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. In the fourth quarter the Group recognised as profit a dividend received of $7m.

Business Segment Analysis

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

	2005	2004

	($ million)	
Revenue by business segment		
Reconstruction	829	722
Trauma and Clinical Therapies	438	363
Endoscopy	606	562
Advanced Wound Management	679	654
Total revenue	2,552	2,301
Revenue by geographic market		
Europe (Continental Europe and United Kingdom)	800	755
United States	1,259	1,122
Africa, Asia and Australasia and other America	493	424
Total revenue	2,552	2,301
Trading profit by business segment		
Reconstruction	206	179
Trauma and Clinical Therapies	90	67
Endoscopy	125	115
Advanced Wound Management	96	91
Total trading profit	517	452
Operating profit by business segment		
Reconstruction	196	19
Trauma and Clinical Therapies	90	67
Endoscopy	108	113
Advanced Wound Management	28	91
Total operating profit	422	290

Reconstruction

Revenue

Revenue increased by $107m, or 15%, to $829m of which 14% was underlying growth and 1% arose from the full year effect of the revenues from MMT compared with nine months in the previous year. The principal factors in the growth in revenue were the growth in the global orthopaedic reconstruction market (excluding the spine sector) which was estimated to be 12% in the year and the 21% increase in the size of the global combined reconstruction and trauma and clinical therapies sales force from 1,260 to 1,532. The sales force was expanded in order to improve market coverage, particularly in the US, through the continuing strategy of creating specialist sales forces for each of the reconstruction, trauma and clinical therapies sectors.

In the US, revenue increased by $54m to $470m (13%) all of which was underlying growth. The main contributory factor in the underlying growth rate was the increase in the year of 25% in the size of the combined US sales force from 815 to 1,021 and the estimated market growth of 12%.

Outside the US, revenue increased by $53m to $359m (17%) of which 3% was due to the full year effect of the MMT acquisition and 14% was underlying growth. Revenue growth was driven by Japan at 36%, which comprised 40% underlying growth mainly, due to an increase of 25% in the combined sales force following the purchase of the business and assets of Leading Medical less 4% adverse foreign currency translation. UK revenue grew 29% and underlying growth was 31%; as it benefited from combining its business with MMT, resulting in increased numbers of sales representatives and greater access to surgeons and new customers; less 2% unfavourable currency translation. Australia/New Zealand revenue grew by 23% of which 4% was due to favourable foreign currency translation and 19% was underlying growth largely due to the purchase, in late 2004, of the rights to distribution of the BHR product.

Global knee revenue increased by $60m to $454m (15%) all of which was underlying growth. 4% of the underlying growth was due to growth in revenue of OXINIUM and the balance was due to sales force additions. This is a slower rate of growth than the 21% achieved in 2004 which is believed to reflect a reduction in the number of procedures in the US market and the fact that the Group launched fewer knee products during the year pending a number of new releases in 2006.

Global hip revenue increased by $47m to $343m (16%), of which the MMT acquisition accounted for 3% of growth and underlying growth was 13% which was due to the increased size of the sales force. The FDA Advisory Panel recommended conditional approval of the BHR product to the FDA for use in the US and it was expected that this product would be released during 2006.

Trading Profit

Trading profit rose by $27m (15%) from $179m in 2004 to $206m in 2005. The trading profit margin remained constant at 24.8% between 2004 and 2005. An improvement in gross margin due to transactional currency and lower research and development expenditure was offset by increases in other expenses caused by ongoing sales force investment, higher costs of insurance and the cost of relocating and combining the UK business with MMT.

Operating Profit

Operating profit increased by $177m of which $27m was trading profit, $154m was due to the macrotextured claim in 2004 less $4m due to an increase in amortisation of acquisition intangibles arising from the MMT acquisition.

Trauma and Clinical Therapies

Revenue

Revenue increased by $75m, or 20%, to $438m all of which was underlying growth. The principal factors in the growth in revenue were the growth in the global fixation market (excluding the spine sector) which was estimated to be 13% in the year and the 21% increase in the size of the combined global sales force. 6% of this growth was due to the launch of the PERI-LOC locking compression plate system. The sales force expanded in order to improve market coverage, particularly in the US, through the continuing strategy of creating specialist sales forces for each of the reconstruction, trauma and clinical therapies sectors.

Globally clinical therapies revenues grew by 38% all of which represented underlying growth in EXOGEN and SUPARTZ driven by market share gains through the increased size of the sales force.

In the US, revenue increased by $69m to $316m (28%) all of which was underlying growth. Fixation products grew by 21% and clinical therapies by 40% all of which was underlying growth. The main contributory factor in the underlying growth rate was the increase in the year of 25% in the size of the US combined sales force from 815 to 1,021 and the estimated market growth in fixation products of 13%. Outside the US, revenue increased by $6m to $122m (6%) all of which was underlying growth.

Trading Profit

Trading profit rose by $23m (34%) from $67m in 2004 to $90m in 2005. The trading profit margin increased from 18.5% to 20.5% as a result of an improvement in gross margin due to transactional currency and lower research and development expenditure, partly offset by increase in other expenses caused by ongoing sales force investment and higher costs of insurance.

Operating Profit

Operating profit increased by $23m which comprised the $23m increase in trading profit.

Endoscopy

Revenue

Revenue increased by $44m, or 8%, to $606m all of which was underlying growth. In the US, revenue increased by $19m to $330m (6%) all of which was underlying growth.

Outside the US, revenue increased by $25m to $276m (10%) all of which was underlying growth. Revenue growth was driven by Japan at 20%, of which 24% was underlying growth driven by higher revenue from knee repair products due to the increased adoption of ACL reconstruction surgery in that market, less 4% unfavourable foreign currency translation. Canada revenue grew by 23%, of which 15% was underlying growth, due to an increase in government healthcare funding in the year and 8% was due to favourable foreign currency translation.

Global revenue of repair products grew by $32m to $181m (21%) all of which was underlying growth driven by the release of a number of new products in the knee and shoulder segments.

Revenue in the global resection products sector grew $2m to $236m (1%) of which 2% was underlying growth and currency was 1% negative. Within the underlying growth blades grew by 4%, benefiting from lower levels of re-use in the US of these disposable devices and radio-frequency arthroscopy products declined by 1% because 2005 included only 4 months of revenue of the products affected by the injunction in the patent dispute with ArthroCare Inc. compared with 6 months in 2004 prior to the injunction.

Global visualisation and Digital Operating Room revenue grew by $9m to $120m (8%), of which 1% was due to favourable foreign currency translation and 7% was underlying growth. This was due to a number of new contracts being gained in Digital Operating

Rooms due to the enhanced expertise gained with the acquisition of Reed Medical in 2004.

In total, products brought to market within the last 3 years comprised 24% of total sales mainly in knee and shoulder repair, a new camera in visualisation, a new pump in the access sector and a new hip arthroscopy product.

Trading Profit

Trading profit rose by $10m (9%) from $115m in 2004 to $125m in 2005. The trading profit margin was largely unchanged at 20.6% compared with 20.5% in 2004.

Operating Profit

Operating profit decreased by $5m comprising an increase of $10m in trading profit, a $1m reduction in amortisation of acquisition intangibles less $16m of costs related to the closure of the Andover manufacturing facility.

Advanced Wound Management

Revenue

Revenue increased by $25m, or 4%, to $679m all of which was underlying growth.

In the US, revenue decreased by $3m to $144m (-2%) all of which comprised negative underlying growth. The main factors were inventory reduction by major distributors as they sought to become more efficient in their supply chains, which reduced revenues by an estimated 5% and lower sales of intermediate products to industrial customers which reduced revenues by 6%. Outside the US, revenue grew by $28m, to $535m (6%) all of which was underlying growth. Growth in Japan was 29% of which negative 3% was due to currency translation and 32% was underlying growth driven by the acquisition of distribution rights to the CADEX product which increased revenue by 11% and by the increased market acceptance of ALLEVYN hydrocellular dressings which added 13% to underlying growth. UK revenue growth was negative 1% comprising only 1% underlying growth due to the NHS, the largest customer, operating under severe budget constraints and negative 2% currency translation.

The global sales force continued to develop during the year with an increased focus on clear market segments. Focus on the key brands of ALLEVYN and ACTICOAT combined with the launch of the ACTICOAT Moisture Control product resulted in underlying revenue growth for these product lines of 13% and 25% respectively.

Trading Profit

Trading profit rose by $5m (5%) from $91m in 2004 to $96m in 2005 broadly in line with revenue growth. The trading profit margin barely changed at close to 14%.

Operating Profit

Operating profit decreased by $63m comprising an increase of $5m in trading profit less $68m of restructuring charges related to the exit from tissue engineering operations.

FINANCIAL POSITION, LIQUIDITY AND CAPITAL RESOURCES

Cash Flow and Net Debt

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

	2006	2005	2004
		($ million)	
Cash generated from operations	506	372	415
Interest received net of interest paid	10	9	7
Income taxes paid	(144)	(112)	(70)
Net cash inflow from operating activities	372	269	352
Capital expenditure (net of disposal of property, plant and equipment)	(222)	(200)	(185)
Acquisitions (net of loan notes issued on acquisition of $91m in 2004)	(83)	(25)	(64)
Disposal of joint venture	537		
Dividends received from joint venture		25	26
Equity dividends paid	(96)	(91)	(84)
Issue of ordinary share capital and own shares purchased	16	19	8
Change in net debt from net cash flow (see Note 28 of the Notes to the Group Accounts)	524	(3)	53
Loan notes issued	(15)		(91)
Exchange adjustments	7	(71)	51
Opening net debt	(306)	(232)	(245)
Closing net cash/(net debt)	210	(306)	(232)

The Group s net debt decreased by $455m from $245m at the beginning of 2004 to become a net cash position of $210m at the end of 2006. Translation of foreign currency net debt into US Dollars had the effect of increasing net debt by $13m in the three-year period ended 31 December 2006. Closing net cash includes $2m of net currency swap liabilities (2005 net currency swap liabilities of $19m and 2004 net currency swap assets of $61m).

Net Cash Inflow from Operating Activities

Cash generated from operations in 2006 of $506m is after paying out $33m of macrotextured claim settlements unreimbursed by insurers, $4m of bid related costs, $21m of restructuring and rationalisation costs and $26m of pension funding in excess of current service cost.

In 2005 cash generated from operations of $372m was after paying $47m for macrotextured claim settlements unreimbursed by insurers, $7m of restructuring and rationalisation costs and $86m of special pension contributions.

In 2004 cash generated from operations of $415m was after paying $32m of macrotextured claim settlements unreimbursed by insurers and $4m of acquisition integration costs.

Capital Expenditure

The Group s ongoing capital expenditure and working capital requirements have been financed through cash flow generated by business operations and, where necessary, through short-term committed and uncommitted bank facilities. In recent years capital expenditure on tangible and intangible fixed assets has represented approximately 8% of continuing group revenue and is expected to be the same in 2007.

In 2006 capital expenditure of $231m ($222m net of disposals of property, plant and equipment) was incurred. The principal areas of investment were the placement of reconstruction and trauma instruments with customers, patents and licenses, plant and equipment and information technology.

At 31 December 2006, $2m of capital expenditure had been contracted but not provided for which will be funded from cash inflows.

Acquisitions and Disposals

In the three-year period ended 31 December 2006, $263m (including the issuance of $91m of Loan Notes in 2004) was spent on acquisitions, funded from net debt and cash inflows. Acquisitions comprised OBI $73m, MMT $129m, Acticoat $15m, Versajet $12m, Collagenase $10m and other $24m.

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

Liquidity

The Group s policy is to ensure that it has sufficient funding and facilities in place to meet foreseeable borrowing requirements. New borrowing facilities of $2.5bn are currently being negotiated to replace $0.6bn of existing facilities in order to fund the acquisition of Plus ($0.9bn) and share buybacks ($1.5bn). A bridging facility of $550m has been arranged for a period of six months pending the agreement of these new facilities.

At 31 December 2006, the Group held $346m in cash and balances at bank and had committed and uncommitted bank facilities of $610m and $446m respectively. Undrawn bank facilities amounted to $955m, of which $610m were committed. Of the undrawn committed facilities, $10m expires within one year and $600m after two but within five years. Of the drawn facilities, all expire within one year. In addition Smith & Nephew has $17m of loan notes payable within one year and finance lease commitments of $16m (of which $10m extends beyond five years). Smith & Nephew intends to repay the amounts due within one year by using available cash and drawing down on the longer-term facilities.

The principal variations in the Group s borrowing requirements result from the timing of dividend payments, acquisitions and disposals of businesses, the share buyback, timing of capital expenditure and working capital fluctuations. In 2006 the settlement of macrotextured patient claims was a factor which will continue in 2007. In February 2006 the Group received $537m net from the sale of the BSN Medical joint venture which was used to repay borrowing facilities.

Smith & Nephew believes that its capital expenditure needs and its working capital funding for 2007, as well as its other known or expected commitments or liabilities, can be met from its existing resources and facilities.

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

Further information regarding borrowings at 31 December 2006 is set out in Note 19 of the Notes to the Group Accounts. The Group believes that the borrowing facilities do not contain restrictions that are expected to impact on funding or investment policy for the foreseeable future.

Payment Policies

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

LEGAL PROCEEDINGS

The Company and its subsidiaries are parties to product liability and various legal proceedings, some of which include claims for substantial damages, which are considered to constitute ordinary and routine litigation incidental to the businesses conducted by the Group. The outcome of such proceedings cannot readily be foreseen, but other than as detailed below management believes that they will not result in any material adverse effect on the financial position or results of operations of the Group.

Product Liability Claims

In August 2003 the Group withdrew voluntarily from all markets the macrotextured versions of its OXINIUM femoral knee components. 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.

In December 2004 the Group was notified that two insurance carriers who comprise 35% of the first and 80% of the second excess layers of the Group s global product liability programme had declined coverage for macrotextured claims due to differences in the interpretation of the policy wording. In 2005 the remaining insurance carrier with a 20% participation in the second excess layer declined coverage. In 2006 two other insurance carriers 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 have been no subsequent changes to the original estimated liability.

The charge was calculated based on: (1) the amount outstanding at 31 December 2004 from the insurers who declined coverage; (2) an estimate of the average cost in respect of revisions where claims were unresolved at that date; and (3) an estimate of the number of settlements of future revisions based on the current trend and decaying to zero after five years and an estimation of the average future cost per settlement. The amount of provision remaining at 31 December 2006 to cover pending claims and claims in respect of future revisions, assuming no insurance cover is available, was $42m, which management believes is adequate.

As at 31 December 2006, 999 implants had been revised and settlements agreed with patients in respect of 923 of these revisions. The total amount paid out in settlements, legal costs and associated expenses was $172m of which $60m was recovered from the insurer that provides 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 insurers. At the end of February 2007, 1,005 implants had been revised and settlements agreed with patients in respect of 926 of these revisions. The costs remain in line with expectations.

The Group s assessment of the impact of these revisions and related matters constitute forward looking statements that are subject to uncertainties, including uncertainties relating to the outcome of settlements as compared to the assumptions made in estimating claim amounts. Smith & Nephew cannot provide assurance that these estimates will prove correct. Depending on the number and average cost of future settlements, costs may be greater or less than the amount provided (see Risk Factors).

Equal Employment Opportunity Commission Charges (EEOC Charges)

In 2006, seven EEOC charges and one federal law suit have been filed in Memphis, Tennessee against the Group s orthopaedic business alleging that the Company s employee promotion practices are discriminatory. An eighth EEOC charge, which was filed by the same lawyers involved in all of the other charges and the suit, alleges

that the Company did not provide the employee with necessary training. Seven of the eight who have filed charges are the plaintiffs in the suit. Both the charges and the suit seek certification as class actions. Smith & Nephew believes that it has meritorious defences to the charges and the suit and it intends to defend these matters vigorously. As at 15 March 2007, the EEOC charges have been dismissed but the class actions remain.

US Department of Justice Investigations

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 US 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 cooperating fully with the United States Attorney. The results of this investigation may not be known for several years. However, the scope of the investigation has currently been narrowed by the United States Attorney to a specific geographic region and specific product lines. It is the Group s belief that the investigations of the other orthopaedic companies that received similar subpoenas have been similarly narrowed. It is also the Group s belief that the investigation was prompted by an e-mail sent by an independent sales representative of Smith & Nephew that proposed a common pricing strategy in connection with a particular hospital. This email was not authorised by the Group. No action was taken by any competitor in response to the e-mail, and Smith & Nephew believes that no anticompetitive activity took place as a result of it. Following the disclosure of the anti-trust investigations six complaints in class action law suits were filed against the Group and the other orthopaedic companies alleging violations of the Sherman Antitrust Act that received similar subpoenas seeking compensation for price fixing alleging to have occurred as a result of the matters under investigation. Smith & Nephew believes that it has meritorious defences to the claims being asserted and intends to defend these suits vigorously.

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 Group is co-operating fully with the US Attorney, has provided copies of the requested contracts and is gathering additional documents which have also been requested.

OUTLOOK AND TREND INFORMATION

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

As described in Financial Summary Change in Functional and Reporting Currency the Group commenced reporting its results in US Dollars instead of Pounds Sterling with effect from 1 January 2006. The effect of this change on future trends will be to reduce the Group s exposure to translational exchange rate fluctuations and thereby reduce the volatility of its revenues and profits.

The markets on which the Group concentrates continue to demonstrate robust growth and are expected to benefit in 2007 and for the foreseeable future from an ageing population, obesity, more active lifestyles and technological developments including less invasive techniques in orthopaedic and endoscopic surgery. In advanced wound management continuing innovation and the potential for further penetration of moist wound healing and wound bed preparation techniques should continue to stimulate expansion of this market. Management continues to seek acquisitions that add to shareholder value.

New products launched in 2006, together with further launches planned for 2007, are expected to enable the Group to exceed market growth in 2007.

The Group has indicated its intention to increase its focus on margin enhancement through a review to identify areas for improvement across all businesses. This Earnings Improvement Project is in the advanced planning stage and management expects to make a further announcement with its 2007 Quarter One results.

Following the Group s commencement in February 2007 of a share buy-back programme of up to $1.5 billion over the next two years, the Group s interest cost will increase and the weighted average number of shares in issue will decrease depending on the actual number of shares purchased. Overall this is expected to be broadly neutral to earnings per share and EPSA.

Management does not anticipate that the dispute with certain insurers over their declination of coverage of macrotextured product liability claims will be resolved during 2007. Consequently, it is expected that settlements with patients will not be reimbursed by insurers and that this will continue to have an adverse impact on cash flow of approximately $25m during 2007. See Legal Proceedings and Risk Factors .

CONTRACTUAL OBLIGATIONS

Contractual obligations at 31 December 2006 were as follows:

		Payments due by period			
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			($ million)		
Short-term debt obligations	101	101			
Loan Notes	17	17			
Finance lease obligations	25	1	4	4	16
Operating lease obligations	152	41	48	24	39
Retirement benefit obligation	35	35			
Purchase obligations	21	21			
Capital expenditure	2	2			
Other	26	23		3	
	379	241	52	31	55

Other contractual obligations consist of $2m of credit balances on currency swaps, $7m of foreign exchange contracts and $17m of acquisition consideration. Provisions that do not represent contractual obligations are not included in the above table.

The agreed contributions for 2007 in respect of the Group s defined benefit pension plans are: $20m for the UK plan (including $12m of supplementary payments), $11m for the US plan and $4m for the other funded defined benefit plans. The table above does not include amounts payable in respect of 2008 and beyond as these are subject to future agreement and amounts cannot be reasonably estimated.

OFF-BALANCE SHEET ARRANGEMENTS

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

RELATED PARTY TRANSACTIONS

Except for BSN Medical (see Note 35 of Notes to the Group Accounts), no other related party had material transactions or loans with Smith & Nephew over the last three financial years.

US GAAP FINANCIAL SUMMARY

Smith & Nephew prepares its accounts in accordance with IFRS as adopted by the EU which differ in certain respects from US GAAP. Reconciliations of profit for the financial year and equity are set out in Note 40 of the Notes to the Group Accounts.

Results

	2006	2005	2004
Profit for the financial year	$ 709m	$ 308m	$ 257m
Basic earnings per Ordinary Share	75.3¢	32.8¢	27.5¢
Diluted earnings per Ordinary Share	75.1¢	32.7¢	27.3¢

US GAAP profit for the financial year in 2006 is $36m lower than IFRS with the main differences being:

higher amortisation of other intangible assets of $14m since IFRS amortisation applies only to acquisitions after transition in 2003;

higher pension expense of $11m mainly due to the amortisation of actuarial gains and losses through the income statement rather than through equity; and

write-off of in-process research and development of $24m in 2006; and

higher rationalisation and restructuring costs of $29m since certain costs are recognised later in US GAAP; partly offset by

higher profit on the disposal of the joint venture of $29m primarily due to different goodwill recorded in the US GAAP Balance Sheet on formation and different recycled cumulative translation reserves; and

differences of $6m in deferred taxation.

Equity

	2006	2005
At 31 December	$ 2,227m	$ 1,597m

US GAAP equity in 2006 is $53m higher than IFRS with the main differences being the higher book value of $73m for goodwill and intangibles less deferred tax of $34m, most of which is related to adjustments to goodwill and intangibles, resulting from:

- recognition in US GAAP of goodwill set off directly to reserves pre-1998 under IFRS, less related deferred tax liabilities;
- recognition of intangible assets, separately from goodwill thereby increasing amortisation and reducing the net balance of goodwill and intangibles and increasing related deferred tax liabilities; and
- in-process research and development written off in accordance with US GAAP which was capitalised under IFRS.

Prospects

Smith & Nephew have published expectations of future results in Outlook and Trend Information .

New accounting standards in the US which may affect US GAAP results are detailed in Note 38 of the Notes to the Group Accounts.

CORPORATE GOVERNANCE

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

THE BOARD AND EXECUTIVE OFFICERS

Board

The Board of Directors of Smith & Nephew as at 15 March 2007 comprised:

Director	Position	Initially elected or appointed	Term of appointment expires at AGM in
John Buchanan	Independent Non-Executive Chairman	3 February 2005	2008
Sir Christopher O Donnell	Executive Director, Chief Executive	1 September 1992	2007
Adrian Hennah	Executive Director, Chief Financial Officer	15 June 2006	2007
David J. Illingworth	Executive Director, Chief Operating Officer	8 February 2006	2009
Dr. Pamela J. Kirby	Independent Non-Executive Director	1 March 2002	2008
Warren D. Knowlton	Independent Non-Executive Director	1 November 2000	2007
Brian Larcombe	Independent Non-Executive Director	1 March 2002	2008
Richard De Schutter	Independent Non-Executive Director	1 January 2001	2007
Dr. Rolf W. H. Stomberg	Independent Non-Executive Director	1 January 1998	2007

Directors Biographies

John Buchanan (63). Independent non-executive Chairman. He was appointed independent non-executive Deputy Chairman in 2005 and became Chairman in April 2006. He is Chairman of the Nominations Committee. He is Deputy Chairman of Vodafone Group Plc and a non-executive director of AstraZeneca PLC and BHP Billiton. He was formerly Group Chief Financial Officer of BP p.l.c.

Sir Christopher O Donnell (60). Chief Executive. He joined the Group in 1988 as managing director of the Group s medical division, was appointed a director in 1992 and was appointed Chief Executive in 1997. He is a member of the Nominations Committee. Previously he held senior positions with UK and US companies in the medical engineering and devices industry.

Adrian Hennah (49). Chief Financial Officer. He joined the Group and was appointed a director in June 2006. He was previously Chief Financial Officer of Invensys plc and held various senior positions within GlaxoSmithKline.

David Illingworth (53). Chief Operating Officer. He joined the Group in May 2002 as President of Orthopaedics and was appointed a director and Chief Operating Officer in February 2006. Prior to joining the Group he held posts within GE Medical, as Chief Executive Officer of a publicly traded medical devices company, President of a respiratory/critical care company and President of a technology incubator company.

Dr. Pamela J. Kirby (53). Independent non-executive director. She was appointed a director in March 2002 and is a member of the Remuneration Committee. She is non-executive Chairman of Scynexis Inc and a non-executive director of Informa plc and

Curalogic A/S.

Warren D. Knowlton (60). Independent non-executive director. He was appointed a director in November 2000 and is Chairman of the Audit Committee and a member of the Remuneration Committee. He is Chief Executive Officer of Graham Packaging Inc. and a non-executive director of Filtrona plc and Ameriprise Financial Inc. Previously he was Group Chief Executive Officer of Morgan Crucible plc.

Brian Larcombe (53). Independent non-executive director. He was appointed a director in March 2002 and is a member of the Audit Committee. He is a non-executive director of F&C Asset Management plc and Gallaher Group plc. Previously he was Chief Executive Officer of 3i Group plc.

Richard De Schutter (66). Independent non-executive director. He was appointed a director in January 2001 and is a member of the Audit Committee and the Remuneration Committee. He is non-executive Chairman of Incyte Corporation and a non-executive director of Varian Inc., MedPointe Pharmaceuticals, Ecolab Inc, and Navicure Inc.

Dr. Rolf W. H. Stomberg (66). Independent non-executive director and Senior Independent Director. He was appointed a director in 1998 and is Chairman of the Remuneration Committee and a member of the Audit Committee and Nominations Committee. He is Chairman of Management Consulting Group plc, Francotyp Postalia Holding AG and Lanxess AG and a non-executive director of Reed Elsevier plc, Hoyer GmbH, TNT N.V., Deutsche BP AG, Biesterfeld AG and Serverstal.

In April 2006, Dudley Eustace retired as Chairman and in June 2006, Peter Hooley retired as Finance Director.

Corporate Governance

Executive Officers

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

Dr. Peter Arnold (45). Group Director of Technology. He joined the Group in 1997 and worked in corporate business development and corporate research and development roles. He was appointed to his current role in 2004. Prior to joining the Group he was responsible for research and development for Johnson & Johnson s wound care business.

Mark Augusti (41). President of Orthopaedic Trauma and Clinical Therapies. He joined the Group in 2003 as Vice President of Global Marketing for the Trauma Division and was promoted to Senior Vice President and General Manager Trauma Division in 2005 becoming President Orthopaedic Trauma and Clinical Therapies in February 2006. He previously worked for GE Medical Systems in the US and Asia.

Sarah Byrne-Quinn (43). Group Director of Strategy and Business Development. She joined the Group in 2004 as Group Director of Strategy and Business Development. Prior to joining the Group, she held management positions with Cable & Wireless plc and a number of investment banks.

Michael Frazzette (45). President of Endoscopy. He joined the Group as President Endoscopy in July 2006. Previously he was President and Chief Executive Officer of a US manufacturer of medical devices and spent 15 years at Tyco Healthcare becoming President of each of Patient Care and Health Systems divisions.

Peter W. Huntley (46). Group Director Indirect Markets. He joined the Group in April 1998, responsible for Group strategy and business planning. He was appointed Group Director Indirect Markets in December 2003. Prior to joining the Group, he was a consultant with Deloitte Haskins and Sells and the Business Development Director for Matthew Clark plc.

James A. Ralston (60). Chief Legal Officer. He joined the Group in 1999 as Executive Vice President and Chief Legal Officer for North America becoming Chief Legal Officer for the Group in February 2002. Prior to joining the Group he was in private practice and VP General Counsel and Secretary for Eagle-Picher Industries, Inc.

Paul M. Williams (60). Group Director Human Resources. He joined the Group as Group Director Human Resources in December 1998. Prior to joining the Group he held senior human resources director roles with NCR, Heinz, Glaxo and Rolls-Royce.

Joe Woody (41). President of Advanced Wound Management. He joined the Group in 2003 as Vice President and General Manager of the Clinical Therapies Division. He was appointed President Advanced Wound Management in February 2006. He previously worked for Alliance Imaging, Acuson and GE Medical Systems.

James M. Taylor and Scott Flora resigned and James L. Dick retired during 2006.

Group Company Secretary

Paul R. Chambers (62). Company Secretary. He joined the Group in 1994 as Assistant Company Secretary and was appointed Company Secretary in April 2002.

GOVERNANCE AND POLICY

The Combined Code on Corporate Governance (the Code), as revised by the Financial Reporting Council in 2006, requires UK listed companies to make a disclosure statement on the application of the Principles and Supporting Principles and compliance with the Provisions of the Code.

The Board is committed to the highest standards of Corporate Governance and considers that it has complied with all relevant provisions of the Code adopted in 2006 throughout the year, except that:

i. no member of the Audit Committee has a professional qualification from one of the professional accountancy bodies as recommended by the Smith Guidance. However, the Board considers that all members have relevant financial experience as senior executives of large corporations. The Board further considers that the members of the Audit Committee have the skills and experience of corporate financial matters to discharge properly the Committee s responsibilities. All members of the Audit Committee are independent, as defined by the New York Stock Exchange (NYSE), and meet the definition of financial expert in the Sarbanes-Oxley Act in the US; and

ii. the notice period for David Illingworth as a new internally appointed director is up to 24 months from the date of appointment to the Board. Such notice period reduces to 12 months after the expiry of the initial term, in line with the Code. The Board considered that such notice period was required in line with competitive practice for external appointments.

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

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

The Board

The Board of Directors of Smith & Nephew consists of an independent non-executive Chairman, three executive directors and five independent non-executive directors. In 2006, the Board met on nine occasions and individual attendance together with attendance at Board Committee meetings, is shown in the table on page 56. If directors are unable to attend a Board meeting or Board Committee meeting, they are advised of matters to be discussed and have an opportunity to make their views known to the Chairman prior to the meeting.

The Board is responsible for the strategic direction and overall management of the Group and has a formal schedule of matters reserved for its decisions which include the approval of certain policies, budgets, financing plans, large capital expenditure projects, acquisitions, divestments and treasury arrangements. Otherwise it delegates the executive management of the Group to the Chief Executive and certain specific responsibilities to Board Committees, as described on pages 55 to 56. It reviews the key activities and performance of the businesses and considers and reviews the work undertaken by the Committees. Succession planning is

regularly reviewed and appropriate measures are taken to ensure the Board has the appropriate balance of skills and experience necessary for a major global medical devices company.

Non-executive directors meet regularly prior to each Board meeting without management in attendance and the Senior Independent Director meets with the other non-executive directors annually to evaluate the performance of the Chairman. Board meetings are held at the major business units enabling directors to have a greater understanding of the business and to meet the management of these units. All directors have full and timely access to all relevant information and, if necessary, to independent professional advice. Induction programmes are provided for new directors and training is offered to all directors. In 2006, additional training was provided to directors on corporate governance issues and an internal on-line resource was developed for on-going corporate governance developments. Directors have access to the advice and services of the Company Secretary, who is also responsible to the Board for ensuring that board and governance procedures are complied with.

Appropriate directors and officers liability insurance is in place and Deeds of Indemnity have been entered into between the Company and directors following changes to the Companies Act 1985 and the approval given by shareholders at the 2006 AGM. The Deeds of Indemnity allow for indemnification of directors in respect of

proceedings brought by third parties and for the Company to provide funds for directors ongoing costs in defending a legal action as they are incurred rather than after judgement has been given. Individual directors would still be liable to pay any damages awarded to the Company in an action against them and to repay their defence costs to the extent funded by the Company if their defence is unsuccessful.

Whilst the Chairman and Chief Executive collectively are responsible for the leadership of the Group, there is a clear division of respective responsibilities which have been agreed by the Board. The Chairman s primary responsibility is for leading the Board including setting its agenda and ensuring its effectiveness. The Chief Executive is responsible for managing and supervising the business of the Group in accordance with the strategy, policies, budgets and business plans approved by the Board. The Chief Operating Officer reporting to the Chief Executive is responsible for the management and performance of the four business units and the Indirect Market unit.

The Senior Independent Director is Dr. Rolf Stomberg, whose role includes consulting with members of the Board on issues relating to the Chairman and chairing meetings of the Nominations and Audit Committee in the absence of the Chairman or Chairman of the Audit Committee. He is available to shareholders if they have concerns that cannot be resolved through the normal channels of contact with the Chairman or Chief Executive. In view of the retirement of the Chairman and Group Finance Director in 2006, Dr. Stomberg, having served nine years as a director, has been asked to continue to serve as a director for up to a further three years. He brings considerable experience and stability to the Board and acts in an independent and questioning manner at Board meetings. The Board therefore is of the view that he remains independent.

In 2004, a formal evaluation of the performance of the Board and its Committees was undertaken by an external consultant. This was followed up in 2005 and 2006 with an internal evaluation of the Board and its Committees led by the Senior Independent Director with the emphasis on continuous improvement and effectiveness. In 2006, the evaluation was effected through a confidential questionnaire and discussions with the Senior Independent Director. Whilst some points relating to process between meetings arose from the review it concluded that the Board continues to function effectively as a team and to manage the direction of the Group appropriately, and the Board Committees continue to function effectively and discharge their duties in the manner prescribed by their charters.

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

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

None of the directors or Executive Officers (or any relative or spouse of such person, or any relative of such spouse, who has the same address as the director or officer, or who is a director or officer of any subsidiary of Smith & Nephew) has any family relationship with any other directors or officers nor has a material interest in any contract to which the Company or any of its

subsidiaries are or were a party from the beginning of fiscal year 2005 to 15 March 2007.

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

Board Committees

The Board is assisted by the Audit, Remuneration and Nominations committees, each of which has its own terms of reference, which may be found on the Group s website at www.smith-nephew.com. The Company Secretary is secretary to each of the committees.

Audit Committee

The Audit Committee met on six occasions in 2006 (individual attendance is shown in the table on page 56). The Committee, consisting entirely of independent non-executive directors, is chaired by Warren D. Knowlton. He was

appointed to the Committee in February 2001 and became Chairman of the Committee in July 2001. The other members of the Committee are Brian Larcombe who was appointed to the Committee in January 2003, Richard De Schutter who was appointed in February 2001 and Dr. Rolf Stomberg who was appointed in February 1998. The Chairman of the Committee reports orally to the Board and minutes of the meetings are circulated to all members of the Board. A description of the work of the Committee in 2006 is on page 58.

Remuneration Committee

The Remuneration Committee, consisting entirely of independent non-executive directors, met three times in 2006 (individual attendance is shown in the table below) and is chaired by Dr. Rolf Stomberg. The other members of the Committee are Dr. Pamela Kirby, Warren Knowlton and Richard De Schutter. The Remuneration Committee sets the pay and benefits of the executive directors and Executive Officers, approves their main terms of employment and determines share options and long-term incentive arrangements for the Group. It also reviews senior management succession planning. The Remuneration Report is on pages 61 to 72.

Nominations Committee

The Nominations Committee, consisting of two independent non-executive directors and the Chief Executive, met twice in 2006 and its Chairman, John Buchanan, and members, Dr. Rolf Stomberg and Sir Christopher O Donnell, attended all meetings. The Committee oversees the Board s plans for succession, recommends appointments to the Board and determines the fees of the non-executive directors. There is a formal and transparent procedure for the appointment of new directors to the Board. Candidate profiles are agreed by the Committee before external consultants are engaged to advise on prospective Board appointees. Shortlisted candidates are interviewed by members of the Committee who then recommend candidates to be interviewed by all members of the Board. The final decision is made by the Board. The Senior Independent Director oversees the process for the appointment of a new Chairman. This process was followed for John Buchanan s appointment to the Board.

Board and Committee Attendance

	Board 9 meetings	Remuneration Committee 3 meetings	Audit Committee 6 meetings	Nominations Committee 2 meetings
John Buchanan	9	n/a	n/a	2
Sir Christopher O Donnell	9	n/a	n/a	2
Adrian Hennah (i)	5	n/a	n/a	n/a
David J. Illingworth	9	n/a	n/a	n/a
Dr. Pamela J. Kirby	9	3	n/a	n/a
Warren D. Knowlton	9	2	6	n/a
Brian Larcombe	9	n/a	6	n/a
Richard De Schutter	9	3	6	n/a
Dr. Rolf W. H. Stomberg	9	3	5	2
Dudley G. Eustace (ii)	3	n/a	n/a	1
Peter Hooley (iii)	4	n/a	n/a	n/a

(i) Appointed Chief Financial Officer on 15 June 2006.
(ii) Retired as Chairman on 27 April 2006.
(iii) Retired as Finance Director on 30 June 2006.

Directors Re-appointment

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

Adrian Hennah was appointed a director by the Board on 15 June 2006 and, in accordance with the articles of association, will retire at the annual general meeting to be held in May 2007 and, being eligible, will offer himself for re-election. In accordance with the articles of association, Sir Christopher O Donnell, Warren Knowlton, Richard De Schutter and Dr. Rolf Stomberg will retire and, being eligible, will offer themselves for re-election at the AGM.

Corporate Governance

ACCOUNTABILITY, AUDIT AND INTERNAL CONTROL FRAMEWORK

Risk Management and Internal Control

The Board has overall responsibility for the maintenance of the Group s systems of risk management and internal control and for reviewing their effectiveness. These systems, which accord with the Turnbull Guidance, have been in place for 2006 and to the date of approval of the report and accounts, involve: the identification, evaluation and management of key risks through a Risk Committee, which reports to the Board annually; business reviews by the Board of each of the business units; and the review by the Audit Committee of internal financial controls and the risk management process. These systems are reviewed annually by the Board. Whilst not providing absolute assurance against material misstatements or loss, these systems are designed to identify and manage those risks that could adversely impact the achievement of the Group s objectives.

Risk Committee

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

The annual Group Risk Report of the Risk Committee to the Board details all principal risks categorised by potential financial impact on profit and share price. The most significant Group risks are reported to the Board quarterly, which include new key or significantly increased risks along with actions put in place to mitigate such risks. The principal risks are detailed in Risk Factors to be found on pages 21 to 25.

In 2006 the effectiveness of the business units systems to identify and manage material risk were evaluated and the findings reported to the Board. No material weaknesses were identified in these systems.

Management s Report on Internal Control over Financial Reporting

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

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

In accordance with the requirement in the US under s404 of the Sarbanes-Oxley Act, management assessed the effectiveness of the Group s internal control over financial reporting as at 31 December 2006. In making this assessment, management used the

criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission in Internal Control-Integrated Framework. Based on its assessment, management has concluded and hereby reports that, as at 31 December 2006, the Group s internal control over financial reporting is effective based on those criteria.

Ernst & Young LLP, an independent registered public accounting firm, has issued an audit report on management s assessment as of 31 December 2006 of the Group s internal control over financial reporting. This report appears on page 78.

Changes in Internal Control Over Financial Reporting

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

Disclosures Committee and Evaluation of Disclosure Controls and Procedures

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

The Chief Executive and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Group s disclosure controls and procedures as at 31 December 2006. Based upon, and as of the date of, that evaluation, the Chief Executive and Chief Financial Officer concluded that the disclosure controls and procedures were effective.

Codes of Business Principles

The Codes of Business Principles, which include a whistleblowing policy are available at www.smith-nephew.com/sustainability and are available on request, apply to all directors, officers and employees. Any breaches of the Codes are reported to the Company Secretary who is obliged to raise the issue with the Chief Executive or Chairman and the Audit Committee. During 2006 and up until 15 March 2007 there have been no breaches of the Codes and no waivers have been put in place nor any amendments made to the Codes.

Code of Ethics for Senior Financial Officers

The Board of Directors has adopted a Code of Ethics for Senior Financial Officers, which is available at www.smith-nephew.com/sustainability and is available on request. It applies to the Chief Executive, the Chief Financial Officer, Group Financial Controller and the Group s senior financial officers. There have been no waivers to any of the Code s provisions nor any amendments made to the Code during 2006 or up until 15 March 2007.

Activities of the Audit Committee for 2006

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

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

reviewing arrangements by which staff may raise complaints against the Group regarding financial reporting or other matters.

The Group has specific policies which govern:

the conduct of non-audit work by the external auditors which prohibits the auditors from performing services which would result in the auditing of their own work, participating in activities normally undertaken by management, acting as advocate for the Group and creating a mutuality of interest between the auditors and the Group, for example being remunerated through a success fee structure. Each year, the Audit Committee pre-approves the budget for fees relating to audit and non-audit work, including taxation services, in accordance with a listing of particular services. In the event that limits for these services are expected to be exceeded or the Group wants the external auditors to perform services that have not been pre-approved, approval by the Chairman of the Audit Committee is required, together with a notification to the Audit Committee of the service and the fees involved. All services provided by the independent auditors during the year were pre-approved by the Audit Committee; and

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

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

The principal activities of the Audit Committee during the year ended 31 December 2006 included:

consideration of the quarterly, interim and preliminary results and the annual accounts;

consideration of the Group s compliance with s404 of the Sarbanes-Oxley Act 2002;

Corporate Governance

a review of the Group s approach to internal financial control, its processes, outcomes and disclosures;

a review of the Internal Review department s activities for the year, together with its resource requirements and findings;

a review of whistleblowing procedures;

a review of the reports from the auditors, Ernst & Young LLP, on their professional and regulatory compliance in order to maintain independence and objectivity, including the rotation of partners;

a review of the audit, audit-related and tax services provided by Ernst & Young LLP;

review and the pre-approval of all services provided by the auditors during the year including all non-audit work performed by the auditors together with associated fees, to ensure that the objectivity and independence of Ernst & Young LLP as auditors of the Group was not compromised. Ernst & Young LLP only provided consultancy work in respect of accounting and tax related matters;

consideration of Ernst & Young LLP s in-depth reports to the Committee on the scope and outcome of the annual audit and management s response. Their reports included accounting matters, governance and control and accounting developments;

a review of the effectiveness of the performance of Ernst & Young LLP effected by the completion of a questionnaire by the units audited within the Group and by the members of the Committee;

recommending the re-appointment of Ernst & Young LLP as the Group s auditors;

confirmation that no concerns were raised with the Committee about possible improprieties in matters of financial reporting or other matters;

reviewing the Committee s terms of reference to ensure they reflect developments in corporate governance in the UK and the US;

consideration of the Group s risk management process; and

an evaluation of its own performance during the year, effected by means of a questionnaire and individual discussions.

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

Principal Accountant Fees and Services

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

	2006	2005
	($ million)	
Audit fees	4.6	3.1
Audit-related fees	0.7	0.9
Tax fees	2.6	1.9
All other fees	1.8	
	9.7	5.9

Audit fees include fees associated with the annual audit and local statutory audits required internationally. Audit-related fees principally include accounting consultation in relation to International Financial Reporting Standards and advice regarding compliance with Sarbanes-Oxley. Tax fees include tax compliance, tax advice and tax planning services. All other fees relate to those incurred in relation to the bid related costs for Biomet Inc. A more detailed breakdown of audit fees may be found in Note 36 of the Notes to the Accounts.

Disclosure of Information to the Auditors

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

Auditors

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

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REMUNERATION REPORT

For ease of reference the Remuneration Report is broken down into the following sections, of which Directors Emoluments and Pensions, Senior Management Remuneration and Directors Interests were subject to audit:

Remuneration Policy

The Remuneration Committee

The Principal Components of Executive Remuneration

Total Reward Composition

Remuneration Committee Initiatives

Service Contracts

External Non-executive Directorships

Non-executive Directors

Directors Emoluments and Pensions

Senior Management Remuneration

Directors Interests

Total Shareholder Return

Remuneration Policy

The Group wide remuneration policy, as approved by the Remuneration Committee, for 2006 and future years, is summarised as follows: base pay and benefits are targeted at the market place median for fully acceptable performance; bonus schemes are targeted to deliver upper quartile pay for upper quartile performance; remuneration practice is based on robust competitive survey data in the context of the Company s ability to pay; and there are no automatic pay adjustments unless required by law or local protocol.

A share based incentive portfolio operates for executive directors, executive officers and the next level of senior executives. The plan comprises a performance share plan, share option plan and co-investment plan and increases the proportion of executives variable reward that is dependent on the Group s performance. Other levels of management are able to participate in the 2001 share option plans.

Major changes to the remuneration policy are discussed with the principal shareholders.

The Remuneration Committee

The Committee, which comprises Dr. Rolf Stomberg (Chairman), Dr. Pamela Kirby, Warren Knowlton and Richard De Schutter, determines the compensation of executive directors, executive officers and the broad policy for executive remuneration. The Committee is assisted by Sir Christopher O Donnell, Chief Executive and Paul Williams, Group Human Resources Director, both of whom have advised on all aspects of the Group s reward structures and policies but neither is present at any discussion concerning their own remuneration.

The Committee reviews:

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

The terms of reference, which are available on the company s website at www.smith-nephew.com, enable the Committee to obtain its own external advice on any matter, at the Company s expense. During the year, the Committee received information from a number of independent consultants appointed by the Company: Watson Wyatt on a broad range of remuneration issues; Towers Perrin and Hay Group on salary data when considering base salaries of executive directors and executive officers; PricewaterhouseCoopers LLP on long-term incentive plan comparative performance and Deloitte & Touche LLP on current US compensation market practice. Watson Wyatt also acts as one of the retirement benefit consultants to the Group, PricewaterhouseCoopers LLP provided consultancy services to the Group including due diligence for the Biomet bid, project and taxation advice and Deloitte & Touche LLP provided taxation advice.

The Principal Components of Executive Remuneration

(a) Basic Salary and Benefits

Basic salary reflects the responsibility of the position and individual performance. Salaries are reviewed annually. The Group also provides certain benefits such as private healthcare coverage and a company car or allowance in line with competitive practice. The Remuneration Committee considers any pension consequences and costs to the Company when determining basic salary increases for executive directors and executive officers.

(b) Performance Related Bonus

For executive directors, the Group operates an annual bonus scheme. In 2006, 75% of the annual bonus was based on annual growth in EPSA and 25% was based on personal objectives underpinned by asset velocity measurements. The scheme is designed to encourage outstanding performance. Achievement of 12% target EPSA growth and the personal objectives would produce a bonus of 50% of annual salary. The maximum bonus is 100% of annual salary. Bonuses are not pensionable. Under the Co-investment Plan, part of the annual bonus may be taken in shares.

The actual bonus earned in 2006 by executive directors is shown in the table on page 67 and ranged from 44% to 69% of annual salary.

For executive officers with corporate responsibilities, the 2006 annual bonus plan was linked to EPSA growth, sales growth and personal objectives. For those executive officers with specific business unit responsibilities, targets were linked to EPSA growth, sales growth and trading profit of their respective business unit. As with executive directors, part of the annual bonus may be taken in shares.

(c) Long-Term Incentives

(i) Performance Share Plan

Annual awards over shares made under the 2004 Performance Share Plan vest if defined levels of total shareholder returns are attained over three years beginning in the year of award. There is no retesting.

The award shares are divided equally into two tranches, so as to measure Total Shareholder Return (TSR) relative to the FTSE 100 and the major companies in the medical devices industry respectively. TSR performance of the Sterling priced ordinary shares against the FTSE 100 companies and the Dollar priced ADR TSR performance against major companies in the medical devices industry (the majority of which are US listed) are the most suitable measures to encourage high levels of business performance and align the interests of the Group, its shareholders and senior executives.

Remuneration Report

The medical devices companies for comparison for the 2006 award which the Committee considered appropriate to the Company were:

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

The shares of each tranche will vest if the Group s TSR is ranked at the median level in that tranche. If, in relation to either tranche, the Group ranks at median, 25% of the award of that tranche will vest and if the Group is at the 75th centile, then all of the shares of that tranche will vest. Between the median and 75th centiles, the shares will vest on a straight-line basis. If the Group is above the 75th centile, then the number of shares increases above the award on a straight-line basis up to a maximum of 150% of the award if the Group is ranked at or above the 90th centile.

In relation to awards made to executive directors, the initial market value of the award shares is equivalent to their basic annual salary and in relation to awards made to executive officers, the initial market value of the awards was equivalent to 75% of their basic annual salary. For 2007 and future years the initial market value of the award shares for executive directors will be 150% of their basic annual salary.

The Remuneration Committee has the discretion to reduce the number or percentage of shares which vest, if, notwithstanding the Group is ranked at or above the median level in respect of either tranche of award shares, the Remuneration Committee is of the opinion that the growth in the Group s TSR achieved for either tranche is not a genuine reflection of the Group s underlying financial performance. The Group s TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by PricewaterhouseCoopers LLP. For the awards made in 2004 no award vested as the Company was ranked below median in the FTSE 100 comparator group and 11th in the medical devices group.

(ii) Executive Share Options

In 2006, share options were granted under the 2004 Executive Share Option Plan and 2001 UK Approved Plan for UK resident executive directors and senior executives. Under the 2004 Plan, the maximum market value of options which may be granted each year is equivalent to the basic annual salary of the director or executive. Options are exercisable up to ten years from the date of grant and are only exercisable if graduated target levels of growth in EPSA over the three-year performance period are achieved, beginning with that in which the option is granted. Options were granted under the 2001 UK Approved Plan up to the value of £30,000 and formed part of the overall grant. Performance conditions for these awards were the same as for the 2004 Plan.

The target levels of performance are set by the Remuneration Committee for each grant. For 2006 they were: 25% of the option shares will vest if growth in EPSA over the three-year period ending 31 December 2008 is 26% (i.e. 8% compounded annually) with

50% vesting if such growth is 40% (i.e. 12% compounded annually). Only if growth in EPSA over that period exceeds 64% (i.e. 18% compounded annually) will all of the option shares vest. Option shares will vest pro rata on a straight-line basis if growth in EPSA is between these levels. There is no retesting of performance conditions. For the awards made in 2004 77.4% vested as EPSA growth for the three year period was 61.7%.

(iii) Co-investment Plan

The 2004 Co-investment Plan enables executive directors and senior executives to take part of their annual bonus in the form of shares. The participant elects the level of bonus to be used for this purpose up to a maximum of one half of the annual gross bonus capped at 20% of basic annual salary for executive directors and executive officers. The net amount of the gross amount elected is then used to purchase shares.

For the 2006 award, and provided such shares are held for three years and the participant remains employed within Smith & Nephew, the participant will be entitled to matching shares if the Company achieves a target level of growth in EPSA over that three-year period of 40% (i.e. 12% compounded annually). At this level, the participant is entitled to one matching share for every share acquired out of the gross equivalent amount of the

net bonus used to acquire shares. If growth in EPSA is 50% or more the participant is entitled to two matching shares for each share acquired out of the gross equivalent amount of the net bonus applied to shares. There is no sliding scale nor pro rata vesting of matching awards between these performance levels, nor is there any retesting. For the awards made in 2004, executives will receive two matching shares as EPSA growth for the three year period was 61.7%.

In the event of a change of control of the Company, the Remuneration Committee will determine what proportion of the awards or options will vest and what proportion of the matching shares will be transferred to the executives taking into account both the proportion of the performance period and the performance of the Company over that period. In the event that an executive resigns or if employment is terminated for cause, all the options lapse. If an executive retires or leaves for other reasons, the award is prorated for the proportion of the performance period then elapsed. The prorated award is still subject to the attainment of the performance criteria before vesting.

Senior executives are expected to build and maintain a personal equity stake in the Company. Executive directors are required to accumulate a personal holding equivalent to 100% of basic salary within five years and executive officers are required to accumulate a personal holding equivalent to 75% of basic salary within five years.

(iv) Other Long-Term Incentive Plans (Pre 2004)

The Performance Share Plan adopted in 2004 replaced the long-term incentive plan (LTIP) established in 1997 for executive directors and executive officers. The last award was 2003 and vested in 2006. No further awards will be made under this LTIP. However, as every encouragement is given to executive directors and senior managers to build up a significant shareholding in the Group, participants in the LTIP who have not left the Group will, at the fifth and seventh anniversaries of the date of the original award, be awarded one additional share for every five so retained.

The 2001 UK Approved Share Option Plan, the 2001 UK Unapproved Share Option Plan and the 2001 US Share Plan are now, in the main, for the benefit of those executives not eligible for the 2004 share incentive plans. Each year the Remuneration Committee determines the maximum value of options to be granted to executives by reference to multiples of salary.

With the exception of the 2001 US Share Plan, the exercise of these options is subject to EPSA growth of not less than RPI plus 3% per annum, on average, in a period of three consecutive years. From 2005, there is no retesting of the performance conditions. Performance conditions were selected to be in line with market practice at the time. The awards made in 2004 will vest in 2007 as EPSA growth over the three year performance period exceeded the RPI +3% target. Options granted under the 2001 US Share Plan, in line with US market practice, are not subject to performance targets but are exercisable cumulatively up to a maximum of 10% after one year, 30% after two years, 60% after three years and the remaining balance after four years. Awards of restricted stock under the 2001 US Share Plan are not subject to performance targets but are subject to the executive remaining with the Group for a specified period, normally two years.

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

UK executive directors and executive officers are eligible to participate in the Smith & Nephew Employee Share Option Scheme (ShareSave) and US executive directors and executive officers are eligible to participate in the Employee Stock Purchase Plan.

Both these plans are available to all UK or US employees with three months service.

(d) Pensions

Pensions UK

UK based executive directors and executive officers have a normal retirement age of 62. Those in service pre-2003 participate in the defined benefit Smith & Nephew UK Pension Fund and UK Executive Pension Scheme, under which pension has been accrued in the year at an annual rate of one-thirtieth of final pensionable salary up to a limit based on service of two-thirds of final pensionable salary, subject to Inland Revenue constraints. Pensions in payment are guaranteed to increase by 5% per annum or the rate of inflation in the UK, if lower. Death in service cover of four times salary and spouse s pension at the rate of two thirds of the member s pension are provided on death. A salary supplement partially compensates for the UK Inland Revenue earnings cap on final pensionable salary which continues to apply in the defined benefit plans.

Remuneration Report

Those commencing employment post 2002 either participate in the defined contribution plan to which a company contribution of 30% of base salary is made or have a non-pensionable non-bonusable salary supplement of 30% of base salary. Death in service cover of seven times salary (of which four times is provided as a lump sum) is provided on death. The non-pensionable non-bonusable salary supplement is also available to any executive director or executive officer who wishes to opt out of the defined pension plans for future service.

Pensions US

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

Total Reward Composition

In 2006, excluding pension entitlements, the composition of remuneration for Sir Christopher O Donnell was: base pay (fixed) 33%, annual bonus (variable) 16%, and long-term incentives (variable) 51%; for David J. Illingworth was: base pay (fixed), 15% annual bonus (variable), 8% and long-term incentives (variable) 77%; and for Adrian Hennah was: base pay (fixed) 29%, annual bonus (variable) 14%, and long-term incentives (variable) 57%.

The following table provides a comparison of variable remuneration of executive directors and executive officers and business unit management shown as a percentage of salary. Except for the annual bonus, the components are measured over a three year period.

	Annual bonus	Performance Share Plan	Share option Plan	Co-investment Plan
Executive Directors and executive officers	0% to 100% depending on performance	Equal to 100% of salary (75% for executive officers) for 75th centile TSR	Equal to 50% of salary for EPSA growth of 40%	Maximum 20% of salary with 1 to 1 matching at EPSA growth of 40%
GBU Executives	0% to 80% depending on performance	Equal to 35% of salary for 75th centile TSR	Equal to 50% of salary for EPSA growth of 40%	Maximum 18% of salary with 1 to 1 matching at EPSA growth of 40%

Remuneration Committee Initiatives

During 2006 the Committee reviewed the performance conditions for all share plans and were of the view that they remained appropriate. However, some changes were made to the annual bonus plan for the year and for future years. For executive directors the budgeted improvement in ROCE which accounted for 25% of the bonus was replaced by personal objectives. Achievement of the personal objectives would be underpinned by asset velocity. For 2007 and onwards achievement of target performance will produce a bonus of 65% for executive directors. To reflect current market practice, the bonus payable to UK executives was increased from 30% to 50% of salary on the achievement of the target performance conditions. With the relative slowdown in 2006 of growth in the markets in which the Group operates, the EPSA growth rates for bonus purposes were reduced by 2% although target remained at 8%. For Group Head Office executives sales growth replaced budgeted improvement in ROCE. Further amendments were made to the sales element of the bonus for the business unit executives.

For 2006 only, the Committee approved amendments to EPSA for bonus, stock options and co-investment plan vesting, which were largely in line with guidance given to the market in Quarter 1 of 2006 and included the dilution resulting from the sale of BSN Medical and the loss of interest rate differentials with the change to US dollar reporting.

In line with current good practice to minimise attrition risks, change-in-control measures were put in place at senior executive levels. For the Chief Executive a 12 months change-in-control was inserted into his contract and for the Chief Financial Officer 24 months reducing to 12 months after the initial period. For US business unit Presidents the change-in-control period is now 24 months. The change-in-control arrangements do not enhance current pay and benefit entitlements.

During the year executive attrition risks in the medical devices sector and particularly in the US have increased. To mitigate this the Committee approved the issue of restricted stock to selected US executives considered to be most at risk. This includes an award to David J. Illingworth of 96,710 shares in December 2006. One half of this award will vest if he remains in continuous employment until 31 December 2007 and the remainder will vest if he remains in continuous employment until 31 December 2008.

To facilitate his recruitment to the Board in June 2006, the Committee approved an award of 57,603 restricted stock under Rule 9.4 of the Listing Rules of the FSA to Adrian Hennah. This award will vest if he remains in continuous employment until 15 June 2009.

Service Contracts

All appointments of executive directors are intended to have twelve month notice periods, but it is recognised that for some new appointments a longer period may initially be necessary for competitive reasons, reducing to twelve months thereafter. Accordingly the Committee approved that, for the appointments of Adrian Hennah and David J. Illingworth, their notice periods on appointment would effectively be 24 months, reducing to 12 months on the expiry of the initial term.

Sir Christopher O Donnell, appointed to the Board of Directors in September 1992, has a service agreement dated January 1992 which expires on his 62nd birthday in October 2008. David J. Illingworth, appointed to the Board of Directors in February 2006, has a service agreement dated February 2006 which expires on his 62nd birthday in 2015. Adrian Hennah, appointed to the Board of Directors in June 2006, has a service agreement dated June 2006 which expires on his 62nd birthday in 2019. The service agreement for David J. Illingworth is terminable by the Company on not more than 24 months notice reducing to 12 months after the initial term. Adrian Hennah s service agreement is terminable by the company on 12 months notice. Under his service agreement, the earliest that such notice may be given by the Company is June 2007. The service agreement for Sir Christopher O Donnell is terminable by the Company on 12 month s notice The agreements are terminable by the executive director on six months notice. There is no enhancement of termination rights on a change of control of the Group. During 2006 termination of the contract by the Group, except for cause , would effectively entitle the executive directors to up to 24 months basic salary for David J. Illingworth and Adrian Hennah reducing to 12 months after the initial term and 12 months for Sir Christopher O Donnell, bonus at target of 50%, a contribution to reflect the loss of pension benefits, an amount to cover other benefits and a time apportionment of the 2004 senior executive share plans entitlement. The Committee has determined to include the requirement for mitigation in the contracts of the executive directors appointed during the year. Peter Hooley, whose service agreement was due to expire in June 2008, retired in June 2006.

External Non-executive Directorships

Currently, none of the executive directors is a non-executive director of another company. Such appointments would be subject to the approval of the Nominations Committee and are restricted to one appointment for each executive director. All fees receivable by a director would normally be paid to the Company.

Non-executive Directors

Non-executive directors do not have service contracts but instead have letters of appointment. Non-executive directors are normally appointed for three terms of three years terminable at will, without notice by either the Group or the director and without compensation. The Chairman has a three month notice period. The remuneration of the non-executive directors is determined by the Nominations Committee who aim to set fees that are competitive with other companies of equivalent size and complexity. Non-executive directors are expected to accumulate a personal holding in the Company equivalent to the annual basic fee, within three years.

The Chairmen of the Audit and Remuneration Committees and the Senior Independent Director receive an extra £7,500 for their additional responsibilities. In 2006, Dr. Rolf Stomberg waived his extra fee entitlement due to him as Senior Independent Director.

Remuneration Report

Directors Emoluments and Pensions

	Salaries and fees	Benefits (i)	Bonus	Total emoluments excluding pension entitlements	Pension entitlements	Total including pension entitlements 2006	Total excluding pension entitlements 2005	Total including pension entitlements 2005
					(£ thousands)			
Chairman (non-executive):								
John Buchanan (ii)	235			235		235	90	90
Executive Directors:								
Sir Christopher O Donnell	894	2	435	1,331	27	1,358	884	934
David J. Illingworth (iii)	349	117	214	680	110	790		
Adrian Hennah (iv)	321	12	169	502		502		
Non-executive Directors:								
Dr. Rolf W. H. Stomberg	56			56		56	53	53
Warren D. Knowlton	56			56		56	53	53
Richard De Schutter	47			47		47	45	45
Dr. Pamela J. Kirby	47			47		47	45	45
Brian Larcombe	47			47		47	45	45
Former Directors:								
Dudley G. Eustace (v)	83			83		83	251	251
Peter Hooley (vi)	295	8	119	422	43	465	484	596
Total	2,430	139	937	3,506	180	3,686	1,950	2,112

(i) Benefits shown in the table above include cash allowances and benefits in kind.
(ii) Appointed Chairman on 27 April 2006.
(iii) Appointed Chief Operating Officer on 8 February 2006. Benefits include £88,000 for tax equalisation purposes.
(iv) Appointed Chief Financial Officer on 15 June 2006.
(v) Retired 27 April 2006.
(vi) Retired 30 June 2006. Peter Hooley has acted in a consultancy capacity to the Group from 30 June 2006 to 31 December 2006 at a fee of £75,000. This is included in the table above.

Christopher O Donnell s salaries and fees includes £163,000 relating to a salary supplement as in April 2006 he opted out of the defined benefit pension plan for future service and elected to receive a non-pensionable, non-bonusable salary supplement. Adrian Hennah s salaries and fees include £74,000 as he elected to receive a non-pensionable, non-bonusable salary supplement rather than join the defined contribution salary pension scheme. Peter Hooley s salaries and fees include a salary supplement of £22,000.

(a) Pensions

	Accrued pension as at 1 Jan 2006	Increase in accrued pension excluding inflation	Accrued pension at 31 Dec 2006	Transfer value of accrued pension at 1 Jan 2006	Directors contributions during 2006	Increase in transfer value over year less directors contributions	Transfer value of accrued pension at 31 Dec 2006
		(£ per annum)		(£)	(£)	(£)	(£)
Sir Christopher O Donnell	295,000	19,000	322,000	4,653,000	8,000	1,705,000	6,366,000
David J. Illingworth	1,700		1,700	5,000		1,000	6,000
Former Director:							
Peter Hooley (retired)	39,000	6,000	45,000	649,000	37,000	444,000	1,096,000

An amount of £37,000 (2005 £108,000) was provided under the supplementary unfunded defined contribution arrangement for Peter Hooley, bringing his total taxable benefit under the plan to £639,000 (2005 £602,000). An amount of £110,000 was provided under the US defined contribution arrangements for David J. Illingworth bringing his total benefit under the plan to £446,000. The increase in the transfer values are as a result of a change in the underlying factors to reflect current market conditions, particularly allowing for the impact of increased longevity and lower gilt rates, the unwinding of the previous year s salary increase within the definition of final pensionable salary and the increase in pension as a result of the salary increase granted during the year.

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

(b) Directors Share Options

	Option type	Options 1 Jan 2006 or on appointment	Granted during 2006	Exercised	Lapsed	Options 31 Dec 2006	Average exercise price	Range of exercisable dates of options held at 31 Dec 2006
		(Number)	(Number)	(Number)	(Number)	(Number)	(p)	(Date)
Sir Christopher O Donnell	Exec (1)	121,951	134,046			255,997	523.0	05/07-03/16
	Exec (1)	113,140				113,140	574.5	05/07-05/14
	SAYE (2)		2,715			2,715	348.0	11/09-04/10
	LTIP (3)	457,753	90,516(4)			548,269		07/03-03/13
Total		692,844	227,277			920,121		
David J. Illingworth	Exec (1)	144,791	174,784			319,575	470.0	03/03-03/16
	Exec (1)	44,940				44,940	574.5	05/07-05/14
Total		189,731	174,784			364,515		
Adrian Hennah	Exec (1)		103,686			103,686	434.0	06/09-06/16
Total			103,686			103,686		
Former Director:								
Peter Hooley	Exec (1)	64,727	71,984(7)		(89,551)(6)	47,160	528.0	05/07-03/16
	Exec (1)	60,050			(10,009)(6)	50,041	574.5	05/07-05/14
	SAYE (2)	2,404		(1,363)	(1,041)			
	LTIP (3)	282,965	75,953(5)	(358,918)				
Total		410,146	147,937	(360,281)	(100,601)	97,201		

(1) Options granted under Executive Share Option Plans. In 2004 options were granted at an exercise price of 574.5p which was higher than the share price at 31 December 2006.
(2) Options granted under the UK ShareSave schemes with an exercise price of 394p. The market price on Peter Hooley s date of exercise was 486p. 1,041 of Peter Hooley s Sharesave options lapsed during the year due to retirement.
(3) Nil cost options acquired through vesting of LTIP awards. The market price on Peter Hooley s date of exercise was 488p.
(4) Comprises vesting of 2003 LTIP award at 49% (68,408 shares) and award of 22,108 anniversary bonus shares.
(5) Comprises vesting of 2003 LTIP award at 49% (38,744 shares) and award of 37,209 anniversary bonus shares.
(6) 99,560 options lapsed during the year due to retirement.
(7) Options granted to Peter Hooley in the year were granted prior to his retirement.

The range in the market price of the Company s Ordinary Shares during the year was 400p to 571p and the market price at 31 December 2006 was 533p. The total profit on exercise of options during the year was £1,752,774 consisting of £1,254 from the exercise of Peter Hooley s SAYE options and £1,751,520 from Peter Hooley s exercise of nil cost options under the 1997 LTIP (2005 £1,492,440: Sir Christopher O Donnell £6,767 and Peter Hooley £1,485,673).

100,000 options granted during 2006 to David J. Illingworth under the 2001 US Share Plan lapsed on 8 February 2007 as performance criteria were not met. 25,570 options granted to Sir Christopher O Donnell in 2004 under the 2004 Executive Share Option Plan also lapsed as 77.4% of the grant vested in accordance with performance criterion. 10,157 options granted to David J. Illingworth in 2004 under the 2004 Executive Share Option Plan also lapsed.

Remuneration Report

(c) Long-Term Incentive Plan Awards

	Award type	Maximum number of shares awarded at 1 Jan 2006 or date appointed	Awards during the year	Market price on award date	Vested Award [1]	Lapsed award	Number of shares awarded at 31 Dec 2006	Latest performance
		(Number)	(Number)	(p)	(Number)	(Number)	(Number)	(Year ending)
Sir Christopher O Donnell	LTIP(1)	139,609			(68,408)	(71,201)		
	PSP(2)	235,090	134,046	514			369,136	2008
Total		374,699	134,046		(68,408)	(71,201)	369,136	
David J. Illingworth	LTIP(1)	48,371			(23,701)	(24,670)		
	PSP(2)	67,090	74,350	514			141,440	2008
	RSA(3)		96,710	533			96,710	2008
Total		115,461	171,060		(23,701)	(24,670)	238,150	
Adrian Hennah	RSA(3)		57,603	434			57,603	2009(6)
	PSP(2)		103,686	434			103,686	2008
Total			161,289				161,289	
Former Director:								
Peter Hooley (retired 30.06.06)	LTIP(1)	79,070			(38,744)	(40,326)		
	PSP(2)	124,776	71,984	514		(102,362)(4)	94,398	2008
	LTIP		20,830(5)		(20,830)			
Total		203,846	92,814		(59,574)	(142,688)	94,398	

(1) Awards under previous Long-Term Incentive Plan. The market price at the date the awards were made in 2003 under the previous Long-Term Incentive Plan was 361.3p. These awards vested at 49%. At the date of vesting the market price was 507p. For UK executives the vested award may be taken in the form of nil cost options exercisable up to 7 years thereafter.
(2) Awards under 2004 Performance Share Plan. Subject to attainment of performance conditions, a further 50% of the award may vest.
(3) Award of restricted stock. No performance conditions but subject to remaining with the Group for specified period.
(4) Awards over 102,362 shares lapsed during the year due to retirement.
(5)

Receipt of shares from re-investment of cash dividends under previous Long-Term Incentive Plan. At the date of vesting the market price was 488p.

(6) No performance conditions but subject to remaining with the Group until 15 June 2009.

Adrian Hennah, who was appointed to the Board in June 2006 was awarded 57,603 shares related to his appointment. This award will vest if he remains in continuous employment until the third anniversary of his appointment. David J. Illingworth was awarded 96,710 shares in December 2006. One half of these awards will vest if he remains in continuous employment until 31 December 2007 and the remaining will vest if he remains in continuous employment until 31 December 2008.

Awards over 113,140 shares made in 2004 for Sir Christopher O Donnell under the 2004 Performance Share Plan lapsed on 8 February 2007 as the performance criteria were not met. Awards over 33,700 shares made in 2004 to David J. Illingworth under the 2004 Performance Share Plan also lapsed.

(d) Co-investment Plan Awards

The number of matched shares to be allocated to each Executive Director is subject to the growth in EPSA over a three-year period. Details of the Plan can be found on pages 63 and 64.

	Total matched Award as at 1 Jan 2006 or date appointed	Shares acquired with net bonus in March 2006	Matched Share award during year	Lapsed award	Total Matched Share award at 1 x gross bonus held at 31 Dec 2006 (ii)
Sir Christopher O Donnell	46,339	10,795	18,498		64,837
David J Illingworth	17,410	7,040	11,850		29,260
Adrian Hennah					
Former Director:					
Peter Hooley (retired 30 June 2006)	24,594			(8,356)(i)	16,238

(i) Awards over 8,356 shares lapsed during the year due to retirement
(ii) Dependent upon EPSA performance. One for one matching could increase to two for one matching.

Awards over 22,286 shares to Sir Christopher O Donnell made in 2004 under the 2004 Co-investment Plan will vest on the third anniversary of their date of award (16 June 2007) at 2 x gross bonus as performance conditions were met. Awards over 8,520 shares to David J. Illingworth made in 2004 under the 2004 Co-investment Plan will also vest at 2 x gross bonus.

Senior Management Remuneration

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

In respect of the financial year 2006 the total compensation (excluding pension emoluments but including payments under the performance related bonus plans) paid to the senior management for the year was £6,427,000, the aggregate increase in accrued pension benefits was £93,000 and the aggregate amounts provided for under the supplementary schemes was £304,000.

During 2006 senior management were granted options over 1,012,526 shares and 193,800 restricted stock awards under the Executive Share Option Plans, over 5,430 shares under the employee ShareSave schemes and awarded 452,416 shares and 34,162 ADSs under the 2004 Performance Share Plan and 40,596 shares and 3,487 ADSs under the Co-investment Plan. As of 15 March 2007 the senior management (11 persons) owned 407,835 shares and 12,004 ADSs, constituting less than 1% of the issued share capital of the Company. Senior Management also held, as of this date, options to purchase 1,684,950 shares; 193,800 restricted stock awards and 596,580 shares and 48,788 ADSs awarded under the Performance Share Plan and 142,622 shares and 5,068 ADSs under the Co-investment Plan.

Remuneration Report

Directors Interests

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

	15 March 2007 (i)		31 December 2006		1 January 2006 or date appointed	
	Shares (ii)	Options	Shares (ii)	Options	Shares (ii)	Options
			(Number)			
John Buchanan	60,351		60,351		20,000	
Sir Christopher O Donnell	209,881	894,551	209,881	920,121	197,031	692,844
Sir Christopher O Donnell	50,000(iii)		50,000			
David Illingworth	31,855	304,358	31,855	364,515	21,210	189,731
Adrian Hennah		103,686		103,686		
Brian Larcombe	5,000		5,000		5,000	
Dr. Pamela J. Kirby	8,500		8,500		8,500	
Dr. Rolf W. H. Stomberg	13,092		13,092		13,092	
Warren D. Knowlton	59,501		54,001		27,001	
Richard De Schutter	250,000		250,000		250,000	
Former Directors:						
Dudley G. Eustace (iv)	67,023		67,023		66,109	
Peter Hooley (v)	30,173	97,201	246,726	97,201	227,340	410,146

(i) The latest practicable date for this Annual Report.
(ii) Holdings of the directors together represent less than 1% of the Ordinary Share Capital of the Company.
(iii) Following the redenomination of Ordinary Shares into US Dollars, on 23 January 2006, Sir Christopher O Donnell was issued with 50,000 £1 Deferred shares. These shares are not listed on any Stock Exchange and have extremely limited rights attached to them.
(iv) Retired 27 April 2006.
(v) Retired 30 June 2006.

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

Total Shareholder Return

Schedule 7A to the Companies Act 1985 requires a graph to be published showing the Company s TSR against the TSR performance of a broad equity market index. As a component company of the FTSE 100 index, a graph of the Company s TSR performance compared to that of the TSR of the FTSE 100 index is shown below:

By order of the Board, 20 March 2007:

Paul Chambers

Secretary

Group Accounts

ACCOUNTS

DIRECTORS RESPONSIBILITIES FOR THE ACCOUNTS

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

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

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

Under United Kingdom law the directors have elected to prepare the Parent company accounts in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), which are required by law to give a true and fair view of the state of affairs of the Parent company and of the profit or loss of the Parent company for that period. In preparing the Parent company accounts, the directors are required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts; and
- Prepare the accounts on a going concern basis unless it is inappropriate to presume that the company will continue in business.

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

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and the Parent company and enable them to ensure that the accounts comply with the Companies Act 1985 and, in the case of the Group accounts, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group and the Parent company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group s website. It should be noted that information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

Group Accounts

INDEPENDENT AUDITORS UK REPORT

Independent Auditors Report to the Shareholders of Smith & Nephew plc

We have audited the Group accounts of Smith & Nephew plc for the year ended 31 December 2006 which comprise the Group income statement, the Group balance sheet, the Group cash flow statement, the Group Statement of recognised income and expense, and the related Notes 1 to 40. These Group accounts have been prepared under the accounting policies set out therein.

We have reported separately on the Parent company accounts of Smith & Nephew plc for the year ended 31 December 2006 and on the information in the Remuneration Report that is described as having been audited.

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

Respective responsibilities of directors and auditors

The directors responsibilities for preparing the annual report and the Group accounts in accordance with applicable United Kingdom law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Directors Responsibilities for the Accounts.

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

We report to you our opinion as to whether the Group accounts give a true and fair view, the Group accounts have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation and whether the information given in the directors report is consistent with the Group accounts. The information given in the Directors report includes that specific information presented in the Introduction and Financial Summary that is cross referred from the Operating and Financial Review Section of the Directors Report.

We also report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Group s compliance with the nine provisions of the 2003 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board s statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group s corporate governance procedures or its risk and control procedures.

We read other information contained in the annual report and consider whether it is consistent with the audited Group accounts. The other information comprises only the Financial Summary , the Description of the Group , the Operating and Financial Review, Liquidity and Prospects , the Corporate Governance Statement and the unaudited part of the Remuneration Report . We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group accounts. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Group accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Group accounts, and of whether the accounting policies are appropriate to the Group s circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Group accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Group accounts.

Opinion

In our opinion the Group accounts:

give a true and fair view in accordance with IFRSs as adopted by the European Union of the state of the Group s affairs as at 31 December 2006 and of its profit for the year then ended;

the Group accounts have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and

the information given in the directors report is consistent with the Group accounts.

Ernst & Young LLP

Registered auditor

London, England

20 March 2007

Group Accounts

INDEPENDENT AUDITORS US REPORTS

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

We have audited the accompanying Group balance sheets of Smith & Nephew plc as of 31 December 2006 and 2005, and the related Group income statements, Group statements of recognised income and expense and Group cash flow statements for each of the three years in the period ended 31 December 2006. These accounts are the responsibility of the Company s management. Our responsibility is to express an opinion on these accounts based on our audits.

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

In our opinion, the accounts referred to above present fairly, in all material respects, the consolidated financial position of Smith & Nephew plc at 31 December 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended 31 December 2006, in conformity with International Financial Reporting Standards adopted by the European Union which differ in certain respects from United States generally accepted accounting principles (see Note 40 of the Notes to the Group Accounts).

As discussed in Note 25 and Note 40, the accounts for each of the two years in the period ended 31 December 2005 have been restated.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Smith & Nephew plc s internal control over financial reporting as of 31 December 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated 20 March 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

London, England

20 March 2007

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

We have audited management s assessment, included in the accompanying, managements report on internal control over financial reporting on page 57 that Smith & Nephew plc maintained effective internal control over financial reporting as of 31 December 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Smith & Nephew plc s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, management s assessment that Smith & Nephew plc maintained effective internal control over financial reporting as of 31 December 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Smith & Nephew plc maintained, in all material respects, effective internal control over financial reporting as of 31 December 2006, based on the COSO criteria**.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Group balance sheets of Smith & Nephew plc as of 31 December 2006 and 2005, and the related Group income statements, Group statements of recognised income and expense and Group cash flow statements for each of the three years in the period ended 31 December 2006 and our report dated 20 March 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

London, England

20 March 2007

Group Accounts

GROUP INCOME STATEMENT

	Years ended 31 December		
	2006	2005 (i) (ii)	2004 (i) (ii)
	($ million, except per Ordinary Share amounts)		
Revenue (Note 3)	2,779	2,552	2,301
Trading profit (Note 3)	571	517	452
Bid related costs (Note 5)	(20)		
Restructuring and rationalisation expenses (Note 5)		(84)	
Macrotextured claim (Note 6)			(154)
Amortisation of acquisition intangibles (Note 13)	(14)	(11)	(8)
Operating profit (Notes 3 and 4)	537	422	290
Interest receivable (Note 7)	19	27	31
Interest payable (Note 7)	(9)	(18)	(24)
Other finance income/(costs) (Note 8)	6	(5)	(3)
(Loss)/gain on hedge of the sale proceeds of the joint venture (Note 8)	(3)	2	
Profit before taxation	550	428	294
Taxation (Note 9)	(156)	(126)	(77)
Profit from continuing operations	394	302	217
Discontinued operations:			
Share of results of the joint venture (Note 15)		31	28
Net profit on disposal of the joint venture (Note 15)	351		
Profit from discontinued operations	351	31	28
Attributable profit for the year (iii) (iv)	745	333	245
Earnings per Ordinary Share (Note 11)			
Including discontinued operations:			
Basic	79.2¢	35.5¢	26.2¢
Diluted	78.9¢	35.3¢	26.0¢
Continuing operations:			
Basic	41.9¢	32.2¢	23.2¢
Diluted	41.7¢	32.0¢	23.1¢
Discontinued operations:			
Basic	37.3¢	3.3¢	3.0¢
Diluted	37.2¢	3.3¢	2.9¢

(i) As restated for the change in reporting currency from Sterling to US Dollars on 1 January 2006 see Note 1 of the Notes to the Group Accounts.

(ii) As restated see Note 25 of the Notes to the Group Accounts.

(iii) A summary of the adjustments to attributable profit for the year that would be required had accounting principles generally accepted in the US been applied rather than IFRS as adopted by the EU is set out in Note 40 of the Notes to the Group Accounts.

(iv) All attributable profit is attributable to equity holders of the Parent Company.

GROUP BALANCE SHEET

	At 31 December	
	2006	2005 (i) (ii)
	($ million)	
ASSETS		
Non-current assets:		
Property, plant and equipment (Note 12)	635	589
Intangible assets (Note 13)	831	673
Investments (Note 14)	10	10
Deferred tax assets (Note 23)	110	148
	1,586	1,420
Current assets:		
Inventories (Note 17)	619	557
Trade and other receivables (Note 18)	680	620
Current asset derivatives (Note 19)		10
Cash and bank (Note 19)	346	151
	1,645	1,338
Held for sale Investment in joint venture (Note 15)		218
TOTAL ASSETS	3,231	2,976
EQUITY AND LIABILITIES		
Equity attributable to equity holders of the parent:		
Called up equity share capital (Note 24)	189	203
Share premium account (Note 25)	329	299
Own shares (Note 27)	(1)	(4)
Other reserves (Note 25)	63	22
Accumulated profits (Note 25)	1,594	915
Total equity (iii)	2,174	1,435
Non-current liabilities:		
Long-term borrowings (Note 19)	15	211
Retirement benefit obligation (Note 33)	154	206
Other payables due after one year (Note 21)	3	16
Provisions due after one year (Note 22)	34	48
Deferred tax liabilities (Note 23)	35	48
	241	529
Current liabilities:		
Bank overdrafts and loans due within one year (Note 19)	119	227
Trade and other payables (Note 21)	419	452
Provisions due within one year (Note 22)	49	91
Current liability derivatives (Note 19)	2	29
Current tax payable	227	213

	816	1,012
Total liabilities	1,057	1,541
TOTAL EQUITY AND LIABILITIES	3,231	2,976

The accounts were approved by the Board and authorised for issue on 20 March 2007 and are signed on its behalf by:

John Buchanan Chairman **Christopher O Donnell** Chief Executive **Adrian Hennah** Chief Financial Officer

(i) As restated for the change in reporting currency from Sterling to US Dollars on 1 January 2006 see Note 1 of the Notes to the Group Accounts.

(ii) As restated see Note 25 of the Notes to the Group Accounts.

(iii) A summary of the adjustments to equity that would be required had accounting principles generally accepted in the US been applied rather than IFRS as adopted by the EU is set out in Note 40 of the Notes to the Group Accounts.

Group Accounts

GROUP CASH FLOW STATEMENT

	Years ended 31 December		
	2006	2005 (i)(ii)	2004 (i)(ii)
		($ million)	
Net cash inflow from operating activities			
Profit before taxation	550	428	294
Less: Net interest receivable	(10)	(9)	(7)
Depreciation, amortisation and impairment	166	177	128
Loss on sale of property, plant and equipment	3	3	5
Share based payment expense	14	13	11
Increase in inventories	(37)	(77)	(102)
Increase in trade and other receivables	(30)	(52)	(75)
(Decrease)/increase in trade and other payables and provisions (iii)	(150)	(111)	161
Cash generated from operations (iv)	506	372	415
Interest received	19	27	31
Interest paid	(9)	(18)	(24)
Income taxes paid	(144)	(112)	(70)
Net cash inflow from operating activities	372	269	352
Cash flows from investing activities			
Acquisitions	(85)	(25)	(67)
Cash acquired with acquisitions	2		3
Disposal of the joint venture	537		
Dividends received from the joint venture		25	26
Capital expenditure	(231)	(202)	(187)
Disposal of property, plant and equipment	9	2	2
Net cash provided by/(used in) investing activities (v)	232		