Financial review

Operating results for the year ended 31 May 2006

	Revenue		Operating profit		Return on revenue	
	2006 £m	2005 £m	2006 £m	2005 £m	2006 %	2005 %
Banking	265	248	37	41	14	17
Healthcare	314	304	49	45	15	15
Sesame	370	313	9	5	2	2
Group	–	–	(9)	(9)		
Like for like results	949	865	86	82	9	10
Changes in exchange rates	–	(16)	–	(2)		
Profit on disposal of WebMD common stock	–	–	–	3		
Disposals	–	6	–	1		
Acquisitions	4	–	–	–		
Adjusted results	953	855	86	84		
Exceptional items	–	–	(28)	(12)		
Other	–	–	(2)	–		
Statutory operating results from continuing operations	953	855	56	72		

i. The statutory operating profit from continuing operations is analysed by business into Banking £22.3m (2005: £40.9m), Healthcare £45.4m (2005: £42.6m), Sesame £1.9m loss (2005: £5.3m loss) and Group costs £10.0m (2005: £6.4m).

ii. Restating the results for 2005 using the average exchange rates for 2006 has increased 2005 revenues by £16.8m (Banking: £3.4m and Healthcare: £13.4m) and operating profit £2.5m (Banking: £0.3m, Healthcare: £2.2m). The most significant impact is from the movement in the US dollar, where the average exchange rate in 2006 was US$1.78:£1 compared to US$1.86:£1 in 2005.

iii. Profit on disposal of WebMD common stock of £nil (2005: £2.7m) are included within Group costs.

iv. The businesses disposed of in the current year related solely to Sesame and contributed revenue of £0.4m in the current year (2005: £6.4m) and adjusted operating loss of £0.1m (2005: £0.9m profit).

v. The businesses acquired in the current and prior year contributed incremental revenue and adjusted operating profit for Banking: revenue of £1.7m and profit of £0.4m and for Healthcare: revenue £2.3m and losses of £0.8m.

vi. Exceptional items consist of: Restructuring programme in Banking £13.9m (2005: £nil); Acquisition integration costs in Healthcare £2.0m (2005: £nil); Profit on disposal of associate in Sesame £8.0m (2005: £nil); Loss on disposal of businesses in Sesame £2.8m (2005: £2.7m); Estimated costs and redress payments associated with regulatory reviews and complaints in Sesame £15.7m (2005: £8.9m) and Discontinued disposal costs in Group £1.4m (2005: £nil).

vii. Other items include gains on embedded derivatives in Banking £0.3m (2005: £nil) and amortisation of acquired intangibles in Banking £1.9m (2005: £0.3m) and Healthcare £0.5m (2005: £nil).

Revenue may be analysed under five generic headings, being ILF, maintenance (including recurring licence fees ('RLF')), transaction processing, professional services and hardware. ILF is the revenue generated when Misys sells the right to use a software product (including significant upgrades) to a customer. When a customer buys software they also enter into either a maintenance or RLF contract. These contracts provide technical support or trouble-shooting assistance (helpdesk, etc). In addition, a maintenance contract provides routine upgrades and enhancements. Maintenance also includes fees for support contracts for hardware.

Related to some products, Misys provides transaction processing services, comprising both EDI services, being an electronic link between parties who wish to exchange data, and computer aided processing activities, such as data centre capabilities or Internet transactions. Misys undertakes both forms of transaction processing in Sesame; while Healthcare and to a much lesser extent in Banking currently focuses on EDI.

On a like for like basis, all revenue streams have recorded growth in the current year. The strongest growth was in transaction processing driven by the strong performance in Sesame. ILF also grew strongly up 9% driven by another strong performance in Banking. Maintenance revenues also showed good growth at 5% compared with a growth rate of 4% last year driven by an increase in the rate of growth in both Healthcare and Banking. Professional services showed more muted growth up 4% compared with last year with stronger growth in Healthcare and in Banking remaining in line with last year following certain contract deferrals during the year as discussed earlier. Hardware revenues are less significant due both to their size and their lower margin and were in line with last year.

Other financial information

Unless otherwise stated, the information in this section is presented on an 'as reported' basis.

Deferred income

Deferred income on the balance sheet, which represents amounts invoiced but not yet recognised as revenue, is £119m (2005: £117m) on a reported basis. Within the overall balance, £84m (2005: £80m) relates to deferred maintenance fees which are generally invoiced annually in advance and recognised over the contract period. The remaining £35m (2005: £37m) relates to amounts invoiced for products and services that have not yet been delivered, completed or fully accepted by the customer at the balance sheet date. The reduction reflects the disposal of General Insurance and adjusting for this the amount is in line with last year.

Finance costs

The interest and other finance costs charge at £16m was £6m higher than last year. This was due mainly to increased average interest rates and a small increase in average borrowings, the latter due to the share buyback programme towards the end of the year ended 31 May 2005 and during the year ended 31 May 2006. Interest cover, including results from discontinued operations and before exceptional items, gains and losses on embedded derivatives and amortisation of acquired intangibles, was slightly more than six times.

Profit before taxation

Statutory profit before taxation, at £39m, was £22m below last year reflecting the increased charge for exceptional items and higher financing costs. The tax charge on ongoing ordinary activities at £15m is broadly in line with last year. The underlying effective tax rate, based on the adjusted profit before taxation of continuing and discontinued operations, at 18% was slightly ahead of last year. Adjusted profit before taxation excludes exceptional items, gains and losses on embedded derivatives, amortisation of acquired intangibles and exchange gains and losses on debt previously hedging goodwill written off to reserves.

Acquisitions and disposals

Within Banking, the Group acquired Almonde Inc in July 2005, INTESIO GmbH in February 2006 and NEOMAlogic SARL in March 2006, for a total consideration, including expenses, of £29m, which resulted in goodwill of £13m. Since we were already acting as agent for Almonde there are no incremental results for this business. Excluding Almonde, the acquisitions have contributed £1.5m revenue and £0.6m operating profit in the period since acquisition.

Within the Healthcare business, the Group acquired Payerpath Inc in January 2006, along with other assets in the physicians market in March 2006, for a total consideration, including expenses, of £31m, resulting in goodwill of £20m. The acquisitions have contributed revenue of £2.3m and operating losses of £2.8m in the period since acquisition, of which £2.0m of acquisition integration costs has been disclosed as an exceptional item.

Within Sesame, the Group disposed of its 60% shareholding in AssureWeb Ltd in July 2005 and its 29% investment in First Software (UK) Ltd in August 2005 for total net consideration of £11m, realising a combined profit in the year of £5m which has been disclosed as an exceptional item. The revenue and losses for AssureWeb up to the date of disposal were £0.4m and £0.1m respectively (2005: £6.4m revenue and £1.8m operating loss – after an impairment of assets of £2.7m disclosed as an exceptional item in 2005).

Discontinued operations

During the year the Group disposed of the General Insurance business which has been shown under discontinued operations. In the current year, this business generated profit after tax of £187m comprising the realised profit on disposal of £172m after taxation and an operating profit and profit after taxation of £15m up to the date of disposal on 5 May 2006. The prior year figure of £16m relates to the operating profit and profit after taxation for the whole of the year ended 31 May 2005. In calculating the adjusted EPS figures, the operating profits noted above have been included within this calculation whereas the realised profit on disposal of £172m after taxation has been excluded.

Cash flow and net debt

The Group has maintained its strong cash performance with net cash flow generated from operations of £107m (2005: £100m). This good performance, which follows equally strong cash generation in prior years, results from the Group's rigorous focus on cash and cash management by operating businesses.

Cash payments in respect of both interest and taxation of £16m and £15m respectively, are broadly in line with the charge in the income statement. These cash outflows were significantly ahead of the prior year as a result of higher financing costs, mainly as a result of higher prevailing interest rates, and the timing of the settlement of taxation charges. As a result net cash flow from operating activities of £76m was £7m below last year.

Capitalised expenditure on developed software and other capital expenditure totalled £23m compared with £20m last year. Accordingly the net cash flow generated by operating activities after capitalised development costs and other capital expenditure was £54m compared with £63m last year.

Dividend payments in the full year, being last year's final dividend and this year's interim dividend totalled £34m in line with last year as the increase in the dividend per share was offset by the effect of the shares repurchased both this year and at the end of last year. During the year the Group has repurchased a further 12m shares at a cost of £25m compared with £53m last year for 26m shares.

The net cash inflow from corporate activities (i.e. proceeds from disposals less the cost of acquisitions) was a net inflow in the year of £119m compared with an outflow last year of £9m. In the year just ended, this principally related to the disposal of the General Insurance business which raised net cash of £180m, offset by net cash consideration of £51m in respect of acquisitions during the year. The principal acquisition was in respect of Payerpath within the Healthcare business.

As a result of these various cash flows net debt at 31 May 2006 was £95m compared with £219m last year.

Earnings per share and proposed dividend

Basic EPS at 44.0p was 31.6p above last year, principally due to the profit on the disposal of the General Insurance business. Adjusted EPS (adjusted to exclude exceptional items, gains and losses on embedded derivatives, amortisation of acquired intangibles and exchange gains and losses on debt previously hedging goodwill written off to reserves) at 14.3p (2005: 14.8p) was 3% below last year. In the opinion of the Directors the adjusted basic EPS provides more comparable and representative information on continuing and established trading activities of the Group. The Board is recommending a final dividend of 4.49p per share. This will raise the full year dividend to 7.18p, an increase of 5% over last year.

IFRS

Misys has adopted International Financial Reporting Standards ('IFRS') as adopted by the European Union and with those parts of the Companies Act 1985 that are applicable to companies reporting under IFRS from 1 June 2005 with a transition date of 1 June 2004. Comparative figures for the year ended 31 May 2005 and the balance sheet at 31 May 2005 that were previously reported in accordance with accounting principles generally accepted in the United Kingdom, have been restated to comply with IFRS, with the exception of IAS 32 'Financial Instruments: Disclosures and Presentation' and IAS 39 'Financial Instruments: Recognition and Measurement' which have been applied prospectively from 1 June 2005.

The most significant impacts of transition to IFRS on net assets are the removal of amortisation of goodwill and the capitalisation of development costs, which along with share-based payments also effect the income statement. There has been no impact on the underlying cash flows generated by the businesses.

Further information on the transition to IFRS, including a reconciliation of retained profit for the year ended 31 May 2005 and shareholders equity at 1 June 2004 and 31 May 2005, is shown in note 38 to the financial statements.

Risk factors

Our business is influenced by a number of risks and the more significant of these are described below. However the financial performance of our business could be adversely affected not only by these factors but also by the risks that we do not presently consider to be significant or by other risks that are presently unknown to us. Not all of the risks that are identified below are under the direct control of Misys but in most cases we have built systems and controls into the Group operations to monitor and, where possible, mitigate the potential damage that could result from these risks (see also the Corporate governance report).

Risks arising from the markets in which we operate

Economic cycles

The market demand for the products offered by our Banking and Sesame businesses are sensitive to an economic downturn. The strength of the revenues of the Banking business is reliant upon banks continuing to seek competitive advantage and greater efficiencies from technology and this encourages them to make further investments in this area. Such investments are more likely to be made during periods of economic growth. The same can be said of Sesame which owes its revenues to the success of the member firms which it services and this can be related to economic growth particularly in the UK. However the Healthcare business is not considered to be as sensitive to the state of the economy, as the US propensity to spend on healthcare has been somewhat insensitive to the condition of the US economy.

Strategy

The markets in which we operate move quickly. Entering and exiting new segments of the market, developing new products and discontinuing others can have substantial lead times. To do this successfully we need to predict both future areas of demand and also the future capabilities of our competitors. At times it is difficult to obtain quality information on the changing demands of the market which may result in decisions needing to be made with imperfect data. Failure in this area could result in our making investments in the wrong product or failing to invest in a product that will enjoy a successful market. In view of these risks the strategy adopted is comprehensively communicated throughout the senior management team and the implementation of this strategy is regularly reviewed.

Acquisitions and disposals

One of our key strategic objectives going forward is to seek acquisition opportunities with a view to complementing our existing product and services portfolio. Consequently we regularly acquire or dispose of companies. This gives rise to execution risks in identifying and valuing the target, managing the process to best advantage and integrating or separating the target business. These tasks are therefore performed to a set of procedures by a dedicated team that call upon external resources as required.

Product development

Likewise, having made a decision to invest in a product there are many risks in bringing a product development project to a conclusion on schedule and within budget. This process is managed by developing a product roadmap, for each product group, that identifies the enhancements that will be made to successive versions of the product in the years ahead. Our application software products and services are complex and may contain undetected errors, failures, performance problems or defects. The early releases of a product will have been subjected to beta tests but not the more stringent test of widespread use by large numbers of users. Consequently, despite rigorous pre release testing, problems may not become apparent until the system is used in production environments. Certain Healthcare products will need to meet with the regulations imposed by the US Food and Drug Administration, which impose high standards of quality assurance that become an inherent part of our procedures. However the ultimate risk of patient harm remains. The product development teams network extensively amongst themselves and beyond to ensure best practice is followed.

Risks arising from operations

People

Our people are our greatest asset and the market for quality technology skills and management is very competitive. It consequently remains a constant challenge to retain, develop, incentivise, manage and motivate our staff. If we were to lose the services of members of management or employees who possess specialised market knowledge and technology skills, we may not be able to manage our operations effectively or develop new application software products and services. We therefore take talent management very seriously. Our people are appraised regularly, given individual development plans and other incentive packages. Potential successors are identified for all senior roles.

Contract implementation

Misys prides itself on being seen as a business partner to its customers and supplying them with mission critical systems. Often the system will transcend departmental boundaries within the client's organisation and may be a part of a larger project involving other suppliers. The process of introducing a system in such an environment may be disruptive to the client in the short term and the implementation may be subject to project management by the client or by others. Consequently our large contracts, such as some of the contracts we have with banks and hospitals, will have long implementation schedules and an increased risk of delays during these implementation periods with consequential risks to the cash flows and profits that were expected from that contract. It is also possible that the needs of the client will change during the implementation period for a reason that is outside Misys' control. In the extreme, the client may no longer have a need for the Misys product that they have contracted for. Such instances are rare and typically resolved through negotiation.

Furthermore the products and services developed by the software applications industry in general, are characterised by lengthy sales cycles that may cause revenues and operating results to be unpredictable and to vary significantly from period to period.

Political uncertainty

Misys has operations in over 30 countries and customers in over 120. This geographic diversity exposes parts of our business to the risk of political unrest. We maintain significant research and development operations in Bangalore and Manila. Political or social instability in either of those areas could seriously harm our research and development operations. Our operations do have business continuity plans but a level of disruption could nevertheless be expected if political unrest, or indeed any other disruptive event such as a natural disaster, should occur.

Key suppliers

Certain of our products are dependent upon inputs from key suppliers. We are dependent on the performance, service and reliability of operating systems, middleware, databases, programming language compilers and similar software infrastructure, all of which we obtain from a large number of third party providers. Such third party applications may suffer from defects or errors which could adversely affect the performance of our application software products and services. Moreover, if we are unable to adapt our application software products and services to function with new releases of such third party applications, or if such third party applications were to be withdrawn or discontinued, we may incur significant costs in eliminating these third party components from our products and our ability to deliver new systems and maintain existing customers could be adversely affected. Suppliers are consequently chosen that have stable strategies that match our own and produce a mutually beneficial relationship that is carefully managed by both parties.

Infringement of intellectual property rights

Over many years we have made significant investments in our products which have resulted in Misys owning substantial intellectual property rights. We generally protect our proprietary application software products and services by licensing rights to use the application, rather than selling or licensing the computer source code. We also protect our proprietary software and services by copyright law. Possible infringement of our intellectual property rights could cause us to lose revenue, adversely affect our ability to operate our business and could damage our trademarks. Furthermore there is always the risk that we have inadvertently infringed the intellectual property rights of a third party. If any such claim against us were successful we would probably face one of three choices. Firstly we may need to re-design our product, which would demand further investment in that product. Secondly we could take a licence on the infringing intellectual property that is contained within our product and this may not always be possible on acceptable commercial terms. Thirdly we could cease to sell that product and accept the decline in revenues. An intellectual property claim that is made against us, whether or not it has merit, would also be a drain on management attention and so prove to be disruptive to our business and could cause delays in product development. The risk is mitigated through our contractual arrangements and by the careful adherence to Group policy on open sourced software.

Government regulation

In recent years the UK financial services industry has been subject to increased regulation from the Financial Services Authority. This has resulted in many cases of parties successfully claiming to have been mis-sold financial products. The cost to Sesame of investigating these claims is significant. Furthermore, if the claims are ultimately found to be justified, there are further costs to Sesame which may or may not be recoverable from the member firms or from our insurers. Consequently an increase in the rate of claims being made, an increase in the uphold rates of such claims, further regulation by the Financial Services Authority or further mis-selling reviews under existing regulation could all consequently result in further costs to Sesame. In addition, the Group is subject to the laws and regulations of a number of countries covering a wide variety of areas affecting international transactions, including export controls, anti-corruption legislation and data protection requirements.

Attack by IT viruses

As an IT business this will always be a threat that requires sound IT infrastructure and virus protection software. Furthermore Sesame and Healthcare both obtain substantial revenues from online trading activity. A disruption to service would, in time, result in customers reverting to traditional means of conducting business and so circumventing the Misys service. Finally if third parties misappropriate our users' information, we may be liable for substantial damages, our reputation may be damaged and users may be deterred from using our application software products and services.

Financial risks

Tax risks

The geographic diversity of Misys was described above under Political Uncertainty. We may be subject to tax audit in many of the countries in which we operate, in accordance with the local practice. This introduces an exposure to new tax risks, such as a challenge to our transfer pricing policies, and it raises the possibility of the same profits being taxed in more than one country. Furthermore tax legislation is complex and often results in lengthy negotiations before certainty of the tax treatment to a complex transaction is achieved.

Legislative risks

Some of the countries in which we have operations control the repatriation of earnings and capital. These controls may vary at short notice and consequently give us a risk of delaying or even preventing cash flows back to the parent.

Fluctuations in exchange rates

The same geographic diversity leaves us exposed to fluctuations in exchange rates with the highest exposure being against the US dollar and euro. Where possible we routinely hedge currency exposures on trading transactions that would otherwise give us a risk from movements in the exchange rate; for example between entering into a sales contract and receiving payment. However the translation risk which arises when consolidating the financial results of the overseas entities is not hedged. We also run the economic risk that results for example from the cost base of the development centres being unrelated to the currencies of the markets in which the end products are eventually sold.

Retirement benefits

We operate a number of ongoing and legacy pension schemes in the countries in which we operate. While we do not foresee a material problem from a deficit on a defined contribution scheme, in many countries pensions are highly regulated and we therefore remain at risk from falling outside of local regulations.

Treasury controls and operations

The Group has in place treasury policies that are reviewed annually by the Board and more regularly by the Treasury Committee that comprises certain executive Directors and a non-executive Director. The policy covers all significant areas of treasury activity, including foreign exchange, interest rate, liquidity and credit risk. The Group has a centralised treasury that provides a service to the corporate centre and to the operating businesses. Its primary function is to manage the foreign exchange, interest rate, liquidity and credit risks arising from the operations of the business. It is not a profit centre and enters into derivative contracts solely for the purpose of hedging the exposures that arise in the normal course of business. The Group's policy is not to enter into speculative transactions.

The Treasury Committee is responsible for ensuring that the Group operates within the treasury policies agreed by the Board. Regular reports are made to the Board from the Treasurer and from the Treasury Committee.

The Group finances its operations through a mixture of retained profits, new equity, loan notes and bank borrowings. It is policy to ensure that the Group has sufficient financial resources to support the business and, as a result, substantial committed facilities are maintained. The Group also has a policy to ensure that it maintains a comfortable margin between committed facilities and the likely peak borrowings during a year.

The core debt financing of the Group is provided by a revolving facility of $850m (£454m at 31 May 2006 exchange rates). This comprises a tranche of $585m, which matures in March 2010, and a second tranche of $265m, which matures no later than March 2008. During the year the maturity of the second tranche was extended from a final maturity which had been March 2007. These facilities allow the Group to borrow funds in any major currency at the related floating rates of interest.

The Group has substantial investments in the US and consequently the debt drawn under the revolving facility is predominantly in US dollars. However the floating rate nature of the debt gives the Group an exposure to interest rate fluctuations. In managing this we have sought a balance between the certainty of interest charge and the flexibility to permit our borrowing levels to change dramatically, such as following a substantial corporate transaction. Consequently the Group has protected the interest charge on $100m of the bank debt from increases in interest rates via an interest rate cap that matures in June 2007. This gives the Group a mixture of floating rate and capped debt.

The Group has operations in over 30 countries and trades in over 120. Subsidiaries may trade in currencies other than the functional currency of their operation and in such cases the currency is usually sterling or US dollars. It is the Group's policy to eliminate transactional currency exposures through forward foreign currency contracts as soon as the contractual commitments to receive (or pay) the foreign currency is known.

The Group is also subject to a currency exposure on the translation of the net assets of, and profits earned by, its overseas subsidiaries which are primarily those located in the US and Europe. This exposure is not hedged.

The Group invests its cash and cash equivalents, and enters into contracts for derivative financial instruments, with institutions of high credit quality, and limits its exposure to any one counterparty. The Group's revenue is derived from various industries and could be directly affected by the overall conditions of those industries. The large number of customers, their geographical distribution, and the reasonably short collection terms mitigates the credit risk associated with this. The Group routinely monitors its exposure to credit losses and maintains an allowance for anticipated losses.

Howard Evans
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