

Application of the principles of good governance

The Board is committed to the maintenance of high standards of Corporate Governance. The policy of the Board is to manage the affairs of the Company in accordance with the Principles of Good Governance and the Code Provisions set out in Section 1 of the Combined Code on Corporate Governance ("the Combined Code") issued by the Financial Services Authority in June 1998.

The Group is controlled and directed by a Board consisting of a non-executive Chairman, four executive Directors and three other non-executive Directors. Their biographies appear on page 28. The Board considers each of the non-executive Directors to be independent. The Board recognises that the revised Combined Code considers that a non-executive director ceases to be independent upon appointment as chairman, however the Board believes that Mr Unwin's Chairmanship of the Board does not interfere with his independence as regards, in particular, membership of the Audit and Remuneration Committees. In assessing independence, the Board considers that the Chairman and non-executive Directors are independent of management and free from business and other relationships which could interfere with the exercise of independent judgement now and in the future. The Board believes that any shareholdings of non-executive Directors serve to align their interests with those of all shareholders. Mr Stone is acknowledged as the Senior Independent Director. Upon appointment and at regular intervals, all Directors are offered appropriate training. Each Director is subject to re-election at least every three years.

The Directors retain responsibility for the formulation of corporate strategy, investment decisions, and treasury and risk management policies. There is a formal schedule of matters reserved for the Board's decision and the Board meets at least eight times each year with further ad hoc meetings as required. Directors are issued an agenda and comprehensive board papers in the week preceding each Board Meeting. All Directors have access to the advice and services of the Company Secretary as well as there being an agreed procedure for obtaining independent professional advice.

Mr Stone chairs the Remuneration Committee of which each of the non-executive Directors is a member. Mr Walker and Mr Pettit joined the Committee during the year. Mr Barber was a member until his retirement in July 2003 and Lord McGowan remained a member until his death in May 2003. Formal terms of reference exist which follow the recommendations of the Combined Code and are available on request from the Company Secretary. The Committee makes recommendations to the Board on the framework for executive Directors' and senior executives' remuneration based on proposals formulated by the Group Chief Executive. The Committee meets at least twice per year.

Following Lord McGowan's death, Mr Unwin chaired the Audit Committee. In October 2003, Mr Walker assumed the Chairmanship of the Audit Committee. Each of the non-executive Directors is a member of the Committee. Formal terms of reference exist which follow the recommendations of the Combined Code and are available on request from the Company Secretary. The Committee reviews the interim and annual accounts, the statement on internal controls and is responsible for the relationship with the external auditors. The Group Chief Executive, Group Finance Director and representatives from the Auditors attend Committee meetings by invitation in order to provide appropriate advice. The Committee meets at least three times per year.

Mr Barber chaired the Nomination Committee until his retirement at which point Mr Unwin assumed the role of Chairman. Mr Stone and Mr O'Shea are also members of the Committee. Formal terms of reference exist which follow the

recommendations of the Combined Code and are available on request from the Company Secretary. The Committee makes recommendations to the Board on the appointment of new Directors. External search consultancies are retained when recruiting non-executive Directors. The Committee meets at least annually.

Control of divisional operating matters is delegated to the Executive Board of which the Group Chief Executive, Group Finance Director and all of the Divisional Chief Executives are members. Biographies of Executive Board members appear on page 28. The Group Chief Executive chairs the Executive Board, which meets regularly, thereby ensuring the Board's strategies are communicated to those overseeing operations.

The Executive Board reviews operational activities, trading results, budgets, policy matters, investment opportunities, resource allocation and risk exposures. Any matters arising out of the Executive Board meetings are reported to the Board via the Group Chief Executive's report to the Board.

The Group Chief Executive and Group Finance Director also meet regularly with each Divisional Chief Executive to monitor progress against key objectives and review operational performance.

Individual operating company boards, chaired by the appropriate Divisional Chief Executive, manage operating companies. These boards have clearly defined responsibilities for the operation of their businesses, including compliance with legislation and regulations, and for internal reporting. The system of internal control exercised within the Group is described below.

Investor relations

In regular meetings with shareholders and analysts the Group Chief Executive and Group Finance Director communicate the Group's methods and results. Meetings include the Annual General Meeting and briefings following the interim and annual results. The Financial Calendar is set out on page 26.

The Group website, www.halma.com, contains copies or summaries of all Company announcements, summaries of presentations to analysts, electronic versions of the latest Annual Report and Accounts, biographical information on key Directors and Officers, share price information, and full subsidiary company contact details as well as hotlinks to their own websites. The website also contains the facility to request e-mail alerts relating to announcements made by the Group.

Going concern

After making enquiries, the Directors have a reasonable expectation that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

Internal control

The Board of Directors has overall responsibility to the shareholders for the Group's system of internal control and responsibility for reviewing its effectiveness has been delegated to the Audit Committee. Any system of internal control can provide only reasonable but not absolute assurance against material misstatement or loss.

Following publication by the Turnbull Committee of the guidance for directors on internal control ("Internal Control: Guidance for Directors on the Combined Code"), the Board confirms that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the Group, that this has been in place for the year under review and up to the date of approval of the Annual Report and Accounts. This process has been reviewed by the Board, and the Group accords with the Turnbull guidance.

The Group's external auditors, Deloitte & Touche LLP, have audited the financial statements and have reviewed the internal financial control systems to the extent they consider necessary to support their audit report.

The Board meets regularly throughout the year and has adopted a schedule of matters which are required to be brought to it for decision. This procedure is intended to ensure that the Directors maintain full and effective control over all significant strategic, financial and organisational issues.

Group companies operate under a system of controls which includes but is not limited to:

- a defined organisational structure with an appropriate delegation of authority to operational management
- the identification and appraisal of risks both formally, through the annual process of preparing business plans and budgets, and informally through close monitoring of operations
- a comprehensive financial reporting system within which actual results are compared with approved budgets and previous year's figures on a monthly basis and reviewed at both local and Group level
- an investment evaluation procedure to ensure an appropriate level of approval for all capital expenditure
- self-certification by operating company management of compliance and control issues
- a prescribed robust structure under which it is appropriate to adopt means of electronic communication and to conduct e-commerce.

The processes which the Board has applied in reviewing the effectiveness of the Group's system of internal control are summarised below.

- Operating companies carry out a detailed risk assessment each year and identify mitigating actions in place or proposed for each significant risk. A risk register is compiled from this information, against which action is monitored through to resolution. In addition, Divisional Chief Executives carry out an independent risk assessment for each operating company. A review of Group risks is also conducted.
- Each month the board of each operating company meets, discusses and reports on its operating performance, its opportunities, the risks facing it and the resultant actions. The relevant Divisional Chief Executive chairs this meeting. Divisional Chief Executives meet regularly with the Group Chief Executive and Group Finance Director and report progress to the Executive Board.
- The Group Chief Executive submits a report to each Halma p.l.c. Board meeting which includes financial information, the main features of Group operations and an analysis of the significant risks facing the Group at that time.
- Internal control visits are carried out by senior finance staff resulting in actions fed back to each company and followed up by Divisional Finance Directors; visit reports are coded in terms of risk with any significant control failings reported directly to the Audit Committee and a summary of all such visits reported to the Audit Committee regularly; senior finance staff also carry out financial reviews at each operating company prior to publication of half year and year end figures.

- The Group Finance Director and Group Chief Executive report to the Audit Committee on all aspects of Internal Control for its review. The Board receives the minutes of the Audit Committee meetings and uses these as a basis for its annual review of internal control.

As noted above, a programme of internal control visits is conducted. Following its review of internal control activities in 2004, the Audit Committee has now put in place procedures for independent reporting of the outcome of these visits to the Audit Committee. Whilst internal audit is not a separate function within the Group, the Board anticipates that the procedures now in place will allow it to report in 2004/05 that it has procedures which amount to an internal audit function.

Auditor independence

The Audit Committee has responsibility for reviewing auditor independence and objectivity annually. During the year, the Committee set down the "Policy on Auditor Independence and Services provided by the External Auditor". This policy states that the Group will only use the appointed external auditor for non-audit services in cases where these services do not conflict with the auditor's independence. The policy also sets a fee level above which non-audit services are subject to a tendering process.

Compliance with the code of best practice

The Company complied with the provisions of the Combined Code throughout the financial year.

The following sections of the Report on Remuneration have been audited: the table of Directors' remuneration; pension benefits; Directors' interests in shares.

Remuneration policy

The policy on Directors' Remuneration is to provide the remuneration packages necessary to attract, retain and motivate Directors of the quality required to run the Group successfully, manage the business of the Group and to align the interests of the Directors with those of the shareholders.

In accordance with rule 12.43A(c) of the Listing Rules of the Financial Services Authority the Board presents its Report on Remuneration to the shareholders. The Board confirms that when determining the remuneration policy for executive Directors for 2003/04 full consideration was given to the Combined Code appended to the Listing Rules of the Financial Services Authority.

The Remuneration Committee consists entirely of non-executive Directors, the current members being Mr R A Stone (Chairman of the Committee), Mr E G Unwin, Mr A J Walker and Mr S R Pettit. Messrs Walker and Pettit were appointed to the Committee during the past year. Mr D S Barber was a member of the Committee prior to his retirement and Lord McGowan was a member prior to his death. The Board has considered and confirmed Mr Stone's independence following the third anniversary of his appointment to the Board. The Board has also affirmed its decision to appoint Mr Unwin to the Committee as the Board believes that his Chairmanship of the Board does not interfere with his independence as regards membership of the Committee. Mr Unwin does not take part in discussions concerning his own remuneration.

The Committee makes recommendations to the Board on the framework for executive remuneration, based on proposals formulated by the Group Chief Executive, and determines the terms of service and remuneration of executive Directors and senior executives. The Committee's Terms of Reference are available from the Company Secretary on request.

Basic salary and benefits

In determining recommended basic salary levels for each individual, the Committee does not currently employ remuneration consultants but uses independent surveys, compiled by New Bridge Street Consultants, IDS and Deloitte & Touche LLP, and other relevant data to relate remuneration levels to comparable publicly quoted companies. In assessing the data that the Committee utilises, the Committee considers the benefits in comparable companies, the Company's market capitalisation, the Group's turnover and the complexity of Group operations in order to determine each Executive's basic salary level. Basic salary levels are set in order to achieve a balance between fixed and variable remuneration.

Share options

The Directors have long believed that share option plans are an excellent way to align the interests of senior management with those of shareholders and that share options provide excellent motivation. The Committee recognises the need to continually assess and evaluate such incentives and therefore has asked Ernst & Young LLP to assist them in developing the next phase of incentive arrangements to introduce across the Group.

The 1990 and 1996 Share Option Plans each provide for the grant of two categories of option both of which are subject to performance criteria. The exercise criteria for these two plans are noted in Note 19 on the Accounts. No further grants may be made from either of these plans.

Options under the 1999 Company Share Option Plan have more stringent exercise criteria than the 1990 and 1996 Share Option Plans. Section 'A' options are exercisable after three years if the Company's earnings per share growth exceeds the growth in the Retail Price Index plus 3% per annum. Section 'B' options are exercisable after five years if the Company's earnings per share growth exceeds the earnings per share growth of all but the top quarter of companies which were within a peer group at the date of grant of any option.

The granting of options is spread over the life of the plan. Executive Directors receive a triennial award of 'A' options, an annual award of 'B' options and the possibility of further 'A' options under the Performance Related Bonus Scheme.

Performance related bonus scheme

This scheme, which applies only to executive Directors and Divisional Chief Executives, is reviewed annually by the Remuneration Committee and approved by the Board. Without approval of this scheme there is no alternative bonus arrangement for Directors and Divisional Chief Executives. During 2003/04 the Remuneration Committee carefully considered existing bonus arrangements and determined that incentive levels are appropriately set.

In the case of a Divisional Chief Executive a bonus would be earned if the profit of the Division for which he is responsible exceeds a target calculated from the profits of the three preceding financial years. The profits calculated for this purpose regard each Division as a stand-alone group of companies charging it with the cost of capital it utilises including the cost of acquisitions.

For the Group Chief Executive and Group Finance Director, bonuses are based on the aggregated profit of the Divisions exceeding a target calculated from the profits of the Divisions for the three preceding financial years.

A pre-determined percentage of the profit improvement is payable in cash and generally a further percentage is granted in the form of Section 'A' share options. The percentage payable in cash commences at a low level for modest growth increasing, in percentage terms, as performance improves. The maximum cash bonus payable to any one Director or Divisional Chief Executive is capped at 100% of his salary.

Directors' remuneration

	Salaries and fees £000	Bonus £000	Benefits £000	2004 Total £000	2003 Total £000
D S Barber	52	-	-	52	81
E G Unwin	112	-	12	124	65
S R O'Shea	315	90	24	429	314
C Q Summerhayes	-	-	-	-	16
Lord McGowan	8	-	-	8	22
H M J Ritchie	-	-	-	-	10
K J Thompson	160	46	9	215	158
N Quinn	160	81	18	259	162
R A Stone	32	-	-	32	22
K J Roy	135	2	18	155	143
A J Walker	27	-	-	27	-
S R Pettit	16	-	-	16	-
	<u>1,017</u>	<u>219</u>	<u>81</u>	<u>1,317</u>	<u>993</u>

The fees paid in relation to Mr E G Unwin were paid to Gunwin Limited.

After inclusion of gains on the exercise of share options, where applicable, Mr S R O'Shea was the highest paid director in the financial year.

Pension benefits

The executive Directors participate in the appropriate section of the Halma Group Pension Plan. This section is a funded, Inland Revenue approved, final salary occupational pension scheme, which provides a pension equal to the lower of two-thirds of final pensionable salary and the Inland Revenue maximum pension at normal pension age (60). Pensionable salary is the greatest salary of the last three complete tax years immediately before retirement or leaving service. Bonuses and other fluctuating emoluments and benefits in kind are not pensionable. The scheme also provides for life cover of three times pensionable salary, pensions in the event of early retirement through ill health and dependants' pensions of one-half of the member's prospective pension. Early retirement pensions, possible from age 50 with the consent of the Company and the Trustees of the Halma Group Pension Plan, are subject to actuarial reduction. Pensions in payment increase by 3% per annum for service up to 5 April 1997 and by price inflation thereafter subject to a maximum of 5%.

Details of the value of individual pension entitlements are shown below.

	Age at 3.4.04	Years of service at 3.4.04	Accrued pension 2003 £000	Increase in the year £000	Accrued pension 2004 £000
S R O'Shea	58	28	145	16	165
K J Thompson	44	16	44	6	51
N Quinn	54	16	52	6	60
K J Roy	53	11	23	9	33

The accrued pension shown is that which would be paid annually on retirement based on service to the end of the year.

The increase in accrued pension during the year is the amount in excess of the increase due to inflation.

	Transfer value 29.3.03 £000	Directors' contributions £000	Increase in transfer value net of contributions £000	Transfer value 3.4.04 £000
S R O'Shea	2,279	25	418	2,722
K J Thompson	363	12	69	444
N Quinn	674	12	126	812
K J Roy	297	10	132	439

The transfer values disclosed above do not represent a sum paid or payable to the individual Director. Instead they represent a potential liability of the pension scheme. These values have been calculated on the basis of actuarial advice in accordance with Actuarial Guidance Note GN11.

Total shareholder return

The graph below shows the Company's total shareholder return performance over the five years to 3 April 2004 as compared to the FTSE 250 and Engineering & Machinery indices which have been chosen as the Company is a constituent of both of these indices. Over the period indicated, the Company's total shareholder return was 95% compared to 33% for the FTSE 250 and 8% for the FTSE Engineering & Machinery sector.



At the commencement of the five-year period depicted in the graph, the Halma p.l.c. ordinary share price was 92p and the total of dividends in respect of the year ended 3 April 1999 was 3.327p per share. The Halma p.l.c. ordinary share price at 3 April 2004 was 149.25p and the total of dividends in respect of the year then ended was 6.19p per share.

Directors’ interests in shares

The beneficial interests of Directors and their families in the ordinary shares of the Company during the financial year were as follows:

	Shares 3.4.04	Shares 29.3.03
E G Unwin	38,250	38,250
S R O’Shea	258,075	242,482
K J Thompson	49,749	47,786
N Quinn	33,788	25,596
R A Stone	5,000	5,000
K J Roy	744,587	744,587
A J Walker	35,714	—*
S R Pettit	1,000	—*

*as at date of appointment

There are no non-beneficial interests of Directors.

There were no changes in Directors’ interests from 3 April 2004 to 22 June 2004.

The movements in share options during the financial year were as follows:

	As at 29.3.03	Granted	Exercised	Lapsed	As at 3.4.04
S R O’Shea	1,458,328	94,030	142,398	—	1,409,960
K J Thompson	579,346	167,164	8,354	—	738,156
N Quinn	731,358	167,164	34,442	—	864,080
K J Roy	436,992	40,299	16,177	—	461,114

The total gains on options exercised by Directors during the financial year amounted to £39,853. The gains are calculated by deducting the exercise price from the closing middle market price at the date of exercise or the actual gross sales proceeds if appropriate.

Options granted to Directors during the financial year were at an exercise price of 134p. The closing middle market price of the Company's ordinary shares on Friday, 2 April 2004, the last trading day preceding the financial year end, was 149.25p per share and the range during the year was 109p to 151.25p.

Details of Directors' options outstanding at 3 April 2004 are set out in the table below. The status of the options can be summarised as follows:

- 1 Exercisable at that date at a price less than 149.25p.
- 2 Not yet exercisable, will only be exercisable when the performance criteria, set out above, have been met and have an exercise price per share of less than 149.25p.
- 3 Not yet exercisable, will only be exercisable when the performance criteria, set out above, have been met and have an exercise price per share of greater than 149.25p.

	Status of options (see above)	Year of grant	Number of shares	Weighted average exercise price (p) per share
S R O'Shea	1	1994-99	690,131	126.34
	2	1997-00; 2002-03	619,029	132.68
	3	2001	100,800	163.50
K J Thompson	1	1994-98	260,206	121.73
	2	1997-00; 2002-03	429,550	125.15
	3	2001	48,400	163.50
N Quinn	1	1994-99	297,630	120.38
	2	1997-00; 2002-03	469,550	123.64
	3	2001	96,900	163.50
K J Roy	1	1994-99	169,565	120.78
	2	1997-00; 2002-03	236,849	132.61
	3	2001	54,700	163.50

All options lapse if not exercised within 10 years from the date of grant.

The Company's Register of Directors' Interests, which is open to inspection at the Registered Office, contains full details of Directors' shareholdings and share options.

Service contracts

It is the Company's policy that executive Directors should have contracts with an indefinite term providing for a maximum of one year's notice. The service contract of Mr S R O'Shea has a two-year rolling notice period which reduces monthly in the two years preceding normal retirement. At the date of this report, Mr O'Shea's notice period is, effectively, 18 months. The Board reviewed this contract term during the year and confirmed its appropriateness. All other executive Directors have contracts with a notice period of one year. None of the contracts has pre-determined compensation clauses in the event of early termination. The Board and the Remuneration Committee confirm that these contracts are appropriate having regard, amongst other things, to the individuals' length of service.

Non-executive Directors

All non-executive Directors have specific terms of engagement and their remuneration is determined by the Board based on independent surveys of fees paid to non-executive directors of similar companies. The non-executive Directors receive a basic fee supplemented by additional fees for membership and/or chairmanship of the Audit and Remuneration Committees.

The contract in respect of Mr Unwin's services provides for termination, by either party, by giving not less than six months' notice. Mr Unwin's basic fee for 2003/04 was set at £108,000 per annum excluding Committee membership fees, and he received a contribution of £1,000 per month towards his office costs.

The other non-executive Directors do not have service contracts.

Non-executive Directors' fees were last reviewed by the Board of Directors in April 2004.

By Order of the Board

R A Stone Chairman of the Remuneration Committee
Misbourne Court Rectory Way Amersham Bucks HP7 0DE
22 June 2004

United Kingdom 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 the Group as at the end of the financial year and of the profit or loss for that period.

The Directors have responsibility for ensuring that proper accounting records are maintained which disclose with reasonable accuracy at any time the financial position of the Company and the Group and which enable them to ensure that the financial statements comply with the Companies Act 1985.

The Directors also have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities and are responsible for the system of internal control.

The Directors consider that, in preparing the financial statements on pages 48 to 73 and the disclosures on pages 40 to 45 relating to the remuneration of the Directors, appropriate accounting policies have been used, which have been consistently applied and supported by reasonable and prudent judgements and estimates, that all accounting standards which they consider to be applicable have been followed.