the introduction of three-car trains to replace the current two-car trains on the line between Bank and Lewisham.

We are pleased that we are going to be responsible for marketing the network too, thus growing the business in the years to come. This endorses our strong relationships with local communities, which have earned Serco Docklands 'Business in the Community' awards for the past two years.

The growth of the network will mean increased passenger numbers, and our track record in handling large volumes of passengers will stand us in good stead for the 2012 Olympics where the DLR will play a key role in transporting visitors and officials.

Our aim is to continue providing a world-class service that passengers can rely on and build their lives around. With up to 13,000 station departures a day and 52 million passenger journeys a year, it's an exhilarating challenge.

Transport is a very strong sector for Serco, with revenue growing 59% to £548.7m in 2005, driven by the first full year of operation of Northern Rail. Transport accounted for 24% of our revenue in the year.

Our strategy is to grow our presence in rail and to develop our urban transportation business – which integrates our light rail and traffic management capabilities – with a focus on major conurbations. We are also seeking to expand our position in air, where we are one of the leading private sector providers of air traffic control and associated services.

Rail

UK

Serco has established a strong presence in rail through our two franchises, Northern Rail and Merseyrail, which we operate in conjunction with our partner NedRailways.

With 472 stations and over 4,500 staff, Northern Rail – the largest franchise in the UK – stretches more than 1,600 miles and serves major cities including Manchester, York, Leeds, Newcastle and Sunderland. Since we began running this network, passengers have benefited from significant enhancements to performance, with train punctuality now at its highest level for four years.

Our Merseyrail service – which operates in and around Liverpool, with 66 stations and over 1,000 staff – continues to go from strength to strength. Its punctuality levels of over 92% are consistently amongst the best in the country. In the January 2006 National Passenger Survey, Merseyrail's overall satisfaction rating was 86%, six percentage points above the national average.

In 2006, we will continue to build upon these high service levels, look to improve our services further and add new work. Our customer for Merseyrail – Merseytravel – is currently negotiating with Network Rail to take over track maintenance in the region, and we are optimistic that we will run this on its behalf.

With other franchises coming up for tender in the near future, we will look to bid where we see profitable opportunities. As our expertise in this sector grows, we are also looking to overseas markets. In particular, we are enthusiastic about Germany, the most advanced rail franchise market outside the UK.

Asia Pacific

In Australia, we run the Great Southern Railway. Its service between Adelaide and Darwin - known as The Ghan - won several travel and tourism industry awards in 2005, including the prestigious national Australian Newspaper Award for the most Innovative New Tourism Experience.

In 2005, we launched a second, weekly service for the three-month peak tourism season to meet growth in demand. Responding to continued strength in bookings, from March 2006 we will be operating a second weekly north-south return transcontinental service.

Urban transportation

Many developed economies, not least the UK, are looking for integrated transport strategies where there is a balance of different methods of travel, encouragement of wider use of public transport and up-to-date travel information. This shift is in response to road congestion and its attendant economic and environmental costs.

Accordingly, we are offering our light rail and traffic management operations in combination to provide integrated urban transport services. In addition, our capabilities in passenger information systems, bus lane design and traffic control centres further enhance the all-round service. We can offer a complete range of light rail and traffic management services which customers can choose as a package or take individual elements.

UK

We are a leader in the light rail market and our Docklands Light Railway service (DLR) in London is recognised for its quality both inside and outside the UK. This was acknowledged in September 2005 when we picked up the Outstanding Achievement title at the National Rail Awards – one of the highest accolades in the UK rail industry. In 2005, DLR consistently beat stringent performance targets.

Our success in running the DLR since 1997 led to us, in November, being named preferred bidder to continue operating the service. We subsequently signed the contract in March 2006. The new contract, valued at around £400m, will run for seven years with a possible two-year extension subject to performance.

The new contract will coincide with an exciting period for the DLR, not least because of the 2012 Olympics in London, much of which will be in areas of the city served by our network. 2005 saw the opening of the extension to City Airport, and further extensions to Woolwich and Stratford are due to open in 2009 and 2010 respectively. As the London Organising Committee acknowledged, the DLR will have a significant role to play once the Olympics gets under way.

As anticipated, our Metrolink contract was put out to tender by our customer as part of a major reinvestment planned in this light rail network in Manchester. We are bidding for two contracts to operate and maintain the trams and maintain track and stations. We are also looking at a potential bid for the Metro network in Tyne and Wear.

We operate the National Traffic Control Centre which helps travellers in England plan and complete their journeys by providing real-time traffic information, including alternative routing advice, direct to the media and the public via a website and interactive phone service. Achieving full implementation has taken longer than envisaged and we are now finalising the implementation phase with our client, the Highways Agency.

Having been shortlisted for the Lorry Road User Charge project, we were disappointed when the Government cancelled it. However, the Government has stated its general support for road pricing and is funding pilot studies for congestion charging in seven areas of the UK, which may create further opportunities.

North America

In March 2005 we announced our appointment as preferred bidder, with SNC-Lavalin, for the operation and maintenance of a driverless, rapid rail network in Vancouver, Canada. The contract was due to start in late 2009.

We have since decided to change the nature of our involvement, and have agreed that SNC-Lavalin will be responsible for operations and maintenance. Serco will now provide consultancy and support to SNC-Lavalin during the development of the operational solution for the network and for the first four years of operation – to the end of 2013.

This is an excellent chance for us to demonstrate our skills and experience in light rail in the design phase of a new metro system. It will position us well for similar roles in other new transit systems.

Middle East

We have strong links with the Middle East transport market through our work in air traffic control. This base, plus our skills and experience in the UK and elsewhere, position us to expand into urban transportation in the Middle Eastern market. Plans to create an urban network in Dubai are likely to provide us with an opportunity that we are currently exploring.

Air

Middle East

We continue to build on our outstanding track record in air traffic control (ATC). In April, we extended our ATC contract with Dubai Civil Aviation, which has been a Serco client for 45 years. The extension is valued at £12m over two years.

We signed a one-year extension to our contract at Bahrain Airport. This contract is worth £2m and positions Serco favourably in view of major expansion work due to be undertaken at the airport.

We also successfully re-bid a three-year flight information region contract with the General Civil Aviation Authority of the United Arab Emirates. The contract includes the provision of ATC and engineering services at the Emirates Area Control Centre based in Abu Dhabi. The contract is valued at around £12m.

Our aeronautical services business in the Middle East is developing a niche providing air safety management consultancy in several countries – notably Qatar, Kuwait and Egypt – allowing us to increasing our aviation footprint in the region.

Our Army Careers and Alumni Programme helps soldiers to prepare for civilian life

Defence

"After 25 years in the military, the civilian world felt very new and the idea of finding a job seemed pretty scary. However, the ACAP centre staff gave me so much confidence in my skills."

This is one of many endorsements from soldiers who have benefited from the Army Careers and Alumni Programme (ACAP), which Serco has managed on behalf of the US Department of Army since late 1990.

ACAP was established to give soldiers and their families the support they need to make a successful transition to civilian life. Over the last 15 years, Serco's 205-strong team based at 53 centres worldwide has provided job-seeking support to around 1.5 million people.

The ACAP contract is currently worth nearly US$16m to Serco annually. We successfully rebid for the contract in 2005 – an endorsement of the strong service we are delivering to a satisfied customer.

According to Serco's Steve Sultan, who has been involved with the programme since its launch: "Serco employees provide a wide range of training, counselling, and assistance services to ACAP clients. We have developed a sophisticated set of tools, processes and workshops to help soldiers catch the attention of suitable employers. The emphasis is on giving individuals the skills and confidence to manage their own future."

Among the vital services supplied are seminars in resumé writing, help with technology such as job search software, and counselling on career exploration and interview preparation.

As with all our contracts, Serco is always looking for ways to improve the ACAP service. Our innovations include a web-based management information system, which gives clients access to automated tools, such as a resumé writer, and helps staff and clients to schedule activities such as workshops. We have also developed a web-based client critique system that allows us to collect, collate, and analyse client comments on our services to help us continue enhancing the programme to the benefit of those taking part.

As one ACAP participant put it: "Wow! This programme really takes care of the soldier."

Our defence business enjoyed a successful year in 2005, growing by 52% to £565.6m, and representing 25% of our revenue.

Serco's involvement in the provision of public services began in the UK defence sector in the 1960s. Since then, we have built a significant presence in this market, including contracts in Europe, Asia Pacific and North America. Our North American presence was substantially bolstered by the acquisition of RCI in March 2005.

UK

During 2005 our defence and aerospace business has consolidated its position as the leading services partner to the UK Ministry of Defence (MoD) and further enhanced its key role in ensuring the operational readiness of Britain's armed forces. In addition, we continue to develop our strategy and business in the non-UK defence and aerospace markets.

Serco's success comes as the UK Government seeks to achieve greater efficiencies in the defence budget without compromising the Services' ability to meet new and demanding challenges. This approach received prominence in the MoD's Defence Industrial Strategy (DIS), and its implementation presents opportunities and challenges to the defence and aerospace industry. Serco is well placed to deliver at both strategic and operational levels.

As a result of our thought leadership and strong track record in service integration and delivery, we were recently invited to join the National Defence Industry Council, the high level MoD-industry forum chaired by the Secretary of State for Defence. As the service company represented at this level, we will bring our experience to bear on the implementation of the Government's objectives as set out in the DIS.

Our position as a trusted partner to the MoD was reflected in strong business growth throughout the year and is driving a healthy new business pipeline, which could present us with opportunities for all of Serco's capabilities.

Our long term partnership with the MoD at the Defence Academy goes from strength to strength. We operate the Joint Services Command and Staff College, an internationally-renowned centre of excellence for training military commanders. Building on this partnership we were awarded a contract valued at around £400m to manage and integrate the design and build of new premises for the academy, and to integrate new IT systems supporting training for the military leaders of tomorrow.

We were appointed preferred bidder for a strategic partnership with the Defence Science and Technology Laboratory (Dstl). This contract, valued at around £400m over 15 years, will see us manage the design and build of new facilities and provide IT and support services across the Dstl estate.

Early in 2006, we were selected as preferred bidder on a 15-year contract valued at around £1bn to help sustain the operational capacity of the Royal Navy at Portsmouth, Devonport and the Clyde. Our unrivalled record in delivering marine services over the past ten years played a major role in securing preferred bidder status, and we are looking forward to strengthening our partnership with the Defence Logistics Organisation and with the Royal Navy as it strives to be a single, adaptable and dynamic force wherever it is most needed.

We will continue to build on our constructive partnership with the MoD. This means using our expertise in service integration to help our customer succeed with its ongoing change programme, and continuing to deliver excellent services that enhance the capability of the UK's armed forces to meet new and emerging threats.

Europe

In Germany we have been successful in securing all our support activities for the German Armed Forces and have expanded our system integration activities for the supply of mobile systems. There is a growing demand for mobile systems due to the increasing out-of-area activities of the German Armed Forces. Our operations running the Army Battlefield Training Centre (GUZ) have been further expanded.

North America

In the US, 2005 proved to be a very successful year in defence for Serco.

In March, we completed the $215m acquisition of RCI, significantly increasing our position in the world's largest service contracting market. The acquisition has been well received by our clients and by industry and we aim to build on RCI's impressive presence.

We deliver personnel services, studies and analysis support and recruitment processing services to the US Army. The program has resulted in a good flow of task orders for us.

We continue to perform strongly in human resources (HR) outsourcing as the fiscal trend affecting Army HR outsourcing remains strong. We successfully rebid for the Army Career and Alumni Program (ACAP), a socially important endeavour that helps servicemen and women, civilians and their families make the transition from Army to civilian life. Valued at around $16m per year, we have held this contract since 1990 – an exceptional achievement in US defence contracting.

In November, we were awarded a contract to provide 102 embedded recruiters for the Recruiting Command. The base contract is for one year, with two one-year options. Each contract year could be valued at up to $5m. Towards the end of the year we were awarded a contract to support the United States Army Community and Family Support Center with advocacy services for victims of domestic abuse and sexual assault. The contract is valued at around $21m, over a period of up to two years and seven months.

The US Army is embarking on a six-year plan to boost its combat power by 40,000 troops while reducing the number of non-combat jobs. We are well positioned to perform much of the non-combat workload previously performed by these troops.

The Department of Defense's Base Realignment and Closure programme, which commenced in November 2005 and will run until 2011, will see a consolidation of the US Army and other armed forces bases and will result in shared resources and, in some instances, co-basing. This is likely to lead to a change in how support services are acquired and a shift towards an outsourcing model that is one of Serco's strengths.

Our Navy command, control, communication, computer, information and reconnaissance (C4ISR) engineering and installations business remains strong as we successfully rebid our electronics support measures contract in December for five more years. The contract is valued at around $22m.

Logistics continues its strong growth in support of Department of Defense supply chain management initiatives. The major contributor to this growth was our Price Fighter contract, under which we focus on streamlining parts and material procurement, purchasing, inventorying and delivery through the central supply and support group for the Army, and the Convergence program consolidating enterprise resource planning systems across the Navy.

In Canada, the Serco team in Goose Bay received positive news when the Department of National Defense announced a commitment to keep base funding available to 2010, including maintaining the presence of 444 Squadron. Serco provides all base operations services to this airbase.

Asia Pacific

In August, Serco Sodexho Defence – our joint venture with Sodexho Alliance – renewed and expanded its contract with the Australian Defence Force to provide garrison support services in the Sydney West South region of New South Wales. The contract is valued at AUS$200m to Serco over a term of up to nine years.

NPL works to ensure the safe and effective measurement and delivery of radiotherapy for cancer patients

Science

The UK Government's National Physical Laboratory (NPL) has been at the cutting edge for nearly a century. NPL is a world-leading measurement institute – top three of more than fifty such institutes around the world – and the Department of Trade and Industry's largest science and technology asset.

Serco has operated NPL since 1995. Our teams of scientists and technicians are responsible for driving forward measurement science, developing national standards and transferring those capabilities to NPL's customers.

Why is this necessary? Because accurate measurement enables UK industry to innovate and control quality. It is essential for international collaboration and fair trade. It allows policy makers to make informed decisions and enables effective regulation. And it delivers a vital contribution to health, safety, security and the environment.

NPL's contribution to the UK economy and our quality of life is valued at billions of pounds each year.

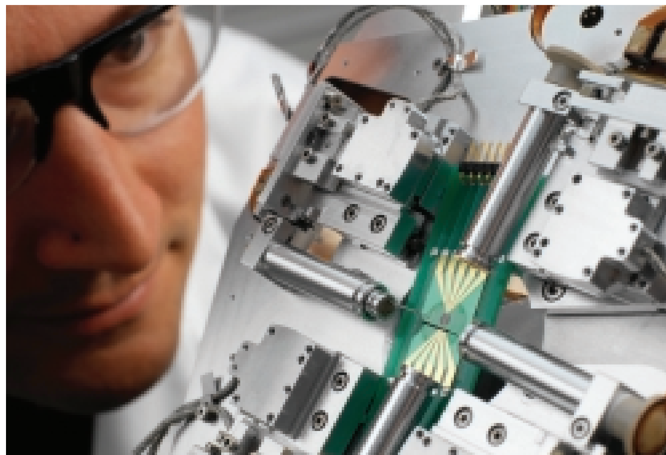
When our initial contract came up for renewal in 2003, our rebid proposed a major restructuring of NPL. Our vision was for NPL to be the national measurement institute that delivered the highest economic and social impact, through excellent and responsive science. The DTI awarded us the contract for a further ten years - the longest period of secure funding in NPL's history.

Since winning the rebid we have reorganised NPL to maximise the laboratory's impact in productivity, regulation and innovation. To ensure we employed the right people, we undertook a detailed role-profiling exercise and competency-based recruitment. We put in place a smaller and simpler support structure. And we are growing third-party revenue as we work directly with industry to help it achieve its aims. At the same time, we have maintained the standing of NPL's science and reduced the cost to the DTI.

NPL's work in ensuring the safe and effective delivery of radiotherapy for cancer patients is just one example of its contribution to improving quality of life. Radiotherapy is one of the two most effective treatments for cancer. But its success depends on delivering the right dose: too little and cancer cells may survive, too much and healthy tissue can be damaged.

NPL has led the world in developing new standards for measuring therapy-level doses, and in designing and producing new equipment to perform those measurements. And our scientists ensure those standards are put into practice, calibrating radiotherapy equipment used to treat 140,000 cancer patients each year, so that they receive the treatment they need - truly bringing service to life.

Serco is a leading private sector partner for the management of scientific and knowledge transfer activities. Our success in 2005 saw our science revenue grow by 18% to £342.4m, representing 15% of our revenue.



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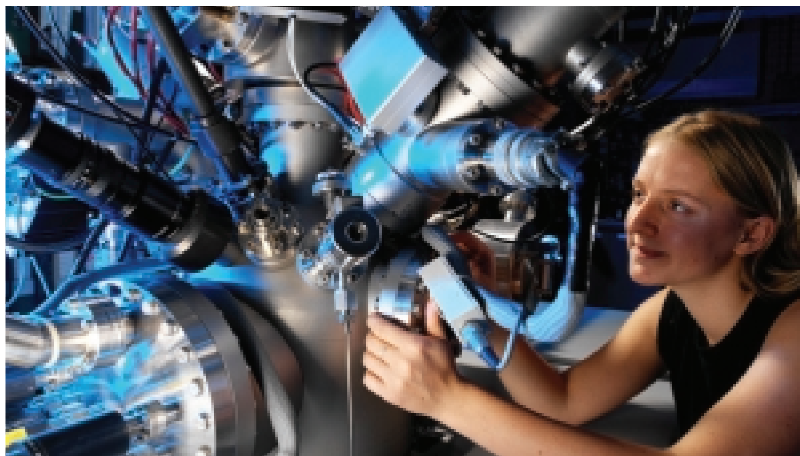


Our strategy is to address the science market through three key offerings: whole agency outsourcing, such as our contract at the National Physical Laboratory (NPL); knowledge transfer programmes – such as our Envirowise contract – which deliver integrated communications focused on innovation and business support; and technical services, which are short-term projects drawing directly on our scientific and engineering expertise.

UK

The key development in our science business during 2005 was the expansion of our work at the Atomic Weapons Establishment (AWE) sites at Aldermaston and Burghfield in the UK, which we operate as a joint venture with BNFL and Lockheed Martin.

The MoD oversees AWE and in July it announced plans to upgrade skills and facilities at the two sites, in order to provide continued reliability and safety assurance. As a result, it signed an amendment which significantly increased its funding for the project. The additional investment organically grows our business and is valued at around £350m to Serco over three years, further enhancing our position as a key player in the nuclear industry.

Our track record with the MoD creates a strong platform for new business. We secured a £13m contract to supply the MoD's Integrated Sensor Management System. This intelligent network is designed to detect nuclear, chemical or biological attacks and the technology behind it gives us opportunities in other sectors.

In other business, we have cemented our reputation in the creation of innovation and technology centres. In a contract valued at £8m, we have teamed up with the University of Wales to manage the Centre for Advanced Software Technology in Bangor, North Wales. This centre will help develop a cluster of software businesses in the region.

We expect significant opportunities to arise from the activities of the Nuclear Decommissioning Authority. This organisation was set up in April 2005 to decommission 20 civil nuclear sites. With the first contract likely to be going to tender this year, our expertise at NPL, AWE and elsewhere in our science business means that we are strongly positioned as the market opens up.

Our position has been further strengthened by the transfer of around 60 staff, together with an associated income stream, from BNFL Magnox Electric to Serco. The employees are predominantly highly qualified experts in the nuclear field.

Beyond the nuclear market, we are responding to growing demand for knowledge transfer and innovation support services in central government and the regional development agencies.

Europe

The European Space Agency (ESA) provided Serco with two successful rebids in 2005. We successfully rebid for ESA's Earth observation programme. The contract is worth €14m over three years and will see a Serco-led consortium run a programme that provides remote-sensing data to scientific users.

Through this award, we have kept our position as the leading provider of support services to ESA.

We also won our rebid for engineering support at ESA's technical centre in the Netherlands. This contract, which includes support for spacecraft design, mission simulation and scientific research, is valued at around €20m over an expected five-year period.

The strategic importance of the private sector has risen since our acquisition of ITNET at the start of 2005. Our portfolio of blue-chip clients includes Microsoft, Airbus, GlaxoSmithKline, The Boots Company, BMW and Volkswagen.

Under International Financial Reporting Standards, we no longer report the private sector as a separate segment. Instead, its revenues are included in our four main segments. However, the private sector is a significant source of business for us. In 2005 our revenues were £192m, an increase of 54%.

UK and Europe

Our relationship with Microsoft exemplifies our ability to extend the range of services we offer to clients. Initially, we provided the company with conventional facilities management. We now operate Microsoft's global shared services from its European Operations Centre in Dublin. We also provide licensing, processing, documentation control, revenue and rebate recognition services. In February, we were awarded a contract to provide administration and personal assistant services to senior Microsoft managers and directors.

We renewed our contract with Airbus for integrated services to its manufacturing facility at Filton, UK. This contract is valued at around £25m over five years. Serco already provides a fire and rescue service at Filton, and in April we were presented with the 'Top Airport Fire Service Award' by the Civil Aviation Authority.

Our relationship with Starwood Group Hotels & Resorts Worldwide Inc. continues to thrive. We were awarded the contract to supply maintenance and property services at the Westin Turnberry resort in Ayrshire and the Sheraton Grand Hotel and Spa in Edinburgh, Scotland. We won a contract with Bank of Ireland to provide facilities management services to its properties in Northern Ireland. And Volkswagen Group UK awarded us a contract to provide support services to its five properties in Milton Keynes, including the group headquarters and national learning centre.

We continue to build on our relationships with key customers in food and drinks manufacturing. We won a three-year extension to our IT services contract with Coca-Cola Enterprises Ltd. Our dual data centres in Birmingham now host a UK-wide enterprise resource planning solution for Cadbury Schweppes and we have introduced a new service solution for the food services provider 3663. It provides a common IT delivery platform at each of the client's sites, enhancing the efficiency of distribution systems.

In December, we were appointed preferred bidder to extend our existing contract with the world's largest speciality retail jeweller, Signet. The new contract will run for five years. Serco provides service desk, desktop, batch processing and data centre services to Signet's stores infrastructure across the UK, a relationship which dates back to 1995.

SAP remains a key focus for us and German-owned MAN B&W, which builds marine engines, renewed our SAP facilities management support contract to the end of 2008. In addition we won the SAP application support contract for three years.

North America

We continue to grow our fleet and power distribution business with US companies such as Dayton Power & Light and several smaller utilities.

We have won further contracts to provide computer-aided facilities management services in the commercial and government sectors, expanding an existing client portfolio that includes major lending institutions and financial services companies as well as state and local governments.

Prospects for private sector growth in North America have been enhanced by the information technology and asset management capabilities that were added by the RCI acquisition.

Middle East

The construction boom in the Middle East is driving an exponential increase in demand for facilities management operational consultancy. We provide consultancy, operational advice and client support on all aspects of development and business, facility and property management and operations. During 2005, we provided consultancy services for several iconic Dubai projects including the Burj Dubai and the Palm Jumeirah.

Finance review

Andrew Jenner
Finance Director

1. Introduction

2005 is the first year the Group has reported its results under International Financial Reporting Standards (IFRS). Explanation of the impact of adopting IFRS was provided in the Group's announcement 'Transition to IFRS Report', which was released on 31 August 2005. All comparatives throughout this report have been restated under IFRS. Effective from 1 January 2005, the Group adopted IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement'.

2. Financial performance

The Group continued to generate strong organic growth during 2005. We also benefited from the contributions of ITNET plc (ITNET) and RCI Holding Corp (RCI), which we acquired in February 2005 and March 2005 respectively.

The Group's income statement for 2005 is shown in Figure 1. This includes the results of our joint ventures, which have been proportionately consolidated.

Figure 1: Income statement

	2005 £m	2004 £m	Increase
Revenue	2,260.3	1,636.9	38.1%
Gross profit	325.0	242.6	34.0%
Administrative expenses before amortisation	(214.3)	(166.2)	28.9%
Investment revenue and finance costs	(19.2)	(5.2)	
Profit before tax and intangible amortisation	91.5	71.2	28.5%
Intangible amortisation	(13.6)	(7.2)	
Profit before tax	77.9	64.0	21.7%
Tax	(23.5)	(19.5)	
Profit for the year	54.4	44.5	22.2%
Minority interest	(1.0)	(1.0)	-
Retained earnings	53.4	43.5	22.8%
Effective tax rate	30.2%	30.5%	
Basic earnings per share before intangible amortisation	14.09p	11.46p	22.9%
Basic earnings per share	11.66p	10.11p	15.3 %
Dividend per share	2.97p	2.63p	12.9%

2.1 Revenue

Revenue increased by 38.1% to £2,260.3m. Excluding the effect of £337.2m of revenue from our acquisitions in 2005 and £26.0m of disposals in 2004, our organic revenue growth was 19.4%. Joint venture revenue increased by 109.8% to £536.1m, primarily reflecting a full year of operation of the Northern Rail franchise, which began in December 2004, and continued growth at AWE.

2.2 Gross margin

Gross margin – the average contract margin across our portfolio – was 14.4% in 2005.

2.3 Investment revenue and finance costs

Investment revenue and finance costs totalled a net cost of £19.2m (2004: £5.2m). Included within finance costs was £13.4m of interest on the debt used to fund our acquisitions, the net interest on the assets and liabilities of our defined benefit pension schemes and interest on our underlying net debt, which has reduced compared with 2004.

2.4 Profit before tax and intangible amortisation (PBTA)

PBTA increased 28.5% to £91.5m (2004: £71.2m), representing a net margin of 4.0% (2004: 4.3%). Excluding the profits generated by the acquisitions and their associated funding costs, organic PBTA increased by 13.1%.

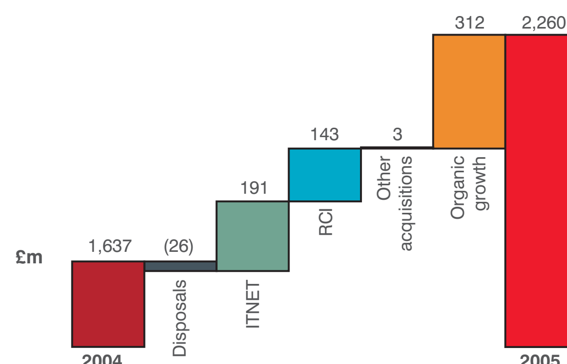
2.5 Intangible amortisation

Intangible amortisation was £13.6m (2004: £7.2m). The increase results principally from the amortisation of intangible assets acquired with ITNET and RCI, together with the additional amortisation of pension-related intangible assets arising from the rights to manage and operate certain of our contracts and franchises.

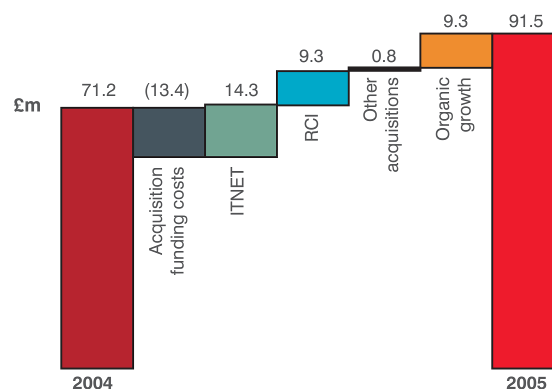
2.6 Profit before tax

Profit before tax increased by 21.7% to £77.9m (2004: £64.0m).

Revenue



Profit before tax and intangible amortisation



2.7 Tax
The tax charge of £23.5m (2004: £19.5m) represents an effective rate of 30.2%, broadly similar to 2004.

2.8 Earnings per share (EPS)
Basic EPS before intangible amortisation increased by 22.9% to 14.09p. Basic EPS increased by 15.3% to 11.66p.

EPS before intangible amortisation and the effect of acquisitions increased by 15.6% to 13.25p, and on a post-amortisation basis increased by 10.4% to 11.16p.

EPS is calculated on an average share base of 458.1m during the year (2004: 430.1m). The majority of the increase resulted from the issue of 30.4m shares in part consideration for the acquisition of ITNET.

3. Dividends
Our policy is to increase the total dividend per share each year broadly in line with the increase in underlying earnings. The proposed final dividend of 2.06p per share represents a 13.2% increase on 2004. The total dividend for the year is 2.97p, an increase of 12.9%. The dividend will be paid on 17 May 2006 to shareholders on the register at 10 March 2006.

4. Cash flow
Our cash performance in 2005 was strong, with a Group free cash inflow of £73.8m, an increase of £18.0m compared with 2004.

The Group's cash flow is analysed in Figure 2. The presentation is consistent with our analysis in previous years and is designed to show the true cash performance of the Group – the cash flows generated by Serco's subsidiaries, plus dividends received from joint ventures. It therefore differs from the consolidated cash flow presented on page 74, in which the cash flows of joint ventures have been proportionately consolidated. The adjustment line in Figure 2 reconciles the movement in Group cash to the consolidated cash flow.

Group free cash flow

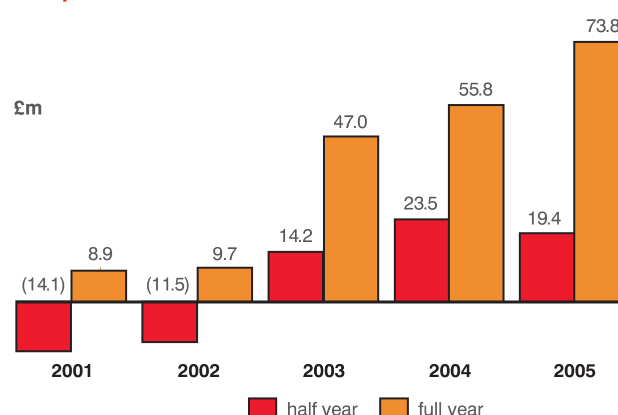


Figure 2: Cash flow

	2005 £m	2004 £m
Operating profit excluding joint ventures	62.4	43.5
Non cash items	45.2	32.1
Group EBITDA	107.6	75.6
Working capital movement	(11.2)	(5.3)
Group operating cash flow	96.4	70.3
Interest	(15.7)	(3.8)
Tax	(1.0)	(1.5)
Expenditure on tangible and intangible assets	(31.6)	(23.4)
Dividends from joint ventures	25.7	14.2
Group free cash flow	73.8	55.8
Acquisitions	(281.7)	(9.1)
Other financing	269.4	(7.6)
Dividends paid	(12.5)	(10.4)
Group non recourse debt financed assets	(15.6)	(25.2)
Group net increase in cash and cash equivalents	33.4	3.5
Adjustment to include joint venture cash impacts	4.1	12.8
Net increase in cash and cash equivalents	37.5	16.3

Note: Group EBITDA is earnings from subsidiaries before interest, tax, depreciation and intangible amortisation.

4.1 Group operating cash flow

The Group operating cash inflow for the year was £96.4m (2004: £70.3m), an increase of 37.1%. This represents a conversion of Group EBITDA into cash of 90% (2004: 93%). The Group's cash conversion is particularly notable given the level of organic growth, which typically results in a working capital outflow equivalent to one month's incremental revenue.

4.2 Tax

Tax paid in 2005 was £1.0m, compared with £1.5m in the previous year. The level of tax paid in 2005 reflects a number of factors, including our continued progress in closing previous years' tax returns, with a refund of £8m in the year, as well as residual accelerated capital allowances and other timing differences. Tax paid in 2004 benefited from a repayment of nearly £7m, as we were able to utilise tax losses in subsidiaries which were previously joint ventures. From 2006, we expect our tax paid to be close to the tax charge in our income statement.

4.3 Expenditure on tangible and intangible assets

Expenditure on tangible and intangible assets was £31.6m (2004: £23.4m). This represents around 1.8% of revenue excluding joint ventures. Included within this is £7m of cash spent on designing and building our new SAP accounting system and shared service centre. This programme of expenditure will continue through 2006 and 2007.

4.4 Dividends from joint ventures

Dividends received from joint ventures during 2005 were £25.7m (2004: £14.2m). This is equivalent to 101% (2004: 78%) of our share of joint ventures' profit after tax. The high level of conversion reflects dividend payments made by joint ventures from reserves retained in previous years. We expect a conversion rate in the range of 70% to 80% going forward.

4.5 Acquisitions

The cash outflow in 2005 of £281.7m primarily relates to the acquisitions of ITNET and RCI. The other significant acquisition during the year was our purchase of the outstanding 50% of Defence Management Holdings Limited (DMHL) for £5.9m. DMHL, which owns the special purpose company for the Joint Services Command and Staff College PFI, was previously a joint venture.

4.6 Other financing

Other financing of £269.4m primarily relates to the net draw down of loans to fund the acquisitions of ITNET and RCI.

4.7 Group non recourse debt financed assets

The £15.6m outflow is the net of expenditure on PFI assets under construction, the movement on non recourse loans and changes in other PFI balances.

Over the life of each PFI contract, we expect these movements to offset each other.

5. Net debt

At 31 December 2005, Group recourse net debt was £264.0m (31 December 2004: £15.3m). Further analysis is provided in Figure 3.

Figure 3: Net debt

As at 31 December	2005 £m	2004 £m
Group - cash and cash equivalents	210.0	173.9
Group - recourse debt	(453.1)	(168.4)
Group - obligations under finance leases	(20.9)	(20.8)
Group recourse net debt	(264.0)	(15.3)
Joint venture recourse net cash/(debt)	18.0	(4.6)
Total recourse net debt	(246.0)	(19.9)
Group non recourse debt	(326.8)	(256.5)
Joint venture non recourse debt	(22.4)	(47.1)
Total non recourse debt	(349.2)	(303.6)
Total net debt	(595.2)	(323.5)

5.1 Group recourse net debt

The strength of our cash flow resulted in a reduction in Group recourse net debt in the second half of the year, from £315.2m at 30 June 2005 to £264.0m at the year end.

The net increase in the Group's other loans during the year reflects the debt funding for the acquisitions of ITNET and RCI. These loans have covenants consistent with our private placements and allow sufficient headroom to fund known commitments and working capital requirements.

5.2 Group non recourse debt

Group non recourse debt, which we have utilised to fund PFI assets and the acquisition of the DES franchise, increased during the year to £326.8m (31 December 2004: £256.5m). This was the result of our acquisition of the remaining 50% share of DMHL. Since the acquisition, we have consolidated 100% of DMHL's non recourse debt in our balance sheet. The increase was partly offset by the scheduled repayments of debt across all our non recourse debt funded projects.

The Group's debt is non recourse if no Group company other than the relevant borrower - typically a special purpose company for a PFI - has an obligation to repay the debt under a guarantee or other arrangement. The debt is excluded from all of our credit agreements and other covenant calculations, and therefore has no impact on the Group's ability to borrow.

6. Pensions

To assist understanding of the complexities of accounting for pension schemes under IFRS, we have provided an overview. Further detail was provided in our announcement 'Transition to International Financial Reporting Standards', on 31 August 2005.

Figure 4: Defined benefit pension schemes

As at 31 December	2005 £m	2004 £m
Group schemes - non contract specific	(200.4)	(164.6)
Contract specific schemes		
- reimbursable	(84.9)	(56.0)
- not certain to be reimbursable	(21.3)	(22.3)
Net retirement benefit liabilities	(306.6)	(242.9)
Intangible asset arising from rights to operate franchises and contracts	19.0	21.2
Reimbursable rights debtor	84.9	56.0
Deferred tax asset	52.8	41.0
Net balance sheet position	(149.9)	(124.7)

The total pension cost included within PBTA for 2005 was £55.6m (2004: £39.5m). At the year end, the net amount included in the balance sheet arising from our obligations in respect of defined benefit pension schemes was £149.9m (31 December 2004: £124.7m). Further analysis is provided in Figure 4. Under IFRS, Serco has three main types of scheme which are accounted for as defined benefit pension schemes. Each type has its own accounting treatment under IAS 19 'Employee Benefits'. These are:

- Schemes which do not relate to specific contracts or franchises - principally the Group scheme. For these schemes, the actuarial gain or loss for the period is charged to the consolidated statement of recognised income and expense (the SORIE)

- Schemes relating to specific contracts or franchises, where the deficit will pass back to the customer or to the next contractor at the end of the relevant contract. For these schemes, the actuarial gain or loss for the period is charged to the SORIE, and a recoverable intangible asset is recognised on the balance sheet and amortised to the income statement over the contract or franchise life, and

- The AWE contract, where there is a right of cost reimbursement, and where the pension scheme deficit and offsetting debtor are both included in the balance sheet.

The increase in net liabilities during the year resulted primarily from the reduction in the AA bond rate, which increased the liabilities on all defined benefit pensions. These increases, together with the related deferred tax movement, have been reflected in the SORIE.

Figure 5: Pension assumption sensitivities

	Change in assumption	Change in liability
Discount rate	+0.5%	(10)%
	(0.5)%	+11%
Price inflation	+0.5%	+8%
	(0.5)%	(7)%
Salary	+0.5%	+3%
	(0.5)%	(3)%
Longevity	Increase by one year	+2.5%

Figure 5 shows the approximate sensitivities of the liabilities on our defined benefit pension schemes to movements in the discount rate, and to changes in our actuarial assumptions regarding the rate of inflation, the rate of increase of scheme members' salaries and life expectancies.

The main Group defined benefit pension scheme accounts for around two thirds of our net balance sheet position. In recent years, we have taken action to manage the liabilities of the Group scheme. We have closed the scheme to new members, other than those joining the Group as a result of TUPE transfers. We increased employer contributions to the scheme from 2003, and employee contributions from 2004. We have also introduced annual actuarial valuations, which ensure that we have up-to-date information on the position of the scheme.

During 2006, in conjunction with the scheme's trustees, we will further consider the funding and risk profile of the Group scheme.

7. Acquisitions

We completed the acquisition of ITNET on 3 February 2005. The consideration of £245.5m comprised £171.3m of cash and 30.4m shares worth £74.2m. The acquisition gave rise to goodwill of £260.9m, including fair value adjustments and acquisition costs of £28.1m. Intangible assets arising on the acquisition have been recognised at £20.6m and will be amortised on a straight-line basis over their expected life of eight years. From the date of ownership ITNET contributed £190.6m to revenue and £14.3m to PBTA.

Our acquisition of RCI was completed on 21 March 2005 for consideration of £116.3m in cash. The acquisition gave rise to goodwill of £93.7m, including fair value adjustments and acquisition costs of £7.0m. Intangible assets arising on the acquisition have been recognised at £2.2m and will be amortised on a straight-line basis over their expected life of five years. From the date of ownership, RCI contributed £143.3m to revenue and £9.3m to PBTA.

Our other acquisitions during the year, principally the 50% of DMHL, contributed £3.3m to revenue and £0.8m to PBTA.

8. PFIs

8.1 PFI portfolio

The Group has a portfolio of 11 PFI projects. We have operating contracts for all our PFIs, and equity investments in ten. Following our purchase of 50% of DMHL, we now own 100% of eight of our PFI projects.

8.2 Accounting for PFI contracts

In March 2005, the International Financial Reporting Interpretations Committee (IFRIC) issued a draft interpretation on accounting for service concession arrangements. These are arrangements such as PFIs, under which a government or other body grants contracts for the supply of public services – such as prisons or hospitals – to private operators. The IFRIC is still working towards a final interpretation, which it expects to publish in the second half of 2006.

In the absence of specific guidance within IFRS, from 1 January 2005 we have recognised our PFI debtors at amortised cost, as defined by IAS 39. This maintains an accounting treatment consistent with UK GAAP and existing IFRS.

The draft guidance from IFRIC, if it were issued in final form, could require a number of changes to the accounting treatment of service concession arrangements. This could result in a significant increase in the carrying value of the Group's PFI debtors.

9. Treasury

9.1 Credit facilities and liquidity management

The £420m bank credit facility we used to provide funding for the acquisitions of ITNET and RCI comprises a term loan facility and a revolving credit facility. As at 31 December 2005, term loans totalling £279m were outstanding and the revolving credit facility was undrawn. The bank facility has covenants and obligations typical of these types of arrangement, is unsecured and expires in December 2009. Loans drawn under the bank facility accrue interest at a rate of 50 basis points over LIBOR.

Serco has also issued loan notes under two private placements. The first, for £43.2m, matures in December 2007. The second, for £117m, amortises evenly from 2011 to 2015.

9.2 Impact of IAS 32 and IAS 39

The Group adopted IAS 32 and IAS 39 effective from 1 January 2005. Adopting IAS 39 resulted in a reduction in our opening net assets of £27.1m. This principally represents a fair value loss from marking to market the interest rate swaps we use to hedge the interest obligations of PFI special purpose companies into fixed rate obligations, and the cross-currency swaps used to hedge long term loan notes.

All designated hedges are highly effective and, as a result, the impact on the income statement for the period was immaterial. Further details of the effect of applying IAS 32 and IAS 39 can be found in our announcement of 31 August 2005, 'Transition to IFRS Report'.

Acquisitions

Our two significant acquisitions during 2005 – ITNET (now Serco Solutions) and RCI (now part of Serco Inc) – are delivering the benefits we expected.

The additional skills, capabilities and customer relationships of ITNET and RCI are providing significant opportunities for the Group in new markets and enabling us to compete for larger and higher value contracts in markets where we are well established.

Serco Solutions contributed revenue of £190.6m and profit of £14.3m, at a margin of 7.5%. More information on its contract wins since we acquired it is given on page 19, under civil government – regional and local government, and page 33 under private sector.

Since the acquisition was completed in March, the RCI business contributed £143.3m to revenue and £9.3m to profit, at a margin of 6.5%. The business continues to grow strongly, receiving numerous new task orders and expanding or extending existing contracts. Further information on the key developments since we acquired it is given on page 27, under defence – North America.

Risk management

Risk management is a fundamental part of Serco's business. Every business decision we make is carried out with the associated risks in mind. We have set out below the principal risks that Serco faces, and the systems and processes we use to manage them. This summarises the more detailed explanation contained in the Corporate Governance report on page 48.

Principal risks

We divide the principal risks we face into six categories. The most significant risks relate to the strategy and safety areas. Social, environmental and ethical issues, while recognised within a number of our risks, do not represent significant threats to the achievement of our strategy at present.

Business strategy

These are threats to the long term deliverability of our strategy. The principal risks include loss of competitive position and strategic risks associated with recent acquisitions.

Financial/commercial performance

These are threats to the short term performance of our existing business. The principal risks include the loss of key contracts, the failure to meet financial business plans, pension fund liabilities and delays or cost over-runs in major transition programmes.

Compliance

These are risks covering compliance with all relevant legislation and regulations. Our principal risks in this category include legal action resulting from compliance failures, the introduction of International Financial Reporting Standards and unethical behaviour by directors or members of staff.

Safety

These are threats to the safety of staff, sub-contractors, members of the public and the environment. The risks include the responsibility for a major accident or incident where public and employee safety is concerned, environmental pollution and assaults on staff in the course of their duties.

Business continuity

These are threats to the continuity of our business operations after adverse events. Our principal risks include the failure of information systems, loss of key infrastructure and the recruitment and retention of key staff.

Hostile actions

These are threats posed by the deliberate actions of individuals and organisations affecting our interests. Principle risks include crime and fraud, pressure group action, terrorism and industrial action.

Reputation

More generally, we face risks to the Group's reputation. These are assessed by our corporate communications team and the Board on an ongoing basis.

Serco's approach to risk management

We have a well-embedded system of risk management, designed to safeguard shareholders' investments and our assets and reputation. Our risk management process identifies the key risks facing each business

and reports to the Board on how those risks are being managed.

Our risk management standard defines the processes that we require at each level in the organisation in order to manage and mitigate the threats to the achievement of our business objectives.

We maintain risk registers at a project/contract, business unit, divisional and Group level and we review the registers at least quarterly. The risk registers identify the key risks, the probability of those risks occurring, their potential impact on the business and the actions we are taking to reduce and mitigate the risks. We prioritise the risks using a consistent scoring system across the business. Guidance on the Group's risk appetite has been issued to managers, which defines the appetite and tolerance levels both for individual risks and for projects or business units where multiple risks may be present.

Each risk is assigned an owner at Board or senior management level and we identify specific actions to reduce and mitigate risk. The Board may ask for additional information in respect of risk reduction or mitigation actions from risk owners or request that a specific audit is undertaken to provide additional assurance in respect of the risk controls.

Some of our key management and control techniques are described below.

- We have comprehensive business review processes, which ensure that our services and products meet customer expectations, comply with regulations and deliver our required financial and operational performance

- Our operational risk framework tracks key risk indicators, including analysis of business performance against plan, customer and staff satisfaction and retention, health and safety, and error and exception reporting

- We apply sound project, programme management and change implementation disciplines to all major development projects, including phasing-in new contracts, acquisitions and new technology

- Our operating processes fully reflect the principles of clear delegation of authority and segregation of duties

- Our staff receive ongoing training and career development to improve their skills, and our human resources policies, including selective recruitment and succession planning, ensure that staff skills are aligned with the Group's needs

- The investment committee meets on a monthly basis to consider new or developing projects against a defined set of criteria, after which projects can be submitted to our global management board for consideration and allocation of appropriate resources

- Our review and approval process for all proposals and business acquisitions includes delegated authority for sign-off based on the financial value, capital requirement and risk of the transaction

- Each of our business units has qualified and experienced staff to provide advice and support on health, safety and environmental issues, and to undertake regular audits

- Our aviation, rail, defence, marine and nuclear businesses have safety specialists who report directly to the Board, and who maintain and develop the very high standards of safety these industries require

- The company secretary reviews ethical issues arising from our activities and manages the 'whistle blowing' process, to which staff can report illegal, dangerous, dishonest or unethical activities

- We conduct internal audits to confirm that controls are in place and being applied across our activities

- We use insurance policies to protect the Group from losses such as damage or destruction of assets, theft and liability for third party losses.

Joint ventures and associated companies

In addition to contracts held in Serco's name, we have material investments in a number of joint ventures and associated companies. As we do not wholly own these investments, we can influence, but not control, management practices. Our representatives within these companies ensure that the processes and procedures for identifying and managing risk are appropriate for the business and that internal controls exist and are regularly monitored. Employees from our joint ventures participate in our Assurance network and our Risk Oversight and Rail Safety Oversight Groups.

Corporate responsibility

Corporate responsibility – which encompasses safety, people, community and the environment – is fundamental to the way Serco operates. The emphasis we place on these matters reflect their importance to those we come into contact with during the course of our activities. And corporate responsibility is also good business practice, which we believe will ultimately help us deliver better returns to our shareholders.

The responsibilities of our Corporate Assurance Group (CAG), which reports directly to the Board, include developing and overseeing our corporate responsibility activities. Our corporate responsibility model, which is described in detail in our separate Corporate Responsibility report, encompasses four elements:

- Safety – recognising our legal responsibility for the safety of our staff and the general public for whom we have a duty of care
- People – addressing our legal and moral responsibility for our employees
- Community – addressing our social responsibility for the communities within which we operate
- Environment – recognising our legal and moral responsibility to protect the environment from damage as a direct result of our operations and to promote activities to protect and sustain the wider environment.

For 2005, we set three targets or objectives in each of these four areas, giving a total of 12. We achieved, or are on track to achieve, 11 of the 12, and made progress towards achieving the 12th. Further details of our performance, and the new targets and objectives for 2006, are included in the Corporate Responsibility report.

CAG reports formally to the Executive Chairman and to the Board on a quarterly basis providing analyses of performance against our assurance targets and also advises the Board regarding policy and future activities to enhance best practice around the organisation. CAG undertook reviews of internal controls during 2005 including health, safety and environmental management. As a result, CAG has included a number of activities in its programme for 2006 to strengthen the Group's performance in these areas.

Directors, secretary and advisors

Chairman
Kevin Beeston

Directors
Margaret Ford*
Ralph Hodge CBE*
(retiring May 2006)
Christopher Hyman
Andrew Jenner
DeAnne Julius* ^
David Richardson*
Leonard V. Broese
van Groenou
(effective April 2006)*

Secretary
Joanne Roberts

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Stockbrokers
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* Non-Executive Director
^ Senior Independent Director

Corporate governance report

"The Group has a well-established and embedded system of internal control...designed to safeguard shareholders' investments and the Group's assets and reputation."

The Board of Serco Group plc (the Company) is committed to achieving high standards of corporate governance, integrity and business ethics for all its activities around the world. The Company supports the Combined Code on Corporate Governance issued by the Financial Reporting Council (the Combined Code). The Company has achieved full compliance with Section 1 of the Combined Code during 2005.

The Board and its Directors

The Board currently comprises seven directors, Kevin Beeston, Margaret Ford, Ralph Hodge, Christopher Hyman, Andrew Jenner, DeAnne Julius and David Richardson. Excluding the Executive Chairman, the Board comprises four Non-Executive Directors and two other Executive Directors. In February 2005 the Board approved the appointment of Leonard V. Broese van Groenou as a Non-Executive Director effective from 3 April 2006. Ralph Hodge will be retiring from the Board following the completion of the Annual General Meeting in May 2006.

Since the Group has been listed it has been run with a structure consisting of both an Executive Chairman and a Chief Executive with distinct and complementary roles. The Group has also maintained a position of Senior Independent Director throughout this time.

The Board continues to believe in the need for a full time Executive Chairman who is responsible for the effective operation of the Board, oversight of corporate governance and assurance activities, and the Company's relationship with the City and key business stakeholders. This role is distinct from that of the Chief Executive who focuses on the formation and implementation of the Group strategy, chairing and managing the Global Management Board and delivery of all aspects of the business. Job specifications are in place for both the Executive Chairman and the Chief Executive defining their roles and responsibilities. The Board have reviewed and re-approved the individual roles and responsibilities of both the Chairman and the Chief Executive during the year. The Directors' profiles are set out on page 57.

The Board believes that all the Non-Executive Directors are independent of management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgment. They bring a wide range of experience to the Board including international business operations, strategy, human resources, finance and economics. The Senior Independent Director is DeAnne Julius. David Richardson is the Chairman of the Audit Committee. David was previously the Finance Director of a FTSE 100 Company and the Board believes that David has the relevant financial experience to chair this Committee as recommended by the Combined Code. The Non-Executive Directors have met on an informal basis during the year without the presence of the Executive Directors. The Non-Executive Directors are initially appointed for a three-year term, which may be extended for a further period of three years.

During the year the Board met on four occasions for two days at a time, at varying locations, and took the opportunity to combine the formal business of the Group with site visits and divisional

presentations and discussions. Six additional meetings were held during the first quarter of the year to approve various stages of the acquisitions of ITNET and RCI. No apologies were received for any of the meetings.

There is a formal schedule of matters reserved for the Board including the responsibility for leading and directing the affairs of the Group. This schedule together with the terms of reference for each of the Board Committees were reviewed and revised by the Board in November 2003 following publication of the revised Combined Code. Terms of reference of the Committees are available on the Company's website www.serco.com. Membership of the Committees was revised following the changes to the Board in May 2004.

Board evaluation – in December 2004, a rigorous evaluation of the Board and its Committees was undertaken which included a formal evaluation questionnaire and 1:1 meetings for all Directors held with the Chairman plus an evaluation of the Chairman's performance led by the Senior Independent Director. During 2005, further meetings have been held to review the individual roles and responsibilities of the Board and its Committees. A small number of procedural changes were made as a result of the evaluation.

All Directors have access to the Company Secretary and independent professional advice at the Company's expense. The Company Secretary has the responsibility for ensuring that the Board procedures are followed and for advising on governance matters. The appointment and removal of the Company Secretary is one of the matters reserved for the Board. The Company Secretary is also Secretary to all the Board Committees and responsible for operation of the Group's 'whistle-blowing' procedure. The information provided to the Board is reviewed by the Chairman and the Company Secretary on a regular basis, to ensure that it remains appropriate, timely and adequate and enables the Directors to discharge their duties. The information provided to the Board was assessed as part of the earlier Board evaluation process.

In accordance with the Company's Articles of Association, a Director must retire at the Annual General Meeting (but is eligible for re-appointment) if he or she has held office for more than 30 months (as at the date of the notice convening the meeting) since he or she was appointed or last re-appointed.

Other Directorships – The Board believes that it is in the customer's best interests for Executive Directors to gain additional experience through limited, but carefully selected, non-executive appointments. Christopher Hyman is a Non-Executive Director of United Business Media plc for which he received £35,000 in remuneration and 1,577 shares during the year. He is also Non-Executive Director of the Prince of Wales' charity In Kind Direct which is a non-fee earning role. Kevin Beeston is a Non-Executive Director of Ipswich Town Football Club plc and a Non-Executive of IMI plc for which he received fees of £35,995. His role with Ipswich Town Football Club is non-fee earning. The Board is fully supportive of the external roles undertaken by Kevin and Christopher and consider that the time commitment required will not significantly impact their positions in the Company.

Board committees

The Board has delegated authority to a number of committees to deal with matters in accordance with written terms of reference. The terms of reference were reviewed and revised in November 2003 to take account of the changes to the Combined Code. The Chairmen of the Board committees attend the Annual General Meeting to answer questions from shareholders.

The terms of reference for the Board committees and matters reserved for the Board are displayed on the Company's website www.serco.com.

The Audit Committee

The Audit Committee is chaired by David Richardson. Margaret Ford and DeAnne Julius, Non-Executive Directors, are also members of the Committee. In accordance with best practice the Committee has produced a report on its activities during the year, which can be found below.

Report of the Audit Committee

The Audit Committee met three times during the year with all Committee members in attendance at every meeting. At the meetings, additionally attended by the internal and external auditors and, by invitation, the Finance Director, matters relating to the integrity of the financial statements of the Company, the accounting policies adopted, significant financial reporting judgements made and the role of the internal auditors were discussed. During the year the Committee held discussions regarding the business risk auditing activities undertaken by the Company's internal audit providers, Grant Thornton. Members of the Committee have received updates on accounting standards and generally accepted accounting principles on a quarterly basis as part of the

Finance Director's report to the Board, and also on a half-yearly basis from the external auditors. The Committee has also received a presentation and update reports on the impact of the International Financial Reporting Standards on the Company and the Group. During the year the Company has complied with the policy set by the Committee in respect of the provision of audit and non-audit services by Deloitte & Touche LLP (Deloitte). Where appropriate non audit services have been provided by companies other than Deloitte.
The Committee considered and recommended approval of the annual audit fee for Deloitte, which was subsequently approved by the Board.

The independence, objectivity and effectiveness of the external auditors has been examined by the Committee and discussions were held regarding their terms of engagement, remuneration and proposal for partner rotation. The Committee has met with both the internal and external auditors without the presence of the Executive Directors.

In accordance with the Combined Code, the Committee is responsible for a formal 'whistle-blowing' policy and procedure which applies throughout the Group. Responsibility for the operation of this policy has been delegated to the Company Secretary.

The Committee recommended to the Board that Deloitte be proposed for re-appointment at the forthcoming Annual General Meeting. This recommendation has been accepted and will be proposed to shareholders.

The Nomination Committee

The Nomination Committee comprises the Executive Chairman, who chairs the Committee, and the four independent Non-Executive Directors. The Committee met once during 2005 and all Committee members attended the meeting. Matters considered included succession planning and crisis management planning for the Board, plus the Board structure. In addition the Committee led the process for identifying a new Non-Executive Director for recommendation to the board for appointment on the retirement of Ralph Hodge. The process included an evaluation of the balance of skills, knowledge and experience required for the role. Recommendations made to the Board were based on an assessment of individual merit and against objective criteria. Following discussions amongst the Nominations Committee and the Board suitable candidates were identified and the Committee did not consider that the use of an external search consultant or open advertising was required on this occasion.

The Remuneration Committee

The Remuneration Committee is chaired by Ralph Hodge, with the other three Non-Executive Directors being the remainder of the Committee. The Committee met five times during the year to deal with matters relating to remuneration policy and individual remuneration for Executive Directors. All meetings were attended by each of the Committee members. The Remuneration Report is set out on pages 59 to 68. The Committee also considered the framework of remuneration for senior executives within the Group. The individual remuneration of these executives is considered and approved by the Remuneration Committee of the Global Management Board, which comprises the Executive Team of the Group and is advised by the Group Human Resources Director. On the retirement of Ralph Hodge in May 2006, Margaret Ford will take over the Chair.

There are three further committees of the Board, details of which are below:

The Approvals and Allotment Committee

This Committee meets on an as required basis and comprises the Executive Directors and the Company Secretary. Thirty one meetings were held during the year. The business of the Committee is varied and ranges from bid and contract approval to the releasing of share options. The Committee also considers matters requiring formal approval following discussion by the GMB. The Committee forms a key part of the Group's internal controls and acts to facilitate and authorise the operations of the business on a day-to-day basis. The level of authority delegated to this Committee is reviewed on an annual basis.

The Global Management Board (GMB)

The Board has delegated responsibility for the day-to-day management of the business to the GMB. The GMB comprises a number of senior managers within the business and includes all three of the Executive Directors. The GMB meets formally three times a year to review Company activities and discuss operational issues. Other meetings are scheduled where required. Representatives from across the Serco businesses are often invited to the meetings to discuss aspects of their business or give presentations on specific topics. By bringing together senior managers from across the Group, the GMB is able to take a broad view of the business. Matters discussed by the GMB which require formal approval, are submitted to the Board or the Approvals and Allotment Committee, details of which are provided above.

The Training and Development Committee

The Training and Development Committee comprises Margaret Ford, Christopher Hyman, Ralph Hodge and is chaired by Kevin Beeston. The Committee met once during the year to consider the training needs of all Directors and the Company Secretary, ensuring the appropriateness of the induction process for new Directors in providing a comprehensive familiarisation programme including the role of the Board and its Committees, the corporate governance framework and latest financial statements, together with site visits and meetings with senior management around the Group. In addition the Committee reviewed the progress made on the leadership development programme being implemented across the Group.

All Board members are encouraged to attend training courses at the Company's expense.

The Company and its shareholders

The Board is committed to ongoing dialogue with the Company's shareholders. The Chairman and Finance Director are responsible for relationships with investors, supported by the Head of Investor Relations. The Chief Executive also regularly attends meetings with shareholders and the Non-Executive Directors are encouraged to do so where time allows or at investors' request. In the 2005 Investor Relations Magazine awards, investors and analysts voted the Company best in the support services sector for investor relations.

The Company has a regular programme of events and announcements for institutional investors and analysts. We presented on the interim and preliminary results, and held conference calls for overseas investors. The presentations were also webcast.

In June and December, the Company released trading updates ahead of its closed periods. Throughout the year, announcements were made on key business events, notably major contract wins. The Company also introduced news updates, to keep investors and analysts informed of other developments in the business.

During 2005, the Company regularly met institutional shareholders in the UK and North America, on both a one-on-one and group basis. To continue to improve the Company's dialogue with institutional investors, the Chairman began a programme of meetings with senior fund managers and heads of corporate governance at a number of the Company's largest shareholders.

The Company has continued its programme of educational presentations for institutional investors and analysts, designed to improve their understanding of the Company's businesses, markets and prospects. During 2005, the Company held a seminar on its Transport business in June, and its Defence and Home Affairs businesses in November.

The Board receives an investor relations report on a quarterly basis. This reviews share price movements and valuation, changes on the share register, the Company's recent and planned investor relations activities, analyst recommendations and significant news from the support services sector. The report ensures that the Board has a clear understanding of the Company's investor relations performance.

The principal methods of communication with private investors remain the news announcements, Interim Report, Annual Review and Accounts, Annual Review and Summary Financial Statement, the Annual General Meeting and the Company's website, www.serco.com.

The website includes an area tailored for investors, including information such as archives of all reports, announcements, presentations and webcasts, share price tools, the terms of reference for all the Board committees and information on voting at the annual general meeting. It also has a link directly to the Company's registrars, allowing shareholders to view their shareholding online and to vote on the resolutions set out in the notice of the 2006 Annual General Meeting.

Internal control and risk management

The Group has a well-established and embedded system of internal control, including financial, operational and compliance controls and risk management designed to safeguard shareholders' investments and the Group's assets and reputation. Whilst the Board has overall responsibility for the Group's system of internal control and for reviewing its effectiveness, it is the role of management to implement the policies on risk and control. The Group's risk management process identifies the key risks facing each business and reports to the Board on how those risks are being managed. The Board confirms that this process has been in place for the year under review and up to the date of approval of the Annual Review and Accounts. These processes are reviewed regularly by the Board and conform to the requirements of the Combined Code. Such a system, however, can only be designed to mitigate, rather than eliminate, the risk of failure to achieve

business objectives, and can only provide reasonable, and not absolute assurance, against misstatement or loss.

The Serco Management System (SMS), provides the framework within which the business divisions, operating companies and contracts have implemented processes and procedures in ways that are appropriate to the type of business being undertaken. Divisional Chief Executives and business unit managers have the responsibility and authority to implement the system and monitor its operation within their businesses. The SMS defines the Group's vision and strategy, the core values that define the context within which the business operates, a set of business principles that define the corporate behaviour of the organisation, the operating structure and roles and responsibilities of the principal elements of the organisation and the core processes of the business.

As part of the SMS, a set of policy statements has been authorised by the Board and supporting standards, guidance and training material have also been produced.

An ethics and business conduct standard defines the following principles that apply to all business activities undertaken by the Group:

- We will comply with the laws of the country in which business is being transacted
- We will respect the human rights and dignity of individuals
- We will respect the traditions and culture of communities and protect the environment within which we operate
- We will undertake our business activities in accordance with the highest standards of professionalism, integrity and honesty.

These broad principles are further interpreted in respect of individual and corporate behaviours. A separate standard defines the corporate responsibility programme that is implemented throughout the Group.

A risk management standard defines the processes that are required at each level in the organisation in order to manage and mitigate the threats to the achievement of our business objectives. The risk management process adopted at all levels of the business is described in a Risk Management Manual and supported by a set of guidance notes covering specific aspects of the process and techniques appropriate to particular business activities. An internally developed and supported risk database tool supports the risk management process and is used to create risk, opportunity, assumption and issue registers. Risk registers are maintained at a project/contract, business unit, divisional and Group level and are reviewed at least quarterly and more frequently as required. The risk registers identify the key risks, the probability of those risks occurring, their potential impact on the business and the actions being taken to reduce and mitigate the risks. Risks are prioritised using a consistent scoring system across the business. Guidance on the risk appetite of the Group has been issued to managers which defines the appetite/tolerance levels both for individual risks and for projects or business units where multiple risks may be present.

The Group risk register identifies the key principal risks facing the business including risks that are managed directly at a Group level. The risks identified in the Group risk register could arise as a result of internal or external events or decisions and could affect the Group's short or long term value, its reputation, the safety of its staff or third parties or compliance with statutory obligations. The risk management process specifically identifies the business objectives and the interests not only of shareholders but also of other stakeholders that are likely, directly or indirectly, to influence the performance of the business and its value. These include, but are not limited to, customers, suppliers, staff, trade unions, government, regulators, banks and insurers. The interests of the wider community in areas such as social, environmental and ethical impact are recognised in the Group's corporate responsibility programme.

The Group risk register is updated at least quarterly, reviewed six monthly by the Risk Oversight Group and discussed at quarterly Board meetings; active risks are ranked into five categories of importance based on the risk score and grouped under the following six headings:

- Business strategy – covering threats to the long-term deliverability of the Group's strategy. Principal risks of the Group include loss of competitive position, and strategic risks associated with recent acquisitions

- Financial/commercial performance – covering threats to the short term performance of the Group's existing business. Principal risks of the Group include the loss of key contracts, the failure to meet financial business plans, pension fund liabilities and delays or cost over-runs in major transition programmes

"Risk management techniques used by Serco include appropriate systems, staff, internal controls, public and media relations and business continuity planning."

- Compliance – covering compliance with all relevant legislation and regulations. Principal risks of the Group include legal action resulting from compliance failures, the introduction of the International Financial Reporting Standards (IFRS) and unethical behaviour by Directors or members of staff

- Safety – covering threats to the safety of staff, sub-contractors, members of the public and the environment. Risks of the Group include the responsibility of a major accident or incident where public safety is concerned, environmental pollution and assaults on staff in the course of their duties

- Business continuity – covering threats to the continuity of business operations in the event of adverse events. Principal risks of the Group include the failure of information systems, loss of key infrastructure and the recruitment and retention of key staff

- Hostile actions – covering threats posed by the deliberate actions of individuals and organisations affecting the interests of the Group. Principal risks of the Group include crime and fraud, pressure group action, terrorism and industrial action.

Additionally, more general risks relating to the reputation of the Group are assessed by Corporate Communications and the Board on an ongoing basis.

For the Group, the most significant risks relate to the strategy and safety areas; social, environmental and ethical issues, while recognised within a number of the Group's risks, do not represent significant threats to the achievement of the Group's strategy at present. All risks and potential threats are kept under regular review and the Board informed of changes as they occur.

Each risk is assigned an owner at Board or senior management level and specific risk reduction and risk mitigation actions are identified. The Board may ask for additional information in respect of risk reduction or mitigation actions from risk owners or request that a specific audit is undertaken to provide additional assurance in respect of the risk controls. Risk management techniques used by Serco include appropriate systems, staff, internal controls, public and media relations and business continuity planning. These techniques are designed with clarity of accountability and responsibility and with certain formal policies covering areas such as compliance, safety and environmental protection. Serco's business units build and maintain an understanding of their operational risk profiles and are expected to fully understand the likelihood and potential impact of any operational incidents, at the same time making appropriate and informed decisions that balance the risks against the potential returns and opportunities.

While operational risk can never be eliminated, the Group endeavours to minimise the impact by ensuring that appropriate infrastructure, controls, systems, staff and processes are in place. Some of the key management and control techniques are set out below:

- The principles of clear delegation of authority and segregation of duties are fully reflected in the Group's operating processes

- Comprehensive business review processes ensure that our services and products meet customer expectations, performance criteria, operational effectiveness, regulatory requirements, investment returns and profitability

- An Investment Committee meets on a monthly basis to consider new or developing projects against a defined set of criteria. Projects can then be considered for the allocation of appropriate resources

- There is a formal review and approval process for all proposals and business acquisitions including delegated authority for sign-off based on the financial value and capital requirement of the transaction and the assessed risk of the project

- Sound project and programme management and change implementation disciplines are applied to all major development projects including new contract phase-ins, acquisitions, new technology applications, change programmes and other major initiatives

- The commitment and capability of staff is critical for the effective management of operational risk. Ongoing training and career development constantly improves the skills of our workforce. Selective recruitment, succession planning and other human resource policies and practices are in place to ensure that staff skills are aligned with the needs of the organisation

- Safety management systems in the Group's aviation, rail, defence, nuclear and marine businesses have been addressed by the appointment of safety specialists for each area who report directly to the Board and are charged with maintaining and further developing the very high standards of safety expected in these industries

- The Group's approach to health, safety and environmental protection is described in the Directors' Report. Qualified and experienced staff in each business unit provide advice and support on health, safety and environmental issues and undertake regular audits

- The Company Secretary is responsible for the review of ethical issues that may arise from the Group's activities and for managing the confidential reporting service (whistle-blowing), to which staff can report illegal, dangerous, dishonest or unethical activities. The process is overseen by the Audit Committee

- A programme of internal audits confirms the extent to which key controls are in place and are being applied across the Group's business activities. Audit priorities are established on the basis of risk assessments, regulatory requirements and business imperatives

- The operational risk framework tracks key risk indicators. These include analysis of business performance and variances from plan, customer satisfaction and retention data, staff turnover and satisfaction levels, occupational health and safety incidents, and error and exception reporting

- The Group maintains insurance policies to provide protection from losses arising from circumstances such as damage or destruction of physical assets, theft and legal liability for third party loss. The adequacy of the insurance cover is reviewed at regular intervals.

The Corporate Assurance Group (CAG), reporting directly to the Board, has the responsibility to oversee and review the internal control and risk policies, procedures and management framework within the Group and to develop guidance, training material and management training to ensure the current and future needs of the business are met. The Board recognises not only its responsibilities to shareholders but also to the wider community where social, environmental and ethical issues are becoming increasingly important. CAG is responsible for developing and overseeing the corporate responsibility activities within the Group. The corporate responsibility model is described in the separate Corporate Responsibility Report and encompasses four elements:

- Safety – recognising the Group's legal responsibility for the safety of our staff and the general public for whom we have a duty of care

- People – addressing the Group's legal and moral responsibility for its employees

- Community – addressing the Group's social responsibility for the communities within which we operate

- Environment – recognising the Group's legal and moral responsibility to protect the environment from damage as a direct result of its operations and to promote activities to protect and sustain the wider environment.

The Corporate Responsibility Report includes performance measures against key objectives within these four areas.

CAG reports formally to the Executive Chairman and to the Board on a quarterly basis providing analyses of performance against previously established assurance targets and also advises the Board regarding policy and future activities to enhance best practice around the organisation.

CAG has undertaken a number of reviews of internal controls during 2005 including risk management, health, safety and environmental management. As a result of these reviews, a number of activities have been included in CAG's programme for 2006 to strengthen the Group's performance in these areas.

CAG sponsors five specialist Groups:

- An Assurance Network Group, chaired by the Assurance Director, and comprising senior assurance representatives from across the Group. During the year, this group met four times to review policy and procedures, and the development, integration and dissemination of the SMS that defines how the Group operates

- A Risk Oversight Group, chaired by the Risk Director, comprising assurance representatives from across the Group, met twice during the year to review the Group risk register and key risk controls. This group provides additional assurance in relation to the system of internal control and risk management and enhances the Board's ability to discharge its responsibilities in relation to internal control. The role of the Risk Oversight Group has been extended to address emergent risks whose impact cannot yet be adequately defined

- An Aviation Safety Oversight Group, chaired by the Aviation Safety Director and comprising the aviation safety representatives from across the Group met twice during the year. This group has been responsible for the implementation of the aviation safety management system across the Group and for transferring best practice between Serco's aviation operating companies

- A Rail Safety Oversight Group, chaired by the Rail Technical Director of the Integrated Transport division and comprising the rail safety representatives from across the Group was established in 2003 to oversee safety management systems within Serco's rail businesses in the United Kingdom, Denmark and Australia. It met four times during the year

- A Corporate Responsibility Steering Group, chaired by the Executive Chairman, provides direction on projects that address the social and environmental issues affecting our staff and the communities within which we work.

During 2005, Grant Thornton has continued to provide an internal audit function within the Group, in addition to that provided by internal peer review and CAG. Their programme is complementary to the Group's broader programme and has been designed to address internal control and risk management processes and the recommendations of the Combined Code. Grant Thornton reported to the Audit Committee twice during the year. There were no material weaknesses identified as a result of the audits undertaken and corrective action has been taken where deficiencies were found.

In addition to contracts held in Serco's name, the Group has material investments in a number of joint ventures and associated companies. Where these investments are not wholly owned by Serco, the Group can influence, but not control, management practices. Serco representatives within these companies ensure that the processes and procedures for identifying and managing risk are appropriate for the business and that internal controls exist and are regularly monitored. Employees from the Company's joint ventures participate in the Assurance network and the Risk Oversight and Rail Safety Oversight Groups.

Going concern

The Directors confirm that they have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future and therefore continue to adopt the going concern basis in preparing the Annual Review and Accounts.

Compliance during 2005

The Company has achieved full compliance with the code provisions set out in section 1 of the Combined Code during 2005.

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

Joanne Roberts
Secretary

Serco House
16 Bartley Wood Business Park
Bartley Way
Hook
Hampshire
RG27 9UY

1 March 2006

Directors' report

"The Group is committed to ensuring equal opportunity and a safe and healthy working environment. Equally the Group is committed to the protection of the environment."

Annual review and accounts

The Directors have pleasure in presenting the Annual review and accounts of the Group for the year ended 31 December 2005.

Activities

The Company is a holding company, which operates via its subsidiaries and its joint ventures to provide facilities management, systems engineering and equity investment management.

The review of the business for the year ended 31 December 2005 can be found in the Business Review on pages 10 to 43.

Share capital

The authorised and issued share capital of the Company, together with the details of shares issued during the year are shown in note 30 of the financial statements.

Dividends and transfers to reserves

An interim dividend of 0.91p (2004 – 0.81p) per Ordinary Share was paid on 19 October 2005. The Directors recommend a final dividend of 2.06p (2004 – 1.82p) per Ordinary Share, which if approved by shareholders at the Annual General Meeting, will be paid on 17 May 2006, to those shareholders on the register at the close of business on 10 March 2006. After dividends, retained profits of £53.4m will be transferred to reserves.

Substantial shareholdings

At close of business on 28 February 2006 (being the latest practical date prior to the signing of the Report of the Directors), the Company had received notifications of the following substantial interests representing over 3% of the issued share capital:

Fidelity International Limited	7.66%
Legal and General Group plc	3.42%
Morley Fund Management Limited	5.49%

In the case of non-material interests representing 10% or more of the issued share capital, the Company had received the following notification:

HBOS PLC	10.33%

Changes to the Board

The current Directors of the Company are listed on page 44 and their profiles are on page 57.

With effect from 2 February 2005, Joanne Roberts was appointed Company Secretary of the Group.

Ralph Hodge will be retiring from the Board following the completion of the Annual General Meeting in May 2006. The Board would like to thank Ralph for his contribution to the Board since joining in April 2000 and wish him well with his retirement.

On 24 February 2006, the Board approved the appointment of Leonard V. Broese van Groenou as a Non-Executive Director, effective from 3 April 2006. In accordance with the Company's Articles of Association he will be subject to election by shareholders at the forthcoming Annual General Meeting.

Directors' interests

With the exception of the Executive Directors' service contracts and Non-Executive Directors' letters of appointment, there are no contracts in which any Director has an interest.

Details of the Directors' interests in the Ordinary Shares and options over the Ordinary Shares of the Company are set out in the Remuneration Report on pages 64 to 66.

Annual General Meeting

The 19th Annual General Meeting of the Company will be held at the Queen Elizabeth II Conference Centre, London on 5 May 2006 at 11.00am.

The Notice of the Annual General Meeting, together with relevant notes and proxy card are circulated with this document.

Employment policies

The Board is committed to maintaining a working environment where staff are individually valued and recognised. The Board is committed to the adherence to our Governing Principles which provide a set of values for all of our staff to follow.

The Group is committed to ensuring equal opportunity, honouring the rights of the individual and fostering partnership and trust in every working relationship. We maintain a safe working environment that provides appropriate remuneration and benefits, training, personal development and compliance with employment laws and regulations of the countries within which we operate. The Group recognises the United Nations Universal Declaration of Human Rights and implements appropriate policies and processes to meet the requirements of the declaration. The Group is also committed to the creation of diverse teams, placing diversity at the heart of business performance. The Board regularly review data relating to the diversity within our businesses to ensure we continue to measure our progress in this area.

The Group remains proud of its record of managing employee relations and continues to believe that the structure of individual and collective consultation and negotiation are best developed at a local level. Over the years the Company has demonstrated that working with trade unions and creating effective partnerships allows improvements to be delivered in business performance as well as terms and conditions of employment. Where employees choose not to belong to a trade union, employee communication forums such as works councils exist to ensure involvement of staff within the business.
The Board understands its responsibility to encourage and assist in the employment, training, promotion and personal career development of all employees.

The Group gives full and fair consideration to applications for employment, career development and promotion, received from people with disabilities and offers employment when suitable opportunities arise. If employees become disabled during their service with the Group, wherever practicable, arrangements are made to continue their employment and training.

Participation by staff in the success of the Group is encouraged by the availability of sharesave schemes, and a share scheme for senior management, which effectively aligns their interests with those of shareholders by requiring that performance criteria are achieved prior to exercise.

Health, safety and environmental policies

The Group recognises and accepts its responsibility for health, safety and the environment (H,S&E). A full time Director of Health, Safety and Environment, a member of the Corporate Assurance Group, is responsible for the development and monitoring of H,S&E policies, procedures and control systems and reports to the Board via the Executive Chairman. The Executive Chairman is the Director responsible for H,S&E matters on behalf of the Board. Appropriate H,S&E risk assessment and management processes are applied across the Group and are subject to regular audit as part of wider assurance processes with key performance indicators formally reported to the Board on a quarterly basis as part of the Corporate Assurance Report. This report consolidates divisional assurance reports that have been reviewed and approved by the respective divisional Boards.

The Group is committed to maintaining a safe and healthy working environment in all places that the Company operates, for our staff, our customers, members of the public and any other third party. Our 2005 global reportable incident rate shows an improvement of some 7.5% against that reported in 2004. The Group recognises that it is everyone's responsibility to reduce injury and illness at work. Equally, the Group is committed to the protection of the environment, recognising everyone's responsibility for minimising the impact that we have on it. This commitment extends to all our activities, wherever they take place, which have the potential to adversely affect the environment. The Group aims to reduce environmental harm, minimise the use of energy and other resources and ensure that the principles of sustainable development are operated throughout the range of activities in which we are engaged.

CAG is supported by dedicated H,S&E teams in divisional support offices or in contracts, which provide advice and support on H,S&E issues. All employees share responsibility for continually improving the Group's performance in relation to H,S&E management.

Regular H,S&E meetings are held and representatives from the operating divisions attend quarterly Assurance Network meetings. In order to maintain a high level of H,S&E awareness, great emphasis is placed on training both in relation to specific H,S&E matters but also in the overall context of assurance within the Company.

Serco has been committed to addressing issues of work-related ill-health and has established occupational support across the business. Our aim is to provide a working environment where the health of our employees is not affected by the work that they undertake. Our occupational health providers support management in their efforts to identify and prevent work-related illness and provide support and guidance about health problems at work. They also provide health surveillance where appropriate and assist in issues such as absence from work and supporting the Group's programme of encouraging individuals back to work where possible. The number of workplace stress cases referred to our UK occupational health provider has decreased significantly since 2003, with 62% less cases being managed during 2005.

Creditor payment policies

The Company requires each of its business units to negotiate and agree terms and conditions for payment for the supply of capital and revenue items just as keenly as they negotiate prices and other commercial matters. Suppliers are made aware of the terms and the way in which disputes are to be settled. Payment is then made in accordance with those terms.

During the year the Company has undertaken a comprehensive review of spending patterns and is seeking to expand the level of preferred suppliers relationships, thereby improving supply chain management and value for money.

The Group's average creditor payment terms in 2005 were 26 days (2004: 24 days); Company 20.5 days (2004: 21 days).

Donations

The Company continues to encourage all staff to participate in their local communities and has a process to capture investment on a worldwide basis. This measure is based upon the Business in The Community (BiTC) reporting format. The value of this investment at £1,017,129 (2004: £795,000) represents 1.3% (2004: 1.4%) of the Group's pre tax profit, and a 28% increase on investment made in 2004.

During the year the Company made no political donations and intends to continue with this policy.

The Companies Act 1985 (the Act) requires companies to obtain shareholder approval before incurring European Union (EU) political expenditure. The Group may need, as part of its business, to contact politicians and political parties within the EU on a non-partisan basis in order to make them aware of industry views, technology and trends. As the Act defines EU political organisations and political expenditure widely, the Directors are proposing to seek shareholder authority to incur such expenditure at the forthcoming Annual General Meeting. Shareholders unanimously passed a similar resolution in April 2005.

Auditors

Deloitte & Touche LLP have expressed their willingness to continue in office as auditors and a resolution to re-appoint them will be proposed at the forthcoming Annual General Meeting.

Approved by the Board of Directors and signed on its behalf

Joanne Roberts
Secretary

Serco House
16 Bartley Wood Business Park
Bartley Way
Hook
Hampshire RG27 9UY

1 March 2006

Joint Services Command and Staff College
Shrivenham, Wiltshire

From left to right:
Christopher Hyman,
Margaret Ford,
Joanne Roberts,
Ralph Hodge,
David Richardson,
Andrew Jenner,
Kevin Beeston,
DeAnne Julius

Kevin Stanley Beeston FCMA (43)
Executive Chairman

Since joining Serco in 1985, Kevin has worked in both financial and commercial roles. He was Group Finance Director 1996-1999 and Chief Executive 1999-2002, becoming Executive Chairman in May 2002. He is a member of the CBI's President's Committee, Deputy Chairman of the CBI's Public Services Strategy Board, a Board member of the Chartered Management Institute and a Non-Executive Director of IMI plc and Ipswich Town Football Club plc.

Margaret Ford MA MPhil (48)
Non-Executive Director

Margaret is the Chairman of English Partnerships, the national regeneration agency. She spent her early career in a variety of roles either in the public sector or as an adviser to Government and is a specialist in leadership development, culture change and public sector reform. From 1997-2000 she was Chairman of Lothian Health Board and from 2000-2003 was a Non-Executive Director of Ofgem. From 2000-2005 she was a Director of Good Practice Ltd, the publishing company that she founded, and from 2002-2005 she was a Director of Thus plc.

Ralph Noel Hodge CBE BEng (Hons) (71)
Non-Executive Director

Ralph joined Serco as a Non-Executive Director in April 2000 and chairs the Board's Remuneration Committee. He is a Non-Executive Director of British Ceramic Tiles and ORC (Inc). He was previously Non-Executive Chairman of Enron Europe, Chief Executive of ICI Chemicals and Polymers and Non-Executive Director of the Halifax Building Society. Ralph will be retiring from the Serco Board in May 2006.

Christopher Rajendran Hyman CA (SA) (42)
Chief Executive

Christopher was appointed Chief Executive of Serco Group plc in 2002. He is a Non-Executive Director of both United Business Media plc and the Prince of Wales' charity In Kind Direct. He is also a member of the UK Government's Honours Advisory Committee for Economy. He joined Serco in 1994 as the European Finance Director and has held the roles of Group Company Secretary, Corporate Finance Director and Group Finance Director. Christopher is responsible for setting the vision and strategy of the Group.

Andrew Mark Jenner ACA (37)
Finance Director

Andrew joined Serco in 1996 as Group Financial Controller, having previously worked for Unilever. He became Corporate Finance Director with additional responsibility for Treasury activities in 1999 and Group Finance Director in May 2002. Andrew shares with the Executive Chairman responsibility for our relationship with shareholders and the city.

DeAnne Shirley Julius CBE PhD (Econ) (56)
Senior Independent Director

DeAnne joined Serco as a Non-Executive Director in October 2001. She is Chairman of The Royal Institute of International Affairs and was a founder member of the Bank of England Monetary Policy Committee (1997-2001) and also sat on the Court of the Bank of England until May 2004. She has held senior strategy positions with British Airways and Royal Dutch Shell, and spent seven years with the World Bank developing infrastructure projects in Asia and Africa. She is a Non-Executive Director of Lloyds TSB, BP and Roche.

David Hedley Richardson BSc (FCA) (54)
Non-Executive Director

David joined Serco as a Non-Executive Director in June 2003 and chairs the Board's Audit Committee. He has previously held the position of Finance Director of Whitbread, where his roles in a 20-year career included eight years as Strategy Director. He was instrumental in transforming Whitbread from a brewing and pubs company into a market leader in hotels, restaurants and leisure clubs. During the year David was appointed a Non-Executive Director of Dairy Crest Group plc, Forth Ports Plc and De Vere Group plc where he will be taking on the role of Non-Executive Chairman in April 2006.

Directors' responsibilities

The Directors are required by law to prepare consolidated financial statements of Serco Group plc and its subsidiaries (together, the Group) in accordance with the Companies Act 1985, International Financial Reporting Standards and Article 4 of the IAS Regulation.

The Directors are responsible for preparing the Annual Report and the financial statements. The Directors are required to prepare financial statements for the Group in accordance with International Financial Reporting Standards (IFRS) and have elected to prepare financial statements for the company in accordance with UK GAAP. Company law requires the directors to prepare such financial statements in accordance with IFRS, the Companies Act 1985 and Article 4 of the IAS Regulation.

IAS 1 'Presentation of Financial Statements' requires that financial statements present fairly for each financial year the Group's financial position, financial performance and cash flows. This requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definition and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements". In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable IFRS. Directors are also required to:

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

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group, for safeguarding the assets, for taking reasonable steps for the prevention and detection of fraud and other irregularities and for the preparation of a Directors' Report and Directors' Remuneration Report which comply with the requirements of the Companies Act 1985.

The Directors are also responsible for the maintenance and integrity of the company website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

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

Joanne Roberts
Secretary

Serco House
16 Bartley Wood Business Park
Bartley Way
Hook
Hampshire
RG27 9UY

1 March 2006

Remuneration report

Introduction

The following report details the remuneration policy and the actual remuneration of the Directors of the Company for the year ended 31 December 2005, as determined by the Remuneration Committee (the Committee) and adopted by the Board. In preparing this report, consideration has been given to the Combined Code and the requirements for disclosure in the Directors' Remuneration Regulations 2002.

During 2005, the Committee carried out its triennial comprehensive review of executive remuneration to ensure that the Company's arrangements continue to be aligned with the business strategy and current best practice. The review included consultation with the Company's 14 largest institutional Shareholders, representing approximately 58% of the Shareholder base, as well as the Association of British Insurers and the National Association of Pension Funds.

The following principles were adopted as a framework for evaluating changes to executive remuneration. The proposals should:

- Support Serco's business strategy
- Align the financial interests of executives and shareholders
- Provide market competitive reward opportunities for performance in line with expectations, but have the potential to deliver significant financial rewards for sustained out-performance
- Reflect UK market norms
- Be supported by a clear rationale which participants, shareholders and other stakeholders are able to understand.

The results of the review are included in the Remuneration Report below. A resolution for the adoption of a revised Long Term Incentive Plan will be proposed at the Company's forthcoming Annual General Meeting.

Composition and terms of reference of the Remuneration Committee

The Committee currently comprises all four independent Non-executive Directors: Margaret Ford, DeAnne Julius, David Richardson and Ralph Hodge (Chairman). Ralph Hodge is retiring from the Board and Committee in May 2006 at which time Margaret Ford will be elected Chairman. It operates in accordance with written terms of reference, which are determined by the Board and take into account best practice and the requirements of the Combined Code. The Executive Chairman and the Group Human Resources Director (HR Director) may attend the Committee meetings by invitation.

Advisers to the Remuneration Committee

During the year, Mercer Human Resource Consulting (Mercer) were re-appointed as Remuneration Advisors to the Remuneration Committee, following a competitive tendering process. The Committee has sought advice from Lucy Adams, HR Director, and Mercer on remuneration policy and philosophy, benchmarking exercises for individual Executive Directors and remuneration packages based on current market trends.

Mercer also provides advice to the Trustees of the Serco Pension and Life Assurance Scheme. The Committee do not consider there to be any conflict in relation to Mercer acting both for the Committee and the pension trustees.

Remuneration policy and practice

Executive Directors' remuneration comprises a combination of short and long term rewards, as explained below and then detailed on pages 63 to 66. The Committee recognises the importance of maintaining an appropriate balance between those elements of remuneration that are fixed and those which are variable by performance, with the proportion of performance-related pay being significant.

Salaries and benefits

1. Base salary

Following the executive remuneration review, the Committee's policy continues to be that base salary for the Executive Directors should be targeted at the median of the compensation peer group. However, the Company has achieved considerable growth since its last comprehensive review in 2002 and, as a consequence, the peer group was updated to reflect the Company's increased revenue and market capitalisation.

In the 2005 remuneration review, the Committee was advised by Mercer that the salary levels of the Executive Directors were positioned significantly below the median of the revised peer group. As a result of this review, the Committee implemented base salary increases for both the Executive Chairman and Chief Executive of 16% and a base salary increase for the Finance Director of 9%.

Following this increase, base salaries for Executive Directors are at approximately the market median, and will be reviewed again in 2006.

2. Annual bonuses

In 2003, the Company introduced an annual bonus plan which included an ability to defer a portion of the bonus earned for full time Executive Directors, and this was approved by Shareholders at the Annual General Meeting in May 2003. The target and maximum value of annual bonus was 40% of base salary and it was awarded on the basis of growth in the Company's earnings per share before goodwill amortisation (EPS) in comparison to the increase in the retail prices index (RPI).

The target / maximum award was paid if EPS growth reached RPI plus 10 percentage points. No award was achieved if EPS growth was less than RPI plus 5 percentage points. For EPS growth between 5 and 10 percentage points above RPI, the bonus was reduced from 40% to 20% on a straight line basis.

As mentioned above, participants could elect to defer, for three financial years, up to 100% of the bonus earned to purchase shares in the Company. The shares purchased will be matched by the Company if stretching performance targets are met.

The performance condition for matching shares on bonuses deferred in 2004 was total shareholder return (TSR) relative to the FTSE 350 over the three year deferral period. The matching shares awarded are based on the following criteria:

- No matching shares will be awarded if the Company does not meet or exceed the median TSR of the FTSE 350.
- A one for two match of shares deferred will be made if performance is at the median, or between median and upper quartile, and
- A one for one match of shares deferred will be made if performance is at or above the upper quartile.

Bonuses for the Executive Directors who are members of the Serco Pension and Life Assurance Scheme have been, to date, pensionable. As reported last year, the Committee agreed to remove bonuses from the definition of pensionable salary for pension accrued after 31 December 2005. More detail of this is provided in the pensions and life assurance section below.

As part of its executive remuneration review in 2005, the Committee decided to increase the annual bonus opportunity to make it more competitive with market levels. For Executive Directors:

- The threshold payment will remain unchanged at 20% of base salary
- The target payment will be increased from 40% to 50% of base salary
- The maximum payment will be increased to 100% of base salary.

The performance level for target payments will remain as challenging as before and exceptional performance will be required to earn the maximum bonus.

In addition, the Committee has decided to discontinue the opportunity for Executive Directors to defer bonuses and earn matching shares for bonuses paid in respect of 2006 and onwards.

As part of its alignment of the annual bonus plan with business strategy, the Committee has increased the number of performance measures for Executive Directors. There will be a mixture of financial and corporate measures, including but not limited to:

- Revenue growth
- Margin improvement
- Free cash flow conversion
- EPS growth.

The performance measures and targets for 2006 will be disclosed in next year's Remuneration Report with a comment on the size of payments earned.

3. Share-based incentives

Long term share-based incentives have been awarded to Executive Directors under the Serco Group plc 2005 Long Term Incentive Scheme (LTIS) and the Serco Group plc 2005 Executive Option Plan (EOP), which were approved at the Annual General Meeting on 29 April 2005 as replacements for, respectively, the 1996 Long Term Incentive Scheme and the 1998 Executive Option Plan.

As a result of its review of executive remuneration during 2005, the Committee has decided to replace the LTIS with the Serco Group plc 2006 Long Term Incentive Plan (the 2006 LTIP), which will provide the potential for higher rewards than the LTIS for superior performance. Approval will be sought from Shareholders at this year's Annual General Meeting. Further details of the 2006 LTIP can be found in the Circular to Shareholders relating to the Notice of Annual General Meeting. The EOP will continue unchanged.

The Company complies with the ABI's guidelines by limiting grants involving the issue of new shares in any 10 year period to no more than 10% of issued share capital for all its employee share schemes in aggregate.

Long Term Incentive Scheme (LTIS)

Awards made under the LTIS, which are structured as options with a zero exercise price, may be exercised after the third anniversary of grant once confirmation has been received regarding the achievement of the performance criteria. Awards made to Executive Directors are calculated at 64% of salary at the time of grant.

Pre 1 January 2003 Awards: For awards made in relation to performance periods commencing up to and including 1 January 2002, the extent to which an award vests (and therefore becomes exercisable) is measured by reference to the absolute growth in the Company's EPS over the performance period of three financial years.

The vesting of the awards is based on the following criteria:

- Full vesting will only occur if the cumulative EPS growth over the three year performance period is at least 64%
- Awards will partially vest where the cumulative EPS growth is at least 35%
- Awards will vest on a straight line basis for each percentage increase in EPS growth above 35% over the three year period until full vesting is achieved.

For LTIS awards made during 2002, the Company's cumulative EPS growth was 47.9%, which resulted in 74.8% of these awards vesting.

For awards granted after January 2003, performance is measured by reference to the Company's TSR relative to the companies comprising the FTSE 350 index at the start of the performance period.

The vesting of the awards is based on the following schedule:

- No award vests if the Company's performance is below the median of the comparator group over the three year performance period
- 40% of the award vests if performance is at the median
- The award vests in full if performance reaches or exceeds the upper quartile
- For performance between the median and the upper quartile, a proportion of the award will vest.

The Committee selected the FTSE 350 as an appropriate broad benchmark of performance, as Serco is a constituent of the FTSE 350. The performance comparator group was reviewed in 2005 and a more closely aligned comparator group with apply for the 2006 LTIP.

For awards which completed their performance period on 31 December 2005, the Company's TSR performance was between the median and upper quartile of the comparator group over the three year performance period.

No further awards will be made under the LTIS.

2006 Long Term Incentive Plan

As mentioned above, Shareholders will be asked to approve the adoption of the 2006 LTIP at the Annual General Meeting to be held on 5 May 2006. If approved, the first awards will be made soon after that meeting. Awards made to Executive Directors are calculated at 100% of salary at the time of grant. During the financial year in which the 2006 LTIP is approved by shareholders, this will be limited to 200% of salary (as no LTIS awards were made in 2005).

The vesting of awards made during 2006 will depend on the Company's TSR measured relative to the top 250 companies in the FTSE, by market capitalisation, excluding those in certain sectors which are not comparable with the Company. The proportion of awards that vests will be determined by the following schedule:

- No part of the awards will vest if the Company's TSR is below the median
- 30% of awards will vest for median performance
- 100% of awards will vest for upper quartile performance
- Between median and upper quartile performance a proportion between 30% and 100% of the awards will vest pro rata

- 200% of awards will vest for top decile performance
- Between upper quartile and top decile, a proportion between 100% and 200% will vest pro rata

The Committee will have discretion to vary the proportion of awards that vest if they consider that the TSR performance does not reflect the underlying financial performance of the Company.

Executive Option Plan (EOP)
Options granted under the EOP may be exercised after the third anniversary of grant, dependent upon the achievement of a financial performance target over three years. The options are granted at market value and awards made to Executive Directors are over shares worth 100% of salary as at the 31 December prior to grant.

Pre 1 January 2003 Grants: For grants made in relation to performance periods commencing up to and including 1 January 2002, the extent to which an option vests (and therefore becomes exercisable) is measured by reference to absolute growth in the Company's EPS over the three year performance period.

The vesting of the grants is based on the following schedule:

- If the annual compound growth in EPS is less than 10%, none of the options may be exercised
- If compound growth in EPS is more than 15%, all of the options may be exercised
- For a compound growth in EPS of between 10% and 15% a proportion of the options may be exercised.

For the EOP awards granted during 2002, which vested during 2005, the annual compound growth in EPS was 13.93%, which resulted in 89.3% of the options becoming exercisable.

Post 1 January 2003 Grants: For awards granted after 1 January 2003, performance criteria is measured by reference to the Company's EPS growth relative to the increase in the RPI over the three year performance period.

The vesting of the grants is based on the following schedule:

- If the level of EPS growth is less than RPI + 5 percentage points per annum, none of the options may be exercised
- If the level of EPS growth equals RPI + 5 percentage points per annum, 40% of the options may be exercised
- If the level of EPS growth is equal to RPI + 10 percentage points per annum, all of the options may be exercised
- For an EPS growth of between RPI + 5 percentage points and RPI + 10 percentage points per annum, a proportion of the options may be exercised.

For awards which have completed their performance period on 31 Decemer 2005, the annual compound growth has been at least 10% plus RPI.

4. Pensions and life assurance
Serco operates both defined benefit and defined contribution pension schemes. The Executive Directors participate in the Serco Pension and Life Assurance Scheme. This is a funded, defined benefit scheme which provides for a pension of two-thirds of pensionable salary following a full career. The normal retirement age for Executive Directors is 60. Members contribute to the scheme at rates varying according to the section of the scheme. The Executive Directors contribute at either 7% or 8% of pensionable salary.

For the year ended 31 December 2005, bonuses for the Executive Chairman were included in pensionable salary in accordance with the rules of the scheme. The Committee reviewed this during 2004 and decided that, as a policy, bonuses should not be pensionable for any Serco employee. Therefore the rules have been amended to define pensionable salary as base salary only for pension accrued after 31 December 2005. No compensation has been paid to any Director or other staff member for the removal of bonuses from the definition of pensionable salary.

As a result of their joining the company after 1989, Christopher Hyman and Andrew Jenner have been subject to the HM Revenue & Customs Earnings Cap on pensionable salary within the Serco Pension and Life Assurance Scheme. The Company has provided defined contribution pension arrangements to supplement the Serco Pension and Life Assurance Scheme for Christopher Hyman and Andrew Jenner. However contributions to these arrangements ceased during 2005 and were replaced by a cash alternative. This is a short term measure until April 2006 when pensions in the Serco Pension and Life Assurance Scheme for service after this time will no longer be subject to the earnings cap.

The Committee has been advised by Mercer throughout the year on the implications of the new legislation on tax simplification for pensions. The Committee has considered its response to the legislation and concluded that it would take the following approach.

Firstly, it will ensure that scheme members are provided with full information concerning the changes in legislation and how it may affect them.

Secondly, the Committee has ensured that it was provided with regular and current analysis of the approaches adopted by other companies within its comparator group and within the broader FTSE 250.

Thirdly, it considered and produced a response to the new legislation which complies with any ABI guidelines but also enables the company to continue to recruit and retain talented individuals within its senior management.

In particular, it has been agreed that the Earnings Cap on pensionable salary will not apply to pension earned from 6 April 2006. Pension earned before that date will not be affected and the overall limits on target pensions at retirement will remain unchanged.

Executive Directors whose total pension benefits exceed the new Lifetime Allowance (and any other members in a similar position), will be given the option to remain in the Pension Scheme or to opt out and receive a cash alternative in lieu of further pension provision.

5. Service contracts and compensation

Each Executive Director has a rolling service contract with the Company and these service contracts will be available for inspection prior to the start of and immediately after the Company's Annual General Meeting. The service contracts all have a notice period of 12 months.

Under the service contracts for the Executive Directors, the Company reserves the right to make a payment in lieu of notice. In addition, where a Director leaves the Company following a change of control, whether or not he is dismissed or he elects to leave on notice, he will be entitled to receive a payment equivalent to up to one year's remuneration. The service contracts do not provide for termination payments to be made in any other circumstances.

There have been no payments made during the year in relation to compensation for loss of office.

A summary of details relating to each Director who served during the year is provided below:

Name of Director	Date joined Group	Date of appointment to the Board	Date of contract/ Letter of appointment	Unexpired term and notice period at December 2005
Executive Directors:				
K S Beeston	29 April 1985	29 February 1996	21 July 2003	Rolling contract with 12 months notice period
C R Hyman	30 August 1994	1 April 1999	21 July 2003	Rolling contract with 12 months notice period
A M Jenner	4 November 1996	3 May 2002	21 July 2003	Rolling contract with 12 months notice period

Name of Director	Date of appointment to the Board	Date of contract/ Letter of appointment	Unexpired term and notice period at December 2005
Non-Executive Directors:			
M A Ford	8 October 2003	7 October 2003	9 months
R N Hodge	5 April 2000	17 March 2004	4 months
D S Julius*	29 October 2001	18 November 2004	23 months
D H Richardson	2 June 2003	29 May 2003	5 months

*Senior Independent Director

Note: Non-Executive Directors have a three-month notice period and no compensation or other benefits are payable on early termination.

Non-Executive Directors of the Company are initially appointed for a three-year term, and that appointment may be terminated on three months' written notice. Renewal of appointments is not automatic, and Non-Executive Directors are required to retire and stand for re-election in accordance with the Company's Articles of Association.

As at 31 December 2005, the Non-Executive Directors of the Company have no personal financial interest in the matters determined by the Committee, there are no conflicts of interest arising from cross-directorships and no involvement in the day-to-day running of the Group.

The fees and terms of engagement of Non-Executive Directors are reviewed on an annual basis and approved by the Board. They are currently set at a rate of £35,000 per annum. The Board has also approved the payment of £10,000 per annum to the Chairmen of the Audit and Remuneration Committees with effect from 1 June 2005 (previously £5,000 per annum), and £5,000 per annum to the Senior Independent Director. The Board does not believe that the partial payment of fees in shares is appropriate and will therefore continue to make cash-only payments. Non-Executive Directors' fees are not performance-related.

1 Directors' remuneration

The Remuneration of the Directors for the year was as follows:

	Note	Remuneration	Fees	Bonus	Total Estimated Value of any other non-cash benefits	Total Remuneration excluding Pensions 2005	Total Remuneration excluding Pensions 2004
K S Beeston	1, 2	£454,400		£200,000	£50,414	£704,814	£566,754
M A Ford			£35,000			£35,000	£34,166
R N Hodge			£42,917			£42,917	£39,166
C R Hyman	1, 2	£454,400		£200,000	£48,508	£702,908	£569,018
A M Jenner	1, 2	£283,120		£170,000	£48,593	£501,713	£363,601
D S Julius			£40,000			£40,000	£37,500
D H Richardson			£44,083			£44,083	£36,999
Total		£1,191,920	£162,000	£570,000	£147,515	£2,071,435	£1,647,204

1. The bonuses shown include performance bonuses earned in the period under review, but not paid in the financial year
2. The value of non-cash benefits relates to the provision of a car allowance and private healthcare.

2 Directors' shareholdings

The Directors' interests in the shares of the Company were as follows:

	Ordinary Shares of 2p each fully paid 1 January 2005	Ordinary Shares of 2p each fully paid 31 December 2005
K S Beeston	182,638	182,638*
M A Ford	0	6,983
R N Hodge	2,010	2,010
C R Hyman	106,234	116,598*
A M Jenner	54,976	60,994*
D S Julius	15,000	15,000
D H Richardson	10,000	10,000

* 21,557 of K S Beeston's shares, 31,587 of C R Hyman's shares and 18,729 of A M Jenner's shares are all held in trust on their behalf under the terms of their participation in the Deferred Bonus Scheme, under which, provided that such shares remain in trust for three years, they are also granted an award over an equivalent number of shares.

Ordinary shares are beneficial holdings which include the Directors' personal holdings and those of their spouses and minor children. They also include the beneficial interests in shares which are held in trust under the Serco Group plc (1998) Employee Share Ownership Trust and the Serco Group plc Employee Benefit Trust.

3. Share-based incentives

This section has been audited by Deloitte & Touche LLP

(i) Serco Group plc 2004 Executive Deferred Bonus Scheme

	Number of Shares under award at 31 December 2005	Date of grant	Vesting date
K S Beeston	21,557	2 March 2004	2 March 2007
C R Hyman	21,557	2 March 2004	2 March 2007
	10,030	9 March 2005	9 March 2008
A M Jenner	12,711	2 March 2004	2 March 2007
	6,018	9 March 2005	9 March 2008

3. Share-based incentives (continued)

ii) Serco Group plc 1996 Long Term Incentive Scheme (LTIS)

		Number of shares under option at 1 Jan 2005	Granted during period	Exercised during period	Lapsed unexercised during period	Number of shares under option at 31 Dec 2005	Exercise price £	Market price at grant £	Value realised on exercise £	Date exercisable	Date of expiry of option
K S Beeston	3 yr award	38,736	–	–	–	38,736	Nil	4.26	–	31 Dec 2002	4 Apr 2010
	3 yr award	51,886*	–	–	1,089	50,797	Nil	4.90	–	31 Dec 2003	23 Nov 2010
	3 yr award	54,676*	–	–	13,778	40,898	Nil	4.65	–	31 Dec 2004	15 Nov 2011
	3 yr award	185,289*	–	–	–	185,289	Nil	1.53	–	31 Dec 2005	5 May 2013
	3 yr award	173,142*	–	–	–	173,142	Nil	1.75	–	31 Dec 2006	26 Nov 2013
	3 yr award	–	119,411	–	–	119,411	Nil	2.31	–	31 Dec 2007	22 Dec 2014
M A Ford	–	–	–	–	–	–	–	–	–	–	–
R N Hodge	–	–	–	–	–	–	–	–	–	–	–
C R Hyman	3 yr award	32,868	–	–	–	32,868	Nil	4.26	–	31 Dec 2002	4 Apr 2010
	3 yr award	44,473*	–	–	933	43,540	Nil	4.90	–	31 Dec 2003	23 Nov 2010
	3 yr award	46,865*	–	–	11,809	35,056	Nil	4.65	–	31 Dec 2004	15 Nov 2011
	3 yr award	185,289*	–	–	–	185,289	Nil	1.53	–	31 Dec 2005	5 May 2013
	3 yr award	173,142*	–	–	–	173,142	Nil	1.75	–	31 Dec 2006	26 Nov 2013
	3 yr award	–	119,411	–	–	119,411	Nil	2.31	–	31 Dec 2007	22 Dec 2014
A M Jenner	3 yr award	111,174*	–	–	–	111,174	Nil	1.53	–	31 Dec 2005	5 May 2013
	3 yr award	105,138*	–	–	–	105,138	Nil	1.75	–	31 Dec 2006	26 Nov 2013
	3 yr award	–	76,101	–	–	76,101	Nil	2.31	–	31 Dec 2007	22 Dec 2014
D S Julius	–	–	–	–	–	–	–	–	–	–	–
D H Richardson	–	–	–	–	–	–	–	–	–	–	–

*Approximately 14.67% (13.5% for prior year grants) of the options granted under the LTIS represent supplementary options, granted for the sole purpose of compensating participants for agreeing to bear the Company's liability to employers' National Insurance Contributions upon the exercise of the underlying LTIS options. These options can only be exercised in conjunction with and to the extent of the underlying award.

The scheme is an unapproved scheme for HM Revenue and Customs purposes.

No payment was made for the grant of the awards, no awards have had terms varied during the period, and no awards have been exercised by the Directors since the end of the financial year.

The performance criteria to which the exercise of awards under the LTIS is conditional are set out on page 61.

For each share under an LTIS option that is unexpired at the end of the financial year, the market price at the end of the financial year was 314.25p and the highest and lowest market prices during the financial year were 317p and 234p respectively.

3. Share-based incentives (continued)

iii) Serco Group plc 1998 Executive Option Plan and Serco Group plc 2005 Executive Option Plan (EOP)

		Number of shares under option as at 1 Jan 2005	Granted during period	Exercised during period	Lapsed unexercised during period	Number of shares under option as at 31 Dec 2005	Market price on exercise date £	Exercise price £	Value realised on exercise £	Date from which exercisable	Date of expiry of option
K S Beeston	Approved	13,788	–	–	–	13,788	–	2.18	–	21 May 2001	20- May 2008
	Unapproved	68,922	–	–	–	68,922	–	2.18	–	21 May 2001	20 May 2008
	Unapproved	76,734	–	–	–	76,734	–	2.45	–	1 Apr 2002	31 Mar 2009
	Unapproved	58,764	–	–	–	58,764	–	4.26	–	5 Apr 2003	4 Apr 2010
	Unapproved	91,321*	–	–	–	91,321	–	4.35	–	28 Mar 2004	2 Mar 2011
	Unapproved	152,035*	–	–	16,267	135,768	–	2.64	–	3 May 2005	2 May 2012
	Unapproved	289,515*	–	–	–	289,515	–	1.53	–	6 May 2006	5 May 2013
	Unapproved	219,320	–	–	–	219,320	–	2.17	–	3 Mar 2007	2 Mar 2014
	Unapproved	–	183,404	–	–	183,404	–	2.35	–	28 Apr 2008	27 Ap 2015
M A Ford	–	–	–	–	–	–	–	–	–	–	–
R N Hodge	–	–	–	–	–	–	–	–	–	–	–
C R Hyman	Approved	13,788	–	–	–	13,788	–	2.18	–	21 May 2001	20 May 2008
	Unapproved	25,290	–	–	–	25,290	–	2.18	–	21 May 2001	20 May 2005
	Unapproved	40,812	–	–	–	40,812	–	2.45	–	1 Apr 2002	31 Mar 2005
	Unapproved	49,830	–	–	–	49,830	–	4.26	–	5 Apr 2003	4 Apr 2007
	Unapproved	78,275*	–	–	–	78,275	–	4.35	–	28 Mar 2004	27 Mar 2008
	Unapproved	130,316*	–	–	13,943	116,373	–	2.64	–	3 May 2005	2 May 2009
	Unapproved	289,515*	–	–	–	289,515	–	1.53	–	6 May 2006	5 May 2010
	Unapproved	219320	–	–	–	219,320	–	2.17	–	3 Mar 2007	2 Mar 2011
	Unapproved	–	183,404	–	–	183,404	–	2.35	–	28 Apr 2008	27 Apr 2015
A M Jenner	Approved	4,134	–	–	–	4,134	–	2.18	–	21 May 2001	20 May 2008
	Approved	8,574	–	–	–	8,574	–	2.45	–	1 Apr 2002	31 Mar 2009
	Unapproved	7,422	–	–	–	7,422	–	2.45	–	1 Apr 2002	31 Mar 2006
	Unapproved	12,336	–	–	–	12,336	–	4.26	–	5 Apr 2003	4 Apr 2007
	Unapproved	18,524*	–	–	–	18,524	–	4.35	–	28 Mar 2004	27 Mar 2008
	Unapproved	78,189*	–	–	8,365	69,824	–	2.64	–	3 May 2005	2 May 2009
	Unapproved	173,709*	–	–	–	173,709	–	1.53	–	6 May 2006	5 May 2009
	Unapproved	133,178	–	–	–	133,178	–	2.17	–	3 Mar 2007	2 Mar 2011
	Unapproved	–	116,885	–	–	116,885	–	2.35	–	28 Apr 2008	27 Apr 2015
D S Julius	–	–	–	–	–	–	–	–	–	–	–
D H Richardson	–	–	–	–	–	–	–	–	–	–	–

* Approximately 14.67% (13.5% for prior year grants) of the options granted as unapproved options under the EOP represent supplementary options, granted for the sole purpose of compensating participants for agreeing to bear the Company's liability to employers' National Insurance Contributions upon the exercise of the underlying unapproved options. These options can only be exercised in conjunction with and to the extent of the underlying options.

The scheme is approved for HM Revenue and Customs purposes but has an unapproved schedule.

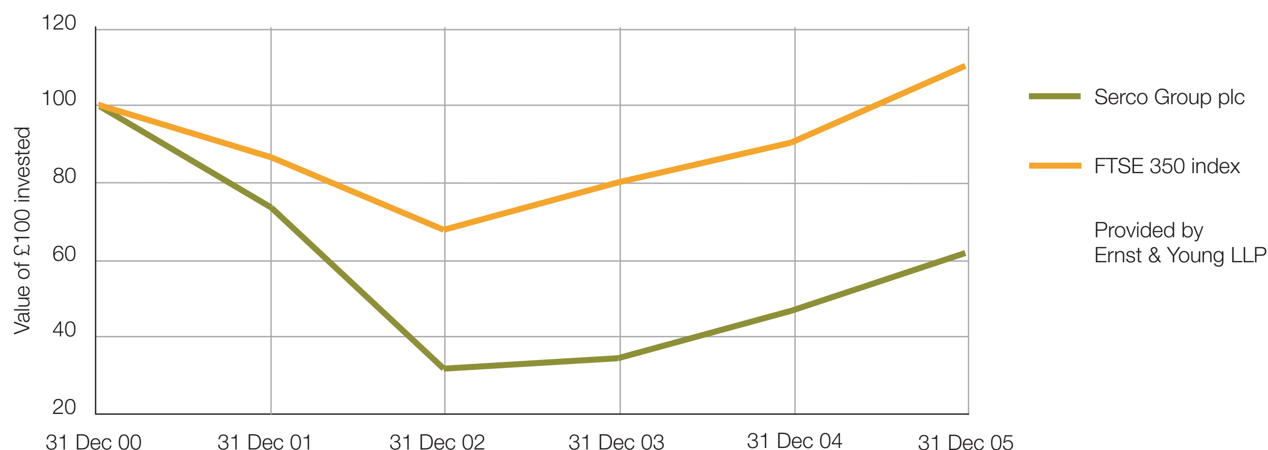
No payment was made for the grant of the awards, no awards have had terms varied during the period, and no awards have been exercised by the Directors since the end of the financial year.

The performance criteria on which the exercise of awards under the EOP is conditional are as set out on page 62.

For each share under an EOP option that is unexpired at the end of the financial year, the market price at the end of the financial year was 314.25p and the highest and lowest market prices during the financial year were 317p and 234p respectively.

4. Performance graph – Serco five year TSR vs FTSE 350 Index

Serco Group plc TSR vs FTSE 350 Total return Index



In drawing this graph it has been assumed that all dividends paid have been re-invested. The TSR level shown at 31 December each year is the average of the closing daily TSR levels for the 30-day period up to and including that date.

As detailed earlier, TSR is defined as the return shareholders would receive if they held a notional number of shares, and received dividends on those shares over a period of time. It measures the percentage growth in the relevant company's share price together with the value of any dividends paid, assuming that the dividends are reinvested into the company's shares.

5. Pensions and life assurance

This section has been audited by Deloitte & Touche LLP.

The Directors receive pension and life assurance benefits consistent with those provided by other leading companies. The details of the defined benefit schemes operated by the Group are set out in note 28. In the event of death in service, each scheme provides for a lump sum payment as well as a dependants' pension. The accrued pension benefits of all Directors under the Serco Pension and Life Assurance Scheme, which is a defined benefit scheme, are as follows:

	Transfer value of accrued benefits at 31 December 2005 (1) £	Transfer value of accrued benefits at 31 December 2004 (2) £	Director's contributions for the year (3) £	Increase in transfer value during the year (4) = (1)-(2)-(3) £	Gross increase in accrued pension during the year (5) £ p.a.	Increase in accrued pension during the year, net of inflation (6) £ p.a.	Value of net increase in accrual over the year (7) £	Total accrued pension at year end (8) £ p.a.
K S Beeston	1,706,038	1,153,549	31,511	520,978	41,667	36,809	306,390	221,585
C R Hyman	259,286	183,260	15,705	60,321	4,390	3,724	17,549	29,040
A M Jenner	95,513	54,965	15,705	24,843	3,850	3,598	10,326	13,200

Notes to pension benefits:

(a) The total accrued pension shown is that which would be paid annually on retirement, based on service to the end of this year. The increase in accrued pension during the year is shown both as a gross increase and excluding any increase in respect of inflation.

(b) Transfer values have been calculated in accordance with version 9.2 of the Guidance Note GN11 issued by the actuarial profession. The difference between the transfer values at the beginning and end of the year, shown in (4), includes the effect of fluctuations in the transfer value due to factors beyond the control of the Company and the Directors, such as stockmarket movements. It is calculated after deducting Directors' contributions.

(d) The value of the net increase in accrual represents the incremental value to the Director of his service during the year, calculated on the assumption that his service terminated at the year end. It is based on the increase in the accrued pension net of inflation after deducting the Director's contributions.

(e) Members have the option to pay Additional Voluntary Contributions: neither the contributions nor the resulting benefits are included in the above table.

(f) Transfer values disclosed do not represent the sum paid or payable to the individual Director. Instead, they represent a potential liability of the pension scheme.

(g) C R Hyman also benefits from a defined contribution arrangement to which the Company contributed prior to April 2005. The Company contributions to this arrangement were 15 per cent of remuneration in excess of the Permitted Maximum under the approved Scheme. These amounted to £10,815 in 2005.

C R Hyman has received non-pensionable cash payments totalling £98,406 during 2005 in place of Company contributions to the defined contribution arrangement. In September 2004 he received a non-pensionable cash payment of £95,400 in recognition of the higher contribution due from his time of appointment as Chief Executive.

(h) A M Jenner also benefits from a defined contribution arrangement to which the Company contributed prior to June 2005. The Company contributions to this arrangement were 15 per cent of remuneration in excess of the Permitted Maximum under the approved Scheme. These amounted to £7,690 in 2005.

A M Jenner has received non-pensionable cash payments totalling £51,189 during 2005 in place of Company contributions to the defined contribution arrangement.

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

Joanne Roberts
Secretary

Serco House
16 Bartley Wood Business Park
Bartley Way
Hook
Hampshire
RG27 9UY

1 March 2006

Independent auditors' report

Independent Auditors' Report to the Members of Serco Group plc

We have audited the Group financial statements of Serco Group plc for the year ended 31 December 2005 which comprise the consolidated income statement, consolidated statement of recognised income and expense, consolidated balance sheet, consolidated cash flow statement and the related notes on pages 71 to 125.

These Group financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the directors' remuneration report that is described as having been audited.

We have reported separately on the individual Company financial statements of Serco Group plc for the year ended 31 December 2005.

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report, the directors' remuneration report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted for use in the European Union are set out in the statement of directors' responsibilities.

Our responsibility is to audit the Group financial statements and the part of the directors' remuneration report described as having been audited in accordance with relevant United Kingdom legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the Group financial statements give a true and fair view in accordance with the relevant financial reporting framework and whether the Group financial statements and the part of the directors' remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We report to you if, in our opinion, the directors' report is not consistent with the Group financial statements. We also report to you if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' transactions with the Company and other members of the Group is not disclosed.

We also report to you if, in our opinion, the Company has not complied with any of the four directors' remuneration disclosure requirements specified for our review by the Listing Rules of the Financial Services Authority. These comprise the amount of each element in the remuneration package and information on share options, details of long term incentive schemes, and money purchase and defined benefit schemes. We give a statement, to the extent possible, of details of any non-compliance.

We review whether the corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statement on internal control covers all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read the directors' report and the other information contained in the annual report for the above year as described in the contents section including the unaudited part of the directors' remuneration report and we consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures

in the Group financial statements and the part of the directors' remuneration report described as having been audited. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted for use in the European Union, of the state of the Group's affairs as at 31 December 2005 and of its profit for the year then ended; and
- the Group financial statements and the part of the directors' remuneration report described as having been audited have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

Deloitte & Touche LLP

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
London

1 March 2006

Consolidated income statement

for the year ended 31 December 2005

	Notes	2005 £m	2004 £m
Continuing operations			
Revenue	4, 5	**2,260.3**	1,636.9
Cost of sales		**(1,935.3)**	(1,394.3)
Gross profit		**325.0**	242.6
Administrative expenses		**(214.3)**	(166.2)
Other expenses – amortisation of intangibles		**(13.6)**	(7.2)
Total administrative expenses		**(227.9)**	(173.4)
Operating profit	5, 6	**97.1**	69.2
Investment revenue	8	**33.6**	35.3
Finance costs	9	**(52.8)**	(40.5)
Profit before tax		**77.9**	64.0
Tax	10	**(23.5)**	(19.5)
Profit for the year		**54.4**	44.5
Attributable to:			
Equity holders of the parent		**53.4**	43.5
Minority interest		**1.0**	1.0
Earnings per ordinary share (EPS)			
Basic EPS	12	**11.66p**	10.11p
Diluted EPS	12	**11.46p**	9.99p

Consolidated statement of recognised income and expense

for the year ended 31 December 2005

	Notes	**2005 £m**	2004 £m
Net actuarial loss on defined benefit pension schemes	28, 32	**(58.4)**	(29.4)
Actuarial gain on reimbursable rights	28, 32	**35.6**	13.0
Goodwill previously written off, released on sale of subsidiary	32	**–**	0.2
Net exchange gain/(loss) on translation of foreign operations	32	**6.9**	(3.3)
Fair value gain on cash flow hedges during the year	32	**6.1**	–
Tax credit on items taken directly to equity	32	**2.0**	5.6
Net expense recognised directly in equity		**(7.8)**	(13.9)
Profit for the year		**54.4**	44.5
Total recognised income and expense for the year		**46.6**	30.6
Attributable to:			
Equity holders of the parent		**45.6**	29.6
Minority interest		**1.0**	1.0

Consolidated balance sheet

at 31 December 2005

	Note	2005 £m	2004 £m
Non-current assets			
Goodwill	13	**544.5**	177.4
Other intangible assets	14	**107.8**	75.0
Property, plant and equipment	16	**103.0**	96.2
Investments	17	**–**	13.7
Trade and other receivables	20	**459.8**	390.6
Deferred tax assets	23	**91.2**	50.1
		1,306.3	803.0
Current assets			
Inventories	19	**36.4**	26.9
Trade and other receivables	20	**528.8**	390.1
Cash and cash equivalents	21	**240.7**	200.5
		805.9	617.5
Total assets		**2,112.2**	1,420.5
Current liabilities			
Trade and other payables	25	**(531.1)**	(417.0)
Current tax liabilities		**(19.5)**	(5.8)
Obligations under finance leases	24	**(8.2)**	(8.1)
Loans	22	**(64.8)**	(46.4)
Financial instruments	27	**(4.9)**	–
		(628.5)	(477.3)
Non-current liabilities			
Trade and other payables	25	**(5.0)**	(0.6)
Obligations under finance leases	24	**(18.2)**	(18.2)
Loans	22	**(744.7)**	(451.3)
Financial instruments	27	**(30.8)**	–
Retirement benefit obligations	28	**(306.6)**	(242.9)
Provisions	29	**(26.3)**	(6.0)
Deferred tax liabilities	23	**(92.1)**	(55.0)
		(1,223.7)	(774.0)
Total liabilities		**(1,852.2)**	(1,251.3)
Net assets		**260.0**	169.2
Equity			
Share capital	30	**9.4**	8.7
Share premium account	31	**269.5**	191.5
Capital redemption reserve		**0.1**	0.1
Retained earnings	32	**132.8**	104.4
Retirement benefit obligations reserve	32	**(139.0)**	(124.4)
Share-based payment reserve	32	**16.6**	6.2
Own shares reserve	32	**(16.4)**	(16.4)
Hedging and translation reserve	32	**(15.1)**	(2.6)
Equity attributable to equity holders of the parent		**257.9**	167.5
Minority interest		**2.1**	1.7
Total equity		**260.0**	169.2

The financial statements were approved by the Board of Directors on 1 March 2006 and signed on its behalf by:

Kevin Beeston
Executive Chairman

Andrew Jenner
Finance Director

Consolidated cash flow statement

for the year ended 31 December 2005

	Note	2005 £m	2004 £m
Net cash inflow from operating activities	33	**140.8**	87.6
Investing activities			
Interest paid		**(47.6)**	(39.4)
Interest received		**32.8**	35.0
Disposal of subsidiary and business undertakings		–	3.2
Proceeds from disposal of property, plant and equipment		**0.4**	0.4
Proceeds from reduction in investment in joint venture		–	1.8
Acquisition of franchise		–	(4.1)
Acquisition of subsidiaries, net of cash acquired	15	**(281.7)**	(13.7)
Purchase of other intangible assets		**(13.1)**	(4.1)
Purchase of property, plant and equipment		**(22.3)**	(21.9)
Net cash outflow from investing activities		**(331.5)**	(42.8)
Financing activities			
Dividends paid	11	**(12.5)**	(10.4)
Repayment of borrowings		**(5.8)**	(0.8)
New loan advances		**272.0**	10.2
Capital element of finance lease repayments		**(8.4)**	(9.0)
Proceeds from issue of share capital		**4.4**	0.7
Decrease in non recourse loans		**(21.5)**	(19.2)
Net cash inflow/(outflow) from financing activities		**228.2**	(28.5)
Net increase in cash and cash equivalents		**37.5**	16.3
Cash and cash equivalents at beginning of year		**200.5**	184.6
Net exchange gain/(loss)		**2.7**	(0.4)
Cash and cash equivalents at end of year	21	**240.7**	200.5

Notes to the financial statements

1. General information

Serco Group plc (the Group) is a company incorporated in the United Kingdom under the Companies Act 1985. The address of the registered office is Serco House, 16 Bartley Wood Business Park, Bartley Way, Hook, Hampshire, RG27 9UY. These consolidated financial statements (the financial statements) are presented in pounds sterling because this is the currency of the primary economic environment in which the Group operates. Foreign operations are included in accordance with the policies set out in note 2.

2. Significant accounting policies

Basis of accounting

These financial statements on pages 71 to 125 have been prepared in accordance with International Financial Reporting Standards (IFRS) adopted for use in the European Union.

First-time adoption of International Financial Reporting Standards

The financial statements have been prepared in accordance with the accounting policies adopted under IFRS for the first time with a transition date of 1 January 2004. The disclosures required by IFRS 1 'First-time Adoption of International Financial Reporting Standards' concerning the transition from UK GAAP to IFRS can be found in our announcement of 31 August 2005 'Transition to IFRS Report' published as part of the interim report 2005. Reconciliations to IFRS from the previously published UK GAAP financial statements are shown in note 39.

General

The financial statements have been prepared on the historical cost basis. The principal accounting policies adopted are set out below.

The Group adopted IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' prospectively from 1 January 2005. Accordingly, comparative information has not been restated. Details of the adoption are set out in note 39.

Presentation of financial information

The primary statements within the financial information contained in this document have been presented in accordance with IAS 1 'Presentation of Financial Statements'.

Basis of consolidation

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

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

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

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

Minority interests represent the portion of profit or loss and net assets in subsidiaries that is not held by the Group and is presented separately from parent shareholders' equity within equity in the consolidated balance sheet.

2. Significant accounting policies (continued)

Business combinations

The acquisition of subsidiaries is accounted for using the purchase method. The cost of the acquisition is measured at the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the Group in exchange for control of the acquiree, plus any costs directly attributable to the business combination. The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 'Business Combinations' are recognised at their fair value at the acquisition date.

Goodwill arising on acquisition is recognised as an asset and initially measured at cost, being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognised. If, after reassessment, the Group's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the business combination, the excess is recognised immediately in the income statement.

The interest of minority shareholders in the acquiree is initially measured at the minority's proportion of the net fair value of the assets, liabilities and contingent liabilities recognised.

Goodwill

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

Goodwill is recognised as an intangible asset. Goodwill is not amortised and is reviewed for impairment at least annually. Any impairment is recognised immediately in the income statement and is not subsequently reversed.

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

Goodwill arising on acquisitions before the date of transition to IFRS has been carried forward as the unadjusted UK GAAP amounts. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated.

Investments in joint ventures

The Group's investments in joint ventures are reported in the financial statements using the proportionate consolidation method, whereby the Group's share of each of the assets, liabilities, income and expenses of its joint ventures is combined line by line with similar items in the Group's financial statements or reported as separate line items within the Group's financial statements.

Revenue recognition

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

Sales of goods are recognised when goods are delivered and title has passed.

Revenue from long-term project-based contracts is recognised in accordance with the Group's accounting policy below.

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

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

2. Significant accounting policies (continued)

Segmental information

Segmental information is based on two segment formats: the primary format reflects the Group's management structure, whereas the secondary format is geographically-orientated.

Unallocated items comprise mainly corporate expenses. Specific corporate expenses are allocated to the corresponding segments. Segment assets comprise goodwill, other intangible assets, property, plant and equipment, other debtors and prepayments, inventories and trade and other receivables (excluding corporation tax recoverable). Liabilities comprise trade and other payables and retirement benefit obligations. Inter-segment trading is not significant.

Long-term project-based contracts

The Group has a number of long-term contracts for the provision of complex, project-based services. Where the outcome of such long-term project-based contracts can be measured reliably, revenue and costs are recognised by reference to the stage of completion of the contract activity at the balance sheet date in accordance with IAS 18 'Revenue'. This is measured by the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs, except where this would not be representative of the stage of completion. Variations in contract work, claims and incentive payments are included to the extent that they have been agreed with the customer.

Where the outcome of a long-term project-based contract cannot be estimated reliably, contract revenue is recognised to the extent of contract costs that it is probable will be recovered. Contract costs are recognised as expenses in the period in which they are incurred.

When it is probable that the total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately.

All bid costs are expensed through the income statement up to the point where contract award (or full recovery of costs) is virtually certain. Bid costs incurred after this point are then capitalised within trade and other receivables. On contract award these bid costs are amortised through the income statement over the contract period by reference to the stage of completion of the contract activity at the balance sheet date.

Inventories

Inventories are stated at the lower of cost and net realisable value and comprise service spares and long-term project-based contract balances. Cost comprises direct materials and, where applicable, direct labour costs that have been incurred in bringing the inventories to their present location and condition.

Leases

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

Assets held under finance leases are recognised as assets of the Group at fair value or, if lower, at the present value of minimum lease payments determined at the inception of the lease. The corresponding liability to the lessor is included in the balance sheet as a finance lease obligation. Lease payments are apportioned between finance charges and reduction of the lease obligation so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income, unless they are directly attributable to a qualifying asset, in which case they are capitalised in accordance with the Group's general policy on borrowing costs (see below).

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

2. Significant accounting policies (continued)

Foreign currencies
Transactions in currencies other than pounds sterling are recorded at the rates of exchange on the dates of the transactions. At each balance sheet date, monetary assets and liabilities that are denominated in foreign currencies are retranslated at the rates prevailing on the balance sheet date. Non-monetary assets and liabilities carried at fair value that are denominated in foreign currencies are translated at the date when the fair value was determined. Gains and losses arising on retranslation are included in the net profit or loss for the period, except for exchange differences arising on non-monetary assets and liabilities where the changes in fair value are recognised directly in equity in the statement of recognised income and expense (SORIE).

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

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

Borrowing costs
Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale.

All other borrowing costs are recognised as an income or expense in the period in which they are incurred.

Retirement benefit costs
Payments to defined contribution pension schemes are charged as an expense as they fall due.

For defined benefit pension schemes, the cost of providing benefits is determined using the projected unit credit method, with actuarial valuations being carried out at each balance sheet date. Actuarial gains and losses are recognised in full in the period in which they occur. They are recognised outside the income statement and are presented in the SORIE.

The current service cost represents the increase in the present value of the plan liabilities expected to arise from employee service in the current period.

Past service cost is recognised immediately to the extent that the benefits are already vested, and is amortised on a straight-line basis over the average period until the benefit becomes vested. Gains and losses on curtailments or settlements are recognised in the period in which the curtailment or settlement occurs.

The retirement benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligation as adjusted for unrecognised past service costs, and as reduced by the fair value of scheme assets. Any asset resulting from this calculation is limited to past service cost, plus the present value of available refunds and reductions in future contributions to the plan.

Defined benefit obligations arising from contractual obligations
Where the Group takes on a contract and assumes the obligation to contribute variable amounts to the defined benefit pension scheme throughout the period of the contract and it is not virtually certain that the contributions will be recovered from the customer, the Group's share of the defined benefit obligation less its share of the pension scheme assets that it will fund over the period of the contract is recognised as a liability at the start of the contract with a corresponding amount being recognised as an intangible asset. The intangible asset, which reflects the Group's right to manage and operate the contract, is amortised over the contract period. The Group's share of the scheme assets and liabilities is calculated by reducing the scheme assets and liabilities by a franchise adjustment. The franchise adjustment represents the amount of scheme deficits that will be funded outside the contract period. Subsequent actuarial gains and losses in relation to the Group's share of pension obligations are recognised outside the income statement and are presented in the SORIE.

2. Significant accounting policies (continued)

Defined benefit obligations arising from contractual obligations (continued)
Where the Group takes on a contract and assumes the obligation to contribute variable amounts to the defined benefit pension scheme throughout the period of the contract and it is virtually certain that the contributions will be recovered from the customer, the Group's share of the defined benefit obligation less its share of the pension scheme assets are recognised as a liability at the start of the contract with a corresponding amount being recognised as a financial asset at fair value, being the fair value of the reimbursable rights. In the consolidated income statement, the expense relating to the defined benefit plan is presented net of the amount recognised for reimbursement. Subsequent actuarial gains and losses in relation to the Group's share of pension obligations are recognised outside the income statement and are presented in the SORIE. The change in fair value of the reimbursable right that is not presented in the income statement is reported in the SORIE.

Multi-employer pension schemes
Multi-employer pension schemes are classified as a defined contribution pension scheme or a defined benefit scheme under the terms of the scheme.

When sufficient information is not available to use defined benefit accounting for a multi-employer defined benefit pension scheme, the Group accounts for the scheme as if it were a defined contribution scheme.

Tax
The tax expense represents the sum of current tax expense and deferred tax expense.

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

Deferred tax is provided, using the liability method, on temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for accounting purposes.

Deferred tax liabilities are generally recognised for all taxable temporary differences. Deferred tax assets are generally recognised for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which these items can be utilised.

Deferred tax assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition of an asset and liability in a transaction other than a business combination and, at the time of the transaction, affects neither the tax profit nor the accounting profit.

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

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

Deferred tax is measured at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised, based upon tax rates and legislation that have been enacted or substantively enacted at the balance sheet date. Deferred tax is charged or credited in the income statement, except where it relates to items charged or credited directly to equity, in which case the deferred tax is also recognised in equity.

Deferred tax assets and liabilities are offset when there is a legal enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same tax authority where the Group intends to settle its current tax assets and liabilities on a net basis.

2. Significant accounting policies (continued)

Property, plant and equipment

Assets held for use in the rendering of services, or for administrative purposes, are stated in the balance sheet at cost, net of accumulated depreciation and any provision for impairment.

Depreciation is provided on a straight-line basis at rates to reduce the assets to their residual value over their estimated useful lives.

The principal annual rates used are:

Freehold buildings	2.5%
Short-leasehold building improvements	the higher of 10% or the rate produced by lease term
Machinery	15% – 20%
Motor vehicles	18% – 50%
Furniture	10%
Office equipment	20% – 33%
Leased equipment	the higher of the rate produced by lease term or useful life

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

Research and development costs

Expenditure on research is recognised as an expense in the period in which it is incurred. Development costs are expensed in the period in which the costs are incurred unless the criteria for capitalisation are met (see Other intangible assets policy below).

Other intangible assets

Customer relationships represent the value of contracts acquired on the acquisition of subsidiaries and are amortised over the average length of contracts of five years.

Development expenditure relating to software is capitalised as an intangible asset only if all of the following conditions are met:

- an asset is created that can be identified;
- it is probable that the asset created will generate future economic benefits; and
- the development cost of the asset can be measured reliably.

Development expenditure is amortised over the period in which the Group is expected to benefit. This period is between three to five years, or the length of the contract if longer. Provision is also made for any impairment. All other development expenditure is written off as incurred. Assets under the course of construction are not depreciated.

Licences comprise premiums paid for the acquisition of licences, which are amortised on a straight-line basis over the life of the licence.

Franchises represent costs incurred in obtaining franchise rights and franchise goodwill arising on the acquisition of franchises. These are amortised on a straight-line basis over the life of the franchise.

Pension related intangibles represent assets arising in relation to the Group's right to manage and operate contracts where there is a defined benefit pension scheme and it is not virtually certain that contributions will be recovered from the customer but where the Group's obligation to contribute to the scheme ends when the contract ends. The intangible assets represent the Group's share of scheme net liabilities on the date that contracts commence and are amortised on a straight-line basis over the contract life.

2. Significant accounting policies (continued)

Impairment of tangible and intangible assets excluding goodwill

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

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

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

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

Impairment losses and reversals are included within other expenses within the consolidated income statement.

Share-based payment

The Group has applied the requirements of IFRS 2 'Share-based payment'. In accordance with the transitional provisions, IFRS 2 has been applied to all grants of equity instruments after 7 November 2002 that were not fully vested as of 1 January 2005.

The Group issues equity-settled share-based payments to certain employees and operates an Inland Revenue approved Save As You Earn share option scheme open to eligible employees which allows the purchase of shares at a discount. These are measured at fair value at the date of grant. The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares that will eventually vest.

Fair value is measured by use of the Black Scholes, Binomial or Monte Carlo Simulation models depending on the type of scheme, as set out in note 35. The expected life used in the models has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioural considerations. Where relevant, the value of the option has also been adjusted to take account of market conditions applicable to the option.

Accounting for PFI contracts

Within Public Private Partnership (PPP) projects (including Private Finance Initiative (PFI) projects), where the concession agreement transfers limited risks and rewards associated with ownership to the contractors, during the period of initial asset construction, costs incurred as a direct consequence of financing, designing and constructing the asset are shown as 'PFI assets in the course of construction' within non-current trade and other receivables. On completion of the asset construction phase the asset is transferred within trade and other receivables to a 'PFI debtor'.

Revenues received from the customer are apportioned between capital repayments and operating revenue. The 'finance income' element of the capital repayment is shown as notional interest receivable within investment revenue.

The Group has seven fully owned Special Purpose Companies (SPC) which are used for the purpose of running the PFI business. All other SPCs are joint ventures and accounted for using the proportionate consolidation method.

Cash and cash equivalents

Cash and cash equivalents comprise cash in hand and balances with banks and similar institutions, which are readily convertible to known amounts of cash and which are subject to insignificant changes in value and have a maturity of three months or less. This definition is also used for the consolidated cash flow statement.

2. Significant accounting policies (continued)

Dividends
Dividends are recorded in the Group's consolidated financial statements in the period in which they are approved by the Group's shareholders.

Loans
Loans are initially stated at the amount of the net proceeds after deduction of issue costs. The carrying amount is increased by the finance cost in respect of the accounting period and reduced by payments made in the period.

Loans of certain SPCs and joint ventures are described as 'non recourse loans' and classified as such only if no Group company other than the relevant borrower has an obligation, under a guarantee or other arrangement, to repay the debt.

Derivative financial instruments and hedging activities
The Group has adopted IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' with effect from 1 January 2005. Derivatives are initially accounted for and measured at fair value on the date a derivative contract is entered into and subsequently measured at fair value. The gain or loss on re-measurement is taken to the income statement except where the derivative is a designated cash flow hedging instrument. The accounting treatment of derivatives classified as hedges depends on their designation, which occurs on the date that the derivative contract is committed to. The Group designates derivatives as:

- a hedge of the fair value of an asset or liability (fair value hedge)
- a hedge of the income/cost of a highly probable forecast transaction or commitment (cash flow hedge)
- a hedge of net investment in a foreign entity.

Gains and losses on fair value hedges are recorded in the income statement with the gain or loss on the hedged item attributable to the hedged risk.

Gains or losses on cash flow hedges that are regarded as highly effective are recognised in equity. Where the forecast transaction results in a financial asset or liability, only gains or losses previously recognised in equity are reclassified to profit or loss in the same period as the asset or liability affects profit or loss. Where the forecast transaction or commitment results in a non-financial asset or liability, any gains or losses previously deferred in equity are included in the cost of the related asset or liability if the forecast transaction or commitment results in future income or expenditure. Gains and losses deferred in equity are transferred to the income statement in the same period as the underlying income or expenditure. The ineffective portion of the gain or loss on the hedging instrument is recognised in the consolidated income statement.

For the ineffective portion of hedges or transactions that are not designated for hedge accounting under IAS 39, any change in assets or liabilities is recognised immediately in the income statement. Where a hedge no longer meets the effectiveness criteria, any gains or losses deferred in equity are only transferred to the income statement when the committed or forecast transaction is recognised in the income statement. However, where cash flow hedge accounting has been applied for a forecast or committed transaction that is no longer expected to occur, then the cumulative gain or loss that has been recorded in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement.

Where the Group hedges net investments in foreign entities through currency borrowings, the gains or losses on the translation of the borrowings are recognised in equity. Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of.

Provisions
Provisions are recognised when the Group has a present obligation as a result of a past event, and it is probable that the Group will be required to settle that obligation. Provisions are measured at the Directors' best estimate of the expenditure required to settle the obligation at the balance sheet date.

2. Significant accounting policies (continued)

New standards and interpretations not applied

During the year, the IASB and IFRIC have issued the following standards and interpretations with an effective date after the date of these financial statements:

International Accounting Standards (IAS/IFRSs)		*Effective date*
IFRS 1	Amendment relating to IFRS 6	1 January 2006
IFRS 6	Amendment relating to IFRS 6	1 January 2006
IFRS 7	Financial Instruments: Disclosures	1 January 2006
IAS 1	Amendment – Presentation of Financial Statements: Capital Disclosures	1 January 2006
IAS 19	Amendment – Actuarial Gains and Losses, Group Plans and Disclosures	1 January 2006
IAS 39	Fair Value Option	1 January 2006
IAS 39	Amendments to IAS 39 – Transition and Initial Recognition of Financial Assets and Financial Liabilities (Day 1 profits)	1 January 2006
IAS 39	Cash Flow Hedge Accounting	1 January 2006
IAS 39	Amendment to IAS 39 and IFRS 4 – Financial Guarantee Contracts	1 January 2006
International Financial Reporting Interpretations Committee (IFRIC)		
IFRIC 4	Determining whether an arrangement contains a lease	1 January 2006

The Directors do not anticipate that the adoption of these standards and interpretations will have a material impact on the Group's financial statements in the period of initial application.

Upon adoption of IFRS 7, the Group will have to disclose additional information about its financial instruments, their significance and the nature and extent of risks that they give rise to. More specifically the Group will need to disclose the fair value of its financial instruments and its risk exposure in greater detail. There will be no effect on reported income or net assets.

3. Critical accounting judgements and key sources of estimation uncertainty

Critical judgements in applying the Group's accounting policies

In the process of applying the Group's accounting policies, which are described in note 2 above, management has made the following judgements that have the most significant effect on the amounts recognised in the financial statements (apart from those involving estimations, which are dealt with below).

Revenue recognition

Revenue is recognised for certain long-term project-based contracts based on the stage of completion of the contract activity. This is measured by the proportion of costs incurred to estimated contract costs except where this would not be representative of the stage of completion.

Key sources of estimation uncertainty

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

Impairment of goodwill

Determining whether goodwill is impaired requires an estimation of the value in use of the CGUs to which goodwill has been allocated. The value in use calculation involves an estimation of the future cash flows of CGUs and also the selection of appropriate discount rates, which involves judgement, to calculate present values (see note 13). The carrying value of goodwill is £544.5m (2004: £177.4m) at the balance sheet date.

Retirement benefit obligations

The calculation of retirement benefit obligations is dependent on material key assumptions including discount rates, future returns on assets and future contribution rates (see note 28). The value of retirement benefit obligations at the balance sheet date is £306.6m (2004: £242.9m). Details of the impact of changes in assumptions relating to retirement benefit obligations are disclosed in the Finance Review (page 39).

4. Revenue

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

	2005 £m	2004 £m
Rendering of services	2,260.3	1,636.9
Revenue as disclosed in the consolidated income statement	2,260.3	1,636.9
Investment revenue (note 8)	33.6	35.3
Total revenue as defined in IAS 18	2,293.9	1,672.2

5. Segmental information

The Group manages its business on a market segment basis and these segments are the basis on which the Group reports its primary segment information.

Business segments

Year ended 31 December 2005	Civil government £m	Defence £m	Transport £m	Science £m	Total £m
Revenue	803.6	565.6	548.7	342.4	2,260.3
Result					
Segment result	37.5	33.3	25.0	31.4	127.2
Unallocated expenses					(30.1)
Operating profit					97.1
Investment revenue					33.6
Finance costs					(52.8)
Profit before tax					77.9
Tax					(23.5)
Profit for the year					54.4
Capital expenditure including acquisitions					
Property, plant and equipment	23.3	5.3	6.7	1.0	36.3
Goodwill	262.1	93.7	–	–	355.8
Intangible assets – segments	24.8	2.4	0.6	0.4	28.2
Intangible assets – unallocated					12.4
					40.6
Depreciation and amortisation					
Depreciation	17.7	6.8	4.3	1.5	30.3
Amortisation – segments	9.4	0.5	1.7	1.5	13.1
Amortisation – unallocated					0.5
					13.6
Segment assets					
Business segment assets	818.1	403.6	248.9	271.8	1,742.4
Unallocated assets					36.4
					1,778.8
Segment liabilities					
Business segment liabilities	(324.8)	(149.5)	(146.8)	(172.1)	(793.2)
Unallocated liabilities					(49.5)
					(842.7)

5. Segmental information (continued)

Business segments

Year ended 31 December 2004	Civil government £m	Defence £m	Transport £m	Science £m	Total £m
Revenue	629.1	372.3	345.8	289.7	1,636.9
Result					
Segment result	26.6	21.6	20.7	26.5	95.4
Unallocated expenses					(26.2)
Operating profit					69.2
Investment revenue					35.3
Finance costs					(40.5)
Profit before tax					64.0
Tax					(19.5)
Profit for the year					44.5
Capital expenditure including acquisitions					
Property, plant and equipment	11.1	4.3	6.9	4.9	27.2
Intangible assets	3.3	–	7.7	13.5	24.5
Depreciation and amortisation					
Depreciation	5.1	2.8	11.0	3.3	22.2
Amortisation	5.3	–	1.0	0.9	7.2
Segment assets					
Business segment assets	547.6	125.0	192.0	267.8	1,132.4
Unallocated assets					20.0
					1,152.4
Segment liabilities					
Business segment liabilities	(134.0)	(136.0)	(160.8)	(209.5)	(640.3)
Unallocated liabilities					(20.2)
					(660.5)

Geographical segments

Year ended 31 December 2005	**United Kingdom £m**	**North America £m**	**Europe and Middle East £m**	**Asia Pacific £m**	**Total £m**
Revenue	**1,661.7**	**254.5**	**205.2**	**138.9**	**2,260.3**
Capital expenditure including acquisitions					
Property, plant and equipment	**26.8**	**3.5**	**3.1**	**2.9**	**36.3**
Goodwill	**262.1**	**93.7**	**–**	**–**	**355.8**
Intangible assets	**37.4**	**2.4**	**0.8**	**–**	**40.6**
Assets					
Geographical segment assets	**1,343.3**	**249.6**	**118.4**	**67.5**	**1,778.8**

5. Segmental information (continued)

Geographical segments

Year ended 31 December 2004	United Kingdom £m	North America £m	Europe and Middle East £m	Asia Pacific £m	Total £m
Revenue	1,202.3	94.6	186.7	153.3	1,636.9
Capital expenditure including acquisitions					
Property, plant and equipment	19.3	1.2	4.7	2.0	27.2
Goodwill	–	–	–	–	–
Intangible assets	24.5	–	–	–	24.5
Assets					
Geographical segment assets	892.8	87.3	107.3	65.0	1,152.4

	2005 £m	2004 £m
Segment assets comprise:		
Goodwill	**544.5**	177.4
Property, plant and equipment	**103.0**	96.2
Other intangible assets	**107.8**	75.0
Trade and other receivables – non-current	**459.8**	390.6
Inventories	**36.4**	26.9
Trade and other receivables – current excluding tax recoverable (see note 20)	**527.3**	386.3
	1,778.8	1,152.4

	2005 £m	2004 £m
Segment liabilities comprise:		
Trade and other payables – current	**(531.1)**	(417.0)
Trade and other payables – non-current	**(5.0)**	(0.6)
Retirement benefit obligations	**(306.6)**	(242.9)
	(842.7)	(660.5)

6. Operating profit

Operating profit is stated after charging/(crediting):

	2005 £m	2004 £m
Net foreign exchange losses/(gains)	**0.1**	(0.1)
Research and development costs	**29.3**	34.2
Depreciation of property, plant and equipment	**30.3**	22.2
Amortisation of intangible assets included in other expenses	**13.6**	7.2
Staff costs (note 7)	**1,018.2**	771.1
Operating lease payments	**88.5**	40.6
Operating lease income	**(0.2)**	(0.2)
Auditors' remuneration for audit services (below)	**1.2**	1.1

Amounts payable to Deloitte & Touche LLP and their associates by the Company and its subsidiary undertakings in respect of non-audit services were £1.6m (2004: £1.4m).

6. Operating profit (continued)

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

	2005 £m	2004 £m
Fees paid to Deloitte & Touche LLP:		
– Audit services	**1.0**	0.9
– Bid support	**0.1**	0.3
– Tax advice	**0.8**	0.8
– Other	**0.7**	0.3
	2.6	2.3
Other fees paid to other accountancy firms:		
– Audit services	**0.2**	0.2
– Internal audit	**0.4**	0.2
– Other	**0.6**	0.1
	1.2	0.5
	3.8	2.8

In addition to the above, there are other fees capitalised in the balance sheet in respect of acquisition advice from Deloitte & Touche LLP of £0.8m (2004: £0.8m) and from other accountancy firms of £0.4m (2004: £0.6m).

7. Staff costs

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

	2005 Number	2004 Number
Civil government	**20,475**	14,278
Defence	**6,752**	6,917
Transport	**6,869**	6,030
Science	**2,851**	2,852
Unallocated	**306**	293
	37,253	30,370

Their aggregate remuneration comprised:

	2005 £m	2004 £m
Wages and salaries	**886.1**	668.6
Social security costs	**70.8**	58.5
Other pension costs (note 28)	**55.6**	39.5
	1,012.5	766.6
Share-based payment (note 35)	**5.7**	4.5
	1,018.2	771.1

8. Investment revenue

	2005 £m	2004 £m
Interest receivable by PFI companies	**26.7**	31.8
Interest receivable on other loans and deposits	**6.9**	3.5
	33.6	35.3

9. Finance costs

	2005 £m	2004 £m
Interest payable on non recourse loans	**19.9**	23.6
Interest payable on obligations under finance leases	**0.8**	0.7
Fair value adjustment on fair value hedges and non IAS 39 designated hedges	**(0.4)**	–
Interest payable on other loans	**27.8**	13.8
Net interest payable on retirement benefit obligations (note 28)	**4.7**	2.4
	52.8	40.5

10. Tax

	2005 £m	2004 £m
Current tax:		
UK corporation tax	**16.1**	12.5
Foreign tax	**5.7**	3.6
Adjustment in respect of prior years:		
UK corporation tax	**3.1**	(8.7)
Foreign tax	**(0.3)**	(0.6)
	24.6	6.8
Deferred tax:		
Current year	**1.3**	5.6
Adjustment in respect of prior years	**(2.4)**	7.1
	(1.1)	12.7
	23.5	19.5

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

	2005 £m	2004 £m
Profit before tax	**77.9**	64.0
Tax calculated at a rate of 30% (2004: 30%)	**23.4**	19.2
Difference between tax and accounting basis of assets disposed	**–**	1.6
Expenses not deductible for tax purposes	**3.6**	3.1
Unrelieved tax losses and different tax rates on overseas earnings	**0.4**	2.2
Untaxed income and the effect of the use of unrecognised tax losses	**(2.1)**	(0.9)
Tax incentives	**(2.2)**	(3.5)
Adjustments in respect of prior years	**0.4**	(2.2)
Tax charge	**23.5**	19.5

11. Dividends

	2005 £m	2004 £m
Amounts recognised as distributions to equity holders in the period:		
Final dividend for the year ended 31 December 2004 of 1.82p per share on 457.7 million ordinary shares (2004: Final dividend for the year ended 31 December 2003 – 1.62p on 429.5 million ordinary shares)	**8.3**	6.9
Interim dividend for the year ended 31 December 2005 of 0.91p per share on 461.3 million ordinary shares (2004: Interim dividend for the year ended 31 December 2004 – 0.81p on 429.6 million ordinary shares)	**4.2**	3.5
	12.5	10.4
Proposed final dividend for the year ended 31 December 2005 of 2.06p per share on 463.0 million ordinary shares (2004: 1.82p on 457.7 million ordinary shares)	**9.5**	8.3

The proposed final dividend for 2005 is subject to approval by shareholders at the Annual General Meeting and has not been included as a liability in these financial statements. A dividend waiver is effective for those shares held on behalf of the Company by its Employee Share Ownership Trust (note 32).

12. Earnings per share

Basic and diluted earnings per ordinary share have been calculated in accordance with IAS 33 'Earnings Per Share'. Earnings per share (EPS) is shown both before and after amortisation of intangible assets to assist in the understanding of the impact of IAS 38 'Intangible Assets' on the Group financial statements.

The calculation of the basic and diluted EPS is based on the following data:

Number of shares

	2005 millions	2004 millions
Weighted average number of ordinary shares for the purpose of basic EPS	**458.1**	430.1
Effect of dilutive potential ordinary shares: share options	**8.0**	5.3
Weighted average number of ordinary shares for the purpose of diluted EPS	**466.1**	435.4

Earnings

	2005		2004	
	Earnings £m	Per share amount Pence	Earnings £m	Per share amount Pence
Earnings for the purpose of basic EPS being net profit attributable to the equity holders of the parent	**53.4**	**11.66**	43.5	10.11
Add back:				
Amortisation of intangible assets, net of tax	**11.2**	**2.43**	5.8	1.35
Basic earnings before amortisation of intangible assets	**64.6**	**14.09**	49.3	11.46
Earnings for the purpose of basic EPS	**53.4**	**11.66**	43.5	10.11
Effect of dilutive potential ordinary shares	**–**	**(0.20)**	–	(0.12)
Diluted EPS	**53.4**	**11.46**	43.5	9.99

At 31 December 2005 options over 9.4 million (2004: 13.8 million) shares were excluded from the weighted average number of shares used for calculating diluted earnings per share because their share price was below the average share price for the year and they were, therefore, anti-dilutive.

13. Goodwill

Cost	£m
At 1 January 2004	179.8
Disposals	(1.3)
Exchange differences	(1.1)
At 1 January 2005	177.4
Additions	355.8
Exchange differences	11.3
At 31 December 2005	**544.5**

Goodwill acquired during the year relates to the acquisition of ITNET plc (£260.9m), which is in the Civil Government segment, RCI Holding Corp (£93.7m), which is in the Defence segment, and Healthcare Services 24 Ltd (£1.2m), which is in the Civil Government segment. Goodwill has been allocated to CGUs in the following business segments, which is how the Group monitors its goodwill internally:

Cost	2005 £m	2004 £m
Civil Government	**58.9**	57.4
Defence	**6.8**	6.6
Science	**99.9**	100.9
Transport	**13.2**	12.5
ITNET	**260.9**	–
RCI	**104.8**	–
At 31 December	**544.5**	177.4

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

The recoverable amounts of the CGUs are determined from value in use calculations using cash flow projections based on financial plans approved by senior management covering a five year period. The key assumptions for the value in use calculations are those regarding the discount rates, growth rates and expected changes to revenue and direct costs during the period. Management estimates discount rates using pre-tax rates that reflect current market assessments of the time value of money and the risks specific to the CGUs. The growth rates are based on industry growth forecasts. Changes in revenue and direct costs are based on past practices, the Group's order book and expectations of future changes in the market.

The Group prepares cash flow forecasts derived from the most recent financial plans approved by management for the next five years and extrapolates cash flows for the following five years based on an estimated growth rate of 2.25%. This rate does not exceed the average long-term growth rate for the UK.

The rates used to discount the forecast cash flows for the Group are as follows:

	2005 %	2004 %
Civil Government	**11.8**	11.8
Defence	**11.3**	11.3
Science	**11.3**	11.3
Transport	**11.8**	11.8
ITNET	**13.5**	–
RCI	**12.3**	–

14. Other intangible assets

	Customer relationships £m	Software and development expenditure £m	Licences and franchises £m	Pension related intangibles £m	Total £m
Cost					
At 1 January 2005	–	9.2	53.3	22.4	84.9
Additions	–	16.0	1.6	–	17.6
Disposals	–	(0.2)	–	–	(0.2)
Acquired on acquisition of subsidiaries	22.4	0.6	–	–	23.0
Reclassifications	–	(0.4)	0.4	–	–
Exchange differences	–	(0.2)	7.4	–	7.2
At 31 December 2005	22.4	25.0	62.7	22.4	132.5
Amortisation					
At 1 January 2005	–	1.0	7.7	1.2	9.9
Charge for the year	2.6	2.6	6.2	2.2	13.6
Disposals	–	(0.1)	–	–	(0.1)
Exchange differences	–	–	1.3	–	1.3
At 31 December 2005	2.6	3.5	15.2	3.4	24.7
Net book value					
At 31 December 2005	19.8	21.5	47.5	19.0	107.8

	Customer relationships £m	Software and development expenditure £m	Licences and franchises £m	Pension related intangibles £m	Total £m
Cost					
At 1 January 2004	–	2.7	50.8	4.1	57.6
Additions	–	4.2	2.0	18.3	24.5
Transfers	–	2.3	–	–	2.3
Exchange differences	–	–	0.5	–	0.5
At 31 December 2004	–	9.2	53.3	22.4	84.9
Amortisation					
At 1 January 2004	–	–	2.3	–	2.3
Charge for the year	–	1.0	5.0	1.2	7.2
Exchange differences	–	–	0.4	–	0.4
At 31 December 2004	–	1.0	7.7	1.2	9.9
Net book value					
At 31 December 2004	–	8.2	45.6	21.2	75.0

The following amortisation rates have been determined for the intangible assets acquired during this year:

Customer relationships – 5 years

Software and development expenditure – over their estimated useful lives

Licences and franchises – life of licence or franchise

15. Acquisitions

(a) Acquisition of ITNET plc

On 3 February 2005, the Group acquired all of the issued share capital of ITNET plc for purchase consideration of £245.5m comprising cash and the issue of shares. ITNET plc is the parent company of a group of companies involved in information technology solutions. This transaction has been accounted for by the purchase method of accounting. The goodwill arising is attributable to the anticipated profitability arising from new business and the anticipated future operating synergies from the combination.

	Book value £m	Fair value adjustments £m	Fair value £m
Net assets acquired			
Goodwill	12.8	(12.8)	–
Other intangible assets	0.6	20.0	20.6
Property, plant and equipment	9.4	(1.4)	8.0
Deferred tax assets	6.3	3.2	9.5
Inventories	6.0	–	6.0
Trade and other receivables	43.6	(4.1)	39.5
Trade and other payables	(39.9)	(7.4)	(47.3)
Current tax liabilities	(0.4)	(1.0)	(1.4)
Provisions	(4.4)	(19.2)	(23.6)
Loans	(4.0)	–	(4.0)
Retirement benefit obligations	(11.5)	–	(11.5)
Obligations under finance leases	(5.8)	–	(5.8)
	12.7	(22.7)	(10.0)
Goodwill			260.9
Total consideration			250.9
Satisfied by:			
Issue of Serco Group plc ordinary shares			74.2
Cash			171.3
Purchase consideration			245.5
Directly attributable costs			5.4
			250.9
Net cash outflow arising on acquisition:			
Cash consideration paid in 2004			13.7
Cash consideration paid in 2005			163.0
			176.7

ITNET plc contributed £190.6m to revenue and £14.3m to the Group's profit before tax and intangible amortisation for the period between the date of acquisition and the balance sheet date.

15. Acquisitions (continued)

(b) Acquisition of RCI Holding Corp (RCI)

On 21 March 2005, the Group acquired all of the issued share capital of RCI for cash consideration of £116.3m. RCI is the parent company of a group of companies involved in business process management for the US Federal Government. This transaction has been accounted for by the purchase method of accounting. The goodwill arising is attributable to the anticipated profitability arising from new business.

	Book value £m	Fair value adjustments £m	Fair value £m
Net assets acquired			
Goodwill	4.3	(4.3)	–
Other intangible assets	0.1	2.1	2.2
Property, plant and equipment	1.9	–	1.9
Deferred tax assets	1.0	0.1	1.1
Inventories	0.7	–	0.7
Trade and other receivables	35.3	–	35.3
Trade and other payables	(13.7)	(2.8)	(16.5)
	29.6	(4.9)	24.7
Goodwill			93.7
Total consideration			118.4
Satisfied by:			
Cash			116.3
Directly attributable costs			2.1
Net cash outflow arising on acquisition			118.4

RCI contributed £143.3m to revenue and £9.3m to the Group's profit before tax and intangible amortisation for the period between the date of acquisition and the balance sheet date.

15. Acquisitions (continued)

(c) Other

On 23 March 2005, Serco Limited acquired all of the issued share capital of Healthcare Services 24 Limited for total consideration of £1.0m of which £0.7m is deferred. This transaction has been accounted for by the purchase method of accounting.

On 3 October 2005, the Group purchased Equion Limited's 50% share of Defence Management Holdings Limited (DMHL) for consideration of £5.9m. DMHL was formerly a 50:50 joint venture between Serco and Equion. DMHL owns Defence Management Watchfield Limited, the Special Purpose Company that operates the Ministry of Defence's Joint Services Command and Staff College at Shrivenham. The goodwill arising is attributable to the anticipated profitability arising from new business.

	Fair value £m
Net assets acquired	
Intangible assets	**0.2**
Property, plant and equipment	**0.1**
Trade and other receivables	**66.0**
Cash and cash equivalents	**5.0**
Trade and other payables	**(2.0)**
Loans	**(43.1)**
Deferred tax liabilities	**(16.9)**
Provisions	**(0.2)**
Financial instruments	**(3.3)**
	5.8
Goodwill	**1.2**
Total consideration	**7.0**
Satisfied by:	
Cash	**5.2**
Loan note	**0.3**
Deferred consideration	**0.7**
Liabilities assumed	**0.7**
Purchase consideration	**6.9**
Directly attributable costs	**0.1**
	7.0
Net cash outflow arising on acquisition:	
Cash consideration	**5.3**
Cash and cash equivalents acquired	**(5.0)**
	0.3

Other acquisitions contributed £3.3m revenue and £0.8m to the Group's profit before tax and amortisation for the period between the date of acquisition and the balance sheet date.

If all of the acquisitions had been completed on 1 January 2005 instead of the dates above, total Group revenue for the period would have been approximately £2,315.0m, and profit before tax and amortisation for the year would have been approximately £94.0m on a pro forma basis.

16. Property, plant and equipment

	Freehold land and buildings £m	Short-leasehold building improvements £m	Machinery, motor vehicles, furniture and equipment £m	Total £m
Cost				
At 1 January 2005	10.0	20.4	171.2	201.6
Additions	1.1	1.8	23.4	26.3
Acquired on acquisition of subsidiaries	–	0.3	9.7	10.0
Exchange differences	0.2	0.6	2.4	3.2
Disposals	–	(0.7)	(11.3)	(12.0)
At 31 December 2005	11.3	22.4	195.4	229.1
Accumulated depreciation and impairment				
At 1 January 2005	3.2	7.6	94.6	105.4
Charge for the year	0.4	2.3	27.6	30.3
Exchange differences	0.1	0.2	1.3	1.6
Disposals	–	(0.6)	(10.6)	(11.2)
At 31 December 2005	3.7	9.5	112.9	126.1
Net book value				
At 31 December 2005	7.6	12.9	82.5	103.0

	Freehold land and buildings £m	Short-leasehold building improvements £m	Machinery, motor vehicles, furniture and equipment £m	Total £m
Cost				
At 1 January 2004	10.1	18.6	166.2	194.9
Additions	0.6	3.2	23.4	27.2
Transfers	–	–	2.6	2.6
Exchange differences	0.1	(0.1)	(0.2)	(0.2)
Disposals	(0.1)	(0.7)	(11.8)	(12.6)
Disposal of subsidiary	(0.7)	(0.6)	(9.0)	(10.3)
At 31 December 2004	10.0	20.4	171.2	201.6
Accumulated depreciation and impairment				
At 1 January 2004	2.9	6.7	91.2	100.8
Charge for the year	0.3	1.9	20.0	22.2
Exchange differences	–	0.1	(0.2)	(0.1)
Disposals	–	(0.7)	(10.8)	(11.5)
Disposal of subsidiary	–	(0.4)	(5.6)	(6.0)
At 31 December 2004	3.2	7.6	94.6	105.4
Net book value				
At 31 December 2004	6.8	12.8	76.6	96.2

The carrying amount of the Group's machinery, motor vehicles, furniture and equipment includes an amount of £27.5m (2004: £29.7m) in respect of assets held under finance leases.

The carrying amount of the Group's freehold land and buildings includes an amount of £0.3m (2004: £0.4m) in respect of assets held under finance leases.

The carrying amount of the Group's short leasehold building improvements includes an amount of £0.5m (2004: £nil) in respect of assets held under finance leases.

17. Investments

The investment of £13.7m held at 31 December 2004 represented the cost of listed UK equity investments of 4,254,542 ordinary shares of 10 pence each in ITNET plc, which had a market value at 31 December 2004 of £13.9m. On 3 February 2005, the Group acquired the remaining share capital of ITNET plc (see note 15(a)). This transaction has been accounted for in accordance with IFRS 3 'Business Combinations'.

18. Joint ventures

The Group's interests in joint ventures are reported in the consolidated financial statements using the proportionate consolidation method.

The effect of the Group's joint ventures on the consolidated income statement and balance sheet is as follows:

Income statement

	2005 £m	2004 £m
Revenue	**536.1**	255.5
Expenses	**(501.4)**	(229.8)
Operating profit	**34.7**	25.7
Investment revenue	**4.3**	4.1
Finance costs	**(2.6)**	(4.6)
Profit before tax	**36.4**	25.2
Tax	**(10.4)**	(6.3)
Profit for the year	**26.0**	18.9
Minority interest	**(0.5)**	(0.6)
Share of post-tax results from joint ventures	**25.5**	18.3

Expenses include £6.6m (2004: £nil) of costs incurred by Group.

Balance sheet

	2005 £m	2004 £m
Non-current assets	**117.2**	155.0
Current assets	**111.3**	86.6
Current liabilities	**(106.3)**	(75.3)
Non-current liabilities	**(107.3)**	(137.8)
Net assets	**14.9**	28.5

19. Inventories

	2005 £m	2004 £m
Service spares	**17.3**	17.3
Long-term project-based contract balances	**19.1**	9.6
	36.4	26.9

20. Trade and other receivables

	2005 £m	2004 £m
Trade and other receivables: Non-current		
PFI debtor*	**363.1**	243.1
PFI assets in the course of construction*	**–**	70.2
Amounts owed by joint ventures	**0.9**	1.6
Amounts recoverable on retirement benefit obligations (note 28)	**84.9**	56.0
Other debtors	**10.9**	19.7
	459.8	390.6

	2005 £m	2004 £m
Trade and other receivables: Current		
Amounts recoverable on contracts	**370.2**	287.3
PFI debtor*	**15.4**	5.4
Corporation tax recoverable	**1.5**	3.8
Prepayments and accrued income	**62.2**	50.6
Amounts owed by joint ventures	**3.5**	3.0
Financial instruments (note 27)	**0.5**	–
Other debtors	**75.5**	40.0
	528.8	390.1

* The PFI debtors analysed above are funded by non recourse loans of £278.3m (2004: £256.0m).

21. Cash and cash equivalents

	Sterling 2005 £m	Other currencies 2005 £m	Total 2005 £m	Sterling 2004 £m	Other currencies 2004 £m	Total 2004 £m
Cash of PFI and other project companies securing credit obligations	**13.0**	**3.8**	**16.8**	11.5	3.8	15.3
Customer advance payments	**–**	**5.9**	**5.9**	–	7.2	7.2
Cash collateralisation of performance bonds	**–**	**–**	**–**	–	0.7	0.7
Other cash and short-term deposits	**202.0**	**16.0**	**218.0**	162.4	14.9	177.3
Total cash and cash equivalents	**215.0**	**25.7**	**240.7**	173.9	26.6	200.5

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

22. Loans

	Non recourse loans (relating to PFI assets) 2005 £m	Other non recourse loans 2005 £m	Other loans 2005 £m	Total 2005 £m	Non recourse loans (relating to PFI assets) 2004 £m	Other non recourse loans 2004 £m	Other loans 2004 £m	Total 2004 £m
The loans are repayable as follows:								
On demand or within one year	**26.9**	**28.6**	**9.3**	**64.8**	21.7	4.7	20.0	46.4
Between one and two years	**24.3**	**6.3**	**51.8**	**82.4**	17.8	5.3	10.2	33.3
Between two and five years	**77.0**	**17.7**	**281.3**	**376.0**	68.1	15.7	46.2	130.0
After five years	**150.0**	**18.4**	**117.9**	**286.3**	148.4	21.9	117.7	288.0
	278.2	**71.0**	**460.3**	**809.5**	256.0	47.6	194.1	497.7
Less: Amount due for settlement within 12 months (shown under current liabilities)	**(26.9)**	**(28.6)**	**(9.3)**	**(64.8)**	(21.7)	(4.7)	(20.0)	(46.4)
Amount due for settlement after 12 months	**251.3**	**42.4**	**451.0**	**744.7**	234.3	42.9	174.1	451.3

23. Deferred tax

Deferred income taxes are calculated in full on temporary differences under the liability method using a principal tax rate of 30%.

The gross movement on the deferred income tax account is as follows:

	2005 £m	2004 £m
At 1 January	**4.9**	4.2
Income statement (credit)/charge (note 10)	**(1.1)**	12.7
Acquisitions/(deconsolidation)	**9.8**	(6.3)
Items taken directly to equity on adoption of IAS 39	**(10.8)**	–
Items taken directly to equity	**(2.0)**	(5.6)
Exchange differences	**0.1**	(0.1)
At 31 December	**0.9**	4.9

The movement in deferred tax assets and liabilities during the year was as follows:

	Temporary differences on assets/ intangibles £m	Share-based payment and employee benefits £m	Retirement benefit schemes £m	Derivative financial instruments £m	Other temporary differences £m	Total £m
At 1 January 2005	52.1	(6.7)	(41.0)	–	0.5	4.9
(Credited)/charged to income statement	(1.6)	(1.7)	–	–	2.2	(1.1)
Acquisitions	25.5	(2.2)	(3.6)	(1.0)	(8.9)	9.8
Items taken directly to equity on adoption of IAS 39	–	–	–	(10.8)	–	(10.8)
Items taken directly to equity	9.5	(4.7)	(8.2)	1.4	–	(2.0)
Exchange differences	0.1	–	–	–	–	0.1
At 31 December 2005	85.6	(15.3)	(52.8)	(10.4)	(6.2)	0.9

23. Deferred tax (continued)

The movement in deferred tax assets and liabilities during the previous year was as follows:

	Temporary differences on assets/ intangibles £m	Share-based payment and employee benefits £m	Retirement benefit schemes £m	Derivative financial instruments £m	Other temporary differences £m	Total £m
At 1 January 2004	49.4	(6.0)	(38.2)	(1.7)	0.7	4.2
Charged/(credited) to income statement	4.7	(0.7)	2.8	1.7	4.2	12.7
Deconsolidation	(2.0)	–	–	–	(4.3)	(6.3)
Items taken directly to equity	–	–	(5.6)	–	–	(5.6)
Exchange differences	–	–	–	–	(0.1)	(0.1)
At 31 December 2004	52.1	(6.7)	(41.0)	–	0.5	4.9

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority. The following is the analysis of the deferred tax balances (after offset) for financial reporting purposes:

	2005 £m	2004 £m
Deferred tax liabilities	**92.1**	55.0
Deferred tax assets	**(91.2)**	(50.1)
	0.9	4.9

At the balance sheet date, the Group did not recognise deferred tax assets of £7.3m (2004: £10.9m) in respect of the aggregate of deductible temporary differences, unused tax losses and unused tax credits.

24. Obligations under finance leases

	Minimum lease payments 2005 £m	**Present value of minimum lease payments 2005 £m**	Minimum lease payments 2004 £m	Present value of minimum lease payments 2004 £m
Amounts payable under finance leases:				
Within one year	**9.9**	**8.2**	9.9	8.1
In the second to fifth year inclusive	**19.8**	**17.3**	20.9	17.8
After five years	**1.3**	**0.9**	0.5	0.4
	31.0	**26.4**	31.3	26.3
Less: future finance charges	**(4.6)**	**–**	(5.0)	–
Present value of lease obligations	**26.4**	**26.4**	26.3	26.3
Less: Amount due for settlement within 12 months (shown under current liabilities)	**(9.9)**	**(8.2)**	(9.9)	(8.1)
Amount due for settlement after 12 months	**16.5**	**18.2**	16.4	18.2

Finance lease obligations are secured by the lessors' title to the leased assets.

The fair value of the Group's lease obligations approximates their carrying amount.

25. Trade and other payables

	2005 £m	2004 £m
Trade and other payables: Current		
Trade creditors	**124.3**	94.2
Other creditors	**104.2**	92.1
Accruals and deferred income	**297.2**	223.6
Amounts owed to joint ventures	**5.4**	7.1
	531.1	417.0
Trade and other payables: Non-current	**5.0**	0.6

The average credit period taken for trade purchases is 26 days (2004: 24 days). The directors estimate that the carrying amount of trade creditors approximates to their fair value.

26. Financial risk management

Financial risk
The Group's treasury function is responsible for managing the Group's exposure to financial risk and operates within a defined set of policies and procedures reviewed and approved by the Board.

Credit facilities and liquidity management
The Group maintains committed credit facilities that are designed to ensure that the Group has sufficient available funds for operations and planned expansions. The Group's main committed credit facility (the 'Bank Facility'), expires in December 2009, and comprises term loans of £146m and USD229m, and an undrawn £155m revolving credit facility.

The Bank Facility is unsecured, with covenants and obligations typical of these types of arrangement.

The Group continues to service two private placements. The first, for £43.2m, was taken out in 1997 and matures in 2007. The second, for £117.0m, was taken out in 2003 and amortises from 2011 to 2015.

Foreign exchange risk
The nature of the Group's business in general does not involve a significant amount of cross-border trade. Consequently, the Group is not exposed to substantial foreign currency transaction risk as sales and costs are approximately matched within overseas operations. Material transactional exposures of individual business units are hedged by forward foreign exchange contracts.

The foreign exchange exposure on the US Dollar tranches of the private placements has been fully hedged into Sterling.

Central funding of individual business units gives rise to monetary assets and liabilities centrally and in the business units. The currency of resultant debt is selected to ensure that any foreign exchange risk is borne and managed by the Group's treasury function using forward foreign exchange contracts.

Interest rate risk
The Group's exposure to interest rate fluctuations on its interest-bearing assets and liabilities is selectively managed, using interest rate swaps.

Lenders of non recourse debt generally require that the debt is maintained on fixed rate terms or is swapped to fixed rate terms. Therefore the Group hedges its interest rate risk by using interest rate swaps to exchange floating interest cash flows to fixed interest cash flows.

Credit risk
The Group's principal financial assets are cash and cash equivalents and trade and other receivables.

The Group's credit risk is relatively low because a high proportion of trade and other receivables have a sovereign or close to sovereign credit rating and the Group has a large number of counterparties and customers.

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

26 (a) Currency management

The Group's net foreign exchange transaction exposure is £5.8m (2004: £8.0m).

26 (b) Interest rate management

An analysis of financial assets and liabilities exposed to interest rate risk is set out below:

(i) Financial assets

	2005			2004		
	Floating rate £m	Fixed rate £m	Weighted average fixed interest rate received %	Floating rate £m	Fixed rate £m	Weighted average fixed interest rate received %
Cash and cash equivalents	240.7	–	–	200.5	–	–
Other financial assets	2.1	2.0	8.50	2.6	4.9	11.94
	242.8	2.0		203.1	4.9	

(ii) Financial liabilities

	2005			2004		
	Floating rate £m	Fixed rate £m	Weighted average fixed interest rate paid %	Floating rate £m	Fixed rate £m	Weighted average fixed interest rate paid %
Non recourse Sterling loans (related to PFI assets)	–	278.3	6.50	–	256.0	6.69
Other non recourse Sterling loans	22.4	–	–	–	–	–
Non recourse Canadian Dollar loans	–	48.6	5.27	–	47.6	5.27
Sterling loans	311.9	140.8	5.98	52.3	140.8	5.98
US Dollar loans	6.1	–	–	–	–	–
Other loans	1.4	–	–	1.0	–	–
	341.8	467.7		53.3	444.4	

Excluded from the above analysis is £26.4m of amounts payable under finance leases, which are subject to fixed rates of interest (2004: £26.3m).

The interest rate on floating rate financial liabilities is linked to three-month or six-month LIBOR.

26 (c) Hedge of net investment in foreign entity

The Group has US Dollar denominated borrowings, which it has designated as a hedge of part of the net investment in its subsidiaries in the USA. The fair value of the designated borrowings was £28.5m (2004: £nil). The foreign exchange loss of £2.5m (2004: £nil) on translation of the borrowings into Sterling has been recognised within the Group's hedging and translation reserve.

27. Financial instruments

	1 January 2005 £m	Movement in fair value of cash flow hedges £m	Movement in fair value of fair value hedges £m	Movement in fair value on non-designated hedges £m	31 December 2005 £m
Currency swaps	(9.1)	3.6	0.8	–	(4.7)
Forward foreign exchange contracts	(8.6)	2.2	0.4	0.2	(5.8)
Interest rate swaps	(20.2)	(4.5)	–	–	(24.7)
	(37.9)	1.3	1.2	0.2	(35.2)

	Currency swaps 2005 £m	Forward foreign exchange contracts 2005 £m	Interest rate swaps 2005 £m	Total 2005 £m
The maturity of derivative financial instruments is as follows:				
On demand or within one year	(0.2)	0.2	(4.4)	(4.4)
Between one and two years	(2.8)	(0.5)	(3.9)	(7.2)
Between two and five years	(0.5)	(1.7)	(12.1)	(14.3)
After five years	(1.2)	(3.8)	(4.3)	(9.3)
	(4.7)	(5.8)	(24.7)	(35.2)

The net asset representing the fair value of the forward foreign exchange contracts repayable within one year comprises an asset of £0.5m (see note 20) and a liability of £0.3m.

The fair value of the Group's derivative financial instruments are based on quoted market prices for equivalent instruments at the balance sheet date.

As set out in note 2, as permitted by IFRS 1, the Group opted to delay the adoption of IAS 32 and IAS 39 until 1 January 2005.

27 (a) Currency risk management

The Group utilises currency derivatives to hedge significant future transactions and cash flows. The Group is party to a variety of foreign currency forward contracts and swaps in the management of its exchange rate exposures. The instruments purchased are primarily denominated in the currencies of the Group's principal markets.

At the balance sheet date, the total notional amount of outstanding forward foreign exchange contracts to which the Group is committed is £72.6m (2004: £31.1m).

These arrangements are mainly designed to address significant exchange exposures for the next eighteen months.

27 (a) Currency risk management (continued)

Cash flow hedges
At 31 December 2005 the Group held a number of currency swaps designated as cash flow hedges. Fixed interest cash flows denominated in US Dollars are exchanged for fixed interest cash flows denominated in Sterling. The profile of these currency swaps held by the Group was as follows:

At 31 December 2005 and at 1 January 2005 Maturity	Notional amount USDm	Payable USD interest rate %	Receivable GBP interest rate %
December 2007	39.0	7.6	6.8
August 2015	35.0	5.7	5.7
August 2015	20.0	5.7	5.7

The Group also held a number of forward foreign exchange contracts designated as cash flow hedges with a notional amount of £24.7m (2004: £0.5m).

All currency derivatives designated as cash flow hedges are highly effective and the fair value thereof has been deferred in equity.

Fair value hedges
At 31 December 2005, the Group had currency swaps in place with a notional amount of USD31m whereby it receives a fixed interest rate of 6.81% and pays a floating rate based on LIBOR on the notional amount. The swaps are being used to hedge the exposure to changes in the fair value of the Group's US Dollar denominated private placement loans. In addition, the Group held a forward foreign exchange contract with a notional amount of USD15m designated as a fair value hedge, hedging the foreign exchange exposure on the final repayment of the Group's US Dollar denominated private placement loans.

27 (b) Interest rate risk management

Cash flow hedges
The Group uses interest rate swaps to manage its exposure to interest rate risk on its non recourse loans by swapping these loans from floating to fixed rates. These swaps cover seven, non recourse loans. The profile of these interest rate swaps is as follows:

At 31 December 2005 Maturity	Notional amount £m	Payable GBP interest rate %	Receivable GBP interest rate %
June 2010	5.3	6.2	LIBOR
February 2011	45.8	5.5	LIBOR
June 2014	19.2	8.7	LIBOR
June 2015	23.4	7.3	LIBOR
December 2015	22.3	6.7	LIBOR
December 2017	59.8	6.8	LIBOR
February 2023	86.0	5.6	LIBOR
	261.8		

27 (b) Interest rate risk management (continued)

At 1 January 2005

Maturity	Notional amount £m	Payable GBP interest rate %	Receivable GBP interest rate %
June 2010	6.3	6.2	LIBOR
February 2011	49.3	5.5	LIBOR
June 2014	20.7	8.7	LIBOR
June 2015	24.9	7.3	LIBOR
December 2015	23.7	6.7	LIBOR
December 2017	63.6	6.8	LIBOR
February 2023	47.0	5.6	LIBOR
	235.5		

Apart from a small portion of one interest rate swap, all swaps are designated and highly effective as cash flow hedges and the fair value thereof has been deferred in equity. An amount of £4.0m (2004: £3.5m) has been offset against hedged interest payments made in the period.

28. Retirement benefit schemes

The Group has accounted for pensions in accordance with IAS 19 'Employee Benefits'. The Group operates and is a member of a number of defined benefit schemes and defined contribution schemes. The pension charge for the year ended 31 December 2005, including the proportionate share of joint ventures, was £55.6m (2004: £39.5m).

28 (a) Defined benefit schemes

The Group operates defined benefit schemes for qualifying employees of its subsidiaries in the UK, Europe and the Middle East. In addition the Group has interests in joint ventures, which operate defined benefit schemes for qualifying employees.

The assets of the funded plans are held independently of the Group's assets in separate trustee administered funds. The Group's major plans are valued by independent actuaries annually using the projected unit credit method. This reflects service rendered by employees to the dates of valuation and incorporates actuarial assumptions primarily regarding discount rates used in determining the present value of benefits, projected rates of salary growth, and long-term expected rates of return for plan assets. Discount rates are based on the market yields of high-quality corporate bonds in the country concerned. Long-term expected rates of return for plan assets are based on published brokers' forecasts for each category of scheme assets. Pension assets and liabilities in different defined benefit schemes are not offset unless the Group has a legally enforceable right to use the surplus in one plan to settle obligations in the other plan and intends to exercise this right.

The amounts recognised in the consolidated balance sheet are grouped together as follows:

Contract specific – Virtually certain costs reimbursed
The Group has an obligation to contribute to the pension scheme over the term of the contract. At rebid any deficit or surplus would transfer to the next contractor. Throughout the contract, it is virtually certain that the Group will be reimbursed the expenditure required to settle the defined benefit obligation. The Group's share of the defined benefit obligation less its share of the fair value of scheme assets that it will fund over the period of the contract has been recognised as a liability. The Group has recognised the right to reimbursement as a separate asset.

In the consolidated income statement, the expense relating to this defined benefit plan has been presented net of the amount recognised for the reimbursement, resulting in a nil charge to the income statement.

Contract specific – Not certain costs will be reimbursed
These are pre-funded defined benefit schemes. The Group has obligations to contribute variable amounts to the pension schemes over the terms of the related contracts. At rebid any deficit or surplus would transfer to the next contractor. The Group has recognised as a liability the defined benefit obligation less the fair value of scheme assets that it will fund over the period of the contracts with a corresponding amount recognised as intangible assets at the start of the contracts. Subsequent actuarial gains and losses in relation to the Group's share of the pension obligations have been recognised in the consolidated statement of recognised income and expense (the SORIE). The intangible assets are amortised over the term of the contracts.

28 (a) Defined benefit schemes (continued)

Non contract specific

These consist of a pre-funded defined benefit scheme which does not relate to any specific contract (the funding policy is to contribute such variable amounts, on the advice of the actuary, as will achieve 100% funding on a projected salary basis); an unfunded defined benefit scheme and an unfunded hybrid scheme all of which do not relate to any specific contract. Any liabilities arising are recognised in full.

The assets and liabilities of the schemes at 31 December are:

Year ended 31 December 2005	Virtually certain costs reimbursed £m	Not certain costs reimbursed £m	Non contract specific £m	Total £m
Scheme assets at fair value				
Equities	153.2	177.3	291.7	622.2
Bonds	37.9	28.7	95.7	162.3
Gilts	–	5.5	130.7	136.2
Property	–	20.2	11.9	32.1
Cash and other	4.3	8.2	8.6	21.1
Annuity policies	–	–	18.8	18.8
Fair value of scheme assets	195.4	239.9	557.4	992.7
Present value of scheme liabilities	(280.3)	(307.7)	(759.1)	(1,347.1)
Net amount recognised	(84.9)	(67.8)	(201.7)	(354.4)
Members' share of deficit	–	14.2	1.3	15.5
Franchise adjustment	–	32.3	–	32.3
Net pension liability	**(84.9)**	**(21.3)**	**(200.4)**	**(306.6)**
Related assets at 31 December 2005				
Intangible assets (note 14)	–	19.0	–	19.0
Trade and other receivables (note 20)	84.9	–	–	84.9
	84.9	19.0	–	103.9

Year ended 31 December 2004	£m	£m	£m	£m
Scheme assets at fair value				
Equities	126.5	144.1	203.0	473.6
Bonds	31.3	19.7	82.5	133.5
Gilts	–	–	101.7	101.7
Property	–	14.4	11.8	26.2
Cash and other	1.8	15.1	4.5	21.4
Annuity policies	–	–	20.1	20.1
Fair value of scheme assets	159.6	193.3	423.6	776.5
Present value of scheme liabilities	(215.6)	(249.9)	(590.0)	(1,055.5)
Net amount recognised	(56.0)	(56.6)	(166.4)	(279.0)
Members share of deficit	–	11.6	1.8	13.4
Franchise adjustment	–	22.7	–	22.7
Net pension liability	**(56.0)**	**(22.3)**	**(164.6)**	**(242.9)**
Related assets at 31 December 2004				
Intangible assets (note 14)	–	21.2	–	21.2
Trade and other receivables (note 20)	56.0	–	–	56.0
	56.0	**21.2**	**–**	**77.2**

Liabilities in relation to unfunded schemes included above amount to £37.6m (2004: £34.3m).

In some schemes, employee contributions vary over time to meet a specified proportion of the overall costs, including a proportion of any deficit. The liabilities recognised in the balance sheet for these schemes are net of the proportion attributed to employees. In addition, the amounts charged to the consolidated income statement for these schemes are net of the proportion attributed to employees. The amounts attributed to employees are shown separately in the reconciliation of changes in the fair value of scheme assets and liabilities.

28 (a) Defined benefit schemes (continued)

The amounts recognised in the financial statements for the year are analysed as follows:

Year ended 31 December 2005	Virtually certain costs reimbursed £m	Not certain costs reimbursed £m	Non contract specific £m	Total £m
Recognised in the consolidated income statement				
Current service cost – employer	7.9	10.3	17.3	35.5
Past service cost	–	–	2.0	2.0
Reimbursed to employer	(7.9)	–	–	(7.9)
Recognised in arriving at operating profit	–	10.3	19.3	29.6
Expected return on scheme assets – employer	(10.7)	(8.8)	(27.4)	(46.9)
Interest on franchise adjustment	–	(1.3)	–	(1.3)
Interest cost on scheme liabilities – employer	11.6	9.3	32.9	53.8
Reimbursed to employer	(0.9)	–	–	(0.9)
Finance costs	–	(0.8)	5.5	4.7
Included within the SORIE				
Actual return on scheme assets	32.8	42.9	79.8	155.5
Less: expected return on scheme assets	(10.7)	(13.4)	(28.4)	(52.5)
	22.1	29.5	51.4	103.0
Other actuarial gains and losses	(48.5)	(38.3)	(74.6)	(161.4)
Actuarial gains and losses on scheme assets and liabilities	(26.4)	(8.8)	(23.2)	(58.4)
Change in franchise adjustment	–	8.4	–	8.4
Change in members' share	–	1.3	(0.5)	0.8
Reimbursed to employer	26.4	–	–	26.4
Actuarial gains and losses on reimbursable rights	26.4	9.7	(0.5)	35.6
Total actuarial gains and losses recognised in the SORIE	–	0.9	(23.7)	(22.8)

Year ended 31 December 2004	£m	£m	£m	£m
Recognised in the consolidated income statement				
Current service cost – employer	7.3	3.3	14.1	24.7
Past service cost	–	–	0.8	0.8
Reimbursed to employer	(7.3)	–	–	(7.3)
Recognised in arriving at operating profit	–	3.3	14.9	18.2
Expected return on scheme assets – employer	(10.0)	(2.6)	(24.5)	(37.1)
Interest on franchise adjustment	–	(0.7)	–	(0.7)
Interest cost on scheme liabilities – employer	10.0	3.4	26.8	40.2
Reimbursed to employer	–	–	–	–
Finance costs	–	0.1	2.3	2.4
Included within the SORIE				
Actual return on scheme assets	14.6	5.2	29.6	49.4
Less: expected return on scheme assets	(10.0)	(3.5)	(25.6)	(39.1)
	4.6	1.7	4.0	10.3
Other actuarial gains and losses	(16.3)	(4.3)	(19.1)	(39.7)
Actuarial gains and losses on scheme assets and liabilities	(11.7)	(2.6)	(15.1)	(29.4)
Change in franchise adjustment	–	2.5	–	2.5
Change in members' share	–	0.3	(1.5)	(1.2)
Reimbursed to employer	11.7	–	–	11.7
Actuarial gains and losses on reimbursable rights	11.7	2.8	(1.5)	13.0
Total actuarial gains and losses recognised in the SORIE	–	0.2	(16.6)	(16.4)

Cumulative actuarial gains and losses recognised in the SORIE since 1 January 2004 are £39.2m (2004: £16.4m).

28 (a) Defined benefit schemes (continued)

Changes in the fair value of plan liabilities are analysed as follows:

	Virtually certain costs reimbursed £m	Not certain costs reimbursed £m	Non contract specific £m	Total £m
At 1 January 2004	184.7	29.3	543.5	757.5
Arising on acquisition	–	207.8	–	207.8
Current service cost – employer	7.3	3.3	14.1	24.7
Current service cost – employee	–	0.5	0.6	1.1
Past service cost	–	–	0.8	0.8
Plan participants contributions	0.5	0.1	4.6	5.2
Interest cost – employer	10.0	3.4	26.8	40.2
Interest cost – employee	–	2.8	0.8	3.6
Benefits paid	(3.2)	(1.6)	(19.4)	(24.2)
Actuarial gains and losses	16.3	4.3	19.1	39.7
Foreign currency differences	–	–	(0.9)	(0.9)
At 31 December 2004	**215.6**	**249.9**	**590.0**	**1,055.5**
Arising on acquisition	**–**	**–**	**57.8**	**57.8**
Current service cost – employer	**7.9**	**10.3**	**17.3**	**35.5**
Current service cost – employee	**–**	**4.7**	**0.5**	**5.2**
Past service cost	**–**	**–**	**2.0**	**2.0**
Plan participants contributions	**0.7**	**0.2**	**4.8**	**5.7**
Interest cost – employer	**11.6**	**9.3**	**32.9**	**53.8**
Interest cost – employee	**–**	**4.1**	**0.8**	**4.9**
Benefits paid	**(4.0)**	**(9.1)**	**(20.6)**	**(33.7)**
Actuarial gains and losses	**48.5**	**38.3**	**74.6**	**161.4**
Foreign currency differences	**–**	**–**	**(1.0)**	**(1.0)**
At 31 December 2005	**280.3**	**307.7**	**759.1**	**1,347.1**

Changes in the fair value of plan assets are analysed as follows:

	Virtually certain costs reimbursed £m	Not certain costs reimbursed £m	Non contract specific £m	Total £m
At 1 January 2004	142.0	24.3	388.5	554.8
Arising on acquisition	–	161.5	–	161.5
Expected return on plan assets – employer	10.0	2.6	24.5	37.1
Expected return on plan assets – employee	–	0.9	1.1	2.0
Employer contributions	5.7	3.3	19.3	28.3
Contributions by employees	0.5	0.6	4.8	5.9
Benefits paid	(3.2)	(1.6)	(18.6)	(23.4)
Actuarial gains and losses	4.6	1.7	4.0	10.3
At 31 December 2004	**159.6**	**193.3**	**423.6**	**776.5**
Arising on acquisition	**–**	**–**	**46.3**	**46.3**
Expected return on plan assets – employer	**10.7**	**8.8**	**27.4**	**46.9**
Expected return on plan assets – employee	**–**	**4.6**	**1.0**	**5.6**
Employer contributions	**6.3**	**9.6**	**22.4**	**38.3**
Contributions by employees	**0.7**	**3.2**	**5.0**	**8.9**
Benefits paid	**(4.0)**	**(9.1)**	**(19.7)**	**(32.8)**
Actuarial gains and losses	**22.1**	**29.5**	**51.4**	**103.0**
At 31 December 2005	**195.4**	**239.9**	**557.4**	**992.7**

No assets are invested in the Group's own financial instruments, properties or other assets used by the Group.

28 (a) Defined benefit schemes (continued)

History of experience gains and losses

	2005	2004
Experience adjustments arising on scheme assets:		
Amount (£m)	103.6	10.2
Percentage of scheme assets	10%	1%
Experience adjustments arising on scheme liabilities:		
Amount (£m)	11.8	6.4
Percentage of the present value of the scheme liabilities	1%	1%
Fair value of scheme assets (£m)	992.7	776.5
Present value of scheme liabilities (£m)	(1,347.1)	(1,055.5)
Deficit (£m)	(354.4)	(279.0)

The contribution expected to be paid during the financial year ended 31 December 2006 is £40.7m.

	2005 %	2004 %
Main assumptions:		
Rate of salary increases	3.20 – 4.20	3.75 – 4.75
Rate of increase in pensions in payment	2.70	2.75
Rate of increase in deferred pensions	2.70	2.75
Inflation assumption	2.70	2.75
Discount rate	4.80	5.30
Expected rates of return on scheme assets:		
Equities	7.00	7.00
Bonds	4.80	5.30
Gilts	4.10	4.50
Property	5.35	6.15
Cash and other	4.50	4.75
Annuity policies	4.80	5.30

	2005 years	2004 years
Post-retirement mortality:		
Current pensioners at 65 – male	18.7	17.9
Current pensioners at 65 – female	21.7	20.8
Future pensioners at 65 – male	21.3	20.4
Future pensioners at 65 – female	24.2	23.4

For some of the smaller schemes, allowance for expected future improvements in life expectancy has been made by reducing the discount rate by 0.2% per annum from the rate shown above.

28 (b) Defined contribution schemes

The Group paid employer contributions of £19.7 million (2004: £15.6 million) into UK and other defined contribution schemes, foreign state pension schemes and multi-employer schemes, including those of joint ventures.

Pre-funded defined benefit schemes treated as defined contribution

Serco accounts for this scheme as a defined contribution scheme because the contributions are fixed until the end of the current concession and at rebid any surplus or deficit would transfer to the next contractor. Cash contributions are recognised as pension costs and no asset or liability is shown on the balance sheet.

29. Provisions

	Employee related £m	Other £m	Total 2005 £m	Employee related £m	Other £m	Total 2004 £m
At 1 January	6.0	–	6.0	6.0	–	6.0
Transfers	1.1	0.1	1.2	–	–	–
Arising from acquisitions	–	23.8	23.8	–	–	–
Charged to income statement	1.1	2.1	3.2	0.3	–	0.3
Utilised during the year	(0.5)	(7.4)	(7.9)	(0.3)	–	(0.3)
At 31 December	7.7	18.6	26.3	6.0	–	6.0

Employee related provisions relate to long-term service awards and terminal gratuities liabilities which have been accrued and are based on contractual entitlement together with an estimate of the probabilities that employees will stay until retirement and receive all relevant amounts.

Other provisions include amounts relating to property and restructuring.

30. Share capital

	2005 £m	2005 Number millions	2004 £m	2004 Number millions
Authorised:				
550,000,000 (2004: 550,000,000) ordinary shares of 2p each	**11.0**	**550.0**	11.0	550.0
Issued and fully paid:				
435,352,903 (2004: 434,880,837) ordinary shares of 2p each at 1 January	**8.7**	**435.4**	8.7	434.9
Issued as consideration for acquisitions during the year	**0.6**	**30.4**	–	–
Issued on the exercise of share options	**0.1**	**2.4**	–	0.5
468,231,512 (2004: 435,352,903) ordinary shares of 2p each at 31 December	**9.4**	**468.2**	8.7	435.4

The Company has one class of ordinary shares which carry no right to fixed income.

During the year 2,522,336 ordinary shares of 2p each were allotted to the holders of options or their personal representatives using newly listed shares.

31. Share premium account

	2005 £m	2004 £m
Balance at 1 January	**191.5**	190.8
Premium on shares issued	**78.0**	0.7
Balance at 31 December	**269.5**	191.5

32. Reserves

Retained earnings

	2005 £m	2004 £m
At 1 January	**104.4**	71.6
Loss on fair value hedges on adoption of IAS 39	**(3.5)**	–
Tax credit on fair value hedges	**0.5**	–
Restated at 1 January	**101.4**	71.6
Dividends paid	**(12.5)**	(10.4)
Profit for the year	**53.4**	43.5
Goodwill previously written off, released on sale of subsidiary	–	0.2
Transfer from own shares reserve	–	(0.5)
Tax charge on items taken directly to equity	***(9.5)**	–
At 31 December	**132.8**	104.4

Other reserves

	Retirement benefit obligations reserve £m	Share-based payment reserve £m	Own shares reserve £m	Hedging and translation reserve £m	Total £m
At 1 January 2004	(113.6)	1.7	(16.9)	0.7	(128.1)
Net exchange loss on translation of foreign operations	–	–	–	(3.3)	(3.3)
Transfer to retained earnings	–	–	0.5	–	0.5
Net actuarial loss on defined benefit pension schemes	(29.4)	–	–	–	(29.4)
Actuarial gain on reimbursable rights	13.0	–	–	–	13.0
Credit in relation to share-based payment	–	4.5	–	–	4.5
Tax credit on items taken directly to equity	5.6	–	–	–	5.6
At 31 December 2004	(124.4)	6.2	(16.4)	(2.6)	(137.2)
At 1 January 2005	**(124.4)**	**6.2**	**(16.4)**	**(2.6)**	**(137.2)**
Fair value loss on cash flow hedges on adoption of IAS 39	–	–	–	**(34.4)**	**(34.4)**
Tax credit on cash flow hedges	–	–	–	**10.3**	**10.3**
Restated at 1 January 2005	**(124.4)**	**6.2**	**(16.4)**	**(26.7)**	**(161.3)**
Net exchange gain on translation of foreign operations	–	–	–	**6.9**	**6.9**
Net actuarial loss on defined benefit pension schemes	**(58.4)**	–	–	–	**(58.4)**
Actuarial gain on reimbursable rights	**35.6**	–	–	–	**35.6**
Credit in relation to share-based payment	–	**5.7**	–	–	**5.7**
Fair value gain on cash flow hedges during the year	–	–	–	**6.1**	**6.1**
Tax charge on cash flow hedges	–	–	–	**(1.4)**	***(1.4)**
Tax credit on items taken directly to equity	**8.2**	**4.7**	–	–	***12.9**
At 31 December 2005	**(139.0)**	**16.6**	**(16.4)**	**(15.1)**	**(153.9)**

*These amounts and £(9.5m) in retained earnings represent £2.0m of tax credit taken directly to equity in the SORIE.

The retirement benefit obligations reserve represents the actuarial gains and losses recognised in respect of annual actuarial valuations for defined benefit retirement schemes, the fair value adjustments on reimbursable rights and the related movements in deferred tax balances.

The share-based payment reserve represents credits relating to equity-settled share-based payment transactions granted after 7 November 2002 but not fully vested at 31 December 2005.

The own shares reserve represents the cost of shares in Serco Group plc purchased in the market and held by the Serco Group plc Employee Share Ownership Trust (ESOP) to satisfy options under the Group's share options schemes. At 31 December 2005, the ESOP held 5,183,003 (2004: 5,183,003) shares equal to 1.10% of current allotted share capital (2004: 1.19%). The market value of shares held by the Trust as at 31 December 2005 was £16,287,587 (2004: £12,439,207).

The hedging and translation reserve represents foreign exchange differences arising on translation of the Group's overseas operations and movements relating to cash flow hedges.

33. Notes to the consolidated cash flow statement

Reconciliation of operating profit to net cash from operating activities

	2005 £m	2004 £m
Operating profit for the year	**97.1**	69.2
Adjustments for:		
Share-based payment	**5.7**	4.5
Depreciation of property, plant and equipment	**30.3**	22.2
Amortisation of intangible assets	**13.6**	7.2
Loss on disposal of property, plant and equipment	**0.4**	0.8
Loss on disposal of intangible assets	**0.1**	–
Loss on disposal of subsidiary undertakings	–	0.1
Operating cash inflows before movements in working capital	**147.2**	104.0
(Increase)/decrease in inventories	**(1.9)**	2.3
Increase in receivables	**(47.2)**	(34.4)
Increase in payables	**44.6**	31.7
Cash generated by operations before PFI asset expenditure	**142.7**	103.6
Movement on PFI debtor	**15.3**	7.6
Expenditure on PFI assets in the course of construction	**(7.8)**	(16.3)
Cash generated by operations after PFI asset expenditure	**150.2**	94.9
Tax paid	**(9.4)**	(7.3)
Net cash inflow from operating activities	**140.8**	87.6

Additions to fixtures and equipment during the year amounting to £5.6 million (2004: £5.2 million) were financed by new finance leases.

Analysis of net debt

	At 1 January 2005 £m	Cash flow £m	Additions/ disposals £m	Exchange differences £m	Non-cash movements £m	At 31 December 2005 £m
Cash and cash equivalents	**200.5**	**32.5**	**5.0**	**2.7**	**–**	**240.7**
Non recourse loans (related to PFI assets)	**(256.0)**	**20.5**	**(43.1)**	**–**	**0.4**	**(278.2)**
Other non recourse loans	**(47.6)**	**1.0**	**–**	**(6.9)**	**(17.5)**	**(71.0)**
Other loans	**(194.1)**	**(266.2)**	**(4.0)**	**(12.2)**	**16.2**	**(460.3)**
Obligations under finance leases	**(26.3)**	**8.4**	**(5.8)**	**(0.2)**	**(2.5)**	**(26.4)**
	(323.5)	**(203.8)**	**(47.9)**	**(16.6)**	**(3.4)**	**(595.2)**

	At 1 January 2004 £m	Cash flow £m	Additions/ disposals £m	Exchange differences £m	Non-cash movements £m	At 31 December 2004 £m
Cash and cash equivalents	184.6	16.3	–	(0.4)	–	200.5
Non recourse loans (related to PFI assets)	(357.6)	16.3	–	–	85.3	(256.0)
Other non recourse loans	(49.8)	2.9	–	(0.7)	–	(47.6)
Other loans	(185.2)	(9.4)	0.4	0.1	–	(194.1)
Obligations under finance leases	(31.9)	9.0	–	(0.2)	(3.2)	(26.3)
	(439.9)	35.1	0.4	(1.2)	82.1	(323.5)

Non-cash movements in 2005 primarily relate to fixed assets acquired under finance leases. Non-cash movements in 2004 relate to the deconsolidation of Laser and fixed assets acquired under finance leases.

34. Capital and other commitments

	2005 £m	2004 £m
Capital expenditure contracted but not provided	**3.8**	1.5

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

	2005 £m	2004 £m
Within one year	**83.5**	80.8
Between one and five years	**251.9**	258.1
After five years	**211.9**	240.7
	547.3	579.6

Future minimum rentals receivable under non-cancellable operating leases where the Group is the lessor are as follows:

	2005 £m	2004 £m
Not later than one year	**0.2**	0.2
Between one year and five years	**0.6**	0.6
After five years	**0.5**	0.6
	1.3	1.4

35. Share-based payment

The Group recognised the following expenses related to equity-settled share-based payment transactions:

	2005 £m	2004 £m
Executive Option Plan	**2.7**	2.5
Long-Term Incentive Scheme	**0.8**	0.4
Sharesave 2004	**2.2**	1.6
	5.7	4.5

Executive Option Plan (the EOP)

Options granted under the EOP may be exercised after the third anniversary of grant, dependent upon the achievement of a financial performance target over three years. The options are granted at market value and awards made to eligible employees are based on between 50% and 100% of salary as at 31 December prior to grant. If the options remain unexercised after a period of 10 years from the date of grant, the options expire. Furthermore, options may be forfeited if the eligible employee leaves the group before the options vest.

	Number of options '000	Weighted average exercise price £
Outstanding at 1 January 2005	12,108	1.611
Granted during the year	927	2.350
Exercised during the year	(602)	1.525
Expired during the year	(325)	1.525
Outstanding at 31 December 2005	12,108	1.674

None of these options were exercisable at the end of the year.

35. Share-based payment (continued)

The weighted average share price at the date of exercise for share options exercised during the year was £2.470 (2004: £1.525). The options outstanding at 31 December 2005 had a weighted average exercise price of £1.674 (2004: £1.611) and a weighted average remaining contractual life of 0.62 years (2004: 1.46 years).

The fair value of options granted under the EOP is measured by use of the Binomial lattice model. The Binomial model is considered to be most appropriate for valuing options granted under this scheme as it allows exercise over a longer period of time between the vesting date and the expiry date.

The inputs into the Binomial model are:

	2005	2004
Weighted average share price	**260p**	240p
Weighted average exercise price	**167.4p**	161.1p
Expected volatility	**45.5% to 46.6%**	45.5% to 46.6%
Expected life	**5 years**	5 years
Risk free rate	**4.0% to 4.9%**	4.0% to 4.9%
Expected dividends	**1.1% to 1.5%**	1.1% to 1.5%

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous 5 years. The expected life used in the model has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioural considerations.

Long-Term Incentive Scheme (the LTIS)

Awards made to eligible employees under the LTIS, which are structured as options with a zero exercise price, may be exercised after the third anniversary of grant. The extent to which an award vests (and therefore becomes exercisable) is measured by reference to the growth in the Company's earnings per share over the performance period of three financial years.

If the options remain unexercised after a period of 10 years from the date of grant, the options expire. Furthermore, options may be forfeited if the eligible employee leaves the group before the options vest.

	Number of options '000	Weighted average exercise price £
Outstanding at 1 January 2005	1,978	Nil
Granted during the year	314	Nil
Outstanding at 31 December 2005	2,292	Nil

None of these options were exercisable at the end of the year.

The fair value of options granted under the LTIS is measured by use of a Monte Carlo Simulation model. This model is considered to be most appropriate for valuing options granted under the LTIS as it takes into account the changes in performance conditions by which the options are measured.

35. Share-based payment (continued)

The inputs into the Monte Carlo Simulation model are:

	2005	2004
Weighted average share price	**260p**	240p
Weighted average exercise price	**Nil**	Nil
Expected volatility	**41.8% to 51.0%**	41.8% to 51.0%
Expected life	**3 years**	3 years
Risk free rate	**3.8% to 4.8%**	3.8% to 4.8%
Expected dividends	**1.0% to 1.5%**	1.0% to 1.5%

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

Sharesave 2004

The Sharesave 2004 scheme provides for a purchase price equal to the daily average market price on the date of grant less 20%. The shares can be purchased during a two-week period each year.

	Number of options '000	Weighted average exercise price £
Outstanding at 1 January 2005	7,793	1.72
Exercised during the year	(76)	1.72
Expired during the year	(660)	1.72
Outstanding at 31 December 2005	7,057	1.72

Options were valued using the Black Scholes model as this model reflects the fact that the options are exercisable only for a short period of 6 months following their vesting. An expected life of 3 years and three months is the mid point between the vesting and expiry dates. The model used the following assumptions:

	2005	2004
Weighted average share price	**260p**	240p
Weighted average exercise price	**172p**	172p
Expected volatility	**47.6%**	47.6%
Expected life	**3.25 years**	3.25 years
Risk free rate	**4.7%**	4.7%
Expected dividends	**1.1%**	1.1%

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

36. Related party transactions

Transactions between the Company and its wholly owned subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note. Transactions between the Group and its joint venture undertakings are disclosed below, with the relevant proportion being eliminated on consolidation. Transactions between the Company and its subsidiaries and joint ventures are disclosed in the company's separate financial statements.

Trading transactions

During the year, Group companies entered into the following material transactions with joint ventures:

	2005 £m	2004 £m
Sales of goods and services	**2.2**	12.6
Royalties and management fees receivable	**1.0**	1.6
Dividends receivable	**25.7**	13.6
	28.9	27.8

The following receivable balances relating to joint ventures were included in the consolidated balance sheet:

	2005 £m	2004 £m
Current:		
Loans	**3.5**	3.0
Royalties and management fees	**2.1**	2.1
	5.6	5.1

	2005 £m	2004 £m
Non-current:		
Loans	**0.9**	1.6
	0.9	1.6

The following payable balances relating to joint ventures were included in the consolidated balance sheet:

	2005 £m	2004 £m
Amounts payable within one year:		
Loans	**5.4**	7.1
	5.4	7.1

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

36. Related party transactions (continued)

Remuneration of key management personnel

The Directors of Serco Group plc had no material transactions with the Group during the year other than service contracts and Directors' liability insurance.

The remuneration of the Directors, who are the key management personnel of the Group, is set out below in aggregate for each of the categories specified in IAS 24 'Related Party Disclosures':

	2005 £m	2004 £m
Short-term employee benefits	1.9	1.7
Post-employment benefits	0.6	1.1
Share-based payment	0.9	0.6
	3.4	3.4

37. List of principal undertakings

The companies listed below are, in the opinion of the Directors, the principal undertakings of Serco Group plc as at 31 December 2005. The percentage of equity capital directly or indirectly held by Serco Group plc is shown. The voting rights are the same as the percentage holding. The companies are incorporated and principally operate in the countries stated below.

Principal subsidiaries		2005	2004
United Kingdom	Serco Limited	100%	100%
	Serco-Denholm Limited	90%	90%
	Serco-IAL Limited	100%	100%
	Serco Railtest Limited	100%	100%
	Serco Systems Limited	100%	100%
	NPL Management Limited	100%	100%
	Serco Docklands Limited	100%	100%
	Traffic Information Services (TIS) Limited	100%	100%
	Serco Leisure Operating Limited	100%	100%
	Kilmarnock Prison Services Limited	100%	100%
	Lowdham Grange Prison Services Limited	100%	100%
	Medomsley Training Services Limited	100%	100%
	Pucklechurch Custodial Services Limited	100%	100%
	Moreton Prison Services Limited	100%	100%
	Altram (Manchester) Limited	100%	100%
	Healthcare Services 24 Limited	100%	–
	Serco Solutions Limited	100%	–
	Defence Management Watchfield Limited	100%	50%
Europe and Middle East			
Belgium	Serco Belgium S.A	100%	100%
Denmark	Metro Service A/S	100%	100%
France	Serco France SAS	100%	100%
Germany	Serco GmbH	100%	100%
Ireland	Serco Services Ireland Limited	100%	100%
	CCM Software Services Limited	100%	100%
Italy	Serco SpA	100%	100%
The Netherlands	Serco Facilities Management BV	100%	100%
Spain	Serco Gestion de Negocias SL	100%	100%
Switzerland	Serco Facilities Management S.A	100%	100%

37. List of principal undertakings (continued)

Principal subsidiaries		2005	2004
Asia Pacific			
Australia	Serco Australia Pty Limited	**100%**	100%
	Great Southern Railway Limited	**100%**	100%
Hong Kong	Serco Group (Hong Kong) Limited	**100%**	100%
North America			
Canada	Serco Facilities Management Inc	**100%**	100%
	Serco DES Inc	**100%**	100%
USA	Serco, Inc	**100%**	100%
	Serco Management Services, Inc. (Delaware)	**100%**	100%
	Serco Management Services, Inc. (Tennessee)	**100%**	100%
	RCI Holding Corp	**100%**	–

Joint venture undertakings		2005	2004
United Kingdom	Serco Gulf Engineering Limited	**50%**	50%
	AWE Management Limited	**33%**	33%
	Merseyrail Electrics 2002 Limited	**50%**	50%
	Northern Rail Limited	**50%**	50%
Asia Pacific			
Australia	Defence Maritime Services Pty Limited	**50%**	50%
	Serco Sodexho Defence Services Pty Limited	**50%**	50%
Other			
Bahrain	Aeradio Technical Services WLL	**49%**	49%
Singapore	Serco Guthrie Pte Ltd	**50%**	50%
South Africa	Equity Aviation Services Limited	**50%**	50%

All joint ventures are accounted for using the proportionate consolidation method. All the subsidiaries of the Group have been consolidated. At 31 December 2005, Group companies had branches in UAE, Bahrain, Chile, Korea, Saudi Arabia and Gibraltar.

All the principal subsidiaries of Serco Group plc and its joint venture undertakings are engaged in the provision of services. Full details of related undertakings will be attached to the Company's Annual Return to be filed with the Registrar of Companies.

38. Contingent liabilities

The Company has guaranteed overdrafts, finance leases, and bonding facilities of its joint ventures up to a maximum value of £4.1m (2004: £5.9m). The actual commitment outstanding at 31 December 2005 was £0.2m (2004: £1.3m).

In addition to this, the Company and its subsidiaries have provided performance guarantees, and indemnities relating to performance bonds and letters of credit issued by its banks on its behalf, in the ordinary course of business. These are not expected to result in any material financial loss.

Further details of the contingent liabilities of Serco Group plc are contained in Note 17 to the Serco Group plc Company financial statements.

39. Transition to IFRS

For all periods up to and including the year ended 31 December 2004, the Group prepared its financial statements in accordance with UK GAAP. These financial statements are the first the Group is required to prepare in accordance with IFRS.

IFRS 1 establishes the transitional requirements for the preparation of financial statements in accordance with IFRS for the first time. The general principle is that the IFRS effective at the first-time adoption reporting date (31 December 2005 for the Group) are to be applied retrospectively to the opening IFRS balance sheet (1 January 2004) the comparative period (2004) and the reporting period (2005).

Outlined below is the Group's position in relation to key exemptions and exceptions that are available under IFRS.

Business combinations

The Group has adopted the exemption not to apply IFRS 3 'Business Combinations' in respect of acquisitions occurring prior to 1 January 2004. As a result, in the opening balance sheet, goodwill arising from past business combinations (excluding amounts reclassified as intangible assets) remains as stated under UK GAAP at 1 January 2004.

Employee benefits

The Group has recognised actuarial gains and losses in relation to employee benefit schemes at 1 January 2004. The Group has recognised actuarial gains and losses in full in the period in which they occur in the consolidated statement of recognised income and expense in accordance with the amendment to IAS 19 'Employee Benefits', issued on 16 December 2004.

Share-based payment

IFRS 2 has been applied to all grants of equity instruments after 7 November 2002 that had not vested as at 1 January 2005. Under UK GAAP the Group's shares held in the Employee Share Ownership Plan (ESOP) trust were amortised within the ESOP reserve, and charged to the profit and loss account.

Under IFRS 2, the fair value of all share and share option awards is calculated and then amortised in the income statement over the vesting period. The carrying amount of the ESOP reserve on transition to IFRS has been maintained at the carrying amount under UK GAAP at that date. On transition to IFRS, the cumulative IFRS 2 charge has been shown within a separate share-based payment reserve within Equity.

Cumulative translation differences

The Group has adopted the exemption to set cumulative translation differences for all foreign operations to zero at 1 January 2004. The gain or loss on a subsequent disposal of any foreign operation will exclude translation differences that arose before 1 January 2004, but will include later translation differences.

Financial instruments

The Group has adopted IAS 32 'Financial Instruments: Disclosure and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' effective from 1 January 2005 and therefore there is no impact on the Group's balance sheet as at 1 January 2004 or 31 December 2004 on transition to IFRS. Adjustments arising from adopting IAS 39 impact the opening balance sheet at 1 January 2005 as certain financial instruments, notably interest rate swaps, are recognised at fair value. The effect of these adjustments is shown in note 27.

Movements in the fair value of these financial instruments are recognised within a separate Hedging and Translation reserve within Equity.

Accounting for PFI contracts

In March 2005, the IFRIC issued a draft interpretation on accounting for service concession arrangements, including PPP projects and PFI projects, which has since been withdrawn.

The Group has, from 1 January 2005, recognised the PFI debtors relating to concession arrangements held by PFI companies at amortised cost as defined by IAS 39. The effect of adopting this policy is to maintain an accounting treatment consistent with UK GAAP while ensuring that the accounting treatment remains consistent with existing IFRS.

39. Transition to IFRS (continued)

The draft guidance from IFRIC, if it were re-issued in final form, would potentially require a number of changes to the accounting treatment of service concession arrangements. One of the more significant aspects would be the requirement to recognise the assets associated with concession arrangements at fair value. This requirement could potentially produce a significant increase in the carrying value of the Group's PFI debtors held within PFI companies.

Key IFRS adjustments and their impact on the financial statements

Key IFRS adjustments are outlined below, with summary financial details for the specific accounting periods being provided.

IAS 31 'Interests in Joint Ventures'

IAS 31 requires that interests in joint ventures are recognised using proportionate consolidation or the alternative equity method of accounting. This is a change from the gross equity method required under UK GAAP.

The Group has elected to recognise its interests in joint ventures using the proportionate consolidation method whereby the Group's share of each of the assets, liabilities, income and expenses of its joint ventures is combined line by line with similar items in the Group's financial statements or reported as separate line items within the Group's financial statements.

Consequently, the presentation of information on joint ventures is now comprehensive.

There is no impact on profit for the year as a result of the change.

IFRS 3 'Business Combinations'

IFRS 3 prohibits the amortisation of goodwill. The goodwill amortisation charge under UK GAAP of £15.9m for the year ended 31 December 2004 has been reversed in the IFRS restated results.

IAS 38 'Intangible Assets'

Franchise assets which are identifiable non-monetary assets have been reclassified as intangible assets in accordance with IFRS requirements. The effect of this is to reclassify assets from goodwill to other intangible assets of £47.7m as at 1 January 2004 and £59.0m as at 31 December 2004. Net assets are not affected by this adjustment.

The amortisation charge relating to these franchise assets was £5.4m for the year ended 31 December 2004.

In addition where the Group has recognised its share of a defined benefit pension obligation that it will fund over the period of a contract or franchise, the liability recognised on transition to IFRS or at the beginning of the contract or franchise is treated as an intangible asset representing the rights to the future economic benefits of the contract or franchise.

IAS 19 'Employee Benefits: Pension scheme adjustments'

In accordance with IAS 19, the Group has recognised retirement benefit obligations in relation to defined benefit schemes. Where the Group takes on a contract and assumes the obligation to contribute variable amounts to the defined benefit scheme throughout the contract, and it is not virtually certain that these contributions will be recovered from the customer, the Group has recognised its proportionate share of the pension scheme obligations together with a corresponding amount as an intangible asset, representing the right to the future economic benefits of operating the contract or franchise over its life. Where it is virtually certain that pension contributions will be recovered, the Group has recognised a financial asset in trade and other receivables.

The Group has potential deferred tax assets in respect of the deficits on defined benefit pension schemes. Under IAS 12, these are recognised to the extent that it is probable that taxable profits will be available against which the deductible temporary difference can be utilised.

39. Transition to IFRS (continued)

These changes have resulted in the following adjustments to the balance sheet:

	As at 1 January 2004 £m	As at 31 December 2004 £m
Other intangible assets	4.1	15.5
Deferred tax asset	42.0	50.8
Trade and other receivables	12.1	20.0
Deferred tax liabilities	–	(4.0)
Retirement benefit obligation	(169.9)	(204.5)
Change in net assets	(111.7)	(122.2)

Under UK GAAP, the pension charge was included in cost of sales and administrative expenses. The IAS 19 pension charge includes a service cost which is included in cost of sales and administrative expenses, and interest on pension obligations net of the return on pension fund assets which is included in finance costs. The amortisation of intangible assets is included within other operating expenses. The net effect is to increase profit before tax by £0.4m for the year ended 31 December 2004.

IAS 19 'Employee Benefits: Employee benefit accruals and provisions'

IAS 19 requires that when employees provide a service to a company, the estimated amount that will be paid in exchange for those services should be recognised.

On transition to IFRS, the Group has recognised employee benefit accruals and provisions in respect of holiday pay, long-term disability benefits and long-term service award benefits. The adjustment on transition reflects a cumulative adjustment for the services provided by employees up to the date of transition. Following transition, the movement on these accruals and provisions reflects the current period service cost.

Arising from the recognition of these accruals and provisions, net of deferred tax, net assets have reduced by £16.0m as at 1 January 2004 and £17.5m as at 31 December 2004.

IAS 10 'Events After the Balance Sheet Date'

Under IAS 10, dividends declared after the balance sheet date are not recognised as a liability at the balance sheet date.

Dividends are recorded in the Group's consolidated financial statements in the period in which they are approved by the Group's shareholders.

The dividends proposed but not approved at the balance sheet date have been reversed from the financial statements. This has the effect of increasing the net assets of the Group by the amount of the proposed dividend of £7.0m as at 1 January 2004 and £8.3m as at 31 December 2004.

IFRS 2 'Share-based Payment'

IFRS 2 'Share-based Payment' requires the recognition of an expense in relation to all share-based payment such as the Group's share and share option schemes.

The Group issues equity-settled share-based payments to certain employees and operates an Inland Revenue approved Save As You Earn share option scheme open to eligible employees which allows the purchase of shares at a discount to the market value. These are measured at fair value at the date of grant.

The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares that will eventually vest.

Fair value is measured by use of the Black Scholes, Binomial or Monte Carlo Simulation models depending on the type of scheme.

Under UK GAAP, the Group's shares held in the ESOP trust were amortised within the ESOP reserve and charged to the profit and loss account. This charge has been reversed and replaced with the IFRS 2 charge.

The IFRS 2 charge for 2004 was £4.6m and after reversing the amortisation of shares held in the ESOP reserve of £1.2m, the net effect is to reduce profit before tax by £3.4m for the year ended 31 December 2004. A related deferred tax asset of £0.5m as at 1 January 2004 and £1.4m as at 31 December 2004 has been recognised and will be realised as and when share options vest and are exercised.

39. Transition to IFRS (continued)

IAS 12 'Income Taxes'

The income tax adjustments required under IAS 12 fall into two categories: Firstly, deferred tax that needs to be provided in respect of other IFRS restatement accounting adjustments (for example, pension scheme adjustments, employee benefits accruals, goodwill). Secondly, specific deferred tax adjustments that arise on the different recognition criteria of deferred tax balances between UK GAAP (FRS 19) and IFRS (IAS 12) (for example, share-based payment, PFI contracts and unremitted earnings from overseas subsidiaries, joint ventures and investments).

The most significant tax adjustments for the Group relate to the deferred tax treatment of pensions and PFI contracts. The Group has accounted for deferred tax assets in respect of the pension related assets and deficits (refer to the above note regarding pension scheme adjustments under IAS 19). The principles for the calculation of and recognition of deferred tax for PFI contract companies under IAS 12 are different to those applied under FRS 19. Specifically, IAS 12 requires that whenever a PFI debtor is acquired as a business combination, deferred tax needs to be provided upon recognition of that debtor for all future tax that will become payable as the debtor is recovered. For the Group, this has resulted in additional deferred tax liabilities being recognised at the date of transition. In addition, IAS 12 further requires that whenever a PFI debtor is recognised but not by way of a business combination, deferred tax is only recognised as the debtor is recovered – no additional deferred tax is recognised on transition and this therefore leads to smaller deferred tax liabilities in early periods of the contract with an increasing effective tax rate over the project life. As a result of the change in accounting for deferred tax on PFI debtors, the tax charge has reduced by £2.5m for the year ended 31 December 2004. The additional deferred tax in the balance sheet has led to a reduction in net assets of £17.6m as at 1 January 2004 and £18.7m as at 31 December 2004.

IAS 39 'Financial Instruments: Recognition and Measurement'

The Group adopted IAS 39 on 1 January 2005; the standard therefore had no effect on the Group's financial statements prior to that date. Adoption of IAS 39 resulted in a £27.1m reduction in opening net assets (£37.9m net of a tax credit of £10.8m) on 1 January 2005. This represents the net effect of marking to market the interest rate swaps, cross-currency swaps and other derivatives held by the Group. The effect on opening net assets has been reflected in reserves. These derivatives are mainly held to convert the floating rate interest obligations of PFI Special Purpose Companies into fixed rate obligations, and to hedge the Group's obligations under its long term loan notes.

39. Transition to IFRS (continued)

39(a) Reconciliation of equity at 1 January 2004

This table highlights the financial impact of the key IFRS adjustments on the consolidated balance sheet at 1 January 2004.

	UK GAAP	IAS 31 Interest in joint ventures	IAS 38 Intangible assets	IAS 19 Employee benefits - pensions	IAS 19 Employee benefits - other	IAS 10 Dividends	IFRS 2 Share-based payment	IAS 12 Income taxes	Other	IFRS
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Non-current assets										
Goodwill	221.9	5.2	(47.7)	–	–	–	–	–	0.4	179.8
Other intangible assets	1.1	–	47.7	4.1	–	–	–	–	2.4	55.3
Property, plant and equipment	77.3	15.1	–	–	–	–	–	–	1.7	94.1
Investment in joint ventures	24.9	(24.9)	–	–	–	–	–	–	–	–
Trade and other receivables	395.9	61.2	–	42.7	–	–	–	–	(2.0)	497.8
Deferred tax assets	1.7	–	–	42.0	5.5	–	0.5	4.7	0.3	54.7
	722.8	56.6	–	88.8	5.5	–	0.5	4.7	2.8	881.7
Current assets										
Inventories	39.5	3.0	–	–	–	–	–	–	–	42.5
Trade and other receivables	299.3	50.2	–	(30.6)	–	–	–	–	(1.2)	317.7
Cash and cash equivalents	170.9	13.7	–	–	–	–	–	–	–	184.6
	509.7	66.9	–	(30.6)	–	–	–	–	(1.2)	544.8
Current liabilities										
Trade and other payables	(338.7)	(36.9)	–	–	(15.4)	–	–	–	0.6	(390.4)
Current tax liabilities	1.7	(3.4)	–	–	–	–	–	–	–	(1.7)
Obligations under finance leases	(5.9)	(1.3)	–	–	–	–	–	–	(0.5)	(7.7)
Loans	(4.5)	(11.0)	–	–	–	–	–	–	–	(15.5)
Proposed dividend	(7.0)	–	–	–	–	7.0	–	–	–	–
	(354.4)	(52.6)	–	–	(15.4)	7.0	–	–	0.1	(415.3)
Non-current liabilities										
Trade and other payables	–	–	–	–	–	–	–	–	(3.0)	(3.0)
Obligations under finance leases	(17.5)	(5.5)	–	–	–	–	–	–	(1.2)	(24.2)
Loans	(522.2)	(54.6)	–	–	–	–	–	–	–	(576.8)
Retirement benefit obligations	(29.7)	(1.6)	–	(169.9)	–	–	–	–	2.6	(198.6)
Provisions	–	–	–	–	(6.0)	–	–	–	–	(6.0)
Deferred tax liabilities	(27.9)	(8.6)	–	–	(0.1)	–	–	(22.3)	–	(58.9)
	(597.3)	(70.3)	–	(169.9)	(6.1)	–	–	(22.3)	(1.6)	(867.5)
Net assets	280.8	0.6	–	(111.7)	(16.0)	7.0	0.5	(17.6)	0.1	143.7
Equity										
Share capital	8.7	–	–	–	–	–	–	–	–	8.7
Share premium account	190.8	–	–	–	–	–	–	–	–	190.8
Capital redemption reserve	0.1	–	–	–	–	–	–	–	–	0.1
Retained earnings	98.1	–	–	1.9	(16.0)	7.0	(1.2)	(17.6)	(0.6)	71.6
Share-based payment reserve	–	–	–	–	–	–	1.7	–	–	1.7
Retirement benefit obligations reserve	–	–	–	(113.6)	–	–	–	–	–	(113.6)
Own shares reserve	(16.9)	–	–	–	–	–	–	–	–	(16.9)
Hedging and translation reserve	–	–	–	–	–	–	–	–	0.7	0.7
Equity attributable to equity holders of the parent	280.8	–	–	(111.7)	(16.0)	7.0	0.5	(17.6)	0.1	143.1
Minority interest	–	0.6	–	–	–	–	–	–	–	0.6
Total equity	280.8	0.6	–	(111.7)	(16.0)	7.0	0.5	(17.6)	0.1	143.7

39. Transition to IFRS (continued)

39(b) Reconciliation of the income statement for the year ended 31 December 2004

This table highlights the financial impact of the key IFRS adjustments on the consolidated income statement for the year ended 31 December 2004.

	UK GAAP £m	IAS 31 Interest in joint ventures £m	IFRS3 Business combinations £m	IAS 38 Intangible assets £m	IAS 19 Employee benefits - pensions £m	IFRS 2 Share-based payment £m	IAS 12 Income taxes £m	Other £m	IFRS £m
Revenue	1,381.4	255.5	–	–	–	–	–	–	1,636.9
Cost of sales	(1,190.5)	(207.1)	–	–	3.9	–	–	(0.6)	(1,394.3)
Gross profit	190.9	48.4	–	–	3.9	–	–	(0.6)	242.6
Administrative expenses	(139.7)	(23.0)	–	–	0.2	(3.4)	–	(0.3)	(166.2)
Other expenses – amortisation of intangibles	(16.5)	–	15.9	(5.4)	(1.2)	–	–	–	(7.2)
Total administrative expenses	(156.2)	(23.0)	15.9	(5.4)	(1.0)	(3.4)	–	(0.3)	(173.4)
Operating profit	34.7	25.4	15.9	(5.4)	2.9	(3.4)	–	(0.9)	69.2
Joint venture operating profit	25.4	(25.4)	–	–	–	–	–	–	–
Investment revenue	35.3	*–	–	–	–	–	–	–	35.3
Finance costs	(38.0)	*–	–	–	(2.5)	–	–	–	(40.5)
Profit before tax	57.4	–	15.9	(5.4)	0.4	(3.4)	–	(0.9)	64.0
Tax	(20.4)	*–	(1.5)	–	(0.2)	0.9	2.5	(0.8)	(19.5)
Profit for the year	37.0	–	14.4	(5.4)	0.2	(2.5)	2.5	(1.7)	44.5
Attributable to:									
Equity holders of the parent	36.0	–	14.4	(5.4)	0.2	(2.5)	2.5	(1.7)	43.5
Minority interest	1.0	–	–	–	–	–	–	–	1.0

Earnings per share (EPS)	UK GAAP	IFRS
Basic EPS	8.37p	10.11p
Diluted EPS	8.27p	9.99p

*UK GAAP values include the Group's share of joint venture investment income, finance costs and tax.

39. Transition to IFRS (continued)

39(c) Reconciliation of equity at 31 December 2004

This table highlights the financial impact of the key IFRS adjustments on the consolidated balance sheet at 31 December 2004.

	UK GAAP £m	IAS 31 Interest in joint ventures £m	IFRS 3 Business combinations £m	IAS 38 Intangible assets £m	IAS 19 Employee benefits - pensions £m	IAS 19 Employee benefits - other £m	IAS 10 Dividends £m	IFRS 2 Share-based payment £m	IAS 12 Income taxes £m	Other £m	IFRS £m
Non-current assets											
Goodwill	208.2	11.4	15.9	(59.0)	–	–	–	–	–	0.9	177.4
Other intangible assets	7.0	–	–	53.6	15.5	–	–	–	–	(1.1)	75.0
Property, plant and equipment	79.5	16.0	–	–	–	–	–	–	–	0.7	96.2
Investment in joint ventures	27.2	(27.2)	–	–	–	–	–	–	–	–	–
Investments	13.7	–	–	–	–	–	–	–	–	–	13.7
Trade and other receivables	296.9	62.6	–	–	32.3	–	–	–	–	(1.2)	390.6
Deferred tax assets	–	1.3	–	–	50.8	5.4	–	1.4	(12.2)	3.4	50.1
	632.5	64.1	15.9	(5.4)	98.6	5.4	–	1.4	(12.2)	2.7	803.0
Current assets											
Inventories	23.0	3.9	–	–	–	–	–	–	–	–	26.9
Trade and other receivables	343.0	56.7	–	–	(12.3)	–	–	–	–	2.7	390.1
Cash and cash equivalents	173.9	27.2	–	–	–	–	–	–	–	(0.6)	200.5
	539.9	87.8	–	–	(12.3)	–	–	–	–	2.1	617.5
Current liabilities											
Trade and other payables	(352.2)	(47.4)	–	–	–	(16.9)	–	–	–	(0.5)	(417.0)
Retirement benefit obligation	(0.4)	–	–	–	0.4	–	–	–	–	–	–
Current tax liabilities	–	(3.9)	–	–	–	–	–	–	–	(1.9)	(5.8)
Obligations under finance leases	(6.5)	(1.3)	–	–	–	–	–	–	–	(0.3)	(8.1)
Loans	(23.5)	(22.6)	–	–	–	–	–	–	–	(0.3)	(46.4)
Proposed dividend	(8.3)	–	–	–	–	–	8.3	–	–	–	–
	(390.9)	(75.2)	–	–	0.4	(16.9)	8.3	–	–	(3.0)	(477.3)
Non-current liabilities											
Trade and other payables	–	(1.1)	–	–	–	–	–	–	–	0.5	(0.6)
Obligations under finance leases	(13.6)	(4.2)	–	–	–	–	–	–	–	(0.4)	(18.2)
Loans	(401.5)	(50.1)	–	–	–	–	–	–	–	0.3	(451.3)
Retirement benefit obligations	(29.8)	(9.2)	–	–	(204.9)	–	–	–	–	1.0	(242.9)
Provisions	–	–	–	–	–	(6.0)	–	–	–	–	(6.0)
Deferred tax liabilities	(32.2)	(10.4)	(1.5)	–	(4.0)	–	–	–	(6.5)	(0.4)	(55.0)
	(477.1)	(75.0)	(1.5)	–	(208.9)	(6.0)	–	–	(6.5)	1.0	(774.0)
Net assets	304.4	1.7	14.4	(5.4)	(122.2)	(17.5)	8.3	1.4	(18.7)	2.8	169.2
Equity											
Share capital	8.7	–	–	–	–	–	–	–	–	–	8.7
Share premium account	191.5	–	–	–	–	–	–	–	–	–	191.5
Capital redemption reserve	0.1	–	–	–	–	–	–	–	–	–	0.1
Retained earnings	122.6	–	14.4	(5.4)	2.2	(17.5)	8.3	(4.2)	(18.7)	2.7	104.4
Share-based payment reserve	–	–	–	–	–	–	–	6.2	–	–	6.2
Retirement benefit obligations reserve	–	–	–	–	(124.4)	–	–	–	–	–	(124.4)
Own shares reserve	(15.8)	–	–	–	–	–	–	(0.6)	–	–	(16.4)
Hedging and translation reserve	(2.7)	–	–	–	–	–	–	–	–	0.1	(2.6)
Equity attributable to equity holders of the parent	304.4	–	14.4	(5.4)	(122.2)	(17.5)	8.3	1.4	(18.7)	2.8	167.5
Minority interest	–	1.7	–	–	–	–	–	–	–	–	1.7
Total equity	304.4	1.7	14.4	(5.4)	(122.2)	(17.5)	8.3	1.4	(18.7)	2.8	169.2

UK GAAP directors' responsibilities – Serco Group plc – company

Directors' responsibilities

Company Law requires the Directors to prepare Accounts and Notes for each financial year, which give a true and fair view of the state of affairs of the Company as at the end of the financial year and of the profit and loss of the Company for that period. In preparing those Accounts and Notes the Directors are required to:

• Select suitable accounting policies and apply them consistently;
• Make judgements and estimates that are reasonable and prudent; and
• State whether applicable accounting standards have been followed.

The Directors are responsible for ensuring proper accounting records are kept which disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the Accounts and Notes comply with the Companies Act 1985. They are also responsible for the Company's system of internal control, for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

Joanne Roberts
Secretary

Serco House
16 Bartley Wood Business Park
Bartley Way
Hook
Hampshire
RG27 9UY

1 March 2006

Independent Auditors' Report to the Members of Serco Group plc

We have audited the individual company financial statements of Serco Group plc for the year ended 31 December 2005 which comprise the balance sheet and the related notes 1 to 18. These individual company financial statements have been prepared under the accounting policies set out therein.

The corporate governance statement and the directors' remuneration report are included in the group annual report of Serco Group plc for the year ended 31 December 2005. We have reported separately on the group financial statements of Serco Group plc for the year ended 31 December 2005 and on the information in the directors' remuneration report that is described as having been audited.

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

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the annual report and the individual company financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities.

Our responsibility is to audit the individual company financial statements in accordance with relevant United Kingdom legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the individual company financial statements give a true and fair view in accordance with the relevant financial reporting framework and whether the individual company financial statements have been properly prepared in accordance with the Companies Act 1985. We report to you if, in our opinion, the directors' report is not consistent with the individual company financial statements. We also report to you 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 other transactions is not disclosed.

We read the directors' report and the other information contained in the annual report for the above year as described in the contents section and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the individual company financial statements.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the individual company financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the individual company financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion:

- the individual company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 2005; and

- the individual company financial statements have been properly prepared in accordance with the Companies Act 1985.

Deloitte & Touche LLP
Chartered Accountants and Registered Auditors
London

1 March 2006

Company balance sheet

at 31 December 2005

	Note	2005 £m	2004 £m
Fixed Assets			
Intangible assets	3	**10.9**	–
Tangible assets	4	**4.5**	3.9
Investments in subsidiary undertakings	5	**748.2**	453.3
Other investments	5	**–**	13.7
		763.6	470.9
Current Assets			
Stock	6	**–**	0.1
Amounts owed by subsidiary companies due after more than one year		**16.0**	12.4
Debtors: Amounts due within one year	7	**50.5**	28.4
Debtors: Amounts due after more than one year	7	**7.4**	1.5
Cash at bank and in hand		**21.1**	84.7
		95.0	127.1
Creditors: Amounts falling due within one year			
Bank loans and overdrafts		**–**	(105.4)
Trade creditors		**(0.6)**	(0.9)
Other creditors including tax and social security	8	**(6.2)**	(7.1)
Financial instruments	10	**(0.5)**	–
Accruals and deferred income		**(17.0)**	(12.0)
		(24.3)	(125.4)
Net current assets		**70.7**	1.7
Total assets less current liabilities		**834.3**	472.6
Creditors: Amounts falling due after more than one year	9	**(440.3)**	(160.6)
Financial instruments	10	**(10.5)**	–
Provisions for liabilities and charges	11	**–**	(0.2)
Net Assets		**383.5**	311.8
Capital and reserves			
Called up share capital	12	**9.4**	8.7
Share premium account	13	**269.5**	191.5
Capital redemption reserve		**0.1**	0.1
Share-based payment reserve	14	**15.5**	6.2
Hedging and translation reserve	15	**(6.0)**	–
Profit and loss account	16	**95.0**	105.3
Equity shareholders' funds		**383.5**	311.8

The financial statements were approved by the Board of Directors on 1 March 2006 and signed on behalf of the Board by:

Kevin Beeston
Executive Chairman

Andrew Jenner
Finance Director

Notes to the company financial statements

1. Accounting policies

The principal accounting policies adopted are shown below.

Basis of accounting

These financial statements have been prepared in accordance with UK GAAP and applicable UK law.

Accounting convention

These accounts have been prepared under the historical cost convention.

Prior year comparatives

The Company has restated the prior year comparatives in accordance with the revisions to UK GAAP under FRS 20 'Share-based payment' and FRS 21 'Post balance sheet events'.

Fixed asset investments

Investments held as fixed assets are stated at cost less provision for any impairment in value.

Tangible fixed assets

Tangible fixed assets are stated at cost or valuation, net of depreciation and any provision for impairment.

Depreciation

Depreciation is provided on a straight-line basis at rates which, in the opinion of the Directors, reduce the assets to their residual value over their estimated useful lives.

The principal annual rates used are:

Short leasehold building improvements	the higher of 10% or rate produced by lease term
Machinery	15% – 20%
Furniture	10%
Office equipment	20% – 33%

Share-based payment

The Group has applied the requirements of FRS 20 'Share-based payment'. In accordance with the transitional provisions, FRS 20 has been applied to all grants of equity instruments after 7 November 2002 that were not fully vested as of 1 January 2005.

The Group issues equity-settled share-based payments to certain employees and operates an Inland Revenue approved Save As You Earn share option scheme open to eligible employees which allows the purchase of shares at a discount. These are measured at fair value at the date of grant. The fair value is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares that will eventually vest.

Fair value is measured by use of the Black Scholes, Binomial or Monte Carlo Simulation models depending on the type of scheme. The expected life used in the models has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioural considerations. Where relevant, the value of the option has also been adjusted to take account of market conditions applicable to the option.

Derivative financial instruments and hedging activities

The Company has adopted FRS 26 'Financial instruments: Measurement' with effect from 1 January 2005.

Derivatives are initially accounted for and measured at fair value on the date a derivative contract is entered into and subsequently measured at fair value. The gain or loss on re-measurement is taken to the profit and loss account except where the derivative is a designated cash flow hedging instrument. The accounting treatment of derivatives classified as hedges depends on their designation, which occurs on the date that the derivative contract is committed to. The Company designates derivatives as:

- a hedge of the fair value of an asset or liability (fair value hedge)
- a hedge of the income/cost of a highly probable forecast transaction or commitment (cash flow hedge)
- a hedge of net investment in a foreign entity

Gains and losses on fair value are recorded in the profit and loss account with the gain or loss on the hedged item attributable to the hedged risk.

1. Accounting policies (continued)

Gains or losses on cash flow hedges that are regarded as highly effective are recognised in equity. Where the forecast transaction results in a financial asset or liability only gains or losses previously recognised in equity are reclassified to profit or loss in the same period as the asset or liability affects profit or loss. Where the forecast transaction or commitment results in a non-financial asset or liability, any gains or losses previously deferred in equity are included in the cost of the related asset or liability if the forecast transaction or commitment results in future income or expenditure. Gains and losses deferred in equity are transferred to the profit and loss account in the same period as the underlying income or expenditure. The ineffective portion of the gain or loss on the hedging instrument is recognised in the profit and loss account.

For the ineffective portion of hedges or transactions that are not designated for hedge accounting under FRS 26, any change in assets or liabilities is recognised immediately in the profit and loss account. Where a hedge no longer meets the effectiveness criteria, any gains or losses deferred in equity are only transferred to the profit and loss account when the committed or forecast transaction is recognised in the profit and loss account. However, where cash flow hedge accounting has been applied for a forecast or committed transaction that is no longer expected to occur, then the cumulative gain or loss that has been recorded in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the profit and loss account.

Where the Company hedges net investments in foreign entities through currency borrowings, the gains or losses on the translation of the borrowings are recognised in equity. Gains and losses accumulated in equity are included in the profit and loss account when the foreign operation is disposed of.

Current tax

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

Deferred tax

The charge for tax takes account of taxation deferred because of differences between the timing of recognition of certain items for taxation purposes and for accounting purposes. Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where the transactions or events that give rise to an obligation to pay more or less tax in the future have occurred by the balance sheet date. A deferred tax asset is recognised only when it is considered more likely than not that it will be recovered.

Deferred tax is recognised on a non-discounted basis using tax rates in force at the balance sheet date.

2. Auditors' remuneration

Auditors' remuneration and other charges from Deloitte & Touche LLP are borne by another group company.

3. Intangible assets

	Software and development expenditure £m
Cost	
At 1 January 2005	–
Additions	**10.9**
At 31 December 2005	**10.9**
Accumulated amortisation	
At 1 January and 31 December 2005	–
Net book value	
At 31 December 2005	**10.9**
At 31 December 2004	–

4. Tangible assets

	Short leasehold building improvements £m	Machinery furniture and equipment £m	Total £m
Cost			
At 1 January 2005	**1.0**	**5.5**	**6.5**
Additions	**0.8**	**0.7**	**1.5**
Disposals	**(0.8)**	–	**(0.8)**
At 31 December 2005	**1.0**	**6.2**	**7.2**
Accumulated depreciation			
At 1 January 2005	**0.2**	**2.4**	**2.6**
Charged for the year	**0.1**	**0.2**	**0.3**
Disposals	**(0.1)**	**(0.1)**	**(0.2)**
At 31 December 2005	**0.2**	**2.5**	**2.7**
Net book value			
At 31 December 2005	**0.8**	**3.7**	**4.5**
At 31 December 2004	0.8	3.1	3.9

The cost of assets held by the Company under finance leases at 31 December 2005 was £0.8m (2004: £0.8m). The accumulated depreciation provided for those assets at 31 December 2005 was £nil (2004: £0.1m).

5. Investments in subsidiary undertakings

	£m
Shares in subsidiary companies at cost:	
At 1 January 2005	**453.3**
Increase in investments in Group companies	**294.9**
At 31 December 2005	**748.2**

At 31 December 2004, other investments of £13.7m represented listed UK equity investments of 4,254,542 ordinary shares of 10p each in ITNET plc. On 3 February 2005, the Company completed the purchase of all remaining shares in ITNET plc, making ITNET plc a 100% owned subsidiary of the Company.

Notes to the financial statements

6. Stock

	2005 £m	2004 £m
Long-term project-based contract balances	–	0.1

7. Debtors

	2005 £m	2004 £m
a) Amounts due within one year:		
Amounts recoverable on contracts	**0.1**	0.1
Amounts owed by subsidiary companies	**13.5**	–
Other debtors	**10.1**	13.3
Financial instruments (see note 10)	**0.5**	–
Corporation tax recoverable	**26.3**	15.0
	50.5	28.4
b) Amounts due after more than one year:		
Other debtors	**1.5**	1.5
Deferred tax asset	**5.9**	–
	7.4	1.5
	57.9	29.9

8. Other creditors including taxation and social security

	2005 £m	2004 £m
Obligations under finance leases	**0.3**	0.2
Other creditors	**0.8**	0.2
Amounts owed to joint ventures	**5.1**	6.7
	6.2	7.1

9. Creditors: Amounts falling due after more than one year

	2005 £m	2004 £m
a) Obligations under finance leases	**0.8**	0.5
Other loans	**439.8**	160.2
	440.6	160.7
Less: amounts included in creditors falling due within one year	**(0.3)**	(0.1)
Amounts falling due after more than one year	**440.3**	160.6
b) Analysis of loan repayments due:		
Obligations under finance leases:		
Within one year or on demand	**0.3**	0.1
Between one and two years	**0.5**	0.4
Other loans:		
Between one and two years	**42.7**	–
Between two and five years	**279.4**	43.0
After five years	**117.7**	117.2
	440.6	160.7

10. Financial instruments

	Assets 2005 £m	Liabilities 2005 £m	Assets 2004 £m	Liabilities 2004 £m
Currency swaps	–	4.7	–	9.0
Forward foreign exchange contracts	0.5	6.3	–	8.7
	0.5	11.0	–	17.7
Analysed as:				
Non-current	–	10.5	–	16.7
Current	0.5	0.5	–	1.0

The Company has adopted FRS 26 from 1 January 2005 and has taken advantage of the exemption provided under FRS 25 not to restate 2004 comparatives. The 2004 comparatives are for information only.

The Company holds derivative financial instruments in accordance with the Group's policy in relation to its financial risk management. Details of the disclosures are set out in note 26 of the Group's consolidated financial statements.

11. Provisions for liabilities and charges

	At 1 January 2005 £m	Utilised £m	Charged to the profit and loss account £m	Foreign exchange differences £m	At 31 December 2005 £m
Deferred tax	0.2	–	(0.2)	–	–

	2005 £m	2004 £m
The amounts of deferred tax provided in the accounts are:		
Tax allowances in excess of depreciation	–	(0.2)
Other timing differences	–	0.4
	–	0.2

12. Called up share capital

	2005		2004	
	£m	Number millions	£m	Number millions
Authorised:				
550,000,000 (2004: 550,000,000) ordinary shares of 2p each	11.0	550.0	11.0	550.0
Issued and fully paid:				
435,352,903 (2004: 434,880,837) ordinary shares of 2p each at 1 January	8.7	435.4	8.7	434.9
Issued as consideration for acquisitions during the year	0.6	30.3	-	-
Issued on the exercise of share options	0.1	2.5	-	0.5
468,231,512 (2004: 435,352,903) ordinary shares of 2p each at 31 December	9.4	468.2	8.7	435.4

The Company has one class of ordinary shares which carry no right to fixed income.

During the year 2,522,336 ordinary shares of 2p each were allotted to the holders of options or their personal representatives using newly listed shares.

13. Share premium account

	£m
At 1 January 2005	191.5
Premium on shares issued	78.0
At 31 December 2005	269.5

14. Share-based payment reserve

	2005 £m	2004 restated £m
At 1 January	**6.2**	–
Transfer from profit and loss account – prior year adjustment	–	1.6
Restated at 1 January	**6.2**	1.6
Charged in the period	**5.7**	3.4
Transfer from ESOP trust	–	1.2
Tax on items taken directly to equity	**3.6**	-
At 31 December	**15.5**	6.2

Details of the share-base payment disclosures are set out in note 35 of the Group's consolidated financial statements.

15. Hedging and translation reserve

	2005 £m	2004 £m
At 1 January	–	–
Fair value loss on cash flow hedges on adoption of FRS 25 and FRS 26	**(14.5)**	–
Restated at 1 January	**(14.5)**	–
Fair value gain on cash flow hedges during the period	**5.9**	–
Tax credit on items taken directly to equity	**2.6**	–
At 31 December	**(6.0)**	–

16. Profit and loss account

	2005 £m	2004 restated £m
At 1 January	**105.3**	86.5
Transfer to share-based payment reserve - prior year adjustment	–	(1.6)
As restated	**105.3**	84.9
Fair value loss on fair value hedges on adoption of FRS 25 & FRS 26	**(1.8)**	–
As restated	**103.5**	84.9
Equity dividends	–	7.0
Restated at 1 January	**103.5**	91.9
Profit for the year	**4.0**	23.8
Equity dividends	**(12.5)**	(10.4)
At 31 December	**95.0**	105.3

As permitted by Section 230 of the Companies Act 1985, the profit and loss account of the Company is not presented as part of these accounts.

17. Contingent liabilities

The Company has provided certain financial guarantees and indemnities in respect of the loans, overdraft and bonding facilities, and other financial commitments of its subsidiaries. The total commitment outstanding at 31 December 2005 was £20.6m (2004: £7.1m).

The Company has also guaranteed overdrafts, finance leases, and bonding facilities of its joint ventures up to a maximum value of £4.1m (2004: £5.9m). The actual commitment outstanding at 31 December 2005 was £0.2m (2004: £1.3m).

In addition to this, the Company has provided performance guarantees and indemnities relating to performance bonds and letters of credit issued by its banks on its behalf, in the ordinary course of business. These are not expected to result in any material financial loss.

18. Related parties

The Directors of Serco Group plc had no material transactions with the Company or its subsidiaries during the year other than service contracts and Directors' liability insurance. Details of the Directors' remuneration are disclosed in the Remuneration Report for the Group.

Investor information

Registrars

Computershare Investor Services maintains our register of members and makes dividend payments to our shareholders. Please direct any correspondence about your holding – including change of address and dividend mandate instructions – to Computershare at this address.

Computershare Investor Services PLC
PO Box 82
The Pavilions
Bridgwater Road
Bristol BS99 7NH

Computershare's shareholder website is at www.computershare.com. A dedicated shareholder services helpline is available on
Tel: +44 (0) 870 873 5839.
The helpline is open during working hours (UK time) if you have any questions about your holding in the company.

Shares in issue

At 31 December 2005 there were 468,231,512 Serco Group plc Ordinary 2p Shares in issue.

Dividend mandate

Dividends can be paid directly into your bank or building society account. To take advantage of this facility, please complete the dividend mandate form attached to your dividend cheque or contact Computershare by phone, fax or post.

The form is also available from the Computershare website.

Dividend re-investment plan

The Serco Dividend Re-investment Plan (DRIP) gives shareholders the chance to re-invest their dividends in Serco shares instead of receiving cash.

If you participate in the DRIP, your cash dividend will be paid directly to Computershare, who will calculate the number of shares to which you are entitled and buy them on the stock market. Because participants' share purchases are aggregated, the dealing costs are relatively low.

To register, simply complete a form and send it to the registrar. For further information about the DRIP please contact Computershare directly on the number provided above, or alternatively look under the home page section on the Computershare website.

Electronic mailing

Where the law allows, you can now choose not to receive a paper copy of the documentation we send out. Instead we can send you an email notification every time a new shareholder document is posted on our website. This will include the annual and interim reports and other shareholder communications. You can then view the document(s) on our website at www.serco.com.

To receive documents electronically you will need to register on line on the Computershare website. This is a secure, straightforward online service operated free of charge by Computershare.

Postal share dealing services

Serco has arranged with Cazenove & Co a simple, low-cost method of buying and selling its shares by post. Shares are bought and sold on the day Cazenove receives the instruction. For a dealing form, please contact the postal dealing department at Cazenove.

Cazenove & Co. Ltd
Share Dealing Service
20 Moorgate
London EC2R 6DA
United Kingdom

Tel: +44 (0) 20 7155 5155

The terms and conditions for this service are shown on the last page of the form.

Unsolicited mail

We are legally obliged, whenever requested, to provide copies of our shareholder register to any third parties, so from time to time you may receive unsolicited mail. You can limit the amount of unsolicited mail you receive by contacting:

The Mailing Preference Service
Freepost 22
London W1E 7EZ
United Kingdom

Financial calendar

8 March 2006	Ex dividend date
10 March 2006	Record date
31 March 2006	Accounts published
25 April 2006	Last day for DRIP election
5 May 2006	Annual General Meeting
17 May 2006	Proposed payment of final dividend
August 2006	Proposed announcement of interim results
October 2006	Proposed payment of interim dividend