



INSPIRING YOUR PRODUCTS AND MANUFACTURING
Annual Report and Accounts 2006

Our goal is to be a leader in the optical fibre-based laser market.

SPI is now a recognised leader in the design and manufacture of fibre lasers. The Group's technology is rapidly becoming an integral part of producing many end-user products by improving, and in some cases enabling, its customers' manufacturing processes. SPI continues to expand the applications space for fibre lasers, with powers from mWs to kW.

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HIGHLIGHTS

- ➔ Turnover doubled to £7.1 million (2005: £3.5 million) in line with market expectations
- ➔ Product sales of £4.7 million (2005: £2.0 million) and contract sales of £2.4 million (2005: £1.5 million) representing growth of 135% and 60% respectively
- ➔ Continued strong growth in MICRO with largest single deployment being in excess of 70 lasers
- ➔ 102 new accounts, increased demand for MARKING, a new market sector established in MEDICAL AESTHETICS and several new market verticals established within sectors
- ➔ Technical problems encountered at mid-year have been resolved
- ➔ Strong increase in activity in Asia
- ➔ Strengthened balance sheet post year end following February 2007 placing raising £10 million (net)

WHAT WE DO AT A GLANCE

MARKING

The production of equipment to produce permanent marking on a wide range of products. Examples include consumer electronics, semi-conductor, automotive and aerospace.



MEDICAL

A growing range of aesthetic laser applications such as skin resurfacing and rejuvenation.



MICRO

A term for a diverse set of applications that require fine or precise cutting or welding. These include medical components (e.g. stents), electronic assembly, printing etc.



MACRO

Cutting and welding of larger parts in industries such as automotive, white goods, etc.



OUR MARKET

The market is set to grow strongly over the next three years. The majority of our business falls into the overall category of industrial materials processing. Within this market, the fibre laser is set to continue as the fastest growing sub-segment.

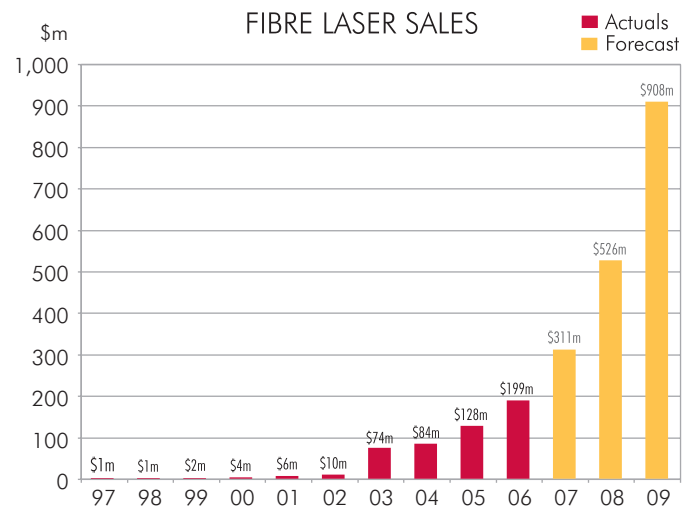
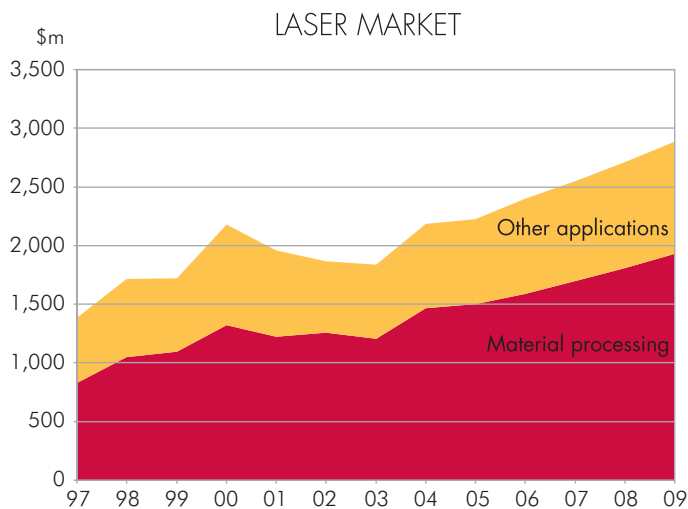
OUR TECHNOLOGY AND CURRENT PRODUCTS

The fibre laser requires the same basic elements as any other laser system.

In the case of the fibre laser, all of the elements are contained within the optical fibre, thus leading to an integrated solution which avoids the need for complex precision assemblies found in conventional lasers. The flexible nature of the optical fibre allows for a compact format which is significantly smaller than its industrial counterparts. The properties of the optical fibre lead to superior performance in many parameters.

The entire laser unit is contained in a standard 19 inch rack or compact OEM unit. One product can serve many markets and they are software configurable. SPI Lasers enjoys a wide range of intellectual property and know-how, most notably our GTWave™ technology, which allows robust and simple assembly without the use of complex or expensive sub-components. This is deployed as a standard technology platform throughout the product set.





Source: fibre laser market penetration per LaserFocusWorld Lasers & Photonics Marketplace Seminar 2006 and 2006 actuals

50-100W AIR COOLED

This laser is used in the MICRO market for fine feature cutting. The air cooling aids installation where machine mobility is required.

2-20W CW & PULSED

This product has been designed to meet the needs of the MARKING market. It operates at high speed which translates into faster throughput for end-users.

10-20W CW LONG WAVELENGTH

The wavelength of these lasers has been matched to maximise their effectiveness for aesthetic medical applications.

50-200W WATER COOLED

Our water cooled product is designed to offer industry leading stability, hence increasing cut and weld quality for end-users in its MICRO market.

The rapid growth of fibre laser sales is due to the widely recognised advantages offered by the product:

PERFORMANCE

Small, highly intense output beams with industry leading stability

SIZE

Compact and easy to integrate

EFFICIENCY

Significant improvements in efficiency compared to conventional lasers

MAINTENANCE

Little or no replacement parts or post-installation maintenance

CHAIRMAN'S STATEMENT



SUMMARY OF CHAIRMAN'S STATEMENT

- ➔ TURNOVER DOUBLED FOR THE SECOND SUCCESSIVE YEAR
- ➔ FOURTH QUARTER PRODUCT REVENUES EXCEEDED THOSE FOR THE WHOLE OF 2005
- ➔ TECHNICAL PROBLEMS RESOLVED
- ➔ FIBRE LASER MARKET CONTINUES TO DEVELOP RAPIDLY
- ➔ BALANCE SHEET STRENGTHENED

"CUSTOMER INTEREST IN OUR PRODUCTS REMAINS STRONG. THE CORE TASK FOR 2007 IS TO ACHIEVE THE EFFECTIVE SCALING UP OF OUR PRODUCTION AT LOWER COSTS."

PERFORMANCE DURING 2006

The twelve months ended 31 December 2006 was SPI's first full financial year as an AIM quoted company. It was another period of significant progress, with turnover doubling for the second successive year. Whilst the business advanced broadly to plan in the first half of the year, the Group confronted process related issues during the middle of the year that slowed its momentum.

The difficulties encountered in power-scaling the GTWave fibre resulted in a delay of around three months and in additional costs. Nevertheless, at the end of year 2006 the Group is back on track and turnover is in line with market expectations. Fourth quarter product revenues exceeded those for the whole of 2005, and the business entered 2007 with a record order book.

FINANCING

During the financial year, the Group raised a total of £6.6 million in equity and debt after expenses. A placing in August 2006 raised £4.8 million (net) and was supported by a wide range of our existing investors, as well as some new shareholders. In December 2006 ETV Capital S.A. (Luxembourg) provided the Company with £1.8 million through a convertible loan. Further details are provided in the Financial Review and will be covered in the Report and Accounts.

In addition, SPI has completed a further equity fundraising in February 2007 of £10 million (net). This again was well supported by existing shareholders and a number of new investors.

THE BOARD

In November 2006 it was announced that David Shrigley was stepping down as non-executive Director to pursue other interests. Dave initially represented one of our venture capital investors, but since flotation he demonstrated the value of his wide experience in a truly independent manner. I would like to thank Dave for his guidance and contribution at an important stage of the Group's development.

Equally, I am grateful to the continuing six members of the Board for their valuable insights and unfailing support over the past twelve months.

EMPLOYEES

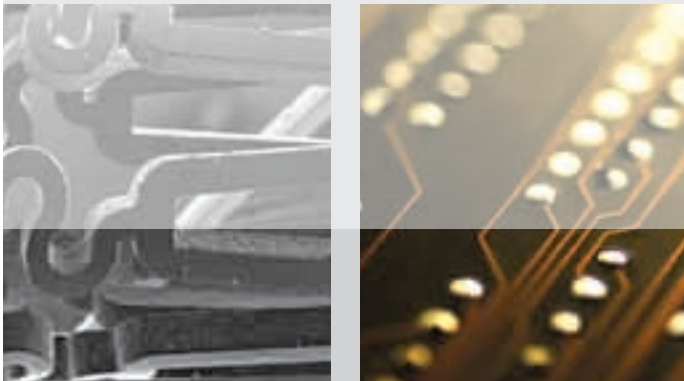
As already discussed, 2006 was not without its challenges for the business. SPI has managed successfully to overcome these issues and finish the year in a strong position. This is due principally to the unstinting efforts of management and staff.

CUTTING

With a strong ethos of product innovation, technology leadership and customer focus, SPI Lasers is enabling the resolution of some of today's most challenging and commercially sensitive manufacturing issues.

Where existing technology has previously limited the precision cutting of miniature parts, the fibre laser has enabled manufacturers to produce ground breaking microscopic cut detail in some of the world's smallest coronary stents.

The highly competitive electronics sector continues to leverage the enormous benefits of SPI's technology, for example, superior cut quality of solder mask stencils for circuit boards.



WELDING

Most people, when they think lasers, think welding. And this is true of the fibre laser from SPI. However, due to SPI's innovative approach, it is now possible to weld various materials, including ones that are dissimilar to one another, at incredibly small dimensions.

Previous welding tools, including traditional lasers simply could not achieve the diminutive yet robust bond that the fibre laser produces. Not only is the fibre laser playing an integral part in the miniaturisation of consumer products, the technology is making a massive contribution to the quest for sustainable energy sources.



PROSPECTS

The fibre laser market continues to develop rapidly, attracting both new customers and displacing longer-established laser technologies in an ever wider range of applications. The competition to share in this opportunity is certain to intensify, but the technical barriers to successful market entry are significant and SPI remains well positioned with its product offering.

As promised last year, SPI managed to sustain its earlier momentum with a broader range of products and across a greater number of market verticals. Customer interest in our products remains strong. The core task for 2007 is to achieve the effective scaling up of our production at lower costs.

GRAHAM MEEK
CHAIRMAN
8 MARCH 2007

CHIEF EXECUTIVE'S REVIEW



SUMMARY OF CHIEF EXECUTIVE'S REVIEW

- ➔ STRONG FINISH TO THE YEAR AND MOMENTUM RESTORED
- ➔ SUSTAINED PROGRESS IN THE MICRO SECTOR
- ➔ RAPID TAKE UP OF NEW PRODUCTS IN THE MARKING SECTOR
- ➔ NEW GROWTH SECTOR ESTABLISHED IN MEDICAL AESTHETICS
- ➔ GROUP ENTERED 2007 WITH STRONG ORDER BOOK

"THE EXCITING CHALLENGE FOR 2007 AND BEYOND IS THEREFORE TO DELIVER ON THE INCREASING NUMBER OF OPPORTUNITIES BY DEVELOPING NEW PRODUCTS AND ACCELERATING THOSE ALREADY INTRODUCED."

INTRODUCTION

I am pleased to report that the end of 2006 saw the Group executing well on the commercial front. The year finished with a significant improvement in the sales run-rate, a strong order book and a record level of forward visibility. This return of momentum was particularly pleasing given the process related issues encountered in the middle of the year and sets the scene for significant growth expectations in 2007. The post-interims revision of market expectations of full year 2006 sales of £7 million still represented a top line growth of 100% over 2005. Meeting this was a key objective for the second half, on which the Group delivered. After resolving the technical problems, the next key objective was to bring to market the new products that underpin the growth potential of 2007 and beyond. This was also achieved towards the end of 2006.

In summary, 2006 was a year of meeting and tackling challenges head on to ensure that the momentum required for sustained growth was generated. We believe that we achieved this and in doing so there are a number of significant areas to highlight:

MARKETS, CUSTOMERS AND CHANNEL

The laser industry is a large and established market. During 2006, fibre lasers continued to be more widely recognised as tools that deliver real advantages for a range of applications and many end-users. I believe that SPI's successes to date as a supplier of industrial grade products is proof of this maturing process.

SPI's customers are mainly system integrators building end-user systems that incorporate our lasers as the optical source. In some cases these integrators are part of the end-user entity, but in the majority of cases they are an intermediary. Consequently, we have invested heavily in creating awareness of the many advantages of fibre lasers in the end-user community to create "pull through" in the sales channel. I am pleased to report that this strategy is continuing to be successful.

In 2006 the Group continued to gain momentum in the MICRO sector. Of note within this sector was the further progress we made in penetrating the medical device manufacturing market, where the fibre laser's ability to cut and weld fine feature size items rapidly and with high quality has been a differentiator against traditional lasers. Initial successes were gained in stent cutting (a stent is a spring-like structure that is expanded within veins and arteries) leading to a number of stent industry leaders now deploying SPI products and with our largest single deployment being in excess of 70 lasers. Having established ourselves in this sub-sector, we are now engaged with a number of other customers and working on new applications.

This reflects our distinct market approach: excel at an application and then drive penetration. Corresponding with SPI's growth, we have succeeded in adding further market verticals in automotive, consumer electronics and semi-conductors. To support this, we have invested in our channel resources, both direct and through specialist distribution partners, and established applications and support capabilities in the UK, the USA and, more recently, China.

MEDICAL AESTHETICS

Fibre laser technology from SPI has more to offer than just industrial applications.

There has been significant growth in the use of lasers in the area of medical aesthetics: techniques such as thermal skin rejuvenation and wrinkle removal are becoming widely available, enabled in part by fibre lasers.

Where previous technologies were limited by cost, unpleasant side effects and long recovery times, the SPI laser when incorporated into our customers' systems revolutionises the way we think about, and deal with, scarring and facial skin ageing.



MARKING

SPI Lasers technology leadership is helping to transform the way companies identify and track their products. Previously, placing unique marks on products or components was greatly limited by the type of marks and a potential for a lack of permanence. In a world where counterfeit products could endanger the commercial viability of an organisation, the ability to cost-effectively make unique, complex, permanent and inert identification marks is, quite literally, changing the face of products.

The fibre laser from SPI is also playing a key role in the development of many consumer products. Where complex layer combinations such as metal and plastic require material removal in order, for example, to produce keypads – the unique properties of SPI's technology enables increased processing accuracy, precision and speed.



Towards the end of 2006, we began shipping our pulsed laser products for the MARKING sector securing several supply contracts, and establishing a strong order book with a number of customers.

We identified and established ourselves within a new sector, namely MEDICAL AESTHETICS, wherein the fibre laser is used as a direct tool for cosmetic enhancement and correction. The majority of our 2006 sales growth in Asia came from this new sector.

All of these activities are consistent with our strategy of utilising our specialised optical fibre capability to establish a technology platform that can be sold into multiple markets. We continue to strive for products that deliver the end-user benefits in performance and cost of ownership that industry watchers believe will fuel the rapid growth of fibre lasers.

OPERATIONAL

The 2006 year started well with sales of the products introduced in 2005 meeting the first half market expectations of £3 million which was almost 90% of the full year 2005 result. As previously reported, towards the end of the first half the Group experienced several process related technical issues in relation to power-scaling the GTWave fibre. The equipment modifications that were required to resolve the underlying problems were completed during the second half and have since proved themselves to be reliable.

The cumulative effect of these issues resulted in a delay in completion of the development, market introduction and production ramp up of both higher power and pulsed lasers for the MICRO

and MARKING sectors respectively. It was the resolution of these issues, and the subsequent progress towards completion of the associated product developments that enabled the strong sales performance in the final quarter of the year.

In particular we achieved volume shipments of our novel pulsed laser for the MARKING sector, which is designed to operate faster than the competitive offering and the new 200W laser for the MICRO sector, which is facilitating several new applications in both small feature welding as well as cutting.

The Group also made progress in developing the basic technology required to allow scale up of power in a reliable manner. This was not only essential for the products released in 2006, but the developments carried out will allow future product lines to be released, for example, into the MACRO sector.

During 2006 there were a number of other initiatives designed to manage the growth of the Group in a more reliable and predictable manner. These included both human resource and infrastructure projects.

OUTLOOK AND KEY EVENTS

In 2007 we expect to sustain the momentum built towards the end of 2006. We intend to expand our sales channel and manufacturing resources to enable us to increase output of the established products and address multiple new market verticals. The new 200W product will broaden our offering in the MICRO sector. This, combined with the general release of our MARKING laser and the addition of products for MEDICAL AESTHETICS,

should more than double the size of the market available to the Group. We also expect that by leveraging our customer funded R&D and through organic investment we will make strides towards the commercialisation of our technology in the MACRO sector for later years.

At the time of the placing in January 2007, our order book (including sales made) for the first half of 2007 stood at £5.0 million and was £0.5 million for the second half of the year. I am pleased to report that we have continued to make progress on this front and now have secured orders (including sales made) of nearly £7 million over the year. What is particularly pleasing is that most of the increase has come from new business wins rather than the conversion of framework agreements. Given this progress, we remain confident in delivering on market expectations for the year.

The exciting challenge for 2007 and beyond is therefore to deliver on the increasing number of opportunities by developing new products and accelerating those already introduced, to take advantage of the expanding market and to do so whilst improving the cost structure of the business, as we move towards profitability.

DR. DAVID PARKER
CHIEF EXECUTIVE OFFICER
8 MARCH 2007

FINANCIAL REVIEW



SUMMARY OF FINANCE DIRECTOR'S REVIEW

- ➔ SALES GREW BY 103% TO £7.1 MILLION
- ➔ GROWTH IN ALL GEOGRAPHIC MARKETS, PARTICULARLY ASIA
- ➔ R&D INVESTMENT INCREASED BY 13%
- ➔ EQUITY PLACING AND LOANS IN 2006 RAISED £6.6 MILLION (NET)
- ➔ FURTHER EQUITY OF £10.0 MILLION (NET) RAISED IN EARLY 2007

"2006 WAS A YEAR OF EXPANSION FOR THE SPI GROUP, AND WE SAW VERY STRONG GROWTH IN THE GROUP'S SALES OF FIBRE LASER PRODUCTS IN ALL OF OUR GEOGRAPHIC MARKETS."

OVERVIEW

2006 was a year of expansion for the SPI Group, and we saw very strong growth in the Group's sales of fibre laser products in all of our geographic markets. Our investment in manufacturing expansion, product development and particularly in sales and marketing were all important factors in achieving strong top-line growth partially funded by the mid-year secondary placing that raised £4.8 million (net). However, the technical problems encountered in the middle of the year led to a slow down in sales and an increase in costs. This further increased the financing need of the Group and lies behind our decision to secure debt finance in the fourth quarter and, subsequently in early 2007, a further equity placing to raise £10 million (net).

SALES

Total sales grew by 103% over 2005 from £3.5 million to £7.1 million. Product sales grew from £2.0 million in 2005 to £4.7 million in 2006, a growth of 135%.

Contract sales, which relate to our US and UK defence and aerospace development contracts, grew by 60% in the year, building on initial US contract awards and now servicing both US and UK agencies and contractors.

The US remains our biggest market with £2.6 million of total sales, an increase of 24% on the prior year's sales of £2.1 million. However, SPI's dependency upon sales to the US has continued to decrease: 36% of sales in 2006, down from 60% in 2005 as other market areas were further expanded. Sales to Asia increased from £0.3 million (10%

of total sales) in 2005 to £1.6 million (23% of total sales) in 2006. Sales to Europe (excluding the UK) increased from £0.6 million (17% of total sales) in 2005 to £1.3 million (18% of total sales) in 2006. The balance of sales was in the UK, which increased from £0.5 million (13% of total sales) in 2005 to £1.6 million (23% of total sales) in 2006.

OPERATIONAL CHANGES

GROSS LOSS

The gross loss was £3.1 million (£1.4 million in 2005). This increase is a reflection of, firstly, the increase in fixed costs associated with capability and capacity within manufacturing and, secondly, the impact of the technical problems that led to an increased consumption of materials and a delay in product cost reductions. The resolution of the technical problems coupled with increased volume throughput now enables SPI to leverage off its predominantly fixed-cost manufacturing base as volumes increase. This trend will continue as volumes continue to grow.

ADMINISTRATIVE EXPENSES

Administrative expenses in total, before exceptional costs, were £1.0 million higher than in 2005, an increase of 14% due to increased R&D and expansion in sales.

Administrative expenses include £2.4 million of Group funded product research and development (R&D) costs, £0.6 million less than in 2005. However, in addition, and charged against cost of sales, the Group spent £2.1 million on customer funded R&D. The total incurred investment in R&D was therefore £4.5 million, an increase of 13%

over the £4.0 million equivalent spend in 2005. Sales and marketing costs increased by 28% to £2.2 million as the Group expanded its sales team and increased its geographic presence. Provisions for royalties, warranty costs, and inventory obsolescence increased by £0.7 million over 2005. The balance of the administrative expenses relates to general administration costs.

The exceptional charge in 2005 of £0.3 million related to costs associated with the flotation of the Company that were not chargeable to the share premium account.

TAXATION

SPI has an unrecognised deferred tax asset of £12.8 million, which has primarily arisen from the losses incurred to date. In 2006, an R&D tax credit of £0.4 million (£0.5 million in 2005) was recognised; the associated cash receipt from HM Revenues & Customs is expected to be received in the second half of 2007 (the 2005 related tax credit was received in January 2007).

LOSS AFTER TAXATION

The loss after taxation for 2006 was £11.0 million (2005: £8.5 million). Before exceptional charges, the loss increased by £2.8 million (34%) over the equivalent loss in 2005 of £8.2 million. This is primarily due to the issues referred to above in Gross Loss and Administrative Expenses.

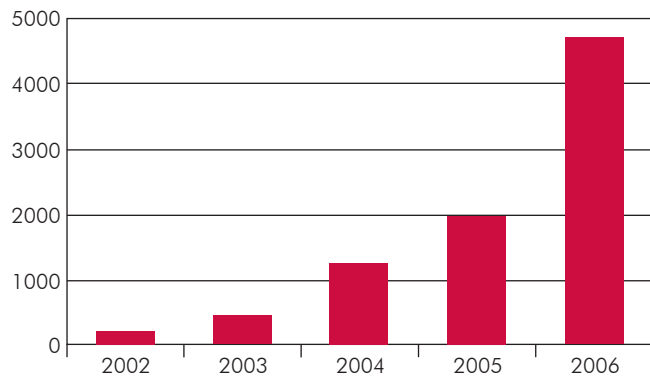
DIVIDEND

The directors do not propose to pay a dividend (2005: £nil).

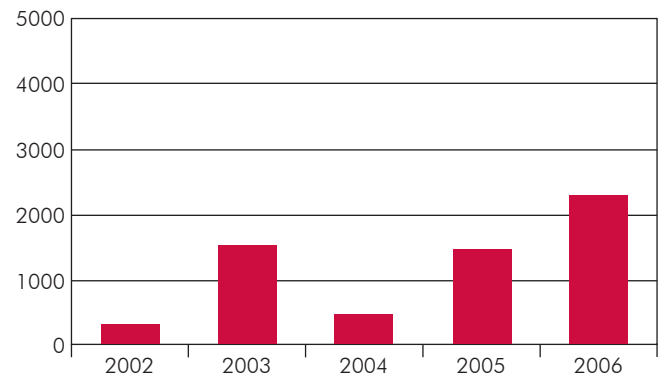
HEADCOUNT

Average heads increased from 88 in 2005 to 126 in 2006 due to investment in manufacturing,

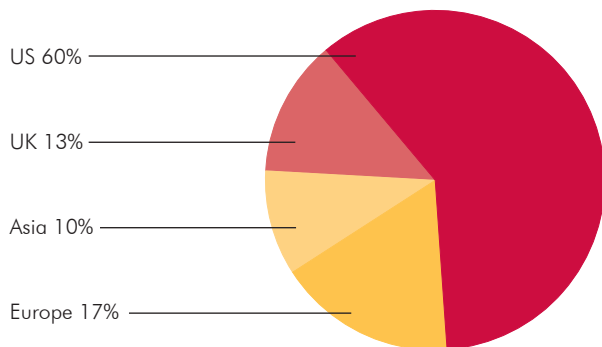
SPI LASERS PRODUCT SALES (£'000)



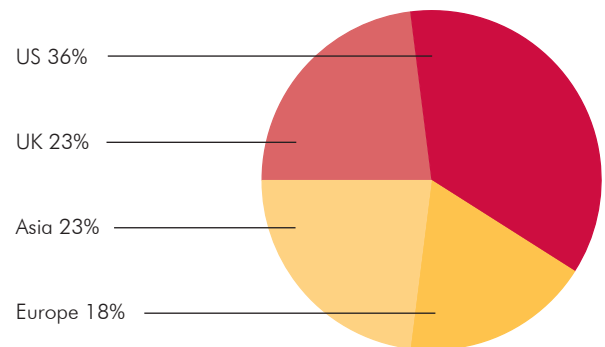
SPI LASERS CONTRACT SALES (£'000)



2005 SALES



2006 SALES



logistics, engineering and sales. Sales increased from £39,000 per head in 2005 to £56,000 per head in 2006 and the loss after tax for 2005 and 2006 reduced from £96,000 per head to £87,000 per head respectively.

FIXED ASSETS

Gross fixed assets grew by £0.7 million during 2006, an increase of 6% on the balance as at 31 December 2005. £0.3 million of this expenditure related to the expansion of manufacturing capacity. This comparatively low level of total expenditure is a reflection of the significant investment in fixed assets in earlier years, particularly pre-2004, which created the inherent capability to produce fibre lasers in volume. The Group's investment in fixed assets is now mostly related to a further increase in capacity rather than the underlying capability.

Depreciation for 2006 was £0.6 million (2005: £0.5 million). Accumulated depreciation at 31 December 2006 stands at 80% of the gross cost of the assets.

WORKING CAPITAL

Net current assets, excluding cash and loans (working capital), increased from £2.2 million at 31 December 2005 to £3.0 million at 31 December 2006. Debtors increased by £1.7 million, offset by an increase in creditors of £0.8 million and a reduction in stock of £0.1 million. The net increase in working capital of £0.8 million was primarily as a result of the strong sales volume growth experienced by the Group during the fourth quarter of 2006.

LOANS

A convertible loan was provided in December 2006 by ETV Capital S.A. (Luxembourg) to provide working capital for the Company in advance of the equity placing in February 2007. The loan is secured on the assets of the Company, and is interest only until June 2007 and is thereafter repayable over 33 months at an initial interest rate of 13.2% per annum. Additionally, the previous loan of £2.0 million provided by ETV in 2005 was also restructured to be on an interest only basis until May 2007.

EQUITY FUNDRAISING

The placing in August 2006 raised £5.0 million gross, £4.8 million net after transaction costs of £0.2 million. The costs were direct costs of the share issue and have been set off against the share premium account. The cash balance at 31 December 2006 was £2.1 million, in line with expectations.

POST YEAR END EVENTS

FUNDRAISING

As referred to in my overview, the Company raised additional equity in February 2007 of £10.0 million (net).

INTERNATIONAL FINANCIAL REPORTING STANDARDS

International Financial Reporting Standards (IFRS) came into effect for AIM listed companies on 1 January 2007. The Group's first set of audited financial statements reported under IFRS will be for the year ending 31 December 2007. The Group will prepare its interim statement as at

30 June 2007 under IFRS which will include a reconciliation of the adjustments which have been made between UK GAAP and IFRS.

STEVE BERG
CHIEF FINANCIAL OFFICER
8 MARCH 2007

BOARD OF DIRECTORS

GRAHAM MEEK *1 § ¥1

NON-EXECUTIVE CHAIRMAN

Graham Meek, age 59, joined the Group in 2005. He is currently chairman of ICM Computer Group plc (having served as senior independent director from 2002–2004), a non-executive director of Filtronic plc and a non-executive director of Capital Gearing Trust plc. He has had a long career in investment banking and stockbroking, with particular experience of the information technology and telecommunications sectors. Graham was previously head of corporate finance at Beeson Gregory plc, a managing director of Merrill Lynch Capital Markets and an executive director of Smith New Court plc.



DAVID PARKER ¥

CHIEF EXECUTIVE OFFICER

David Parker, age 44, joined the Group in 2002 and has been the chief executive officer since this time. He is the former chief executive officer of Marconi Optical Components ("MOC"). Under his leadership, MOC was sold to Bookham Technology in February 2002. Prior to this, he was vice president general manager of Agilent Technologies' Ipswich components operation and a corporate vice president of Agilent. During his tenure, this business unit became the market leader in the supply of high performance networking components. In previous roles, he has gained experience in manufacturing, research and development and business development. He serves as a non-executive director on the board of Zinwave, Inc. and was formerly a member of the supervisory board of Xignal Technologies AG. He was elected a Fellow of the Institute of Physics in 1997. David has a PhD from Imperial College, University of London and a BSc from the University of Leeds.



STEVE BERG

CHIEF FINANCIAL OFFICER AND COMPANY SECRETARY

Steve Berg, age 52, has been chief financial officer of the Group since February 2003. Prior to joining the Group, he was the chief financial officer of Marconi Optical Components until it was sold to Bookham Technology in 2002. Steve joined Marconi in 1988, first in the GEC-Marconi defence division before moving to GEC's telecommunications subsidiary, GPT (GEC-Plessey Telecommunications), in 1991 and was appointed GPT's chief financial officer in 1997. He moved to Marconi Capital in 1999 as a director of corporate finance, where he was involved in various investment activities in North America, Europe, the Middle East and Asia. Prior to joining GEC, he gained experience with NORTEL and Invensys. Steve is a Chartered Management Accountant (Fellow) with a postgraduate diploma in management from Coventry University.

DAVID PAYNE

PART TIME EXECUTIVE DIRECTOR

David Payne, age 62, co-founded SPI Inc. in 1997 and was its first chairman. He heads the Optoelectronics Research Centre at the University of Southampton ("ORC") from which today's fibre laser first emerged. The facility contains over 60 research laboratories and more than 150 full-time researchers. He led the team that invented the erbium-doped fibre amplifier, the enabling technology for dense wavelength-division-multiplexing and the growth of the Internet. In 1998, the Franklin Institute recognised this achievement and awarded him with its prestigious Benjamin Franklin Medal for the invention. David is a Fellow of the Royal Society and the Royal Academy of Engineering and was awarded the CBE in 2004.



PETER SCHULTZ * §1 ¥
NON-EXECUTIVE DIRECTOR

Peter Schultz, age 64, joined the Group in 2005. He is retired president of Heraeus Tenevo Inc., a technical glass manufacturer specialising in fibre optics and semi-conductor markets, and chief technical officer North America for Heraeus Holding GmbH. Following graduation from Rutgers University (BSc 1964, PhD 1967), he co-developed the world's first practical glass optical fibre for communications in 1970 as a scientist at Corning, Inc. He is co-inventor of the fibre optics now used worldwide for telecommunications. In 1993, he was inducted into the National Inventors Hall of Fame and in 2000 received the National Medal of Technology from President Clinton for this accomplishment and he was elected member of the US National Academy of Engineering in 2001. Peter is the recipient of numerous awards, including the International Glass Science Award (1977), SPIE Technology Achievement Award (1981), ASM Engineering Materials Achievement Award (1983) and the First American Innovators Award (US Department of Commerce 1995).

DAVID CHEESMAN * §
NON-EXECUTIVE DIRECTOR

David Cheesman, age 64, joined the Group in 2003. He worked in the computer industry for over 20 years, becoming chief engineer at Computer and Systems Engineering Limited and Univac's director of technical operations for Europe. In 1978, he set up Prime Computer Inc's research and development operations in the UK, before becoming managing director of Dowty Information Systems Limited. In 1988, he left the industry to join the venture capital community, becoming a director of 3i's high-tech unit. Subsequently, he was a founding partner in TriTech Investment Managers and, in 1997, became a partner at Advent Venture Partners, specialising in IT investment. David has invested in over 40 high-tech companies and been active on the boards of 32 of these. David has an Honours degree in Electrical Engineering and is a Chartered Engineer and a Fellow of the Institute of Electrical Engineers.

BILL O'NEILL
SPECIAL ADVISOR TO THE BOARD

Dr O'Neill is the Head of the Centre of Industrial Photonics which is part of the Cambridge University Institute for Manufacturing.

He has written extensively on the subject of laser-matter interactions, optical engineering and rapid manufacturing process technologies. He is a member of a number of government and industrial advisory boards, a member of EPSRC Peer Review College, and is a non-executive director of Advanced Laser Solutions Ltd. More recently, he was elected as a director of the Laser Institute of America (LIA) to help steer and develop worldwide operations in this field.

- *1 Chairman of Audit Committee
- * Member of Audit Committee
- §1 Chairman of Remuneration Committee
- § Member of Remuneration Committee
- ¥1 Chairman of Nominations Committee
- ¥ Member of Nominations Committee



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DIRECTORS' REPORT

The directors present their Annual Report and audited Group financial statements for the year ended 31 December 2006.

PRINCIPAL ACTIVITIES AND BUSINESS REVIEW

The Group is a leader in the design, development, engineering and manufacture of optical fibre-based laser sources for a range of markets and applications. The Group's products are based on the innovative and proprietary fibre technology platform which enables high performance together with a substantial reduction in the size of the product and the total cost to the end-user compared to more traditional lasers.

Further details of the Group's performance during the year and expected future developments are contained in the chairman's and chief executive's statements and the Financial review.

RESULTS AND DIVIDENDS

The loss for the financial year of £10,985,000 (restated 2005: loss £8,476,000) has been taken to reserves. The directors do not recommend the payment of a dividend (2005: £nil).

CORPORATE GOVERNANCE

INTRODUCTION

SPI Lasers plc was listed on AIM on 26 October 2005. Although the AIM Rules do not require the Group to comply with the Combined Code on Corporate Governance ('the Code'), the Group supports the principles set out in the Code and will attempt to comply wherever it considers it appropriate to do so, given both the size and resources available to the Group. Details are provided below of how the Group applies the principles of the Code.

THE BOARD

The Board of directors comprises three executive directors (one of whom is part-time), and three non-executive directors, one of whom is the chairman.

The Board meets each month and receives a Board pack comprising reports from each of the executive directors together with any other material deemed necessary for the Board to discharge its duties. It is the Board's responsibility for formulating, reviewing and approving the Group's strategy, budgets, major items of expenditure and acquisitions.

BOARD COMMITTEES

The Board has established three committees: the Audit Committee, the Remuneration Committee and the Nominations Committee, each of which has written terms of delegated responsibilities.

AUDIT COMMITTEE

The Audit Committee, chaired by Graham Meek, comprises three non-executive directors and meets at least three times a year with the chief executive and the Chief Financial Officer in attendance. It is the Audit Committee's role to provide formal and transparent arrangements for considering how to apply the financial reporting and internal control requirements of the Code, whilst maintaining an appropriate relationship with the independent auditors of the Group. The Audit Committee assists the Board in the discharge of its duties concerning the announcements of results, the Annual Report and Accounts and the maintenance of proper internal controls. It reviews the scope and planning of the audit and the auditor's findings and considers Group accounting policies and the compliance of those policies with applicable legal and accounting standards. The Audit Committee meets at least twice a year with the auditors without the executive directors being present.

REMUNERATION COMMITTEE

The Remuneration Committee, chaired by Peter Schultz, comprises three non-executive directors and meets at least twice a year. It is the Remuneration Committee's role to establish a formal and transparent policy on executive remuneration and to set remuneration packages for individual executive directors, within agreed terms of reference. No director may participate in discussions relating to their own terms and conditions of service or remuneration.

NOMINATIONS COMMITTEE

The Nominations Committee, chaired by Graham Meek, comprises two non-executive directors and the chief executive and meets at least twice a year to consider the size, structure and composition of the Board, to formulate and review proposals for the appointment and retirement of directors and make recommendations thereon to the Board.

INTERNAL CONTROL AND RISK MANAGEMENT

The Board is responsible for the system of internal control and for reviewing its effectiveness. The Group maintains a system of internal control consistent with a Group at its stage of development and as it grows, the Board intends to continue to enhance its processes to identify risks facing the business and implement procedures to eliminate, mitigate and monitor those risks.

The Group does not currently have an internal audit function due to the small size of the administrative function and the high level of director review and authorisation of transactions.

A comprehensive budgeting process is completed once a year and is reviewed and approved by the Board. The Group's results, as compared against budget, are reported to the Board on a monthly basis and discussed in detail at each meeting of the Board.

The Group maintains appropriate insurance cover in respect of legal actions against the directors as well as against material loss or claims against the Group and reviews the adequacy of the cover regularly.

ROTATION OF DIRECTORS

At the Annual General Meeting, two directors, one executive and one non-executive, will retire and will then be eligible to stand for re-election. In subsequent years, one third of the directors who are subject to retirement by rotation shall retire from office, and will be then similarly eligible to stand for re-election. Each director is thereby subject to stand for re-election at least once every three years.

A statement of the directors' responsibilities in respect of the financial statements is set out on page 16.

RESEARCH AND DEVELOPMENT (R&D)

During the year the Group spent £2.4 million (2005: £3.0 million) on research and development, representing 34% of turnover (2005: 85%). In addition, and charged against cost of sales, the Group spent £2.1 million on customer funded R&D (2005: £1.0 million). The total incurred investment in R&D was therefore £4.5 million, an increase of 12% over the £4.0 million equivalent spend in 2005. It is anticipated that the Group will continue to increase total research and development expenditure in order to accelerate the development of the product portfolio.

OVERSEAS PRESENCE

The Group has offices in the US and China for sales representation and product application activities.

DIRECTORS' REPORT

KEY PERFORMANCE INDICATORS (KPIs)

Financial KPIs are addressed in the Financial review and include: sales growth, sales by region, sales by product and contract development, R&D spend, sales per head, gross profit, selling costs, operating profit and profit after tax.

The Group uses a number of non-financial KPIs to monitor its performance in a number of areas on a regular basis. These areas include: order success, order acknowledgement, on time delivery, field failures, warranty returns, milestones achievement on development programmes, days holding and age of inventory, debtor days, creditor days, health and safety related incidents and lost days, staff turnover, and a range of subsidiary KPIs. These KPIs are reviewed by management and the Board, as a minimum, on a monthly basis.

RISKS

FINANCIAL RISK

The Group's sales are predominantly US dollar (USD) denominated or, if in other currencies, are generally based upon the equivalent USD price. This leaves the Group exposed to adverse movements in the USD to GB Pound (GBP) exchange rate. However, the Group's purchases of components and its US operational costs are similarly USD-based and so there is a degree of internal hedging of the exchange rate exposure. It is for this reason that the Group does not enter into currency hedging contracts. This policy will be under regular review as the Group's sales and geographic presence expand in the coming years. There is also a funding risk if trading does not achieve the expected levels of performance. However management would be able to mitigate this risk by reducing the level of investment in additional resources.

DEVELOPMENT RISK

Group sales are reliant upon the success of new or recently introduced products. Consequently, there is a risk of application or field related problems that could inhibit sales growth. In addition, a key focus for the Group in 2007 will be on the product cost reduction programmes. There is a risk of not achieving expected gross profit levels, if such programmes were to fall behind schedule.

COMPETITIVE RISK

In 2006, there were only two industrial scale fibre laser manufactures; ourselves and IPG Photonics. There are significant barriers to entry into the fibre laser market, including: intellectual property rights; manufacturing know how; and investment in physical infrastructure. However, 2007 may see new entrants into the market, attracted by the growth opportunities therein. Such a widening of the competitive landscape could threaten the growth ambitions of the Group.

COMMERCIAL RISK

As the Group enters new market sectors or new market verticals, the customer buying cycle may adversely differ from that experienced to date. This could lead to a lower than expected rate of growth.

DIRECTORS AND THEIR INTERESTS

The directors in office during the year, their interests in shares in the Group and their emoluments were as follows:

	Ordinary shares		Total emoluments 2006 £000	Total emoluments 2005 £000
	31 December 2006 Number	31 December 2005 Number		
G Meek	34,722	34,722	35	6
D Parker	325,312	322,682	231	288
S Berg	3,472	3,472	162	187
D Payne	169,844	169,844	33	33
P Schultz	9,792	9,792	25	15
D Cheesman	—	—	—	—
D Shrigley	—	—	19	—

There have been no changes to directors' shareholdings between the end of the financial year and the date of this report.

* D Shrigley resigned as a director on 1 November 2006.

At the year end and the date of this report, the directors had the following share options:

	At 31 December 2005		At 31 December 2006		Exercise price	Date from which exercisable	Expiry date
	Granted	Exercised	Granted	Exercised			
D Parker*	675	—	—	675	£122.37	April 2003	September 2012
D Parker**	299	—	—	299	£122.37	April 2003	September 2012
D Parker**	148,599	—	—	148,599	£0.07	September 2005	September 2012
D Parker***	—	67,600	—	67,600	£0.025	January 2008	September 2018
D Parker****	—	2,867	—	2,867	£1.20	January 2009	January 2009
S Berg*	180	—	—	180	£181.28	February 2004	March 2013
S Berg*	54,700	—	—	54,700	£0.03	February 2004	October 2013
S Berg*	26,229	—	—	26,229	£0.05	February 2004	August 2014
S Berg*	67,563	—	—	67,563	£0.07	September 2005	September 2015
S Berg***	—	13,866	—	13,866	£0.025	January 2008	September 2018
S Berg****	—	2,867	—	2,867	£1.20	January 2009	January 2009
D Payne***	—	25,884	—	25,884	£0.025	January 2008	September 2018

* Award granted under EMI scheme

** Award granted under Unapproved scheme

*** Award granted under Salary & benefits sacrifice scheme

**** Award granted under Sharesave scheme

DIRECTORS' INDEMNITY

The Group has indemnified the directors of the Company against liability in respect of proceedings brought by third parties subject to the conditions set out in the Companies Act 1985. Such qualifying third party indemnity provision was in force during the year and continues to be in force as at the date of this report. The Group has purchased directors and officers' liability insurance with an indemnity limit of £2.0 million in order to minimise the potential impact of such proceedings.

PRINCIPAL SHAREHOLDERS

The Company is aware of the following shareholders holding interests of 3% or more of the Company's issued ordinary share capital as at 7 March 2007.

	Ordinary 2.5p shares	% of issued share capital
AXA Framlington	3,452,780	13.21
Advent Venture Partners	2,884,292	11.04
Artemis Fund Managers	2,479,341	9.49
Interwest Partners	2,244,749	8.59
Sevin Rosen	2,244,749	8.59
Amadeus Capital Partners	1,726,729	6.61
Gartmore Investment Management	1,622,942	6.21
Majedie Asset Management	1,563,900	5.98
Morley Fund Management	1,017,800	3.89
Herald Investment Management	959,400	3.67
Fidelity	859,900	3.29

CHARITABLE CONTRIBUTIONS

During the year, the Group made charitable contributions totalling £400 (2005: £300). There were no political donations.

EMPLOYEE INVOLVEMENT

Details of the number of employees and related costs can be found in note 5 to the financial statements on page 24.

The Group is proactive in providing employees with information about the Group.

It operates equal opportunities in recruitment, training and promotion regardless of gender, ethnic origin, nationality, disability or sexual orientation.

ENVIRONMENT

The Group recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any damage that might be caused by the Group's activities.

CREDITOR PAYMENT POLICY AND PRACTICE

It is the Group's policy to abide by the payment terms agreed between the Group and its suppliers whenever it is satisfied that the supplier has provided goods and services in accordance with agreed terms and conditions. At 31 December 2006, the Group had 52 days purchases outstanding in trade creditors (2005: 35 days).

SUBSEQUENT EVENTS

On 27 February 2007, 5,250,000 ordinary shares of £0.025 each with an aggregate nominal value of £131,250 were issued at 200p per share with total gross consideration amounting to £10,500,000 (£10,000,000 net of costs).

PROVISION OF INFORMATION TO AUDITORS

Each of the persons who is a director at the date of approval of this report confirms that:

- (1) so far as the director is aware, there is no relevant audit information of which the Group's auditors are unaware; and
- (2) the director has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the Group's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of s234ZA of the Companies Act 1985.

AUDITORS

Deloitte & Touche LLP have indicated that they are willing to continue in office and a resolution proposing their reappointment will be put to the shareholders at the Annual General Meeting.

STEVE BERG

COMPANY SECRETARY
8 MARCH 2007

STATEMENT OF DIRECTORS' RESPONSIBILITIES

IN RESPECT OF THE FINANCIAL STATEMENTS

The directors are responsible for preparing the Annual Report and financial statements. The directors have chosen to prepare the accounts for the Company and the Group in accordance with United Kingdom Generally Accepted Accounting Practice. Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the Group and of the profit or loss of the Group for that period and comply with UK GAAP and the Companies Act 1985. In preparing those financial statements, the directors are required to:

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

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

INDEPENDENT AUDITORS' REPORT

TO THE MEMBERS OF SPI LASERS PLC

We have audited the Group and parent Company financial statements (the "financial statements") of SPI Lasers plc for the year ended 31 December 2006 which comprise the Group profit and loss account, the Group statement of total recognised gains and losses, the Group and Company balance sheets, the Group cash flow statement and the related notes 1 to 28. 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 auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

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

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

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

We read the other information contained in the Annual Report for the above year as described in the contents section and consider whether it is consistent with the audited financial statements. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any further information outside the Annual Report.

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 circumstances of the Company and the Group, 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 Group's and the individual Company's affairs as at 31 December 2006 and of the Group's loss for the year then ended;
- ➔ the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- ➔ the directors' report is consistent with the financial statements.

DELOITTE & TOUCHE LLP

CHARTERED ACCOUNTANTS AND REGISTERED AUDITORS
SOUTHAMPTON, UNITED KINGDOM
8 MARCH 2007

GROUP PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31 DECEMBER 2006

	Notes	2006 £000	Restated ¹ 2005 £000
Turnover	2	7,065	3,468
Cost of sales		(10,115)	(4,872)
Gross loss		(3,050)	(1,404)
Administrative expenses		(8,394)	(7,394)
Exceptional items	4	—	(315)
Total administrative expenses		(8,394)	(7,709)
Other net operating income		147	131
		(8,247)	(7,578)
Operating loss	3	(11,297)	(8,982)
Interest receivable and similar income	6	140	161
Interest payable and similar charges	6	(183)	(190)
Loss on ordinary activities before taxation		(11,340)	(9,011)
Tax credit on loss on ordinary activities	7	355	535
Loss on ordinary activities after taxation		(10,985)	(8,476)
Retained loss for the financial year	22	(10,985)	(8,476)
Loss per ordinary share			
Basic	9	(58.1p)	(47.9p)

All amounts are derived from continuing activities.

GROUP STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

FOR THE YEAR ENDED 31 DECEMBER 2006

	Notes	2006 £000	Restated ¹ 2005 £000
Loss for the financial year		(10,985)	(8,476)
Foreign exchange differences on retranslation of net assets of subsidiary undertakings		(126)	25
Total recognised gains and losses relating to the year		(11,111)	(8,451)
Prior year adjustment for FRS20	10	(52)	
Total gains and losses recognised since the last Annual Report and financial statements		(11,163)	

¹Details of the restatement are given in note 10.

GROUP BALANCE SHEET

AT 31 DECEMBER 2006

	Notes	2006 £000	Restated ¹ 2005 £000
Fixed assets			
Tangible assets	11	2,596	2,424
Current assets			
Stocks	13	1,991	2,084
Debtors	14	4,371	2,686
Cash at bank and in hand		2,113	8,126
		8,475	12,896
Creditors: amounts falling due within one year	15	(4,171)	(3,074)
Net current assets		4,304	9,822
Total assets less current liabilities		6,900	12,246
Creditors: amounts falling due after more than one year	16	(1,950)	(1,039)
Provisions for liabilities and charges	19	(104)	(165)
Net assets		4,846	11,042
Capital and reserves			
Called up share capital	21	522	442
Share premium account	22	15,330	10,605
Merger reserve	22	50,389	50,389
Equity reserve	22	162	52
Profit and loss account deficit	22	(61,557)	(50,446)
Total equity shareholders' funds		4,846	11,042

¹Details of the restatement are given in note 10.

GRAHAM MEEK
CHAIRMAN
8 MARCH 2007

COMPANY BALANCE SHEET

AT 31 DECEMBER 2006

	Notes	2006 £000	Restated ¹ 2005 £000
Fixed assets			
Investments	12	13,076	13,007
Current assets			
Debtors	14	13,465	2,894
Cash at bank and in hand		1,230	7,221
		14,695	10,115
Creditors: amounts falling due within one year	15	(147)	(249)
Net current assets		14,548	9,866
Total assets less current liabilities		27,624	22,873
Creditors: amounts falling due after more than one year	16	(12,994)	(12,192)
Net assets		14,630	10,681
Capital and reserves			
Called up share capital	21	522	442
Share premium account	22	15,330	10,605
Equity reserve	22	162	52
Profit and loss account deficit	22	(1,384)	(418)
Total equity shareholders' funds		14,630	10,681

¹Details of the restatement are given in note 10.

GRAHAM MEEK
CHAIRMAN
8 MARCH 2007

GROUP CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 DECEMBER 2006

	Notes	2006 £000	2005 £000
Net cash outflow from operating activities	24	(11,176)	(9,997)
Returns on investments and servicing of finance			
Interest received		140	161
Interest paid		(183)	(190)
Net cash outflow from returns on investments and servicing of finance		(43)	(29)
Taxation			
UK tax credit received		—	451
Net cash inflow from taxation		—	451
Capital expenditure and financial investment			
Payments to acquire tangible fixed assets		(747)	(453)
Net cash outflow from capital expenditure and financial investment		(747)	(453)
Management of liquid resources			
Decrease in current asset investments		—	256
Net cash inflow from management of liquid resources		—	256
Net cash outflow before financing		(11,966)	(9,772)
Financing			
Issue of share capital		5,014	12,003
Issue of share capital prior to Group reconstruction		—	3,841
Payments of expenses on issue of equity shares		(209)	(1,190)
New borrowings		1,750	2,565
Repayment of borrowings		(573)	(898)
Net cash inflow from financing		5,982	16,321
(Decrease)/increase in cash in the year		(5,984)	6,549

NOTES TO THE FINANCIAL STATEMENTS

AT 31 DECEMBER 2006

1. ACCOUNTING POLICIES

BASIS OF PREPARATION

The financial statements are prepared under the historical cost convention and in accordance with applicable United Kingdom Generally Accepted Accounting Practice. The particular accounting policies adopted are described below. They have all been applied consistently throughout the year and preceding year except as noted.

The Group will adopt IFRS accounting and reporting requirements during 2007.

BASIS OF CONSOLIDATION

The Group financial statements consolidate the financial statements of SPI Lasers plc and all its subsidiary undertakings drawn up to 31 December each year.

COMPANY

No profit and loss account is presented for SPI Lasers plc as permitted by section 230 of the Companies Act 1985.

TURNOVER

Turnover represents amounts receivable for goods and services provided in the normal course of business, net of trade discounts, VAT and other sales related taxes. Turnover is recognised when title passes, or the right to consideration in exchange for performance, has been completed.

Profit is recognised on long term contracts, if the final outcome can be assessed with reasonable certainty, by including in the profit and loss account both turnover and related costs as contract activity progresses. Turnover is calculated by reference to the value of work performed to date as a proportion of the total contract value.

FIXED ASSETS

Tangible fixed assets are included at their original historic cost.

Depreciation of tangible fixed assets is calculated on a straight line basis at rates estimated to write down the cost of each asset to its estimated residual value over its useful life.

Expected useful lives are as follows:

Leasehold improvements	– ten years from commencement of lease
Plant and machinery	– five years
Computer equipment	– three years

The carrying values of tangible fixed assets are reviewed for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Any impairment in the value is charged to the profit and loss account. Profits or losses on disposal of fixed assets reflect the difference between net selling price and net book value at the date of disposal.

INVESTMENTS

Investments in subsidiary undertakings are stated in the parent Company's accounts at cost, less provisions for any impairment.

STOCKS

Stocks are stated at the lower of cost and net realisable value with due allowance for any obsolete or slow moving items. Cost includes materials and an attributable proportion of manufacturing overheads.

Net realisable value is based on estimated selling price less any further costs expected to be incurred to completion and disposal.

Stocks held for demonstration purposes are held at original cost and amortised over a period of no more than twelve months.

PROVISIONS FOR LIABILITIES AND CHARGES

A provision is recognised when the Group has a legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation.

PROVISION FOR PRODUCT WARRANTY

This relates to estimated warranty costs which are expected to be incurred under the Group's terms and conditions of sale.

The costs are expected to arise between one and two years of the balance sheet date.

TAXATION

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

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

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

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

1. ACCOUNTING POLICIES (CONTINUED)

FINANCIAL LIABILITIES AND EQUITY

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the Group after deducting all of its liabilities.

CONVERTIBLE DEBT

Convertible debt is regarded as a compound instrument, consisting of a liability component and an equity component. At the date of issue the fair value of the liability component is estimated using the prevailing market interest rate for non-convertible debt. The difference between the proceeds of issue of the convertible loan and the fair value assigned to the liability element, representing the embedded option to convert the liability into equity of the Group, is included in equity.

EQUITY INSTRUMENTS

Equity instruments issued by the Company are recorded at the proceeds received, net of direct issue costs.

SHARE-BASED PAYMENT

The Group has applied the requirements of FRS20 Share-based Payments. In accordance with the transitional provisions, FRS20 has been applied to all grants of equity instruments after 7 November 2002 that had not vested as of 1 January 2006.

The Group issues equity-settled share-based payments to employees. Equity-settled share-based payments are measured at fair value at the date of grant. The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the Group's estimate of shares that will eventually vest. Fair value is measured by use of a stochastic model.

The expected life used in the model has been adjusted based on management's best estimate, for the effects of non-transferability, exercise restrictions and behavioural considerations. Further information is given in note 10.

FOREIGN CURRENCIES

COMPANY

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date. All differences are taken to the profit and loss account.

GROUP

The financial statements of overseas subsidiary undertakings are translated at the rate of exchange ruling at the balance sheet date. The exchange difference arising on the translation of the opening net assets is taken directly to reserves. All other translation differences are taken to the profit and loss account.

RESEARCH AND DEVELOPMENT

Research and development expenditure is charged to the profit and loss account as incurred.

LEASING COMMITMENTS

Rentals payable under operating leases are charged in the profit and loss account on a straight line basis over the lease term.

PENSIONS AND OTHER POST-RETIREMENT BENEFITS

The Group makes defined contributions to employee personal pension plans. The pension cost charged to the profit and loss account represents the contributions payable to the pension plans in respect of the accounting year.

LONG TERM CONTRACTS

Amounts recoverable on long term contracts, which are included in debtors, are stated at the net sales value of the work done less amounts received as progress payments on account. Excess progress payments are included in creditors as payments on account.

2. TURNOVER AND SEGMENTAL ANALYSIS

In the opinion of the directors, the Group has only one class of business and turnover and losses were generated predominantly in the United Kingdom.

Geographical analysis of turnover by destination:	2006 £000	2005 £000
North America	2,574	2,077
United Kingdom	1,613	452
Rest of Europe	1,275	589
Asia	1,603	350
	7,065	3,468

Geographical analysis of net assets by location:	2006 £000	2005 £000
North America	608	775
United Kingdom	4,238	10,267
	4,846	11,042

NOTES TO THE FINANCIAL STATEMENTS

AT 31 DECEMBER 2006

3. OPERATING LOSS

This is stated after charging/(crediting):

	2006 £000	2005 £000
Auditors' remuneration – audit services	65	59
– non-audit services	32	161
Depreciation and impairment of fixed assets	575	534
Rentals received under operating leases	(199)	(131)
Operating lease rentals – land and buildings	304	357
Foreign exchange charge	57	86
Research and development	2,404	2,962

	2006 £000	2005 £000
Fees payable to the Company's auditors for the audit of the Company's annual accounts	12	12
The audit of the Company's subsidiaries pursuant to legislation	38	47
Other audit service fees	15	—
Total audit fees	65	59
Other services pursuant to legislation		
Tax services	30	161
Other accounting advice	2	—
Total non-audit fees	32	161

In addition to the above amounts, the auditors received £207,000 in the prior year relating to the listing. These costs were booked to the share premium account in line with FRS 4.

4. EXCEPTIONAL ITEMS

	2006 £000	2005 £000
Recognised in arriving at operating loss:		
Transaction costs	—	315
	—	315

In 2005 there was an exceptional item of £315,000 that related to costs associated with the flotation of the Company but which was not considered to be direct costs of the share issue.

5. STAFF COSTS

(A) STAFF COSTS

Group

	2006 £000	2005 £000
Wages and salaries	5,125	3,989
Social security costs	563	450
Other pension costs	463	364
	6,151	4,803

The average monthly number of employees during the year was made up as follows:

	2006 Number	2005 Number
Production and production support	67	40
Research and development	31	26
Sales and marketing	16	12
Administration	12	10
	126	88

5. STAFF COSTS (CONTINUED)

(A) STAFF COSTS (CONTINUED)

Company

	2006 £000	2005 £000
Wages and salaries	516	471
Social security costs	56	58
Other pension costs	78	73
	650	602

The average monthly number of employees during the year was made up as follows:

	2006 Number	2005 Number
Administration	2	2

In addition, the Company employed three non-executive directors and one part time director.

(B) DIRECTORS' EMOLUMENTS

	2006 £000	2005 £000
Directors' emoluments	505	529
Company contributions paid to money purchase schemes	77	37
Number of directors who exercised options over shares in the Company	—	—
Number of directors accruing benefits under defined contribution schemes	3	3

The amounts in respect of the highest paid director are as follows:

	2006 £000	2005 £000
Emoluments	231	288
Company contributions paid to money purchase schemes	62	21

6. FINANCE COSTS (NET)

(A) INTEREST RECEIVABLE AND SIMILAR INCOME

	2006 £000	2005 £000
Interest on cash deposits	140	161

(B) INTEREST PAYABLE AND SIMILAR CHARGES

	2006 £000	2005 £000
Other loans	183	190

7. TAX

(A) TAX CREDIT ON ORDINARY ACTIVITIES

The tax credit is made up as follows:

	2006 £000	Restated ¹ 2005 £000
Current tax:		
UK corporation tax credit	—	—
R&D tax credits for the year	352	484
Adjustment in respect of prior years	3	51
Total current tax credit	355	535

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7. TAX (CONTINUED)

(B) FACTORS AFFECTING CURRENT TAX CREDIT

The tax credit on the loss of ordinary activities for the year is lower (2005: lower) than the standard rate of corporation tax in the UK of 30% (2005: 30%). The differences are reconciled below:

	2006 £000	Restated ¹ 2005 £000
Loss on ordinary activities before tax	(11,340)	(9,011)
Loss on ordinary activities multiplied by standard rate of corporation tax in the UK of 30% (2005: 30%)	(3,402)	(2,703)
Expenses not deductible for tax purposes	273	114
Depreciation in excess of capital allowances	104	155
Losses arising in the year not utilised	2,786	2,819
Movement in short term timing differences	83	47
Unrealised exchange movement	—	(1,037)
50% uplift for R&D tax credit	(220)	(302)
Losses surrendered for R&D tax credit	661	907
Adjustments in respect of previous years	(3)	(51)
R&D tax credit receivable	(352)	(484)
Tax relief on exercise of share options	(285)	—
Total current tax (note 7(A))	(355)	(535)

¹ Details of the restatement are given in note 10.

(C) FACTORS THAT MAY AFFECT FUTURE TAX CHARGES

A deferred tax asset has not been recognised in respect of differences relating primarily to tax losses as there is insufficient evidence that the asset will be recovered, due to the uncertainty regarding the timing of relief and in the US, the quantum of losses that will be available to set against profits arising in the future. The amount of the asset not recognised is £12.8 million (2005: £10.0 million).

The unrecognised deferred tax asset is comprised of the following elements.

	2006 £000	2005 £000
Tax losses	11,706	9,077
Depreciation in excess of capital allowances	954	908
Other timing differences	158	68
	12,818	10,053

8. LOSS ATTRIBUTABLE TO MEMBERS OF THE PARENT COMPANY

The loss on ordinary activities after taxation includes a loss of £966,000 (2005: £384,000) attributable to the parent Company. As permitted by section 230 of the Companies Act 1985, no separate profit and loss account is prepared in respect of the parent Company.

9. LOSS PER ORDINARY SHARE

Basic loss per share for the year ended 31 December 2006 of 58.1p per ordinary share is calculated using 18,921,668 shares, being the weighted average number of shares for 2006.

For the year ended 31 December 2006, the loss attributable to ordinary shareholders and weighted average number of shares for the purpose of calculating the diluted loss per share are identical to those used for the basic loss per ordinary share. This is because the potential diluting effect of reducing the loss per ordinary share is not dilutive under the terms of FRS 22.

10. EQUITY-SETTLED SHARE OPTION SCHEMES

The Group has six share option schemes for all employees of the Group. The vesting period ranges from one to four years. Options are forfeited if the employee leaves the Group before the options vest.

SHARE OPTIONS

The number of options outstanding to directors under the Group's share option schemes is disclosed in the directors' report. The total number of shares under option is as follows:

	2006	2005
Number of options outstanding at 1 January	1,073,079	709,991
Options granted during the year	518,103	383,842
Options forfeited during the year	(115,319)	(11,018)
Options exercised during the year	(483,456)	(9,736)
Number of options outstanding at 31 December	992,407	1,073,079

The analysis by scheme is as follows:

UK EMI SCHEME

	2006		2005	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding at beginning of period	779,725	£0.273	591,557	£0.344
Granted during the period	26,668	£1.875	208,915	£0.067
Forfeited during the period	(14,331)	£0.820	(11,011)	£0.374
Exercised during the period	(426,071)	£0.032	(9,736)	£0.020
Outstanding at the end of the period	365,991	£0.649	779,725	£0.273
Exercisable at the end of the period	262,513	£0.717	492,075	£0.353

The total vesting period is four years, with 25% of the options vesting after twelve months and the remainder vesting equally on a monthly basis over the following 36 months. If the options remain unexercised after a period of ten years from the date of grant the options expire. Options are forfeited if the employee leaves the Group before the options vest.

UK APPROVED SCHEME

	2006		2005	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding at beginning of period	40,449	£1.497	39,988	£1.599
Granted during the period	—	—	468	£0.040
Forfeited during the period	(15)	£484.820	(7)	£484.820
Exercised during the period	—	—	—	—
Outstanding at the end of the period	40,434	£1.318	40,449	£1.497
Exercisable at the end of the period	40,228	£1.324	31,683	£1.886

The total vesting period is four years, with 25% of the options vesting after twelve months and the remainder vesting equally on a monthly basis over the following 36 months. If the options remain unexercised after a period of ten years from the date of grant the options expire. Options are forfeited if the employee leaves the Group before the options vest.

UK UNAPPROVED SCHEME

	2006		2005	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding at beginning of period	148,898	£0.333	299	£130.900
Granted during the period	—	—	148,599	£0.070
Forfeited during the period	—	—	—	—
Exercised during the period	—	—	—	—
Outstanding at the end of the period	148,898	£0.333	148,898	£0.333
Exercisable at the end of the period	86,904	£0.520	49,737	£0.799

The total vesting period is four years, with 25% of the options vesting after twelve months and the remainder vesting equally on a monthly basis over the following 36 months. If the options remain unexercised after a period of ten years from the date of grant the options expire. Options are forfeited if the employee leaves the Group before the options vest.

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10. EQUITY-SETTLED SHARE OPTION SCHEMES (CONTINUED)

SHARE BONUS PLAN

	2006		2005	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding at beginning of period	—	—	—	—
Granted during the period	396,483	£0.025	—	—
Forfeited during the period	(98,387)	£0.025	—	—
Exercised during the period	—	—	—	—
Outstanding at the end of the period	298,096	£0.025	—	—
Exercisable at the end of the period	22,554	£0.025	—	—

The vesting period is 13 months. If the options remain unexercised after a period of ten years from the date of grant the options expire. Options are forfeited if the employee leaves the Group before the options vest.

US STOCK PLAN

	2006		2005	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding at beginning of period	104,007	£0.176	78,147	£0.066
Granted during the period	—	—	25,860	£0.510
Forfeited during the period	—	—	—	—
Exercised during the period	(57,385)	£0.025	—	—
Outstanding at the end of the period	46,622	£0.362	104,007	£0.176
Exercisable at the end of the period	24,533	£0.364	56,769	£0.115

The total vesting period is four years, with 25% of the options vesting after twelve months and the remainder vesting equally on a monthly basis over the following 36 months. If the options remain unexercised after a period of ten years from the date of grant the options expire. Options are forfeited if the employee leaves the Group before the options vest.

SHARESAVE SCHEME

	2006		2005	
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price
Outstanding at beginning of period	—	—	—	—
Granted during the period	94,952	£1.200	—	—
Forfeited during the period	(2,586)	£1.200	—	—
Exercised during the period	—	—	—	—
Outstanding at the end of the period	92,366	£1.200	—	—
Exercisable at the end of the period	30,701	£1.200	—	—

The vesting period is three years. If the options remain unexercised after a period of three years from the date of grant the options expire. Options are forfeited if the employee leaves the Group before the options vest.

The weighted average share price at the date of exercise for share options exercised during the period was 199.5p. The options outstanding at 31 December 2006 had a weighted average exercise price of £0.479 and a weighted average remaining contractual life of 1.2 years. In 2006, options were granted in January, May, November and December. The aggregate of the estimated fair values of the options granted in those periods is £1.0 million. In 2005, options were granted in May and September. The aggregate of the estimated fair values of the options granted in those periods is £0.3 million.

10. EQUITY-SETTLED SHARE OPTION SCHEMES (CONTINUED)

The inputs into the Black-Scholes option pricing model are as follows:

	2006
Weighted average share price	£1.079
Weighted average exercise price	£0.258
Expected volatility	50%
Weighted average expected life	3.8 years
Risk-free rate	4.25%
Expected dividends	0%

Expected volatility was estimated at 50% in the absence of meaningful historical data for volatility of the Group's share price since flotation in October 2005. The expected life used in the model has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions and behavioural considerations.

No comparison for inputs into the model for 2005 is shown as 2006 is the first year such a calculation has been made.

The Group recognised total expenses of £110,000 and £40,000 related to equity-settled share-based payment transactions in 2006 and 2005 respectively.

PRIOR YEAR ADJUSTMENT

As described above, during the period the Group has adopted FRS20 Share-based Payments in respect of accounting for employee share option schemes. The comparative figures in the primary statements and notes have been restated to reflect the new policy.

The effects of the change in policy are summarised below:

	2005 £000
Profit and loss account	
Administrative expenses	(40)
Decrease in profit for the financial year	(40)
Balance sheet	
Equity reserve	52
Profit and loss deficit	(52)
Increase/(decrease) in net assets	—

11. TANGIBLE FIXED ASSETS

GROUP

	Leasehold improvements £000	Plant and machinery £000	Computers £000	Total £000
Cost				
At 1 January 2006	3,094	8,270	1,193	12,557
Additions	404	254	89	747
At 31 December 2006	3,498	8,524	1,282	13,304
Depreciation				
At 1 January 2006	1,570	7,408	1,155	10,133
Charge for the year	230	286	59	575
At 31 December 2006	1,800	7,694	1,214	10,708
Net book value at 31 December 2006	1,698	830	68	2,596
Net book value at 31 December 2005	1,524	862	38	2,424

12. INVESTMENTS

COMPANY

	Restated ¹ £000
Shares in Group undertakings:	
At 1 January 2006	13,007
Additions	69
At 31 December 2006	13,076

¹ Details of the restatement are given in note 10.

The increase in investments represents the FRS20 share option charge relating to SPI Lasers UK Limited and SPI Lasers LLC.

Shares in Group undertakings represent the Company's investment in the following entities:

Name of company	Holding	Proportion of voting rights and shares held	Country of incorporation	Nature of business
SPI Lasers UK Limited	Ordinary shares	100%	England	Optical fibre-based lasers
SPI Lasers LLC	Declared 100% interest	100%	United States	Optical fibre-based lasers

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13. STOCKS GROUP

	2006	2005
	£000	£000
Raw materials and component parts	982	789
Work in progress	543	508
Finished goods	466	787
	1,991	2,084

The difference between purchase price or production cost of stocks and their replacement cost is not material.

14. DEBTORS

	Group		Company	
	2006	2005	2006	2005
	£000	£000	£000	£000
Trade debtors	2,796	1,280	—	—
Amounts owed by Group undertakings	—	—	13,441	2,883
Other debtors	245	532	20	3
Prepayments and accrued income	491	390	4	8
Corporation tax recoverable	839	484	—	—
	4,371	2,686	13,465	2,894

All debtors are due within one year.

15. CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	Group		Company	
	2006	2005	2006	2005
	£000	£000	£000	£000
Loans (note 17)	894	628	—	—
Payments received on account	36	95	—	—
Trade creditors	2,149	997	13	10
Other creditors including taxation and social security	385	353	26	25
Accruals and deferred income	707	1,001	108	214
	4,171	3,074	147	249

16. CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	Group		Company	
	2006	2005	2006	2005
	£000	£000	£000	£000
Loans (note 17)	1,950	1,039	—	—
Amounts owed to Group undertakings	—	—	12,994	12,192
	1,950	1,039	12,994	12,192

17. LOANS

	Group		Company	
	2006 £000	2005 £000	2006 £000	2005 £000
Amounts falling due: in one year or less or on demand	894	628	—	—
In more than one year but not more than two years	1,077	714	—	—
In more than two years but not more than five years	873	325	—	—
	2,844	1,667	—	—
Less: included in creditors: amounts falling due within one year	894	628	—	—
	1,950	1,039	—	—

Loans consist of two loans provided by ETV Capital SA (Luxembourg) ("ETV").

LOAN 1.

The loan was provided in June 2005. The loan amount was £2,000,000, repayable by thirty six equal monthly instalments at an interest rate of 12.65%. It is secured on the fixed assets of the Group. In December 2006 the loan was restructured to be interest only for the period December 2006 to May 2007 inclusive and thereafter repayable in twelve equal monthly instalments. ETV was granted a warrant to purchase, at its discretion, 201,388 ordinary shares at the IPO price of 144p per share. The warrant is exercisable until June 2015. The warrant may be exchanged without the payment of any additional consideration for the Group's shares based upon the value of the warrant and the shares at the time of the exchange.

LOAN 2.

This convertible loan was provided in December 2006. The loan amount was £1,750,000, on an interest only basis for the period December 2006 to June 2007 inclusive and thereafter repayable in thirty three equal monthly instalments at an interest rate of 13.2%. It is secured on all tangible and intangible assets of the Group.

ETV may convert part or the entire outstanding principal of the loan, at its discretion, at a price calculated by reference to the market price over the preceding two weeks prior to conversion, subject to a maximum price of 244.79p. There is also a minimum price, determined by a restriction on the post conversion shareholding of ETV not exceeding 5.0% of the issued shares of the Group. At 31 December 2006, the minimum price is calculated as 167.58p. The net proceeds from the issue of the convertible loan have been split between the liability element and an equity element, representing the fair value of the embedded option to convert the liability into equity. The value of this option has been determined to be £nil.

18. OBLIGATIONS UNDER LEASES

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

GROUP

	2006 £000	2005 £000
Land and buildings		
Operating leases which expire:		
In over five years	344	325
	344	325

19. PROVISIONS FOR LIABILITIES AND CHARGES

GROUP

	Dilapidations £000	Product warranty £000	Total £000
At 1 January 2006	77	88	165
Arising during the year	—	202	202
Amounts utilised during the year	(77)	(186)	(263)
At 31 December 2006	—	104	104

DILAPIDATIONS

Provision was made during 2005 for potential dilapidations to a building for which the lease had expired. The Group vacated the building in September 2005 and the provision has been utilised during 2006.

PRODUCT WARRANTY

Provision is made for estimated warranty costs which are expected to be incurred under the Group's terms and conditions of sale. These costs are expected to arise between one and two years of the balance sheet date.

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20. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS

An explanation of the Group's objectives, policies and strategies for the role of derivatives and other financial instruments in creating and changing the risks of the Group in its activities is discussed in this note. The disclosures below exclude short term debtors and creditors.

INTEREST RATE RISK PROFILE OF FINANCIAL LIABILITIES

The interest rate profile of the financial liabilities of the Group as at 31 December is as follows:

	Total £000	Fixed rate Financial liabilities £000
2006		
Sterling- borrowings	2,844	2,844
2005		
Sterling – borrowings	1,667	1,667
		Weighted average period for which rate is fixed Years
2006		
Sterling- borrowings	12.68	2.5
2005		
Sterling – borrowings	12.65	2.4

INTEREST RATE RISK PROFILE OF FINANCIAL ASSETS

The interest rate profile of the financial assets of the Group as at 31 December is as follows:

	Total £000	Fixed rate financial assets £000	Floating rate financial assets £000	Financial assets on which no interest is earned £000
2006				
Sterling	1,245	—	1,245	—
US dollar	868	—	868	—
Total	2,113	—	2,113	—
2005				
Sterling	7,887	—	7,887	—
US dollar	239	—	239	—
	8,126	—	8,126	—

Floating rate financial assets comprise cash deposits on money market deposit at call.

CURRENCY EXPOSURES

The Group does not hedge the currency exposures arising from its net investment overseas (in other words, its structural currency exposures). Gains and losses from these structural currency exposures are recognised in the statement of total recognised gains and losses.

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

20. DERIVATIVES AND OTHER FINANCIAL INSTRUMENTS (CONTINUED)
NET FOREIGN CURRENCY MONETARY ASSETS/(LIABILITIES)

Functional currency of Group operations	Total £000	Euros £000	US dollar £000
2006			
Sterling	1,123	195	928
2005			
Sterling	99	50	49

MATURITY OF FINANCIAL LIABILITIES

The maturity profile of the Group's financial liabilities at 31 December is as follows:

	2006 £000	2005 £000
In one year or less, or on demand	894	628
In more than one year but not more than two	1,077	714
In more than two years, but not more than five	873	325
	2,844	1,667

BORROWING FACILITIES

The Group has no further borrowing facilities available to it, other than the loan with ETV Capital SA (Luxembourg).

FAIR VALUES OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Set out below is a comparison by category of book values and fair values of the Group's financial assets and financial liabilities as at 31 December:

	Book value 2006 £000	Fair value 2006 £000	Book value 2005 £000	Fair value 2005 £000
Primary financial instruments				
Short term borrowings and current portion of long term borrowings	894	894	628	628
Current asset investment	—	—	—	—
Long term borrowings	1,950	1,950	1,039	1,039
Cash and short term deposits	2,113	2,113	8,126	8,126

MARKET PRICE RISK

The Group accepts a degree of interest rate risk and currency risk as long as the effects of various changes in rates remain within certain prescribed ranges.

21. SHARE CAPITAL

The authorised and issued share capital of the Company as at 31 December 2006 is as follows:

Authorised	2006 Number	2006 £000
Ordinary shares of £0.025 each	100,000,000	2,500
<hr/>		
Allotted, called up and fully paid	2006 Number	2006 £000
Ordinary shares of £0.025 each	20,885,275	522

On 4 August 2006, 2,702,784 ordinary shares of £0.025 each with an aggregate nominal value of £67,570 were issued at 185p per share with total gross consideration amounting to £5,000,150. Share issue costs netted against the share premium account total £208,641.

During the year, 483,456 ordinary shares of £0.025 each with an aggregate nominal value of £12,086 were issued upon the exercising of vested share options by employees.

SHARE OPTIONS

The number of options outstanding under the Group's share option schemes is disclosed in note 10.

NOTES TO THE FINANCIAL STATEMENTS

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22. MOVEMENT IN SHAREHOLDERS' FUNDS GROUP

	Share capital £000	Share premium £000	Merger reserve £000	Equity reserve £000	Profit and loss £000	Total £000
At 1 January 2006 as previously stated	442	10,605	50,389	—	(50,394)	11,042
Prior year adjustment in respect of FRS20	—	—	—	52	(52)	—
At 1 January 2006 as restated	442	10,605	50,389	52	(50,446)	11,042
Arising on share issues	80	4,934	—	—	—	5,014
Share issue costs	—	(209)	—	—	—	(209)
FRS20 charge	—	—	—	110	—	110
Retained loss for the year	—	—	—	—	(10,985)	(10,985)
Exchange differences on retranslation of net assets of subsidiary undertakings	—	—	—	—	(126)	(126)
At 31 December 2006	522	15,330	50,389	162	(61,557)	4,846

COMPANY

	Share capital £000	Share premium £000	Equity reserve £000	Profit and loss £000	Total £000
At 1 January 2006 as previously stated	442	10,605	—	(384)	10,663
Prior year adjustment in respect of FRS20	—	—	52	(34)	18
At 1 January 2006 as restated	442	10,605	52	(418)	10,681
Arising on share issues	80	4,934	—	—	5,014
Share issue costs	—	(209)	—	—	(209)
FRS20 charge	—	—	110	—	110
Retained loss for the year	—	—	—	(966)	(966)
At 31 December 2006	522	15,330	162	(1,384)	14,630

23. RELATED PARTY TRANSACTIONS

The University of Southampton is a related party under FRS 8 as David Payne, a director of SPI Lasers plc, is an employee of the University. Included within the profit and loss account are costs of £285,000 (2005: £172,000) in respect of a series of technology development contracts with the University. Purchases of goods and services made from the University of Southampton amounted to £90,000 (2005: £66,000). Royalties of £5,000 (2005: £23,000) were due to the University under licence agreements. The year end balance with the University totalled £265,000 (2005: £83,000) and is included within trade creditors. All transactions were conducted on an arm's length basis. The Group has an agreement with the University of Southampton whereby the University of Southampton has the use of certain facilities at the premises of the Group. The total amount charged in the year to the University of Southampton for these facilities was £135,000.

24. NOTES TO THE STATEMENT OF CASH FLOWS

(A) RECONCILIATION OF OPERATING LOSS TO NET CASH OUTFLOW FROM OPERATING ACTIVITIES

	2006 £000	Restated ¹ 2005 £000
Operating loss	(11,297)	(8,982)
Depreciation charges	575	534
Increase in debtors	(1,330)	(1,303)
Decrease/(increase) in stocks	93	(1,508)
Increase in creditors	770	1,136
Exchange difference	(97)	86
FRS20 cost	110	40
Net cash outflow from operating activities	(11,176)	(9,997)

¹ Details of the restatement are given in note 10.

(B) RECONCILIATION OF NET CASH FLOW TO MOVEMENT IN NET FUNDS

	2006 £000	2005 £000
(Decrease)/increase in cash in the year	(5,984)	6,549
Cash inflow from increase in debt finance	(1,750)	(2,565)
Cash outflow from decrease in debt	573	898
Decrease in liquid resources	—	(256)
Change in net debt resulting from cash flows	(7,161)	4,626
Exchange differences	(29)	(61)
Movement in net debt in the year	(7,190)	4,565
Opening net funds	6,459	1,894
Closing net (deficit)/funds	(731)	6,459

24. NOTES TO THE STATEMENT OF CASH FLOWS (CONTINUED)

(C) ANALYSIS OF NET DEBT

	At 1 January 2006 £000	Cash flow £000	Non cash movement £000	Exchange differences £000	At 31 December 2006 £000
Cash at bank and in hand	8,126	(5,984)	—	(29)	2,113
Loans – short term	(628)	300	(566)	—	(894)
Loans – long term	(1,039)	(1,477)	566	—	(1,950)
	6,459	(7,161)	—	(29)	(731)

(D) MAJOR NON-CASH TRANSACTIONS

There were no major non-cash transactions in the year.

(E) EXCEPTIONAL ITEMS

There were cash flows of £nil relating to operating exceptional items in the year (2005: £315,000).

25. PENSION SCHEMES

The Group pays contributions to personal pension plans for directors and employees. These contributions are charged to the profit and loss account as they arise. Contributions made during the year amounted to £455,000 (2005: £359,000). The Group pays contributions to a 401k pension plan for US employees. These contributions are charged to the profit and loss account as they arise. Contributions made during the year amounted to £8,000 (2005: £5,000). At the year end amounts outstanding were £80,000 (2005: £60,000) and these have been included within creditors.

26. CAPITAL COMMITMENTS

Amounts contracted for but not provided in the financial statements amounted to £nil (2005: £nil) for the Group and £nil for the Company (2005: £nil).

27. CONTINGENT LIABILITIES

The directors are not aware of any contingent liabilities.

28. SUBSEQUENT EVENTS

On 27 February 2007, 5,250,000 ordinary shares of £0.025 each with an aggregate nominal value of £131,250 were issued at 200p per share with total gross proceeds amounting to £10,500,000 (£10,000,000 net of costs).

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