

The Board of Directors is accountable to shareholders for the good corporate governance of the Group. The principles of corporate governance are set out in the Combined Code on corporate governance issued in July 2004. Under the rules of the Alternative Investment Market (AIM) the Company is not required to comply with the Code and the Board considers that the size of the Group does not warrant compliance with all of the Code's requirements. This statement sets out how the principles of the Code that the Directors consider are relevant to Flomerics Group PLC are applied.

Board of Directors

The Non-Executive Chairman of the Company is David Mann. On 9 September 2005 Gary Carter was appointed as Chief Executive. David Tatchell the co-founder of the company and Chief Executive since 1989 has moved into the role of Chief Technology Officer. Tom Rowbotham as the Non-Executive Deputy Chairman is the senior independent Non-Executive Director. The Board now comprises three Executive Directors (Chief Executive, Finance Director and Chief Technology Officer) and three independent Non-Executive Directors. For the size of the Group, it is considered that this gives the necessary mix of industry specific and broad business experience necessary for the effective governance of the Group. The Board meets regularly, normally on a monthly basis and is particularly concerned with the Group's strategy.

The Group has a senior management team which is responsible for the day to day management of the Group. This is comprised of the Chief Executive, the Finance Director, the Chief Technology Officer, Regional Directors for the US, Europe and Asia Pacific, the Director of Marketing and the Director of Software Development.

Biographies of the Board of Directors and the other members of the senior management team are shown on page 17.

Board Evaluation

As reported in last year's Annual Report, following the Board Evaluation, early in 2005, two specific actions have taken place:

- the sub committees of the Board have now been supplemented by a Nomination Committee.
- The Audit Committee meetings have been supplemented by one further meeting, outside the reporting timetable, to focus on internal controls and developments in accounting standards

The Board carried out a further internal evaluation early in 2006 of its performance over the year under review. Some of the conclusions are noted below:

- Overall it was felt that good progress has been made in the board's contribution to the testing and development of the Group's strategy. Further efforts will be made in 2006 to ensure that strategic issues are identified early and given time for proper debate.
- External communications have been stepped up, for example through an improved Annual Report. The Board will give consideration to a separate meeting to be held for smaller shareholders, separate from the Annual General Meeting.

From this evaluation, an action plan has been compiled and will form the basis for the Board's performance objectives for 2006.

Audit Committee

The Audit Committee comprises Tim Morris (Chairman), David Mann and Tom Rowbotham, with Gary Carter, Chris Ogle and the external auditors generally in attendance. The remit of the Committee is to ensure the continued operation of good financial practices throughout the Group; to monitor that controls are in force to ensure the integrity of financial information; to review the interim statement and annual financial statements; and to provide a line of communication between the Board and the external auditors. The Audit Committee normally meets three times a year.

Remuneration Committee

A separate report on remuneration including the composition and remit of the Committee has been included on page 20.

Risk Committee

The Risk Committee is chaired by the Non-Executive Deputy Chairman, Tom Rowbotham, and currently comprises Chris Ogle, the Finance Director, Ian Clark, the Product Manager for the company's major product, FLOTHERM, and David Johns, the Vice President Microwave Engineering, who is based in USA.

This Committee was set up in 2000 in response to a recommendation of the Turnbull Report, which offered guidance to directors on complying with the internal control requirements of the Combined Code.

The role of the Committee is to identify the risks facing the business, quantify their impact and to ensure that they are managed within acceptable levels.

During 2005 the Committee reviewed the current status of the management of the major risks to the business, and the impact of the actions that the executives had taken during 2004.

As a result they proposed a list of high priority risks for 2005 which were approved by the Board, and the executives were invited to draw up an action plan to address each risk.

One senior executive was assigned responsibility for each risk in order to assure its continuous relevance, that actions were carried out to plan, and that quarterly progress reports were produced. The Risk Committee reviewed these reports and informed the Board about progress, while feeding back comments to the Executives.

The Committee is satisfied that in every case the programme executed by management has resulted in either the probability of occurrence, or the impact of the risk, being managed downwards during the year, although in the opinion of the Committee in some cases further progress still has to be made to come within acceptable bounds.

However if the planned programme continues to be executed as well as it has been in 2005, the Committee believes that all risks will be come within acceptable bounds. For this reason the Committee will continue to formally review progress every quarter throughout 2006.

Nomination Committee

A Nomination Committee has been established with David Mann, Tom Rowbotham and Gary Carter as members. It is chaired by David Mann except on matters concerning the chairmanship.

The Committee is responsible for reviewing the structure, size and composition of the board, identifying suitable candidates for the approval of the board when vacancies arise and ensuring effective board succession planning.

In order to give some refreshing of the board, it has been agreed that during 2006 the Committee will develop a specification and conduct a search for someone to succeed Tim Morris as a non-executive director and chairman of the Audit Committee. Tim Morris has agreed to continue serving on the board until a successor is appointed.

Internal financial control

The Board is ultimately responsible for the Group's system of internal financial control and for reviewing its effectiveness. This is achieved through the following means:

The Group maintains a comprehensive process of financial reporting. The annual budget is reviewed and approved by the Board before being formally adopted. The Board receives financial reports of the Group's performance compared to the budget and prior years with explanations of significant variances. In addition, monthly reforecasts and cash flow forecasts are presented to the Board.

A thorough recruitment process ensures, as far as possible, that its employees hold principles of the highest integrity. This is an essential part of the Group's culture.

The effectiveness of the Group's internal financial controls is the responsibility of the Audit Committee and to the extent that they are perceived to be a risk, of the Risk Committee. The maintenance and constant improvement of these controls is the responsibility of the Finance Director. The external auditors review the internal financial controls relevant to expressing their audit opinion and report to the Audit Committee on their findings where appropriate.

The existence of internal controls cannot entirely eliminate risk and no absolute assurance against loss to the Group can be made.

Going concern

The Board reports as to whether it is appropriate for the financial statements to be prepared on a going concern basis.

The Group's finances are currently sound and the net funding position is positive. Looking beyond the annual budget, the product roadmap and financial plans for the Group are reviewed and updated annually. On this basis, the board continues to adopt the going concern basis in preparing the financial statements.

report on remuneration

for the year ended 31 December 2005

Remuneration Policy

The Remuneration Committee is chaired by David Mann and comprises the Non-Executive Directors. The Chief Executive is normally in attendance, except during discussions on his own remuneration.

The principal function of the Committee is to set the remuneration and other benefits of the executive directors including pension contributions, share options and bonus payments. The Committee also approves the overall salary increase made across the Group as recommended by the Chief Executive and it oversees all bonus and share option schemes.

The policy of the Committee is to pay remuneration comparable to other peer companies, within the limits of what can be afforded. At various times the Committee has undertaken informal surveys of the remuneration of directors of comparable public software companies.

During the year, the Committee reviewed the provision of long-term share incentives to the Company's executive directors and senior management. Changes resulting from that review, including certain proposals for which shareholder approval is being sought at the Annual General Meeting are described in later sections of this Report.

Bonus Payments

The Committee oversees a bonus scheme for the senior management team which is reviewed annually. The intention behind the scheme is to ensure that the executive directors are strongly incentivised to exceed budget performance. 52.5% of the potential bonus payment is directly related to the financial performance of either the entire Group or, where relevant, the area under their responsibility. The other 47.5% is paid at the discretion of the Committee and is based on their individual performance.

During 2005 the executive directors, excluding the Chief Executive could earn up to a maximum of 50% of their basic salary as a bonus. The Chief Executive could earn up to a maximum of 60% of his basic salary as a bonus.

The Group also runs a scheme for employees whereby a portion of the Company's pre-tax profit is set aside to be distributed amongst the Group's employees. For the year ended 31 December 2005 approximately 10% of the Company's pre-tax profits have been set aside in this way.

Share Options

The Committee recognises that share options can play an important part in aligning the interests of shareholders, directors and staff. The Company has in the past provided for share-based incentives for senior executives via the grant of market value options under the Company's Executive Share Option Scheme (the "ESOS") and the Enterprise Management Incentive Scheme (the "EMI Scheme"). To date all options granted to senior executives have been subject to performance conditions, which ensure that the options only vest if the Company's earnings per share, as shown in the financial statements, exceed the percentage increase in the Retail Price Index plus 3% over a 3-year reference period before the options become exercisable.

The ESOS is due to expire this year. With this in mind, and having regard to emerging trends in market and best practice the Committee reviewed the structure of its share-based incentive arrangements and concluded that the ESOS should be replaced with a similar executive share option scheme, which would provide for both the grant of HM Revenue & Customs approved options and unapproved options over market value options and nil (or nominal) cost options. The Committee also concluded that the existing EMI Scheme should be amended to allow for the grant of both market value options and nil (or nominal) cost options.

All awards granted to executive directors under the new executive share option scheme and the EMI Scheme will be subject to appropriately challenging performance conditions to be measured over a single three year period. Further details of the new executive share options plan and amendments to the EMI Scheme are set out in the Chairman's letter dated 31 March 2006.

Directors' Service Contracts

Executive directors have "rolling" service contracts. The Chief Executive's contract is terminable by either party giving 12 months' notice. In the case of all other executive directors the notice period is 6 months.

Non-executive directors do not have service contracts. Letters of agreement are in place dated 7 November 1995 for David Mann, 1 November 1996 for Tim Morris and 28 July 1999 for Tom Rowbotham. In each case the arrangement is terminable with 3 months' notice.

Remuneration to Non-executive directors

Fees paid to non-executive directors are detailed below. The intention is to pay fees that are comparable to companies of similar size and complexity. The remuneration of the non-executive directors is proposed by the Chief Executive and the Finance Director and approved by the Board.

Directors' Remuneration

Emoluments paid to Directors in the year comprised:

	Salaries/ fees £'000	Bonus £'000	Benefits £'000	Total 2005 £'000	Total 2004 £'000
D W Mann	26	–	–	26	22
G C Carter	120	46	1	167	–
C J R Ogle	107	34	1	142	145
D G Tatchell	123	37	3	163	168
T R Rowbotham	18	–	–	18	16
T R T Morris	12	–	–	12	12
	406	117	5	528	363

Pension Contributions

The Group made contributions under the Company Group Personal Pension Plan, a defined contribution scheme, as follows:

	2005 £'000	2004 £'000
G C Carter	10	–
C J R Ogle	9	8
D G Tatchell	10	10
	29	18

Directors' Interests in Share Options

Share options have been granted to the following Directors under the Company's Share option scheme:

Director	No. of shares under option					
	At 31 December 2004	Issued in year	Lapsed in year	At 31 December 2005	Exercise Price	Exercise Date
G C Carter	–	100,000	–	100,000	70.0	2008-2015
G C Carter	–	100,000	–	100,000	87.5	2008-2015
C J R Ogle	100,000	–	–	100,000	54.5	2002-2009
C J R Ogle	8,750	–	–	8,750	84.0	2005-2012
C J R Ogle	12,500	–	–	12,500	51.0	2006-2013
C J R Ogle	45,000	–	–	45,000	61.5	2007-2014
C J R Ogle	–	35,000	–	35,000	70.0	2008-2015
D G Tatchell	8,750	–	–	8,750	84.0	2005-2012
D G Tatchell	12,500	–	–	12,500	51.0	2006-2013
D G Tatchell	80,000	–	–	80,000	61.5	2007-2014
D G Tatchell	–	60,000	–	60,000	70.0	2008-2015

report of the directors

for the year ended 31 December 2005

The Directors present their report together with the audited financial statements for the year ended 31 December 2005.

Results and dividends

The profit and loss account is set out on page 25 and shows the profit for the year.

The Directors recommend the payment of a dividend of 1.3p (2004: 1.1p) per ordinary share. In accordance with Financial Reporting Standards dividends are now recognised on the basis of the period in which they are paid or proposed prior to the year end rather than proposed subsequent to the year end. As a result these statements state the 2005 dividend as 1.1p, (2004: 1.0p).

The consolidated profit for the year after deduction of dividends paid amounted to £768,000 (2004: £423,000 as restated).

Principal activities, trading review and future developments

The principal activities of the Group are the provision of virtual prototyping software and other related activities. A review of the development of the business during the year is given in the Chairman's statement on page 4. This also includes reference to the Group's future prospects. An indication of the Group's activities in research and development is given in the Chief Executive's review on pages 8 to 9.

Areas of Operation

The Group's headquarters and primary centre for research and development is in the United Kingdom. During the year, the Group acquired Microelectronics Research and Development Limited, a hardware sales and development operation based in Hungary. The Group also has sales and support offices in the United States of America, France, Germany, Italy, China, Singapore, Sweden, Japan and India.

Political and charitable contributions

During 2005, the Group contributed a total of £4,051 (2004: £858) to support local charities. The Group made no political donations.

Directors and their interests

The Directors of the Company during the year were:

D W Mann	Non-Executive Chairman
G C Carter	Chief Executive
C J R Ogle	Finance Director
D G Tatchell	Chief Technology Officer
T R Rowbotham	Non-Executive Deputy Chairman
T R T Morris	Non-Executive Director

Details of Directors' remuneration and Directors' share options are given in the Report on Remuneration on page 21.

The Directors who held office at the end of the financial year had the following interests in the ordinary shares of the Company as recorded in the register of Directors' share and debenture interests:

	At 31 December 2005 Ordinary shares Number	At 1 January 2005 Ordinary shares Number
D W Mann	138,500	138,500
D W Mann – non beneficial	45,000	45,000
G C Carter	8,000	–
C J R Ogle	12,500	12,500
D G Tatchell	1,332,800	1,332,800
T R Rowbotham	361,326	361,326
T R T Morris	40,000	40,000

There were no changes in the Directors' shareholdings between 31 December 2005 and 14 March 2006.

Significant shareholdings

As at 14 March 2006 notification had been received that the following were interested in more than 3% of the Company's ordinary share capital:

	Number of ordinary shares	Percentage of issued ordinary share capital
F & C Asset Management (formerly ISIS Asset Management)	1,987,505	13.39
Fidelity Investments	1,184,358	7.98
Simon Ward-Jackson	550,000	3.7

Creditor payment policy and practice

The Group policy for all suppliers is to fix terms of payment when agreeing the terms of each business transaction, to ensure the supplier is aware of those terms and to abide by the agreed terms of payment. The creditor payment days outstanding for the Group at 31 December 2005 was 16 days (2004: 33 days). The Company has no trade creditors.

Auditors

BDO Stoy Hayward LLP have expressed their willingness to continue in office and a resolution to re appoint them will be proposed at the annual general meeting.

By order of the Board

C J R Ogle
Secretary
14 March 2006

statement of directors' responsibilities

Company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and Group 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 then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

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

Financial statements are published on the Group's website in accordance with legislation in the United Kingdom governing the preparation and dissemination of financial statements, which may vary from legislation in other jurisdictions. The maintenance and integrity of the Group's website is the responsibility of the Directors. The Directors' responsibility also extends to the ongoing integrity of the financial statements contained therein.

To the shareholders of Flomerics Group PLC

We have audited the financial statements of Flomerics Group PLC for the year ended 31 December 2005 on pages 25 to 39 which have been prepared under the accounting policies set out on page 29.

Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the annual report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Report of the Directors is not consistent with the financial statements, if 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 transactions with the Group is not disclosed.

We read other information contained in the annual report and consider whether it is consistent with the audited financial statements. This other information comprises only the Report of the Directors, the Chairman's statement, the Chief Executive's review, the Operating and financial review, Information for shareholders, the Corporate governance statement and the Report on remuneration. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Our report has been prepared pursuant to the requirements of the Companies Act 1985 and for no other purpose. No person is entitled to rely on this report unless such a person is a person entitled to rely upon this report by virtue of and for the purpose of the Companies Act 1985 or has been expressly authorised to do so by our prior written consent. Save as above, we do not accept responsibility for this report to any other person or for any other purpose and we hereby expressly disclaim any and all such liability.

Basis of audit opinion

We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the 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 financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Company and the Group at 31 December 2005 and of the profit of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

BDO STOY HAYWARD LLP
Chartered Accountants and Registered Auditors
London
14 March 2006