SMITH & NEPHEW PLC
Form 20-F
March 28, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

(Mark One)

¨ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**
or

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
or

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number 0-19003

Smith & Nephew plc

(Exact name of Registrant as specified in its charter)

England and Wales

(Jurisdiction of incorporation or organization)

15 Adam Street, London WC2N 6LA

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name on each exchange on which registered
American Depositary Shares	**New York Stock Exchange**
Ordinary Shares of 20¢ each	**New York Stock Exchange***

***Not for trading, but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.**

Securities registered or to be registered pursuant to Section 12(g) of the Act: None.

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None.

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report: 943,482,941 Ordinary Shares of 20¢ each

Indicate by check mark if the registrant is a well seasoned issuer, as defined in Rule 405 of the Securities Act Yes x No ¨

If this Report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large Accelerated Filer x Accelerated Filer ¨ Non-accelerated filer ¨

Indicate by check mark which financial statement item the registrant has elected to follow: Item 17 ¨ Item 18 x

If this is an annual report, indicated by check mark whether the registrant is a shell company (as defined in Rule

12b-2 of the Exchange Act). Yes ¨ No x

INTRODUCTION AND FINANCIAL SUMMARY

The Smith & Nephew Group is a global medical devices business engaged in orthopaedic reconstruction, orthopaedic trauma and clinical therapies, endoscopy and advanced wound management having revenue of over $2.7 billion in 2006. 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 ADSs.

This report is the Annual Report of Smith & Nephew plc for the year ended 31 December 2006. 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 2006, intended for the investor not requiring the full detail of the Annual Report, is produced as a separate document. The Summary Financial Statement includes a summary review of operations, a summary remuneration report and summary financial statements.

Both the Annual Report and Summary Financial Statement are available on Smith & Nephew s corporate website at www.smith-nephew.com/investors.

The Group s fiscal year ends on 31 December of each year. 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 176. 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 a non Generally Accepted Accounting Principles (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-by-like basis. This is done by adjusting for the impact both of sales of products acquired in business combinations in the current year and the prior year, and of 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 in which 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 and approved from the Group Corporate centre in line with strategic objectives and also funded centrally.

The material limitation of the underlying growth in revenue measure is that it excludes certain factors, described above, 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 for the first two years. 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) and adjusted attributable profit

Growth in EPSA is a measure which presents the trend growth in the long-term profitability of the Group excluding the impact of specific transactions that management considers affect the Group s short-term profitability. The Group presents this measure to assist investors in their understanding of trends. EPSA growth is also the key measure 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), therefore, focuses primarily on profit and earnings before these items.

The items to be adjusted are identified in principle as those for which the Group presents separate lines and headings in its income statement in accordance with IAS 1 Presentation of Financial Statements, in order to better enable an understanding of the Group s financial performance. Specifically, the Group has identified the following items, where material, as those to be identified separately: acquisition and disposal related items including amortisation of acquisition intangible assets; significant restructuring events; and gains and losses arising from legal disputes and uninsured losses. 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 165.

EPSA is a permitted measure under IFRS but not under US GAAP. The material limitation of EPSA is that it excludes significant income and costs that have a direct impact on current and prior years profit attributable to shareholders. It does not, therefore, measure the overall performance of the Group presented by the GAAP measure of earnings per share. 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 measure by considering it in conjunction with the GAAP measure of earnings per share. 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 to be made which includes consideration of financial returns, generation of shareholder value and the impact on the Group s accounts. Amortisation of acquisition intangibles will occur each year, whilst other excluded items will disappear over time; some items may appear 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 overseas currencies. The Group used the average exchange rates prevailing during the year to translate the results of overseas companies into US Dollars. The currencies which most influenced these translations in the years covered by this report were Sterling 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 pounds 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 15 March 2007, the Noon Buying Rate was US$1.94 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, 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

	2006	2005
	$ million	$ million
Revenue	2,779	2,552
Trading profit	571	517
Operating profit	537	422
Attributable profit for the year	745	333
Adjusted attributable profit	425	397
Basic earnings per Ordinary Share	79.2¢	35.5¢
EPSA	45.2¢	42.3¢
Dividends per Ordinary Share (i) (ii)	10.81¢	5.60p

(i) The Board has declared a second interim dividend of 6.71¢ per share which together with the first interim dividend of 4.10¢, makes a total for 2006 of 10.81¢. All shareholders will receive the Sterling equivalent of 3.41p per Ordinary share. The second interim dividend will be paid on 11 May 2007 to shareholders on the register at the close of business on 20 April 2007.

(ii) Dividends in 2005 were declared in pence.

Change in Functional and Reporting Currency

As the Group s principal assets and operations are in the US and the majority of its operations are conducted in US Dollars, the Group changed its presentational currency from Pounds Sterling to US Dollars with effect from 1 January 2006. 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 has been restated from Pounds Sterling into US Dollars in accordance with IAS 21.

Restatement and Change in Accounting Policies

Prior year Income Statements and Balance Sheets have been restated for the following items:

a) To correct the method of calculating the elimination of intra-group profit carried in inventory, the effect of which is to reduce the amount of overhead expense included in inventory valuation. The impact of correcting this error is to reduce inventory at 31 December 2005 by $53m (2004 $49m) and trading profit for the year ended 31 December 2005 by $9m (2004 $8m). In addition, deferred tax assets at 31 December 2005 increased by $17m (2004 $16m) and taxation for the year ended 31 December 2005 reduced by $3m (2004 $3m).

b) To correct the classification of certain indirect production overhead expenses from Administration expenses to Cost of goods sold. There is no effect on inventory or trading profit. In the year ended 31 December 2005 Cost of goods sold is increased by $37m (2004 $39m) and Administrative expenses reduced accordingly.

c) A change in accounting policy for the recognition of the death-in-service benefits liability in the UK pension plan. Under IFRS alternative treatments are permissible however management believes that it is more appropriate to apply the projected unit credit method rather than the value at risk approach previously adopted as this better reflects the Group s obligations and costs. The effect was an increase of $17m in Retirement benefit obligation at 31 December 2006 (2005 $16m, 2004 $20m) and a decrease in deferred tax liabilities of $5m (2005 $5m, 2004 $6m). There was an immaterial impact on trading profit and finance income in all years presented.

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 our business and in our trading margins discussed under Outlook and Trend Information are forward-looking statements as are discussions of our 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 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 21 of this Annual Report.

All forward-looking statements in this Annual Report are based on information available to Smith & Nephew as of 20 March 2007. 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 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.

CONTENTS

This Annual Report including the Report of the Directors was approved by the Board of Directors on 20 March 2007.

(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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Group Description

DESCRIPTION OF THE GROUP

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

Discussion of the Group s management structure and corporate governance procedures is set out in the Corporate Governance section (pages 51 to 59).

The Remuneration Report gives details of the Group s policies on senior management s remuneration in 2006 (pages 61 to 72).

Discussion of the Group s operating and financial performance liquidity and financial resources for 2006 and 2005 is given in the Operating and Financial Review, Liquidity and Prospects (pages 27 to 50).

THE BUSINESS

HISTORY AND DEVELOPMENT

Group Strategy

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

Group History

The Group has a history dating back 151 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

On 12 March 2007 the Group announced that it had agreed the purchase of Plus Orthopedics Holding AG (Plus), a private Swiss orthopaedic company, for a total of CHF 1,086m ($889m) in cash, including assumed debt. Completion of the agreement is conditional on receipt of competition clearances which are expected to take two to three months. Plus reported revenues of CHF367m ($300m) in 2006 and profit before interest and tax of CHF44m ($36m). The acquisition will be financed by bank borrowings.

In February 2007 the Group commenced a share buy back programme of up to $1.5 billion over the next two years. This followed an assessment of the medium term capital needs of the Group both internally and for acquisitions in which management determined that shareholder value and balance sheet efficiency would be enhanced by returning capital to shareholders.

During the fourth quarter of 2006 the Group entered into discussions to acquire Biomet, Inc. These discussions were terminated in December.

In July 2006 the Group acquired OsteoBiologics, Inc (OBI) for $73m in cash. OBI markets bioabsorbable bone graft substitutes in Europe to repair cartilage defects in the knee and offers the TRUFIT BGS Plug in the US as a bone void filler. OBI has been

integrated with the endoscopy business.

In June 2006, the United States Attorney s Office in Indianapolis, Indiana issued a federal grand jury subpoena to Smith & Nephew s orthopaedic business at the request of the Department of Justice, Antitrust Division, asking for copies of documents regarding possible violations of federal criminal law, including possible violations of the antitrust laws, relating to the manufacture and sale of orthopaedic implant devices. Four of the business major competitors received similar subpoenas. Smith & Nephew is co-operating fully with the United States Attorney. The results of this investigation may not be known for several years. See Legal Proceedings .

In May 2006, the Group exited the tissue engineering operations of its advanced wound management business. A rationalisation charge of $68m was recorded in 2005.

On 23 February 2006, Smith & Nephew, together with its partner Beiersdorf AG, sold its joint venture, BSN Medical, to Montagu Private Equity for an enterprise value of 1,030m (the Group s share was cash proceeds of $562m) resulting in a net profit to the Group of $351m. The Group s share of the results of BSN Medical and the gain on disposal have been classified as Discontinued Operations in accordance with IFRS.

At the beginning of 2006 the orthopaedics business was split into two separate business units, reconstruction and trauma and clinical therapies. Each business has its own management and resources although certain administrative and logistics functions remain shared. Management believes that this divisionalisation will improve focus on markets and customers.

Group Description

In 2006 there were a number of changes to the Board. John Buchanan, Deputy Chairman, was appointed Chairman, replacing Dudley Eustace who retired at the AGM. David J. Illingworth was promoted to the newly created position of Chief Operating Officer and appointed to the Board in February and Adrian Hennah was appointed to the Board as Chief Financial Officer in June, replacing Peter Hooley who retired.

In March 2005 the US Attorney s Office in Newark, New Jersey issued a subpoena to the Group s orthopaedic business asking for copies of its consulting, professional service and remuneration agreements with orthopaedic reconstructive surgeons. Four of the divisions major competitors received similar subpoenas. The Company is co-operating fully with the US Attorney and providing copies of the requested contracts and additional documents as requested. The results of this investigation may not be known for several years.

In August 2003, Smith & Nephew withdrew from all markets the macrotextured version of its OXINIUM femoral knee component. As at that date 2,971 components had been implanted of which approximately 2,471 were in the USA, 450 in Australia and 50 in Europe. As at the end of February 2007 revision surgeries had been carried out on affected patients and settlements were agreed with patients in respect of 926 of these revisions. As discussed more fully under Legal Proceedings , due to the denial of insurance coverage by certain of the Group s product liability insurers in respect of existing claims and future claims, a provision of $154m was recorded in 2004, representing unsettled insurance claims and an estimate of claims likely to arise in the future assuming that no further insurance cover is available. After adjusting for costs charged against the provision $38m remains at the end of February 2007 to settle pending and future claims. These estimates constitute forward looking statements that are subject to uncertainties. Depending on the number and average cost of actual revisions, costs to Smith & Nephew may be greater or less than the amount of this provision. See Legal Proceedings and Risk Factors .

BUSINESS DESCRIPTION

Organisation

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

Smith & Nephew is organised currently into four global business units of reconstruction, trauma and clinical therapies, endoscopy and advanced wound management and a separate indirect market unit. Each of the global business units manages its sales directly in twelve international markets the US, Canada, the UK, Germany, Japan, Australia, Belgium, France, Italy, the Netherlands, New Zealand and Ireland and takes responsibility for strategy, research and development (R&D), manufacturing, marketing, sales and financial performance. The remaining 19 markets in which the Group has operations are managed by country managers who are responsible only for sales and distribution of the Group s product range, and comprise the indirect market unit.

A head office team in London, England directs the overall business and supports the business units, primarily in the areas of business development, company secretarial, finance, human resources and investor relations, with a legal department based in Memphis, Tennessee. A central research facility in York, England is charged with the development of enabling technologies in both materials science and biology, particularly cell biology.

Reconstruction

Overview

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.

The reconstruction business is managed worldwide from Memphis, Tennessee, which is also the site of its main manufacturing facility. Implants are also manufactured at small facilities in Tuttlingen, Germany and in Warwick, UK.

The Group s knee product range is built on two major knee systems: GENESIS II, designed to facilitate the accuracy and efficiency of the operating procedure and provide improved long-term clinical results; and PROFIX, a reconstructive knee system featuring simpler instruments and surgical technique. Both of these systems have a ten year clinical experience. Two major new knee systems JOURNEY and LEGION, a revision system, were added to the product offering in 2006.

Within the hip line, the SPECTRON cemented hip system and the REFLECTION acetabular cup system have documented positive long-term clinical performance. More recently, the success of SYNERGY, a tapered titanium stem system, ANTHOLOGY, a tapered flat stem and BIRMINGHAM HIP RESURFACING (BHR), a hip resurfacing system (approved for sale in Quarter 2 2006 in the US) have established Smith & Nephew as a strong player in this product segment. The EMPERION hip system was also launched in 2006 as a modular hip system for primary and revision hip replacement.

The Group has developed and manufactures knee and hip implant components made from oxidised zirconium (OXINIUM) which is patent protected and which management believes possesses improved wear characteristics which may be of significant benefit to younger, more active patients. The OXINIUM manufacturing facility acquired in 2005 in Memphis, Tennessee has improved yields and created additional capacity with further expansion possibilities.

To compete effectively in the growing global reconstruction market, management believes that as well as having a leading edge product range it is important to have a skilled sales force that can build strong relationships with surgeons and to provide high levels of customer service. At the end of 2006 the global sales force numbers 919 of whom 569 serve the US market.

Strategy

Smith & Nephew s reconstruction strategy is to become the leading innovator of solutions for the active, informed patient. Management believes that by focusing innovation on the needs of the growing demographic segment of younger, more active patients, that Smith & Nephew can become a leader in providing hip and knee implants to these segments. As an example, in the US patients aged 64 and under represent 40% of the primary hip and knee replacement market and management believes this sector is growing at twice the market rate. New product launches such as JOURNEY, LEGION and BHR (in the US) support this strategy.

The reconstruction strategy also calls for investment in major orthopaedic markets around the world. Smith & Nephew intends to further penetrate these markets by expanding its sales force and by introducing new implants that offer a greater level of function for the active patient. The reconstruction business is also investing in strategies to encourage patient demand through integrated information programs including direct-to-consumer, public relations and internet based initiatives.

During 2006 the Group completed the integration of the Leading Kabushiki Kaisah (Leading Medical) orthopaedic distributor in Japan which doubled the size of the Group s reconstruction sales force in Japan and created a strong sales channel with the objective of increasing market share in what management believes to be the second largest orthopaedic market in the world.

New Products

In 2006, the reconstruction business had three major launches: JOURNEY, BHR in the US and EMPERION. The late 2005 launches of LEGION and ANTHOLOGY continued throughout 2006 as well, creating new opportunities for growth. Products launched in 2006 accounted for 15% of sales and management believes that this will accelerate in 2007. JOURNEY, launched in Quarter 2 2006 is a knee replacement designed to offer the patient more natural motion. The BHR launch in the US gave Smith & Nephew the only approved resurfacing product in the US market. The launch program required Smith & Nephew to provide training to all surgeons using the device. The US training efforts for BHR trained 336 surgeons in 2006. This effort will continue into 2007, where the Group expects to see its first competitor enter the market in the second half. In addition, the EMPERION hip modular system was launched in Quarter 3 2006, expanding Smith & Nephew s offering for primary and revision hips.

The reconstruction business continued to invest in medical education through cadaveric training centres, training meetings, and the use of the MOBILAB mobile training centre. In 2006, the MOBILAB was used in over 40 US locations to provide training to support 2006 product launches and core product offerings.

Recent Regulatory Approvals

In May 2006, the FDA approved the BHR system as the first hip resurfacing system approved for sale in the US, thus providing a unique opportunity for Smith and Nephew to strategically position and maintain itself as an innovative player in the orthopaedic market.

Competition

Management estimates that the worldwide reconstruction market (excluding the spine segment) served by the Group grew by 8% in 2006 and is currently worth more than $9 billion per annum. Management believes that Smith & Nephew holds a 9% share of this market by value.

Group Description

Principal global competitors in the orthopaedic reconstruction market and their estimated 2006 global shares, are Zimmer (29%), Stryker (20%), DePuy/Johnson & Johnson (22%) and Biomet (11%).

Trauma and Clinical Therapies

Overview

Trauma and Clinical Therapies products comprise trauma products and associated clinical therapies. Trauma products consist of internal and external fixation devices and orthobiological materials used in the stabilisation of severe fractures and deformity correction procedures. Clinical therapies consist of products applied in an orthopaedic office or clinic setting and in 2006 comprised the areas of bone growth stimulation and joint fluid therapy.

The trauma and clinical therapies business is managed worldwide from Memphis, Tennessee, which is also the site of its main manufacturing facility. Trauma fixation products are also manufactured at the facility in Tuttlingen, Germany and by third party manufacturers.

Within the trauma business, internal fixation products, such as the TRIGEN intramedullary nail system, the PERI-LOC locked plating system and the IMHS CP hip fracture device and external fixation systems such as JET-X and TAYLOR SPATIAL FRAME provide orthopaedic surgeons a comprehensive offering of products to address trauma and deformity correction procedures. Orthobiologic products, including VIAGRAF demineralised bone matrix are also offered for use in conjunction with reconstructive and trauma surgeries.

The EXOGEN line of ultrasonic bone healing stimulators and SUPARTZ hyaluronic acid joint fluid therapy are the main products in the clinical therapies sector. EXOGEN is the only ultrasound technology approved to treat fractures that have failed to heal (known as non-unions) and the only bone stimulator approved to help specific fresh fractures heal faster. In March 2006, the FDA approved a label amendment for SUPARTZ allowing physicians to choose as few as three weekly injections for their patients with osteoarthritis knee pain if the physician judges the patients would experience benefit. Previously, the FDA approved a course of five weekly injections only. SUPARTZ is manufactured by Seikagaku Corporation of Japan, a pioneer in the area of glycoscience research and development.

At the end of Quarter 2 2006, the Group and a Swedish company, Q-MED AB (Q-MED), formed a strategic alliance to develop and commercialise Q-MED s proprietary technology for the production of stabilised non-animal hyaluronic acid, NASHA, for the management of orthopaedic conditions and diseases. The immediate impact of the alliance is a licensing and supply agreement that grants Smith & Nephew the global exclusive right to market, sell and distribute DUROLANE (currently only approved in Europe and Canada), a single-injection hyaluronic acid therapy for the treatment of osteoarthritis of the hip and knee.

To compete effectively in the growing global orthopaedic trauma market, management believes that as well as having a leading edge product range it is important to have a skilled sales force that can build strong relationships with surgeons and to provide high levels of customer service. At the end of 2006 the global sales force numbers 472 of whom 255 serve the US market.

Strategy

Smith & Nephew s trauma and clinical therapies strategy is to deliver growth through innovative product development in its existing core business and expansion into fast-growing market areas including alternative therapies for pain management and fracture healing. Management believes that the trauma and clinical therapies market 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, continuous advancements in the surgical treatment of fractures, and the need to manage pain in younger, more active patients.

Smith & Nephew also intends to further penetrate these markets by expanding its sales force and by introducing less invasive and alternative therapies. The Group is also contributing to patient education and empowerment through its websites and other direct-to-consumer activities.

Management believes customers of the Group s minimal intervention spinal products, including IDET IntraDiscal ElectroThermal Therapy and discography, are better served by the sales channels and increased resources available in the clinical therapies business and the responsibility for this product group transferred from the endoscopy business with effect from January 2007.

New Products

In 2005, the PERI-LOC Periarticular Locked Plating System was launched, this is a trauma plate and screw system used to treat bone fractures which allows the surgeon to save time in the operating room and perform less invasive surgeries. The upper extremity system was launched in Quarter 3 2006. Other key product launches in 2006 included two significant additions to the TRIGEN intramedullary nail system, the INTERTAN Intertrochanteric Antegrade Nail for the treatment of femoral fractures, the META Nail for fractures of the femur and tibia, as well as the EXOGEN 4000+ Bone Healing System.

Recent Regulatory Approvals

In 2006 US approvals were obtained for 6.5mm and 8.0mm Cannulated Screws (April), CAPTION Disposable Platelet Concentrator (May) and PERI-LOC B Plates (September).

Competition

Management estimates that the worldwide orthopaedic fixation market increased by 11% in 2006 and is currently worth more than $3 billion per annum. Management believes that Smith & Nephew holds an 11% share of this market by value.

Principal global competitors in the orthopaedic fixation market and their estimated global shares, are Synthes (45%), Stryker (16%), DePuy/Johnson & Johnson (8%), Zimmer (6%) and Biomet (3%).

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, articulating joints and vascular structures. The business focuses principally 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, fixation systems and bioabsorbable materials to repair damaged tissue; fluid management and insufflation equipment for surgical access; digital cameras, digital image capture, central control, multimedia broadcasting, scopes, light sources and monitors to assist with visualisation; and radiofrequency wands, electromechanical and mechanical blades, and hand instruments for resecting damaged tissue. The business also designs, markets and provides service to its Digital Operating Room suites, which use computer and internet technology to put surgeons and other medical professionals in full control of the operating room environment.

Manufacturing facilities are located currently in Andover and Mansfield, Massachusetts, Oklahoma City, Oklahoma and San Antonio, Texas. The Andover manufacturing facility will close in the first half of 2007. Major service centres are located in the US, the UK, Germany, Japan and Australia.

The global sales force at the end of 2006 was 713 of which 397 serve the US market.

Strategy

Smith & Nephew s strategic intent is to establish the business as the leading provider of endoscopic techniques 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 payors.

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 2006, Smith & Nephew broadened its joint repair offerings with the launch of its CALAXO Osteoconductive Interference Screw, which is used to secure a graft in ACL reconstruction of the knee. During the 12 months following a procedure the screw is resorbed by the body and compounds within the screw stimulate the natural process of bone formation.

Group Description

The move towards advanced biomaterials was enhanced in July 2006 with the acquisition of OsteoBiologics Inc. The company had developed bioabsorbable bone graft substitutes (BGS), which are marketed in Europe and Canada as TRUFIT CB Plugs for the repair of cartilage defects in the knee. In the US, the material is marketed as the TRUFIT BGS Plug, a bone void filler.

Smith & Nephew enhanced its position in the arthroscopic hip repair marketplace with the release of two products: the BIORAPTOR Hip Suture Anchor which is the first device introduced for repair of the hip labrum, the fibrous ring of cartilage which helps stabilise the joint; and the Hip Positioning System which enables a surgeon to access and treat the hip joint using arthroscopic techniques. The device attaches to most standard operating tables, and is designed to gently separate the hip joint, creating space for the surgeon to work.

The launch of the KINSA Suture Anchor provides surgeons with a fast, secure and consistent method of repairing instability of the shoulder. This anchor encases a self-locking, sliding knot, which enables the surgeon to secure the repair without tying knots.

Recent additions to the Digital Operating Room (Digital OR) suite of products include the 660HD Image Management System and the CONDOR Control System. The former can digitally capture, edit, export and print high-definition endoscopic surgical images. These images can then be stored with patients electronic medical records. The CONDOR Control System enables the medical staff to send commands to medical devices, digital cameras, image management systems and other operating room components using voice commands or a wireless touch panel.

Recent Regulatory Approvals

During 2006, the endoscopy business obtained regulatory clearances for the following products in most major markets, except Japan where the approval process is more lengthy: KINSA suture anchor for shoulder instability repair; expanded indications for BIORAPTOR and TWINFIX Ti to include repair of the hip labrum; Levelert and Remote Control accessories for the Dyonics 25 Fluid Management System, launched in 2005; 660HD Image Management System; SV420 Single Chip Camera system; and various other arthroscopy instruments and devices.

Competition

Management estimates that the global arthroscopy market in which the business principally participates is worth approximately $2 billion a year and is growing at 9% 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. Following a reassessment of the global market sizes management believes that Smith & Nephew has a 23% share of the global arthroscopy market.

Smith & Nephew s main competitors and their estimated shares of the global arthroscopy market are: Arthrex (19%), Mitek/Johnson & Johnson (17%), Stryker (11%) Linvatec/Conmed (9%), and Arthrocare (8%).

Advanced Wound Management

Overview

Smith & Nephew s advanced wound management business is headquartered in Hull, England. It offers a range of products from initial wound bed preparation through to full wound closure. These products are targeted particularly at chronic wounds connected with the older population, such as pressure sores and venous leg ulcers, burns and complex surgical wounds.

Advanced wound management products are manufactured in facilities in Hull and Gilberdyke, England; Largo, Florida and by certain third party manufacturers.

Strategy

The strategy for the advanced wound management business is to focus on the higher added value segments of wound bed preparation and moist and active healing.

The 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, Japan and Europe. At the end of 2006 the global sales force was 915 of whom 172 were in the US.

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 nursing and clinician time and aftercare in the home.

In 2006, the range of ALLEVYN hydrocellular dressings was extended. Management believes that the new version of ALLEVYN handles up to three times more fluid than the previous version, and that the Non Adhesive variant with sealed and shaped edges provides greater protection against leakage. From a clinician s perspective, management believes that the improved ALLEVYN optimises the moist wound environment leading to promotion of faster healing of the wound and reduced risk of maceration.

Sales of ACTICOAT have been augmented by the launch in 2005 of ACTICOAT Moisture Control, an antimicrobial barrier dressing with foam and waterproof film layers. The moisture control product provides an effective barrier to bacterial penetration and is designed to help maintain a moist wound environment in the presence of exudate. 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.

2006 was the second full year of VERSAJET, a fluid jet debridement system. Growth in product revenues continue to exceed management expectations, particularly in the US where the product has gained FDA approval for use in burns.

Recent Regulatory Approvals

During 2006, the advanced wound management business secured over 155 medical device and 65 pharmaceutical registration approvals in various markets throughout the world. Among the most significant approvals were those for ALLEVYN Adhesive Improved Fluid Handling CE mark, ALLEVYN Shaped & Sealed CE mark and ACTICOAT Moisture Control CE mark. Both IODOSORB and VERSAJET burns indication received notification in the US and three notification approvals were received in Japan for IV3000, MELOLIN and PRIMAPORE

Competition

Management estimates that the sales value of the advanced wound management market worldwide was $4 billion in 2006, an increase of 9% in the year, and that Smith & Nephew has 17% market share. 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, with approximately half of chronic wounds globally still treated with conventional dressings, there is strong growth potential for advanced technology products.

Worldwide competitors in advanced wound management and their estimated market shares comprise Kinetic Concepts (26%), the Convatec division of Bristol-Myers Squibb (11%), Molnlycke (8%), 3M (7%) and Johnson & Johnson (6%).

Joint Ventures and Discontinued Operations

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

Discontinued operations represent the share of results and 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. Results were accounted for using the equity method up to 1 October 2005, whereby 50% of the profit after taxation was incorporated into Smith & Nephew s income statement as a single line item. Following the Group s announcement in August 2005 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.

Group Description

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 governmental 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 governmental 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. Sales to these customers in 2006 each represented approximately 3% of the Group s worldwide revenue.

In the US the Group s products are marketed directly to doctors, hospitals and other healthcare facilities. Each business unit operates a separate specialised sales force. In both reconstruction and endoscopy the US sales forces consist largely of independent commissioned sales agents who are managed by a mix of independent agents and the Group s own managers. These agents are not permitted contractually to sell products that compete with Smith & Nephew s. In both businesses, products are shipped and invoiced directly to the ultimate customer. The trauma and clinical therapies and advanced wound management businesses in the US operate sales forces of their own employees who market directly to the ultimate customer. In the US, trauma and clinical therapy products are shipped and invoiced directly to the ultimate customer whereas advanced wound management products are shipped and invoiced to a number of large wholesale distributors.

In the other direct markets of the UK, Belgium, Ireland, France, Germany, Italy, Australia, the Netherlands, New Zealand, Canada and Japan the business units manage separate sales forces directly, except in Australia and New Zealand where independent sales agents are used. The sales forces of the direct markets comprise employees and market directly to the ultimate customer.

The indirect markets unit comprises direct selling and marketing operations in Austria, Denmark, Finland, Norway, Poland, Portugal, Spain, Sweden, Switzerland, China, Hong Kong, Korea, Malaysia, Singapore, Thailand, the United Arab Emirates, South Africa, Mexico and Puerto Rico. In these markets reconstruction, trauma and clinical therapies and endoscopy frequently share sales resources. The advanced wound management sales force is separate since it calls on different customers. In all other countries Smith & Nephew sells to third party distributors which market the Group s products locally.

In Continental Europe, the Group operates three centralised distribution facilities. The reconstruction and trauma businesses operate a facility in Paris which acts as a central holding and consolidation point for Continental European inventory and inventory returns. Product is shipped to Group companies who hold small amounts of inventory locally for immediate or urgent customer requirements. Advanced wound management operates distribution centres at Nijmegen, Netherlands and Gothenburg, Sweden from where inventory is shipped directly to the ultimate customer in most European markets.

SEASONALITY

Smith & Nephew s revenues are generally at their highest in quarter four 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 trauma and endoscopy products. Reconstruction revenues are lower in quarter three due to fewer elective surgeries in the summer and higher in quarter four 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 may outsource other manufacturing for several reasons including requirements for specialised expertise, lower costs of production and 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 provide products and services, their ability to establish and maintain a quality system and their financial stability. Suppliers are monitored by 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 comprise principally 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 for all businesses. Management believes that whilst prices of principal raw materials can be volatile the effect is not material to the Group. Finished goods purchased for resale are primarily SUPARTZ joint lubricant in the trauma and clinical therapies business, the BHR hip resurfacing product in the reconstruction business, screen displays, optical and electrical devices in the endoscopy business and enzyme debrider agents and ACTICOAT in the advanced wound management business.

PROPERTY, PLANTS 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	83
Reconstruction headquarters and reconstruction, trauma and clinical therapies manufacturing facilities in Memphis, Tennessee	686
Reconstruction, trauma and clinical therapies distribution facility in Memphis, Tennessee	102
Trauma and clinical therapies headquarters in Memphis, Tennessee	84
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	546
Advanced Wound Management manufacturing facility in Gilberdyke, England	41
Advanced Wound Management manufacturing facility in Largo, Florida	188

The reconstruction headquarters and reconstruction, trauma and clinical therapies manufacturing facilities in Memphis and the advanced wound management facilities in Hull, Gilberdyke and Largo are freehold while all other principal locations are leasehold. The Group has freehold and leasehold interests in real estate in other countries throughout the world, but no other is significant individually to the Group. Where required, the appropriate governmental authorities have approved the facilities.

During 2005 the Group announced the closure of its endoscopy manufacturing facility in Andover, Massachusetts. This will be closed in the first half of 2007; its production has been relocated partly to other endoscopy facilities and partly out-sourced to third party suppliers.

Group Description

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 to continue to provide growth opportunities for their businesses. The Group s research and development is directed towards all four business segments. Expenditure on research and development amounted to $120m in 2006 (2005 $122m, 2004 $122m), representing approximately 4% of Group revenue (2005 5%, 2004 5%).

The Group s principal research facility is located in York, England. The Group s research programme seeks 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 bio-resorbable materials, cell biology and non-invasive healing devices across the Group. In-house research is supplemented by work performed by academic institutions and other external research organisations principally in the UK and the US.

Product development is carried out at the Group s principal locations, notably in Memphis, Tennessee (reconstruction and trauma and clinical therapies), Andover and Mansfield, Massachusetts (endoscopy) and Hull, England (advanced wound management).

INTELLECTUAL PROPERTY

Management believes that the Group s policy concerning intellectual property rights promotes innovation in its businesses. Smith & Nephew has a policy of protecting, with patents, the results of the research and development carried out by the Group. Patents have been obtained for a wide range of products, including those in the fields of orthopaedic, endoscopic and advanced wound management technologies. Patent protection for Group products is sought routinely in the Group s principal markets. Currently, the Group s patent portfolio stands at over 2,350 existing patents 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 as soon as possible 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 3,250 trademarks and design rights.

Smith & Nephew s principal products are protected by intellectual property comprising patents, licences and know how, and it strives to provide a collection of intellectual property for each major product that reduces the risk associated with failure of any individual piece of intellectual property. In addition, most pieces of intellectual property protect a relatively small proportion of the Groups 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 maintaining a policy of protecting its market position by the filing and enforcement of patents and trademarks, Smith & Nephew has a policy of opposing third party patents and trademark filings 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. Smith & Nephew 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.

Smith & Nephew 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.

Group Description

THE BUSINESS AND THE COMMUNITY

CORPORATE 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 products and instruments, the training of medical professionals and the procedures used to provide treatment and recovery. Cost effective solutions for healthcare systems are achieved through the use of advanced technology.

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 and contribute to more cost effective solutions for healthcare services.

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

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 seventh Sustainability Report, which gives detailed information, will be published on the Group s website in May 2007 at www.smith-nephew.com.

Smith & Nephew s progress is measured by three leading organisations that assess sustainable development. In 2006, the company was included in the Dow Jones Sustainability Index (DJSI) and was named as 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 banks 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. Smith & Nephew does not give or receive improper financial inducements, either directly or indirectly, for business or financial gain. The Group complies with the industry standards set by 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 and US GAAP.

The Group s Code of Business Principles (available at www.smith-nephew.com/who) governs the way it operates so that it respects stakeholders and seeks to build open, honest and constructive relationships. 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. The success of these actions is demonstrated by the positive responses seen in the 2006 Employee Global Opinion Survey to questions about ethical operation.

Innovation

Smith & Nephew uses innovation to create cost-effective products and techniques which deliver benefits for clinicians and patients. The Group s scientific and technical leadership 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.

It is the Group s practice to develop platform technologies on which to build product ranges. This provides an efficient and cost effective means for product development. A measure of the Group s success in innovation is the proportion of revenue from new products introduced in the last three years to total revenue. This information for 2006 is: reconstruction 16%, trauma and clinical therapies 26%, endoscopy 28% and advanced wound management 13%.

Health, Safety and Environment Management

The Group has a health, safety and environmental (HSE) policy which 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.

Recognise, promote and reinforce the responsibility of employees, contractors and visitors to work safely and follow procedures.

In 2006 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 IS014001. 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:

	2006	2005	2004	2003	2002
Emissions to air VOCs (tonnes)	1	1	1	10	20
Emissions to air carbon dioxide (tonnes)	50,359	50,212	48,954	50,160	47,888
Waste (tonnes)	4,759	4,685	3,596	4,054	3,774
Hazardous waste (tonnes)	256	303	234	275	270
Waste recycled (tonnes)	1,189	1,009	767	646	750
Total energy (GwH)	138	139	132	145	137
Water usage (1,000 cu. Metres)	562	480	427	457	433
Discharges/effluent (1,000 cu. Metres)	485	400	384	399	386
Lost time accidents (ii)	0.5	0.6	1.0	0.9	1.4
Lost time ill health (iii)	1.2	1.8	5.6	1.9	10.1

(i) Totals are for the Group as a whole for the year and therefore include divested businesses.
(ii) Number of accidents (resulting in a person being unable to work the following day) per 200,000 hours worked.
(iii) Number of cases of occupational ill health (resulting in a day or more away from work) per 1,000 people employed.

The 2004 hazardous waste figure excludes a spillage of chrome plating materials which occurred at the manufacturing site in Memphis. 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.

Carbon dioxide emissions are calculated from the energy consumption and are dependent on the mix of energy used. As a result of that mix, emissions rose in 2006 despite a slight fall in total energy consumption.

The rise in non-hazardous waste arose from the introduction, validation and optimising of new processes at the advanced wound management factory in Hull, England.

The fall in hazardous waste was largely the result of a change in the classification of FLAMAZINE burn treatment production waste at Hull, England from hazardous to non-hazardous.

Advanced wound management and the orthopaedics businesses continued to focus on the opportunities to recycle waste leading to a significant increase in 2006.

The increase in water consumption in 2006 arises from increased manufacturing output at Memphis, Tennessee.

The Group continues to show a year on year improvement in its lost time accident and occupational ill health performance.

A full analysis of these measurements and key health and safety performance measures will be included in the 2007 Sustainability Report on the Group s website when it is published in May 2007.

Group Description

Social responsibility

The Smith & Nephew Code of Business Principles and Code of Ethics governs the Group s interactions with its stakeholders. This sets out the behaviours and conduct stakeholders can expect from the Group. The Code of Business Principles describes the Group s values and provides a framework for employees.

Employees

The HR Policy Framework introduced group-wide in 2006 sets the key HR policies, values and behaviours and management principles that provide the structure within which the business units operate and deliver successful results.

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 positive efforts 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.

The 2006 Global Opinion Survey was completed towards the end of the year and the results communicated to employees by February 2007. The results indicated continued high levels of employee engagement with the values and direction of the Group. 90% of employees said that they were proud to work for Smith & Nephew, 84% believed that they would stay with the Group for the forseeable future and would recommend the Group as a good employer to friends and family. The Group s employees also told management that it needs to improve ways of working, speed of decision making and strengthen the link between performance and reward. This survey used improved methodology providing a wider scope of measurements and the facility to be able to analyse down to individual departments provided they are of sufficient size. For the first time, it was conducted online only and the Group had a high participation rate of 86%. Details of the results and planned improvement actions will be covered in the next Sustainability Report in May 2007.

In 2006 the Group has continued to assess a number of 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. Three years data is now available and is building into a useful database.

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 2006 an average of 28.2% (2005 23.1%) of vacancies across all parts of the business were filled by internal applicants with over 37% (2005 35%) of vacancies filled in the Group s business units. The target for all employees, realistic in a growth environment, is 40%. During 2006 the Group has started to specifically measure the percentage of management positions filled internally: advanced wound management was 80%; endoscopy was 60%; and the Research centre was 100%. The target for management positions is 70%. In 2007 these figures will be available for the whole Group. 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

For the last three years the Group measured 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 6.2% (2005 4.3%) ranging from 2.1% 15.2% for the year. The average labour turnover figures are within the expected level for businesses in the Group s sector. Average labour turnover in the Group s business units was 2.8%.

Training and Development Investment

The Group is committed to providing training and information so that all employees can make the best contribution possible. Learning and development programmes are used to attract, retain and develop employees. These programmes are linked to formal performance appraisal and development planning. 2005 saw the development and implementation of a range of 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 have been added in 2006 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. The senior management supports a set of group-wide leadership competencies and management development is a regular item on their meeting agenda. Performance evaluation, coaching and attendance at leadership programmes are utilised.

2005 was the first full year of a Group leadership excellence programme , a three-day purpose designed residential course facilitated by a business school coach and this has been continued in 2006. The programme focuses on leadership style and interaction and to date, over 100 senior managers have attended the programme which continues in 2007.

Workplace

Smith & Nephew provides 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.

Society and Community

The Group works with national and local government 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 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 who receive donations of Smith & Nephew products with sponsorship and help from the Group s employees. Teamed 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. It makes awards to individuals in the nursing professions for postgraduate research to improve clinical practice in nursing and midwifery. The Foundation is the largest single charitable awarding body to the nursing professions in the UK.

More examples of the programmes supported by Smith & Nephew are given in the Sustainability Report.

In 2006, direct donations to charitable and community activities totalled $1,375,000 of which $279,000 was given to the Smith & Nephew Foundation. Smith & Nephew made no political contributions in 2006.

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. It will continue to provide education and training support for healthcare professionals and maintain investment in research and development.

In 2006 Smith & Nephew had one of the strongest new product launch programmes in its history particularly in reconstruction where two new hips and two new knees were launched. In addition, Smith & Nephew s BIRMINGHAM HIP Resurfacing product was approved by the FDA in the US bringing the benefits of this product to the American market.

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.

Group Description

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 has been done in 2006 to improve the monitoring of supplier standards for service quality and activities relevant to their corporate responsibility.

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.

The Group has built expertise in the area of measuring healthcare economics within its advanced wound management business and continues to make good progress in developing similar systems across the business. 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 its areas of expertise. Increased demands are being made on healthcare systems as the baby boomer generation ages and obesity becomes more widespread. More active lifestyles and the increased incidence of diabetes, and other diseases increase also the demand for Smith & Nephew s products.

Smith & Nephew s strategy is to build upon its leading technologies, expand its markets and provide advanced technology to the medical profession. 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. The Group s aim is to innovate to improve treatments and reduce healthcare costs thus contributing to sustainable and improving healthcare systems.

In reporting sustainability, Smith & Nephew is committed to improved monitoring of its performance in its development as a sustainable business. It has made progress in introducing a range of non-financial Key Performance Indicators. It is intended to introduce these during 2007 for health, safety and environment and social responsibility and to expand economic impact reporting.

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EMPLOYEES

The average number of full-time equivalent employees in 2006 was 8,830, of whom 1,776 were located in the UK, 4,087 were located in the US and 2,967 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:

	2006	2005	2004
Reconstruction	2,129	2,081	1,769
Trauma and Clinical Therapies	1,724	1,500	1,247
Endoscopy	1,870	1,788	1,644
Advanced Wound Management	3,107	3,249	3,206
	8,830	8,618	7,866

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 26 of the Notes to the Group Accounts).

Further information about Smith & Nephew employees, management principles and Vision and Values is set out in the sustainability report on the Smith & Nephew corporate website.

Group Description

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 independent medical advisors. These conclusions are subsequently reviewed by the Group s independent medical advisor.

Product liability is a commercial risk for the industry of which the Group is a part, particularly in the US. Smith & Nephew has implemented systems it believes are appropriate in respect of loss control techniques. These include reporting mechanisms to ensure early notification of complaints and a legal department which manages product liability claims and lawsuits.

The Group carries product liability insurance to cover exposure as far as practicable. Apart from the macrotextured claims, discussed under Legal Proceedings , and Risk Factors , there are no individual product liability claims, and no group of similar claims, that are expected to have a material adverse effect on the Group s financial position.

There can be no assurance that consumers, particularly in the US, 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 continue to resolve such claims within insurance limits in view of changing legal doctrines and attitudes regarding such matters. See Risk Factors Product Liability Claims and Loss of Reputation .

RISK FACTORS

Smith & Nephew s products include implantable devices but are not life support medical devices. If these devices malfunction, they could damage or impair the repair of body functions. Management believes that the Group s quality, regulatory and medical controls and insurance cover is adequate and appropriate for this class of products. The Group s reputation is crucially dependent on strong performance in this area and on appropriate crisis management if a serious medical incident or product recall should occur.

The Group maintains insurance against product, employers and directors and officers liabilities, and physical and consequential loss, subject to limits and deductibles. The Group maintains liability provisions to cover known uninsured risks. See Legal Proceedings .

There are risks and uncertainties related to Smith & Nephew s business. The factors listed below are those that Smith & Nephew believes could cause the Group s actual financial condition or results of operations to differ materially from expected and historical results. Factors other than those listed here, that Smith & Nephew cannot presently identify, could also adversely affect Smith & Nephew s business. The factors listed below should be considered in connection with any forward-looking statements in this report and the cautionary statements contained in Financial Summary Special Note Regarding Forward-Looking Statements .

Product Liability Claims and Loss of Reputation

The development, manufacture and sale of medical devices and products entail risk of product liability claims or recalls. Design defects and manufacturing defects with respect to products sold by the Group or by companies it has acquired could result in damage to or impairing the repair of body functions. Smith & Nephew may become subject to liability, which could be substantial, because of actual or alleged malfunction of its products. In addition, product malfunction could also lead to the need to recall from the market existing products, which may be costly and harmful to the Group s reputation which is crucially dependent on product safety and efficacy.

Product liability is a risk in the medical devices industry, particularly in the US, the Group s largest geographic market where claims for pain and suffering and loss of earnings may involve substantial amounts. There is a risk that patients bring product liability or related claims that could have a material adverse effect on the Group s financial position. The potential exists for claimants to join together in a class action which could have the effect of increasing the total potential liability.

The Group maintains product liability insurance, but this insurance is subject to limits and deductibles. There is a risk that this insurance could become unavailable at a reasonable cost or at all, or will be inadequate to cover

specific product liability claims. Insurance premiums are relatively high, particularly for coverage in the US, and there is a risk at the medical devices industry level that insurance coverage could become increasingly costly. If Smith & Nephew or any companies it acquires do not have adequate insurance, product liability claims and costs associated with product recalls could significantly limit Smith & Nephew s available cash flow and negatively impact product sales from any associated loss of business.

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 USA, 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). It appears that some patients do not achieve adequate initial fixation and other patients who are able to achieve adequate initial fixation, are not able to maintain it. Smith & Nephew has extensively tested and investigated the cause of these early revisions. An investigation by a group of medical and scientific experts retained and managed by the Group s defence lawyers concluded that the cause of the limited number of early revisions that have been reported is the textured surface of the implant that apposes bone.

As at 31 December 2006 the total amount paid out to date in settlements, legal costs and associated expenses was $172m of which $60m was recovered from the insurer who provided the primary layer and 65% of the first excess layer in the Group s global product liability programme. The balance of $112m is due from five other insurers who have declined coverage. Management is taking steps in order to enforce insurance coverage: the Group is preparing its breach of contract suit against certain of its product liability insurers for trial which has been scheduled by the Court for February 2008. A charge of $154m representing the amount outstanding from insurers and an estimate of the cost associated with claims likely to arise in the future assuming that insurance cover continues to be unavailable from these and subsequent excess layer insurers was recorded in 2004. There has been no subsequent change to the original estimated liability.

Medical Device Company Valuations

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

Highly Competitive Markets

The Group s principal business units compete across a diverse range of geographic and product markets. The markets in which each of the business units operates each contain 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 deliver products on more attractive terms, more aggressively market their products or invest larger amounts of capital and research and development into their businesses. The competitive risk in the endoscopy market from the reprocessing and re-use of single use disposable devices such as arthroscopic resection blades declined in the US during 2005 and 2006 but is still a factor in certain countries outside the US.

There is a risk of further consolidation 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 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.

Group Description

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 and new product development and in the reconstruction, trauma and clinical therapies and endoscopy sales forces of which the largest are in the US. 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.

Reimbursement

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. 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. 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.

Trends in the Healthcare Industry

Business practice in the healthcare industry is subject to review by government authorities and regulators. In March 2005 the Group s orthopaedic business was issued with a subpoena by the US Attorney s office requesting copies of its consulting, professional service and remuneration agreements with orthopaedic reconstruction surgeons. There have been no significant developments since then but any unfavourable ruling against the Group or the orthopaedics industry as a whole could have a material adverse impact on the Group s results or cause a loss of reputation. See Legal Proceedings .

In June 2006, a subpoena was issued to the orthopaedic business by the United States Department of Justice, Antitrust Division, requesting documents for the period beginning January 2001 through to the present relating to possible violations of US antitrust laws, in respect of the manufacture and sale of orthopaedic implant devices. Similar enquiries have been directed to a number of the Group s US competitors.

In connection with this subpoena, the Group has received six complaints in class action lawsuits alleging violations of the Sherman Antitrust Act. Although the Group intends to vigorously defend itself, any adverse judgement may have a material adverse effect on the Group s reputation and results of operations and the Group may be required to significantly change some of its existing business practices. In addition, Smith & Nephew s cooperation with these investigations may divert the attention of management and require the devotion of a substantial amount of time and resources.

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 and 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 and marketing of its products, particularly in US, UK and Continental Europe. Such controls have become increasingly demanding and management believes that this trend will continue. Failure to comply with such 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.

Patent Infringement Claims

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 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 significant resources to pay damages, develop non-infringing products or to obtain licences to the products which are the subject of such litigation.

Continual Development and Introduction of New Products

The Group operates in the medical devices industry, which 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 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 six main facilities in Memphis, Tennessee, Mansfield, Massachusetts, Oklahoma City, Oklahoma, and Largo, Florida in the United States and Hull and Gilberdyke in the United Kingdom. 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 reconstruction 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. If any of these suppliers is unable to meet the Group s needs 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. 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. There is currently a risk that supplies of SUPARTZ, which is extracted from rooster combs, may be impacted by the outbreak of avian flu in Asia. Any interruption of supply caused by these or other factors could negatively impact Smith & Nephew s revenue and operating profit.

Currency Fluctuations

Beginning in 2006 the Group adopted the US Dollar as its reporting currency and the functional currency of Smith & Nephew plc changed to the US Dollar. In 2006 49% of Group revenue arose in the US, 22% in Continental Europe, 20% in Africa, Asia, Australia, Canada, New Zealand and Latin America and 9% in the UK. 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 1%.

The Group s manufacturing cost base is situated in the US and the UK 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 and Sterling and the currencies of the Group s selling operations, particularly the Euro and the Japanese Yen. If the US Dollar and/or Sterling should strengthen against the Euro and the Japanese Yen then Group trading margin would be adversely affected.

Political and Economic Uncertainties

Because the Group has operations in 31 countries, political and economic 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, including conflict in the Middle East, could adversely impact the Group.

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.

Foreign Exchange Exposure

The Group trades in over 90 countries and as a consequence has transactional and translational foreign exchange exposure. The Group s policy is to protect shareholders funds by matching foreign currency assets, including acquisition goodwill, with foreign currency liabilities wherever practicable. These liabilities take the form of either borrowings or currency swaps. It is the Group s policy for operating units not to hold 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, the currency cost of purchases by Group companies of finished products and raw materials. The principal flows of currency are purchases of US Dollars and Sterling from Euros, Japanese yen and Australian dollars, as well as cross purchases between the US and the UK.

The Group partly mitigates the translational impact on profits through the interest arising on foreign currency borrowings or swaps. The impact of currency movements on the cost of purchases is partly mitigated by the use of forward foreign exchange contracts.

The Group managed $660m of foreign currency purchase transactions by using forward foreign exchange contracts, of which the major transaction flow is Euros into US Dollars. 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. If the Euro were to weaken against US Dollar on average by 10% over the year, the fair value of forward foreign exchange contracts would increase by $9m (2005 increase by $7m).

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 2006 would have decreased by $29m 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 2006 would have increased by $53m.

The Group s net cash is exposed to movements in exchange rates. Based upon the net cash position at 31 December 2006 (as detailed in Note 19 of the Notes to the Group Accounts) if the US Dollar were to weaken against all currencies by 10%, the Group s net cash would decrease by $24m.

At 31 December 2005 the Group had transacted a contingent foreign exchange contract to hedge the anticipated proceeds on the sale of its investment in the BSN Medical joint venture. This contract did not qualify for hedge accounting. The maturing of the contract was contingent on the receipt of the proceeds of sale. Should the sale not have completed no amounts would have been payable or receivable in respect of the contract. The transaction was completed on 23 February 2006.

Interest Rate Risk

The Group is exposed to interest rate risk on cash, borrowings and currency swaps which are all at floating rates. As at 31 December 2006, the Group had not fixed future interest rates.

Based upon the net cash position at 31 December 2006, a decrease in short-term interest rates across all currencies by one percentage point would decrease the Group s annual net interest receivable by $2m (2005 decrease the net interest payable by $3m). The Group s financial assets and liabilities were principally at floating interest rates and thus their fair values are not directly affected by movements in market rates of interest.

Financial Instruments

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 foreign currency assets are accounted for as hedges. As a result, changes in fair values of these financial instruments do not affect the Group s profit on ordinary activities before taxation.

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. Smith & Nephew does not anticipate non-performance of counterparties and believes it is not subject to material concentration of credit risk.

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:

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

BUSINESS OVERVIEW

Smith & Nephew s operations are organised into four business units that operate globally: reconstruction, trauma and clinical therapies, 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.

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

	2006	2005	2004
		(%)	
Reconstruction	33	32	31
Trauma and Clinical Therapies	18	17	16
Endoscopy	24	24	24
Advanced Wound Management	25	27	29
Total revenue	100	100	100

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

	2006	2005	2004
		(%)	
Europe (Continental Europe and United Kingdom)	31	31	33
United States	49	49	49
Africa, Asia and Australia and Other America	20	20	18
Total revenue	100	100	100

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

	2006	2005	2004
		(%)	
Reconstruction	41	40	40
Trauma and Clinical Therapies	18	17	15
Endoscopy	21	24	25
Advanced Wound Management	20	19	20

Total trading profit	100	100	100

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

	2006	2005	2004
		(%)	
Reconstruction	37	46	7
Trauma and Clinical Therapies	19	21	23
Endoscopy	23	26	39
Advanced Wound Management	21	7	31
Total operating profit	100	100	100

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-by-like basis. This is done by adjusting for the impact both of sales of products acquired in business combinations in the current year and the prior year, and of 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 2006 as follows:

	Reported growth	Constant currency exchange effect	Acquisitions effect	Underlying growth
	(%)	(%)	(%)	(%)
Reconstruction	11	(1)		10
Trauma and Clinical Therapies	13			13
Endoscopy	10	(1)		9
Advanced Wound Management	3	(2)		1
Total revenue	9	(1)		8

Reported growth in revenue by business segment reconciles to underlying growth in 2005 as follows:

	Reported growth	Constant currency exchange effect	Acquisitions effect	Underlying growth
	(%)	(%)	(%)	(%)
Reconstruction	15		(1)	14
Trauma and Clinical Therapies	20			20

Endoscopy	8			8
Advanced Wound Management	4			4
Total revenue	11			11

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 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. Management believes that the creation of separate global business units in 2006 for reconstruction and trauma and clinical therapies has increased focus and resulted in increased revenue growth for both businesses.

The endoscopy business is benefiting from the continued trend worldwide towards less invasive surgery but with particular focus on arthrosopic 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 spinal disc repair and arthroscopic hip repair.

The advanced wound management business 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 2006 represented 4% of Group turnover and products launched within the last three years represented 20% of Group turnover.

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 attempts to manage the impact of exchange rate movements on cost of goods sold by a policy of purchasing forward all its foreign currency commitments when firm purchase orders are placed. In addition, businesses are required to purchase forward a minimum of 50% of their forecast foreign currency requirements on a twelve-month rolling basis. 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 indebtness 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 Reimbursement) 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 IFRS1, 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 reconstruction and trauma businesses (whose finished goods inventory makes up 54% 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 reconstruction and trauma 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 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 and intangible and tangible assets 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, trading profit and finance income. The most critical assumptions are the discount rate and mortality assumptions to be applied to future pension plan liabilities. For example a 1% increase in discount rate would reduce the combined UK and US pension plan deficit by $155m whilst a 1% decrease would increase the combined deficit by $193m. A 1% increase in discount rate would decrease profit before taxation by $3m whilst a 1% decrease would increase it by $1m. A one year increase in the longevity of a 60 year old male pension plan member in both the UK and US would increase the combined deficit by $33m. 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 33 of the Notes to the Group Accounts for a summary of how the assumptions selected in the last three 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 deemed 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 macrotextured 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 $20m. If the average cost of settlement of the estimated claims outstanding or not yet notified should rise by 20% the cost would increase by $8m.

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.

2006 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. The Group s Accounts are prepared in accordance with IFRS, as adopted in the EU, which differ in certain respects from US GAAP. Reconciliations reflecting the effect of the significant differences between IFRS and US GAAP are set forth in Note 40 of Notes to the Group Accounts.

Financial Highlights of 2006

Group revenue was $2,779m for the year ended 31 December 2006, representing 9% growth compared to 2005. Underlying growth in revenue was 8% and translational currency added 1%.

Profit before taxation was $550m, compared with $428m in 2005. Attributable profit was $745m compared with $333m in 2005. Adjusted attributable profit (calculated as set out in Selected Financial Data), rose 7% to $425m from $397m.

Basic earnings per Ordinary Share were 79.2¢ , a 123% increase compared to 35.5¢ for 2005. EPSA (as set out in Selected Financial Data) was 45.2¢ compared to 42.3¢ for 2005, representing a 7% increase. The loss of earnings from the divested BSN joint venture, net of interest income on the proceeds, reduced growth in EPSA by an estimated 3%, whilst losses, integration costs and interest expense arising from the acquisition of OBI reduced growth by a further 1%. The loss of favourable interest rate differentials between US Dollar borrowings and Sterling cash deposits in 2005 further diluted earnings by 3%.

Fiscal 2006 Compared with Fiscal 2005

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

	2006	2005
	($ million)	
Revenue (i)	2,779	2,552
Cost of goods sold (ii)	(769)	(754)
Gross profit	2,010	1,798
Marketing, selling and distribution expenses (iii)	(1,092)	(991)
Administrative expenses (iv)	(286)	(290)
Research and development expenses	(120)	(122)
BSN agency and management fees	25	27
Operating profit (i)	537	422
Net interest receivable	10	9
Other finance income/(costs)	6	(5)
(Loss)/gain on hedge of the sale proceeds of the joint venture	(3)	2
Profit before taxation	550	428
Taxation	(156)	(126)
Profit from continuing operations	394	302
Discontinued operations share of results of the joint venture		31
Discontinued operations net profit on disposal of the joint venture	351	
Attributable profit for the year	745	333

(i) Group revenue, trading profit and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 35-37.
(ii) In 2005 includes $53m of restructuring and rationalisation expenses.
(iii) In 2005 includes $7m of restructuring and rationalisation expenses.
(iv) In 2006 includes $20m of bid related costs and $14m of amortisation of acquisition intangibles (2005 $24m of restructuring and rationalisation expenses and $11m of amortisation of acquisition intangibles).
(v) Items detailed in (ii), (iii) and (iv) are excluded from the calculation of trading profit.

Transactional and Translational Exchange

The Group s principal markets outside the US are, in order of importance, 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 $1.24 to $1.27 (+2%); the pound Sterling strengthened from $1.81 to $1.86 (+3%); the Australian dollar was unchanged at $0.76; and the Japanese yen weakened from 111 to 116 (- 4%).

The Group s principal manufacturing locations are in the US (reconstruction, trauma and endoscopy) and in the UK (advanced wound management). The Group s selling and distribution subsidiaries around the world purchase finished products from these locations in their local currencies which are principally those outlined in the previous paragraph. As a result of currency movements compared with the previous year purchases from the US became relatively cheaper whilst purchases from the UK became more expensive. The group s policy of purchasing forward a proportion of its currency requirements mitigated the impact of these movements to some extent. Overall there was a broadly neutral impact on trading profit and trading margin compared with the previous year.

Revenue

Group revenue increased by $227m (9%) to $2,779m from $2,552m. Underlying revenue growth was 8% and favourable currency translation, reflecting the strength of the pound Sterling and Euro relative to the US Dollar, added 1%.

Reconstruction revenues increased by $90m or 11% of which 10% was underlying growth and 1% was due to favourable currency translation. Trauma and clinical therapies revenues increased by $59m or 13% all of which was underlying growth. Endoscopy revenues increased by $59m or 10%, of which 9% was underlying growth and 1% was due to favourable currency translation. Advanced wound management revenues increased by $19m or 3%, of which 1% was underlying growth and 2% due to favourable currency translation.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 35-37.

The Group s sales force, which includes independent commissioned sales agents, increased by 5% to 3,292 during 2006. Reconstruction increased by 2%, trauma and clinical therapies by 15%, endoscopy by 4% and advanced wound management by 2%.

Cost of goods sold

Cost of goods sold at $769m increased by $15m from $754m in 2005, which included $53m of restructuring and rationalisation costs related to the closure of the endoscopy factory and exit from tissue engineering. Other movements were an improvement of $14m following the exit from tissue engineering and an additional charge of $10m due to an increase in inventory provisions. Adjusting for these factors cost of goods sold grew broadly in line with revenue.

Further margin analysis is included within the Trading Profit sections of the individual business segments that follow on pages 35-37.

Marketing, selling and distribution expenses

These expenses increased by $101m to $1,092m from $991m in 2005 which included $7m of restructuring and rationalisation costs. The increase was principally due to increases in selling and marketing costs in reconstruction in support of three major product launches in the year, the LEGION and JOURNEY knees and the BHR in the US and headcount additions in endoscopy to accelerate revenue growth.

Administrative expenses

Administrative expenses were $4m lower than in 2005. Costs of $20m, relating to the failed bid to acquire Biomet Inc., are included. In 2005, $24m of restructuring and rationalisation costs were incurred in impairing the intangible assets of the tissue engineering business which was to be exited. In 2006 the charge for amortisation of acquisition intangible assets was $14m and in 2005, $11m,

with the increase largely attributable to the acquisition of OBI. Expenses decreased by $3m which was due to effective expense management in reconstruction and a reduction in the Group s insurance costs.

Research and Development expenses

Expenditure as a percentage of revenue fell from 4.8% to 4.3% caused by sales leverage as expenses were held flat. The Group continues to invest in innovative technologies and products to differentiate itself from competitors and, in 2006, 20% of the Group s revenue was from products introduced in the last three years.

BSN Medical agency and management fees

Agency and management fees of $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 and is intended to be for a transitional period only. Fees were lower than 2005 by $2m due to a further reduction in the number of shared service agreements somewhat offset by a small translation benefit from the strengthening of the Euro against the US Dollar.

Operating profit

Operating profit increased by $115m to $537m compared with $422m in 2005, comprising increases of $4m in reconstruction, $11m in trauma and clinical therapies, $14m in endoscopy and $86m in advanced wound management.

Net interest receivable

The receipt of proceeds from the BSN Medical disposal enabled borrowings to be repaid in 2006 whilst the change to US Dollar reporting and functional currency resulted in the repayment from cash balances of borrowings used for net asset hedging. Overall net interest receivable moved favourably by $1m from $9m to $10m. Interest income fell by $8m from $27m in 2005 to $19m in 2006. Net interest income benefited by $26m from the proceeds of the disposal of BSN Medical but suffered by $20m from the loss of favourable interest rate differentials between US Dollar borrowings and Sterling cash deposits received in 2005. Interest on the cost of OBI was $2m.

Other finance income/(costs)

Income of $6m compares with expense of $5m in 2005 with the improvement due to the increase in defined benefit pension plan assets created by special funding contributions in 2005, further funding payments in 2006 and higher market values.

(Loss)/gain on the hedge of the sale proceeds of the joint venture

A financial instrument was purchased in December 2005 to hedge the anticipated proceeds of the BSN Medical disposal from Euros into US Dollars. This matured in 2006 on completion of the disposal of the joint venture resulting in a loss of $3m compared with a fair value gain recognised in 2005 of $2m.

Taxation

The taxation charge rose by $30m to $156m in 2006. The effective rate of tax before discontinued operations was 28.9%, compared with 29.3% in 2005. The taxation charge was reduced in 2006 by $6m as a consequence of the taxation benefit on bid related costs and in 2005 by $29m as a consequence of the restructuring and rationalisation expenses.

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:

	2006	2005
	($ million)	
Non-current assets	1,586	1,420
Current assets	1,645	1,338

Held for sale - investment in joint venture		218
Total assets	3,231	2,976
Non-current liabilities	241	529
Current liabilities	816	1,012
Total liabilities	1,057	1,541
Total equity	2,174	1,435
Total equity and liabilities	3,231	2,976

Non-current assets increased by $166m from $1,420m in 2005 to $1,586m in 2006. Intangible assets increased by $158m of which $81m related to the acquisition of OBI, $61m came from additions to other intangibles and currency translation added $35m. Amortisation reduced the balance by $24m. Property, plant and equipment increased by $46m comprising additions of $170m, currency translation of $30m less depreciation of $142m and net book value of disposals of $12m.

Current assets increased by $307m from $1,338m in 2005 to $1,645m in 2006. $195m of this increase was as a result of cash and bank balances increasing as a consequence of selling the BSN Medical joint venture for net cash proceeds of $562m (the balance was used to reduce long-term borrowings within non-current liabilities and borrowings within current liabilities). Translational exchange on inventories and receivables added $50m. The remaining increase in current assets was as a result of an increase in inventories of 7% and an increase in receivables of 10% which reflect the 9% increase in Group revenue.

The investment in joint venture (BSN Medical) that was held for sale at the end of 2005 was sold on 23 February 2006.

Non-current liabilities reduced by $288m from $529m in 2005 to $241m in 2006. $196m of this decrease was as a result of long-term borrowings decreasing as a consequence of selling the BSN Medical joint venture. The retirement benefit obligation decreased by $52m principally as a result of funding payments of $26m, actuarial gains of $30m less exchange translation of $10m. Provisions decreased by $14m due to lower macrotextured liability provisions.

Current liabilities decreased by $196m from $1,012m in 2005 to $816m in 2006. $42m of this decrease was as a result of net utilisation of provisions relating to the macrotextured claim and restructuring and rationalisation. $108m of this decrease was as a result of borrowings decreasing as a consequence of selling the BSN Medical joint venture. Translational exchange increased current liabilities by $16m.

Total equity increased by $739m from $1,435m in 2005 to $2,174m in 2006 principally from $745m of attributable profit, $59m of translational exchange and $30m of actuarial gains on retirement benefit obligations less $96m of equity dividends paid in the year.

Business Segment Analysis

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

	2006	2005
	($ million)	
Revenue by business segment		
Reconstruction	919	829
Trauma and Clinical Therapies	497	438
Endoscopy	665	606
Advanced Wound Management	698	679
Total revenue	2,779	2,552
Revenue by geographic market		
Europe (Continental Europe and United Kingdom)	867	800
United States	1,365	1,259
Africa, Asia and Australasia and other America	547	493
Total revenue	2,779	2,552
Trading profit by business segment		
Reconstruction	233	206
Trauma and Clinical Therapies	101	90
Endoscopy	123	125
Advanced Wound Management	114	96

Total trading profit	571	517
Operating profit by business segment		
Reconstruction	200	196
Trauma and Clinical Therapies	101	90
Endoscopy	122	108
Advanced Wound Management	114	28
Total operating profit	537	422

Reconstruction

Revenue

Revenue increased by $90m, or 11%, to $919m of which 10% was underlying growth and 1% due to favourable currency translation movements. The principal factors in the underlying growth in revenue were the growth in the global orthopaedic reconstruction market which was estimated to be 8% in the year and the launch of new products in the US.

In the US, revenue increased by $44m to $514m (9%) all of which was underlying growth. The main factor was the launch of the LEGION knee in mid 2005 and the JOURNEY knee and BHR in 2006. These new products contributed $45m of incremental revenue.

Outside the US, revenue increased by $46m to $405m (13%), of which 12% was underlying growth and 1% due to foreign currency translation. Japan revenue grew by 24% of which 30% was underlying growth and 6% unfavourable currency translation. The main driver was the full year effect of the enlarged sales force following the acquisition of Leading Medical in 2005 which enhanced market coverage in Japan. Revenue growth in Europe was 11% of which 8% was underlying growth and 3% favourable currency translation.

Global knee revenue increased by $55m (11%) to $509m, of which 1% was due to foreign currency translation and 12% was underlying growth. This compares with the estimated global market growth of 8%. Global hip revenue increased by $35m to $378m (10%) all of which was due to underlying growth. The global hip market grew by an estimated 6%. Growth in other reconstruction products, mainly shoulder implants and cement was flat. Products brought to market in the last three years comprised 16% (2005 16%) of revenues.

Trading Profit

Trading profit rose by $27m (13%) from $206m in 2005 to $233m in 2006. This resulted in an increase in trading margin from 24.8% to 25.4%. The principal factors were sales leverage of administration and research and development expenses partly offset by new product launch and support costs and higher inventory provisions.

Operating Profit

Operating profit increased by $4m of which $27m was trading profit less $20m due to the bid related costs in 2006 and $3m due to an increase in the charge for amortisation of acquisition intangibles.

Trauma and Clinical Therapies

Revenue

Revenue increased by $59m, or 13% all of which was underlying growth. The translational impact of currency in this business is less than in others since it has a higher proportion of revenues arising within the US. Growth in fixation products was 9%, all of which was underlying growth. Growth in clinical therapies was 23%, all of which was underlying growth of which 1% came from the sales of DUROLANE hyaluronic acid product outside the US, the rights to which were acquired in June 2006.

In the US, revenue increased by $41m to $357m representing 13% growth. The main contributory factor in the underlying growth rate was 20% growth in clinical therapies. The US market for joint fluid therapy products is believed to have grown by 12% in 2006 whilst SUPARTZ revenues grew by 21%. The US market for long bone stimulation products is estimated to have grown by 5% during the year whilst EXOGEN revenues grew by 19%. These market share gains are believed to result from continuing additions to the US clinical therapies sales force. Fixation revenue growth was 8% all of which came from the continued growth of the PERI-LOC compression plate system, launched in 2005, and from the launch of the INTERTAN nail but this was lower than the

estimated market growth of 14%

Outside the US, revenue increased by $18m to $140m (15%) all of which was underlying growth. Revenue growth was driven by market growth and by DUROLANE which represented 2% of growth.

Products brought to market in the last three years comprised 26% (2005 19%) of revenues.

Trading Profit

Trading profit rose by $11m (12%) from $90m in 2005 to $101m in 2006 resulting in a trading profit margin decrease from 20.5% to 20.3%. This was due to additional investment in selling and marketing resource following divisionalisation in order to position the business for enhanced future revenue growth.

Operating Profit

Operating profit increased by $11m all of which was trading profit.

Endoscopy

Revenue

Endoscopy revenue increased by $59m, or 10%, to $665m, comprising 1% favourable currency translation and 9% underlying growth. The global arthroscopy market is estimated to have grown 9% in the year. In the US, revenue increased by $25m to $355m (8%), of which 7% was underlying growth and 1% due to the acquisition of OBI in July 2006.

In the US the main driver of growth was the knee and shoulder repair sector at 23% due to market sector growth and new products, and Digital Operating Room revenue which grew 31% due to additions to the sales force. Resection revenues grew 2%, in line with the trend of recent years and visualisation products declined by 7% as customers anticipate the release of the new HD660 camera in 2007.

Outside the US, revenue increased by $34m to $310m (12%), of which 11% was underlying growth and 1% due to favourable foreign currency translation.

Global revenue of knee and shoulder repair products increased by $39m to $220m (22%), of which 19% was underlying growth, 1% due to foreign currency translation and 2% due to the OBI acquisition. Revenue in the global resection products sector increased by $9m to $245m (4%), of which 3% was underlying growth and 1% due to foreign currency translation. Global visualisation and Digital Operating Room revenue increased by $7m to $127m (6%), of which 5% was underlying growth and 1% was due to favourable currency.

Products brought to market within the last three years comprised 28% (2005 24%) of total revenue.

Trading Profit

Trading profit fell by $2m (2%) from $125m in 2005 to $123m in 2006 resulting in a trading profit margin decline from 20.6% to 18.5%. This was due to higher inventory write-offs (0.8% points), losses and integration costs of OBI (0.6% points) and additional investment in the sales force for Digital Operating Room equipment in order to gain market share in the US.

Operating Profit

Operating profit increased by $14m of which $16m was due to the restructuring and rationalisation expenses in 2005 less the $2m reduction in trading profit.

Advanced Wound Management

Revenue

Revenue increased by $19m, or 3%, to $698m, comprising 2% favourable currency translation and 1% underlying growth. Compared with 2005, $20m of tissue engineering revenues were lost following the exit from the business, representing 3% of total revenues.

In the US, revenue decreased by $5m to $139m (3%), of which $17m was due to the loss of tissue engineering revenues. Outside the US, revenue increased by $24m to $559m (4%), of which 2% was underlying growth and 2% due to foreign currency translation. Continental Europe revenue increased by 4% of which 2% was favourable currency translation and underlying growth was 2%. Revenues in the UK increased by 2% of which 2% represented favourable currency translation. Underlying growth was flat caused by funding constraints which reduced purchases by the NHS, the Group s largest customer. Similar funding constraints in the German market resulted in a revenue reduction of 4% of which 6% was an underlying reduction and 2% favourable currency translation. Growth in Japan was 6% of which 11% was underlying growth and 5% unfavourable currency translation. Products brought to market within the last three years comprised 13% (2005 14%) of total revenue.

Trading Profit

Trading profit rose by $18m (19%) from $96m in 2005 to $114m in 2006. The trading profit margin increased from 14.1% to 16.3% as a result of a 2% uplift from the exit from tissue engineering.

Operating Profit

Operating profit increased by $86m of which $18m was trading profit and $68m was due to the restructuring and rationalisation expenses incurred in 2005.

2005 YEAR

Financial Highlights of 2005

Group revenue was $2,552m for the year ended 31 December 2005, representing 11% growth compared to 2004. Underlying growth in revenue was 11%.

Profit before taxation was $428m, compared with $294m in 2004. Attributable profit increased from $245m to $333m. Adjusted attributable profit (calculated as set out in Selected Financial Data), improved 12% to $397m.

Basic earnings per Ordinary Share were 35.5¢, a 35% increase compared to 26.2¢ for 2004. EPSA (as set out in Selected Financial Data) was 42.3¢ compared to 37.8¢ for 2004, representing a 12% increase.

Fiscal 2005 Compared with Fiscal 2004

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

	2005	2004
	($ million)	
Revenue (i)	2,552	2,301
Cost of goods sold (ii)	(754)	(664)
Gross profit	1,798	1,637
Marketing, selling and distribution expenses (iii)	(991)	(879)
Administrative expenses (iv)	(290)	(374)
Research and development expenses	(122)	(122)
BSN agency and management fees	27	28
Operating profit (i)	422	290
Net interest receivable	9	7
Other finance costs	(5)	(3)
Gain on the hedge of the sale proceeds of the joint venture	2	
Profit before taxation	428	294
Taxation	(126)	(77)
Profit from continuing operations	302	217
Discontinued operations share of results of the joint venture	31	28
Attributable profit for the year	333	245

(i) Group revenue, trading profit and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 40-43.
(ii) In 2005 includes $53m of restructuring and rationalisation expenses.
(iii) In 2005 includes $7m of restructuring and rationalisation expenses.
(iv) 2005 includes $24m of restructuring and rationalisation expenses and $11m of amortisation of acquisition intangibles (2004 $154m of macrotextured claim and $8m of amortisation of acquisition).
(v) Items detailed in (ii), (iii) and (iv) are excluded from the calculation of trading profit.

Transactional and Translational Exchange

The Group s principal markets outside the US are, in order of importance, 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 weakened from $1.25 to $1.24 (-1%); the pound Sterling weakened from $1.84 to $1.81 (-2%); the Australian dollar strengthened from $0.74 to $0.76 (+3%); and the Japanese yen weakened from 108 to 111 (-3%).

The Group s principal manufacturing locations are in the US (reconstruction, trauma and endoscopy) and in the UK (advanced wound management). The Group s selling and distribution subsidiaries around the world purchase finished products from these locations in their local currencies which are principally those outlined in the previous paragraph. As a result of currency movements compared with the previous year purchases from the US became relatively cheaper whilst purchases from the UK became more expensive. The Group s policy of purchasing forward a proportion of its currency requirements mitigated the impact of these movements to some extent. Overall there was a broadly neutral impact on trading profit and trading margin compared with the previous year.

Revenue

For the year ended 31 December 2005 Group revenue increased by $251m (11%) to $2,552m from $2,301m. Underlying revenue growth was 11% and there was no impact from translation of foreign currency.

Reconstruction revenues increased by $107m or 15% of which 14% was underlying growth and 1% arose from the full year effect of the revenues of MMT, compared with nine months in the previous year. Trauma and clinical therapies revenues increased by $75m or 20% all of which was underlying growth. Endoscopy revenues increased by $44m or 8% which comprised underlying growth. Advanced wound management revenues increased by $25m or 4% which comprised underlying growth.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 40-43.

The Group s sales force, which includes independent commissioned sales agents, increased by 10% to 3,140 during 2005. The biggest increase was 21% in reconstruction and trauma and clinical therapies where the most significant increase was in the US. The size of the endoscopy sales force increased by 4% whereas the advanced wound management sales force was broadly unchanged.

Cost of goods sold

Cost of goods sold at $754m, increased by $90m, compared to 2004. This included a charge of $53m for the costs of exiting tissue engineering and the closure of the Andover, Massachusetts endoscopy manufacturing facility. Adjusting for this factor cost of goods sold increased by $37m compared to 2004. The main factor in this improvement was the 0.7% margin effect of business mix caused by the higher rate of revenue growth of reconstruction and trauma and clinical therapies which have the lowest cost of goods sold, compared with the lower growth rates of endoscopy and advanced wound management. A secondary factor was a 0.2% margin benefit from transactional currency. This was achieved despite the US Dollar appreciating against the Euro and Sterling through the group s policy of covering forward its foreign exchange purchases on a rolling twelve month basis.

Further margin analysis is included within the Trading Profit sections of the individual business segments that follow on pages 40-43.

Marketing, selling and distribution expenses

These expenses increased by $112m from $879m to $991m. 2005 expenses include $7m of restructuring and rationalisation. Expenses increased at a faster rate than sales mainly due to the costs of increasing the number of sales representatives in reconstruction and trauma and clinical therapies in the US.

Administrative expenses

Administrative expenses were $84m lower than in 2004. 2005 includes $24m of restructuring and rationalisation expenses whilst 2004 included the $154m provision for the costs of the macrotextured product liability claim. Amortisation of acquisition intangible assets was $11m in 2005 an increase of $3m due to the full year effect of MMT compared with nine months in 2004. Adjusting for these factors, administrative expenses grew in line with revenue growth except that increases in insurance premiums accounted for $9m and the costs of combining and relocating the UK orthopaedic reconstruction business with MMT was $4m.

Research and Development expenses

There was no material change in expenditure on research and development but expenditure as a percentage of revenue fell from 5.3% to 4.8%. This was caused by a rationalisation of development projects at reconstruction, trauma and clinical therapies and endoscopy. The Group continues to invest in innovative technologies and products to differentiate itself from competitors. In 2005, 17% of the Group s revenue was from products introduced in the last three years.

BSN Medical agency and management fees

Agency and management fees of $27m 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 and is intended to be for a transitional period only. Recoveries were broadly unchanged in 2005 as there was no material change in the number or nature of shared service agreements.

Operating profit

Operating profit was $422m an increase of $132m compared with 2004.

Net Interest Receivable

Interest income decreased by $4m from $31m in 2004 to $27m in 2005. Interest expense decreased by $6m from $24m in 2004 to $18m in 2005. Overall net interest receivable moved favourably by $2m from $7m to $9m.

Other finance costs

Comprises imputed interest on the defined benefit pension plan deficit less the expected return on investing pension plan assets.

Gain on the hedge of the sale proceeds of the joint venture

A financial instrument was purchased in December 2005 to hedge the anticipated proceeds of the BSN Medical disposal from Euros into US Dollars. This was fair valued at the end of the year resulting in a gain of $2m.

Taxation

The taxation charge rose by $49m to $126m in 2005. The effective rate before discontinued operations was 29.3% compared with 26.7% in 2004. The taxation charge was reduced in 2005 by $29m as a consequence of the restructuring and rationalisation expenses and in 2004 by $54m as a consequence of the macrotextured claim. Adjusting for these items the tax charge increased by $24m due to higher profits and changes in the mix of profits.

Discontinued operations Share of Results of the Joint Venture

The Group s share of results of the joint venture rose by $3m from $28m in 2004 to $31m in 2005. Revenues decreased by $74m from $305m to $231m as a result of the Group ceasing to equity account with effect from 1 October 2005 following the reclassification of the investment to Held for sale . Operating profits decreased by $6m from $43m to $37m due to the short period. Interest payable was unchanged from prior year at $2m and the tax charge was $2m lower at $11m, compared with $13m.