Part IV. Operating and Financial Review and Prospects

The following is a discussion of Halfords' results of operations and financial condition for the 2004 financial year, the 2003 financial year and the 2002 financial year. Prospective investors should read the following discussion, together with the whole of this document, including Investment Considerations, the Group's historical consolidated financial statements and the related notes included in Part V (Accountants' Report on the Group) and Part VI (Pro Forma Statement of Net Assets of the Group) and should not just rely on the key or summarised information contained in this Part IV (Operating and Financial Review and Prospects). The Group's historical consolidated financial statements were prepared in accordance with UK GAAP, which differs from IFRS and US GAAP in a number of significant respects. For a summary of the material differences between UK GAAP, IFRS and US GAAP relevant to the historical consolidated financial statements, see paragraphs 14 (Summary of Significant Differences Between UK GAAP and IFRS) and 15 (Summary of Significant Differences Between UK GAAP and US GAAP) below. The financial information in this Part IV (Operating and Financial Review and Prospects) has been extracted without material adjustment from Part V (Accountants' Report on the Group), Part VI (Pro Forma Statement of Net Assets of the Group) or has been extracted without material adjustment from Halfords' accounting records which formed the underlying basis of the Accountants' Report.

This section contains "forward-looking statements". Those statements are subject to risks, uncertainties and other factors that could cause Halfords' future results of operations or cash flows to differ materially from the results of operations or cash flows expressed or implied in such forward-looking statements.

1. OVERVIEW

Halfords is the UK's leading retailer, on the basis of turnover in each of the four product markets in which it operates, being car maintenance products, car enhancement products, travel solutions products and cycling products.

Halfords' national store portfolio, comprising 387 stores across the UK as at 2 April 2004, represented a total of approximately 2.9 million sq. ft. of selling space. Of these stores, 343 (representing approximately 2.8 million sq. ft. of selling space) were out-of-town superstores and 44 (representing approximately 0.1 million sq. ft. of selling space) were small stores located in high streets and other urban locations.

In August 2002, Halfords Limited was acquired by the Company in a leveraged buy-out backed by the CVC Shareholders. Since the CVC Acquisition, Halfords' new management team has undertaken key strategic initiatives which have significantly improved the operating and financial performance of the business. Halfords achieved a significant increase in turnover in the 2004 financial year primarily through a shift in marketing focus which included greater emphasis on price and promotional activity, expansion into new product areas, and service differentiation. The management team also refined the Arcade format by extracting and implementing the most successful elements of the original Arcade format in a more cost effective manner, known internally as SMART Arcade. Operating profit also benefited from streamlining head office and operational structures and reducing headcount, as well as from improving purchase price and payment terms across key areas of expenditure.

2. CURRENT TRADING AND PROSPECTS

Since the end of the 2004 financial year, Halfords has opened four stores, comprising two superstores, each with supermezzanines, and two small stores. It has also completed the conversion of three superstores in the SMART Arcade format.

For the four week period from 3 April 2004 to 30 April 2004, unaudited turnover was 10.6 per cent. ahead of the equivalent period in the 2004 financial year and was ahead of the Directors' expectations. The Group has continued to progress its strategic priorities through both the conversion of existing stores to the SMART Arcade format and the opening of new stores in this format, increased Far East sourcing and the development of key areas of

infrastructure. Overall the outlook for the Group's trading for the full financial year remains in line with the Directors' expectations and the Directors are confident of the Group's prospects for the current financial year.

3. DIVIDEND POLICY

The Directors intend to adopt a progressive dividend policy, which will reflect the long-term earnings and cash flow potential of the Group, whilst maintaining an appropriate level of dividend cover. The Directors intend to follow a policy which, in the absence of unforeseen circumstances and assuming that there are sufficient distributable reserves available at the time, targets paying approximately half of the annual reported Group net income (before goodwill amortisation) in the form of dividends to holders of Ordinary Shares.

It is envisaged that the Company will pay an interim dividend in January and a final dividend in July of each year. Assuming that there are sufficient distributable reserves available at the time, the first dividend to be declared by the Company following the Global Offer is expected to be the interim dividend in respect of the 26 weeks ending 1 October 2004, which will be payable in January 2005 to shareholders on the register in October 2004, reflecting the capital structure and dividend policy of the Group following Admission.

4. SIGNIFICANT FACTORS AFFECTING HISTORIC RESULTS OF OPERATIONS

Improved marketing and trading

During the 2004 financial year, Halfords' management implemented a number of marketing and trading initiatives aimed at increasing the number of products purchased by customers in each shop visit. These initiatives included a significantly increased emphasis on promotional pricing activity to increase store visits, the expansion of the product offering, particularly into contiguous product areas, and the more dynamic use of space at the front of each store to highlight products which are being specifically promoted. In addition, during the 2004 financial year Halfords widened staff participation in sales-based incentives and implemented additional targeted sales incentives during peak trading periods. These initiatives resulted in significantly improved like-for-like sales growth in the 2004 financial year.

Effect of Arcade conversions

Halfords created the Arcade format in the 2001 financial year to refresh its out-of-town superstores by expanding existing ranges and introducing new ranges; creating designated sub-shops under the "Ripspeed" and "Bikehut" brands for the car enhancement and cycling product offerings, respectively; introducing an enlarged area dedicated to in-car entertainment products; introducing specialist staff to provide customers with enhanced product knowledge, customer service and service provision (e.g. cycle repair); and enhancing in-store layout, complemented by orange and black Halfords signage. As part of the conversion of its out-of-town superstores, and depending on the size of the store, turnover and demographic catchment, Halfords added a mezzanine floor, which has resulted in a significant increase in selling space. In the 2002 financial year, Halfords converted an additional 41 superstores to the Arcade format and added approximately 58,000 sq. ft. of selling space through the addition of mezzanine floors in 26 of these stores.

Following the CVC Acquisition in August 2002, the Group introduced a revised version of the Arcade format, known as SMART Arcade, which was designed to deliver the principal sales generating elements of the original Arcade format at significantly reduced capital expenditure. In addition, Halfords expanded the mezzanine concept to a larger supermezzanine floor (including the extension of existing mezzanine floors to the supermezzanine size). In the 2003 financial year, Halfords converted 44 superstores to the Arcade format, and added approximately 39,000 sq. ft. of selling space by adding mezzanine floors in 18 of these stores. In the 2004 financial year, Halfords converted 70 superstores to the Arcade format (all of which were the SMART Arcade format), and added approximately

21,000 sq. ft. of selling space by adding supermezzanine floors in five of these stores and three supermezzanine extensions in existing Arcade format superstores.

The introduction of the Arcade format and the increases in selling space associated with the installation of mezzanine and supermezzanine floors have resulted in significant sales uplifts at the relevant stores, as compared to sales prior to the store conversion. The aggregate effect of the individual store sales uplifts has been an important factor affecting the Group's turnover growth in all periods under review.

Effect of new stores

The Group's results were impacted in each period under review by the introduction of new stores.

Set out below is a breakdown of Halfords stores at the period end for each of the periods under review:

	2002 financial year	**2003 financial year**	**2004 financial year**
Out-of-town superstores	331	336	343
Small stores	58	50	44
Motorway stores	12	12	10[1]

(1) These motorway stores ceased trading in March 2004

Prior to the CVC Acquisition, Halfords' strategy focused on the development of out-of-town superstores and de-emphasised high street and smaller stores. As a result, the number of superstores increased in both the 2003 financial year and the 2004 financial year, while the number of smaller stores declined. Following the CVC Acquisition, the new management team has developed strategies for increasing the number of both superstores and small stores (see Part II (Business of the Group)).

Disposal of garage services business

During the 2002 financial year, Halfords sold its garage services business, comprising 129 servicing and repair outlets, all but one located on existing superstore premises, for a net consideration of £4.3 million. The garage services business had generated turnover of £17.3 million prior to the date of disposition (i.e. from 30 March to 31 August 2001). During this period, the garage services business generated an operating loss of £1.2 million.

Trade creditor term renegotiation

Following the CVC Acquisition, the Group reviewed its business terms with approximately 350 of its suppliers. As a result of this review, Halfords extended payment terms for both goods suppliers (from an average of 45 days to an average of 60 days) and non-goods suppliers (from an average of 60 days to 90 days). This renegotiation resulted in a one-off reduction in working capital estimated by the Directors to be approximately £25 million in the 2004 financial year. In addition, Halfords achieved improved pricing terms from many of these suppliers, which the Directors estimate reduced its annual supply costs by approximately £4 million (principally as a result of reduced cost prices and additional rebates from suppliers).

Cost management

Following the CVC Acquisition, the new management team has reduced costs significantly thereby enhancing operating margins. In the 2003 financial year, management undertook various initiatives to reduce staff costs which succeeded in reducing store payroll as a percentage of net sales from 13.3 per cent. in the 2003 financial year to 12.3 per cent. in the 2004 financial year. In the 2004 financial year, management initiated a strategy of reducing its payroll costs through changing the store management structure and employing a higher proportion of part-time staff in order to increase staff flexibility, prevent store over-

staffing and limiting the availability of overtime to full-time staff. In addition to the above initiatives at store level, the Group reduced central costs by £3.4 million in the 2004 financial year through a reduction of 110 head office jobs, reductions in discretionary expenditure, and reduced spend on store conversions under the SMART programme.

Effect of the CVC Acquisition

The CVC Acquisition occurred on 30 August 2002 and resulted in the recognition of goodwill of £274.8 million. The initial financing to fund the CVC Acquisition included £220 million of senior debt (split into three facilities), £70 million of mezzanine debt, Deep Discount Bonds issued at £136.9 million and £0.5 million of management loan stock. The Group's results of operations have been significantly impacted by the addition of significant goodwill amortisation expense and interest expense resulting from the CVC Acquisition.

Exceptional interest charges in connection with the refinancing of indebtedness

Halfords will use a portion of the proceeds from the Global Offer to refinance all of its existing indebtedness. As a result, Halfords has recognised in the 2004 financial year an exceptional charge of £6.3 million in respect of the acceleration of the amortisation of previously capitalised fees and expenses associated with indebtedness that will be re-financed. In addition, in the 2004 financial year an exceptional charge of £2.4 million was recognised in respect of the write-off of capitalised fees and expenses associated with a refinancing of its bank indebtedness undertaken in November 2003.

Effect of 53-week year in the 2004 financial year

Halfords prepares its financial statements on the basis of a 52-or-53 week financial period, generally ending on the Friday closest to March 31 in each year. The 2002 and 2003 financial years were 52-week periods and the 2004 financial year was a 53-week period. Consequently, Halfords' results for the 2004 financial year included an additional week of trading which makes a comparison of the 2004 financial year with earlier financial years more difficult.

5. FACTORS AFFECTING FUTURE RESULTS OF OPERATIONS

Set forth below are several known factors which the Directors believe will affect the Group's future results of operations. The Group's future results of operations may also be affected by changes in general economic conditions in the UK, as well as unforeseen or unpredictable factors. For a description of certain risks facing the Group's business, see Investment Considerations.

Implementation of Growth Strategy

As discussed in more detail in Part I (Business of the Group) under the heading "Growth Strategy", the Group is implementing a number of strategies to increase turnover and to increase operational efficiency, including the continued development of its property portfolio through conversion of existing stores and opening new stores. The Directors believe that these strategies will improve the Group's results over time.

Debt reduction upon completion of the Global Offer

As at 2 April 2004, Halfords' net debt was £349.5 million. On a pro forma basis and as set out in Part VI (Pro Forma Statement of Net Assets of the Group) after giving effect to the Global Offer and the use of proceeds thereof, Halfords' net debt at 2 April 2004 would have been approximately £214.5 million. In addition, the interest margins on its floating rate indebtedness under the New Bank Facilities will be lower than those under its existing bank facility. As a result of the Global Offer, Halfords expects its interest expense to decrease significantly in future periods.

Exceptional interest charge in connection with the refinancing of existing indebtedness

As discussed above Halfords has recognised an exceptional interest charge of £6.3 million in connection with the refinancing of its existing indebtedness with the proceeds of the Global Offer in the 2004 financial year. A further exceptional interest charge of £1.8 million will be recognised for the current financial year to cover the remaining accelerated amortisation during the period between 3 April 2004 and Admission.

6. LIKE-FOR-LIKE TURNOVER COMPARISONS

To facilitate period-to-period comparison of turnover, the discussion below includes an analysis of turnover on a like-for-like basis for the 2004 financial year as compared to the 2003 financial year, and the 2003 financial year as compared to the 2002 financial year. This analysis compares turnover attributable only to stores that were operating during the entirety of the two financial periods being compared. As a result, new stores opened or existing stores closed during the period are excluded from the calculation. These like-for-like comparisons include stores that have been converted during the period to the SMART Arcade or new small store formats, or which have been expanded during the period through the introduction of a mezzanine or supermezzanine floor. Significant factors in like-for-like growth in turnover during the periods under review have been improved trading and marketing, the introduction of mezzanine floors and the conversion of stores to the Arcade or SMART Arcade format.

7. REVIEW OF RESULTS OF OPERATIONS

The table below sets forth Halfords' results of operations, and as a percentage of total turnover, for each of the periods under review.

	2002 financial year		2003 financial year (£ in millions, except for percentages)		2004 financial year	
		%		%		%
Turnover	519.8	100.0	525.8	100.0	578.6	100.0
Cost of sales	(243.3)	(46.8)	(244.4)	(46.5)	(269.0)	(46.5)
Gross profit	276.5	53.2	281.4	53.5	309.6	53.5
Net operating expenses	(225.0)	(43.3)	(247.9)	(47.1)	(244.1)	(42.2)
Operating profit	51.5	9.9	33.5	6.4	65.5	11.3
Loss on sale of business	(2.3)	(0.4)	–	–	–	–
Profit on the sale of fixed assets	–	–	–	–	6.4	1.1
Net interest (payable)/receivable	(0.5)	(0.1)	(21.9)	(4.2)	(44.1)	(7.6)
Profit on ordinary activities before taxation	48.7	9.4	11.6	2.2	27.8	4.8
Tax on profit on ordinary activities	(16.7)	(3.2)	(6.5)	(1.2)	(14.3)	(2.5)
Profit for the financial year	32.0	6.2	5.1	1.0	13.5	2.3

7.1 Results of Operations for the 53-week 2004 Financial Year Compared to the 52-week 2003 Financial Year

(a) Turnover

	2003 financial year	2004 financial year
	(£ in millions, except for number of stores)	
Turnover	525.8	578.6
Number of Stores (at end of period)	398	397[(1)]

(1) Includes ten motorway stores, which ceased trading in March 2004.

Halfords' turnover increased by 10.0 per cent., from £525.8 million in the 2003 financial year to £578.6 million in the 2004 financial year, principally reflecting strong like-for-like sales growth, the addition of 7 new superstores, the effect of an extra week of trading in the 2004 financial year and the positive impact of a particularly warm, dry summer. On a like-for-like basis, Halfords' turnover increased by 7.0 per cent. from the 2003 financial year to the 2004 financial year. The principal driver of this like-for-like growth was the improved marketing and trading described above. The increase also reflected the positive effects of the SMART Arcade format roll out and the increased selling space resulting from the addition (or extension) of mezzanine floors in certain stores.

(b) Gross Profit

Gross profit represents turnover less cost of sales. Cost of sales includes the actual cost of products from suppliers for products sold and for products lost to shrinkage, offset amongst other things by supplier volume rebates. Halfords' gross profit and gross margin (gross profit as a percentage of turnover) for the periods under review were:

	2003 financial year	**2004 financial year**
	(£ in millions, except percentages)	
Gross profit	281.4	309.6
Gross margin	53.5%	53.5%

Halfords' gross profit increased by 10.0 per cent., from £281.4 million in the 2003 financial year to £309.6 million in the 2004 financial year, reflecting the strong growth in turnover discussed above. Gross margins were static year-on-year. Margin declines associated with changes in product mix and increased promotional activity were offset by improved cost prices Halfords negotiated with suppliers and increased volume rebates.

(c) Net operating expenses

Net operating expenses consist of selling and distribution costs, administrative expenses, goodwill amortisation and exceptional costs. Halfords' net operating expenses and net operating expenses as a percentage of turnover for the periods under review were:

	2003 financial year	**2004 financial year**
	(£ in millions, except percentages)	
Net operating expenses	247.9	244.1
Net operating expenses as a percentage of turnover	47.1%	42.2%

Net operating expenses decreased by 1.5 per cent., from £247.9 million in the 2003 financial year to £244.1 million in the 2004 financial year. The components of net operating expenses in these periods are set forth below:

	2003 financial year	**2004 financial year**
	(£ in millions)	
Selling and distribution costs	190.2	195.2
Administrative expenses	40.4	35.2
Goodwill amortisation	8.0	13.7
Exceptional costs	9.3	–

Selling costs include store property costs, store staff wages and other costs of operating the stores. Distribution costs include the costs of operating the distribution centres (including staff wages) and the costs of transporting products. Selling and distribution costs increased by 2.6 per cent., from £190.2 million in the 2003 financial year to £195.2 million in the 2004 financial year. This increase was primarily a result of a £2.8 million increase in store property costs (mainly due to rent reviews) and a £1.3 million increase in store payroll costs reflecting

an increase in store staff in line with an increase in the Group's turnover. Nevertheless, both store payroll costs and total selling costs as a percentage of sales decreased as a result of a number of management initiatives implemented to reduce these costs. These cost-saving initiatives included rationalising the cost of the Arcade roll out by introducing the SMART Arcade format, improving contractual terms (e.g. heating, lighting, power and cleaning services) and shifting from store security guards to closed-circuit television and other more cost-effective methods of reducing shrinkage. In addition, Halfords' management undertook various initiatives to reduce store staff costs, including the employment of a higher proportion of part-time staff (to increase staff flexibility, prevent store over-staffing and reduce expensive overtime payments to existing full-time staff), the change of store management structure from one manager and three to four supervisors to one manager and one team leader, and the reduction of specialist staff. The staff reduction was implemented at the end of the 2003 financial year, and resulted in the reduction of 205 store employees and managers.

Administrative expenses consists primarily of the costs of operating Halfords' headquarters. Administrative expenses decreased by 12.9 per cent., from £40.4 million in the 2003 financial year to £35.2 million in the 2004 financial year. This decrease was primarily a result of a reduction in headcount of approximately 110 employees at Halfords' headquarters, implemented at the end of the 2003 financial year.

Goodwill amortisation increased by 71.3 per cent., from £8.0 million in the 2003 financial year to £13.7 million in the 2004 financial year, reflecting the full year impact of the amortisation of goodwill recognised on the CVC Acquisition.

The exceptional costs in the 2003 financial year are discussed below in section 7.2(c).

(d) Profit on the sale of fixed assets

Halfords recognised a profit of £6.2 million in the 2004 financial year on the sale of its head office which formed part of a sale and leaseback transaction (see paragraph 19.8 of Part VII (Additional Information)).

(e) Net interest

Halfords' net interest payable increased by 101.4 per cent., from £21.9 million in the 2003 financial year to £44.1 million in the 2004 financial year. This increase reflected the full year impact of the indebtedness incurred in connection with the CVC Acquisition and £8.7 million of exceptional interest charges (comprising separate charges of £6.3 million and £2.4 million respectively) relating to the accelerated amortisation of deferred debt issue costs discussed in section 4 under the heading "Exceptional interest charges in connection with the refinancing of indebtedness". As discussed above, following completion of the Global Offer, the Group's indebtedness will be substantially reduced, and interest expense in future periods will reduce accordingly.

(f) Taxation

Halfords' tax, statutory tax rate and effective tax rate for the periods under review were:

	2003 financial year	**2004 financial year**
	(£ in millions, except for percentages)	
Tax on profit on ordinary activities	6.5	14.3
Statutory tax rate	30%	30%
Effective tax rate	56.0%	51.4%

Halfords' tax on profit on ordinary activities increased by 120 per cent., from £6.5 million in the 2003 financial year to £14.3 million in the 2004 financial year. This increase was primarily attributable to the Group's improved profit. Halfords' effective tax rate exceeded its statutory tax rate in both periods primarily due to the non-deductibility of goodwill amortisation. Commencing with the 2006 financial year, Halfords expects to cease amortisation of goodwill when it is required to adopt IFRS. See paragraph 13 below for more information regarding the transition to IFRS.

7.2 Results of Operations for the 52-week 2003 Financial Year compared to the 52-week 2002 Financial Year

(a) Turnover

	2002 financial year	2003 financial year
	(£ in millions, except for number of stores)	
Turnover	519.8	525.8
Turnover excluding garage services business	502.5	525.8
Number of Stores (at end of period)	401	398

Halfords' turnover increased by 1.2 per cent., from £519.8 million in the 2002 financial year to £525.8 million in the 2003 financial year. During the 2002 financial year, the Group disposed of its garage services business, which contributed £17.3 million to turnover. Turnover (excluding the garage services business) increased by 4.6 per cent., from £502.5 million in the 2002 financial year to £525.8 million in the 2003 financial year. This increase principally reflected like-for-like turnover growth, as well as turnover from new superstores opened in the 2003 financial year (net 5 superstores), and the full year impact of stores Halfords opened during the 2002 financial year. On a like-for-like basis, Halfords' turnover increased by approximately 3.9 per cent. from the 2002 financial year to the 2003 financial year. This increase was predominantly driven by portfolio development, as Halfords converted 44 stores to the Arcade format. Like-for-like growth was offset partially by car maintenance product availability issues (associated with the introduction of the third distribution centre at Cowley) and cycle availability issues (associated with late delivery of cycles during the pre-Christmas 2002 trading period).

(b) Gross Profit

Halfords' gross profit and gross margin (gross profit as a percentage of turnover) for the periods under review were:

	2002 financial year	2003 financial year
	(£ in millions, except for percentages)	
Gross profit	276.5	281.4
Gross profit excluding garage services business	264.4	281.4
Gross margin excluding garage services business	52.6%	53.5%

Halfords' gross profit increased by 1.8 per cent., from £276.5 million in the 2002 financial year to £281.4 million in the 2003 financial year, principally reflecting the growth in turnover discussed above. Excluding the garage services business, the gross profit increased by 6.4 per cent. from £264.4 million to £281.4 million. Gross margin (excluding the garage services business) increased slightly over the period. This margin improvement reflected improved stock control which reduced shrinkage levels, and improved pricing strategies, particularly in non-discretionary product categories.

(c) Net operating expenses

Halfords' net operating expenses, and net operating expenses as a percentage of turnover for the periods under review were:

	2002 financial year	2003 financial year
	(£ in millions, except for percentages)	
Net operating expenses	225.0	247.9
Net operating expenses excluding garage services business	211.7	247.9
Net operating expenses excluding garage services business as a percentage of turnover	42.1%	47.1%

Net operating expenses increased by 10.2 per cent., from £225.0 million in the 2002 financial year to £247.9 million in the 2003 financial year. Excluding the garage services business, the increase was 17.1 per cent. from £211.7 million to £247.9 million. This increase was largely driven by increased selling and distribution costs and administrative expenses, the commencement of goodwill amortisation associated with the CVC Acquisition and the recognition of certain exceptional costs. In the five-month period of the 2002 financial year when Halfords operated its garage services business, the operating costs of this business were £13.3 million. These costs ceased when Halfords disposed of this business. The components of net operating expenses are set forth below:

	2002 financial year	**2003 financial year**
	(£ in millions)	
Selling and distribution costs	193.0	190.2
Selling and distribution costs excluding garage services business	180.0	190.2
Administrative expenses	32.0	40.4
Administrative expenses excluding garage services business	31.7	40.4
Goodwill amortisation	–	8.0
Exceptional costs	–	9.3

Selling and distribution costs decreased by 1.5 per cent., from £193.0 million in the 2002 financial year to £190.2 million in the 2003 financial year. This decrease primarily reflected the sale of the garage services business in the 2002 financial year. Excluding the effect of the garage services business, selling and distribution costs increased by 5.7 per cent., principally reflecting increased rent costs (following rent reviews) and increased payroll costs resulting from the introduction of specialist staff in stores as part of the roll-out of the Arcade concept. The increase also reflected costs associated with the introduction of a third distribution centre in Cowley in order to expand future capacity. The addition of this distribution centre increased fixed costs (space and management overheads) and transport costs.

Administrative expenses increased by 26.3 per cent., from £32.0 million in the 2002 financial year to £40.4 million in the 2003 financial year. This increase was primarily a result of increased costs associated with achieving independence from Boots following completion of the CVC Acquisition. The most significant elements of this increase were increased expenditure on the development of store formats, increased financing costs and increased insurance and information technology costs.

Goodwill amortisation increased from nil in the 2002 financial year to £8.0 million in the 2003 financial year, reflecting the goodwill arising from the CVC Acquisition.

The exceptional costs in the 2003 financial year were incurred as a result of the CVC Acquisition as follows:

	£m
Write-off of pension prepayment	8.1
Professional fees and expenses	0.5
Transfer of property obligations and other obligations to the Boots Group	(4.0)
Restructuring costs	4.7
	9.3

The £8.1 million write-off represented prepaid pension contributions to the Boots pension scheme, which Halfords wrote-off immediately prior to the CVC Acquisition.

Restructuring costs related to redundancy and related charges arising from the staff reduction initiatives discussed above covering both head office (£2.7 million) and retail operations (£2.0 million).

(d) Net interest

Halfords' net interest payable increased from £0.5 million in the 2002 financial year to £21.9 million in the 2003 financial year. This substantial increase reflected the partial year impact of the significant indebtedness incurred in connection with the CVC Acquisition.

(e) Taxation

Halfords' tax, statutory tax rate and effective tax rate for the periods under review were:

	2002 financial year	**2003 financial year**
	(£ in millions, except for percentages)	
Tax on profit on ordinary activities	16.7	6.5
Statutory tax rate	30.0%	30.0%
Effective tax rate	34.3%	56.0%

Halfords' tax on profit on ordinary activities decreased by 61.1 per cent., from £16.7 million in the 2002 financial year to £6.5 million in the 2003 financial year. This decrease reflected the significant reduction in profit from ordinary activities before taxation resulting from the factors discussed above. Halfords' effective tax rate in the 2003 financial year significantly exceeded its statutory tax rate due primarily to the non-deductibility of goodwill amortisation, and due to the depreciation charged on assets that do not qualify for capital allowances.

8. LIQUIDITY AND CAPITAL RESOURCES

The largest use of cash during the periods under review related to the CVC Acquisition in the 2003 financial year, which was financed principally through increased indebtedness. Excluding CVC Acquisition-related items, Halfords' principal uses of cash during the periods under review have been for capital expenditure to fund the expansion and renovation of stores and to fund its working capital requirements. Halfords has funded these requirements with cash flows from its operating activities.

Cash flow from operating activities was £63.6 million, £61.9 million and £114.8 million in the 2002 financial year, the 2003 financial year and the 2004 financial year respectively. The significant increase in cash flow in the 2004 financial year reflected the improved operating profit discussed above together with the estimated one-time benefit working capital improvement of £25 million resulting from the extension of supplier payment terms during the 2004 financial year discussed above.

As a result of the CVC Acquisition, the Group incurred a substantial level of debt. Halfords' total debt at 2 April 2004 was £349.5 million. As discussed in Part III (Global Offer), upon completion of the Global Offer, the Group will use £135 million of the net proceeds of the Global Offer together with an estimated £195 million in borrowings under the New Bank Facilities (consisting of £150 million of term loans and an estimated £45 million in borrowings under the revolving credit facility) and available cash balances to repay all of its existing indebtedness. On a pro forma basis and as set out in Part VI (Pro Forma Statement of Net Assets of the Group) after giving effect to the Global Offer and the use of proceeds thereof, Halfords' net debt at 2 April 2004 would have been approximately £214.5 million. The New Bank Facilities include a revolving credit facility permitting borrowings from time to time (up to a maximum of £120 million), subject to compliance with certain drawing conditions. A portion of the revolving credit facility will be utilised to fund the repayment of existing indebtedness discussed above and the remainder will be available for general corporate purposes.

Review of capital expenditure programmes

Halfords' cash capital expenditure on tangible fixed assets for the 2004 financial year, the 2003 financial year and the 2002 financial year was £19.3 million, £20.9 million and £21.6 million, respectively. Set forth below is a breakdown of the principal components of this

expenditure, extracted without material adjustment from Halfords' accounting records which formed the underlying basis for the Accountants' Report.

	2002 financial year (£ in millions)	2003 financial year (£ in millions)	2004 financial year (£ in millions)
New stores and store environment	14.1	12.3	10.5
Information technology	0.6	0.6	6.1
Warehouse and distribution	0.2	3.6	1.7
Other	4.2	1.7	1.8
Capital creditor	2.5	2.7	(0.8)
Total capital expenditure	21.6	20.9	19.3

New store costs and Arcade format roll out costs in the 2003 financial year and the 2004 financial year reflect 44 and 73 Arcade format conversions in the respective periods. The Arcade format was originally introduced in 2001, and has been refined by the new management team since the CVC Acquisition into the more cost effective SMART Arcade model. As a result, although total capital expenditure for the Arcade format roll out decreased from the 2003 financial year to the 2004 financial year, Halfords converted a greater number of stores. The decrease also reflected the installation of fewer mezzanine floors in the 2004 financial year than in the 2003 financial year.

The significant increase in capital expenditure for information technology in the 2004 financial year reflects Halfords' investment in the upgrade of its information systems and its need to achieve independence from the Boots mainframe system following the CVC Acquisition.

Warehouse distribution capital expenditure in both the 2003 and 2004 financial years was driven by the alteration of the Washford distribution centre truck yard to accommodate double deck trailers and the implementation of the PkMS™ warehouse management system at that distribution centre.

Future financing of capital expenditure and working capital

The Group is currently budgeting approximately £78.0 million for capital expenditure over the next three years. The bulk of this capital expenditure relates to its continued roll out of supermezzanine and mezzanine extensions, the SMART Arcade and small store format roll outs at its existing stores, and the opening of new stores. In addition, the budget includes on-going investment in information technology related to completing the implementation of SAP™ in commercial areas, PkMS™ and a planned upgrade of store systems. The Directors anticipate that such capital expenditure, together with working capital increases associated with the anticipated increases in selling space, will be funded out of cash flows from operations. However, the Group will also have access to the revolving credit facility under the New Facilities Agreement to cover short-term cash needs, if necessary.

Contractual commitments and contingencies

Set forth below are the Group's indebtedness contractual commitments as at 2 April 2004:

	Payments due by period (£ in millions)			
	Total	Less than 1 year	1-5 years	More than 5 years
Bank Indebtedness[(1)]	367.2	182.2	80.0	105.0
Commitments for future capital expenditure	1.9	1.9	–	–
Finance lease	0.8	0.2	0.6	–

(1) Following the Global Offer, the Company's indebtedness will be reduced. See paragraph 1 of Part III (Details of the Global Offer)

In addition, the Group is committed to pay £62.5 million in operating lease payments during the current financial year. Of this amount, £0.7 million, £2.8 million and £59.0 million relates to operating leases which expire within less than one year, between one and five years and

beyond five years, respectively. The bulk of these leases relate to store properties which are subject to periodic rent reviews. For more information regarding the rent review process, see Section 8 of Part I (Business of the Group) under the heading "Property". The operating lease payment obligations include rental payments of approximately £6.3 million in respect of 125 properties sub-let to the AA on coterminous leases and guaranteed by GB Gas Holdings Limited, both of which are subsidiaries of Centrica plc.

9. SEASONALITY

In general, the Group's results are not seasonal. However, sales of certain of Halfords' products tend to fluctuate by season. For example, sales of children's cycles peak in the Christmas season, and sales of adult cycles tend to peak in the summer. In addition, sales of travel solutions products tend to peak in the summer.

10. DISCLOSURE ABOUT MARKET RISK

The following discussion of estimated amounts which Halfords generated from a sensitivity analysis is "forward-looking", and involves risks and uncertainties. Actual results could differ materially from those projected due to actual developments in the global financial markets. Such risks principally include country risk, legal risk and political risk, which are not represented in the following analyses.

Foreign Exchange Risk

Halfords purchases goods both in US dollars and pounds sterling. Halfords' dollar purchases amounted to $50 million in the 2004 financial year.

Halfords has hedged approximately 85 per cent. of the current financial year's estimated U.S. dollar requirements; Halfords' formal policy is to hedge no less than 75 per cent. of the following year's foreign currency requirements.

The average exchange rate of the forward currency contracts, as well as of any necessary spot market purchases, is applied to all transactions during the respective financial year in which hedging has been arranged.

The pound sterling has strengthened significantly against the U.S. dollar in recent months. Halfords' results of operations may be positively impacted by continued strength of the pound sterling against the U.S. dollar.

The following table shows information about Halfords' foreign exchange forward contracts as at 2 April 2004. Halfords enters into all these instruments for hedging purposes, and accounts for them as such under UK GAAP because they apply to specific expenditure. The table presents the value of the contracts in pounds sterling at the contract exchange rate as well as the fair value of the contracts outstanding as at 2 April 2004.

Trade Date	Maturity date	£ Sold	$ Bought	Contract Rate	£ Fair Value as at 2 April 2004
09/01/04	15/04/04	98,497	180,000	1.8275	167
09/01/04	17/05/04	587,143	1,070,000	1.8224	977
01/01/04	14/06/04	880,030	1,600,000	1.8181	1,532
09/01/04	14/07/04	920,806	1,670,000	1.8136	1,104
09/01/04	16/07/04	1,497,982	2,710,000	1.8091	1,389
09/01/04	16/09/04	609,654	1,100,000	1.8043	285
09/01/04	18/10/04	872,416	1,570,000	1.7996	381
09/01/04	15/11/04	2,199,173	3,950,000	1.7961	824
09/01/04	13/12/04	1,840,132	3,300,000	1.7934	2,369
09/01/04	13/01/05	2,074,132	3,710,000	1.7887	2,900
09/01/04	11/02/05	2,390,282	4,270,000	1.7864	(5,151)
09/01/04	11/03/05	487,696	870,000	1.7839	(1,478)

In addition to the $26 million bought in the contracts set forth in the table above, Halfords has also bought $24 million ($2 million per month) on a participating forward basis. This means that Halfords is obliged to buy $600,000 each month at $1.7765. If the prevailing spot rate falls below $1.7765 in the applicable month, Halfords has the right and obligation to buy $2 million at $1.7765. If the prevailing spot rate is above $1.7765 in the applicable month, Halfords can purchase any amount on the open market at the market rate. The first two of these additional contracts were executed on 1 April and 1 May 2004 respectively. As the prevailing spot rate was above $1.7765 on each date, $1.4 million was purchased at $1.8542 on 1 April 2004 and $1.4 million was purchased at $1.7953 on 1 May 2004 whilst $600,000 was purchased on each such date at the contract rate of $1.7765.

As discussed under Part I (Business of the Group) under the heading "Growth Strategy", the Directors intend to increase the value of products that Halfords sources directly from the Far East. Contracts for products from the Far East are typically denominated in US dollars, and as Halfords' sourcing from the Far East increases, so too will its exposure to foreign exchange risk.

Interest Rate Risk
The Group's policy is to hedge at least 75 per cent. of its net interest rate exposure.

Interest rate hedges currently in place comprise (i) an interest rate swap for £71.8 million whereby Halfords pays fixed rate interest of 5.01 per cent. and receives floating rate interest semi-annually and (ii) an interest rate cap for £145.7 million, whereby Halfords receives semi-annual interest compensation if six month LIBOR rises above 5.01 per cent. These hedges mature in September 2005, and are replaced by two forward start interest rate swaps totalling £100.0 million maturing in September 2007. Halfords pays 4.99 per cent. fixed rate interest and receives floating rate interest semi-annually on these latter instruments. The fair value of these instruments as at 2 April 2004 was £0.8 million.

11. CRITICAL ACCOUNTING POLICIES

Halfords currently prepares its financial statements based on the application of relevant UK GAAP accounting polices. Several of these policies require Halfords to make significant estimates and assumptions that, if changed, could materially alter its stated financial results. The most significant of these assumptions and estimates are discussed below. Prospective investors should also read note 2 included in Part V (Accountants' Report on the Group).

Revenue recognition
Halfords recognises revenue, net of estimated returns, at the time the customer takes possession of the merchandise or receives services. Halfords estimates the liability for sales returns based on historical return levels. Halfords believes that its estimate for sales returns is an accurate reflection of likely future returns, and it has not been required to book any significant adjustment to its estimated liability for sales returns in the past. However, if the actual rate of returns were to be significantly higher than historical trends, recognised revenue could be adversely impacted.

When Halfords receives payment from customers before the customer has taken possession of the merchandise or the service has been performed, the amount received is recorded as deferred revenue until the sale or service is completed.

Recognition of rebates received from suppliers
Halfords recognises rebate income as a reduction to the cost of sales. Rebate income is calculated in accordance with agreed rates set out in supplier agreements. These are principally based on percentage values applied to the annual purchases from the supplier. Halfords assesses the level of percentage by reference to purchases made in the year covered by the supplier agreement. Rebate arrangements are usually agreed and updated

with suppliers annually. Rebates from suppliers with agreements that cover more than one year are recognised in the accounts in the period in which the rebates are earned.

Leases

Halfords leases certain retail locations, office space, warehouse and distribution space, equipment and vehicles. Halfords occupies all of its stores on leases with an average remaining term of 13 years for superstores and 5 years for small stores and accordingly accounts for them as operating leases. Halfords has one finance lease relating to computer hardware. As leases expire in the normal course of business, Halfords expects that it would renew or replace them.

Total rental expenses for leased property for the 2004 financial year, the 2003 financial year and the 2002 financial year were £56.4 million, £54.5 million and £54.4 million, respectively. Under the lease agreements, obligations relating to maintenance and operating expenses rest with Halfords.

Amortisation of goodwill

Halfords amortises purchased goodwill arising over its estimated economic life on a straight line basis subject to a maximum of 20 years. Unexpected future events may suggest an economic life which is less than this period, in which case a higher amortisation charge would be made in future financial statements as a result of this shorter estimated life.

Depreciation of tangible fixed assets

Tangible fixed assets are written-off in equal instalments to their estimated residual value over their expected useful economic lives. This policy is reviewed on a regular basis to ensure that the lives remain appropriate.

The current estimates of the useful economic lives of the assets result in depreciation rates as follows:

Short leasehold land and buildings	Over the period of the lease
Short leasehold improvements	Over the period of the lease
Motor vehicles	33 per cent. per annum
Fixtures, fittings and equipment	10 to 25 per cent. per annum
Computer equipment	33 per cent. per annum

Impairment

Halfords assesses whether there has been any material impairment of identifiable tangible fixed assets and goodwill, whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Where there is evidence of a potential impairment to the carrying value of such assets, Halfords undertakes an estimation of the fair value of that asset in accordance with the approach set out in FRS 11 “Impairment of Fixed Assets and Goodwill”. The fair value is in most cases based on the discounted present value of the future cash flows expected to arise from the business unit to which the goodwill relates. Estimates are used in deriving these cash flows and the discount rate.

Halfords has not recognised any material impairments during the last three years.

Stock valuation

Halfords records stock at the lower of cost and net realisable value. Cost comprises the purchase price of goods and, where appropriate, costs relating to storage and distribution.

In order to assess the final net realisable value of stock, Halfords makes estimates as to the future demand, and compares that with the current stock levels. Estimated future demand will take account of changes in strategic direction, such as discontinuance of product lines, as well

as changes in market conditions. Where Halfords identifies that stock held exceeds estimated future demand, it makes an estimate of the likely proceeds obtainable from the excess stock. This estimate takes into account the current market conditions, the age and nature of the stock and the price at which this stock could be sold via promotions or similar methods, or the extent to which it could be returned to suppliers. Where the estimates of potential revenues are lower than the original cost, Halfords makes provisions to reduce the stock values to the estimated net realisable values.

12. RECENTLY ISSUED UK GAAP ACCOUNTING PRONOUNCEMENTS

As noted above, Halfords currently prepares its financial statements based on the application of relevant UK GAAP accounting policies. Set out below is a summary of a recently issued UK GAAP accounting pronouncement which may impact on the Group's financial statements in the future.

FRS 20 – Share based payments

FRS 20 was issued on 7 April 2004 and will apply to the Group's financial statements for the first time in the year ended March 2006. It will govern the accounting treatment to be adopted in respect of the current and proposed share option schemes.

The principal differences between FRS 20 and current UK GAAP as set out in UITF 17, that will impact on the Group's financial statements, are as follows:

- FRS 20 does not contain any exemption for SAYE schemes.
- FRS 20 requires the charge to the profit and loss account in respect of share options to be based on the fair value of the options (as typically calculated using an option pricing model) rather than the difference between the fair value of the shares at the date of grant and the exercise price (the "intrinsic value" basis).
- The period over which the charge is recognised under FRS 20 is the vesting period whereas under UITF 17, the period could be that over which any performance conditions need to be satisfied.

UITF Abstract 38 – Accounting for ESOP Trusts

UITF Abstract 38 was published on 15 December 2003 and is mandatory for accounting periods ending on or after 22 June 2004. Consequently it will apply to the Group's financial statements for the first time in the year ended March 2005.

UITF Abstract 38 supercedes UITF Abstract 13 and changes the presentation of an entity's own shares held by an ESOP trust. Under UITF Abstract 13, such shares are required to be recognised as assets, whereas under UITF Abstract 38, they should be deducted in arriving at shareholders' funds.

Guidance is awaited as to the impact of this change in respect of the treatment of profits available for distribution.

13. TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

On 7 June 2002, the European Council approved a Regulation requiring all listed companies in the European Union to prepare their consolidated financial statements under EU adopted international financial reporting standards ("IFRS" or International Accounting Standards "IAS") for financial years beginning on or after 1 January 2005. Consequently the Group will be required to prepare its financial statements for the 2006 financial year in accordance with IFRS/IAS.

14. SUMMARY OF SIGNIFICANT DIFFERENCES BETWEEN UK GAAP AND IFRS

As noted above, the Group will be required to prepare its financial statements for the 2006 financial year in accordance with IFRS. Significant differences exist between UK GAAP and IFRS and a summary of those differences which are most relevant to the Group is set out below. This summary reflects differences between UK GAAP and IFRS as at the date of this document. No attempt has been made to quantify the impact of these differences, nor has a reconciliation of UK GAAP and IFRS financial information been prepared. Had the Group undertaken any such quantification or preparation of such a reconciliation, other potentially significant differences might have come to its attention which are not highlighted below. In addition, a number of significant changes to IFRS have recently been introduced or announced and additional changes are expected before Halfords will be required to implement IFRS. Future developments or changes in IFRS may give rise to additional differences. Accordingly, the Group can provide no assurance that the differences highlighted below represent all the differences between UK GAAP and IFRS which could have a significant impact on the Group.

Presentation of financial information

The main components of a set of IFRS financial statements are broadly similar to those required for UK GAAP financial statements. However, there are certain differences in the presentation of items (e.g. exceptional items), definitions (e.g. discontinued operations) and classifications (e.g. non-current assets and liabilities).

Cash flow statements

There are major differences between a cash flow statement prepared under IAS 7 and one prepared under FRS 1.

- IAS 7 reports movements in cash and cash equivalents, whereas there is no concept of cash equivalents under FRS 1.
- IAS 7 requires cash flows to be reported under three headings (operating, investing and financing) whereas FRS 1 requires cash flows to be reported under nine standard headings.
- IAS 7 does not require a reconciliation of movements in cash flows to the movements in net debt.

Segmental reporting

The approach to segmental reporting under IAS 14 is based on management's approach to organising its business. An entity's internal organisation and management structure and its system of internal financial reporting will normally be the basis for determining the nature of the disclosures that are required under IFRS. IAS 14 also makes a distinction between primary and secondary segments.

The disclosure requirements under IAS 14 for primary segments are significantly more extensive than those required under SSAP 25.

Goodwill

Under UK GAAP, FRS 10, goodwill arising on acquisitions is capitalised and amortised over its useful economic life. There is a rebuttable presumption that the useful life does not exceed 20 years.

Under IFRS 3 which will apply to the Group's first IFRS financial statements, goodwill is not amortised but is subject to an annual impairment test.

Deferred tax

IAS 12 is conceptually different from UK GAAP, FRS 19. Under IAS 12, deferred tax is recognised on the basis of taxable temporary differences (which includes all timing differences and many permanent differences). Under FRS 19 deferred tax is recognised on the basis of timing differences subject to certain exceptions. The implementation of IAS 12 would probably lead to the recognition of additional deferred tax provisions and a reduction in net assets.

Dividends

Under IAS 10, entities are not permitted to recognise a liability for dividends declared after the balance sheet date. Under current UK GAAP (principally SSAP 17), dividends that are declared after the year end are recognised as liabilities at the balance sheet date.

Leases

The broad approach to leases under IAS 17 and UK GAAP, SSAP 21 is similar, with a distinction made between finance leases and operating leases.

The definition of a finance lease is the same in both standards, but IAS 17 does not provide a quantitative test of whether a lease is a finance lease (the "90%" test).

IAS 17 requires that property leases be split into a lease of land and a lease of buildings. Unless title passes at the end of the lease, leases of land should be treated as operating leases. The buildings element would fall to be classified as an operating or finance lease as appropriate.

Financial instruments

The disclosure requirements under IAS 32 are significantly more voluminous than those required under UK GAAP, FRS 4 and FRS 13 and the Companies Act 1985.

IAS 39 covers the recognition and measurement of financial instruments and rules on hedge accounting. There is currently no UK Accounting Standard that comprehensively addresses accounting for financial instruments or hedge accounting.

IAS 39 is a partial rather than full fair value model with financial assets and liabilities measured at fair value or amortised cost depending on which defined category they fall into under the standard. Changes in the fair value of derivatives that are not hedging instruments are recognised in the income statement.

Hedge accounting under IFRS is more complex than under UK GAAP and depends on whether the hedge relates to a fair value hedge, cash flow hedge or net investment hedge. In order to qualify for hedge accounting, under IFRS formal documentation is required and the entity must be able to measure and track the effectiveness of the hedging instrument.

15. SUMMARY OF SIGNIFICANT DIFFERENCES BETWEEN UK GAAP AND US GAAP

The financial information of the Group included in this document has been prepared and presented in accordance with UK GAAP. Such policies and standards are laid down in the Companies Act and by UK accounting standards. Significant differences exist between UK GAAP and US GAAP, which might be material to the financial information herein.

Such differences not only affect the measurement of net income and shareholders' funds, but the fundamental basis for preparing the Group's financial statements. In making an investment decision, investors must rely upon their own examination of the Group's business and financial condition and the financial information provided in this document. No attempt has been made to quantify the impact of any differences to the financial information of the Group, nor has a reconciliation of UK GAAP and US GAAP financial information been prepared. Potential investors should consult their own professional advisors for an understanding of the differences between UK GAAP and US GAAP, and how those differences might affect the Group's financial information contained herein.

Had the Company undertaken any such quantification or the preparation of such reconciliation in respect of the Group's financial information, other potentially significant accounting and disclosure differences might have come to its attention, which are not identified below. Accordingly, the Group can provide no assurance that the differences highlighted in this document represent all the significant differences between UK GAAP and US GAAP, as they would apply to the Group's financial information presented.

Set out below is a summary of the significant differences between UK GAAP and US GAAP as they relate to the Group for the 2004 financial year, the 2003 financial year and the 2002 financial year. This summary details the significant differences between UK GAAP and US GAAP on the basis of existing guidance. Regulatory bodies that promulgate UK GAAP and US GAAP have significant ongoing projects that could affect future comparisons such as this one between UK GAAP and US GAAP. Future developments or changes in either UK GAAP or US GAAP may give rise to additional differences between UK GAAP and US GAAP, which could have a significant impact on the Group.

Disclosures

The disclosures required under US GAAP are more extensive in certain respects than those required under UK GAAP. For example, under US GAAP more detailed disclosures would be included with respect to segmental reporting taxation (details of the components of current and deferred tax expense and deferred tax items, including valuation allowances), and equity (a statement of changes in shareholders' equity).

Under UK GAAP, indebtedness is presented net of deferred debt issuance costs, while under US GAAP, such deferred costs are classified as a separate asset in the balance sheet with indebtedness being reported on a gross basis.

Consolidated balance sheet presentation

The consolidated balance sheet prepared in accordance with UK GAAP differs in certain respects from US GAAP. Under UK GAAP, assets in the consolidated balance sheet are presented in ascending order of liquidity in accordance with the requirements of the Companies Act, whereas under US GAAP assets are presented in descending order of liquidity. Under US GAAP, the analysis is between total assets and liabilities and shareholders' funds. Certain items which are disclosed in the notes under UK GAAP would be disclosed on the face of the balance sheet under US GAAP.

Consolidated statement of cash flows

Under UK GAAP, cash flow represents increases or decreases in “cash”, which is comprised of cash in hand and balances repayable on demand less overdrafts. Cash flows are presented in the following categories: (i) operating activities; (ii) returns on investments and servicing of finance; (iii) taxation; (iv) capital expenditure; (v) acquisitions and disposals; (vi) management of liquid resources; (vii) equity dividends; and (viii) financing activities.

Under US GAAP, cash flow represents increases or decreases in “cash and cash equivalents”, which include short-term highly liquid investments with original maturities of less than 90 days and exclude overdrafts. Cash flows are reported in only the three categories of operating activities, investing activities and financing activities. Cash flows arising from taxation, returns on investments and servicing of finance would be included as operating activities under US GAAP. The payment of dividends and debt issue costs would be included under financing activities. Movements in bank overdrafts are classified as a financing activity.

Goodwill, intangible assets and amortisation

Both UK GAAP and US GAAP require purchase consideration in a business combination to be allocated to the net assets acquired at their fair value on the date of acquisition with the difference between the consideration and the fair value of the identifiable net assets recorded as goodwill.

Under UK GAAP for periods ending subsequent to 1 January 1998, goodwill is capitalised as an asset and is amortised over its estimated useful life, subject to a rebuttable presumption of a maximum of 20 years.

Under US GAAP for periods ending prior to 1 January 2002, goodwill was capitalised as an asset and amortised over its estimated useful life. From 1 January 2002 and for all acquisitions after 1 July 2001, goodwill is capitalised but not amortised, but rather subject to impairment test on at least an annual basis.

Impairment of goodwill is measured according to a two-step approach. In the first step, the fair value of a reporting unit is compared to the carrying amount of the reporting unit, including goodwill. If the carrying amount exceeds the fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. In the second step, the implied fair value of the goodwill is estimated as the fair value of the reporting unit less the fair values of all the other tangible and intangible assets of the reporting unit. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognised in an amount equal to that excess, not to exceed the carrying amount of the goodwill.

Under UK GAAP in order to recognise an intangible asset, the Group must be able to dispose of it without disposing of the business to which it relates.

Under US GAAP acquired assets such as non-compete agreements, patents, technology licenses, brand names or trade marks may be recognised as separate intangible assets and amortised over their individual estimated useful lives.

Deferred taxes

Under UK GAAP, deferred tax is provided in full on all material timing differences. Deferred tax assets are recognised where their recovery is considered more likely than not. Assets and liabilities are calculated at the rates expected to apply in the period in which the timing differences are expected to reverse, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax assets and liabilities are not discounted.

Under US GAAP, deferred taxes are accounted for on all temporary differences between the tax and book bases of assets and liabilities, and a valuation allowance is established to reduce deferred tax assets to the amount which "more likely than not" will be realised in future tax returns. Assets and liabilities are calculated based upon tax rates and laws that have been enacted by the balance sheet date.

Derivative financial Instruments

Under UK GAAP, there is no recognition and measurement standard for derivative financial instruments. Such instruments, that reduce exposures on anticipated future transactions, may be accounted for using hedge accounting.

In June 1998, the Financial Accounting Standards Board (the FASB) issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133), as amended by SFAS No. 137 and SFAS No. 138. SFAS 133 requires the Group to record all derivatives on the balance sheet at fair value. Changes in fair value are accounted for through the income statement or comprehensive income statement depending on whether the derivative is designated as a hedging instrument and, if appropriate, its effectiveness as a hedging instrument.

Proposed dividends

Under UK GAAP, dividends paid and proposed are shown on the face of the profit and loss account as an appropriation of the current year's earnings. Proposed dividends are provided on the basis of recommendation by the Directors and are subject to subsequent approval by shareholders.

Under US GAAP, dividends are recorded in the period in which they are approved by the shareholders.

Acquisition accounting

Under UK GAAP, adjustments to fair values assigned to assets and liabilities acquired on an acquisition of a business are only permitted if they arise before the date on which the Directors approve the second post-acquisition financial statements of the acquiring company. Under US GAAP, the period allowed for adjusting the fair value of pre-acquisition contingencies is a maximum of one year from the date of acquisition.

Under UK GAAP, the fair value of inventory is represented by the acquired companies cost of reproducing that inventory.

Under US GAAP, the fair value of inventory represents the selling price less any further costs to be incurred to sale.

Leases

While UK GAAP is similar in concept to US GAAP, certain differences in detail exist. Leases classified as finance leases under UK GAAP are likely to be classified as capital leases under US GAAP. Certain operating leases under UK GAAP, however, may also be classified as capital leases under US GAAP based upon extensive form-driven requirements. Additionally, under US GAAP any profit on sale in a sale and leaseback transaction may be required to be deferred and recognised over the lease term.

Restructuring costs

Under UK GAAP, a provision for restructuring costs is recognised only when an entity has a present obligation (legal or constructive) as a result of a past event; it is probable that a

transfer of economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation. A constructive obligation to restructure arises when an entity has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Under US GAAP, for restructuring plans initiated after 1 January 2003, a liability for a cost associated with an exit or disposal activity can only be recognised when the liability is incurred. An entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. The timing of recognition and related measurement of a liability for one-time termination benefits in relation to employees who are to be involuntarily terminated depends on whether the employees are required to render service until they are terminated in order to receive the termination benefits and, if so, whether employees will be retained to render service beyond a minimum retention period.

Exceptional items

Under UK GAAP, exceptional items are those material items which derive from events or transactions within the ordinary activities of the entity, which, in management judgement, by virtue of their size or incidence need to be disclosed if the financial statements are to give a true and fair view.

There is no concept of "exceptional items" under US GAAP. Under US GAAP, events and transactions that have a material effect and are distinguishable by both their unusual nature and their infrequency of occurrence are classified as extraordinary items. Operating items that do not meet these criteria and that relate to continuing operations would be included within operating profit under US GAAP although this may be separately disclosed.

Discontinued operations

Under UK GAAP, a disposal can only be classified as a discontinued operation if the sale or termination is completed either in the period or before the earlier of three months after the commencement of the subsequent period and the date on which the financial statements are approved; and if a termination, the former activities have ceased permanently. The sale or termination has to have had a material effect on the nature and focus of the reporting entity's operations and represents a material reduction in its operating facilities resulting either from its withdrawal from a particular market (whether class of business or geographical) or from a material reduction in turnover in the reporting entity's continuing markets and the assets, liabilities, results of operations and activities have to be clearly distinguishable, physically, operationally and for financial reporting purposes.

Under US GAAP a disposal of a component of an entity that can be clearly distinguished operationally and for financial reporting purposes from the rest of the entity is reported in discontinued operations if the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction, and the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.