ARM®

# Annual report and accounts 2006

ARM designs the technology that lies at the heart of advanced digital products, from mobile, home and enterprise solutions, to embedded and emerging applications.

ARM's comprehensive product offering includes 16/32-bit RISC microprocessors, data engines, graphics processors, digital libraries, embedded memories, peripherals, software and development tools, as well as analogue functions and high-speed connectivity products.

Combined with the Company's broad partner community, this provides a total system solution that offers a fast, reliable path to market for leading electronics companies.

## ARM Holdings plc, the world's leading semiconductor intellectual property (IP) supplier is at the heart of the development of digital electronic products.

## The continuing evolution of electronic devices has escalated to the extent that the use of IP is now providing the technological foundation for nearly every electronic device in the world today.

(Source: Gartner Dataquest's 2004 IP company rankings)

### ARM North America

Austin, Texas
Boston, Massachusetts
Detroit, Michigan
Irvine, California
Cary, North Carolina
Olympia, Washington
Plano, Texas
Salem, New Hampshire
San Diego, California
Sunnyvale, California

### ARM Europe and Middle East

Aachen, Germany
Blackburn, UK
Cambridge, UK
Grasbrunn, Germany
Grenoble, France
Kfar Saba, Israel
Leuven-Heverlee, Belgium
Maidenhead, UK
Munich, Germany
Paris, France
Sentjernej, Slovenia
Sheffield, UK
Sophia Antipolis, France
Trondheim, Norway

### ARM Asia Pacific

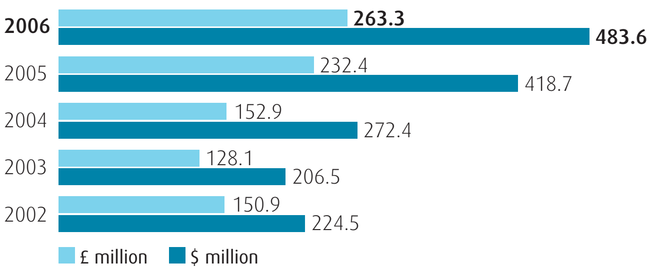
Beijing, PR China
Seoul, South Korea
Shanghai, PR China
Singapore
Taipei, Taiwan
Shin-Yokohama, Japan

### ARM India

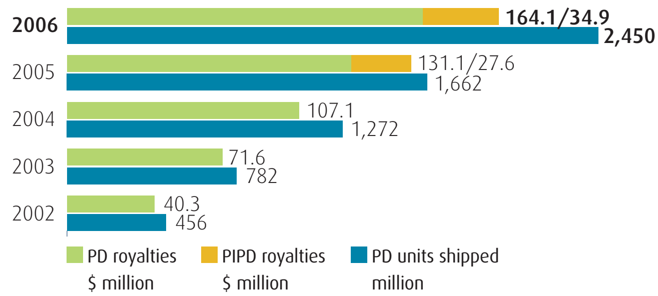
Bangalore, India

# Key performance indicators

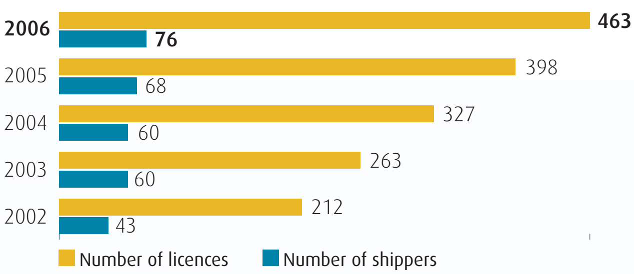
Total revenues



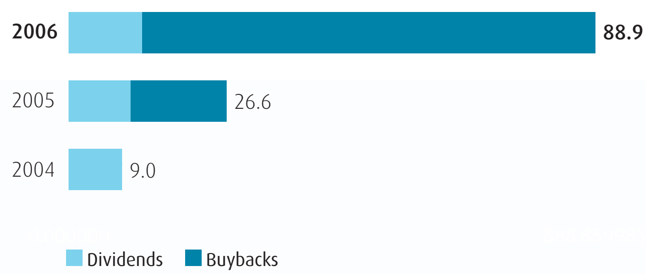

Royalty revenues



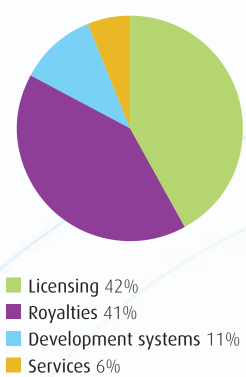

Cumulative PD processor licences and partners shipping



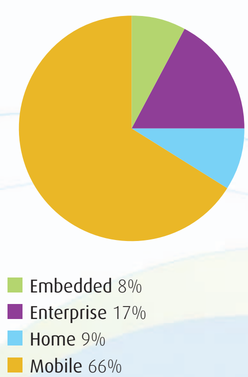

Cash returned to shareholders (£ million)



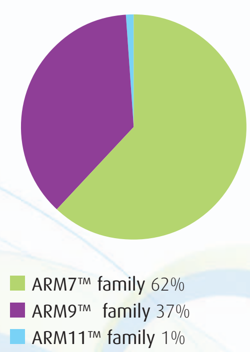

Revenue analysis
%



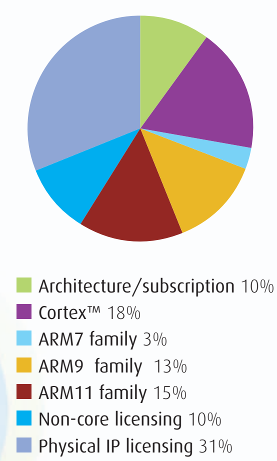

Processor division royalty units
%




Royalty units by family
%




Licence revenues by product
%




- Total revenues of £263.3 million in 2006 compared with £232.4 million in 2005
- Our partners shipped a total of 2,450 million units in 2006 based on ARM® technology (an increase of 47% on 2005)
- 65 processor licences and 77 physical IP licences signed in 2006 bringing cumulative totals to 463 and 287 respectively
- £89 million of cash returned to shareholders through share buyback programme and dividends

**It was with great pleasure that I accepted the position of Chairman of ARM from 1 October 2006, following the retirement of Sir Robin Saxby. I took up my role towards the end of another successful year for the Company, and we entered 2007 well placed to build on our market-leading position.**

## Results and dividend

The increasingly widespread adoption of ARM technology in consumer electronic devices was illustrated during 2006 by the 47% increase in the reported total shipments of ARM Powered® products to 2.45 billion units, up from the reported 1.66 billion units in 2005. Our strong financial performance continued: dollar revenue growth increased by 16% and there was a 20% increase compared with 2005 in the year-end order backlog.

The strong cash generation resulting from this robust operational performance, together with our confidence in the Company's long-term prospects, enabled us to invest heavily in our business and to strengthen our IP portfolio through the acquisitions during 2006 of Falanx Microsystems, an innovative graphics IP company, and Soisic, a leading company in physical IP based on silicon on insulator (SOI) technology. These acquisitions add to ARM's microprocessor and physical IP capabilities, which have accelerated the Company's momentum towards becoming the architecture for the digital world.

Strong cash flow has not only enabled us to invest in the business and make acquisitions of operations with complementary technology, but also to return cash to shareholders through dividends and the share buyback programme. It is the board's intention to increase the dividend over time, taking into account the opportunity for continued investment in the business and the Company's underlying operational performance. With this in mind, the board is recommending a final dividend of 0.60 pence per share, bringing the total for the year to 1.0 pence per share, an increase of 19% over the dividend paid in respect of 2005.

We see the return of cash to shareholders through a dividend as part of a package of measures to make the best use of the business's cash resources and plan to continue the share buyback programme, which we initiated in July 2005. During 2006, we purchased a total of 63.6 million shares at a total cost of £76.5 million.

## The market

The year was another one of healthy growth, approximately 10%, for the semiconductor industry as a whole, although it began to show signs of slowing by the end of the year.

**The 16% increase in ARM's dollar revenue was, once again, significantly ahead of the industry growth rate and exemplifies the opportunities that exist for the Company.**

Looking to 2007, we expect the industry to continue to be impacted by the inventory correction in the first half at least, but we believe that the effect on ARM will be attenuated and we expect to exceed the industry growth rate in 2007 as we have done in past years.

Our confidence in the development of our business in 2007 is underpinned by a healthy technology portfolio of processor and physical IP, comprising new and mature products. There is the prospect of more synergistic deals for the physical IP division and continued acceleration of the penetration of our IP into royalty-generating designs, in both mobile and non-mobile markets.

Momentum for our processor and physical IP portfolio increased throughout 2006. Demand continues to grow for the Cortex™ family of processors which enabled ARM to complete 13 licence deals in the year. This has been the most successful introduction of any family of ARM processors and we expect this success to continue in 2007.

In physical IP, we completed seven licence deals with some of the world's largest foundries (TSMC, Samsung, IBM, and Chartered) for our most advanced 45nm physical IP products. In 2007, further opportunities for licensing exist across the Physical IP portfolio as we seek to benefit from the desire of semiconductor companies to offset the impact of increasing costs, as envisaged when we outlined industry transitions in the original rationale for the acquisition of Artisan in 2004.

## People

2006 was a year of investment in new businesses and people, resulting in a significant increase in our total number of employees. I thank all employees worldwide for the contribution they have made to the excellent results achieved in 2006 in the increasingly demanding market in which we operate. At 31 December 2006, we had 1,659 full-time employees compared with 1,324 at the end of 2005. Of these, 671 are based in the UK, 582 in the US, 153 in continental Europe, 203 in India and 50 in the Asia Pacific region.

We were delighted that the efforts of our people were recognised recently by the Company winning three prestigious awards, which were open to businesses from all sectors. In November 2006, ARM was chosen as UK Business of the Year at the National Business Awards, an award which takes market leadership, innovation, growth and financial return into consideration. In January 2007, the Company was recognised as European Business of the Year, competing against the other national award winners within the European Union. Further, at the *Management Today* awards in November 2006 for Britain's Most Admired Companies, ARM was recognised as the company with the "greatest capacity to innovate". While these awards were for companies with headquarters in the UK or the European Union, they recognise the efforts of all ARM employees worldwide.

## Board changes

As part of a planned succession, Sir Robin Saxby retired as Chairman and as a director of the Company on 1 October 2006, when he took up his role as President of the Institute of Engineering and Technology (IET). In his year as President of the IET, Robin will continue to be associated with ARM as Chairman Emeritus. During his 15 years with ARM, the Company has earned a reputation as one of the world's most respected technology companies and has become a global leader in semiconductor intellectual property. On behalf of the board I thank him for the very significant contribution he has made to ARM's success.

We were very pleased to welcome Kathleen O'Donovan as an independent non-executive director on 7 December 2006. She is a non-executive director and Chairman of the audit committee of Prudential plc and Great Portland Estates plc, and a former non-executive director and Chairman of the audit committee of the Court of the Bank of England. She has been appointed to the audit and remuneration committees with effect from 1 January 2007. We were also very pleased to welcome Young Sohn as an independent non-executive director on 2 April 2007. He has extensive experience in the semiconductor industry both in Silicon Valley and in Asia. He is a director of Cymer, Inc. and M-Stream Technology Limited. He will be appointed to the audit and remuneration committees of the Company with effect from 15 May 2007.

These appointments are part of the planned succession for Peter Cawdron who has been a member of the board since 1998 and will step down at the AGM on 15 May 2007. More detailed biographies appear on page 18.

## Current trading and prospects

2006 was a year of building for the future. We invested significantly in the business, with the majority of the investment going to the Physical IP Division and the emerging business units. Increasing momentum across our business lines resulted in an above-industry level revenue growth of 16%.

A broad technology portfolio for licensing, a healthy opportunity pipeline, an increasing drive in royalties, and the prospect of more synergistic revenues arising from the combination of processor IP and physical IP, underpin our confidence in another strong performance in 2007.

**Doug Dunn** Chairman

**ARM has, for some years, defined itself as being the architecture for the digital world and in last year's report I wrote that we were well on the way to achieving that. What progress have we made during 2006?**

A large number of products in everyday use, from personal organisers to cars, and from televisions to washing machines, are already likely to have ARM IP (intellectual property) embedded within them. We are at the point in the digital revolution where intelligent microelectronics have made their way out of the workplace – where they have been transforming technology for a number of years – into people's everyday lives.

Our products (our IP) enable companies to design and market their electronic devices more quickly and more economically and, what is most important to end consumers, to make them more "intelligent", secure and reliable. In my view, we are still only part way through the digital revolution and we do not really know when we will reach the end. Therein lie the opportunities for ARM. By enabling innovative products to be designed and brought to market, our architecture ensures that the digital revolution will continue to transform our lives.

### The digital world

Advances in technology, particularly over the past 20 years, have made people's lives more productive and saved them time – man's most finite, and therefore most valuable, commodity. People in the developed world, for example, work approximately 17% fewer hours than they did in 1950, work itself tends to be more rewarding because many routine tasks have been taken over by technology, and a huge number of labour-saving devices at home have removed much of the time-consuming drudgery traditionally associated with housework. The digital world not only provides access to hitherto unprecedented levels of communication, information creation, storage and retrieval, but also makes life that little bit easier.

The widespread use of ARM processors and technology in mobile telephony and digital communications is well known, but they are increasingly permeating other aspects of our everyday lives. Electronics have, for example, driven more than 90% of the innovation in the automotive industry. Features which, only a few years ago, were exclusive to luxury cars are now commonplace: mid-range vehicles now incorporate up to 70 embedded processors which have improved safety, added convenience and increased functionality. Our microprocessors improve braking systems by enabling the wheels to "talk" to one another; airbags to "read" the size and weight of the person they are there to protect; engines to start at one turn of the key, no matter

how cold the weather; car interiors quickly to reach a comfortable temperature; and sound systems to entertain passengers while GPS (Global Positioning Systems) help find the way. Perhaps most important, however, in a world in which car use is growing exponentially, technology has enabled manufacturers to reduce fuel consumption by as much as 40% and, as a result, to reduce pollution. Safety and environmental regulations will undoubtedly continue to become more onerous for manufacturers, and the need to replace expensive mechanical parts in vehicles with more economical electro-mechanical and electronic systems will increase. The performance and power-consumption characteristics of our processors, together with the unparalleled scope of the design environment we facilitate for the automotive manufacturers and their semiconductor suppliers, means that the automotive industry continues to be an exciting growth market for ARM technology.

There is, however, more to the digital world than making life easier and more enjoyable for those who live in developed countries. Advanced technology is playing a leading role in fuelling growth in the developing world. Its contribution to education, one of the principal means of lifting people out of poverty, is immense. Equally it contributes to saving lives, worldwide, by making it possible to predict accurately natural disasters, such as earthquakes and tsunamis; and plays an important role in drug research and delivery.

Technology will continue to evolve. ARM’s digital architects are a vital part of that evolution – they create products that are, and will continue to be, fundamental to the implementation of the digital world.

### Our role in the industry

In any industry progress comes at a cost; in the digital world, this is because of the significantly increased complexity of the underlying technology. While consumers (you and I) will be prepared to pay some premium for new intelligence in a product, they will not pay significantly more; as a result, manufacturers – and their suppliers – are under huge pressure to find less expensive ways to produce ever more intelligent devices. This is where ARM comes into the picture: our technology makes it easier and more cost effective for companies to design and make advanced digital products. Our role is not only to innovate, but also to take structural cost out of the process: we enable the retail cost of electronic devices to be reduced. Through our licensing business model, semiconductor companies can effectively share the cost of the design of our products; they can use our microprocessors at a fraction of the cost of in-house design. This process applies across our technology portfolio of microprocessors (the brains of a digital device) and physical and fabric IP (the bricks and mortar); in the future, it will also apply to other new products, including graphics, security, and digital signal processing technology.

**We estimate that in 2006, 1.5 billion people, a quarter of the world’s estimated 6 billion population, bought an ARM Powered product.**

The IP we sell to our customers enables end users to operate their devices for long periods without recharging, to connect people more easily to one another, and to access information whenever and wherever they want to. I believe it is true to say that without ARM IP, which balances power with performance and cost, consumer electronics would not have reached the point they are at today.

When we, our customers, and the other companies which play a part in bringing digital electronics to the market “get it right”, consumers barely notice that there is a digital revolution taking place; products quickly become “must-haves” because of the impact they have on peoples’ lives. It is hard to believe that MP3 players were conceived as recently as 1991; that the all-in-one Blackberry wireless device was introduced only seven years ago; and that flat-screen televisions were first available to the public as recently as 1997. Digital cameras have become so commonplace that Kodak stopped selling film cameras in North America and Western Europe in 2004.

### The opportunity

The semiconductor industry in which ARM operates is huge – in 2006 it was worth approximately $260 billion, of which IP was approximately $1.6 billion. We occupy a leading position in the semiconductor market and expect not only to benefit from the overall growth of the IP industry, but also to continue to expand our market share by continuing to bring industry-leading technology to the market. We have already built a consistently successful business by establishing the world’s leading microprocessor technology in digital electronic products – now we are on our way to achieving the same result with physical IP, which we believe is the next wave of opportunity for optimising structural costs in the semiconductor industry.

Our future success lies, however, in more than simply seizing the opportunity to licence technology to our partners; a bigger opportunity lies in the ubiquity of our technologies in digital products used by consumers. We estimate that in 2006, 1.5 billion people, a quarter of the world’s estimated 6 billion population, bought an ARM Powered product. Approximately 90% of the mobile phones manufactured today contain at least one ARM product; our goal is for our technology to penetrate the billions of other products – from washing machines to printers, and from cars to exercise bicycles – that are bought by the other three-quarters of the world’s population. The more people who use our technology in their daily lives, the more benefit we will accrue from the royalty revenue stream which forms the cornerstone of our business model and strategy.

During 2006, we implemented and delivered the highest quality technology to our partners, the industry, and end consumers. I am confident that we have a bright future as we continue to benefit from the digital revolution: we are, indeed, well on the way to becoming the architecture for the digital world.

Warren East

**Warren East** Chief Executive Officer

**2006 was another year of consistent execution and significant investment in our business, and we are encouraged to have grown revenues and maintained operating margins despite the weakened dollar as well as seeing volumes of ARM Powered products growing 47% year-on-year to 2.45 billion units**

## Performance

Certain revenue key performance indicators appear on page 3. Other cost and profit indicators are discussed as part of this review.

### Revenues

Total revenues for the year ended 31 December 2006 amounted to £263.3 million (2005: £232.4 million). In US dollar terms, revenues grew from $418.7 million in 2005 to $483.6 million in 2006, an increase of 16%. The actual average dollar exchange rate for ARM in 2006 was $1.84 compared with $1.80 in 2005, which had the effect of reducing total reported revenues by approximately £5.2 million based on 2005 rates.

Total licensing revenues in 2006 were £110.6 million, being 42% of total revenues, compared with £104.3 million or 45% of total revenues in 2005. In US dollars, total licensing revenues in 2006 were $202.5 million compared with $187.0 million in 2005, an increase of 8%.

Royalty revenues in 2006 were £107.8 million, representing 41% of total revenues in the year, compared with £87.8 million or 38% of total revenues in 2005. Total royalty revenues in US dollars in 2006 were $199.0 million, up 25% from $158.7 million in 2005.

Sales of development systems in 2006 were up 13% to £28.8 million, being 11% of total revenues, compared with £25.6 million, or 11% of total revenues in 2005. Service revenues, which include consulting services and revenues from support, maintenance and training, were up 10% to £16.1 million in 2006, representing 6% of total revenues, compared with £14.7 million, or 6% of total revenues in 2005.

### Royalty revenues and unit shipments

Total royalty revenues for 2006 were £107.8 million, comprising £88.7 million from the Processor Division ("PD") and £19.1 million from the Physical IP Division ("PIPD"). Royalties in PD came from record unit shipments of 2.45 billion compared with £72.5 million and 1.67 billion units in 2005. Dollar royalty revenues earned in PD were $164.1 million, up 25% on 2005 compared with the increase in year-on-year unit shipments of 47%. Unit volume growth more than compensated for the lower average royalty rates and, as all royalty revenue is earned effectively at 100% margin, represents incremental returns on the development cost of the ARM technology on which the royalty is earned.

ARM continued to benefit from significant growth in the mobile segment (which includes mobile handsets, Bluetooth devices and portable media players, such as the Apple iPod), which accounted for 66% of the units shipped by the ARM Partnership. We also saw significant growth across a myriad of applications outside the mobile segment, including smartcards, microcontrollers, automotive, connectivity devices, hard disk drives and many others. Total non-mobile shipments which, at 838 million units in 2006 were higher than total shipments into all applications as recently as 2003, illustrates ARM's increasing penetration across the full range of consumer electronics products.

The total number of partners shipping ARM technology-based products at the end of 2006 was 76 after taking into account corporate activity within the ARM Partnership. 29 companies were paying royalties for physical IP products at the end of the year. Strong momentum in PIPD royalties continued, with a 26% growth in both total and underlying royalties. Sales of the 130nm and 90nm process nodes continued to be the fastest-growing segments for PIPD, although more than half of royalties received in 2006 came from older geometries. The growth in royalties within PIPD demonstrates the increasing penetration of ARM physical IP in chip designs.

## Gross margin

Gross margins for the year to 31 December 2006 were 88.3% compared with 88.6% in 2005. Cost of sales in 2006 includes compensation charges in respect of share-based payments of £1.0 million (2005: £1.3 million). Excluding compensation charges in respect of share-based payments, gross margins for the year to 31 December 2006 were 88.7% (2005: 89.1%).

## Operating expenses

Over the past several years, ARM has acquired various companies with significant values of intangible assets other than goodwill being recognised; these amounts are amortised over the expected useful lives of the assets acquired, with the cost recorded against research and development, sales and marketing or general and administrative expenses, as appropriate. In order to aid comparability, these costs have been separately identified as "acquisition-related charges" in the narrative below. In addition, the issuance of ARM share options to the employees of Artisan on acquisition, as well as to the ongoing share-based compensation to employees of the Group, gives rise to significant non-cash share-based compensation charges. These are also separately identified in the narrative below.

Total operating expenses in the year to 31 December 2006 were £182.5 million compared with £170.7 million in 2005, with the increase primarily attributable to the increase in average headcount from 1,234 in 2005 to 1,472 in 2006. Operating expenses in 2006 include acquisition-related charges relating to amortisation of intangibles of £19.3 million (2005: £17.9 million), other acquisition-related charges of £1.1 million (2005: £nil) and compensation charges in respect of share-based payments and related payroll taxes of £16.4 million (2005: £20.3 million). Excluding acquisition-related charges and compensation charges in respect of share-based payments and related payroll taxes, total operating expenses in 2006 were £145.7 million in 2005, compared with £132.5 million in 2005.

Research and development expenses in 2006 were £84.5 million, representing 32% of revenues. This compares with £80.3 million or 35% of revenues in 2005. Average headcount in this area increased from

## Selected financial data/IFRS

| | 2006 £000 | 2005 £000 | 2004** £000 | 2003* £000 | 2002* £000 |
|---|---|---|---|---|---|
| Revenues | **263,254** | 232,439 | 152,897 | 128,070 | 150,922 |
| Cost of revenues | **(30,825)** | (26,610) | (12,240) | (11,022) | (13,185) |
| Gross profit | **232,429** | 205,829 | 140,657 | 117,048 | 137,737 |
| Total net operating expenses | **(182,531)** | (170,672) | (112,328) | (98,609) | (96,608) |
| Profit from operations | **49,898** | 35,157 | 28,329 | 18,439 | 41,129 |
| Investment income | **6,758** | 5,317 | 6,944 | 4,801 | 4,373 |
| Profit before tax | **56,656** | 40,474 | 35,273 | 23,240 | 45,502 |
| Tax | **(8,068)** | (10,827) | (9,398) | (7,977) | (13,031) |
| Profit after tax | **48,588** | 29,647 | 25,875 | 15,263 | 32,471 |
| Equity minority interest | **–** | – | – | (105) | (232) |
| Profit for the year | **48,588** | 29,647 | 25,875 | 15,158 | 32,239 |
| Dividends paid | **12,367** | 10,436 | 8,975 | – | – |
| Capital expenditure | **8,559** | 6,064 | 5,036 | 3,605 | 15,616 |
| Research and development expenditure | **84,494** | 80,273 | 54,674 | 48,131 | 48,674 |
| Cash, short- and long-term investments | **128,494** | 160,902 | 142,817 | 159,786 | 130,304 |
| Shareholders' funds | **663,204** | 746,847 | 642,538 | 180,435 | 172,140 |
| Employees at end of year (number) | **1,659** | 1,324 | 1,171 | 740 | 721 |

* Figures for the years 2003 and 2002 are shown under UK GAAP and are not comparable with 2004 to 2006 prepared under IFRS.
** Figures for 2004 have been restated from UK GAAP to IFRS

783 in 2005 to 961 in 2006. Research and development expenses in 2006 include total acquisition-related charges of £10.6 million (2005: £8.1 million) and compensation charges in respect of share-based payments and related payroll taxes of £10.1 million (2005: £12.3 million). Excluding acquisition-related charges and compensation charges in respect of share-based payments and related payroll taxes, research and development expenses in 2006 were £63.8 million and £59.9 million in 2005, representing 24% and 26% of revenues respectively.

Sales and marketing costs in 2006 were £53.2 million or 20% of revenues, compared with £47.4 million or 20% of revenues in 2005. Average headcount in this area increased from 286 in 2005 to 302 in 2006. Sales and marketing costs in 2006 include total acquisition-related charges of £9.1 million (2005: £9.1 million) and compensation charges in respect of share-based payments and related payroll taxes of £3.5 million (2005: £4.3 million). Excluding acquisition-related charges and compensation charges in respect of share-based payments and related payroll taxes, sales and marketing costs in 2006 were £40.6 million and £34.0 million in 2005, representing 15% of revenues in both years.

General and administrative expenses in 2006 were £50.1 million or 19% of revenues, compared with £43.0 million or 19% of revenues in 2005. Average headcount in this area increased from 165 in 2005 to 209 in 2006. General and administrative expenses in 2006 include total acquisition-related charges of £0.7 million (2005: £0.7 million) and compensation charges in respect of share-based payments and related payroll taxes of £2.8 million (2005: £3.6 million). Excluding acquisition-related charges and compensation charges in respect of share-based payments and related payroll taxes, general and administrative expenses in 2006 were £46.6 million, compared with £38.7 million in 2005 representing 18% and 17% of revenues respectively.

Additionally in 2006, the Group sold its investment in CSR plc, resulting in a profit of £5.3 million.

### Operating margin

The operating margin in 2006 was 19.0% compared with 15.1% in 2005. The operating margin in 2006, excluding acquisition-related charges of £20.4 million and compensation charges in respect of share-based payments and related payroll taxes of £17.4 million, was 33.3% compared with 32.1%, before acquisition-related charges of £17.9 million and compensation charges in respect of share-based payments of £21.5 million, in 2005.

### Earnings and taxation

Profit before income tax in 2006 was £56.7 million compared with £40.5 million in 2005. Profit before income tax in 2006, excluding acquisition-related charges of £20.4 million and compensation charges in respect of share-based payments and related payroll taxes of £17.4 million, was £94.5 million or 35.9% of revenues. This compares with £79.9 million, before acquisition-related charges of £17.9 million and compensation charges in respect of share-based payments of £21.5 million, or 34.4% of revenues in 2005.

The Group's effective taxation rate in 2006 was 14.2%, compared with 26.8% in 2005. This reduction was primarily due to a non-recurring tax credit in the year arising from a tax-deductible foreign exchange loss.

Fully-diluted earnings per share in 2006 were 3.5 pence compared with 2.1 pence in 2005. Earnings per fully diluted share in 2006, before acquisition-related charges of £20.4 million, compensation charges in respect of share-based payments and related payroll taxes of £17.4 million and related estimated tax adjustments thereon of £9.2 million, were 5.5 pence, compared with 4.2 pence before acquisition-related charges of £17.9 million, compensation charges in respect of share-based payments of £21.5 million and related estimated tax adjustments thereon of £8.9 million, in 2005.

### Balance sheet and cash flow

Goodwill at 31 December 2006 was £428.4 million, compared with £474.4 million at 31 December 2005. The decrease in goodwill in 2006 is primarily due to foreign exchange movements, given the weakening of the US dollar against sterling, from $1.72 at 31 December 2005 to $1.96 at the end of 2006. Goodwill arising on the Falanx acquisition amounted to £9.4 million and on Soisic to £2.2 million. Goodwill is not amortised under IFRS but is subject to impairment review on at least an annual basis. The review performed in 2006 concluded that no impairment was required.

Other intangible assets at 31 December 2006 were £62.9 million, compared with £79.7 million at 31 December 2005. The movement in other intangible assets in 2006 reflects the amortisation in the year of the intangible assets arising on acquisitions of £19.3 million, the addition of £10.5 million arising on the acquisitions of Falanx and Soisic and certain assets of PowerEscape during the year and the revaluation of the currency denominated intangibles, predominantly those in US dollars. The other intangible assets will be amortised through the income statement over their estimated useful lives to the Group.

Accounts receivable at 31 December 2006 were £69.6 million, compared with £55.5 million at 31 December 2005. The allowance against receivables was £2.6 million at 31 December 2006, compared with £2.2 million at 31 December 2005. Deferred revenues were £31.5 million at 31 December 2006, compared with £20.4 million at the end of 2005.

### Resources available

The consolidated cash, cash equivalents, short-term investments and marketable securities balance was £128.5 million at 31 December 2006 compared with £160.9 million at 31 December 2005. This reduction is as a result of the continued share buyback programme and payment of dividends (see below), as well as the acquisitions of Falanx and Soisic. Excluding these outflows, the Group generated £73.7 million of cash in the year (2005: £65.0 million).

### Interest receivable

Interest receivable was £6.8 million for the year to 31 December 2006 compared with £5.3 million in 2005.

### Returns to shareholders

#### Dividends

The directors recommend payment of a final dividend in respect of 2006 of 0.6 pence per share which, taken together with the interim dividend of 0.4 pence per share paid in October 2006, gives a total dividend in respect of 2006 of 1.0 pence per share, an increase of 19% over the 0.84 pence per share in 2005. Subject to shareholder approval, the final dividend will be paid on 21 May 2007 to shareholders on the register on 4 May 2007.

Total dividends actually paid in 2006 amounted to £12.4 million (2005: £10.4 million).

#### Share buyback programme

In 2006, the Group continued its rolling share-buyback programme to supplement dividends in returning surplus funds to shareholders. During the year, the Company bought back 63.6 million shares (2005: 13.9 million) at a total cost of £76.5 million (2005: £16.2 million).

Since introducing dividend payments in 2004 and commencing the Company's share buyback programme in July 2005, £125 million has been returned to shareholders and 77.5 million shares, 5.6% of issued share capital, have been bought back. This has contributed to a net reduction in the average fully diluted shares in issue from 1,424 million in 2005 to 1,402 million in 2006. This programme will continue during 2007 and beyond.

#### Capital structure

The authorised share capital of the Company is 2,200,000,000 ordinary shares of 0.05 pence each (2005: 2,200,000,000). The issued share capital at 31 December 2006 was 1,389,907,834 ordinary shares of 0.05 pence each (2005: 1,386,102,680). As a result of the buyback programme, the Company held 49,500,000 of its own shares at 31 December 2006 (2005: 12,751,107).

#### Treasury policies and objectives and liquidity

The Group has established treasury policies aimed both at mitigating the impact of foreign exchange fluctuations on reported profits and cash flows and at ensuring appropriate returns are earned on the Group's cash resources.

With more than 95% of Group revenues earned in US dollars and approximately 45% of Group costs being incurred in US dollars, the Group has a significant exposure to movements in the exchange rate between the US dollar and sterling. This exposure is partially mitigated by an ongoing hedging programme, involving forward contracts and low-risk option contracts where appropriate.

## Principal risks and uncertainties

In line with the guidance for the preparation of an operating and financial review, certain risk factors faced by the Group are identified below. A more detailed description is included in the Group's annual report on Form 20-F. Details of the Group's internal control and risk management procedures are included in the corporate governance report on pages 20 to 23.

### ARM's quarterly results may fluctuate significantly and be unpredictable which could adversely affect the market price of ARM ordinary shares

ARM has experienced, and may in the future experience, significant quarterly fluctuations in its results of operations. Quarterly results may fluctuate because of a variety of factors. Such factors include:

- the timing of entering into agreements with new licencees;
- the mixture of licence fees, royalties, revenues from the sale of development systems and fees from services;
- the introduction of new technology by us, our licencees or our competition;
- the timing of orders from, and shipments to, systems companies of ARM technology-based microprocessors from our semiconductor partners;
- sudden technological or other changes in the microprocessor industry; and
- new litigation or developments in current litigation.

In future periods, ARM's operating results may not meet the expectations of public market analysts or investors. In such an event the market price of our shares could be materially adversely affected.

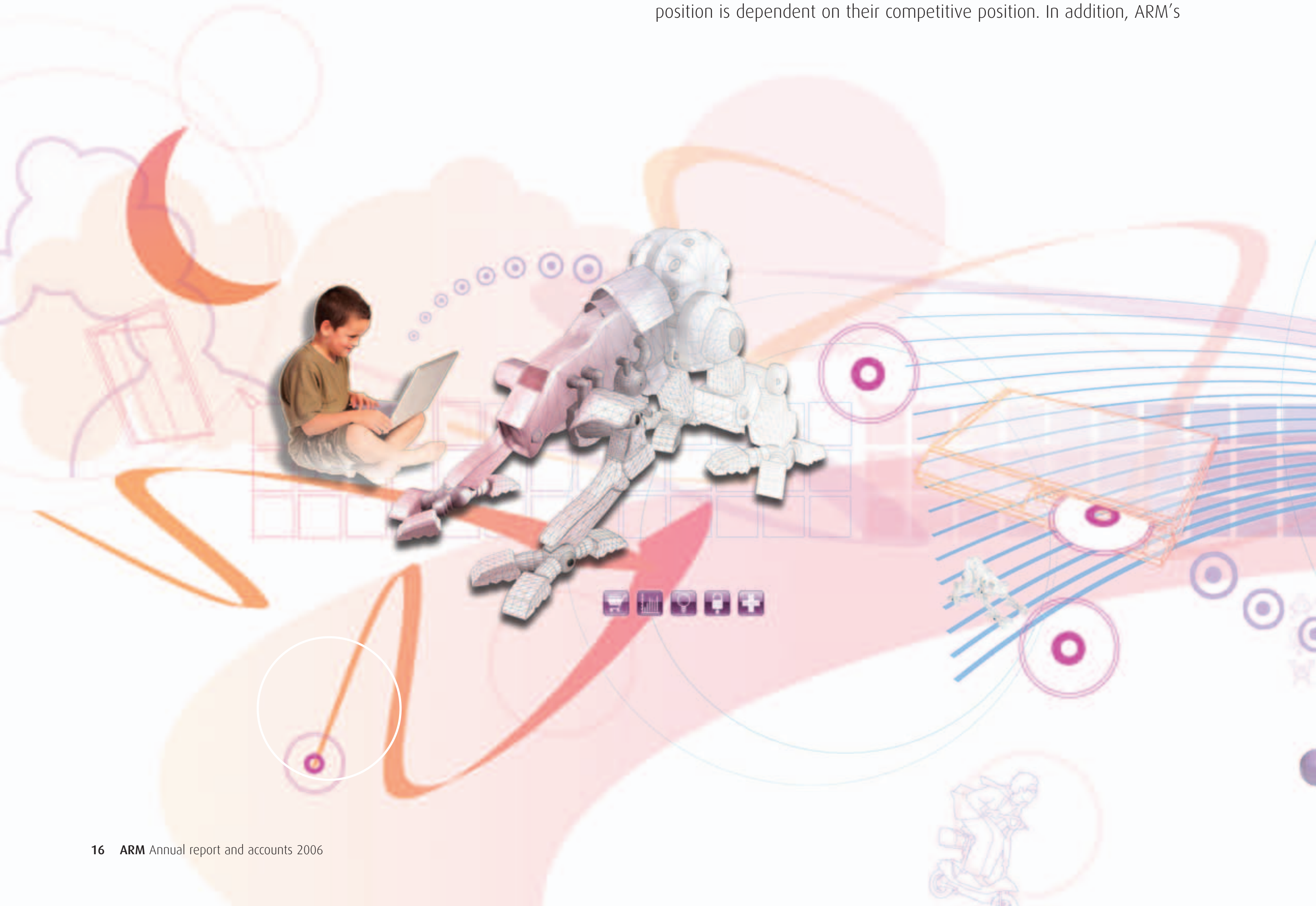
### General economic conditions may reduce ARM's revenues and harm ARM's business

ARM is subject to risks arising from adverse changes in global economic conditions. Because of economic uncertainties in many of our key markets, many industries may delay or reduce technology purchases and investments. The impact of this on ARM is difficult to predict, but if businesses defer licensing our technology, require less services or development tools, or if consumers defer purchases of new products which incorporate ARM's technology, revenue could decline. A decline in revenue would have an adverse effect on the results of operations and could have an adverse effect on ARM's financial condition.

### ARM competes in the intensely competitive semiconductor market

The semiconductor market is intensely competitive and characterised by rapid technological change. ARM cannot give assurance that it will have the financial resources, technical expertise, or marketing or support capabilities to compete successfully in the future.

Competition is based on a variety of factors including price, performance, product quality, software availability, marketing and distribution capability, customer support, name recognition and financial strength. Further, given ARM's reliance on our semiconductor partners, its competitive position is dependent on their competitive position. In addition, ARM's



semiconductor partners do not license ARM's architecture exclusively, and several of them also design, develop, manufacture and market microprocessors based on their own architectures or on other non-ARM architectures.

### ARM may not operate systems which comply fully with the requirements of the Sarbanes-Oxley Act

Attestation under section 404 of the Sarbanes-Oxley Act as at 31 December 2006 has been successfuly completed. Full details appear in the Group's annual report on Form 20-F. There can be no guarantee, however, that in future the detailed testing of internal controls required as part of the attestation process will not identify significant control deficiencies or material weaknesses that impact on the auditors' opinion on internal controls over financial reporting and/or require disclosure on Form 20-F for future years.

Other risks include ARM's inability to manage the significant changes in the number of its employees and the size of its operations in the United States, dependence on semiconductor Partners and systems companies, availability of development tools, systems software and operating systems compatible with ARM's architecture, dependence on a small number of customers and products, ARM's inability to develop new products on a timely basis, unanticipated costs due to products that could have technical difficulties or undetected design errors, the ARM architecture not being continued to be accepted by the market, risks associated with any strategic investments or acquisitions, dependence on senior management personnel and on hiring and retaining qualified engineers, exposure from international operations, litigation and threats of litigation and protection of ARM's intellectual property, unavailability of debt financing or additional equity funding to satisfy future capital needs, adverse effects resulting from changes in stock option accounting rules adversely impacting ARM's reported operating results and its competitiveness in the marketplace.

**Tim Score** Chief Financial Officer

# Directors and advisers

**Doug Dunn** age 62, Chairman
Doug Dunn joined the board as an independent non-executive director in December 1998 and became non-executive Chairman on 1 October 2006. He was previously President and Chief Executive Officer of ASM Lithography Holding N.V. until his retirement in December 2004. Before joining ASML, he was Chairman and Chief Executive Officer of the Consumer Electronics Division of Royal Philips Electronics N.V. and a member of the board. He was previously Managing Director of the Plessey and GEC Semiconductor divisions and held several engineering and management positions at Motorola. He was awarded an OBE in 1992. He is a non-executive director of ST Microelectronics N.V., Soitec S.A., LG. Philips LCD Co. Ltd and TomTom N.V.

**Warren East** age 45, Chief Executive Officer
Warren East joined ARM in 1994 to set up ARM's consulting business. He was Vice President, Business Operations from February 1998. In October 2000 he was appointed to the board as Chief Operating Officer and in October 2001 was appointed Chief Executive Officer. Before joining ARM he was with Texas Instruments. He is a chartered engineer, FIEE and a Companion of the Chartered Management Institute. He is a non-executive director of Reciva Limited and of De La Rue Holdings plc.

**Tim Score** age 46, Chief Financial Officer
Tim Score joined ARM as Chief Financial Officer and director in March 2002. Before joining ARM, he was Finance Director of Rebus Group Limited. He was previously Group Finance Director of William Baird plc, Group Controller at LucasVarity plc and Group Financial Controller at BTR plc. He is a non-executive director and Chairman of the Audit Committee of National Express Group PLC.

**Tudor Brown** age 48, Chief Operating Officer
Tudor Brown was one of the founders of ARM. Before joining the Company, he was Principal Engineer at Acorn Computers, where he worked on the ARM R&D programme. At ARM, he was Engineering Director and Chief Technical Officer from 1993; in October 2000, he was appointed Executive Vice President, Global Development and in October 2001, he was appointed to the board as Chief Operating Officer. He is a non-executive director of ANT plc.

**Mike Inglis** age 47, Executive Vice President, Sales and Marketing
Mike Inglis joined ARM as EVP, Marketing in June 2002 and was appointed to the board in August that year. He became EVP, Sales and Marketing in January 2007. Before joining ARM, he led the UK Communications and High Technology team at A.T. Kearney Management Consultants and held a number of senior operational and strategic marketing positions at Motorola. He previously worked in marketing, design and consultancy with Texas Instruments, Fairchild Camera and Instruments and BIS Macintosh and gained his initial industrial experience with GEC Telecommunications. He is a chartered engineer and a MCIM. He is a non-executive director of Superscape Group plc.

**Mike Muller** age 48, Chief Technology Officer
Mike Muller was one of the founders of ARM. Before joining the Company, he was responsible for hardware strategy and the development of portable products at Acorn Computers. He was previously at Orbis Computers. At ARM he was Vice President, Marketing from 1992 to 1996 and Executive Vice President, Business Development until October 2000 when he was appointed Chief Technology Officer. In October 2001, he was appointed to the board.

**Simon Segars** age 39, Executive Vice President, Business Development
Simon Segars joined the board in January 2005. He was appointed EVP Business Development in January 2007. He was previously EVP of Engineering and then EVP, Worldwide Sales from January 2004. He joined ARM in early 1991 and has worked on most of the ARM CPU products since then. He led the development of the ARM7 and ARM9 Thumb® families. He holds a number of patents in the field of embedded CPU architectures.

**Kathleen O'Donovan** age 49, Independent non-executive director
Kathleen O'Donovan joined the board in December 2006. She is a non-executive director and Chairman of the Audit Committees of Prudential plc and Great Portland Estates plc and Chairman of the Invensys Pension Scheme. She will take up her appointment as a non-executive director of Trinity Mirror plc in May 2007. Previously she was a non-executive director and Chairman of the Audit Committee of the Court of the Bank of England and a non-executive director of $O_2$ plc and EMI Group plc. Prior to that, she was Chief Financial Officer of BTR and Invensys and before that she was a partner at Ernst & Young.

**Peter Cawdron** age 63, Senior independent director (non-executive)
Peter Cawdron joined the board in March 1998 and will retire at the 2007 AGM. From 1983 to 1997 he worked for Grand Metropolitan plc, where he served as Group Strategy Development Director. He was previously Chief Financial Officer and a director of D'Arcy-MacManus & Masius Worldwide, Inc., and before that a member of the corporate finance team at S.G. Warburg & Co., Ltd. He qualified as a chartered accountant at Peat, Marwick, Mitchell & Co. in 1966. He is Chairman of GCap Media Plc and Punch Taverns plc and is a non-executive director of the following UK listed companies: The Capita Group Plc, Johnston Press plc and ProStrakan Group plc.

**Young Sohn** age 51, Independent non-executive director
Young Sohn joined the board in April 2007. He has extensive experience in the semiconductor industry both in Silicon Valley and in Asia. He is a director of Cymer, Inc. and M-Stream Technology Limited and an adviser to Panorama Capital, a Silicon Valley based venture capital firm. Previously he was President of the semiconductor products group at Agilent Technologies, Inc. and Chairman of Oak Technology, Inc. Prior to that he was President of the hard drive business of Quantum Corporation and, before that, Director of Marketing at Intel Corporation.

**Lucio Lanza** age 62, Independent non-executive director
Lucio Lanza joined ARM as a non-executive director in December 2004 following ARM's acquisition of Artisan. He was previously a director of Artisan, from 1996, becoming Chairman in 1997. He is currently Managing Director of Lanza techVentures, an early stage venture capital and investment firm, which he founded in January 2001. In 1990, he joined US Venture Partners, a venture capital firm, as a venture partner and was a general partner. From 1990 to 1995, he was an independent consultant to companies in the semiconductor, communications and computer-aided design industries, including Cadence Design Systems, Inc. and, from 1986 to 1989, was Chief Executive Officer of EDA Systems, Inc. He is also on the board of directors of PDF Solutions, Inc., a provider of technologies to improve semiconductor manufacturing yields. He holds a doctorate in electronic engineering from Politecnico of Milano.

**Philip Rowley** age 54, Independent non-executive director
Philip Rowley joined the board in January 2005. He was Chairman and CEO of AOL Europe, the interactive services, web brands, internet technologies and e-commerce provider until February 2007. He is a qualified chartered accountant and was Group Finance Director of Kingfisher plc from 1998 to 2001. Prior to that his roles included Executive Vice President and Chief Financial Officer of EMI Music Worldwide.

**John Scarisbrick** age 54, Independent non-executive director
John Scarisbrick joined the board in August 2001. He had previously worked for 25 years at Texas Instruments (TI) in a variety of roles including as Senior Vice President responsible for TI's $5 billion ASP chip business, President of TI Europe and leader of the team that created TI's DSP business in Houston, Texas. Before joining TI, he worked in electronics systems design roles at Rank Radio International and Marconi Space and Defence Systems in the UK. He is Chief Executive Officer of CSR plc and a non-executive director of Intrinsity, Inc.

**Jeremy Scudamore** age 59, Independent non-executive director
Jeremy Scudamore joined the board in April 2004. He was Chief Executive Officer of Avecia Group (formerly the specialty chemicals business of Zeneca) until April 2006 and previously held senior management positions both in the UK and overseas with Zeneca and ICI. He has been a board member of the Chemical Industries Association and is Chairman of England's North West Science Council. He was also a member of the DTI's Innovation and Growth Team for the Chemical Industry and Chairman of the Innovation Team. He is a non-executive director of Stem Cell Sciences plc and Oxford Catalysts Group PLC.

**From left:** Doug Dunn, Warren East, Tim Score, Tudor Brown, Mike Inglis, Mike Muller, Simon Segars, Kathleen O'Donovan, Peter Cawdron, Young Sohn, Lucio Lanza, Philip Rowley, John Scarisbrick, Jeremy Scudamore.

## Role of the board

The board is committed to high standards of corporate governance and business integrity, which it believes are essential to maintaining the trust of investors and other stakeholders in the Company. The board is responsible for setting the Company's strategic aims and standards of conduct, monitoring performance against the business plan and budget prepared by the executive directors and ensuring that the necessary financial and human resources are in place for it to meet its objectives. The board and all employees are subject to a Code of Business Conduct and Ethics, a copy of which is published on the corporate website at www.arm.com. The board has a formal schedule of matters specifically reserved for its decision, which includes the approval of major business matters, policies and operating and capital expenditure budgets. The board is also responsible for sanctioning unusual commercial arrangements such as atypical licence agreements and investments. The board delegates authority to various committees that are constituted within written terms of reference and chaired by independent non-executive directors where required by the Combined Code.

## Compliance with the Combined Code

The Group complies and complied throughout 2006 with the Combined Code, as issued in July 2003, with the exception only that the board did not comprise a majority of independent non-executive directors throughout the year. The board has considered the overall balance between executive and non-executive directors and believes that the number of executive directors is fully justified by the contribution made by each of them. To increase the size of the board further to meet this particular provision is not considered appropriate.

## Composition and operation of the board

The balance of the board and roles of the directors have undergone some changes during the year. At the date of this report, the board comprises six executive directors, seven independent non-executive directors and the Chairman. The executive directors are the Chief Executive Officer, the Chief Operating Officer, the Chief Financial Officer, the Chief Technology Officer, the Executive Vice President, Sales and Marketing, and the Executive Vice President, Business Development, all of whom play significant roles in the day-to-day management of the business. The board reviews the independence of directors on appointment and at appropriate intervals and considers that each of the seven non-executive directors is independent in character, judgment and behaviour based on both participation and performance at board and committee meetings. There are no relationships or circumstances which are likely to affect the judgment of any of them. The beneficial interests of the directors in the share capital of the Company are set out on pages 30 to 35. In the opinion of the board these shareholdings do not detract from their independent status.

Mark Templeton stepped down as a non-executive director in July 2006 and Doug Dunn, who was an independent non-executive director, became Chairman on the retirement of Sir Robin Saxby on 1 October 2006. Kathleen O'Donovan joined the board as an independent non-executive director on 7 December 2006 and became a member of the audit and remuneration committees on 1 January 2007. She has a strong financial background and is a financial expert. The non-executive directors provide a blend of experience and considerable knowledge to the board's deliberations. Young Sohn joined the board as an independent non-executive director on 2 April 2007. He has extensive experience in the semiconductor industry in both Silicon Valley and Asia. He will join the audit and remuneration committees in May 2007. Peter Cawdron, will be retiring from the board at the AGM on 15 May 2007 having served for nine years. He will be replaced as senior independent director by Jeremy Scudamore, who has a strong background in industry and commerce. Jeremy has also taken over the role of Chairman of the remuneration committee following Doug Dunn's appointment as Group Chairman. Lucio Lanza and John Scarisbrick both have a broad understanding of the Group's technology and the practices of major US-based technology companies. Philip Rowley is a financial expert and has knowledge of internet technologies and e-commerce. As part of the planned succession, Philip replaced Peter Cawdron as Chairman of the audit committee in April 2006.

The table below shows directors' attendance at meetings which they were eligible to attend during the 2006 financial year:

| | Board | Audit Committee | Remuneration Committee | Nomination Committee |
|---|---|---|---|---|
| **Total number of meetings** | **8** | **4** | **4** | **2** |
| Doug Dunn | 7/8C | – | 1/1 | 2/2C |
| Warren East | 8/8 | – | – | – |
| Tudor Brown | 7/8 | – | – | – |
| Peter Cawdron | 5/8 | 2/4 | 3/4 | 1/2 |
| Mike Inglis | 7/8 | – | – | – |
| Lucio Lanza | 8/8 | 4/4 | – | 2/2 |
| Mike Muller | 8/8 | – | – | – |
| Kathleen O'Donovan | 1/1* | – | – | – |
| Philip Rowley | 6/8 | 4/4C | – | – |
| John Scarisbrick | 6/8 | 2/4 | 3/4 | 2/2 |
| Jeremy Scudamore | 8/8 | 4/4 | 4/4C | – |
| Tim Score | 8/8 | – | – | – |
| Simon Segars | 8/8 | – | – | – |
| Sir Robin Saxby | 6/6** | – | – | 2/2 |
| Mark Templeton | 5/5*** | – | – | – |

* Kathleen O'Donovan was appointed to the board on 7 December 2006 and to the audit and remuneration committees on 1 January 2007

** Sir Robin Saxby retired from the board on 1 October 2006

*** Mark Templeton resigned from the board on 25 July 2006

C Chairman

There is a procedure in place for additional meetings or conference calls on any pertinent issues to be organised as necessary during the year. In addition, the Chairman held at least two meetings with the non-executive directors without the executives present and the non-executive directors met on at least one occasion without the Chairman being present.

The board has an established procedure for individual directors, who consider it necessary in the furtherance of their duties, to obtain independent professional advice at the Group's expense. In addition all members of the board have access to the advice of the Company Secretary.

## Information and communication with shareholders

Before each meeting, the board is furnished with information concerning the state of the business and its performance in a form and of a quality appropriate for it to discharge its duties. The ultimate responsibility for reviewing and approving the annual report and accounts and the quarterly reports, and for ensuring that they present a balanced assessment of the Group's position, lies with the board. The board delegates day-to-day responsibility for managing the Group to the executive committee and has a number of other committees, details of which are set out below.

The board makes considerable efforts to establish and maintain good relationships with shareholders. The main channel of communication continues to be through the CEO, the CFO and the VP Investor Relations, although the Chairman, the senior independent director and the other non-executive directors remain willing to engage in dialogue with major shareholders as appropriate. The Chairman met with one major institutional shareholder at its request during 2006.

There is regular dialogue with institutional shareholders throughout the year other than during close periods. The board also encourages communication with private investors and part of the Group's website is dedicated to providing accurate and timely information for all investors including comprehensive information about the business, its Partners and products, all press releases, RNS and Securities and Exchange Commission ("SEC") announcements. At present, around 20 analysts write research reports on the Group. The Group publishes telephone numbers on its website enabling shareholders to listen to earnings presentations and audio conference calls with analysts, and webcasts of the AGM and other key presentations are also made available through the website. Members of the board, including some of the non-executive directors, attend the annual analysts' day and develop an understanding of the views of major shareholders through any direct contact that may be initiated by shareholders, or through analysts' and brokers' briefings. The board also receives feedback from the Group's financial PR advisers, who obtain feedback from analysts and brokers following investor roadshows. All shareholders may register to receive the Group's press releases via the internet.

The board actively encourages participation at the Annual General Meeting, scheduled for 15 May 2007, which is the principal forum for dialogue with private shareholders. A presentation will be made outlining recent developments in the business and an open question-and-answer session will follow to enable shareholders to ask questions about the business in general.

The resolutions put to shareholders at the meeting and the voting results will be published via RNS and the SEC and will be available on the Group's website.

### Board evaluation, induction and training

The board undertakes an annual board evaluation. During 2006, this exercise was conducted internally with each director completing a questionnaire and was facilitated by the Company Secretary. The evaluation covered board performance, processes, committees, composition, skills, director induction and performance of individual directors against ten criteria. The overall conclusion was that individual board members are satisfied that the board works well. They are also satisfied with the contribution made by their colleagues and that board committees operate properly and efficiently. Various recommendations resulted from the evaluation which have been discussed by the board and will be reviewed and acted upon by the board in 2007, as appropriate. It is intended that there will be a further board evaluation each year, involving external consultants as and when the board deems appropriate. A full, formal induction programme is arranged for new directors, tailored to their specific requirements, the aim of which is to introduce them to key executives across the business and to enhance their knowledge and understanding of the Group and its activities. The Group has a commitment to training and all directors, executive or non-executive are encouraged to attend suitable training courses at the Company's expense.

### Executive committee

The executive committee is responsible for implementing the strategy approved by the board. Among other things, this committee is responsible for ensuring that the Group's budget and forecasts are properly prepared, that targets are met, and generally managing and developing the business within the overall budget. Variations from the budget and changes in strategy require approval from the main board of the Group. The executive committee, which meets monthly, comprises the executive directors and the directors of ARM Limited, which now include the Company Secretary, and meetings are attended by other senior operational personnel, as appropriate.

### Audit committee

The audit committee has written terms of reference which are published on the corporate website at www.arm.com. The committee has responsibility for, among other things, monitoring the integrity of the financial statements of the Company and any formal announcements relating to the Company's financial performance, and for reviewing any significant financial reporting judgments contained in them; reviewing the Company's internal controls and risk management systems; making recommendations to the board in relation to the appointment, remuneration and resignation or dismissal of the Group's external auditors; reviewing and monitoring the external auditors' independence and objectivity and the effectiveness of the audit process; developing and implementing policy on the engagement of the external auditors to supply non-audit services; and considering compliance with legal requirements, accounting standards, the Listing Rules of the Financial Services Authority and the requirements of the SEC. There is a procedure in place for the committee to receive reports of any whistleblowing incidents from the compliance committee. No such incidents were reported in 2006 or, to date, in 2007.

The committee also keeps under review the value for money of the audit and the nature, extent and cost-effectiveness of the non-audit services provided by the auditors. The committee has discussed with the external auditors their independence, and has received and reviewed written disclosures from the external auditors as required by the Auditing Practices Board's International Standard on Auditing (ISA) (UK and Ireland) 260 "Communication of audit matters with those charged with governance", as well as those required by the US Independence Standards Board's Standard No. 1, "Independence discussions with audit committees". To avoid the possibility of the auditors' objectivity and independence being compromised, the Group's tax consulting work is carried out by the auditors only in cases where they are best suited to perform the work. In other cases, the Group has engaged another independent firm of accountants to perform tax consulting work. The Group does not normally award general consulting work to the auditors. From time to time, however, the Group will engage the auditors to perform work on matters relating to human resources and royalty audits. The Group may also seek professional advice from another firm of independent consultants or its legal advisers.

The current audit committee comprises Philip Rowley (Chairman), Kathleen O'Donovan, Lucio Lanza and Jeremy Scudamore. Philip Rowley is the financial expert as defined in the Sarbanes Oxley Act 2002 (US) ("SOX") and Kathleen O'Donovan and Peter Cawdron are also qualified to fulfil this role. The external auditors, Chief Executive Officer, Chief Financial Officer and the Company Secretary attend all meetings in order to ensure that all the information required by the audit committee for it to operate effectively is available. Representatives of the Group's external auditors meet with the audit committee at least once a year without any executive directors being present.

### Remuneration committee

A description of the composition, responsibility and operation of the remuneration committee is set out in the remuneration report on page 28. The terms of reference of the remuneration committee are published on the Group's website www.arm.com.

### Nomination committee

The nomination committee leads the process for board appointments and makes recommendations to the board in relation to new appointments of executive and non-executive directors and on board composition and balance. The terms of reference of the nomination committee are published on the Group's website www.arm.com. It is chaired by Doug Dunn, and the other members are Peter Cawdron, John Scarisbrick and Lucio Lanza. The committee considers the roles and capabilities required for each new appointment, based on an evaluation of the skills and experience of the existing directors. In relation to the appointment of new directors, the services of external search consultancies are generally used.

In relation to the appointment of Doug Dunn as Chairman during 2006, the board considered that he had all the skills and experience to meet the demands of the role and unanimously approved his appointment without the need for an external search. The appointments of Kathleen O'Donovan and Young Sohn followed the prescribed procedure laid down by the nomination committee and involved the use of external search consultants.

### Internal control/risk management

The Company fully complies with the Combined Code's provisions on internal control, having established procedures to implement the guidance in the Turnbull Report (2005). The board has established a continuous process for identifying, evaluating and managing the significant risks faced by the Company. The board confirms that the necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from this process.

The board of directors also has overall responsibility for ensuring that the Group maintains an adequate system of internal control and risk management and for reviewing its effectiveness. During 2006, a considerable amount of resource and effort was committed to the project to achieve compliance with section 404 of SOX, which was successfully completed in relation to the 2006 year end and is reported on in more detail in the Annual Report on Form 20-F that is filed with the SEC. The processes and procedures which were successfully integrated into day-to-day business operations during 2006 provide a sustainable solution for compliance in 2007 and beyond. The board has reviewed the system of internal control, including internal financial controls, which has been in place for the year under review and up to the date of approval of the annual report. Such systems are designed to manage rather than eliminate the risks inherent in a fast-moving, high-technology business and can, therefore, provide only reasonable and not absolute assurance against material misstatement or loss.

The Company has a number of other committees which contribute to the overall control environment:

A risk review committee consisting of the Chief Technology Officer, the Chief Financial Officer, the Financial Controller and the Company Secretary which receives and reviews quarterly reports from the business units and corporate functions. The committee is responsible for identifying and evaluating risks which may impact the Group's strategic and business objectives and for monitoring the progress of actions designed to mitigate such risks. The risk review committee reports formally to the executive committee twice a year where its findings are considered and challenged and, in turn, the executive committee reports to the board once a year.

A compliance committee consisting of the General Counsel, the Chief Operating Officer, the Chief Financial Officer, the EVP Business Development, the EVP Human Resources, the Director of Quality, the Director of IT and the Company Secretary. The committee oversees compliance throughout the business with all appropriate international regulations, trading requirements and standards, including oversight of financial, employment, environmental and security processes and policies. The compliance committee reports to the audit committee.

A disclosure committee in compliance with SOX comprises the Chief Executive Officer, the Chief Financial Officer, the Financial Controller, the General Counsel, the VP Investor Relations and the Company Secretary. The committee is responsible for ensuring that disclosures made by the Company to its shareholders and the investment community are accurate, complete and fairly present the Company's financial condition in all material respects.

In addition, there is a series of interconnected meetings that span the Group from the weekly management meeting chaired by the Chief Executive Officer, and the weekly business review meeting chaired by the Chief Operating Officer, the purpose of which is to monitor and control all main business activities, sales forecasts and other matters requiring approval that have arisen within the week, to the board meetings of the Group. Each month there are customer satisfaction and process review meetings attended by managers representing different functions across the Group to review key performance indicators such as revenues, orders booked, costs, product and project delivery dates and levels of defects found in products in development. The outputs of the weekly business review meeting and the monthly operations meeting are reviewed by the executive committee which, in turn, raises relevant issues with the board of the Group. These processes for identifying, evaluating and managing the significant business, operational, financial, compliance and other risks facing the Group have been in place for the year under review and up to the date of approval of the annual report and financial statements.

As required by the Combined Code, the audit committee has considered whether it would be appropriate for the Group to have its own financial internal audit function and has concluded that, taking account of its relatively small number of employees and a high degree of centralisation in the way the business is run, this is not appropriate at present. The committee has confirmed this view to the board. The Group does, however, have an operational internal audit function that audits the Group's business and product/project management processes.

These processes are documented, maintained and continuously improved, for effectiveness and efficiency. In addition, they are audited externally by independent auditors for compliance with ISO 9001:2000.

Ernst & Young has been retained by the Company during 2006 to provide skilled resource to assist with management's testing of processes and procedures for S404 compliance.

Any significant control failings identified are brought to the attention of the compliance committee and undergo a detailed process of evaluation of both the failing and the steps taken to remedy it. There is then a process for escalation of any significant control failures to the audit committee.

### Corporate, social and ethical policies

While the Group is accountable to its shareholders, it also endeavours to take into account the interests of all its stakeholders, including its employees, customers and suppliers and the local communities and environments in which it operates. The Chief Financial Officer takes responsibility for matters relating to corporate, social and ethical policies and these matters are considered at board level. A corporate social responsibility report is on pages 24 to 25 of this report and also on the Group's website www.arm.com. The Company's Code of Business Conduct and Ethics is available on the Group's website www.arm.com. The Group also operates a whistleblowing policy which provides for employees to have access to senior management to raise concerns in strict confidence about any unethical business practices. These procedures were enhanced during 2006 by the addition of a facility to make reports by telephone to an independent third party through a whistleblowing hotline.

As a company whose primary business is the licensing of IP, employees are highly valued and their rights and dignity are respected. The Group strives for equal opportunities for all its employees and does not tolerate any harassment of, or discrimination against, its staff. In November 2006, ARM was chosen as UK Business of the Year at the National Business Awards, an award taking account of market leadership, innovation, growth and financial return. In January 2007, ARM was recognised as European Business of the Year, competing against other national award winners within the European Union. Further, at the *Management Today* awards in November 2006 for Britain's Most Admired Companies, ARM was recognised as the company with the "greatest capacity to innovate". Whilst these awards were for companies with headquarters in the UK or the European Union, they recognise the efforts of all ARM employees worldwide.

The Group endeavours to be honest and fair in its relationships with its customers and suppliers and to be a good corporate citizen respecting the laws of the countries in which it operates.

### Environmental policies

The Group's premises are composed entirely of offices since it has no manufacturing activities. Staff make use of computer-aided design tools to generate IP. This involves neither hazardous substances nor complex waste emissions. With the exception of Development Systems products, the majority of "products" sold by the Group comprise microprocessor core designs that are delivered electronically to customers.

The Group recognises the increasing importance of environmental issues and these are discussed at board level where the Chief Financial Officer takes responsibility for them. A number of initiatives in this area have continued in 2006. The Group's environmental policy is published on its website www.arm.com within the Corporate Social Responsibility ("CSR") report. An environmental action plan is implemented through various initiatives. These include monitoring resource consumption and waste creation so that targets set for improvement are realistic and meaningful, ensuring existing controls continue to operate satisfactorily and working with suppliers to improve environmental management along supply chains.

Energy usage and resource consumption data is published in the Group's CSR report on its website.

At the 2007 AGM resolutions will be proposed to amend the Articles of Association in line with the Companies Act 2006 to enable the Company to send information to shareholders electronically and make documents available through the website rather than in hard copy, which will provide both environmental and cost benefits. Shareholders can opt to continue receiving a printed copy of the annual report if they prefer.

### Health and safety

Although ARM operates in an industry and in environments which are considered low risk from a health and safety perspective, the safety of employees, contractors and visitors is a priority in all ARM workplaces worldwide. Continual improvement in safety management systems is achieved through detailed risk assessments to identify and eliminate potential hazards and occupational health assessments for employees. More detail about the Group's approach to environmental matters and health and safety is included in the CSR report on page 25.

By order of the board

**Patricia Alsop** Company Secretary

ARM considers itself to be a good corporate citizen and continually strives to improve its performance in this area. The Group aims to reduce the impact it makes on the environment and to make positive connections with the communities in which it operates. Considerable efforts are made to communicate effectively with the Group's shareholders, partners, suppliers and employees.

The Group is a corporate member of the Institute of Business Ethics (IBE) and was one of the first members of the GoodCorporation, which was founded in 2001 to help organisations to develop, manage and monitor their corporate responsibilities. Based on principles set out by the IBE, the GoodCorporation charter enables companies to measure how effective they are in achieving these responsibilities. The charter includes being verified against a 62-point charter standard covering the fair treatment and protection of its employees, customers, suppliers, shareholders, the community and the environment. This independent verification process is repeated each year and, during 2006, the Group successfully retained its membership. The GoodCorporation assessment satisfied some of the testing requirements for SOX compliance in 2006. In addition, ARM is listed on the FTSE4Good Index, is a member of Business in the Community and takes part in its Business in the Environment Index and Corporate Responsibility Index each year.

### The environment

The Group's business focuses on designing IP which enables devices to use less power and, as a result, to be more environmentally friendly. Its activities do not produce harmful waste or emissions and the Ethical Investment Research Service (EIRIS) grades ARM as an environmentally "low impact" business. Nevertheless, environmental performance is monitored to enable targets to be set, for example reducing resource usage, increasing the amount recycled and controlling carbon emissions through energy use. The Group can demonstrate an increase in paper and packaging recycling, improved facilities to promote recycling of these and other materials and increased recycling initiatives with much impetus being created by employees themselves. Energy usage is now monitored across an increased number of sites to understand how it is used, which aids the setting of new targets. The monitoring of larger sites in 2007 will see a web-based resource made available so that all employees can understand the environmental impact and their role in reducing it. Renewable energy sources have also been investigated and are planned for 2007 where the majority of the UK sites will be supplied with power through green tariffs. Application of a greener policy on energy procurement will be extended to other ARM locations globally. Where the policy cannot be applied, such as in smaller serviced offices, ARM is committed to offsetting its carbon impact. There are recycling bins for aluminium cans in the majority of the Group's offices and air conditioning systems run on non-ozone-depleting refrigerants.

The supply of company cars is discouraged and in a Group of more than 1,600 people, there are less than 30 company cars. Employees are encouraged to cycle to work through the provision of improved facilities at the Group's offices, to share car journeys, or to use public transport. Business travel is important in maintaining ARM's very effective partnership network but ways in which it can be reduced are regularly reviewed and, where possible, travel is reduced through the use of video conferencing equipment.

The Group has continued to work closely with the British Safety Council in 2006 to establish ways to formalise its environmental objectives and performance as well as implementing recommendations made through working with The Carbon Trust. A Facilities Summit was held in 2006 where the sustainability of ARM Built Environments dominated the agenda. ARM invited key suppliers to the event, which concluded with a commitment to consider the environmental case in the provision of facilities and infrastructure to ARM's business operations. To this end, ARM is working with suppliers and service providers to provide sustainable solutions wherever practicable.

### Connecting with local communities

The Group aims to be a good corporate citizen of the communities in which it operates and supports local initiatives and fundraising. In the UK, the focus has been on educational projects, particularly for pupils who are interested in mathematics, science, IT and business subjects. This support is sometimes financial and sometimes in the form of providing employees' time and skills. ARM has established relationships with the local business community and is a founding member of The Learning Collaboration (TLC) within the Cambridge business community in the UK. The TLC enables member companies to pool resources to collaborate to learn, improving the quality, availability and value of training and related services.

### Supporting education

ARM's support for education stretches from financial sponsorship of science/IT-related education initiatives, donations of redundant computer equipment to schools and education charities, working on extra-curricular engineering projects with school and college students and working on specific projects with students at management schools. The Group supports the Engineering Education Scheme, Young Engineers, and contributes funding to train the UK team for the International Maths Olympics. ARM's University Programme directly engages with universities worldwide, designing course material, providing technical seminars, donating equipment and software and offering assistance to students. ARM has now worked with universities, in nearly every region of the world including the EU, North and South America, Australia and with new initiatives in India and China. This reflects ARM's commitment to help universities produce graduates with the necessary skills that its partners need. In addition, the Group has some formal involvement with a number of universities. The Chairman Emeritus, for example, is a visiting professor at Liverpool University in the UK.

### Supporting good causes

ARM encourages employees to support their local communities. Some are school governors, some organise events to raise money, others support charities directly. In India, ARM employees have given time and donations to help children at a local orphanage. In the US, ARM employees have supported a variety of charitable organisations including those supporting sufferers of cancer, multiple sclerosis, diabetes and AIDS. The Group "doubles the efforts" of employees who raise money for approved charities by matching the funds they raise (with the exception of political donations or other non-approved causes). Charities supporting the care of premature babies, sufferers of heart disease and those with autism or colitis and Crohn's disease have been some of the beneficiaries of this scheme.

### Connecting with employees

ARM's aim is to attract and retain the best people available by being a good and ethical employer. The skills, knowledge and motivation of employees are crucial to ARM's success. The Group promotes and supports individuals and teams through on-the-job and formal training, coaching and mentoring. A comprehensive portfolio of learning and development opportunities is available to all employees, depending upon their needs and career aspirations. Every effort is made to keep employees well informed about the Company and matters that affect them. This is done through both formal and informal communication methods across all offices worldwide and includes employee consultation groups in regions where they are culturally appropriate. The Group also carries out a regular, comprehensive, global opinion survey to monitor employee views and to provide valuable input on how the Company operates. The Employee Assistance Programme helps staff and their families with issues such as care for children or elderly relatives, legal and health advice and stress or other counselling.

### Equal opportunities

The Group needs highly-qualified staff and does not see age, colour, disability, ethnic origin, gender, political or other opinion, religion or sexual orientation as a barrier to employment. If any member of staff becomes disabled, their needs and abilities are assessed with a view to them continuing in their current role. If this is impossible, every effort is made to offer them alternative employment.

### Benefits

Employees receive benefits including private medical/healthcare; health, travel and life insurance; pensions/401k plan; sabbaticals; flexible working; restricted shares under the Employee Equity Plan and a Save As You Earn share scheme. The Group supports family friendly initiatives and offers a child care voucher scheme for UK tax payers. Flexible working arrangements are available for all employees, regardless of whether they have children. Understanding and acceptance of national and cultural diversity is encouraged by giving employees the opportunity to work in offices other than in their home country, where appropriate.

### Accessibility

The Group endeavours to provide access to all whether through building design to allow easy disabled access or through improving access to our website for those with visual impairments.

### Health and safety

The safety and welfare of employees, contractors and visitors is a priority. ARM measures and analyses all accidents and "near misses" as part of its continuous improvement in this area. This data along with sickness data is monitored to ensure trends are understood and action taken to reduce these occurrences. To date ARM has had no serious issues and retains a very low accident rate. Despite the low-risk nature of its operations, ARM aims to provide a safe, secure and sustainable working environment for all employees and stakeholders.

The Group is verified by GoodCorporation each year to ensure that its health and safety requirements are met and, in addition, its UK offices are audited by the British Safety Council. With the UK legislative framework being seen as one of the most developed, ARM has adopted this as a corporate standard in health and safety provision to all sites worldwide. To this end, ARM engaged the British Safety Council to audit its two largest sites outside the UK in 2006, being Sunnyvale, California and Bangalore, India. In the UK, there is a health and safety committee and all other ARM offices have fire wardens and first aiders. Health and safety is high on the agenda and there has been an increase in the amount of communication with employees particularly on occupational health matters. Health and safety issues are communicated through different media, including the intranet, and an extensive health and safety workshop is run as part of the Company's induction process.

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

### Principal activities and review of business

The principal activities of the Group and its subsidiaries are the licensing, marketing, research and development of RISC-based microprocessors and systems. The nature of the global semiconductor industry is such that most of its business is conducted overseas and, to serve its customers better, the Group has sales offices around the world. These include six offices in the US and offices in Shanghai and Beijing, PR China; Shin-Yokohama, Japan; Seoul, South Korea; Taipei, Taiwan; Kfar Saba, Israel; Paris, France; Munich, Germany and Bangalore, India. Design offices are based in Cambridge, Maidenhead, Sheffield and Blackburn, UK; Sophia Antipolis and Grenoble, France; Leuven-Heverlee, Belgium; Aachen and Grasbrunn, Germany; Trondheim, Norway; Sentjernej, Slovenia; Austin, Texas; Olympia, Washington; Sunnyvale and San Diego, California in the US and Bangalore, India. More information about the business is set out in the business review, comprising the Chairman's statement on pages 4 to 6, the Chief Executive Officer's review of operations on pages 7 to 9, and the operating and financial review on pages 10 to 17.

### Future developments

The Group's stated objective is to establish a global standard for RISC architecture and physical IP for the embedded microprocessor market. The directors believe that to achieve this goal it is important to expand the number and range of potential customers for its technology. The Group intends to enter into licence agreements with new customers and to increase the range of new technology supplied to existing customers. Relationships will continue to be established with third-party tools and software vendors to ensure that their products will operate with the ARM architecture. As a result of its position as an emerging standard in its industry, the Group is presented with many opportunities to acquire complementary technology or resources. It continues to review these opportunities and in May 2006, the Group acquired Falanx Microsystems AS (now ARM Norway AS), an innovative graphics IP company and certain assets of PowerEscape Inc., which will enhance the portfolio of development systems products. In October 2006, the Group acquired Soisic SA, a company with physical IP based on silicon on insulator ("SOI") technology.

### Going concern

After reviewing the 2007 budget and longer term plans, the directors are satisfied that, at the time of approving the financial statements, it is appropriate to adopt the going concern basis in preparing the financial statements of both the Group and the parent company.

### Dividends

The directors recommend a final dividend in respect of the year to 31 December 2006 of 0.6 pence per share which, subject to approval at the Annual General Meeting on 15 May 2007, will be paid on 21 May 2007 to shareholders on the register on 4 May 2007. This final dividend, combined with the interim dividend of 0.4 pence per share paid during the year, makes a total of 1.0 pence per share for the year (2005: 0.84 pence).

### Share buyback programme

In accordance with the rolling authority given by shareholders at the 2006 AGM, 63.6 million shares of 0.05 pence each were bought back by the Company in 2006 (2005: 13.9 million) at a total cost of £76.5 million (2005: £16.2 million).

### Research and development (R&D)

R&D is of major importance and, as part of its research activities, the Group collaborates closely with universities worldwide and plans to continue its successful engagement with the University of Michigan. Key areas of product development for 2007 include the development of further low power, high-performance engines for both data and control applications and ARM processors based on symmetric multiprocessor and superscalar technology. The Group is investing in future physical IP development including low power, low leakage technologies and through its recent acquisition of SOI technology to ensure leadership in this market. In addition, the Group will deliver development tools, 3D graphics and fabric IP to enable its customers to design and programme system-on-chip products.

The Group incurred R&D expenses of £84.5 million in 2006, representing 32% of revenues, compared with £80.3 million in 2005. R&D expenses have been charged to the income statement since the requirements for capitalisation were not met. The requirements for capitalisation are considered in more detail in note 1 on page 43.

### Donations

During the year the Group made donations for charitable purposes of £44,831 (2005: £65,795). The total amounts given were:

| | |
|---|---|
| Local Cambridge charities | £9,184 |
| Promotion of education | £16,616 |
| Wider understanding of science, maths and information technology | £15,000 |
| Medical research | £3,724 |
| Relief of poverty | £250 |
| Other | £57 |

The Group does not make any political donations. ARM employees are encouraged to offer their time and expertise to help charities and other groups in need. The Group operates a gift matching system for employee fundraising.

### Directors in the year

The following served as directors of the Company during the year ended 31 December 2006:
Doug Dunn OBE (Chairman from 1 October 2006, previously an independent non-executive director)
Warren East (Chief Executive Officer)
Tim Score (Chief Financial Officer)
Tudor Brown (Chief Operating Officer)
Mike Muller (Chief Technology Officer)
Mike Inglis (Executive Vice President, Sales and Marketing)
Simon Segars (Executive Vice President, Business Development)
Peter Cawdron (independent non-executive director and financial expert)
Lucio Lanza (independent non-executive director)
Kathleen O'Donovan (independent non-executive director and financial expert – appointed 7 December 2006)
Philip Rowley (independent non-executive director and financial expert)
John Scarisbrick (independent non-executive director)
Jeremy Scudamore (independent non-executive director)
Sir Robin Saxby KBE (Chairman – retired 1 October 2006)
Mark Templeton (resigned 25 July 2006)

## Election and re-election of directors

In accordance with Article 79 of the Group's Articles of Association, Warren East and Lucio Lanza will retire by rotation at the Company's Annual General Meeting (AGM) and will seek re-election at that meeting. Kathleen O'Donovan and Young Sohn retire under Article 83 and are seeking election at that meeting (See pages 18 to 19 for the directors' biographies.)

## Directors' shareholdings in the Company

The interests of the directors in the Company's ordinary shares of 0.05 pence, all of which were beneficially held, are disclosed in the remuneration report on page 30.

## Substantial shareholdings

The directors are aware of the following substantial interests in the issued share capital of the Company as at 28 March 2007:

| | Percentage of issued ordinary share capital |
|---|---|
| Fidelity Investments | 13.25% |
| Janus Capital Corporation | 11.04% |
| Capital Group Companies | 8.85% |
| Legal and General Investment Management | 6.23% |
| Nordea Investment Management | 3.37% |
| MFS International | 3.09% |

Save for the above, the Company has not been notified, as at 28 March 2007, of any material interest of 3% or more or any non-material interest exceeding 10% of the issued share capital of the Company.

## Disabled persons

The Group has a strong demand for highly-qualified staff and, as such, disability is not seen to be an inhibitor to employment or career development. In the event of any staff becoming disabled while with the Group, their needs and abilities would be assessed and the Group would, where possible, seek to offer alternative employment to them if they were no longer able to continue in their current role.

## Employee involvement

As the Group is an IP enterprise, it is vital that all levels of staff are consulted and involved in its decision-making processes. To this end, internal conferences and communications meetings are held regularly which involve employees from all parts of the Group in discussions on future strategy and developments. Furthermore, employee share ownership is encouraged and all employees are able to participate in one of the Group's schemes to encourage share ownership. The Group has an informal and delegated organisational structure. It does not presently operate any collective agreements with any trade unions.

## Policy on payment of creditors

The Group's policy is to pay suppliers before the end of the month following receipt of the invoice, unless terms have been specifically agreed in advance. This policy and any specific terms agreed with suppliers are made known to the appropriate staff and to suppliers on request. Trade creditors of the Group at 31 December 2006 were equivalent to nine days' purchases for the Group (2005: 11 days') and nil days for the Company in both years.

## Financial instruments

The Group's financial risk management and policies and exposure to risks are detailed in note 20.

## Annual General Meeting (AGM)

The AGM will be held at 110 Fulbourn Road, Cambridge, CB1 9NJ, UK, on 15 May 2007 at 2pm. A presentation will be made at this meeting outlining recent developments in the business. The Group will convey the results of proxy votes cast at the AGM. Shareholders are invited to submit written questions in advance of the meeting. Questions should be sent to The Secretary, ARM Holdings plc, 110 Fulbourn Road, Cambridge CB1 9NJ.

A resolution to reappoint PricewaterhouseCoopers LLP as auditors to the Group will be proposed at the AGM. Details of other resolutions to be proposed at the meeting are set out in the Circular and Notice of AGM which will be sent to all shareholders together with a proxy card.

## Statement of directors' responsibilities

The directors are responsible for preparing the annual report, remuneration report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the Group and the Company, and of the profit or loss of the Group for that period. In preparing those financial statements, the directors, are required to:

- Select suitable accounting policies and apply them consistently;
- Make judgments 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 and Company will continue in business.

The directors confirm that they have complied with the above requirements in preparing the financial statements. The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Group and Company and for ensuring that the financial statements comply with the Companies Act 1985. They are also responsible for the system of internal control, for safeguarding the assets of the Group and Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the Group's website. Information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

## Disclosure of information to auditors

So far as each director is aware, there is no relevant audit information of which the Company's auditors are unaware. Each director has taken all steps that he or she ought to have taken in his or her duty as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

By order of the board

**Patricia Alsop** Company Secretary

### Remuneration committee

The remuneration committee has responsibility for determining and agreeing with the board, within agreed terms of reference, the Group's policy for the remuneration of the executive directors and the individual remuneration packages for each executive director. This includes basic salary, annual bonus, the level and terms of conditional awards under the Long Term Incentive Plan and the terms of performance conditions that apply to such benefits, pension rights and any compensation payments. Where the remuneration committee considers it appropriate, the committee will make recommendations in relation to the remuneration of senior management. The committee also liaises with the board in relation to the preparation of the board's annual report to shareholders on the Group's policy on the remuneration of executive directors and in particular the directors' remuneration report, as required by the Companies Act 2005, the Combined Code and the Listing Rules of the Financial Services Authority.

Chairmanship of the committee passed to Jeremy Scudamore on 1 October 2006, on the appointment of Doug Dunn as Group Chairman and the other members are Peter Cawdron, and Kathleen O'Donovan (who was appointed with effect from 1 January 2007 in place of John Scarisbrick). The committee met four times during 2006. Given their diverse experience, the three independent non-executive directors are able to offer a balanced view with respect to remuneration issues for the Group. The committee has access to professional advice from external advisers (generally appointed by the Executive Vice President, Human Resources) in the furtherance of its duties and makes use of such advice. During 2006, KPMG provided advice on the new Deferred Annual Bonus Plan and Employee Equity Plan, Linklaters provided legal services, Deloitte and the Executive Vice President, Human Resources, have provided other advice or services to the committee and to the Group. The Chief Executive Officer and the Executive Vice President, Human Resources, normally attend for part of remuneration committee meetings. No director is involved in deciding his own remuneration.

Following an extensive review of executive remuneration by the remuneration committee, a new Deferred Annual Bonus Plan for executive directors and senior managers and an Employee Equity Plan for all other employees were approved by shareholders at the 2006 AGM. These plans brought the remuneration structure more closely in line with UK market norms, increased alignment between remuneration and financial performance and strengthened the retention aspect of the deferred bonus. Cessation of option grants to executive directors (other than in exceptional circumstances) and the reduction from three plans to two for executive directors and senior managers, together with the move away from options to shares for all employees reduces potential dilution and simplifies remuneration arrangements.

### Remuneration policy

The remuneration committee, in its deliberations on the remuneration policy for the Group's directors, seeks to give full consideration to the principles set out in the Combined Code. The committee also monitors developments in the accounting for equity-based remuneration on an ongoing basis.

The Group operates a remuneration policy and framework for executive directors designed to ensure that it attracts and retains the high-quality management skills necessary to achieve a high level of corporate performance, in line with the best interests of shareholders. This policy seeks to provide rewards and incentives for the remuneration of executive directors that reflect their performance and align with the objectives of the Group. These comprise a mix of performance-related and non-performance-related remuneration. The committee believes that a director's total remuneration should seek to recognise his worth in the external market and, to this end, operates a policy of paying base salaries which are in line with the market median, as part of a total remuneration package which is upper quartile. The committee believes that this is justified, recognising that more than 50% of total potential remuneration is performance-related. The committee obtains information about the external market from various surveys, including the Watson Wyatt High Technology and Executive Reward Surveys and the Deloitte Executive Directors' Remuneration Survey.

The nature of the Group's development has meant that there has been a good deal of focus on the attainment of short-term objectives with a high level of variable remuneration. In 2006, variable remuneration consisted of three elements: annual cash bonus, a conditional award under the Long Term Incentive Plan and a final award of discretionary share options to provide potential benefits in 2009, when there would otherwise be a gap because deferred shares under the deferred bonus plan will not vest until 2010. As described above this will reduce to two elements in 2007, both of which are performance-related and, as a result, more than half of each executive director's remuneration is targeted to be performance linked. A shareholding guideline is in place for executive directors and certain senior managers who are required to build up a holding of shares in the Company over a period of five years. The shareholdings may be built up of shares received under the Company's share option schemes and/or the Long Term Incentive Plan and/or the Deferred Annual Bonus Plan and, in the case of executive directors, the required holding is 100% of basic salary.

### Incentive arrangements

The remuneration committee aims to ensure that individuals are fairly rewarded for their contribution to the success of the Group. The various incentive schemes that comprise the remuneration packages of executive directors and senior managers are described below:

### Deferred Annual Bonus Plan

There is a strong bonus element to executive directors' remuneration and for 2006 a bonus of up to 125% of base salary (including a personal performance multiplier which flexes the payment by 0.75 to 1.25), could have been earned through the Deferred Annual Bonus Plan if all targets were met. There is compulsory deferral into shares of 50% of the bonus earned and an opportunity to earn an equity match of up to 2:1, subject to achievement of an EPS performance condition. Deferred shares and any matching shares earned will normally be transferred three years from the date of award. Payment of bonus is subject to the achievement of US$ revenue and EPS targets set by the remuneration committee, which are directly related to the Group's financial results and encourage the achievement of the Group's short-term financial goals. The bonuses payable to executive directors in respect of performance during 2006 are shown in the table on page 36 and are in the range 70% to 73% of base salary, 50% of which was compulsorily deferred into shares. At EPS growth equal to the increase in the Consumer Prices Index ("CPI") plus 4% per annum, the deferred shares will be matched on a 0.3:1 basis, rising to 2:1 when EPS growth is in excess of CPI plus 12% per annum. While the deferral can only be forfeited for gross misconduct, the matching shares are subject to forfeiture for "bad leavers". For 2007, 50% of bonus is dependent on achieving the US$ revenue target and 50% on achieving the EPS target. Maximum bonus is 125% of base salary depending on the personal performance multiplier described above.

### Existing option schemes

The grant of options under the existing share option schemes ceased once the new Deferred Annual Bonus Plan and the new Employee Equity Plan were approved by shareholders at the 2006 AGM. These plans have the facility for option grants to be made, but this will be done only in exceptional circumstances. The existing option grants to executive directors remain available for exercise and vesting in accordance with the rules of the relevant schemes. In line with practice among the Group's peers in the technology sector, there are generally no performance conditions attached to the issue or exercise of discretionary options under the existing schemes, except for those issued to executive directors where performance conditions based on real EPS apply. Share options issued to executive directors prior to their appointment to the board of the Group do not have performance conditions attached to them. However, discretionary options issued to executive directors after their appointment to the board of the Group do have performance conditions attached to them. These discretionary options will vest after seven years, but may vest after three years from grant if the performance conditions are satisfied.

The performance conditions applicable to the Long Term Incentive Plan are described in more detail below and are based on TSR rather than EPS, providing the link to performance against an appropriate peer group.

These performance conditions were selected having regard to the position of the Group within its sector and the nature of the companies against which it competes to attract and retain high calibre employees. The Committee believes that the performance conditions represent the correct balance between being motivational and challenging.

### Pensions

The Group does not operate its own pension scheme but makes payments into a Group personal pension plan, which is a money purchase scheme. For executive directors, the rate of Group contribution is 10% of the executive's basic salary.

### Service agreements

Executive directors have "rolling" service contracts that may be terminated by either party on one year's notice. The service contracts also terminate when executive directors reach age 65. These agreements provide for each of the directors to provide services to the Group on a full-time basis and contain restrictive covenants for periods of three to six months following termination of employment relating to non-competition, non-solicitation of the Group's customers, non-dealing with customers and non-solicitation of the Group's suppliers and employees. In addition, each service contract contains an express obligation of confidentiality in respect of the Group's trade secrets and confidential information and provides for the Group to own any intellectual property rights created by the directors in the course of their employment.

The dates of the service contracts of each person who served as an executive director during the financial year are as follows:

| Director | Date |
|---|---|
| Warren East | 29 January 2001 |
| Tim Score | 1 March 2002 |
| Tudor Brown | 3 April 1996 |
| Mike Inglis | 17 July 2002 |
| Mike Muller | 31 January 1996 |
| Simon Segars | 4 January 2005 |
| Sir Robin Saxby (retired 1 October 2006) | 31 January 1996 |

Where notice is served to terminate the appointment, whether by the Group or the executive director, the Group in its absolute discretion shall be entitled to terminate the appointment by paying to the executive director his salary in lieu of any required period of notice.

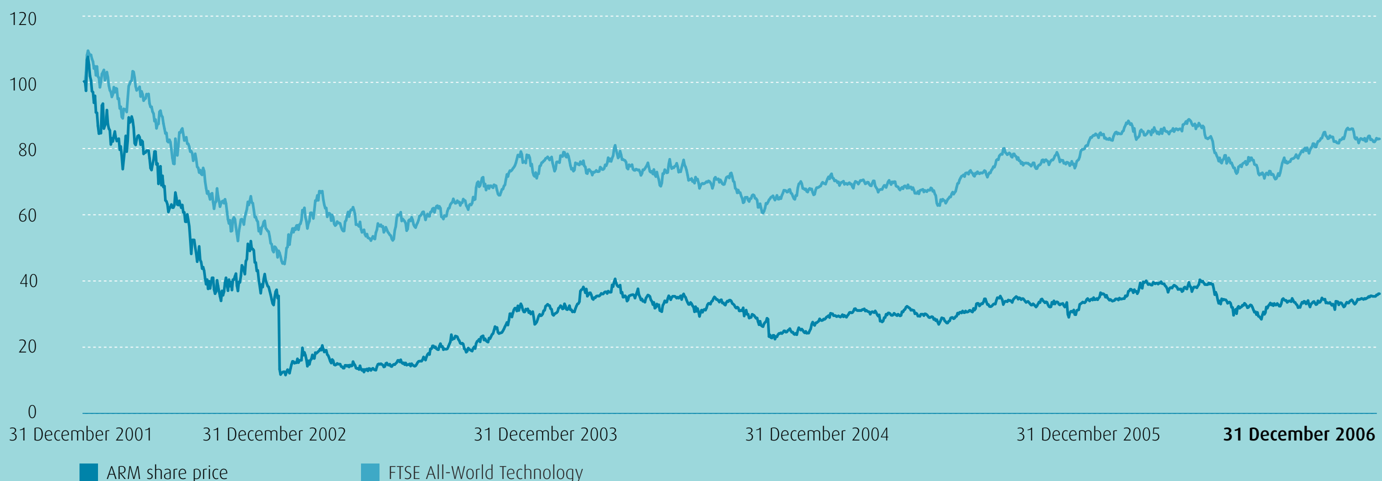
### Non-executive directors

During 2006, the Chairmen of the audit and remuneration committees and the senior independent director each received a total fee of £37,000 per annum and the other non-executive directors each received a total fee of £33,000 per annum. These fees were arrived at by reference to fees paid by other companies of similar size and complexity, and reflected the amount of time non-executive directors were expected to devote to the Group's activities during the year, which is between 10 to 15 working days a year. The remuneration of the non-executive directors is set by the board and the term of appointment is three years. Non-executive directors do not have service contracts, are not eligible to participate in bonus or share incentive arrangements and their service does not qualify for pension purposes or other benefits. No element of their fees is performance-related. Share options held by Lucio Lanza were granted prior to the Group's acquisition of Artisan and share options held by Mark Templeton (who resigned on 25 July 2006) were granted prior to his change of status from executive to non-executive director in October 2005.

### Performance graphs

A performance graph showing the Company's total shareholder return ("TSR") together with the TSR for the FTSE All-World Technology Index from 31 December 2001 is shown below. The TSR has been calculated in accordance with the Directors' Remuneration Report Regulations 2002. The TSR for the Company's shares was -64% over this period compared with -17% for the FTSE All-World Technology Index for the same period.

### ARM total shareholder return performance from 31 December 2001 to 31 December 2006




The directors consider the FTSE All-World Technology Index to be an appropriate choice as the Index contains companies from the US, Asia and Europe and therefore reflects the global environment in which the Group operates. In addition, the Index includes many companies that are currently the Group's customers, as well as companies which use ARM technology in their end products.

### Directors' shareholdings in the Company

The directors' beneficial interests in the Company's ordinary shares of 0.05 pence, which excludes interests under its share option schemes and Deferred Annual Bonus Plan, are set out below.

| Director | **28 March 2007 Number** | **31 December 2006 Number** | 31 December 2005 Number |
|---|---|---|---|
| Warren East | **302,480** | **332,480** | 204,920 |
| Tim Score | **77,250** | **147,250** | 30,000 |
| Tudor Brown | **1,655,636** | **1,755,636** | 1,546,460 |
| Mike Inglis | **149,771** | **129,771** | 10,000 |
| Mike Muller | **1,911,860** | **1,911,860** | 1,911,860 |
| Simon Segars | **172,735** | **172,735** | 42,000 |
| Peter Cawdron | **98,000** | **98,000** | 98,000 |
| Doug Dunn | **48,000** | **48,000** | 48,000 |
| Lucio Lanza | **1,277,291** | **1,277,291** | 1,277,291 |
| Kathleen O'Donovan (appointed 7 December 2006) | **–** | **–** | – |
| Philip Rowley | **50,000** | **50,000** | 24,102 |
| John Scarisbrick | **10,800** | **10,800** | 10,800 |
| Jeremy Scudamore | **125,000** | **125,000** | 100,000 |
| Young Sohn (appointed 2 April 2007) | **–** | **–** | – |
| Sir Robin Saxby (retired 1 October 2006) | **n/a** | **19,578,831*** | 21,363,060 |
| Mark Templeton (resigned 25 July 2006) | **n/a** | **10,535,552*** | 10,535,552 |

* At date of appointment, retirement or resignation.

In addition to the interests disclosed above, all the executive directors (together with all the employees of the Group) are potential beneficiaries of the ARM Holdings plc Employee Share Ownership Plan. They are, therefore, treated as interested in all the shares held by this trust, being 2,882,979 ordinary shares at 31 December 2006 and (5,000,000 ordinary shares at 31 December 2005). The executive directors also have interests in dividend shares that could be awarded under the Long Term Incentive Plan, the amount of which will depend on the extent to which the performance criteria are satisfied and the dividends declared during the performance period. There have been no changes in directors' interests in the Company's shares to the date of approval of the remuneration report.

### Auditable information

The following information has been audited by the Company's auditors, PricewaterhouseCoopers LLP, as required by Schedule 7A to the Companies Act 1985.

### Interests in share options

Details of discretionary options beneficially held by directors are set out below:

| Director | As at 1 January 2006 Number | Granted Number | Exercised Number | Lapsed Number | **As at 31 December 2006 Number** | Exercise price £ | Earliest date of exercise | Expiry date |
|---|---|---|---|---|---|---|---|---|
| Sir Robin Saxby | 140,000 | – | (140,000) | – | **–** | 1.224 | 11/03/02 | 10/03/06** |
| | 25,000 | – | – | – | **25,000** | 6.155 | 22/05/01 | 21/05/07† |
| | 165,000 | – | (140,000) | – | **25,000** | | | |
| Warren East | 131,520 | – | (131,520) | – | **–** | 1.224 | 11/03/02 | 10/03/06** |
| | 8,480 | – | – | – | **8,480** | 1.224 | 11/03/02 | 10/03/09* |
| | 3,187 | – | – | – | **3,187** | 6.155 | 22/05/03 | 21/05/10* |
| | 20,962 | – | – | – | **20,962** | 6.155 | 22/05/01 | 21/05/07† |
| | 62,909 | – | – | – | **62,909** | 3.815 | 22/05/04 | 22/05/08*** |
| | 100,000 | – | – | – | **100,000** | 2.465 | 19/04/05 | 19/04/09*** |
| | 914,285 | – | – | – | **914,285** | 0.4375 | 30/01/06 | 30/01/10*** |
| | 400,000 | – | – | – | **400,000** | 1.25 | 30/01/07 | 30/01/11*** |
| | 592,417 | – | – | – | **592,417** | 1.055 | 04/02/08 | 04/02/12*** |
| | – | 573,585 | – | – | **573,585** | 1.325 | 01/02/09 | 01/02/13*** |
| | 2,233,760 | 573,585 | (131,520) | – | **2,675,825** | | | |
| Tim Score | 206,896 | – | – | – | **206,896** | 2.465 | 19/04/05 | 19/04/09*** |
| | 777,142 | – | – | – | **777,142** | 0.4375 | 30/01/06 | 30/01/10*** |
| | 320,000 | – | – | – | **320,000** | 1.25 | 30/01/07 | 30/01/11*** |
| | 473,934 | – | – | – | **473,934** | 1.055 | 04/02/08 | 04/02/12*** |
| | – | 483,019 | – | – | **483,019** | 1.325 | 01/02/09 | 01/02/13*** |
| | 1,777,972 | 483,019 | – | – | **2,260,991** | | | |
| Tudor Brown | 140,000 | – | (140,000) | – | **–** | 1.224 | 11/03/02 | 10/03/06** |
| | 3,736 | – | – | – | **3,736** | 6.155 | 22/05/03 | 21/05/10* |
| | 21,264 | – | – | – | **21,264** | 6.155 | 22/05/01 | 21/05/07† |
| | 2,091 | – | – | – | **2,091** | 3.35 | 14/05/04 | 13/05/11* |
| | 22,909 | – | – | – | **22,909** | 3.35 | 14/05/02 | 13/05/08† |
| | 50,000 | – | – | – | **50,000** | 2.465 | 19/04/05 | 19/04/09*** |
| | 731,428 | – | – | – | **731,428** | 0.4375 | 30/01/06 | 30/01/10*** |
| | 320,000 | – | – | – | **320,000** | 1.25 | 30/01/07 | 30/01/11*** |
| | 436,019 | – | – | – | **436,019** | 1.055 | 04/02/08 | 04/02/12*** |
| | – | 392,453 | – | – | **392,453** | 1.325 | 01/02/09 | 01/02/13*** |
| | 1,727,447 | 392,453 | (140,000) | – | **1,979,900** | | | |
| Mike Inglis | 223,515 | – | – | – | **223,515** | 2.1475 | 27/05/03 | 26/05/09† |
| | 731,428 | – | (438,856) | – | **292,572** | 0.4375 | 30/01/06 | 30/01/10*** |
| | 288,000 | – | – | – | **288,000** | 1.25 | 30/01/07 | 30/01/11*** |
| | 379,147 | – | – | – | **379,147** | 1.055 | 04/02/08 | 04/02/12*** |
| | – | 339,623 | – | – | **339,623** | 1.325 | 01/02/09 | 01/02/13*** |
| | 1,622,090 | 339,623 | (438,856) | – | **1,522,857** | | | |

| Director | As at 1 January 2006 Number | Granted Number | Exercised Number | Lapsed Number | **As at 31 December 2006 Number** | Exercise price £ | Earliest date of exercise | Expiry date |
|---|---|---|---|---|---|---|---|---|
| Mike Muller | 140,000 | – | (140,000) | – | **–** | 1.224 | 11/03/02 | 10/03/06** |
| | 3,736 | – | – | – | **3,736** | 6.155 | 22/05/03 | 21/05/10* |
| | 17,615 | – | – | – | **17,615** | 6.155 | 22/05/01 | 21/05/07† |
| | 2,091 | – | – | – | **2,091** | 3.35 | 14/05/04 | 13/05/11* |
| | 22,909 | – | – | – | **22,909** | 3.35 | 14/05/02 | 13/05/08† |
| | 50,000 | – | – | – | **50,000** | 2.465 | 19/04/05 | 19/04/09*** |
| | 731,428 | – | (731,428) | – | **–** | 0.4375 | 30/01/06 | 30/01/10*** |
| | 288,000 | – | – | – | **288,000** | 1.25 | 30/01/07 | 30/01/11*** |
| | 398,104 | – | – | – | **398,104** | 1.055 | 04/02/08 | 04/02/12*** |
| | – | 339,623 | – | – | **339,623** | 1.325 | 01/02/09 | 01/02/13*** |
| | 1,653,883 | 339,623 | (871,428) | – | **1,122,078** | | | |
| Simon Segars | 5,920 | – | (5,920) | – | **–** | 1.224 | 11/03/02 | 10/03/09* |
| | 134,080 | – | (134,080) | – | **–** | 1.224 | 11/03/02 | 10/03/06** |
| | 6,155 | – | – | – | **6,155** | 6.155 | 22/05/03 | 21/05/07** |
| | 6,792 | – | – | – | **6,792** | 3.35 | 14/05/04 | 13/05/11* |
| | 33,208 | – | – | – | **33,208** | 3.35 | 14/05/02 | 13/05/08† |
| | 40,000 | – | – | – | **40,000** | 2.465 | 19/04/03 | 18/04/09† |
| | 425,142 | – | (100,000) | – | **325,142** | 0.4375 | 30/01/04 | 29/01/10† |
| | 224,000 | – | – | – | **224,000** | 1.25 | 30/01/05 | 29/01/11† |
| | 341,232 | – | – | – | **341,232** | 1.055 | 04/02/08 | 04/02/12*** |
| | – | 316,981 | – | – | **316,981** | 1.325 | 01/02/09 | 01/02/13*** |
| | 1,216,529 | 316,981 | (240,000) | – | **1,293,510** | | | |
| Lucio Lanza | 89,912 | – | – | – | **89,912** | 0.57 | 17/03/00 | 16/02/10 |
| | 7,498 | – | – | – | **7,498** | 0.22 | 16/05/01 | 15/04/11 |
| | 26,236 | – | – | – | **26,236** | 0.44 | 07/03/02 | 06/02/12 |
| | 588,134 | – | (588,134) | – | **–** | 0.50 | 09/05/03 | 08/04/13 |
| | 577,615 | – | (400,000) | – | **177,615** | 0.66 | 11/04/04 | 10/03/14 |
| | 411,421 | – | (411,421) | – | **–** | 0.55 | 11/04/04 | 08/04/14 |
| | 1,700,816 | – | (1,399,555) | – | **301,261** | | | |
| Mark Templeton | 449,561 | – | (449,561) | – | **–** | 0.39 | 18/04/01 | 17/04/10 |
| | 1,078,947 | – | (1,078,947) | – | **–** | 0.25 | 05/11/02 | 04/11/11 |
| | 449,561 | – | (309,067) | (140,494) | **–** | 0.47 | 15/08/04 | 22/10/13 |
| | 170,832 | – | (74,728) | (96,104) | **–** | 0.70 | 23/12/04 | 19/08/14 |
| | 498,774 | – | – | (498,774) | **–** | 1.055 | 04/02/08 | 04/02/12*** |
| | 2,647,675 | – | (1,912,303) | (735,372) | **–** | | | |

* Denotes share options issued under the Group's Approved Share Option Scheme.
** Denotes share options issued under the Group's Unapproved Share Option Scheme.
*** Denotes share options issued under the Group's Unapproved Share Option Scheme with performance conditions attached.
† Denotes share options issued under the Group's Unapproved Share Option Scheme which are exercisable as follows:
25% maximum from first anniversary, 50% maximum from second anniversary, 75% maximum from third anniversary, 100% maximum on fourth anniversary.

For options granted before January 2003, the performance condition is that the Group must achieve average real EPS growth of at least 33.1% (i.e. 33.1% greater than the percentage over a performance period of three years from the start of the financial year in which the options were granted (the "performance period").

For options granted in 2003 and 2004 the performance conditions requiring average real EPS growth of at least 33.1% were satisfied and 100% of the options vested on 1 February 2006 and 8 February 2007 respectively.

For options granted in 2005 and 2006 under the performance condition, 50% of the shares under option will vest after three years if the Group achieves average real EPS growth of 12.5% over the performance period. If average real EPS growth of at least 33.1% is achieved over the performance period, 100% of the shares under option will vest after three years. Where the average real EPS growth over the performance period is between 12.5% and 33.1%, the number of shares which vest after three years increases on a straight-line basis.

Details of options held by directors under the Group's Save As You Earn option schemes are set out below:

| Director | As at 1 January 2006 Number | Granted Number | Exercised Number | **As at 31 December 2006 Number** | Exercise price £ | Earliest date of exercise | Expiry date |
|---|---|---|---|---|---|---|---|
| Sir Robin Saxby | 15,771 | – | (15,771) | **–** | 0.5865 | 01/08/06 | 31/01/07 |
| Warren East | 15,771 | – | (15,771) | **–** | 0.5865 | 01/08/06 | 31/01/07 |
| Tim Score | 27,152 | – | – | **27,152** | 0.5865 | 01/08/08 | 31/01/09 |
| Mike Inglis | 15,771 | – | (15,771) | **–** | 0.5865 | 01/08/06 | 31/01/07 |
| Mike Inglis | – | 9,109 | – | **9,109** | 1.0264 | 01/08/09 | 31/01/10 |

Options issued under this scheme are issued at a 15% discount to market value.

Details of options exercised by directors during the year are as follows:

| Director | Number of shares | Exercise price £ | Market price on date of exercise £ | Gains on exercise £ |
|---|---|---|---|---|
| Warren East | 131,520 | 1.224 | 1.3675 | 18,873 |
| | 15,771 | 0.5865 | 1.1675 | 9,163 |
| Tudor Brown | 140,000 | 1.224 | 1.3628 | 19,432 |
| Mike Inglis | 438,856 | 0.4375 | 1.360305 | 404,979 |
| | 15,771 | 0.5865 | 1.1425 | 8,769 |
| Mike Muller | 140,000 | 1.224 | 1.3628 | 19,432 |
| | 731,428 | 0.4375 | 1.3628 | 676,790 |
| Simon Segars | 140,000 | 1.224 | 1.3614 | 19,231 |
| | 100,000 | 0.4375 | 1.3613 | 92,380 |
| Luzio Lanza | 588,134 | 0.50 | 1.330286 | 488,319 |
| | 400,000 | 0.66 | 1.1503 | 196,120 |
| | 411,421 | 0.55 | 1.1645 | 252,822 |
| Mark Templeton | 449,561 | 0.39 | 1.155869 | 344,305 |
| | 1,078,947 | 0.25 | 1.155869 | 977,385 |
| | 309,067 | 0.47 | 1.155869 | 211,979 |
| | 74,728 | 0.70 | 1.155869 | 34,066 |
| Sir Robin Saxby | 140,000 | 1.224 | 1.375 | 21,140 |
| | 15,771 | 0.5865 | 1.1675 | 9,163 |

Details of options exercised by directors since the balance sheet date are as follows:

| Director | Number of shares | Exercise price £ | Market price on date of exercise £ | Gains on exercise £ |
|---|---|---|---|---|
| Mike Inglis | 292,572 | 0.4375 | 1.3098 | 255,211 |
| Simon Segars | 120,000 | 0.4375 | 1.307763 | 104,432 |

## Long Term Incentive Plan

A Long Term Incentive Plan ("LTIP") was approved by shareholders at the 2003 Annual General Meeting. Conditional share awards held by directors are as follows:

| Director | Performance period ending 31 December | Award date | Market price at date of award £ | As at 1 January 2006 Number | Conditional award Number | Vested Number | **As at 31 December 2006 Number** | Vesting date |
|---|---|---|---|---|---|---|---|---|
| Warren East | 2005 | 25 July 2003 | 0.805 | 248,447 | – | (248,447)* | **–** | February 2006 |
| | 2006 | 3 November 2004 | 1.005 | 248,756 | – | – | **248,756**** | February 2007 |
| | 2007 | 20 July 2005 | 1.165 | 268,240 | – | – | **268,240** | February 2008 |
| | 2008 | 8 May 2006 | 1.365 | – | 278,388 | – | **278,388** | February 2009 |
| | | | | 765,443 | 278,388 | (248,447)* | **795,384** | |
| Tim Score | 2005 | 25 July 2003 | 0.805 | 211,180 | – | (211,180)* | **–** | February 2006 |
| | 2006 | 3 November 2004 | 1.005 | 199,005 | – | – | **199,005**** | February 2007 |
| | 2007 | 20 July 2005 | 1.165 | 214,592 | – | – | **214,592** | February 2008 |
| | 2008 | 8 May 2006 | 1.365 | – | 234,432 | – | **234,432** | February 2009 |
| | | | | 624,777 | 234,432 | (211,180)* | **648,029** | |
| Tudor Brown | 2005 | 25 July 2003 | 0.805 | 198,758 | – | (198,758)* | **–** | February 2006 |
| | 2006 | 3 November 2004 | 1.005 | 199,005 | – | – | **199,005**** | February 2007 |
| | 2007 | 20 July 2005 | 1.165 | 197,425 | – | – | **197,425** | February 2008 |
| | 2008 | 8 May 2006 | 1.365 | – | 190,476 | – | **190,476** | February 2009 |
| | | | | 595,188 | 190,476 | (198,758)* | **586,906** | |
| Mike Inglis | 2005 | 25 July 2003 | 0.805 | 198,758 | – | (198,758)* | **–** | February 2006 |
| | 2006 | 3 November 2004 | 1.005 | 179,104 | – | – | **179,104**** | February 2007 |
| | 2007 | 20 July 2005 | 1.165 | 171,674 | – | – | **171,674** | February 2008 |
| | 2008 | 8 May 2006 | 1.365 | – | 164,835 | – | **164,835** | February 2009 |
| | | | | 549,536 | 164,835 | (198,758)* | **515,613** | |
| Mike Muller | 2005 | 25 July 2003 | 0.805 | 198,758 | – | (198,758)* | **–** | February 2006 |
| | 2006 | 3 November 2004 | 1.005 | 179,104 | – | – | **179,104**** | February 2007 |
| | 2007 | 20 July 2005 | 1.165 | 180,258 | – | – | **180,258** | February 2008 |
| | 2008 | 8 May 2006 | 1.365 | – | 164,835 | – | **164,835** | February 2009 |
| | | | | 558,120 | 164,835 | (198,758)* | **524,197** | |
| Simon Segars | 2005 | 25 July 2003 | 0.805 | 124,224 | – | (124,224)* | **–** | February 2006 |
| | 2006 | 3 November 2004 | 1.005 | 149,254 | – | – | **149,254**** | February 2007 |
| | 2007 | 20 July 2005 | 1.165 | 154,506 | – | – | **154,506** | February 2008 |
| | 2008 | 8 May 2006 | 1.365 | – | 153,846 | – | **153,846** | February 2009 |
| | | | | 427,984 | 153,846 | (124,224)* | **457,606** | |

* The performance conditions applicable to the 2003 conditional awards were satisfied to the extent of 175.9% plus dividend shares as detailed below

** The performance conditions applicable to the 2004 conditional awards were not satisfied and these awards lapsed in January 2007.

Conditional awards vest to the extent that the performance criteria are satisfied over a three-year performance period from 1 January of the year of award and no re-testing thereafter is possible. The performance conditions are based on the Company's TSR when measured against that of two comparator groups (each testing half of the shares comprised in the award). The first index comprises UK companies across all sectors (FTSE 350) and the second comprises predominantly US companies within the Hi Tech sector (FTSE Global Technology Index). For each comparator group, the number of shares that may vest may be up to a maximum of 200% of the shares conditionally awarded if the Company's TSR ranks in the upper decile, 50% will vest in the event of median performance and between median and upper decile performance vesting will increase on a straight-line basis. Additional shares may vest to cover dividends paid by the Company during the performance period. No shares will be received for below-median performance. In addition, no shares will vest unless the committee is satisfied that there has been a sustained improvement in the underlying financial performance of the Company.

The performance conditions applicable to the conditional awards granted on 25 July 2003 were satisfied to the extent of 175.9% plus dividend shares which vested on 1 February 2006, as follows:

| Director | Conditional award Number | Vested award Number | Dividend shares Number | Total award Number | Market value at vesting £ |
|---|---|---|---|---|---|
| Warren East | 248,447 | 437,018 | 6,771 | 443,789 | 605,550 |
| Tim Score | 211,180 | 371,465 | 5,755 | 377,220 | 514,717 |
| Tudor Brown | 198,758 | 349,616 | 5,416 | 355,032 | 484,441 |
| Mike Inglis | 198,758 | 349,616 | 5,416 | 355,032 | 484,441 |
| Mike Muller | 198,758 | 349,616 | 5,416 | 355,032 | 484,441 |
| Simon Segars | 124,224 | 218,510 | 3,385 | 221,895 | 302,776 |
| **Total** | 1,180,125 | 2,075,841 | 32,159 | 2,108,000 | 2,876,366 |

The following awards over ordinary shares were made under the LTIP on 8 February 2007: Warren East 308,594; Tim Score 261,719; Tudor Brown 214,844; Mike Inglis 187,500; Mike Muller 183,594 and Simon Segars 179,688.

### Deferred annual bonus plan

As described above, there is a compulsory deferral of 50% of the annual bonus earned by executive directors in the year. The emoluments detailed below include the full bonus earned, although only half has been settled in cash and the deferred element will be settled in shares after three years. The following awards over ordinary shares were made on 8 February 2007 in respect of the deferred portion of the 2006 bonus: Warren East 108,828; Tim Score 91,645; Tudor Brown 74,461; Mike Inglis 64,438; Mike Muller 61,860 and Simon Segars 57,736.

Except as described above, there have been no changes in directors' interests under the Group's share option, LTIP or Deferred Annual Bonus schemes since the end of the 2006 financial year up to the date of approval of the remuneration report.

The Company's register of directors' interests contains full details of directors' shareholdings, options to subscribe for shares and conditional awards under the LTIP.

### Share prices

The market value of the shares of the Company as at 31 December 2006 was 125.75 pence. The closing mid-price ranged from 99 pence to 141 pence during the year.

## Directors' emoluments

The emoluments of the executive directors of the Group in respect of services to the Group were paid through its wholly-owned subsidiary, ARM Limited, whilst the non-executive directors were paid through ARM Holdings plc, with the exception of Lucio Lanza and Mark Templeton who were paid through ARM Physical IP Inc., and were as follows:

| Director | Fees £ | Basic salary £ | Benefits** £ | Bonus payments*** £ | Subtotal £ | Pension contributions £ | **Total 2006 £** | Subtotal 2005 £ | Pension contributions 2005 £ | Total 2005 £ |
|---|---|---|---|---|---|---|---|---|---|---|
| **Executive** | | | | | | | | | | |
| Warren East | – | 380,000 | 11,931 | 278,599 | 670,530 | 31,140 | **701,670** | 331,000 | 10,470 | 341,470 |
| Tim Score | – | 320,000 | 20,154 | 234,610 | 574,764 | 26,640 | **601,404** | 267,171 | 10,470 | 277,641 |
| Tudor Brown | – | 260,000 | 11,931 | 190,621 | 462,552 | 22,140 | **484,692** | 246,719 | 10,470 | 257,189 |
| Mike Inglis | – | 225,000 | 11,931 | 164,960 | 401,891 | 19,515 | **421,406** | 216,071 | 10,470 | 226,541 |
| Mike Muller | – | 225,000 | 11,931 | 158,862 | 395,793 | 19,515 | **415,308** | 226,287 | 10,470 | 236,757 |
| Simon Segars | – | 210,000 | 11,931 | 147,804 | 369,735 | 18,390 | **388,125** | 228,984 | 10,470 | 239,454 |
| Sir Robin Saxby | – | 112,500 | 8,948 | – | 121,448 | 25,350 | **146,798** | 154,775 | 26,175 | 180,950 |
| Total | – | 1,732,500 | 88,757 | 1,175,456 | 2,996,713 | 162,690 | **3,159,403** | 1,671,007 | 88,995 | 1,760,002 |
| **Non-executive** | | | | | | | | | | |
| Doug Dunn | 65,250 | – | – | – | 65,250 | – | **65,250** | 33,000 | – | 33,000 |
| Peter Cawdron | 37,000 | – | – | – | 37,000 | – | **37,000** | 33,000 | – | 33,000 |
| Lucio Lanza | 33,000 | – | – | – | 33,000 | – | **33,000** | 30,000 | – | 30,000 |
| Kathleen O'Donovan* | 2,354 | – | – | – | 2,354 | – | **2,354** | – | – | – |
| Philip Rowley | 35,728 | – | – | – | 35,728 | – | **35,728** | 30,000 | – | 30,000 |
| John Scarisbrick | 33,000 | – | – | – | 33,000 | – | **33,000** | 30,000 | – | 30,000 |
| Jeremy Scudamore | 34,000 | – | – | – | 34,000 | – | **34,000** | 30,000 | – | 30,000 |
| Mark Templeton* | 16,500 | – | – | – | 16,500 | – | **16,500** | 180,610 | 8,708 | 189,318 |
| Total | 256,832 | – | – | – | 256,832 | – | **256,832** | 366,610 | 8,708 | 375,318 |
| **Total** | 256,832 | 1,732,500 | 88,757 | 1,175,456 | 3,253,545 | 162,690 | **3,416,235** | 2,037,617 | 97,703 | 2,135,320 |

* M Templeton's fees are for the period up to his date of resignation on 25 July 2006. K O'Donovan's fees are for the period from appointment on 7 December 2006.

** All the executive directors receive family healthcare and annual travel insurance as part of their benefits in kind. In addition, T Score has the use of a company car and W East, T Brown, M Inglis, M Muller and S Segars receive a car and petrol allowance.

*** The bonus payments above represent the full bonus earned during 2006. According to the terms of the deferred annual bonus, 50% of this bonus is paid in cash and 50% is deferred and becomes payable in shares after three years. Details of the awards made in February 2007 in respect of these deferrals are detailed above.

It is the Company's policy to allow executive directors to hold non-executive positions at other companies and to receive remuneration for their services. The board believes that experience of the operations of other companies and their boards and committees is valuable to the development of the executive directors. Details of executive directors' roles within other companies and their remuneration are as follows:

Warren East is a non-executive director of Reciva Limited and of De La Rue Holdings plc. The Group holds 1.43% of the issued share capital of Reciva Limited and more details about this investment are included in note 14 on page 56. In relation to Reciva Limited he was awarded options on 17 February 2006 which vested monthly in equal instalments as to 1,360 shares at an option price of £16.50 between March and July 2006 and as to 1,080 shares at an option price of £25.00 between August 2006 and January 2007 and received no other remuneration. In relation to De La Rue Holdings plc he joined the board in January 2007, so did not receive remuneration in 2006.

Tudor Brown is a non-executive director of ANT plc. In this capacity he received remuneration totalling £30,000 up to 31 December 2006 (2005: £20,000). Mike Inglis is a non-executive director of Superscape Group plc. The Group holds 8.12% of the issued share capital of Superscape Group plc and more details about this investment are included in note 14 on page 56. In this capacity, Mike Inglis received remuneration totalling £17,019 up to 31 December 2006 and options over 13,333 shares in Superscape Group plc vested and are exercisable until 7 January 2014 at an option price of 33 pence. Tim Score is a non-executive director of National Express Group plc. In this capacity he received remuneration totalling £45,000 up to 31 December 2006. Simon Segars was a non-executive director of Plastic Logic Limited during 2006 and in this capacity he received remuneration totalling £15,000 up to 31 December 2006 (2005: £10,000).

All the executive directors are accruing benefits under a money purchase pension scheme as a result of their services to the Group, contributions for which were all paid during the year.

**Jeremy Scudamore** Chairman of the Remuneration Committee

# Independent auditors' report to the shareholders of ARM Holdings plc/IFRS

We have audited the Group financial statements of ARM Holdings plc for the year ended 31 December 2006 which comprise the consolidated income statement, the consolidated balance sheet, the consolidated cash flow statement, the consolidated statement of change in shareholders' equity and the related notes. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent company financial statements of ARM Holdings plc for the year ended 31 December 2006 and on the information in the remuneration report that is described as having been audited.

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

Our responsibility is to audit the Group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Group financial statements give a true and fair view and whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the directors' report is consistent with the Group financial statements.

In addition we report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding director's remuneration and other transactions is not disclosed.

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

We read other information contained in the annual report and consider whether it is consistent with the audited Group financial statements. The other information comprises only ARM at a glance, the Chairman's statement, the Chief Executive Officer's review of operations, the financial review, directors and advisors, the corporate governance statement, the corporate social responsibility statement, the directors' report and that part of the remuneration report that is unaudited. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the group financial statements. Our responsibilities do not extend to any other information.

**Basis of audit opinion**
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Group financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

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

**Opinion**
In our opinion:

– the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 December 2006 and of its profit and cash flows for the year then ended;

– the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and

– the information given in the directors' report is consistent with the Group financial statements.

**PricewaterhouseCoopers LLP**
Chartered Accountants and Registered Auditors
London
2 April 2007

# Consolidated income statement/IFRS

For the year ended 31 December 2006

| | Note | 2006 £000 | 2005 £000 |
|---|---|---|---|
| **Revenues:** | | | |
| Product revenues | | **247,194** | 217,711 |
| Service revenues | | **16,060** | 14,728 |
| **Total revenues** | 2 | **263,254** | 232,439 |
| **Cost of revenues:** | | | |
| Product costs | | **(24,156)** | (19,265) |
| Service costs | | **(6,669)** | (7,345) |
| **Total cost of revenues** | | **(30,825)** | (26,610) |
| **Gross profit** | | **232,429** | 205,829 |
| **Operating expenses:** | | | |
| Research and development | | **(84,494)** | (80,273) |
| Sales and marketing | | **(53,180)** | (47,389) |
| General and administrative | | **(50,127)** | (43,010) |
| Profit on disposal of available-for-sale investment | | **5,270** | – |
| **Total operating expenses** | | **(182,531)** | (170,672) |
| **Profit from operations** | | **49,898** | 35,157 |
| Investment income | | **6,758** | 5,317 |
| **Profit before tax** | 6 | **56,656** | 40,474 |
| Tax | 7 | **(8,068)** | (10,827) |
| **Profit for the year** | | **48,588** | 29,647 |
| **Earnings per share** | | | |
| Basic and diluted earnings | | **48,588** | 29,647 |
| **Number of shares ('000)** | | | |
| Basic weighted average number of shares | | **1,366,816** | 1,369,335 |
| Effect of dilutive securities: | | | |
| Employee incentive schemes | | **35,145** | 55,027 |
| Diluted weighted average number of shares | | **1,401,961** | 1,424,362 |
| Basic EPS | 9 | **3.6p** | 2.2p |
| Diluted EPS | 9 | **3.5p** | 2.1p |

All activities relate to continuing operations. All the profit for the year is attributable to the equity holders of the parent. The Company has opted to present its own accounts under UK GAAP. The accompanying notes are an integral part of the financial statements.

Details of dividends paid and proposed are in notes 8 and 29 of the financial statements respectively.

# Consolidated balance sheet/IFRS

**At 31 December 2006**

| | Note | 2006 £000 | 2005 £000 |
|---|---|---|---|
| **Assets** | | | |
| Current assets: | | | |
| Cash and cash equivalents | 10 | **90,743** | 128,077 |
| Financial assets: Short-term investments | 14 | **18,600** | 23,990 |
| Short-term marketable securities | 14 | **19,151** | 8,835 |
| Fair value of currency exchange contracts | 14 | **439** | – |
| Accounts receivable | 11 | **69,552** | 55,518 |
| Prepaid expenses and other assets | 12 | **12,229** | 12,567 |
| Current tax assets | | **5,761** | – |
| Inventories: finished goods | 13 | **1,933** | 1,490 |
| **Total current assets** | | **218,408** | 230,477 |
| Non-current assets: | | | |
| Financial assets: Available-for-sale investments | 14 | **3,855** | 8,800 |
| Prepaid expenses and other assets | 12 | **1,328** | 1,674 |
| Property, plant and equipment | 15 | **10,296** | 9,003 |
| Goodwill | 16 | **428,366** | 474,338 |
| Other intangible assets | 17 | **62,913** | 79,743 |
| Deferred tax assets | 7 | **19,090** | 13,633 |
| **Total non-current assets** | | **525,848** | 587,191 |
| **Total assets** | | **744,256** | 817,668 |
| **Liabilities and shareholders' equity** | | | |
| Current liabilities: | | | |
| Accounts payable | | **1,826** | 2,221 |
| Current tax liabilities | | **5,572** | 10,826 |
| Accrued and other liabilities | 18 | **36,119** | 26,519 |
| Financial liabilities: Fair value of currency exchange contracts | 19 | **–** | 1,708 |
| Deferred revenue | | **31,485** | 20,354 |
| **Total current liabilities** | | **75,002** | 61,628 |
| **Net current assets** | | **143,406** | 168,849 |
| Non-current liabilities: | | | |
| Deferred tax liabilities | 7 | **6,050** | 9,193 |
| **Total liabilities** | | **81,052** | 70,821 |
| **Net assets** | | **663,204** | 746,847 |
| **Capital and reserves attributable to equity holders of the Company** | | | |
| Share capital | 21 | **695** | 693 |
| Share premium account | | **449,195** | 447,091 |
| Share option reserve | | **61,474** | 61,474 |
| Retained earnings | | **163,731** | 166,656 |
| Revaluation reserve | | **(544)** | 2,921 |
| Cumulative translation adjustment | | **(11,347)** | 68,012 |
| **Total equity** | | **663,204** | 746,847 |

The accompanying notes are an integral part of the financial statements. The financial statements on pages 38 to 77 were approved by the board of directors on 2 April 2007 and were signed on its behalf by:

**Doug Dunn** Chairman

# Consolidated cash flow statement/IFRS

For the year ended 31 December 2006

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Operating activities** | | |
| Profit from operations | **49,898** | 35,157 |
| Depreciation and amortisation of tangible and intangible assets | **26,726** | 28,608 |
| Profit on disposal of available-for-sale investment | **(5,270)** | – |
| Loss on disposal of property, plant and equipment | **63** | 16 |
| Impairment of available-for-sale investments | **–** | 337 |
| Compensation charge in respect of share-based payments | **17,437** | 20,863 |
| Provision for doubtful debts | **932** | 722 |
| Provision for obsolescence of inventories | **65** | 22 |
| Changes in working capital: | | |
| Accounts receivable | **(18,986)** | (21,247) |
| Inventories | **(508)** | (519) |
| Prepaid expenses and other assets | **1,015** | (61) |
| Fair value of currency exchange contracts | **(2,147)** | 3,382 |
| Accounts payable | **(672)** | (1,931) |
| Deferred revenue | **11,071** | (2,043) |
| Accrued and other liabilities | **4,723** | (7,199) |
| Cash generated by operations before tax | **84,347** | 56,107 |
| Income taxes paid | **(21,147)** | (14,447) |
| **Net cash from operating activities** | **63,200** | 41,660 |
| **Investing activities** | | |
| Interest received | **6,636** | 5,444 |
| Purchases of property, plant and equipment | **(7,189)** | (5,492) |
| Proceeds on disposal of property, plant and equipment | **31** | 37 |
| Purchases of other intangible assets | **(1,370)** | (572) |
| Purchases of available-for-sale investments | **(165)** | (274) |
| Proceeds on disposal of available-for-sale investments | **5,567** | 96 |
| Purchase of short-term investments | **(4,926)** | (599) |
| Purchase of subsidiaries, net of cash acquired* | **(17,270)** | (20,304) |
| **Net cash used in investing activities** | **(18,686)** | (21,664) |
| **Financing activities** | | |
| Cash received on issue of new share capital on exercise of share options | **2,106** | 13,083 |
| Proceeds received on issuance of shares from treasury | **15,754** | 838 |
| Purchase of own shares | **(76,519)** | (16,211) |
| Dividends paid to shareholders | **(12,367)** | (10,436) |
| **Net cash used in financing activities** | **(71,026)** | (12,726) |
| **Net (decrease)/increase in cash and cash equivalents** | **(26,512)** | 7,270 |
| Cash and cash equivalents at beginning of the year | **128,077** | 110,561 |
| Effect of foreign exchange rate changes | **(10,822)** | 10,246 |
| **Cash and cash equivalents at end of the year** | **90,743** | 128,077 |

* The aggregate cash outflow for purchase of subsidiaries in 2006 was £17,241,000 (2005: £23,247,000) and net overdraft acquired was £29,000 (2005: net cash of £2,943,000).

The accompanying notes are an integral part of the financial statements.

## Consolidated statement of changes in shareholders' equity/IFRS
For the year ended 31 December 2006

| | Attributable to equity holders of the Company | | | | | | |
|---|---|---|---|---|---|---|---|
| | Share capital £000 | Share premium account £000 | Share option reserve £000 | Retained earnings* £000 | Revaluation reserve** £000 | Cumulative translation adjustment £000 | Total £000 |
| Balances, At 31 December 2004 | 675 | 434,026 | 61,474 | 140,291 | 5,237 | 835 | 642,538 |
| Dividends | – | – | – | (10,436) | – | – | (10,436) |
| Movement on tax arising on share options | – | – | – | (4,408) | – | – | (4,408) |
| Tax benefits on exercise of options issued as part consideration for a business combination | – | – | – | 6,072 | – | – | 6,072 |
| Purchase of own shares | – | – | – | (16,211) | – | – | (16,211) |
| Proceeds from sale of own shares | – | – | – | 838 | – | – | 838 |
| Unrealised holding losses on available-for-sale investments (net of deferred tax of £981,000) | – | – | – | – | (2,316) | – | (2,316) |
| Currency translation adjustment | – | – | – | – | – | 67,177 | 67,177 |
| Total income/(expense) recognised directly in equity in 2005 | – | – | – | (24,145) | (2,316) | 67,177 | 40,716 |
| Shares issued on exercise of options | 18 | 13,065 | – | – | – | – | 13,083 |
| Profit for the year | – | – | – | 29,647 | – | – | 29,647 |
| Credit in respect of employee share schemes | – | – | – | 20,863 | – | – | 20,863 |
| Balances, At 31 December 2005 | 693 | 447,091 | 61,474 | 166,656 | 2,921 | 68,012 | 746,847 |
| Dividends | – | – | – | (12,367) | – | – | (12,367) |
| Movement on tax arising on share options | – | – | – | 4,182 | – | – | 4,182 |
| Purchase of own shares | – | – | – | (18,622) | – | – | (18,622) |
| Appropriation for future cancellation of shares | – | – | – | (57,897) | – | – | (57,897) |
| Proceeds from sale of own shares | – | – | – | 15,754 | – | – | 15,754 |
| Realised gain on available-for-sale investments transferred to profit for the year (net of tax benefit of £850,000) | – | – | – | – | (2,375) | – | (2,375) |
| Unrealised holding losses on available-for-sale investments (net of deferred tax of £477,000) | – | – | – | – | (1,090) | – | (1,090) |
| Currency translation adjustment | – | – | – | – | – | (79,359) | (79,359) |
| **Total expense recognised directly in equity in 2006** | **–** | **–** | **–** | **(68,950)** | **(3,465)** | **(79,359)** | **(151,774)** |
| Shares issued on exercise of options | 2 | 2,104 | – | – | – | – | 2,106 |
| Profit for the year | – | – | – | 48,588 | – | – | 48,588 |
| Credit in respect of employee share schemes | – | – | – | 17,437 | – | – | 17,437 |
| **Balances, At 31 December 2006** | **695** | **449,195** | **61,474** | **163,731** | **(544)** | **(11,347)** | **663,204** |

* **Own shares held** Offset within retained earnings is an amount of £58,245,000 (2005: £16,315,000) representing the cost of own shares held. These shares are expected to be used in part for the benefit of the Group's employees and directors to satisfy share option, restricted stock units (RSUs) and conditional share awards in future periods. Own shares held include £348,000 (2005: £1,438,000), being the cost of 1,201,434 (2005: 5,000,000) shares in the Company held by the Group's ESOP. Own shares also include £57,897,000 (2005: £14,877,000), being the cost of 49,500,000 (2005: 12,751,107) shares in the Company which are expected to be cancelled in 2007. Refer to note 22 for further details on the movement on these balances in 2006.

** **Revaluation reserve** The Group includes on its balance sheet publicly traded investments, which are classified as available-for-sale. These are carried at market value. Unrealised holding gains or losses on such securities are included, net of related taxes, within the revaluation reserve. Any unrealised gains within this reserve are undistributable.

# Notes to the IFRS financial statements

## 1 The Group and a summary of its significant accounting policies

**The business of the Group** ARM Holdings plc and its subsidiary companies ("ARM" or "the Group") design reduced instruction set computing (RISC) microprocessors, physical IP and related technology and software and sell Development Systems, to enhance the performance, cost-effectiveness and power-efficiency of high-volume embedded applications. The Group licenses and sells its technology and products to leading international electronics companies, which in turn manufacture, market and sell microprocessors, application-specific integrated circuits (ASICs) and application-specific standard processors (ASSPs) based on the Group's architecture to systems companies for incorporation into a wide variety of end products. By creating a network of Partners, and working with them to best utilise the Group's technology, the Group is establishing its architecture as a RISC processor for use in many high-volume embedded microprocessor applications, including digital cellular phones, modems and automotive functions and for potential use in many growing markets, including smart cards and digital video. The Group also licenses and sells Development Systems direct to systems companies and provides consulting and support services to its licensees, systems companies and other systems designers. The Group's principal geographic markets are Europe, the US and Asia Pacific.

**Incorporation and history** ARM is a public limited company incorporated and domiciled under the laws of England and Wales. The registered office of the Company is 110 Fulbourn Road, Cambridge, CB1 9NJ. The Company was formed on 16 October 1990, as a joint venture between Apple Computer (UK) Limited and Acorn Computers Limited, and operated under the name Advanced RISC Machines Holdings Limited until 10 March 1998, when its name was changed to ARM Holdings plc. Its initial public offering was on 17 April 1998.

Group undertakings include ARM Limited (incorporated in the UK), ARM Inc. (incorporated in the US), ARM KK (incorporated in Japan), ARM Korea Limited (incorporated in South Korea), ARM France SAS (incorporated in France), Soisic SA (incorporated in France, acquired during 2006), ARM Belgium N.V. (incorporated in Belgium), ARM Germany GmbH (incorporated in Germany), Keil Elektronik GmbH (incorporated in Germany), ARM Norway AS (incorporated in Norway, acquired and renamed during 2006), ARM Embedded Technologies Pvt. Limited (incorporated in India), ARM Physical IP Asia Pacific Pte. Limited (incorporated in Singapore), ARM Taiwan Limited (incorporated in Taiwan) and ARM Consulting (Shangai) Co. Limited (incorporated in PR China).

**Basis of preparation** These financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the EU, and IFRIC interpretations and with those parts of the Companies Act 1985 applicable to companies reporting under IFRS.

The financial statements have been prepared under the historical cost convention as modified by the revaluation of available-for-sale investments and derivative instruments.

**Critical accounting estimates and judgments**
The preparation of financial statements in accordance with generally accepted accounting principles requires the directors to make critical accounting estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates and judgments are continually evaluated and are based on historical experiences and other factors, including expectations of future events that are believed to be reasonable under the circumstances. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

**Impairment of goodwill** The Group tests goodwill for impairment at least annually. This requires an estimation of the value in use of the cash generating units (CGUs) to which goodwill is allocated. As discussed in detail in note 16, estimating the value in use requires the Group to make an estimate of the expected future cash flows from the CGUs and also to choose a suitable discount rate in order to calculate the present values of those cash flows.

**Provisions for income taxes** The Group is subject to income taxes in numerous jurisdictions. Significant judgment is required in determining the worldwide provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Group recognises liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

**Provision for impairment of trade receivables** The Group assesses trade receivables for impairment which requires the directors to estimate the likelihood of payment forfeiture by customers.

**Legal settlements and other contingencies** Determining the amount to be accrued for legal settlement requires the directors to estimate the committed future legal and settlement fees the Group is expecting to incur. Where suits are filed against the Group for infringement of patents, the directors assess the extent of any potential infringement based on legal advice and written opinions received from external counsel and then estimate the level of accrual required.

Contingent consideration for an acquisition is recognised as part of the purchase consideration if the contingent conditions are expected to be satisfied. This requires the directors to estimate the acquiree's future financial performance, typically more than one year post-acquisition.

**Revenue recognition** Revenue from the sale of licence agreements which are designed to meet the specific requirements of each customer is recognised on a percentage-of-completion method basis. Use of this method requires the directors to estimate the total project resource requirement and also any losses on uncompleted contracts.

**Principles of consolidation** The consolidated financial statements incorporate the financial statements of the Company and all its subsidiaries. Intra-group transactions, including sales, profits, receivables and payables, have been eliminated on consolidation. All subsidiaries use uniform accounting policies for like transactions and other events and similar circumstances.

**Business combinations** The results of subsidiaries acquired in the year are included in the income statement from the date they are acquired. On acquisition, all of the subsidiaries' assets and liabilities that exist at the date of acquisition are recorded at their fair values reflecting their condition at that date.

## 1 The Group and a summary of its significant accounting policies continued

**Goodwill** Goodwill represents the excess of the fair value of the consideration paid on acquisition of a business over the fair value of the assets, including any intangible assets identified and liabilities acquired. Goodwill is not amortised but is measured at cost less impairment losses. In determining the fair value of consideration, the fair value of equity issued is the market value of equity at the date of completion, the fair value of share options assumed is calculated using the Black-Scholes valuation model, and the fair value of contingent consideration is based upon whether the directors believe any performance conditions will be met and thus whether any further consideration will be payable.

As permitted by IFRS 1, "First-time adoption of international financial reporting standards", goodwill arising on acquisitions before 1 January 2004 (date of transition to IFRS) has been frozen at the UK GAAP amounts subject to being tested for impairment at that date. Goodwill is tested for impairment at least annually. The Group performs its annual impairment review at the cash-generating unit level. At the date of transition, and at the annual tests in 2005 and 2006, impairment tests showed there was no impairment with respect to goodwill.

**Available-for-sale investments** Publicly-traded investments are classified as available-for-sale and are carried at market value. Unrealised holding gains or losses on such securities are included, net of related taxes, directly in equity via a revaluation reserve. Impairment losses and realised gains and losses of such securities are reported in earnings. Equity securities that are not publicly traded are also classified as available-for-sale and are recorded at fair value. At 31 December 2006 and 2005, the estimated fair value of these investments approximated to cost less any permanent diminution in value, based on estimates determined by the directors.

**Research and development expenditure** All ongoing research expenditure is expensed in the period in which it is incurred. Where a product is technically feasible, production and sale are intended, a market exists, expenditure can be measured reliably, and sufficient resources are available to complete the project, development costs are capitalised and amortised on a straight-line basis over the estimated useful life of the respective product. The Group believes its current process for developing products is essentially completed concurrently with the establishment of technological feasibility which is evidenced by a working model. Accordingly, development costs incurred after the establishment of technological feasibility have not been significant and, therefore, no costs have been capitalised to date.

Where no internally-generated intangible asset can be recognised, development expenditure is recognised as an expense in the period in which it is incurred. Any collaborative agreements whereby a third party agrees to partially fund the Group's research and development is recognised over the period of the agreement as a credit within research and development costs.

**Impairment charges** The Group considers at each reporting date whether there is any indication that non-current assets are impaired. If there is such an indication, the Group carries out an impairment test by measuring the assets' recoverable amount, which is the higher of the assets' fair value less costs to sell and their value in use. If the recoverable amount is less than the carrying amount an impairment loss is recognised, and the assets are written down to their recoverable amount. In addition, as discussed under "Goodwill" above, goodwill is tested for impairment at least annually.

**Revenue recognition** The Group follows the principles of IAS 18, "Revenue recognition", in determining appropriate revenue recognition policies. In principle, therefore, revenue is recognised to the extent that it is probable that the economic benefits associated with the transaction will flow into the Group.

Revenue (excluding VAT) comprises the value of sales of licences, royalties arising from the resulting sale of licensees' ARM technology-based products, revenues from support, maintenance and training, consulting contracts and the sale of boards and software toolkits.

Revenue from standard licence products which are not modified to meet the specific requirements of each customer is recognised when the risks and rewards of ownership of the product are transferred to the customer.

Many licence agreements are for products which are designed to meet the specific requirements of each customer. Revenue from the sale of such licences is recognised on a percentage-of-completion basis over the period from signing of the licence to customer acceptance. Under the percentage-of-completion method, provisions for estimated losses on uncompleted contracts are recognised in the period in which the likelihood of such losses is determined. The percentage-of-completion is measured by monitoring progress using records of actual time incurred to date in the project compared with the total estimated project requirement, which approximates to the extent of performance.

Where invoicing milestones on licence arrangements are such that the receipts fall due significantly outside the period over which the customisation is expected to be performed or significantly outside its normal payment terms for standard licence arrangements, the Group evaluates whether it is probable that economic benefits associated with these milestones will flow to the Group and therefore whether these receipts should initially be included in the arrangement consideration. In particular, it considers:
- whether there is sufficient certainty that the invoice will be raised in the expected timeframe, particularly where the invoicing milestone is in some way dependent on customer activity;
- whether it has sufficient evidence that the customer considers that the Group's contractual obligations have been, or will be, fulfilled;
- whether there is sufficient certainty that only those costs budgeted to be incurred will indeed be incurred before the customer will accept that a future invoice may be raised; and
- the extent to which previous experience with similar product groups and similar customers support the conclusions reached.

Where the Group considers that there is insufficient evidence that it is probable that the economic benefits associated with such future milestones will flow to the Group, taking into account these criteria, such milestones are excluded from the arrangement consideration until there is sufficient evidence that it is probable that the economic benefits associated with the transaction will flow into the Group. The Group does not discount future invoicing milestones, as the effect of so doing would be immaterial.

If the amount of revenue recognised exceeds the amounts invoiced to customers, the excess amount is recorded as amounts recoverable on contracts within accounts receivable.

## 1 The Group and a summary of its significant accounting policies continued

Where agreements involve several components, the entire fee from such arrangements is allocated to each of the individual components based on each component's fair value, where fair value is the price that is regularly charged for an item when sold separately. The Group uses vendor-specific objective evidence (VSOE) of fair value to determine fair value of the individual components in multiple-component agreements. VSOE is determined by reference to licence agreements with other customers where the components are sold, where fair value is the price that is regularly charged for an item when sold separately. Where, in substance, two elements of a contract are linked and cannot be allocated to the individual components, the revenue recognition criteria are applied to the elements as if they were a single element.

Agreements including rights to unspecified products (as opposed to unspecified upgrades and enhancements) are accounted for using subscription accounting, with revenue from the arrangement being recognised on a straight-line basis over the term of the arrangement, or an estimate of the economic life of the products offered if no term is specified, beginning with the delivery of the first product.

Certain products have been co-developed by the Group and a collaborative partner, with both parties retaining the right to sell licences to the product. In those cases where the Group makes sales of these products and is exposed to the significant risks and benefits associated with the transaction, the total value of the licence is recorded as revenue and the amount payable to the collaborative partner is recorded as cost of sales. Where the collaborative partner makes sales of these products, the Group records as revenue the commission it is due when informed by the collaborative partner that a sale has been made and cash has been collected.

In addition to the licence fees, contracts generally contain an agreement to provide post-delivery service support, in the form of support, maintenance and training which consists of the right to receive services and/or unspecified product upgrades or enhancements that are offered on a when-and-if-available basis. Fees for post-delivery service support, which takes place after customer acceptance of delivery, are generally specified in the contract. Revenue related to post-delivery service support is recognised based on VSOE of fair value, which is determined with reference to contractual renewal rates. If no renewal rates are specified, the entire fee under the transaction is amortised and recognised on a straight-line basis over the contractual post-delivery service support period. Where renewal rates are specified, revenue for post-delivery service support is recognised on a straight-line basis over the period for which support and maintenance is contractually agreed by the Group with the licensee.

The excess of licence fees and post-delivery service support invoiced over revenue recognised is recorded as deferred revenue.

Sales of software, including development systems, which are not specifically designed for a given licence (such as off-the-shelf software) are recognised upon delivery, when the significant risks and rewards of ownership have been transferred to the customer. At that time, the Group has no further obligations except that, where necessary, the costs associated with providing PCS have been accrued. Services (such as training) that the Group provides which are not essential to the functionality of the IP are separately stated and priced in the contract and, therefore, accounted for separately. Revenue is recognised as services are performed and it is probable that the economic benefits associated with the transaction will flow into the Group.

Royalty revenues are earned on sales by the Group's customers of products containing ARM technology. Royalty revenues are recognised when it is probable that the economic benefits associated with the transaction will flow to the Group and the amount of revenue can be reliably measured.

Revenue from consulting is recognised when the service has been provided and all obligations to the customer under the consulting agreement have been fulfilled. For larger consulting projects containing several project milestones, revenue is recognised on a percentage-of-completion basis as milestones are achieved. Consulting costs are recognised when incurred.

As disclosed above, in accordance with IAS 8, "Accounting policies, changes in accounting estimates and errors", the Group makes significant estimates in applying its revenue recognition policies. In particular, as discussed in detail above, estimates are made in relation to the use of the percentage-of-completion accounting method, which requires that the extent of progress toward completion of contracts may be anticipated with reasonable certainty. The use of the percentage-of-completion method is itself based on the assumption that, at the outset of licence agreements, there is an insignificant risk that customer acceptance is not obtained. The Group also makes assessments, based on prior experience, of the extent to which future milestone receipts represent a probable future economic benefit to the Group. In addition, when allocating revenue to various components of arrangements involving several components, it is assumed that the fair value of each element is reflected by its price when sold separately. The complexity of the estimation process and issues related to the assumptions, risks and uncertainties inherent with the application of the revenue recognition policies affect the amounts reported in the financial statements. If different assumptions were used, it is possible that different amounts would be reported in the financial statements.

**Government grants** Grants in respect of specific research and development projects are credited to research and development costs within the income statement to match the projects' related expenditure.

**Retirement benefit costs** The Group contributes to defined contribution plans substantially covering all employees in Europe and the US and to government pension schemes for employees in Japan, South Korea, Taiwan, PR China, Israel and India. The Group contributes to these plans based upon various fixed percentages of employee compensation, and such contributions are expensed as incurred.

**Cash and cash equivalents** The Group considers all highly-liquid investments with original maturity dates of three months or less to be cash equivalents.

**Short-term investments and short-term marketable securities** The Group considers all highly-liquid investments with original maturity dates of greater than three months but less than one year to be either short-term investments or short-term marketable securities. Any investments with a maturity date of greater than one year from the balance sheet date are classified as long term.

## 1 The Group and a summary of its significant accounting policies continued

**Provision for impairment of trade receivables** Trade receivables are first assessed individually for impairment, or collectively where the receivables are not individually significant. Where there is no objective evidence of impairment for an individual receivable, it is included in a group of receivables with similar credit risk characteristics and these are collectively assessed for impairment. Movements in the provision for impairment of trade receivables are recorded in the income statement.

**Inventories** Inventories are stated at the lower of cost and net realisable value. In general, cost is determined on a first-in, first-out basis and includes transport and handling costs. Where necessary, provision is made for obsolete, slow-moving and defective inventory.

**Property, plant and equipment** The cost of property, plant and equipment is their purchase cost, together with any incidental costs of acquisition. External costs and internal costs are capitalised to the extent they enhance the future economic benefit of the asset.

Depreciation is calculated so as to write off the cost of property, plant and equipment, less their estimated residual values, which are adjusted, if appropriate, at each balance sheet date, on a straight-line basis over the expected useful economic lives of the assets concerned. The principal economic lives used for this purpose are:

| | |
|---|---|
| Freehold buildings | 25 years |
| Leasehold improvements | Five years or term of lease, whichever is shorter |
| Computers | Three to five years |
| Fixtures and fittings | Five to ten years |
| Motor vehicles | Four years |

Provision is made against the carrying value of property, plant and equipment where an impairment in value is deemed to have occurred. Asset lives and residual values are reviewed on an annual basis.

**Acquired intangible assets** Computer software, purchased patents and licences to use technology are capitalised at cost and amortised on a straight-line basis over a prudent estimate of the time that the Group is expected to benefit from them, which is typically three to five years. Costs that are directly attributable to the development of new business application software and which are incurred during the period prior to the date that the software is placed into operational use, are capitalised. External costs and internal costs are capitalised to the extent they enhance the future economic benefit of the asset.

Although an independent valuation is made of any intangible assets purchased as part of a business combination, the directors are primarily responsible for determining the fair value of intangible assets. Developed technology, existing agreements and customer relationships, core technology, trademarks and tradenames, and order backlog are capitalised and amortised over a period of one to six years, being a prudent estimate of the time that the Group is expected to benefit from them.

In-process research and development projects purchased as part of a business combination may meet the criteria set out in IFRS 3, "Business combinations", for recognition as intangible assets other than goodwill. The directors track the status of in-process research and development intangible assets such that their amortisation commences when the assets are brought into use. This typically means a write-off period of one to five years.

Amortisation is calculated so as to write off the cost of intangible assets, less their estimated residual values, which are adjusted, if appropriate, at each balance sheet date, on a straight-line basis over the expected useful economic lives of the assets concerned. The principal economic lives used for this purpose are:

| | |
|---|---|
| Computer software | Three to five years |
| Patents and licences | Three to five years |
| In-process research and development | One to five years |
| Developed technology | One to five years |
| Existing agreements and customer relationships | Two to six years |
| Core technology | Five years |
| Trademarks and tradenames | Four to five years |
| Order backlog | One year |

Provision is made against the carrying value of acquired intangible assets where an impairment in value is deemed to have occurred.

**Operating leases** Costs in respect of operating leases are charged on a straight-line basis over the lease term even if payments are not made on such a basis.

**Currency translation** The functional currency of each Group entity is the currency of the primary economic environment in which each entity operates. The consolidated financial statements are presented in sterling, which is the presentation currency of the Group.

Transactions denominated in foreign currencies have been translated into the functional currency of each Group entity at actual rates of exchange ruling at the date of transaction. Monetary assets and liabilities denominated in foreign currencies have been translated at rates ruling at the balance sheet date. Such exchange differences have been included in general and administrative expenses.

### 1 The Group and a summary of its significant accounting policies continued

The assets and liabilities of subsidiaries denominated in foreign currencies are translated into sterling at rates of exchange ruling at the balance sheet date. Income statements of overseas subsidiaries are translated at the average monthly exchange rates during the period. Translation differences are taken directly to equity via the cumulative translation adjustment. On disposal of a subsidiary such amounts are recycled to the income statement.

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

**Derivative financial instruments** The Group utilises currency exchange contracts to manage the exchange risk on actual transactions related to accounts receivable, denominated in a currency other than the functional currency of the business. The Group's currency exchange contracts do not subject the Group to risk from exchange rate movements because the gains and losses on such contracts offset losses and gains, respectively, on the transactions being hedged. The currency exchange contracts and related accounts receivable are recorded at fair value at each period end. Fair value is estimated using the settlement rates prevailing at the period end. All recognised gains and losses resulting from the settlement of the contracts are recorded within general and administrative expenses in the income statement. The Group does not enter into currency exchange contracts for the purpose of hedging anticipated transactions.

**Embedded derivatives** From time to time, the Group enters into contracts denominated in a currency (typically US dollars) that is neither the functional currency of the Group nor the functional currency of the customer or the collaborative partner. Where there are uninvoiced amounts on such contracts, the Group carries such derivatives at fair value. The resulting gain or loss is recognised in the income statement under general and administrative expenses.

**Income taxes** Income taxes are computed using the liability method. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted rates and laws that will be in effect when the differences are expected to reverse. The deferred tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax assets are recognised to the extent that it is probable that future taxable profits will arise against which the temporary differences will be utilised.

Deferred tax is provided on temporary differences arising on investments in subsidiaries except where the timing of the reversal of the temporary difference is controlled by the Group and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax assets and liabilities arising in the same tax jurisdiction are offset.

In the UK and the US, the Group is entitled to a tax deduction for amounts treated as compensation on exercise of certain employee share options under each jurisdiction's tax rules. As explained under "Share-based payments" below, a compensation expense is recorded in the Group's income statement over the period from the grant date to the vesting date of the relevant options. As there is a temporary difference between the accounting and tax bases, a deferred tax asset is recorded. The deferred tax asset arising is calculated by comparing the estimated amount of tax deduction to be obtained in the future (based on the Company's share price at the balance sheet date) with the cumulative amount of the compensation expense recorded in the income statement. If the amount of estimated future tax deduction exceeds the cumulative amount of the remuneration expense at the statutory rate, the excess is recorded directly in equity, against retained earnings.

As explained under "Share-based payments" below, no compensation charge is recorded in respect of options granted before 7 November 2002 or in respect of those options which have been exercised or have lapsed before 1 January 2005. Nevertheless, tax deductions have arisen and will continue to arise on these options. The tax effects arising in relation to these options are recorded directly in equity, against retained earnings.

**Earnings per share** Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the period, excluding treasury stock and those shares held in the Employee Share Ownership Plan (ESOP) which are treated as cancelled. For diluted earnings per share, the weighted number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares. The diluted share base for the year ended 31 December 2006 excludes incremental shares of approximately 33,390,000 (2005: 39,614,000) related to employee share options and RSUs. These shares are excluded due to their anti-dilutive effect as a result of the exercise price of these shares being higher than the market price.

**Share-based payments** The Group issues equity-settled share-based payments to certain employees. In accordance with IFRS 2, "Share-based payments", equity-settled share-based payments are measured at fair value at the date of grant. Fair value is measured by use of the Black-Scholes pricing model. 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 the number of shares that will eventually vest.

The Group operates Save As You Earn (SAYE) schemes in the UK and an Employee Share Purchase Plan (ESPP) in the US. Options under these schemes are granted at a 15% discount to market price of the underlying shares on the date of grant. The UK SAYE schemes are approved by the Inland Revenue, which stipulates that the saving period must be at least 36 months. The Group has recognised a compensation charge in respect of the UK SAYE plans and US ESPPs. The charges for these are calculated as detailed above.

The Group also has an LTIP on which it is also required to recognise a compensation charge under IFRS 2, calculated as detailed above.

The Group has applied the exemption available, and has applied the provisions of IFRS 2 only to those options granted after 7 November 2002 and which were outstanding at 31 December 2004.

The share-based payments charge is allocated to cost of sales, research and development expenses, sales and marketing expenses and general and administrative expenses on the basis of headcount.

## 1 The Group and a summary of its significant accounting policies continued

**Employer's taxes on share options** Employer's National Insurance in the UK and equivalent taxes in other jurisdictions are payable on the exercise of certain share options. In accordance with IFRS 2, this is treated as a cash-settled transaction. A provision is made, calculated using the fair value of the Group's shares at the balance sheet date, pro-rated over the vesting period of the options.

**Employee share ownership plans** The Company's ESOP is funded by loans from the Company, and the assets of which comprise shares in the Company. The Company recognises the assets and liabilities of the ESOP in its own accounts and shares held by the trust are recorded at cost as a deduction in arriving at shareholders' funds until such time as the shares vest unconditionally to employees.

**Treasury shares** Where the Company purchases its own equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs is deducted from equity attributable to the Company's equity holders until the shares are cancelled or reissued. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable incremental transaction costs and the related income tax effects, is included in equity attributable to equity holders of the Company.

**Investment income** Investment income relates to interest income, which is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable.

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

**Dividends payable** Distributions to equity holders are not recognised in the income statement under IFRS, but are disclosed as a component of the movement in shareholders' equity. A liability is recorded for a dividend when the dividend is approved by the Company's shareholders. Interim dividends are recognised as a distribution when paid.

**Provisions** Provisions for restructuring costs and legal claims are recognised when: the Group has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated.

**Segmental reporting** The primary reporting format is based on business segments, comprising the Processor Division, the Physical IP Division and the Development Systems Division. The secondary reporting format is based on geographical segments, these being Europe, the US and Asia Pacific. The primary reporting format requires segmentation of the Group's revenue and result before gains or losses on the disposal of available-for-sale investments, investment income and tax. Segment expenses are expenses that are directly attributable to a segment together with the relevant portion of other expenses that can reasonably be allocated to the segment. Foreign exchange gains or losses, gains or losses on the disposal of available-for-sale investments, investment income and tax are not segmented. The primary reporting format also requires segmentation of the Group's assets and liabilities. Segment assets and liabilities include items that are directly attributable to a segment plus an allocation on a reasonable basis of shared items. Corporate assets and liabilities are not included in business segments and are thus unallocated. At 31 December 2006 and 2005, these comprise cash and cash equivalents, short-term investments, short-term marketable securities, tax-related and corporate prepaid expenses and other assets and the fair value of currency exchange contracts. Any current and deferred tax assets and liabilities are also not included in business segments and are thus unallocated.

**Forthcoming accounting standards** At the date of approval of these financial statements the following standards and interpretations which have not been applied in these financial statements were in issue but not yet effective: an amendment to IAS 1, "Presentation of financial statements: capital resources", requiring disclosure of qualitative and quantitative information about entities' management of capital resources; a new accounting standard, IFRS 7, "Financial instruments: disclosures". This standard replaces IAS 30, "Disclosures in bank financial statements", and the disclosure requirements in IAS 32, "Financial instruments: disclosure and presentation", and locates in one place all disclosures relating to financial instruments. The new requirements incorporate many of IAS 32's disclosures as well as additional qualitative and quantitative disclosures on the risks arising from financial instruments; IFRIC 10, "Interim financial reporting and impairment", which addresses the interaction between the requirements of IAS 34, "Interim financial reporting", and the recognition of impairment losses on goodwill in IAS 36, "Impairment of assets", and certain financial assets in IAS 39, "Financial instruments: recognition and measurement", and the effect of that interaction on subsequent interim and annual financial statements; IFRIC 11, "IFRS 2 – Group and treasury share transactions", which clarifies how share-based payment charges should be calculated where employees of a subsidiary receive the shares of a parent. IFRIC 11 also addresses the accounting for share-based payment transactions involving two or more entities within one group; and a new accounting standard, IFRS 8, "Operating segments", which supersedes IAS 14, "Segmental reporting", under which segments were identified and reported on risk and return analysis. Under IFRS 8, segments are reported based on internal reporting.

The directors expect that the adoption of these standards and interpretations in the future periods will have no material impact on the financial statements when they come into effect for periods after 1 January 2007.

## 2 Segmental reporting

At 31 December 2006 the Group is organised on a worldwide basis into three main business segments:

**Processor Division (PD)** The Processor Division encompasses those resources that are centred around microprocessor cores, including specific functions such as graphics IP, fabric IP, embedded software and configurable digital signal processing IP.

**Physical IP Division (PIPD)** The Physical IP Division is concerned with the building blocks necessary for translation of a circuit design into actual silicon.

**Development Systems Division (DevSys)** The Development Systems Division is concerned with the tools and models used to create and debug software and system-on-chip (SoC) designs.

## 2 Segmental reporting continued

Following the acquisition of Artisan in December 2004, the Group had two reportable segments in 2005 (namely PD and PIPD).

This was based upon the Group's internal organisation and management structure and was the primary way in which the board of directors were provided with financial information. Whilst revenues were reported into four main revenue streams (namely licensing, royalties, development systems and services), the costs, operating results and balance sheets were only analysed into the two segments.

In 2006, this structure and system of internal financial reporting to the board of directors was changed resulting in a third division, namely DevSys, becoming a separate reportable segment. In 2005, the results of DevSys were reported within PD, but for ease of comparability, have been separated out in the comparatives below. PIPD consists of the business stream previously undertaken by Artisan. PD primarily comprises the legacy ARM products and services. Recent acquisitions have been allocated to the various divisions as follows: Axys in 2004 to DevSys, Artisan in 2004 to PIPD, KEG and KSI in 2005 to DevSys, Falanx in 2006 to PD and Soisic in 2006 to PIPD. Goodwill on each acquisition has also been allocated into these divisions, except for Artisan whereby this has been allocated between PD and PIPD.

There are no sales between the business segments. Foreign exchange gains or losses, gains or losses on the disposal of available-for-sale investments, investment income and tax are unallocated. Segment assets include property, plant and equipment, intangible assets, goodwill, inventories and receivables but exclude tax-related and corporate assets, current tax assets and deferred tax assets. Segment liabilities comprise operating liabilities but exclude tax-related and corporate liabilities, current tax liabilities and deferred tax liabilities. Capital expenditure comprises additions to property, plant and equipment and other intangible assets, including additions resulting from acquisitions through business combinations.

### Primary reporting format – business segments

| Year ended 31 December 2006 | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Unallocated £000 | Group £000 |
|---|---|---|---|---|---|
| Revenue | 180,426 | 53,996 | 28,832 | – | 263,254 |
| Segment profit/(loss) before foreign exchange gains, profit on disposal of available-for-sale investment, investment income and tax | 64,727 | (13,041) | (11,580) | – | 40,106 |
| Foreign exchange gains | – | – | – | 4,522 | 4,522 |
| Profit on disposal of available-for-sale investment | – | – | – | 5,270 | 5,270 |
| Investment income | – | – | – | 6,758 | 6,758 |
| **Profit before tax** | | | | | **56,656** |
| Tax | – | – | – | (8,068) | (8,068) |
| **Profit for the year** | | | | | **48,588** |
| Segment assets* | 170,819 | 383,536 | 33,530 | – | 587,885 |
| Unallocated assets | | | | | |
| – Cash and cash equivalents | – | – | – | 90,743 | 90,743 |
| – Financial assets: Short-term investments | – | – | – | 18,600 | 18,600 |
| Short-term marketable securities | – | – | – | 19,151 | 19,151 |
| Fair value of currency exchange markets | – | – | – | 439 | 439 |
| – Tax-related and corporate prepaid expenses and other assets | – | – | – | 2,587 | 2,587 |
| – Current tax assets | – | – | – | 5,761 | 5,761 |
| – Deferred tax assets | – | – | – | 19,090 | 19,090 |
| **Total assets** | | | | | **744,256** |
| Segment liabilities | 36,967 | 21,141 | 11,322 | – | 69,430 |
| Unallocated liabilities | | | | | |
| – Current tax liabilities | – | – | – | 5,572 | 5,572 |
| – Deferred tax liabilities | – | – | – | 6,050 | 6,050 |
| **Total liabilities** | | | | | **81,052** |
| **Other segment items** | | | | | |
| Capital expenditure (including acquisitions) | 9,396 | 6,768 | 3,107 | – | 19,271 |
| Depreciation | 2,775 | 1,300 | 1,210 | – | 5,285 |
| Amortisation of other intangible assets | 1,870 | 15,735 | 3,836 | – | 21,441 |
| Impairment of trade receivables | 589 | 343 | – | – | 932 |
| Other non-cash expenses** | 23 | 43 | 62 | – | 128 |

* Segment assets include £3,855,000 of available-for-sale investments which are attributable to the Processor Division.

** Comprises (gain)/loss on disposal of property, plant and equipment and provision for obsolescence of inventories.

## 2 Segmental reporting continued

| Year ended 31 December 2005 (as restated) | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Unallocated £000 | Group £000 |
|---|---|---|---|---|---|
| Revenue | 156,641 | 50,159 | 25,639 | – | 232,439 |
| Segment profit/(loss) before foreign exchange losses, investment income and tax | 59,873 | (14,758) | (7,673) | – | 37,442 |
| Foreign exchange losses | – | – | – | (2,285) | (2,285) |
| Investment income | – | – | – | 5,317 | 5,317 |
| **Profit before tax** | | | | | **40,474** |
| Tax | – | – | – | (10,827) | (10,827) |
| **Profit for the year** | | | | | **29,647** |
| Segment assets* | 161,753 | 441,863 | 37,339 | – | 640,955 |
| Unallocated assets | | | | | |
| – Cash and cash equivalents | – | – | – | 128,077 | 128,077 |
| – Financial assets: Short-term investments | – | – | – | 23,990 | 23,990 |
| Short-term marketable securities | – | – | – | 8,835 | 8,835 |
| – Tax-related and corporate prepaid expenses and other assets | – | – | – | 2,178 | 2,178 |
| – Deferred tax assets | – | – | – | 13,633 | 13,633 |
| **Total assets** | | | | | **817,668** |
| Segment liabilities | 22,256 | 15,363 | 11,475 | – | 49,094 |
| Unallocated liabilities | | | | | |
| Financial liabilities: Fair value of currency exchange contracts | – | – | – | 1,708 | 1,708 |
| – Current tax liabilities | – | – | – | 10,826 | 10,826 |
| – Deferred tax liabilities | – | – | – | 9,193 | 9,193 |
| **Total liabilities** | | | | | **70,821** |
| **Other segment items** | | | | | |
| Capital expenditure (including acquisitions) | 2,737 | 1,584 | 11,500 | – | 15,821 |
| Depreciation of plant, property and equipment | 2,998 | 1,075 | 1,826 | – | 5,899 |
| Amortisation of other intangible assets | 3,561 | 17,380 | 1,768 | – | 22,709 |
| Impairment of trade receivables | 426 | 227 | 69 | – | 722 |
| Other non-cash expenses** | 343 | 10 | 22 | – | 375 |

* Segment assets include £8,800,000 of available-for-sale investments which are attributable to the Processor Division.

** Comprises impairment of unlisted investments, loss on disposal of property, plant and equipment and provision for obsolescence of inventories.

### Secondary format – geographical segments

The Group manages its business segments on a global basis. The operations are based in three main geographical areas. The UK is the home country of the parent. The main operations in the principal territories are as follows:

- Europe
- United States
- Asia Pacific

| | Revenue (by destination)* | | Segment assets | | Capital expenditure | |
|---|---|---|---|---|---|---|
| | **2006 £000** | 2005 £000 | **2006 £000** | 2005 £000 | **2006 £000** | 2005 £000 |
| Europe | **42,746** | 32,971 | **372,648** | 159,675 | **14,624** | 6,594 |
| United States | **111,194** | 99,727 | **340,819** | 637,055 | **3,552** | 8,673 |
| Asia Pacific | **109,314** | 99,741 | **5,938** | 7,305 | **1,095** | 554 |
| | **263,254** | 232,439 | **719,405** | 804,035 | **19,271** | 15,821 |
| Unallocated tax assets | | | **24,851** | 13,633 | | |
| | | | **744,256** | 817,668 | | |

* Destination is defined as the location of ARM's customers.

## 2 Segmental reporting continued

Analysis of revenue by origin:

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Europe | **198,386** | 170,505 |
| United States | **63,028** | 59,183 |
| Asia Pacific | **1,840** | 2,751 |
| | **263,254** | 232,439 |

Analysis of revenue by revenue stream:

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Licensing | **110,548** | 104,223 |
| Royalties | **107,814** | 87,849 |
| Services | **16,060** | 14,728 |
| Development systems | **28,832** | 25,639 |
| | **263,254** | 232,439 |

## 3 Recognised income and expense

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Movement on tax arising on share options | **4,182** | (4,408) |
| Loss on revaluation of publicly-traded available-for-sale investments, net of deferred tax of £477,000 (2005: £981,000) | **(1,090)** | (2,316) |
| Foreign exchange difference on consolidation | **(79,359)** | 67,177 |
| **Total recognised (loss)/income recognised directly in equity for the year** | **(76,267)** | 60,453 |
| Profit for the year | **48,588** | 29,647 |
| **Total recognised (loss)/income for the year** | **(27,679)** | 90,100 |

All activities relate to continuing operations. All of the total recognised loss for the year is attributable to the equity holders of the parent.

## 4 Key management compensation and directors' emoluments

**Key management compensation**

The directors are of the opinion that the key management of the Group comprises the executive and non-executive directors of ARM Holdings plc together with the board of directors of ARM Limited. These persons have authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly. At 31 December 2006, key management comprised 17 people (2005: 17).

The aggregate amounts of key management compensation are set out below:

| | 2006 £ | 2005 £ |
|---|---|---|
| Salaries and short-term employee benefits | **4,169,728** | 2,420,373 |
| Share-based payments | **4,212,981** | 2,973,424 |
| Group pension contributions to money purchase schemes | **205,860** | 124,231 |
| | **8,588,569** | 5,518,028 |

**Directors' emoluments**

The aggregate emoluments of the directors of the Group are set out below:

| | 2006 £ | 2005 £ |
|---|---|---|
| Aggregate emoluments in respect of qualifying services | **3,253,545** | 2,037,617 |
| Aggregate Group pension contributions to money purchase schemes | **162,690** | 97,703 |
| Aggregate gains on exercise of share options | **3,804,348** | – |
| Aggregate amounts receivable under the Long Term Incentive Plan | **2,876,366** | – |
| | **10,096,949** | 2,135,320 |

Detailed disclosures of directors' emoluments are shown on page 36. Details of directors' interests in share options are shown on pages 31 and 32 which form part of the financial statements.

## 5 Employee information

The average monthly number of persons, including executive directors, employed by the Group during the year was:

| | 2006 Number | 2005 Number (as restated)* |
|---|---|---|
| By segment: | | |
| Processor Division | **850** | 703 |
| Physical IP Division | **417** | 360 |
| Development Systems Division | **205** | 171 |
| | **1,472** | 1,234 |

* Refer to note 2 for the reasons of the restatement.

| | 2006 Number | 2005 Number |
|---|---|---|
| By activity: | | |
| Research and development | **961** | 783 |
| Sales and marketing | **302** | 286 |
| General and administrative | **209** | 165 |
| | **1,472** | 1,234 |

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Staff costs (for the above persons): | | |
| Wages and salaries | **83,007** | 65,745 |
| Share-based payments (note 24) | **17,437** | 20,863 |
| Social security costs | **8,480** | 6,683 |
| Other pension costs | **3,840** | 3,371 |
| | **112,764** | 96,662 |

Of the total pension costs above, £252,000 (2005: £91,000) remained unpaid at the year end.

## 6 Profit before tax

The following items have been charged/(credited) to the income statement in arriving at profit before tax:

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Staff costs, including share-based payments (note 5) | **112,764** | 96,662 |
| Cost of inventories recognised as an expense (included in cost of sales) | **4,951** | 4,050 |
| Depreciation of property, plant and equipment: | | |
| – Owned assets | **5,285** | 5,899 |
| Amortisation of other intangible assets: | | |
| – cost of sales | **310** | 123 |
| – research and development | **9,791** | 10,052 |
| – sales and marketing | **9,351** | 9,977 |
| – general and administrative | **1,989** | 2,557 |
| Impairment of available-for-sale investments | **–** | 337 |
| Profit on disposal of available-for-sale investment | **(5,270)** | – |
| Loss on disposal of property, plant and equipment | **63** | 16 |
| Other operating lease rentals payable | | |
| – plant and machinery | **13,398** | 10,687 |
| – property | **5,402** | 5,122 |
| Repairs and maintenance expenditure on property, plant and equipment | **1,696** | 878 |
| Trade receivables impairment | **932** | 722 |
| Amortisation of government grants | **(467)** | – |
| Foreign exchange (gains)/losses | **(4,522)** | 2,285 |

## 6 Profit before tax continued

### Services provided by the Group's auditor and its associates

During the year the Group (including its overseas subsidiaries) obtained the following services from the Group's auditor and its associates:

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Fees payable to the Group's auditor for the audit of the Company and consolidated financial statements | **320** | 244 |
| Fees payable to the Group's auditor and its associates for other services: | | |
| – the audit of the Group's subsidiaries pursuant to legislation | **222** | 209 |
| – services pursuant to section 404 of the Sarbanes-Oxley Act | **533** | 14 |
| – other services pursuant to legislation | **79** | 42 |
| – tax services | **861** | 1,152 |
| – all other services | **90** | 113 |
| | **2,105** | 1,774 |

In the first quarter of 2007, fees of £255,000 were incurred in relation to section 404 of the Sarbanes-Oxley Act.

Fees payable to other major firms of accountants for non-audit services for 2006 amount to £1,466,000 (2005: £658,000).

## 7 Tax

### Analysis of charge in the year

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Current tax | **15,192** | 16,578 |
| Deferred tax | **(7,124)** | (5,751) |
| **Taxation** | **8,068** | 10,827 |

### Analysis of tax on items charged to equity

| | £000 | £000 |
|---|---|---|
| Deferred tax credit on available-for-sale investments | **1,327** | 981 |
| Deferred tax credit/(charge) on outstanding share options | **399** | (4,408) |
| Current tax benefit on share options | **3,783** | – |
| Deferred tax credit on tax benefits on exercise of options issued as part consideration for a business combination | **–** | 6,072 |

The tax for the year is lower than the standard rate of corporation tax in the UK (30%). The differences are explained below:

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Profit before tax | **56,656** | 40,474 |
| Profit before tax multiplied by rate of corporation tax in the UK of 30% (2005: 30%) | **16,997** | 12,142 |
| Effects of: | | |
| Adjustments to tax in respect of prior years | **1,220** | 138 |
| Adjustments in respect of foreign tax rates | **613** | (45) |
| Research and development tax credits | **(2,879)** | (1,911) |
| Permanent differences – foreign exchange | **(4,164)** | – |
| Permanent differences – other* | **(5,951)** | 1,710 |
| Foreign withholding tax | **2,450** | 1,444 |
| Amortisation of other intangible assets | **(1,546)** | (7,105) |
| Timing differences in respect of share-based payments | **1,415** | 4,551 |
| Other timing differences | **(87)** | (97) |
| **Total taxation** | **8,068** | 10,827 |

* Includes benefits resulting from restructuring following the acquisition of Artisan.

**Deferred tax**

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate relevant to each tax jurisdiction.

The movement on the deferred tax account is shown below:

| | 2006 £000 | 2005 £000 |
|---|---|---|
| At 1 January | **4,440** | 261 |
| Amount acquired with subsidiary undertakings | **(1,347)** | (3,336) |
| Profit and loss credit | **7,124** | 5,751 |
| Available-for-sale investments | **1,327** | 981 |
| Adjustment in respect of share-based payments | **399** | (4,408) |
| Adjustment in respect of share option benefits | **–** | 6,072 |
| Transfer to current tax liabilities | **757** | – |
| Exchange differences | **340** | (881) |
| **At 31 December** | **13,040** | 4,440 |

Deferred tax assets have been partially recognised in respect of tax losses and other temporary differences giving rise to deferred tax assets because it is not probable that the unrecognised portion of these assets will be recovered. The amount of deferred tax assets unrecognised at 31 December 2006 is £6,049,000 (2005: £366,000).

No deferred tax is recognised on the unremitted earnings of overseas subsidiaries. As the earnings are continually reinvested by the Group, no tax is expected to be payable on them in the foreseeable future. If the earnings were remitted, tax of £10,578,000 would be payable.

The movements in deferred tax assets and liabilities (prior to offsetting of balances within the same tax jurisdiction as permitted by IAS 12, "Income Taxes") during the year are shown below. Deferred tax assets and liabilities are only offset where there is a legally enforceable right of offset and there is an intention to settle the balances net.

**Deferred tax assets**

| | Amounts relating to share-based payments £000 | Temporary difference on available-for-sale investments £000 | Temporary differences relating to fixed assets £000 | Tax losses and R&D tax credits carried forward £000 | Non-deductible reserves £000 | Amounts relating to share option benefits £000 | Total £000 |
|---|---|---|---|---|---|---|---|
| At 1 January 2006 | 10,574 | (1,096) | 5,214 | 11,988 | 1,662 | 6,646 | 34,988 |
| Amount acquired with subsidiary undertakings | – | – | – | 1,935 | – | – | 1,935 |
| Profit and loss (charge)/credit | 2,342 | – | 30 | (5,010) | 1,027 | – | (1,611) |
| Available-for-sale investments | – | 1,327 | – | – | – | – | 1,327 |
| Movement on deferred tax arising on outstanding share options | 399 | – | – | – | – | – | 399 |
| Transfer | – | – | – | 6,646 | – | (6,646) | – |
| Exchange differences | | – | | (2,620) | | | (2,620) |
| **At 31 December 2006 (prior to offsetting)** | **13,315** | **231** | **5,244** | **12,939** | **2,689** | **–** | **34,418** |
| Offsetting of deferred tax liabilities | | | | | | | (15,328) |
| **At 31 December 2006 (after offsetting)** | | | | | | | **19,090** |

**Deferred tax liabilities**

| | Amounts relating to intangible assets arising on acquisition £000 | Other £000 | Total £000 |
|---|---|---|---|
| At 1 January 2006 | 29,791 | 757 | 30,548 |
| Amount acquired with subsidiary undertakings | 3,282 | – | 3,282 |
| Movement in respect on amortisation of intangible assets | (8,735) | – | (8,735) |
| Transfer to current tax liabilities | – | (757) | (757) |
| Exchange differences | (2,960) | – | (2,960) |
| **At 31 December 2006 (prior to offsetting)** | **21,378** | **–** | **21,378** |
| Offsetting of deferred tax assets | | | (15,328) |
| **At 31 December 2006 (after offsetting)** | | | **6,050** |

The deferred tax liability due after more than one year prior to offsetting is £13,783,000 (2005: £22,128,000).

## 8 Dividends

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Final 2004 paid at 0.42 pence per share | – | 5,759 |
| Interim 2005 paid at 0.34 pence per share | – | 4,677 |
| Final 2005 paid at 0.50 pence per share | 6,918 | – |
| Interim 2006 paid at 0.40 pence per share | 5,449 | – |

In addition, the directors are proposing a final dividend in respect of the financial year ended 31 December 2006 of 0.6 pence per share which will absorb an estimated £8,002,000 of shareholders' funds. It will be paid on 21 May 2007 to shareholders who are on the register of members on 4 May 2007.

## 9 Earnings per share

Basic earnings per share is calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares in issue during the year, excluding those held in the ESOP and treasury stock which are treated as cancelled.

For diluted earnings per share, the weighted average number of ordinary shares in issue is adjusted to assume conversion of all dilutive potential ordinary shares. The Company had two categories of dilutive potential ordinary shares during the year: those being share options granted to employees and directors where the exercise price is less than the average market price of the Company's ordinary shares during the year and the contingently issuable shares under the Company's Long Term Incentive Plan (LTIP). For 2006 and 2005 no shares that were allocated for awards under the LTIP were included in the diluted EPS calculation as the performance criteria could not be measured until the conclusion of the performance period.

Reconciliations of the earnings and weighted average number of shares used in the calculations are shown on the face of the income statement.

## 10 Cash and cash equivalents

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Cash at bank and in hand | 40,477 | 36,264 |
| Short-term bank deposits | 50,266 | 91,813 |
| | 90,743 | 128,077 |

The effective interest rate on short-term deposits was 4.7% (2005: 4.5%) and these deposits have an average maturity of 38 days (2005: 53 days).

## 11 Accounts receivable

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Amounts falling due within one year:** | | |
| Accounts receivable | 48,276 | 37,191 |
| Less: Provision for impairment of receivables | (2,556) | (2,173) |
| Accounts receivable, net | 45,720 | 35,018 |
| Amounts recoverable on contracts | 23,832 | 20,500 |
| | 69,552 | 55,518 |

## 12 Prepaid expenses and other assets

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Amounts falling due within one year:** | | |
| Other receivables | 2,733 | 2,259 |
| Prepayments and accrued income | 9,496 | 10,308 |
| | 12,229 | 12,567 |

Within non-current assets is an amount of £1,328,000 (2005: £1,674,000) relating to prepayments falling due after more than one year.

## 13 Inventories

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Finished goods | **2,020** | 1,512 |
| Less: Provision for obsolescence of inventories | **(87)** | (22) |
| | **1,933** | 1,490 |

## 14 Financial assets

Financial assets include the following:

| | Current financial assets 2006 £000 | Current financial assets 2005 £000 | Non-current financial assets 2006 £000 | Non-current financial assets 2005 £000 |
|---|---|---|---|---|
| Short-term investments – UK | **18,372** | 23,990 | **–** | – |
| Short-term investments – Korea | **228** | – | **–** | – |
| Listed securities: | | | | |
| – Equity securities – UK | **–** | – | **1,885** | 6,995 |
| Unlisted securities: | | | | |
| – Equity securities – UK | **–** | – | **50** | 50 |
| – Equity securities – US | **–** | – | **1,920** | 1,481 |
| – Marketable securities – US | **19,151** | 8,835 | **–** | – |
| Convertible loan notes – US | **–** | – | **–** | 274 |
| | **37,751** | 32,825 | **3,855** | 8,800 |

Also included in current financial assets at 31 December 2006 is £439,000 (2005: £nil) in respect of the fair value of currency exchange contracts.

**Current financial assets**

| | Short-term investments £000 | Short-term marketable securities £000 | Total £000 |
|---|---|---|---|
| At 1 January 2006 | 23,990 | 8,835 | 32,825 |
| Cash invested in short-term investments and short-term marketable securities | 75,266 | 56,764 | 132,030 |
| Maturity of short-term investments and short-term marketable securities | (80,656) | (45,260) | (125,916) |
| Revaluation surplus | – | 22 | 22 |
| Foreign exchange | – | (1,210) | (1,210) |
| **At 31 December 2006** | **18,600** | **19,151** | **37,751** |

| | Short-term investments £000 | Short-term marketable securities £000 | Total £000 |
|---|---|---|---|
| At 1 January 2005 | 5,307 | 21,511 | 26,818 |
| Cash invested in short-term investments and short-term marketable securities | 44,010 | – | 44,010 |
| Maturity of short-term investments and short-term marketable securities | (25,327) | (12,646) | (37,973) |
| Revaluation deficit | – | (30) | (30) |
| **At 31 December 2005** | **23,990** | **8,835** | **32,825** |

Refer to note 1 for definitions of short-term investments and short-term marketable securities.

## 14 Financial assets continued

### Non-current financial assets

| | Available-for-sale investments Listed £000 | Other £000 | Total £000 |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2006 | 6,995 | 3,804 | 10,799 |
| Additions | – | 165 | 165 |
| Disposals | (3,521) | – | (3,521) |
| Revaluation deficit | (1,589) | – | (1,589) |
| **At 31 December 2006** | **1,885** | **3,969** | **5,854** |
| **Aggregate impairment** | | | |
| **At 1 January and 31 December 2006** | **–** | **1,999** | **1,999** |
| **Net book value** | | | |
| **At 31 December 2006** | **1,885** | **1,970** | **3,855** |

| | Long-term marketable securities £000 | Available-for-sale investments Listed £000 | Other £000 | Total £000 |
|---|---|---|---|---|
| **Cost** | | | | |
| At 1 January 2005 | 5,438 | 10,262 | 3,642 | 19,342 |
| Additions | – | – | 274 | 274 |
| Disposals | (5,438) | – | (112) | (5,550) |
| Revaluation deficit | – | (3,267) | – | (3,267) |
| **At 31 December 2005** | **–** | **6,995** | **3,804** | **10,799** |
| **Aggregate impairment** | | | | |
| At 1 January 2005 | – | – | 1,669 | 1,669 |
| Impairment charges | – | – | 337 | 337 |
| Disposals | – | – | (7) | (7) |
| **At 31 December 2005** | **–** | **–** | **1,999** | **1,999** |
| **Net book value at 31 December 2005** | **–** | **6,995** | **1,805** | **8,800** |

**Listed investments** The Group owns an 8.1% holding in Superscape Group plc ("Superscape"), the cost and market value of which as at 31 December 2006 were £2,652,000 and £1,885,000 respectively (2005: £2,652,000 and £3,474,000 respectively). The investment was made in order to broaden the scope of the Group's collaboration with Superscape in the area of 3D technology for wireless devices. At 31 December 2005, the Group owned a less than 1% holding in CSR plc, a company that develops Bluetooth solutions. The cost and market value of this investment as at 31 December 2005 were £688,000 and £3,521,000 respectively. During 2006, the Group divested its less than 1% holding in CSR plc.

**Other investments** Included in other investments are the Group's less than 1% investment in the share capital of Palmchip Corporation, a private fabless chip company based in California, a 1.2% investment in the share capital of Pixim Inc., also a private fabless chip company based in California and a 1.4% holding in Reciva Limited, an internet radio company based in the UK. The Group also has an investment in the preference share capital of CoWare Inc., a company which develops system-on-chip software for a wide range of applications, which confers no voting rights. During 2005, the Group made an investment via convertible loan notes in Luminary Micro Inc. ("Luminary"), a private fabless semiconductor company based in Austin which develops pioneering ARM architecture-based SoC products. In 2006, the loan notes converted to preference shares and the Group made a further investment via preference shares. The Group's investment in the preference shares of Luminary confers no voting rights. During 2005, the Group divested its less than 1% holding in Zeevo Inc.

Provisions have been made against other investments to reflect any impairment in value.

## 14 Financial assets continued

**Interests in Group undertakings** Details of principal subsidiary undertakings are shown below. Not all subsidiaries are included as the list would be excessive in length.

| Name of undertaking | Country of registration | Principal activity | Proportion of issued nominal value issued shares held % |
|---|---|---|---|
| ARM Limited | England and Wales | Marketing, research and development of RISC-based microprocessors | 100* |
| ARM Inc. | US | Marketing and development of RISC-based microprocessors and marketing, research and development of physical IP components | 100 |
| ARM KK | Japan | Marketing of RISC-based microprocessors | 100 |
| ARM Korea Limited | South Korea | Marketing of RISC-based microprocessors | 100 |
| ARM France SAS | France | Development of RISC-based microprocessors | 100 |
| Soisic SA (acquired in 2006) | France | Development of silicon-on-insulator IP | 100 |
| ARM Belgium N.V. | Belgium | Development of data engine microprocessors | 100 |
| ARM Norway AS (acquired and renamed in 2006) | Norway | Marketing, research and development of graphics IP | 100 |
| ARM Germany GmbH | Germany | Marketing of RISC-based microprocessors and development of integrated processor modelling solutions | 100 |
| Keil Elektronik GmbH | Germany | Marketing, research and development of microcontroller tools | 100 |
| ARM Embedded Technologies Pvt. Ltd. | India | Marketing, research and development of RISC-based microprocessors and physical IP | 100 |
| ARM Physical IP Asia Pacific Pte. Limited | Singapore | Marketing of physical IP | 100 |
| ARM Taiwan Limited | Taiwan | Marketing of RISC-based microprocessors | 99.9 |
| ARM Consulting (Shanghai) Co. Ltd. | PR China | Marketing of RISC-based microprocessors | 100 |

* The Company owns less than 1% of the share capital of ARM Limited, with ARM Finance Limited, which itself is 100% owned by the Company, owning 99.9%.

Nominees of the Company hold 100% of the ordinary share capital of ARM Employee Benefit Trustee Ltd, a company which acts as trustee to the Group's ESOP.

## 15 Property, plant and equipment

| | Freehold buildings £000 | Leasehold improvements £000 | Computer equipment £000 | Fixtures, fittings and motor vehicles £000 | Total £000 |
|---|---|---|---|---|---|
| **Cost** | | | | | |
| At 1 January 2006 | 190 | 20,058 | 17,950 | 4,183 | 42,381 |
| Acquisitions | – | 87 | 80 | 11 | 178 |
| Transfers to other intangible assets | – | – | (551) | – | (551) |
| Additions | – | 1,083 | 5,088 | 1,018 | 7,189 |
| Disposals | – | (3,037) | (3,377) | (190) | (6,604) |
| Exchange differences | – | (137) | (745) | (346) | (1,228) |
| **At 31 December 2006** | **190** | **18,054** | **18,445** | **4,676** | **41,365** |
| **Aggregate depreciation** | | | | | |
| At 1 January 2006 | 57 | 17,868 | 12,993 | 2,460 | 33,378 |
| Transfers to other intangible assets | – | – | (385) | – | (385) |
| Charge for the year | 7 | 1,496 | 3,034 | 748 | 5,285 |
| Disposals | – | (3,009) | (3,369) | (132) | (6,510) |
| Exchange differences | – | (89) | (468) | (142) | (699) |
| **At 31 December 2006** | **64** | **16,266** | **11,805** | **2,934** | **31,069** |
| **Net book value** | | | | | |
| **At 31 December 2006** | **126** | **1,788** | **6,640** | **1,742** | **10,296** |

## 15 Property, plant and equipment continued

| | Freehold buildings £000 | Leasehold improvements £000 | Computer equipment £000 | Fixtures, fittings and motor vehicles £000 | Total £000 |
|---|---|---|---|---|---|
| **Cost** | | | | | |
| At 1 January 2005 | 190 | 21,405 | 12,282 | 3,215 | 37,092 |
| Acquisitions | – | – | 17 | 7 | 24 |
| Transfers | – | (1,488) | 1,488 | – | – |
| Additions | – | 108 | 4,453 | 931 | 5,492 |
| Disposals | – | (66) | (720) | (165) | (951) |
| Exchange differences | – | 99 | 430 | 195 | 724 |
| **At 31 December 2005** | **190** | **20,058** | **17,950** | **4,183** | **42,381** |
| **Aggregate depreciation** | | | | | |
| At 1 January 2005 | 50 | 16,020 | 10,106 | 1,820 | 27,996 |
| Transfers | – | (1,004) | 1,004 | – | – |
| Charge for the year | 7 | 2,845 | 2,374 | 673 | 5,899 |
| Disposals | – | (43) | (722) | (133) | (898) |
| Exchange differences | – | 50 | 231 | 100 | 381 |
| **At 31 December 2005** | **57** | **17,868** | **12,993** | **2,460** | **33,378** |
| **Net book value at 31 December 2005** | **133** | **2,190** | **4,957** | **1,723** | **9,003** |

## 16 Goodwill

| | Total £000 |
|---|---|
| **Cost and net book value** | |
| At 1 January 2005 | 419,174 |
| Acquisition (KSI) | 2,249 |
| Acquisition (KEG) | 3,466 |
| Exchange differences | 49,449 |
| **At 31 December 2005** | **474,338** |
| Acquisition (Falanx) | 9,383 |
| Acquisition (Soisic) | 2,213 |
| Exchange differences | (57,568) |
| **At 31 December 2006** | **428,366** |

During the fourth quarter of 2006, the Group tested its balance of goodwill for impairment in accordance with IAS 36, “Impairment of assets”. No impairment charge was recorded as a result of this annual impairment test.

Goodwill is allocated to the Group’s CGUs according to business segment. The carrying amounts of goodwill by CGU at 31 December 2006 are summarised below:

| | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Group £000 |
|---|---|---|---|---|
| Goodwill relating to Artisan | 97,440 | 305,496 | – | 402,936 |
| Goodwill relating to Axys | – | – | 6,221 | 6,221 |
| Goodwill relating to KEG and KSI | – | – | 5,507 | 5,507 |
| Goodwill relating to Soisic | – | 2,228 | – | 2,228 |
| Goodwill relating to other acquisitions | 11,443 | – | 31 | 11,474 |
| | **108,883** | **307,724** | **11,759** | **428,366** |

The recoverable amount for each CGU has been measured based on a value in use calculation.

**Processor Division (PD)**
The Processor Division encompasses those resources that are centred around microprocessor cores, including specific functions such as graphics IP, fabric IP, embedded software IP and configurable digital signal processing (DSP) IP.

The key assumptions in the value in use calculations were:

**Period over which the directors have projected cash flows** A ten-year forecast period is used with an assumed terminal growth rate after 2016 of 3% per annum. It is considered appropriate to use a ten-year forecast period to properly reflect the period over which the benefits of the acquisition of Artisan to the Processor Division are expected to accrue. It is expected that it will take between four and seven years from acquisition before a meaningful proportion of ARM's larger semiconductor partners are licensing physical IP from the Group, with royalties being generated from these licences a further two to four years later, i.e. a total period of six to 11 years.

**Forecast revenue growth** Revenue is forecast to grow by an amount consistent with the Group's five-year plan as well as analysts' expectations. These have proved to be reliable guides in the past and the directors believe that these estimates are appropriate.

**Revenue attributable to the benefits afforded by owning the PIPD unit** The directors believe that revenue will accrue to the Processor Division as a result of the ownership of the Physical IP Division for the following reasons:
– the development of faster and more power-efficient microprocessors as a result of collaboration between PD and PIPD engineering teams. This is expected to generate more PD licensing deals at higher prices;
– the potential for PD to win more microprocessor licensing business as a result of ARM being able to offer both processor and physical IP in-house; and
– the improvement in PD operating margins as a result of being able to transfer a number of engineering tasks to the Bangalore design centre acquired with Artisan.

**Operating margins** Operating margins have been assumed to remain consistent with current operating margins over the period of the calculation.

**Discount rate** Future cash flows are discounted in line with ARM's estimated weighted average cost of capital of approximately 10% pre-tax.

The directors are confident that the amount of goodwill allocated to the Processor Division is appropriate and that the assumptions used in estimating its fair value are appropriate. Whilst it is conceivable that a key assumption in the calculation could change, the directors believe that no reasonably foreseeable changes to key assumptions would result in an impairment of goodwill, such is the margin by which the estimated fair value exceeds the carrying value.

**Physical IP Division (PIPD)**
The Physical IP Division is concerned with the building blocks necessary for translation of a circuit design into actual silicon.

The key assumptions in the value in use calculations were:

**Period over which the directors have projected cash flows** A ten-year forecast period is used with an assumed terminal growth rate after 2016 of 3% per annum. It is considered appropriate to use a ten-year forecast period to properly reflect the period over which the benefits of the acquisitions of Artisan and Soisic are expected to accrue. It is expected that it will take between four and seven years from acquisition before the majority of ARM's larger semiconductor partners are licensing physical IP from the Group, with royalties being generated from these licences a further two to four years later, i.e. a total period of six to 11 years.

**Forecast revenue growth** Revenue is forecast to grow by approximately 20% in the first five years, falling to 7% by 2016 to reflect the uncertainty of forecasting revenues in the years further in the future. In assessing the appropriate valuation of Artisan in 2004, the directors assumed revenue growth of approximately 20% per annum was achievable in the Artisan stand-alone business based on process geometry shrinks bringing more licensing opportunities across a broader range of foundries and based on the significant increase in the usage of Artisan IP in 2003 and 2004 which is yet to generate royalties.

Confidence in achieving revenue growth of 20% is underpinned by the expected increasing contribution from synergistic revenues in addition to the growth potential in the stand-alone business. Licence revenues increased by 2% year-on-year in 2006, with the order backlog at the end of the year being approximately 20% up on the level at the beginning of the year. Royalty revenue growth was 26%. During 2006, a significant proportion of engineering resource was deployed to accelerate the technology portfolio rather than working on the conversion of order backlog into short-term revenue. The directors believe that this investment in the technology portfolio means a revenue growth of 20% is achievable.

**Operating margins** Operating margins are assumed to increase gradually over time with growth to the low-40s% by 2013. In 2006, PIPD's operating margin was 28%, reflecting both flatter licensing revenues and additional R&D investment in order to accelerate the development of leading edge products. This is expected to increase significantly in future years as licence revenues from leading edge products gather pace and royalties increase at effectively 100% margins. Costs are expected to grow broadly in line with licence revenue growth.

This timescale is consistent with ARM's experience in developing the processor licensing and royalty model. ARM has signed approximately 465 processor licences over the last 16 years with less than half of these yielding royalties thus far. As royalty revenues are a function of cumulative licensing, royalty growth gathers momentum as the licensing base grows – ARM processor royalties have increased from $38 million in 2002 to $164 million in 2006.

### 16 Goodwill continued

**Discount rate** Future cash flows are discounted in line with estimated weighted average cost of capital for the Physical IP business of approximately 10% pre-tax.

The directors are confident that the amount of goodwill allocated to the Physical IP Division is appropriate and that the assumptions used in estimating its fair value are appropriate. Whilst it is conceivable that a key assumption in the calculation could change, the directors believe that no reasonably foreseeable changes to key assumptions would result in an impairment of goodwill, such is the margin by which the estimated fair value exceeds the carrying value.

**Development Systems Division**
The Development Systems Division is concerned with the tools and models used to create and debug software and system-on-chip (SoC) designs.

The key assumptions in the value in use calculations were:

**Period over which the directors have projected cash flows** A five-year forecast period is used with an assumed terminal growth rate after 2011 of 3% per annum. It is considered appropriate to use a five-year forecast period to properly reflect the weighted average period over which the benefits of the acquisitions of Axys, KEG and KSI are expected to accrue.

**Forecast revenue growth** Revenue is forecast to grow by an amount consistent with the Group's five-year plan as well as analysts' expectations. These have proved to be reliable guides in the past and the directors believe that these estimates are appropriate.

**Operating margins** Operating margins are assumed to grow by an amount consistent with the Group's five-year plan.

**Discount rate** Future cash flows are discounted in line with estimated weighted average cost of capital for the Development Systems Division of approximately 10% pre-tax.

The directors are confident that the amount of goodwill allocated to the Development Systems Division is appropriate and that the assumptions used in estimating its fair value are appropriate. Whilst it is conceivable that a key assumption in the calculation could change, the directors believe that no reasonably foreseeable changes to key assumptions would result in an impairment of goodwill, such is the margin by which the estimated fair value exceeds the carrying value.

### 17 Other intangible assets

| | Software £000 | Patents and licences £000 | In-process research and development £000 | Developed technology £000 | Existing agreements and customer relationships £000 | Core technology £000 | Trademarks £000 | Order backlog £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | | | |
| At 1 January 2006 | 36,530 | 14,102 | 4,365 | 23,477 | 46,941 | 13,455 | 4,225 | 1,864 | 144,959 |
| Acquisitions (Falanx) | 2 | – | – | 4,267 | 990 | – | – | – | 5,259 |
| Acquisitions (Soisic) | – | – | – | 4,283 | – | – | – | – | 4,283 |
| Acquisitions (PowerEscape) | – | – | 992 | – | – | – | – | – | 992 |
| Additions | 1,370 | – | – | – | – | – | – | – | 1,370 |
| Transfers from PPE | 551 | – | – | – | – | – | – | – | 551 |
| Disposals | (29,774) | – | – | – | – | – | – | – | (29,774) |
| Exchange differences | (222) | – | (589) | (2,518) | (5,239) | (1,653) | (518) | (229) | (10,968) |
| **At 31 December 2006** | **8,457** | **14,102** | **4,768** | **29,509** | **42,692** | **11,802** | **3,707** | **1,635** | **116,672** |
| **Aggregate amortisation** | | | | | | | | | |
| At 1 January 2006 | 32,717 | 12,984 | 694 | 5,420 | 7,976 | 2,749 | 812 | 1,864 | 65,216 |
| Charge for the year | 1,610 | 494 | 947 | 6,009 | 8,940 | 2,515 | 926 | – | 21,441 |
| Transfers from PPE | 385 | – | – | – | – | – | – | – | 385 |
| Disposals | (29,774) | – | – | – | – | – | – | – | (29,774) |
| Exchange differences | (155) | – | (138) | (948) | (1,390) | (493) | (156) | (229) | (3,509) |
| **At 31 December 2006** | **4,783** | **13,478** | **1,503** | **10,481** | **15,526** | **4,771** | **1,582** | **1,635** | **53,759** |
| **Net book value** | | | | | | | | | |
| **At 31 December 2006** | **3,674** | **624** | **3,265** | **19,028** | **27,166** | **7,031** | **2,125** | **–** | **62,913** |

## 17 Other intangible assets continued

| | Software £000 | Patents and licences £000 | In-process research and development £000 | Developed technology £000 | Existing agreements and customer relationships £000 | Core technology £000 | Trademarks £000 | Order backlog £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | | | |
| At 1 January 2005 | 35,796 | 13,060 | 3,903 | 18,540 | 37,692 | 12,031 | 2,694 | 1,667 | 125,383 |
| Acquisitions (KSI) | – | – | – | – | 482 | – | 1,175 | – | 1,657 |
| Acquisitions (KEG) | – | – | – | 2,744 | 4,290 | – | – | – | 7,034 |
| Additions | 572 | 1,042 | – | – | – | – | – | – | 1,614 |
| Exchange differences | 162 | – | 462 | 2,193 | 4,477 | 1,424 | 356 | 197 | 9,271 |
| **At 31 December 2005** | **36,530** | **14,102** | **4,365** | **23,477** | **46,941** | **13,455** | **4,225** | **1,864** | **144,959** |
| **Aggregate amortisation** | | | | | | | | | |
| At 1 January 2005 | 30,775 | 10,065 | 28 | 192 | 176 | 53 | 21 | 36 | 41,346 |
| Charge for the year | 1,851 | 2,919 | 633 | 4,924 | 7,369 | 2,543 | 747 | 1,723 | 22,709 |
| Exchange differences | 91 | – | 33 | 304 | 431 | 153 | 44 | 105 | 1,161 |
| **At 31 December 2005** | **32,717** | **12,984** | **694** | **5,420** | **7,976** | **2,749** | **812** | **1,864** | **65,216** |
| **Net book value** | | | | | | | | | |
| **At 31 December 2005** | **3,813** | **1,118** | **3,671** | **18,057** | **38,965** | **10,706** | **3,413** | **–** | **79,743** |

Refer to note 23 for the methods and significant assumptions applied in estimating the fair value of other intangible assets acquired as part of business combinations.

Included within the net book value of other intangible assets at 31 December 2006 are significant amounts relating to intangibles that were acquired with Artisan in 2004. £8,363,000 (2005: £14,354,000) relates to the carrying value of developed technology, £21,850,000 (2005: £31,171,000) relates to the carrying value of existing agreements and customer relationships and £7,030,000 (2005: £10,705,000) relates to the carrying value of core technology. At 31 December 2006, these items have remaining useful economic lives of two years, four years and three years respectively.

## 18 Accrued and other liabilities

| | **2006 £000** | 2005 £000 |
|---|---|---|
| Accruals | **26,181** | 20,782 |
| Other taxation and social security | **1,446** | 1,359 |
| Other payables | **8,492** | 4,378 |
| | **36,119** | 26,519 |

## 19 Financial liabilities

| | **2006 £000** | 2005 £000 |
|---|---|---|
| Fair value of currency exchange contracts | **–** | 1,708 |

Refer to note 20 for further details on this item.

## 20 Financial instruments

### Financial risk factors

The Group's operations expose it to a variety of financial risks that include currency risk, interest rate risk, price risk, credit risk and liquidity risk. The Group has no derivative financial instruments to manage interest rate fluctuations in place at the year end since it has no loan financing, and as such no hedge accounting is applied.

Given the size of the Group, the directors have not delegated the responsibility for monitoring financial risk management to a sub-committee of the board. The policies set by the board of directors are implemented by the Group's finance department. The department has a policy and procedures manual that sets out specific guidelines to manage currency risk, interest rate risk, price risk, credit risk and liquidity risk and also sets out circumstances where it would be appropriate to use financial instruments to manage these.

## 20 Financial instruments continued

**Currency risk** The Group's earnings and liquidity are affected by fluctuations in foreign currency exchange rates, principally in respect of the US dollar, reflecting the fact that most of its revenues and cash receipts are denominated in US dollars, while a significant proportion of its costs are settled in sterling. The Group seeks to use currency exchange contracts and currency options to manage the US dollar/sterling risk as appropriate, by monitoring the timing and value of anticipated US dollar receipts (which tend to arise from low-volume, high-value licence deals and royalty receipts) in comparison with its requirement to settle certain expenses in US dollars. The Group reviews the resulting exposure on a regular basis and hedges this exposure using currency exchange contracts and currency options for the sale of US dollars as appropriate. Such contracts are entered into with the objective of matching their maturity with projected US dollar cash receipts. As the timing of large cash receipts cannot be predicted with certainty, the Group enters into currency exchange contracts which allow exercise between two dates, typically between three and four months from the invoice date. In those cases where customers settle debts before the expiry of the currency exchange contract, the Group evaluates whether money market rates available for US dollar investments exceed those for sterling investments. It then seeks to maximise its returns by remitting US dollars against currency exchange contracts at the beginning or end of the exercise period, depending on the prevailing money market rates for US dollars and sterling at the time.

At 31 December 2006, the Group had outstanding currency exchange contracts to sell $29,000,000 (2005: $36,000,000) and potential exercisable currency options of $60,000,000 (2005: $76,000,000). The Group had $91,063,000 (2005: $59,987,000) of accounts receivable denominated in US dollars at that date, and US dollar cash, cash equivalents, short-term investments and short-term marketable securities balances of $111,186,000 (2005: $121,427,000). Thus 56% (2005: 38%) of the Group's US dollar current assets were not hedged by matching currency exchange contracts and currency options at the year end. The Group does not qualify for hedge accounting, and all movements in the fair value of derivative foreign exchange instruments are recorded in the income statement, offsetting the foreign exchange movements on the accounts receivable, cash, cash equivalents, short-term investments and short-term marketable securities balances being hedged.

In addition, certain customers remit royalties and licence fees in other currencies, primarily the euro. The Group is also required to settle certain expenses in euros, primarily in its French, Belgian and German subsidiaries, and as the net amounts involved are not considered significant, the Group does not take out euro currency exchange contracts.

**Interest rate risk** At 31 December 2006, the Group had £128,494,000 (2005: £160,902,000) of interest-bearing assets. At 31 December 2006, 68% (2005: 77%) of interest-bearing assets, comprising cash equivalents, short-term investments and short-term marketable securities, are at fixed rates and are therefore exposed to fair value interest rate risk. Floating rate cash earns interest based on relevant national LIBID equivalents and is therefore exposed to cash flow interest rate risk. The proportion of funds held in fixed rather than floating rate deposits is determined in accordance with the "liquidity policy" below. Other financial assets, such as available-for-sale investments, are not directly exposed to interest rate risk.

**Price risk** The Group is exposed to equity securities price risk on available-for-sale investments. As there can be no guarantee that there will be a future market for securities (which are generally unlisted at the time of investment) or that the value of such investments will rise, the directors evaluate each investment opportunity on its merits before committing ARM's funds. The board of directors reviews holdings in such companies on a regular basis to determine whether continued investment is in the best interests of the Group. Funds for such ventures are strictly limited in order that the financial effect of any potential decline of the value of investments will not be substantial in the context of the Group's financial results.

**Credit risk** The Group has no significant concentrations of credit risk. The Group has implemented policies that require appropriate credit checks on potential customers before sales commence. Financial instrument counterparties are subject to pre-approval by the board of directors and such approval is limited to financial institutions with an AAA rating. The amount of exposure to any individual counterparty is subject to a limit, which is reassessed annually by the board of directors.

**Liquidity risk** The Group's policy is to maintain balances of cash, cash equivalents, short-term investments and short-term marketable securities, such that highly liquid resources exceed the Group's projected cash outflows at all times.

**Use of financial instruments**

**External borrowings** At 31 December 2006, the Group owed £nil (2005: £nil) extending beyond one year from the balance sheet date. The Group had no undrawn committed borrowing facilities at 31 December 2006 (2005: £nil) or during the financial year.

**Numerical disclosures** Numerical disclosures are set out in the tables below. These balances are as of 31 December in each year.

| | Assets | | Liabilities | |
|---|---|---|---|---|
| | **2006 £000** | 2005 £000 | **2006 £000** | 2005 £000 |
| **At 31 December** | | | | |
| Short-term investments | **18,600** | 23,990 | **–** | – |
| Short-term marketable securities | **19,151** | 8,835 | **–** | – |
| Fair value of currency exchange contracts | **439** | – | **–** | 1,708 |
| Available-for-sale investments | **3,855** | 8,800 | **–** | – |
| Embedded derivatives (included in accrued and other liabilities) | **–** | – | **1,620** | 722 |
| | **42,045** | 41,625 | **1,620** | 2,430 |

**Short-term investments** The carrying amount approximates to fair value because of the short-term maturity of these instruments, being greater than three months but less than one year.

## 20 Financial instruments continued

**Short-term marketable securities** There is a readily available market for these investments. Unrealised gains and losses on these investments are recognised directly in equity via the revaluation reserve. The Group recognises an impairment charge when the decline in fair value below cost is judged to be other than temporary. At 31 December 2006, the fair value is £22,000 more than (2005: £30,000 less than) cost with a corresponding amount being credited (2005: charged) to equity as the decline is judged to be temporary.

**Fair value of currency exchange contracts** The fair value of currency exchange contracts is estimated using the settlement rates. The estimation of the fair value of the asset in respect of currency exchange contracts is £439,000 at 31 December 2006 (2005: liability of £1,708,000). The increase in 2006 is due to the value and relative exchange rates of contracts outstanding compared to 2005. The resulting gain or loss on the movement of the fair value of currency exchange contracts is recognised in the income statement under general and administrative expenses, as shown below:

| | **2006 £000** | 2005 £000 |
|---|---|---|
| Gain/(loss) in income statement | **2,147** | (3,382) |

**Available-for-sale investments: investments in unlisted companies** Those companies in which the Group has invested are early-stage development enterprises, which are generating value for shareholders through research and development activities, and most do not currently report profits. The directors do not consider it possible to estimate with precision the fair value of the Group's investments in unlisted companies (carrying value at 31 December 2006: £1,970,000) as they are, by definition, not traded on an organised market and are unique in their activities. However, based on recent fundraising transactions by these companies and, where possible, following review of relevant financial information prepared by the companies, the directors are of the opinion that the fair value of these investments approximates to carrying value.

**Available-for-sale investments: investments in listed companies** The fair value of listed investments is determined with reference to prices quoted on the London Stock Exchange at 31 December 2006. On this basis, the fair value of the Group's listed investments is £1,885,000 at 31 December 2006 (2005: £6,995,000).

**Embedded derivatives** In accordance with IAS 39, "Financial instruments: recognition and measurement", the Group has reviewed all its contracts for embedded derivatives that are required to be separately accounted for if they do not meet certain requirements set out in the standard. From time to time, the Group enters into contracts denominated in a currency (typically US dollars) that is neither the functional currency of the Group nor the functional currency of the customer or the collaborative partner. Where there are uninvoiced amounts on such contracts, the Group carries such derivatives at fair value. The resulting gain or loss is recognised in the income statement under general and administrative expenses, as shown below:

| | **2006 £000** | 2005 £000 |
|---|---|---|
| (Loss)/gain in income statement | **(898)** | 2,101 |

### Hedge of net investment in foreign entity

The Group, where required, invests profits in the subsidiary in which they were earned. The Group does not hedge any foreign net asset investment using foreign currency loans, as there is currently no requirement for external borrowings.

### Fair value of other financial assets and liabilities

| | **2006** | | 2005 | |
|---|---|---|---|---|
| | **Book value £000** | **Fair value £000** | Book value £000 | Fair value £000 |
| Primary financial instruments held or issued to finance the Group's operations: | | | | |
| Trade and other payables, excluding embedded derivatives of £1,620,000 (2005: £722,000) | **(36,325)** | **(36,325)** | (28,097) | (28,097) |
| Trade and other receivables | **83,109** | **83,109** | 69,759 | 69,759 |
| Cash and cash equivalents | **90,743** | **90,743** | 128,077 | 128,077 |
| | **137,527** | **137,527** | 169,739 | 169,739 |

**Trade and other payables** The carrying amount approximates to fair value as this is the amount which would be payable if the liabilities had crystallized at the balance sheet date. Any current tax liabilities are not included in this category.

**Trade and other receivables** The carrying amount approximates to fair value as this is the amount which would be receivable if the assets had crystallized at the balance sheet date. Any current tax assets are not included in this category.

**Cash and cash-equivalents** The carrying amount approximates to fair value because of the short-term maturity of these instruments, being no greater than three months.

### Financial instruments held for trading purposes

The Group does not trade in financial instruments.

## 21 Called-up share capital

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Authorised** | | |
| 2,200,000,000 ordinary shares of 0.05 pence each (2005: 2,200,000,000) | **1,100** | 1,100 |

| | 2006 | | 2005 | |
|---|---|---|---|---|
| | Number of shares (000) | Value £000 | Number of shares (000) | Value £000 |
| **Issued and fully paid** | | | | |
| At 1 January | **1,386,103** | **693** | 1,350,787 | 675 |
| Allotted under employee incentive schemes | **3,805** | **2** | 35,316 | 18 |
| At 31 December | **1,389,908** | **695** | 1,386,103 | 693 |

## 22 Own shares held

| | Own shares held for future cancellation £000 | Treasury stock £000 | ESOP £000 | Total £000 |
|---|---|---|---|---|
| At 1 January 2006 | – | 14,877 | 1,438 | 16,315 |
| Purchase of own shares | – | 18,622 | – | 18,622 |
| Appropriation for future cancellation of shares | 57,897 | – | – | 57,897 |
| Issuance of shares | – | (33,499) | (1,090) | (34,589) |
| **At 31 December 2006** | **57,897** | **–** | **348** | **58,245** |

During the year £76,519,000 (2005: £16,211,000) of shares were repurchased, representing 63.6 million (2005: 13.9 million) shares. Share repurchase transactions in respect of 49,500,000 shares carried out between 19 May 2006 and 31 December 2006 took place at a time when ARM Holdings plc (Company only) had no distributable reserves and accordingly such shares have not been properly acquired in accordance with the Companies Act 1985, and are not available for re-issue or cancellation. ARM Holdings plc intends to make an application to the Court in due course to cancel these shares pursuant to a special resolution to be proposed at the 2007 AGM. At 31 December 2006, a total of 49.5 million shares were held for future cancellation and 1.2 million within the ESOP. These shares have a nominal value of 0.05 pence and represent 3.6% of called-up share capital at 31 December 2006.

## 23 Acquisitions

### Falanx Microsystems AS

On 30 May 2006, the Group purchased the entire share capital of Falanx Microsystems AS ("Falanx"), a graphics IP company incorporated in Norway for total consideration of £13.4 million, comprising £13.3 million cash consideration and £0.1 million of related acquisition expenses. This purchase has been accounted for as an acquisition.

Falanx develops graphics accelerator IP and software for semiconductor system-on-chip (SoC) vendors that deliver high-quality multimedia images without compromising performance, power consumption or system cost. The acquisition fits the ARM strategy of enabling users to create SOCs seamlessly in their design process. The Mali™ Graphics Processor Unit (GPU) is a combination of hardware and software that enables industry-leading 3D graphics and video on mobile phones, portable media players, set-top boxes, handheld gaming devices and automotive systems, providing the Group with full control over the development of its future 3D graphics solutions. For the reasons given above, combined with the ability to hire the entire workforce of Falanx and synergistic benefits that may arise, the Group paid a premium on the Falanx acquisition, giving rise to goodwill.

From the date of acquisition to 31 December 2006 the acquisition contributed £nil to revenue, and incurred a loss of £1.5 million before both interest and tax. The acquisition did not make a material contribution to the Group's post-acquisition net operating cash flows, tax paid and capital expenditure.

All intangible assets were recognised at their respective fair values. The residual excess over the net assets acquired is recognised as goodwill in the financial statements.

The accounting for the Falanx acquisition has been determined on a provisional basis at 31 December 2006 because the fair values assigned to the acquiree's identifiable assets and liabilities have been determined only provisionally. Any adjustments to these provisional values as a result of completing work on the fair values of assets and liabilities acquired will be recognised within 12 months of the acquisition date and will be recognised as if they had occurred as at the date of acquisition.

## 23 Acquisitions continued

| | Carrying value pre-acquisition £000 | Provisional fair value £000 |
|---|---|---|
| Cash and cash equivalents | 24 | 24 |
| Receivables | 219 | 219 |
| Property, plant and equipment | 60 | 60 |
| Other intangible assets | 2 | 5,259 |
| Payables | (319) | (319) |
| Deferred revenue | (287) | (287) |
| Tax | | |
| – Deferred tax asset | 543 | 543 |
| – Deferred tax liability | – | (1,472) |
| **Net assets acquired** | **242** | **4,027** |
| Goodwill | | 9,383 |
| **Consideration** | | **13,410** |
| **Consideration satisfied by:** | | |
| Cash consideration paid | | 13,280 |
| Expenses | | 130 |
| | | **13,410** |

The outflow of cash and cash equivalents on the acquisition of Falanx is calculated as follows:

| | £000 |
|---|---|
| Cash consideration paid | 13,280 |
| Expenses paid | 130 |
| Cash acquired | (24) |
| **Net cash outflow** | **13,386** |

The intangible assets acquired as part of the acquisition of Falanx can be analysed as follows:

| | £000 |
|---|---|
| Computer software | 2 |
| Developed technology | 4,267 |
| Customer relationships | 990 |
| **Total** | **5,259** |

The methods and significant assumptions involved in valuing these identifiable intangible assets are described below:

**Developed technology** Developed technology of £4.3 million comprises internally-developed software and hardware technologies. Falanx employs a number of unique pieces of software that have been internally developed, allowing them to be highly bespoke and continually adapted. Internally-developed hardware technologies comprise the Mali family of graphics processors which are controlled by Falanx through numerous patents. At the date of acquisition, both internally-developed software and hardware technologies were complete and had reached technological feasibility. Any costs incurred in the future will relate to ongoing maintenance of the technologies and will be expensed as incurred. To estimate the fair value of the internally-developed software the replacement cost approach was used with a post-tax discount rate of 14.9%. To estimate the fair value of the internally-developed hardware, a discounted cash flow method, specifically the income approach, was used with a post-tax discount rate of 15.4%. Developed technologies are being amortised over an estimated useful life of three to five years.

**Customer relationships** The customer base of £1.0 million represented the fair value of existing customer contracts. To estimate their fair value, a discounted cash flow method, specifically the income approach, was used with reference to the terms of the contracts and management's estimates of the level of revenue which will be generated from the customer relationships. A post-tax discount rate of 14.9% was used for the valuation. Customer relationships are being amortised over an estimated useful life of three years.

Falanx made a loss after tax for the year ended 31 December 2005 of £0.5 million and for the period from 1 January 2006 until acquisition made a loss after tax of £0.4 million. The results of the Group would not have been significantly different had the acquisition of Falanx occurred on 1 January 2006.

## 23 Acquisitions continued

### Soisic SA acquisition

On 30 October 2006, the Group purchased the entire share capital of Soisic SA ("Soisic"), a silicon-on-insulator (SOI) IP company incorporated in France for total consideration of £5.8 million, comprising £3.1 million cash consideration, £2.4 million contingent consideration and £0.3 million of related acquisition expenses. This purchase has been accounted for as an acquisition.

With this acquisition, the Group is making an investment in new technologies related to physical IP to enhance its leadership position in providing customers access to the higher performance and lower power offered by SOI process technologies. Soisic develops a similar set of products to the Physical IP Division, specifically standard cells, static random access memory (SRAM) compilers and input/output (I/O) cells, however, based on SOI design rules and process models. Integrating this capability with ARM's widely-used physical IP opens the possibility for SoC designers to access SOI technology, which currently is used only in full custom designs, such as high-performance microprocessors.

The Group is investing in this area to be at the forefront of the design technologies needed to exploit the potential advantages of SOI as its usage grows in mobile, home and enterprise SoC and ASIC applications. For the reasons given above, combined with the ability to hire the entire workforce of Soisic and synergistic benefits that may arise, the Group paid a premium on the Soisic acquisition, giving rise to goodwill.

From the date of acquisition to 31 December 2006 the acquisition contributed £nil million to revenue, and incurred a loss of £0.2 million before both interest and tax. The acquisition did not make a material contribution to the Group's post-acquisition net operating cash flows, tax paid and capital expenditure.

All intangible assets were recognised at their respective fair values. The residual excess over the net assets acquired is recognised as goodwill in the financial statements.

The accounting for the Soisic acquisition has been determined on a provisional basis at 31 December 2006 because the fair values assigned to the acquiree's identifiable assets and liabilities have been determined only provisionally. Any adjustments to these provisional values as a result of completing work on the fair values of assets and liabilities acquired will be recognised within 12 months of the acquisition date and will be recognised as if they had occurred as at the date of acquisition.

| | Carrying value pre-acquisition £000 | Provisional fair value £000 |
|---|---|---|
| Receivables | 273 | 273 |
| Property, plant and equipment | 117 | 117 |
| Other intangible assets | – | 4,283 |
| Payables | (1,415) | (1,415) |
| Tax | | |
| – Current tax asset | 303 | 303 |
| – Deferred tax asset | – | 1,392 |
| – Deferred tax liability | – | (1,413) |
| **Net (liabilities) assumed/assets acquired** | **(722)** | **3,540** |
| Goodwill | | 2,213 |
| **Consideration** | | **5,753** |
| **Consideration satisfied by:** | | |
| Cash consideration paid (including net debt of £22,000) | | 1,843 |
| Retentions* | | 1,268 |
| Contingent cash consideration** | | 2,342 |
| Expenses | | 300 |
| | | **5,753** |

* Retentions represent consideration held back to cover possible future liabilities.
** The contingent consideration will be determined based on Soisic's future revenue in the first 1.5 years post-acquisition.

The outflow of cash and cash equivalents on the acquisition of Soisic is calculated as follows:

| | £000 |
|---|---|
| Cash consideration paid (excluding net debt of £22,000) | 1,821 |
| Expenses paid | 300 |
| Bank overdraft acquired | 53 |
| **Net cash outflow** | **2,174** |

## 23 Acquisitions continued

The intangible assets acquired as part of the acquisition of Soisic can be analysed as follows:

| | £000 |
|---|---|
| Developed technology | 4,283 |
| **Total** | **4,283** |

The methods and significant assumptions involved in valuing these identifiable intangible assets are described below:

**Developed technology** Developed technology of £4.3 million represents primarily SOI wafers from 16nm up to 65nm. At the date of acquisition the technology was complete and had reached technological feasibility. Any costs incurred in the future will relate to the ongoing maintenance of the technology and will be expensed as incurred. To estimate the fair value of the technology, a discounted cash flow method, specifically the excess profit method, was used with a post-tax discount rate of 30%. Developed technology is being amortised over an estimated useful life of five years.

Soisic made a loss after tax for the year ended 31 March 2006 of £2.6 million and for the period from 1 April 2006 until acquisition made a loss after tax of £1.5 million. The results of the Group would not have been significantly different had the acquisition of Soisic occurred on 1 January 2006.

**PowerEscape Inc.**

On 21 June 2006, the Group purchased certain assets of PowerEscape Inc., a private company incorporated in the US, for total consideration of £0.6 million, comprising £0.5 million cash consideration and £0.1 million of related acquisition expenses.

The PowerEscape team, which has been integrated into the Group's Development System Division, will focus on adding innovative profiling and analysis features to the Group's portfolio of market-leading development tools.

From the date of acquisition to 31 December 2006 the acquisition did not make a material contribution to revenue, profit before interest nor profit before tax. The acquisition did not make a material contribution to the Group's post-acquisition net operating cash flows, tax paid and capital expenditure.

All intangible assets were recognised at their respective fair values. No goodwill has been recognised on this acquisition.

The accounting for the PowerEscape acquisition has been determined on a provisional basis at 31 December 2006 because the fair values assigned to the acquiree's identifiable assets and liabilities have been determined only provisionally. Any adjustments to these provisional values as a result of completing work on the fair values of assets and liabilities acquired will be recognised within 12 months of the acquisition date and will be recognised as if they had occurred as at the date of acquisition.

| | Carrying value pre-acquisition £000 | Provisional fair value £000 |
|---|---|---|
| Property, plant and equipment | 1 | 1 |
| Other intangible assets | – | 992 |
| Tax | | |
| – Deferred tax liability | – | (397) |
| **Net assets acquired** | **1** | **596** |
| Goodwill | | – |
| **Consideration** | | **596** |
| **Consideration satisfied by:** | | |
| Cash consideration paid | | 540 |
| Expenses | | 56 |
| | | **596** |

The outflow of cash and cash equivalents on the acquisition of PowerEscape is calculated as follows:

| | £000 |
|---|---|
| Cash consideration paid | 540 |
| Expenses paid | 56 |
| **Net cash outflow** | **596** |

The intangible assets acquired as part of the acquisition of PowerEscape can be analysed as follows:

| | £000 |
|---|---|
| In-process research and development | 992 |
| **Total** | **992** |

## 23 Acquisitions continued

The methods and significant assumptions involved in valuing these identifiable intangible assets are described below:

**In-process research and development** In-process research and development of £1.0 million reflects certain research projects that had not yet reached technological feasibility and commercial viability. The fair value assigned to in-process research and development was estimated using the discounted cash flow method with a post-tax discount rate of approximately 20%.

As part of the purchase agreement, the results of PowerEscape for the year ended 31 December 2005 and for the period from 1 January 2006 until acquisition are not disclosable in this annual report. The results of the Group would not have been significantly different had the acquisition of PowerEscape occurred on 1 January 2006.

**Keil Elektronik GmbH and Keil Software Inc. acquisitions**
On 27 October 2005, the Group purchased the entire share capital of Keil Elektronik GmbH ("KEG"), a leading provider of software development tools for the microcontroller (MCU) market and incorporated in Germany for total consideration £7.4 million. On the same day, the Group purchased the entire share capital of Keil Software Inc. ("KSI"), also a leading provider of software development tools for the MCU market and incorporated in the US for total consideration of £3.4 million. These purchases have been accounted for as acquisitions.

The Group has identified the MCU market as a critical growth area for the Group's future business and with this acquisition, the Group will be able to accelerate progress in that market by offering a more complete solution. As the MCU applications shift from 8/16-bit to 32-bit solutions, the combination of the ARM Cortex-M3 processor, which is ideally suited for microcontroller applications, the RealView® high-performance compiler and Keil's complementary MCU tools for ARM, will enable new generations of ARM MCU solutions. For the reasons given above, the Group paid a premium on both the Keil® acquisitions, giving rise to goodwill.

From the date of acquisition to 31 December 2005 the acquisitions contributed £0.9 million to revenue, and £0.6 million to both profit before interest and profit before tax. The acquisition did not make a material contribution to the Group's post-acquisition net operating cash flows, tax paid and capital expenditure.

All intangible assets were recognised at their respective fair values. The residual excess over the net assets acquired is recognised as goodwill in the financial statements.

**KEG acquisition**

| | Carrying value pre-acquisition £000 | Final fair value £000 |
|---|---|---|
| Cash and cash equivalents | 2,911 | 2,911 |
| Receivables | 488 | 488 |
| Inventories | 60 | 60 |
| Property, plant and equipment | 12 | 12 |
| Other intangible assets | – | 7,034 |
| Payables | (2,341) | (2,303) |
| Deferred revenue | (108) | – |
| Tax | | |
| – Current tax liability | (1,570) | (1,570) |
| – Deferred tax liability | – | (2,673) |
| **Net (liabilities)/assets acquired** | **(548)** | **3,959** |
| Goodwill | | 3,466 |
| **Consideration** | | **7,425** |
| **Consideration satisfied by:** | | |
| Cash consideration paid | | 4,397 |
| Retentions* | | 1,477 |
| Contingent cash consideration** | | 1,288 |
| Expenses | | 263 |
| | | **7,425** |

* Retentions represent consideration held back to cover possible future liabilities.
** The contingent consideration will be determined based on KEG's future revenue in the first two years post-acquisition.

The outflow of cash and cash equivalents on the acquisition of KEG is calculated as follows:

| | £000 |
|---|---|
| Cash consideration paid | 4,397 |
| Expenses paid | 263 |
| Cash acquired | (2,911) |
| **Net cash outflow** | **1,749** |

## 23 Acquisitions continued

The intangible assets acquired as part of the acquisition of KEG can be analysed as follows:

| | £000 |
|---|---|
| Developed technology | 2,744 |
| Customer relationships | 4,290 |
| **Total** | **7,034** |

The methods and significant assumptions involved in valuing these identifiable intangible assets are described below:

**Developed technology** Developed technology of £2.7 million related to software development tools for the MCU market, consisting of 8-,16- and 32-bit technology. At the date of acquisition, the technology was complete and had reached technological feasibility. Any costs incurred in the future will relate to the ongoing maintenance of the technology and will be expensed as incurred. To estimate the fair value of technology, the relief from royalty method within an income approach was used with a post-tax discount rate of 11%, with a specific surcharge of 5% for both the 8- and 16-bit technology and 3.4% for the 32-bit technology.

To derive the royalty cash flows, the revenues from each identified technology were used. All developed technologies are being amortised over an estimated useful life of one to five years.

**Customer relationships** The customer base of £4.3 million represented the fair value of existing customer relationships and contracts. These have been divided into different customer groups: direct company customers and dealers. To estimate the fair value of the customer base, the multi-period excess earnings method has been applied, with the valuation based on the planned free cash flows resulting from existing customer relationships as of the valuation date. Direct company customers and dealers are being amortised over their estimated useful lives of two and three years respectively.

KEG made a profit after tax for the year ended 31 December 2004 of £1.0 million and for the period from 1 January 2005 until acquisition a profit after tax of £1.0 million. The results of the Group would not have been significantly different had the acquisition of KEG occurred on 1 January 2005.

In 2006, £1.1 million was paid by the Group in respect of retentions.

**KSI acquisition**

| | Carrying value pre-acquisition £000 | Final fair value £000 |
|---|---|---|
| Cash and cash equivalents | 32 | 32 |
| Receivables | 174 | 174 |
| Inventories | 36 | 36 |
| Plant, property and equipment | – | 13 |
| Other intangible assets | – | 1,657 |
| Payables | (57) | (81) |
| Deferred revenue | (74) | – |
| Tax | | |
| – Deferred tax liabilities | – | (663) |
| **Net assets acquired** | **111** | **1,168** |
| Goodwill | | 2,249 |
| **Consideration** | | **3,417** |
| **Consideration satisfied by:** | | |
| Cash consideration paid | | 2,415 |
| Retentions* | | 373 |
| Contingent cash consideration** | | 497 |
| Expenses | | 132 |
| | | **3,417** |

* Retentions represent consideration held back to cover possible future liabilities.
** The contingent consideration will be determined based on KSI's future revenue in the first two years post-acquisition.

The outflow of cash and cash equivalents on the acquisition of KSI is calculated as follows:

| | £000 |
|---|---|
| Cash consideration paid | 2,415 |
| Expenses paid | 132 |
| Cash acquired | (32) |
| **Net cash outflow** | **2,515** |

### 23 Acquisitions continued

The intangible assets acquired as part of the acquisition of KSI can be analysed as follows:

| | £000 |
|---|---|
| Customer relationships | 482 |
| Tradenames | 1,175 |
| **Total** | **1,657** |

The methods and significant assumptions involved in valuing these identifiable intangible assets are described below:

**Tradenames** Tradenames of £1.2 million represented the trade names and internet domain names legally held by Keil Software, Inc. To estimate the fair value of these tradenames, the relief from royalty method within an income approach was applied with a post-tax discount rate of 14.5%. To derive the royalty cash flows, the revenues from KSI and KEG were used. All tradenames are being amortised over an estimated useful life of five years.

**Customer relationships** The customer base of £0.5 million represented the fair value of existing customer relationships and contracts. These have been divided into different customer groups: direct customers and distributors. To estimate the fair value of the customer base, the multi-period excess earnings method has been applied, with the valuation based on the planned free cash flows resulting from existing customer relationships as of the valuation date. Direct company customers and distributors are being amortised over their estimated useful lives of two and three years respectively.

KSI made a loss after tax for the year ended 31 December 2004 of £95,000 and for the period from 1 January 2005 until acquisition a loss after tax of £40,000. The results of the Group would not have been significantly different had the acquisition of KSI occurred on 1 January 2005.

### 24 Share-based payments

The Group has several share option schemes in current operation, whereby options over shares in the Company can be granted to employees and directors. The different schemes are described below, but all options are granted with a fixed exercise price equal to the market price of the shares under option at the date of grant, except for those options within the SAYE schemes which are issued at a 15% discount. Furthermore, from 2006, the Company has begun issuing RSUs to employees instead of options, as approved at the 2006 AGM. RSUs are actual share awards on vesting rather than options to buy shares at a fixed exercise price. Whilst the Company reserves the right to award options to employees going forward, the majority of awards to employees will be in RSUs.

Under the UK Inland Revenue Executive Approved Share Option Plan (the "Executive Scheme"), the Company may grant options to employees meeting certain eligibility requirements. Options under the Executive Scheme are exercisable between three and ten years after their issue, after which time the options expire.

Under the Company's Unapproved Scheme (the "Unapproved Scheme"), for which it has not sought approval from the UK Inland Revenue, options are exercisable one to seven years after their issue, after which time the options expire. The Company also operates the US ISO Scheme, which is substantially the same as the Unapproved Scheme, the main difference being that the options are exercisable one to five years after their issue. Under both of these schemes options are exercisable as follows: 25% maximum on first anniversary, 50% maximum on second anniversary, 75% maximum on third anniversary, 100% maximum on fourth anniversary. Various options to directors under the Unapproved Scheme have certain performance criteria attached, which if met are exerciseable after three years, otherwise they will become exerciseable after seven years.

There are further schemes for our French and Belgian employees (the "French Scheme" and the "Belgian Scheme"). In the French Scheme, options are exercisable between four and seven years after their issue, whilst in the Belgian Scheme, options are exercisable from 1 January following the third anniversary after their issue, up to seven years from issue.

The main RSU awards (to employees in all jurisdictions other than France) vest similarly to the unapproved scheme above, namely 25% on each anniversary over four years. RSU awards to our French employees vest 50% after two years, and then a further 25% after three and four years.

The fair value of our RSUs and LTIP awards is based on the share price at the date of grant, discounted for any dividends that won't be earned during the vesting period.

Upon the acquisition of Artisan in 2004, the Company assumed the share schemes of Artisan existing at acquisition. The schemes remained substantially the same as prior to the acquisition, other than the options became options to purchase shares in ARM Holdings plc instead of Artisan Components Inc. The number and value of options were amended in line with the conversion ratio as detailed in the merger agreement. The schemes assumed were the "1993 Plan", the "1997 Plan", the "2000 Plan", the "2003 Plan", the "Director Plan", the "Executive Plan" and the "ND00 Plan".

## 24 Share-based payments continued

Under each plan, there are multiple vesting templates and vesting periods. The majority of the options were already vested upon acquisition, and the most common template was 25% vesting after one year, and then 6.25% vesting each quarter thereafter, until 100% vest after four years. Some options vest on a monthly basis, and some vest over five years. All options lapse ten years from the date of grant.

The Company also offers savings-related share option schemes for all employees and executive directors of the Company. The number of options granted is related to the value of savings made by the employee. The period of savings is three or five years except for employees of ARM Inc. where the period is two years. The option price is currently set at 85% of the market share price prior to the grant, and the right to exercise normally only arises for a six-month period once the savings have been completed except for ARM Inc. where the right to exercise normally only arises for a three-month period once the savings have been completed.

The fair value of options granted was estimated on the date of grant using the Black-Scholes option pricing model. The following assumptions for each option grant during 2006 and 2005 were as follows:

| | | | | | |
|---|---|---|---|---|---|
| Grant date | 1 Feb 2006 | 1 Feb 2006 | 1 Feb 2006 | 1 Feb 2006 | 1 Feb 2006 |
| Scheme | Performance | Unapproved | ISO | French | Belgian |
| Share price at grant date | £1.325 | £1.325 | £1.325 | £1.325 | £1.325 |
| Exercise price | £1.325 | £1.325 | £1.325 | £1.325 | £1.325 |
| Number of employees | 6 | 44 | 29 | 1 | 2 |
| Shares under option | 2,445,284 | 2,313,098 | 1,068,269 | 85,000 | 22,500 |
| Vesting period (years) | 3 | 1-4 | 1-4 | 4 | 3.9 |
| Expected volatility | 40% | 40% | 40% | 40% | 40% |
| Expected life (years) | 4 | 2-5 | 1-4 | 5 | 4 |
| Risk free rate | 4.0% | 4.0% | 4.0% | 4.0% | 4.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | 0.7% |
| Fair value per option | £0.46 | £0.33-£0.51 | £0.23-£0.46 | £0.51 | £0.46 |
| Grant date | 4 May 2006 | 4 May 2006 | 4 May 2006 | 1 Feb 2006 | 20 Jun 2006 |
| Scheme | Unapproved | ISO | French | Belgian | SAYE |
| Share price at grant date | £1.36 | £1.36 | £1.36 | £1.325 | £1.2075 |
| Exercise price | £1.36 | £1.36 | £1.36 | £1.325 | £1.0264 |
| Number of employees | 47 | 28 | 3 | 2 | 298 |
| Shares under option | 350,333 | 294,500 | 13,250 | 22,500 | 2,249,806 |
| Vesting period (years) | 1-4 | 1-4 | 4 | 3.9 | 2-5 |
| Expected volatility | 40% | 40% | 40% | 40% | 40% |
| Expected life (years) | 2-5 | 1-4 | 5 | 4 | 2-5 |
| Risk free rate | 4.0% | 4.0% | 4.0% | 4.0% | 4.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | 0.7% |
| Fair value per option | £0.33-£0.53 | £0.23-£0.47 | £0.53 | £0.46 | £0.38-£0.53 |
| Grant date | 1 Sep 2006 | 1 Sep 2006 | 1 Sep 2006 | 20 Nov 2006 | |
| Scheme | Unapproved | ISO | Belgian | Unapproved | |
| Share price at grant date | £1.1875 | £1.1875 | £1.1875 | £1.16 | |
| Exercise price | £1.1875 | £1.1875 | £1.1875 | £1.16 | |
| Number of employees | 16 | 8 | 2 | 8 | |
| Shares under option | 119,750 | 77,500 | 5,000 | 20,000 | |
| Vesting period (years) | 1-4 | 1-4 | 3.3 | 1-4 | |
| Expected volatility | 40% | 40% | 40% | 40% | |
| Expected life (years) | 2-5 | 1-4 | 4 | 2-5 | |
| Risk free rate | 4.5% | 4.5% | 4.5% | 5.0% | |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | |
| Fair value per option | £0.30-£0.47 | £0.21-£0.42 | £0.42 | £0.29-£0.47 | |
| Grant date | 4 Feb 2005 | 4 Feb 2005 | 4 Feb 2005 | 4 Feb 2005 | 4 Feb 2005 |
| Scheme | Performance | Approved | Unapproved | ISO | French |
| Share price at grant date | £1.055 | £1.055 | £1.055 | £1.055 | £1.055 |
| Exercise price | £1.055 | £1.055 | £1.055 | £1.055 | £1.055 |
| Number of employees | 6 | 175 | 500 | 435 | 29 |
| Shares under option | 3,119,627 | 840,249 | 9,794,828 | 8,540,500 | 423,772 |
| Vesting period (years) | 3 | 3 | 1-4 | 1-4 | 4 |
| Expected volatility | 50% | 50% | 50% | 50% | 50% |
| Expected life (years) | 4 | 4 | 2-5 | 1-4 | 5 |
| Risk free rate | 4.0% | 4.0% | 4.0% | 4.0% | 4.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | 0.7% |
| Fair value per option | £0.43 | £0.43 | £0.31-£0.48 | £0.22-£0.43 | £0.48 |

## 24 Share-based payments continued

| Grant date | 4 Feb 2005 | 27 Apr 2005 | 27 Apr 2005 | 27 Apr 2005 | 26 Jul 2005 |
|---|---|---|---|---|---|
| Scheme | Belgian | Unapproved | ISO | Belgian | Unapproved |
| Share price at grant date | £1.055 | £1.005 | £1.005 | £1.005 | £1.185 |
| Exercise price | £1.055 | £1.005 | £1.005 | £1.005 | £1.185 |
| Number of employees | 29 | 37 | 10 | 1 | 67 |
| Shares under option | 347,650 | 199,000 | 130,000 | 5,000 | 590,000 |
| Vesting period (years) | 3.9 | 1-4 | 1-4 | 3.7 | 1-4 |
| Expected volatility | 50% | 50% | 50% | 50% | 50% |
| Expected life (years) | 4 | 2-5 | 1-4 | 4 | 2-5 |
| Risk free rate | 4.0% | 4.0% | 4.0% | 4.0% | 4.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | 0.7% |
| Fair value per option | £0.43 | £0.30-£0.46 | £0.21-£0.41 | £0.41 | £0.35-£0.54 |

| Grant date | 26 Jul 2005 | 26 Jul 2005 | 26 Jul 2005 | 31 Oct 2005 | 31 Oct 2005 |
|---|---|---|---|---|---|
| Scheme | ISO | French | Belgian | Unapproved | ISO |
| Share price at grant date | £1.185 | £1.185 | £1.185 | £1.0425 | £1.0425 |
| Exercise price | £1.185 | £1.185 | £1.185 | £1.0425 | £1.0425 |
| Number of employees | 28 | 2 | 1 | 82 | 22 |
| Shares under option | 504,760 | 18,250 | 2,500 | 831,636 | 228,250 |
| Vesting period (years) | 1-4 | 4 | 3.4 | 1-4 | 1-4 |
| Expected volatility | 50% | 50% | 50% | 40% | 40% |
| Expected life (years) | 1-4 | 5 | 4 | 2-5 | 1-4 |
| Risk free rate | 4.0% | 4.0% | 4.0% | 4.0% | 4.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | 0.7% |
| Fair value per option | £0.25-£0.49 | £0.54 | £0.49 | £0.26-£0.40 | £0.18-£0.36 |

| Grant date | 31 Oct 2005 | 31 Oct 2005 | 20 Jun 2005 |
|---|---|---|---|
| Scheme | French | Belgian | SAYE |
| Share price at grant date | £1.0425 | £1.0425 | £1.07 |
| Exercise price | £1.0425 | £1.0425 | £0.9095 |
| Number of employees | 4 | 1 | 272 |
| Shares under option | 14,000 | 2,500 | 1,535,108 |
| Vesting period (years) | 4 | 3.2 | 2-5 |
| Expected volatility | 40% | 40% | 50% |
| Expected life (years) | 5 | 4 | 2-5 |
| Risk free rate | 4.0% | 4.0% | 4.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% |
| Fair value per option | £0.40 | £0.36 | £0.38-£0.54 |

The fair value of RSUs granted was estimated on the date of grant using the Black-Scholes option pricing model. As RSUs are share awards with no exercise price, all awards have been deemed to have an exercise price of £0.0000001 in the Black-Scholes model. The following assumptions for each RSU grant during 2006 were as follows:

| Grant date | 8 May 2006 | 8 May 2006 | 1 Sep 2006 | 1 Sep 2006 | 20 Nov 2006 |
|---|---|---|---|---|---|
| Scheme | RSU | French RSU | RSU | French RSU | RSU |
| Share price at grant date | £1.365 | £1.365 | £1.1875 | £1.1875 | £1.16 |
| Number of employees | 1,167 | 28 | 108 | 2 | 152 |
| Shares awarded | 6,282,180 | 164,292 | 623,402 | 2,852 | 890,676 |
| Vesting period (years) | 1-4 | 2-4 | 1-4 | 2-4 | 1-4 |
| Expected volatility | 40% | 40% | 40% | 40% | 40% |
| Expected life (years) | 1-4 | 2-4 | 1-4 | 2-4 | 1-4 |
| Risk free rate | 4.0% | 4.0% | 4.5% | 4.5% | 5.0% |
| Dividend yield | 0.7% | 0.7% | 0.7% | 0.7% | 0.7% |
| Fair value per award | £1.327-£1.355 | £1.327-£1.346 | £1.155-£1.179 | £1.155-£1.171 | £1.128-£1.152 |

## 24 Share-based payments continued

| | |
|---|---|
| Grant date | 20 Nov 2006 |
| Scheme | French RSU |
| Share price at grant date | £1.16 |
| Number of employees | 18 |
| Shares awarded | 189,445 |
| Vesting period (years) | 2-4 |
| Expected volatility | 40% |
| Expected life (years) | 2-4 |
| Risk free rate | 5.0% |
| Dividend yield | 0.7% |
| Fair value per award | £1.128-£1.144 |

The expected volatility was primarily based upon historical volatility adjusted for past one-time events that are not expected to re-occur. The expected life is the expected period to exercise.

A reconciliation of option and RSU movements over the year to 31 December 2006 is shown below. Note that RSUs do not have an exercise price and thus only a reconciliation of the number of awards has been shown and not of their weighted average exercise price.

| | **2006** | | | 2005 | |
|---|---|---|---|---|---|
| | **Options Number** | **Weighted average exercise price** | **RSUs Number** | Options Number | Weighted average exercise price |
| Outstanding at 1 January | **143,023,990** | **£1.014** | **–** | 164,019,815 | £0.870 |
| Granted | **9,064,290** | **£1.250** | **8,152,847** | 27,127,630 | £1.051 |
| Forfeited | **(8,491,783)** | **£1.499** | **(259,207)** | (11,012,172) | £1.103 |
| Expired | **(1,016,500)** | **£3.350** | **–** | (15,000) | £6.155 |
| Exercised | **(30,656,261)** | **£0.583** | **–** | (37,096,283) | £0.374 |
| Outstanding at 31 December | **111,923,736** | **£1.093** | **7,893,640** | 143,023,990 | £1.014 |
| Exercisable at 31 December | **74,533,736** | **£1.118** | **–** | 64,431,089 | £1.22 |

Shares options were regularly exercised during the year. The average share price in 2006 was £1.22 (2005: £1.13).

The following options over ordinary shares and RSU awards were in existence at 31 December 2006:

| | **2006** | | | | 2005 | | | |
|---|---|---|---|---|---|---|---|---|
| Exercise price (£) | **Number outstanding** | **Weighted average exercise price £** | **Weighted average remaining life in years Expected** | **Contractual** | Number oustanding | Weighted average exercise price £ | Weighted average remaining life in years Expected | Contractual |
| 0.00 (RSUs) | **7,893,640** | **–** | **1.96** | **1.96** | – | – | – | – |
| 0.02 – 0.40 | **15,662,942** | **0.25** | **0.97** | **4.24** | 22,988,380 | 0.26 | 0.97 | 5.31 |
| 0.405 – 0.50 | **21,310,841** | **0.45** | **1.32** | **4.13** | 33,861,103 | 0.45 | 1.36 | 5.23 |
| 0.51 – 0.9475 | **17,465,042** | **0.71** | **1.10** | **5.96** | 26,183,870 | 0.68 | 2.56 | 6.49 |
| 1.005 – 1.224 | **25,943,761** | **1.07** | **2.84** | **4.37** | 31,257,471 | 1.09 | 2.23 | 4.80 |
| 1.25 – 7.738 | **31,541,150** | **2.18** | **2.45** | **3.52** | 28,733,166 | 2.50 | 2.46 | 3.77 |
| **Total** | **111,923,736** | **1.09** | **1.91** | **4.31** | 143,023,990 | 1.01 | 1.93 | 5.09 |

## 25 Capital and other financial commitments

| | **2006 £000** | 2005 £000 |
|---|---|---|
| Contracts placed for future capital expenditure not provided in the financial statements | **525** | 1,371 |

## 26 Operating lease commitments – minimum lease payments

At 31 December 2006, the Group had commitments under non-cancellable operating leases as follows:

| | 2006 | | | 2005 | | |
|---|---|---|---|---|---|---|
| | Land and buildings £000 | Other £000 | Total £000 | Land and buildings £000 | Other £000 | Total £000 |
| **Commitments under non-cancellable operating leases expiring:** | | | | | | |
| Within one year | **5,209** | **11,564** | **16,773** | 4,787 | 1,569 | 6,356 |
| Later than one year and less than five years | **12,253** | **14,520** | **26,773** | 12,588 | 110 | 12,698 |
| After five years | **9,107** | **15** | **9,122** | 11,378 | – | 11,378 |
| **At 31 December 2006** | **26,569** | **26,099** | **52,668** | 28,753 | 1,679 | 30,432 |

## 27 Financial contingencies

**Legal claims** In May 2002, Nazomi Communications, Inc. ("Nazomi") filed suit against ARM alleging wilful infringement of Nazomi's US Patent No. 6,332,215 ("'215 Patent"). ARM answered Nazomi's complaint in July 2002 denying infringement. ARM moved for summary judgment and a ruling that the technology does not infringe Nazomi's patent. The United States District Court for the Northern District of California granted ARM's motion, and Nazomi appealed the District Court's ruling. In September 2004, the Court of Appeals for the Federal Circuit heard the appeal and issued its decision in April 2005. Because, in the opinion of the Court of Appeals for the Federal Circuit, the District Court did not construe the disputed claim term in sufficient detail for appellate review, the Court of Appeals for the Federal Circuit remanded the dispute back to the District Court for further analysis. A supplementary "Markman" hearing was held in October 2005 to decide the construction of a fundamental term in the '215 Patent and a decision on claim construction was delivered on 6 September 2006. The decision emphatically supports ARM's construction of the relevant term and consequently strongly supports ARM's non-infringement arguments. In December 2006, ARM filed a renewed motion for summary judgment and a ruling that the accused technology does not infringe the '215 patent. On 17 January 2007 Nazomi filed a response to ARM's renewed motion for summary judgment in which they stipulated that, based on the claim construction delivered by the District Court, the ARM technology accused in the suit does not infringe the '215 patent but also objected to the claim construction delivered by the District Court and indicated their intention to appeal the claim construction to the Court of Appeals for the Federal Circuit. On 30 January 2007, the District Court granted ARM's motion for summary judgment. Furthermore, on 13 February 2007, Nazomi filed notice of appeal to the Court of Appeals for the Federal Circuit. Based on independent legal advice, ARM is confident that the Court of Appeals will uphold the claim construction ruling delivered by the District Court in September 2006.

In October 2005, Technology Properties Limited, Inc. ("TPL") filed suit, in the United States District Court for the Eastern District of Texas (Marshall Division), against certain companies in the Fujitsu, Matsushita, NEC and Toshiba groups of companies alleging infringement of TPL's US Patents Nos. 5,809,336; 5,784,584 and 6,598,148 (the "Litigation"). All of the defendants are licensees of various ARM technologies. It was revealed as part of the preliminary infringement contentions in the Litigation, filed in July 2006, that certain ARM technology is alleged to infringe a single claim in US Patent No. 5,784,584 (the "'584 Patent"). In September 2006 ARM filed a motion to intervene in the Litigation and that motion has been granted. ARM is now a defendant party in the Litigation. The claim construction (or "Markman") hearing is scheduled for May 2007 and the trial date is scheduled for November 2007. Based on legal advice and written opinions received from external counsel, ARM is confident that the accused ARM technology does not infringe any of the claims of the '584 Patent or that the patent is invalid. ARM has voluntarily joined as a party to the Litigation to proactively defend its technology against ill-conceived and false infringement allegations and fully expects to prove the case for non-infringement or invalidity in the course of the Litigation.

ARM does not expect any significant liability in respect of these claims, except in relation to legal costs, for which £1.0 million has been accrued at 31 December 2006.

**Guarantees** It is common industry practice for licensors of technology to offer to indemnify their licensees for loss suffered by the licensee in the event that the technology licensed is held to infringe the intellectual property of a third party. Consistent with such practice, the Group provides such indemnification to its licensees but subject, in all cases, to a limitation of liability. The obligation for the Group to indemnify its licensees is subject to certain provisos and is usually contingent upon a third party bringing an action against the licensee alleging that the technology licensed by the Group to the licensee infringes such third party's intellectual property rights. The indemnification obligations typically survive any termination of the licence and will continue in perpetuity.

The Group does not provide for any such guarantees unless it has received notification from the other party that they are likely to invoke the guarantee. The provision is made if both of the following conditions are met: (i) information available prior to the issuance of the financial statements indicates that it is probable that a liability had been incurred at the date of the financial statements; and (ii) the amount of the liability can be reasonably estimated. Any such provision is based upon the directors' estimate of the expected costs of any such claim.

**Contingent consideration** Acquisition-related contingent consideration is disclosed in note 23.

## 28 Related party transactions

During the year, the Group paid royalty fees of £124,000 (2005: £33,000) and made cross-licence payments of £nil (2005: £26,000) to Superscape Group plc ("Superscape"), a company in which Mike Inglis, an executive director of the Group, is a non-executive director. Amounts owed to Superscape at 31 December 2006 and 2005 were £nil. In addition, in 2006 the Group received royalty fees of £19,000 (2005: £2,000) and licence fees of £nil (2005: £11,000) from Superscape. £17,000 was owed by Superscape at 31 December 2006 (2005: £nil).

Also in 2006, the Group received licence fees of £3,085,000 (2005: £321,000), support and maintenance income of £37,000 (2005: £37,000) and evaluation tools fees of £82,000 (2005: £17,000) from CSR plc, a company in which John Scarisbrick, a non-executive of the Group, is an executive director. Amounts owed by CSR at 31 December 2006 were £14,000 (2005: £nil).

During 2006, the Group received funding for SOI technology development of £319,000 from SOI TEC Silicon On Insulator Technologies SA ("Soitec"). Soitec is an SOI IP company in which Doug Dunn, Group Chairman, is a non-executive director. £383,000 is owed by Soitec at 31 December 2006.

There were no other related party transactions during 2006 or 2005 which require disclosure.

Key management compensation is disclosed in note 4.

## 29 Post-balance sheet events

After the year end, the directors declared payment of a final dividend in respect of 2006 of 0.6 pence per share. Subject to shareholder approval, the final dividend will be paid on 21 May 2007 to shareholders on the register on 4 May 2007. The final dividend has not been recognised as a distribution during the year ended 31 December 2006.

Following the year end, the UK Government announced a cut of 2% in the UK corporation tax rates for large businesses with effect from 1 April 2008. Although not material, an adjustment to the Group's deferred tax assets will be required in 2007.

## 30 Summary of significant differences between US GAAP and IFRS

**Goodwill** Under both IFRS and US GAAP, goodwill is not subject to amortisation, but is tested at least annually for impairment. As permitted by IFRS 1, the Group's goodwill under IFRS has been frozen at the amount recorded under UK GAAP as at 1 January 2004. Under US GAAP, following the provisions of SFAS 142, "Goodwill and other intangible assets", the carrying value of goodwill was frozen at the amount recorded under previous US GAAP as at 1 January 2002. Under both previous US GAAP and UK GAAP, goodwill was amortised over its useful economic life. Thus, while ongoing accounting policies in respect of goodwill are similar under US GAAP and IFRS, the difference in the dates of transition means that different amounts of goodwill are recorded.

Under US GAAP, certain costs to be incurred on restructuring on business combination are treated as a fair value adjustment in the balance sheet acquired. Under IFRS, these costs are expensed post-acquisition. Additionally, under US GAAP, tax benefits arising from the exercise of options issued as part of the consideration for a business combination become a deduction to goodwill, only to the extent that those benefits do not exceed the fair value of the consideration relating to those options at the appropriate tax rate. Any excess tax benefits are a deduction to equity. Under IFRS, the full tax benefit is a deduction to equity.

Where provisional assessments of the fair values of assets and liabilities acquired on acquisition are refined, adjustments to fair values are recorded as prior year adjustments to goodwill under IFRS. Under US GAAP, such revisions are recorded as amendments to goodwill in the subsequent year.

**Recognition and amortisation of intangibles** The Group has taken advantage of the exemption under IFRS 1 not to apply IFRS retrospectively to business combinations occurring before 1 January 2004. This means that for business combinations occurring before this date, the previously reported UK GAAP treatment has continued to be followed. Under previous UK GAAP, intangible assets were recognised separately from goodwill only where they could be sold separately without disposing of a business of the entity. This separability criterion does not apply under either IFRS or US GAAP. Thus, a number of intangible assets which are required to be recognised separately from goodwill under both IFRS 3 and SFAS 142, were subsumed within goodwill under UK GAAP. Under both US GAAP and IFRS, such intangible assets are amortised over their useful economic lives. Except in relation to in-process research and development (see below), there is no difference in accounting policy for intangible assets recognised as a result of business combinations entered into after 1 January 2004.

**In-process research and development** Under IFRS, in-process research and development projects purchased as part of a business combination may meet the criteria set out in IAS 38, "Intangible assets", for recognition as intangible assets other than goodwill and are amortised over their useful economic lives commencing when the asset is brought into use. Under US GAAP, in-process research and development is immediately written-off to the income statement. This accounting policy difference gives rise to an associated difference in deferred tax.

**Valuation of consideration on business combination** Under both IFRS and US GAAP, the fair value of consideration in a business combination includes the fair value of both equity issued and any share options granted as part of that combination. Under IFRS, any equity issued is valued at the fair value as of the date of completion, whilst under US GAAP, the equity is valued at the date the terms of the combination were agreed to and announced. For options, under US GAAP, the fair value is based upon the total number of options granted, both vested and unvested, whilst under IFRS the fair value only includes those that have vested, together with a pro-rata value for partially vested options. Furthermore, where there is contingent consideration for an acquisition, under IFRS this is recognised as part of the purchase consideration if the contingent conditions are expected to be satisfied, whilst under US GAAP it is only recognised if the conditions have actually been met, other than to the extent necessary to eliminate any potential negative goodwill under US GAAP.

## 30 Summary of significant differences between US GAAP and IFRS continued

**Deferred compensation** Under US GAAP, the intrinsic value of unvested share options issued by an acquirer as part of a business combination in exchange for unvested share options of the acquiree is recorded as a debit balance within shareholders' funds. This amount is charged to the income statement over the vesting period of the share options in accordance with FIN 28. Under IFRS, no such adjustment to shareholders' funds is made on acquisition. Following the adoption of FAS No. 123 (revised 2004) (FAS 123(R)), "Share-based payment", the unamortised balance has been transferred to additional paid-in capital.

**Compensation charge in respect of share-based payments** The Group issues equity-settled share-based payments to certain employees. In accordance with IFRS 2, equity-settled share-based payments are measured at fair value at the date of grant, using the Black-Scholes pricing model. 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 the number of shares that will eventually vest. Under US GAAP, the Group is required, effective as of 1 January 2006, to adopt FAS123(R). FAS123(R) requires the Group to expense share-based payments, including employee share options, based on their fair value. The Group has elected to utilise the "modified prospective" method of adoption, such that compensation cost is recognised beginning with the effective date (i) based on the requirements of FAS123(R) for all share-based payments granted after the effective date and (ii) based on the requirements of FAS123(R) for all awards granted to employees prior to the effective date of FAS123(R) that remain unvested on the effective date.

Some awards made by the Group are liability-classified awards under FAS123(R) as either: (i) there is an obligation to settle a fixed monetary amount in a variable number of shares; or (ii) the award is indexed to a factor other than performance, market or service condition. The fair value of these awards is remeasured at each period end until the award has vested. Once the award has vested, or for (i) above when number of shares becomes fixed, the award becomes equity-classified.

In 2005 under US GAAP, the Group had elected to use the intrinsic value-based method to account for all its employee share-based compensation plans, under the recognition and measurement principles of APB Opinion No. 25, "Accounting for stock issued to employees", and related interpretations. Thus no compensation expense was recorded in 2005 where the exercise price of the option was equal to the share price on the date of grant.

In 2005 under US GAAP, the Group recognised a compensation charge in respect of the UK SAYE plans. The compensation charge was calculated as the difference between the market price of the shares at the date of grant and the exercise price of the option and was recorded on a straight-line basis over the savings period. In addition, certain options attracted a charge under variable plan accounting under US GAAP. Under IFRS, this charge is calculated in the same manner as other share-based payments, as detailed above.

In 2005 under US GAAP, the Group followed variable plan accounting for the LTIP grants, measuring compensation expense as the difference between the exercise price and the fair market value of the shares at each period end over the vesting period of the options. Increases in fair market value of the shares resulted in a charge and decreases in fair market value of the shares resulted in a credit, subject to the cumulative amount previously expensed. Under IFRS, this charge is calculated in the same manner as other share-based payments, as detailed above.

**Deferred tax on UK and US share options** In the US and the UK, the Group is entitled to a tax deduction for the amount treated as employee compensation under US and UK tax rules on exercise of certain employee share options. The compensation is equivalent to the difference between the option exercise price and the fair market value of the shares at the date of exercise.

Under IFRS, deferred tax assets are recognised and are calculated by comparing the estimated amount of tax deduction to be obtained in the future (based on the Group's share price at the balance sheet date) with the cumulative amount of the compensation expense recorded in the income statement. If the amount of estimated future tax deduction exceeds the cumulative amount of the remuneration expense at the statutory tax rate, the excess is recorded directly in equity, against the profit and loss reserve. In accordance with the transitional provisions of IFRS 2, no compensation charge is recorded in respect of options granted before 7 November 2002 or in respect of those options which have been exercised or have lapsed before 31 December 2004. Nevertheless, tax deductions have arisen and will continue to arise on these options. The tax effects arising in relation to these options are recorded directly in equity, against retained earnings.

Under US GAAP, deferred tax assets are recognised by multiplying the compensation expense recorded by the prevailing tax rate in the relevant tax jurisdiction. Where, on exercise of the relevant option, the tax benefit obtained exceeds the deferred tax asset in relation to the relevant options, the excess is recorded in additional paid-in capital. Where the tax benefit is less than the deferred tax asset, the write-down of the deferred tax asset is recorded against additional paid-in capital to the extent of previous excess tax benefits recorded in this account, with any remainder recorded in the income statement.

**Employer taxes on share options** Under IFRS, employer's taxes that are payable on the exercise of share options are provided for over the vesting period of the options. Under US GAAP, such taxes are accounted for when the options are exercised.

**Accrued legal costs** Under IFRS, future legal fees that the Group is expecting to incur on current cases are accrued when the obligating event giving rise to the legal costs has occurred. Under US GAAP, such costs are charged to the income statement in the period in which the costs are incurred.

## 30 Summary of significant differences between US GAAP and IFRS continued

### a) Reconciliation of IFRS profit to US GAAP net income

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Profit for the financial year as reported under IFRS** | **48,588** | 29,647 |
| Adjustments for: | | |
| Amortisation of intangibles | **914** | 548 |
| Write-off of in-process research and development | **(595)** | (335) |
| Deduct: US GAAP compensation charge in respect of LTIP | **–** | (3,814) |
| Deduct: US GAAP compensation charge in respect of SAYE schemes | **–** | (417) |
| Deduct: US GAAP deferred stock-based compensation re. acquisition | **–** | (5,496) |
| Deduct: US GAAP compensation charge in respect of all share-based payments | **(21,787)** | – |
| Add: IFRS compensation charge in respect of all share-based payments | **17,437** | 20,863 |
| Employer's taxes on share options | **8** | 3 |
| Utilisation of restructuring provision | **–** | 1,368 |
| Provision for legal costs (net of tax) | **715** | – |
| Foreign exchange on contingent consideration | **(104)** | 40 |
| Tax on UK and US share options | **(2,204)** | (370) |
| Tax difference on amortisation of intangibles | **(378)** | (248) |
| Tax difference on share-based payments | **2,569** | 91 |
| **Net income as reported under US GAAP** | **45,163** | 41,880 |

### b) Reconciliation of shareholders' equity from IFRS to US GAAP

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Shareholders' funds as reported under IFRS** | **663,204** | 746,847 |
| Adjustments for: | | |
| Employer's taxes on share options | **38** | 30 |
| Utilisation of restructuring provision | **1,368** | 1,368 |
| Provision for legal costs (net of tax) | **715** | – |
| Liability-classified share awards | **(2,416)** | – |
| Cumulative difference on amortisation of goodwill | **2,713** | 2,713 |
| Cumulative difference on amortisation of intangibles | **1,355** | 441 |
| Cumulative write-off of in-process research and development | **(4,692)** | (4,097) |
| Cumulative difference on deferred tax | **(642)** | (263) |
| Valuation of equity consideration on acquisition | **(82,435)** | (82,435) |
| Valuation of option consideration on acquisition | **17,476** | 17,476 |
| Deferred compensation on acquisition | **(9,579)** | (9,579) |
| Deferred tax on share-based payments | **(8,911)** | (8,775) |
| Portion of tax benefit arising on exercise of options issued on acquisition taken to goodwill under US GAAP | **(4,844)** | (4,844) |
| Foreign exchange on valuation of intangible assets and deferred tax | **1,358** | (9,872) |
| Foreign exchange on valuation of contingent consideration | **(61)** | 40 |
| **Shareholders' equity as reported under US GAAP** | **574,647** | 649,050 |

### c) Reconciliation of goodwill from IFRS to US GAAP

| | 2006 £000 | 2005 £000 |
|---|---|---|
| **Goodwill as reported under IFRS** | **428,366** | 474,338 |
| Adjustments for: | | |
| Amendments to provisional fair values | **1,235** | 1,248 |
| Cumulative difference on amortisation of goodwill | **2,713** | 2,713 |
| Cumulative write-off of in-process research and development | **(150)** | (150) |
| Separately identifiable intangible assets | **(302)** | (302) |
| Deferred tax on capitalised in-process research and development | **(1,570)** | (1,570) |
| Portion of tax benefit arising on exercise of options issued on acquisition taken to goodwill under US GAAP | **(4,248)** | (4,248) |
| Valuation of equity consideration on acquisition | **(82,435)** | (82,435) |
| Valuation of option consideration on acquisition | **17,476** | 17,476 |
| Deferred compensation on acquisition | **(9,579)** | (9,579) |
| Contingent consideration | **(3,117)** | (1,785) |
| Foreign exchange on revaluation of goodwill | **854** | (10,134) |
| **Goodwill as reported under US GAAP** | **349,243** | 385,572 |

# Selected consolidated financial data/US GAAP

The following selected financial data should be read in conjunction with, and is qualified in its entirety by reference to, the financial statements of ARM Holdings plc ("the Company"), expressed in sterling, set forth on pages 86 to 114 of this report.

**Selected consolidated financial data – US GAAP**

| | 2002<br>£000 | 2003<br>£000 | 2004<br>£000 | 2005<br>£000 | **2006**<br>**£000** |
|---|---|---|---|---|---|
| Revenues | 150,922 | 128,070 | 152,897 | 232,439 | **263,254** |
| Cost of revenues | (13,185) | (11,022) | (11,799) | (27,847) | **(30,877)** |
| Operating expenses | (96,456) | (99,785) | (109,587) | (156,675) | **(187,357)** |
| Income from operations | 41,281 | 17,263 | 31,511 | 47,917 | **45,020** |
| Interest | 4,373 | 4,801 | 6,944 | 5,317 | **6,758** |
| Profit on disposal of available-for-sale security | – | – | – | – | **5,270** |
| Minority interest | (232) | (105) | – | – | **–** |
| Income before income tax and cumulative effect of change in accounting policy | 45,422 | 21,959 | 38,455 | 53,234 | **57,048** |
| Provision for income taxes | (13,785) | (8,943) | (10,478) | (11,354) | **(9,438)** |
| Net income before cumulative effect of change in accounting policy | 31,637 | 13,016 | 27,977 | 41,880 | **47,610** |
| Cumulative effect of change in accounting policy | – | – | – | – | **(2,447)** |
| Net income | 31,637 | 13,016 | 27,977 | 41,880 | **45,163** |
| Diluted earnings per common share | 3.1p | 1.3p | 2.7p | 2.9p | **3.2p** |
| Research and development as a percentage of revenues | 31.3% | 37.6% | 33.0% | 26.5% | **28.7%** |
| Capital expenditure | £15,616 | £3,605 | £5,036 | £6,064 | **£8,559** |
| Cash, cash equivalents, short-term investments and marketable securities | £130,304 | £159,786 | £142,817 | £160,902 | **£128,494** |
| Shareholders' equity | £172,470 | £188,075 | £552,327 | £649,050 | **£574,647** |
| Total assets | £205,744 | £222,997 | £637,937 | £716,093 | **£652,703** |
| Employees at year end (number) | 721 | 740 | 1,171 | 1,324 | **1,659** |

# Operating and financial review and prospects/US GAAP

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto. The matters addressed in this operating and financial review and prospects, with the exception of the historical information presented, contain forward-looking statements involving risks and uncertainties.

**Overview** ARM designs the technology that lies at the heart of advanced digital products, from wireless, networking and consumer entertainment solutions to imaging, automotive, security and storage devices. ARM's comprehensive product offering includes 16/32-bit RISC microprocessors, data engines, graphics processors, digital libraries, embedded memories, peripherals, software and development tools, as well as analog functions and high-speed connectivity products. The Company licenses this technology to semiconductor companies which, in turn, manufacture, market and sell microprocessors and related products. ARM has developed an innovative, intellectual property-centred and market-driven business model in which it neither manufactures nor sells the products incorporating ARM technology, but concentrates on the research and development, design and support of the ARM architecture and supporting development tools and software. Combined with the Company's broad Partner community, they provide a total system solution that offers a fast, reliable path to market for leading electronics companies.

**Market conditions** 2006 was another year of healthy growth, approximately 10%, for the semiconductor industry as a whole, although it began to show signs of slowing by the end of the year. Looking into 2007, we expect the industry to continue to be impacted by the inventory correction in the first half at least, but we believe that the effect on ARM will be attenuated and we expect to exceed the industry growth rate in 2007 as we have done in past years. This is underpinned by a healthy technology portfolio of processor and physical IP, comprising both new and mature products.

The Company has remained both profitable and cash generative (before investing activities). On operating profits of £45.0 million, cash inflows from operating activities were £66.1 million, cash returned to shareholders through dividends and share buybacks of £88.9 million and a year-end cash, cash equivalents, short-term investments and marketable securities balance of £128.5 million.

The table below sets forth, for the periods indicated, the percentage of total revenues represented by certain items reflected in the Company's consolidated statements of income.

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 | 2005 | **2006** |
| | % | % | **%** |
| **Revenues:** | | | |
| Product revenues | 90.7 | 93.7 | **93.9** |
| Service revenues | 9.3 | 6.3 | **6.1** |
| **Total revenues** | 100.0 | 100.0 | **100.0** |
| **Cost of revenues:** | | | |
| Product costs | 4.4 | 9.4 | **9.1** |
| Service costs | 3.3 | 2.6 | **2.6** |
| Total cost of revenues | 7.7 | 12.0 | **11.7** |
| **Gross profit** | 92.3 | 88.0 | **88.3** |
| **Operating expenses:** | | | |
| Research and development | 33.0 | 26.5 | **28.7** |
| Sales and marketing | 15.8 | 15.6 | **16.8** |
| General and administrative | 20.2 | 17.7 | **18.5** |
| In-process research and development | 2.3 | 0.1 | **0.2** |
| Amortization of intangibles purchased through business combination | 0.4 | 7.5 | **7.0** |
| **Total operating expenses** | 71.7 | 67.4 | **71.2** |
| **Income from operations** | 20.6 | 20.6 | **17.1** |
| Interest | 4.5 | 2.3 | **2.6** |
| Profit on disposal of available-for-sale security | – | – | **2.0** |
| **Income before income tax and cumulative effect of change in accounting policy** | 25.1 | 22.9 | **21.7** |
| Provision for income taxes | 6.8 | 4.9 | **3.6** |
| **Net income before cumulative effect of change in accounting policy** | 18.3 | 18.0 | **18.1** |
| Cumulative effect of change in accounting policy, net of tax | – | – | **0.9** |
| **Net income** | 18.3 | 18.0 | **17.2** |

**Total revenues** Total revenues were £263.3 million, an increase of 13% from £232.4 million in 2005, which was an increase of 52% from £152.9 million in 2004. Dollar revenues were $483.6 million in 2006, an increase of 16% from $418.7 million in 2005, which was an increase of 54% from $272.4 million in 2004. The actual average dollar exchange rate in 2006 was $1.84 compared with $1.80 in 2005. This had the effect of reducing total reported revenues by approximately £5.1 million. The figures for 2004 do not include revenues for the Artisan business acquired in December 2004 (now the Physical IP Division). If these were included, dollar revenues increased by 18% in 2005 from the pro forma $355.5 million in 2004 of the combined ARM and Artisan businesses.

**Product revenues** Product revenues consist of license fees, sales of development systems and royalties. Product revenues for 2004, 2005 and 2006 were £138.7 million, £217.7 million and £247.2 million, representing 91%, 94% and 94% of total revenues respectively.

License revenues increased from £59.4 million in 2004 to £104.2 million in 2005, and increased further to £110.6 million in 2006 representing approximately 39%, 45% and 42% of total revenues in 2004, 2005 and 2006 respectively.

Processor Division (PD) dollar license revenues have grown by 19% and 12% in 2005 and 2006 respectively. The portfolio of licensable products comprises a rich mix of proven ARM technology, such as the ARM7, ARM9 and ARM11 families of products and newer technology in the Cortex family of products. Three Cortex products became available for general licensing during 2006.

65 new licenses were signed in 2006 compared to 71 in 2005 and 64 in 2004. ARM11 accounted for 22% of PD license revenues in 2006, compared to 21% in 2005 and 17% in 2004. Revenues from Cortex family products accounted for 26% of PD license revenues in 2006, compared to 16% in 2005. Cortex products started generating revenue in 2005. 23 companies became new ARM Partners in 2006, bringing the total number of semiconductor partners to 188 at the end of 2006. This total number of semiconductor partners was net of those companies that have signed licenses with ARM in the past but have since been acquired by other companies or who no longer have access to ARM technology for other reasons.

Having licensed Cortex family products to lead partners prior to 2006, the current portfolio of three Cortex family products became available for more general licensing as the year progressed. During 2006, 13 Cortex family licenses were signed, bringing the accumulated total of Cortex family licenses to 23, signed by 18 semiconductor companies.

In addition, 2006 continued to be a year of strong licensing of the ARM11 family of products. In the year, ARM signed 15 ARM11 family licenses, bringing the total number to 52 from 36 semiconductor companies. 2006 signified a shift in ARM11 family licensing activity from the traditional first-mover mobile companies with the majority of licenses being taken for applications outside of the mobile segment.

As part of the Cortex family licensing in 2006, ARM signed a lead partner agreement with a semiconductor company for the next-generation Cortex microprocessor. This product is expected to become available for mainstream licensing in 2008.

License revenues from non-core products, covering items such as platforms, peripherals, embedded trace modules, embedded software, data engines, models and sub-systems were £10.9 million in 2006, compared to £11.1 million in 2005 and £10.5 million in 2004 representing approximately 14% of processor license revenues in 2006, 16% in 2005 and 18% in 2004.

In 2006 ARM maintained progress in achieving the long-term strategic goal of providing ARM's physical IP to leading Integrated Device Manufacturer (IDM) and Fabless semiconductor companies and continued to sign synergistic licenses that have been enabled by the combination of ARM and Artisan. Synergistic deals include, in management's determination, both instances of physical IP being licensed to ARM Partners and instances of contracts being won against the competition due to both processor and physical IP being available from ARM.

Licensing momentum for ARM's 65nm physical IP products grew, with 12 new licenses signed in 2006. By the end of 2006, ARM had signed a total of 25 65nm licenses with 10 companies and had signed seven licenses for physical IP with four Foundries at the most advanced process of 45nm. ARM's Physical IP division (PIPD) reported license revenues of £34.9 million in 2006, representing approximately 31% of total license revenues.

During 2006 the combination of ARM and Artisan has continued to provide benefits other than synergistic license revenues. In addition to the benefits to the Cortex range of processors, including the development of the new 12 track Advantage libraries in 65nm enabling higher performance, and the high-performance ARM1176JZF-S implementation, the combination has enabled the development of lower-power processors with lower leakage, a new compact ARM11 MPCore dual processor delivering greater performance at lower power and development work on 45nm physical IP which will influence and optimize the design of future processors.

Revenues from the sale of development systems increased from £19.7 million in 2004 to £25.6 million in 2005 to £28.8 million in 2006 representing approximately 13%, 11% and 11% of total revenues in 2004, 2005 and 2006 respectively. This growth has been generated by working with customers on longer-term relationships for the supply of RealView® Developer tools for software development, continued momentum behind the RealView Create tools for ESL customers and a healthy market place for tools to support the broad portfolio of ARM microprocessors. Development Systems has entered into more multi-year contracts for larger product volumes which improves the visibility of business going forward and builds a good customer base from which to drive new innovation.

Royalties are either set as a percentage of the licensee's average selling price (ASP) per chip or, less frequently, as a fixed amount and are recognized when the Company receives notification from the customer of product sales. In effect, this means that it is normally in the quarter following the shipments that data is received and so royalty data for a year reflects actual shipments made from the beginning of October of the previous year to the end of September of the current year. As the penetration of ARM technology-based chips grows across a wide range of end-market applications, the range of ASPs gets wider. The average royalty rate (ARR) earned by ARM in any one reporting period is dependent on the mix of the ASPs of the chips shipped in that period. In 2006, significant unit volume growth was driven by products which incorporate chips with lower ASPs including ultra low cost handsets, smartcards, microcontrollers and Bluetooth chips. As a result, the ARR in 2006 was 6.7 cents compared to 7.9 cents in 2005. Unit volume growth more than compensated for this reduction in ARR and dollar royalty revenues grew by 25% year-on-year.

Royalties increased from £59.6 million in 2004 to £87.8 million in 2005 and increased further to £107.8 million in 2006, representing 39%, 38% and 41% of total revenues in 2004, 2005 and 2006 respectively. Royalty revenues in 2006 comprised £88.7 million from PD and £19.1 million from PIPD. PD volume shipments increased from 1,272 million units in 2004 to 1,662 million in 2005, with the increase in volumes coming from all market segments. Total unit shipments in 2006 of 2,450 million represented an increase of 47% compared to 2005. Unit shipments in the mobile segment grew by 50% year-on-year and in the non-mobile segments by 42%. Growth in the non-mobile segments was achieved across a broad range of product applications including smartcards, microcontrollers, automotive, connectivity devices, hard disk drives and many others.

The Company expects royalty revenues to grow year-on-year although they may be subject to significant fluctuations from quarter to quarter. The total number of partners shipping ARM technology-based products at the end of 2006 was 76 after taking into account corporate activity within the ARM partnership. 29 companies are paying royalties for physical IP products at the end of the year. PIPD royalties have grown in 2006, demonstrating the increased widespread use of ARM physical IP in chip designs.

**Service revenues** Service revenues consist of design consulting services and revenues from support, maintenance and training. Service revenues increased from £14.2 million in 2004 to £14.7 million in 2005 and further to £16.1 million in 2006, representing 9%, 6% and 6% of total revenues in 2004, 2005 and 2006 respectively. Services revenues in US dollars, being the primary currency of revenues generated grew from $25.1 million in 2004 to $26.5 million in 2005 and $29.1 million in 2006.

**Geographic analysis** Operating in a global environment, the geographic destinations of the Company's revenues fluctuate from period to period depending upon the country in which its customers are located. The pattern of revenues in 2006 was 42% of revenues coming from the US, 16% from Japan, 26% from Asia Pacific, excluding Japan, and 16% from Europe. In 2005, revenues from the US represented 43%, Japan 18%, Asia Pacific, excluding Japan, 25%, and Europe 14%. In 2004, revenues from the US represented 51%, Japan 21%, Asia Pacific, excluding Japan, 12%, and Europe 16%.

**Product costs** Product costs are limited to variable costs of production such as the costs of manufacture of development systems, amortization of our third-party technology licenses, cross-license payments to collaborative partners and time of engineers on PIPD projects. Product costs were £6.7 million in 2004, £21.8 million in 2005 and £24.2 million in 2006, representing 4%, 9% and 9% of total revenues in 2004, 2005 and 2006 respectively. The large increase in product costs in 2005 was as a result of the PIPD direct costs of revenue, namely the associated engineering time spent on revenue-bearing projects. Approximately two-thirds of total product cost of sales were made up of development systems costs in 2004, with the balance comprising additional costs related to the costs of third-party licenses and cross-license payments to collaborative partners. In 2005 and 2006, the proportion of development systems costs fell to approximately a quarter, PIPD direct costs approximately two-thirds and the balance third-party licenses and cross-license payments. Product gross margin in 2006 was 90%, compared to 90% in 2005 and 95% in 2004. Included within product costs in 2005 and 2006 are £2.5 million of deferred stock-based compensation relating to options assumed on the Artisan acquisition and £1.1 million of FAS 123R stock-based compensation following the adoption of this standard in 2006. The Company does not currently expect a significant increase in product costs in 2007.

**Service costs** Service costs include the costs of support and maintenance services to licensees of ARM technology as well as the costs directly attributable to consulting work performed for third parties. Cost of services increased from £5.1 million in 2004 to £6.1 million in 2005 and £6.7 million in 2006. The gross margins earned on service revenues were approximately 64% in 2004, 59% in 2005 and 58% in 2006. Whilst services revenues remained relatively flat in 2004 and 2005, costs have increased as the business invests more into the engineering departments, a proportion of which is allocated to services costs. The margin in 2006 was slightly lower primarily due to US dollar foreign exchange rates having a greater impact on revenues than costs.

**Research and development costs** Research and development costs increased from £50.4 million in 2004 to £61.6 million in 2005 to £75.5 million in 2006, representing 33%, 27% and 29% of total revenues in 2004, 2005 and 2006 respectively. Costs in 2006 included £10.6 million of share-based compensation charges in accordance with FAS 123R and in 2004 and 2005 included £0.3 million and £1.6 million of deferred share-based compensation respectively, in accordance with previously applicable standards. Excluding these charges, R&D costs were 33%, 26% and 25% of total revenues in 2004, 2005 and 2006 respectively. Continued investment in research and development remains an essential part of the Company's strategy since the development of new products to license is key to its ongoing success.

Total engineering headcount increased from 739 at the end of 2004 to 846 at the end of 2005 with the increases coming from organic growth predominantly in India but in all locations around the world, as well as from the Keil acquisitions. Engineering headcount at the end of 2006 was 1,083 with the increases again coming predominantly from organic growth in India but also from the Falanx and Soisic acquisitions. Staff costs increased in line with these headcount figures, but bonuses payable on the achievement of financial performance targets were paid in 2004 and 2006, with only a negligible amount payable in 2005.

**Sales and marketing** Sales and marketing expenditure increased from £24.2 million in 2004 to £36.2 million in 2005 and was £44.2 million in 2006, representing 16% of total revenues in 2004, 16% in 2005, and 17% in 2006. Costs in 2006 included £3.7 million of FAS 123R compensation charge and in 2004 and 2005 included £0.2 million and £2.1 million of deferred stock-based compensation. The proportion of sales and marketing costs to revenue in 2004, 2005 and 2006 excluding these charges were 16%, 15% and 15% respectively. Headcount in this area increased from 282 at the end of 2004 to 297 at the end of 2005, and was 337 at the end of 2006. As the Company increases its technological portfolio, further investment has been made to strengthen customer support and after-sales service. Staff bonuses fluctuated in each year as shown above.

**General and administrative** General and administrative headcount at 31 December 2006 was 239, up from 181 at the end of 2005 and 150 at the end of 2004. The increases year-on-year have partly come from the acquisitions but also organic growth to strengthen the infrastructure of the Company as it continually expands. Staff bonuses fluctuated in each year as shown above. General and administrative costs were £30.8 million in 2004, £41.1 million in 2005 and £48.6 million in 2006, representing 20%, 18% and 18% of total revenues respectively. Excluding £0.4 million and £3.5 million of deferred stock-based compensation in 2004 and 2005 and £2.9 million of FAS 123R compensation costs in 2006, G&A costs were 20%, 16% and 17% of total revenues in 2004, 2005 and 2006 respectively.

Litigation costs were £5.1 million in 2004, £0.4 million in 2005 and £0.8 million in 2006, fluctuations arising largely as a result of annual variations in the amount of legal expenses relating to patent protection cases and other similar costs. £4.5 million of these costs in 2004 related to a technology license agreement signed in the year.

Expense in relation to provisions for doubtful debts and write-offs were £0.9 million in 2006, £0.5 million in 2005 and a release of £0.3 million in 2004. Unrealized future foreign exchange losses on certain committed but not yet invoiced future revenue streams of £0.9 million (2005: gains of £2.1 million; 2004: losses of £0.7 million) were recorded in accordance with SFAS 133. There was a loss on foreign exchange of £1.5 million and £2.3 million in 2004 and 2005 respectively and a gain of £3.6 million in 2006, mainly as a result of the revaluation of an intra-group dollar loan. See "Foreign Currency Fluctuations" below.

Other increases in 2006 over 2005 include additional recruitment and training costs for the net increase of 335 employees in the Company in the year, increased IT costs to continually develop the ARM internal network as the number of offices and people grow and increased administrative costs relating to Sarbanes-Oxley compliance work.

**In-process research and development** During 2004, the Company purchased Axys Design Automation Inc. and Artisan Components Inc. (now ARM Inc.). Those intangible assets that were still in development (known as in-process research and development) were charged directly to the income statement, amounting to £0.4 million and £3.2 million for Axys and Artisan respectively. A further £0.3 million of Artisan in-process research and development was charged to the income statement in 2005 as the final valuation of intangibles was completed. In 2006, the Company acquired certain assets of PowerEscape, resulting in £0.6 million of in-process research and development being charged to the income statement. All acquired in-process research and development from the Axys, Artisan and PowerEscape acquisitions are progressing as expected with some still incomplete as at 31 December 2006.

**Amortization of intangible assets** Various licenses to use third party technology have been signed over the past several years, with their values being capitalized and amortized over the useful economic period that the Company is expected to gain benefit from them (generally between three and five years). Licenses totaling £5.9 million were purchased during 2001 to 2005 with amortization of these licenses amounting to £0.4 million in 2006 (2005: £0.5 million; 2004: £0.5 million). At 31 December 2006, the net book value of these assets was £0.6 million which will be amortized over the next three years.

Following the out-of-court settlement of the Company's litigation against picoTurbo, Inc. in December 2001, picoTurbo assigned its intellectual property rights to the Company for a payment of £7.5 million. This has been amortized over four years and £1.5 million was charged to the income statement in 2002 and £2.0 million in 2003, 2004 and 2005. The asset was fully written-down in 2005 and thus there was no further amortization charge in 2006. The Company also purchased a patent for £0.7 million in 2002 which is being amortized over five years. The amortization charge was £0.1 million in 2004, 2005 and 2006.

During 2003, the Company purchased Adelante Technologies NV (now ARM Belgium NV). Included with the assets purchased were £0.3 million of intangible assets comprising developed technology and customer relationships which are being amortized over five years and two years respectively. The amortization charge for the assets during 2005 and 2004 was £0.1 million in each year, but was less than £0.1 million in 2006.

During 2004, the Company purchased Axys Design Automation Inc. and Artisan Components Inc. (now ARM Inc.) Intangibles acquired and capitalized as part of these business combinations (including developed and core technology, customer relationships and trademarks) totaled £1.9 million and £70.9 million respectively and are being amortized over five years and between one and six years respectively (see note 6 for further details). The total charge during 2004 was £0.1 million and £0.3 million for Axys and Artisan respectively, during 2005 was £0.4 million and £16.5 million and during 2006 was £0.4 million and £14.6 million respectively.

During 2005, the Company purchased Keil Elektronik GmbH and Keil Software Inc. Intangibles acquired and capitalized consisted of developed technology, customer relationships and tradenames and totaled £8.7 million. These are being amortized between two and five years and the amortization totaled £0.4 million during 2005 and £2.5 million in 2006.

During 2006, the Company purchased Falanx Microsystems AS, a graphics IP company in Norway. Intangibles acquired and capitalized consisted of developed technology and customer relationships and totaled £5.3 million. These are being amortized over three to five years and the charge in 2006 was £0.7 million. The Company also purchased Soisic SA, an IP company based in France and the US. Intangibles acquired and capitalized were all developed technology and totaled £4.3 million. This is being amortized over five years with £0.1 million being charged in 2006.

**Interest** Interest receivable decreased from £6.9 million in 2004 to £5.3 million in 2005, but increased in 2006 to £6.8 million. The growth in interest in 2006 was due to higher average cash balances and increasing interest rates. The fall in 2005 was a result of the cash outflow at the end of 2004 for the acquisition of Artisan. The Company invested cash balances over periods of up to one year during 2006, although most were for periods less than six months.

**Profit on disposal of available-for-sale security** In 2006, the Company disposed of its investment in CSR plc for cash proceeds of £5.6 million and realized a profit of £5.3 million. The Company made no profit or loss on its disposal of a minority investment in Zeevo Inc. in 2005.

**Income before income tax and cumulative effect of change in accounting policy** Income before income tax was £38.5 million in 2004, £53.2 million in 2005 and £57.0 million in 2006, representing 25%, 23% and 22% of total revenues respectively. The primary reason for the fall in margin in 2005 was due to acquisition-related charges (in-process research and development of £0.3 million and £17.4 million of business combination intangible amortization) and deferred stock-based compensation of £10.4 million. The margin fell again in 2006 due to FAS 123R share-based compensation charges of £18.3 million, intangible amortization relating to business combinations of £19.0 million, increased investment throughout the business in additional headcount as well as the negative impact of foreign exchange with the weakening of the US dollar in the year.

**Tax charge** The Company's effective tax rates were 27.2% in 2004, 21.3% in 2005 and 16.5% in 2006. The effective tax rate in 2004 was lower than the blended tax rates from the relevant tax jurisdictions due to additional costs being allowable for research and development tax credits, additional deferred tax credits arising from employee share options and some of the non-cash accounting charges being claimed in 2004. It fell further in 2005 primarily as a result of benefits arising from the structuring of the Artisan acquisition, as well as increased benefits of research and development tax credits. It fell further in 2006 due to a non-recurring tax credit arising from a tax-deductible foreign exchange loss and continued benefits from the structuring of the Artisan acquisition.

**Cumulative effect of change in accounting policy** On 1 January 2006, the Company adopted FAS 123R as detailed in the accounting for share-based payments section of the significant accounting policies in note 1. The transitional rules detailed in FAS 123R require the Company to make a remeasurement adjustment for compensation cost for liability awards that has been recognized in the current year as a cumulative effect of change in accounting policy in the income statement. The charge in the year, net of tax, was £2,447,000.

**Liquidity and capital resources** The Company's operating activities provided net cash of £46.5 million, £47.2 million and £66.1 million in 2004, 2005 and 2006 respectively.

Accounts receivable increased by £1.4 million in 2004, £21.2 million in 2005 and a further £19.0 million in 2006. This is partly due to the overall increasing revenues earned in the periods leading up to the end of the respective years but largely to do with timing of invoicing in the respective periods. In the final week of 2006, there was significantly more invoicing to customers than in the final week of 2005 resulting in a large increase in receivables. Despite this increase, days' sales outstanding improved from 54 at 31 December 2005 to 43 at 31 December 2006. Included within accounts receivable are amounts recoverable on contracts as discussed within deferred revenue below. Prepaid expenses increased by £3.4 million in 2004 and fell by £1.4 million in 2005 and a further £0.5 million in 2006. This increase in 2004 was due to a technology license agreement signed in the year under which amounts representing prepaid royalties will be released over the next several years. The fall in 2005 and 2006 reflected this amortization. There were no other significant movements within prepaid expenses and other current assets.

Accounts payable increased in 2004 by £1.2 million but fell by £1.9 million in 2005 and a further £0.7 million in 2006. This is purely related to the timing of receipt of supplier invoices in the respective years. Accrued liabilities increased by £2.8 million in 2004, fell by £5.6 million in 2005 and increased again by £2.1 million in 2006. The increase in 2004 was as a result of provisions for staff costs and further payments on a technology license agreement signed in the year. These fell in 2005 as payments on the technology license agreement were made and accrued employee compensation was lower in 2005 than in 2004. Similarly, the main increase in 2006 was as a result of increased staff bonus and commission provisions following a record bookings quarter in the final quarter of 2006.

At 31 December 2006, the Company recorded approximately £31.5 million of deferred revenues which represented cash or receivables scheduled to be recognized as revenues in varying amounts after 31 December 2006. At 31 December 2005, the Company recorded approximately £20.4 million of deferred revenues. Deferred revenues are an element of customer backlog, and represent amounts invoiced to customers not yet recognized as revenues in the income statement. Similarly, the Company recorded £23.8 million of amounts recoverable on contracts ("AROC") at 31 December 2006, compared to £20.5 million at 31 December 2005. AROC represents amounts that have been recognized as revenue in the income statement but are yet to be invoiced to customers. Both deferred revenue and AROC fluctuate due to the maturity profile of ARM's products, and invoicing milestones within contracts.

The Company believes that, given its current level of business, it has sufficient working capital for the foreseeable future.

Cash flow from operations has been used to fund the working capital requirements of the Company as well as capital expenditure. Cash outflows from capital expenditure in 2006 was £8.6 million, compared with £6.1 million in 2005 and £5.3 million in 2004. Capital expenditure increased in 2005 and 2006 with staff levels increasing and general operational assets being replaced.

In 2004, the Company acquired the entire share capitals of Axys Design Automation Inc. and Artisan Components Inc. for total consideration of £6.9 million and £481.7 million respectively, with cash consideration comprising £6.9 million and £122.3 million respectively. Cash acquired with these businesses amounted to £82.7 million.

In 2005, the Company made final payments relating to acquisition costs for Artisan of £14.4 million, as well as £1.7 million of contingent consideration from the Axys acquisition as a result of performance conditions being achieved. A further £4.3 million (net of cash acquired) was paid for the acquisitions of Keil Elektronik GmbH and Keil Software Inc.

In 2006, the Company acquired both Falanx Microsystems AS and Soisic SA for cash consideration paid in the year of £13.4 million and £2.1 million respectively. Further payments of £1.3 million for Soisic were made in early 2007, and additional amounts will become payable on the achievement of various post-acquisition financial milestones. Additionally in 2006, a further £1.1 million was paid for Keil (acquired in 2005) and £0.6 million for certain assets of PowerEscape.

The Company envisages making further strategic investments in the future, in situations where the Company can broaden its product portfolio, where it can obtain skilled engineering resources and where the potential for furthering ARM core-based design wins is improved significantly.

In 2004, the Company invested a total of £0.2 million in two small unlisted companies, Zeevo Inc. and Reciva Limited, giving a minority holding of less than 3% in both companies. The investment in Zeevo Inc. was sold in 2005. In 2005, £0.3 million was invested via convertible loan notes in Luminary Micro Inc., a small unlisted company. A further £0.2 million was invested in Luminary in 2006.

The Company sold its investment in CSR plc in 2006 for £5.6 million.

During 2005, the Company initiated a share buyback program to supplement dividends in returning surplus funds to shareholders and this was continued in 2006. During 2005, the Company bought back over 13.9 million shares at a total cost of £16.2 million. During 2006, the Company bought back 63.6 million shares at a total cost of £76.5 million. Dividends totalling £12.4 million were also paid to shareholders during the year (2005: £10.4 million; 2004: £9.0 million). See the Companies Act 1985 section of the significant accounting policies within note 1 for further information on the share buybacks and dividends paid in 2006. Share option exercises in 2006 gave rise to £17.9 million cash inflow to the Company compared to £13.9 million in 2005 and £1.3 million in 2004.

Cash, cash equivalents, short- and long-term investments and marketable securities' balances at 31 December 2006 were £128.5 million compared to £160.9 million at 31 December 2005 and £142.8 million at 31 December 2004.

**Foreign currency fluctuations** The Company's earnings and liquidity are affected by fluctuations in foreign currency exchange rates, principally the US dollar rate, reflecting the fact that most of the Company's revenues and cash receipts are denominated in US dollars while a high proportion of its costs are in sterling.

The Company reduces this US dollar/sterling risk where possible by currency hedging. Due to the high value and timing of receipts on individual licenses and the requirement to settle certain expenses in US dollars, the Company reviews its foreign exchange exposure on a transaction-by-transaction basis. It then hedges this exposure using forward contracts for the sale of US dollars, which are negotiated with major UK clearing banks. The average size of each forward contract was $5.1 million in 2004, $4.3 million in 2005 and $3.9 million in 2006. The Company also uses currency options as a further translation instrument for limited proportions of its dollar exposure. The fair values of the financial instruments outstanding at 31 December 2004, 2005 and 2006 are disclosed in note 15 to the financial statements. The settlement period of the forward contracts outstanding at 31 December 2006 is between 9 January 2007 and 22 March 2007. The settlement period of the option contracts outstanding at 31 December 2006 is between 16 January 2007 and 18 December 2007.

**Quantitative and qualitative information on market risk** During the preceding fiscal year, the Company was exposed to foreign currency exchange risk inherent in its sales commitments, anticipated sales, anticipated purchases and assets and liabilities denominated in currencies other than sterling. ARM transacts business in approximately eight foreign currencies worldwide, of which the most significant to the Company's operations were the US dollar, the Indian rupee, the euro and the Japanese yen for 2006. For most currencies, the Company is a net receiver of foreign currencies, predominantly US dollars, and therefore benefits from a weaker sterling and is adversely affected by a stronger sterling relative to those foreign currencies. The Company has performed a sensitivity analysis at 31 December 2006, 2005 and 2004, using a modeling technique that measures the changes in the fair values arising from a hypothetical 10% adverse movement in the levels of foreign currency exchange rates relative to sterling with all other variables held constant. The analysis covers all of the Company's foreign currency contracts offset by the underlying exposures. The foreign currency exchange rates used were based on market rates in effect at 31 December 2006, 2005 and 2004. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a loss in the fair values of ARM's foreign exchange derivative financial instruments, net of exposures, of £8.9 million at 31 December 2006 (2005: £3.9 million, 2004: £8.6 million).

**Risk factors** The Company operates in the intensely competitive semiconductor industry which is characterized by price erosion, rapid technological change, short product life cycles, cyclical market patterns and heightened foreign and domestic competition. The Company believes that its future operating results will continue to be subject to quarterly variations based upon a wide variety of factors. These include the timing of entering into agreements with new licensees, the mixture of license fees, royalties and fees from services, the introduction of new technology by the Company, the timing of orders from, and shipments to, systems companies of ARM core-based microprocessors from the Company's semiconductor partners and sudden technological change in the microprocessor industry.

Other risks include the reliance on semiconductor partners, dependence upon systems companies, patent protection, attraction and retention of employees, management of growth, competition and vulnerability to general economic conditions. Risk factors are more fully discussed in the Company's annual report on Form 20-F.

## Consolidated statements of income/US GAAP
For the years ended 31 December

| | 2004 £000 | 2005 £000 | **2006 £000** |
|---|---|---|---|
| **Revenues:** | | | |
| Product revenues | 138,732 | 217,711 | **247,194** |
| Service revenues | 14,165 | 14,728 | **16,060** |
| Total revenues | 152,897 | 232,439 | **263,254** |
| **Cost of revenues:** | | | |
| Product costs | (6,735) | (21,754) | **(24,156)** |
| Service costs | (5,064) | (6,093) | **(6,721)** |
| Total cost of revenues | (11,799) | (27,847) | **(30,877)** |
| **Gross profit** | 141,098 | 204,592 | **232,377** |
| **Operating expenses:** | | | |
| Research and development | (50,433) | (61,633) | **(75,498)** |
| Sales and marketing | (24,157) | (36,234) | **(44,198)** |
| General and administrative | (30,809) | (41,082) | **(48,643)** |
| In-process research and development | (3,612) | (335) | **(595)** |
| Amortization of intangibles purchased through business combination | (576) | (17,391) | **(18,423)** |
| **Total operating expenses** | (109,587) | (156,675) | **(187,357)** |
| **Income from operations** | 31,511 | 47,917 | **45,020** |
| Interest | 6,944 | 5,317 | **6,758** |
| Profit on disposal of available-for-sale security | – | – | **5,270** |
| **Income before income tax and cumulative effect of change in accounting policy** | 38,455 | 53,234 | **57,048** |
| Provision for income taxes | (10,478) | (11,354) | **(9,438)** |
| **Net income before cumulative effect of change in accounting policy** | 27,977 | 41,880 | **47,610** |
| Cumulative effect of change in accounting policy, net of tax | – | – | **(2,447)** |
| **Net income** | 27,977 | 41,880 | **45,163** |
| Basic earnings (before cumulative effect of change in accounting policy) per common share | 2.7p | 3.1p | **3.5p** |
| Basic earnings (after cumulative effect of change in accounting policy) per common share | 2.7p | 3.1p | **3.3p** |
| Diluted earnings (before cumulative effect of change in accounting policy) per common share | 2.7p | 2.9p | **3.4p** |
| Diluted earnings (after cumulative effect of change in accounting policy) per common share | 2.7p | 2.9p | **3.2p** |

All activities relate to continuing operations.

The accompanying notes are an integral part of the financial statements.

## Consolidated statements of comprehensive income/US GAAP
For the years ended 31 December

| | 2004 £000 | 2005 £000 | **2006 £000** |
|---|---|---|---|
| **Net income** | 27,977 | 41,880 | **45,163** |
| Realized gain on available-for-sale security, net of tax | – | – | **(2,375)** |
| Unrealized holding gains/(losses) on available-for-sale securities, net of tax | 4,196 | (2,316) | **(1,090)** |
| Currency translation adjustment | (421) | 58,561 | **(68,128)** |
| **Total comprehensive income/(loss)** | 31,752 | 98,125 | **(26,430)** |

# Consolidated balance sheets/US GAAP
At 31 December

| | 2005 £000 | **2006 £000** |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | 128,077 | **90,743** |
| Short-term investments | 23,990 | **18,600** |
| Marketable securities | 8,835 | **19,151** |
| Accounts receivable, net of allowances for doubtful debts of £2,556,000 (2005: £2,173,000) (see footnote 10) | 55,518 | **69,552** |
| Inventory: finished goods | 1,490 | **1,933** |
| Income taxes receivable | – | **5,761** |
| Prepaid expenses and other assets | 12,567 | **12,668** |
| **Total current assets** | 230,477 | **218,408** |
| Deferred income taxes | 4,422 | **9,872** |
| Prepaid expenses and other assets | 1,674 | **1,328** |
| Property and equipment, net | 12,803 | **13,970** |
| Goodwill | 385,572 | **349,243** |
| Other intangible assets | 72,345 | **56,027** |
| Investments | 8,800 | **3,855** |
| **Total assets** | 716,093 | **652,703** |
| **Liabilities and shareholders' equity** | | |
| Current liabilities: | | |
| Accounts payable | 2,221 | **1,826** |
| Income taxes payable | 10,826 | **5,572** |
| Personnel taxes | 1,329 | **1,408** |
| Accrued liabilities (see footnote 11) | 25,024 | **33,021** |
| Deferred revenue | 20,354 | **31,485** |
| **Total current liabilities** | 59,754 | **73,312** |
| Deferred income taxes | 7,289 | **4,744** |
| **Total liabilities** | 67,043 | **78,056** |
| Contingencies and commitments (see footnote 13) | | |
| **Shareholders' equity** | | |
| Ordinary shares: £0.0005 par value; 2,200,000,000 authorized (2005: 2,200,000,000); 1,389,907,834 issued (2005: 1,386,102,680) | 693 | **695** |
| Additional paid-in capital | 425,252 | **446,005** |
| Deferred compensation | (4,404) | **–** |
| Treasury stock, at cost: 50,701,434 ordinary shares (2005: 17,751,107) | (16,315) | **(58,245)** |
| Retained earnings | 183,913 | **197,874** |
| Accumulated other comprehensive income: | | |
| Unrealized holding gain on available-for-sale securities, net of tax asset of £231,000 (2005: tax liability of £1,096,000) | 3,859 | **394** |
| Cumulative translation adjustment | 56,052 | **(12,076)** |
| **Total shareholders' equity** | 649,050 | **574,647** |
| **Total liabilities and shareholders' equity** | 716,093 | **652,703** |

The accompanying notes are an integral part of the financial statements.

# Consolidated statements of cash flows/US GAAP
For the years ended 31 December

| | 2004 £000 | 2005 £000 | **2006 £000** |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Net income | 27,977 | 41,880 | **45,163** |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization of tangible and intangible assets | 13,124 | 28,060 | **25,812** |
| Write-off in-process research and development | 3,612 | 335 | **595** |
| Profit on disposal of available-for-sale security | – | – | **(5,270)** |
| Stock option compensation | 960 | 9,727 | **21,788** |
| Deferred income taxes | (1,281) | – | **–** |
| Excess tax benefits from share-based compensation | – | – | **(3,682)** |
| Provision for doubtful accounts | (321) | 722 | **932** |
| Provision for slow-moving inventories | – | 22 | **65** |
| Accounts receivable converted to trade investments | (112) | – | **–** |
| Amount written off investments | – | 337 | **–** |
| Other | 20 | 16 | **63** |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (1,358) | (21,247) | **(18,986)** |
| Inventory | 34 | (519) | **(508)** |
| Prepaid expenses and other current assets | (3,370) | 1,446 | **454** |
| Accounts payable | 1,176 | (1,931) | **(672)** |
| Income taxes payable | 158 | (3,093) | **(12,758)** |
| Deferred revenue | 3,013 | (2,043) | **11,071** |
| Accrued liabilities and other creditors | 2,771 | (5,569) | **2,056** |
| Personnel taxes | 76 | (963) | **(71)** |
| **Net cash provided by operating activities** | 46,479 | 47,180 | **66,052** |
| Cash flows from investing activities: | | | |
| Purchase of equipment | (3,933) | (5,956) | **(7,476)** |
| Purchase of leasehold improvements | (1,397) | (108) | **(1,083)** |
| Sale of equipment | 23 | 37 | **31** |
| Purchase of patent and licenses | (65) | – | **–** |
| Purchase of investments | (50) | (274) | **(165)** |
| Sale of investments available-for-sale securities | – | 96 | **5,567** |
| (Purchase)/maturity of short-term investments | 24,677 | (569) | **(4,926)** |
| Purchase of subsidiaries and businesses, net of cash acquired | (77,899) | (20,304) | **(17,270)** |
| **Net cash used in investing activities** | (58,644) | (27,078) | **(25,322)** |
| Cash flows from financing activities: | | | |
| Cash received on issue of new share capital on exercise of share options | 1,311 | 13,083 | **2,106** |
| Proceeds received on issuance of shares from treasury stock | 2 | 838 | **15,754** |
| Expenses of issuing share capital | (360) | – | **–** |
| Excess tax benefits from share-based compensation | – | – | **3,682** |
| Purchase of own shares | – | (16,211) | **(76,519)** |
| Payment of dividends | (8,975) | (10,436) | **(12,367)** |
| **Net cash used in financing activities** | (8,022) | (12,726) | **(67,344)** |
| Effect of foreign exchange on cash and cash equivalents | 26 | 10,140 | **(10,720)** |
| Net increase/(decrease) in cash and cash equivalents | (20,161) | 17,516 | **(37,334)** |
| Cash and cash equivalents at beginning of the period | 130,722 | 110,561 | **128,077** |
| **Cash and cash equivalents at end of the period** | 110,561 | 128,077 | **90,743** |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid for income taxes | 11,601 | 14,447 | **21,147** |
| Cash received on interest | 7,233 | 5,444 | **6,636** |

The accompanying notes are an integral part of the financial statements.

# Consolidated statements of changes in shareholders' equity/US GAAP

| | Ordinary shares Number | Ordinary shares Amount £000 | Additional paid-in capital £000 | Deferred compensation £000 | Treasury stock £000 | Retained earnings* £000 | Accumulated other comprehensive income: Unrealized holding gain £000 | Accumulated other comprehensive income: Cumulative translation adjustment £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|---|
| Balances, 31 December 2003 | 1,023,345,650 | 512 | 63,321 | (2,499) | (7,569) | 134,419 | 1,979 | (2,088) | 188,075 |
| Shares issued on exercise of options | 3,041,914 | 1 | 1,310 | – | – | – | – | – | 1,311 |
| Shares issued on acquisition | 324,399,411 | 162 | 272,238 | – | – | – | – | – | 272,400 |
| Share issue costs | | | (3,094) | – | – | – | – | – | (3,094) |
| Issuance of options in relation to acquisition of Artisan | | – | 78,950 | (9,579) | – | – | – | – | 69,371 |
| Net income | | – | – | – | – | 27,977 | – | – | 27,977 |
| Dividends | | – | – | – | – | (8,975) | – | – | (8,975) |
| Tax effect of disqualfying dispositions | | – | 515 | – | – | – | – | – | 515 |
| Deferred compensation arising on share schemes | | – | 965 | (965) | – | – | – | – | – |
| Amortization of deferred compensation | | – | – | 960 | – | – | – | – | 960 |
| Issuance of shares from treasury | | – | (72) | – | 84 | – | – | – | 12 |
| *Accumulated other comprehensive income:* | | | | | | | | | |
| Unrealized holding gains on available-for-sale securities (net of tax charge of £1,631,000) | | – | – | – | – | – | 4,196 | – | 4,196 |
| Currency translation adjustment | | – | – | – | – | – | – | (421) | (421) |
| Balances, 31 December 2004 | 1,350,786,975 | 675 | 414,133 | (12,083) | (7,485) | 153,421 | 6,175 | (2,509) | 552,327 |
| Shares issued on exercise of options | 35,315,705 | 18 | 13,065 | – | – | – | – | – | 13,083 |
| Net income | | – | – | – | – | 41,880 | – | – | 41,880 |
| Dividends | | – | – | – | – | (10,436) | – | – | (10,436) |
| Tax effect of disqualifying dispositions | | – | 370 | – | – | – | – | – | 370 |
| Deferred compensation arising on share schemes | | – | 3,290 | (3,290) | – | – | – | – | – |
| Tax benefits on exercise of options issued as part consideration for a business combination | | – | 1,227 | – | – | – | – | – | 1,227 |
| Amortization of deferred compensation | | – | – | 9,727 | – | – | – | – | 9,727 |
| Reversal of unearned compensation | | – | (1,242) | 1,242 | – | – | – | – | – |
| Issuance of shares from treasury | | – | (5,591) | – | 7,381 | (952) | – | – | 838 |
| Purchase of own shares | | – | – | – | (16,211) | – | – | – | (16,211) |
| *Accumulated other comprehensive income:* | | | | | | | | | |
| Unrealized holding losses on available-for-sale securities (net of tax benefit of £981,000) | | – | – | – | – | – | (2,316) | – | (2,316) |
| Currency translation adjustment | | – | – | – | – | – | – | 58,561 | 58,561 |
| Balances, 31 December 2005 | 1,386,102,680 | 693 | 425,252 | (4,404) | (16,315) | 183,913 | 3,859 | 56,052 | 649,050 |
| Shares issued on exercise of options | 3,805,154 | 2 | 2,104 | – | – | – | – | – | 2,106 |
| Net income | | – | – | – | – | 45,163 | – | – | 45,163 |
| Dividends | | – | – | – | – | (12,367) | – | – | (12,367) |
| Tax effect of option exercises | | – | 3,682 | – | – | – | – | – | 3,682 |
| Netting of deferred compensation** | | – | (4,404) | 4,404 | – | – | – | – | – |
| Amortization of deferred compensation | | – | 19,371 | – | – | – | – | – | 19,371 |
| Issuance of shares from treasury | | – | – | – | 34,589 | (18,835) | – | – | 15,754 |
| Purchase of own shares | | – | – | – | (76,519) | – | – | – | (76,519) |
| *Accumulated other comprehensive income:* | | | | | | | | | |
| Realized gain on available-for-sale security (net of tax benefit of £850,000) | | – | – | – | – | – | (2,375) | – | (2,375) |
| Unrealized holding losses on available-for-sale securities (net of tax benefit of £477,000) | | – | – | – | – | – | (1,090) | – | (1,090) |
| Currency translation adjustment | | – | – | – | – | – | – | (68,128) | (68,128) |
| **Balances, 31 December 2006** | **1,389,907,834** | **695** | **446,005** | **–** | **(58,245)** | **197,874** | **394** | **(12,076)** | **574,647** |

* The amount of shareholders' equity available for distribution to shareholders is the amount of profits determined under UK GAAP in the statutory accounts of the parent company. At 31 December 2006 this company did not have any distributable profits. In February 2007, dividends were paid up to the company from subsidiary undertakings. Unaudited interim accounts prepared to 22 February 2007 showed the company having distributable profits on that date of £90,735,000.

** FAS 123R requires that deferred stock-based compensation on the date of adoption be netted against additional paid-in capital.

The accompanying notes are an integral part of the financial statements.

## 1 The Company and a summary of its significant accounting policies

**The business of the Company** ARM Holdings plc and its subsidiary companies ("ARM" or "the Company") design reduced instruction set computing (RISC) microprocessors, physical IP and related technology and software, and sell Development Systems, to enhance the performance, cost-effectiveness and power-efficiency of high-volume embedded applications. The Company licenses and sells its technology and products to leading international electronics companies, which in turn manufacture, market and sell microprocessors, application-specific integrated circuits (ASICs) and application-specific standard processors (ASSPs) based on the Company's architecture to systems companies for incorporation into a wide variety of end products. By creating a network of Partners, and working with them to best utilize the Company's technology, the Company is establishing its architecture as a RISC processor for use in many high-volume embedded microprocessor applications, including digital cellular phones, modems and automotive functions and for potential use in many growing markets, including smart cards and digital video. The Company also licenses and sells Development Systems products direct to systems companies and provides consulting and support services to its licensees, systems companies and other systems designers. The Company's principal geographic markets are Europe, the US and Asia Pacific.

**Incorporation and history** ARM is a public limited company incorporated under the laws of England and Wales. The Company was formed on 16 October 1990, as a joint venture between Apple Computer (UK) Limited, and Acorn Computers Limited, and operated under the name Advanced RISC Machines Holdings Limited until 10 March 1998, when its name was changed to ARM Holdings plc. Its initial public offering was on 17 April 1998.

Group undertakings include ARM Limited (incorporated in the UK), ARM Inc. (incorporated in the US), ARM KK (incorporated in Japan), ARM Korea Limited (incorporated in South Korea), ARM France SAS (incorporated in France), Soisic SA (incorporated in France, acquired during 2006), ARM Belgium N.V. (incorporated in Belgium), ARM Germany GmbH (incorporated in Germany), Keil Elektronik GmbH (incorporated in Germany), ARM Norway AS (incorporated in Norway, acquired and renamed during 2006), ARM Embedded Technologies Pvt Limited (incorporated in India), ARM Physical IP Asia Pacific Pte. Limited (incorporated in Singapore), ARM Taiwan Limited (incorporated in Taiwan) and ARM Consulting (Shanghai) Co. Limited (incorporated in PR China). All entities are 100% owned.

**Basis of preparation** The accompanying consolidated financial statements have been prepared under the historical cost convention and in accordance with accounting principles generally accepted in the United States (US GAAP). The Company maintains its accounting records and prepares its financial statements in UK sterling.

**Use of estimates** The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

**Principles of consolidation** The consolidated financial statements incorporate the financial statements of the Company and all its subsidiaries. Intra-group transactions, including sales, profits, receivables and payables, have been eliminated on consolidation. The results of subsidiaries acquired in the year are included in the income statement from the date they are acquired. On acquisition, all of the subsidiaries' assets and liabilities that exist at the date of acquisition are recorded at their fair values reflecting their condition at that date.

**Investments** Publicly traded investments are classed as available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No.115, "Accounting for certain investments in debt and equity securities", and are carried at fair value. Unrealized holding gains or losses on such securities are included, net of related taxes, in other comprehensive income. Other-than-temporary impairment losses and realized gains and losses of such securities are reported in earnings. Equity securities that are not publicly traded are recorded at cost less permanent diminution in value; at 31 December 2006 and 2005, the estimated fair value of these investments approximated their recorded basis, based on estimates determined by management.

In 2005, the Company made an investment by way of convertible loan notes in Luminary Micro Inc. which have now converted into preference shares – further investment in 2006 has been made in Luminary Micro Inc. by way of preference shares.

**Intangible assets** Purchased patents and licenses to use technology are capitalized and amortized on a straight-line basis over a prudent estimate of the time that the Company is expected to benefit from them.

Although an independent valuation is made of any intangible assets purchased as part of a business combination, management is primarily responsible for determining the fair value of intangible assets. Such assets are capitalized and amortized over a period of one to six years, being a prudent estimate of the time that the Company is expected to benefit from them, with the exception of in-process research and development which is written off immediately.

## 1 The Company and a summary of its significant accounting policies continued

**Goodwill** Goodwill represents the excess of the fair value of the consideration paid on acquisition of a business over the fair value of the assets, including any intangible assets identified and liabilities acquired.

Prior to 2002, purchased goodwill was capitalized and amortized on a straight-line basis over a prudent estimate of the time that the Company was expected to benefit from it. Upon adoption of SFAS 142, on 1 January 2002, the Company ceased amortizing goodwill. The value of goodwill carried forward at the end of 2001 has been frozen at £2,274,000. This goodwill together with goodwill arising on acquisitions since 2002, is tested for impairment at least annually. An annual impairment review in 2006 determined, primarily with reference to cash flow forecasts, that there was no indication of impairment with respect to goodwill. The estimates of future cash flows involve considerable management judgment and are based on assumptions about expected future operating performance. The actual cash flows could differ from management's estimates due to changes in business conditions, operating performance and economic conditions.

In accordance with SFAS 131 "Disclosures about Segments of an Enterprise and Related Information", the Company has identified its operating segments based on the information used by the Chief Operating Decision Maker in monitoring the business. For the purposes of assessing the carrying value of goodwill for impairment, goodwill has been allocated to reporting units. Based on the nature and extent of discrete information available to management, the Company believes that, for ARM, each operating segment consists of a single reporting unit. Goodwill has been allocated to the three reporting units as shown in note 9.

**Impairment charges** The Company reviews goodwill for impairment annually or more frequently if events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. It also reviews long-lived assets and identifiable intangibles for impairment if an event occurs that indicates that the carrying amount may not be recoverable. If the sum of the expected future cash flows (undiscounted and without interest charges) of the long-lived assets is less than the carrying amount of such assets, an impairment loss would be recognized, and the assets would be written down to their estimated fair value.

**Revenue recognition** Revenue consists of license fees received under the terms of license agreements with customers to enable them to use the Company's intellectual property ("IP"), which is customized to each customer's manufacturing process. The Company receives royalties on sales by the Company's customers of products containing ARM technology. It also supplies off-the-shelf software tools, bought-in boards and toolkits, training and consultancy services.

The Company primarily earns revenues from licensing its IP to leading electronics companies which in turn manufacture, market and sell microprocessors, ASICs and ASSPs based on the Company's architecture to systems companies for incorporation into a wide variety of end products. The Company's IP consists of software and related documentation which enables a customer to design and manufacture microprocessors and related technology and software. Most licenses are designed to meet the specific requirements of each customer and are generally not time limited in their application. In general, the time between the signing of a license and final validation of the customer's ARM technology-compliant product is between six and 15 months. Upgrades or modifications to the licensed IP are not provided. Following validation of the customer's ARM technology-compliant product, the Company has no further obligations under the license agreement.

In accordance with SOP 81-1, "Accounting for performance of construction-type and certain production type contracts", when license agreements include deliverables that require "significant production, modification or customization", contract accounting is applied. Revenues from license fees are recognized based on the percentage-of-completion method over the period from signing of the license to validation of the customer's ARM-compliant product and the completion of all outstanding obligations. The amount of revenue recognized is based on the total license fees under the license agreement, or that portion of the total license fees which is determined to be fixed or determinable in arrangements involving extended payment terms and the percentage-of-completion achieved. Those amounts that are not deemed fixed or determinable at the outset of the arrangement are recognized as the payments become due. Where an arrangement is for multiple elements, each requiring significant production, modification or customization, the Company evaluates whether the bifurcation criteria of SOP 81-1 are met, and if so, the total arrangement fee is allocated accordingly. The percentage-of-completion is measured by monitoring progress using records of actual time incurred to date in the project, compared with the total estimated project requirement. Revenues are recognized only when collectability is probable. Estimates of total project requirements are based on prior experience of customization, delivery and validation of the same or similar technology and are reviewed and updated regularly by management. Under the percentage-of-completion method, provisions for estimated losses on uncompleted contracts are recognized in the period in which the likelihood of such losses is determined.

Agreements that include rights to unspecified products (as opposed to unspecified upgrades and enhancements) are accounted for using subscription accounting, revenue from the arrangement being recognized over the term of the arrangement, or an estimate of the economic life of the products offered if no term is specified, beginning with the delivery of the first product.

### 1 The Company and a summary of its significant accounting policies continued

In accordance with SOP 97-2, "Software revenue recognition", where agreements involve multiple elements that do not require "significant production, modification or customization", the Company recognizes license revenue when a signed contract or other persuasive evidence of an arrangement exists, the product has been shipped or electronically delivered, the license fee is fixed or determinable and collection of the resulting receivable is probable. Where agreements include multiple elements, the revenue recognition criteria for each element are typically met within the same accounting period, i.e. on delivery of the elements. If an element is undelivered at a period end, the Company determines whether it has sufficient vendor specific objective evidence ("VSOE") of fair value in order to make an allocation amongst the elements. For the majority of its products and services, with the exception of post-contract support ("PCS"), certain Development Systems products and certain services undertaken by the Company, the Company does not believe it has sufficient VSOE of fair value to make such allocations. Accordingly, no revenue is recognized on an arrangement where deliverables other than PCS and the aforementioned Development Systems products and services remain undelivered.

License fees are considered fixed or determinable if they are not dependent on customers completing specific milestones and they are not subject to extended payment terms, i.e. the payment terms do not extend over a substantial period when compared to the payment terms in similar license arrangements and when compared with the licensed products' life cycle. If all the fees in an arrangement are deemed to be fixed or determinable, the Company recognizes revenue when all other revenue recognition criteria have been met. The excess of revenue recognized in respect of such fees over fees invoiced is recorded as an accrued revenue asset. Where an arrangement includes fees that are not deemed fixed or determinable, revenue from the arrangement is recognized as the payments become due and the excess of fees invoiced over revenue recognized in respect of such fees is recorded as a deferred revenue liability.

PCS consists of the right to receive services and/or unspecified product upgrades/enhancements that are offered on a when-and-if-available basis. PCS is generally priced separately from the initial licensing fee in a contract and revenue is allocated to PCS based on VSOE of fair value. VSOE of fair value is determined with reference to contractual renewal rates. If no renewal rates are specified, the entire fee under the arrangement is amortized and recognized ratably over the contractual PCS period. Where renewal rates are specified, PCS revenue is recognized ratably over the term of the PCS arrangement.

Certain products have been co-developed by the Company and a collaborative partner, with both parties retaining the right to sell licenses to the product. In those cases where the Company makes sales of these products and considers itself to be the principal under EITF 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent", the total value of the license is recorded as revenue and the amount payable to the collaborative partner is recorded as cost of sales. Where the collaborative partner makes sales of these products, the Company records as revenue the commission it is due when informed by the collaborative partner that a sale has been made and cash has been collected.

Sales of boards and toolkits are recognized upon delivery. While some arrangements with distributors provide very limited rights of return, the Company's history is that actual returns are negligible and accordingly no provisions are deemed necessary.

Services, such as consulting and training are typically sold in stand-alone arrangements. Where they are sold in conjunction with other deliverables and they are not considered essential to the functionality of those other deliverables, they are accounted for separately based on VSOE, if VSOE has been established. Revenue for these services is recognized as the services are performed and collectability is probable. If VSOE for the services does not exist or the services are deemed to be essential to the functionality of the other deliverables in the arrangement, the entire arrangement fee is recognized as the services are performed. The excess of fees invoiced over revenue recognized in respect of such fees is recorded as a deferred revenue liability.

Revenues from consulting projects, which are typically of a short duration, are recognized when the service has been provided and all obligations to the customer under the consulting agreement have been fulfilled. For longer term and more complex consulting projects, typically containing several project milestones, where significant modification to ARM core-based IP is required, revenues are recognized on a percentage-of-completion basis as milestones are achieved. This method approximates to percentage-of-completion based on labor inputs.

Royalty revenues are earned on sales by the Company's customers of products containing ARM technology. Revenues are recognized when the Company receives notification from the customer of product sales, or receives payment of any fixed royalties. Notification is typically received in the quarter following shipment of product by the customer.

Where the Company enters into more than one agreement with the same customer in the same, short time frame, an assessment is made to establish whether the group of agreements is so closely related that they effectively form a single multiple-element arrangement. The factors considered in making this assessment include, but are not limited to:
- whether the different elements are closely interrelated or interdependent in terms of design, technology, or function;
- whether the fee for one or more of the agreements is subject to a refund or forfeiture or other concession if one of the other contracts is not completed satisfactorily;
- whether one or more elements in one agreement are essential to the functionality of an element in another agreement;
- whether payment terms under one agreement coincide with performance criteria of another agreement; and
- whether the negotiations are conducted jointly with two or more parties to do what in essence is a single project.

### 1 The Company and a summary of its significant accounting policies continued

**Research and development** All ongoing research and development expenditure is expensed in the period in which it is incurred. Costs include salaries of engineers and associated staff, relevant EDA tools costs and other directly related expenditure, such as contractors, as well as an allocation of facilities costs. The facilities costs for each office are allocated according to the proportion of employees in engineering functions within these offices. Any collaborative agreements whereby a third party agrees to partially fund the Company's research and development is recognized over the period of the agreement as a credit within research and development costs.

**Grants** Grants in respect of specific research and development projects are receivable from the European Commission, a European organization which funds certain research and development activities on application to it for the purposes of furthering research and development activities within the European Union. The Company retains significant rights to IP developed under projects which are funded under these arrangements. Grants received are typically intended to cover 50% of expected project costs. Grant income is recognized over the period of the project in line with the costs incurred. Unconditional undertakings have been received from the European Commission to provide the funding, and there is no obligation to refund any amounts already received. Amounts receivable under these arrangements in the year ended 31 December 2006 were £467,000 (2005: £nil; 2004: £338,000) and were netted against related research and development costs.

**Pension costs** The Company contributes to defined contribution plans substantially covering all employees in Europe and the US and to government pension schemes for employees in Japan, South Korea, Taiwan, PR China and Israel. The Company contributes to these plans based upon various fixed percentages of employee compensation and such contributions are expensed as incurred. The amount of contributions expensed by the Company for the years ended 31 December 2004, 2005 and 2006 were £2,067,000, £3,371,000 and £3,840,000 respectively.

**Loss contingencies** The Company accrues an estimated loss contingency when it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated.

**Fair value of financial instruments** The Company's financial instruments consist principally of cash and cash equivalents, short-term investments and marketable securities, accounts receivable and foreign currency exchange contracts. The Company believes all of the financial instruments' carrying values approximate to fair value due to their nature and respective durations.

**Cash equivalents** The Company considers all highly liquid investments with original maturity dates of three months or less to be cash equivalents.

**Short-term investments and marketable securities** The Company considers all highly liquid investments with original maturity dates of greater than three months but less than one year to be either short-term investments (when invested on deposit with major clearing banks) or short-term marketable securities (when custodied with major financial institutions). Any investments with a maturity date of greater than one year are classified as long-term marketable securities.

**Allowance for doubtful debts** Allowance is made for doubtful debts following reviews of individual customer circumstances by management.

**Inventory** Inventory is stated at the lower of cost and net realizable value. In general, cost is determined on a first-in-first-out basis and includes transport and handling costs. Where necessary, provision is made for obsolete, slow-moving and defective inventory.

**Property and equipment** The cost of property and equipment is their purchase cost, together with any incidental costs of acquisition. Costs that are directly attributable to the development of new business application software and which are incurred during the period prior to the date that the software is placed into operational use, are capitalized. External costs and internal costs are capitalized to the extent they enhance the future economic benefit of the business.

Depreciation is calculated so as to write off the cost of property and equipment, less their estimated residual values, on a straight-line basis over the expected useful economic lives of the assets concerned. The principal economic lives used for this purpose are:

| | |
|---|---|
| Freehold buildings | 25 years |
| Leasehold improvements | Five years or term of lease, whichever is shorter |
| Computers and software | Three to five years |
| Fixtures and fittings | Five to ten years |
| Motor vehicles | Four years |

Provision is made against the carrying value of property and equipment where an impairment in value is deemed to have occurred.

## 1 The Company and a summary of its significant accounting policies continued

**Operating leases** Costs in respect of operating leases are charged on a straight-line basis over the lease term.

**Currency translation** The Company's functional currency is the currency of the primary economic environment in which the Company operates.

The assets and liabilities of subsidiaries denominated in foreign currencies are translated into sterling at rates of exchange ruling at the balance sheet date. Statements of income of overseas subsidiaries are translated at the monthly exchange rates during the year. Translation differences are taken to the cumulative translation adjustment.

The Company utilizes forward exchange contracts and currency options to manage the exchange risk on actual transactions related to accounts receivable, denominated in a currency other than the functional currency of the business. The Company's forward exchange contracts do not subject the Company to risk from exchange rate movements because the gains and losses on such contracts offset losses and gains, respectively, on the transactions being hedged. Because the Company does not meet the criteria for hedge accounting, the forward and option contracts and the related accounts receivable are recorded at fair value at each period end. All recognized gains and losses resulting from the settlement of the contracts are recorded within general and administrative costs in the income statement. The fair value of derivative instruments are disclosed within either prepaid expenses and other assets or accrued liabilities on the balance sheet and within net cash provided by operating activities in the cash flow statement. The Company does not enter into foreign exchange contracts for the purpose of hedging anticipated transactions.

Other transactions denominated in foreign currencies have been translated into sterling at actual rates of exchange ruling at the date of transaction. Monetary assets and liabilities denominated in foreign currencies have been translated at rates ruling at the balance sheet date. Exchange differences have been included in general and administrative costs.

From time to time, the Company enters into contracts denominated in a currency (typically US dollars) that is neither the functional currency of the Company nor the functional currency of the customer. In accordance with SFAS 133, "Accounting for derivative instruments and hedging activities", where there are unpaid amounts on such contracts, the Company carries such derivatives at fair value. The resulting gain or loss is recognized in the income statement under general and administrative costs. For the year ended 31 December 2006 the loss on exchange is £898,000 (2005: gain of £2,101,000; 2004: loss of £732,000).

**Income taxes** Income taxes are computed using the liability method. Under this method, deferred income tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established against deferred tax assets where it is more likely than not that some portion or all of the asset will not be realized.

The Company applies the "with and without" approach with respect to the allocation of net operating losses and other reliefs due to share-based compensation costs. Under this approach a benefit is recorded in additional paid-in capital only to the extent that the amount of available net operating losses generated for operations can be offset against the current year taxable income.

**Earnings per share** Basic earnings per common share is computed based on the weighted average number of ordinary shares. Diluted earnings per common share is computed by including potential common shares where the effect of their inclusion would be dilutive. The diluted share base for the year ended 31 December 2006 excludes incremental shares of approximately 33,390,000 (2005: 39,614,000; 2004: 38,143,000) related to employee stock options. These shares are excluded due to their antidilutive effect as a result of the exercise price of these shares being higher than the market price. The ordinary equivalent shares for share options were determined using the treasury stock method.

**Accounting for share-based payments** On 1 January 2006, the Company adopted FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("FAS 123R"). Under FAS 123R, share-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee's requisite service period. The fair value of these awards is calculated using appropriate valuation techniques.

Some awards made by the Company are liability-classified awards under FAS 123R as (i) there is an obligation to settle a fixed monetary amount in a variable number of shares; or (ii) the awards are indexed to a factor other than performance, market or service condition. The fair value of these awards is remeasured at each period end until the award has vested. Once the award has vested, or for (i) above when number of shares becomes fixed, the award becomes equity-classified. The transitional rules detailed in FAS 123R require the Company to make a remeasurement adjustment for compensation cost for liability awards that has been recognized in the current year as a cumulative effect of change in accounting policy in the income statement.

The Company adopted the provisions of FAS 123R using a modified prospective application. Accordingly, prior periods have not been revised for comparative purposes. The valuation provisions of FAS 123R apply to new awards and to awards that are outstanding on the effective date, which are subsequently modified or cancelled. Estimated compensation expense for awards outstanding at the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under FASB Statement No. 123, "Accounting for Stock-Based Compensation" (FAS 123).

### 1 The Company and a summary of its significant accounting policies continued

On 10 November 2005, the FASB issued FASB Staff Position No. FAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards". The Company has elected to adopt the alternative transition method provided in this FASB Staff Position for calculating the tax effects of share-based compensation pursuant to FAS 123R. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee share-based compensation, which is available to absorb tax deficiencies which could be recognized subsequent to the adoption of FAS 123R.

For a summary of all the Company's share-based award schemes, please refer to the Shareholders' equity section in footnote 12.

The Company uses the Black-Scholes option pricing model to estimate the fair value of share-based payments. This model is consistent with that used for the Company's pro forma information required under FAS 123. The determination of the fair value using this model is affected by the share price at grant, as well as a number of other assumptions including expected volatility, expected life, risk-free interest rate and expected dividends.

The Company used the historical price of the Company's stock for the expected volatility assumption, including some adjustments for non-recurring one-time events, consistent with the guidance in FAS 123R and the Securities and Exchange Commission's Staff Accounting Bulletin No. 107. Adjustments were made as the Company's assessment of future stock price trends were more representative of historical data excluding these events rather than including them. The expected life of options is based on known vesting dates and historical exercise patterns for the different schemes. The risk-free interest rate is based on observed interest rates appropriate for the terms of the share options. The dividend yield assumption is based on our last declared dividend and expected payouts.

The fair value of our restricted stock units and LTIP awards is based on the share price at date of grant, discounted for any dividends that won't be earned during the vesting period.

The per share fair values of share options granted have been estimated with the following weighted average assumptions:

| | Options | | | RSUs/LTIP awards | | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | **2006** | 2004 | 2005 | **2006** |
| Expected life (in years) | 3.34 | 3.07 | **3.11** | 3.00 | 3.00 | **2.57** |
| Volatility | 90% | 50% | **40%** | 85% | 50% | **40%** |
| Risk-free interest rate | 4.05% | 4.00% | **4.01%** | 4.5% | 4.00% | **4.13%** |
| Dividend yield | 0.51% | 0.70% | **0.70%** | 0.70% | 0.70% | **0.70%** |
| Weighted average fair value (£) | 0.74 | 0.38 | **0.43** | 1.01 | 1.17 | **1.31** |

The following table presents details of the total stock-based compensation expense that is included in each functional line item of the Company's consolidated statements of income for the years ended 31 December: Note that the 2004 and 2005 comparable income statements have been re-analyzed to absorb the stock-based compensation expenses into the functional line items rather than as a separate line as reported in the income statements in those years.

| | 2004 £000 | 2005 £000 | **2006* £000** |
|---|---|---|---|
| Cost of revenues | – | 2,489 | **1,098** |
| Research and development costs | 300 | 1,582 | **10,609** |
| Sales and marketing costs | 222 | 2,132 | **3,658** |
| General and administrative costs | 438 | 3,524 | **2,927** |
| Cumulative effect of change in accounting policy | – | – | **3,496**** |
| Share-based payment expense | 960 | 9,727 | **21,788** |
| Tax benefit for share-based payment compensation expense | – | (1,799) | **(4,181)**** |
| Share-based payment expense, net of tax | 960 | 7,928 | **17,607** |

* The amounts included in 2006 reflect the adoption of FAS 123R. In accordance with the modified prospective transition method, the Company's consolidated statements of income for 2005 and 2004 have not been restated to reflect, and do not include, the impact of FAS 123R.

** The cumulative effect of change in accounting policy arises as a remeasurement adjustment for liability-classified awards on cumulative share-based compensation for earlier years on adoption of FAS 123R. Included within tax benefits above is £1,049,000 relating to this cumulative effect of change in accounting policy.

The adoption of FAS 123R will continue to have a significant adverse impact on the Company's reported results of operations, although it should not have a material impact on its overall financial position. The amount of unearned stock-based compensation currently estimated to be expensed in the period from 2007 to 2011 related to unvested share-based payment awards at 31 December 2006 is £19.5 million. Of this amount, £11.8 million is estimated to be expensed in 2007, £5.6 million in 2008, £1.7 million in 2009 and £0.4 million in 2010. The weighted average period over which the unearned share-based compensation is expected to be recognized is approximately 1.0 years. If there are any cancellations or accelerated vestings, the Company may be required to accelerate or cancel some of the remaining compensation expense. The share-based compensation expense in future periods will be more than stated above to the extent that the Company grants additional options or awards after the balance sheet date. Furthermore, the estimated future compensation charge may be affected by any change to the fair value of liability-classified awards.

## 1 The Company and a summary of its significant accounting policies continued

In accordance with the requirements of the disclosure-only alternative of FAS 123, the following table illustrates the effect on net income and earnings per share for 2005 and 2004 had the Company applied the fair value recognition provisions of FAS 123 instead of the guidelines provided by APB 25.

| | 2004 £000 | 2005 £000 |
|---|---|---|
| Net income: | | |
| As reported | 27,977 | 41,880 |
| Deduct: Total stock-based compensation expense determined under fair value-based method for all awards, net of related tax effects | (12,546) | (20,120) |
| Add back: Total stock-based compensation expense determined under the intrinsic value-based method for all awards, net of related tax effects | 960 | 7,928 |
| Pro forma net income | 16,391 | 29,688 |
| Basic earnings per common share (pence): | | |
| As reported | 2.7p | 3.1p |
| Pro forma | 1.6p | 2.2p |
| Diluted earnings per common share (pence): | | |
| As reported | 2.7p | 2.9p |
| Pro forma | 1.6p | 2.1p |

**Treasury stock** Treasury stock represents the cost of shares in the Company held by the Company, the Employee Benefit Trust (ESOP) and the QUEST.

During 2006, to supplement the payment of dividends to shareholders, the Company continued its rolling share buyback programme under the shareholder authority conferred at the 2005 Annual General Meeting. The quantum and frequency of share repurchases is not predetermined and will take into account prevailing market conditions, the short- to medium-term cash needs of the business and the level of employee share-based remuneration going forward. In 2006, a total of 63,600,000 (2005: 13,868,000) shares were repurchased from the market at a cost of £76,519,000 (2005: £16,211,000). At 31 December 2006, there were 49,500,000 (2005: 12,751,107) shares in the Company still held from these purchases with a market value of £62,246,000 (2005: £15,429,000). Whilst shares repurchased from the market have been used to satisfy some employee share option exercises, all those shares held at the end of 2006 are expected to be canceled in 2007. See the Companies Act 1985 section below for further information on these share buybacks and need for subsequent cancellation.

The ESOP was set up on 16 April 1998 to facilitate the recruitment, retention and motivation of employees. Under the Company's Long Term Incentive Plan, 7,771,416 shares could be awarded from shares already issued within the ESOP and treasury stock held by the Company. The number of unearned shares within the ESOP at 31 December 2006 was 1,201,434 (2005: 5,000,000) with a market value of £1,511,000 (2005: £6,050,000).

All costs relating to the schemes are recognized in the income statement as they accrue and the ESOP has waived the right to receive dividends of over and above 0.01 pence per share on all shares held. For the purpose of earnings per share calculations, the shares are treated as canceled until such time as they vest unconditionally.

The Company also has a QUEST which was established to acquire new shares in the Company for the benefit of employees and directors of the Company. Following the final allocations in 2005, the QUEST held no further shares in the Company and is in the process of being wound-up.

**Employer's taxes on share options** Employer's National Insurance in the UK and equivalent taxes in other jurisdictions are payable on the exercise of certain share options issued to employees in certain tax jurisdictions. In accordance with EITF 00-16 no provision has been made for the employer's taxes on these share options. These amounts are recognized in the consolidated income statement when payable.

**Recently issued accounting standards** In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109" (FIN 48). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements. FIN 48 requires companies to determine whether it is "more likely than not" that a tax position will be sustained upon examination by the appropriate taxing authorities before any part of the benefit can be recorded in the financial statements. It also provides guidance on the recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 will also require significant additional disclosures. This Interpretation will be effective for fiscal years beginning after 15 December 2006. We will implement this Interpretation in the first quarter of 2007 on a prospective basis. We are currently evaluating the potential impact this Interpretation will have on our financial position and results of operations.

## 1 The Company and a summary of its significant accounting policies continued

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157), which provides guidance on how to measure assets and liabilities that use fair value. SFAS 157 will apply whenever another US GAAP standard requires (or permits) assets or liabilities to be measured at fair value but does not expand the use of fair value to any new circumstances. SFAS 157 will be effective for financial statements issued for fiscal years beginning after 15 November 2007. We are currently evaluating the potential impact this standard may have on our financial position and results of operations, but do not believe the impact of the adoption will be material.

In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" (SAB 108). SAB 108 was issued in order to eliminate the diversity of practice in how public companies quantify misstatements of financial statements, including misstatements that were not material to prior years' financial statements. We have applied the provisions of SAB 108 in connection with the preparation of our annual financial statements for the year ended 31 December 2006 and the impact on our financial position and results of operations was not material.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)" (SFAS 158). Part of this Statement was effective as of 31 December 2006, and requires companies that have defined benefit pension plans and other postretirement benefit plans to recognize the funded status of those plans on the balance sheet on a prospective basis from the effective date. The funded status of these plans is determined as of the plans' measurement dates and represents the difference between the amount of the obligations owed to participants under each plan (including the effects of future salary increases for defined benefit plans) and the fair value of each plan's assets dedicated to paying those obligations. To record the funded status of those plans, unrecognized prior service costs and net actuarial losses experienced by the plans will be recorded in the Other Comprehensive Income (OCI) section of shareholders' equity on the balance sheet. This does not have a material impact on our financial position.

On 12 September 2006 the EITF issued the statement EITF 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits". This becomes effective for financial statements issued for fiscal years beginning after 15 December 2006. The EITF was issued to clarify the issue of when to make accruals for the provision of sabbaticals by the Company. We are currently evaluating the potential impact this standard may have on our financial position and results of operations, but do not believe the impact of the adoption will be material, other than the adjustment for cumulative effect of change in accounting policy.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No.115" (FAS 159). Under this standard, entities will now be permitted to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis (the fair value option). The fair value option represents a significant step in the evolution of financial reporting because it considerably expands the ability of entities to select the measurement attribute for certain assets and liabilities. FAS 159 is effective for fiscal years beginning after 15 November 2007. We are currently evaluating the impact this standard may have on our financial position and results of operations.

**Companies Act 1985** These financial statements do not comprise statutory accounts within the meaning of Section 240 of the Companies Act 1985 of Great Britain (the "Companies Act"). The Company's statutory accounts, which are its primary financial statements, are prepared in accordance with International Financial Reporting Standards (IFRSs) for consolidated accounts and accounting principles generally accepted in the United Kingdom (UK GAAP) for ARM Holdings plc company only accounts. They are prepared in compliance with the Companies Act and are presented in pounds sterling. Statutory accounts (upon which the auditors gave unqualified reports under Section 235 of the Companies Act and which did not contain statements under sub-sections 237(2) and (3) of the Companies Act) for the years ended 31 December 2004 and 2005 have been, and those for the year ended 31 December 2006 will be delivered to the Registrar of Companies for England and Wales. Dividends are required to be declared in sterling out of profits available for that purpose as determined in accordance with UK GAAP and the Companies Act.

Substantially the whole of the Company's distributable reserves are generated in ARM Limited, a subsidiary within the ARM Holdings plc group. The amount of distributable reserves in ARM Limited at 31 December 2006 was £166 million. However, it came to the attention of the directors in February 2007 that the distributable reserves of ARM Holdings plc (company only), which are required to fund both the share buyback programme and dividends, had been fully utilized by 19 May 2006 (although sufficient distributable reserves were available in ARM Limited). Accordingly, 49.5 million of the shares acquired by the Company in 2006 and a further 6.2 million shares acquired in early 2007 were acquired at a time when ARM Holdings plc had insufficient distributable reserves. Had the board been aware of the shortfall in distributable reserves in ARM Holdings plc at the relevant time, it would have arranged for the payment of a dividend to ARM Holdings plc from ARM Limited to cover the shortfall.

As a result of the shortfall in distributable reserves, the relevant shares have not been properly acquired under the applicable statutory requirements, and so ARM Holdings plc is unable to re-issue such shares or cancel them. ARM Holdings plc has been advised that this matter should be resolved by cancelling the relevant shares by Court order.

A similar issue has arisen in relation to the interim dividend for 2006 which was paid to shareholders on 6 October 2006. At that time, ARM Holdings plc did not have sufficient distributable reserves to make such a payment, being approximately £5.5 million in aggregate (although sufficient distributable reserves were available in ARM Limited). This amounts to a technical breach of the statutory requirements.

A dividend from ARM Limited to ARM Holdings plc (via an intermediary holding company) was paid on 21 February 2007 and the directors have filed with the Registrar of Companies accounts for ARM Holdings plc as at 22 February 2007 reflecting such dividend. This resolves the position regarding ARM Holdings plc's distributable reserves with regard to the final dividend for 2006 and the Company's share buyback programme.

## 2 Related party transactions

During the year, the Company paid royalties of £124,000 (2005: £33,000; 2004: £411,000) and made cross-license payments of £nil (2005: £26,000; 2004: £14,000) to Superscape Group plc ("Superscape"), a company in which Mike Inglis is a non-executive director. £nil (2005: £nil) was owed to Superscape at 31 December 2006. In addition, in 2006 the Company received royalty fees of £19,000 (2005: £2,000; 2004: £6,000) and license fees of £nil (2005: £11,000; 2004: £nil). £17,000 was owed by Superscape at 31 December 2006 (2005: £nil).

Also during 2006, the Company received license fees of £3,085,000 (2005: £321,000; 2004: £209,000), support and maintenance income of £37,000 (2005: £37,000; 2004: £37,000) and evaluation tools fees of £82,000 (2005: £17,000; 2004: £nil) from CSR plc, a company in which John Scarisbrick is an executive director. £14,000 was owed by CSR at 31 December 2006 (2005: £nil).

During 2006, the Company received funding for SOI technology development of £319,000 from SOI TEC Silicon On Insulator Technologies SA ("Soitec"). Soitec is an SOI IP company in which Doug Dunn, Company Chairman, is a non-executive director. £383,000 is owed by Soitec at 31 December 2006.

## 3 Income taxes

Income before income tax is analyzed as follows:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 £000 | 2005 £000 | **2006 £000** |
| United Kingdom | 34,569 | 47,930 | **19,886** |
| Foreign | 3,886 | 5,304 | **37,162** |
| | 38,455 | 53,234 | **57,048** |

The provision for income taxes consisted of:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 £000 | 2005 £000 | **2006 £000** |
| **Current:** | | | |
| United Kingdom | 10,619 | 15,519 | **9,958** |
| Foreign | 1,490 | 1,430 | **6,138** |
| Total current | 12,109 | 16,949 | **16,096** |
| **Deferred:** | | | |
| United Kingdom | (1,171) | (1,241) | **(5,476)** |
| Foreign | (460) | (4,354) | **(1,182)** |
| Total deferred | (1,631) | (5,595) | **(6,658)** |
| Total provision for income taxes | 10,478 | 11,354 | **9,438** |

Included in the income tax payable is a current tax benefit of £3,682,000 (2005: £370,000; 2004: £826,000) and a deferred tax credit of £nil (2005: £6,072,000; 2004: £311,000) in relation to employee stock options. Such benefits are reflected as additional paid-in capital.

Also included in the provision for income taxes is utilization of the deferred tax liability in relation to acquired intangibles of £6,264,000 (2005: £6,921,000; 2004: £188,000).

Total income tax expense differs from the amounts computed by applying the UK statutory income tax rate of 30% for 2006, 2005 and 2004 to income before income tax as a result of the following:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 £000 | 2005 £000 | **2006 £000** |
| UK statutory rate 30% (2005: 30%; 2004: 30%) | 11,537 | 15,970 | **17,114** |
| Research and development tax credits | (1,651) | (1,911) | **(2,879)** |
| Permanent differences – foreign exchange* | – | – | **(4,164)** |
| Permanent differences – other** | 1,828 | (616) | **(3,856)** |
| Amortization of intangibles | (188) | (1,730) | **(1,467)** |
| Differences in statutory rates of foreign countries | 231 | (45) | **613** |
| Foreign withholding tax | – | 1,444 | **2,450** |
| Other, net*** | (1,279) | (1,758) | **1,627** |
| | 10,478 | 11,354 | **9,438** |

* The permanent difference on foreign exchange is net of valuation allowance charge of £3,394,000 in 2006.

** Permanent differences comprise permanent adjustments and benefits resulting from restructuring following the acquisition of Artisan.

*** Other, net comprises prior year adjustments, timing differences and deferred tax adjustments.

## 3 Income taxes continued

Significant components of the deferred tax assets/(liabilities) are as follows:

| | At 31 December 2005 £000 | At 31 December 2006 £000 |
|---|---|---|
| Stock compensation charge | 553 | **5,016** |
| Fixed asset temporary differences | 5,214 | **5,244** |
| Temporary difference on available-for-sale securities | (1,096) | **231** |
| Non-deductible accruals and reserves | 1,662 | **1,766** |
| Amounts relating to intangible assets arising on acquisition | (28,323) | **(20,074)** |
| Losses carried forward | 10,995 | **12,816** |
| R&D tax credits carried forward | 8,494 | **6,178** |
| Total deferred tax assets/(liabilities) | (2,501) | **11,177** |
| Valuation allowance | (366) | **(6,049)** |
| Net deferred tax assets/(liabilities) | (2,867) | **5,128** |

Disclosed on the balance sheet within:

| | At 31 December 2005 £000 | At 31 December 2006 £000 |
|---|---|---|
| Assets | 4,422 | **9,872** |
| Liabilities | (7,289) | **(4,744)** |
| Net deferred tax assets/(liabilities) | (2,867) | **5,128** |

Included in the amount of £20,074,000 (2005: £28,323,000) relating to intangible assets on acquisition is £13,178,000 (2005: £20,925,000) relating to liabilities that are expected to accrue after more than one year. All deferred tax assets of £25,202,000 (2005: £26,213,000) are expected to accrue after more than one year.

UK income taxes have not been provided at 31 December 2006 on unremitted earnings of approximately £31,809,000 (2005: £14,958,000; 2004: £5,670,000) of subsidiaries located outside the UK as such earnings are considered to be permanently invested. If these earnings were to be remitted without offsetting tax credits in the UK, taxes would be approximately £10,578,000 (2005: £2,379,000; 2004: £1,122,000). The valuation allowance relates to net operating loss carryforwards of certain subsidiaries, where management believes it is more likely than not such amounts will not be realized. None of the loss carryforwards expires before 2018. The future use of the net operating losses carried forward in ARM Inc. may be restricted in the event of a purchase by a third party, whereby the level of losses to be utilized on an annual basis would be limited to 4% of the market value of ARM Inc. at the date of the transaction.

As at 31 December 2006 the Company had federal net operating losses of £17,520,000 and a deferred tax asset thereon of £5,957,000. These losses begin to expire in 2019.

The Company also had state net operating losses of £2,814,000 and a deferred tax asset of £151,000 which begin to expire in 2013.

In addition to the net operating losses the Company also had unutilized federal R&D tax credits of £3,626,000 which will begin to expire in 2012 and unutilized state R&D tax credits of £2,552,000 which have no expiration date.

As a result of FAS 123R, the Company's deferred tax assets at 31 December 2006 do not include £1,909,000 of excess tax benefits from employee share option exercises that are a component of the Company's research and development and net operating loss carryovers. Equity will be increased by £1,909,000 if and when such excess tax benefits are ultimately realized.

## 4 Earnings per share

| | Income £ | Year ended 31 December 2004 Shares Number | Per share Amount |
|---|---|---|---|
| Net income | 27,977,000 | | |
| Basic EPS: | | | |
| Income available to common stockholders | 27,977,000 | 1,026,889,882 | 2.7p |
| Effect of dilutive securities: | | | |
| Stock options | | 22,878,223 | |
| Diluted EPS: | | | |
| Income available to common stockholders plus assumed conversion | 27,977,000 | 1,049,768,105 | 2.7p |

| | Income £ | Year ended 31 December 2005 Shares Number | Per share Amount |
|---|---|---|---|
| Net income | 41,880,000 | | |
| Basic EPS: | | | |
| Income available to common stockholders | 41,880,000 | 1,369,335,202 | 3.1p |
| Effect of dilutive securities: | | | |
| Stock options | | 57,701,294 | |
| Diluted EPS: | | | |
| Income available to common stockholders plus assumed conversion | 41,880,000 | 1,427,036,496 | 2.9p |

| | **Income £** | **Year ended 31 December 2006 Shares Number** | **Per share Amount** |
|---|---|---|---|
| Basic EPS: | | | |
| Net income before cumulative effect of change in accounting policy | **47,610,000** | **1,366,816,499** | **3.5p** |
| Cumulative effect of change in accounting policy | **(2,447,000)** | | **(0.2p)** |
| Net income after cumulative effect of change in accounting policy | **45,163,000** | | **3.3p** |
| Effect of dilutive securities: | | | |
| Stock options | | **37,934,830** | |
| Diluted EPS: | | | |
| Net income before cumulative effect of change in accounting policy | **47,610,000** | **1,404,751,329** | **3.4p** |
| Cumulative effect of change in accounting policy | **(2,447,000)** | | **(0.2p)** |
| Net income after cumulative effect of change in accounting policy | **45,163,000** | | **3.2p** |

## 5 Business risks and credit concentration

The Company operates in the intensely competitive semiconductor industry which has been characterized by price erosion, rapid technological change, short product life cycles, cyclical market patterns and heightened foreign and domestic competition. Significant technological changes in the industry could affect operating results.

Financial instruments that potentially subject the Company to concentrations of credit risk comprise principally cash, cash equivalents, short- and long-term investments and marketable securities and accounts receivable. The Company generally does not require collateral on accounts receivable, as many of the Company's customers are large, well-established companies. The Company has not experienced any significant losses related to individual customers or groups of customers in any particular industry or geographic area.

The Company markets and sells to a relatively small number of customers with individually large value transactions. At 31 December 2004, 2005 and 2006 no customers accounted for more than 10% of accounts receivable.

At 31 December 2005 and 2006, the Company's cash, cash equivalents, short-term investments and marketable securities were deposited with major clearing banks and building societies in the UK and US in the form of money market deposits and corporate bonds for varying periods up to two years.

## 6 Acquisitions

**Falanx Microsystems AS**

On 30 May 2006, the Company purchased the entire share capital of Falanx Microsystems AS ("Falanx"), a graphics IP company incorporated in Norway for total consideration of $25.1 million (£13.4 million), comprising $24.9 million cash consideration and $0.2 million of related acquisition expenses.

Falanx develops graphics accelerator IP and software for semiconductor system-on-chip (SoC) vendors that deliver high-quality multimedia images without compromising performance, power consumption or system cost. The acquisition fits the ARM strategy of enabling users to create SoCs seamlessly in their design process. The Mali Graphics Processor Unit (GPU) is a combination of hardware and software that enables industry-leading 3D graphics and video on mobile phones, portable media players, set-top boxes, handheld gaming devices and automotive systems, providing the Company with full control over the development of its future 3D graphics solutions.

The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date.

The operating results for Falanx have been included in these financial statements for the period from 30 May 2006 to 31 December 2006. The acquisition was accounted for under SFAS 141.

The following table sets out the provisional fair values of the assets acquired and liabilities assumed at the date of acquisition:

| | Fair value to Company £000 |
|---|---|
| **Assets:** | |
| Cash and cash equivalents | 24 |
| Accounts receivable, net | 118 |
| Other debtors | 101 |
| Deferred tax asset | 543 |
| Property and equipment, net | 62 |
| **Total assets acquired** | **848** |
| **Liabilities:** | |
| Accounts payable and other creditors | (238) |
| Accrued liabilities and deferred revenue | (368) |
| **Total liabilities assumed** | **(606)** |
| **Net assets acquired** | **242** |

The intangible assets recognized, apart from goodwill, represented contractual or other legal rights of Falanx and those intangible assets of Falanx that could be clearly identified. These intangibles were identified and valued through interviews and analysis of data provided by Falanx concerning development projects, their stage of development, the time and resources needed to complete them, and if applicable, their expected income generating ability. There were no other contractual or other legal rights of Falanx clearly identifiable by management, other than those identified below. The allocation of the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed was as follows:

| | Useful estimated life (years) | £000 |
|---|---|---|
| Fair value of net assets acquired | | 242 |
| Intangible assets acquired: | | |
| Developed technology | 3 – 5 | 4,267 |
| Customer relationships | 3 | 990 |
| Deferred tax liability | | (1,472) |
| Goodwill | | 9,383 |
| **Purchase price** | | **13,410** |

If the acquisition of Falanx had occurred on 1 January 2006, net income for the Company would have been £0.8 million lower than reported, including the additional amortization of intangibles.

## 6 Acquisitions continued

**Soisic SA**

On 30 October 2006, the Company purchased the entire share capital of Soisic SA ("Soisic"), a silicon-on-insulator (SOI) IP company incorporated in France for consideration of €5.1 million (£3.4 million), comprising €4.7 million cash consideration and €0.4 million of related acquisition expenses.

With this acquisition, the Company is making an investment in new technologies related to physical IP to enhance its leadership position in providing customers access to the higher performance and lower power offered by SOI process technologies. Soisic develops a similar set of products to the ARM Physical IP Division, specifically standard cells, static random access memory (SRAM) compilers and input/output (I/O) cells, however, based on SOI design rules and process models. Integrating this capability with ARM's widely-used physical IP opens the possibility for system-on-chip (SoC) designers to access SOI technology, which currently is used only in full custom designs, such as high-performance microprocessors.

The Company is investing in this area to be at the forefront of the design technologies needed to exploit the potential advantages of SOI as its usage grows in mobile, home and enterprise SoC and ASIC applications.

The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date. A further €8 million is potentially payable on the achievement of various post-acquisition financial milestones and will be accrued when the milestones have been achieved, other than as noted below, whereby a small portion of this contingent consideration has been accrued at acquisition.

The operating results for Soisic have been included in these financial statements for the period from 30 October 2006 to 31 December 2006. The acquisition was accounted for under SFAS 141.

The following table sets out the provisional fair values of the assets acquired and liabilities assumed at the date of acquisition:

| | Fair value to Company £000 |
|---|---|
| **Assets:** | |
| Accounts receivable, net | 165 |
| Other debtors | 411 |
| Deferred tax asset | 1,392 |
| Property and equipment, net | 117 |
| **Total assets acquired** | **2,085** |
| **Liabilities:** | |
| Cash overdraft | (53) |
| Accounts payable and other creditors | (949) |
| Accrued liabilities | (413) |
| **Total liabilities assumed** | **(1,415)** |
| **Net assets acquired** | **670** |

The intangible assets recognized represented those intangible assets of Soisic that could be clearly identified. These intangibles were identified and valued through interviews and analysis of data provided by Soisic concerning development projects, their stage of development, the time and resources needed to complete them, and if applicable, their expected income generating ability. There were no other contractual or other legal rights of Soisic clearly identifiable by management, other than those identified below. The allocation of the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed was as follows:

| | Useful estimated life (years) | £000 |
|---|---|---|
| Fair value of net assets acquired | | 670 |
| Intangible assets acquired: | | |
| Developed technology | 5 | 4,283 |
| Deferred tax liability | | (1,413) |
| **Purchase price** | | **3,540** |

The purchase price above includes £0.1 million of contingent consideration. Whilst the Company does not normally accrue this payable until earned, in line with SFAS 141 it has been accrued to reduce any potential negative goodwill to nil.

If the acquisition of Soisic had occurred on 1 January 2006, net income for the Company would have been £2.5 million lower than reported, including the additional amortization of intangibles.

## 6 Acquisitions continued

**PowerEscape Inc.**
On 21 June 2006, the Company purchased certain assets of PowerEscape Inc., a private company incorporated in the US, for total consideration of $1.1 million (£0.6 million), comprising $1.0 million cash consideration and $0.1 million of related acquisition expenses.

The PowerEscape team, which has been integrated into the Company's Development Systems Division, will focus on adding innovative profiling and analysis features to the Company's portfolio of market-leading development tools.

The Company has allocated £595,000 of the purchase price to in-process research and development which reflects certain research projects that have not yet reached technological feasibility and commercial viability or had no alternative future use at the time of the acquisition. In-process research and development has been written-off immediately to the income statement.

**Keil Elektronik GmbH and Keil Software Inc.**
On 27 October 2005, the Company purchased the entire share capital of Keil Elektronik GmbH (KEG), a company incorporated in Germany for total consideration of $10.9 million (£6.1 million), comprising $10.4 million cash consideration and $0.5 million of related acquisition expenses. On the same day, the Company purchased the entire share capital of Keil Software Inc. (KSI), a US company, for total consideration of $5.2 million (£2.9 million), comprising $5.0 million cash consideration and $0.2 million of related acquisition expenses.

The Company has identified the MCU market as a critical growth area for the Company's future business and with this acquisition, the Company will be able to accelerate progress in that market by offering a more complete solution. As the MCU applications shift from 8/16-bit to 32-bit solutions, the combination of the ARM Cortex-M3 processor, which is ideally suited for microcontroller applications, the RealView high-performance compiler, and Keil's complementary MCU tools for ARM, will enable new generations of ARM MCU solutions.

The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date. A further $2.3 million for KEG and $1.0 million for KSI was potentially payable on the achievement of various post-acquisition financial milestones. The financial milestones relating to the first year post-acquisition were achieved in 2006 and are accrued at the year end. Further potential payments relating to the second year post-acquisition will be accrued when payable. Keil is a leading independent provider of software development tools for the microcontoller (MCU) market.

The acquisition was accounted for under SFAS 141. The operating results for Keil have been included in these financial statements for the period 27 October 2005 to 31 December 2005 in the 2005 comparatives and for the entire year in 2006.

The following table sets out the provisional fair values of the assets acquired and liabilities assumed at the date of acquisition as reported in the 2005 annual report:

| Fair value to Company | KEG £000 | KSI £000 |
|---|---|---|
| **Assets:** | | |
| Cash and cash equivalents | 2,911 | 32 |
| Accounts receivable, net | 477 | 169 |
| Inventories | 60 | 36 |
| Other debtors | 11 | 5 |
| Property and equipment, net | 12 | – |
| **Total assets acquired** | **3,471** | **242** |
| **Liabilities:** | | |
| Accounts payable and other creditors | (1,593) | (19) |
| Accrued liabilities and deferred revenue | (2,280) | (62) |
| **Total liabilities assumed** | **(3,873)** | **(81)** |
| **Net (liabilities assumed)/assets acquired** | **(402)** | **161** |

## 6 Acquisitions continued

The intangible assets recognized, apart from goodwill, represented contractual or other legal rights of Keil and those intangible assets of Keil that could be clearly identified. These intangibles were identified and valued through interviews and analysis of data provided by Keil concerning development projects, their stage of development, the time and resources needed to complete them, and if applicable, their expected income generating ability. There were no other contractual or other legal rights of Keil clearly identifiable by management, other than those identified below. The allocation of the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed was as follows:

| | Useful estimated life (years) | KEG £000 | KSI £000 |
|---|---|---|---|
| Fair value of net (liabilities assumed)/assets acquired | | (402) | 161 |
| Intangible assets acquired: | | | |
| Customer relationships | 2 – 3 | 4,290 | 482 |
| Developed technology | 1 – 5 | 2,744 | – |
| Trade names | 5 | – | 1,175 |
| Deferred tax liability | | (2,673) | (663) |
| Goodwill | | 2,178 | 1,764 |
| **Purchase price** | | **6,137** | **2,919** |

KEG made a profit after tax for the year ended 31 December 2004 of £1.0 million and for the period from 1 January 2005 until acquisition a profit after tax of £1.0 million. KSI made a loss after tax for the year ended 31 December 2004 of £95,000 and for the period from 1 January 2005 until acquisition a loss after tax of £40,000. The results of the Company would not have been significantly different had the acquisition of KEG and KSI occurred on the 1 January 2005.

During 2006, a further $1.1 million and $0.4 million consideration became payable for KEG and KSI respectively following the achievement of various post-acquisition financial milestones, with a corresponding increase to total consideration and goodwill. In addition, the provisional fair values in respect of KEG's income tax liabilities were finalized resulting in an increase in the net assets acquired by £1.1 million. Due to this change in fair value, an additional £1.1 million of consideration was paid. As both consideration and net assets were increased by the same amount, there was no corresponding change to goodwill.

**Axys Design Automation Inc.**
On 16 August 2004, the Company purchased the entire share capital of Axys Design Automation Inc., a US company, for total consideration of $12.5 million (£6.9 million), comprising $11.6 million cash consideration and $0.9 million of related acquisition expenses. The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date. A further $3 million was potentially payable on the achievement of various post-acquisition financial milestones. These were achieved during 2005 and were accrued and paid during the year. Axys is a provider of fast, accurate, integrated, processor and system modeling and simulation solutions and adds electronic system level expertise to ARM's design tools portfolio.

The acquisition was accounted for under SFAS 141. The operating results for Axys have been included in these financial statements for the period 16 August 2004 to 31 December 2004 in the 2004 comparatives and for the entire year in 2005 and 2006.

The following table sets out the provisional fair values of the assets acquired and liabilities assumed at the date of acquisition as reported in the 2004 annual report:

| | Fair value to Company £000 |
|---|---|
| **Assets:** | |
| Cash and cash equivalents | 107 |
| Accounts receivable, net | 270 |
| Other debtors | 74 |
| Deferred tax asset | 710 |
| Property and equipment, net | 50 |
| **Total assets acquired** | **1,211** |
| **Liabilities:** | |
| Accounts payable and other creditors | (17) |
| Accrued liabilities and deferred revenue | (729) |
| **Total liabilities assumed** | **(746)** |
| **Net assets acquired** | **465** |

## 6 Acquisitions continued

The intangible assets recognized, apart from goodwill, represented contractual or other legal rights of Axys and those intangible assets of Axys that could be clearly identified. These intangibles were identified and valued through interviews and analysis of data provided by Axys concerning development projects, their stage of development, the time and resources needed to complete them, and if applicable, their expected income generating ability. There were no other contractual or other legal rights of Axys clearly identifiable by management, other than those identified below. The allocation of the purchase price, as at 31 December 2004, to the tangible and identifiable intangible assets acquired and liabilities assumed was as follows:

| | Useful estimated life (years) | £000 |
|---|---|---|
| Fair value of net assets acquired | | 465 |
| Intangible assets acquired: | | |
| Developed technology | 5 | 1,379 |
| Customer relationships | 5 | 425 |
| Trademarks | 5 | 96 |
| In-process research and development | | 383 |
| Deferred tax liability | | (760) |
| Goodwill | | 4,914 |
| **Purchase price** | | **6,902** |

Axys' profit after tax for the year ended 31 December 2003 was £0.02 million and for the period from 1 January 2004 until acquisition was a loss of £0.9 million.

As noted above, a further $3 million consideration was paid during 2005 following the achievement of various post-acquisition financial milestones. As a result, total consideration and resultant goodwill increased by £1,690,000 during that year.

**Artisan Components Inc.**

On 23 December 2004, the Company acquired the entire share capital of Artisan Components Inc., a leading provider of physical IP components for the design and manufacture of complex system-on-chip (SoC) integrated circuits. The acquisition enables the combined company to deliver one of the industry's broadest portfolios of SoC intellectual property to their extensive, combined customer base, with highly complementary sales channels combining ARM's channel to more than 170 silicon manufacturers with Artisan's channel to more than 2,000 companies. It better positions the combined company to benefit from growth opportunities across multiple industries as system design complexity increases, and strengthens the links between the key aspects of SoC development, enabling the combined company to deliver solutions that are further optimized for power and performance.

The acquisition was accounted for under SFAS 141. The operating results for Artisan have been included in these financial statements for the period 23 December 2004 to 31 December 2004 in the 2004 comparatives and for the entire year in 2005 and 2006.

The total consideration paid was $926.9 million (£481.7 million), comprising cash of $235.4 million (£122.3 million), 324,399,411 ordinary shares in the Company with a fair value of $524.2 million (£272.4 million), approximately 90.4 million share options issued to existing Artisan employees with fair value of $151.9 million (£79.0 million) and related direct acquisition fees of $15.4 million (£8.0 million) including legal, valuation and accounting fees. The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed on the basis of their estimated fair values on the acquisition date. These provisional fair values were subsequently amended during 2005 as noted below.

The shares issued in the acquisition were valued in accordance with Emerging Issues Take Force Issue No. 99-12 (EITF 99-12), "Determination of the measurement date for the market price of acquirer securities issued in a purchase business combination". In accordance with EITF 99-12, the Company established the first date on which the number of the Company shares and the amount of other consideration became fixed as of 23 August 2004. Accordingly the Company valued the transaction using the average closing price of the Company's ordinary shares two days before and after 23 August 2004, or $1.616 per share. The assumed options to acquire ordinary shares were valued using the Black-Scholes valuation model with volatility of between 80% and 94%, an average risk-free interest rate of 4.5%, an estimated life of between zero and six years, and dividend yield of 0.7%.

## 6 Acquisitions continued

The following table sets out the provisional fair values of the assets acquired and liabilities assumed at the date of acquisition as reported in the 2004 annual report:

| | Fair value to Company £000 |
|---|---|
| **Assets:** | |
| Cash, cash equivalents and marketable securities | 82,567 |
| Accounts receivable, net | 15,078 |
| Prepaid expenses and other assets | 3,225 |
| Deferred tax asset | 15,446 |
| Property and equipment, net | 2,509 |
| **Total assets acquired** | **118,825** |
| **Liabilities:** | |
| Accounts payable and other creditors | (3,674) |
| Accrued and other liabilities | (13,245) |
| Deferred revenue | (6,545) |
| **Total liabilities assumed** | **(23,464)** |
| **Net assets acquired** | **95,361** |

The intangible assets recognized, apart from goodwill, represented contractual or other legal rights of Artisan and those intangible assets of Artisan that could be clearly identified. These intangibles were identified and valued through interviews and analysis of data provided by Artisan concerning development projects, their stage of development, the time and resources needed to complete them, and if applicable, their expected income-generating ability. There were no other contractual or other legal rights of Artisan clearly identifiable by management, other than those identified below. The provisional allocation of the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed was as follows:

| | Useful estimated life (years) | £000 |
|---|---|---|
| Fair value of net assets acquired | | 95,361 |
| Intangible assets acquired: | | |
| Developed technology | 4 – 5 | 18,177 |
| Patents/core technology | 5 – 7 | 11,719 |
| Existing agreements and customer relationships | 3 – 8 | 36,354 |
| Trademarks/tradenames | 4 – 5 | 2,500 |
| Order backlog | 0 – 1 | 1,354 |
| In-process research and development | | 3,229 |
| Deferred stock-based compensation | | 9,579 |
| Deferred tax liability | | (28,042) |
| Goodwill | | 331,432 |
| **Purchase price** | | **481,663** |

**Developed technology** Developed technology of £18.2 million and patents and core technology of £11.7 million included intellectual property components for use in SoC integrated circuits and consisted of the following: embedded memory, standard cell, input/output components, and analog and mixed-signal products. In addition, developed technology included a combination of processes, patents, patent applications, core modular architecture and trade secrets that are the buildings blocks of the technology. At the date of acquisition, the developed technology was complete and had reached technological feasibility. Any costs incurred in the future will relate to the ongoing maintenance of the developed technology and will be expensed as incurred. To estimate the fair value of the developed technology, an income approach was used with a discount rate of 14% for existing technology and 16% for patents and core technology, which included an analysis of future cash flows and the risks associated with achieving such cash flows. All developed technologies are being amortized over the estimated useful lives of four to five years.

**Existing agreements and customer relationships and order backlog** The customer base of £36.4 million and order backlog of £1.4 million represented the fair value of existing customer relationships and contracts, royalty arrangements, and support and maintenance agreements. To estimate the fair value of the customer base and order backlog, a cost approach (replacement value) was used. The customer base and order backlog are being amortized over their estimated useful lives of three to six years for customer base and one year for order backlog.

**Trademarks and tradenames** The fair value assigned to trademarks and tradenames, including the company name Artisan, was estimated using the income approach, which discounts the present value of attributable cash flows at a discount rate of 16%.

**In-process research and development** Development projects that had reached technological feasibility were classified as developed technology and the value assigned to developed technology was capitalized. Expensed in-process research and development of £3.2 million reflected certain research projects that had not yet reached technological feasibility and commercial viability or had no alternative future use at the time of the acquisition. The fair value assigned to in-process research and development was estimated using the income approach, which discounts to present value the cash flows attributable to the technology once it has reached technological feasibility using a discount rate of 19%. In-process research and development has been written-off immediately to the income statement.

## 6 Acquisitions continued

Goodwill of £331.4 million represented the excess of the purchase price over the fair value of the net tangible and intangible sets acquired. As stated, the acquisition enables the combined company to deliver one of the industry's broadest portfolios of SoC intellectual property to their extensive, combined customer base and it better positions the combined company to benefit from growth opportunities across multiple industries as system design complexity increases. These, combined with the ability to hire the entire Artisan work force, were significant contributing factors to the establishment of the purchase price, resulting in the recognition of a significant amount of goodwill. In accordance with SFAS 142, the Company is not amortizing goodwill relating to the acquisition. It is being carried at cost and the Company tests it for impairment annually and whenever events indicate that an impairment may have occurred.

The pro forma results of the Company for 2004, had the acquisition occurred on 1 January 2004, and for the prior year, had the acquisition occurred on 1 January 2003, would have been:

| | 2003 Unaudited £000 | 2004 Unaudited £000 |
|---|---|---|
| Revenues | 173,277 | 197,852 |
| Income from operations | 3,730 | 15,973 |
| Net income | 1,650 | 16,365 |
| Diluted earnings per ordinary share | 0.1p | 1.2p |

Net income has been reduced in these pro forma results in relation to reduced interest income as a result of the cash portion of the acquisition consideration, amortization of intangibles acquired and amortization of deferred compensation.

During 2005, the provisional fair values were finalized resulting in an increase in the net assets acquired of $2.9 million (£1.5 million) with a corresponding decrease to goodwill. The principal adjustments were an increase to the deferred tax asset (representing deductions arising on exercise of options issued in a business combination, in accordance with EITF00-23) of £4.8 million, an increase in intangible assets acquired (including in-process research and development but net of deferred tax) of £0.8 million, a reduction in deferred tax assets relating to carried forward losses of £1.4 million, and additional provisions for unaccrued costs of £2.7 million.

## 7 Investments and marketable securities

| | Listed investments £000 | Unlisted investments £000 | Total investments £000 |
|---|---|---|---|
| **Cost** | | | |
| At 1 January 2006 | 2,010 | 1,805 | 3,815 |
| Additions | – | 165 | 165 |
| Disposal | (296) | – | (296) |
| **At 31 December 2006** | **1,714** | **1,970** | **3,684** |
| **Aggregate movements in fair value** | | | |
| At 1 January 2006 | 4,985 | – | 4,985 |
| Unrealized holding losses | (1,589) | – | (1,589) |
| Disposal | (3,225) | – | (3,225) |
| **At 31 December 2006** | **171** | **–** | **171** |
| **Carrying value** | | | |
| **At 31 December 2006** | **1,885** | **1,970** | **3,855** |
| At 31 December 2005 | 6,995 | 1,805 | 8,800 |

Listed investments comprise an investment in Superscape Group plc, the fair value of which at 31 December 2006 is £1,885,000 (2005: £3,474,000; 2004: £8,795,000). In 2006, the Company disposed of its investment in CSR plc for £5.6 million resulting in a profit of £5.3 million that was recognized in the 2006 income statement. The fair value of this investment at 31 December 2005 was £3,521,000 (2004: £1,467,000).

In 2005, the Company invested £274,000 in Luminary Micro Inc., an unlisted company, and made a further investment of £165,000 in the company in 2006.

At 31 December 2006, the Company had £19,151,000 (2005: £8,835,000) of short-term marketable securities. These represent both the fair market value and amortized cost of these securities.

## 8 Property and equipment

| | At 31 December 2005 £000 | 2006 £000 |
|---|---|---|
| Owned buildings | 190 | **190** |
| Leasehold improvements | 20,058 | **18,054** |
| Computers | 17,944 | **18,445** |
| Software | 36,530 | **8,457** |
| Fixtures, fittings and motor vehicles | 4,176 | **4,676** |
| | 78,898 | **49,822** |
| Less: accumulated depreciation | (66,095) | **(35,852)** |
| Property and equipment, net | 12,803 | **13,970** |

Depreciation charged to income for the years ended 31 December 2004, 2005 and 2006 was £9,927,000, £7,750,000 and £6,895,000 respectively. The net book value of software at 31 December 2006 was £3,674,000 (2005: £3,813,000) with depreciation charged in 2006 on software of £1,610,000 (2005: £1,851,000; 2004: £4,395,000).

## 9 Intangible assets

| | Goodwill £000 | Patents £000 | Licenses £000 | Developed technology £000 | Existing agreements & customer relationships £000 | Core technology £000 | Trademarks £000 | Order backlog £000 | Total £000 |
|---|---|---|---|---|---|---|---|---|---|
| **Cost** | | | | | | | | | |
| At 1 January 2006 | 388,892 | 8,196 | 5,906 | 23,644 | 47,076 | 13,455 | 4,225 | 1,864 | 493,258 |
| Additions (Falanx) | 9,383 | – | – | 4,267 | 990 | – | – | – | 14,640 |
| Additions (Soisic) | – | – | – | 4,283 | – | – | – | – | 4,283 |
| Additions (KEG) | 635 | – | – | – | – | – | – | – | 635 |
| Additions (KSI) | 209 | – | – | – | – | – | – | – | 209 |
| Exchange differences | (46,556) | – | – | (2,518) | (5,239) | (1,653) | (518) | (229) | (56,713) |
| **At 31 December 2006** | **352,563** | **8,196** | **5,906** | **29,676** | **42,827** | **11,802** | **3,707** | **1,635** | **456,312** |
| **Aggregate amortization** | | | | | | | | | |
| At 1 January 2006 | 3,320 | 8,014 | 4,970 | 5,501 | 8,111 | 2,749 | 812 | 1,864 | 35,341 |
| Charge for the year | – | 137 | 357 | 6,042 | 8,940 | 2,515 | 926 | – | 18,917 |
| Exchange differences | – | – | – | (948) | (1,390) | (493) | (156) | (229) | (3,216) |
| **At 31 December 2006** | **3,320** | **8,151** | **5,327** | **10,595** | **15,661** | **4,771** | **1,582** | **1,635** | **51,042** |
| **Net book value** | | | | | | | | | |
| **At 31 December 2006** | **349,243** | **45** | **579** | **19,081** | **27,166** | **7,031** | **2,125** | **–** | **405,270** |
| At 31 December 2005 | 385,572 | 182 | 936 | 18,143 | 38,965 | 10,706 | 3,413 | – | 457,917 |

Amortization charged to income for the years ended 31 December 2004, 2005 and 2006 was £3,197,000, £20,310,000 and £18,917,000 respectively.

Licenses to use technology are being amortized over periods of three to five years. The amortization periods for licenses have been determined according to their estimated useful economic life.

Patents are being amortized over four to five years, developed and core technology (the main IP of the Company existent at acquisition and generating revenue) over five years and customer relationships (relationships with customers which were generating revenue at acquisition) over two to six years, being the periods over which the Company is expected to derive benefit from them.

The estimated amortization expense of intangible assets in each of the next five years is set forth below:

| | £000 |
|---|---|
| 2007 | 18,879 |
| 2008 | 17,469 |
| 2009 | 10,989 |
| 2010 | 7,645 |
| 2011 | 1,045 |

## 9 Intangible assets continued

Until the adoption of SFAS 142 on 1 January 2002 (see footnote 1), goodwill was being amortized on a straight-line basis over periods of up to three years, determined in each case by reference to employee turnover rates in the industry and the individual technology acquired with the acquisitions. In accordance with SFAS 142, goodwill is no longer amortized, and is tested for impairment at least annually.

The split of goodwill by segment is shown below. Additions in the year relating to Keil and Falanx have been allocated to the Development Systems and Processor divisions respectively. The foreign exchange difference arises as goodwill on Artisan, Axys and KSI is denominated in US dollars and thus is subject to revaluation at the period-end rates. Changes in the carrying amount for the year are as follows:

| | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Total £000 |
|---|---|---|---|---|
| Balance at 1 January 2006 | 113,358 | 259,197 | 13,017 | 385,572 |
| Additions (KEG) | – | – | 635 | 635 |
| Additions (KSI) | – | – | 209 | 209 |
| Additions (Falanx) | 9,383 | – | – | 9,383 |
| Exchange differences | (13,645) | (31,836) | (1,075) | (46,556) |
| **Balance at 31 December 2006** | **109,096** | **227,361** | **12,786** | **349,243** |

## 10 Accounts receivable

Included within accounts receivable at 31 December 2006 are £23.8 million (2005: £20.5 million) of amounts recoverable on contracts.

## 11 Accrued liabilities

Included within accrued liabilities at 31 December 2006 are £8.8 million (2005: £0.7 million) for staff costs and £3.2 million (2005: £1.8 million) representing unpaid consideration for acquisitions.

## 12 Shareholders' equity

**Share options** The board is authorized to issue options to acquire ordinary shares in the Company up to a maximum of 10% of the issued ordinary share capital in any five-year period. Options issued prior to the listing of the Company are excluded from this calculation. The exercise of options or vesting of share awards will be satisfied either out of newly-issued share capital, or from shares held by the Company as treasury stock or within the ESOP. Treasury stock is purchased from the market and the quantum and timing of these purchases is at the discretion of the directors, and based on the share price and short-term cash requirements of the Company.

Under the UK Inland Revenue Executive Approved Share Option Plan (the "Executive Scheme"), the Company may grant options to employees meeting certain eligibility requirements. Options under the Executive Scheme are exercisable between three and ten years after their issue, after which time the options expire.

Under the Company's Unapproved Scheme (the "Unapproved Scheme"), for which it has not sought approval from the UK Inland Revenue, options are exercisable one to seven years after their issue, after which time the options expire. The Company also operates the US ISO Scheme, which is substantially the same as the Unapproved Scheme, the main difference being that the options are exercisable one to five years after their issue. Under both of these schemes options are exercisable as follows: 25% maximum on first anniversary, 50% maximum on second anniversary, 75% maximum on third anniversary, 100% maximum on fourth anniversary. Various options to directors under the Unapproved Scheme have certain performance criteria attached, which if met are exerciseable after three years, otherwise they will become exerciseable after seven years.

There are further schemes for our French and Belgian employees (the "French Scheme" and the "Belgian Scheme"). In the French Scheme, options are exercisable between four and seven years after their issue, whilst in the Belgian Scheme, options are exercisable from 1 January following the third anniversary after their issue, up to seven years from issue.

From 2006, the Company has begun issuing Restricted Stock Units ("RSUs") to employees instead of options as approved at the 2006 AGM. RSUs are actual share awards on vesting rather than options to buy shares at a fixed exercise price. The main RSU awards (to employees in all jurisdictions other than France) vest similarly to the unapproved scheme above, namely 25% on the each anniversary over four years. RSU awards to our French employees vest 50% after two years, and then a further 25% after three and four years. Whilst the Company reserves the right to award options to employees going forward, the majority of awards to employees will be in RSUs.

## 12 Shareholders' equity continued

Additionally from 2006, the Company has started the new Deferred Annual Bonus plan ("DAB"). Under the DAB, which is for directors and selected senior management within the Company, participants are required to defer 50% of any related annual bonus into shares on a compulsory basis. These shares will be deferred for three years, and then a further matching award will be made depending on the achievement of an EPS performance condition over that time. The Company also operates the Long Term Incentive Plan ("LTIP"), also for directors and selected senior management, whereby share awards are made and vest depending on the Company's TSR performance compared to two comparator groups over the three-year performance period.

Upon the acquisition of Artisan in 2004, the Company assumed the share schemes of Artisan existing at acquisition. The schemes remained substantially the same as prior to the acquisition, other than the options became options to purchase shares in ARM Holdings plc instead of Artisan Components Inc. The number and value of options were amended in line with the conversion ratio as detailed in the merger agreement. The schemes assumed were the "1993 Plan", the "1997 Plan", the "2000 Plan", the "2003 Plan", the "Director Plan", the "Executive Plan" and the "ND00 Plan".

Under each plan, there are multiple vesting templates and vesting periods. The majority of the options were already vested upon acquisition, and the most common template was 25% vesting after one year, and then 6.25% vesting each quarter thereafter, until 100% vest after four years. Some options vest on a monthly basis, and some vest over five years. All options lapse ten years from the date of grant.

In 1998, the Company set up two savings-related share option schemes for all employees and executive directors of the Company. The number of options granted is related to the value of savings made by the employee. The period of savings is three or five years except for employees of ARM Inc. where the period is two years. The option price is currently set at 85% of the market share price prior to the grant, and the right to exercise normally only arises for a six-month period once the savings have been completed except for ARM Inc. where the right to exercise normally only arises for a three-month period once the savings have been completed. The Company set up further savings-related option schemes in each year up to and including 2006 for all employees and executive directors of the Company, which have the same characteristics as those schemes set up in 1998.

Activity under all share schemes is detailed below, including weighted average exercise prices for share options and weighted average grant-date fair values for share awards:

| | Outstanding options | | Outstanding RSUs/LTIP awards | |
|---|---|---|---|---|
| | Options Number | Weighted average exercise price £ | Awards Number | Weighted average grant-date fair value £ |
| Balances, 31 December 2003 | 65,491,080 | 1.455 | 2,572,646 | 0.805 |
| Granted in year | 16,934,076 | 1.226 | 2,597,114 | 1.005 |
| Assumed on acquisition of Artisan | 90,414,815 | 0.434 | – | – |
| Lapsed in year | (5,770,196) | 1.914 | (166,036) | 0.805 |
| Exercised in year | (3,049,960) | 0.431 | – | – |
| Balances, 31 December 2004 | 164,019,815 | 0.870 | 5,003,724 | 0.909 |
| Granted in year | 27,127,630 | 1.051 | 3,543,455 | 1.165 |
| Lapsed in year | (11,027,172) | 1.110 | (786,298) | 0.987 |
| Exercised in year | (37,096,283) | 0.374 | – | – |
| Balances, 31 December 2005 | 143,023,990 | 1.014 | 7,760,881 | 1.018 |
| Granted in year | 9,064,290 | 1.250 | 10,589,718 | 1.310 |
| Additional awards earned based on performance conditions | – | – | 1,672,009 | 0.805 |
| Lapsed in year | (9,508,283) | 1.697 | (558,985) | 1.255 |
| Options exercised/awards vested in year | (30,656,261) | 0.583 | (3,798,567) | 0.805 |
| **Balances, 31 December 2006** | **111,923,736** | **1.093** | **15,665,056** | **1.236** |

The total number of options exerciseable at 31 December 2006 was 74,533,736 (2005: 64,431,089; 2004: 69,624,728).

The weighted average grant-date fair value of options granted during 2006 was £0.43 (2005: £0.38; 2004: £0.74). Included within these are options within the SAYE scheme which have an exercise price that was 85% of the market price at date of grant. The weighted average grant-date fair value of these SAYE options granted during 2006 was £0.44 (2005: £0.40; 2004: £0.73). The weighted-average exercise price of these SAYE options granted during 2006 was £1.0264 (2005: £0.9095; 2004: £0.9435).

The total pre-tax intrinsic value of options exercised and LTIP awards made in 2006 was £21.6 million and £5.2 million respectively. This intrinsic value represents the difference between the fair market value of the Company's shares on the date of exercise and the exercise price of each option. The total fair value of LTIP awards that vested in 2006 was £1.7 million. Based on the closing price of the Company's shares on 31 December 2006 of £1.2575 per share, the total pre-tax intrinsic value of all outstanding options, RSUs and LTIP awards was £67.3 million. The total pre-tax intrinsic value of all exerciseable options at 31 December 2006 was £39.2 million.

The total cash received on the exercise of options in the year was £17.9 million. The total tax benefits realized from the exercise of options and share awards in the year was £9.0 million.

## 12 Shareholders' equity continued

The following options over ordinary shares were in existence at 31 December:

| 2006 Exercise price (£) | Number outstanding | Options outstanding Weighted average remaining life (years) | Weighted average exercise price (£) | Number outstanding | Options exercisable Weighted average remaining life (years) | Weighted average exercise price (£) |
|---|---|---|---|---|---|---|
| 0.026 – 0.40 | 15,662,942 | 4.24 | 0.25 | 15,662,942 | 4.24 | 0.25 |
| 0.405 – 0.50 | 21,310,841 | 4.13 | 0.45 | 19,649,705 | 4.01 | 0.45 |
| 0.51 – 0.9475 | 17,465,042 | 5.96 | 0.71 | 9,678,857 | 6.48 | 0.66 |
| 1.005 – 1.224 | 25,943,761 | 4.37 | 1.07 | 9,884,878 | 4.03 | 1.09 |
| 1.25 – 7.738 | 31,541,150 | 3.52 | 2.18 | 19,657,354 | 2.55 | 2.72 |
| **Total** | **111,923,736** | **4.31** | **1.09** | **74,533,736** | **4.00** | **1.12** |

There were also 7,893,640 RSUs and 7,771,416 LTIP awards outstanding at 31 December 2006 with a weighted average remaining life of 1.51 years. RSUs and LTIP awards have no exercise price and all were unvested at 31 December 2006.

## 13 Commitments and contingencies

The Company leases its office facilities (which expire at various dates through 2018) and certain equipment (including EDA design tools which expire at various dates through 2009) under non-cancelable operating lease agreements.

Future minimum lease commitments at 31 December 2006, are as follows:

| Years ending 31 December | Operating leases £000 |
|---|---|
| 2007 | 16,773 |
| 2008 | 15,619 |
| 2009 | 6,526 |
| 2010 | 2,445 |
| 2011 | 2,183 |
| Thereafter | 9,122 |
| Total minimum lease payments | 52,668 |

Rental expense under operating leases totaled £12,627,000, £15,809,000 and £18,800,000 for the years ended 31 December 2004, 2005 and 2006 respectively.

In May 2002, Nazomi Communications, Inc. ("Nazomi") filed suit against ARM alleging willful infringement of Nazomi's US Patent No. 6,332,215 ("'215 Patent"). ARM answered Nazomi's complaint in July 2002 denying infringement. ARM moved for summary judgment and a ruling that the technology does not infringe Nazomi's patent. The United States District Court for the Northern District of California granted ARM's motion, and Nazomi appealed the District Court's ruling. In September 2004, the Court of Appeals for the Federal Circuit heard the appeal and issued its decision in April 2005. Because, in the opinion of the Court of Appeals for the Federal Circuit, the District Court did not construe the disputed claim term in sufficient detail for appellate review, the Court of Appeals for the Federal Circuit remanded the dispute back to the District Court for further analysis. A supplementary "Markman" hearing was held in October 2005 to decide the construction of a fundamental term in the '215 Patent and a decision on claim construction was delivered on 6 September 2006. The decision emphatically supports ARM's construction of the relevant term and consequently strongly supports ARM's non-infringement arguments. In December 2006, ARM filed a renewed motion for summary judgment and a ruling that the accused technology does not infringe the '215 patent. On 17 January 2007 Nazomi filed a response to ARM's renewed motion for summary judgment in which they stipulated that, based on the claim construction delivered by the District Court, the ARM technology accused in the suit does not infringe the '215 patent but also objected to the claim construction delivered by the District Court and indicated their intention to appeal the claim construction to the Court of Appeals for the Federal Circuit. On 30 January 2007 the District Court granted ARM's motion for summary judgment. Furthermore, on 13 February 2007 Nazomi filed notice of appeal to the Court of Appeals for the Federal Circuit. Based on independent legal advice, ARM is confident that the Court of Appeals will uphold the claim construction ruling delivered by the District Court in September 2006.

In October 2005, Technology Properties Limited, Inc. ("TPL") filed suit, in the United States District Court for the Eastern District of Texas (Marshall Division), against certain companies in the Fujitsu, Matsushita, NEC and Toshiba groups of companies alleging infringement of TPL's US Patents Nos. 5,809,336; 5,784,584 and 6,598,148 (the "Litigation"). All of the defendants are licensees of various ARM technologies. It was revealed as part of the preliminary infringement contentions in the Litigation, filed in July 2006, that certain ARM technology is alleged to infringe a single claim in US Patent No. 5,784,584 (the "'584 Patent"). In September 2006 ARM filed a motion to intervene in the Litigation and that motion has been granted. ARM is now a defendant party in the Litigation. The claim construction (or "Markman") hearing is scheduled for May 2007 and the trial date is scheduled for November 2007. Based on legal advice and written opinions received from external counsel, ARM is confident that the accused ARM technology does not infringe any of the claims of the '584 Patent or that the patent is invalid. ARM has voluntarily joined as a party to the Litigation to proactively defend its technology against ill conceived and false infringement allegations and fully expects to prove the case for non-infringement or invalidity in the course of the Litigation.

ARM does not expect any significant liability in respect of these claims.

### 13 Commitments and contingencies continued

**Guarantees** It is common industry practice for licensors of technology to offer to indemnify their licensees for loss suffered by the licensee in the event that the technology licensed is held to infringe the intellectual property of a third party. Consistent with such practice, the Company provides such indemnification to its licensees but subject, in all cases, to a limitation of liability. The obligation for the Company to indemnify its licensees is subject to certain provisos and is usually contingent upon a third party bringing an action against the licensee alleging that the technology licensed by the Company to the licensee infringes such third party's intellectual property rights. The indemnification obligations typically survive any termination of the license and will continue in perpetuity.

The Company does not provide for any such guarantees unless it has received notification from the other party that they are likely to invoke the guarantee. The provision is made if both of the following conditions are met: (i) information available prior to the issuance of the financial statements indicates that it is probable that a liability had been incurred at the date of the financial statements; and (ii) the amount of the liability can be reasonably estimated. Any such provision is based upon the directors' estimate of the expected costs of any such claim.

There was no provision for such guarantees at either 31 December 2006 or 31 December 2005.

At 31 December 2006, ARM had provided in aggregate £1.1 million (2005: £0.8 million) in relation to claims, being the expected future costs to be incurred.

At 31 December 2006, the Company had outstanding capital commitments of £525,000 (2005: £1,371,000).

### 14 Geographic and segment information

At 31 December 2006, the Company is organized on a worldwide basis into three business segments, namely the Processor Division ("PD"), the Physical IP Division ("PIPD") and the Development Systems Division ("DevSys"). In 2004, the directors were of the opinion the Company only had one class of business, and then following the acquisition of Artisan in December 2004, the Company had two reportable segments in 2005 (namely PD and PIPD).

This was based upon the Company's internal organization and management structure and was the primary way in which the Chief Operating Decision Maker ("CODM") and the rest of the board were provided with financial information. Whilst revenues were reported into four main revenue streams (namely licensing, royalties, development systems and services), the costs, operating results and balance sheets were only analyzed into the two segments.

In 2006, this structure and system of internal financial reporting to the CODM and board was changed resulting in a third division, namely DevSys, becoming a separate reportable segment. In previous years, the results of DevSys were reported within PD, but for ease of comparability, have been separated out in the comparatives below. PIPD consists of the business stream previously undertaken by Artisan. PD primarily comprises the legacy ARM products and services. Recent acquisitions have been allocated to the various divisions as follows: Axys in 2004 to DevSys, Artisan in 2004 to PIPD, KEG and KSI in 2005 to DevSys, Falanx in 2006 to PD and Soisic in 2006 to PIPD. Goodwill on each acquisition has also been allocated into these divisions, except for Artisan whereby this has been allocated between PD and PIPD.

The following analysis is of revenues, operating costs, interest income, income before income tax, depreciation and amortization, capital expenditure, total assets and liabilities, net assets and goodwill of each segment and of the Company in total:

**Year ended 31 December 2006**

| | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Unallocated £000 | Total £000 |
|---|---|---|---|---|---|
| Revenues | 180,426 | 53,996 | 28,832 | – | 263,254 |
| Operating costs | (115,196) | (66,593) | (40,967) | 4,522 | (218,234) |
| Interest income | – | – | – | 6,758 | 6,758 |
| Profit on disposal of available-for-sale security | – | – | – | 5,270 | 5,270 |
| Income/(loss) before income tax | 65,230 | (12,597) | (12,135) | 16,550 | 57,048 |
| Cumulative effect of change in accounting policy | (2,028) | (979) | (489) | – | (3,496) |
| Depreciation and amortization | 4,678 | 16,352 | 5,377 | – | 26,407 |
| Capital expenditure | 4,077 | 2,368 | 2,114 | – | 8,559 |
| Total assets | 157,350 | 314,586 | 33,614 | 147,153 | 652,703 |
| Total liabilities | (37,308) | (19,589) | (10,843) | (10,316) | (78,056) |
| Net assets | 120,042 | 294,997 | 22,771 | 136,837 | 574,647 |
| Goodwill | 109,096 | 227,361 | 12,786 | – | 349,243 |

## 14 Geographic and segment information continued

### Year ended 31 December 2005

| | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Unallocated £000 | Total £000 |
|---|---|---|---|---|---|
| Revenues | 156,641 | 50,159 | 25,639 | – | 232,439 |
| Operating costs | (87,357) | (64,012) | (30,868) | (2,285) | (184,522) |
| Interest income | – | – | – | 5,317 | 5,317 |
| Income/(loss) before income tax | 69,284 | (13,853) | (5,229) | 3,032 | 53,234 |
| Depreciation and amortization | 6,632 | 18,245 | 3,518 | – | 28,395 |
| Capital expenditure | 2,737 | 1,584 | 1,743 | – | 6,064 |
| Total assets | 161,885 | 349,769 | 36,068 | 168,371 | 716,093 |
| Total liabilities | (22,226) | (20,115) | (12,168) | (12,534) | (67,043) |
| Net assets | 139,659 | 329,654 | 23,900 | 155,837 | 649,050 |
| Goodwill | 113,358 | 259,197 | 13,017 | – | 385,572 |

### Year ended 31 December 2004

| | Processor Division £000 | Physical IP Division £000 | Development Systems Division £000 | Unallocated £000 | Total £000 |
|---|---|---|---|---|---|
| Revenues | 132,983 | 195 | 19,719 | – | 152,897 |
| Operating costs | (88,627) | (4,070) | (27,218) | (1,471) | (121,386) |
| Interest income | – | – | – | 6,944 | 6,944 |
| Income/(loss) before income tax | 44,356 | (3,875) | (7,499) | 5,473 | 38,455 |
| Depreciation and amortization | 9,671 | 3,586 | 3,479 | – | 16,736 |
| Capital expenditure | 3,525 | – | 1,511 | – | 5,036 |
| Total assets | 146,539 | 321,080 | 18,496 | 151,822 | 637,937 |
| Total liabilities | (35,207) | (38,212) | (5,846) | (6,345) | (85,610) |
| Net assets | 111,332 | 282,868 | 12,650 | 145,477 | 552,327 |
| Goodwill | 101,702 | 232,002 | 6,712 | – | 340,416 |

Unallocated operating costs are foreign exchange revaluation on monetary items, including cash and cash equivalents. Unallocated assets and liabilities include cash and cash equivalents, short-term investments and marketable securities, some deferred tax balances, current tax and VAT. There are no inter-segment revenues. The results of each segment have been prepared using consistent accounting policies with those of the Company as a whole.

The following analysis is of revenues by geographic segment and origin and long-lived assets, excluding deferred tax assets, by Group companies in each territory:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 £000 | 2005 £000 | **2006 £000** |
| Revenues (by market destination): | | | |
| Europe | 23,837 | 32,971 | **42,746** |
| US | 77,457 | 99,727 | **111,194** |
| Japan | 32,754 | 42,270 | **40,303** |
| Asia Pacific excluding Japan | 18,849 | 57,471 | **69,011** |
| Total revenues | 152,897 | 232,439 | **263,254** |

The Company's exports from the UK were £138,078,000, £172,592,000 and £195,868,000 for the years ended 31 December 2004, 2005 and 2006 respectively.

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 £000 | 2005 £000 | **2006 £000** |
| Revenues (by origin): | | | |
| Europe | 141,974 | 170,505 | **198,386** |
| US | 6,384 | 59,183 | **63,028** |
| Asia Pacific | 4,539 | 2,751 | **1,840** |
| **Total revenues** | 152,897 | 232,439 | **263,254** |

### 14 Geographic and segment information continued

| | At 31 December 2005 £000 | 2006 £000 |
|---|---|---|
| Long-lived assets (excluding deferred tax assets): | | |
| Europe | 17,550 | **13,045** |
| US | 3,268 | **3,614** |
| Asia Pacific | 785 | **1,166** |
| **Total long-lived assets** | 21,603 | **17,825** |

In 2006, 2005 and 2004, no single customer accounted for more than 10% of total revenues.

### 15 Fair values of financial instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

**Cash and cash equivalents, short-term investments and accounts receivable** The carrying amount approximates fair value because of the short maturity of those instruments.

**Marketable securities** The carrying amount approximates fair value because these instruments are marked-to-market.

**Foreign currency forward contracts** The fair value of foreign currency contracts and embedded derivatives are estimated using the settlement rates prevailing at the period end.

The estimated fair values of the Company's financial instruments are as follows:

| | At 31 December 2005 | | 2006 | |
|---|---|---|---|---|
| | Carrying amount £000 | Fair value £000 | **Carrying amount £000** | **Fair value £000** |
| Cash and cash equivalents | 128,077 | 128,077 | **90,743** | **90,743** |
| Short-term investments | 23,990 | 23,990 | **18,600** | **18,600** |
| Marketable securities | 8,835 | 8,835 | **19,151** | **19,151** |
| Accounts receivable | 55,518 | 55,518 | **69,552** | **69,552** |
| Foreign currency contracts | (1,708) | (1,708) | **439** | **439** |
| Embedded derivatives | (722) | (722) | **(1,620)** | **(1,620)** |

### 16 Valuation and qualifying accounts

| | Balance at 1 January £000 | Charged/ (credited) to income statement £000 | Acquired with subsidiary undertaking £000 | Reclassification £000 | Foreign exchange £000 | **Balance at 31 December £000** |
|---|---|---|---|---|---|---|
| 2006 – allowance for doubtful debts | 2,173 | 932 | – | (377) | (172) | **2,556** |
| 2005 – allowance for doubtful debts | 1,451 | 547 | 27 | – | 148 | **2,173** |
| 2004 – allowance for doubtful debts | 1,115 | (321) | 657 | – | – | **1,451** |
| 2006 – valuation allowance against deferred tax assets | 366 | 3,394 | 2,289 | – | – | **6,049** |
| 2005 – valuation allowance against deferred tax assets | 254 | 112 | – | – | – | **366** |
| 2004 – valuation allowance against deferred tax assets | 503 | (249) | – | – | – | **254** |

### 17 Post balance sheet events

At the 2007 Annual General Meeting of the Company, a final dividend of 0.6 pence per share (total cost £8,002,000) will be proposed in respect of the 2006 financial year, and if approved will be paid on 21 May 2007 to shareholders on the register at 4 May 2007.

Following the year end, the UK Government announced a cut of 2% in the UK corporation tax rates for large businesses with effect from 1 April 2008. Although not material, an adjustment to the Company's deferred tax assets will be required in 2007.

# Report of independent registered public accounting firm/US GAAP

**To the board of directors and shareholders of ARM Holdings plc**

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, consolidated statements of comprehensive income, changes in shareholders' equity and cash flows present fairly, in all material respects, the financial position of ARM Holdings plc and its subsidiaries at 31 December 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended 31 December 2006 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in footnote 1 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

**PricewaterhouseCoopers LLP** Chartered Accountants
London, England
2 April 2007

## Company balance sheet/UK GAAP

**At 31 December 2006**

| | Notes | 2006 £000 | 2005 £000 |
|---|---|---|---|
| **Fixed assets** | | | |
| Investments | 4 | **512,490** | 495,053 |
| **Current assets** | | | |
| Debtors | 5 | **10,039** | 9 |
| Cash at bank and in hand | | **123** | 613 |
| | | **10,162** | 622 |
| **Creditors:** amounts falling due within one year | 6 | **(96,429)** | (22,604) |
| **Net current liabilities** | | **(86,267)** | (21,982) |
| **Total assets less current liabilities** | | **426,223** | 473,071 |
| **Net assets** | | **426,223** | 473,071 |
| **Capital and reserves** | | | |
| Called-up share capital | 7 | **695** | 693 |
| Share premium account | 8 | **97,616** | 95,512 |
| Option reserve | 8 | **61,474** | 61,474 |
| Other reserve | 8 | **267,418** | 267,418 |
| Profit and loss account | 8 | **(980)** | 47,974 |
| **Equity shareholders' funds** | 9 | **426,223** | 473,071 |

The financial statements on pages 116 to 122 were approved by the board of directors on 2 April 2007 and were signed on its behalf by:

**Doug Dunn** Chairman

# Notes to the financial statements/UK GAAP

## 1 Principal accounting policies

The financial statements have been prepared in accordance with the Companies Act 1985 and applicable Accounting Standards in the UK. A summary of the more important accounting policies, which have been consistently applied and reviewed by the board of directors in accordance with Financial Reporting Standard (FRS) 18, "Accounting policies", is set out below:

**Basis of accounting** The financial statements are prepared in accordance with the historical cost convention.

**Investments in subsidiaries** Investments in subsidiaries are initially recorded at cost. Where an acquisition satisfied the provisions of sections 131 to 134 of the Companies Act 1985 for merger relief, the investment is stated at the nominal value of shares issued plus the fair value of any other consideration.

**Cash flow statement** The Company has taken advantage of the exemption in FRS 1 Revised 1996 "Cash flow statements" which provides that where a company is a member of a group and a consolidated cash flow statement is published, the company does not have to prepare a cash flow statement.

**Foreign currency** Transactions denominated in foreign currencies have been translated into sterling at actual rates of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies have been translated at rates ruling at the balance sheet date. Exchange differences have been included in operating profit.

**Taxation** Current tax is provided at amounts expected to be paid using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

**Financial instruments** The Company does not have any financial instruments, other than intercompany payables and receivables and cash. Due to the short-term nature of these balances, the Company considers the fair value of these items to equal the carrying value.

**Share schemes** The Group's Employee Share Ownership Plan (ESOP) and Qualifying Employee Share Ownership Trust (QUEST) are separately administered trusts which are funded by loans (the ESOP) and loans and gifts (the QUEST) from the Group, and the assets of which comprise shares in the Company. In accordance with UITF 38, "Accounting for ESOP Trusts", the Company recognises the assets and liabilities of the ESOP and the QUEST in its own accounts and shares held by the trusts are recorded at cost as a deduction in arriving at shareholders' funds until such time as the shares vest unconditionally to employees.

The Company issues equity-settled share-based payments, including an LTIP, to certain employees of subsidiary undertakings. In accordance with FRS 20, equity-settled share-based payments are measured at fair value at the date of grant. Fair value is measured by use of the Black-Scholes pricing model. The fair value determined at the grant date of the equity-settled share-based payments is expensed in the accounts of the subsidiary companies on a straight-line basis over the vesting period, based on the Company's estimate of the number of shares that will eventually vest.

The Company operates Save As You Earn (SAYE) schemes in the UK and an Employee Share Purchase Plan (ESPP) in the US. Options under these schemes are granted at a 15% discount to market price of the underlying shares on the date of grant. The UK SAYE schemes are approved by the Inland Revenue, which stipulates that the saving period must be at least 36 months. The Company's subsidiaries have recognised a compensation charge in respect of the UK SAYE plans and US ESPPs. The charges for these are calculated as detailed above.

The Company has taken advantage of the exemption available, and has applied the provisions of FRS 20 only to those options granted after 7 November 2002 and which were outstanding at 31 December 2004. The Company does not have any employees and as such all share-based compensation has been recorded as capital contributions to subsidiaries.

**Treasury shares** The Company has a share buyback programme under which the Company purchases its own shares and holds them as treasury shares. These shares will be used to satisfy employee share option exercises and other share awards. In accordance with UITF 38, the Company recognises these shares at cost as a deduction in arriving at shareholders' funds.

## 2 Profit for the financial year

As permitted by Section 230 of the Companies Act 1985, the parent company's profit and loss account has not been included in these financial statements. The parent company's profit after taxation, including dividends receivable and before dividends payable was £6,741,000 (2005: £19,908,000). Apart from six directors who have contracts of service with ARM Limited, the Company has no employees. All emoluments of these directors are paid by ARM Limited and are disclosed in the remuneration report within these financial statements.

### 3 Dividends paid and proposed

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Final dividend paid of 0.5 pence per ordinary share in respect of 2005 (2005: 0.42 pence in respect of 2004) | **6,918** | 5,673 |
| Interim dividend paid of 0.4 pence (2005: 0.34 pence) per ordinary share | **5,449** | 4,763 |
| | **12,367** | 10,436 |

The ESOP trust has waived its right to receive dividends of over 0.01 pence per share, and the QUEST has waived its right to receive any dividends. As such, dividends will not be payable on the 1,201,434 shares currently held within ESOP. The QUEST had no shares remaining at the balance sheet date. Also, 49,500,000 were held as treasury stock by ARM Holdings plc at 31 December 2006 and the Company has waived its right to dividends on these shares.

The directors have recommended the payment of a final dividend of 0.6 pence per share in respect of 2006 (total cost of £8,002,000), bringing the total dividend payable in respect of 2006 (including the interim of 0.4 pence per share) to 1.0 pence per share. This will be paid to shareholders after approval by the shareholders at the 2007 AGM.

The directors have been advised that the 2006 interim dividend of 0.4 pence per share was paid at a time when the Company had insufficient distributable reserves. At the 2007 AGM, a resolution will be proposed rectifying the position and approving the release of shareholders from any liability to repay or reimburse the Company in respect of such payment.

### 4 Fixed asset investments

The cost and net book value of interests in Group undertakings held by the Company was £512,490,000 at 31 December 2006 and £495,053,000 at 31 December 2005. The Company took advantage of merger relief in 2004 and did not record the premium on the issue of shares for the acquisition of Artisan Components Inc. (now ARM Inc.) and thus did not record the premium within the value of the investment in the Company balance sheet at that time.

| | Investments in subsidiary undertakings £000 |
|---|---|
| **Cost and net book value** | |
| At 1 January 2006 | **495,053** |
| Capital contributions arising from FRS 20 charges | **17,437** |
| **At 31 December 2006** | **512,490** |

Where options over the Company's shares have been issued to the employees of subsidiary undertakings, the fair value of employee services performed (equal to the FRS 20 charge) has been recorded as a capital contribution.

**Interests in Group undertakings** Details of subsidiary undertakings are as follows:

| Name of undertaking | Country of registration | Description of shares held | Proportion of nominal value of issued shares held |
|---|---|---|---|
| ARM Limited | England and Wales | Ordinary £1 shares | less than 0.01% |
| ARM Finance UK Limited | England and Wales | Ordinary $1 shares | 100% |
| ARM QUEST Trustees Limited | England and Wales | Ordinary £1 shares | 100% |

The principal activity of ARM Limited is the marketing, research and development of RISC-based microprocessors. The remaining shares in ARM Limited are held by ARM Finance UK Limited. The principal activity of ARM Finance UK Limited is as an intermediate holding company. ARM QUEST Trustees Limited is the trustee company of the Company's QUEST.

Nominees of the Company hold 100% of the ordinary share capital of ARM Employee Benefit Trustee Ltd, a company which acts as trustee to the group's ESOP.

### 5 Debtors

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Amounts owed from group undertakings | **10,014** | – |
| Corporation tax | **25** | – |
| Prepayments and accrued income | **–** | 9 |
| | **10,039** | 9 |

## 6 Creditors: amounts falling due within one year

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Amounts owed to Group undertakings | **96,058** | 22,234 |
| Corporation tax | **–** | 47 |
| Accruals and deferred income | **371** | 323 |
| | **96,429** | 22,604 |

## 7 Called-up share capital

| Company | 2006 £000 | 2005 £000 |
|---|---|---|
| **Authorised** | | |
| 2,200,000,000 ordinary shares of 0.05 pence each (2005: 2,200,000,000) | **1,100** | 1,100 |
| **Allotted, called-up and fully paid** | | |
| 1,389,907,834 ordinary shares of 0.05 pence each (2005: 1,386,102,680) | **695** | 693 |

3,805,154 ordinary shares of 0.05 pence each were issued in the year for cash consideration of £2,106,000 as a result of the exercise of employee share options at various times during the year.

**Share options** The Company had the following options outstanding over ordinary shares of 0.05 pence at 31 December 2006:

| | Year of grant | Number of options | Range of exercise prices £ | Weighted average exercise price £ | Latest date of exercise |
|---|---|---|---|---|---|
| **Executive Scheme** | 1997 | 260,000 | 0.026 | 0.026 | 4 March 2007 |
| | 1998 | 301,000 | 0.1125 – 0.5275 | 0.1666 | 15 October 2008 |
| | 1999 | 2,013,097 | 1.224 – 4.26 | 1.3236 | 15 November 2009 |
| | 2000 | 378,973 | 6.136 – 7.738 | 6.5234 | 21 May 2010 |
| | 2001 | 570,136 | 2.84 – 3.75 | 3.3862 | 5 November 2011 |
| | 2002 | 828,994 | 2.465 | 2.465 | 18 April 2012 |
| | 2003 | 1,058,248 | 0.4375 | 0.4375 | 29 January 2013 |
| | 2004 | 929,501 | 1.0575 – 1.25 | 1.2493 | 22 July 2014 |
| | 2005 | 633,254 | 1.055 | 1.055 | 3 February 2015 |
| | | 6,973,203 | | 1.6434 | |
| **Unapproved Scheme** | 2000 | 2,223,097 | 6.136 – 7.738 | 6.2213 | 12 October 2007 |
| | 2001 | 2,991,949 | 2.84 – 4.43 | 3.4671 | 5 November 2008 |
| | 2002 | 3,445,056 | 0.425 – 3.145 | 2.3818 | 7 November 2009 |
| | 2003 | 8,459,896 | 0.4375 – 1.1475 | 0.4519 | 4 November 2010 |
| | 2004 | 8,135,146 | 0.9475 – 1.25 | 1.2357 | 21 October 2011 |
| | 2005 | 10,271,280 | 1.005 – 1.185 | 1.0602 | 30 October 2012 |
| | 2006 | 2,786,181 | 1.16 – 1.36 | 1.3225 | 19 November 2013 |
| | | 38,312,605 | | 1.5921 | |
| **Unapproved Performance Scheme** | 2001 | 62,909 | 3.815 | 3.815 | 22 May 2008 |
| | 2002 | 630,411 | 2.1475 – 2.465 | 2.3524 | 27 May 2009 |
| | 2003 | 2,715,427 | 0.4375 | 0.4375 | 30 January 2010 |
| | 2004 | 1,616,000 | 1.25 | 1.25 | 30 January 2011 |
| | 2005 | 2,620,853 | 1.055 | 1.055 | 4 February 2012 |
| | 2006 | 2,445,284 | 1.325 | 1.325 | 1 February 2013 |
| | | 10,090,884 | | 1.0837 | |
| **US ISO Scheme** | 2002 | 1,054,450 | 0.425 – 3.145 | 2.3917 | 7 November 2007 |
| | 2003 | 1,787,473 | 0.4375 – 1.1475 | 0.4440 | 4 November 2008 |
| | 2004 | 2,153,139 | 0.9475 – 1.25 | 1.2111 | 21 October 2009 |
| | 2005 | 6,392,686 | 1.005 – 1.185 | 1.0638 | 30 October 2010 |
| | 2006 | 1,048,182 | 1.1875 – 1.36 | 1.3247 | 31 August 2011 |
| | | 12,435,930 | | 1.1348 | |

## 7 Called-up share capital continued

| | Year of grant | Number of options | Range of exercise prices £ | Weighted average exercise price £ | Latest date of exercise |
|---|---|---|---|---|---|
| **French Scheme** | 2000 | 56,250 | 6.33 | 6.33 | 12 October 2007 |
| | 2001 | 124,500 | 3.35 – 4.43 | 3.4962 | 5 November 2008 |
| | 2002 | 134,250 | 1.505 – 3.145 | 2.4799 | 14 August 2009 |
| | 2003 | 575,900 | 0.4375 – 1.1475 | 0.4415 | 4 November 2010 |
| | 2004 | 353,504 | 0.9475 – 1.25 | 1.2409 | 21 October 2011 |
| | 2005 | 436,886 | 1.0425 – 1.185 | 1.0601 | 30 October 2012 |
| | 2006 | 98,250 | 1.325 – 1.36 | 1.3297 | 3 May 2013 |
| | | 1,779,540 | | 1.3548 | |
| **Belgian Scheme** | 2003 | 230,600 | 1.1475 | 1.1475 | 4 November 2010 |
| | 2004 | 353,700 | 1.25 | 1.25 | 29 January 2011 |
| | 2005 | 331,200 | 1.055 | 1.055 | 3 February 2012 |
| | 2006 | 27,500 | 1.1875 – 1.325 | 1.3000 | 31 August 2013 |
| | | 943,000 | | 1.1579 | |
| **1993 Plan** | 1997 | 112,390 | 0.14 | 0.14 | 27 May 2007 |
| | 1998 | 398,992 | 0.15 – 0.49 | 0.2690 | 17 December 2008 |
| | 1999 | 796,933 | 0.16 – 0.37 | 0.2116 | 15 November 2009 |
| | 2000 | 1,583,984 | 0.20 – 0.58 | 0.3358 | 29 November 2010 |
| | 2001 | 4,392,654 | 0.24 – 0.46 | 0.2589 | 30 December 2011 |
| | 2002 | 4,164,574 | 0.27 – 0.60 | 0.4193 | 30 December 2012 |
| | 2003 | 1,137,984 | 0.48 – 0.50 | 0.4984 | 27 February 2013 |
| | | 12,587,511 | | 0.3396 | |
| **2000 Plan** | 2001 | 5,025,044 | 0.22 – 0.28 | 0.2233 | 27 September 2011 |
| | 2002 | 558,426 | 0.24 – 0.27 | 0.2571 | 29 August 2012 |
| | | 5,583,470 | | 0.2267 | |
| **2003 Plan** | 2003 | 6,067,744 | 0.47 – 0.66 | 0.5125 | 22 October 2013 |
| | 2004 | 10,319,286 | 0.55 – 1.07 | 0.7162 | 15 December 2014 |
| | | 16,387,030 | | 0.6408 | |
| **Director Plan** | 2000 | 89,912 | 0.57 | 0.57 | 16 February 2010 |
| | 2001 | 7,498 | 0.22 | 0.22 | 15 April 2011 |
| | 2002 | 26,236 | 0.44 | 0.44 | 6 February 2012 |
| | | 123,646 | | 0.5212 | |
| **ND00 Plan** | 2000 | 191,905 | 0.19 | 0.19 | 19 October 2010 |
| | 2001 | 118,506 | 0.37 | 0.37 | 13 August 2011 |
| | 2002 | 152,247 | 0.37 | 0.37 | 2 July 2012 |
| | 2003 | 995,341 | 0.51 | 0.51 | 18 February 2013 |
| | | 1,457,999 | | 0.4419 | |
| **SAYE** | 2002 | 10,878 | 1.82537 | 1.82537 | 31 December 2007 |
| | 2003 | 927,254 | 0.5865 | 0.5865 | 31 December 2008 |
| | 2004 | 301,031 | 0.9435 | 0.9435 | 31 December 2009 |
| | 2005 | 1,791,586 | 0.9095 | 0.9095 | 31 December 2010 |
| | 2006 | 2,218,169 | 1.0264 | 1.0264 | 31 December 2011 |
| | | 5,248,918 | | 0.9057 | |
| **Total** | | **111,923,736** | | | |

Under the UK Inland Revenue Executive Approved Share Option Plan (the "Executive Scheme"), the Company may grant options to directors and employees meeting certain eligibility requirements. Options under the Executive Scheme are exercisable between three and ten years after their issue, after which time the options expire.

## 7 Called-up share capital continued

Under the Company's Unapproved Scheme (the "Unapproved Scheme"), for which it has not sought approval from the UK Inland Revenue, options are exercisable one to seven years after their issue, after which time the options expire. The Company also operates the US ISO Scheme, which is substantially the same as the Unapproved Scheme, the main difference being that the options are exercisable one to five years after their issue. Under both of these schemes options are exercisable as follows: 25% maximum on first anniversary, 50% maximum on second anniversary, 75% maximum on third anniversary, 100% maximum on fourth anniversary. Various options to directors under the Unapproved Scheme have certain performance criteria attached, which if met are exerciseable after three years, otherwise they will become exerciseable after seven years.

There are further schemes for our French and Belgian employees (the "French Scheme" and the "Belgian Scheme"). In the French Scheme, options are exercisable between four and seven years after their issue, whilst in the Belgian Scheme, options are exercisable from 1 January following the third anniversary after their issue, up to seven years from issue.

From 2006, the Company has begun issuing Restricted Stock Units ("RSUs") to employees instead of options as approved at the 2006 AGM. RSUs are actual share awards on vesting rather than options to buy shares at a fixed exercise price. The main RSU awards (to employees in all jurisdictions other than France) vest similarly to the unapproved scheme above, namely 25% on the each anniversary over four years. RSU awards to our French employees vest 50% after two years, and then a further 25% after three and four years. Whilst the Company reserves the right to award options to employees going forward, the majority of awards to employees will be in RSUs. At 31 December 2006, 7,893,640 share awards remained outstanding under the RSU scheme.

Additionally from 2006, the Company has started the new Deferred Annual Bonus plan ("DAB"). Under the DAB, which is for directors and selected senior management within the Company, participants are required to defer 50% of any related annual bonus into shares on a compulsory basis. These shares will be deferred for three years, and then a further matching award will be made depending on the achievement of an EPS performance condition over that time. The Company also operates the Long Term Incentive Plan ("LTIP"), also for directors and selected senior management, whereby share awards are made and vest depending on the Company's TSR performance compared to two comparator groups over the three-year performance period.

Upon the acquisition of Artisan in 2004, the Company assumed the share schemes of Artisan existing at acquisition. The schemes remained substantially the same as prior to the acquisition, other than the options became options to purchase shares in ARM Holdings plc instead of Artisan Components Inc. The number and value of options were amended in line with the conversion ratio as detailed in the merger agreement. The schemes assumed were the "1993 Plan", the "2000 Plan", the "2003 Plan", the "Director Plan" and the "ND00 Plan".

Under each plan, there are multiple vesting templates and vesting periods. The majority of the options were already vested upon acquisition, and the most common template was 25% vesting after one year, and then 6.25% vesting each quarter thereafter, until 100% vest after four years. Some options vest on a monthly basis, and some vest over five years. All options lapse ten years from the date of grant.

The Group also operates savings-related share option schemes for all employees and executive directors of the Group ("SAYE"). The number of options granted is related to the value of savings made by the employee. The period of savings is either three or five years, except under the US scheme where the period is two years. The option price is normally 85% of the market share price at grant, and the right to exercise normally only arises for a six-month period once the savings have been completed, except for the US scheme where the right to exercise only arises for a three-month period.

Under the Group's Long Term Incentive Plan, a further 7,771,416 shares could be awarded to the extent that the performance criteria are satisfied over a three-year period as detailed in the remuneration report. These shares will be awarded from shares already issued within the ESOP and treasury stock.

For disclosures relating to the grants in the year and fair value assumptions, reconciliations of opening to closing option balances and related items, please refer to note 24 in the IFRS accounts within these financial statements.

## 8 Share premium account and reserves

| | Share premium account £000 | Option reserve £000 | Other reserve £000 | Profit and loss account £000 |
|---|---|---|---|---|
| At 1 January 2006 | 95,512 | 61,474 | 267,418 | 47,974 |
| Premium on exercise of share options | 2,104 | – | – | – |
| Purchase of treasury shares | – | – | – | (18,622) |
| Appropriation for future cancellation of shares | – | – | – | (57,897) |
| Proceeds on issue of treasury shares on exercise of share options | – | – | – | 15,754 |
| Credit in respect of FRS 20 employee share scheme charges | – | – | – | 17,437 |
| Loss for the financial year | – | – | – | (5,626) |
| **At 31 December 2006** | **97,616** | **61,474** | **267,418** | **(980)** |

The Company has taken advantage of merger relief and not recorded the premium on the issue of shares for the acquisition of Artisan Components Inc. (now ARM Inc.). The option reserve represents the fair value of options granted on the acquisition of Artisan Components Inc. in 2004. The other reserve represents the unrealised profit on the intra-group sale of investments.

### 8 Share premium account and reserves continued

During 2006, to supplement the payment of dividends to shareholders, the Company continued its rolling share buyback programme under the shareholder authority conferred at the 2005 Annual General Meeting. The quantum and frequency of share repurchases is not predetermined and will take into account prevailing market conditions, the short- to medium-term cash needs of the business and the level of employee share-based remuneration going forward. In 2006, a total of 63,600,000 (2005: 13,868,000) shares were repurchased from the market at a cost of £76,519,000 (2005: £16,211,000). At 31 December 2006, there were 49,500,000 (2005: 12,751,107) shares in the Company still held from these purchases with a market value of £62,246,000 (2005: £15,429,000). Share repurchase transactions in respect of 49,500,000 shares carried out between 19 May 2006 and 31 December 2006 took place at a time when the Company had no distributable reserves and accordingly such shares have not been properly acquired in accordance with the Companies Act 1985, and are not available for re-issue or cancellation. The Company intends to make an application to the Court in due course to cancel these shares pursuant to a special resolution to be proposed at the 2007 AGM.

Offset within the profit and loss account is an amount of £58,245,000 (2005: £16,315,000) representing the cost of own shares held with the ESOP and treasury shares. This comprises £348,000 (2005: £1,438,000), being the cost of 1,201,434 (2005: 5,000,000) shares held within the ESOP and £57,897,000 (2005: £14,877,000) being the cost of 49,500,000 (2005: 12,751,107) shares held for future cancellation.

The Company considers the share premium account, option reserve and other reserve as non-distributable. Within the profit and loss account is £50,029,000 of credits in respect of FRS 20 employee share scheme charges in respect of services performed by employees of subsidiary undertakings and recorded as a capital contribution. The Company also considers these credits as non-distributable. As such, the entire profit and loss account is considered non-distributable. In February 2007, dividends from subsidiaries within the ARM Holdings plc group have been declared and paid up to the Company resulting in sufficient distributable profits for the 2006 final dividend and continued share buybacks.

### 9 Reconciliation of movements in shareholders' funds

| | 2006 £000 | 2005 £000 |
|---|---|---|
| Profit attributable to shareholders | **6,741** | 19,908 |
| Equity dividends | **(12,367)** | (10,436) |
| | **(5,626)** | 9,472 |
| New share capital issued | **2,106** | 13,083 |
| Unrealised profit on intra-group sale | **–** | 267,418 |
| Purchase of treasury shares | **(18,622)** | (16,211) |
| Appropriation for future cancellation of shares | **(57,897)** | – |
| Proceeds on issue of treasury shares on exercise of share options | **15,754** | 838 |
| Credit in respect of FRS 20 employee share scheme charges recorded as capital contributions | **17,437** | 20,863 |
| Net (reduction in)/addition to shareholders' funds | **(46,848)** | 295,463 |
| Opening shareholders' funds | **473,071** | 177,608 |
| Closing shareholders' funds | **426,223** | 473,071 |

### 10 Capital commitments

The Company had no capital commitments at 31 December 2006 and 2005.

### 11 Financial commitments and contingencies

At 31 December 2006 and 2005 the Company had no annual commitments under non-cancellable operating leases.

### 12 Related party transactions

The Company has taken advantage of the exemption from disclosure available to parent companies under FRS 8, "Related party disclosures", where transactions and balances between Group entities have been eliminated on consolidation.

### 13 Post balance sheet events

On 21 February 2007, the Company received dividends of £150 million from subsidiary undertakings. These have created sufficient distributable reserves in the Company for the 2006 final dividend and continued share buybacks.

# Independent auditors' report to the shareholders of ARM Holdings plc/UK GAAP

We have audited the parent company financial statements of ARM Holdings plc for the year ended 31 December 2006 which comprises the company balance sheet and the related notes. These parent company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the directors' remuneration report that is described as having been audited.

We have reported separately on the Group financial statements of ARM Holdings plc for the year ended 31 December 2006.

**Respective responsibilities of directors and auditors**

The directors' responsibilities for preparing the annual report, the directors' remuneration report and the parent company financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the statement of directors' responsibilities.

Our responsibility is to audit the parent company financial statements and the part of the directors' remuneration report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the parent company financial statements give a true and fair view and whether the parent company financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the directors' report is consistent with the parent company financial statements. The information given in the directors' report includes that specific information presented in the Chairman's statement and the Chief Executive Officer's business review that is cross referred from the review of business section of the directors' report.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the annual report and consider whether it is consistent with the audited parent company financial statements. The other information comprises only ARM at a glance, the Chairman's statement, the Chief Executive Officer's review of operations, the financial review, directors and advisors, the corporate governance statement, the corporate social responsibility statement, the directors' report, and that part of the remuneration report that is unaudited. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent company financial statements. Our responsibilities do not extend to any other information.

**Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the parent company financial statements and the part of the directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the parent company financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

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

**Opinion**

In our opinion:

– the parent company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 2006

– the parent company financial statements and the part of the directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985; and

– the information given in the directors' report is consistent with the parent company financial statements.

**PricewaterhouseCoopers LLP**
Chartered Accountants and Registered Auditors
London
2 April 2007

# Shareholder information

**ARM Holdings plc**

**Secretary and registered office**
Patricia Alsop
110 Fulbourn Road
Cambridge CB1 9NJ
United Kingdom

**Registered number**
2548782

**Auditors**
PricewaterhouseCoopers LLP
1 Embankment Place
London WC2N 6RH
United Kingdom

**Stockbrokers**
Morgan Stanley & Co. International Limited
25 Cabot Square
Canary Wharf
London E14 4QA
United Kingdom

UBS Limited
2 Finsbury Avenue
London EC2M 2PP
United Kingdom

**Registrars**
Lloyds TSB Registrars
The Causeway
Worthing
West Sussex BN99 6DA
United Kingdom
Tel: +44 (0)870 600 3984

**Depositary**
The Bank of New York
101 Barclays Street
New York
New York 10286
United States of America

**Legal advisers**

**UK Law**
Linklaters
One Silk Street
London EC2Y 8HQ
United Kingdom

**US Law**
Davis Polk & Wardwell
99 Gresham Street
London EC2V 7NG
United Kingdom

# Group directory

**ARM Holdings plc**
110 Fulbourn Road
Cambridge CB1 9NJ
United Kingdom
Tel: +44 (0) 1223 400400
Fax: +44 (0) 1223 400410

**ARM Limited**
Liberty House
Moorbridge Road
Maidenhead
Berkshire SL6 8LT
United Kingdom
Tel: +44 (0) 1628 427700
Fax: +44 (0) 1628 427701

Rockingham Court
Rockingham Street
Sheffield S1 4EB
United Kingdom
Tel: +44 (0) 114 8000
Fax: +44 (0) 114 8001

Blackburn Design Centre
Belthorn House
Walker Road
Blackburn BB1 2QE
United Kingdom
Tel: +44 (0) 1254 893900
Fax: +44 (0) 1254 893901

**ARM Belgium**
Geldenaaksebaan 329
1st fl.
3001 Leuven-Heverlee
Belgium
Tel: +32 16 391 411
Fax: +32 16 406 076

**ARM France**
12 Avenue des Prés
Montigny le Bretonneux
78059 Saint Quentin en
Yvelines, Cedex
France
Tel: +33 1 30 79 05 10
Fax: +33 1 30 79 05 11

Les Cardoulines B2
Route des Doline
Sophia Antipolis
06560 Valbonne
France
Tel: +33 4 92 96 88 60
Fax: +33 4 92 96 88 79

Miniparc Polytec
60 Rue des Berges
38000 Grenoble
France
Tel: +33 4 56 38 47 00
Fax: +33 4 56 38 47 01

**ARM Germany**
Lehrer-Wirth-Strasse 4
D-81829 Munich
Germany
Tel: +49 89 928 615-0
Fax: +49 89 928 615-19

Keil Elektronik GmbH
Bretonischer Ring 15
D-85630 Grasbrunn
Germany
Tel: +49 89 456 040-0
Fax: +49 89 468 162

Kaiser Strasse 100
TPC 111C
D-52134 Herzogenrath
Germany
Tel: +49 24 079 086-0
Fax: +49 24 079 086-11

**ARM Israel**
23 Hataa-as St
44425 Kfar Saba
Israel
Tel: +972 9 7678040
extension 201
Fax: +972 9 7677020

**ARM Norway**
Nedre Bakklandet 60
7014 Trondheim
Norway
Tel: +47 4000 5757
Fax: +47 7351 3181

**ARM Physical IP Inc. and ARM Inc.**
141 Caspian Court
Sunnyvale, CA 94089-1013
United States
Tel: +1 408 734 5600
Fax: +1 408 734 5050

1250 Capital of Texas Highway
Building 3, Suite 560
Austin, TX 78746
United States
Tel: +1 512 327 9249
Fax: +1 512 314 1078

8000 Regency Parkway
Suite 660
Cary, NC 27518
United States

5 East Street
Franklin, MA 02038
United States
Tel: +1 508 520 1905
Fax: +1 508 520 1907

1 Jenner Drive, Suite 260
Irvine, CA 92618
United States
Tel: +1 949 341 1900
Fax: +1 949 341 1901

Crystal Glen Center
39555 Orchard Hill Place
Suite 600
Novi, MI 48375
United States
Tel: +1 248 374 5055
Fax: +1 248 374 5056

264B North Broadway
Suite 204A
Salem, NH 03079
United States
Tel: +1 603 896 6322
Fax: +1 603 896 6324

9645 Scranton Road
Suite 140
San Diego, CA 92121
United States
Tel: +1 858 455 7570
Fax: +1 858 457 5578

1501 10th Street
Suite 110
Plano, TX 75074
United States
Tel: +1 972 312 1107
Fax: +1 972 312 1159

204 Chandler Court SW
Suite 290
Olympia, WA 98502
United States
Tel: +1 972 312 1107
Fax: +1 972 312 1159

**ARM KK**
Daini-Ueno Building 8F
3-7-18 Shin-Yokohama
Kohoku-Ku, Yokohama-Shi
Kanagawa 222-0033
Japan
Tel: +81 45 477 5260
Fax: +81 45 477 5261

**ARM Korea Limited**
Room 1115
Hyundai Building
9-4, Soonae-Dong
Boondang-Ku
Sungnam
Kyunggi-do 463-020
Korea
Tel: +82 31 712 8234
Fax: +82 31 713 8225

**ARM Taiwan Limited**
10F-3, No. 17, Lane 91
Sec. 1, Nei Hu Rd,
Taipei, 114
Taiwan
Tel: +886 2 2627 1681
Fax: +886 2 2627 1682

**ARM Consulting (Shanghai) Co. Ltd**
Room 809, Building B
Far East International Plaza
No. 317 XianXia Road
Shanghai 200051
PR China
Tel: +86 21 62351296
Fax: +86 21 62351207

Room 905, Silver Tech Tower
No. 38 Hai Dian Avenue
Hai Dian District
Beijing 100080
PR China
Tel: +86 10 82603570
Fax: +86 10 82603573

**ARM Embedded Technologies Pvt. Limited**
Level III, Block B
Salarpuria Hall Mark
Marthahalli-Sarjapur Outer Ring Road
Bangalore 560 087
India
Tel: +91 80 4138 4000
Fax: +91 80 4112 7403

**ARM Physical IP Asia Pacific Pte. Ltd**
700 Lorong 1 Toa Payoh
30-07 Trellis Towers
Singapore 319773

Tel: +65 6728 0950
Fax: +65 6728 7901

Designed and produced by 85four
Directors' photographs by Bob Wheeler
Illustrations by www.jacey.com
Printed by St Ives Westerham, Press, environmentally accredited printers, ISO 14001
Printed on Hello Silk, which is made from virgin wood fibre from sawmill residues, forest thinnings and sustainable forests in Austria, and from pulp which is totally chlorine-free (TCF) and elemental chlorine-free (ECF). It is recyclable and biodegradable.

**ARM Holdings plc**
110 Fulbourn Road
Cambridge CB1 9NJ
United Kingdom

Telephone +44 (0)1223 400400
Facsimile +44 (0)1223 400410

Further information available at:
**www.arm.com**

THE ARCHITECTURE FOR THE DIGITAL WORLD®