

Enabling people to live healthier, more active lives.





The 'ink people' is an Orthopaedics' brand project. The ink figures are being used in a range of still and animated advertising projects including TV slots entitled "Peak Performance Powered by Smith & Nephew" and "Smith & Nephew - Innovation in Motion". The style is the personification of our aim of empowering people to recapture their right to an active lifestyle and can be viewed on: [www.youtube.com/user/SNmarcom](http://www.youtube.com/user/SNmarcom).

# INTRODUCTION AND FINANCIAL SUMMARY

The Smith & Nephew Group (the “Group”) is a global medical devices business operating in the orthopaedics, endoscopy and advanced wound management markets with revenue of approximately \$3.8 billion in 2008. Smith & Nephew plc is the parent company of the Smith & Nephew Group. It is an English public limited company with its shares listed on the official list of the UK Listing Authority and it is traded on the London Stock Exchange and on the New York Stock Exchange in the form of American Depositary Shares (“ADSs”).

This report is the Annual Report of Smith & Nephew plc for the year ended 31 December 2008. It comprises in a single document the Annual Report and Accounts of the company in accordance with UK requirements and the Annual Report on Form 20-F in accordance with the regulations of the Securities and Exchange Commission in the US.

A summary report on the year, the Summary Financial Statement 2008, intended for the investor who does not require the full detail of the Annual Report is available on Smith & Nephew’s corporate website at [www.smith-nephew.com/investors](http://www.smith-nephew.com/investors) along with the electronic version of this Annual Report. The Summary Financial Statement includes a summary remuneration report and summary financial statements.

The Group’s fiscal year end is 31 December. References in this Annual Report to a particular year are to the fiscal year unless otherwise indicated. Except as the context otherwise requires, “Ordinary Share” or “share” refer to the Ordinary Shares of Smith & Nephew plc of US 20¢ each.

For the convenience of the reader, a Glossary of technical and financial terms used in this document is included on page 164. The product names referred to in this document are identified by the use of capital letters and are trademarks owned by or licensed to members of the Smith & Nephew Group.

## **Key Performance Indicators**

The Report of the Directors includes a number of measures that management uses as key performance indicators. Underlying growth in revenue is not presented in the accounts prepared in accordance with IFRS and is therefore not a Generally Accepted Accounting Principle (“non-GAAP”) measure. The principal key performance indicators presented in the Annual Report are:

### ***Underlying growth in revenue***

Underlying growth in revenue is a non-GAAP financial measure which is a key performance indicator used by the Group’s management in order to compare the revenue in a given year to that of the previous year on a like-for-like basis. This is achieved by adjusting for the impact both of sales of products acquired in business combinations and for movements in exchange rates. An explanation of how this non-GAAP measure is calculated is presented in the “Business Overview” on page 28.

The Group believes that the tabular presentation and reconciliation of revenue growth from reported to underlying assists investors in their assessment of the Group’s performance in each business segment and for the Group as a whole.

Underlying growth in revenue is considered by the Group to be an important measure of performance in terms of local functional currency since it excludes those items considered to be outside the influence of local management. The Group’s management uses this non-GAAP measure in its internal financial reporting, budgeting and planning to assess performance on both a business segment and a consolidated Group basis. Revenue growth at constant currency is important in measuring business performance compared to competitors and compared to the growth of the market itself. The Group’s annual bonus incentive plans include an element which relates to revenue growth performance. Targets are set and performance measured in constant currency excluding the step-change impact of acquisitions.

The Group considers that the revenue from sales of products acquired in business combinations results in a step-up in growth in revenue in the year of acquisition that cannot be wholly attributed to local management’s efforts with respect to the business in the year of acquisition. Depending on the timing of the acquisition there will usually be a further step change in the following year. A measure of growth excluding the effects of business combinations also allows senior management to evaluate the performance and relative impact of growth from the existing business and growth from acquisitions. The process of making business acquisitions is directed, approved and funded from the Group corporate centre in line with strategic objectives.

The material limitation of the underlying growth in revenue measure is that it excludes certain factors, described on page (i), which ultimately have a significant impact on total revenues. The Group compensates for this limitation by taking into account relative movements in exchange rates in its investment, strategic planning and resource allocation. In addition, as the evaluation and assessment of business acquisitions is not within the control of local management, performance of acquisitions is monitored centrally until the business is integrated. The Group's management considers that both the non-GAAP measure of underlying growth in revenue and the GAAP measure of growth in revenue are complementary measures neither of which management use exclusively.

***Basic adjusted earnings per ordinary share ("EPSA"), trading profit and adjusted attributable profit***

Growth in EPSA and trading profit are measures which present the trend growth in the long-term profitability of the Group excluding the impact of specific transactions or events that management considers affect the Group's short-term profitability. The Group presents these measures to assist investors in their understanding of trends. EPSA growth and trading profit are also the key measures used for remunerating senior management in order to align the interests of senior management with those of investors. The Group's internal financial reporting (budgets, monthly reporting, forecasts, long-term planning and incentive plans), focuses primarily on profit and earnings before these items.

The Group has identified the following items, where material, as those to be adjusted and identified separately: acquisition and disposal related items including amortisation and impairment of acquisition intangible assets; significant restructuring events; gains and losses arising from legal disputes and uninsured losses; and taxation thereon. A reconciliation of attributable profit to adjusted attributable profit, which represents the numerator used in the EPSA calculation, is presented in "Selected Financial Data" on page 155. An explanation of how trading profit is calculated is presented in "Business Overview" on page 28.

EPSA and trading profit are not recognised measures under IFRS. The material limitation of these measures is that they exclude significant income and costs that have a direct impact on current and prior years' profit attributable to shareholders. They do not, therefore, measure the overall performance of the Group presented by the GAAP measures of earnings per share and operating profit. The Group considers that no single measure enables it to assess overall performance and therefore it compensates for the limitation of the adjusted earnings per share and trading profit measures by considering them in conjunction with their GAAP equivalents. Gains or losses which are identified separately arise from irregular events or transactions. Such events or transactions are authorised centrally and require a strategic assessment which includes consideration of financial returns and generation of shareholder value. Amortisation of acquisition intangibles will occur each year, whilst other excluded items arise irregularly depending on the events that give rise to such items.

**Presentation**

The results of the Group, as reported in US Dollars, are affected by movements in exchange rates between US Dollars and other currencies. The Group applied the average exchange rates prevailing during the year to translate the results of non-US companies into US Dollars. The currencies which most influenced these translations in the years covered by this report were Sterling, Swiss Franc and the Euro.

The Group Accounts of Smith & Nephew in this Annual Report are presented in US Dollars. Solely for the convenience of the reader, certain parts of this Annual Report contain translations of amounts in US Dollars into Sterling at specified rates. These translations should not be construed as representations that the US Dollar amounts actually represent such Sterling amounts or could be converted into Sterling at the rate indicated. Except as where stated otherwise, the translation of US Dollars and cents to Sterling and pence appearing in this Annual Report has been made at the noon buying rate in The City of New York for cable transfers in Sterling as certified for customs purposes by the Federal Reserve Bank of New York (the "Noon Buying Rate") on the date indicated. On 11 March 2009, the Noon Buying Rate was US\$1.38 per £1.

The Accounts of the Group in this Annual Report are presented in millions ("m") unless otherwise indicated.

Smith & Nephew's corporate website, [www.smith-nephew.com](http://www.smith-nephew.com), gives additional information on the Group. Information made available on the website is not intended to be, and should not be regarded as being, part of this Annual Report.

## Financial Summary

### Financial Highlights

	2008 \$ million	2007 \$ million
Revenue	3,801	3,369
Trading profit	776	706
Operating profit	630	493
Attributable profit for the year	377	316
Adjusted attributable profit	493	480
Basic earnings per Ordinary Share	42.6¢	34.2¢
Basic EPSA	55.6¢	52.0¢
Dividends per Ordinary Share (i)	13.08¢	11.89¢

- (i) The Board has declared a second interim dividend of 8.12¢ per share which together with the first interim dividend of 4.96¢ makes a total for 2008 of 13.08¢. The second interim dividend will be paid on 8 May 2009 to shareholders on the Register of Members at the close of business on 17 April 2009.

### Special Note Regarding Forward-Looking Statements

The Group's reports filed with, or furnished to, the US Securities and Exchange Commission ("SEC"), including this document and written information released, or oral statements made, to the public in the future by or on behalf of the Group, constitute "forward-looking statements" within the meaning of the US Private Securities Litigation Reform Act of 1995. In particular, statements regarding planned growth in the Group's business and trading margins discussed under "Outlook and Trend Information" are forward-looking statements as are discussions of the Group's product pipeline and discussions of the costs of future revisions of the macrotextured knee product under "Recent Developments", "Legal Proceedings" and "Operating and Financial Review — Liquidity and Prospects". When used in this Annual Report, the words "aim", "anticipate", "believe", "consider", "estimate", "expect", "intend", "plan", "target", "well-placed" and similar expressions are generally intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors (including, but not limited to, the outcome of litigation and regulatory approvals) that could cause the actual results, performance or achievements of Smith & Nephew, or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Specific risks faced by the Group are described under "Risk Factors" on page 22 of this Annual Report.

All forward-looking statements in this Annual Report are based on information available to Smith & Nephew as of 17 March 2009. All written and oral forward-looking statements attributable to Smith & Nephew or any person acting on behalf of Smith & Nephew are expressly qualified in their entirety by the foregoing. Smith & Nephew does not undertake any obligation to update or revise any forward-looking statement contained herein to reflect any change in Smith & Nephew's expectation with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

### Market Data

Market data and market share estimates throughout this report are derived from a variety of sources including publicly available competitors' information, internal management information and independent market research reports.

### Documents on Display

It is possible to read and copy documents referred to in this Annual Report at the Registered Office of the Company. Documents referred to in this Annual Report that have been filed with the Securities and Exchange Commission in the US may be read and copied at the SEC's public reference room located at 450 Fifth Street, NW, Washington DC 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms and their copy charges. The SEC also maintains a web site at [www.sec.gov](http://www.sec.gov) that contains reports and other information regarding registrants that file electronically with the SEC. This Annual Report and some of the other information submitted by the Group to the SEC may be accessed through the SEC website.

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This Annual Report including the Report of the Directors was approved by the Board of Directors on 17 March 2009.

(i) A discussion of the Group's Key Performance Indicators is given in "Introduction and Financial Summary" on pages i and ii.

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# DESCRIPTION OF THE GROUP

This section discusses the activities, resources and operating environment of the business under the following headings:

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Discussion of the Group's management structure and corporate governance procedures is set out in the "Corporate Governance" section (pages 51 to 61).

The "Remuneration Report" gives details of the Group's policies on senior management's remuneration in 2008 (pages 63 to 72).

Discussion of the Group's operating and financial performance, liquidity and financial resources for 2008 and 2007 is given in the "Operating and Financial Review, Liquidity and Prospects" (pages 27 to 49).

Details of the structure of the Company's share capital and securities, persons with significant shareholdings in the Company and a summary of the Memorandum and Articles of association are incorporated into the Directors Report and are given in "Investor Information" (pages 147 to 167).

# THE BUSINESS

## HISTORY AND DEVELOPMENT

### **Group Strategy**

Smith & Nephew is a global business engaged in the development, manufacture, marketing and sales of medical devices in the sectors of orthopaedics (which includes reconstruction, trauma and clinical therapies), endoscopy and advanced wound management.

### **Group History**

The Group has a history dating back 153 years to the family enterprise of Thomas James Smith who opened a small pharmacy in Hull, England in 1856. On his death in 1896, his nephew Horatio Nelson Smith took over the management of the business. Smith & Nephew was incorporated and listed on the London Stock Exchange in 1937. Today it is a public limited company incorporated in the UK, registered in, and conducted under the laws of, England and Wales. The corporate headquarters is in the UK. Operations in countries other than the UK are under the laws of those countries. In November 1999, the Group was listed on the New York Stock Exchange.

In 2001, Smith & Nephew became a constituent member of the FTSE-100 index in the UK. This means that Smith & Nephew is included in the top 100 companies traded on the London Stock Exchange measured in terms of market capitalisation.

### **Recent Developments**

The Reconstruction and Trauma and Clinical Therapies segments reported separately in the annual accounts of the Group for the year ended 31 December 2007 are now combined into a single reporting segment named Orthopaedics for the year ended 31 December 2008. This reflects the unification of the management reporting structure for these businesses announced during the year. Where relevant, revenue, trading profit and operating profit comparative figures have been restated.

During 2008, a dedicated Biologics business was formed, bringing together the research programmes and skills from across the Group, focusing on advanced locally delivered biological therapies to promote healing and pain relief.

In February 2007, the Group commenced a share buy-back programme of up to \$1.5 billion over an initial two years. In 2008, 16 million shares were purchased at a total cost of \$193m. Since the programme began, the Group has purchased 68 million shares at a cost of \$833m. In light of the current conditions in the financial markets, the Group announced in November 2008 to suspend the share buy-back programme. There has been no change in the Group's long-term target balance sheet, cash generation or acquisition policy. The programme will remain under review going forward.

On 27 September 2007, settlements were reached in respect of the subpoenas issued by the US Attorney for the District of New Jersey's office to the Group's Orthopaedics business in 2005 and four of its primary competitors. The Group paid a civil restitution payment of \$29m and entered into a Deferred Prosecution Agreement and Corporate Integrity Agreement which required improvements to its compliance program. See "Legal Proceedings" (pages 47 to 48).

On 31 May 2007, the Group completed the purchase of Plus Orthopedics Holding AG ("Plus") a private Swiss orthopaedic company for a total of CHF1,086m (\$889m) in cash, including assumed debt. The acquisition was financed by bank borrowings and was integrated into the Group's Orthopaedics business. The acquisition of Plus increased the Group's share of the global orthopaedics market, making it the fourth largest global orthopaedics reconstruction company.

In January 2009, the Group reached an agreement with the vendors of Plus to reduce the total original purchase price by CHF159m. As part of the agreement the parties resolved their disputes on the contractual purchase price adjustments. In addition, the Group released the vendors from substantially all of their warranties, including those relating to taxation, under the original purchase agreement and dropped all existing claims under the original warranties.

On 10 May 2007, the Group purchased BlueSky Medical Group, Inc., (“BlueSky”), a private US company for an initial payment of \$15m with further milestone payments of up to \$95m related to revenues and other events. The company developed products for treating chronic wounds using negative pressure wound therapy and markets a range of negative pressure pumps and wound dressing kits. BlueSky has been integrated into the Group’s Advanced Wound Management business.

Following a group-wide in-depth review, the Group launched an Earnings Improvement Programme (“EIP”) during the first quarter of 2007. The objectives of the programme were to enhance short and medium term performance, to liberate resources for investment and to establish a culture of continuous improvement. Workstreams were created to address improved performance, mainly in the following areas of the Group’s business:

- in cost of goods by increased use of lower-cost locations, mainly in Asia, and savings in procurement by taking advantage of opportunities on a Group wide basis;
- in a number of administration functions by centralising, where appropriate, functions formerly run separately by each business, for example, Information Systems and Human Resources;
- in marketing by exploring opportunities to rationalise the Group’s product portfolio; and
- in sales functions by optimising the structure, deployment and efficiency of sales forces and sales channels.

The financial objectives of the EIP are to contribute to an increase in trading profit margin by an average of 1% per annum to the end of 2010, net of a planned increase in research and development expenditure. Cash restructuring costs are estimated to be \$125m spread over three years to 2010.

## BUSINESS DESCRIPTION

### **Organisation**

Smith & Nephew operates on a worldwide basis. This has been achieved through a series of acquisitions, in the US and in Europe, and through continued emphasis on the development and introduction of new products in the Group’s principal markets.

Smith & Nephew is currently organised into three global business units of Orthopaedics (which includes Reconstruction, Trauma and Clinical Therapies), Endoscopy and Advanced Wound Management. The Group also has a separate emerging markets unit. In 21 of the 32 countries in which the Group operates, the global business units take direct responsibility for business operations. These are referred to as direct markets. The remaining markets in which the Group has operations are managed by country managers, who are responsible for sales and distribution of the Group’s product range, and comprise the emerging markets unit.

A head office team in London, England directs the overall business and supports the business units, primarily in the areas of business development, legal, company secretarial, finance, human resources and investor relations. A dedicated Biologics business located in York, England and Durham, North Carolina brings together the research programmes and skills from across the Group, focusing on advanced, locally delivered biological therapies to promote healing and pain relief.

### **Orthopaedics**

#### ***Overview***

Orthopaedics comprises reconstruction, trauma and clinical therapies products.

Orthopaedic reconstruction implants include hip, knee and shoulder joints as well as ancillary products such as bone cement and mixing systems used in cemented reconstruction joint surgery. Orthopaedic trauma fixation products consist of internal and external devices and orthobiological materials used in the stabilisation of severe fractures and deformity correction procedures. Clinical therapies products are those that are applied in an orthopaedic office or clinic setting and include bone growth stimulation, joint fluid therapies and outpatient spine products.

The Orthopaedics business is managed worldwide from Memphis, Tennessee, which is also the site of its main manufacturing facility. Products are also manufactured at smaller facilities in Switzerland, Germany, and the UK

as well as third-party manufacturers. The Clinical Therapies business is headquartered in Durham, North Carolina, and also maintains operations in Memphis, Tennessee.

The Total Knee product portfolio includes the LEGION Total Knee System and the JOURNEY family of products. The LEGION Total Knee System is comprehensive and technologically advanced. It enables a surgeon to move from a simple primary procedure to a difficult revision procedure with a single surgical technique philosophy. VERILAST is one of the newest technologies offered as part of the LEGION System. It is the combination of OXINIUM and XLPE and provides and maintains extremely low wear rates. The JOURNEY family includes a range of products developed for the active patient. The JOURNEY BCS Knee System is designed by the Group to reproduce normal kinematics. Other highlights of the Group's early intervention portfolio include the new JOURNEY Uni System, the JOURNEY PFJ, and the JOURNEY DEUCE implants. VISIONAIRE is a key new technology spanning the Group's total knee portfolio that includes the development of patient specific cutting blocks with the goal of improved outcomes, less surgical complications, and shorter surgical time.

The trauma fixation product portfolio consists of internal and external devices used in the stabilisation of many types of fractures and limb deformity correction procedures. Internal fixation products, such as the TRIGEN INTERTAN Intertrochanteric Nail, the PERI-LOC upper and lower locked plating systems, PERI-LOC VLP and external fixation systems such as JET-X and TAYLOR SPATIAL FRAME provide orthopaedic surgeons with a comprehensive offering of products to address trauma and deformity correction procedures.

Smith & Nephew integrated Plus into its worldwide business during 2008. The Plus Gliding Nail and IP-XS trauma products were added to the Group's European business. The Plus spine business consists of internal spinal fixation products sold in certain European countries. The majority of the products are sourced through a distribution agreement with a third party. Smith & Nephew plans to continue to maintain this spinal fixation business and will evaluate opportunities for future growth in this market segment.

The EXOGEN line of ultrasonic bone healing stimulators, DUROLANE and SUPARTZ hyaluronic acid joint fluid therapies, and outpatient spine products, are the main products in the clinical therapies portfolio. EXOGEN retained its number one market share position for long bone stimulation in 2008. EXOGEN is an ultrasound technology approved to treat fractures that have failed to heal (known as non-unions) and in some cases prescribed to help specific fresh fractures heal faster. DUROLANE is a single injection therapy used to treat osteoarthritis of the knee and hip (currently only approved in Europe and Canada), and is manufactured by Q-MED AB of Sweden. SUPARTZ is an injection therapy used to treat osteoarthritis of the knee, and is manufactured by Seikagaku Corporation of Japan.

### ***Strategy***

Smith & Nephew's strategy for the reconstruction market is to become the leading innovator of solutions for the active, informed patient. Management believes that by focusing innovation on the needs of younger, more active patients, Smith & Nephew can lead the sector in providing hip and knee implants to this growing demographic segment. For example, in the US, patients aged 64 and under represent 41% of the primary hip and knee replacement market, and management believes this segment is growing at twice the overall market rate. The Orthopaedics business continues to invest in strategies that drive patient demand through integrated communications programs, including direct-to-consumer advertising, public relations and internet-based initiatives.

Smith & Nephew's strategy for the trauma and clinical therapies markets is to deliver growth through innovative product development in its existing core business while expanding into fast-growing market areas including alternative therapies for pain management and fracture healing. Management believes these markets will continue to grow for the foreseeable future. This is largely attributable to a global population increasingly at risk from fractures due to age, osteoporosis, obesity and diabetes, and to continuous advancements in the surgical treatment of fractures. Smith & Nephew intends to further penetrate these markets by expanding its sales force and by introducing less invasive therapies. The Group is also contributing to patient education and empowerment through its websites, traditional medical education and cadaveric training of residents and attending surgeons.

### ***New Products***

In 2008, for the reconstruction market, Orthopaedics launched the R3 Acetabular System, supporting XLPE, metal and ceramic liners in a single cup system, giving the surgeon all advanced bearing options without changing implants intraoperatively. Also launched was VERILAST technology, introduced this year with the LEGION family of knee products. VERILAST couples XLPE with the Group's proprietary OXINIUM technology to reduce wear rates while maintaining superior femoral and tibial integrity.

In the trauma market, several significant product innovations were commercialised in 2008. The polyaxial locking mechanism of the PERI-LOC Variable-Angle Locked Plating System (“VLP”) allows the angles at which locking screws can be inserted and locked into any of the low profile plates to be adjusted for optimal intraoperative versatility. PERI-LOC VLP specifically targets partial articular fractures in areas of the body where implant prominence and soft-tissue irritation are major concerns. Additionally, the PERI-LOC Periarticular Reduction Forceps Set provides a variety of soft-tissue sparing instruments for percutaneous reduction of fractures prior to definitive fixation. The Large Cannulated Screw System (6.5mm, 7.0mm and 8.0mm) offers new implants and enhanced instrumentation for percutaneous and/or open fracture fixation using cannulated screws. The PERI-LOC PFP (proximal femoral plate) presents an alternative to traditional femoral plating with locked plating technology. The TRIGEN META-NAIL Blocking Screw Instruments allow precision placement of blocking screws during intramedullary nail procedures to assist with fracture reduction, nail insertion, and postoperative implant stability. The TRIGEN Percutaneous Intertrochanteric/Femoral Antegrade Nail Instruments facilitate minimally invasive antegrade femoral nailing procedures and optimise intraoperative efficiency by combining all proximal locking options into a single intuitive radiolucent drill guide drop.

### ***Recent Regulatory Approvals***

In February 2008, the Japanese government approved the use of the OXINIUM technology in the GENESIS II Knee System in Japan. Regulatory teams in Memphis and Tokyo had been seeking approval for OXINIUM femoral components in the Japanese market for more than six years. Approval of OXINIUM technology will allow additional OXINIUM implant products to be registered in Japan and will eventually give Japanese customers access to the company’s complete hip and knee portfolios.

In 2008, US approvals for the R3 Acetabular Shell and Metal Liner for use with BHR and BHR manufacturing site change were received. US clearance was obtained for fifteen products: MIS Hip Stem; JET-X Bar System Quick Clamp Bar and Post, MR Conditional; INTERTAN Compression Hip Screw; PERI-LOC Volar Distal Radius Plate; Ti ECHELON Hip Stem; SL-PLUS Hip Stem; PIGALILEO 4<sup>th</sup> Generation Surgical Navigation System; MDF Revision Hip Stem; JOURNEY Uni Femoral Component; LEGION Hinge Knee; OXINIUM DH Femoral Head; PERI-LOC Hexalobular Bone Screw; PROMOS Reverse Shoulder; PIGALILEO Surgical Navigation System Knee Replacement Software Module; and VISIONAIRE Patient Matched Cutting Blocks.

### ***Competition***

Management estimates that the worldwide orthopaedic market (excluding clinical therapies) served by the Group grew by approximately 8% in 2008 and is currently worth more than \$15.5 billion per annum. Management believes that Smith & Nephew holds a 12% share of this market by value. Principal global competitors in the orthopaedic market are Zimmer, Stryker, DePuy/Johnson & Johnson, Synthes and Biomet.

Management estimates that the worldwide market for clinical therapies increased by 5% in 2008 and is currently worth more than \$1.6 billion per annum. Smith & Nephew’s primary market for clinical therapies is in the US. In the US long bone stimulation market management estimates Smith & Nephew’s market share to be 41%. Principal competitors are Biomet, DJ Ortho and Orthofix. In the US joint fluid therapies market Smith & Nephew maintains a share of 21%. The principal competitors are Genzyme, Sanofi Aventis, DePuy/Johnson & Johnson and Ferring Pharmaceuticals.

## **Endoscopy**

### ***Overview***

Smith & Nephew’s Endoscopy business, headquartered in Andover, Massachusetts, develops and commercialises endoscopic (minimally invasive surgery) techniques, educational programmes and value-added services for surgeons to treat and repair soft tissue and articulating joints. The business focuses on the arthroscopy sector of the endoscopy market. Arthroscopy is the minimally invasive surgery of joints, in particular the knee, shoulder and hip.

The Endoscopy business offers surgeons endoscopic technologies for surgery, including: specialised devices and fixation systems to repair damaged tissue; fluid management and insufflation equipment for surgical access; digital cameras, digital image capture, scopes, light sources and monitors to assist with visualisation; and radiofrequency wands, electromechanical and mechanical blades, and hand instruments for resecting damaged tissue.

Manufacturing facilities are currently located in Mansfield, Massachusetts, Oklahoma City, Oklahoma and San Antonio, Texas. Major service centres are located in the US, the UK, Germany, Japan and Australia.

### ***Strategy***

Smith & Nephew's strategic intent is to maintain and grow the business as the leading provider of endoscopic techniques and technologies for joint and ligament repair. Management believes that the business capitalises on the growing acceptance of endoscopy as a preferred surgical choice among physicians, patients and customers.

To sustain growth and enhance its market position, the Endoscopy business supports its strategy with surgeon education programmes, financing solutions, global fellowship support initiatives, partnerships with professional associations and surgeon advisory boards.

### ***New Products***

In 2008, Smith & Nephew continued to expand its arthroscopic repair portfolio with the launch of the FOOTPRINT PK Suture Anchor, a system used to attach rotator cuff tissue to bone in the shoulder.

Additionally, the BIORAPTOR 2.3 PK Suture Anchor was launched for repair of instability in both the shoulder and hip joints. This anchor is designed to be implanted in the dense bone along the rim of the joint socket. Its small size and design provide strong fixation, and enable a surgeon to use more than one to establish multiple attachment points. Its delivery system also enables a surgeon to insert it directly through an incision in the skin rather than through a cannula.

Smith & Nephew's new CROSSTRAC Hip Guide and ARTHROGARDE Hip Access Cannula systems were launched in 2008. They are designed to ensure more consistent and accurate minimally invasive pathways for the diagnosis and repair of injuries in the hip joint.

The business also launched its BIOSURE HA Interference Screw line for use in reconstructing the Anterior Cruciate Ligament (ACL) and Posterior Cruciate Ligament (PCL) in the knee. BIOSURE Interference screw can be used to secure the tibial or femoral end of an ACL or PCL graft.

### ***Recent Regulatory Approvals***

During 2008, the Endoscopy business obtained regulatory clearances for the following products in most major markets, except Japan where the approval process is more lengthy: BIOSURE HA bioabsorbable interference screw, made with poly-L-lactic acid (PLLA) and Hydroxyapatite (HA); FOOTPRINT PK suture anchor for shoulder rotator cuff repair; OSTEORAPTOR suture anchor for shoulder instability repair, featuring PLLA with HA; and various other arthroscopy instruments and devices. In addition, the business also gained approval in Japan for the BioRCI bioabsorbable interference screw.

### ***Competition***

Management estimates that the global arthroscopy market in which the business principally participates is worth more than \$2.5 billion a year and is growing at 12% annually, driven by increasing numbers of sports injuries, longer and more active lifestyles, patient desire for minimally invasive procedures, innovative technological developments and a need for cost effective procedures. Management believes that Smith & Nephew has a 23% share of the global arthroscopy market.

Smith & Nephew's main competitors in the global arthroscopy market in 2008 were Arthrex, Mitek/Johnson & Johnson, Stryker, Arthrocare and Linvatec/Conmed.

## **Advanced Wound Management**

### ***Overview***

Smith & Nephew's Advanced Wound Management business has its global headquarters in Hull, England and its North American headquarters in St Petersburg, Florida. The business offers a range of products from initial wound bed preparation through to full wound closure. These products are targeted at chronic wounds connected with the older population, such as pressure sores and venous leg ulcers, and the alleviation of wounds such as burns and invasive surgery that impact the wider population.

Advanced Wound Management products are manufactured at facilities in Hull and Gilberdyke, England; Largo, Florida; and by certain third party manufacturers around the world.

### ***Strategy***

The strategy for the Advanced Wound Management business is to focus on the higher added value segments of exudate and infection management through improved wound bed preparation and moist and active healing. In 2007 the business entered the negative pressure wound therapy ("NPWT") market with the acquisition of BlueSky, which management believes will allow the business to build further presence in the technologically advanced areas of advanced wound management.

The Advanced Wound Management business has built its sales and marketing infrastructure in the world's major markets, largely through investment in additional sales teams particularly in the key markets of the US and Europe.

In 2007 and 2008, management has taken part in the Group-wide EIP and reviewed cost and efficiency across the Advanced Wound Management business. Savings have been delivered in 2007 and 2008 in areas ranging from support functions to the outsourcing of some manufacturing to low cost countries. In 2007 the business announced the planned closure of the Largo, Florida manufacturing facility. A manufacturing facility in Suzhou, China is currently being built for opening in 2009.

### ***New Products***

Management believes that the market will continue the trend towards advanced products with their ability to accelerate healing rates, reduce hospital stay times and cut the cost of clinician and nursing time and aftercare in the home.

The move into the NPWT market, particularly in the US, provides access to a market place that management estimates is worth \$1.4billion in annual revenue and to a range of products that management believes can deliver a sophisticated medium using negative pressure to enhance wound healing.

The ALLEVYN hydrocellular dressings range has been considerably enhanced by new versions introduced in recent years that management believes deliver efficient fluid management and an optimal moist wound environment that can lead to promotion of faster healing of the wound, reduced risk of maceration and protection from infection. During 2008, the ALLEVYN range was extended further with the development of variants that included soft gel adhesives. This new range of dressings has the efficient fluid management capability of the existing ALLEVYN dressings whilst improving comfort and reducing pain on removal for the patient.

The ACTICOAT range was enhanced during 2008 with the launch of ACTICOAT Flex, a conformable range of dressings designed to address wounds in awkward anatomical areas such as face and hands and to improve patient comfort during wear. The ACTICOAT range incorporates the smallest crystallised silver (nanocrystalline silver) used in the treatment of wounds or burns. The silver reduces the risk of bacterial colonisation and acts to kill micro-organisms that can cause infection and prevent or retard healing.

### ***Recent Regulatory Approvals***

During 2008, the Advanced Wound Management business secured approvals for a new variant of ALLEVYN Heel, which includes the addition of silver, for ACTICOAT Flex and for low friction Flexigrid. In addition the Group secured European approval for BIOSTEP, a denatured collagen dressing designed to stimulate tissue granulation. In Japan there have been eight product approvals including ALLEVYN Lite, a thinner version of the ALLEVYN range.

### ***Competition***

Management estimates that the sales value of the advanced wound management market worldwide was \$5.2 billion in 2008, an increase of 7% from 2007 which includes the impact of the continuing expansion of the NPWT segment. Management estimates that Smith & Nephew has a 17% market share of the wider market. Growth is driven by an ageing population and by a steady advance in technology and products that are more clinically efficient and cost effective than their conventional counterparts. Management believes that there is strong growth potential for advanced technology products.

Worldwide competitors in advanced wound management in 2008 include Kinetic Concepts, who are wholly in the NPWT segment, Convatec, Mölnlycke and Systagenix, the former Johnson & Johnson wound care business.

### **Joint Ventures and Discontinued Operations**

Joint ventures are those in which the Group holds an interest on a long-term basis and which are jointly controlled by the Group and one other entity under a contractual agreement.

Discontinued operations in 2006 represent the gain on disposal of the Group's joint venture, BSN Medical. Smith & Nephew owned 50% of the BSN Medical joint venture, which was jointly owned with Beiersdorf AG and was independently managed. BSN Medical comprised traditional woundcare, fracture casting and bandaging and compression hosiery businesses. Following the Group's announcement in August 2005 of its intention to dispose of BSN Medical, Smith & Nephew and Beiersdorf AG announced in December 2005 that they had signed an agreement to sell BSN Medical to Montagu Private Equity for an enterprise value of €1,030m. This transaction was completed on 23 February 2006.



# OPERATING ACTIVITIES

## SALES, MARKETING AND DISTRIBUTION

Smith & Nephew's customers are the various providers of medical and surgical services worldwide. In certain parts of the world, including the UK, much of Continental Europe, Canada and Japan, these are largely government organisations funded by tax revenues. In the US, the Group's major customers are public and private hospitals, which receive revenue from private health insurance and government reimbursement programmes. In the US, Medicare is the major source of reimbursement for knee and hip reconstruction procedures and for wound healing treatment regimes.

Competition exists among healthcare providers to gain patients on the basis of quality, service and price. In many countries, providers are under pressure to reduce the total cost of healthcare delivery. There has been some consolidation in the Group's customer base, as well as amongst the Group's competitors, and these trends are expected to continue in the long term. Smith & Nephew competes against both specialised and multinational corporations, including those with greater financial, marketing and other resources.

The Group's customers reflect the wide range of distribution channels, purchasing agents and buying entities in over 90 countries worldwide. The largest single customers worldwide are the National Health Service in the UK and HealthTrust in the US which represented 4% and 2% respectively of the Group's worldwide revenue in 2008.

In the US, the Group's products are marketed directly to doctors, hospitals and other healthcare facilities with each business unit operating a separate specialised sales force. The US sales forces consist of a mixture of independent commissioned sales agents and direct employees. The independent agents are not permitted contractually to sell products that compete with Smith & Nephew's. Orthopaedics and Endoscopy products are shipped and invoiced directly to the ultimate customer. Advanced Wound Management products are marketed directly to the ultimate customer. However, the products are shipped and invoiced to a number of wholesale distributors. In most other direct markets, the business units typically manage employee sales forces directly.

The emerging markets unit comprises direct selling and marketing operations in India, China, Hong Kong, Korea, Malaysia, Singapore, Thailand, the United Arab Emirates, South Africa, Mexico and Puerto Rico. In these markets, Orthopaedics and Endoscopy frequently share sales resources. The Advanced Wound Management sales force is typically separate because it calls on different customers. In other countries, Smith & Nephew sells to third party distributors which market the Group's products locally.

The Group operates a number of central distribution facilities in the key geographical areas in which it operates. Orthopaedics and Endoscopy operate a facility in Baar, Switzerland which acts as the main holding and consolidation point for markets outside of the US. Hubs serving the US are located in Memphis for Orthopaedics and Oklahoma for Endoscopy. Product is shipped to Group companies who hold small amounts of inventory locally for immediate or urgent customer requirements. Advanced Wound Management distribution hubs include Neunkirchen, Germany; Nottingham, UK; and Atlanta, US.

## SEASONALITY

Smith & Nephew's revenues are generally at their highest in the fourth quarter of any year. This is caused by the relatively high number of accidents and sports injuries which occur in the North American and European autumn and winter seasons which increase revenues of orthopaedic trauma and endoscopy products. Orthopaedic reconstruction revenues are lower in the third quarter due to fewer elective surgeries in the summer and higher in the fourth quarter as elective surgeries increase.

## MANUFACTURE AND SUPPLY

Where management considers that the Group possesses a core competence, its policy is to manufacture products internally whenever possible to ensure quality, regulatory and cost goals are met. The Group invests in the expansion of its manufacturing facilities and equipment to meet these aims. The Group will outsource manufacturing where a need is identified. This might include a requirement for specialised expertise, lower costs of production or capacity constraints.

Where products and services are outsourced, suppliers are determined based on a number of factors which include the complexity of the product, manufacturing technology, manufacturing capabilities, cost competitiveness and intellectual property. Suppliers are selected based on their capability to deliver products and services to specification, their ability to establish and maintain a quality system and their financial stability. Suppliers are monitored through on-site assessments and ongoing monitoring of delivered products. Ongoing product assurance is maintained by effective quality plans.

Each business unit purchases raw materials, components, finished products and packaging materials from certain key suppliers. These principally include metal forgings and stampings for Orthopaedics, optical and electronic sub-components and finished goods for Endoscopy, active ingredients and finished goods for Advanced Wound Management and packaging materials across all businesses. Management believe that whilst prices of principal raw materials can be volatile, the effect is not material to the Group. Finished goods purchased for resale include SUPARTZ joint and DUROLANE fluid therapy products in the Orthopaedics business, screen displays, optical and electrical devices in the Endoscopy business and enzyme debrider agents and ACTICOAT in the Advanced Wound Management business.

## PROPERTY, PLANT AND EQUIPMENT

The Group's principal locations are as follows:

	Approximate area
	(Square feet 000's)
Group head office in London, England . . . . .	15
Group research facility in York, England . . . . .	88
Orthopaedics headquarters and manufacturing facilities in Memphis, Tennessee . . . . .	770
Orthopaedics distribution facility in Memphis, Tennessee (i) . . . . .	102
Orthopaedics distribution facility in Memphis, Tennessee (new facility) . . . . .	210
Orthopaedics manufacturing facility in Aarau, Switzerland . . . . .	77
Orthopaedics European headquarters in Rotkreuz, Switzerland (i) . . . . .	28
Orthopaedics manufacturing in Beijing, China . . . . .	20
Orthopaedics and Endoscopy distribution facility in Baar, Switzerland . . . . .	50
Endoscopy headquarters in Andover, Massachusetts . . . . .	112
Endoscopy manufacturing facility in Mansfield, Massachusetts . . . . .	98
Endoscopy manufacturing and distribution facility in Oklahoma City, Oklahoma . . . . .	150
Advanced Wound Management headquarters and manufacturing facility in Hull, England . . . . .	439
Advanced Wound Management manufacturing facility in Gilberdyke, England . . . . .	41
Advanced Wound Management manufacturing facility in Suzhou, China . . . . .	128
Advanced Wound Management manufacturing facility in Largo, Florida (i) . . . . .	135
Advanced Wound Management US headquarters in St. Petersburg, Florida . . . . .	40
Biologics headquarters in Durham, North Carolina . . . . .	27

(i) It has been announced these facilities will close in 2009.

The Orthopaedics headquarters and manufacturing facilities in Memphis, the facilities in Aarau and the Advanced Wound Management facilities in Hull, Gilberdyke, and Largo are freehold while all other principal locations are leasehold. In 2008, improved Orthopaedics distribution facilities were opened in Baar (leasehold) and Memphis (freehold). Advanced Wound Management are nearing completion on their manufacturing facility in Suzhou which is leasehold. The Group has freehold and leasehold interests in real estate in other countries throughout the world, but no other is individually significant to the Group. Where required, the appropriate governmental authorities have approved the facilities. During 2008 a dedicated Biologics business was formed, which is headquartered in Durham, North Carolina.

As part of the EIP programme, the Group announced its intention to close the Largo manufacturing facility in 2009 and to outsource or relocate its manufacturing output. The Advanced Wound Management business purchased land in Suzhou, China and is building a new facility to supply certain wound management products on a global basis. The Orthopaedics business has purchased land near Beijing, China and construction is due to start on a new facility to supply implants to the local market and orthopaedic instruments for export.

## RESEARCH AND DEVELOPMENT

The business units each manage a portfolio of short and long-term product development projects designed to meet the future needs of their customers and continue to provide growth opportunities for their businesses. The Group's research and development is directed towards all three business segments. Expenditure on research and development amounted to \$152m in 2008 (2007 — \$142m, 2006 — \$120m), representing approximately 4% of Group revenue (2007 — 4%, 2006 — 4%).

The Group's principal research facility is located in York, England with research programmes that seek to underpin the longer-term technology requirements for its businesses and to provide a flow of innovative products. The Group continues to invest in future technology opportunities, particularly active biologic solutions for clinical needs identified from across the Smith & Nephew businesses. In-house research is supplemented by work performed by academic institutions and other external research organisations in Europe, America and Asia.

Product development is carried out at the Group's principal locations, notably in Memphis, Tennessee and Aarau, Switzerland (Orthopaedics), Mansfield, Massachusetts (Endoscopy) and Hull, England (Advanced Wound Management).

## INTELLECTUAL PROPERTY

Smith & Nephew has a policy of protecting, with patents, the results of research and development carried out by the Group. Patents have been obtained in a wide range of fields, including orthopaedic reconstruction and trauma, clinical therapies, endoscopy and advanced wound management. Patent protection for Group products is sought routinely in the Group's principal markets. Currently, the Group's patent portfolio stands at over 3,400 patents in force and patent applications.

Smith & Nephew also has a policy of protecting the Group's products in the markets in which they are sold by registering trademarks under local laws. The Group vigorously protects its trademarks against infringement and currently is not aware of any significant infringement of its trademark registrations. The present trademark portfolio of the Group consists of over 3,800 trademarks, trademark applications and design rights.

Smith & Nephew's goal is to provide a collection of intellectual property, which may include patents, trade secrets and licenses, for each major product that reduces the risk associated with failure of any individual piece of intellectual property. Most pieces of intellectual property protect a relatively small proportion of the Group's annual revenue. As a result, the Group tries to ensure that its overall business is not sensitive to the loss (however caused) of any single piece of intellectual property.

In addition to protecting its market position by the filing and enforcement of patents and trademarks, Smith & Nephew may oppose third party patents and trademark filings where appropriate in those areas that might conflict with the Group's business interests.

In the ordinary course of its business, the Group enters into a number of licensing arrangements with respect to its products. None of these arrangements individually is considered material to the current operations and the financial results of the Group.

## REGULATION

The international medical device industry is highly regulated. Regulatory requirements are a major factor in determining whether substances and materials can be developed into marketable products and the amount of time and expense that should be allotted to such development.

National regulatory authorities administer and enforce a complex series of laws and regulations that govern the testing, approval, manufacturing, labelling, marketing and sale of healthcare and pharmaceutical products. They also review data supporting the safety and efficacy of such products. Of particular importance is the requirement in many countries that products be authorised or registered prior to manufacture, marketing or sale and that such authorisation or registration be subsequently maintained. The major regulatory agencies for Smith & Nephew's products are the FDA in the US, the Medicines and Healthcare products Regulatory Agency in the UK and the Ministry for Health Labour and Welfare in Japan. Payment for many medical device products is governed by reimbursement tariff agencies in each individual country.

The trend in recent years has been towards greater regulation and higher standards of technical appraisal, which generally entail lengthy inspections for compliance with appropriate standards, including regulations such as good manufacturing practices. The Group believes that these recent changes will not have a material adverse effect on the Group's financial condition and the results of operations. All significant facilities within the Group are subject to regular internal audit for medical device regulatory compliance with national and Group standards and policies.

Management believes that the Group's operations currently comply in all material respects with applicable environmental laws and regulations. Although the Group continues to make capital expenditure for environmental compliance, it is not currently aware of any significant expenditure that would be required as a result of such laws and regulations that would have a material adverse impact upon the Group's financial condition.

# THE BUSINESS AND THE COMMUNITY

## CORPORATE AND SOCIAL RESPONSIBILITY

Smith & Nephew's aim is to help people live longer, healthier and more active lives by repairing and healing the human body with advanced technology products. The Group contributes to the treatment and recovery of patients throughout the cycle of medical care. This is achieved by the design of innovative products and instruments, the training of medical professionals and the procedures used to provide treatment and recovery. In particular Smith & Nephew offers products throughout the continuum of care for patients, not only with osteoarthritis, from early intervention through primary joint replacements to revisions, but also in the wider field of injuries to knee, hip, shoulder and overall bone and skin repair.

The Group prides itself on the strength of its relationship with its clinicians and other professional healthcare customers with whom it has a reputation for product innovation and high standards of customer service. Healthcare economic considerations are integrated into the product development process to ensure that the benefits of the Group's new products and line extensions not only improve patient outcomes, but provide better treatment and procedures for both clinician and patient whilst contributing to more cost effective solutions for healthcare services.

In developing a sustainable business, Smith & Nephew has a low impact on the environment and is committed to improving the management of its environmental, social and economic effect.

The Group has published a Sustainability Report since 2001. The Group monitors progress and views sustainable development as an integral part of the way the Group does business. The ninth Sustainability Report, which gives detailed information, will be published on the Group's website at the end of May 2009 at [www.smith-nephew.com](http://www.smith-nephew.com). As part of Smith & Nephew's commitment to continuous improvements to reporting on its corporate responsibility developments, this year the Sustainability Report will more closely reflect the structure recommended by the Global Reporting Index. This will expand the scope of reporting whilst moving towards an internationally recognised and common standard.

Smith & Nephew's progress is measured by leading organisations that assess sustainable development. In 2008 the Group was again included in the Dow Jones Sustainability Index ("DJSI") and continues to be a leader in its sector. In the UK, Smith & Nephew is a member of FTSE4Good and in France, Vigeo publishes an assessment report on Smith & Nephew used by some of the leading investment firms in Europe.

### **Business Integrity**

Smith & Nephew aims to be honest and fair in all aspects of its business and expects the same from those with whom it does business. The code of standards for suppliers, and the compliance processes for these standards is under continuous development. During 2008 and the early part of 2009, the Group has been working on a major enhanced ethics and compliance programme. In early 2009 the first part of a Code of Conduct and Business Principles was issued to the majority of employees throughout the Group. A new website (<http://Compliance.Smith-Nephew.com>) lays out the aims, policies and performance of the Group's enhanced ethics and compliance programme.

Smith & Nephew's policy is to not give or receive improper financial inducements, either directly or indirectly, for business or financial gain. The Group's policy is to comply with the industry standards set by regional bodies, such as Eucomed in Europe and Advamed in the US, in its relationships with customers. Accounting records and supporting documents are designed to accurately describe and reflect the business transactions and conform to IFRS.

The Group's Code of Conduct and Business Principles governs the way it operates so that it respects stakeholders and seeks to build open, honest and constructive relationships. This is regularly reviewed and a revised code was published on the Smith & Nephew website in March 2009. The Group takes account of ethical, social, environmental, legal and financial considerations as part of its operating methods. Since 2005, the Group has operated a Code of Business Ethics and a Whistleblower Policy for all employees. In 2008 an independently operated whistleblowing service was introduced in the US operations of the Group. In early 2009 this was extended to all other jurisdictions in which the Company operates where such service is allowed.

## Innovation

Smith & Nephew uses innovation to create cost-effective products and techniques which deliver benefits for clinicians, patients and healthcare providers. The Group's scientific and technical capability combined with an understanding of the needs of clinicians, enables Smith & Nephew to produce unique new products with distinct advantages in clinical performance and cost-effectiveness.

The Group's research and development strategy is based on assessment of market needs and a longer range view of future requirements and opportunities. Fundamental scientific work and the development of new technologies are used to create new products and surgical techniques for delivery in the future.

In particular, the Group has brought together various initiatives across its businesses to form a business focused on Biologics, which are advanced, locally delivered biological therapies to promote healing and pain relief.

## Health, Safety and Environment Management

The Group's health, safety and environmental ("HSE") policy was reviewed in November 2007. This policy sets out the Group's vision, aim, commitment and operating principles with respect to HSE. The Group's commitment is to:

- give due regard to the effects of its operations on the environment and community to create a sustainable business;
- provide and maintain a safe and healthy work environment for employees, contractors and visitors;
- require each Smith & Nephew business to achieve the HSE standards specified by the policy;
- seek to improve HSE performance through continuous evaluation and development of measures to control risk, conserve resources and minimise waste; and
- recognise, promote and reinforce the responsibility of employees, contractors and visitors to work safely and follow procedures.

The Board receives a health and safety report two times a year.

In 2008, the Advanced Wound Management factory in Hull, England and the Orthopaedics sites in Memphis, Tennessee and Tuttlingen, Germany maintained accreditation of their environmental management systems under ISO14001. All Group manufacturing and research sites have designed environmental management systems to deliver cost savings and benefits to the environment.

Manufacturing processes are relatively low in environmental impact. Particular emphasis is placed on close control of energy, water consumption and waste in manufacturing and research and development. Improvement targets are set and performance is measured against these targets. Smith & Nephew's key environmental measurements over the last five years are as follows:

	2008 (i)	2007 (ii)	2006	2005	2004
Emissions to air carbon dioxide (tonnes) . . . . .	55,271	50,178	50,359	50,212	48,954
Waste (tonnes) . . . . .	4,616	4,016	4,759	4,685	3,596
Hazardous waste (tonnes) . . . . .	477	204	256	303	234
Waste recycled (tonnes) . . . . .	2,167	1,496	1,189	1,009	767
Total energy (GwH) . . . . .	153	140	138	139	132
Water usage (1,000 cu. Metres) . . . . .	589	542	562	480	427
Discharges/effluent (1,000 cu. Metres) . . . . .	453	453	485	400	384
Lost time accidents (iii) . . . . .	0.47	0.54	0.50	0.58	1.00
Work related injuries (iv) . . . . .	1.3	1.7	1.4	1.9	n/a

(i) Environmental figures include the research facility at York and all Group manufacturing sites with the exception of Beijing whose figures were not available at the time of going to press. The contribution from this site is however very low. The Orthopaedics facilities at Aarau and Warwick are included for the first time and account for much of the increase in environmental impacts.

(ii) Totals in 2007 exclude the Plus and BlueSky businesses acquired in the year.

(iii) Number of accidents (resulting in a person being unable to work the following day) per 200,000 hours worked.

(iv) Number of cases of work related injuries per 200,000 hours worked which are required to be recorded under Occupation Safety and Health Administration Regulations. The same criteria have been used at all sites whether or not the regulations apply. Data was not collected in 2004 so no information is available for this year.

Carbon dioxide emissions are calculated from the energy consumption. They include both direct emissions from the combustion of fossil fuels on sites and secondary emissions from the generation by utility companies of the electricity consumed. These rose 10% in 2008, in line with energy consumption. Normalising for the level of production, emissions fell by 11%.

Non-hazardous waste rose by 15%. This increase is attributable to the inclusion of the Orthopaedics facilities at Aarau and Warwick and due to an increase in waste at the Wound Management facility at Largo due to increased ALLEVYN manufacture.

Hazardous waste rose by 134%. Inclusion of the Orthopaedics facilities at Aarau and Warwick has had a disproportionately large effect as both facilities use large volumes of cutting fluid which has to be disposed as hazardous waste. The 2004 hazardous waste figure excludes a spillage of chrome plating materials which occurred at the manufacturing site in Memphis, Tennessee. Working closely with the state authorities, prompt action was taken resulting in a total of 920 tonnes of affected soil being removed from the site to eliminate any possible contamination.

Continued emphasis on recycling waste across the Group has led to an increase in the percentage of waste recycled from 26% to 30%.

In the 2008 Sustainability Report, Smith & Nephew published targets for the above environmental measurements for the second year. These targets were based on figures normalised for changes in production levels rather than the absolute figures shown in the previous table. This is so that any impact arising from changes in production is taken into account. The performance against the published targets is as follows, together with targets for 2009:

	Target 2009	Actual 2008	Target 2008
Energy consumption . . . . .	Improvement programme across all manufacturing sites, targets to be fixed by GBU	11% reduction	5% reduction
Waste . . . . .	10% reduction	7% reduction	10% reduction
Lost time accidents . . . . .	n/a	16% reduction	5% reduction
Work related injuries . . . . .	n/a	26% reduction	5% reduction
OSHA Recordable incidents (i) . . . . .	5-25% reduction depending on 2008 performance	n/a	n/a
Internal Audit performance . . . . .	Minimum Internal Audit Rating of 75%	n/a	n/a
HSE management . . . . .	Introduction of pro-active measures for HSE	n/a	n/a

(i) The US Occupational Safety & Health Administration require certain cases of occupational injury and ill health to be recorded if they result in lost time from work, modifications to the persons work or require treatment by a medical practitioner. It is a broader definition of a Work Related Injury than lost time accidents and, although it is only of legal significance in the US, it has been adopted as a measure across the Group.

A full analysis of these measurements and key health and safety performance measures will be included in the 2009 Sustainability Report on the Group's website when it is published at the end of May 2009.

## Social responsibility

### Employees

The Smith & Nephew Code of Conduct and Business Principles and Code of Ethics govern the Group's interactions with all of its stakeholders including employees. This sets out the values and behaviours that the Group expects from every employee. The first part of the Code of Conduct relating to interactions with Health Care Professionals ("HCPs") and suppliers was launched in January 2009. This document describes the standards that all employees in Smith & Nephew and third parties representing the company must operate to when working with HCPs and agents. The Business principles and associated policies and procedures have also been reviewed and are scheduled to be launched to all employees in April 2009. Every employee is expected to work to these standards.

The HR Policy Framework introduced in 2006 continues to provide a framework of key HR policies, values and behaviours and management principles that provide the structure within which the business units and Global functions plan and deliver successful results. There is also a published HR Strategy document which provides the direction on how the Group intends to attract, retain and develop the right talent to meet the business needs and create a culture that is aligned to Smith & Nephew values and deliver the Group's long term strategic plans.

Smith & Nephew has a policy of non-discrimination and aims to provide an open environment based on constructive relationships. Smith & Nephew welcomes people with disabilities and makes every effort to retain any employee who has a disability. The Group is committed to engaging with employees through the regular and timely dissemination of Group information and encouraging their feedback and ideas. An employee global opinion survey is used every two years as a catalyst for improvements and plans.

The 2008 Global Opinion Survey was completed towards the end of 2008 and the results reported to employees were completed in early 2009. The survey extended the scope of previous research. Across the Group, the response rate was very good with nearly 6,500 people taking the survey. Overall the results were positive and indicated continued high levels of employee engagement with the values and direction of the Group. 95% of employees said that they were proud to work for Smith & Nephew, and most (70%) would recommend it as a great place to work. There were high marks (86%) for the honesty and ethical behaviour of employees. The feedback identified several areas where the Group needed to improve, including the alignment and overhauling of systems and processes to enable better execution of plans and greater visibility of results. The most encouraging outcome was that the survey reinforced the value of the Group's new "One Company" strategy and the efforts to reengineer many of the Group's processes and systems. While the Group still has work to do to fully align its organisation and the strategy and to build-in accountability at every level, employees believe the Group is moving in the right direction.

In 2008, the Group has continued to assess indicators of employee engagement. These measurements are a useful monitoring tool and alert mechanism for action as well as giving trend indicators of improved performance. During 2008 the Group introduced a more robust employee data collection process for the majority of the business (i.e. US and UK) and will report on these in 2009. These systems will be rolled out to the rest of Smith & Nephew in 2009 which will enable the provision of Group wide data in future.

### ***Internal Appointments***

The internal appointments measure is an indicator of how well the Group believes it is developing its employees and the success of the Group's internal recruitment policy. In 2008, the percentage of vacancies filled by internal applicants showed significant variation across the Group's businesses. The range for non-management positions was 0-38% and the range for management positions was 3-50%. The Group target for all employees is 40%, (including management positions) which the Group believes is challenging but achievable. The target for management positions is 70%. The Group has a policy of open advertising and providing opportunities for existing employees wherever possible, while recognising the need to bring in new ideas and approaches that external recruitment brings.

### ***Labour Turnover***

The Group measures both general voluntary labour turnover and turnover relating specifically to employees who have been with the business less than two years. The latter measure is an indication of how well the Group recruits and then retains its employees so that they can make a contribution to the business.

The average turnover for employees leaving the Group within two years of joining was 2.7% (2007 — 10.5%).

As reported in the 2007 Annual Report, the impact of EIP, the integration of Plus and the transition of many countries from indirect to direct market operations had the effect of increasing voluntary labour turnover from 2.8% in 2006 to 10.5% in 2007. In 2008 the voluntary labour turnover statistic has fallen to 1.6% which the Group believes is a more representative level.

### ***Training and Development Investment***

The Group is committed to providing training and information so that all employees can make the best contribution possible. To ensure that the Group continues to improve in this important area, during 2007, a central global organisational development team was created to lead talent management, performance management and learning and development across the whole of the Group. Learning and development programmes are used to attract, retain and develop employees. These programmes are linked to formal



performance appraisal and development planning. The Group operates training programmes under the banner of Management Excellence. These continue to provide the key management skills required to be successful managers and leaders, covering the requirements of both new and experienced individuals. Further programmes were added in 2008 and the Group has continued to invest in on-line learning resources to further enable access to training for all employees.

### ***Leadership***

The Group continues to develop its current and future leaders to improve the performance of the business. Senior management supports a set of group-wide leadership competencies and management development and talent tracking is a regular item on their meeting agenda. Performance evaluation, coaching and attendance at leadership programmes are utilised.

The Group's leadership excellence programme is a three-day purpose designed residential course facilitated by a business school coach. The programme focuses on leadership style and interaction.

### ***Workplace***

Smith & Nephew aims to provide healthy and safe working conditions for all its employees. Health and safety is managed as an integral part of the business and employee involvement is recognised as a key part of the process.

The Group does not use any form of forced, compulsory or child labour. The Group supports the Universal Declaration of Human Rights of the United Nations and respects human rights, the dignity and privacy of the individual, the right of employees to freedom of association, freedom of expression and the right to be heard.

The legal frameworks governing employee relations vary from country to country, as does custom and practice. Relations with trade unions are nationally determined and managed locally in line with the applicable legal framework and standards of good practice. The well-developed arrangements for interactions with trade union and worker councils provide the forum for productive discussion and collaborations with regard to collective bargaining agreements and other employment issues. It is the Group's policy to conform to the nationally determined arrangements.

### ***Society and Community***

The Group works with national and local governments and other organisations to meet its legal and civic obligations, manage its impact on the environment, and contribute to the development of laws and regulations that affect its business. Smith & Nephew values community involvement and is an active member of its local communities and supports employees who undertake community work.

The Group's principles for charitable giving are based on criteria relevant to its business, with priority given to medical education. Individual company sites support their local communities in a range of charitable causes giving donations of money, gifts in kind and employee time.

The Group is dedicated to the advancement of innovation, education and patient care. In Orthopaedics, to facilitate the Group's continuing support for critical research and educational programmes, the Group has entered into a grant administration agreement with the independent Orthopaedic Research and Education Foundation.

The Group realises that its technologies and products do not reach everyone. Project Apollo is a charitable and humanitarian service programme of the Orthopaedics business. This links up with physicians and non-profit groups engaged in medical philanthropy that receive donations of Smith & Nephew products through sponsorship and help from the Group's employees. By working in collaboration with these individuals and organisations, Smith & Nephew considers that this is a way of increasing the impact of charitable giving and the work it undertakes.

The Smith & Nephew Foundation is an independent charitable trust funded by Smith & Nephew Advanced Wound Management. The Foundation makes awards to individuals in the nursing profession for postgraduate research to improve clinical practice in nursing and midwifery. The Foundation is the largest single charitable awarding body to the nursing profession in the UK.

More examples of the programmes supported by the Group are given in the Sustainability Report.

In 2008, direct donations to charitable and community activities totalled \$1,498,000, of which \$550,000 was given to the Smith & Nephew Foundation. Smith & Nephew made no political contributions in 2008.

### ***Customers***

The Group is committed to providing innovative, cost-effective healthcare solutions benefiting healthcare professionals and their patients through improved treatment, ease and speed of product use and reduced healthcare costs.

The Group's products are designed to be safe and reliable for their intended use and comply with or exceed all legal and regulatory requirements, including those concerning packaging, labelling and user instructions. The aim is to anticipate future standards and requirements promoting health and safety of its customers and patients.

### ***Business Partners***

Smith & Nephew is committed to establishing mutually beneficial relationships with its suppliers, customers and business partners. The Group works only with partners whom it believes adhere to business principles and health, safety, social and environmental standards consistent with its own. Additional work continues each year to improve the monitoring of supplier standards for service quality and activities relevant to their corporate responsibility. Additional focus on supplier standards has been implemented in the manufacturing area to ensure Smith & Nephew's standards are maintained throughout.

### ***Economic Contribution***

The Group's business policies are designed to achieve long-term growth and profits — which in turn bring continued economic benefits to shareholders, employees, suppliers and local communities. Smith & Nephew's sustainable development depends on its ability to provide a satisfactory economic return.

The Group prides itself on the strength of its relationship with its clinicians and other healthcare professionals with whom it has a reputation for product innovation and high standards of customer service. Healthcare economic considerations are integrated into the product development process to ensure that the benefits from the Group's products improve patient outcomes, treatments and procedures for both clinician and patient and create cost effective solutions for healthcare services.

A description of the principles of healthcare economics and its integration into the business is given in the Sustainability Report.

### ***Looking Ahead***

The Group is fulfilling an important role in the healthcare sector. Increased demands are being placed on healthcare systems by the demographic trends of an ageing population and as the problems with obesity become more widespread. More active lifestyles and the increased incidence of diabetes, and other diseases also increase the demand for Smith & Nephew's products. In addition, developing and newly industrialised countries are increasing their demands for advanced products driven by similar demographic and health issues as developed nations.

Smith & Nephew's vision is to be the best in helping people regain their lives by improving and healing the human body. The Group believes that it can achieve this by setting and meeting ambitious performance targets, by constant innovation in products and services and by earning the trust of its stakeholders. In all its business activities, the drive towards sustainability is an ongoing process and Smith & Nephew is committed to maintaining a consistent effort to improve.

## EMPLOYEES

The average number of full-time equivalent employees in 2008 was 9,757, of whom 1,653 were located in the UK, 4,212 were located in the US and 3,892 were located in other countries. The Group does not employ a significant number of temporary employees.

The average number of employees for the past three years by business segment:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Orthopaedics .....	4,840	4,405	3,893
Endoscopy .....	1,849	1,798	1,830
Advanced Wound Management .....	<u>3,068</u>	<u>2,987</u>	<u>3,107</u>
	<u>9,757</u>	<u>9,190</u>	<u>8,830</u>

Where the Group has collective bargaining arrangements in place with labour unions, these reflect local market circumstances and operate effectively.

Smith & Nephew operates share option schemes that are available to the majority of employees (for further information see Note 28 of the Notes to the Group Accounts). The Group has no share schemes in which shares have rights with regard to control of the Company that are not exercisable directly by employees.

# RISK

## PRODUCT LIABILITY

The Group monitors the safety of its products from initial product development through to product use or application. In addition, the businesses of the Group analyse on a worldwide basis reports of adverse reactions and complaints relating to its products. Each business reviews these adverse reactions and complaints and any safety matters arising with its independent medical advisors.

Product liability is a commercial risk for the industry of which the Group is a part, particularly in the US. Smith & Nephew has taken steps it believes are appropriate to minimise losses. Management believes that the Group's regulatory and medical controls are robust and insurance cover is adequate and appropriate for this class of products. The Group's reputation depends on strong risk management controls and on appropriate crisis management if a serious medical incident or product recall should occur.

In August 2003, the Group voluntarily withdrew the macrot textured versions of its OXINIUM femoral knee components from all markets. As at that date 2,971 components had been implanted of which approximately 2,471 were in the US, 450 in Australia and 50 in Europe, the first component having been implanted in December 2001.

The product was withdrawn when management became aware of a higher than usual percentage of reports of early revisions ("revisions" are implants which need to be replaced). Evidence suggested that the cause of some revisions was the failure of the textured surface of the implant to achieve adequate fixation with the bone.

As at 31 December 2008, 1,044 of these implants had undergone revision surgery, and settlements had been agreed with patients in respect of 997 of these revisions. The total amount paid as of 31 December 2008 in settlements, legal costs and associated expenses was \$206m, of which \$60m was received from insurers and \$22m from a successful legal settlement. A claim against other insurers is pending. See "Legal Proceedings".

In addition to the macrot textured claims, the Group has faced other claims from time to time. Even if there is no product defect, an unsuccessful patient procedure can lead to a claim of product liability against the Group. The Group carries insurance against product liability risk in amounts and subject to terms that it believes are appropriate, with a substantial self-insured retention amount.

## RISK FACTORS

There are risks and uncertainties related to Smith & Nephew's business. The factors listed below could cause the Group's financial condition or results of operations to differ materially from expected and historical levels. Factors not listed here, that Smith & Nephew cannot presently identify or does not believe to be equally significant, could also adversely affect Smith & Nephew's business.

### ***Product Liability Claims and Loss of Reputation***

The development, manufacture and sale of medical devices entail risk of product liability claims or recalls. Design and manufacturing defects with respect to products sold by the Group or by companies it has acquired could damage, or impair the repair of, body functions. Smith & Nephew may become subject to liability, which could be substantial, because of actual or alleged defects in its products. In addition, product defects could lead to the need to recall from the market existing products, which may be costly and harmful to the Group's reputation. See "Product Liability".

There can be no assurance that customers, particularly in the US, the Group's largest geographical market, will not bring product liability or related claims that would have a material adverse effect on the Group's financial position or results of operations in the future, or that the Group will be able to resolve such claims within insurance limits.

### ***Highly Competitive Markets***

The Group's business units compete across a diverse range of geographic and product markets. The markets in which each of the business units operates each contains a number of different competitors, including specialised

and international corporations. Significant product innovations, technical advances or the intensification of price competition by competitors could adversely affect the Group's operating results. Some of these competitors may have greater financial, marketing and other resources than Smith & Nephew. These competitors may be able to initiate technological advances in the field, deliver products on more attractive terms, more aggressively market their products or invest larger amounts of capital and research and development into their businesses.

There is a risk of further consolidation of companies, particularly in the orthopaedic industry, which could adversely affect the Group's ability to compete with much larger companies due to insufficient financial resources. If any of the Group's businesses were to lose market share or achieve lower than expected sales growth there could be a disproportionate adverse impact on the Group's share price and its strategic options.

In addition, competition exists among healthcare providers to gain patients on the basis of quality, service and price. There has been some consolidation in the Group's customer base, as well as among the Group's competitors, and these trends are expected to continue long term. Increased competition and unanticipated actions by competitors or customers could lead to downward pressure on prices and/or a decline in market share in any of the Group's business areas which would adversely affect Smith & Nephew's results of operations and hinder its growth potential.

#### ***Failure to Make Successful Acquisitions***

A key element of the Group's strategy for continued growth is to make strategic acquisitions or alliances to complement its existing businesses. Failure to identify appropriate acquisition targets or failure to integrate them successfully would have an adverse impact on the Group's competitive position and profitability. This could result from the diversion of management resources towards the acquisition or integration process, challenges of integrating organisations of different geographical, jurisdictional and ethical backgrounds, as well as the prospect of taking on unexpected liabilities of strategic partners. In addition, the recent contraction of available global capital may make financing less attainable or more expensive and could result in the Group failing in its strategic aim of growth by acquisition or alliance.

#### ***Stock Market Valuations***

As a growth industry, medical device companies have higher stock market valuations than many other industrial companies. If market conditions change, other companies in its sector fail to perform, or if the Group is perceived to be performing less well than the sector, then the share price of the Group may be adversely affected.

#### ***Attracting and Retaining Key Personnel***

The Group's continued development depends on its ability to hire and retain highly skilled personnel with particular expertise. This is critical, particularly in research, new product development and in the sales forces. If Smith & Nephew is unable to retain key personnel in research and new product development or if its largest sales forces suffer disruption or upheaval, its sales and operating profit would be adversely affected. Additionally, if the Group is unable to recruit, hire, develop and retain a talented, competitive workforce, it may not be able to meet its strategic business objectives.

#### ***Dependance on Government and Other Funding***

In most markets throughout the world, expenditure on medical devices is ultimately controlled to a large extent by governments. Funds may be made available or withdrawn from healthcare budgets depending on government policy. The Group is therefore largely dependent on future governments providing increased funds commensurate with the increased demand arising from demographic trends.

Pricing of the Group's products is governed in most major markets largely by governmental reimbursement authorities. Initiatives sponsored by government agencies, legislative bodies and the private sector to limit the growth of healthcare costs, including price regulation and competitive pricing, are ongoing in markets where the Group has operations. This control may be exercised by determining prices for an individual product or for an entire procedure. The Group is exposed to changes in reimbursement policy and pricing which may have an adverse impact on sales and operating profit. There may be an increased risk of adverse changes to government funding policies arising from the deterioration from macro-economic conditions in most parts of the world.

The Group must adhere to the rules laid down by funding agencies including the US Medicare and Medicaid fraud and abuse rules. Failure to do so could result in fines or loss of future funding.

### ***Regulatory Compliance in the Healthcare Industry***

Business practices in the healthcare industry are subject to regulation and review by various government authorities. In general, the trend in many countries in which the Group does business is towards higher expectations and increased enforcement activity by governmental authorities. While the Group is committed to doing business with integrity and welcomes the trend to higher standards in the healthcare industry, the Group and other companies in the industry have been subject to investigations and other enforcement activity that have incurred and may continue to incur significant expense. See “Legal Proceedings”.

The Group has taken steps to introduce best practices developed in certain countries to other regions around the world. As the Group continues to enhance its compliance programs globally, it is possible that operations in some regions may be disrupted.

### ***Regulatory Approvals and Controls***

The medical device industry is highly regulated. Regulatory requirements are a major factor in determining whether substances and materials can be developed into marketable products and the amount of time and expense that should be allotted to such development. At any time the Group is awaiting a number of regulatory approvals, which if not received, could adversely affect results of operations. Regulatory approval of new products and new materials is required in each country in which the Group operates although a single approval may be obtained for all countries within the European Union. Regulatory approval of new products may entail a lengthy process particularly if materials are employed which have not previously been used in similar products. Regulatory approvals in the US, Europe and Japan are the most critical to the Group’s success in launching new products.

The Group is required to comply with a wide range of regulatory controls over the manufacturing, testing, distribution, marketing and sale of its products, particularly in the US, UK and Continental Europe. Such controls have become increasingly demanding and costly to comply with and management believes that this trend will continue. Failure to comply with these controls could have a number of adverse consequences, including withdrawal of approval to sell a product in a country or temporary closure of a manufacturing facility.

### ***Proprietary Rights and Patents***

Due to the technological nature of medical devices, the Group is subject to the potential for patent infringement claims. Smith & Nephew attempts to protect its intellectual property and regularly opposes third party patents and trademarks where appropriate in those areas that might conflict with the Group’s business interests. If Smith & Nephew fails to successfully enforce its intellectual property rights, its competitive position could suffer, which could harm its results of operations.

Claims asserted by third parties regarding infringement of their intellectual property rights, if successful, could require the Group to expend time and significant resources to pay damages, develop non-infringing products or to obtain licenses to the products which are the subject of such litigation, thereby affecting the Group’s growth and profitability.

### ***Continual Development and Introduction of New Products***

The Group operates in the medical devices industry, which is highly competitive and has a rapid introduction rate of new products. In order to remain competitive, each of the Group’s business units must continue to develop innovative products that satisfy customer needs and preferences or provide cost or other advantages. Developing new products is a costly, lengthy and uncertain process. A potential product may not be brought to market for any number of reasons, including failure to work optimally, failure to receive regulatory approval, failure to be cost-competitive, infringement of patents or other intellectual property rights and changes in consumer demand. The Group’s products and technologies are also subject to marketing attack by competitors. Furthermore, new products that are developed and marketed by the Group’s competitors may affect price levels in the various markets in which the Group’s business units operate. If new products do not remain competitive with competitors’ products, the Group’s sales revenue could decline.

There is a risk that a major disruptive technology could be introduced into one of the Group’s markets and adversely affect its ability to achieve business plans and targets.

### ***Manufacturing and Supply***

The Group's manufacturing production is concentrated at eleven main facilities in Memphis, Tennessee, Mansfield, Massachusetts, Oklahoma City, Oklahoma, and Largo, Florida in the US, Hull, Warwick and Gilberdyke in the UK, Aarau in Switzerland, Tüttlingen in Germany, and Suzhou and Beijing in China. If major physical disruption took place at any of these sites, it would adversely affect the results of operations. Physical loss and consequential loss insurance is carried to cover such risks but is subject to limits and deductibles and may not be sufficient to cover catastrophic loss.

Management of orthopaedic inventory is complex, particularly forecasting and production planning. There is a risk that failures in operational execution could lead to excess inventory or individual product shortages.

Each of the business units is reliant on certain key suppliers of raw materials, components, finished products and packaging materials. These suppliers must provide the materials and perform the activities to the Group's standard of quality requirements. If any of these suppliers is unable to meet the Group's needs, compromises on standards of quality or substantially increases its prices, Smith & Nephew would need to seek alternative suppliers. There can be no assurance that alternative suppliers would provide the necessary raw materials on favourable or cost-effective terms at the desired quality. Consequently, the Group may be forced to pay higher prices to obtain raw materials, which it may not be able to pass on to its customers in the form of increased prices for its finished products. In addition, some of the raw materials used may become unavailable, and there can be no assurance that the Group will be able to obtain suitable and cost-effective substitutes. Any interruption of supply caused by these or other factors could negatively impact Smith & Nephew's revenue and operating profit.

As part of the EIP programme the Group is in the process of outsourcing to third parties or relocating to lower cost countries certain of its manufacturing processes. As a result of these transfers, there is a risk of disruption to supply.

### ***Currency Fluctuations***

The Group uses the US Dollar as its reporting currency and the functional currency of Smith & Nephew plc. In 2008, 44% of Group revenue arose in the US, 28% in Continental Europe, 20% in Africa, Asia, Australia, Canada, New Zealand and Latin America, and 8% in the UK. During 2008 fluctuations in the exchange rates used to translate the financial statements of operations outside the US into US Dollars had the effect of increasing Group revenue by 2%.

The Group's manufacturing cost base is situated principally in the US, the UK and Switzerland from where finished products are exported to the Group's selling operations worldwide. Thus, the Group is exposed to fluctuations in exchange rates between the US Dollar, Sterling and Swiss Franc and the currencies of the Group's selling operations, particularly the Euro and Japanese Yen. If the US Dollar, Sterling or Swiss Franc should strengthen against the Euro and the Japanese Yen then Group trading margin would be adversely affected.

In 2008, the Group managed \$1bn of foreign currency purchase transactions by using forward foreign exchange contracts, of which the major transaction flows are from Euros into US Dollars and Sterling. The Group's policy is for firm commitments to be fully covered and forecast transactions to be covered between 50% and 90% for up to one year.

Had the Group not transacted forward foreign exchange purchase contracts and if the Euro were to have weakened on average over the year by 10% against all other currencies, Smith & Nephew's profit before taxation in 2008 would have decreased by an estimated \$45m (2007 — decreased by an estimated \$46m) on account of transactional and translational movements; if the US Dollar were to have weakened on average over the year by 10% against all other currencies, profit before taxation in 2007 would have increased by an estimated \$51m (2007 — increased by an estimated \$42m).

### ***Political Uncertainties***

The Group has operations in 32 countries. Political upheaval in those countries or in the regions surrounding those countries may impact the Group's results of operations. Political changes in a country could prevent the Group from receiving remittances of profit from a member of the Group located in that country or from selling its investments in that country. Furthermore, legislative measures in a country could result in changes in tariffs, import quotas or taxation that could adversely affect the Group's turnover and operating profit. Terrorist activities and ongoing global political uncertainties could adversely impact the Group.

### ***World Economic Conditions***

Demand for the Group's products is driven by demographic trends, including the ageing population and the incidence of osteoporosis and obesity, which continue to remain as favorable trends for Group performance. Supply, use and payment for products is influenced by world economic conditions which could place increased pressure on demand and pricing, adversely impacting the Group's ability to deliver revenue and margin growth. The conditions could favour larger, more capitalised groups, with higher market shares and margins. As a consequence the Group's prosperity is linked to general economic conditions and there is a risk of deterioration of the Group's performance and finances during the current macro-economic events.

### ***Other Risk Factors***

The Board considers that Smith & Nephew is subject to a number of other risks which are common to most global medical technology groups and which are reviewed as part of its risk management process.

In the financial area these include interest rate volatility, share price volatility, challenges by taxation authorities, failures in reporting and internal financial controls and uninsured losses.

Adverse events in the areas of corporate social responsibility could also adversely impact Group operating results.

## **EXCHANGE AND INTEREST RATE RISK AND FINANCIAL INSTRUMENTS**

The Board of Directors of the Company has established a set of policies to manage funding, currency and interest rate risks. Derivative financial instruments are used only to manage the financial risks associated with underlying business activities and their financing. See Note 22 of the Notes to the Group accounts for further details of these risks.

The Group's financial instruments are subject to changes in fair values as a result of changes in market rates of exchange and forward interest rates. Financial instruments entered into to hedge foreign currency purchase transactions and interest rate exposures are accounted for as hedges. As such, changes in fair values of these financial instruments would not affect the Group's income statement. The movements in the fair value of financial instruments that are not accounted for as hedges offset movements in the values of assets and liabilities and are recognised through the income statement. The net impact of these changes in fair value on the Group's income statement is not significant.



# OPERATING AND FINANCIAL REVIEW, LIQUIDITY AND PROSPECTS

The Operating and Financial Review, Liquidity and Prospects discusses the operating and financial performance of the Group, including the financial outlook and the financial resources of the Group, under the following headings:

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The results for each year are compared primarily with the results for the preceding year.

## BUSINESS OVERVIEW

Smith & Nephew's operations are organised into three business units that operate globally: Orthopaedics, Endoscopy and Advanced Wound Management. Smith & Nephew believes that its businesses have the opportunities for strong growth due to its markets benefiting from an ageing population, an increase in active lifestyles and trends toward less invasive medical procedures.

The Group formed a single Orthopaedics business by combining its Reconstruction and Trauma businesses in July 2008 in an effort to increase the efficiency of its management and operational structure. All comparative periods have been amended to conform to the current year presentation.

Revenue by business segment as a percentage of total revenue was as follows:

	2008	2007	2006
		(%)	
Orthopaedics .....	57	55	52
Endoscopy .....	21	22	23
Advanced Wound Management .....	22	23	25
Total revenue .....	<u>100</u>	<u>100</u>	<u>100</u>

Revenue by geographic market as a percentage of total revenue was as follows:

	2008	2007	2006
		(%)	
Europe (Continental Europe and United Kingdom) .....	36	35	31
United States .....	44	46	49
Africa, Asia and Australia and Other America .....	20	19	20
Total revenue .....	<u>100</u>	<u>100</u>	<u>100</u>

### Underlying Growth in Revenue

"Underlying growth in revenue" is a non-GAAP financial measure which is a key performance indicator used by the Group's management in order to compare the revenue in a given year to that of the previous year on a like-for-like basis. This is achieved by adjusting for the impact both of sales of products acquired in business combinations and for movements in exchange rates. The Group's management uses this non-GAAP measure in its internal financial reporting, budgeting and planning to assess performance on both a business segment and a consolidated Group basis.

"Underlying growth in revenue" reconciles to growth in revenue reported in accordance with IFRS by making two adjustments, the "constant currency exchange effect" and the "acquisitions effect", described below. The material limitation of the underlying growth in revenue measure is that it excludes certain factors, described above, which do ultimately have a significant impact on total revenues. The Group measures the performance of local managers using underlying growth in revenue whilst the Group's management additionally considers GAAP revenue each quarter and further assesses the excluded items by monitoring against internal budget amounts.

The "constant currency exchange effect" is a measure of the increase/decrease in revenue resulting from currency movements on non-US Dollar sales. This is measured as the difference between the increase in revenue translated into US Dollars on a GAAP basis (i.e. current year revenue translated at the current year average rate, prior year revenue translated at the prior year average rate) and the increase measured by translating current year revenue into US Dollars using the prior year average rate.

The "acquisitions effect" is the measure of the impact on revenue from newly acquired business combinations. This is calculated by excluding the revenue from sales of products acquired as a result of a business combination consummated in the current year, with non-US Dollar sales translated at the prior year average rate. Additionally, prior year revenue is adjusted to include a full year of revenue from the sales of products acquired in those

business combinations consummated in the previous year, calculated by adding back revenue from sales of products in the period prior to the Group's ownership. These sales are separately tracked in the Group's internal reporting systems and are readily identifiable.

Reported growth in revenue by business segment reconciles to underlying growth in 2008 as follows:

	Reported growth	Constant currency exchange effect	Acquisitions effect	Underlying growth
	(%)	(%)	(%)	(%)
Orthopaedics .....	16	(2)	(9)	5
Endoscopy .....	9	(1)	–	8
Advanced Wound Management .....	8	(1)	–	7
Total revenue .....	<u>13</u>	<u>(2)</u>	<u>(5)</u>	<u>6</u>

Reported growth in revenue by business segment reconciles to underlying growth in 2007 as follows:

	Reported growth	Constant currency exchange effect	Acquisitions effect	Underlying growth
	(%)	(%)	(%)	(%)
Orthopaedics .....	30	(4)	(13)	13
Endoscopy .....	13	(3)	–	10
Advanced Wound Management .....	12	(6)	(1)	5
Total revenue .....	<u>21</u>	<u>(4)</u>	<u>(7)</u>	<u>10</u>

### Trading Profit

Trading profit is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers as affect the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. The Group has identified the following items, where material, as those to be excluded from operating profit when arriving at trading profit: acquisition and disposal related items including amortisation and impairment of acquisition intangible assets; significant restructuring events; and gains and losses resulting from legal disputes and uninsured losses.

Operating profit reconciles to trading profit in 2008 as follows:

	Operating profit	Acquisition related costs	Restructuring and rationalisation costs	Amortisation and impairment of acquisition intangibles	Trading Profit
			(\$ million)		
Orthopaedics .....	382	61	9	29	481
Endoscopy .....	146	–	4	16	166
Advanced Wound Management .....	102	–	21	6	129
Total .....	<u>630</u>	<u>61</u>	<u>34</u>	<u>51</u>	<u>776</u>

Operating profit reconciles to trading profit in 2007 as follows:

	Operating profit	Acquisition related costs	Restructuring and rationalisation costs	Legal settlement	Amortisation and impairment of acquisition intangibles	Trading Profit
			(\$ million)			
Orthopaedics .....	243	111	14	30	25	423
Endoscopy .....	141	–	4	–	2	147
Advanced Wound Management .....	109	–	24	–	3	136
Total .....	<u>493</u>	<u>111</u>	<u>42</u>	<u>30</u>	<u>30</u>	<u>706</u>

Trading profit by business segment as a percentage of total trading profit was as follows:

	2008	2007	2006
		(%)	
Orthopaedics .....	62	60	59
Endoscopy .....	21	21	21
Advanced Wound Management .....	17	19	20
Total trading profit .....	<u>100</u>	<u>100</u>	<u>100</u>

Operating profit by business segment as a percentage of total operating profit was as follows.

	2008	2007	2006
		(%)	
Orthopaedics .....	61	49	56
Endoscopy .....	23	29	23
Advanced Wound Management .....	16	22	21
Total operating profit .....	<u>100</u>	<u>100</u>	<u>100</u>

## Factors Affecting Smith & Nephew's Results of Operations

### *Sales Trends*

Smith & Nephew's business units participate in the global medical devices market and share a common focus on the repair of human tissue. Smith & Nephew's principal geographic markets are in the well-developed healthcare economies of the US, Europe, Japan and Australia.

These markets are characterised by an increase in the average age of the population caused by the immediate post-World War II "baby boomer" generation approaching retirement, increased longevity, more active lifestyles, obesity and increased affluence. Together these factors have created significant demand for more effective healthcare products which deliver improved outcomes through technology advances. Furthermore pressure to resist increases in overall healthcare spending has led healthcare providers to demand products which minimise the length of hospital stays and the use of surgeon and nursing resources.

A recent trend has been increasing consumer awareness of available healthcare treatments through the Internet and direct-to-customer advertising. This has led to increased consumer influence over product purchasing decisions.

In orthopaedic reconstruction, improvements in technology have lengthened the effective life of implants and have facilitated the implantation of knees and hips in relatively young patients thereby improving the quality of life for a new generation. Both the orthopaedic trauma and clinical therapies markets are expected to continue to grow due to a global population increasingly at risk from fractures due to age, osteoporosis, obesity and diabetes and also due to continuous advancements in the surgical treatment of fractures, and the need to manage pain in younger, more active patients.

The endoscopy market is benefiting from the continued trend worldwide towards less invasive surgery but with particular focus on arthroscopic repair of the knee and shoulder using a broad range of technology. The Group also expects to benefit from the demand for less invasive approaches to arthroscopic hip repair.

The advanced wound management market is focused on the treatment of chronic wounds of the older population and other hard-to-heal wounds such as burns and certain surgical wounds and is therefore also expected to benefit from demographic trends. The market for advanced wound treatments is relatively unpenetrated and it is estimated that the potential market is significantly larger than the current market. This increased penetration is expected to be driven by improved outcomes from new technology, health economic benefits, increasing nursing shortages, quality of life expectations and education of healthcare providers to convert from traditional to advanced treatments.

In order to take advantage of the expanding markets the Group must continually develop its existing and new technologies and bring new products to its customers. Expenditure on research and development in 2008 represented approximately 4% of Group revenue.

### ***Currency Movements***

Smith & Nephew's results of operations are affected by transactional exchange rate movements in that they are subject to exposures arising from revenue in a currency different from the related costs and expenses. The Group manages the impact of exchange rate movements on cost of goods sold by a policy of purchasing forward foreign currency commitments when firm purchase orders are placed. In addition, the Group's policy is for firm commitments to be fully covered and forecast transactions to be covered between 50% and 90% for up to one year. The Group's revenues, profits and earnings are also affected by exchange rate movements on the translation of results of operations in foreign subsidiaries for financial reporting purposes. This exposure is offset partly because the Group incurs interest in currencies other than US Dollars on its indebtedness denominated in currencies other than US Dollars. See "Financial Position, Liquidity and Capital Resources".

### ***Other***

Other than national governments seeking to control or reduce healthcare expenditure, (see "Risk Factors — Dependence on Government and Other Funding") management is not aware of any governmental economic, fiscal, monetary or political policies or factors that have materially affected, directly or indirectly, the Group's operations or investments by shareholders.

### **Critical Accounting Policies**

The Group's significant accounting policies and those elective exemptions taken by the Group on the adoption of IFRS in accordance with IFRS 1 are set out in Note 2 of the Notes to the Group Accounts. Of those, the policies which require the most use of management's judgment are as follows:

#### ***Inventories***

A feature of the Orthopaedics business (whose finished goods inventory makes up approximately 75% of the Group total finished goods stock) is the high level of product inventory required, some of which is located at customer premises and is available for customers' immediate use. Complete sets of product, including large and small sizes, have to be made available in this way. These sizes are used less frequently than standard sizes and towards the end of the product life cycle are inevitably in excess of requirements. Adjustments to carrying value are therefore required to be made to orthopaedic inventory to anticipate this situation. These adjustments are calculated in accordance with a formula based on levels of inventory compared with historical usage. This formula is applied on an individual product line basis and is first applied when a product group has been on the market for two years. This method of calculation is considered appropriate based on experience, but it does involve management judgements on effectiveness of inventory deployment, length of product lives, phase-out of old products and efficiency of manufacturing planning systems.

#### ***Impairment***

In carrying out impairment reviews of goodwill, intangible assets and property, plant and equipment a number of significant assumptions have to be made when preparing cash flow projections. These include the future rate of market growth, the market demand for the products acquired, the future profitability of acquired businesses or products, levels of reimbursement and success in obtaining regulatory approvals. If actual results should differ or changes in expectations arise, impairment charges may be required which would adversely impact operating results.

#### ***Retirement Benefits***

A number of key judgements have to be made in calculating the fair value of the Group's defined benefit pension plans. These assumptions impact the Balance Sheet liability, operating profit and finance income/costs. The most critical assumptions are the discount rate and mortality assumptions to be applied to future pension plan liabilities. For example a 0.5% increase in discount rate would reduce the combined UK and US pension plan deficit by \$76m whilst a 0.5% decrease would increase the combined deficit by \$81m. A 0.5% increase in discount rate would decrease profit before taxation by \$2m whilst a 0.5% decrease would increase it by \$3m. A one year increase in the assumed life expectancy of the average 60 year old male pension plan member in both the UK and US would increase the combined deficit by \$24m. In making these judgements, management takes into account the advice of professional external actuaries and benchmarks its assumptions against external data.

The discount rate is determined by reference to market yields on high quality corporate bonds at the balance sheet date. The Group selects its discount rate by benchmarking against published indices and by consultation with its actuaries. The principal index used for benchmarking is the iBOXX Corporate AA index for bonds with terms consistent with the estimated defined benefit payments.

See Note 35 of the Notes to the Group Accounts for a summary of how the assumptions selected in the last five years have compared with actual results.

### ***Contingencies and Provisions***

The recognition of provisions for legal disputes is subject to a significant degree of estimation. Provision is made for loss contingencies when it is considered probable that an adverse outcome will occur and the amount of the loss can be reasonably estimated. In making its estimates management takes into account the advice of internal and external legal counsel. Provisions are reviewed regularly and amounts updated where necessary to reflect developments in the disputes. The ultimate liability may differ from the amount provided depending on the outcome of court proceedings and settlement negotiations or if investigations bring to light new facts.

The estimation of the liability for the costs of the macrot textured product withdrawal for which coverage has been declined is dependent upon two main variables. These are the number of implant revisions that will ultimately be required and the average cost of settlements with patients. The estimate of the remaining number of implant revisions is based on trends to date and the advice of external statistical and other advisors. If the actual number remaining was double the current estimate the cost would increase by approximately \$30m. If the average cost of settlement of the estimated claims outstanding or not yet notified should rise by 10% the cost would increase by \$3m.

The Group operates in numerous tax jurisdictions around the world. Although it is Group policy to submit its tax returns to the relevant tax authorities as promptly as possible, at any given time the Group has unagreed years outstanding and is involved in disputes and tax audits. Significant issues may take several years to resolve. In estimating the probability and amount of any tax charge management takes into account the views of internal and external advisors and updates the amount of provision whenever necessary. The ultimate tax liability may differ from the amount provided depending on interpretations of tax law, settlement negotiations or changes in legislation.

## **2008 YEAR**

The following discussion and analysis is based upon, and should be read in conjunction with, the Group Accounts of Smith & Nephew included elsewhere in this Annual Report.

### **Financial Highlights of 2008**

Group revenue was \$3,801m for the year ended 31 December 2008, representing 13% growth compared to 2007. Underlying growth in revenue was 6%, translational currency added 2% and acquisitions added 5%.

Profit before taxation was \$564m, compared with \$469m in 2007. Attributable profit was \$377m compared with \$316m in 2007. Adjusted attributable profit (calculated as set out in "Selected Financial Data"), rose 3% to \$493m in 2008 from \$480m in 2007.

Basic earnings per Ordinary Share were 42.6¢ compared to 34.2¢ for 2007. EPSA (as set out in "Selected Financial Data") was 55.6¢ in 2008 compared to 52.0¢ for 2007, representing a 7% increase.

## Fiscal 2008 Compared with Fiscal 2007

The following table sets out certain income statement data for the periods indicated:

	2008	2007
	(\$ million)	
Revenue (i) . . . . .	3,801	3,369
Cost of goods sold (ii) . . . . .	(1,077)	(994)
Gross profit . . . . .	2,724	2,375
Marketing, selling and distribution expenses (iii) . . . . .	(1,436)	(1,278)
Administrative expenses (iv) . . . . .	(533)	(487)
Research and development expenses . . . . .	(152)	(142)
BSN agency and management fees . . . . .	27	25
Operating profit (i) . . . . .	630	493
Net interest payable . . . . .	(66)	(30)
Other finance (costs)/income . . . . .	(1)	6
Share of results of associates . . . . .	1	–
Profit before taxation . . . . .	564	469
Taxation . . . . .	(187)	(153)
Attributable profit for the year . . . . .	377	316

- (i) Group revenue and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 36 to 37.
- (ii) 2008 includes \$15m in respect of the utilisation of Plus inventory stepped-up to fair value on acquisition, \$18m of restructuring and rationalisation expenses and \$8m of acquisition related costs (2007 — \$64m in respect of the utilisation of the Plus inventory stepped-up to fair value on acquisition, \$7m of restructuring and rationalisation expenses and \$6m of acquisition related costs).
- (iii) 2008 includes \$7m of acquisition related costs and \$3m of restructuring and rationalisation expenses (2007 — \$12m of acquisition related costs and \$4m of restructuring and rationalisation expenses).
- (iv) 2008 includes \$31m of acquisition related costs, \$13m of restructuring and rationalisation expenses and \$51m of amortisation and impairment of acquisition intangibles (2007 — \$29m of acquisition related costs, \$31m of restructuring and rationalisation expenses, \$30m of legal settlement, and \$30m of amortisation of acquisition intangibles).

### **Transactional and Translational Exchange**

The Group's principal markets outside the US are, in order of significance, Continental Europe, UK, Australia and Japan. Revenues in these markets fluctuate when translated into US Dollars on consolidation. During the year the average rates of exchange against the US Dollar used to translate revenues and profits arising in these markets changed compared to the previous year as follows: the Euro strengthened from \$1.37 to \$1.46 (+7%), Sterling weakened from \$2.00 to \$1.84 (-8%), the Swiss Franc strengthened from \$0.83 to \$0.92 (+11%), the Australian Dollar was flat at \$0.84 and the Japanese Yen strengthened from ¥118 to ¥103 (+13%).

The Group's principal manufacturing locations are in the US (Orthopaedics and Endoscopy), Switzerland (Orthopaedics) and in the UK (Advanced Wound Management and Orthopaedics). The majority of the Group's selling and distribution subsidiaries around the world purchase finished products from these locations. As a result of currency movements compared with the previous year, purchases from the US and Switzerland became relatively less expensive. The Group's policy of purchasing forward a proportion of its currency requirements mitigates the impact of these movements.

### **Revenue**

Group revenue increased by \$432m (13%) from \$3,369m in 2007 to \$3,801m in 2008. Underlying revenue growth was 6%, an additional 5% as a result of acquisitions and 2% attributable to favourable currency translation.

Orthopaedics revenues increased by \$300m or 16%, of which 5% was attributable to underlying growth, 9% due to the acquisition of Plus and 2% due to favourable currency translation. Endoscopy revenues increased by \$68m or 9%, of which 8% was attributable to underlying growth and 1% due to favourable currency translation. Advanced Wound Management revenues increased by \$64m or 8%, of which 7% was attributable to underlying growth and 1% due to favourable currency translation.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 36 and 37.

### ***Cost of goods sold***

Cost of goods sold increased by \$83m to \$1,077m from \$994m in 2007. The main driver of this increase was the growth in revenues across the Group. Other factors contributing to the movement were the decrease of \$49m in the utilisation of the Plus inventory stepped up to fair value on the acquisition, offset by an increase of \$2m in other acquisition related costs and an increase of \$11m in restructuring and rationalisation expenses.

Further margin analysis is included within the “Trading Profit” sections of the individual business segments that follow on pages 36 to 37.

### ***Marketing, selling and distribution expenses***

These expenses increased by \$158m to \$1,436m from \$1,278m in 2007. The increase was largely a result of increased marketing, selling and distribution expenses across the Group in line with the increased revenues.

### ***Administrative expenses***

Administrative expenses increased by \$46m to \$533m from \$487m in 2007, largely as a result of the growth in the business. This increase includes \$14m relating to impairment of acquisition intangibles, \$7m due to a full years amortisation charge on Plus intangibles in comparison to 2007, \$18m reduction in restructuring and rationalisation expenses from 2007 and the impact of \$30m incurred in 2007 on the legal settlement.

### ***Research and development expenses***

Expenditure as a percentage of revenue fell from 4.2% in 2007 to 4.0% in 2008. The Group continues to invest in innovative technologies and products to differentiate itself from competitors.

### ***BSN agency and management fees***

Agency and management fees of \$27m (2007 — \$25m) were received in respect of services provided to BSN Medical for sales force resource, physical distribution and logistics and administration in certain countries. The calculation of the fees is designed to result in a neutral, cost-recovery position for Smith & Nephew.

### ***Operating profit***

Operating profit increased by \$137m to \$630m from \$493m in 2007 comprising increases of \$139m in Orthopaedics and \$5m in Endoscopy, offset by a decline of \$7m in Advanced Wound Management.

### ***Net interest payable***

Net interest payable increased by \$36m from \$30m in 2007 to \$66m in 2008. This is a direct consequence of the additional borrowings put in place to finance the Plus acquisition and the share buy-back programme.

### ***Other finance (costs)/income***

Other finance costs in 2008 were \$1m down from \$6m income in 2007. This is attributable to an increase in interest costs on pension liabilities.

### ***Taxation***

The taxation charge increased by \$34m to \$187m from \$153m in 2007. The effective rate of tax before discontinued operations was 33.2%, compared with 32.6% in 2007. The tax charge was reduced by \$30m in 2008 (2007 — \$49m) as a consequence of restructuring and rationalisation expenses, acquisition related costs, the legal settlement and amortisation and impairment of acquisition intangibles. The effective tax rate was 30.6% (2007 — 29.6%) after adjusting for these items and the tax thereon.



### Group Balance Sheet

The following table sets out certain balance sheet data for the years ended indicated:

	2008	2007
	(\$ million)	
Non-current assets .....	2,523	2,542
Current assets .....	1,985	1,919
Total assets .....	<u>4,508</u>	<u>4,461</u>
Non-current liabilities .....	1,841	357
Current liabilities .....	968	2,288
Total liabilities .....	2,809	2,645
Total equity .....	1,699	1,816
Total equity and liabilities .....	<u>4,508</u>	<u>4,461</u>

Non-current assets decreased by \$19m to \$2,523m from \$2,542 in 2007. Intangible assets and goodwill decreased by \$79m of which \$42m related to currency translation, \$69m to amortisation and impairment and a \$2m adjustment to contingent consideration offset by an increase of \$33m relating to additions and \$1m relating to acquisitions. Property, plant and equipment decreased by \$17m comprising additions of \$259m, less currency translation of \$57m, depreciation of \$204m and disposals of \$15m. Deferred tax assets increased by \$78m in the year, primarily due to the increase in the post retirement obligations.

Current assets increased by \$66m to \$1,985m from \$1,919m in 2007. This was due to an increase in inventory of \$45m and an increase in trade and other receivables of \$46m. These increases were partially offset by a reduction in cash at bank of \$25m.

Non-current liabilities increased by \$1,484m from \$357m in 2007 to \$1,841m in 2008. \$1,322m of this increase was predominantly due to the reclassification of long-term borrowings from short-term borrowings following the Group's decision to exercise its option to extend the multicurrency loan facility for a further four years in May 2008. The retirement benefit obligation increased by \$166m, which was mainly as a result of a reduction in asset values, in line with falling share prices offset by an increase in the corporate bond rate. Deferred tax liabilities decreased by \$11m, other payables decreased by \$11m and provisions increased by \$18m.

Current liabilities decreased by \$1,320m from \$2,288m in 2007 to \$968m in 2008. The primary cause of this decrease was the reclassification of borrowings to long-term following the Group's decision to exercise its option to extend the multicurrency loan facility for a further four years in May 2008.

Total equity decreased by \$117m from \$1,816m in 2007 to \$1,699m in 2008. The principal movements were an increase of \$377m in attributable profit offset by \$99m from translation losses, \$215m actuarial losses on defined benefit pension plans which was offset by \$71m of taxation charged to equity, \$109m of equity dividends paid in the year and \$193m from the purchases of treasury shares.

## Business Segment Analysis

Revenue by business segment and geographic market and trading and operating profit by business segment are set out below:

	2008	2007
	(\$ million)	
<b>Revenue by business segment</b>		
Orthopaedics .....	2,158	1,858
Endoscopy .....	800	732
Advanced Wound Management .....	843	779
Total revenue .....	<u>3,801</u>	<u>3,369</u>
<b>Revenue by geographic market</b>		
Europe (Continental Europe and United Kingdom) .....	1,398	1,177
United States .....	1,657	1,550
Africa, Asia, Australasia and other America .....	746	642
Total revenue .....	<u>3,801</u>	<u>3,369</u>
<b>Trading profit by business segment</b>		
Orthopaedics .....	481	423
Endoscopy .....	166	147
Advanced Wound Management .....	129	136
Total trading profit .....	<u>776</u>	<u>706</u>
<b>Operating profit by business segment</b>		
Orthopaedics .....	382	243
Endoscopy .....	146	141
Advanced Wound Management .....	102	109
Total operating profit .....	<u>630</u>	<u>493</u>

## Orthopaedics

### Revenue

Orthopaedics (which includes Reconstruction, Trauma and Clinical Therapies) revenue increased by 16% to \$2,158m from \$1,858m in 2007. Of this increase, 5% is attributable to underlying growth, 2% is due to favourable currency movements and 9% is due to the effect of the acquisition of Plus. The principal factors in the underlying growth in revenue were the continuing expansion in global orthopaedic markets, the growth of recently launched products and actions the Group has taken to align sales forces.

In the US, revenue increased by \$95m to \$1,127m (9%) of which 8% was underlying growth and 1% as a result of the Plus acquisition effected in 2007. The main factors were the continued growth of products launched in recent years including the LEGION and JOURNEY knees, and BHR.

Outside the US, revenue increased by \$205m to \$1,031m (25%), of which 2% was underlying growth, 19% as a result of acquisitions and 4% due to foreign currency translation.

Global knee revenue increased by \$124m (20%) to \$758m, of which 3% was due to foreign currency translation, 10% was due to acquisitions and 7% was underlying growth.

Global hip revenue increased by \$121m to \$688m (21%) of which 5% was due to underlying growth, 2% was due to foreign currency translation and 14% due to acquisitions.

### Trading Profit

Trading profit rose by \$58m (14%) to \$481m from \$423m in 2007. Trading profit margin decreased from 22.8% to 22.3%. This decrease reflects the consolidation of lower margin Plus sales, the margin impact of Plus lost sales and increased compliance costs, together exceeding the operational improvements the business has been making.

**Operating Profit**

Operating profit increased by \$139m. This largely comprises the \$58m increase in trading profit, a \$50m decrease in acquisition related costs and a \$30m legal settlement in 2007.

**Endoscopy****Revenue**

Endoscopy revenue increased by \$68m, or 9%, to \$800m from \$732m in 2007, comprising 1% favourable currency translation and 8% underlying growth.

In the US, revenue increased by \$11m to \$372m (3%), all of which was underlying growth. This is largely attributable to the actions taken to reinvigorate sales performance and drive further growth from the Group's portfolio of products, particularly in the repair segment of the arthroscopy market.

Outside the US, revenue increased by \$57m to \$428m (15%), of which 13% was underlying growth and 2% due to favourable foreign currency translation.

Global revenue of knee and shoulder repair products increased by \$48m to \$312m (18%), of which 16% was underlying growth and 2% due to foreign currency translation.

Revenue in the global resection products sector increased by \$10m to \$277m (4%), of which 3% was underlying growth and 1% due to foreign currency translation.

Global Visualisation revenue increased by \$9m to \$150m (6%), all of which was underlying growth.

**Trading Profit**

Trading profit increased by \$19m (13%) to \$166m from \$147m in 2007 resulting in a trading profit margin increase from 20.1% to 20.8%. This improvement was mainly due to a greater focus on managing costs.

**Operating Profit**

Operating profit increased by \$5m to \$146m from \$141m in 2007. The increase of \$19m in trading profit was offset by an impairment charge on acquisition intangibles of \$14m relating to the OBI acquisition in 2006.

**Advanced Wound Management****Revenue**

Revenue increased by \$64m, or 8%, to \$843m from \$779m in 2007, comprising 1% favourable currency translation and 7% underlying growth. Within the infection management and exudate management markets, growth was driven by the extension of the Group's ALLEVYN brand to new products.

In the US, revenue increased by \$1m to \$158m (1%), of which 2% is attributable to the BlueSky acquisition made in 2007 offset by a fall in underlying revenue of 1%.

Outside the US, revenue increased by \$63m to \$685m (10%), of which 9% was underlying growth and 1% due to foreign currency translation. Continental Europe revenue increased by 15% of which 7% was favourable currency translation and 8% was underlying growth. Underlying growth in the UK was 8%. Reported revenues in the UK decreased by 1%, the difference of 9% representing unfavourable currency translation.

**Trading Profit**

Trading profit fell by \$7m (5%) to \$129m from \$136m in 2007 and trading profit margin decreased from 17.5% to 15.3%. This is largely attributable to investment in the launch of NPWT.

**Operating Profit**

Operating profit decreased by \$7m in line with the decrease in trading profit.

## 2007 YEAR

The following discussion and analysis is based upon, and should be read in conjunction with, the Group Accounts of Smith & Nephew included elsewhere in this Annual Report.

### Financial Highlights of 2007

Group revenue was \$3,369m for the year ended 31 December 2007, representing 21% growth compared to 2006. Underlying growth in revenue was 10%, translational currency added 4% and acquisitions added 7%.

Profit before taxation was \$469m, compared with \$550m in 2006. Attributable profit was \$316m compared with \$745m in 2006. Adjusted attributable profit (calculated as set out in "Selected Financial Data"), rose 13% to \$480m in 2007 from \$425m in 2006.

Basic earnings per Ordinary Share were 34.2¢ compared to 79.2¢ for 2006. EPSA (as set out in "Selected Financial Data") was 52.0¢ in 2007 compared to 45.2¢ for 2006, representing a 15% increase.

### Fiscal 2007 Compared with Fiscal 2006

The following table sets out certain income statement data for the periods indicated:

	2007	2006
	(\$ million)	
Revenue (i) . . . . .	3,369	2,779
Cost of goods sold (ii) . . . . .	(994)	(769)
Gross profit . . . . .	2,375	2,010
Marketing, selling and distribution expenses (iii) . . . . .	(1,278)	(1,092)
Administrative expenses (iv) . . . . .	(487)	(286)
Research and development expenses . . . . .	(142)	(120)
BSN agency and management fees . . . . .	25	25
Operating profit (i) . . . . .	493	537
Net interest (payable)/receivable . . . . .	(30)	10
Other finance income . . . . .	6	3
Profit before taxation . . . . .	469	550
Taxation . . . . .	(153)	(156)
Profit from continuing operations . . . . .	316	394
Discontinued operations — net profit on disposal of the joint venture . . . . .	—	351
Attributable profit for the year . . . . .	316	745

(i) Group revenue and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 41 to 43.

(ii) 2007 includes \$64m in respect of the utilisation of the Plus inventory stepped-up to fair value on acquisition, \$7m of restructuring and rationalisation expenses and \$6m of acquisition related costs.

(iii) 2007 includes \$12m of acquisition related costs and \$4m of restructuring and rationalisation expenses.

(iv) 2007 includes \$29m of acquisition related costs, \$31m of restructuring and rationalisation expenses, \$30m of legal settlement, and \$30m of amortisation of acquisition intangibles (2006 — \$20m of acquisition related costs and \$14m of amortisation of acquisition intangibles).

### Transactional and Translational Exchange

The Group's principal markets outside the US are, in order of significance, Continental Europe, UK, Australia and Japan and revenues in these markets fluctuate when translated into US Dollars on consolidation. During the year the average rates of exchange against the US Dollar used to translate revenues and profits arising in these markets changed compared to the previous year as follows: the Euro strengthened from \$1.27 to \$1.37 (+8%), Sterling strengthened from \$1.86 to \$2.00 (+8%), the Australian Dollar strengthened from \$0.76 to \$0.84 (+11%) and the Japanese Yen weakened from ¥116 to ¥118 (-2%).

The Group's principal manufacturing locations are in the US (Orthopaedics and Endoscopy), Switzerland (Orthopaedics) and in the UK (Advanced Wound Management). The majority of the Group's selling and distribution subsidiaries around the world purchase finished products from these locations in the currency of the manufacturer. As a result of currency movements compared with the previous year, purchases from the US and the UK became relatively cheaper. The Group's policy of purchasing forward a proportion of its currency requirements mitigated the impact of these movements to some extent.

**Revenue**

Group revenue increased by \$590m (21%) to \$3,369m in 2007 from \$2,779m in 2006. Underlying revenue growth was 10%, acquisitions added 7% and favourable currency translation, reflecting the strength of Sterling and Euro relative to the US Dollar, added 4%.

Orthopaedics revenues increased by \$425m or 30%, of which 13% was underlying growth, 13% was due to the acquisition of Plus and 4% due to favourable currency translation. Endoscopy revenues increased by \$84m or 13%, of which 10% was underlying growth and 3% was due to favourable currency translation. Advanced Wound Management revenues increased by \$81m or 12%, of which 5% was underlying growth, 6% due to favourable currency translation and 1% due to the BlueSky acquisition.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 41 and 42.

**Cost of goods sold**

Cost of goods sold increased by \$225m to \$994m in 2007 from \$769m in 2006. The main drivers of this increase were \$64m relating to the utilisation of the Plus inventory stepped up to fair value on the acquisition, \$6m of other acquisition related costs, \$7m of restructuring and rationalisation expenses and \$69m from the inclusion of Plus cost of goods sold. The remaining increase was driven by the growth in revenues across the Group.

Further margin analysis is included within the "Trading Profit" sections of the individual business segments that follow on pages 42 and 43.

**Marketing, selling and distribution expenses**

These expenses increased by \$186m to \$1,278m in 2007 from \$1,092m in 2006. This included \$12m of acquisition related costs and \$4m of restructuring and rationalisation expenses. A further \$78m was due to the inclusion of seven months of Plus expenditure with the remaining increase a result of increased selling and marketing costs across the Group in line with the increased revenues.

**Administrative expenses**

Administrative expenses increased by \$201m to \$487m in 2007 from \$286m in 2006. This includes an increase in acquisition related costs and amortisation of acquisition intangibles of \$9m and \$16m respectively, due to the acquisitions of Plus and BlueSky. In 2007, there were also restructuring and rationalisation expenses of \$31m and costs of \$30m from the legal settlement. A further \$21m increase arose due to the inclusion of the expenditure of the Plus business. The remaining increase in expenditure was a result of the growth in the business.

**Research and Development expenses**

Expenditure as a percentage of revenue fell from 4.3% to 4.2%. The Group continues to invest in innovative technologies and products to differentiate itself from competitors.

**BSN agency and management fees**

Agency and management fees of \$25m (2006 — \$25m) were received in respect of services provided to BSN Medical for sales force resource, physical distribution and logistics and administration in certain countries. The calculation of the fees is designed to result in a neutral, cost-recovery position for Smith & Nephew.

**Operating profit**

Operating profit decreased by \$44m to \$493m in 2007 compared with \$537m in 2006, comprising decreases of \$58m in Orthopaedics and \$5m in Advanced Wound Management offset by an increase of \$19m in Endoscopy.

**Net interest (payable)/receivable**

Net interest decreased by \$40m from \$10m receivable in 2006 to \$30m payable in 2007. This was a direct consequence of the additional borrowings put in place to finance the Plus acquisition and the share buy-back programme.

### **Other finance income**

Other finance income increased by \$3m to \$6m in 2007 from \$3m in 2006. This is mainly due to the fact that 2006 included a loss of \$3m on a financial instrument purchased to hedge the anticipated proceeds of the BSN Medical disposal from Euros into US Dollars.

### **Taxation**

The taxation charge decreased by \$3m to \$153m in 2007 from \$156m in 2006. The effective rate of tax before discontinued operations was 32.6%, compared with 28.9% in 2006. The tax charge was reduced by \$49m in 2007 as a consequence of restructuring and rationalisation expenses, acquisition related costs, the legal settlement and amortisation of acquisition intangibles. The effective tax rate was 29.6% after adjusting for these items and the tax thereon.

### **Discontinued operations — net profit on disposal of the Joint Venture**

On 23 February 2006 the Group sold its 50% interest in the BSN Medical joint venture for cash consideration of \$562m. The net profit of \$351m on the disposal of the joint venture is after a credit of \$14m for cumulative translation adjustments, charges of \$27m for transaction and associated costs, provision for indemnity of \$3m and a credit from the release of unutilised taxation provisions of \$23m.

### **Group Balance Sheet**

The following table sets out certain balance sheet data for the years ended indicated:

	2007	2006
	(\$ million)	
Non-current assets . . . . .	2,542	1,586
Current assets . . . . .	1,919	1,645
Total assets . . . . .	<u>4,461</u>	<u>3,231</u>
Non-current liabilities . . . . .	357	241
Current liabilities . . . . .	2,288	816
Total liabilities . . . . .	2,645	1,057
Total equity . . . . .	<u>1,816</u>	<u>2,174</u>
Total equity and liabilities . . . . .	<u>4,461</u>	<u>3,231</u>

Non-current assets increased by \$956m from \$1,586m in 2006 to \$2,542m in 2007. Intangible assets and goodwill increased by \$813m of which \$771m related to the acquisitions of Plus and BlueSky, \$16m came from additions to other intangibles, currency translation added \$72m and amortisation reduced the balance by \$46m. Property, plant and equipment increased by \$107m comprising \$78m relating to acquisitions, additions of \$202m, currency translation of \$23m less depreciation of \$181m and net book value of disposals of \$15m.

Current assets increased by \$274m from \$1,645m in 2006 to \$1,919m in 2007. This was mainly due to the Plus acquisition which was the principal cause of the increase in inventory of \$215m and the increase in trade and other receivables of \$235m. These increases were partially offset by a reduction in cash and bank of \$176m.

Non-current liabilities increased by \$116m from \$241m in 2006 to \$357m in 2007. \$21m of this increase was due to increases in long term borrowings. The retirement benefit obligation increased by \$30m, \$22m of which was due to the Plus acquisition. Deferred tax liabilities increased by \$22m and other payables increased by \$44m as a result of additional long term acquisition consideration. These increases were partially offset by an decrease in provisions of \$1m.

Current liabilities increased by \$1,472m from \$816m in 2006 to \$2,288m in 2007. The main cause of this increase was the \$1,323m increase in borrowings arising from the acquisition of Plus and the share buy-back programme.

Total equity decreased by \$358m from \$2,174m in 2006 to \$1,816m in 2007. The principal movements were an increase of \$316m from attributable profit and \$47m from transactional exchange offset by \$104m of equity dividends paid in the year and \$640m from the purchases of treasury shares.

## Business Segment Analysis

Revenue by business segment and geographic market and trading and operating profit by business segment are set out below:

	2007	2006
	(\$ million)	
<b>Revenue by business segment</b>		
Orthopaedics .....	1,858	1,433
Endoscopy .....	732	648
Advanced Wound Management .....	779	698
Total revenue .....	<u>3,369</u>	<u>2,779</u>
<b>Revenue by geographic market</b>		
Europe (Continental Europe and United Kingdom) .....	1,177	867
United States .....	1,550	1,365
Africa, Asia, Australasia and other America .....	642	547
Total revenue .....	<u>3,369</u>	<u>2,779</u>
<b>Trading profit by business segment</b>		
Orthopaedics .....	423	334
Endoscopy .....	147	123
Advanced Wound Management .....	136	114
Total trading profit .....	<u>706</u>	<u>571</u>
<b>Operating profit by business segment</b>		
Orthopaedics .....	243	301
Endoscopy .....	141	122
Advanced Wound Management .....	109	114
Total operating profit .....	<u>493</u>	<u>537</u>

## Orthopaedics

### Revenue

Orthopaedics (which includes Reconstruction, Trauma and Clinical Therapies) revenue increased by 30% to \$1,858m from \$1,433m in 2006. Of this movement, 13% is attributable to underlying growth, 4% due to favourable currency movements and 13% due to the effect of the acquisition of Plus. The principal factors in the underlying growth in revenues were the continuing expansion in global orthopaedic markets and the growth of recently launched products in the US.

In the US, revenue increased by \$149m to \$1,032m (17%) of which 16% was underlying growth and 1% as a result of acquisitions. The main factors were the continued growth of products launched in recent years including the LEGION and JOURNEY knees and BHR. An increase in the Clinical Therapies sales force also contributed towards increased EXOGEN and SUPARTZ revenues of 22% and 10% respectively.

Outside the US, revenue increased by \$276m to \$826m (50%), of which 9% was underlying growth, 31% as a result of acquisitions and 10% due to foreign currency translation.

Global knee revenue increased by \$125m (25%) to \$634m, of which 4% was due to foreign currency translation, 12% was due to acquisitions and 9% was underlying growth. This compares with the estimated global market growth of 10%.

Global hip revenue increased by \$189m to \$567m (50%) of which 21% was due to underlying growth, 4% was due to foreign currency translation and 25% due to acquisitions. The global hip market grew by an estimated 9%.

Growth in fixation products was 17% of which 10% was underlying growth, 3% due to acquisitions and 2% favourable currency translation.

### ***Trading Profit***

Trading profit rose by \$89m (27%) from \$334m in 2006 to \$423m in 2007 resulting in a trading profit margin decrease from 23.3% to 22.8%. The principal factors were dilutions arising from the acquisition of the Plus business which caused a decline in margin of 1.4% offset by margin increases arising from the EIP.

### ***Operating Profit***

Operating profit decreased by \$58m. This comprises an increase of \$91m in acquisition related costs, \$14m due to restructuring and rationalisation expenses, \$30m due to the legal settlement and \$12m due to an increase in the charge for amortisation of acquisition intangibles less an increase in trading profit of \$89m.

## **Endoscopy**

### ***Revenue***

Endoscopy revenue increased by \$84m, or 13%, to \$732m from \$648m in 2006, comprising 3% favourable currency translation and 10% underlying growth. The global arthroscopy market is estimated to have grown 12% in the year.

In the US, revenue increased by \$18m to \$361m (5%), of which 4% was underlying growth and 1% was from the OBI acquisition in 2006. The main driver of growth was the knee and shoulder repair sector at 10% due to market sector growth and new products, and Visualisation and Digital Operating Room revenues which grew 7% due to the launch of the HD660 camera.

Outside the US, revenue increased by \$66m to \$371m (22%), of which 15% was underlying growth and 7% due to favourable foreign currency translation.

Global revenue of knee and shoulder repair products increased by \$44m to \$264m (20%), of which 16% was underlying growth, 3% due to foreign currency translation and 1% due to the OBI acquisition in 2006.

Revenue in the global resection products sector increased by \$22m to \$267m (9%), of which 6% was underlying growth and 3% due to foreign currency translation.

Global Visualisation revenue increased by \$14m to \$141m (11%), of which 9% was underlying growth and 2% was due to favourable currency.

### ***Trading Profit***

Trading profit increased by \$24m (20%) from \$123m in 2006 to \$147m in 2007 resulting in a trading profit margin increase from 19.0% to 20.1%. This improvement was mainly due to cost savings and efficiencies achieved as a result of the closure of the manufacturing facility in Andover, Massachusetts.

### ***Operating Profit***

Operating profit increased by \$19m of which \$24m was due to trading profit less \$4m of restructuring and rationalisation expenses and \$1m for the amortisation of acquisition intangibles.

## **Advanced Wound Management**

### ***Revenue***

Revenue increased by \$81m, or 12%, to \$779m from \$698m in 2006, comprising 6% favourable currency translation, 5% underlying growth and 1% acquisitions. In the US, revenue increased by \$18m to \$157m (13%), 9% of this was underlying growth and 4% due to acquisitions.

Outside the US, revenue increased by \$63m to \$622m (11%), of which 4% was underlying growth and 7% due to foreign currency translation. Continental Europe revenue increased by 13% of which 9% was favourable currency translation and 4% was underlying growth. Revenues in the UK increased by 11% of which 8% represented favourable currency translation. Underlying growth of 3% was low due to funding constraints in the NHS, the Group's largest customer. Revenues in the German market increased by 12% of which 4% was an underlying increase and 8% favourable currency translation. Growth in Japan was flat.



**Trading Profit**

Trading profit rose by \$22m (19%) from \$114m in 2006 to \$136m in 2007. The trading profit margin increased from 16.3% to 17.5% of which 2.1% was caused by the benefits from the EIP offset slightly by a dilution of 0.9% as a result of the BlueSky acquisition.

**Operating Profit**

Operating profit decreased by \$5m of which \$24m was due to restructuring and rationalisation expenses, \$3m for the amortisation of acquisition intangibles less the increase in trading profit of \$22m.

## FINANCIAL POSITION, LIQUIDITY AND CAPITAL RESOURCES

### Cash Flow and Net Debt

The main elements of Group cash flow and movements in net debt can be summarised as follows:

	2008	2007	2006
		(\$ million)	
Cash generated from operations	815	693	506
Net interest (paid)/received	(63)	(30)	10
Income taxes paid	(186)	(225)	(144)
Net cash inflow from operating activities	566	438	372
Capital expenditure (net of disposal of property, plant and equipment)	(289)	(194)	(222)
Acquisitions (net of cash acquired)	(16)	(781)	(83)
Disposal of joint venture	–	–	537
Equity dividends paid	(109)	(105)	(96)
Proceeds from own shares	4	–	–
Issue of ordinary share capital	19	28	16
Treasury shares purchased	(193)	(640)	–
Change in net debt from net cash flow (see Note 30 of the Notes to the Group Accounts)	(18)	(1,254)	524
Loan Notes issued	–	–	(15)
New finance leases	–	(7)	–
Facility fee	2	(6)	–
Borrowings and finance leases acquired on acquisition	–	(181)	–
Exchange adjustment	(6)	(72)	7
Opening (net debt)/net cash	(1,310)	210	(306)
Closing (net debt)/net cash	(1,332)	(1,310)	210

The Group's net debt increased by \$1,026m from \$306m at the beginning of 2006 to \$1,332m at the end of 2008. Translation of foreign currency net debt into US Dollars had the effect of increasing net debt by \$71m in the three-year period ended 31 December 2008. Closing net debt includes \$4m of net currency swap liabilities (2007 — \$2m, 2006 — \$2m).

### Net Cash Inflow from Operating Activities

Cash generated from operations in 2008 of \$815m is after paying out \$10m of macrotextured claim settlements unreimbursed by insurers, \$48m of acquisition related costs and \$28m of restructuring and rationalisation expenses.

In 2007 cash generated from operations of \$693m was after paying out \$23m of macrotextured claim settlements unreimbursed by insurers offset by a receipt of \$22m from a successful settlement, \$33m of acquisition related costs, \$39m of restructuring and rationalisation expenses and a legal settlement of \$30m.

In 2006 cash generated from operations of \$506m was after paying \$33m for macrotextured claim settlements unreimbursed by insurers, \$4m of acquisition related costs and \$21m of restructuring and rationalisation expenses.

### Capital Expenditure

The Group's ongoing capital expenditure and working capital requirements have been financed through cash flow generated by business operations and, where necessary, through short-term committed and uncommitted bank facilities. In recent years capital expenditure on tangible and intangible fixed assets has represented approximately 6-8% of continuing group revenue.

In 2008 capital expenditure of \$292m (\$289m net of disposals of property, plant and equipment) was incurred. The principal areas of investment were the placement of orthopaedic instruments with customers, patents and licenses, plant and equipment and information technology.

At 31 December 2008, \$27m of capital expenditure had been contracted but not provided for which will be funded from cash inflows.

### Acquisitions and Disposals

In the three-year period ended 31 December 2008, \$880m was spent on acquisitions, funded from net debt and cash inflows. This comprised Plus \$769m, OBI \$71m, BlueSky \$16m, Acticoat \$10m, Collagenase \$5m, MMT \$3m, Versajet \$3m, and \$3m of other acquisitions.

\$537m was received from the disposal of BSN Medical in 2006 (net of costs).

### Liquidity

The Group's policy is to ensure that it has sufficient funding and facilities in place to meet foreseeable borrowing requirements. In May 2007 the Group entered into a committed \$2,500m revolving multicurrency loan facility. This facility comprises a \$1,000m 364 day facility, which was extended into a term loan for a further 4 years in May 2008 by the giving of notice by the Group, and a five year \$1,500m revolving loan facility.

At 31 December 2008, the Group held \$145m in cash and balances at bank. The Group has drawings under uncommitted facilities of \$340m and has committed facilities of \$2,512m. Of the undrawn committed facilities of \$1,182m, \$10m expires in 2009 and \$1,172m in 2012. In addition Smith & Nephew has finance lease commitments of \$31m (of which \$14m extends beyond five years). Smith & Nephew intends to repay the amounts due within one year by using available cash and drawing down on the longer-term facilities.

The principal variations in the Group's borrowing requirements result from the timing of dividend payments, acquisitions and disposals of businesses, the share buy-back programme (announced as suspended in November 2008), timing of capital expenditure and working capital fluctuations. In 2008 the settlement of macrot textured patient claims was a factor which will continue in 2009.

Smith & Nephew believes that its capital expenditure needs and its working capital funding for 2009, as well as its other known or expected commitments or liabilities, can be met from its existing resources and facilities.

The Group's planned future contributions are considered adequate to cover the current under funded position in the Group's defined benefit plans.

Further disclosure regarding borrowings, related covenants and the liquidity risk exposures is set out in Note 21 of the Notes to the Group Accounts. The Group believes that the borrowing facilities do not contain restrictions that are expected to impact on funding or investment policy for the foreseeable future.

### Going Concern

Although, as disclosed in the Risk factors section, the Group is not immune from the current world economic crisis, the Directors do believe that the Group is well placed to manage its business risks successfully despite the current uncertain economic outlook. As such, the Group Accounts have been prepared on a going concern basis.

### Payment Policies

It is the Group's policy to ensure that suppliers are paid within agreed terms. At the year-end, the Parent Company had no trade creditors.

## LEGAL PROCEEDINGS

The Company and its subsidiaries are parties to various legal proceedings, some of which include claims for substantial damages. The outcome of such proceedings cannot readily be foreseen, but except as detailed below management believes, none of them will result in a material effect on the financial position or results of operations of the Group.

### ***Product Liability Claims***

In August 2003 the Group withdrew voluntarily from all markets the macrotextured versions of its OXINIUM femoral knee components. A number of related claims have been filed, most of which have been settled. See "Product Liability". The Group has sought recovery from its insurers with regard to these claims.

To date the primary insurance carrier has paid \$60m in full settlement of its policy liability. An additional \$22m was received from a successful legal settlement. At 31 December 2008, \$124m remains due, and the Group has sought coverage from five other excess insurers. However, these excess carriers have denied coverage, citing defences relating primarily to the wording of the insurance policies. In December 2004, the Group brought suit against them in federal district court in Memphis, Tennessee, and hearing is expected to commence in late 2009.

A charge of \$154m was recorded in 2004 for anticipated expenses in connection with macrotexture claims. Most of that amount has since been applied to settlements of such claims. Management believes that the \$30m provision remaining is adequate to cover remaining claims. Given the uncertainty inherent in such matters, however, there can be no assurance on this point.

### ***Business Practice Investigations***

In March 2005 the US Attorney's Office in Newark, New Jersey issued subpoenas to the five largest sellers of hip and knee implants to US orthopaedic surgeons, including the Group's Orthopaedic business, asking for certain agreements with orthopaedic reconstructive surgeons. In September 2007 the Group and the other four companies involved settled the criminal and civil matters with respect to any charges against the companies that could result from this investigation, without admitting any wrongdoing as part of the settlement. The Group paid a civil restitution payment of \$29m and entered into a Deferred Prosecution Agreement with the US Attorney which obligated the Group to improve its existing compliance program under the scrutiny of a monitor appointed to oversee its efforts. This agreement is for 18 months, set to expire late in March, 2009, and if the Group meets its terms, the criminal charges that are asserted in the agreement will be dismissed. At the same time, the Group also entered into a Corporate Integrity Agreement with the Office of the Inspector General ("OIG") of the US Department of Health and Human Services which requires certain compliance efforts. This agreement is in effect for five years, until September 2012. If the Group meets its terms, the OIG will not attempt to exclude it from receiving Medicare payments for its products. The Group has devoted substantial effort to comply with both agreements and decided to apply the best practices developed in the process to the rest of its business units as well.

In September 2007, the US Securities and Exchange Commission ("SEC") notified the Group that it was conducting an informal investigation of the Group, regarding possible violations of the Foreign Corrupt Practices Act in connection with the sale of medical devices in certain foreign countries. The US Department of Justice has subsequently joined the SEC's request. The Group is cooperating fully with the US Department of Justice and the SEC regarding these matters.

In June 2006, the US Attorney for the Southern District of Indiana obtained subpoenas requiring Smith & Nephew's Orthopaedics business and certain of its competitors to produce documents in connection with an investigation of possible violations of US antitrust and other laws. In March 2008 the Group was notified that the US Attorney had concluded its investigation and closed its file without bringing any action against the subjects of this investigation.

The Group has received similar inquiries from authorities in other jurisdictions from time to time and, as a matter of policy, cooperates fully.

**Patent Disputes**

The Group is engaged, as both plaintiff and defendant, in litigation with various competitors and others over claims of patent infringement. Some of the claims against the Group relate to products sold by its Orthopaedics and Advanced Wound Management businesses, including negative pressure wound therapy products. These disputes are being heard in courts in the United States and other jurisdictions and also before agencies that examine patents.

In June 2008, the Group won a jury verdict in Portland, Oregon against Arthrex Inc., (“Arthrex”) for infringement of a patent relating to suture anchors. Smith & Nephew was awarded approximately \$15m in damages plus approximately \$6m interest and an injunction forbidding further sales of infringing suture anchors by Arthrex. On appeal by Arthrex, the Court of Appeals stayed the injunction pending a hearing. A second lawsuit against other Arthrex suture anchors has also been stayed pending the appeal. Arthrex has also asked the US Patent and Trademark Office to re-examine the patent in question.

**Other Matters**

In 2008 the Group commenced arbitration against the vendors of a company acquired by the Group in 2007, Plus Orthopedics AG, for breach of warranties in the 2007 purchase agreement. In January 2009 the parties agreed to settle all disputes, including those relating to breach of warranty and purchase price adjustment, by reducing the total original purchase price by CHF159m from CHF1,086m (\$889m at the then prevailing rates) paid in May 2007. This amount has been paid in 2009 and the Group has released the vendors from substantially all of their warranties under the original purchase agreement.

In 2006 and 2007, a number of charges were filed with the US Equal Employment Opportunity Commission (“EEOC”) in Memphis, Tennessee, alleging that the Group’s employee hiring, training or promotion practices were discriminatory. A class action law suit was filed in federal court in Memphis in September 2006 with the same allegations. In 2008 the EEOC dismissed the claims filed with it, and the claims in the lawsuit were settled for an amount that will be paid in full by the Group’s employment practices insurer.

## OUTLOOK AND TREND INFORMATION

The discussion below contains statements that express management's expectations about future events or results rather than historical facts. These forward-looking statements involve known and unknown risks and uncertainties that could cause the Group's actual results, performance or achievements to differ materially from those projected in forward-looking statements. Smith & Nephew cannot give assurance that such statements will prove correct. These risks and uncertainties include factors related to: the medical devices industry in general; product liability claims and related insurance coverage; the geographical markets in which the Group operates; the nature and efficiency of the Group's products; the Group's ability to research, develop, manufacture and distribute its products; and the translation of currencies and the values of international securities markets. For additional information on factors that could cause the Group's actual results to differ from estimates reflected in these forward-looking statements, you should read "Risk Factors" of this document.

The markets in which the Group concentrates continue to demonstrate robust growth and are expected to benefit in 2009 and for the foreseeable future from an ageing population, obesity, more active lifestyles and technological developments including less invasive techniques in orthopaedic and endoscopic surgery. In advanced wound management continuing innovation and the potential for further penetration of moist wound healing and wound bed preparation techniques should continue to stimulate expansion of this market. Management continues to seek acquisitions that add to shareholder value.

The long-term demand fundamentals of the Group's industry continue to be favourable, regardless of the current slowdown in the global economy.

In the orthopaedic reconstruction market, management believes the Group is well positioned and expects continued strength from the Group's strong knee portfolio together with a balanced contribution from across its hip range. In the orthopaedic trauma market, management will continue to focus on achieving sustainable revenue growth at about the market growth rate during 2009. Management continues to believe that the Group's Endoscopy business, particularly capital sales, is the most likely to be impacted by the turmoil in the macro-economy. In Advanced Wound Management, the Group is concentrating on delivering an improved US performance and an increasing NPWT contribution as the Group's product range continues to be enhanced.

The Group is focused on extending its track record of delivering innovative products, bringing clinical benefits to patients and economic benefits to healthcare providers. Through the Earnings Improvement Programme the Group is continuing the development of the processes and systems designed to deliver innovation and customer service efficiently, underpinning the Group's target of an annualised 2010 trading margin exit rate of 24.5%. Management is confident that by executing these priorities the Group will continue to deliver sustainable long-term growth for its shareholders.

## CONTRACTUAL OBLIGATIONS

Contractual obligations at 31 December 2008 were as follows:

	Total	Payments due by period			
		Less than 1 year	1-3 years (\$ million)	3-5 years	More than 5 years
Debt obligations .....	1,442	111	2	1,329	–
Finance lease obligations .....	41	7	9	7	18
Operating lease obligations .....	130	47	50	16	17
Retirement benefit obligation .....	41	41	–	–	–
Purchase obligations .....	5	5	–	–	–
Capital expenditure .....	27	27	–	–	–
Other .....	99	63	36	–	–
	<u>1,785</u>	<u>301</u>	<u>97</u>	<u>1,352</u>	<u>35</u>

Other contractual obligations consist of \$4m of credit balances on currency swaps, \$14m of credit balances on interest rate swaps, \$34m of foreign exchange contracts and \$47m of acquisition consideration. Provisions that do not relate to contractual obligations are not included in the above table.

The agreed contributions for 2009 in respect of the Group's defined benefits plans are: \$18m for the UK (including \$10m of supplementary payments), \$14m for the US plan and \$9m for other funded defined benefit plans. The table above does not include amounts payable in respect of 2010 and beyond as these are subject to future agreement and amounts cannot be reasonably estimated.

There are a number of agreements that take effect, alter or terminate upon a change in control of the Company or the Group following a takeover, such as bank loan agreements and Company share plans. None of these are deemed to be significant in terms of their potential impact on the business of the Group as a whole. In addition, there are no service contracts between the Company and any of its directors which provides for compensation for loss of office or employment that occurs because of a successful takeover bid.

## OFF-BALANCE SHEET ARRANGEMENTS

Management believes that the Group does not have any off-balance sheet arrangements, as defined by the SEC in item 5E of Form 20-F, that have or are reasonably likely to have a current or future effect on the Group's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

## RELATED PARTY TRANSACTIONS

Except for transactions with joint ventures and associates (see Note 37 of Notes to the Group Accounts), no other related party had material transactions or loans with Smith & Nephew over the last three financial years.

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# CORPORATE GOVERNANCE

This section discusses Smith & Nephew's structures and governance procedures.

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# THE BOARD AND EXECUTIVE OFFICERS

The Board of Directors of Smith & Nephew as at 11 March 2009 comprised:

Director	Position	Initially elected or appointed	Term of appointment expires at AGM in
John Buchanan	Independent Non-Executive Chairman	3 February 2005	2011
David J. Illingworth	Executive Director, Chief Executive	8 February 2006	2009
Adrian Hennah	Executive Director, Chief Financial Officer	15 June 2006	2010
Dr. Pamela J. Kirby	Independent Non-Executive Director	1 March 2002	2011
Warren D. Knowlton	Independent Non-Executive Director	1 November 2000	2010
Brian Larcombe	Independent Non-Executive Director	1 March 2002	2011
Joseph C. Papa	Independent Non-Executive Director	1 August 2008	2009
Richard De Schutter	Independent Non-Executive Director	1 January 2001	2010
Dr. Rolf W. H. Stomberg	Independent Non-Executive Director	1 January 1998	2009

## ***Directors' Biographies***

John Buchanan (65). Independent non-executive Chairman. He was appointed independent non-executive Deputy Chairman in 2005 and became Chairman in April 2006. He is Chairman of the Nominations Committee. He is Deputy Chairman of Vodafone Group Plc and a non-executive director of AstraZeneca PLC and BHP Billiton. He was formerly Group Chief Financial Officer of BP plc.

David J. Illingworth (55). Chief Executive. He joined the Group in May 2002 as President of Orthopaedics and was appointed a director and Chief Operating Officer in February 2006. In July 2007 he was appointed Chief Executive. He is a member of the Nominations Committee. Prior to joining the Group he held posts within GE Medical, as Chief Executive Officer of a publicly traded medical devices company, President of a respiratory/critical care company and President of a technology incubator company.

Adrian Hennah (51). Chief Financial Officer. He joined the Group and was appointed a director in June 2006. He was previously Chief Financial Officer of Invensys plc and held various senior positions within GlaxoSmithKline.

Dr. Pamela J. Kirby (55). Independent non-executive director. She was appointed a director in March 2002 and is a member of the Remuneration Committee and the Ethics and Compliance Committee. She is non-executive Chairman of Scynexis Inc and a non-executive director of Informa plc and Novo Nordisk A/S.

Warren D. Knowlton (62). Independent non-executive director. He was appointed a director in November 2000 and is Chairman of the Audit Committee and a member of the Remuneration Committee. He is Chairman of Graham Packaging Inc. and a non-executive director of Ameriprise Financial Inc. Previously he was Group Chief Executive Officer of Morgan Crucible plc.

Brian Larcombe (55). Independent non-executive director. He was appointed a director in March 2002 and is a member of the Audit Committee. He is a non-executive director of F&C Asset Management plc and Gate Gourmet Group Holdings. Previously he was Chief Executive Officer of 3i Group plc.

Joseph C. Papa (53). Independent non-executive director. He was appointed a director in August 2008 and is a member of the Ethics and Compliance Committee and the Audit Committee. He is Chairman and Chief Executive of Perrigo Company. Previously he was Chairman and Chief Executive Officer of the Pharmaceutical and Technology Services segment of Cardinal Health Inc., and President and Chief Operating Officer of Watson Pharmaceuticals Inc.

Richard De Schutter (68). Independent non-executive director. He was appointed a director in January 2001 and is Chairman of the Ethics and Compliance Committee and a member of the Audit Committee and the Remuneration Committee. He is non-executive Chairman of Incyte Corporation and a non-executive director of Varian Inc., Ecolab Inc., and Navicure Inc.

Dr. Rolf W. H. Stomberg (68). Independent non-executive director and Senior Independent Director. He was appointed a director in 1998 and is Chairman of the Remuneration Committee and a member of the Audit Committee and Nominations Committee. He is Chairman of Lanxess AG and a non-executive director of Hoyer GmbH, Biesterfeld AG and Severstal.

### **Executive Officers**

The Chief Executive of Smith & Nephew and other senior executives are responsible for the day-to-day management of the Group. In addition to the executive directors, the following are Executive Officers of Smith & Nephew:

Mark Augusti (43). President of Biologics. He joined the Group in 2003 as Vice President of Global Marketing for the Trauma Division and became President Orthopaedic Trauma and Clinical Therapies in February 2006. He was appointed to his current role in January 2008. He previously worked for GE Medical Systems in the US and Asia.

Elizabeth Bolgiano (46). Chief Human Resources Officer. She joined the Group in July 2004, as Senior Vice President Human Resources for the Orthopaedics global business unit. In August 2007, she was appointed Group Human Resources Director. Previously, she was Vice President Human Resources with Bristol-Myers Squibb, where she held a variety of human resources roles during her 15 year tenure.

John W. Campo (54) Chief Legal Officer. He joined the Group in June 2008. Prior to joining the Group he was employed by General Electric Company for 14 years in a variety of roles, including seven years with GE Healthcare (successor to GE Medical Systems) in the US and Asia.

Joseph DeVivo (41). President of Orthopaedics. He joined the Group in June 2007 as President of Orthopaedic Reconstruction and was appointed to his current role in May 2008. Prior to joining the Group he held senior executive positions with RITA Medical Systems Inc, Computer Motion Inc and United States Surgical a division of Tyco Healthcare where he held a wide variety of roles.

Michael Frazzette (47). President of Endoscopy. He joined the Group as President Endoscopy in July 2006. Previously he was President and Chief Executive Officer of a US manufacturer of medical devices and spent 15 years at Tyco Healthcare becoming President of each of Patient Care and Health Systems divisions.

R. Gordon Howe (46). Senior Vice President Global Planning and Development. He joined the Group in 1998, and served in planning and business development roles in the Orthopaedics division. He was appointed to his current role in August 2007. Prior to joining the Group, he held management positions with United Technologies Corporation.

Joe Woody (43). President of Advanced Wound Management. He joined the Group in 2003 as Vice President and General Manager of the Clinical Therapies Division. He was appointed President Advanced Wound Management in February 2006. He previously worked for Alliance Imaging, Acuson and GE Medical Systems.

James A. Ralston retired and Dr. Peter Arnold resigned in 2008.

### **Group Company Secretary**

Paul R. Chambers (64). Company Secretary. He joined the Group in 1994 as Assistant Company Secretary and was appointed Company Secretary in April 2002.

# GOVERNANCE AND POLICY

The Combined Code on Corporate Governance (the “Code”) requires UK listed companies to make a disclosure statement on the application of the Principles and Supporting Principles and compliance with the Provisions of the Code.

The Board is committed to the highest standards of Corporate Governance and considers that it has complied with all relevant provisions of the Code throughout the year, except that:

- i. no member of the Audit Committee has a professional qualification from one of the professional accountancy bodies as recommended by the Smith Guidance. However, the Board considers that all members have relevant financial experience as senior executives of large corporations. The Board further considers that the members of the Audit Committee have the skills and experience of corporate financial matters to discharge properly the Committee’s responsibilities. All members of the Audit Committee are independent, as defined by the New York Stock Exchange (“NYSE”), and meet the definition of ‘financial expert’ in the Sarbanes-Oxley Act in the US; and
- ii. the notice period for David Illingworth, in accordance with his contract of employment on appointment as Chief Executive is up to 24 months from the date of the appointment. In line with the Code such notice period reduces to 12 months in July 2009. The Board considered that such notice period was appropriate in line with competitive practice for external appointments when appointed Chief Executive in 2007.

In accordance with the Code, the following paragraphs describe Smith & Nephew’s Corporate Governance policies and procedures and how it applies the Principles and Supporting Principles in the Combined Code.

The Company’s American Depositary Shares are listed on the NYSE and the Company is therefore subject to the rules of the NYSE as well as the US securities laws and the rules of the US Securities and Exchange Commission (“SEC”) applicable to foreign private issuers. The Board believes that it has complied throughout the year with both SEC and NYSE requirements related to corporate governance except that, in accordance with the Combined Code, the Nominations Committee consists of a majority of independent directors and does not consist wholly of independent directors, as required by the NYSE.

## **The Board**

The Board of Directors of Smith & Nephew consists of an independent non-executive Chairman, two executive directors and six independent non-executive directors. In 2008, the Board met on eight occasions and individual attendance together with attendance at Board Committee meetings, is shown in the table on page 56. If directors are unable to attend a Board meeting or Board Committee meeting, they are advised of matters to be discussed and have an opportunity to make their views known to the Chairman prior to the meeting.

The Board is responsible for the strategic direction and overall management of the Group and has a formal schedule of matters reserved for its decisions which include the approval of certain policies, budgets, financing plans, large capital expenditure projects, acquisitions, divestments and treasury arrangements. Otherwise it delegates the executive management of the Group to the Chief Executive and certain specific responsibilities to Board Committees, as described on page 56. It reviews the key activities and performance of the businesses and considers and reviews the work undertaken by the Committees. Succession planning is regularly reviewed and appropriate measures are taken to ensure the Board has the appropriate balance of skills and experience necessary for a major global medical devices company.

Non-executive directors meet regularly prior to each quarterly Board meeting without management in attendance and the Senior Independent Director meets with the other non-executive directors annually to evaluate the performance of the Chairman. Board meetings are held at the major business units enabling directors to have a greater understanding of the business and to meet the management of these units. All directors have full and timely access to all relevant information and, if necessary, to independent professional advice. Induction programmes are provided for new directors and training is offered to all directors, who are updated regularly on changes to legal and corporate governance requirements. Directors have access to the advice and services of the Company Secretary, who is also responsible to the Board for ensuring that board and governance procedures are complied with. The Chairman and directors meet with institutional shareholders to discuss matters relating to the Board and governance. The executive directors regularly meet with shareholders on issues relating to the Group, including operational and financial performance.

Appropriate directors and officers liability insurance is in place and Deeds of Indemnity have been entered into between the Company and directors. The Deeds of Indemnity allow for indemnification of directors in respect of proceedings brought by third parties and for the Company to provide funds for directors' ongoing costs in defending a legal action as they are incurred rather than after judgement has been given. Individual directors would still be liable to pay any damages awarded to the Company in an action against them and to repay their defence costs to the extent funded by the Company if their defence is unsuccessful.

Whilst the Chairman and Chief Executive collectively are responsible for the leadership of the Group, there is a clear division of respective responsibilities which have been agreed by the Board. The Chairman's primary responsibility is leading the Board including setting its agenda and ensuring its effectiveness. The Chief Executive is responsible for the performance, management and supervision of the Group in accordance with the strategy, policies, budgets and business plans approved by the Board.

The Senior Independent Director is Dr. Rolf Stomberg, whose role includes consulting with members of the Board on issues relating to the Chairman and chairing meetings of the Nominations and Audit Committee in the absence of the Chairman or Chairman of the Audit Committee. He is available to shareholders if they have concerns that cannot be resolved through the normal channels of contact with the Chairman or Chief Executive. While Dr. Stomberg has served on the Board since 1998, the board is satisfied of his independence. Dr Stomberg seeks re-election each year.

In 2008 Consilium Associates conducted an external review which confirmed the Board's high level of effectiveness. While there were some opportunities for improvement, the Board operated within a sound governance framework with practices compliant with the Combined Code.

Individual evaluation of the directors is carried out by the Nominations Committee with particular emphasis on the evaluation of those directors standing for re-appointment at the AGM. The non-executive directors, led by the Senior Independent Director, evaluate the performance of the Chairman.

The Board has determined that none of the non-executive directors or their immediate families has ever had a material relationship with the Group either directly as an employee or as a partner, shareholder or officer of an organisation that has a relationship with the Group. They are therefore considered independent. They do not receive additional remuneration apart from directors' fees, do not participate in the Group's share option schemes or performance related pay schemes, and are not members of the Group's pension schemes. No director of Smith & Nephew is a director of a company or an affiliate in which any other director of Smith & Nephew is a director.

None of the Directors or Executive Officers (or any relative or spouse of such person, or any relative of such spouse, who has the same address as the director or officer, or who is a director or officer of any subsidiary of Smith & Nephew) has any family relationship with any other director or officer nor has a material interest in any contract to which the Company or any of its subsidiaries are or were a party from the beginning of fiscal year 2006 to 11 March 2009.

With effect from 1 October 2008 a director has a duty under the Companies Act 2006 (the "CA 2006") to avoid a situation in which he has or can have a direct or indirect interest that conflicts or possibly may conflict with the interests of the Company. This duty is in addition to the existing duty that a director owes to the Company to disclose to the Board any transaction or arrangement under consideration by the Company. The CA 2006 allows directors of public companies to authorise conflicts and potential conflicts where the Articles of Association contain a provision to that effect. Shareholders approved amendments to the Company's Articles of Association at the Annual General Meeting held on 1 May 2008 which included provisions giving the directors authority to approve such situations and to include other provisions to allow conflicts of interest to be dealt with in a similar way to the position that existed before 1 October 2008. The Board has a procedure when deciding whether to authorise a conflict or potential conflict of interest. Firstly, only independent directors (i.e. those that have no interest in the matter under consideration) will be able to take the relevant decision. Secondly, in taking the decision the directors must act in a way they consider, in good faith, will be most likely to promote the Company's success. In addition, the directors will be able to impose limits or conditions when giving authorisation if they think this is appropriate. There have been no reported conflicts of interest during the year.

Details of the Group's policies on remuneration, service contracts and compensation payments are included in the "Remuneration Report".

## Board Committees

The Board is assisted by the Audit, Remuneration, Nominations and Ethics and Compliance committees, each of which has its own terms of reference, which may be found on the Group's website at [www.smith-nephew.com](http://www.smith-nephew.com). The Company Secretary is secretary to each of the committees. For each of the Committees the Chairman of the Committee reports orally to the Board and minutes of the meetings are circulated to all members of the Board.

### *Audit Committee*

The Audit Committee met on five occasions in 2008 (individual attendance is shown in the table below). The Committee, consisting entirely of independent non-executive directors, is chaired by Warren D. Knowlton. He was appointed to the Committee in February 2001 and became Chairman of the Committee in July 2001. The other members of the Committee are Brian Larcombe who was appointed to the Committee in January 2003, Richard De Schutter who was appointed in February 2001 and Dr. Rolf Stomberg who was appointed in February 1998. In February 2009 Joseph C. Papa was appointed to the Committee. A description of the work of the Committee in 2008 is on pages 59 to 60.

### *Remuneration Committee*

The Remuneration Committee, consisting entirely of independent non-executive directors, met three times in 2008 (individual attendance is shown in the table below) and is chaired by Dr. Rolf Stomberg. The other members of the Committee are Dr. Pamela J. Kirby, Warren D. Knowlton and Richard De Schutter. The Remuneration Committee sets the pay and benefits of the executive directors and Executive Officers, approves their main terms of employment and determines share options and long-term incentive arrangements for the Group. It also reviews senior management succession planning. The Remuneration Report is on pages 63 to 72.

### *Nominations Committee*

The Nominations Committee, consisting of two independent non-executives and the Chief Executive, met twice in 2008 (individual attendance is shown in the table below) and its Chairman, John Buchanan, and members, Dr. Rolf Stomberg and David J. Illingworth attended both meetings. The Committee oversees the Board's plans for succession, recommends appointments to the Board and determines the fees of the non-executive directors. There is a formal and transparent procedure for the appointment of new directors to the Board. Candidate profiles are agreed by the Committee before external consultants are engaged to advise on prospective Board appointees. Shortlisted candidates are interviewed by members of the Committee who then recommend candidates to be interviewed by all members of the Board. The final decision is made by the Board. However there may be occasions when opportunities arise to appoint a new director without all of this process being strictly adhered to. The Senior Independent Director oversees the process for the appointment of a new Chairman.

### *Ethics and Compliance Committee*

The Board established an Ethics and Compliance Committee in August 2008 which has met on four occasions in 2008 (individual attendance is shown in the table below). The Committee is chaired by Richard De Schutter and the other members are Dr. Pamela J. Kirby and Joseph C. Papa. The Committee reviews and approves Group policies as they relate to ethical and compliance matters; the ethical and compliance strategy plans; and the activities and monitoring of the ethical and compliance procedures and processes.

## Board and Committee Attendance

	Board – 8 meetings	Remuneration Committee – 3 meetings	Audit Committee – 5 meetings	Nominations Committee – 2 meetings	Ethics and Compliance Committee – 4 meetings
John Buchanan . . . . .	7	n/a	n/a	2	n/a
David J. Illingworth . . . . .	8	n/a	n/a	2	n/a
Adrian Hennah . . . . .	8	n/a	n/a	n/a	n/a
Dr. Pamela J. Kirby . . . . .	8	3	n/a	n/a	4
Warren D. Knowlton . . . . .	7	3	5	n/a	n/a
Brian Larcombe . . . . .	8	n/a	5	n/a	n/a
Joseph C. Papa (appointed 1 August 2008) . . . . .	4	n/a	n/a	n/a	4
Richard De Schutter . . . . .	8	3	4	n/a	4
Dr. Rolf W. H. Stomberg . . . . .	8	3	5	2	n/a

### **Directors' Re-appointment**

Under Smith & Nephew's articles of association, any director who has been appointed by the Board of Directors since the previous annual general meeting of shareholders, either to fill a casual vacancy or as an additional director, holds office only until the next annual general meeting and then is eligible for reappointment by the shareholders. Subsequently, directors retire and offer themselves for re-election at the third annual general meeting after the meeting at which they were last reappointed. The directors are subject to removal with or without cause by the Board of Directors or the shareholders. Executive Officers serve at the discretion of the Board of Directors.

Joseph C. Papa was appointed a director by the Board on 1 August 2008 and, in accordance with the articles of association, will retire at the annual general meeting to be held in April 2009 and, being eligible, will offer himself for re-election. Dr Rolf Stomberg who has served more than nine years as a director of the Company will retire at the annual general meeting to be held in April 2009 and, being eligible, will offer himself for re-election. In accordance with the articles of association, David J. Illingworth will retire and, being eligible, will offer himself for re-election at the AGM.

## ACCOUNTABILITY, AUDIT AND INTERNAL CONTROL FRAMEWORK

### **Risk Management and Internal Control**

The Board has overall responsibility for the Group's systems of internal control and risk management and for reviewing their effectiveness. These systems which have been in place for 2008 and to the date of approval of the report and accounts involve: the identification, evaluation and management of key risks through a Risk Committee, which reports to the Board annually; and business reviews by the Board of each of the business units. There is a Group Finance Manual which includes financial control standards which are adhered to by the businesses and the Internal Audit function and the external auditors report to the Audit Committee on the effectiveness of these controls. The Audit Committee also reviews reports on compliance with accounting standards; appropriate accounting policies and practises and any changes to these; accounting and reporting issues; going concern assumptions; and anti fraud programmes and controls. It also reviews the risk management process. These systems are reviewed annually by the Board. Whilst not providing absolute assurance against material misstatements or loss, these systems are designed to identify and manage those risks that could adversely impact the achievement of the Group's objectives.

### **Risk Committee**

The Risk Committee is comprised of the executive directors and the executive officers of the Group and is chaired by the Chief Executive. As an integral part of planning and review, management at each of the business units identify the risks involved in their business, the probability of those risks occurring, the impact if they do occur and the actions being taken to manage and mitigate those risks. Areas of potential major impact are reported to the Risk Committee for review at its meetings, which are held twice a year.

The annual Group Risk Report of the Risk Committee to the Board details all principal risks categorised by potential financial impact on profit and share price. The most significant Group risks are reported to the Board quarterly, and will include new key or significantly increased risks along with actions put in place to mitigate such risks. The principal risks are detailed in "Risk Factors" to be found on pages 22 to 26.

In 2008 the effectiveness of the business units' systems to identify and manage material risk were evaluated and the findings reported to the Audit Committee. No material weaknesses were identified in these systems.

### **Management's Report on Internal Control over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934.

Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In accordance with the requirement in the US under s404 of the Sarbanes-Oxley Act management assessed the effectiveness of the Group's internal control over financial reporting as at 31 December 2008. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission in Internal Control-Integrated Framework. Based on its assessment, management has concluded and hereby reports that, as at 31 December 2008, the Group's internal control over financial reporting is effective based on those criteria.

Ernst & Young LLP, an independent registered public accounting firm, has issued an audit report on the Group's internal control over financial reporting as of 31 December 2008. This report appears on page 79.

There has been no change in the Group's internal control over financial reporting during the period covered by this Annual Report that has materially affected, or is reasonably likely to materially affect, the Group's internal control over financial reporting.

### **Disclosures Committee and Evaluation of Disclosure Controls and Procedures**

The Disclosures Committee is chaired by the Chief Executive and comprises the Chief Financial Officer and the Group Director of Corporate Affairs. The secretary is the Company Secretary. The Committee meets as required and approves the release of all major communications to investors, to the UK Listing Authority and the London and New York stock exchanges.



The Chief Executive and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Group's disclosure controls and procedures as at 31 December 2008. Based upon, and as of the date of, that evaluation, the Chief Executive and Chief Financial Officer concluded that the disclosure controls and procedures were effective.

#### **Code of Conduct and Business Principles**

The Code of Business Principles, which includes the Group's whistleblowing policy is available at [www.smith-nephew.com/sustainability2008](http://www.smith-nephew.com/sustainability2008) and is available on request, apply to all directors, officers and employees. Any breaches of the Code are reported to the Company Secretary who is obliged to raise the issue with the Chief Executive or Chairman and the Audit Committee. During 2008 and up until 11 March 2009 no waivers have been put in place nor any amendments made to the Code.

In 2008, the Ethics and Compliance Committee approved a Code of Conduct and Business Principles and was issued to the majority of employees in January 2009. The Code sets out the basic legal and ethical principles for carrying out business and applies both to employees and those who act on the Company's behalf. It is in two parts. The first part sets out in detail how persons covered by the Code are expected to ethically interact with healthcare professionals and government officials. The second part which is to be issued later in 2009 will cover the broader issues of ethics and compliance throughout the business and will include an updated version of the Code of Business Principles. A copy of the Code can be found at <http://compliance.smith-nephew.com>

The new Code of Conduct and Business Principles includes a revised whistle blowing policy which now enables persons in the majority of jurisdictions where the Company operates to contact the Company anonymously through an independent provider, Silent Whistle. This procedure has been in place in the US throughout 2008. All calls and contacts are investigated and the appropriate action taken when necessary.

#### **Code of Ethics for Senior Financial Officers**

The Board of Directors has adopted a Code of Ethics for senior financial officers, which is available at [www.smith-nephew.com/sustainability2008](http://www.smith-nephew.com/sustainability2008) and is available on request. It applies to the Chief Executive, the Chief Financial Officer, Group Financial Controller and the Group's senior financial officers. There have been no waivers to any of the Code's provisions nor any amendments made to the Code during 2008 or up until 11 March 2009.

#### **Activities of the Audit Committee for 2008**

The Audit Committee's remit, which is set out in its terms of reference, includes responsibility for:

- monitoring the integrity of the Group's accounts, ensuring that they meet statutory and associated legal and regulatory requirements and reviewing significant financial reporting judgments contained in them;
- monitoring announcements relating to the Group's financial performance;
- monitoring and reviewing the effectiveness of the Group's internal audit function;
- recommending for shareholder approval, the appointment, re-appointment and removal of the external auditors, as appropriate;
- approving the remuneration and terms of engagement of the external auditors;
- monitoring and reviewing the external auditors' independence and the effectiveness of the audit process;
- pre-approval of the external auditors to supply non-audit services;
- monitoring the effectiveness of internal financial controls and reviewing compliance with s404 of the Sarbanes-Oxley Act 2002;
- reviewing the operation of the risk management process; and
- reviewing arrangements by which staff may raise complaints against the Group regarding financial reporting or other matters.

The Group has specific policies which govern:

- the conduct of non-audit work by the external auditors which prohibits the auditors from performing services which would result in the auditing of their own work, participating in activities normally undertaken by management, acting as advocate for the Group and creating a mutuality of interest between the auditors

and the Group, for example being remunerated through a success fee structure. Each year, the Audit Committee pre-approves the budget for fees relating to audit and non-audit work, including taxation services, in accordance with a listing of particular services. In the event that limits for these services are expected to be exceeded or the Group wants the external auditors to perform services that have not been pre-approved, approval by the Chairman of the Audit Committee is required, together with a notification to the Audit Committee of the service and the fees involved. All services provided by the independent auditors during the year were pre-approved by the Audit Committee; and

- audit partner rotation, which is in accordance with the Auditing Practices Board Ethical Standards in the UK and the SEC rules in the US. Partners and senior audit staff may not be recruited by the Group unless two years has expired since their previous involvement with the Group.

The Chief Executive, the Chief Financial Officer and other members of management and the Board attend the meetings when necessary and the external auditors have unrestricted access to the Audit Committee. The Audit Committee meets without management in attendance, when appropriate, and meets with the auditors, without management present, from time to time.

The principal activities of the Audit Committee during the year ended 31 December 2008 included:

- consideration of the quarterly, interim and preliminary results and the annual accounts;
- consideration of the Group's compliance with s404 of the Sarbanes-Oxley Act 2002;
- consideration of compliance with accounting standards, appropriate accounting policies and practices, accounting and reporting issues and going concern assumptions;
- a review of the Group's approach to internal financial control, its processes, outcomes and disclosures;
- a review of the Internal Review department's activities for the year, together with its resource requirements and findings;
- a review of 'whistleblowing' procedures;
- a review of the reports from the auditors, Ernst & Young LLP, on their professional and regulatory compliance in order to maintain independence and objectivity, including the rotation of partners;
- a review of the audit, audit-related, tax and other services provided by Ernst & Young LLP;
- review and the pre-approval of all services provided by the auditors during the year including all non-audit work performed by the auditors together with associated fees, to ensure that the objectivity and independence of Ernst & Young LLP as auditors of the Group was not compromised. Ernst & Young LLP only provided advisory work in respect of accounting and tax related matters;
- consideration of Ernst & Young LLP's in-depth reports to the Committee on the scope and outcome of the annual audit and management's response. Their reports included accounting matters, governance and control and accounting developments;
- a review of the effectiveness of the performance of Ernst & Young LLP effected by the completion of a questionnaire by the units audited within the Group and by the members of the Committee;
- recommending the re-appointment of Ernst & Young LLP as the Group's auditors;
- confirmation that no concerns were raised with the Committee about possible improprieties in matters of financial reporting or other matters;
- reviewing the Committee's terms of reference to ensure they reflect developments in corporate governance in the UK and the US;
- consideration of the Group's risk management process; and
- an evaluation of its own performance during the year, effected by means of a questionnaire and individual discussions.

The Committee may obtain legal and other independent professional advice, at the Company's expense, as it deems necessary. During the year, no such advice was sought by the Committee.

### Principal Accountant Fees and Services

Fees for professional services provided by Ernst & Young LLP, the Group's independent auditors in each of the last two fiscal years, in each of the following categories were:

	2008	2007
	(\$ million)	
Audit .....	5	4
Audit-related .....	—	—
Tax .....	3	3
Other .....	1	1
	<u>9</u>	<u>8</u>

Audit fees include fees associated with the annual audit and local statutory audits required internationally. In 2008 other fees related to aborted acquisition costs. In 2007, other fees related to the acquisition costs for Plus. A more detailed breakdown of audit fees may be found in Note 38 of the Notes to the Group Accounts.

### Disclosure of Information to the Auditors

In accordance with s234ZA of the Companies Act, the directors serving at the time of approving the Directors' Report confirm that, to the best of their knowledge and belief, there is no relevant audit information of which the auditors, Ernst & Young LLP, are unaware and the directors also confirm that they have taken reasonable steps to be aware of any relevant audit information and, accordingly, to establish that the auditors are aware of such information.

### Auditors

Ernst & Young LLP have expressed their willingness to continue as auditors and resolutions proposing their reappointment and to authorise the directors to fix their remuneration, which have been approved by the Audit Committee, will be proposed at the AGM.

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# REMUNERATION REPORT

## The Remuneration Committee

The Committee, which comprises Dr. Rolf Stomberg (Chairman), Dr. Pamela J. Kirby, Warren D. Knowlton and Richard De Schutter, determines the compensation of executive directors, executive officers and the broad policy for executive remuneration. The Committee is assisted by David J. Illingworth, Chief Executive and Elizabeth Bolgiano, Chief Human Resources Officer, both of whom have advised on all aspects of the Group's reward structures and policies but neither is present at any discussion concerning their own remuneration. The Chairman, John Buchanan, attends the meetings when possible and offers the Committee a valuable perspective.

The Committee reviews:

- on an annual basis the remuneration, including pension entitlements, of executive directors and executive officers;
- the relationship between the remuneration of executive directors and that of other employees;
- the competitiveness of executive remuneration using data from independent consultants on companies of similar size, technologies and international complexity;
- the performance targets for the bonus plans and long-term incentive plans and the performance against the targets;
- the operation of, and determines the participants and overall grant levels under the long-term incentive plans, share option schemes and the performance related bonus plan; and
- proposals for management succession.

The terms of reference, which are available on the Company's website at [www.smith-nephew.com](http://www.smith-nephew.com), enable the Committee to obtain its own external advice on any matter, at the Company's expense. During the year, the Committee received information from a number of independent consultants appointed by the Company: Deloitte LLP on a broad range of remuneration issues and on long-term incentive plan comparative performance and Towers Perrin, Watson Wyatt and Mercer on salary data when considering base salaries of executive directors and executive officers. Deloitte LLP has provided taxation advice to the Group, Towers Perrin and Mercer have provided general salary data and Watson Wyatt has advised on various compensation matters below Board level.

## Remuneration Policy

The remuneration policy, as approved by the Remuneration Committee, is designed to ensure that remuneration is sufficiently competitive to attract, retain and motivate executive directors and executive officers of a calibre that meets the Group's needs to achieve its business objectives. Remuneration includes base pay and benefits which are referenced to median competitive levels for acceptable performance, and incentive schemes which are designed to motivate and reward for outperformance. Remuneration packages are benchmarked by reference to appropriate UK and US companies and where relevant other local markets. Individual remuneration levels are based on measurable performance against fair and open objectives and there are no automatic pay adjustments unless required by law or local protocol.

The policies described in this report have been applied throughout 2008. Whilst it is intended that these policies will continue to apply in 2009 and subsequent years, the Remuneration Committee has an ongoing process for monitoring its policies, including its arrangements for performance based pay, against evolving market practice and relevant guidance. This is particularly relevant in the current climate as the depth of the economic downturn continues to evolve. Where changes are proposed these would only be implemented following a consultation, review and approval process deemed to be appropriate for such change. Major changes to the remuneration policy are discussed with the Group's principal shareholders.

## The Principal Components of Remuneration

The remuneration package for the Company's senior executives for 2008 and 2009 comprises the following elements:

- Basic salary;
- Annual bonus with a deferred element under the Deferred Bonus Plan;
- Long-term incentives, comprising Performance Share Plan awards and share options; and
- Pension entitlement and other benefits.

### (a) Basic Salary and Benefits

Basic salary reflects the responsibility of the position and individual performance. Salaries are reviewed annually with effect from 1 April each year. The Committee agreed the following base salaries with effect from 1 April 2008:

David J. Illingworth .....	£700,000
Adrian Hannah .....	£500,000

Since 1 January 2009, David Illingworth has had his salary denominated in US dollars reflecting his status as a US citizen.

Following the annual review conducted in February 2009, it was decided that, with effect from 1 April 2009, Adrian Hannah's salary would be increased by 3% and David Illingworth's salary would remain unchanged.

The Group also provides certain benefits such as private healthcare coverage and a company car or allowance in line with competitive practice. The Remuneration Committee considers any pension consequences and costs to the Company when determining basic salary increases for executive directors and executive officers.

### (b) Performance Related Bonus and Deferred Bonus Plan

For executive directors, the Group operates an annual bonus scheme. The scheme is designed to encourage outstanding performance without promoting excessive risk taking to achieve short term bonus opportunity. In 2009, 50% of the annual bonus will be based on annual growth in EPSA, 25% will be based on earnings improvements targets and 25% on personal objectives.

The Deferred Bonus Plan is designed to encourage executives to build-up and maintain a significant shareholding in the Company. Under the plan, one third of any bonus earned at target level or above by an executive director will be compulsorily deferred into shares which vest, subject to continued employment, in equal annual tranches over three years (i.e. one third each year). No further performance conditions will apply to the deferred shares. No bonus deferral occurs for below target level performance.

The maximum annual bonus opportunity for executive directors is 150% of annual salary, of which one third will be compulsorily deferred. The maximum cash bonus opportunity therefore is 100% of salary. The target bonus award for 2009 is 100% of salary and is unchanged from 2008. Bonuses are not pensionable.

For executive officers with corporate responsibilities, the 2009 annual bonus plan will be linked to EPSA growth, earnings improvement targets and personal objectives. For those executive officers with specific business unit responsibilities, targets will be linked to EPSA growth, sales growth, trading profit, margin and earnings improvement targets of their respective business unit. One quarter of the annual bonus earned at target level or above, will be compulsorily deferred into shares, which vest in equal annual tranches over three years, subject to continued employment.

In respect of 2008, the annual bonus targets for executive directors related 75% to annual growth in EPSA and 25% was based on personal objectives underpinned by asset velocity measurements. On this basis, the actual bonus earned in 2008 by executive directors is shown in the table on page 69 and was 67% of the maximum award.

### (c) Long-Term Incentives

#### (i) Performance Share Plan ("PSP")

The performance measures of the Performance Share Plan are aligned with Smith & Nephew's growth strategy, and balance a requirement for strong sustainable financial performance with the alignment of executives' and shareholders' interests through providing reward opportunity linked to the creation of shareholder value.

The initial market value of awards made to executive directors is equivalent to 150% of their basic annual salary and the initial market value of the awards made to executive officers is equivalent to 75% of their basic annual salary. These values are before the application of the TSR multiplier.

Annual awards over shares made under the Performance Share Plan will only vest if pre-defined levels of EPSA growth are achieved. The number of shares that are delivered may be increased if superior total shareholder returns are achieved. There is no retesting.

For awards made in 2008, 25% of the award will vest if growth in EPSA over the three years ending 31 December 2010 is 43% (i.e. 13% compounded annually), with 50% vesting if such growth is 64% (i.e. 18% compounded annually). Only if growth in EPSA over that period exceeds 82% (i.e. 22% compounded annually) will all of the award vest.

PSP awards are made in the second half of the financial year. The Remuneration Committee believes any financial performance targets should be robust and appropriate in the context of market conditions at the time the award is granted. It is intended that the targets for the 2009 award will take account of the economic climate in which the Company is operating and will continue to be stretching and subject to achievement of excellent EPSA and TSR performance.

In order to drive enhanced shareholder value and maintain close alignment of executives' and shareholders' interests, the number of shares delivered to executives for awards made in 2008 and to be made in 2009 may be increased, subject to the achievement of superior TSR measured against the major companies in the medical devices industry.

The TSR of the Group's shares as listed on the London Stock Exchange will be measured over the performance period and compared with the TSR of the medical devices comparator companies using a common currency. If the Company's TSR is positioned above median, the number of vested shares made available to the individual following the achievement of the EPSA targets will be increased by a multiplier as follows:

<b>TSR ranking within comparator group</b>	<b>Multiplier</b>
Median or below . . . . .	No multiplier (i.e. 1.0)
Upper quartile . . . . .	1.3 x
Upper decile or above . . . . .	1.5 x

The multiplier increases on a straight line basis between the above points.

TSR will be measured relative to a tailored sector peer group of medical devices companies. The companies in the comparator group for the 2008 and 2009 awards are:

Arthrocare	KCI
Bard	Medtronic
Baxter	Nobel Biocare
Becton Dickinson	Nuvasive
Boston Scientific	Orthofix
Coloplast Group	Stryker
Conmed	St Jude Medical
Covidien	Synthes-Stratec
Edwards Life Sciences Corp	Wright Medical
Johnson & Johnson	Zimmer

The Group's TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by Deloitte LLP.

For awards made in 2006 (when performance was measured against the FTSE 100 and the medical devices group of companies) which vested in 2008, 46% vested as the Company was ranked 39<sup>th</sup> in the FTSE 100 comparator group and 8<sup>th</sup> in the medical devices group.

### ***(ii) Executive Share Options***

Share options are granted under the 2004 Executive Share Option Plan and 2001 UK Approved Plan to executive directors. Under the 2004 Plan, the maximum market value of options which may be granted each year is equivalent to the basic annual salary of the participant. Share options are exercisable up to ten years from the date of grant and are only exercisable if graduated target levels of growth in EPSA over the three-year performance period are achieved, beginning with that in which the share option is granted. Options granted under the 2001 UK Approved Plan up to a value of £30,000 will form part of the overall grant. Performance conditions for these awards will be the same as for the 2004 Plan.

The performance targets for each grant are set by the Remuneration Committee and will be linked to the Group's long term strategy. There is no retesting of performance conditions nor is performance adjusted retrospectively.

For awards made in 2008, 25% of the options will vest if growth in EPSA over the three-year period ending 31 December 2010 is 43% (i.e. 13% compounded annually) with 50% vesting if such growth is 64% (i.e. 18% compounded annually). Only if growth in EPSA over that period exceeds 82% (i.e. 22% compounded annually) will all of the options vest. Share options will vest pro rata on a straight-line basis if growth in EPSA is between these levels. There is no retesting of performance conditions.

Share options are granted in the second half of the financial year, at the same time as PSP awards. As noted above in respect of PSP awards, the performance targets for the 2009 share options will be considered at the time awards are granted. However, the performance targets will continue to be stretching in the context of market conditions at that time.

For awards made in 2006, 59% of the options granted under the 2004 Executive Share Option Plan, will vest in 2009. This is as a consequence of EPSA growth of 44% (adjusted to exclude certain costs relating principally to the integration of Plus and to compliance activities, on which guidance was provided to the market during the year).

### ***(iii) Co-investment Plan***

The 2004 Co-Investment Plan has now been replaced by the Deferred Bonus Plan. Therefore no awards will be made under the Plan in 2009 and thereafter.

The Plan enabled executive directors and senior executives to take part of their annual bonus in the form of shares. Under the Plan, the participant elected the level of bonus to be used for this purpose up to a maximum of one half of annual gross bonus capped at 20% of basic annual salary. The net amount of the gross amount elected was then used to purchase shares.

For the March 2008 award (based on executives' 2007 bonus), provided such shares are held for three years and the participant remains employed within Smith & Nephew, the participant will be entitled to matching shares if the Company achieves a target level of growth in EPSA over that three year period of 60% (i.e. 17% compounded annually). At this level, the participant is entitled to one matching share for every share acquired out of the gross equivalent amount of the net bonus used to acquire shares. If growth in EPSA is 70% (i.e. 19% compounded annually) or more, the participant is entitled to two matching shares for each share acquired out of the gross equivalent amount of the net bonus used to acquire shares. There is no sliding scale or pro rata vesting of matching awards between these performance levels, nor is there any retesting.

For awards made in 2006 which vested in 2008 the Committee has determined that one matching share will vest as the adjusted EPSA growth as outlined above, over the three year performance period was 44%.

### ***(iv) Restricted stock awards ("RSA")***

The issue of restricted stock to senior executives will be considered in exceptional circumstances, for example external recruitment, subject to the approval of the Remuneration Committee. However no awards of restricted stock were made to executive directors in 2008.

### **(d) Shareholding requirements**

Senior executives are expected to build and maintain a personal equity stake in the Company. Executive directors are required to accumulate a personal holding equivalent to 200% of basic salary within five years and executive officers are required to accumulate a personal holding equivalent to 150% of basic salary within five years.



## (e) Pensions

### ***Pensions — UK***

UK based executive directors and executive officers have a normal retirement age of 62. They either participate in a defined contribution plan to which a company contribution of 30% of base salary is made or have a non-pensionable, non-bonusable salary supplement of 30% of base salary. Death in service cover of seven times salary (of which four times is provided as a lump sum) is provided on death.

### ***Pensions — US***

US based executive directors and executive officers participate in either the defined benefit Smith & Nephew US Pension Plan or the defined contribution US Savings Plan 401(k) Plus. New executives would enter the US Savings Plan 401(k) Plus. Under the US Pension Plan, pensions accrue at an annual rate of approximately one-sixty second of final pensionable salary up to a limit based on service of 60% of final pensionable salary. The plan also provides for a spouse's pension at the rate of one half of the member's pension on death. Normal retirement age under the plan is 65. For executives in the defined benefit US pension plan a supplementary plan is used to enable benefits to be payable from age 62 without reduction for early retirement. A supplementary defined contribution plan is used to compensate for the earnings cap imposed by the US Internal Revenue Code and to provide additional retirement benefits.

### ***Other Long-Term Incentive Plans***

Certain executives below the executive director level are eligible to participate under the Group's other long-term incentive plans. The Remuneration Committee determines the value of awards granted to such executives.

Eligible UK participants may be granted options under the 2001 UK approved Share Option Plan and the 2001 UK Unapproved Share Option Plan. The exercise of these options is subject to EPSA growth of not less than RPI plus 3% per annum, on average, over the three year performance period. There is no retesting of the performance conditions. The awards made in 2006 will vest in 2009 as EPSA growth over the three year performance period exceeded the RPI plus 3% target.

Eligible US participants may be granted options under the 2001 US Share Plan. In line with US market practice, options granted under the 2001 US Share Plan are not subject to performance targets. Awards made prior to 2008 are exercisable cumulatively up to a maximum of 10% after one year, 30% after two years, 60% after three years and the remaining balance after four years. For awards made in 2008 and thereafter, options vest in equal tranches over three years. Awards of restricted stock under the 2001 US Share Plan are not subject to performance targets but are subject to the executive remaining with the Group for a specified period, normally two years.

Executive share options under all schemes are not offered at a discount to the market value at the time of grant and would vest on a change in control.

UK executive directors and executive officers are eligible to participate in the Smith & Nephew Employee Share Option Scheme (ShareSave) and US executive directors and executive officers are eligible to participate in the Employee Stock Purchase Plan. Both these plans are available to all UK or US employees with three months service and are not subject to performance conditions.

### **Total Reward Composition**

The general statement on Remuneration Policy on page 63 sets out the approach taken when setting different elements of pay. In 2008, excluding pension entitlements, the composition of remuneration for both David J. Illingworth and Adrian Hennah was: base pay (fixed) 24%, annual bonus earned (variable) 24%, and the present economic value of long-term incentives (variable) 52%. For executive officers base pay (fixed) was 33%, annual bonus earned was 23% and long term incentives 44%.

### **Service Contracts**

All appointments of executive directors are intended to have twelve month notice periods, but it is recognised that for some new appointments a longer period may initially be necessary for competitive reasons, reducing to twelve months thereafter.

David J. Illingworth was appointed to the Board of Directors in February 2006. He has a service agreement dated June 2007, the date of his appointment as Chief Executive, which expires on his 62<sup>nd</sup> birthday in 2015. The Remuneration Committee approved that on initial appointment as Chief Executive, his notice period would be effectively 24 months. However, on expiry of this initial term (i.e. with effect from 30 June 2009), his notice period will reduce to 12 months.

Adrian Hennah, was appointed to the Board of Directors in June 2006, and has a service agreement dated June 2006 which expires on his 62<sup>nd</sup> birthday in 2019. Adrian Hennah's service agreement is terminable by the Company on 12 months notice.

The agreements are terminable by the executive director on six months notice. There is no enhancement of termination rights on a change of control of the Group. On termination of the contract by the Group, except for 'cause', executive directors are entitled to basic salary over the relevant notice period, a bonus at target, a contribution to reflect the loss of pension benefits, an amount to cover other benefits and a time apportionment of senior executive share plan entitlements. The Group has a policy of not rewarding failure and the Committee will review all circumstances in determining whether to invoke mitigation.

### **External Non-executive Directorships**

Appointments for executive directors as a non-executive director of another company are subject to the approval of the Nominations Committee and are restricted to one appointment for each executive director. Fees earned would be paid to the individual. Currently, neither of the executive directors holds such an appointment.

### **Non-executive Directors**

Non-executive directors do not have service contracts but instead have letters of appointment. Non-executive directors are normally appointed for terms of three years terminable at will, without notice by either the Group or the director and without compensation. The Chairman has a six month notice period. The remuneration of the non-executive directors is determined by the Nominations Committee which aims to set fees that are competitive with other companies of equivalent size and complexity. Non-executive directors are expected to accumulate a personal holding in the Company equivalent to their annual basic fee, within three years. They are not eligible for awards under the Company's long term incentive plans, nor is any part of their fee paid in shares.

The Chairmen of the Audit, Remuneration and Ethics and Compliance Committees and the Senior Independent Director receive an extra £8,500 for their additional responsibilities. In 2008, Dr. Rolf Stomberg waived his extra fee entitlement due to him as Senior Independent Director. An additional fee of £3,000 is paid to non-executive directors each time inter-continental travel is necessary to attend company business meetings.

During 2008, the Nominations Committee resolved to pay overseas non-executive directors in the currency of their country of origin rather than in Sterling.

The information set out on pages 69 to 71 has been audited by Ernst & Young.

## Directors' Emoluments and Pensions

	Salaries and fees	Benefits (i)	Bonus (iv)	Salary supplement in lieu of pension	Total 2008 (v)	Total 2007 (v)
	(thousands)					
Chairman (non-executive):						
John Buchanan	£350	–	–	–	£350	£325
Executive Directors:						
David J. Illingworth	£694	£16	£700	£203	£1,613	£1,199
Adrian Hennah	£494	£21	£503	£148	£1,166	£1,063
Non-executive Directors: (iii)						
Dr. Pamela J. Kirby	£57	–	–	–	£57	£54
Warren D. Knowlton	\$152	–	–	–	\$152	£68
Brian Larcombe	£57	–	–	–	£57	£54
Joseph C. Papa (appointed August 2008)	\$64	–	–	–	\$64	–
Richard De Schutter	\$141	–	–	–	\$141	£60
Dr. Rolf W. H. Stomberg	€98	–	–	–	€98	£62
Former Directors:						
Sir Christopher O'Donnell (ii)	–	–	–	–	–	£974

(i) Benefits shown in the table above include cash allowances and benefits in kind.

(ii) Retired in July 2007

(iii) As from 1 January 2008, non-executive directors have been paid in the currency of their residential country. Prior to this date, these directors were paid in Sterling.

(iv) A third of the total bonus shown above will be deferred by the purchase of shares on the open market, which will vest equally over three years.

(v) Total executive and non-executive directors emoluments for 2008 amounted to \$6,450,000 (2007 — \$7,714,000, 2006 — \$6,535,000).

### (a) Pensions

	Accrued pension as at 1 Jan 2008	Increase in accrued pension excluding inflation	Increase in accrued pension due to inflation	Accrued pension at 31 Dec 2008	Transfer value of accrued pension at 1 Jan 2008	Directors' contributions during 2008	Increase in transfer value over year less directors' contributions	Transfer value of accrued pension at 31 Dec 2008
	(\$ thousands per annum)				(\$ thousands)			
David J. Illingworth	3	–	–	3	12	–	6	18

Nil (2007 — £78,000) was provided under the US defined contribution arrangements and £203,000 (2007 — £34,000) was provided under an International pension plan for David J. Illingworth.

No amounts have been paid to third parties in respect of directors' services and no excess retirement benefits or compensation have been paid to past directors.

## (b) Directors' Share Options

	Options 1 Jan 2008	Granted during 2008	Exercise price of options granted	Exercised during 2008	Lapsed during 2008	Options 31 Dec 2008	Average exercise price	Range of exercisable dates of options held at 31 Dec 2008
	(Number)	(Number)	(p)	(Number)	(Number)	(Number)	(p)	(Date)
David J. Illingworth (i) .....	100,000	—	—	—	—	100,000	402.0	05/06–12/09
(ii) .....	364,862	112,540	622.0	—	(26,875)	450,527	595.1	01/08–08/18
<b>Total</b> .....	<b>464,862</b>	<b>112,540</b>		<b>—</b>	<b>(26,875)</b>	<b>550,527</b>		
Adrian Hennah (i) .....	103,686	—	—	—	—	103,686	434.0	06/09–06/16
(ii) .....	71,827	80,385	622.0	—	—	152,212	615.4	03/10–08/18
(iii) .....	2,107	—	—	—	—	2,107	455.5	11/10–04/11
<b>Total</b> .....	<b>177,620</b>	<b>80,385</b>		<b>—</b>	<b>—</b>	<b>258,005</b>		

(i) Options granted under Executive Share Option Plans at prices below the market price at 31 December 2008 of 438.5p.

(ii) Options granted under Executive Share Option Plans at prices above the market price at 31 December 2008 of 438.5p.

(iii) Options granted under the UK ShareSave schemes.

The range in the market price of the Company's Ordinary Shares during the year was 413p to 691p and the market price at 31 December 2008 was 438.5p. There were no share option exercises by Directors in service during the year (2007 — Sir Christopher O'Donnell gain of £3,333,368).

On 11 February 2009, 41% of the options that were granted to David J. Illingworth and Adrian Hennah in 2006 under the 2004 Executive Share Option Plan lapsed as only 59% of the original grant vested in accordance with performance criterion.

## (c) Long-Term Incentive Plan Awards

	Award type	Maximum number of shares awarded at 1 Jan 2008	Awards during the year	Market price on award	Vested Award	Market price on vesting	Lapsed award	Number of shares awarded at 31 Dec 2008	Latest performance period
		(Number)	(Number)	(p)	(Number)	(p)	(Number)	(Number)	(Date)
David J. Illingworth .....	PSP	272,136	168,810	621.5	(5,675)	616.0	(27,715)	407,556	2010
.....	RSA	129,655	—	—	(48,355)	438.5	—	81,300	2009
<b>Total</b> .....		<b>401,791</b>	<b>168,810</b>		<b>(54,030)</b>		<b>(27,715)</b>	<b>488,856</b>	
Adrian Hennah .....	PSP	211,426	120,578	621.5	—	—	—	332,004	2010
.....	RSA	57,603	—	—	—	—	—	57,603	2009
<b>Total</b> .....		<b>269,029</b>	<b>120,578</b>		<b>—</b>		<b>—</b>	<b>389,607</b>	

On 11 February 2009, 54% of the awards to David J. Illingworth and Adrian Hennah in 2006 under the 2004 Performance Share Plan lapsed as only 46% of the original award vested in accordance with the performance criterion.

## (d) Co-investment Plan Awards

The number of matched shares to be allocated to each Executive Director is subject to the growth in EPSA over a three-year period. Details of the Plan can be found on page 66.

	Total matched Award as at 1 Jan 2008	Shares acquired with net bonus in March 2008 (i)	Matched Share award during year	Matched award vested during year	Lapsed awards	Total Matched Share award at 2 x gross bonus held at 31 Dec 2008
David J. Illingworth ..	57,650	—	—	—	(17,780)	39,870
Adrian Hennah .....	27,042	9,156	31,256	—	—	58,298

(i) Market price at date of award in March 2008 was 590.5p.

Awards over 11,850 shares made in 2006 to David J. Illingworth under the 2004 Co-investment Plan vested on 11 February 2009 at one times gross bonus, as performance conditions were met.

## Senior Management Remuneration

The Group's administrative, supervisory and management body ('the senior management') comprises, for US reporting purposes, executive directors and the executive officers.

In respect of the financial year 2008, the total compensation (excluding pension emoluments but including payments under the performance related bonus plans) paid to the senior management for the year was \$11,059,000 (2007 — \$14,818,000, 2006 — \$11,979,000), the aggregate increase in accrued pension benefits was \$12,000 (2007 — decrease of \$4,000, 2006 — increase of \$173,000) as a number of executives took a lump sum on retirement and the aggregate amounts provided for under the supplementary schemes was \$507,000 (2007 — \$544,000, 2006 — \$566,000).

During 2008, senior management were granted options over 504,977 shares and 5,549 restricted stock awards under the Executive Share Option Plans, nil shares under the employee ShareSave schemes and awarded 319,532 shares and 33,681 ADSs under the 2004 Performance Share Plan and 18,918 shares and 2,489 ADSs under the Co-investment Plan. As of 11 March 2009, the senior management (9 persons) owned 18,917 shares and 44,291 ADSs, constituting less than 1% of the issued share capital of the Company. Senior Management also held, as of this date, options to purchase 1,391,854 shares; 237,188 restricted stock awards and 598,262 shares and 83,317 ADSs awarded under the Performance Share Plan and 34,194 shares and 11,761 ADSs under the Co-investment Plan.

## Directors' Interests

Beneficial interests of the Directors in the Ordinary Shares of the Company are as follows:

	11 Mar 2009 (i)		31 December 2008		1 January 2008 or date appointed	
	Shares (ii)	Options	Shares (ii)	Options	Shares (ii)	Options
	(Number)					
John Buchanan . . . . .	151,792	–	151,792	–	121,131	–
David J. Illingworth . . . . .	144,690	519,865	144,690	550,527	51,045	464,862
David J. Illingworth (iii) . . . . .	50,000	–	50,000	–	50,000	–
Adrian Hennah . . . . .	16,990	213,386	16,990	258,005	7,834	177,620
Dr. Pamela J. Kirby . . . . .	8,500	–	8,500	–	8,500	–
Warren D. Knowlton . . . . .	59,501	–	59,501	–	59,501	–
Brian Larcombe . . . . .	20,000	–	20,000	–	20,000	–
Joseph C. Papa . . . . .	–	–	–	–	–	–
Richard De Schutter . . . . .	250,000	–	250,000	–	250,000	–
Dr. Rolf W. H. Stomberg . . . . .	13,100	–	13,100	–	13,092	–

(i) The latest practicable date for this Annual Report.

(ii) Holdings of the directors together represent less than 1% of the Ordinary Share Capital of the Company.

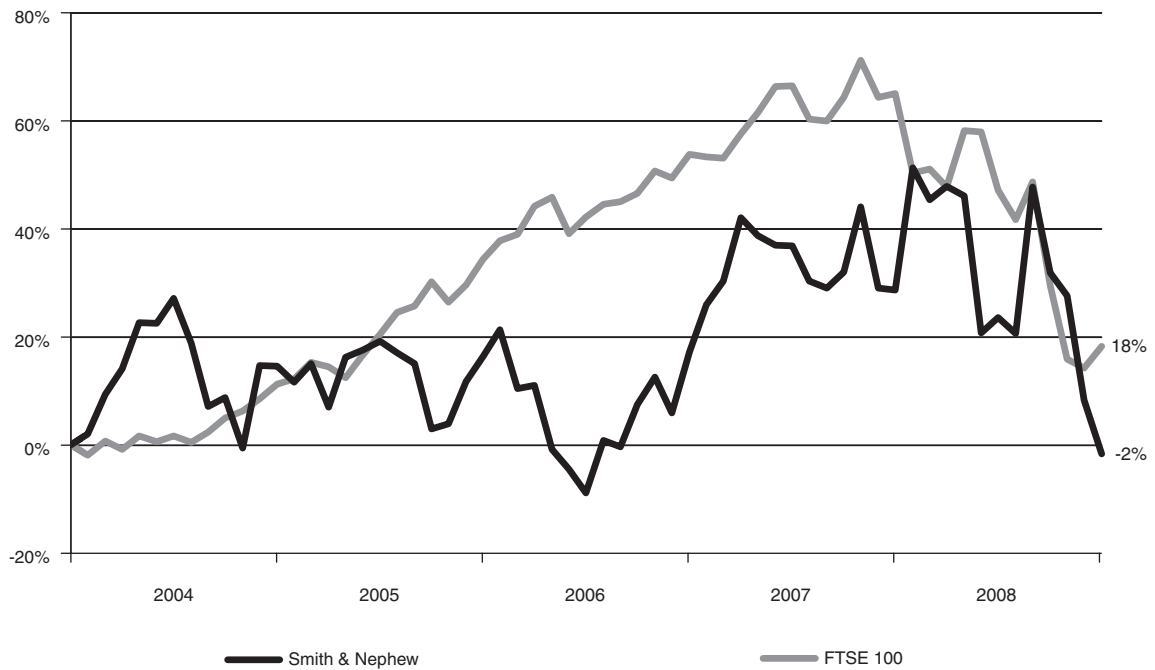
(iii) Following the redenomination of Ordinary Shares into US Dollars, on 23 January 2006, the Company issued 50,000 £1 Deferred shares. These shares are normally held by the Chief Executive Officer and are not listed on any Stock Exchange and have extremely limited rights attached to them.

The register of directors' interests, which is open to inspection at the Company's registered office, contains full details of Directors' shareholdings and share options.

### Total Shareholder Return

Schedule 7A to the Companies Act 1985 requires a graph to be published showing the Company's TSR against the TSR performance of a broad equity market index. As a component company of the FTSE100 index, a graph of the Company's TSR performance compared to that of the TSR of the FTSE100 index is shown below:

**Smith & Nephew - Five year Total Shareholder Return**



By order of the Board, 17 March 2009

**Paul Chambers**  
Secretary

# ACCOUNTS

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## DIRECTORS' RESPONSIBILITIES FOR THE ACCOUNTS

The directors are responsible for preparing the Group and Parent Company accounts in accordance with applicable United Kingdom law and regulations. As a consequence of the Parent Company's Ordinary Shares being traded on the New York Stock Exchange (in the form of American Depositary Shares) the directors are responsible for the preparation and filing of an annual report on Form 20-F with the US Securities and Exchange Commission.

The directors are required to prepare Group accounts for each financial year, in accordance with the International Financial Reporting Standards ("IFRS") as adopted by the European Union which present fairly the financial position of the Group and the financial performance and cash flows of the Group for that period. In preparing those Group accounts, the directors are required to:

- Select suitable accounting policies in accordance with *IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors* and then apply them consistently;
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- Provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Group's financial position and financial performance; and
- State that the Group has complied with IFRS, subject to any material departures disclosed and explained in the accounts.

Under United Kingdom law the directors have elected to prepare the Parent Company accounts in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), which are required by law to give a true and fair view of the state of affairs of the Parent Company and of the profit or loss of the Parent Company for that period. In preparing the Parent Company accounts, 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 UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts; and
- Prepare the accounts on a going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors confirm that they have complied with the above requirements in preparing the accounts.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and the Parent Company and enable them to ensure that the accounts comply with the Companies Act 1985 and, in the case of the Group accounts, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group and the Parent 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 corporate and financial information included on the Group's website. It should be noted that information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.



## DIRECTORS' RESPONSIBILITY STATEMENT PURSUANT TO DISCLOSURE AND TRANSPARENCY RULE 4

The directors confirm that, to the best of each person's knowledge:

- the Group accounts in this report, which have been prepared in accordance with IFRS as adopted by the European Union and those parts of the Companies Act 1985 applicable to companies reporting under IFRS, give a true and fair view of the assets, liabilities, financial position and profit of the Group taken as a whole;
- the Parent Company accounts in this report, which have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice and the Companies Act 1985, give a true and fair view of the assets, liabilities, financial position and profit of the Parent Company; and
- the "Operating and Financial Review ("OFR"), Liquidity and Prospects" contained in the accounts includes a fair review of the development and performance of the business and the financial position of the Parent Company and the Group taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board, 17 March 2009

**Paul Chambers**  
Secretary

# INDEPENDENT AUDITORS' UK REPORT

## **Independent Auditors' Report to the Shareholders of Smith & Nephew plc**

We have audited the Group accounts of Smith & Nephew plc for the year ended 31 December 2008 which comprise the Group income statement, the Group balance sheet, the Group cash flow statement, the Group statement of recognised income and expense, and the related Notes 1 to 40. These Group accounts have been prepared under the accounting policies set out therein.

We have reported separately on the Parent Company accounts of Smith & Nephew plc for the year ended 31 December 2008 and on the information in the Remuneration Report that is described as having been audited.

This report is made solely to the Group's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Group's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Group and the Group's members as a body, for our audit work, for this report, or for the opinions we have formed.

## **Respective Responsibilities of Directors and Auditors**

The directors are responsible for preparing the Annual Report and the Group accounts in accordance with applicable United Kingdom law and International Financial Reporting Standards ("IFRS") as adopted by the European Union as set out in the Directors' Responsibilities for the Accounts.

Our responsibility is to audit the Group accounts in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the Group accounts give a true and fair view, and whether the Group accounts 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 accounts. The information given in the Directors' Report includes that specific information presented in the "Introduction and Financial Summary" that is cross referenced from the "Operating and Financial Review" section of the Directors' Report.

We also 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 directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Group's compliance with the nine provisions of the 2006 Combined Code 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 accounts. The other information comprises only the "Financial Summary", the "Description of the Group", the "Operating and Financial Review, Liquidity and Prospects", the "Corporate Governance Statement" and the unaudited part of the "Remuneration Report". We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group accounts. 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 accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Group accounts, 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 accounts 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 accounts.

## **Opinion**

In our opinion:

- the Group accounts give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended;
- the Group accounts 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 accounts.

## **Separate Opinion in Relation to IFRSs**

As explained in Note 1 to the Group accounts, the Group in addition to complying with its legal obligation to comply with IFRSs as adopted by the European Union, has also complied with IFRS as issued by the International Accounting Standards Board.

In our opinion the Group accounts give a true and fair view, in accordance with IFRS, of the state of the Group's affairs as at 31 December 2008 and of its profit for the year then ended.

**Ernst & Young LLP**  
Registered auditor  
London, England  
17 March 2009

## INDEPENDENT AUDITORS' US REPORTS

### **Report of Independent Registered Public Accounting Firm to the Board of Directors and Shareholders of Smith & Nephew plc**

We have audited the accompanying Group balance sheets of Smith & Nephew plc as of 31 December 2008 and 2007, and the related Group income statements, Group statements of recognised income and expense and Group cash flow statements for each of the three years in the period ended 31 December 2008. These accounts are the responsibility of the Company's management. Our responsibility is to express an opinion on these accounts based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the accounts, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accounts referred to above present fairly, in all material respects, the consolidated financial position of Smith & Nephew plc at 31 December 2008 and 2007, and the consolidated results of its operations and cash flows for each of the three years in the period ended 31 December 2008, in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and International Financial Reporting Standards as adopted by the European Union.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Smith & Nephew plc's internal control over financial reporting as of 31 December 2008, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated 17 March 2009 expressed an unqualified opinion thereon.

**Ernst & Young LLP**  
London, England  
17 March 2009

## Report of Independent Registered Public Accounting Firm to the Board of Directors and Shareholders of Smith & Nephew plc

We have audited Smith & Nephew plc's internal control over financial reporting as of 31 December 2008, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Smith & Nephew plc's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying "Management's Report on Internal Control over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Smith & Nephew plc maintained, in all material respects, effective internal control over financial reporting as of 31 December 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Group balance sheets of Smith & Nephew plc as of 31 December 2008 and 2007, and the related Group income statements, Group statements of recognised income and expense and Group cash flow statements for each of the three years in the period ended 31 December 2008 and our report dated 17 March 2009 expressed an unqualified opinion thereon.

**Ernst & Young LLP**  
London, England  
17 March 2009

## GROUP INCOME STATEMENT

	Years ended 31 December		
	2008	2007	2006
	(\$ million, except per Ordinary Share amounts)		
<b>Revenue</b> — (Note 3) .....	3,801	3,369	2,779
Cost of goods sold .....	(1,077)	(994)	(769)
Gross profit .....	2,724	2,375	2,010
Selling, general and administrative expenses — (Note 4) .....	(1,942)	(1,740)	(1,353)
Research and development expenses .....	(152)	(142)	(120)
<b>Operating profit</b> — (Notes 3 and 4) .....	630	493	537
Interest receivable — (Note 8) .....	5	10	19
Interest payable — (Note 8) .....	(71)	(40)	(9)
Other finance (costs)/income — (Note 9) .....	(1)	6	3
Share of results of associates — (Note 17) .....	1	—	—
<b>Profit before taxation</b> .....	564	469	550
Taxation — (Note 10) .....	(187)	(153)	(156)
<b>Profit from continuing operations</b> .....	377	316	394
Discontinued operations: Net profit on disposal of the joint venture — (Note 16) .....	—	—	351
<b>Attributable profit for the year</b> — (i) .....	377	316	745
<b>Earnings per Ordinary Share</b> — (i) (Note 12)			
Including discontinued operations:			
Basic .....	42.6¢	34.2¢	79.2¢
Diluted .....	42.4¢	34.1¢	78.9¢
Continuing operations:			
Basic .....	42.6¢	34.2¢	41.9¢
Diluted .....	42.4¢	34.1¢	41.7¢
Discontinued operations:			
Basic .....	—	—	37.3¢
Diluted .....	—	—	37.2¢

(i) Attributable to equity holders of the Parent Company.

The Notes on pages 84 to 138 are an integral part of these accounts.

## GROUP BALANCE SHEET

	At 31 December	
	2008	2007*
	(\$ million)	
<b>ASSETS</b>		
<b>Non-current assets:</b>		
Property, plant and equipment — (Note 13) .....	725	742
Goodwill — (Note 18) .....	1,189	1,225
Intangible assets — (Note 14) .....	376	419
Investments — (Note 15) .....	7	9
Investments in associates — (Note 17) .....	12	11
Deferred tax assets — (Note 25) .....	214	136
	2,523	2,542
<b>Current assets:</b>		
Inventories — (Note 19) .....	879	834
Trade and other receivables — (Note 20) .....	961	915
Cash and bank — (Note 21) .....	145	170
	1,985	1,919
<b>TOTAL ASSETS</b> .....	4,508	4,461
<b>EQUITY AND LIABILITIES</b>		
<b>Equity attributable to equity holders of the parent:</b>		
Called up equity share capital — (Note 26) .....	190	190
Share premium account — (Note 27) .....	375	356
Treasury shares — (Note 29) .....	(823)	(637)
Other reserves — (Note 27) .....	1	96
Accumulated profits — (Note 27) .....	1,956	1,811
Total equity .....	1,699	1,816
<b>Non-current liabilities:</b>		
Long-term borrowings — (Note 21) .....	1,358	36
Retirement benefit obligation — (Note 35) .....	350	184
Other payables due after one year — (Note 23) .....	36	47
Provisions due after one year — (Note 24) .....	51	33
Deferred tax liabilities — (Note 25) .....	46	57
	1,841	357
<b>Current liabilities:</b>		
Bank overdrafts and loans due within one year — (Note 21) .....	115	1,442
Trade and other payables due within one year — (Note 23) .....	607	562
Provisions due within one year — (Note 24) .....	54	80
Current tax payable .....	192	204
	968	2,288
<b>Total liabilities</b> .....	2,809	2,645
<b>TOTAL EQUITY AND LIABILITIES</b> .....	4,508	4,461

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

The accounts were approved by the Board and authorised for issue on 17 March 2009 and are signed on its behalf by: **John Buchanan** Chairman **David J. Illingworth** Chief Executive **Adrian Hennah** Chief Financial Officer

The Notes on pages 84 to 138 are an integral part of these accounts.

## GROUP CASH FLOW STATEMENT

	Years ended 31 December		
	2008	2007	2006
	(\$ million)		
<b>Net cash inflow from operating activities</b>			
Profit before taxation	564	469	550
Add: Net interest payable/(less: net interest receivable)	66	30	(10)
Depreciation, amortisation and impairment	275	228	166
Loss on sale of property, plant and equipment	12	9	3
Share based payment expense	24	23	14
Utilisation of Plus inventory stepped-up on acquisition	15	64	–
Share of results of associates	(1)	–	–
Increase in inventories	(117)	(84)	(37)
Increase in trade and other receivables	(54)	(35)	(30)
Increase/(decrease) in trade and other payables and provisions	31	(11)	(150)
Cash generated from operations (i)(ii)	815	693	506
Interest received	5	10	19
Interest paid	(68)	(40)	(9)
Income taxes paid	(186)	(225)	(144)
Net cash inflow from operating activities	566	438	372
<b>Cash flows from investing activities</b>			
Acquisitions — (Note 32)	(16)	(799)	(85)
Cash acquired with acquisitions — (Note 32)	–	18	2
Disposal of the joint venture — (Note 16)	–	–	537
Capital expenditure	(292)	(200)	(231)
Proceeds on disposal of property, plant and equipment	3	6	9
Net cash (used in)/provided by investing activities (iii)	(305)	(975)	232
<b>Cash flows from financing activities</b>			
Proceeds from issue of ordinary share capital	19	28	16
Treasury shares purchased	(193)	(640)	–
Proceeds on borrowings due within one year — (Note 30)	–	1,812	–
Settlement of borrowings due within one year — (Note 30)	(49)	(611)	(5)
Repayment of Loan Notes — (Note 30)	–	(17)	(88)
Proceeds on borrowings due after one year — (Note 30)	1,108	–	–
Settlement of borrowings due after one year — (Note 30)	(1,028)	(106)	(200)
Proceeds from own shares	4	–	–
Settlement of currency swaps — (Note 30)	5	(14)	(10)
Equity dividends paid	(109)	(105)	(96)
Net cash (used in)/provided by financing activities	(243)	347	(383)
<b>Net increase/(decrease) in cash and cash equivalents</b>	18	(190)	221
Cash and cash equivalents at beginning of year — (Note 30)	109	291	65
Exchange adjustments — (Note 30)	(5)	8	5
<b>Cash and cash equivalents at end of year — (Note 30)</b>	122	109	291

(i) Includes \$28m (2007 — \$39m, 2006 — \$21m) of outgoings on restructuring and rationalisation expenses.

(ii) After \$48m (2007 — \$33m, 2006 — \$4m) of acquisition related costs and \$10m (2007 — \$23m, 2006 — \$33m) unreimbursed by insurers relating to macrot textured knee revisions (offset by a receipt of \$22m in 2007 from a successful legal settlement). In 2007, this also includes the legal settlement of \$30m.

(iii) Discontinued operations accounted for nil (2007 — nil, 2006 — \$537m) of investing activities.

The Notes on pages 84 to 138 are an integral part of these accounts.



## GROUP STATEMENT OF RECOGNISED INCOME AND EXPENSE

	Years ended 31 December		
	2008	2007	2006
	(\$ million)		
Cash flow hedges — interest rate swaps:			
— losses taken to equity	(13)	(2)	—
— losses transferred to income statement for the year	2	—	—
Cash flow hedges — forward foreign exchange contracts:			
— gains/(losses) taken to equity	21	(12)	—
— gains transferred to inventories for the year	(6)	—	(4)
Exchange differences on translation	(57)	94	59
Exchange on borrowings classified as net investment hedges	(42)	(47)	—
Cumulative translation adjustment on disposal of the joint venture — (Note 16)	—	—	(14)
Actuarial (losses)/gains on retirement benefit obligations	(215)	(22)	30
Taxation on items taken directly to or transferred from equity	71	8	(11)
Net (expense)/income recognised directly in equity	(239)	19	60
Attributable profit for the year (i)	<u>377</u>	<u>316</u>	<u>745</u>
Total recognised income and expense for the year (i)	<u>138</u>	<u>335</u>	<u>805</u>

(i) Attributable to equity holders of the Parent Company.

The Notes on pages 84 to 138 are an integral part of these accounts.

# NOTES TO THE GROUP ACCOUNTS

## 1. General Information

Smith & Nephew plc (the “Company”) is a public limited company incorporated in England and Wales under the Companies Act. In these accounts, “Group” means the Company and all its subsidiaries. The principal activities of the Group are to develop, manufacture, market and sell medical devices in the sectors of Orthopaedics, Endoscopy and Advanced Wound Management.

### *Presentation of financial information*

The Group changed its presentational currency from Pounds Sterling to US Dollars with effect from 1 January 2006 as at that time the Group’s principal assets and operations were in the US and the majority of its operations were conducted in US Dollars. Additionally, the Company redenominated its share capital into US Dollars on 23 January 2006 and will retain distributable reserves and declare dividends in US Dollars. Consequently its functional currency became the US Dollar. This lowers the Group’s exposure to currency translation risk on its revenue, profits and equity. Financial information for prior periods was restated from Pounds Sterling into US Dollars in accordance with *IAS 21 The Effects of Changes in Foreign Exchange Rates*.

The cumulative translation reserve was set to nil at 1 January 2003 (i.e. the transition date to IFRS). All subsequent movements comprising differences on the retranslation of the opening net assets of non US Dollar subsidiaries and hedging instruments have been charged to the cumulative translation reserve included in “Other Reserves”. Share capital and share premium were translated at the rate of exchange on the date of redenomination.

As required by the European Union’s IAS Regulation and the Companies Act 1985, the Group has prepared its accounts in accordance with International Financial Reporting Standards (“IFRS”) as adopted by the European Union (“EU”) effective as at 31 December 2008. The Group has also prepared its accounts in accordance with IFRS as issued by the International Accounting Standards Board (“IASB”) effective as at 31 December 2008.

The Group applied *IFRS 1 First Time Adoption for International Financial Reporting Standards* in 2005 to provide a starting point for reporting under IFRS. The Group’s date of transition to IFRS was 1 January 2003 and all comparative information in the financial statements was restated to reflect the Group’s adoption of IFRS, except where otherwise required or permitted under IFRS 1.

IFRS 1 required an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. As a general principle, IFRS 1 required the standards effective at the reporting date to be applied retrospectively. However, retrospective application was prohibited in some areas, particularly where retrospective application would require judgements by management about past conditions after the outcome of the particular transaction is already known. A number of optional exemptions from full retrospective application of IFRS were granted where the cost of compliance was deemed to exceed the benefits to users of the financial statements. Where applicable, the options selected by management are set out in Note 2 of the Notes to the Group Accounts.

At 31 December 2007 the cost of the Plus business was allocated on a provisional basis to the assets acquired and liabilities assumed on acquisition. In 2008, the provisional fair value adjustments were finalised to reflect improved knowledge of the Plus business. The final allocation of the purchase price was completed by 31 May 2008, in accordance with the time line stipulated in *IFRS 3 Business Combinations*. The final adjustments to the assets acquired and liabilities assumed increased goodwill by \$25m, decreased intangible assets by \$27m and other assets increased by \$2m. Accordingly, the balance sheet as at 31 December 2007 has been adjusted. These fair value adjustments had a negligible affect on the income statement presented for the year ended 31 December 2007. Further information can be found in Note 32 of the Notes to the Group Accounts.

## 2. Accounting Policies

The Group has adopted *IFRIC 14 — IAS 19 — The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* in the financial year ended 31 December 2008. This is the Group's initial application of this interpretation, which gives further guidance on how to assess the limit on the amount of a defined benefit scheme surplus that can be recognised as an asset. The adoption did not have a material impact on the Group's results of operations or financial position.

The significant accounting policies adopted in the preparation of the Group's accounts are set out below:

### ***Basis of Preparation***

The preparation of accounts in conformity with IFRS requires management to use estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. The accounting policies requiring management to use significant estimates and assumptions are discussed under Critical Accounting Policies within the Operating and Financial Review, Liquidity and Prospects section on pages 31 and 32. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates.

### ***Consolidation***

The Group accounts include the accounts of Smith & Nephew plc (the "Company") and its subsidiaries for the periods during which they were members of the Group.

A subsidiary is an entity controlled by the Group. Subsidiaries are included in the Group accounts from the date that the Group obtains control. Intercompany transactions, balances and unrealised gains and losses on transactions between group companies are eliminated on consolidation.

### ***Business Combinations***

On acquisition, identifiable assets and liabilities (including contingent liabilities) of subsidiaries and associates are measured at their fair values at the date of acquisition with any excess of the cost of acquisition over this value being capitalised as goodwill. The fair value of assets includes the taxation benefits resulting from amortisation for income taxation purposes from which a third party separately acquiring the assets would reasonably be expected to benefit.

The Group elected not to apply *IFRS 3 Business Combinations* retrospectively to transactions occurring prior to the date of transition to IFRS, as permitted by IFRS 1. Goodwill and intangible assets would be different had this election not been made. Had prior business combinations been restated, goodwill arising from transactions occurring prior to 31 December 1998 which was previously set-off against reserves would be reinstated. Goodwill arising from transactions from 1 January 1999 to 31 December 2002 would be lower as significant amounts would be reclassified as separately identified intangible assets. This goodwill would then be increased by the reversal of amortisation charged during that period. In the Income Statement goodwill amortisation would have been zero but amortisation of intangible assets would have been higher.

### ***Interest in BSN Medical Joint Venture***

A joint venture is a contractual arrangement whereby the Group and other parties undertake an economic activity that is subject to joint control. The Group's interest in the results and assets and liabilities of its joint venture BSN Medical, which was a jointly controlled entity prior to disposal, were included in the accounts using the equity method of accounting.

### ***Investments in Associates***

Investments in associates, being those entities over which the Group has a significant influence and which is neither a subsidiary or a joint venture, are accounted for using the equity method, with the Group recording its share of the associate's net income and equity. The Group's share in the results of its associates is included in one separate income statement line and is calculated after deduction of their respective taxes.

## 2. Accounting Policies — (continued)

### ***Minority Interests***

Minority interests in the net assets (excluding goodwill) of consolidated subsidiaries are identified separately from the Group's equity. The interest of minority shareholders in the acquiree is initially measured at the minority's proportion of the net fair value of the assets, liabilities and contingent liabilities recognised. Minority interests consist of the amount of those interests at the date of the original business combination and the minority's share of changes since the date of the combination.

The Group applies a policy of treating transactions with minority interests as transactions with equity holders of the Parent Company. For purchases from minority interests, the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary is deducted from equity.

### ***Non-Current Assets Held for sale***

Non-current assets are classified as held for sale if their carrying amount will be recovered principally through a sale rather than from continued use. Assets held for sale are valued at the lower of their carrying amount and fair value less costs to sell. The joint venture in BSN Medical was classified as such from 1 October 2005.

### ***Revenue***

Revenue comprises sales of products and services to third parties at amounts invoiced net of trade discounts and rebates, excluding taxes on revenue. Revenue from the sale of products is recognised upon transfer to the customer of the significant risks and rewards of ownership. This is generally when goods are delivered to customers. Sales of inventory located at customer premises and available for customers' immediate use are recognised when notification is received that the product has been implanted or used. Appropriate provisions for returns, trade discounts and rebates are deducted from revenue. Rebates comprise retrospective volume discounts granted to certain customers on attainment of certain levels of purchases from the Group. These are accrued over the course of the arrangement based on estimates of the level of business expected and adjusted at the end of the arrangement to reflect actual volumes.

### ***Foreign Currencies***

Balance sheet items of foreign operations and foreign currency borrowings are translated into US Dollars on consolidation at year end rates of exchange. Income statement items and the cash flows of overseas subsidiary undertakings and associated undertakings are translated at average rates as an approximation to actual transaction rates, with actual transaction rates used for large one off transactions.

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.

Transactions in foreign currencies are recorded at the exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date.

The following are recorded as movements in Other reserves within equity: exchange differences on the translation at closing rates of exchange of non-US Dollar opening net assets; the differences arising between the translation of profits into US Dollars at average and closing exchange rates; to the extent that the hedging relationship is effective, the difference on translation of foreign currency borrowings or swaps that are used to finance or hedge the Group's net investments in foreign operations; and the movement in the fair value of forward foreign exchange contracts used to hedge forecast foreign exchange cash flows. All other exchange differences are taken to the income statement. On disposal of a foreign operation, the deferred cumulative amount recognised in equity relating to that particular foreign operation, net of related movements on hedging instruments, would be recycled from equity into income.

Under IFRS 1, the Group was not required to record cumulative translation differences arising prior to the transition date. In utilising this exemption, all cumulative translation differences were deemed to be zero as at 1 January 2003 and subsequent foreign business disposals will exclude any translation differences arising prior to the date of transition. Full retrospective presentation of cumulative translation differences would either increase or decrease "Other reserves" depending on historic exchange rate fluctuations with the corresponding movement taken to "Accumulated profits". Gains or losses on the disposals of foreign operations in the future would be different as a result of the different amount of recycled cumulative translation differences.

## 2. Accounting Policies — (continued)

### *Taxation*

The charge for current taxation is based on the results for the year as adjusted for items which are non-assessable or disallowed. It is calculated using rates that have been enacted or substantively enacted by the balance sheet date.

Deferred taxation is accounted for using the balance sheet liability method in respect of temporary differences arising between the carrying amount of assets and liabilities in the accounts and the corresponding tax bases used in computation of taxable profit.

Deferred tax liabilities are recognised for all taxable temporary differences except in respect of investments in subsidiaries where the Group is able to control the timing of the reversal of the temporary difference and it is probable that this will not reverse in the foreseeable future; on the initial recognition of non-deductible goodwill; and on the initial recognition of an asset or liability in a transaction that is not a business combination and that, at the time of the transaction, does not affect the accounting or taxable profit.

Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary difference can be utilised. Their carrying amount is reviewed at each balance sheet date on the same basis.

Deferred tax is measured on an undiscounted basis, and at the tax rates that have been enacted or substantively enacted by the balance sheet date that are expected to apply in the periods in which the asset or liability is settled. It is recognised in the income statement except when it relates to items credited or charged directly to equity, in which case the deferred tax is also dealt with in equity.

Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority, when the Group intends to settle its current tax assets and liabilities on a net basis and that authority permits the Group to make a single net payment.

### *Advertising Costs*

Expenditure on advertising costs is expensed as incurred.

### *Goodwill and Intangible Assets*

Goodwill recognised prior to the date of transition to IFRS is stated at net book value as at that date. Goodwill recognised subsequent to 1 January 2003, representing the excess of purchase consideration over the Group's share of the fair value of net assets acquired, is capitalised. Goodwill is not amortised but is reviewed for impairment annually.

Purchased intangibles, including purchased patents, know-how, trademarks, licences and distribution rights are capitalised at cost and amortised on a straight line basis over their estimated useful economic lives. The estimated useful economic life of an intangible asset ranges between three and 20 years depending on its nature.

Purchased computer software and certain costs of information technology projects are capitalised as intangible assets. Software that is integral to computer hardware is capitalised as plant and equipment.

### *Research and Development*

The Group considers that the regulatory, technical and market uncertainties inherent in the development of new products means that development costs should not be capitalised as intangible assets until products receive approval from the appropriate regulatory body. Substantially all development expenditure is complete by the time the product is submitted for regulatory approval. Consequently expenditure on research and development is expensed as incurred.

## 2. Accounting Policies — (continued)

### ***Property, Plant and Equipment***

Property, plant and equipment is stated at cost less depreciation and provision for impairment where appropriate. Freehold land is not depreciated. Freehold buildings are depreciated on a straight-line basis at between 2% and 5% per annum. Leasehold land and buildings are depreciated on a straight-line basis over the shorter of their estimated useful economic lives and the terms of the leases. Plant and equipment is depreciated over lives ranging between three and 20 years by equal annual instalments to write down the assets to their estimated residual value at the end of their working lives. Assets in course of construction are not depreciated until they are brought into use.

Finance costs relating to the purchase of property, plant and equipment are not capitalised.

### ***Impairment of assets***

Goodwill is allocated to the reported business segments which are principally the same as the cash-generating units. The recoverable amount of the cash-generating unit to which goodwill has been allocated is tested for impairment annually or when events or changes in circumstances indicate that it might be impaired.

The carrying values of property, plant and equipment, and intangible assets with finite lives are reviewed for impairment when events or changes in circumstances indicate the carrying value may be impaired. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of impairment loss. Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which it belongs.

An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value-in-use. In assessing value-in-use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

In carrying out impairment reviews of goodwill and intangible assets a number of significant assumptions have to be made when preparing cash flow projections. These include annual sales growth, trading margins, capital utilisation and anticipated volume and value growth in the markets served by the Group. If actual results should differ, or changes in expectations arise, impairment charges may be required which would adversely impact operating results.

### ***Leasing Commitments***

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards of ownership to the Group. All other leases are classified as operating leases.

Assets held under finance leases are capitalised as property, plant or equipment and depreciated accordingly. The capital element of future lease payments is included in borrowings and interest is charged to profit before taxation on a reducing balance basis over the term of the lease.

Rentals payable under operating leases are expensed in the income statement on a straight line basis over the term of the relevant lease.

### ***Investments and Other Financial Assets***

Investments, other than those related to associates, are initially recorded at fair value plus transaction costs on the trade date. The Group holds an investment in an entity that holds mainly unquoted equity securities, which is classed as "available for sale" and carried at fair value. The fair value of the investment is based on the underlying fair value of the equity securities: marketable securities are valued by reference to closing prices in the market; non-marketable securities are estimated considering factors including the purchase price, prices of recent significant private placements of securities of the same issuer and estimates of liquidation value. Changes in fair value are recognised in equity except where management considers that there is objective evidence of an impairment of the underlying equity securities, whereupon an impairment is recognised as an expense immediately.

## 2. Accounting Policies — (continued)

### *Investments and Other Financial Assets (continued)*

Loans and receivables are carried at amortised cost, less any allowances for uncollectible amounts. They are included in current assets, except for maturities greater than 12 months after the balance sheet date. These are classified as non-current assets. Loans and other receivables are classified as “Trade and other receivables” in the balance sheet.

### *Inventories*

Finished goods and work-in-progress are valued at factory cost, including appropriate overheads, on a first-in first-out basis. Raw materials and bought-in finished goods are valued at purchase price. All inventories are reduced to net realisable value where lower than cost. Inventory acquired as part of a business acquisition is valued at selling price less costs of disposal and a profit allowance for selling efforts.

Orthopaedic instruments are generally not sold but provided to customers and distributors for use in surgery. They are recorded as inventory until they are deployed at which point they are transferred to plant and equipment and depreciated over their useful economic lives.

A feature of the orthopaedic business is the high level of product inventory required, some of which is located at customer premises and is available for customers' immediate use. Complete sets of product, including large and small sizes, have to be made available in this way. These outer sizes are used less frequently than standard sizes and towards the end of the product life cycle are inevitably in excess of requirements. Adjustments to carrying value are therefore required to be made to orthopaedic inventory to anticipate this situation. These adjustments are calculated in accordance with a formula based on levels of inventory compared with historical or forecast usage. This formula is applied on an individual product line basis and is first applied when a product group has been on the market for two years. This method of calculation is considered appropriate based on experience but it involves management judgements on effectiveness of inventory deployment, length of product lives, phase-out of old products and efficiency of manufacturing planning systems.

### *Derivative Financial Instruments*

Derivative financial instruments are recorded initially at fair value and for reporting purposes are remeasured to fair value at subsequent balance sheet dates.

Changes in the fair value of derivative financial instruments that are designated and effective as cash flow hedges of forecasted third party and intercompany transactions are recognised directly in equity until the associated asset or liability is recognised. Amounts taken to equity are transferred to the income statement when the hedged transaction affects profit and loss. Where the hedged item is the cost of a non-financial asset, the amounts taken to equity are transferred to the initial carrying value of the asset.

Currency swaps to match foreign currency net assets with foreign currency liabilities are fair valued at year end. Currency swaps are classified as financial assets or liabilities at fair value through profit or loss with changes in fair value recognised in the income statement. Changes in the fair values of currency swaps that are designated and effective as net investment hedges are matched in equity against changes in value of the related net assets.

Interest rate swaps transacted to fix interest rates on floating rate borrowings are accounted for as cash flow hedges and changes in the fair values resulting from changes in market interest rates are recognised in equity.

Any ineffectiveness on hedging instruments and changes in the fair value of derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement within other finance income/(costs) as they arise.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, any cumulative gain or loss on the hedging instrument recognised in equity is retained there until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the income statement for the period.

## 2. Accounting Policies — (continued)

### ***Recognition of Financial Assets and Liabilities***

Financial assets and liabilities are recognised on a trade date basis in the Group's balance sheet when the Group becomes party to the contractual provisions of the instrument. The Group carries borrowings in the Balance Sheet at amortised cost.

### ***Retirement Benefits***

The Group's major pension plans are of the defined benefit type. For these plans, the employer's portion of past and current service cost is charged to operating profit, with the interest cost net of expected return on assets in the plans reported within other finance income/(costs). Actuarial gains or losses are recognised directly in equity such that the balance sheet reflects the plan's surplus' or deficits as at the balance sheet date.

The defined benefit obligation is calculated annually by external actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash flows using, where available, interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

A number of key judgements have to be made in calculating the fair value of the Group's defined benefit pension plans. These assumptions impact the balance sheet liability, operating profit and finance income/(costs). The most critical assumptions are the discount rate, inflation and mortality assumptions to be applied to future pension plan liabilities. In making these judgements management takes into account the advice of professional external actuaries and benchmarks its assumptions against external data.

Where defined contribution plans operate, the contributions to these plans are charged to operating profit as they become payable.

### ***Share Based Payments***

The Group operates a number of executive and employee share schemes. For all grants of share options and awards, the fair value at the grant date is calculated using option pricing models and the corresponding expense is recognised over the vesting period.

Under IFRS 1, the Group is required to restate its comparative years for all grants of equity instruments made on or after 7 November 2002. A first time adopter is encouraged to apply IFRS to grants made before this date to the extent information on the fair value of these equity instruments has previously been publicly disclosed. The Group disclosed share option valuations in its US GAAP reporting in prior years and these valuations were used to restate comparatives.

### ***Contingencies and Provisions***

In the normal course of business the Group is involved in numerous legal disputes. Provision is made for loss contingencies when it is deemed probable that an adverse outcome will occur and the amount of the loss can be reasonably estimated. Where the Group is the plaintiff in pursuing claims against third parties legal and associated expenses are charged to the income statement as incurred. Contingent assets are not recognised in the accounts.

The recognition of provisions for legal disputes is subject to a significant degree of estimation. In making its estimates management takes into account the advice of internal and external legal counsel. Provisions are reviewed regularly and amounts updated where necessary to reflect developments in the disputes. The ultimate liability may differ from the amount provided depending on the outcome of court proceedings and settlement negotiations or as new facts emerge.

The estimation of the liability for the costs of the macrotextured product withdrawal for which insurance coverage has been declined is dependent upon two main variables. These are, the number of implant revisions that will ultimately be required and the average cost of settlements with patients. The estimate of the remaining number of implant revisions is based on trends to date and the advice of external statistical and other advisors. The estimate of average settlement costs is based on the most recent settlement experience updated where necessary for other known factors.



## 2. Accounting Policies — (continued)

### *Contingencies and Provisions (continued)*

The Group operates in multiple tax jurisdictions around the world and records provisions for taxation liabilities and tax audits when it is considered probable that a tax charge will arise and the amount can be reasonably estimated. Although Group policy is to submit its tax returns to the relevant tax authorities as promptly as possible, at any time the Group has unagreed years outstanding and is involved in disputes and tax audits. Significant issues may take many years to resolve. In estimating the probability and amount of any tax charge management takes into account the views of internal and external advisors and updates the amount of the provision whenever necessary. The ultimate tax liability may differ from the amount provided depending on interpretations of tax law, settlement negotiations or changes in legislation.

### *Adjusted Earnings Per Share*

Adjusted earnings per share is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers as effect the Group's short-term profitability. Adjusted attributable profit is the numerator used for this measure. Reconciliation from attributable profit to adjusted attributable profit is included in Note 12 of the Notes to the Group Accounts. The Group has identified the following items, where material, as those to be excluded when arriving at adjusted attributable profit: acquisition and disposal related items including amortisation and impairment of acquisition intangible assets; significant restructuring events; gains and losses arising from legal disputes and uninsured losses; and taxation thereon.

## 3(a). Business Segmental Analysis

For management purposes, the Group is organised into three business segments — Orthopaedics, Endoscopy and Advanced Wound Management. These business segments are the basis on which the Group reports its primary segment information.

The Reconstruction and Trauma and Clinical Therapies segments, reported separately in the annual accounts of the Group for the year ended 31 December 2007, are now combined into a single reporting segment named Orthopaedics. This reflects the unification of the Orthopaedics reporting structure announced during 2008. Business segment analysis comparative figures have consequently been restated to conform to current year presentation.

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(\$ million)		
<b>Revenue</b>			
Orthopaedics .....	2,158	1,858	1,433
Endoscopy .....	800	732	648
Advanced Wound Management .....	843	779	698
	<u>3,801</u>	<u>3,369</u>	<u>2,779</u>

There are no material sales between business segments.

### 3(a). Business Segmental Analysis — (continued)

Trading profit is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers as affect the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. The Group has identified the following items, where material, as those to be excluded from operating profit when arriving at trading profit: acquisition and disposal related items including amortisation and impairment of acquisition intangible assets; significant restructuring events; gains and losses arising from legal disputes; and uninsured losses. Operating profit reconciles to trading profit as follows:

	2008	2007	2006
	(\$ million)		
Operating profit	630	493	537
Acquisition related costs — (Note 5)	61	111	20
Restructuring and rationalisation expenses — (Note 6)	34	42	–
Legal settlement — (Note 7)	–	30	–
Amortisation and impairment of acquisition intangibles — (Note 14)	51	30	14
Trading profit	<u>776</u>	<u>706</u>	<u>571</u>

#### Trading profit

Orthopaedics	481	423	334
Endoscopy	166	147	123
Advanced Wound Management	129	136	114
	<u>776</u>	<u>706</u>	<u>571</u>

#### Operating profit by business segment reconciled to attributable profit for the year

Orthopaedics	382	243	301
Endoscopy	146	141	122
Advanced Wound Management	102	109	114
Operating profit	630	493	537
Net interest (payable)/receivable	(66)	(30)	10
Other finance (costs)/income	(1)	6	3
Share of results of associates	1	–	–
Taxation	(187)	(153)	(156)
Profit from discontinued operations	–	–	351
Attributable profit for the year	<u>377</u>	<u>316</u>	<u>745</u>

Other than the share of results of associates, items between operating profit and attributable profit cannot be segmentally allocated. The share of results of associates is segmentally allocated to Orthopaedics. An impairment loss of \$16m was recognised within operating profit in 2008 and included within the administrative expenses line (2007 — \$1m administrative expenses, 2006 — nil). This is segmentally allocated as \$2m Orthopaedics and \$14m Endoscopy (2007 — Orthopaedics \$1m).

#### Capital expenditure

Orthopaedics	218	147	152
Endoscopy	29	47	45
Advanced Wound Management	45	24	34
	<u>292</u>	<u>218</u>	<u>231</u>

Capital expenditure segmentally allocated above comprises additions of property, plant and equipment and intangible assets. Capital expenditure in the Group Cash Flow Statement comprises additions of property, plant and equipment and intangible assets. In 2007, additions are net of \$7m of assets capitalised under finance leases and \$11m of assets transferred into property, plant, equipment from inventory. No such adjustments were required in 2008 (2006 — nil).

### 3(a). Business Segmental Analysis — (continued)

	2008	2007	2006
	(\$ million)		
<b>Depreciation, amortisation and impairment</b>			
Orthopaedics .....	177	157	111
Endoscopy .....	57	40	32
Advanced Wound Management .....	41	31	23
	<u>275</u>	<u>228</u>	<u>166</u>

Amounts comprise depreciation of property, plant and equipment, amortisation of other intangible assets, impairment of investments and amortisation and impairment of acquisition intangibles as follows:

Depreciation of property, plant and equipment .....	204	181	142
Amortisation of other intangible assets .....	18	16	10
Impairment of investments .....	2	1	–
	<u>224</u>	<u>198</u>	<u>152</u>

Amortisation and impairment of acquisition intangibles:

Impairment of acquisition intangibles .....	14	–	–
Amortisation of acquisition intangibles .....	37	30	14
	<u>51</u>	<u>30</u>	<u>14</u>
	<u>275</u>	<u>228</u>	<u>166</u>

#### Other significant non-cash expenses recognised within operating profit

Orthopaedics .....	23	113	16
Endoscopy .....	–	–	–
Advanced Wound Management .....	6	7	–
	<u>29</u>	<u>120</u>	<u>16</u>

In 2008, the \$29m relates to the utilisation of Plus inventory stepped-up on acquisition, acquisition related costs and restructuring and rationalisation expenses. The \$120m in 2007 relates to the utilisation of Plus inventory stepped-up on acquisition, acquisition related costs, restructuring and rationalisation expenses and the increase in the macrotecture provision. The \$16m in 2006 relates to acquisition related costs.

	2008	2007*	2006
	(\$ million)		
<b>Balance Sheet</b>			
<b>Assets:</b>			
Orthopaedics .....	2,755	2,668	1,387
Endoscopy .....	690	705	700
Advanced Wound Management .....	704	782	688
Operating assets by segment .....	<u>4,149</u>	<u>4,155</u>	<u>2,775</u>
Unallocated corporate assets .....	359	306	456
Total assets .....	<u>4,508</u>	<u>4,461</u>	<u>3,231</u>
<b>Liabilities:</b>			
Orthopaedics .....	448	404	227
Endoscopy .....	107	105	114
Advanced Wound Management .....	189	211	164
Operating liabilities by segment .....	<u>744</u>	<u>720</u>	<u>505</u>
Unallocated corporate liabilities .....	2,065	1,925	552
Total liabilities .....	<u>2,809</u>	<u>2,645</u>	<u>1,057</u>

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

### 3(a) Business Segmental Analysis — (continued)

Unallocated corporate assets and liabilities comprise the following:

	<u>2008</u>	<u>2007*</u>	<u>2006</u>
		(\$ million)	
Deferred tax assets .....	214	136	110
Cash and bank .....	145	170	346
Unallocated corporate assets .....	<u>359</u>	<u>306</u>	<u>456</u>
Long-term borrowings .....	1,358	36	15
Retirement benefit obligation .....	350	184	154
Deferred tax liabilities .....	46	57	35
Current liability derivatives — credit balances on currency swaps .....	4	2	2
Bank overdrafts and loans due within one year .....	115	1,442	119
Current tax payable .....	192	204	227
Unallocated corporate liabilities .....	<u>2,065</u>	<u>1,925</u>	<u>552</u>
	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(numbers)	
<b>Average number of employees</b>			
Orthopaedics .....	4,840	4,405	3,893
Endoscopy .....	1,849	1,798	1,830
Advanced Wound Management .....	3,068	2,987	3,107
	<u>9,757</u>	<u>9,190</u>	<u>8,830</u>

### 3(b) Geographical Segmental Analysis

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
<b>Revenue by geographic market</b>			
United Kingdom .....	321	309	255
Continental Europe .....	1,077	868	612
United States .....	1,657	1,550	1,365
Africa, Asia, Australasia and Other America .....	746	642	547
	<u>3,801</u>	<u>3,369</u>	<u>2,779</u>
<b>Capital expenditure by geographic location</b>			
United Kingdom .....	30	32	39
Continental Europe .....	63	51	29
United States .....	149	107	135
Africa, Asia, Australasia and Other America .....	50	28	28
	<u>292</u>	<u>218</u>	<u>231</u>

Capital expenditure segmentally allocated above comprises additions of property, plant and equipment and intangible assets. Capital expenditure in the Group Cash Flow Statement comprises additions of property, plant and equipment and intangible assets. In 2007, additions are net of \$7m of assets capitalised under finance leases and \$11m of assets transferred into property, plant and equipment from inventory. No such adjustments were required in 2008 (2006 — nil).

#### Assets by geographic location

United Kingdom .....	554	687	642
Continental Europe .....	1,496	1,464	321
United States .....	1,661	1,596	1,473
Africa, Asia, Australasia and Other America .....	438	408	339
Operating assets by segment .....	4,149	4,155	2,775
Unallocated corporate assets (see Note 3(a)) .....	359	306	456
Total assets .....	<u>4,508</u>	<u>4,461</u>	<u>3,231</u>

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

#### 4. Operating Profit

	2008	2007	2006
		(\$ million)	
Revenue .....	3,801	3,369	2,779
Cost of goods sold (i) .....	(1,077)	(994)	(769)
Gross profit .....	2,724	2,375	2,010
Research and development expenses .....	(152)	(142)	(120)
Selling, general and administrative expenses:			
Marketing, selling and distribution expenses (ii) .....	(1,436)	(1,278)	(1,092)
Administrative expenses (iii) (iv) .....	(533)	(487)	(286)
BSN agency and management fees (vi) .....	27	25	25
	<u>(1,942)</u>	<u>(1,740)</u>	<u>(1,353)</u>
Operating profit .....	<u>630</u>	<u>493</u>	<u>537</u>

- (i) 2008 includes \$15m in respect of the utilisation of Plus inventory stepped-up to fair value on acquisition, \$18m of restructuring and rationalisation expenses and \$8m of acquisition related costs (2007 — \$64m in respect of the utilisation of Plus inventory stepped-up to fair value on acquisition, \$7m of restructuring and rationalisation expenses and \$6m of acquisition related costs, 2006 — nil).
- (ii) 2008 includes \$7m of acquisition related costs and \$3m of restructuring and rationalisation expenses (2007 — \$12m of acquisition related costs and \$4m of restructuring and rationalisation expenses, 2006 — nil).
- (iii) Includes amortisation of intangible assets — other intangibles.
- (iv) 2008 includes \$31m of acquisition related costs, \$13m of restructuring and rationalisation expenses and \$51m of amortisation and impairment of acquisition intangibles (2007 — \$29m of acquisition related costs, \$31m of restructuring and rationalisation expenses, \$30m of legal settlement and \$30m of amortisation of acquisition intangibles, 2006 — \$20m of acquisition related costs and \$14m of amortisation of acquisition intangibles).
- (v) Items detailed in (i), (ii) and (iv) are excluded from the calculation of trading profit.
- (vi) Agency fees of \$27m (2007 — \$25m, 2006 — \$25m) were received in respect of services provided to BSN Medical for sales force resource, physical distribution and logistics and administration in certain countries. The calculation of the fees is designed to result in a neutral, cost-recovery position for the Group.

Operating Profit is stated after charging the following items:

	2008	2007	2006
		(\$ million)	
Amortisation of intangible assets — acquisition intangibles .....	37	30	14
Impairment of intangible assets — acquisition intangibles .....	14	—	—
Amortisation of intangible assets — other intangibles .....	18	16	10
Depreciation of property, plant and equipment .....	204	181	142
Loss on sale of property, plant and equipment .....	12	9	3
Minimum operating lease payments for land and buildings .....	28	26	24
Minimum operating lease payments for other assets .....	29	26	22
Advertising costs .....	56	48	45

Staff costs during the year amounted to:

	2008	2007	2006
		(\$ million)	
Wages and salaries .....	795	691	595
Social security costs .....	87	79	64
Pension costs — (Note 35) .....	51	40	43
Post-employment benefits other than pension costs — (Note 35) .....	2	2	2
Share based payments — (Note 28 (c)) .....	24	23	14
	<u>959</u>	<u>835</u>	<u>718</u>

## 5. Acquisition Related Costs

In 2008, "acquisition related costs" comprise \$46m relating to Plus integration and \$15m relating to the utilisation of the stepped-up Plus inventory to fair value on acquisition.

In 2007, "acquisition related costs" comprise \$51m relating to Plus integration; \$64m relating to the utilisation of the stepped-up Plus inventory to fair value on acquisition; less \$4m of accrual relating to the failed bid to purchase Biomet Inc., in 2006 that was reversed.

In 2006, \$20m of advisers fees were incurred in relation to the failed bid to purchase Biomet Inc.

## 6. Restructuring and Rationalisation Expenses

In 2008, restructuring and rationalisation costs comprised \$34m relating to the earnings improvement programme, mainly redundancy, consultancy and manufacturing rationalisation.

In 2007, restructuring and rationalisation costs comprised \$45m relating to the earnings improvement programme less \$3m relating to the write back of prior year's provisions.

## 7. Legal Settlement

The legal settlement of \$30m in 2007 relates to the civil settlement agreed with the US Department of Justice following an industry wide investigation.

In 2004, there was a macrotextured claim of \$154m which represented a provision of \$25m for the amount due from excess layer insurers who had declined insurance coverage for claims relating to macrotextured knee revisions together with an estimate of \$129m for the cost of settlements with patients likely to arise in the future and assuming that insurance cover remains unavailable (see Note 34). In 2007, this provision was increased by \$22m to reflect an increase in anticipated costs to settle outstanding and future claims, offset by a receipt of \$22m from a successful legal settlement.

## 8. Interest receivable/(payable)

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
Interest receivable .....	5	10	19
Interest payable:			
Bank borrowings .....	(62)	(33)	(6)
Loan Notes .....	—	—	(1)
Other .....	(9)	(7)	(2)
	<u>(71)</u>	<u>(40)</u>	<u>(9)</u>
Net interest (payable)/receivable .....	<u>(66)</u>	<u>(30)</u>	<u>10</u>

Interest receivable includes net interest receivable of \$1m (2007 — \$2m, 2006 — \$3m) on currency and interest rate swaps and other interest payable includes \$7m (2007 — \$2m, 2006 — nil) of net interest payable on currency and interest rate swaps. The gross interest receivable on these swaps was \$5m (2007 — \$13m, 2006 — \$18m) and the gross interest payable was \$11m (2007 — \$13m, 2006 — \$15m).

## 9. Other Finance (Costs)/Income

	<u>2008</u>	<u>2007</u> (\$ million)	<u>2006</u>
Retirement benefits: Interest cost — (Note 35) . . . . .	(66)	(56)	(47)
Retirement benefits: Expected return on plan assets — (Note 35) . . . . .	66	65	52
Other . . . . .	<u>(1)</u>	<u>(3)</u>	<u>1</u>
	(1)	6	6
Loss on hedge of the sale proceeds of the joint venture . . . . .	—	—	<u>(3)</u>
Other finance (costs)/income . . . . .	<u>(1)</u>	<u>6</u>	<u>3</u>

Foreign exchange gains or losses recognised in the income statement arose primarily on the translation of intercompany and third party borrowings and amounted to a net \$4m loss in 2008 (2007 — net \$14m gain, 2006 — net \$6m loss). These amounts were matched in the income statement by the fair value gains or losses on currency swaps (carried at fair value through profit and loss) held to manage this currency risk.

The contract to hedge the sale proceeds of the joint venture was an economic hedge but did not meet the requirements of IAS 39 for hedge accounting.

## 10. Taxation

	<u>2008</u>	<u>2007</u> (\$ million)	<u>2006</u>
Current taxation:			
UK corporation tax at 28% (2007 — 30%, 2006 — 30%) . . . . .	45	69	64
UK adjustments in respect of prior years . . . . .	<u>(9)</u>	<u>(29)</u>	<u>(44)</u>
	36	40	20
Overseas tax . . . . .	178	147	114
Overseas adjustments in respect of prior years . . . . .	<u>(5)</u>	<u>2</u>	<u>(9)</u>
	<u>173</u>	<u>149</u>	<u>105</u>
Total current taxation . . . . .	209	189	125
Deferred taxation:			
Origination and reversal of temporary differences . . . . .	(19)	(41)	21
Changes in tax rates . . . . .	—	4	—
Adjustments to estimated amounts arising in prior periods . . . . .	<u>(3)</u>	<u>1</u>	<u>10</u>
Total deferred taxation . . . . .	<u>(22)</u>	<u>(36)</u>	<u>31</u>
Taxation charged to the income statement . . . . .	187	153	156
Taxation on items (credited)/charged direct to equity: deferred taxation . . . . .	<u>(71)</u>	<u>(8)</u>	<u>11</u>
Taxation attributable to the Group . . . . .	<u>116</u>	<u>145</u>	<u>167</u>

The tax charge was reduced by \$30m in 2008, and was reduced by \$49m in 2007, as a consequence of restructuring and rationalisation expenses, acquisition related costs, the legal settlement and amortisation and impairment of acquisition intangibles. The tax charge was reduced by \$6m in 2006 as a consequence of the acquisition related costs.

## 10. Taxation — (continued)

The applicable tax for the year is based on the United Kingdom standard rate of corporation tax of 28.5% (2007 — 30%, 2006 — 30%). Overseas taxation is calculated at the rates prevailing in the respective jurisdiction. The average effective tax rate differs from the applicable rate as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(%)	
UK standard rate .....	28.5	30.0	30.0
Non-deductible/non-taxable items .....	1.4	2.6	1.0
Prior year items .....	(3.3)	(5.7)	(5.0)
Tax losses incurred not relieved/(utilised not previously recognised) .....	1.1	0.3	0.2
Overseas income taxed at other than UK standard rate .....	5.5	5.4	2.7
Total effective tax rate before discontinued operations .....	<u>33.2</u>	<u>32.6</u>	<u>28.9</u>
Discontinued operations .....	—	—	(13.8)
Total effective tax rate after discontinued operations .....	<u>33.2</u>	<u>32.6</u>	<u>15.1</u>

During 2008, the enacted UK tax rate applicable from 1 April 2008 was reduced to 28%. The Group also resolved a number of material disputes with various tax authorities. Following the resolution of these open issues the Group was able to release tax accruals relating to these issues and this release is reflected in the prior year tax credits.

## 11. Dividends

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
<b>The following dividends were declared and paid in the year:</b>			
Ordinary second interim of 7.38¢ for 2007 (2006 — 6.71¢, 2005 — 6.10¢) paid 9 May 2008 .....	66	63	57
Ordinary interim of 4.96¢ for 2008 (2007 — 4.51¢, 2006 — 4.10¢) paid 7 November 2008 .....	43	41	39
	<u>109</u>	<u>104</u>	<u>96</u>

A second interim dividend for 2008 of 8.12 US cents per Ordinary Share was declared by the Board on 11 February 2009 and will be paid on 8 May 2009 to shareholders on the Register of Members on 17 April 2009. The estimated amount of this dividend on 11 March 2009 was \$72m.



## 12. Earnings per Ordinary Share

The calculations of the basic, diluted and adjusted earnings per Ordinary Share are based on the following earnings and numbers of shares:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
<b>Earnings</b>			
Including discontinued operations — Attributable profit for the year . . . . .	377	316	745
Excluding discontinued operations — Profit from continuing operations . . . . .	377	316	394
Profit from discontinued operations . . . . .	—	—	351
Adjusted attributable profit (see below) . . . . .	493	480	425

### Adjusted attributable profit

Adjusted earnings per Ordinary Share is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers as affect the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. Adjusted attributable profit is the numerator used for this measure.

Attributable profit is reconciled to adjusted attributable profit as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
Attributable profit for the year . . . . .	377	316	745
Acquisition related costs — (Note 5) . . . . .	61	111	20
Restructuring and rationalisation expenses — (Note 6) . . . . .	34	42	—
Legal settlement — (Note 7) . . . . .	—	30	—
Amortisation and impairment of acquisition intangibles — (Note 14) . . . . .	51	30	14
Loss on hedge of the sale proceeds of the joint venture — (Note 9) . . . . .	—	—	3
Net profit on disposal of the joint venture — (Note 16) . . . . .	—	—	(351)
Taxation on excluded items — (Note 10) . . . . .	(30)	(49)	(6)
Adjusted attributable profit . . . . .	<u>493</u>	<u>480</u>	<u>425</u>

The numerators used for basic and diluted earnings per Ordinary Share are the same. The denominators used for all categories of earnings for basic and diluted earnings per Ordinary Share are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(Shares million)		
<b>Number of shares</b>			
Basic weighted average number of shares . . . . .	886	923	941
Dilutive impact of share options outstanding . . . . .	4	5	3
Diluted weighted average number of shares . . . . .	<u>890</u>	<u>928</u>	<u>944</u>
	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Earnings per Ordinary share</b>			
Including discontinued operations: Basic . . . . .	42.6¢	34.2¢	79.2¢
Including discontinued operations: Diluted . . . . .	42.4¢	34.1¢	78.9¢
Excluding discontinued operations: Basic . . . . .	42.6¢	34.2¢	41.9¢
Excluding discontinued operations: Diluted . . . . .	42.4¢	34.1¢	41.7¢
Discontinued operations: Basic . . . . .	—	—	37.3¢
Discontinued operations: Diluted . . . . .	—	—	37.2¢
Adjusted: Basic . . . . .	55.6¢	52.0¢	45.2¢
Adjusted: Diluted . . . . .	55.4¢	51.7¢	45.0¢

### 13. Property, Plant and Equipment

	Land and buildings		Plant and equipment*		In course of construction	Total*
	Freehold	Leasehold	Instruments	Other		
	(\$ million)					
<b>Cost</b>						
At 1 January 2007	138	41	546	657	38	1,420
Exchange adjustment	2	1	20	26	1	50
Acquisitions — (Note 32)	7	1	44	26	—	78
Additions	—	11	112	50	29	202
Disposals	(2)	(1)	(43)	(36)	—	(82)
Transfers	2	—	27	—	(29)	—
At 31 December 2007	147	53	706	723	39	1,668
Exchange adjustment	(12)	(1)	(39)	(82)	(4)	(138)
Additions	18	4	140	55	42	259
Disposals	—	(4)	(44)	(39)	—	(87)
Transfers	—	2	4	12	(18)	—
At 31 December 2008	153	54	767	669	59	1,702
<b>Depreciation and Impairment</b>						
At 1 January 2007	40	14	325	406	—	785
Exchange adjustment	1	—	10	16	—	27
Charge for the year	4	5	106	66	—	181
Disposals	(1)	(1)	(38)	(27)	—	(67)
At 31 December 2007	44	18	403	461	—	926
Exchange adjustment	(4)	—	(23)	(54)	—	(81)
Charge for the year	4	3	123	74	—	204
Disposals	—	(1)	(31)	(40)	—	(72)
At 31 December 2008	44	20	472	441	—	977
<b>Net book amounts</b>						
At 31 December 2008	109	34	295	228	59	725
At 31 December 2007	103	35	303	262	39	742

Land and buildings includes land with a cost of \$13m (2007 — \$11m) that is not subject to depreciation. Assets held under finance leases with a net book amount of \$17m (2007 — \$18m) are included in leasehold land and buildings and \$14m (2007 — \$15m) are included in instruments, plant and equipment.

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 14. Intangible Assets

	Acquisition intangibles*	Other intangibles (\$ million)	Total*
<b>Cost</b>			
At 1 January 2007	146	163	309
Exchange adjustment	20	1	21
Acquisitions — (Note 32)	237	2	239
Disposals	—	(39)	(39)
Additions	—	16	16
At 31 December 2007	<u>403</u>	<u>143</u>	<u>546</u>
Exchange adjustment	(15)	(9)	(24)
Acquisitions — (Note 32)	1	—	1
Disposals	(2)	—	(2)
Additions	—	33	33
At 31 December 2008	<u><u>387</u></u>	<u><u>167</u></u>	<u><u>554</u></u>
<b>Amortisation and Impairment</b>			
At 1 January 2007	35	83	118
Exchange adjustment	2	—	2
Charge for the year	30	16	46
Disposals	—	(39)	(39)
At 31 December 2007	<u>67</u>	<u>60</u>	<u>127</u>
Exchange adjustment	(13)	(3)	(16)
Charge for the year	37	18	55
Impairment	14	—	14
Disposals	(2)	—	(2)
At 31 December 2008	<u><u>103</u></u>	<u><u>75</u></u>	<u><u>178</u></u>
<b>Carrying amounts</b>			
At 31 December 2008	<u><u>284</u></u>	<u><u>92</u></u>	<u><u>376</u></u>
At 31 December 2007	<u><u>336</u></u>	<u><u>83</u></u>	<u><u>419</u></u>

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

Other intangibles consist primarily of software, distribution agreements, licences and patents.

During 2008 the Group incurred a \$14m impairment charge against one of the intangible assets acquired as part of the OsteoBiologics Inc., acquisition in July 2006.

## 15. Investments

	2008	2007
	(\$ million)	
At 1 January	9	10
Impairment	(2)	(1)
At 31 December	<u><u>7</u></u>	<u><u>9</u></u>

The investment is an available for sale investment in an entity that holds mainly unquoted equity securities which by their very nature have no fixed maturity date or coupon rate. The impairment in 2008 and 2007 was recognised directly in the income statement.

## 16. Discontinued Operations — Investment in Joint Venture (BSN Medical)

From 1 October 2005 the Group's 50% interest in the BSN Medical joint venture (held jointly with Beiersdorf AG) was classified as held for sale. On 23 February 2006 the Group sold this interest for cash consideration of \$562m. The profit on disposal of \$351m is calculated as follows:

	2006
	(\$ million)
Net profit on disposal:	
Cash proceeds	562
Net assets (including goodwill of \$122m)	(218)
Cumulative translation adjustments	14
Transaction and associated costs	(27)
Indemnity provision	(3)
Release of taxation provisions	23
Net profit on disposal	<u>351</u>

## 17. Investments in Associates

On 31 May 2007, the Group acquired 49% of the Austrian entities Plus Orthopedics GmbH and Intraplant GmbH and 20% of the German entity Intercus GmbH as part of the acquisition of Plus Orthopedics Holding AG.

	2008	2007
	(\$ million)	
Investments in associates at 1 January	11	–
Acquired on acquisition — (Note 32)	–	10
Share of results of associates:		
Revenue	11	5
Operating costs and taxation	(10)	(5)
Profit after taxation recognised in the income statement	1	–
Exchange adjustment	–	1
Investments in associates at 31 December	<u>12</u>	<u>11</u>
Investments in associates is represented by:		
Assets	10	9
Liabilities	(2)	(2)
Net assets	8	7
Goodwill	4	4
	<u>12</u>	<u>11</u>

## 18. Goodwill

	2008	2007*
	(\$million)	
At 1 January	1,225	640
Exchange adjustment	(34)	53
Acquisitions	–	532
Adjustment to contingent consideration — (Note 32)	(2)	–
At 31 December	<u>1,189</u>	<u>1,225</u>

Goodwill arising on acquisition is not amortised but reviewed for impairment on an annual basis. Goodwill is allocated to the cash-generating unit that is expected to benefit from the acquisition. If the recoverable amount of the cash-generating unit is less than its carrying amount then an impairment loss is determined to have occurred. Any impairment losses that arise are recognised immediately in the income statement and are allocated first to reduce the carrying amount of goodwill and then to the carrying amounts of the other assets.

Each of the Group's business segments represent a cash-generating unit and include goodwill as follows:

	2008	2007*
	(\$million)	
Orthopaedics	661	697
Endoscopy	280	280
Advanced Wound Management	248	248
	<u>1,189</u>	<u>1,225</u>

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 18. Goodwill — (continued)

In September 2008 and 2007 impairment reviews were performed by comparing the recoverable amount of each business segment with its carrying amount, including goodwill. These were updated during December 2008, taking into account significant events that occurred between September 2008 and December 2008. Management determined there was no impairment.

For each cash-generating unit (“CGU”) the recoverable amounts are based on value-in-use which is calculated from pre-tax cash flow projections for five years using data from the Group’s budget and strategic planning process, the results of which are reviewed and approved by the Board. These projections exclude any estimated future cash inflows or outflows expected to arise from future restructurings. The five-year period is in line with the Group’s strategic planning process. The growth rates used over the five year period for the Orthopaedics business vary up to 10%, for the Endoscopy business up to 10% and for the Advanced Wound Management business up to 12%.

The calculation of value-in-use for the three identified CGUs is most sensitive to discount rates, growth rates and capital utilisation as set out below:

The discount rate reflects management’s assessment of risks specific to the assets of each CGU. The pre-tax discount rate used in the Orthopaedics and Endoscopy businesses is 12% and for the Advanced Wound Management business is 10%.

In determining the growth rate used in the calculation of the value-in-use, the Group considered the annual sales growth and trading margins. Projections are based on anticipated volume and value growth in the markets served by the Group and assumptions as to market share movements. Each year the projections for the previous year are compared to actual results and variances are factored into the assumptions used in the current year.

Specific considerations and strategies taken into account in determining the sales growth and trading margin for each CGU are:

- Orthopaedics – In the Orthopaedic Reconstruction market, management believes that by focusing innovation on the needs of the younger, more active patients, Smith & Nephew can lead the sector in providing hip and knee implants to this growing demographic fragment. As such, the Group is continuing to invest in strategies that drive patient demand through integrated communications programmes, including direct-to-consumer advertising and internet-based initiatives. In the Orthopaedic Trauma and Clinical Therapies markets, management intends on delivering growth through innovative product development in the existing core business, while expanding into fast-growing market areas including alternative therapies for pain management and fracture healing.
- Endoscopy – It is management’s intent to maintain and grow this CGU as the leading provider of endoscopic techniques and technologies for joint and ligament repair. This is driven partly through the growing acceptance of endoscopy as a preferred surgical choice amongst physicians and patients, as well as supporting surgeon educational programmes, global fellowship support initiatives and partnerships with professional associations and surgeon advisory boards.
- Advanced Wound Management — By focusing on the higher added value sectors of exudate and infection management through improved wound bed preparation, moist and active healing and negative pressure wound therapy, management expects increased annual sales and trading margins.

A growth rate of 4% in pre-tax cash flows is assumed after five years in calculating a terminal value for the Group’s CGUs. Management considered this to be an appropriate estimate based on the growth rates of the markets in which the Group operates.

Capital utilisation represents the Group’s expected annual investment in property, plant and equipment and other intangible assets. This is approximately 8% of annual revenue.

Management has considered the following sensitivities:

- Growth of Market and Market Share — Management has considered the impact of a variance in market growth and market share. The value-in-use calculation shows that if the assumed long-term growth rate was reduced to nil, the recoverable amount of all of the CGUs independently would still be greater than their carrying values.

## 18. Goodwill — (continued)

- Discount Rate — Management has considered the impact of an increase in the discount rate applied to the calculation. The value-in-use calculation shows that for the recoverable amount of the CGU to be less than its carrying value, the discount rate would have to be increased to 25% for the Orthopaedics business, 43% for the Endoscopy business and 22% for the Advanced Wound Management business.

## 19. Inventories

	<u>2008</u>	<u>2007*</u>	<u>2006</u>
		(\$ million)	
Raw materials and consumables .....	131	124	96
Work-in-progress .....	32	36	24
Finished goods and goods for resale .....	<u>716</u>	<u>674</u>	<u>499</u>
	<u>879</u>	<u>834</u>	<u>619</u>

In 2008 \$69m (2007 — \$40m, 2006 — \$34m) was recognised as an expense resulting from the write down of excess and obsolete inventory. In 2008 no inventory (2007 — \$23m, 2006 — nil) is carried at fair value less costs to sell.

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 20. Trade and Other Receivables

	<u>2008</u>	<u>2007*</u>	<u>2006</u>
		(\$ million)	
Trade receivables .....	826	797	584
Less: provision for bad and doubtful debts .....	<u>(40)</u>	<u>(22)</u>	<u>(16)</u>
Trade receivables — net (loans and receivables) .....	786	775	568
Current asset derivatives — forward foreign exchange contracts .....	38	1	6
Other receivables .....	73	74	56
Amounts owed by associates .....	2	1	—
Prepayments and accrued income .....	<u>62</u>	<u>64</u>	<u>50</u>
	<u>961</u>	<u>915</u>	<u>680</u>

Management considers that the carrying amount of trade and other receivables approximates their fair value.

The provision for bad and doubtful debts is based on specific assessments of risk and reference to past default experience. The bad debt expense (excluding the macrotextured claim) for the year was \$30m (2007 — \$23m, 2006 — \$15m). Amounts due from insurers to the macrotextured claim of \$124m (2007 — \$114m, 2006 — \$113m) are included within other receivables and have been provided in full.

The Group manages credit risk through credit limits which require authorisation commensurate with the size of the limit and which are regularly reviewed. Credit limit decisions are made based on available financial information and the business case. Significant receivables are regularly reviewed and monitored at Group level. The Group's only significant concentration of credit risk relates to \$71m of debt from hospitals ultimately funded by the Greek government, other exposures are spread over a large number of customers. Furthermore, the Group's principal customers are backed by government and public or private medical insurance funding, who are considered to have low risk of default. The maximum exposure to credit risk at the reporting date is the fair value of each class of receivable. The Group does not hold any collateral as security.

## 20. Trade and Other Receivables — (continued)

The amount of trade receivables that were past due but not impaired were as follows:

	2008	2007*	2006
		(\$ million)	
Past due not more than three months	242	186	159
Past due more than three months and not more than six months	47	42	19
Past due more than six months and not more than one year	41	51	26
Past due more than one year	91	78	31
	<u>421</u>	<u>357</u>	<u>235</u>
Neither past due or impaired	405	440	349
Provision for bad and doubtful debts	(40)	(22)	(16)
Trade receivables — net	<u>786</u>	<u>775</u>	<u>568</u>

Movements in the provision for bad and doubtful debts were as follows:

At 1 January	22	16	14
Exchange adjustment	—	1	—
Receivables provided for during the year	30	23	15
Utilisation of provision	(12)	(18)	(13)
At 31 December	<u>40</u>	<u>22</u>	<u>16</u>

Trade receivables include amounts denominated in the following major currencies:

US Dollar	299	280	258
Sterling	52	68	56
Euro	273	272	130
Other	162	155	124
Trade receivables — net	<u>786</u>	<u>775</u>	<u>568</u>

Trade receivables in the amount of \$23m (2007 — \$7m, 2006 — nil) are under a factoring agreement with third parties. The arrangement does not qualify for de-recognition as the Group retains part of the credit risks — the associated liability amounts to \$20m (2007 — \$7m, 2006 — nil) and is accounted for as part of current payables.

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 21. Cash and Borrowings

Net debt comprises borrowings and credit balances on currency swaps less cash and bank.

	2008	2007
	(\$ million)	
Bank overdrafts and loans due within one year	115	1,442
Long-term borrowings	1,358	36
Borrowings	<u>1,473</u>	<u>1,478</u>
Cash and bank	(145)	(170)
Credit balances on currency swaps (current liability derivatives) — (Note 23)	4	2
Net debt	<u>1,332</u>	<u>1,310</u>

## 21. Cash and Borrowings — (continued)

Borrowings are repayable as follows:

	Within one year or on demand	Between one and two years	Between two and three years	Between three and four years	Between four and five years	After five years	Total
	(\$ million)						
At 31 December							
2008:							
Bank loans . . . . .	86	1	1	1,329	—	—	1,417
Bank overdrafts . . . . .	23	—	—	—	—	—	23
Finance lease liabilities . . . . .	5	4	3	3	2	14	31
Other loans . . . . .	1	—	1	—	—	—	2
	<u>115</u>	<u>5</u>	<u>5</u>	<u>1,332</u>	<u>2</u>	<u>14</u>	<u>1,473</u>
At 31 December							
2007:							
Bank loans . . . . .	1,361	1	1	1	1	—	1,365
Bank overdrafts . . . . .	61	—	—	—	—	—	61
Finance lease liabilities . . . . .	9	6	5	2	2	14	38
Other loans . . . . .	11	—	—	—	—	3	14
	<u>1,442</u>	<u>7</u>	<u>6</u>	<u>3</u>	<u>3</u>	<u>17</u>	<u>1,478</u>

Assets are pledged as security under normal market conditions. Secured borrowings and pledged assets are as follows:

	2008	2007
	(\$ million)	
Secured bank overdrafts and loans . . . . .	37	16
Secured long-term borrowings . . . . .	28	32
Total amount of secured borrowings . . . . .	<u>65</u>	<u>48</u>
Total net book value of assets pledged as security:		
Trade receivables . . . . .	31	7
Property, plant and equipment . . . . .	34	37
	<u>65</u>	<u>44</u>

All currency swaps are stated at fair value. Gross US Dollar equivalents of \$95m (2007 — \$97m) receivable and \$99m (2007 — \$99m) payable have been netted and the difference of \$4m is reported as credit balances on currency swaps (2007 — \$2m). Currency swaps comprise foreign exchange swaps and were used in 2008 and 2007 to hedge intragroup loans.



## 21. Cash and Borrowings — (continued)

Currency swaps mature as follows:

	Amount receivable	Amount payable
	(\$ million)	(Currency million)
At 31 December 2008 — Within one year:		
Australian Dollar . . . . .	13	Aus\$21
Euro . . . . .	14	€10
Japanese Yen . . . . .	15	Yen1,500
Canadian Dollar . . . . .	17	C\$22
Swiss Franc . . . . .	12	CHF13
New Zealand Dollar . . . . .	9	NZ\$16
	<u>80</u>	
	(Currency million)	(\$ million)
Euro . . . . .	€5	7
New Zealand Dollar . . . . .	NZ\$13	<u>8</u>
		<u>15</u>
	(\$ million)	(Currency million)
At 31 December 2007 — Within one year:		
Sterling . . . . .	8	£4
Australian Dollar . . . . .	43	Aus\$50
Euro . . . . .	10	€7
Japanese Yen . . . . .	17	Yen2,010
Canadian Dollar . . . . .	17	C\$17
Swiss Franc . . . . .	2	CHF3
	<u>97</u>	

### Liquidity Risk Exposures

The Board has established a set of policies to manage funding and currency risks. The Group uses derivative financial instruments only to manage the financial risks associated with underlying business activities and their financing.

Liquidity risk is the risk that the Group is not able to settle or meet its obligations on time or at a reasonable price. The Group's policy is to ensure that there is sufficient funding and facilities in place to meet foreseeable borrowing requirements. The Group manages and monitors liquidity risk through the regular reporting of current cash and borrowing balances and the periodic preparation and review of short and medium term cash forecasts having regard to the maturities of investments and borrowing facilities.

Bank loans and overdrafts represent drawings under committed facilities of \$2,512m and uncommitted facilities of \$340m. The Group has undrawn committed facilities of \$1,182m. In 2007, the Group had committed and uncommitted facilities of \$2,517m and \$513m respectively. Of the undrawn committed facilities, \$10m expires within one year and \$1,172m after two but within five years (2007 — undrawn committed facilities: \$1,270m of which \$91m expired within one year and \$1,179m after two but within five years). The interest payable on borrowings under committed facilities is at floating rate and is typically based on the LIBOR interest rate relevant to the term and currency concerned. Borrowings are shown at their amortised cost which is materially the same as their fair value.

In May 2007, the Group entered into a committed \$2,500m revolving multicurrency loan facility. This facility comprised a \$1,000m 364 day facility, which was extended into a term loan for a further 4 years in May 2008 by the giving of notice by the Group, and a five year \$1,500m revolving loan facility. In 2008, the term loan and the drawings under the revolving facility are classified as borrowings due after one year. The margin payable over LIBOR on the borrowings and the term loan is 25 basis points. The commitment fee on the undrawn amount of the revolving facility is 7.5 basis points. The Group is subject to restrictive covenants

## 21. Cash and Borrowings — (continued)

under the facility agreement requiring the Group's ratio of net debt (excluding derivatives) to EBITDA to not exceed 3.0 to 1 and the ratio of EBITA to net interest to not be less than 3.0 to 1, with net debt (excluding derivatives), EBITDA, EBITA and net interest all being calculated as defined in the agreement. These financial covenants are tested at the end of each half year for the 12 months ending on the last day of the testing period. As of 11 March 2009, the Group was in compliance with these covenants. The facility is also subject to customary events of default, none of which are currently anticipated to occur.

The table below analyses the Group's year end financial liabilities by contractual maturity date, including interest payments and excluding the impact of netting arrangements:

	Within one year or on demand	Between one and two years	Between two and five years (\$ million)	After five years	Total
<b>At 31 December 2008:</b>					
Non-derivative financial liabilities:					
Bank overdrafts and loans . . . . .	135	27	1,369	–	1,531
Trade and other payables . . . . .	544	–	–	–	544
Acquisition consideration . . . . .	11	5	33	–	49
Finance lease liabilities . . . . .	7	5	11	18	41
Other loans . . . . .	1	1	1	–	3
Derivative financial liabilities:					
Currency swaps/forward foreign exchange contracts — outflow . . . . .	751	–	–	–	751
Currency swaps/forward foreign exchange contracts — inflow . . . . .	(747)	–	–	–	(747)
Interest rate basis swaps — gross outflow . . . . .	30	–	–	–	30
Interest rate basis swaps — gross inflow . . . . .	(16)	–	–	–	(16)
	<u>716</u>	<u>38</u>	<u>1,414</u>	<u>18</u>	<u>2,186</u>
<b>At 31 December 2007:</b>					
Non-derivative financial liabilities:					
Bank overdrafts and loans . . . . .	1,428	1	3	–	1,432
Trade and other payables* . . . . .	525	–	–	–	525
Acquisition consideration . . . . .	14	18	33	–	65
Finance lease liabilities . . . . .	9	7	12	21	49
Other loans . . . . .	12	1	1	1	15
Derivative financial liabilities:					
Currency swaps/forward foreign exchange contracts — outflow . . . . .	643	–	–	–	643
Currency swaps/forward foreign exchange contracts — inflow . . . . .	(624)	–	–	–	(624)
Interest rate basis swaps — gross outflow . . . . .	18	–	–	–	18
Interest rate basis swaps — gross inflow . . . . .	(18)	–	–	–	(18)
	<u>2,007</u>	<u>27</u>	<u>49</u>	<u>22</u>	<u>2,105</u>

The amounts in the tables above are undiscounted cash flows, which differ from the amounts included in the balance sheet that are based on discounted cash flows.

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 22. Financial Instruments and Risk Management

### Foreign Exchange Exposures

The Group operates in 32 countries and as a consequence has transactional and translational foreign exchange exposure. The Group's policy is to limit the impact of foreign exchange movements on equity by holding liabilities in the same currencies as the Group's non US Dollar assets. These liabilities take the form of either borrowings or currency swaps. The Group designates a portion of the foreign currency borrowings in non-operating units as net investment hedges. As at 31 December 2008, CHF331m of the Group's borrowings were designated as net investment hedges; the movement in the fair value of these hedges attributable to changes in exchange rates is recognised directly in reserves. The fair value of these borrowings at 31 December 2008 was \$311m. It is the Group's policy for operating units not to hold material unhedged monetary assets or liabilities other than in their functional currencies.

Foreign exchange variations affect trading results in two ways. Firstly on translation of overseas sales and profits into US Dollars and secondly, transactional exposures arising where some or all the costs of sale are incurred in a different currency from the sale. The principal transactional exposures arise as the proportion of costs in US Dollars, Sterling and Swiss Francs exceed the proportion of sales in each of these currencies and correspondingly the proportion of sales in Euros exceeds the proportion of costs in Euros.

The impact of currency movements on the cost of purchases is partly mitigated by the use of forward foreign exchange contracts. The Group uses forward foreign exchange contracts, designated as cash flow hedges, to hedge forecast third party and intercompany trading cash flows for forecast foreign currency inventory purchases for up to one year. When a commitment is entered into, forward foreign exchange contracts are used to increase the hedges to 100% of the exposure. The cash flows relating to cash flow hedges are expected to occur within twelve months of inception and the profits and losses on the hedges are expected to enter into the determination of profit (within cost of goods sold) within a further twelve month period. The principal currencies hedged by forward foreign exchange contracts are US Dollars, Euros and Sterling. At 31 December 2008, the Group had contracted to exchange within one year the equivalent of \$652m (2007 — \$480m).

Based on the Group's borrowings as at 31 December 2008, if the US Dollar were to weaken against all currencies by 10%, the Group's net borrowings would increase by \$78m (2007 — \$106m). Excluding borrowings held in the same currency as the relevant reporting entity, if the US Dollar were to weaken by 10% against all other currencies, the Group's borrowings would increase by \$52m (2007 — \$72m). Excluding borrowings designated as net investment hedges, the increase would be \$21m (2007 — \$26m), this increase would be fully offset by corresponding movements in group loan values.

If the US Dollar were to weaken by 10% against all other currencies, then the fair value of the forward foreign exchange contracts as at 31 December 2008 would have been \$16m lower (2007 — \$24m) which would be recognised through the hedging reserve. Similarly, if Euro were to weaken by 10% against all other currencies, then the fair value of the forward foreign exchange contracts as at 31 December 2008 would have been \$19m higher (2007 — \$17m).

A 10% strengthening of the US Dollar against all other currencies at 31 December would have had the equal but opposite effect to the amounts shown above, on the basis that all other variables remain constant.

Since it is the Group's policy to hedge all actual foreign exchange exposures and the Group's forward foreign exchange contracts are designated as cash flow hedges, the net impact of transaction related foreign exchange on the income statement from a movement in exchange rates is not significant.

## 22. Financial Instruments and Risk Management — (continued)

### Interest Rate Exposures

The Group is exposed to interest rate risk on cash, borrowings and currency swaps which are all at floating rates. The Group uses floating to fixed interest swaps to meet its objective of protecting borrowing costs within parameters set by the Board. Interest rate swaps are accounted for as cash flow hedges and, as such, changes in fair value resulting from changes in market interest rates are recognised in equity, with the fair value of the interest rate swaps recorded in the balance sheet. The cash flows resulting from interest rate swaps match cash flows on the underlying borrowings so that there is no net cash flow from movements in market interest rates on the hedged items. The Group had fixed future interest rates on borrowings totalling \$819m at 31 December 2008 (2007 — \$710m) for a period of one year.

Based on the Group's borrowings as at 31 December 2008, if interest rates were to increase by 100 basis points in all currencies then the annual net interest charge would increase by \$5m (2007 — \$6m). Excluding the impact of the Group's interest rate hedges, the increase in the interest charge would be \$13m (2007 — \$13m). Similarly if interest rates were to increase by 100 basis points in all currencies, the fair value of the Group's interest rate swaps would increase equity by \$7m (2007 — \$7m). A decrease in interest rates by 100 basis points in all currencies would have had an equal but opposite effect to the amounts shown above.

### Credit Risk Exposures

The Group limits exposure to credit risk on counterparties used for financial instruments through a system of internal credit limits which, with certain minor exceptions due to local market conditions, require counterparties to have a minimum "A" rating from the major ratings agencies. The financial exposure of a counterparty is determined as the total of cash and deposits, plus the risk on derivative instruments, assessed as the fair value of the instrument plus a risk element based on the nominal value and the historic volatility of the market value of the instrument. The Group does not anticipate non-performance of counterparties and believes it is not subject to material concentration of credit risk as the Group operates within a policy of counter-party limits designed to reduce exposure to any single counter-party.

The maximum credit risk exposure on derivatives at 31 December 2008 was \$38m (2007 — \$1m) being the gross debit fair value on forward foreign exchange contracts, interest rate swaps and currency swaps. The maximum credit risk exposure on cash and bank at 31 December 2008 was \$145m (2007 — \$170m). The Group's exposure to credit risk is not material as the amounts are held in a wide number of banks in a number of different countries.

Credit risk on trade receivables is detailed in Note 20 of the Notes to the Group Accounts.

## 22. Financial Instruments and Risk Management — (continued)

### Currency and Interest Rate Profile of Interest Bearing Liabilities and Assets

In 2008, the Group entered into a series of interest rate swaps to fix the monthly interest payable on \$819m (2007 — \$710m) of the Group's floating rate borrowings for a period of one year. The swaps are denominated in US Dollars, Euros and Swiss Francs. Short-term debtors and creditors are excluded from the following disclosures:

Currency and Interest Rate Profile of Interest Bearing Liabilities:

	Gross borrowings	Currency swaps	Total liabilities (\$ million)	Floating rate liabilities	Fixed rate liabilities	Fixed rate liabilities	
						Weighted average interest rate (%)	Weighted average time for which rate is fixed (Years)
At 31 December 2008:							
US Dollar	635	—	635	264	371	4.1	1
Swiss Franc	348	13	361	140	221	3.0	1
Euro	379	21	400	142	258	4.7	1
Other	111	65	176	176	—	—	—
Total interest bearing liabilities	<u>1,473</u>	<u>99</u>	<u>1,572</u>	<u>722</u>	<u>850</u>		
At 31 December 2007:							
US Dollar	382	—	382	160	222	5.3	2
Swiss Franc	410	2	412	141	271	3.3	1
Euro	512	10	522	267	255	4.8	1
Other	174	87	261	261	—	—	—
Total interest bearing liabilities	<u>1,478</u>	<u>99</u>	<u>1,577</u>	<u>829</u>	<u>748</u>		

\$31m (2007 — \$38m) of fixed rate liabilities relate to finance leases and \$819m (2007 — \$710m) relates to hedged borrowings under the \$2,500m facility. In addition to the above, the Group has liabilities due for acquisition consideration (denominated in US Dollars, Australian Dollars, Euro and Yen) totalling \$47m (2007 — \$61m) on which no interest is payable (see Note 23 of the Notes to the Group Accounts). There are no other significant interest bearing financial liabilities.

Floating rates on liabilities are typically based on the one or three-month LIBOR interest rate relevant to the currency concerned. The weighted average interest rate on short-term borrowings as at 31 December 2008 was 2% (2007 — 4%).

Currency and Interest Rate Profile of Interest Bearing Assets:

	Cash and bank	Currency swaps	Total assets	Floating rate assets
At 31 December 2008:				
US Dollars	20	95	115	115
Other	125	—	125	125
Total interest bearing assets	<u>145</u>	<u>95</u>	<u>240</u>	<u>240</u>
At 31 December 2007:				
US Dollars	32	97	129	129
Other	138	—	138	138
Total interest bearing assets	<u>170</u>	<u>97</u>	<u>267</u>	<u>267</u>

Floating rates on assets are typically based on the short-term deposit rates relevant to the currency concerned. There were no fixed rate assets at 31 December 2008 or 31 December 2007.

## 22. Financial Instruments and Risk Management — (continued)

### Fair Value of Financial Assets and Liabilities

Forward foreign exchange contracts that are taken out as hedges are fair valued. Management considers that the carrying amount of trade and other receivables approximates the fair value.

For cash and cash equivalents, short-term loans and receivables, overdrafts and other short-term liabilities which have a maturity of less than three months, the book values approximate the fair values because of their short-term nature.

Long-term borrowings are measured in the balance sheet at amortised cost. As the Group's long-term borrowings are not quoted publicly and as market prices are not available their fair values are estimated by discounting future contractual cash flows to net present values at the current market interest rates available to the Group for similar financial instruments as at the year end. At 31 December 2008 and 31 December 2007, the fair value of the Group's long-term borrowing was not materially different from amortised cost.

For currency and interest rate derivatives fair value represents the estimated amount the Group would pay or receive if the transaction was terminated. These are calculated using standard market calculation conventions with reference to the relevant published closing interest rates and spot and forward exchange rates taken from an active market.

## 23. Payables

	2008	2007*
	(\$ million)	
<b>Trade and other payables due within one year:</b>		
Trade and other payables .....	544	525
Current liability derivatives — currency swaps — (Note 21) .....	4	2
Current liability derivatives — forward foreign exchange contracts .....	34	19
Current liability derivatives — interest rate swaps .....	14	2
Acquisition consideration .....	11	14
	<u>607</u>	<u>562</u>
<b>Other payables due after one year:</b>		
Acquisition consideration .....	36	47
	<u>36</u>	<u>47</u>

Amounts falling due after more than one year are payable as follows: \$4m in 2010 and \$32m in 2011 (2007 — \$18m in 2009 and \$29m in 2010). Trade payables are not interest bearing and are stated at their nominal value. Management consider that the carrying amount of trade payables approximates the fair value.

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 24. Provisions

	Rationalisation and Integration	Liability	Total
		(\$ million)	
At 1 January 2008 .....	53	60	113
Exchange adjustment .....	(2)	—	(2)
Charge to income statement .....	22	23	45
Utilisation .....	(40)	(11)	(51)
At 31 December 2008 .....	<u>33</u>	<u>72</u>	<u>105</u>
Provisions — due within one year .....	23	31	54
Provisions — due after one year .....	10	41	51
At 31 December 2008 .....	<u>33</u>	<u>72</u>	<u>105</u>
Provisions — due within one year .....	38	42	80
Provisions — due after one year .....	15	18	33
At 31 December 2007 .....	<u>53</u>	<u>60</u>	<u>113</u>

## 24. Provisions — (continued)

The principal provisions within rationalisation and integration provisions relate to rationalisation (mainly severance and legal costs) arising from the Earnings Improvement Programme, integration expenses relating to severance, legal and onerous leases arising from the acquisition of Plus and an onerous lease obligation on the exit from the tissue engineering operation. All provisions are expected to be substantially utilised within four years and none are treated as financial instruments.

Included within the liability provision is \$30m (2007 — \$40m) relating to the declination of insurance coverage for macrot textured knee revisions (see Note 34 of the Notes to the Group Accounts). In addition, \$124m (2007 — \$114m) has been provided against other receivables relating to this issue. In 2007, this provision was increased by \$22m to reflect an increase in anticipated costs to settle outstanding and future claims.

## 25. Deferred Taxation

	2008	2007*
	(\$ million)	
Deferred tax assets . . . . .	214	136
Deferred tax liabilities . . . . .	(46)	(57)
Net position at 31 December . . . . .	<u>168</u>	<u>79</u>

The movement in the year in the Group's net deferred tax position was as follows:

At 1 January . . . . .	79	75
Exchange adjustment . . . . .	(5)	(1)
Credit to income — current year . . . . .	19	37
Credit/(charge) to income — prior years . . . . .	3	(1)
Acquisitions/disposals . . . . .	1	(39)
Credit to equity . . . . .	<u>71</u>	<u>8</u>
At 31 December . . . . .	<u>168</u>	<u>79</u>

Movements in the main components of deferred tax assets and liabilities were as follows:

	Retirement benefit obligation	Macrot textured claim	Other*	Total*
	(\$ million)			
<b>Deferred tax assets:</b>				
At 1 January 2007 . . . . .	24	54	32	110
Exchange adjustment . . . . .	—	—	5	5
Credit/(charge) to income — current year . . . . .	1	(1)	35	35
Credit to income — prior years . . . . .	—	—	6	6
(Charge)/credit to equity . . . . .	(11)	—	4	(7)
Transfers . . . . .	<u>—</u>	<u>—</u>	<u>(13)</u>	<u>(13)</u>
At 31 December 2007 . . . . .	14	53	69	136
Exchange adjustment . . . . .	—	—	(6)	(6)
(Charge)/credit to income — current year . . . . .	—	(1)	24	23
Credit to income — prior years . . . . .	—	—	5	5
Credit to equity . . . . .	52	—	—	52
Acquisitions . . . . .	—	—	1	1
Transfers . . . . .	<u>—</u>	<u>—</u>	<u>3</u>	<u>3</u>
At 31 December 2008 . . . . .	<u>66</u>	<u>52</u>	<u>96</u>	<u>214</u>

## 25. Deferred Taxation — (continued)

The Group has unused tax losses of \$34m (2007 — \$60m) available for offset against future profits. A deferred tax asset has been recognised in respect of \$5m (2007 — \$6m) of such losses. No deferred tax asset has been recognised on the remaining unused tax losses as these are not expected to be realised in the foreseeable future.

	Accelerated tax depreciation	Intangible assets*	Other	Total*
	(\$ million)			
<b>Deferred tax liabilities:</b>				
At 1 January 2007	(33)	(24)	22	(35)
Exchange adjustment	(2)	(1)	(3)	(6)
Credit/(charge) to income — current year	2	4	(4)	2
(Charge)/credit to income — prior years	(3)	2	(6)	(7)
Credit to equity	—	—	15	15
Acquisitions — (Note 32)	(2)	(28)	(9)	(39)
Transfers	(6)	10	9	13
At 31 December 2007	(44)	(37)	24	(57)
Exchange adjustment	6	2	(7)	1
(Charge)/credit to income — current year	(3)	4	(5)	(4)
Charge to income — prior years	—	—	(2)	(2)
Credit to equity	—	—	19	19
Transfers	—	(3)	—	(3)
At 31 December 2008	(41)	(34)	29	(46)

\* Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## 26. Called Up Equity Share Capital

	Ordinary Shares (12 <sup>2</sup> / <sub>p</sub> )		Ordinary Shares (20¢)		Deferred Shares (£1.00)		Total
	('000)	(\$ million)	('000)	(\$ million)	('000)	(\$ million)	(\$ million)
<b>Authorised</b>							
At 31 December 2006	—	—	1,223,591	245	50	—	245
At 31 December 2007	—	—	1,223,591	245	50	—	245
At 31 December 2008	—	—	1,223,591	245	50	—	245
<b>Allotted, issued and fully paid</b>							
At 1 January 2006	940,638	203	—	—	—	—	203
Share options	52	—	—	—	—	—	—
At 23 January 2006	940,690	203	—	—	—	—	203
Cancellation of 12 <sup>2</sup> / <sub>p</sub> shares	(940,690)	(203)	—	—	—	—	(203)
Creation of deferred shares and ordinary 20¢ shares	—	—	940,690	188	50	—	188
Share options	—	—	2,793	1	—	—	1
At 31 December 2006	—	—	943,483	189	50	—	189
Share options	—	—	4,025	1	—	—	1
At 31 December 2007	—	—	947,508	190	50	—	190
Share options	—	—	2,382	—	—	—	—
At 31 December 2008	—	—	949,890	190	50	—	190



## 26. Called Up Equity Share Capital — (continued)

On 23 January 2006 the Ordinary Shares of 12<sup>2</sup>/<sub>9</sub> p were redenominated to US Dollar shares of 20¢ each by means of a Court approved reduction in share capital, creation of a capital redemption reserve and subsequent issue and allotment of new Ordinary Shares of 20¢ each on the basis of one new share for one existing share held.

In 2006, in order to comply with English law the Company issued £50,000 of shares in Sterling. These were issued as deferred shares, which are not listed on any stock exchange, have extremely limited rights and effectively have no value. These rights are summarised as follows:

- The holder shall not be entitled to participate in the profits of the Company;
- The holder shall not have any right to participate in any distribution of the Company's assets on a winding up or other distribution except that after the return of the nominal amount paid up on each share in the capital of the company of any class other than the Deferred Shares and the distribution of a further \$1,000 in respect of each such share there shall be distributed to a holder of a Deferred Share (for each Deferred Share held by him) an amount equal to the nominal value of the Deferred Share;
- The holder shall not be entitled to receive notice, attend, speak or vote at any general meeting of the Company; and
- The Company may create, allot and issue further shares or reduce or repay the whole or any part of its share capital or other capital reserves without obtaining the consent of the holders of the Deferred Shares.

The Group's objectives when managing capital are to ensure the Group has adequate funds to continue as a going concern and sufficient flexibility within the capital structure to fund the ongoing growth of the business and to take advantage of business development opportunities including acquisitions.

The Group determines the amount of capital taking into account changes in business risks and future cash requirements. The Group reviews its capital structure on an ongoing basis and uses share buy-backs, dividends and the issue of new shares to adjust the retained capital.

Other than the share buy-back programme detailed in Note 29 of the Notes to the Group Accounts the Group is not subject to any imposed capital requirements.

The Group considers the capital that it manages to be as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(\$ million)		
Called up equity share capital . . . . .	190	190	189
Share premium account — (Note 27) . . . . .	375	356	329
Treasury shares — (Note 29) . . . . .	(823)	(637)	(1)
Accumulated profits and other reserves — (Note 27) . . . . .	<u>1,957</u>	<u>1,907</u>	<u>1,657</u>
	<u>1,699</u>	<u>1,816</u>	<u>2,174</u>

## 27. Reserves

	2008	2007	2006
	(\$ million)		
<b>Share Premium</b>			
At 1 January	356	329	299
Cancellation of 12 <sup>2</sup> / <sub>9</sub> p shares on share redenomination	—	—	(299)
Issue of shares on share redenomination	—	—	314
Premium on new shares issued on exercise of share options	19	27	15
At 31 December	<u>375</u>	<u>356</u>	<u>329</u>

On 23 January 2006 the Ordinary Shares of 12 <sup>2</sup>/<sub>9</sub>p were redenominated to US Dollar shares of 20¢ each by means of a Court approved reduction in share capital, creation of a capital redemption reserve and subsequent issue and allotment of new Ordinary Shares of 20¢ each on the basis of one new share for one existing share held.

### Other Reserves (i)

At 1 January	96	63	22
Cancellation of 12 <sup>2</sup> / <sub>9</sub> p shares on share redenomination	—	—	502
Issue of new shares on share redenomination	—	—	(502)
Exchange differences on translation	(57)	94	59
Exchange on borrowings classified as net investment hedges	(42)	(47)	—
Cumulative translation adjustment on disposal of the joint venture	—	—	(14)
Gains/(losses) on hedging instruments charged to equity	8	(14)	—
Gains on hedging instruments transferred from equity to the income statement	(4)	—	(4)
At 31 December	<u>1</u>	<u>96</u>	<u>63</u>

(i) The cumulative translation adjustments within Other Reserves at 31 December 2008 were \$11m (2007 — \$110m, 2006 — \$63m).

Other reserves comprise gains and losses on cash flow hedges, exchange differences on translation of foreign operations and the difference arising as a result of translating share capital and share premium at the rate on the date of redenomination instead of the rate at the balance sheet date.

### Accumulated Profits

At 1 January	1,811	1,594	915
Actuarial (losses)/gains on defined benefit plans	(215)	(22)	30
Taxation on items taken directly to or transferred from equity	71	8	(11)
Net (expense)/income recognised directly in equity	(144)	(14)	19
Share based payment recognised in the income statement	24	23	14
Cost of shares transferred to beneficiaries	(3)	(4)	(3)
Attributable profit for the year	377	316	745
Equity dividends paid in the year — (Note 11)	(109)	(104)	(96)
At 31 December	<u>1,956</u>	<u>1,811</u>	<u>1,594</u>

### Minority Interests

At 1 January	—	—	—
Acquisition of minority interests — (Note 32)	—	4	—
Minority interest share of profit (net of taxation of nil)	—	—	—
Purchases of minority interests — (Note 32)	—	(4)	—
At 31 December	<u>—</u>	<u>—</u>	<u>—</u>

## 28(a). Share Based Payments — Share Option Schemes

### Employee Schemes

The Smith & Nephew Sharesave Plan (2002) (adopted by shareholders on 3 April 2002) (the Save As You Earn (“SAYE”) scheme) is available to all employees in the UK employed by participating Group companies, subject to three months service. The scheme provides for employees to save up to £250 per month and gives them an option to acquire shares based on the committed amount to be saved. The option price is not less than 80% of the average of middle market quotations of the Ordinary Shares on the three dealing days preceding the date of invitation. The Smith & Nephew International Sharesave Plan (2002) is offered to employees in Australia, Austria, Canada, Denmark, Finland, Germany, Hong Kong, Japan, South Korea, Mexico, New Zealand, Norway, Poland, Portugal, Puerto Rico, Singapore, South Africa, Spain, Sweden, Switzerland and the United Arab Emirates. Employees in Belgium, Italy, the Netherlands and France are able to participate respectively in the Smith & Nephew Belgian Sharesave Plan (2002), the Smith & Nephew Italian Sharesave Plan (2002), the Smith & Nephew Dutch Sharesave Plan (2002) and the Smith & Nephew France Sharesave Plan (2002). Participants in Ireland are able to participate in the Smith & Nephew Irish Employee Share Option Scheme. These plans operate on a substantially similar basis to the Smith & Nephew Sharesave Plan (2002). Together all of the plans referred to above are termed the “Employee Schemes”.

Employees in the US are able to participate in the Employee Stock Purchase Plan, which gives them the opportunity to acquire shares, in the form of ADSs, at a discount of 15% (or more if the shares appreciate in value during the plan’s quarterly purchase period) to the market price, through a regular savings plan.

### Executive Schemes

The Smith & Nephew 1985 Share Option Scheme (adopted by shareholders on 9 May 1985), the Smith & Nephew 1990 International Executive Share Option Scheme (adopted by shareholders on 15 May 1990), the Smith & Nephew 2001 UK Approved Share Option Plan, the Smith & Nephew 2001 UK Unapproved Share Option Plan, the Smith & Nephew 2001 US Share Plan (adopted by shareholders on 4 April 2001) and the Smith & Nephew 2004 Executive Share Option Plan (adopted by shareholders on 6 May 2004) are together termed the “Executive Schemes”.

Under the terms of the Executive Schemes, the Remuneration Committee, consisting of Non-Executive Directors, may approve the grant of options to employees of the Group to acquire Ordinary Shares in the Company. Options granted under the Smith & Nephew 2001 US Share Plan (the “US Plan”) are to acquire ADSs or Ordinary Shares. For options granted prior to 2001, the option price was not less than the market value of an Ordinary Share, or the nominal value if higher (the market value being the quoted price on the business day preceding the date of grant or the quoted price on the date of grant). For Executive Schemes adopted in 2001 and 2004, the market value is the average quoted price of an Ordinary Share for the three business days preceding the date of grant or, for the US Plan, the average quoted price of an ADS or Ordinary Share, for the three business days preceding the date of grant or the quoted price on the date of grant if higher. With the exception of options granted under the 2001 US Plan, the exercise of options granted from 1997 are subject to achievement of a performance condition. Options granted under the 2001 US Plan are not subject to any performance conditions. Prior to 2008, the 2001 US Plan options become cumulatively exercisable as to 10% after one year, 30% after two years, 60% after three years and the remaining balance after four years. With effect from 2008, the 2001 US Plan options granted become cumulatively exercisable as to 33.3% after one year, 66.7% after two years and the remaining balance after the third year. The 1990 International Executive Share Option Scheme and the 2004 Plan are open to senior managers worldwide. The 2001 UK Unapproved Share Option Plan is open to senior managers outside the US and the US Plan is open to senior managers in the US, Canada, Mexico and Puerto Rico.

The maximum term of options granted, under all schemes, is 10 years from the date of grant. All share option schemes except for the Stock Appreciation Rights Plan (detailed on page 120) are settled in shares.

**28(a). Share Based Payments — Share Option Schemes — (continued)**

At 31 December 2008 21,681,000 (2007 — 21,028,000, 2006 — 20,849,000) options were outstanding under share option schemes as follows:

	Number of shares	Range of option exercise prices	Weighted average exercise price
	(Thousand)	(Pence)	(Pence)
<b>Employee Schemes:</b>			
Outstanding at 1 January 2006	3,757	221.2 – 526.0	364.7
Granted	1,511	348.0 – 451.0	350.6
Forfeited	(486)	289.2 – 526.0	398.3
Exercised	(843)	221.2 – 425.0	311.4
Expired	(2)	221.2 – 296.0	270.0
Outstanding at 31 December 2006	3,937	289.2 – 526.0	369.4
Granted	1,077	455.5 – 600.5	459.7
Forfeited	(470)	296.0 – 498.0	379.5
Exercised	(856)	289.2 – 526.0	353.0
Expired	(10)	296.0 – 348.0	335.8
Outstanding at 31 December 2007	3,678	296.0 – 600.5	397.9
Granted	906	507.0 – 640.0	509.3
Forfeited	(359)	296.0 – 581.0	408.7
Exercised	(633)	296.0 – 526.0	368.2
Expired	(59)	296.0 – 498.0	379.9
Outstanding at 31 December 2008	<u>3,533</u>	321.0 – 640.0	427.4
Options exercisable at 31 December 2008	<u>168</u>	321.0 – 526.0	398.3
Options exercisable at 31 December 2007	<u>602</u>	296.0 – 498.0	362.9
Options exercisable at 31 December 2006	<u>55</u>	289.2 – 403.0	321.7
<b>Executive Schemes:</b>			
Outstanding at 1 January 2006	15,260	145.0 – 582.9	437.6
Granted	5,166	434.0 – 516.5	509.7
Forfeited	(991)	335.4 – 574.0	516.4
Exercised	(2,001)	145.0 – 546.6	311.1
Expired	(522)	145.0 – 580.2	472.4
Outstanding at 31 December 2006	16,912	145.0 – 582.9	478.1
Granted	5,209	615.0 – 637.7	629.5
Forfeited	(1,618)	409.5 – 637.7	554.5
Exercised	(3,153)	145.0 – 514.0	340.0
Outstanding at 31 December 2007	17,350	145.0 – 637.7	525.0
Granted	5,129	465.5 – 680.5	615.1
Forfeited	(1,073)	409.5 – 637.5	559.5
Exercised	(2,696)	265.0 – 637.5	584.1
Expired	(562)	145.0 – 637.7	575.3
Outstanding at 31 December 2008	<u>18,148</u>	183.5 – 680.5	592.5
Options exercisable at 31 December 2008	<u>5,049</u>	183.5 – 672.5	593.2
Options exercisable at 31 December 2007	<u>5,012</u>	145.0 – 581.5	444.0
Options exercisable at 31 December 2006	<u>5,328</u>	145.0 – 552.0	386.5

## 28(a). Share Based Payments — Share Option Schemes — (continued)

The weighted average remaining contractual life of options outstanding at 31 December 2008 was 4.6 (2007 — 4.9 years, 2006 — 5.3 years) years for Executive Schemes and 1.7 (2007 — 2.5 years, 2006 2.7 years) years for Employee Schemes.

The weighted average share prices during each year were as follows:

2006 .....	483 pence
2007 .....	601 pence
2008 .....	579 pence

Options granted during the year were as follows:

	Options granted	Weighted average fair value per option at grant date	Weighted average share price at grant date	Weighted average exercise price	Weighted average option life
	(Thousand)	(Pence)	(Pence)	(Pence)	(Years)
Employee Schemes .....	906	192.0	616.0	509.3	3.9
Executive Schemes .....	5,129	191.3	618.5	615.1	6.5

The weighted average fair value of options granted under employee schemes during 2007 was 196p (2006 — 167p) and those under executive schemes during 2007 was 202p (2006 — 150p).

Options granted in 2008, 2007 and 2006 under the executive schemes were valued using a binomial model. Options granted under employee schemes were valued using the Black-Scholes option model as management considered that options granted under these schemes are exercised within a short period of time after the vesting date. Options granted under each scheme are valued separately and a weighted average fair value calculated.

The binomial model was used for executive schemes so that proper allowance is made for the possibility of early exercise. At the 2008 grant management expected 95% of the options granted under the 2001 Executive Scheme to vest (2007 — 95%, 2006 — 95%) and 60% of the 2004 Executive Scheme to vest (2007 — 60%, 2006—60%). Each year an assessment is made of the current vesting estimates and they are updated to reflect revised expectations of the number of grants that will vest. This includes the effects of any modifications to the share schemes during the year. In 2005 the Group announced its intention to report its results in US Dollars with effect from 2006. For the 2005 awards, the Remuneration Committee decided to retain the same performance targets but base them on US Dollar numbers over the life of the award. In order to reflect the different EPSA growths under US Dollar reporting the estimates of final vesting were amended for schemes with this criteria. To the extent that this is a modification, there was no effect on the charge in the income statement. Commencing in 2006 the impact on the share based payment charge in the income statement over the life of the options was an additional charge of approximately \$1m. There was no effect on the fair value of the share based payments as a result of this change.

## 28(a). Share Based Payments — Share Option Schemes — (continued)

For all schemes the inputs to the option pricing models are reassessed for each grant. The following assumptions were used in calculating the fair value of options granted:

	Employee schemes			Executive schemes		
	2008	2007	2006	2008	2007	2006
	(% , except Expected Life in years)					
Dividend yield	1.0	1.0	1.5	1.0	1.0	1.5
Expected volatility (i)	25.0	23.0	25.0	25.0	23.0	25.0
Risk free interest rate (ii)	4.5	5.0	4.8	4.5	5.0	4.5
Expected life in years (iii)	3.9	4.0	3.9	6.5	6.3	6.6

(i) Volatility is assessed on a historic basis primarily based on past share price movements over the expected life of the options.

(ii) The risk free interest rate reflects the yields available on zero coupon government bonds over the option term and currency.

(iii) An assessment of an Executive Scheme's option life is based on an exercise model. This is based on a mixture of historic experience and generally accepted behavioural traits. 5% (2007 — 5%, 2006 — 5%) of Executive Scheme option holders are assumed to leave and exercise their options (or forfeit them if under water) each year after vesting. In addition, 50% (2007 — 50%, 2006 — 50%) of Executive Scheme option holders are assumed to exercise by choice per annum providing the gain available is at least 50% for the 2004 Plan and 25% for the 2001 Plans (2007 — 50% for the 2004 Plan and 25% for the 2001 Plans, 2006 — 50% for the 2004 Plan and 25% for the 2001 Plans).

Summarised information about options outstanding under the share option schemes at 31 December 2008 is as follows:

	Number outstanding (Thousand)	Weighted average remaining contract life (Years)
Employee Schemes:		
321.0p to 438.5p (i)	1,673	0.7
438.5p (i) to 640.0p	1,860	2.6
	<u>3,533</u>	1.7
Executive Schemes:		
183.5p to 438.5p (i)	1,837	1.1
438.5p (i) to 680.5p	16,311	4.9
	<u>18,148</u>	4.6

(i) The split has been determined based on the year-end share price of 438.5p.

85,135 (2007 — 163,823, 2006 — 259,054) options remain outstanding under the 1999 and 2000 Stock Appreciation Rights Plan and at 31 December 2008 these have a fair value liability of nil (2007 — \$1m, 2006 — \$2m) which is materially the same as intrinsic value.

## 28(b). Share Based Payment — Long-Term Incentive Plans

The Group operated a long-term incentive plan (“LTIP”) for executive directors and executive officers from 1997 to 2003. Vesting of LTIP awards was dependent on the Group’s relative performance in a group of 39 UK listed manufacturing companies with substantial international activities, using total shareholder return (“TSR”) over a three year period as the prime measure. The final awards vested in 2006.

In 2004, a new share based incentive plan was introduced for executive directors, executive officers and the next level of senior executives, which replaced the LTIP. The plan includes a Performance Share Plan (“PSP”) and a Bonus Co-Investment Plan (“CIP”).

Vesting of the PSP award shares is dependent upon performance relative to the FTSE 100 and an index based on major international companies in the medical devices industry.

Under the CIP, participants can elect to use up to a maximum of one-half of their annual bonus to purchase shares. If the shares are held for 3 years and the Group’s EPSA growth targets are achieved participants receive an award of matching shares for each share purchased.

The fair values of awards granted under long-term incentive plans are calculated using a binomial model. The exercise price for all awards granted under the long-term incentive plans is nil. The LTIP and PSP contain vesting conditions based on TSR versus a comparator group which represent market-based performance conditions for valuation purposes and an assessment of vesting probability is therefore factored into the award date calculations. The assumptions include the volatilities for the comparator groups. Given the wide range of companies within the FTSE 100 a correlation of 15% (2007 — 20%, 2006 — 20%) has been assumed with the constituents of the group. A correlation of 15% (2007 — 20%, 2006 — 30%) has also been assumed for the companies in the medical devices sector as they are impacted by similar factors.

The other assumptions used are consistent with the executive scheme assumptions disclosed in Note 28 (a) of the Notes to the Group Accounts.

At 31 December 2008 the maximum number of shares that could be awarded under the Group’s long-term incentive plans were:

	LTIP	PSP	CIP	Total
	(Number of shares in thousands)			
Outstanding at 1 January 2006	445	1,862	620	2,927
Awarded	–	1,484	266	1,750
Vested	(218)	–	–	(218)
Forfeited	(227)	(367)	(90)	(684)
Outstanding at 31 December 2006	–	2,979	796	3,775
Awarded	–	1,793	320	2,113
Vested	–	–	(235)	(235)
Forfeited	–	(1,449)	(121)	(1,570)
Outstanding at 31 December 2007	–	3,323	760	4,083
Awarded	–	1,588	384	1,972
Vested	–	(135)	(89)	(224)
Forfeited	–	(959)	(305)	(1,264)
Outstanding at 31 December 2008	–	<u>3,817</u>	<u>750</u>	<u>4,567</u>

The weighted average remaining contractual life of awards outstanding at 31 December 2008 was 1.5 years (2007 — 1.3 years, 2006 — 1.5 years) for the PSP and 1.3 years (2007 — 1.2 years, 2006 — 1.3 years) for the CIP.

From 2009, the CIP will be replaced by a deferred bonus plan. This plan is designed to encourage executives to build-up and maintain a significant shareholding in the Company. Under the plan, one third of any bonus earned at target level or above by an executive director will be compulsorily deferred into shares which vest, subject to continued employment, in equal annual tranches over three years (i.e. one third each year). No further performance conditions will apply to the deferred shares.

## 28(c). Share Based Payments — Charge to Income Statement

The expense charged to the income statement for share based payments is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
Granted in current year .....	4	9	5
Granted in prior years .....	<u>20</u>	<u>14</u>	<u>9</u>
Total share based expense for the year .....	<u>24</u>	<u>23</u>	<u>14</u>

Under the Executive Schemes, PSP and CIP the number of Ordinary Shares over which options may be granted is limited so that the number of Ordinary Shares issued or that may be issued during the ten years preceding the date of grant shall not exceed 5% of the Ordinary Share capital at the date of grant. The total number of Ordinary Shares which may be issuable in any ten-year period under all share schemes operated by the Company may not exceed 10% of the Ordinary Share capital at the date of grant.

## 29. Treasury Shares

In February 2007, the Group commenced a share buy-back programme of up to \$1.5 billion over an initial two years. This followed an assessment of the medium term capital needs of the Group, both internally and for acquisitions whereby management determined that shareholder value and balance sheet efficiency would be enhanced by returning capital to shareholders. Shares bought back are held in treasury. As announced in November 2008, the Board reviewed the programme in light of current market conditions in the financial markets and decided to suspend the share buy-back programme.

During the year, 16,285,200 (2007 — 51,955,000) Ordinary Shares were purchased at a cost of \$193m (2007 — \$640m). During 2008, 935,000 (2007 — 305,000) Ordinary Shares were transferred out of treasury, at their weighted average cost, to the Smith & Nephew Employee's Share Trust. Shares totalling 365,000 were transferred out of treasury following the exercise of the international, UK and Save As You Earn ("SAYE") share options leaving 66,635,000 shares (2007 — 51,650,000) in treasury at 31 December 2008.

Treasury shares represent the holding of the Parent Company's own shares in respect of the Smith & Nephew Employees' Share Trust (Note 36 of the Notes to the Group Accounts) and the shares bought back as part of the share buy back programme.

	<u>2008</u>	<u>2007</u>	<u>2006</u>
		(\$ million)	
At 1 January .....	637	1	4
Treasury shares purchased .....	193	640	—
Shares transferred to Group beneficiaries .....	<u>(7)</u>	<u>(4)</u>	<u>(3)</u>
At 31 December .....	<u>823</u>	<u>637</u>	<u>1</u>



### 30. Cash Flow Statement

#### *Analysis of (Net Debt)/Net Cash*

	Cash	Overdrafts	Borrowings due within one year	Borrowings due after one year	Loan Notes	Net currency swaps	Total
	(\$ million)						
At 1 January 2006	151	(86)	(55)	(211)	(86)	(19)	(306)
Net cash flow	182	39	5	200	88	10	524
Loan Notes issued on acquisition	—	—	—	—	(15)	—	(15)
Exchange adjustment	13	(8)	3	(4)	(4)	7	7
At 31 December 2006	346	(55)	(47)	(15)	(17)	(2)	210
Net cash flow	(185)	(5)	(1,201)	106	17	14	(1,254)
Facility fee (i)	—	—	(6)	—	—	—	(6)
New finance leases	—	—	(1)	(6)	—	—	(7)
Acquired on acquisition — (Note 32)	—	—	(62)	(119)	—	—	(181)
Exchange adjustment	9	(1)	(64)	(2)	—	(14)	(72)
At 31 December 2007	170	(61)	(1,381)	(36)	—	(2)	(1,310)
Net cash flow	(16)	34	49	(80)	—	(5)	(18)
Other non-cash changes (ii)	—	—	1,248	(1,248)	—	—	—
Facility fee (i)	—	—	—	2	—	—	2
Exchange adjustment	(9)	4	(8)	4	—	3	(6)
At 31 December 2008	145	(23)	(92)	(1,358)	—	(4)	(1,332)

(i) In 2007 the facility fee of \$6m was recognised as a prepayment and charged to income on a straight line basis over the term of the facility. During 2008 \$2m of this prepayment was reclassified as borrowings following the term out of the loan.

(ii) Non-cash changes comprise transfers between categories of borrowings following the Group exercising its option to extend the term of its revolving multicurrency loan facilities (see Note 21 of the Notes to the Group Accounts).

#### *Reconciliation of Net Cash Flow to Movement in (Net Debt)/Net Cash*

	2008	2007	2006
	(\$ million)		
Change in cash net of overdrafts in the year	18	(190)	221
Settlement of currency swaps	(5)	14	10
Change in borrowings (including Loan Notes)	(31)	(1,078)	293
Change in net debt from net cash flow	(18)	(1,254)	524
New finance leases	—	(7)	—
Facility fee paid	2	(6)	—
Loan Notes issued	—	—	(15)
Borrowings and finance leases acquired on acquisition — (Note 32)	—	(181)	—
Exchange adjustment	(6)	(72)	7
Change in net debt in the year	(22)	(1,520)	516
Opening (net debt)/net cash	(1,310)	210	(306)
Closing (net debt)/net cash	(1,332)	(1,310)	210

#### *Cash and Cash Equivalents*

For the purposes of the Group Cash Flow Statement cash and cash equivalents at 31 December comprise cash at bank and in hand net of bank overdrafts.

	2008	2007	2006
	(\$ million)		
Cash and bank	145	170	346
Bank overdrafts	(23)	(61)	(55)
Cash and cash equivalents	122	109	291

### 31. Currency Translation

The exchange rates used for the translation of currencies into US Dollars that have the most significant impact on the Group results were:

	Average rates		
	2008	2007	2006
Sterling .....	1.84	2.00	1.86
Euro .....	1.46	1.37	1.27
Swiss Franc .....	0.92	0.83	0.80

	Year-end rates		
	2008	2007	2006
Sterling .....	1.44	1.99	1.96
Euro .....	1.39	1.46	1.32
Swiss Franc .....	0.94	0.88	0.82

### 32. Acquisitions

#### 2009

In 2009 Smith & Nephew reached an agreement with the vendors of Plus to reduce the total original purchase price by CHF159m from CHF1,086m (\$889m at the then prevailing rates) paid in May 2007. As part of the agreement the parties have resolved their disputes on the contractual purchase price adjustments. In addition, Smith & Nephew is releasing the vendors from substantially all of their warranties, including those relating to taxation, under the original purchase agreement and has dropped all existing claims under the original warranties.

The Group has concluded that this is a non-adjusting post balance sheet event that will be recorded by March 2009. This event has no impact on the income statement.

#### 2008

The aggregate impact of acquisitions that occurred during the year is set out below. The acquisitions primarily relate to minority interest and distributor buyouts, as a result of the Plus acquisition concluded in 2007. There is no material difference between the fair value and book value of the net assets acquired.

	\$ million
Deferred taxation .....	1
Intangible assets .....	1
Assets acquired .....	2
Goodwill (i) .....	(2)
Cost of acquisition .....	—
Discharged by	
Cash .....	2
Deferred consideration (i) .....	(2)
	—
	—

(i) Relating to the reversal of goodwill allocated previously on the basis of contingent consideration.

In 2008, deferred consideration of \$14m in respect of the previous years' acquisitions was paid.

## 32. Acquisitions — (continued)

### 2007

#### *Plus Orthopedics Holding AG*

On 31 May 2007 the Group acquired 100% of the issued share capital of Plus Orthopedics Holding AG ("Plus"), a private Swiss orthopaedic company for a total of CHF1,086m (\$889m) in cash, including assumed debt. This has been integrated into the Group's Orthopaedics business segment. At 31 December 2007 the cost of the Plus acquisition was allocated on a provisional basis to the assets acquired and liabilities assumed on acquisition. In 2008, fair value adjustments were revised to reflect improved knowledge of the Plus business. The final allocation of the purchase price that was completed by 31 May 2008 (in accordance with the time line stipulated in *IFRS 3 Business Combinations*) and the balance sheet as at 31 December 2007 has been adjusted as follows:

	Pre-acquisition carrying amounts	Provisional fair value adjustments	Fair value to Group reported in 2007	Final fair value adjustments	Fair value to Group reported in 2008
			(\$ million)		
Property, plant and equipment . . .	81	(2)	79	(1)	78
Intangible assets — acquisition					
intangibles . . . . .	—	240	240	(27)	213
Intangible assets — other . . . . .	10	(8)	2	—	2
Investments in associates . . . . .	6	4	10	—	10
Deferred taxation assets . . . . .	19	(19)	—	—	—
Inventories . . . . .	106	66	172	(3)	169
Trade and other receivables . . . . .	128	—	128	15	143
Loans and borrowings . . . . .	(181)	—	(181)	—	(181)
Deferred taxation liabilities . . . . .	(4)	(34)	(38)	7	(31)
Retirement benefit obligation . . . . .	(6)	(16)	(22)	—	(22)
Trade and other payables . . . . .	(125)	(4)	(129)	(16)	(145)
Net assets . . . . .	<u>34</u>	<u>227</u>	261	(25)	236
Equity attributable to minority interests (i) . . . . .			(4)	—	(4)
Goodwill on acquisition . . . . .			<u>463</u>	<u>25</u>	<u>488</u>
Cost of acquisition . . . . .			<u>720</u>	<u>—</u>	<u>720</u>
Discharged by:					
Cash . . . . .			726	—	726
Cash acquired in Plus . . . . .			(18)	—	(18)
Costs associated with acquisition . . . . .			<u>12</u>	<u>—</u>	<u>12</u>
			<u>720</u>	<u>—</u>	<u>720</u>

(i) The pre-acquisition carrying amount of the equity attributable to minority interests was \$4m.

Management believes that goodwill represents the value of the workforce, the existing European corporate structure and synergies that are expected to arise from the combined group.

In 2007, from the date of acquisition on 31 May 2007, Plus products contributed \$200m to revenue. It was impracticable to calculate Plus' contribution to attributable profit in 2007, since its acquisition by the Group, as significant integration had occurred during the year.

### 32. Acquisitions — (continued)

As part of the acquisition of Plus, the Group assumed the following minority interests which were previously minority interests under the Plus Group:

<b>Minority Interests</b>	Country	%
Plus Orthopedics Italy Srl	Italy	10%
XMedica Srl	Italy	10%
Plus Orthopedics Netherlands BV	Netherlands	49%
Plus Orthopedics Hellas S.A.	Greece	10%
LifeTek LLC (i) (ii)	US	10%
Biograft de Mexico, S.A. de C.V. (i)	Mexico	12.7%
Endoplant GmbH	Germany	6%
Plus Orthopedics GmbH (ii)	Germany	4%
Endocare Medizinische Geräte Vertriebs — GmbH (iii)	Germany	23.2%

(i) The minority interests in LifeTek LLC and Biograft de Mexico, S.A. de C.V. were disposed of in November 2008 generating a loss of \$0.6m.

(ii) These companies were consolidated with no related minority interest due to deferred purchase consideration agreements.

(iii) Still held at 31 December 2008.

Subsequent to the Plus acquisition the Group acquired Plus' Australian distributor and the minority interests in the Netherlands and Greece for a total of \$13m in cash and \$6m of contingent consideration. This was allocated as inventory of \$3m, goodwill of \$12m and a reduction in minority interests of \$4m.

In addition to the above, the Group acquired Plus' minority interest in Plus Orthopedics GmbH (Germany) and thereby settled deferred consideration accrued of \$25m.

#### **BlueSky Medical Group, Inc**

On 10 May 2007, the Group acquired 100% of the issued share capital of BlueSky Medical Group Inc., ("BlueSky") for an initial payment of \$15m with further milestone payments of up to \$95m related to revenues and other events. The company developed products for treating chronic wounds using negative pressure wound therapy and marketed a range of negative pressure pumps and wound dressing kits. This has been integrated into the Group's Advanced Wound Management business segment. BlueSky's assets and liabilities are included in the Group's balance sheet at fair value at the date of acquisition as follows:

	Pre-acquisition carrying amounts	Fair value adjustments (\$ million)	Fair value to Group
Intangible assets — acquisition intangibles	—	26	26
Inventories	2	—	2
Trade and other receivables	1	—	1
Trade and other payables	(3)	—	(3)
Deferred taxation liabilities	—	(10)	(10)
Net assets	—	16	16
Goodwill on acquisition			34
Cost of acquisition			50
Discharged by:			
Cash			15
Costs associated with acquisition			1
Present value of probable milestone payments			34
			50

In addition to the cash consideration of \$15m, the Group is committed to paying future milestone payments totalling \$95m on the achievement of certain milestones. The Group assessed the present value of the probable milestone payments to be \$34m.

### 32. Acquisitions — (continued)

Management believes that the goodwill arising on the acquisition of BlueSky represents the synergies expected to be achieved.

In 2007, from the date of acquisition on 10 May 2007, BlueSky contributed \$6m to revenue and a loss of \$10m to attributable profit for the year.

#### **Total 2007 acquisitions**

Had all the acquisitions in 2007 occurred at the beginning of the year the revenue of the combined Group would have been \$3,526m and attributable profit, including the results of the acquired companies adjusted for amortisation of acquisition intangibles, utilisation of inventory step-up, the interest expense on debt incurred as result of the acquisition and tax thereon, would have been \$295m.

In addition to the cash consideration of \$792m, for the Plus and BlueSky acquisitions, deferred consideration of \$7m in respect of previous years' acquisitions was paid in 2007.

#### **2006**

On 10 July 2006, the Group acquired 100% of the issued share capital of OsteoBiologics Inc., ("OBI") a company providing bioabsorbable implants for bone healing for a net cost of \$73m settled in cash. OBI has been integrated with the Endoscopy business. OBI's assets are included in the Group's balance sheet at fair value at the date of acquisition as follows:

	Net book value	Fair value adjustments (\$ million)	Fair value to Group
Intangible assets — acquisition intangibles	–	42	42
Inventories	2	–	2
Trade and other receivables	1	–	1
Trade and other payables	(2)	–	(2)
Deferred taxation	–	(9)	(9)
Net assets	<u>1</u>	<u>33</u>	34
Goodwill on acquisition			<u>39</u>
Cost of acquisition			<u>73</u>
Discharged by:			
Cash			74
Cash acquired in OBI			(2)
Costs associated with acquisition			<u>1</u>
			<u>73</u>

The fair value adjustments reflect the recognition of intangible assets, deferred tax thereon and the recognition of tax losses available to the Group. This acquisition gave the Group access to intellectual property and technology for use in cartilage repair and management believes that goodwill represents the value of the synergies that are expected to arise for the Group.

During 2008 the Group recorded an impairment charge of \$14m against one of the intangible assets acquired as part of this acquisition.

In 2006, from the date of acquisition on 10 July 2006, OBI contributed \$3m to revenue and a loss of \$3m to attributable profit for the year. Had the acquisition occurred at the beginning of the year the revenue of the combined Group would have been \$2,782m and attributable profit for the year would have been \$743m.

In addition to the cash consideration of \$73m, deferred consideration of \$10m in respect of previous years' acquisitions was paid in the year.

### 33. Financial Commitments

Group capital expenditure relating to property, plant and equipment contracted but not provided for amounted to \$27m (2007 — \$5m).

Under the Group's acquisition and joint development agreements with NUCRYST Pharmaceuticals Corp., amounts of up to \$8m (2007 — \$8m) could become payable on achievement of certain milestones related to regulatory and reimbursement approvals with a further \$20m (2007 — \$20m) contingent on achievement of sales milestones.

As part of the Group's acquisition of BlueSky Medical Group Inc., a further \$55m (2007 — \$55m) could become payable on achievement of sales milestones. This is in addition to the milestones that management considers probable that have been recognised in the acquisition cost at their present fair value (see Note 32 of the Notes to the Group Accounts).

The Group is contractually committed to four milestone payments, which total \$60m (2007 — \$60m), related to the US approval and commercialisation of DUROLANE which may become payable under the terms of the agreement with Q-MED AB signed in June 2006.

Future minimum lease payments under non-cancellable operating leases fall due as follows:

	2008	2007
	(\$ million)	
Land and buildings:		
Within one year	26	26
After one and within two years	16	18
After two and within three years	12	14
After three and within four years	8	12
After four and within five years	6	9
After five years	17	31
	<u>85</u>	<u>110</u>
Other assets:		
Within one year	21	21
After one and within two years	15	14
After two and within three years	7	8
After three and within four years	2	2
	<u>45</u>	<u>45</u>

Future minimum lease payments under finance leases together with the present value of the minimum lease payments are as follows:

	2008	2007
	(\$ million)	
Within one year	7	9
After one and within two years	5	7
After two and within three years	4	5
After three and within four years	4	4
After four and within five years	3	3
After five years	18	21
Total minimum lease payments	41	49
Discounted by imputed interest	(10)	(11)
Present value of minimum lease payments	<u>31</u>	<u>38</u>

Present value of minimum lease payments can be split out as: \$5m (2007 — \$9m) due within one year, \$12m (2007 — \$15m) due between one to five years and \$14m (2007 — \$14m) due after five years.

### 34. Contingencies

The Group is engaged, as both plaintiff and defendant, in litigation with various competitors and others over claims and patent infringement. The Group is also party to other legal proceedings in the normal course of business. Other than as set out below, the Group considers that these will not result in any material adverse effect on the Group's results of operations or financial position.

In August 2003 the Group withdrew voluntarily from all markets the macrotextured versions of its OXINIUM femoral knee components. As at that date, 2,971 components had been implanted of which approximately 2,471 were in the US, 450 in Australia and 50 in Europe, the first component having been implanted in December 2001. As at 31 December 2008, 1,044 implants required revision surgery as a result of some patients not achieving adequate fixation and settlements had been agreed with patients in respect of 997 of these revisions.

A charge of \$154m was recorded in 2004 for anticipated expenses in connection with macrotexture claims. Most of this amount has since been applied to settlements of such claims. The key variables in assessing the adequacy of the provision are the number of revisions likely to arise and the average cost of settling patient claims for those revisions. Management believes that the \$30m provision remaining is adequate to cover remaining claims.

To date the primary insurance carrier has paid \$60m in full settlement of its policy liability. An additional \$22m was received from a successful legal settlement. At 31 December 2008, \$124m remains due, and the Group has sought coverage from five other excess insurers. However, these excess carriers have denied coverage, citing defences relating primarily to the wording of the insurance policies. In December 2004, the Group brought suit against them in federal district court in Memphis, Tennessee, and hearing is expected to commence in late 2009.

The Group's assessment of the impact of these revisions and related matters constitute forward-looking statements that are subject to uncertainties, including uncertainties relating to the outcome of settlements as compared to the assumptions made in estimating claim amounts. Smith & Nephew cannot provide assurance that these estimates will prove correct. Depending on the number and average cost of future settlements, costs may be greater or less than the amount provided.

In September 2007, the US Securities and Exchange Commission ("SEC") notified the Group that it was conducting an informal investigation of the Group, regarding possible violations of the Foreign Corrupt Practices Act in connection with the sale of medical devices in certain foreign countries. The US Department of Justice has subsequently joined the SEC's request. The Group is cooperating fully with the US Department of Justice and the SEC regarding these matters.

In June 2008, the Group won a jury verdict in Portland, Oregon against Arthrex Inc., ("Arthrex") for infringement of a patent relating to suture anchors. The Group was awarded approximately \$15m in damages, plus approximately \$6m interest and an injunction forbidding further sales of infringing suture anchors by Arthrex. On appeal by Arthrex, the Court of Appeals stayed the injunction pending a hearing. A second lawsuit against other Arthrex suture anchors has also been stayed pending the appeal. Arthrex has also asked the US Patent and Trademark Office to re-examine the patent in question. A decision on the appeal is not expected before the end of 2009. Whilst the outcome is not certain, the Group believes that it is probable that the original decision will ultimately be upheld, and as such is required under *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* to disclose this matter.

### 35. Retirement Benefit Obligation

The Group's retirement benefit obligation comprises:

	2008	2007
	(\$ million)	
<b>Funded Plans:</b>		
UK Plan . . . . .	100	80
US Plan . . . . .	157	27
Other Plans (i) . . . . .	46	25
	<u>303</u>	<u>132</u>
<b>Unfunded Plans:</b>		
Other Plans (i) . . . . .	19	22
Retirement Healthcare . . . . .	28	30
	<u>350</u>	<u>184</u>

(i) The analysis in this note for "Other Plans" combines both the funded and unfunded retirement benefit obligations.

The Group sponsors pension plans for its employees in most of the countries in which it has major operating companies. Pension plans are established under the laws of the relevant country. Funded plans are funded by the payment of contributions to, and the assets held by, separate trust funds or insurance companies. Employees' retirement benefits are the subject of regular management review. The Group's major defined benefit pension plans in the UK and US were closed to new employees in 2003 and replaced by defined contribution plans.

Defined benefit plans provide employees with an entitlement to retirement benefits varying between 1.3% and 66.7% of final salary on attainment of a retirement age of 65. The level of entitlement is dependent on the years of service of the employee.

The present value of the defined benefit obligation, the related current service cost and past service cost are measured using the projected unit method. Under the projected unit method, the current service cost will increase as the members of the defined benefit plans approach retirement. The principal actuarial assumptions used by the independent qualified actuaries in valuing the major plans in the United Kingdom ("UK Plan"), the United States ("US Plan") and all other plans ("Other Plans") including a breakdown of the pension costs charged to income are as follows:

Principal actuarial assumptions:

	2008	2007	2006
	(% per annum)		
<b>UK Plan:</b>			
Discount rate . . . . .	6.1	5.8	5.1
Expected return on plan assets (i) . . . . .	6.5	6.5	6.8
Expected rate of salary increases . . . . .	5.2	5.3	4.9
Future pension increases . . . . .	3.2	3.3	2.9
Inflation . . . . .	3.2	3.3	2.9
Life expectancy of male aged 60 (in years) . . . . .	28.6	28.4	24.7
<b>US Plan:</b>			
Discount rate . . . . .	5.9	6.5	5.8
Expected return on plan assets (i) . . . . .	8.2	8.2	8.2
Expected rate of salary increases . . . . .	5.0	5.0	5.0
Future pension increases . . . . .	Nil	Nil	Nil
Inflation . . . . .	2.7	2.7	3.0
Life expectancy of male aged 60 (in years) . . . . .	23.0	23.0	22.0

(i) The assumption for the expected return on plan assets has been determined using a combination of past experience and market expectations.



### 35. Retirement Benefit Obligation — (continued)

	2008	2007	2006
	(% per annum)		
<b>Other Plans:</b>			
Discount rate (ii) . . . . .	3.5	4.3	4.5
Expected return on plan assets (i) (ii) . . . . .	5.2	4.9	5.4
Expected rate of salary increases (ii) . . . . .	2.2	3.4	4.0
Future pension increases (ii) . . . . .	0.8	1.4	2.5
Inflation (ii) . . . . .	1.0	2.0	2.1

(i) The assumption for the expected return on plan assets has been determined using a combination of past experience and market expectations.

(ii) Other Plans' actuarial assumptions are presented on a weighted average basis and include all funded and unfunded plans.

#### Pension costs:

	2008	2007	2006
	(\$ million)		
Current service cost — employer's portion . . . . .	29	29	29
Interest cost . . . . .	64	55	46
Expected return on plan assets . . . . .	(66)	(65)	(52)
Net defined benefit pension costs . . . . .	27	19	23
Net defined contribution pension costs . . . . .	24	21	20
	<u>51</u>	<u>40</u>	<u>43</u>

Of the \$51m (2007 — \$40m, 2006 — \$43m) net cost for the year, \$53m (2007 — \$50m, 2006 — \$49m) was charged to operating profit. The interest cost and expected return on plan assets are reported as other finance costs. Actuarial losses of \$213m (2007 — loss of \$22m, 2006 — gain of \$32m) were reported in the statement of recognised income and expense making the cumulative loss to date, since the adoption of IFRS, to \$293m (2007 — \$80m, 2006 — \$58m).

The contributions made in the year in respect of defined benefit plans were: UK Plan \$23m (2007 — \$20m, 2006 — \$30m); US Plan \$11m (2007 — \$11m, 2006 — \$19m); and Other Plans \$9m (2007 — \$8m, 2006 — \$6m). The agreed contributions for 2009 in respect of the Group's defined benefit plans are: \$18m for the UK (including \$10m of supplementary payments), \$14m for the US plan and \$9m for other defined benefit plans.

The total cost charged to income in respect of the Group's defined contribution plans represents contributions payable to these plans by the Group at rates specified in the rules of the plans. As at 31 December 2008 there were no outstanding payments due to be paid over to the plans (2007 — nil, 2006 — nil).

The amount included in the balance sheet arising from the Group's obligations in respect of its defined benefit retirement plans and the expected rates of return on investments were:

	UK Plan		US Plan		Other Plans	
	Rate of Return (%)	Value (\$million)	Rate of Return (%)	Value (\$million)	Rate of Return (%)	Value (\$million)
<b>31 December 2008</b>						
Equities . . . . .	7.9	228	9.3	123	7.0	27
Bonds . . . . .	4.7	165	5.5	54	4.2	25
Property . . . . .	6.2	16	—	—	4.5	5
Other . . . . .	4.4	7	3.9	3	3.7	19
Market value of assets . . . . .		416		180		76
Present value of defined benefit obligations . . . . .		(516)		(337)		(141)
Deficit: non-current liability recognised in the balance sheet . . . . .		<u>(100)</u>		<u>(157)</u>		<u>(65)</u>

### 35. Retirement Benefit Obligation — (continued)

	UK Plan		US Plan		Other Plans	
	Rate of Return	Value	Rate of Return	Value	Rate of Return	Value
	(%)	(\$million)	(%)	(\$million)	(%)	(\$million)
<b>31 December 2007</b>						
Equities .....	7.6	430	9.2	195	6.2	42
Bonds .....	4.4	201	5.4	59	4.1	34
Property .....	6.6	30	–	–	5.4	7
Other .....	4.4	12	4.7	2	4.4	15
Market value of assets .....		673		256		98
Present value of defined benefit obligations .....		(753)		(283)		(145)
Deficit: non-current liability recognised in the balance sheet .....		(80)		(27)		(47)

The following tables set out the pension plan asset allocations in the funded UK, US and Other Plans for the last two years:

	Percentage of Plan Assets at 31 December	
	2008	2007
	(%)	
<b>UK Plan</b>		
Asset Category:		
Equity securities .....	55	64
Debt securities .....	39	30
Property .....	4	4
Other .....	2	2
Total .....	100	100
<b>US Plan</b>		
Asset Category:		
Equity securities .....	68	76
Debt securities .....	30	23
Other .....	2	1
Total .....	100	100
<b>Other Plans</b>		
Asset Category:		
Equity securities .....	35	43
Debt securities .....	33	35
Property .....	7	7
Other .....	25	15
Total .....	100	100

### 35. Retirement Benefit Obligation — (continued)

A reconciliation of the present value of defined benefit obligations is shown in the following tables:

	2008	2007
	(\$ million)	
<b>UK Plan</b>		
Present value of defined benefit obligations at 1 January	753	661
Current service cost	12	13
Other finance cost	40	34
Actuarial (gains)/losses	(63)	57
Plan participant contributions	3	2
Benefits paid	(27)	(26)
Exchange adjustment	(202)	12
Present value of defined benefit obligations at 31 December	<u>516</u>	<u>753</u>
<b>US Plan</b>		
Present value of defined benefit obligations at 1 January	283	295
Current service cost	8	10
Other finance cost	18	17
Actuarial losses/(gains)	36	(32)
Benefits paid	(8)	(7)
Present value of defined benefit obligations at 31 December	<u>337</u>	<u>283</u>
<b>Other Plans</b>		
Present value of defined benefit obligations at 1 January	145	60
Acquisitions	–	60
Current service cost	9	6
Settlements to members	–	(7)
Other finance cost	6	4
Actuarial losses	4	12
Benefits paid	(22)	(5)
Plan participant contributions	2	6
Exchange adjustment	(3)	9
Present value of defined benefit obligations at 31 December	<u>141</u>	<u>145</u>

A reconciliation of the fair value of plan assets is shown in the following tables:

<b>UK Plan</b>		
Fair value of plan assets at 1 January	673	617
Expected return on plan assets	39	42
Actuarial (losses)/gains	(126)	8
Plan participant contributions	3	2
Company contributions	23	20
Benefits paid	(27)	(26)
Exchange adjustment	(169)	10
Fair value of plan assets at 31 December	<u>416</u>	<u>673</u>
<b>US Plan</b>		
Fair value of plan assets at 1 January	256	238
Expected return on plan assets	21	19
Actuarial losses	(100)	(5)
Company contributions	11	11
Benefits paid	(8)	(7)
Fair value of plan assets at 31 December	<u>180</u>	<u>256</u>

### 35. Retirement Benefit Obligation — (continued)

	2008	2007
	(\$ million)	
<b>Other Plans - assets</b>		
Fair value of plan assets at 1 January	98	36
Acquisitions	—	38
Expected return on plan assets	6	4
Settlements to members	—	(7)
Actuarial (losses)/gains	(10)	12
Company contributions	9	8
Benefits paid	(22)	(5)
Plan participant contributions	2	6
Exchange adjustment	(7)	6
Fair value of plan assets at 31 December	<u>76</u>	<u>98</u>

The history of experience adjustments is as follows:

	Present value of defined benefit obligations	Fair value of plan assets	Deficit in plan	Experience adjustments on plan liabilities		Experience adjustments on plan assets	
				Amount — gain/ (loss)	Percentage of plan liabilities	Amount — gain/ (loss)	Percentage of plan assets
	(\$ million)	(\$ million)	(\$ million)	(\$ million)	(%)	(\$ million)	(%)
<b>31 December 2008:</b>							
UK Plan	(516)	416	(100)	1	—	(126)	30
US Plan	(337)	180	(157)	(5)	1	(100)	56
Other Plans	(141)	76	(65)	5	4	(10)	13
<b>31 December 2007:</b>							
UK Plan	(753)	673	(80)	—	—	8	1
US Plan	(283)	256	(27)	1	—	(5)	2
Other Plans	(145)	98	(47)	(1)	1	12	12
<b>31 December 2006:</b>							
UK Plan	(661)	617	(44)	15	2	20	3
US Plan	(295)	238	(57)	3	1	14	6
Other Plans	(60)	36	(24)	1	2	1	3
<b>31 December 2005:</b>							
UK Plan	(559)	488	(71)	5	1	45	9
US Plan	(285)	196	(89)	2	1	—	—
Other Plans	(48)	27	(21)	1	2	2	7
<b>31 December 2004:</b>							
UK Plan	(552)	407	(145)	(4)	1	10	3
US Plan	(253)	138	(115)	—	—	4	3
Other Plans	(48)	29	(19)	—	—	—	—

The Group recharges the UK pension plan with the costs of administration and independent advisers. The amount recharged in the year was \$3m (2007 — \$2m, 2006 — \$2m). The amount receivable at 31 December 2008 was nil (2007 — nil, 2006 — nil).

### 35. Retirement Benefit Obligation — (continued)

#### Retirement Healthcare

The Group has various obligations for the provision of retirement healthcare to employees. A reconciliation of the obligation is as follows:

	2008	2007
	(\$ million)	
At 1 January	30	29
Exchange adjustment	(4)	1
Charge to income statement — service cost	—	1
Charge to income statement — other finance costs	2	1
Benefits paid	(2)	(2)
Actuarial losses	2	—
At 31 December	<u>28</u>	<u>30</u>

The cost of providing healthcare benefits after retirement is determined by independent actuaries. The principal actuarial assumptions in determining the cost of providing healthcare benefits are those in the UK and the US and are as follows:

	2008		2007		2006	
	UK	US	UK	US	UK	US
	(% per annum)					
Discount rate	6.1	5.9	5.8	6.5	5.1	5.8
Medical cost inflation	6.5	8.7	6.7	9.0	6.3	8.0

A one percentage point change in the rate of medical cost inflation would not affect the accumulated retirement benefit obligations, or the aggregate of the current service and interest costs, of the UK or US plans in 2008, 2007 or 2006 by more than \$1m.

The assumed retirement healthcare cost trend for 2009 and thereafter is expected to be approximately 1.5% above the discount rate.

### 36. Smith & Nephew Employees' Share Trust

	2008	2007
	(\$ million)	
At 1 January	1	1
Shares transferred from treasury shares	13	4
Shares transferred to group beneficiaries	(7)	(4)
At 31 December	<u>7</u>	<u>1</u>

The Smith & Nephew Employees' Share Trust and the 2004 Employee Share Trust were established to hold shares relating to the Long-Term Incentive Plans. Holdings of the Parent Company's Own Shares in respect of the Trust are disclosed in Note 29 of the Notes to the Group Accounts. The Trusts are administered by an independent professional trust company resident in Jersey and are funded by a loan from the Parent Company. The costs of the Trust are charged to the income statement as they accrue. A dividend waiver is in place in respect of those shares held under the Long-Term Incentive Plan. The waiver represents less than 1% of the total dividends paid.

At 31 December 2008, the Trusts held 0.5m (2007 — 0.3m) Ordinary Shares at an aggregate cost of \$7m (2007 — \$2m). 0.1m shares (2007 — 0.2m), with an original cost of \$0.1m (2007 — \$1m), have vested and are held under option for the benefit of directors and employees. Shares totalling 0.5m, at an aggregate cost of \$7m, are included within equity on the Group balance sheet and shareholders' funds on the Parent Company balance sheet. The market value of these shares at 31 December 2008 was \$3m (2007 — \$2m).

### 37. Related Party Transactions

#### Trading Transactions

In the course of normal operations, the Group traded with its joint venture BSN Medical from 1 April 2001. BSN Medical ceased to be a related party on 23 February 2006. In the course of normal operations, the Group traded with its associates detailed in Note 17 of the Notes to the Group Accounts from 31 May 2007. The aggregated transactions, which have not been disclosed elsewhere in the financial statements, are summarised below:

	2008	2007	2006
		(\$ million)	
Sales to the associates .....	4	9	–
Agency fees received from the joint venture .....	–	–	4
Purchases from the joint venture .....	–	–	2
Purchases from the associates .....	4	3	–

#### Key Management Personnel

The remuneration of executive officers (including non-executive directors) during the year is summarised below:

	2008	2007	2006
		(\$ million)	
Short-term employee benefits .....	12	16	13
Share-based payment .....	9	7	3
Pension and post employment benefit entitlements .....	1	1	1
Termination benefits .....	1	2	–
	<u>23</u>	<u>26</u>	<u>17</u>

Information concerning directors and executive officers' emoluments, pension entitlements, shareholdings and share options is shown in the audited section of the "Remuneration Report".

### 38. Information About the Nature and Cost of Services Provided by Auditors

	2008	2007	2006
		(\$ million)	
Audit services: Group accounts .....	1	1	1
Other services:			
Local statutory audit pursuant to legislation .....	3	2	2
Other services pursuant to legislation .....	1	1	2
Taxation services:			
Compliance services .....	1	1	1
Advisory services .....	2	2	2
	<u>3</u>	<u>3</u>	<u>3</u>
Corporate finance transactions .....	1	1	2
Total auditors' remuneration .....	<u>9</u>	<u>8</u>	<u>10</u>
Arising:			
In the UK .....	5	5	7
Outside the UK .....	4	3	3
	<u>9</u>	<u>8</u>	<u>10</u>

## 39. New Accounting Standards

### ***New IFRS Accounting Standards***

The following IFRS and IFRIC interpretations, which are relevant to the Group, have been issued by the International Accounting Standards Board ("IASB") but are not yet effective or have not yet been adopted by the Group. Unless otherwise listed below, no other standard, amendment or interpretation is likely to have a material effect on the Group's results of operations or financial position.

In November 2006, the IASB issued *IFRS 8 Operating Segments* which is required to be implemented in the financial year commencing 1 January 2009. The IFRS requires segment information to be reported on the same basis as used by management when evaluating performance. This is not expected to change the business segments about which information is given. This IFRS was endorsed by the EU in November 2007.

In March 2007, the IASB issued an amendment to *IAS 23 Borrowing Costs* which the Group will adopt in the financial year commencing 1 January 2009. This amendment removes the option of immediately recognising as an expense borrowing costs that relate to assets that take a substantial period of time to get ready for use or sale. The Group currently applies the policy of expensing all interest costs, and will therefore be required to capitalise borrowing costs as part of the cost of such assets. This amendment was endorsed by the EU in December 2008.

In September 2007, the IASB issued a revised *IAS 1 Presentation of Financial Statements* which the Group will adopt in the financial year commencing 1 January 2009. This revised standard requires information in financial statements to be aggregated on the basis of shared characteristics and introduces a statement of comprehensive income. This revised standard was endorsed by the EU in December 2008.

In January 2008, the IASB issued an amendment to *IFRS 2 Share-based Payment*. The Group will adopt this amendment in the financial year commencing 1 January 2009. The amendment clarifies the terms "vesting conditions" and "cancellation" and their related accounting treatment. This amendment does not have a material impact on the Group's results of operations or financial position. This revised standard was endorsed by the EU in December 2008.

In February 2008, the IASB issued amendments to *IAS 32 Financial Instruments: Presentation* and *IAS 1 Presentation of Financial Statements* with regards to puttable financial instruments and obligations arising on liquidation. The Group will adopt these amendments in the financial year commencing 1 January 2009. As a result of these amendments, some puttable financial instruments and obligations that currently meet the definition of a financial liability will be classified as equity. These amendments do not have a material impact on the Group's results of operations or financial position. These amended standards have been endorsed by the EU in January 2009.

In May 2008, the IASB issued amendments to *IFRS 1 First-time Adoption of International Financial Reporting Standards* and *IAS 27 Consolidated and Separate Financial Statements*. The Group will adopt these in the financial year commencing 1 January 2009. As a result of these amendments, upon initial recognition of an investment, the Group will be allowed an option of the previous GAAP carrying amount of the investment or its fair value as deemed cost. These amendments do not have a material impact on the Group's results of operations or financial position. These amendments have been endorsed by the EU in January 2009.

In January 2008, the IASB issued a revised *IFRS 3 Business Combinations* and an amended *IAS 27 Consolidated and Financial Statements*. The Group will adopt these standards in the financial year commencing 1 January 2010. The amended IFRS 3 clarifies certain areas in accounting for business combinations, whilst the revised IAS 27 reduces the number of alternatives in accounting for subsidiaries in consolidated financial statements. This revised standard will be applied to all business acquisitions with an acquisition date on or after January 2010, and will have a significant impact on how an acquisition will be accounted for from that date. These revised and amended standards have not yet been endorsed by the EU.

In July 2008, the IASB issued amendments to *IAS 39 Financial Instruments: Recognition and Measurement*. The Group will adopt these amendments in the financial year commencing 1 January 2010. These amendments clarify how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation should be applied in particular situations. This amendment does not have a material impact on the Group's results of operations or financial position. These amendments have not yet been endorsed by the EU.

#### 40. Principal Subsidiary Undertakings

The information provided below is given for principal subsidiary undertakings, all of which are 100% owned, in accordance with Section 231(5)(a) of the Companies Act 1985. A full list will be appended to Smith & Nephew's next annual return to Companies House:

<u>Company Name</u>	<u>Activity</u>	<u>Country of operation and incorporation</u>
United Kingdom:		
Smith & Nephew Healthcare Limited	Medical Devices	England & Wales
Smith & Nephew Medical Limited	Medical Devices	England & Wales
T. J. Smith & Nephew Limited	Medical Devices	England & Wales
Continental Europe:		
Smith & Nephew GmbH	Medical Devices	Austria
Smith & Nephew SA-NV	Medical Devices	Belgium
Smith & Nephew A/S	Medical Devices	Denmark
Smith & Nephew OY	Medical Devices	Finland
Smith & Nephew SAS	Medical Devices	France
Smith & Nephew Orthopedics GmbH	Medical Devices	Germany
Smith & Nephew Orthopedics Hellas SA	Medical Devices	Greece
Smith & Nephew Limited	Medical Devices	Ireland
Smith & Nephew Srl	Medical Devices	Italy
Smith & Nephew BV	Medical Devices	Netherlands
Smith & Nephew A/S	Medical Devices	Norway
Smith & Nephew Sp Zoo	Medical Devices	Poland
Smith & Nephew Lda	Medical Devices	Portugal
Smith & Nephew SA	Medical Devices	Spain
Smith & Nephew AB	Medical Devices	Sweden
Plus Orthopedics Holding AG	Medical Devices	Switzerland
US:		
Smith & Nephew, Inc	Medical Devices	United States
Africa, Asia, Australasia and Other America:		
Smith & Nephew Pty Limited	Medical Devices	Australia
Smith & Nephew Inc	Medical Devices	Canada
Smith & Nephew Medical (Shanghai) Co Limited	Medical Devices	China
Smith & Nephew Limited	Medical Devices	Hong Kong
Smith & Nephew Healthcare Private Limited	Medical Devices	India
Smith & Nephew KK	Medical Devices	Japan
Smith & Nephew Limited	Medical Devices	Korea
Smith & Nephew Healthcare Sdn Berhad	Medical Devices	Malaysia
Smith & Nephew SA de CV	Medical Devices	Mexico
Smith & Nephew Limited	Medical Devices	New Zealand
Smith & Nephew Inc	Medical Devices	Puerto Rico
Smith & Nephew Pte Limited	Medical Devices	Singapore
Smith & Nephew (Pty) Limited	Medical Devices	South Africa
Smith & Nephew Limited	Medical Devices	Thailand
Smith & Nephew FZE	Medical Devices	United Arab Emirates



## PARENT COMPANY AUDITORS' REPORT

### **Independent Auditors' Report to the Shareholders of Smith & Nephew plc**

We have audited the Parent Company accounts of Smith & Nephew plc for the year ended 31 December 2008 which comprise the balance sheet and the related Notes A to H. These Parent Company accounts have been prepared under the accounting policies set out therein. We have also audited the information in the Remuneration Report that is described as having been audited.

We have reported separately on the Group accounts of Smith & Nephew plc for the year ended 31 December 2008.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken, so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### ***Respective responsibilities of directors and auditors***

The directors' responsibilities for preparing the Annual Report, the Remuneration Report and the Parent Company accounts in accordance with applicable United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Directors' Responsibilities for the Accounts.

Our responsibility is to audit the Parent Company accounts and the part of the Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the Parent Company accounts give a true and fair view and whether the Parent Company accounts and the part of the 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 accounts.

We also 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 accounts. The other information comprises only the "Financial Summary", the "Description of the Group", the "Operating and Financial Review, Liquidity and Prospects", the "Corporate Governance Statement" and the unaudited part of the "Remuneration Report". We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Parent Company accounts. 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 accounts and the part of the 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 accounts, 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 accounts and the part of the 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 accounts and the part of the Remuneration Report to be audited.

***Opinion***

In our opinion:

- the Parent Company accounts 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 2008;
- the Parent Company accounts and the part of the 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 accounts.

**Ernst & Young LLP**  
Registered auditor  
London, England  
17 March 2009

## PARENT COMPANY BALANCE SHEET

	At 31 December	
	2008	2007
	(\$ million)	
<b>Fixed assets:</b>		
Investments — (Note C) .....	3,598	1,332
<b>Current assets:</b>		
Debtors — (Note D) .....	1,509	1,601
Cash and bank — (Note E) .....	5	22
	1,514	1,623
<b>Creditors: amounts falling due within one year:</b>		
Borrowings — (Note E) .....	(2)	(1,065)
Other creditors — (Note F) .....	(228)	(216)
	(230)	(1,281)
<b>Net current assets</b> .....	1,284	342
<b>Total assets less current liabilities</b> .....	4,882	1,674
<b>Creditors: amount fallings due after one year:</b>		
Borrowings — (Note E) .....	(1,131)	—
<b>Total assets less total liabilities</b> .....	3,751	1,674
<b>Capital and reserves</b>		
Equity shareholders' funds:		
Called up equity share capital — (Note G) .....	190	190
Share premium account — (Note G) .....	375	356
Capital reserve — (Note G) .....	2,266	—
Exchange reserve — (Note G) .....	(52)	(52)
Profit and loss account — (Note G) .....	1,795	1,817
Treasury shares — (Note G) .....	(823)	(637)
Shareholders' funds .....	3,751	1,674

The accounts were approved by the Board and authorised for issue on 17 March 2009 and are signed on its behalf by: **John Buchanan** Chairman **David J. Illingworth** Chief Executive **Adrian Hennah** Chief Financial Officer

## NOTES TO THE PARENT COMPANY ACCOUNTS

### A. General Information

The Company redenominated its share capital into US Dollars on 23 January 2006 and will retain distributable reserves and declare dividends in US Dollars. Consequently its functional currency became the US Dollar. Financial information for prior periods were restated from Sterling into US Dollars in accordance with *FRS 23, The Effects of Changes in Foreign Exchange Rates*.

Share capital and share premium in comparative periods was translated at the rate of exchange on the date of redenomination.

### B. Accounting Policies

The separate accounts of the Parent Company are presented as required by the Companies Act 1985. The accounts have been prepared under the historical cost convention, modified to include revaluation to fair value of certain financial instruments as described below, and in accordance with applicable UK accounting standards. As consolidated financial information has been disclosed under *IFRS 7, Financial Instruments: Disclosures*, the Parent Company is exempt from *FRS 29, Financial Instruments: Disclosures*. The Group accounts have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and are presented on pages 74 to 138.

The Parent Company has taken advantage of the exemption in *FRS 8, Related Party Disclosures* not to present its related party disclosures as the Group accounts contain these disclosures. In addition, the Parent Company has taken advantage of the exemption in *FRS 1, Cash Flow Statements* not to present its own cash flow statement as the Group accounts contain a consolidated cash flow.

In applying these policies management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates.

#### ***Foreign Currencies***

Transactions in foreign currencies are initially recorded at the exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date. All exchange differences are dealt with in arriving at profit before taxation.

#### ***Investments***

Investments in subsidiaries are stated at cost less provision for impairment.

#### ***Financial Instruments***

Currency swaps are used to match foreign currency net assets with foreign currency liabilities. They are initially recorded at fair value and then for reporting purposes remeasured to fair value at exchange rates and interest rates at subsequent balance sheet dates.

Changes in the fair value of derivative financial instruments are recognised in the profit and loss account as they arise.

#### ***Deferred Taxation***

Deferred taxation is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events have occurred at that date that will result in an obligation to pay more, or a right to pay less or to receive more, tax.

## B. Accounting Policies — (continued)

### *Deferred Taxation (continued)*

Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences are expected to reverse. These are based on tax rates and laws substantively enacted at the balance sheet date.

### *Share Based Payments*

The Parent Company operates a number of executive and employee share schemes. For all grants of share options and awards, the fair value as at the date of grant is calculated using an option pricing model and the corresponding expense is recognised over the vesting period. Subsidiary companies are recharged for the fair value of share options that relate to their employees.

The disclosure relating to the Parent Company is detailed in Note 28 of the Notes to the Group accounts.

## C. Investments

	(\$ million)
At 1 January 2008 .....	1,332
Additions .....	7,508
Disposals .....	(4,734)
Impairment .....	(508)
At 31 December 2008 .....	<u>3,598</u>

Investments represents holdings in subsidiary undertakings. During 2008, the Company undertook a reorganisation of its group structure which resulted in a gain on disposal of certain direct subsidiary undertakings. The resulting gain of \$2,266m, which is non-distributable as the disposed subsidiary still resides within the overall group, is included within Capital Reserves.

Following the receipt of a dividend of \$508m from a subsidiary undertaking, the Company recorded a corresponding impairment against the carrying value of this subsidiary.

The information provided below is given for the principal subsidiary undertakings, all of which are 100% owned, in accordance with Section 231(5)(a) of the Companies Act 1985. A full list will be appended to Smith & Nephew's next annual return to Companies House.

<u>Company Name</u>	<u>Activity</u>	<u>Country of operation and incorporation</u>
Smith & Nephew UK Limited	Holding Company	England & Wales
Smith & Nephew (Overseas) Limited	Holding Company	England & Wales

## D. Debtors

	<u>2008</u>	<u>2007</u>
	(\$ million)	
Amounts falling due within one year:		
Amounts owed by subsidiary undertakings .....	1,508	1,594
Other debtors .....	—	1
Prepayments and accrued income .....	1	5
	<u>1,509</u>	<u>1,600</u>
Amounts falling due after more than one year:		
Deferred taxation — other timing differences .....	—	1
	<u>1,509</u>	<u>1,601</u>

## E. Cash and Borrowings

	2008	2007
	(\$ million)	
Bank loans and overdrafts due within one year or on demand	2	1,065
Bank loans due after one year	1,131	–
Borrowings	1,133	1,065
Cash and bank	(5)	(22)
Credit balances on derivatives — currency swaps (Note F)	4	2
Net debt	<u>1,132</u>	<u>1,045</u>

All currency swaps are stated at fair value. Gross US Dollar equivalents of \$95m (2007 – \$97m) receivable and \$99m (2007 – \$99m) payable have been netted and the difference of \$4m is reported as credit balances on currency swaps (2007 – \$2m). Currency swaps comprise foreign exchange swaps and were used in 2008 and 2007 to hedge Intragroup loans.

## F. Other Creditors

	2008	2007
	(\$ million)	
Amounts falling due within one year:		
Amounts owed to subsidiary undertakings	197	209
Accruals and deferred income	–	3
Other creditors	9	–
Current taxation	4	–
Currency liability derivatives — interest rate swaps	14	2
Currency liability derivatives — currency swaps	4	2
	<u>228</u>	<u>216</u>

## G. Equity and Reserves

	2008					2007		
	Share capital	Share premium	Treasury shares	Exchange reserves	Capital reserve	Profit and loss account	Total share-holders funds	Total share-holders funds
	(\$ million)							
At 1 January	190	356	(637)	(52)	–	1,817	1,674	1,608
Attributable profit for the year	–	–	–	–	–	66	66	759
Equity dividends paid in the year	–	–	–	–	–	(109)	(109)	(104)
Equity instruments granted	–	–	–	–	–	24	24	23
Cost of shares transferred to beneficiaries	–	–	7	–	–	(3)	4	–
New shares issued on exercise of share options	–	19	–	–	–	–	19	28
Treasury shares purchased	–	–	(193)	–	–	–	(193)	(640)
Profit on disposal of subsidiary undertaking	–	–	–	–	2,266	–	2,266	–
At 31 December	<u>190</u>	<u>375</u>	<u>(823)</u>	<u>(52)</u>	<u>2,266</u>	<u>1,795</u>	<u>3,751</u>	<u>1,674</u>

Further information on the share capital of the Parent Company can be found in Note 26 of the Notes to the Group Accounts. The treasury shares purchased during the year of \$193m (2007 – \$640m) relate to the share buy-back programme detailed in Note 29 of the Notes to the Group accounts.

The total distributable reserves of the Parent Company are \$920m (2007 – \$1,128m). In accordance with the exemption permitted by Section 230(3) of the Companies Act 1985, the Company has not presented its own profit and loss account. The attributable profit for the year dealt with in the accounts of the Company is \$66m (2007 – \$759m).

**G. Reserves — (continued)**

Fees paid to Ernst & Young LLP for audit and non-audit services to the Company itself are not disclosed in the individual accounts because group financial statements are prepared which are required to disclose such fees on a consolidated basis. The fees for the consolidated Group are disclosed in Note 38 of the Notes to the Group Accounts.

**H. Contingent Liability**

	<u>2008</u>	<u>2007</u>
	(\$ million)	
Guarantees in respect of subsidiary undertakings . . . . .	221	251

The Company has given guarantees to banks to support liabilities under foreign exchange and other contracts and cross guarantees to support overdrafts. Such guarantees are not considered to be liabilities as all subsidiary undertakings are trading as going concerns.

The Company operated defined benefit pension plans in 2004 but at the end of 2005 its pension plan obligations were transferred to Smith & Nephew UK Ltd. In January 2006 the Company provided guarantees to the Trustees of the pension plans to support future amounts due from participating employers (see Note 35 of the Notes to the Group Accounts).

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# INVESTOR INFORMATION

This section discusses shareholder return (the return to shareholders in the form of dividends and share price movements) and provides other information for shareholders. A graph showing total shareholder return is in the Remuneration Report on page 72.

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## SHAREHOLDER RETURN

### Dividend History

Following the capital restructuring and dividend reduction in 2000 the Group adopted a policy of increasing its dividend cover (the ratio of EPSA, as set out in the “Selected Financial Data”, to ordinary dividends declared for the year). This was intended to increase the financing capability of the Group for acquisitions and other investments. From 2000 to 2004 the dividend increased in line with inflation and, in 2004, dividend cover stood at 4.1 times. Having achieved this level of dividend cover the Board changed its policy from that of increasing dividends in line with inflation to that of increasing dividends for 2005 and after by 10%. Following the redenomination of the Company’s share capital into US Dollars the Board re-affirmed its policy of increasing the dividend by 10% a year in US Dollar terms.

Smith & Nephew has paid dividends on its Ordinary Shares in each year since 1937. An interim dividend in respect of each fiscal year is normally declared in August and paid in November. Up to 2004 a final dividend for each year was recommended by the Board of Directors in the following February and paid in May after approval by shareholders at the Company’s Annual General Meeting. Following shareholder approval in December 2005, the directors may declare and pay interim dividends. In 2006, 2007 and 2008 shareholders received two interim dividends and are expected to receive two interim dividends in 2009.

Future dividends of Smith & Nephew will be dependent upon: future earnings; the future financial condition of the Group; the Board’s dividend policy; and the additional factors that might affect the business of the Group set out in “Special Note Regarding Forward-Looking Statements” and “Risk Factors”.

The following table shows the dividends on each Ordinary Share (as increased by the associated UK tax credit of 10%, but before deduction of withholding taxes) for the fiscal years 2004 through 2008. The 2008 second interim dividend will be payable on 8 May 2009. All dividends, up to the second interim dividend for 2005, have been declared in pence per Ordinary Share and have been translated into US cents per share at the Noon Buying Rate on the payment date. All dividends from the second interim dividend for 2005 have been declared in US cents per Ordinary Share.

	Years ended 31 December				
	2008	2007	2006	2005	2004
Pence per share:					
Interim .....	3.194	2.450	2.456	2.333	2.111
Second interim .....	6.547(i)	4.059	3.789	3.889	–
Final .....	–	–	–	–	3.556
Total .....	<u>9.741</u>	<u>6.509</u>	<u>6.245</u>	<u>6.222</u>	<u>5.667</u>
US cents per share:					
Interim .....	5.511	5.011	4.556	4.067	3.916
Second interim .....	9.022	8.200	7.456	6.778	–
Final .....	–	–	–	–	6.532
Total .....	<u>14.533</u>	<u>13.211</u>	<u>12.012</u>	<u>10.845</u>	<u>10.448</u>

(i) Translated at the Noon Buying rate on 11 March 2009.

## Share Prices

The following table sets forth, for the periods indicated, the highest and lowest middle market quotations for the Ordinary Shares, as derived from the Daily Official List of the UK Listing Authority and the highest and lowest sales prices of ADSs as reported on the New York Stock Exchange composite tape.

	Ordinary Shares		ADSs	
	High	Low	High	Low
	£	£	US\$	US\$
<b>Fiscal Year ended 31 December:</b>				
2004 .....	6.14	4.39	59.20	40.36
2005 .....	5.58	4.52	52.83	40.26
2006 .....	5.71	4.00	52.65	36.95
2007 .....	6.50	5.33	67.84	51.54
2008 .....	6.91	4.13	68.57	30.39
<b>Quarters in the Fiscal Year ended 31 December:</b>				
2007:				
1 <sup>st</sup> Quarter .....	6.48	5.33	64.11	51.54
2 <sup>nd</sup> Quarter .....	6.50	5.99	64.35	59.00
3 <sup>rd</sup> Quarter .....	6.30	5.53	64.68	54.08
4 <sup>th</sup> Quarter .....	6.50	5.58	67.84	57.22
2008:				
1 <sup>st</sup> Quarter .....	6.91	5.77	67.35	57.09
2 <sup>nd</sup> Quarter .....	6.91	5.39	68.57	52.69
3 <sup>rd</sup> Quarter .....	6.68	5.20	60.08	51.55
4 <sup>th</sup> Quarter .....	5.84	4.13	51.54	30.39
2009:				
1 <sup>st</sup> Quarter (through 11 March 2009) .....	5.53	4.47	39.63	30.57
<b>Last Six Months:</b>				
September 2008 .....	6.68	5.85	60.08	51.55
October 2008 .....	5.80	4.80	51.54	36.72
November 2008 .....	5.84	4.64	47.09	34.15
December 2008 .....	4.68	4.13	35.28	30.39
January 2009 .....	5.01	4.47	36.60	32.30
February 2009 .....	5.53	4.88	39.63	34.76
March 2009 (through 11 March 2009) .....	4.91	4.50	33.96	30.57

## INFORMATION FOR SHAREHOLDERS

### Shareholder Communications

Following shareholder approval in 2007, the Company will be sending paper copies of the Annual Report only to those shareholders that have elected to receive shareholder documentation by post. ADS holders also will not be sent a hard copy unless they have elected to receive it. The document, as well as the electronic Summary Financial Statement, will be available on the Group's website at [www.smith-nephew.com](http://www.smith-nephew.com) and both ordinary shareholders and ADS holders can request hard copies of these documents, which will be provided free of charge. The Group will continue to send the notice of the Annual General Meeting with an accompanying letter to ordinary shareholders by post which will state that the Annual Report is available on the Group's website. Shareholders who have elected to receive the notice electronically are informed by e-mail of the availability of the documents on the Group's website. ADS holders will receive the form of proxy by post.

From 2007, following regulatory changes in the UK, the Interim Report has been made available through Stock Exchange announcements and on the Group's website. Quarterly reports are made available through Stock Exchange announcements and on the Group's website. Hard copies are available on request. Copies of recent Annual Reports, Summary Financial Statements and Interim Reports are also available on the Smith & Nephew website along with press releases, institutional presentations and audio webcasts.

### Investor Communications

There is a regular dialogue with individual institutional shareholders, together with results presentations. To ensure that all members of the Board develop an understanding of the views of major shareholders, the executive directors review significant issues raised by investors with the Board. Non-executive directors are sent copies of analysts' and brokers' briefings. There is an opportunity for individual shareholders to question the directors at the AGM, at which the level of proxy votes received are advised, and the Company regularly responds to letters from shareholders on a range of issues.

### Financial Calendar

Quarter One results and AGM	30 April 2009
Payment of 2008 second interim dividend	8 May 2009
Half year results announced	30 July 2009 (i)
Quarter Three results announced	6 November 2009
Payment of 2009 first interim dividend	November 2009
Full year results announced	February 2010 (i)
Annual Report available	March 2010
Annual General Meeting	May 2010

(i) Dividend declaration dates.

### Dividend

The Ordinary Shares and ADSs will trade ex-dividend on both the London and New York Stock Exchanges respectively from 15 April 2009 and the record date will be 17 April 2009 in respect of the second interim dividend for the year ended 31 December 2008 of 8.12¢ per Ordinary Share to be paid on 8 May 2009. The Sterling equivalent per Ordinary Share will be set following the record date. Shareholders may elect to receive their dividend in either Sterling or US Dollars and the last day for election will be 15 April 2009.

### Ordinary Shares

#### *Payment of cash dividends*

Shareholders who wish their dividends to be paid directly to a bank or building society and who have not already completed an electronic bank transfer mandate should contact the Company's registrar, Equiniti.

#### *Dividend re-investment plan*

The Company has a dividend re-investment plan that offers shareholders, except those in North America, the opportunity to invest their cash dividends in further Smith & Nephew Ordinary Shares, which are purchased in the market at competitive dealing costs. Application forms for re-investing the 2008 second interim dividend and for future dividends are available from Equiniti who administer the plan on behalf of the Company.

#### *UK capital gains tax*

For the purposes of UK capital gains tax the price of Ordinary Shares on 31 March 1982 was 35.04p.

#### *Smith & Nephew share price*

The Company's Ordinary Shares are quoted on the LSE under the symbol SN. The Company's share price is available on the Smith & Nephew website [www.smith-nephew.com](http://www.smith-nephew.com) and at [www.londonstockexchange.com](http://www.londonstockexchange.com) where it is updated at intervals throughout the day. It is also quoted daily in UK national newspapers.

#### *Smith & Nephew corporate ISA*

The Company has a corporate Individual Savings Account (ISA), for UK shareholders, administered by the Company's registrar. For information about this service if calling from the UK please contact their helpline on telephone 0871 384 2081 (calls to this number are charged at 8p per minute from a BT landline, other telephony providers' costs may vary) or +44 (0) 121 415 7072 if calling from outside the UK.

#### *Shareview*

To view information about your shareholdings on the internet, register at [www.shareview.co.uk](http://www.shareview.co.uk), the registrars enquiry and portfolio management service for shareholders. When you have registered for shareview you will also be able to register your proxy instructions online and elect to receive future shareholder communications via the website at [www.smith-nephew.com](http://www.smith-nephew.com).

#### *Shareholder enquiries*

For information about the AGM, shareholdings, dividends and changes to personal details all shareholders should contact Equiniti, Aspect House, Spencer Road, Lancing, West Sussex BN99 6DA, UK on telephone 0871 384 2081 (calls to this number are charged at 8p per minute from a BT landline, other telephony providers' costs may vary) or +44 (0) 121 415 7072 if calling from outside the UK.

#### **American Depositary Receipts ("ADRs")**

In the US, the Company's Ordinary Shares are traded in the form of ADSs, evidenced by ADRs, and trade on the NYSE under the symbol SNN. Each American Depositary Share represents five Ordinary Shares. The Bank of New York Mellon is the authorised depositary bank for the Company's ADR programme. A Global BuyDIRECT plan is available for US residents, enabling investment directly in ADSs with reduced brokerage commissions and service costs. For further information on Global BuyDIRECT contact: The Bank of New York Mellon on +1-866-259-2287 (toll-free) or visit [www.bnymellon.com/shareowner](http://www.bnymellon.com/shareowner).

The Company furnishes the Bank of New York Mellon, as depositary, with copies of this annual report containing Consolidated Financial Statements and the opinion expressed thereon by its independent auditors. Such financial statements are prepared under IFRS. Upon receipt thereof, the Bank of New York Mellon will mail all such reports to recorded holders who have elected to receive hard copy versions. The Company also furnishes to The Bank of New York Mellon all notices of shareholders' meetings and other reports and communications that are made generally available to shareholders of the Company. The Bank of New York Mellon makes such notices, reports and communications available for inspection by recorded holders of ADSs and mails forms of proxy to all recorded holders of ADSs.

#### *Smith & Nephew ADS price*

The Company's ADS price can be obtained from the official New York Stock Exchange website at [www.nyse.com](http://www.nyse.com) and is quoted daily in the Wall Street Journal.

#### *ADS Enquiries*

All enquiries regarding ADS holder accounts and payment of dividends should be addressed to: BNY Mellon Shareholder Services, PO Box 358516, Pittsburgh, PA 15252-8516, USA; inside the US call toll free +1-866-259-2287; internationally call +1-201-680-6825; or email [shrrelations@bnymellon.com](mailto:shrrelations@bnymellon.com).

#### **Annual General Meeting**

The Company's Annual General Meeting is to be held on 30 April 2009 at 11.00am at The Royal College of Physicians, 11 St Andrews Place, Regent's Park, London, NW1 4LE, UK. Notice of the meeting has been sent to all shareholders with an accompanying letter from the Chairman.

**Corporate Headquarters and Registered office**

The corporate headquarters is in the UK and the registered office address is: Smith & Nephew plc, 15 Adam Street, London WC2N 6LA, UK. Registered in England and Wales No. 324357. Tel: +44 (0) 20 7401 7646. Website: [www.smith-nephew.com](http://www.smith-nephew.com)

**Advisors**

Solicitors:

Ashurst LLP  
Freshfields Bruckhaus Deringer

Auditors:

Ernst &amp; Young LLP

Stockbrokers:

JP Morgan Cazenove

UBS

## SHARE CAPITAL

The principal trading market for the Ordinary Shares is the London Stock Exchange. The Ordinary Shares were listed on the New York Stock Exchange on 16 November 1999, trading in the form of ADSs evidenced by ADRs. The number of ordinary shares represented by each ADS is five. The ADR facility is sponsored by The Bank of New York Mellon acting as depository.

All the Ordinary Shares, including those held by directors and officers, rank *pari passu* with each other. Following approval by shareholders at the Extraordinary General Meeting in December 2005, on 23 January 2006, the Ordinary Shares of 12½ pence were redenominated as Ordinary Shares of US 20¢. The new US Dollar Ordinary Shares carry the same rights as the previous Ordinary Shares. The shares continue to be traded on the London Stock Exchange and quoted in Sterling. The ADSs continued to represent five Ordinary Shares. In order to comply with English law the Company has issued £50,000 of shares in Sterling. These were issued as Deferred Shares, which are not listed on any stock exchange and have extremely limited rights and therefore effectively have no value. These were allotted to the Chief Executive, though the Board reserves the right to transfer them to another member of the Board should it so wish.

### Shareholdings

As at 11 March 2009, 8,404,235 ADSs equivalent to 42,021,175 Ordinary Shares or approximately 4.8% of the total Ordinary Shares in issue, were outstanding and were held by 98 registered holders.

As at 11 March 2009, to the knowledge of the Group, there were 22,787 registered holders of Ordinary Shares, of whom 90 had registered addresses in the US and held a total of 229,544 Ordinary Shares (less than 1% of the total issued). Because certain Ordinary Shares are registered in the names of nominees, the number of shareholders with registered addresses in the US is not representative of the number of beneficial owners of Ordinary Shares resident in the US.

### Major Shareholders

As far as is known to Smith & Nephew, the Group is not directly or indirectly owned or controlled by another corporation or by any government and the Group has not entered into arrangements, the operation of which may at a subsequent date result in a change in control of the Group.

As at 11 March 2009, no persons are known to Smith & Nephew to have any interest (as defined in the Disclosure and Transparency Rules of the FSA) in 3% or more of the Ordinary Shares, other than as shown below. The following tables show changes over the last three years in the percentage and numbers of the issued share capital owned by shareholders holding 3% or more of Ordinary Shares, as notified to the Company under the Disclosure and Transparency Rules:

	11 March 2009	As at 31 December		
		2008	2007	2006
		(%)		
Thornburg Investment Management Inc. ....	5.1	–	–	–
Capital Group of Companies Inc. ....	5.1	5.1	9.8	16.6
Newton Investment Management Limited ....	4.7	5.0	–	–
Legal and General Investment Management ....	4.1	4.5	5.2	3.4
FMR LLC .....	3.9	3.9	–	–
Prudential .....	–	3.1	–	–
		(number in thousands)		
	11 March 2009	2008	2007	2006
Thornburg Investment Management Inc. ....	44,935	–	–	–
Capital Group of Companies Inc. ....	44,594	44,594	88,150	156,412
Newton Investment Management Limited ....	41,893	44,168	–	–
Legal and General Investment Management ....	35,804	40,040	46,324	31,891
FMR LLC .....	34,101	34,101	–	–
Prudential .....	–	26,945	–	–

The company is not aware of any person who has a significant direct or indirect holding of securities in the Company, and is not aware of any persons holding securities which may control the Company. There are no securities in issue which have special rights as to the control of the Company.

### Purchase of Ordinary Shares on behalf of the Company

As announced in November 2008, in light of the current conditions in the financial markets, the share buy-back programme has been suspended. The programme will be kept under review going forward and, at the AGM, the Company will be seeking a renewal of its current permission from shareholders to purchase up to 10% of its own shares. As at 31 December 2008, 68,240,200 (2007 — 51,955,000) ordinary shares had been purchased under the share buy-back programme that commenced in February 2007. The cost of the shares purchased in 2008 was \$193m (2007 — \$640m).

	Total shares purchased	Average price paid per share
	(000s)	(p)
January 2008 .....	3,489	616
February 2008 .....	1,990	663
March 2008 .....	1,750	637
April 2008 .....	350	576
May 2008 .....	2,355	554
June 2008 .....	2,375	579
July 2008 .....	—	—
August 2008 .....	2,026	636
September 2008 .....	1,950	635
Total purchased in year to 31 December 2008 .....	<u>16,285</u>	613

The shares were purchased in the open market by JP Morgan Cazenove Limited on behalf of the Company.

### Exchange Controls and Other Limitations Affecting Security Holders

There are no UK governmental laws, decrees or regulations that restrict the export or import of capital or that affect the payment of dividends, interest or other payments to non-resident holders of Smith & Nephew's securities, except for certain restrictions imposed from time to time by Her Majesty's Treasury of the United Kingdom pursuant to legislation, such as the United Nations Act 1946 and the Emergency Laws Act 1964, against the government or residents of certain countries.

There are no limitations, either under the laws of the UK or under the Articles of Association of Smith & Nephew, restricting the right of non-UK residents to hold or to exercise voting rights in respect of Ordinary Shares, except that where any overseas shareholder has not provided to the Company a UK address for the service of notices, the Company is under no obligation to send any notice or other document to an overseas address. It is, however, the current practice of the Company to send every notice or other document to all shareholders regardless of the country recorded in the register of members, with the exception of details of the Company's dividend re-investment plan, which are not sent to shareholders with recorded addresses in the US and Canada.



## SELECTED FINANCIAL DATA

	2008	2007	2006	2005	2004
	(\$ million, except per Ordinary Share amounts)				
<b>Amounts in accordance with IFRS as adopted by the EU and IFRS as issued by the IASB :</b>					
<b>Income statement</b>					
Revenue	3,801	3,369	2,779	2,552	2,301
Cost of goods sold	(1,077)	(994)	(769)	(754)	(664)
Gross profit	2,724	2,375	2,010	1,798	1,637
Selling, general and administrative expenses	(1,942)	(1,740)	(1,353)	(1,254)	(1,225)
Research and development expenses	(152)	(142)	(120)	(122)	(122)
Operating profit	630	493	537	422	290
Net interest (payable)/receivable	(66)	(30)	10	9	7
Other finance (costs)/income	(1)	6	3	(3)	(3)
Share of results of associates	1	–	–	–	–
Profit before taxation	564	469	550	428	294
Taxation	(187)	(153)	(156)	(126)	(77)
Profit from continuing operations	377	316	394	302	217
Discontinued operations — net profit on disposal and share of results of joint venture	–	–	351	31	28
Attributable profit for the year	<u>377</u>	<u>316</u>	<u>745</u>	<u>333</u>	<u>245</u>
<b>Earnings per Ordinary Share</b>					
Including discontinued operations:					
Basic	42.6¢	34.2¢	79.2¢	35.5¢	26.2¢
Diluted	42.4¢	34.1¢	78.9¢	35.3¢	26.0¢
Continuing operations:					
Basic	42.6¢	34.2¢	41.9¢	32.2¢	23.2¢
Diluted	42.4¢	34.1¢	41.7¢	32.0¢	23.1¢
Discontinued operations:					
Basic	–	–	37.3¢	3.3¢	3.0¢
Diluted	–	–	37.2¢	3.3¢	2.9¢
<b>Adjusted attributable profit</b>					
Attributable profit for the year	377	316	745	333	245
Acquisition related costs	61	111	20	–	–
Restructuring and rationalisation expenses	34	42	–	84	–
Legal settlement	–	30	–	–	154
Amortisation and impairment acquisition intangibles	51	30	14	11	8
Loss/(gain) on hedge of the sale proceeds of the joint venture	–	–	3	(2)	–
Net profit on disposal of the joint venture	–	–	(351)	–	–
Taxation on excluded items	(30)	(49)	(6)	(29)	(54)
Adjusted attributable profit	<u>493</u>	<u>480</u>	<u>425</u>	<u>397</u>	<u>353</u>
Adjusted basic earnings per Ordinary Share (“EPSA”) (i)	55.6¢	52.0¢	45.2¢	42.3¢	37.8¢
Adjusted diluted earnings per Ordinary Share (ii)	55.4¢	51.7¢	45.0¢	42.1¢	37.5¢

	2008	2007 (iv)	2006	2005	2004
	(\$ million, except per Ordinary Share amounts)				
<b>Group Balance Sheet</b>					
Non-current assets	2,523	2,542	1,586	1,420	1,713
Current assets	1,985	1,919	1,645	1,338	1,176
Held for sale — investment in joint venture	—	—	—	218	—
Total assets	<u>4,508</u>	<u>4,461</u>	<u>3,231</u>	<u>2,976</u>	<u>2,889</u>
Called up equity share capital	190	190	189	203	202
Reserves	2,332	2,263	1,986	1,236	1,107
Treasury shares	(823)	(637)	(1)	(4)	(8)
Total equity	<u>1,699</u>	<u>1,816</u>	<u>2,174</u>	<u>1,435</u>	<u>1,301</u>
Non-current liabilities	1,841	357	241	529	759
Current liabilities	968	2,288	816	1,012	829
Total liabilities	<u>2,809</u>	<u>2,645</u>	<u>1,057</u>	<u>1,541</u>	<u>1,588</u>
Total equity and liabilities	<u>4,508</u>	<u>4,461</u>	<u>3,231</u>	<u>2,976</u>	<u>2,889</u>
<b>Group Cash Flow</b>					
Cash generated from operations	815	693	506	372	415
Net interest (paid)/received	(63)	(30)	10	9	7
Income taxes paid	(186)	(225)	(144)	(112)	(70)
Net cash inflow from operating activities	566	438	372	269	352
Capital expenditure (including trade investments and net of disposals of property, plant and equipment)	(289)	(194)	(222)	(200)	(185)
Acquisitions and disposals	(16)	(781)	454	(25)	(64)
Loan Notes issued	—	—	(15)	—	(91)
New finance leases	—	(7)	—	—	—
Facility fee paid	2	(6)	—	—	—
Borrowings and finance leases acquired	—	(181)	—	—	—
Dividends received from joint venture	—	—	—	25	26
Proceeds from own shares	4	—	—	—	—
Equity dividends paid	(109)	(105)	(96)	(91)	(84)
Issue of ordinary capital and treasury shares purchased	(174)	(612)	16	19	8
	(16)	(1,448)	509	(3)	(38)
Exchange adjustments	(6)	(72)	7	(71)	51
Opening (net debt) /net cash	<u>(1,310)</u>	<u>210</u>	<u>(306)</u>	<u>(232)</u>	<u>(245)</u>
Closing (net debt)/net cash	<u>(1,332)</u>	<u>(1,310)</u>	<u>210</u>	<u>(306)</u>	<u>(232)</u>
Gearing (closing net debt as a percentage of total equity)	78%	72%	n/a	21%	18%
<b>Selected Financial Ratios</b>					
Dividends per Ordinary Share (iii)	13.08¢	11.89¢	10.81¢	5.60p	5.10p
Research and development costs to Revenue	4.0%	4.2%	4.3%	4.8%	5.3%
Capital expenditure (including intangibles but excluding goodwill) to Revenue	7.7%	5.9%	8.3%	7.9%	8.2%

(i) Adjusted basic earnings per Ordinary Share is calculated by dividing adjusted attributable profit by the average number of shares.

(ii) Adjusted diluted earnings per Ordinary Share is calculated by dividing adjusted attributable profit by the diluted number of shares.

(iii) Prior to 2006 dividends were declared in pence.

(iv) Restated due to Plus opening balance sheet adjustments. See Note 32 of the Notes to the Group Accounts.

## TAXATION INFORMATION FOR SHAREHOLDERS

The comments below are of a general and summary nature and are based on the Group's understanding of certain aspects of current UK and US federal income tax law and practice relevant to the ADSs and Ordinary Shares not in ADS form. The comments address the material US and UK tax consequences generally applicable to a person who is the beneficial owner of ADSs or Ordinary Shares and who, for US federal income tax purposes, is a citizen or resident of the United States, a corporation (or other entity taxable as a corporation) created or organised in or under the laws of the United States, or an estate or trust the income of which is included in gross income for US federal income tax purposes regardless of its source (each a "US Holder"). The comments set out below do not purport to address all tax consequences of the ownership of ADSs or Ordinary Shares which may be material to a particular holder and in particular do not deal with the position of shareholders who directly or indirectly own 10% or more of the Company's issued Ordinary Shares. This discussion does not apply to persons whose holding of ADSs or Ordinary Shares is effectively connected with or pertains to either (i) a permanent establishment in the United Kingdom through which a US Holder carries on a business in the United Kingdom, (ii) a fixed base from which a US Holder performs independent personal services in the United Kingdom, or (iii) whose registered address is inside the UK. This discussion does not apply to certain investors such as certain financial institutions, tax-exempt entities, insurance companies, broker-dealers, traders in securities that elect to mark to market, partnerships or other entities treated as partnerships for US federal income tax purposes, US Holders holding ADSs or Ordinary Shares as part of a hedging, conversion or other integrated transaction or whose functional currency for US federal income tax purposes is other than the US Dollar and investors liable for alternative minimum tax. In addition, the comments below do not address US state, local or non-US (other than UK) taxes. The summary deals only with US Holders who hold ADSs or Ordinary Shares as capital assets. The summary is based on current UK and US law and practice which is subject to change, possibly with retroactive effect. US Holders are recommended to consult their own tax advisors as to the particular tax consequences to them of the ownership of ADSs or Ordinary Shares.

This discussion is based in part on representations by the depositary and assumes that each obligation under the deposit agreement and any related agreement will be performed in accordance with its terms. For purposes of US federal income tax law, US Holders of ADSs will generally be treated as owners of the Ordinary Shares represented by the ADSs. However, the US Treasury has expressed concerns that parties to whom depositary shares are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by owners of ADSs. Such actions would also be inconsistent with the claiming of the reduced rate of tax, described below, applicable to dividends received by certain non-corporate US Holders. Accordingly, the analysis of the availability of the reduced tax rate for dividends received by certain non-corporate US Holders could be affected by actions that may be taken by parties to whom ADSs are pre-released.

### **Taxation of Dividends in the United Kingdom and the United States**

The UK does not currently impose a withholding tax on dividends paid by a UK corporation, such as the Company.

Distributions paid by the Company will be treated for US federal income tax purposes as foreign source ordinary dividend income to a US Holder to the extent paid out of the Company's current or accumulated earnings and profits as determined for US federal income tax purposes. Such dividends will not be eligible for the dividends-received deduction generally allowed to corporate US Holders.

Dividends paid to certain non-corporate US Holders of Ordinary Shares or ADSs in taxable years beginning before 1 January 2011 may be subject to US federal income tax at lower rates than other types of ordinary income if certain conditions are met. Non-corporate US Holders should consult their own tax advisors to determine whether they are subject to any special rules that limit their ability to be taxed at these favourable rates.

### **Taxation of Capital Gains**

US Holders, who are not resident or ordinarily resident for tax purposes in the UK, will not generally be liable for UK capital gains tax on any capital gain realised upon the sale or other disposition of ADSs or Ordinary Shares unless held in connection with a trade carried on in the UK through a permanent establishment (or in the case of individuals, through a branch or agency). Furthermore, UK resident individuals who acquire ADSs or Ordinary Shares before becoming temporarily non-UK residents, may remain subject to UK taxation of capital gains on gains realised while non-resident.

For US federal income tax purposes, gains or losses realised upon the sale or disposition of ADSs or Ordinary Shares by US Holders generally will be US source capital gains or losses and will be long-term US source capital

gains or losses if the ADSs or Ordinary Shares were held for more than one year. The amount of the US Holder's gain or loss will be equal to the difference between the amount realised on the sale or disposition and such holder's tax basis in the ADSs, or Ordinary Shares, determined in US Dollars.

### **Inheritance and Estate Taxes**

The HM Revenue & Customs imposes inheritance tax on capital transfers which occur on death, and in the seven years preceding death. The HM Revenue & Customs considers that the US/UK Double Taxation Convention on Estate and Gift Tax applies to inheritance tax. Consequently, a US citizen who is domiciled in the United States and is not a UK national or domiciled in the United Kingdom will not be subject to UK inheritance tax in respect of ADSs and Ordinary Shares. A UK national who is domiciled in the United States will be subject to both UK inheritance tax and US federal estate tax but will be entitled to a credit for US federal estate tax charged in respect of ADSs and Ordinary Shares in computing the liability to UK inheritance tax. Conversely, a US citizen who is domiciled or deemed domiciled in the United Kingdom will be entitled to a credit for UK inheritance tax charged in respect of ADSs and Ordinary Shares in computing the liability for US federal estate tax. Special rules apply where ADSs and Ordinary Shares are business property of a permanent establishment of an enterprise situated in the United Kingdom.

### **US Information Reporting and Backup Withholding Tax**

A US Holder may be subject to US information reporting and backup withholding tax on dividends paid or the proceeds of sales from ADSs or Ordinary Shares made within the US or through certain US-related financial intermediaries, unless the US Holder is a corporation or other exempt recipient or, in the case of backup withholding, provides a correct US taxpayer identification number and certain other conditions are met. US backup withholding tax may also apply if there has been a notification from the US Internal Revenue Service of a failure to report all interest or dividends.

Any backup withholding tax deducted may be credited against the US Holder's US federal income tax liability, and, where the withholding tax exceeds the actual liability, the US Holder may obtain a refund by timely filing the appropriate refund claim with the US Internal Revenue Service.

### **UK Stamp Duty and Stamp Duty Reserve Tax**

UK stamp duty is charged on documents and in particular instruments for the transfer of registered ownership of Ordinary Shares. Transfers of Ordinary Shares in certificated form will generally be subject to UK stamp duty at the rate of ½% of the consideration given for the transfer with the duty rounded up to the nearest £5.

UK stamp duty reserve tax ("SDRT") arises when there is an agreement to transfer shares in UK companies "for consideration in money or money's worth", and so an agreement to transfer Ordinary Shares for money or other consideration may give rise to a charge to SDRT at the rate of ½% (rounded up to the nearest penny). The charge of SDRT will be cancelled, and any SDRT already paid will be refunded, if within six years of the agreement an instrument of transfer is produced to HM Revenue & Customs and the appropriate stamp duty paid.

Transfers of Ordinary Shares into CREST (an electronic transfer system) are exempt from stamp duty so long as the transferee is a member of CREST who will hold the Ordinary Shares as a nominee for the transferor and the transfer is in a form that will ensure that the securities become held in uncertificated form within CREST. Paperless transfers of Ordinary Shares within CREST for consideration in money or money's worth are liable to SDRT rather than stamp duty. SDRT on relevant transactions will be collected by CREST at ½%, and this will apply whether or not the transfer is effected in the United Kingdom and whether or not the parties to it are resident or situated in the United Kingdom.

A charge of stamp duty or SDRT at the rates of 1 ½% of the consideration (or, in some circumstances, the value of the shares concerned) will arise on a transfer or issue of Ordinary Shares to the Depositary or to certain persons providing a clearance service (or their nominees or agents) for the conversion into ADRs and will generally be payable by the Depositary or person providing clearance service. In accordance with the terms of the Deposit Agreement, any tax or duty payable by the Depositary on deposits of Ordinary Shares will be charged by the Depositary to the party to whom ADRs are delivered against such deposits.

No liability for stamp duty or SDRT will arise on any transfer of, or agreement to transfer, an ADS or beneficial ownership of an ADS, provided that the ADS and any instrument of transfer or written agreement to transfer remains at all times outside the United Kingdom, and provided further that any instrument of transfer or written agreement to transfer is not executed in the United Kingdom and the transfer does not relate to any matter or thing done or to be done in the United Kingdom (the location of the custodian as a holder of Ordinary Shares not being relevant in this context). In any other case, any transfer of, or agreement to transfer, an ADS or beneficial ownership of an ADS could, depending on all the circumstances of the transfer, give rise to a charge to stamp duty or SDRT.

## MEMORANDUM AND ARTICLES OF ASSOCIATION

The following summarises certain material rights of holders of the Company's Ordinary Shares under the material provisions of the Company's memorandum and articles of association and English law. This summary is qualified in its entirety by reference to the Companies Act and the Company's memorandum and articles of association.

The Company's Ordinary Shares may be held in certificated or uncertificated form. No holder of the Company's shares will be required to make additional contributions of capital in respect of the Company's shares in the future. In accordance with English law the Company's Ordinary Shares rank equally.

In the following description, a "shareholder" is the person registered in the Company's register of members as the holder of an Ordinary Share.

The Company is incorporated under the name Smith & Nephew plc and is registered in England and Wales with registered number 324357. The fourth clause of the Company's memorandum of association provides that its objects include to carry on business as an investment holding company, to carry on all or any of the businesses of dealers in and manufacturers of surgical dressings and instruments, pharmaceutical preparations or articles, proprietary articles of all kinds, surgical and scientific apparatus and materials of all kinds and buyers and sellers of goods of all kinds. The memorandum grants to the Company a range of corporate capabilities to effect these objects.

### **Directors**

Under the Company's articles of association, a director may not vote in respect of any contract, arrangement, transaction or proposal in which he, or any person connected with him, has any material interest other than by virtue of his interests in securities of, or otherwise in or through, the Company. This is subject to certain exceptions relating to proposals (a) indemnifying him in respect of obligations incurred on behalf of the Company, (b) indemnifying a third party in respect of obligations of the Company for which the director has assumed responsibility under an indemnity or guarantee, (c) relating to an offer of securities in which he will be interested as an underwriter, (d) concerning another body corporate in which the director is beneficially interested in less than one percent of the issued shares of any class of shares of such a body corporate, (e) relating to an employee benefit in which the director will share equally with other employees and (f) relating to any insurance that the Company is empowered to purchase for the benefit of directors of the Company in respect of actions undertaken as directors (and/or officers) of the Company.

A director shall not vote or be counted in any quorum present at a meeting in relation to a resolution on which he is not entitled to vote.

The directors are empowered to exercise all the powers of the Company to borrow money, subject to the limitation that the aggregate amount of all monies borrowed after deducting cash and current asset investments by the Company and its subsidiaries shall not exceed the sum of \$6,500,000,000.

Any director who has been appointed by the directors since the previous Annual General Meeting of shareholders, either to fill a casual vacancy or as an additional director, holds office only until the next Annual General Meeting and then shall be eligible for re-election by the shareholders. The other directors retire and are eligible for re-appointment at the third annual general meeting after the meeting at which they were last re-appointed. The directors are subject to removal with or without cause by the Board or the shareholders. Directors are not required to hold any shares of the Company by way of qualification.

### **Rights Attaching to Ordinary Shares**

Under English law, dividends are payable on the Company's Ordinary Shares only out of profits available for distribution, as determined in accordance with accounting principles generally accepted in the United Kingdom and by the Companies Act 1985. Holders of the Company's Ordinary Shares are entitled to receive final dividends as may be declared by the directors and approved by the shareholders in general meeting, rateable according to the amounts paid up on such shares, provided that the dividend cannot exceed the amount recommended by the directors.

The Company's Board of Directors may declare such interim dividends as appear to them to be justified by the Company's financial position. If authorised by an ordinary resolution of the shareholders, the Board may also direct payment of a dividend in whole or in part by the distribution of specific assets (and in particular of paid up shares or debentures of the Company).

Any dividend unclaimed after 12 years from the date the dividend was declared, or became due for payment, will be forfeited and will revert to the Company.

There have been no material modifications to the rights of shareholders under the Articles during 2008.

### **Voting Rights of Ordinary Shares**

Voting at any general meeting of shareholders is by a show of hands unless a poll, which is a written vote, is duly demanded and held. On a show of hands, every shareholder who is present in person at a general meeting has one vote regardless of the number of shares held. On a poll, every shareholder who is present in person or by proxy has one vote for each Ordinary Share held by that shareholder. A poll may be demanded by any of the following:

- the chairman of the meeting;
- at least five shareholders present or by proxy entitled to vote on the resolution;
- any shareholder or shareholders representing in the aggregate not less than one-tenth of the total voting rights of all shareholders entitled to vote on the resolution; or
- any shareholder or shareholders holding shares conferring a right to vote on the resolution on which there have been paid-up sums in aggregate equal to not less than one-tenth of the total sum paid up on all the shares conferring that right.

A proxy form will be treated as giving the proxy the authority to demand a poll, or to join others in demanding one, as above.

The necessary quorum for a general meeting is two shareholders present in person or by proxy carrying the right to vote upon the business to be transacted.

Matters are transacted at general meetings of the Company by the processing and passing of resolutions of which there are two kinds, which are ordinary or special resolutions:

- an ordinary resolution, which includes resolutions for the re-election of directors, the approval of financial statements, the declaration of dividends (other than interim dividends), the appointment and re-appointment of auditors, the increase of authorised share capital or the grant of authority to allot shares;
- a special resolution, which includes resolutions amending the Company's memorandum and articles of association, disapplying statutory pre-emption rights or changing the Company's name; modifying the rights of any class of the Company's shares at a meeting of the holders of such class or relating to certain matters concerning the Company's winding up.

An ordinary resolution requires the affirmative vote of a majority of the votes of those persons voting at the meeting at which there is a quorum.

A Special resolution requires the affirmative vote of not less than three-quarters of the persons voting at the meeting at which there is a quorum.

In the case of an equality of votes, whether on a show of hands or on a poll, the chairman of the meeting is entitled to cast the deciding vote in addition to any other vote he may have as proxy.

Annual General Meetings must be convened upon advance written notice of 21 days. Other general meetings must be convened upon advance written notice at least 14 clear days. The days of delivery or receipt of notice are not included. The notice must specify the nature of the business to be transacted. Meetings are convened by the Board of Directors. Members with 10% of the Ordinary Share capital of the Company may requisition the Board to convene a meeting.

### **Variation of Rights**

If, at any time, the Company's share capital is divided into different classes of shares, the rights attached to any class may be varied, subject to the provisions of the Companies Act, with the consent in writing of holders of three-quarters in value of the shares of that class or upon the adoption of a special resolution passed at a separate meeting of the holders of the shares of that class. At every such separate meeting, all of the provisions of the articles of association relating to proceedings at a General Meeting apply, except that the quorum is to be the number of persons (which must be two or more) who hold or represent by proxy not less than one-third in nominal value of the issued shares of the class and at any such meeting a poll may be demanded in writing by any five persons who hold or represent by proxy not less than one fortieth of the nominal value of the shares of that class. Where a person is present by proxy or proxies, he is treated as holding only the shares in respect of which the proxies are authorised to exercise voting rights.

### **Rights in a Winding-Up**

Except as the Company's shareholders have agreed or may otherwise agree, upon the Company's winding up, the balance of assets available for distribution:

- after the payment of all creditors including certain preferential creditors, whether statutorily preferred creditors or normal creditors; and
- subject to any special rights attaching to any other class of shares;

is to be distributed among the holders of Ordinary Shares according to the amounts paid-up on the shares held by them. This distribution is generally to be made in cash. A liquidator may, however, upon the adoption of any extraordinary resolution of the shareholders and any other sanction required by law, divide among the shareholders the whole or any part of the Company's assets in kind.

### **Limitations on Voting and Shareholding**

There are no limitations imposed by English law or the Company's memorandum or articles of association on the right of non-residents or foreign persons to hold or vote the Company's ordinary shares or ADSs, other than the limitations that would generally apply to all of the Company's shareholders.

### **Transfers of Shares**

The Board may refuse to register the transfer of shares held in certificated form which (a) are not fully paid (provided that it shall not exercise this discretion in such a way as to prevent stock market dealings in the shares of that class from taking place on an open and proper basis), (b) are not duly stamped or duly certified or otherwise shown to the satisfaction of the Board to be exempt from stamp duty, lodged at the Transfer Office or at such other place as the Board may appoint and (save in the case of a transfer by a person to whom no certificate was issued in respect of the shares in question) accompanied by the certificate for the shares to which it relates, and such other evidence as the Board may reasonably require to show the right of the transferor to make the transfer and, if the instrument of transfer is executed by some other person on his behalf, the authority of that person so to do, (c) are in respect of more than one class of shares or (d) are in favour of not more than four transferees.

### **Deferred Shares**

Following the redenomination of share capital on 23 January 2006 the Ordinary Shares' nominal value became US 20¢ each. There were no changes to the rights or obligations of the Ordinary Shares. In order to comply with the Companies Act 1985, a new class of Sterling shares was created, Deferred Shares, of which £50,000 were issued and allotted as fully paid to the Chief Executive Officer though the Board reserves the right to transfer them to another member of the Board should it so wish. These Deferred Shares have no voting or dividend rights and on winding up only are entitled to repayment at nominal value only if all ordinary shareholders have received the nominal value of their shares plus an additional \$1,000 each.

### **Amendments**

The Company does not have any special rules about amendments to its articles of association beyond those imposed by law.

# CROSS REFERENCE TO FORM 20-F

This table has been provided as a cross reference from the information included in this Annual Report to the requirements of Form 20-F.

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# GLOSSARY OF TERMS

Unless the context indicates otherwise, the following terms have the meanings shown below:

<u>Term</u>	<u>Meaning</u>
ADR	In the US, The Company's Ordinary Shares are traded in the term of ADSs evidenced by American Depository Receipts ("ADRs").
ADS	In the US, the Company's Ordinary Shares are traded in the term of American Depository Shares ("ADSs").
Advanced Wound Management products	A product group comprising products associated with the treatment of skin wounds, ranging from products that provide moist wound healing using breathable films and polymers to products providing active wound healing by biochemical or cellular action.
AGM	Annual General Meeting of the Company.
Arthroscopy	Endoscopy of the joints is termed "arthroscopy", with the principal applications being the knee and shoulder.
Bandaging	A product group comprising traditional adhesive and support bandaging.
Basis Point	One hundredth of one percentage point.
Bio-absorbable	Bio-absorbable material: Material used in surgical procedures which degrade and are absorbed by the body after a period of time, thus removing the need to surgically remove them.
Chronic wounds	Chronic wounds are those with long or unknown healing times including leg ulcers, pressure sores and diabetic foot ulcers.
Company	Smith & Nephew plc or, where appropriate, the Company's Board of Directors, unless the context otherwise requires.
Companies Act	Companies Act 1985 or Companies act 2006, as amended, of England and Wales.
Digital operating room	The digital operating room is a custom-designed operating room solution providing auto-video connectivity, medical device control, integration with hospital information systems and surgical documentation devices for medical facilities to help improve efficiency, cost effectiveness and, by extension, patient care.
EBITA	Earnings before interest, tax and amortisation.
EBITDA	Earnings before interest, tax, depreciation and amortisation.
EIP	Earnings Improvement Programme, the objective of which is to enhance short and medium term performance, to liberate resources for investment and to establish a culture of continuous improvement.
Endoscopy	Endoscopy allows surgeons to operate through coin-sized openings in the body, rather than large incisions.
Endoscopy products	A product group comprising specialised viewing and access devices, surgical instruments and powered equipment used in minimally invasive surgical procedures. Through a small incision surgeons are able to see inside the body using a monitor and identify and repair defects.
Euro or €	References to the common currency used in the majority of the countries of the European Union.
External fixation	The use of wires or pins transfixed through bone to hold a frame to the position of a fracture.
FDA	US Food and Drug Administration.

<u>Term</u>	<u>Meaning</u>
Financial statements	Refers to the consolidated Group Accounts of Smith & Nephew plc.
FTSE 100	Index of the largest 100 listed companies on the London Stock Exchange by market capitalisation.
Fracture casting	A product group comprising products that are used externally to immobilize a bone fracture or damaged joint, usually made of plaster of paris or synthetic materials.
Group or Smith & Nephew	Used for convenience to refer to the Company and its consolidated subsidiaries, unless the context otherwise requires.
IFRIC	International Financial Reporting Interpretations as adopted by the EU and as issued by the International Accounting Standards Board.
IFRS	International Financial Reporting Standards as adopted by the EU and as issued by the International Accounting Standards Board.
Insufflation	The use of carbon dioxide to inflate body cavities during endoscopic surgery to enable surgeons to view internal organs.
Intramedullary nail system	Stainless steel or titanium implants shaped like a nail implanted in the intramedullary canal in diaphyseal fractures.
LSE	London Stock Exchange
Metal-on-metal hip resurfacing	A less invasive surgical approach to treating arthritis in younger patients whereby only the surfaces of the hip joint are replaced leaving the hip head substantially preserved.
Negative Pressure Wound Therapy	A technology used to treat chronic wounds such as diabetic ulcers, pressure sores and post operative wounds through the application of sub-atmospheric pressure to an open wound.
NYSE	New York Stock Exchange
Orthobiologic products	Any product that is primarily intended to act as a scaffold and/or actively stimulates bone growth.
Orthopaedic products	Orthopaedic reconstruction products include joint replacement systems for knees, hips and shoulders and support products such as computer assisted surgery and minimally invasive surgery techniques. Orthopaedic trauma devices are used in the treatment of bone fractures including rods, pins, screws, plates and external frames. Clinical therapies products comprise a joint fluid therapy for pain reduction of the knee and an ultrasound treatment to accelerate the healing of bone fractures.
OXINIUM	OXINIUM material is an advanced load bearing technology. It is created through a proprietary manufacturing process that enables zirconium to absorb oxygen and transform to a ceramic on the surface, resulting in a material that incorporates the features of ceramic and metal. Management believes that OXINIUM material used in the production of components of knee and hip implants exhibits unique performance characteristics due to its hardness, low-friction and resistance to roughening and abrasion.
Parent	Smith & Nephew plc.
Pound Sterling, Sterling, £, pence or p	References to UK currency. 1p is equivalent to one hundredth of £1.
Repair	A product group within endoscopy comprising specialized devices, fixation systems and bioabsorbable materials to repair joints and associated tissue.
Resection	Products that cut or ablate tissue within endoscopy comprising mechanical blades, radio frequency wands, electromechanical and hand instruments for resecting tissue.

<u>Term</u>	<u>Meaning</u>
Traditional woundcare	Product group comprising medical textile products, adhesive tapes and fixative sheets to secure wound management products to the body.
UK	United Kingdom of Great Britain and Northern Ireland.
UK GAAP	Accounting principles generally accepted in the United Kingdom.
US	United States of America.
US Dollars, US \$ or cents	References to US currency. 1 cent is equivalent to one hundredth of US\$1.
US GAAP	Accounting principles generally accepted in the United States of America.
Visualisation	Products within endoscopy comprising digital cameras, light sources, monitors, scopes, image capture, central control and multimedia broadcasting systems for use in endoscopic surgery with visualisation.
Wound bed	An area of healthy dermal and epidermal tissue of a wound.

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