

**STRUCTURAL MONITORING SYSTEMS LIMITED**  
(ABN 94 067 556 245)

**HALF-YEAR FINANCIAL REPORT**

**31 DECEMBER 2003**

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## **CORPORATE DIRECTORY**

### **Registered Office**

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### **Independent Auditors**

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## Directors' Report

Your Directors submit their report for the half-year ended 31 December 2003.

### DIRECTORS

The names of the Company's directors in office during the half-year and until the date of this report are as below. Directors were in office for this entire period unless otherwise stated.

Alan Raymond Reed, AO, Air Vice Marshal (RAAF Rtd) (Chairman)

Anthony Thomas Brennan, CA (Deputy Chairman)

Robin John Dean, B.Ec (Managing Director and Chief Executive Officer)

Lennard Steve Brajkovich, OAM, JP.

Paul Ejnar Kristensen, B.Sc. (Hons.), Mech.Eng. CPEng., MIEAust.

Michael John Wynne (Appointed as Alternate for R.J. Dean on 17 June 2003)

### REVIEW AND RESULTS OF OPERATIONS

The Company (SMS) is in a strong financial position with cash reserves as at 31 December 2003 of \$4,612,426. Based on current cash usage, cash reserves would allow in excess of 12 months continuous operation without any other income; however the Company's income is rapidly increasing.

For the half-year ended 31 December 2003, the Company incurred a loss of \$2,219,454 (31/12/02: loss of \$1,851,609). Total revenue for the period was \$531,960 (31/12/02: \$170,082).

During the six months to 31 December 2003 development of the Company's **CVM**<sup>TM</sup> technology continued with commercialisation picking up pace in the aviation sector.

Customer demand continues to drive the direction of the Company's operations in the aviation sector. The focus has been in two principal areas, firstly the retro fit of the **CVM**<sup>TM</sup> technology to existing aircraft both in military and civilian aviation. The driver in this area is the significant cost savings the **CVM**<sup>TM</sup> technology can deliver over the tradition manual inspection procedures. Secondly, in the materials and large scale testing programs for new aircraft that will eventually result in **CVM**<sup>TM</sup> being installed into new aircraft during manufacture.

The aviation manufacturing industry now has a strong interest in Structural Health Monitoring (SHM). The SHM concept is already adopted in the design concept of new aircraft in projects like Lockheed Martin's Joint Strike Fighter (JSF) and Boeing's 7E7. The idea behind SHM is that sensors throughout the aircraft will monitor structures for fatigue, stress and general wear and tear to allow the use of new and lighter materials in the manufacture of aircraft. The use of SHM systems will also deliver savings in operating costs by reducing the maintenance and logistic costs through the automatic scheduling of maintenance and ordering of spare parts.

The Company has positioned itself in the forefront of these new developments with one of the world's largest aircraft manufacturers, Airbus. Airbus has established a dedicated team to work specifically on **CVM**<sup>TM</sup> technology in Germany. In developments since our last report Airbus has 12 separate and extensive work programs planned for **CVM**<sup>TM</sup> for the calendar year 2004. The programs range from materials testing to full-scale fatigue testing of their A380 jumbo aircraft. The value of the base level of work from Airbus for the calendar year 2004 is Euro €475,000 (approximately \$775,000 Australian Dollars). The stated aim of Airbus is to integrate **CVM**<sup>TM</sup> into its new aircraft.

## Directors' Report continued

The Company is currently working on a number of other developments. We advised in the November Newsletter that the Republic of Singapore Air Force (RSAF) had executed a commercial contract for the installation of **CVM™** on its jet trainers, that program is now underway. The Company has also been awarded a commercial contract for component testing with European Aeronautic Defence and Space Company (EADS) in France. British Aerospace (BAE) and Messier Dowty in the UK are also using **CVM™** to test Airbus landing gear components.

In the USA the first **CVM™** system was installed on a commercial passenger airliner on 16 February 2004, a Boeing DC 9 aircraft. Following the install the aircraft has returned to regular passenger service on domestic routes in the USA. This installation is part of the FAA certification process which has taken longer than anticipated as the airline changed the technical specifications; it is now moving forward again. This "in operation" trial fly for at least four months to gain FAA certification. The FAA is also funding independent work on the **CVM™** system at the University of Iowa as part of the certification process, this work is taking place simultaneously with the flight trials in order to obtain the certification as soon as possible. FAA certification opens the way for SMS to aggressively market **CVM™** to commercial airlines.

Boeing has recently approached SMS for a **CVM™** monitoring solution to address an issue on their MD 80 aircraft. SMS engineers are currently working with Boeing in the USA on a program to develop the requisite solution for Boeing. At this time the content and the timetable for the application development are yet to be agreed with Boeing. Over the years Boeing has constructed approximately 1,200 MD 80's which are mainly in service on domestic routes within the USA.

The United States Air Force (USAF) Materials Directorate is continuing their investigative work with **CVM™** so that **CVM™** can be available to USAF as a generic SHM system, this has been underway for the past 18 months and still has a considerable way to go to satisfy the stringent requirements of USAF. The **CVM™** system was installed for the US Navy on a H53 helicopter in January 2002. The US Navy report to SMS monthly, they advise the system continues to operate without any problems.

Closer to home the installation on Royal Australian Air Force (RAAF) P3 Orion aircraft was completed to demonstrate **CVM™** in an operating military environment. In conjunction with the P3 installation Australian Department of Defence (DoD) and RAAF are undertaking a 2 year environmental and durability testing program on **CVM™** sensors which includes testing sensors for UV and extreme weather tolerance at the DoD's outdoor testing facility at Innisvale in Queensland, we are currently 6 months into the program. The testing program covers sensors on a broad range of RAAF and Airbus surface finishes.

The Company is in discussions with the RAAF and the Australian Army to use **CVM™** monitoring systems for Black Hawk helicopters. SMS and RAAF engineers have undertaken the preliminary inspection of the aircraft at the Army's base at Oaky in Queensland.

In the latter part of 2003 Dr Laurie Walker of SMS proved the concept that **CVM™** can be laid up in composite fibre during manufacture to monitor for disbonding, delamination and impact damage to a composite structure. This was demonstrated to Airbus who have now organised funding Euro €200,000 (approximately \$325,000 Australian Dollars) under the European Union SMIST R&D Incentive to allow work to be carried out by the Cooperative Research Centre for Advanced Composite Structures (CRCACS) in Melbourne to further develop **CVM™** in this area. Any intellectual property generated out of this work will belong to SMS. The CRCACS, with the consent of SMS, has also applied to Lockheed Martin (LH) under the Joint Strike Fighter Project (JSF) for funding to develop **CVM™** in the area of composite fibre construction, LH is only likely to provide funding if the request fits into the overall development objectives of the JSF.

## Directors' Report continued

The parent entity (SMS plc) has now established an operation for Europe based in the UK. There is currently a permanent staff of 4 in the UK and they are already in advanced discussions with Royal Air Force for the first installation on an RAF aircraft.

As soon as funds are available from the planned Stock Exchange listing of SMS plc, SMS will commence the build up of infrastructure, sales and technical support personnel in the USA, to capitalise on the inroads already made in both civilian and military applications in the USA.

### Management

Mike Southern joined the Company on 2 February 2004 as Chief Technical Officer in charge of all technical aspects of the Company. Mike formerly held senior positions with Orbital Engine company where he was involved in the successful commercialisation of Orbital's fuel injection system under joint venture with VDO Siemens in Europe. More recently, Mike headed up a vision technology company in Canberra before deciding to return to Western Australia.

### SMS plc

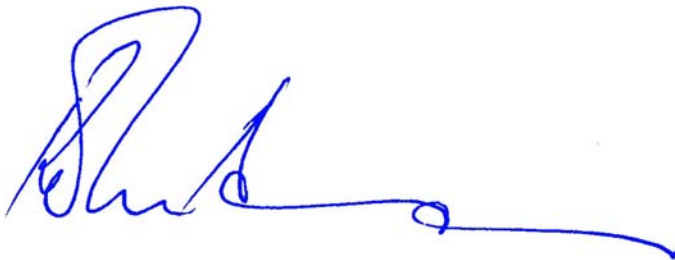
The takeover of Structural Monitoring Systems Limited the Australian company by Structural Monitoring Systems plc the UK company is now complete. The takeover bid was accepted by shareholders representing in excess of 90% of the SMS shares. The small residual that did not respond to the takeover bid has now been acquired by SMS plc under the compulsory acquisitions provisions of the Corporation Act.

In addition to Robin Dean and Tony Brennan, Sir John Walker has joined the Board of Directors of SMS plc.

Air Marshal Sir John Walker (RAF ret'd) **KCB, CBE, AFC, FRAeS**

Sir John is a graduate of the Royal Air Force College and was a fighter pilot flying a broad range of fighter aircraft with the RAF. He has held a number of commands both in the UK and overseas. Prior to his retirement in 1995 he held the position of Chief of Defence Intelligence and Deputy Chairman of the National Joint Intelligence Committee. More recently Sir John was a Special Advisor to the House of Commons Defence Committee.

Signed in accordance with a resolution of the Directors.



Director  
Perth, Western Australia  
22 March 2004

**Condensed Statement of Financial Performance  
For The Half-Year Ended 31 December 2003**

	Note	2003 \$	2002 \$
Sales revenue		-	112,465
Cost of sales		-	(47,106)
Gross profit		-	65,359
Other revenues from ordinary activities	2	531,960	57,617
Net revenues from ordinary activities		531,960	122,976
Administration expenses		(739,155)	(653,568)
Marketing expenses		(330,616)	(619,514)
Research and development expenses		(968,022)	(695,630)
Other expenses from ordinary activities		1,551	(5,873)
<b>Loss from ordinary activities before the effect of change in accounting policy for research and development expenses and income tax</b>		(1,504,282)	(1,851,609)
Cumulative effect of change in accounting policy for research and development expenses	1(b)	(715,172)	-
<b>Loss from ordinary activities before income tax</b>		(2,219,454)	(1,851,609)
Income tax attributable to operating loss		-	-
<b>Net loss</b>		(2,219,454)	(1,851,609)
Share issue costs		(44,574)	-
<b>Total expenses attributable to members of Structural Monitoring Systems Limited and recognised directly in equity</b>		(44,574)	-
<b>Total changes in equity other than those resulting from transactions with owners as owners</b>		(2,264,028)	(1,851,609)

*The accompanying notes form part of these financial statements.*

**Condensed Statement of Financial Position  
Half -Year Ended 31 December 2003**

	<b>As At 31 December 2003 \$</b>	<b>As At 30 June 2003 \$</b>
<b>Current assets</b>		
Cash	4,612,426	3,753,485
Inventories, at cost	24,926	41,497
Receivables	273,737	74,082
Other – prepayments	38,668	63,578
Total current assets	<u>4,949,757</u>	<u>3,932,642</u>
<b>Non-current assets</b>		
Plant and equipment	299,283	206,060
Intangibles	334,205	516,517
Deferred research and development costs	-	673,709
Total non-current assets	<u>633,488</u>	<u>1,396,286</u>
<b>Total assets</b>	<u>5,583,245</u>	<u>5,328,928</u>
<b>Current liabilities</b>		
Non-interest bearing liabilities	1,923,106	-
Payables	346,650	639,548
Provision – employee entitlements	75,851	55,064
Total current liabilities	<u>2,345,607</u>	<u>694,612</u>
<b>NET ASSETS</b>	<u>3,237,638</u>	<u>4,634,316</u>
<b>Equity</b>		
Contributed equity	15,408,468	14,585,692
Accumulated losses	(12,170,830)	(9,951,376)
<b>TOTAL EQUITY</b>	<u>3,237,638</u>	<u>4,634,316</u>

*The accompanying notes form part of these financial statements.*

**Condensed Statement of Cash Flows  
For The Half-Year Ended 31 December 2003**

	<b>2003</b>	<b>2002</b>
	<b>\$</b>	<b>\$</b>
<b>Cash flows from operating activities</b>		
Receipts from customers	235,087	-
Payments to suppliers and employees	(1,703,930)	(1,885,869)
Royalty fee	(68,703)	(66,904)
Interest received	93,057	57,617
<b>Net cash (outflows) from operating activities</b>	<u>(1,444,489)</u>	<u>(1,895,156)</u>
<b>Cash flows from investing activities</b>		
Purchase of plant and equipment	(143,754)	(25,066)
<b>Net cash (outflows) from investing activities</b>	<u>(143,754)</u>	<u>(25,066)</u>
<b>Cash flows from financing activities</b>		
Proceeds of loan from Parent Entity	1,948,408	
Proceeds from issue of shares	662,750	150,000
Payment of share issue costs	(163,974)	-
<b>Net cash flows from financing activities</b>	<u>2,447,184</u>	<u>150,000</u>
<b>Net (decrease)/increase in cash held</b>	858,941	(1,770,222)
Add opening cash brought forward	3,753,485	3,272,924
<b>Closing Cash Carried Forward</b>	<u><b>4,612,426</b></u>	<u><b>1,502,702</b></u>

*The accompanying notes form part of these financial statements.*

## Notes to the Half-Year Financial Statements

31 December 2003

### 1. BASIS OF PREPARATION OF THE HALF-YEAR FINANCIAL REPORT

The half-year financial report does not include all notes of the type normally included within the annual financial report and therefore cannot be expected to provide as full an understanding of the financial performance, financial position and financing and investing activities of the Company as the full financial report.

The half-year financial report should be read in conjunction with the Annual Financial Report of the Company as at 30 June 2003.

#### (a) Basis of accounting

The half-year financial report is a general-purpose financial report, which has been prepared in accordance with the requirements of the Corporations Act 2001, applicable Accounting Standards including AASB 1029 "Interim Financial Reporting" and other mandatory professional reporting requirements (Urgent Issues Group Consensus Views).

The half-year financial report has been prepared in accordance with the historical cost convention.

For the purpose of preparing the half-year financial report, the half-year has been treated as a discrete reporting period.

#### (b) Change in accounting policy

On 12 November 2003 the Company became a controlled entity of Structural Monitoring Systems plc which is incorporated in the United Kingdom. As a consequence of becoming controlled by a UK entity, the Company has adopted the United Kingdom and Irish Accounting Standard No. 13 (Revised) "Accounting for research and development".

Previously, research and development costs were expensed as incurred, except where future benefits were expected, beyond any reasonable doubt, to exceed those costs. Where research and development costs were deferred such costs were amortised over future periods on a basis related to expected future benefits. Unamortised costs were reviewed at each balance date to determine the amount (if any) that was no longer recoverable and any amount identified was written off.

Research and development costs are now expensed as incurred and the existing balance of deferred research and development costs has been written off. The effect of the revised policy has been to increase the amount of research and development expense and the net loss for the reporting period by \$715,172. A restated Statement of Financial Performance is included at Note 7 which shows the information that would have been disclosed had the new accounting policy always been applied.

**Notes continued****31 December 2003**

	<b>2003</b>	<b>2002</b>
	<b>\$</b>	<b>\$</b>
<b>2. PROFIT FROM ORDINARY ACTIVITIES</b>		
<b>(a) Specific Items</b>		
Profit from ordinary activities before income tax expense includes the following revenues and expenses whose disclosure is relevant in explaining the financial performance of the Company:		
<b>(i) Other revenues from ordinary activities</b>		
Revenue from services	438,903	-
Interest – other corporations	93,057	57,617
	<u>531,960</u>	<u>57,617</u>
<b>(ii) Expenses</b>		
Depreciation and amortisation	233,113	317,030
Deferred research and development costs written off	702,106	217,223
<b>3. CONTINGENT ASSETS AND LIABILITIES</b>		
Since the last annual reporting date, no contingent assets or contingent liabilities have arisen.		
<b>4. NON-CASH SHARE TRANSACTIONS</b>		
At 30 June 2003, success fees of \$324,000 were payable to the Company's corporate advisors in respect of a capital raising during the year ended 30 June 2003. In accordance with the agreement between the Company and its advisors, a total of 1,224,695 ordinary shares were issued to settle \$204,600 of the amount owing and the remaining \$119,400 was paid in cash.		
<b>5. SUBSEQUENT EVENTS</b>		
Following a successful takeover bid from Structural Monitoring Systems plc and completion of the compulsory acquisition process, the Company became a wholly-owned controlled entity of Structural Monitoring Systems plc on 2 March 2004.		
<b>6. SEGMENT INFORMATION</b>		
The Company operates in one industry, the Non-destructive Testing and Condition Monitoring industry and in one geographical area, Australia.		

**Notes continued****31 December 2003****7. RESTATED STATEMENT OF FINANCIAL PERFORMANCE**

	<b>2003</b> <b>\$</b> Restated	<b>2002</b> <b>\$</b> Restated
Sales revenue	-	112,465
Cost of sales	-	(47,106)
Gross profit	-	65,359
Other revenues from ordinary activities	531,960	57,617
Net revenues from ordinary activities	531,960	122,976
Administration expenses	(739,155)	(653,568)
Marketing expenses	(330,616)	(619,514)
Research and development expenses	(968,022)	(890,990)
Other expenses from ordinary activities	1,551	(5,873)
<b>Loss from ordinary activities before income tax</b>	(1,504,282)	(2,046,969)
Income tax attributable to operating loss	-	-
<b>Net loss</b>	(1,504,282)	(2,046,969)
Share issue costs	(44,574)	-
<b>Total expenses attributable to members of Structural Monitoring Systems Limited and recognised directly in equity</b>	(44,574)	-
<b>Total changes in equity other than those resulting from transactions with owners as owners</b>	(1,548,856)	(2,046,969)

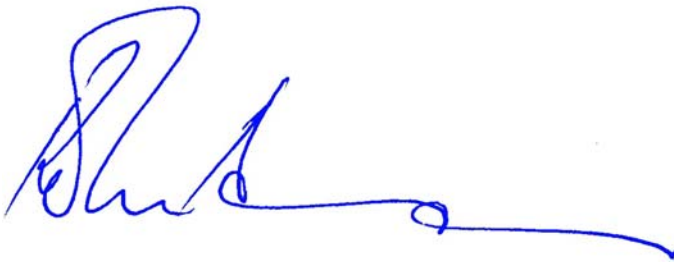
**Directors' Declaration**

In accordance with a resolution of the Directors of Structural Monitoring Systems Limited, I state that:

In the opinion of the Directors:

- (a) the financial statements and notes of the Company:
  - (i) give a true and fair view of the financial position as at 31 December 2003 and the performance for the half-year ended on that date of the Company; and
  - (ii) comply with Accounting Standard AASB 1029 "Interim Financial Reporting" and the Corporations Regulations 2001; and
- (b) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.

On behalf of the Board

A handwritten signature in blue ink, consisting of a large, stylized initial 'D' followed by a series of loops and a long horizontal stroke ending in a small circle.

Director  
Perth, Western Australia  
22 March 2004

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**INDEPENDENT AUDIT REPORT**

**TO THE MEMBERS OF**

**STRUCTURAL MONITORING SYSTEMS LIMITED**



Chartered Accountants  
& Business Advisers

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**Scope**

We have audited the financial report of Structural Monitoring Systems Limited for the half-year ended 31 December 2003 as set out on pages 5 to 11. The disclosing entity's directors are responsible for the financial report. We have conducted an independent audit of this financial report in order to express an opinion on it, so as to enable the disclosing entity to lodge the financial report with the Australian Securities and Investments Commission.

Our audit has been conducted in accordance with Australian Auditing Standards to provide reasonable assurance whether the financial report is free of material misstatement. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial report, and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion whether, in all material respects, the financial report is presented fairly in accordance with Accounting Standard AASB 1029 "Interim Financial Reporting" and other mandatory professional reporting requirements in Australia, and statutory requirements so as to present a view which is consistent with our understanding of the disclosing entity's financial position, and performance as represented by the results of its operations and its cash flows.

The audit opinion expressed in this report has been formed on the above basis.

**Audit Opinion**

In our opinion, the half-year financial report of Structural Monitoring Systems Limited is in accordance with:

- (a) the Corporations Act 2001, including:
  - i) giving a true and fair view of the consolidated entity's financial position as at 31 December 2003 and of its performance for the half-year ended on that date; and
  - ii) complying with Accounting Standard AASB 1029 "Interim Financial Reporting" and the Corporations Regulations 2001; and
- (b) other mandatory professional reporting requirements in Australia.

A stylized, handwritten-style logo for PKF.

PKF  
Chartered Accountants

A handwritten signature in black ink, appearing to read 'Ian P. Olson'.

**IAN P OLSON**

Partner

Dated at Perth this 22 day of March 2004