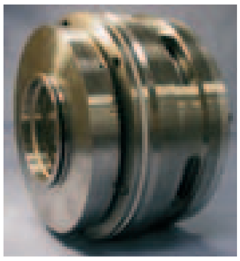
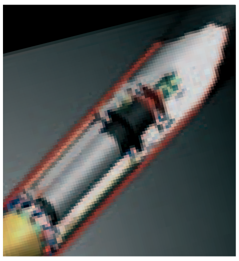
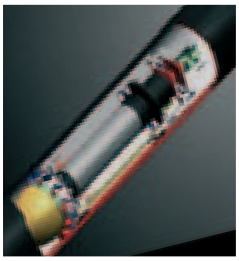
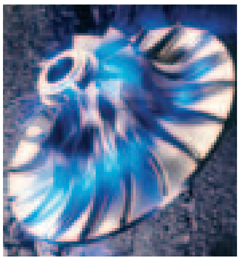
Corac Group plc

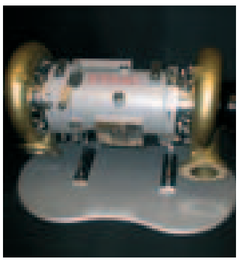
Annual Report and Accounts
Year ended 31 December 2006











CORAC

Corac Group plc is an intellectual property, engineering and licensing group specialisting in air bearings and micro turbo compressor technology. The Group strategy is to generate revenues from the commercial development and exploitation of its core technologies, which provide innovative products that will give end users significant operational benefits.

- *Turbo boosting by Corac's high speed compressor has significantly improved the overall efficiency of other compressor systems.*

Turbo boosting test – April 2006

150 kW machine shipped – September 2006

- *Using Corac's 150 kW machine as a first stage for LMF's high pressure compressors has proved to give an eco friendly solution.*

- *The downhole gas compressor is being tested in a flow loop as the final stage before deployment down a producing well in 2008. The enhancement of ultimate recovery from gas wells is world changing technology for the industry.*

Flow loop test – January 2007

The unique capabilities of the Group are founded on the skills and knowledge of its expert staff, who continue to grow the Group's IP portfolio and know-how. All employees are members of the Company's stock option scheme, which helps to motivate them and aligns their aims with those of the shareholders.

The Group's strategy for commercialisation of its technology is through partnerships with established major players in its target markets to ensure that its products achieve early and significant market penetration.

CORAC

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CORAC

COMPANY INFORMATION

COMPANY NUMBER	3152034	
DIRECTORS	Professor G Musgrave	Executive Chairman
	G W Cromm	Industrial Air Director
	J H Gunn	Non-executive Director
	T E Ivings	Finance Director
	J O Reed	Engineering Director
	A J Wood	Non-executive Director
SECRETARY	T E Ivings	
REGISTERED OFFICE	Brunel Science Park Kingston Lane Uxbridge Middlesex UB8 3PQ	
NOMINATED ADVISER and BROKER	Numis Securities Limited 10 Paternoster Square London EC4M 7LT	
AUDITORS	Grant Thornton UK LLP 1 Westminster Way Oxford OX2 0PZ	
SOLICITORS	Charles Russell 8-10 New Fetter Lane London EC4A 1RS	
BANKERS	National Westminster Bank plc 1 Penn Road Beaconsfield Buckinghamshire HP9 2PV	
PATENT AGENTS	A Messulam & Co 43-45 High Street Bushey Heath Hertfordshire WD2 1EE	
REGISTRARS	Capita Registrars The Registry 34 Beckenham Road Beckenham Kent BR3 4TH	
FINANCIAL PR	Buchanan Communications 45 Moorfields London EC2Y 9AE	

BOARD OF DIRECTORS

Professor Gerry Musgrave, Executive Chairman, aged 64, BTech, MSc, FIEE, MIEEE, MIMC, CEng
Professor Musgrave has combined an academic career and commercial management for 30 years. He has previously been a director of a number of companies including Cirrus Computers, Plessey Finance Corporation, Siemens plc and Non-executive Chairman of Synergo Technologies Limited. He is currently Executive Chairman of Mechadyne plc, an unquoted technology company. He was appointed to the Board in November 1998.

Gerd Cromm, Director – Industrial Air Director, aged 64, Dipl.-Ing
Mr Cromm is currently the director and owner of GCI Consulting GmbH, a consultancy company based in Germany. He has over 30 years experience in the industrial compressor market and has held senior positions in sales and marketing, as well as being Managing Director of a number of German industrial compressor companies. In each of the companies he achieved substantial improvement, profit and growth, and introduced new technology to the industry. His experience is very valuable in helping the Company on an international sales front and with our marketing strategy for our industrial air products. He joined the Board in January 2004.

John Gunn, Non-executive Director, aged 65, BA, LLD
Mr Gunn is a director of a number of quoted and unquoted companies including Hydrodec plc, Ceres Power Holdings plc and Ludgate 181 (Jersey) Limited. He was formerly Chief Executive Officer of Exco International plc, Chairman of Telerate Inc and of British and Commonwealth plc. Mr Gunn was appointed to the Board in July 2000.

Tom Ivings, Finance Director, aged 39, FCCA
Mr Ivings has spent the last 10 years as a freelance business advisor and part-time FD, mainly working with small, high-growth businesses in the Technology sector. He continues to advise several such companies in addition to Corac. He was previously with Littlejohn Frazer, Chartered Accountants, within their Business Advisory Services division. He joined the Board in January 2006, and is also Company Secretary. Mr Ivings is a Fellow of the Association of Chartered Certified Accountants.

Julian Reed, Engineering Director, aged 44, BSc, MIMechE, CEng, ACGI
Mr Reed was recruited to manage and build the design and development team for high-speed centrifugal compressor development and associated technologies at Corac. He was formerly a Senior Mechanical Engineer at WS Atkins Consultants Limited, Director and Consulting Mechanical Engineer at Neale Consulting Engineers, and Design and Development Engineer at British Alcan Aluminium plc. He joined the Company in September 2000 and was appointed to the Board in November 2001.

Alan Wood CBE, Non-executive Director, aged 59, MBA, FIMechE, RAE
Mr Wood has been Chief Executive of Siemens in the UK since 1998, having joined in 1981 and taken on increasingly responsible roles within various of its manufacturing companies and divisions. This experience of productionising technology products will be invaluable to Corac in the move to commercialisation. Mr Wood is also active within the CBI, being Chairman of the South East Regional Council, as well as the German-British Chamber of Industry and Commerce and the Engineering Employers Federation. He was appointed to the Board in April 2006.

EXECUTIVE CHAIRMAN'S STATEMENT

Introduction

I am pleased to report that the Company has continued to make good development progress towards commercialisation of our Downhole Gas Compressor (DGC) as well as achieving success with our Industrial Air partners. The Company has increased research and development expenditure to more rapidly achieve the technical requirements of the industry. It is pleasing that the benefits of our no-oil compressors are being more widely recognised in the industry for their green credentials, being contaminant free and offering significant efficiency improvements over existing air compressor systems.

The Company has reduced net losses after tax to £1.4 million through increased contributions from our industrial partners and from R&D tax credits. The year-end cash balance has remained static at £3.5 million, due in part to a share placing of £1.1 million (net of expenses) at a price of 32 pence per share, as well as tight working capital management.

Our pioneering work at the forefront of high speed motors and drives has enabled us to secure two DTI grants for further advancements in this area. In particular, the Company is working with leading universities to enable our power electronics systems to withstand extreme high temperatures. Additionally, we have recently been recognised by the EU Commission for EUREKA status reflecting the advance of the DGC programme given the technological challenges and the unique benefits to the industry. This status validates our ability to develop innovative solutions in advanced technology areas. Our ability to now secure contracts with industry leaders gives us confidence that our revolutionary technology is being accepted in the market place.

Downhole Gas Compressors

The DGC programme is the most dynamic aspect of Corac's business. Working with leading international exploration/gas production companies and using their knowledge of gas wells has challenged us to design suitable systems for extremely hazardous environments. The Company has taken its proven air turbo compressor design to new levels with breakthroughs in:

- High speed gas-filled brushless permanent magnet motors;
- Outstanding compact downhole power electronics with excellent power transmission;
- Gas lubricated bearings enabling high speed one-piece shaft design;
- The design of low speed turbo-blading to cope with water and sand.

The Company, together with its field operators, is now able to predict production enhancement and the rejuvenation of uneconomic fields. It is these capabilities that support the reason why three major oil and gas companies, Conoco Phillips (UK) Limited, Eni SpA and Repsol YPF, have invested £3.7 million to date in this project. In the final quarter of 2006, the Company's partners in the Joint Industry Programme were sufficiently satisfied with progress to release further funding for 2007.

The main work to be undertaken in the current phase is the loop testing. Simulated downhole conditions in a flow loop have been set up on a test rig in Cumbria, following agreement with Advantica, a subsidiary of National Grid. Specifically, downhole conditions are being simulated where the gas is circulated at various controlled rates, pressures and temperatures, thereby verifying performance parameters in as near downhole well conditions as possible. This will further establish reliability and enable the Company to rework designs and remove risks before the units are inserted into a well. Two of our partners have already identified suitable assets and are actively planning for field deployment in 2008. The existing price of energy and the need for increased recovery from existing gas wells is increasing the market need for the Company's Downhole Compressor units.

Industrial Air

The Company successfully delivered its 150 kW turbo booster demonstrator to its Austrian partner Leobersdorfer Maschinenfabrik AG (LMF), in September 2006. LMF is a specialist compressor manufacturer with a strong international reputation. It supplies compressors for seismic work for the oil and gas industry, high pressure process applications, as well as PET blowers for the plastic bottle industry. Many of LMF's clients are internationally well known companies. LMF are seen as premium suppliers who have patented economic solutions for applications in these areas.

Following the delivery of the demonstration unit, an order for a further four machines was received at the beginning of January 2007 to assist LMF develop a new range of machines for their customers. The Company has good relations with its Austrian partner to ensure cost effective solutions to the end customer. Industry statistics indicate a conservative market of €35m per annum. The turbo boosting concept for high pressure applications has a much greater market potential and could exceed €150m per annum.

EXECUTIVE CHAIRMAN'S STATEMENT (continued)

Further progress has also been made in the area of turbo boosting water screw machines. A Joint Development Agreement has been signed with Fu Sheng, the Taiwanese conglomerate which has a significant market share in South East Asia. Having successfully used Corac's 50 kW turbo demonstrator with Fu Sheng's mono water screw, the Company was able to provide significant improvement in efficiency over the traditional dry screw machines. This hybrid machine combines the benefits of both machine types by providing good variable output at high pressure compressed air with no oil contamination. The Development Agreement will allow both companies to optimise the combination of both machines and establish production procedures ensuring cost effective solutions for the vibrant South East Asian market.

High Pressure Gas Seals Licence

The dry gas seals business continues to progress with AESSEAL taking total responsibility for intellectual property rights, manufacturing and marketing of our technology. Selective presentations to potential end customers continue to be encouraging. As a result of our agreement with AESSEAL, the Company will not incur any further costs but will retain the benefit of the royalty stream on future sales of gas seals. Our highly skilled seals team is now making a contribution towards the downhole project.

Board Appointment

Alan Wood CBE, currently Chief Executive Officer of Siemens in the UK, was appointed to the Board in April 2006 as Non Executive Director. He joined the Audit and Remuneration Committees to replace John Grant who stepped down in December 2006. I take this opportunity of thanking John Grant for his invaluable contribution to Corac over the last six years.

Outlook

The DGC development continues to reduce risk and will soon be demonstrating its ability to recover stranded gas reserves and boost field performance by up to 40%. Whilst the DGC will not be a full commercial product until 2009, it is important that our other target markets have products that deliver income and cash flow now, establishing the Company's presence in these respective sectors.

We are pleased with the Company's ongoing progress and continue to look forward to the future with enthusiasm.

PROFESSOR G MUSGRAVE
EXECUTIVE CHAIRMAN
8 March 2007

DIRECTORS' REPORT

The directors present their annual report and the financial statements for the year ended 31 December 2006.

Principal activity and review of business

The Company's principal activity during the year was the continued innovation, research, development and commercialisation of oil-free industrial air compressors, dynamic gas seals and downhole gas compressors. Following the sale of the gas seals IPR after the year end, this part of the business is now expected to simply generate royalty income.

The directors closely monitor the progress of the research programmes within each of these product sectors, and during this phase of the Company's development consider the most important indicator of the success of the business to be the achievement of technical targets within planned timescales. The main financial indicator is the availability of cash to fund the business through to profitable commercialisation and positive cash flow. Certain areas of technical research have been protracted resulting in some project milestones not being met. The directors are continuing to focus their attention on minimising the effects of this on the business. Cash flow has been tightly controlled and remains on target.

The financial risks of the Company are discussed in note 20.

A review of the business is set out in the Executive Chairman's statement.

The Company made a loss after taxation of £1,373,027 in the year ended 31 December 2006 (2005 restated: £1,911,776). The directors do not recommend the payment of a dividend and propose that the loss be charged to reserves.

Research and development expenditure in the year was £1,117,287 (2005: £974,434).

Creditor payment policy

The Company seeks to agree payment terms with its suppliers in advance of a transaction and will pay in accordance with the agreed terms as long as the Company is satisfied that the supplier has provided goods and services in accordance with the order.

The Company's creditor payment period is 27 days (2005: 26 days).

Directors' and Officers' liability insurance

The Company purchases liability insurance covering its directors and officers.

International Financial Reporting Standards

Since the Alternative Investment Market has not prescribed a date by which companies who do not produce group accounts are required to comply, the Company has decided not to adopt International Financial Reporting Standards at this time.

Directors and their interests

The directors during the year were as follows:

Professor G Musgrave	
G W Cromm	
J A M Grant	(resigned 21 December 2006)
J H Gunn	
T E Ivings	
S D Oakley	(resigned 21 April 2006)
J O Reed	
A J Wood	(appointed 1 April 2006)

Directors' interests in shares are shown in the Remuneration Report.

DIRECTORS' REPORT (continued)

Issue of shares

During the year, the Company placed 3,528,900 ordinary 10p shares at a price of 32p representing 4.76% of the enlarged issued share capital.

Also during the year, the Company issued a total of 322,580 ordinary 10p shares at a price of 32p per share as a result of the exercise of share options.

All new shares issued in the year will rank pari passu with all existing ordinary shares.

Substantial shareholdings

The following members had a holding of 3% or more of the issued share capital as at 7 March 2007.

	Number	%
Mellon Nominees (UK) Limited	5,224,104	7.0
W B Nominees Limited	4,109,230	5.5
HSBC Global Custody Nominee (UK) Limited	2,872,095	3.8
Vidacos Nominees Limited	2,819,318	3.8
Smith & Williamson Nominees Limited	2,512,804	3.4
Roy Nominees Limited	2,350,000	3.1

Related parties

These have been disclosed within note 19 to the accounts.

Independent auditors

Grant Thornton UK LLP offer themselves for reappointment as auditors in accordance with Section 385 of the Companies Act 1985.

This report was approved on behalf of the Board on 8 March 2007 and signed on its behalf

T E Ivings
Company Secretary

CORPORATE GOVERNANCE REPORT

Principles of good corporate governance

The Company is committed to high standards of corporate governance. It has adopted procedures to institute good governance insofar as it is practical and appropriate for an organisation of its size and nature, notwithstanding the fact that companies that have securities traded on the Alternative Investment Market (AIM) are not required to comply with the disclosures of the Combined Code as appended to the Listing Rules issued by the Financial Services Authority.

As the Company grows, it will regularly review the extent of its corporate governance practices and procedures. At its current stage of development, the Company does not consider it appropriate to be fully compliant with the Combined Code.

The Board has implemented the Turnbull Guidance on the aspects of the Combined Code relating to Internal Control.

Application of principles

Directors

During the year the Board consisted of five executive directors, two full time and three part time, and three non-executive directors. The Board does not consider it appropriate at this stage of the Company's development to split the role of Chairman and Chief Executive. The Board meets bi-monthly and is provided with relevant information on financial, business and corporate matters prior to meetings. The Board is responsible for overall Company strategy, acquisition and divestment policy, approval of the budget, approval of major capital expenditure projects and consideration of significant operational and financial matters. The Board monitors the exposure to key business risks and reviews the progress of the Company towards achievement of its budgets and forecasts. The Board also considers employee issues, key appointments and compliance with relevant legislation. The Board has both an Audit and a Remuneration Committee. Given the small size of the Board, it is not considered necessary to constitute a separate Nominations Committee and all members of the Board are consulted on the potential appointment of a new director or a company secretary. The Company also has a Health and Safety Committee that reports to the Board at regular intervals.

All directors can receive appropriate training as necessary and are able to take independent professional advice in relation to their duties if necessary. All directors are subject to re-election every three years.

The Board members during the year were:

Non-executive directors
- J A M Grant (resigned 21 December 2006)
- J H Gunn
- A J Wood (appointed 1 April 2006)

Executive directors
- Professor G Musgrave (Executive Chairman)
- G W Cromm
- T E Ivings
- S D Oakley (resigned 21 April 2006)
- J O Reed

Relationship with shareholders

The Board attaches a high importance to maintaining good relationships with all shareholders. The Company holds regular meetings with institutional shareholders to keep them updated on the Company's performance, strategy, management and Board membership. In addition, the Board welcomes as many shareholders as possible to attend the Annual General Meeting and encourages an open discussion after the formal proceedings. The Company gives regular briefings to a number of analysts who cover the technology sector and actively encourages more analysts to follow the Company.

Accountability and audit

Directors' responsibilities

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare financial statements in accordance with United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to:

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

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

In so far as the directors are aware:

- there is no relevant audit information of which the Company's auditor is unaware; and
- the directors have taken all steps that they ought to have taken to make themselves aware of any relevant audit information and to establish that the auditor is aware of that information.

The directors are responsible for the maintenance and integrity of the website and accordingly the auditors accept no responsibility for the information published. Information published on the website is accessible in many countries and legislation in the UK concerning the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Audit Committee

The Audit Committee comprises two non-executive directors and is currently chaired by Mr J H Gunn who took over from Mr J A M Grant on 19 December 2006. The Committee has specific terms of reference which deal with its authority and duties. It meets at least twice a year, with the Finance Director, Executive Chairman and the auditor attending by invitation. The Committee reviews the independence and objectivity of the auditor each year. The Committee overviews the adequacy of the Company's internal controls, accounting policies and financial reporting and provides a forum through which the Company's external auditor reports to the non-executive directors.

The Board has decided that the size of the Company does not justify a dedicated internal audit function. This position will be reviewed as the Company's activities increase.

Going concern

After making relevant enquiries, including the review of detailed budgets and cash forecasts, the directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

Internal control and risk management

The Board has overall responsibility for ensuring that the Company has processes to identify, evaluate and manage key risks. The nature of the Company's business is changing from research and development to greater emphasis on its application and commercial exploitation. This calls for rigorous cost analysis and market risk assessment. The system is designed to manage and minimise risk of failure to achieve the Company's strategic objectives, and can only provide reasonable, and not absolute, assurance against material misstatement or loss. Key areas of internal control are listed below:

- regular review of the technical development programmes, the commercialisation of the Company's technology and the financial performance of the Company in the context of the Company's business plan.
- an organisation structure with clear executive policies on recruitment, training, appraisals and project management.
- an annual budget showing projected revenues, costs, funding requirements and operational targets. The Board is responsible for approving the budget and monitoring performance against it.
- a system to ensure the security of the Company's intellectual property.

The directors consider that the present system of internal control is sufficient for the needs of the Company and adequately addresses the risks to which the Company is perceived to be exposed. The Board reviews the system formally twice per year.

ON BEHALF OF THE BOARD

J H Gunn
Director
8 March 2007

REMUNERATION REPORT

Remuneration Committee

The Remuneration Committee is made up of two non-executive directors and is currently chaired by Mr A J Wood who took over from Mr J H Gunn on 20 February 2007. The Remuneration Committee set, and annually review, the terms and conditions of employment of the executive directors. The remuneration of non-executive directors is fixed by the Board as a whole. The Remuneration Committee also monitors and reviews the Company-wide appraisal process and approves the proposals from the executive directors for all employees' remuneration and option arrangements.

Remuneration policy

The Company's policy on executive directors' remuneration is to attract and retain high quality executives by paying competitive remuneration packages relevant to each director's role, experience and the external market. The packages include a basic salary, pension contributions and stock options. All new options granted incorporate individual performance conditions which relate to the achievement of key corporate strategic objectives.

Service agreements

No directors have service agreements with notice periods that exceed 12 months.

Directors' emoluments

	Basic salary or fees £	Termination payment £	Benefits £	Pension contributions £	Total emoluments 2006 £	Total emoluments 2005 £
Executive						
Professor G Musgrave	111,539	–	451	6,199	118,189	116,375
G W Cromm	104,204	–	2,083	2,513	108,800	106,799
T E Ivings	53,195	–	–	3,314	56,509	–
S D Oakley (resigned 21 April 2006)	38,824	100,100	–	2,875	141,799	129,238
J O Reed	123,199	–	–	8,624	131,823	129,238
Non-executive						
J H Gunn	25,121	–	–	–	25,121	24,575
J A M Grant (resigned 21 December 2006)	25,121	–	–	–	25,121	24,575
A J Wood (appointed 1 April 2006)	17,213	–	–	–	17,213	–
Totals	498,416	100,100	2,534	23,525	624,575	530,800

The aggregate gains made by directors on one exercise of share options was £54,839 (2005: £322,405). The market price at the date of exercise was 49.0p.

REMUNERATION REPORT (continued)

Directors' share options

The interests of the directors, who were in office at the end of the financial year, in options over the shares of the Company at 31 December 2006 and 1 January 2006 were:

	As at 1 January 2006	Exercised in year	Lapsed in year	Issued in year	As at 31 December 2006	Price (p)	Lapse date
Professor G Musgrave*	384,800	–	–	–	384,800	11.5385	30 January 2007
Professor G Musgrave	1,170,000	–	(86,666)	–	1,083,334	38.4616	7 December 2008
Professor G Musgrave	–	–	–	190,000	190,000	37.5	27 July 2013
G W Cromm	357,142	–	–	–	357,142	28	22 March 2012
G W Cromm	142,858	–	–	–	142,858	28	22 March 2009
G W Cromm	–	–	–	50,000	50,000	37.5	27 July 2013
T E Ivings	–	–	–	217,013	217,013	46.08	6 April 2014
T E Ivings	–	–	–	82,987	82,987	46.08	6 April 2013
T E Ivings	–	–	–	50,000	50,000	37.5	27 July 2013
J O Reed	130,000	–	–	–	130,000	38.4616	15 October 2007
J O Reed	260,000	–	(86,666)	–	173,334	38.4616	29 October 2008
J O Reed**	100,000	–	–	–	100,000	55.3	8 January 2007
J O Reed	100,000	–	–	–	100,000	22	19 December 2009
J O Reed	–	–	–	110,000	110,000	37.5	27 July 2013

*This option was exercised on 8 January 2007.
**This option lapsed on 8 January 2007.

Directors' interests

The directors who held office at the end of the financial year had the following beneficial interests in the ordinary share capital of Corac Group plc at 1 January 2006, 31 December 2006 and at the date of this report:

	Number held at date of this report Ordinary Shares of 10p each	Number held at 31 December 2006 Ordinary Shares of 10p each	Number held at 1 January 2006 Ordinary Shares of 10p each
Professor G Musgrave	1,670,530	1,285,730	1,785,730
J O Reed	13,300	13,300	13,300
J H Gunn	1,223,200	1,223,200	1,361,000

ON BEHALF OF THE REMUNERATION COMMITTEE

A J Wood
Chairman
Remuneration Committee
8 March 2007

REPORT OF THE INDEPENDENT AUDITOR TO THE MEMBERS OF CORAC GROUP PLC

We have audited the financial statements (the "financial statements") of Corac Group plc for the year ended 31 December 2006 which comprise the profit and loss account, the balance sheet, the cash flow statement and notes 1 to 21. These financial statements have been prepared under the accounting policies set out therein.

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 auditor's 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 auditor

The directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. We report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Executive Chairman's Statement, the Directors' Report, the Corporate Governance Report, and Directors' Remuneration Report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

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 financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 December 2006 and of its loss for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements for the year ended 31 December 2006.

GRANT THORNTON UK LLP
REGISTERED AUDITORS
CHARTERED ACCOUNTANTS
OXFORD
8 March 2007

PROFIT AND LOSS ACCOUNT
for the year ended 31 December 2006

	Note	2006 £	2005 (restated) £
Turnover	2	**1,642,040**	835,860
Cost of sales		**(1,479,209)**	(795,698)
Gross profit		**162,831**	40,162
Development costs		**(1,117,287)**	(974,434)
Other administrative expenses		**(1,434,823)**	(1,358,704)
Administrative expenses		**(2,552,110)**	(2,333,138)
Other operating income – grant receivable		**24,314**	82,737
Operating loss	3	**(2,364,965)**	(2,210,239)
Interest receivable	5	**165,226**	182,128
Loss on ordinary activities before taxation		**(2,199,739)**	(2,028,111)
Taxation	6	**826,712**	116,335
Loss for the financial year		**(1,373,027)**	(1,911,776)
Loss per share			
Basic loss, pence per share	7	**(1.8)**	(2.8)

All results relate to continuing activities.

There were no recognised gains and losses in 2006 or 2005 other than those included in the profit and loss account.

Notes 1 to 21 form part of these financial statements.

CORAC

BALANCE SHEET
at 31 December 2006

	Note	2006 £	2005 (restated) £
Fixed assets			
Tangible assets	8	**191,996**	273,118
Current assets			
Stocks	9	**–**	45,571
Debtors	10	**770,429**	555,728
Cash at bank and in hand	11	**3,526,350**	3,460,665
		4,296,779	4,061,964
Creditors			
Amounts falling due within one year	12	**(1,312,448)**	(1,067,462)
Net current assets		**2,984,331**	2,994,502
Total assets less current liabilities		**3,176,327**	3,267,620
Capital and reserves			
Called up share capital	13	**7,442,970**	7,057,822
Share premium account	14	**858,351**	11,025
Capital redemption reserve	14	**575,000**	575,000
Own shares held by Employee Benefit Trust	14	**(298,105)**	(299,604)
Share based payment reserve	14	**150,539**	102,778
Profit and loss account	14	**(5,552,428)**	(4,179,401)
Equity shareholders' funds		**3,176,327**	3,267,620

The financial statements were approved by the Board on 8 March 2007 and signed on its behalf by

Professor G Musgrave
Executive Chairman

Notes 1 to 21 form part of these financial statements.

CORAC

CASH FLOW STATEMENT
for the year ended 31 December 2006

	Note	£	2006 £	£	2005 £
Net cash outflow from operating activities	16		**(1,831,685)**		(1,472,931)
Returns on investment and servicing of finance					
Interest received		**165,226**		182,128	
Net cash inflow from returns on investment and servicing of finance			**165,226**		182,128
Taxation			**515,415**		494,715
Capital expenditure					
Purchase of tangible fixed assets		**(17,559)**		(13,078)	
Sale of tangible fixed assets		**315**		–	
Net cash outflow from capital expenditure			**(17,244)**		(13,078)
Net cash outflow before use of liquid resources and financing			**(1,168,288)**		(809,166)
Management of liquid resources					
Cash transferred (to)/from long-term deposits			**(42,258)**		633,437
Financing					
New share capital subscribed	13	**1,232,474**		186,916	
EBT Shares transferred on exercise of option	14	**1,499**		–	
Net cash inflow from financing			**1,233,973**		186,916
Increase in cash in the year	17		**23,427**		11,187

NOTES TO THE FINANCIAL STATEMENTS
31 December 2006

1 Accounting policies

The financial statements have been prepared in accordance with applicable United Kingdom accounting standards (generally accepted accounting principles) and under the historical cost convention.

The principal accounting policies of the Company are set out below. The policies have remained unchanged from the previous year except for the adoption of FRS 20 'Share based payments' and the effect of not consolidating the Company's wholly-owned dormant subsidiaries. The effects of these changes are explained below.

Basis of preparation

Consolidation
The Group's operations are conducted by its parent company, Corac Group plc, and there is no activity within its two wholly-owned subsidiaries. The Company has previously consolidated the accounts of these subsidiaries and produced group accounts. The Directors have reconsidered this treatment and determined that it is more appropriate not to produce group accounts since the amounts involved are not material and greater clarity of presentation is provided by the presentation of accounts for the Company as an individual undertaking and not about its group. The Directors have therefore claimed exemption from producing group accounts under Section 229 of the Companies Act 1985.

Going concern
The Company incurred a loss during the year ended 31 December 2006 and further losses are being incurred in the current financial period as the development of the compressor range and the downhole compressor continues. The accounts have been prepared on a going concern basis which assumes that the Company will continue in operational existence for the foreseeable future.

The directors are confident that sufficient funds have been raised for the next development stage and to provide working capital. Therefore they believe it is appropriate for the accounts to be prepared on a going concern basis.

Share based payments
FRS 20 requires the recognition of equity-settled share-based payments at fair value at the date of the grant and the recognition of liabilities for cash-settled share-based payments at the current fair value at each balance sheet date.

The Company makes equity-settled share-based payments to its employees and directors. Equity-settled share-based payments are measured at fair value at the date of grant and expensed on a straight-line basis over the vesting period of the award. At each balance sheet date, the Company revises its estimate of the number of options that are expected to become exercisable.

The value of any shares or options granted is charged to the profit and loss account over the period the shares vest, with a corresponding credit to reserves. When share options are exercised, the proceeds received, net of any transaction costs, are credited to share capital (nominal value) and share premium.

Prior to the adoption of FRS 20, the Company did recognise the financial effect of share-based payments in line with UITF Abstract 17 'Employee share schemes'.

In accordance with the transitional provisions of FRS 20, the Standard has been applied retrospectively to all grants of equity instruments after 7 November 2002 that were unvested as of 1 January 2005.

For the year ended 31 December 2005, the change in accounting policy has resulted in a net increase in the loss for the year of £36,544. The balance sheet at 31 December 2005 has been restated to reflect the recognition of a share based payment reserve of £102,778.

For the year ended 31 December 2006 the change in accounting policy has resulted in a net charge to the profit and loss account of £47,761. At 31 December 2006, the share based payment reserve amounted to £150,539.

1 Accounting policies (continued)

Turnover

Turnover on contracts is recognised using the percentage-of-completion method. Under this method revenues recorded represent the aggregate of costs incurred during the year and a portion of estimated profit on individual contracts based on the relationship of costs incurred to total estimated costs for each contract. Revisions in estimates are reflected in the accounting period when the revision becomes known. Anticipated losses on contracts are charged to income in their entirety when the losses become evident.

Turnover from engineering services is recognised over the period services are provided and turnover from up front licence fees is taken to income on commencement of the licence. Turnover from research and development services for third parties, including cost recharges, is recognised over the period such services are provided. All amounts exclude Value Added Tax.

Stocks

Stocks and work in progress are stated at the lower of cost and net realisable value after making due allowance for obsolete or slow moving stocks. Cost includes all direct costs and an appropriate proportion of fixed and variable overhead expenses. Net realisable value is based on the estimated selling price less the estimated cost of disposal.

Taxation

Corporation tax recoverable in respect of research and development cash tax credits is recognised when the decision has been taken to claim such amounts in cash. Until such a decision is made, the potential tax benefit arising from research and development expenditure is included in tax losses carried forward. Corporation tax payable is provided on taxable profits at the current rate. Deferred taxation is recognised on an undiscounted basis on all timing differences where the transactions or events that give the Company an obligation to pay more tax in the future or a right to pay less tax in the future, have occurred by the balance sheet date. Deferred tax assets are recognised when it is more likely than not that they will be recovered.

Fixed assets and depreciation

Fixed assets are stated at cost, net of depreciation. Depreciation is provided on the cost of fixed assets at rates calculated to write off each asset on a straight-line basis over its estimated useful life, as follows:

Computer equipment	33% per annum
Office furniture and fittings	20% per annum
Plant and machinery	20% per annum

Short leasehold improvements are amortised over the life of the lease.

Share-based payments

The Company makes equity-settled share-based payments to its employees and directors. Equity-settled share-based payments are measured at fair value at the date of grant and expensed on a straight-line basis over the vesting period of the award. At each balance sheet date, the Company revises its estimate of the number of options that are expected to become exercisable.

The value of any shares or options granted is charged to the profit and loss account over the period the shares vest, with a corresponding credit to reserves. When share options are exercised, the proceeds received, net of any transaction costs, are credited to share capital (nominal value) and share premium.

The principal assumptions used to calculate the value of options issued are disclosed in note 13.

Research and development

Research and development expenditure is written off in the year in which it is incurred.

Leases

Rentals under operating leases are charged on a straight-line basis over the lease term.

NOTES TO THE FINANCIAL STATEMENTS (continued)

1 Accounting policies (continued)

Pensions

The Company operates a money purchase pension scheme and a stakeholder pension scheme. In addition, the Company contributes to the personal pension plan of one of its directors. The pension charge represents the amounts payable by the Company to these funds in the year.

Patent fees

Patent costs are written off in the year in which they are incurred.

Short term cash deposits

In accordance with FRS 1 (revised), short term cash deposits are included on the Balance Sheet within cash at bank and in hand. These deposits do not constitute cash for the purposes of the Cash Flow Statement and have been disclosed separately in note 11 to these financial statements. These amounts are classified as liquid resources.

Government grants

Government grants of a revenue nature are credited to the profit and loss account in the same period as the related expenditure.

Interest receivable

Interest receivable represents interest earned on short term cash deposits.

Own shares held by Employee Benefit Trust

As required by UITF Abstract 38 “Accounting for ESOP trusts” the consideration paid for shares held by the Company’s Employee Benefit Trust is deducted in arriving at shareholders’ funds.

Financial instruments

Financial assets and financial liabilities are recognised on the balance sheet when the Company becomes a party to the contractual provisions of the instrument.

Trade debtors do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

Trade creditors are not interest bearing and are stated at their nominal value.

2 Turnover

Turnover is attributable to development projects and licence fees.

3 Operating loss

	2006	2005
	£	£
Operating loss is stated after charging:		
Auditor’s remuneration		
– audit services	**12,540**	20,594
– other services supplied pursuant to such legislation	**790**	–
– taxation	**9,740**	6,704
– all other services	**2,826**	–
Depreciation of tangible fixed assets	**98,222**	112,655
Loss on disposal of fixed assets	**144**	–
Staff costs		
– salaries and wages	**1,275,044**	1,332,527
– social security costs	**135,014**	148,742
Operating leases		
– rent	**149,183**	150,032

The average number of employees, including directors, employed by the Company during the period was 26 (2005: 28). These are split between the following departments: administration: 7 (2005: 7) and engineering: 19 (2005: 21).

3 Operating loss (continued)

Pension costs

The Company operates a money purchase pension scheme and a group stakeholder pension scheme. The assets of these schemes are held separately from those of the Company in administered funds. The pension cost charge represents contributions payable by the Company to these funds and amounted to £66,145 (2005: £80,278). In addition, payments of £6,189 (2005: £8,455) were made to the personal pension plans of two directors.

Four directors (2005: four) accrued benefits under the group schemes during the year and one via contribution to his personal pension plan.

There were outstanding contributions of £Nil (2005: £50) payable to these funds at the year end.

The nature of the Company's schemes is such that there is no possibility of a surplus or deficiency in funding arising from past service.

4 Directors' remuneration

	2006	2005
	£	£
Directors' emoluments were as follows:		
Remuneration	**500,950**	549,822
Termination payments	**100,100**	–
Gains made on the exercise of share options	**54,839**	322,405
Pension contributions	**23,525**	28,562
	679,414	900,789

During the year one director (2005: one) not including the highest paid director, exercised share options.

Emoluments of the highest paid director included above is as follows:

	2006	2005
	£	£
Remuneration	**123,199**	120,783
Pension contributions	**8,624**	8,455
	131,823	129,238

5 Interest receivable

	2006	2005
	£	£
Bank interest receivable	**165,226**	182,128

NOTES TO THE FINANCIAL STATEMENTS (continued)

6 Taxation

Current taxation	**2006**	2005
	£	£
Corporation tax – research and development credit – current year	**423,000**	111,703
– prior year	**403,712**	4,632
	826,712	116,335

	2006	2005 (restated)
	£	£
The tax credit for the period is lower than the standard rate of corporation tax in the UK of 30% (2005: 30%). The differences are explained as follows:		
Loss on ordinary activities before taxation	**(2,199,739)**	(2,028,111)
Loss on ordinary activities multiplied by standard rate of corporation tax in the UK of 30% (2005: 30%)	**659,922**	608,433
Effect of:		
Expenses not deductible for tax purposes	**(1,179)**	(1,445)
Depreciation in excess of capital allowances	**(23,513)**	(28,251)
Share-based payments	**2,310**	(2,139)
Research and development enhanced relief	**311,512**	82,481
Research and development difference in tax rate	**(370,125)**	(97,740)
Trading losses carried forward	**(155,927)**	(449,636)
Adjustment in respect of prior periods	**403,712**	4,632
Current tax credit for the period	**826,712**	116,335

Deferred taxation	**2006**	2005 (restated)
	£	£
Accelerated capital allowances and other timing differences	**142,783**	213,458
Losses	**(142,783)**	(213,458)
	–	–

Subject to agreement by HMRC, Corac Group plc has approximately £5,700,000 (2005: £6,900,000) of unrelieved tax losses. A deferred tax asset has not been recognised due to lack of certainty surrounding future utilisation of these losses.

7 Loss per share

The calculation of basic loss per share for the year ended 31 December 2006 is based upon a loss after tax of £1,373,027 (2005 restated: loss £1,911,776), and a weighted average number of shares of 74,211,163 (2005: 68,905,374). Diluted loss per share is not calculated since the conversion to ordinary shares of share options would be anti-dilutive.

CORAC

8 Tangible fixed assets

	Short leasehold improvements £	Computer equipment £	Office furniture and fittings £	Plant and machinery £	Total £
Cost					
At 1 January 2006	189,827	260,705	24,850	307,533	782,915
Additions	–	15,803	–	1,756	17,559
Disposals	–	(1,835)	–	–	(1,835)
At 31 December 2006	**189,827**	**274,673**	**24,850**	**309,289**	**798,639**
Depreciation					
At 1 January 2006	81,137	221,626	19,167	187,867	509,797
Charge for year	22,098	29,409	2,607	44,108	98,222
Released on disposals	–	(1,376)	–	–	(1,376)
At 31 December 2006	**103,235**	**249,659**	**21,774**	**231,975**	**606,643**
Net book value					
At 31 December 2006	**86,592**	**25,014**	**3,076**	**77,314**	**191,996**
At 31 December 2005	**108,690**	**39,079**	**5,683**	**119,666**	**273,118**

9 Stocks

	2006 £	2005 £
Work in progress	**–**	45,571

10 Debtors

	2006 £	2005 £
Trade debtors	**38,149**	186,249
Other debtors	**250,152**	239,640
Other taxes and social security	**59,128**	18,136
Taxation recoverable	**423,000**	111,703
	770,429	555,728

Included within other debtors are recoverable property improvement costs of £75,000 (2005: £100,000) which are due after more than one year.

11 Cash at bank and in hand

Included in cash at bank and in hand are short term deposits amounting to £3,453,589 (2005: £3,411,331).

12 Creditors

	2006	2005
	£	£
Amounts falling due within one year		
Trade creditors	**87,792**	71,286
Other taxes and social security	**39,778**	43,816
Deferred revenue	**667,629**	709,223
Other creditors	**593**	1,511
Amounts owed to subsidiary undertakings	**5,301**	5,301
Accruals	**511,355**	236,325
	1,312,448	1,067,462

13 Share capital

	2006	2005
	£	£
Authorised		
200,000,000 ordinary shares of 10p each	**20,000,000**	20,000,000
Allotted, called up and fully paid		
74,429,700 (2005: 70,578,220) ordinary shares of 10p each	**7,442,970**	7,057,822

	Number	Number
At 1 January 2006	**70,578,220**	68,709,061
Issued in respect of placing	**3,528,900**	–
Issued in respect of share option exercise	**322,580**	1,869,159
At 31 December 2006	**74,429,700**	70,578,220

During the year the Company issued 3,528,900 ordinary shares of 10p each for cash at 32p per share by means of a placing.

Also during the year the company issued 322,580 ordinary shares of 10p each for cash at 32p per share on the exercise of share options.

After the year end, the Company issued 384,800 ordinary shares of 10p each for cash at 11.5385p per share on the exercise of share options. As a result of this issue the total issued share capital of the Company at the date of this report was 74,814,500 ordinary shares of 10p each.

Options

The Company has two unapproved share option schemes and an Enterprise Management Incentive (EMI) scheme. Share options have been granted by both the Company and the Corac EBT (note 14) under the rules of these schemes. The share options granted by the EBT have no dilutive effect on the Company's share capital.

	Unapproved schemes		**EMI scheme**		**Total**		
	Company	**EBT**	**Company**	**EBT**	**Company**	**EBT**	**Total**
Number of options at 1 January 2006	1,845,078	240,000	2,030,122	612,000	3,875,200	852,000	4,727,200
Exercised during the year	–	(3,333)	(322,580)	(4,000)	(322,580)	(7,333)	(329,913)
Lapsed during the year	(177,420)	(146,667)	(581,532)	(39,000)	(758,952)	(185,667)	(944,619)
Issued during the year	–	492,987	–	457,013	–	950,000	950,000
At 31 December 2006	1,667,658	582,987	1,126,010	1,026,013	2,793,668	1,609,000	4,402,668

13 Share capital (continued)

Exercise of an option is generally subject to continued employment and to satisfaction of the applicable performance conditions. The fair value per option granted and the assumptions used in the calculation of fair value for awards made after 7 November 2002 are set out in the table below.

At 31 December 2006 options over unissued ordinary 10p shares were as follows:

Date of grant	Number	Option price per share (pence)	Option periods ending	Closing share price at grant (pence)	Exercise price (pence)	Expected volatility (%)	Risk-free interest rate (%)	Fair value per share (pence)
2000	384,800	11.54	2007					
2000	1,040,000	38.46	2007					
2001	650,868	38.46	2006-2009					
2001	28,000	85.50	2007-2009					
2001	5,000	86.50	2007-2009					
2002	100,000	55.30	2007					
2002	40,000	40.00	2008-2010					
2002	25,000	43.50	2008-2010					
2002	20,000	23.00	2008-2010					
2002	*69,000	22.00	2008-2010	22.00	22.00	50.1860	4.3860	10.72
2002	*100,000	22.00	2008-2010	22.00	22.00	50.1860	4.3818	10.71
2003	*270,000	34.00	2009-2011	34.00	34.00	42.8183	4.7805	15.05
2004	142,858	28.00	2009	28.50	28.00	40.8181	4.6317	12.32
2004	357,142	28.00	2010-2012	28.50	28.00	40.8181	4.6317	12.32
2004	*145,000	33.00	2010-2012	33.00	33.00	37.6867	4.5024	13.28
2005	*85,000	31.25	2011-2013	32.25	31.25	38.5446	4.1971	13.36
2006	*300,000	46.08	2012-2014	46.00	46.08	37.0739	4.5048	14.08
2006	*640,000	37.50	2012-2014	36.50	37.50	38.2617	4.3001	11.41
	4,402,668							

*These options were issue by the EBT.

The market price of the Company's shares at 31 December 2006 was 36.5p and the range during the year was between 31.75p and 52.5p.

The vesting period of an option is assumed to be commensurate with the exercise period of the option and the expected life of an employee share option is five years.

Expected volatility is a measure of the amount by which a share price is expected to fluctuate during a period. The volatility of the Company's share price was calculated as the average of annualised standard deviations of daily continuously compounded returns on the Company's stock, calculated over 1,2 and 3 years back from the date of grant where possible.

The risk-free rate is the yield to maturity on the date of grant of a UK Gilt Strip, with term to maturity equal to the life of the option.

The dividend yield of 0% in all cases reflects the absence of dividends and of a clear dividend policy statement at the relevant dates of grant.

Options granted before 2006 were valued using the Black-Scholes model. Options granted in 2006 were valued using the Monte Carlo model.

14 Reserves

	Capital redemption reserve £	Own shares held by Employee Benefit Trust £	Share premium account £	Share based payment reserve (restated) £	Profit and loss account (restated) £	Total £
At 1 January 2006	575,000	(299,604)	11,025	–	(4,076,623)	(3,790,202)
Prior year adjustment (note 1)	–	–	–	102,778	(102,778)	–
At 1 January 2006 (restated)	575,000	(299,604)	11,025	102,778	(4,179,401)	(3,790,202)
Loss for the year	–	–	–	–	(1,373,027)	(1,373,027)
Shares transferred on exercise of option	–	1,499	–	–	–	1,499
Issue of shares	–	–	847,326	–	–	847,326
FRS20 share option charge	–	–	–	47,761	–	47,761
At 31 December 2006	575,000	(298,105)	858,351	150,539	(5,552,428)	(4,266,643)

Own shares held by Employee Benefit Trust

On 8 November 2002 the Company established the Corac EBT, an employee benefit trust (EBT), as an employees' share scheme for the benefit of and as an incentive for the employees of the Company. The Corac EBT is managed by an independent trustee.

At 31 December 2006 the Company had loaned £300,000 (2005: £300,000) to the Corac EBT. With this loan the Trustee purchased shares in the Company and, at 31 December 2006, the Corac EBT held 1,457,667 (2005: 1,465,000) ordinary shares in Corac Group plc with a book cost of £298,105 (2005: £299,604) which had a market value of £532,048 (2005: £465,138).

Options have been granted over 1,609,000 (2005: 852,000) of these shares to certain employees, 169,000 exercisable at 22p per share until 18 December 2010, 270,000 at 34p per share until 11 December 2011, 145,000 at 33p per share until 16 December 2012, 85,000 at 31.25p per share until 29 December 2013, 300,000 at 46.08p per share until 6 April 2014 and 640,000 at 37.50p per share until 27 July 2014. These options are subject to performance conditions.

The company intends to fund any shortfall should the EBT need to purchase more shares to fulfil its obligations to option holders.

Dividends on the shares owned by the EBT, the purchase of which was funded by an interest free loan to the EBT from Corac Group plc, are waived on the condition that the Trustee shall not be liable for any losses to the EBT as a result of the waiver.

15 Reconciliation of movement in shareholders' funds

	2006 £	2005 (restated) £
Shareholders' funds at 1 January 2005 as previously reported (consolidated)	–	4,961,232
Effect of non-consolidation of subsidiaries	–	(5,296)
Shareholders' funds at 31 December 2005 (company only)	–	4,955,936
Shareholders' funds at 1 January 2006	**3,267,620**	4,955,936
Loss for the year	**(1,373,027)**	(1,911,776)
New shares issued	**1,232,474**	186,916
Movement in share based payment reserve	**47,761**	36,544
Reduction in shares held by EBT	**1,499**	–
Net reduction to shareholders' funds	**(91,293)**	(1,688,316)
Shareholders' funds at 31 December 2006	**3,176,327**	3,267,620

For the year ended 31 December 2005, the change in accounting policy in respect of FRS 20 share-based payments has resulted in an increase in the loss for the year of £36,544 and an increase in the loss brought forward at 1 January 2005 of £66,234. The balance sheet at 31 December 2005 has been restated to reflect the recognition of a share based payment reserve of £102,778.

For the year ended 31 December 2006 the change in accounting policy has resulted in a net charge to the profit and loss account of £47,761. At 31 December 2006, the share based payment reserve amounted to £150,539.

The change in accounting policy has no effect on net assets and shareholders' funds.

16 Reconciliation of operating loss to net cash outflow from operating activities

	2006 £	2005 (restated) £
Operating loss	**(2,364,965)**	(2,210,239)
Loss on disposal of fixed assets	**144**	–
Depreciation	**98,222**	112,655
Decrease in stock and work in progress	**45,571**	4,429
Decrease/(increase) in debtors	**96,596**	(84,268)
Increase in creditors	**244,986**	667,948
Increase in share-based payments provision	**47,761**	36,544
Net cash outflow from operating activities	**(1,831,685)**	(1,472,931)

17 Reconciliation of net cash flow to movement in net funds

	2006 £	2005 £
Increase in cash	**23,427**	11,187
Cash effect of increase/(decrease) in liquid resources	**42,258**	(633,437)
Movement in net funds in the year	**65,685**	(622,250)
Net funds at 1 January 2006	**3,460,665**	4,082,915
Net funds at 31 December 2006	**3,526,350**	3,460,665

18 Analysis of changes in net funds

	As at 1 January 2006 £	Cash flow £	As at 31 December 2006 £
Cash in hand	110	2	112
Cash at bank	49,224	23,425	72,649
	49,334	23,427	72,761
Short term deposits	3,411,331	42,258	3,453,589
Net funds	3,460,665	65,685	3,526,350

19 Related party transactions

The following transactions took place between the directors and Corac Group plc during the year and are included, net of expenses, in directors emoluments:

- Fees of £23,752 (2005: £23,448) were invoiced by Greenwood Control Systems, a partnership of which Professor G Musgrave is a partner, in respect of director's services provided by Professor G Musgrave and certain expenses of which £199 was outstanding at the year end (2005: £132)
- Fees of £25,121 (2005: £24,575) were invoiced by Scheidegg Limited, a company of which Mr J H Gunn is a director, in respect of services provided by Mr J H Gunn and certain expenses of which £Nil was outstanding at the year end (2005: £Nil)
- Fees of £74,241 (2005: £73,828) were invoiced by GCI Consulting GmbH a company of which Mr G W Cromm is a director, in respect of services provided by Mr G W Cromm and certain expenses of which £Nil was outstanding at the year end (2005: £Nil).

In addition, the following transactions took place between the Company and other entities with common directorship. In each case, the director concerned did not benefit financially from the arrangement and was not involved in agreeing the terms which were negotiated on an arms-length basis:

- Fees of £74,311 (2005: £Nil) were invoiced by Mechadyne plc, a Company of which Professor G Musgrave is a director in respect of engineering services provided by various individuals.

20 Financial instruments

The Company has financed its operations by raising equity financing on the Alternative Investment Market and investing the proceeds on a short term basis as its development proceeds.

The Company's financial instruments comprise cash and short term deposits which are placed at fixed interest rates. The Company has various other financial instruments, such as trade debtors and trade creditors, which arise directly from its operations that have not been included in the following disclosures.

The main risk arising from the Company's financial instruments is interest rate risk. The policy for managing this risk is regularly reviewed and agreed by the Board.

It is, and has been throughout the period under review, the Company's policy that no trading in financial instruments shall be undertaken.

The Company is based in the United Kingdom and all of the Company's financial assets and liabilities are denominated in Sterling and there is consequently no exposure to exchange risk.

There is no material difference between the fair values and carrying values of the Company's financial instruments.

The Company does not have an overdraft or a borrowing facility.

The amounts held on short term deposits can be seen in note 11.

NOTES TO THE FINANCIAL STATEMENTS (continued)

21 Financial commitments

Annual commitments under operating leases are as follows:

	2006	2005
	£	£
Land and buildings		
Expiry date:		
– between two and five years	**150,000**	–
– after five years	**–**	150,000

At 31 December 2006 the Company had no capital commitments (2005: £Nil).

Corac Group plc, Brunel Science Park, Kingston Lane, Uxbridge, Middlesex UB8 3PQ
Tel +44 (0)1895 813463 Fax +44 (0)1895 813505 email: info@corac.co.uk www.corac.co.uk
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