SMITH & NEPHEW PLC
Form 20-F
March 27, 2008
Table of Contents

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, 2007

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: 947,507,881 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 basis of accounting the registrant has used to prepare the financial statements included in this filing.

¨ U.S. GAAP x International Financial Reports Standards as issued by the International Accounting Standards Board
¨ Other

If Other has been checked to the previous question indicate by check mark which financial statement item the registrant has elected to follow:
Item 17 ¨ Item 18 ¨

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

Table of Contents

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 with revenue of over $3.3 billion in 2007. Smith & Nephew plc is the parent company of the Smith & Nephew Group. It is an English public limited company with its shares listed on the official list of the UK Listing Authority and it is traded on the London Stock Exchange and on the New York Stock Exchange in the form of American Depositary Shares (ADSs).

This report is the Annual Report of Smith & Nephew plc for the year ended 31 December 2007. 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 2007, intended for the investor not requiring the full detail of the Annual Report is available on Smith & Nephew s corporate website at www.smith-nephew.com/investors along with the electronic version of this Annual Report. The Summary Financial Statement includes a summary remuneration report and summary financial statements.

The Group s fiscal year 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 160. 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 Principle (non-GAAP) measure. The principal key performance indicators presented in the Annual Report are:

Underlying growth in revenue

Underlying growth in revenue is a non-GAAP financial measure which is a key performance indicator used by the Group s management in order to compare the revenue in a given year to that of the previous year on a like-for-like basis. This is 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. 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

Table of Contents

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

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

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

The Group has identified the following items, where material, as those to be adjusted and identified separately: acquisition and disposal related items including amortisation of acquisition intangible assets; significant restructuring events; gains and losses arising from legal disputes and uninsured losses; and taxation thereon. A reconciliation of attributable profit to adjusted attributable profit, which represents the numerator used in the EPSA calculation, is presented in Selected Financial Data on page 151. An explanation of how trading profit is calculated is presented in Business Overview on page 29.

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

Presentation

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

The Group Accounts of Smith & Nephew in this Annual Report are presented in US Dollars. Solely for the convenience of the reader, certain parts of this Annual Report contain translations of amounts in US Dollars into Sterling at specified rates. These translations should not be construed as representations that the US Dollar amounts actually represent such Sterling amounts or could be converted into Sterling at the rate indicated. Except as where stated otherwise, the translation of US Dollars and cents to Sterling and pence appearing in this Annual Report has been made at the noon buying rate in The City of New York for cable transfers in Sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) on the date indicated. On 12 March 2008, the Noon Buying Rate was US$2.02 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.

Table of Contents

Financial Summary

Financial Highlights

	2007 $ million	2006 $ million
Revenue	3,369	2,779
Trading profit	706	571
Operating profit	493	537
Attributable profit for the year	316	745
Adjusted attributable profit	480	425
Basic earnings per Ordinary Share	34.2¢	79.2¢
EPSA	52.0¢	45.2¢
Dividends per Ordinary Share (i)	11.89¢	10.81¢

(i) The Board has declared a second interim dividend of 7.38¢ per share which together with the first interim dividend of 4.51¢, makes a total for 2007 of 11.89¢. The second interim dividend will be paid on 9 May 2008 to shareholders on the register at the close of business on 18 April 2008.

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 , target , well-placed and similar expressions are generally intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors (including, but not limited to, the outcome of litigation and regulatory approvals) that could cause the actual results, performance or achievements of Smith & Nephew, or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Specific risks faced by the Group are described under Risk Factors on page 22 of this Annual Report.

All forward-looking statements in this Annual Report are based on information available to Smith & Nephew as of 18 March 2008. 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 website 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.

Table of Contents

[THIS PAGE INTENTIONALLY LEFT BLANK]

Table of Contents

CONTENTS

This Annual Report including the Report of the Directors was approved by the Board of Directors on 18 March 2008.

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

Table of Contents

[THIS PAGE INTENTIONALLY LEFT BLANK]

Table of Contents

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 60).

The Remuneration Report gives details of the Group s policies on senior management s remuneration in 2007 (pages 61 to 72).

Discussion of the Group s operating and financial performance, liquidity and financial resources for 2007 and 2006 is given in the Operating and Financial Review, Liquidity and Prospects (pages 27 to 50).

Details of the structure of the Company s share capital and securities, persons with significant shareholdings in the Company and a summary of the Memorandum and Articles of association are incorporated into the Directors Report and are given in Investor Information (pages 143 to 163).

Table of Contents

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 152 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 27 September 2007, a settlement was reached in respect of the subpoena issued by the US Attorney for the District of New Jersey s office to the Group s orthopaedic business in 2005. The Group and the other four competitors involved settled the criminal and civil matters with respect to any charges against the companies that could result from this investigation. The Group paid a civil restitution payment of $29m and legal costs of $1m. It also entered into a Deferred Prosecution Agreement which obligates it to improve its existing compliance system and a Corporate Integrity Agreement which also requires certain compliance efforts. See Legal Proceedings (pages 47 to 48).

In July 2007, David J. Illingworth was appointed Chief Executive Officer, replacing Sir Christopher O Donnell who retired from the Board.

On 31 May 2007 the Group completed the purchase of Plus Orthopedics Holding AG (Plus) a private Swiss orthopaedic company for a total of CHF 1,091m ($889m) in cash, including assumed debt. The acquisition was financed by bank borrowings and is being integrated into the Group s reconstruction and trauma and clinical therapies businesses. The acquisition of Plus increases the Group s share of the global orthopaedics market, making it the fourth largest global orthopaedics reconstruction company.

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

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

- in cost of goods by increased use of lower-cost locations, mainly in Asia, and savings in procurement by taking advantage of opportunities on a Group wide basis;

- in a number of administration functions by centralising, where appropriate, functions formerly run separately by each business, for example, Information Systems and Human Resources;

- in marketing by exploring opportunities to rationalise the Group s product portfolio; and

- in sales functions by optimising the structure, deployment and efficiency of sales forces and sales channels.

Table of Contents

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

In February 2007 the Group commenced a share buy back programme of up to $1.5 billion over an initial two years. This followed an assessment of the medium term capital needs of the Group both internally and for acquisitions whereby management determined that shareholder value and balance sheet efficiency would be enhanced by returning capital to shareholders. In February 2008 the Board reviewed the programme in the light of current market conditions and opportunities, and in order to preserve flexibility the Board currently expects to complete the programme over a total of three years. During 2007, 52 million shares were purchased at a total cost of $640m.

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 cooperating fully with the United States Attorney. 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 was classified as Discontinued Operations in accordance with IFRS.

BUSINESS DESCRIPTION

Organisation

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

Smith & Nephew is currently organised into four global business units of reconstruction, trauma and clinical therapies, endoscopy and advanced wound management. The Group also has a separate emerging markets unit. In 21 of the 32 countries in which the Group operates, the global business units take responsibility for strategy, research and development (R&D), manufacturing, marketing, sales and financial performance. These countries are referred to as direct markets. The remaining 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 emerging markets unit.

A head office team in London, England directs the overall business and supports the business units, primarily in the areas of business development, company secretarial, finance, human resources and investor relations, with a legal department headquartered 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 smaller facilities in Aarau, Switzerland, in Tuttlingen, Germany and in Warwick, UK.

Table of Contents

In May 2007, the acquisition of Plus was completed. The rationale behind this acquisition was:

- to increase Smith & Nephew s share of the global orthopaedic reconstruction market to around 12%, taking Smith & Nephew to fourth position in terms of global market share;
- to double Smith & Nephew s share of the European orthopaedic reconstruction market;
- to enhance the product portfolio by adding a highly complementary product range; and
- to generate a range of synergy opportunities including the leverage of the combined sales force in Europe and Asia, cost saving opportunities from increased manufacturing leverage and capacity utilisation and better use of the combined marketing and sales infrastructure.

Following the acquisition of Plus, the reconstruction business has consolidated its European head office operations in Rotkreuz, Switzerland.

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 2007 the global sales force numbers 1,170 of whom 601 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. For example, in the US patients aged 64 and under represent 41% of the primary hip and knee replacement market and management believes this sector is growing at twice the overall market rate. Recent product launches such as JOURNEY, LEGION and the BIRMINGHAM HIP Resurfacing System (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 and marketing presence and by introducing new implants. 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.

2007 represented the first full year of sales in the US for BHR. BHR maintained its market leading position despite the introduction of the first competitive hip resurfacing product. In the fourth quarter, the Group announced the release of the Australian Orthopaedic Association National Joint Replacement Registry. Management believes this information is extremely useful to compare un-biased clinical results of various hip resurfacing prostheses and highlights the continuing clinical performance of BHR.

With the acquisition of Plus, the business decided to enhance the Group s activities in the field of shoulder replacement. A strategy was developed during the year and is in the process of being finalised.

It is the strategy of the Group to develop Computer Assisted Solutions (CAS) that provide value to the surgeon by:

improving implant outcomes through placement accuracy and reproducibility;

increasing operating room efficiencies by decreasing operative time, cost, instruments, and surgical outcomes; and

providing the surgeon with tools to market their practice to the patient to maximise sales of the current implant portfolio.

The acquisition of Plus gives the Group access to the Gallileo Navigation/CAS system.

New Products

In 2007, the reconstruction business launched the JOURNEY DEUCE Bi-compartmental, bi-cruciate retaining knee system. The launch covered the US, Canada, Australia and Europe. The JOURNEY DEUCE is part of a family of next generation products that aim to restore natural motion through implants that preserve bone and ligaments or replace them with more anatomic components. Through an active medical education program, over 300 surgeons have been trained on this new technology in 2007.

Table of Contents

Recent Regulatory Approvals

During the third quarter of 2007, the FDA approved the GENESIS II, JOURNEY (BCS), and the LEGION Revision Systems for gender specific applications. This approval has enabled Smith & Nephew to position the Company s core knee systems as individual solutions in the female segment of the orthopaedic market place.

Competition

Management estimates that the worldwide reconstruction market served by the Group grew by approximately 9% in 2007 and is currently worth more than $10.5 billion per annum. Management believes that Smith & Nephew holds a 12.5% share of this market by value.

Principal global competitors in the orthopaedic reconstruction market and their estimated 2007 global shares, are Zimmer (27%), Stryker (20%), DePuy/Johnson & Johnson (21%) and Biomet (11%).

Trauma and Clinical Therapies

Overview

Trauma and clinical therapies products comprise both trauma fixation products and associated clinical therapies. Trauma fixation products consist of internal and external devices and orthobiological materials used in the stabilisation of severe fractures and deformity correction procedures. Clinical therapies products are those that are applied in an orthopaedic office or clinic setting and also include bone growth stimulation, joint fluid therapies and outpatient spine products.

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

Within the trauma fixation business, internal fixation products, such as the TRIGEN INTERTAN Intertrochanteric Nail, the PERI-LOC upper and lower locked plating systems 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.

The EXOGEN line of ultrasonic bone healing stimulators, DUROLANE and SUPARTZ hyaluronic acid joint fluid therapies, and outpatient spine products, are the main products in the clinical therapies sector. EXOGEN captured the number one market share position for long bone stimulation in August 2007. EXOGEN is an ultrasound technology approved to treat fractures that have failed to heal (known as non-unions) and in some cases prescribed to help specific fresh fractures heal faster. DUROLANE is a single injection therapy used to treat osteoarthritis of the knee and hip (currently only approved in Europe and Canada), and is manufactured by Q-MED AB of Sweden. SUPARTZ is an injection therapy used to treat osteoarthritis of the knee, and is manufactured by Seikagaku Corporation of Japan.

Smith & Nephew began to integrate Plus into its overall worldwide business during 2007. The Plus Gliding Nail and IP-XS trauma products were added to the Group s European business. The Plus biologics business was also integrated. This consists of Lifetek LLC, a subsidiary, and a supply agreement with Regeneration Technologies Inc., both of which supply human tissue for orthopaedic bone and ligament surgery procedures for tissue deficiencies. The Plus spine business consists of internal spinal fixation products sold in certain European countries. A majority of the products are sourced through a distribution agreement with a third party. Smith & Nephew plans to continue to maintain this spinal fixation business and will evaluate opportunities for future growth in this market segment.

To compete effectively in the growing global orthopaedic trauma and clinical therapies market, management believes in a strategy encompassing an innovative world class product range and a skilled sales force that builds strong relationships with surgeons and physicians to provide exceptional customer service. At the end of 2007, the global trauma fixation sales force numbers 456 of whom 211 serve the US market. The clinical therapies sales force numbers 347 of whom 313 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

Table of Contents

markets will continue to grow for the foreseeable future. This is largely attributable to a global population increasingly at risk from fractures due to age, osteoporosis, obesity and diabetes and also continuous advancements in the surgical treatment of fractures and the need to manage pain in younger, more active patients.

Smith & Nephew 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.

In January 2007, trauma and clinical therapies took over the outpatient spine business and its product line from the Endoscopy business unit. Management believes that a focused sales force coupled with existing physician contacts and reimbursement knowledge should allow this product line to flourish under clinical therapies. Additionally, the business transfer allows the trauma business to develop a strong platform for future minimally-invasive spine therapies. In May 2007, trauma and clinical therapies expanded their non-invasive spine business by entering into an agreement with Teknimed SA to distribute market and sell Teknimed s SPINE FIX product in North America, Europe and Australia. SPINE FIX is a ready to use, self-hardening bone cement that is injected into the vertebra through a minimally invasive procedure that treats painful compression fractures in the spine often caused by osteoporosis.

New Products

Several significant product innovations were launched in 2007. The polyaxial locking mechanism of the PERI-LOC Variable-Angle Locked Plating System (VLP) allows the angles at which locking screws can be inserted and locked into any of the low profile plates to be adjusted for optimal intraoperative versatility. PERI-LOC VLP specifically targets partial articular fractures in areas of the body where implant prominence and soft-tissue irritation are major concerns. Additionally, the PERI-LOC Periarticular Reduction Forceps Set provides a variety of soft-tissue sparing instruments for percutaneous reduction of fractures prior to definitive fixation.

The Large Cannulated Screw System (6.5mm, 7.0mm, and 8.0mm) offers new implants and enhanced instrumentation for percutaneous and/or open fracture fixation using cannulated screws. The TRIGEN META-NAIL Blocking Screw Instruments allow precision placement of blocking screws during intramedullary nail procedures to assist with fracture reduction, nail insertion, and postoperative implant stability. The TRIGEN Percutaneous Intertrochanteric/Femoral Antegrade Nail Instruments facilitate minimally invasive antegrade femoral nailing procedures and optimise intraoperative efficiency by combining all proximal locking options into a single intuitive radiolucent drill guide drop.

In 2007, the CAPTION Platelet Rich Concentrate (PRC) System was also launched. This is a biologic product that is a fully disposable, easy-to-use process for concentrating platelets from a patient s own blood. Platelets naturally release growth factors that stimulate the healing cascade. The PRC System s kit includes all components needed to collect and process the blood, and then transfer the PRC to the sterile field.

Recent Regulatory Approvals

In 2007, US approvals were obtained for three supplements related to the EXOGEN Bone Healing System: new Main Operating Unit, housing vendor; miscellaneous circuitry changes; and Lean Manufacturing processing. Additionally, three 510(k) clearances

were obtained: CAPTION Applicator; PERI-LOC VLP Plating System; and Proximal Femoral Plating System & Cable Accessories.

Competition

Management estimates that the worldwide orthopaedic fixation market increased by 10% in 2007 and is currently worth more than $3.2 billion per annum. Management believes that Smith & Nephew holds approximately 12% share of this market by value.

Management estimates that the worldwide market for clinical therapies increased by 7% in 2007 and is currently worth more than $1.5 billion per annum. Management believes that Smith & Nephew holds approximately 14% share of this market by value.

Principal global competitors in the orthopaedic fixation market and their estimated 2007 global shares, are Synthes (47%), Stryker (17%), DePuy/Johnson & Johnson (8%), Zimmer (6%) and Biomet (2%).

Table of Contents

Endoscopy

Overview

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

The endoscopy business offers surgeons endoscopic technologies for surgery, including: specialised devices, 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 Mansfield, Massachusetts, Oklahoma City, Oklahoma and San Antonio, Texas. A manufacturing facility in Andover, Massachusetts was closed 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 2007 was 703 of which 363 serve the US market.

Strategy

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

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

New Products

In 2007, Smith & Nephew expanded its portfolio of shoulder repair products with the launch of the KINSA RC Suture Anchor, designed to repair tears to the rotator cuff. This is the second product in the Group s family of KINSA anchors. The original, for treatment of instability, was released in 2006. Both anchors encase a sliding, self-locking knot that permits the surgeon to secure the repair without tying knots.

Smith & Nephew s 560 Series High Definition Camera System, launched in 2007, is capable of capturing and displaying broadcast-quality HD images in arthroscopic and other minimally invasive surgeries, and is one of the first end-to-end HD surgical visualisation systems available globally. The 560 Series is designed to maintain high-definition resolution through the entire image chain, from the video arthroscope or laparoscope, through the camera head and control unit, to the monitor, resulting in clearer, more detailed surgical images.

Smith & Nephew further enhanced its position in the arthroscopic hip repair market with the launch of the Lateral Hip Positioning System, which enables a surgeon to easily access and treat the hip joint with the patient positioned on his or her side.

The business also redesigned and expanded its family of CLEAR-TRAC disposable cannulas, which provide a sterile pathway through which surgeons insert instruments during minimally invasive procedures. The new CLEAR-TRAC cannulas are designed with a new triple seal system that reduces fluid leakage and helps surgeons manage sutures during arthroscopic surgery. The flexible device features a flexible plastic shaft which provides surgeons with a better feel for changes in tissue density as it is inserted into the body.

Recent Regulatory Approvals

During 2007, the endoscopy business obtained regulatory clearances for the following products in most major markets, except Japan where the approval process is more lengthy: KINSA anchor for shoulder rotator cuff repair; Ultra FAST-FIX, adding high strength ULTRABRAID suture to the FAST-FIX meniscal repair device; TRUFIT BGS, biphasic bone void filler plug; 560 High Definition camera system; and various other arthroscopy instruments and devices.

Table of Contents

Competition

Management estimates that the global arthroscopy market in which the business principally participates is worth more than $2 billion a year and is growing at 12% annually, driven by increasing numbers of sports injuries, longer and more active lifestyles, patient desire for minimally invasive procedures, innovative technological developments and a need for cost effective procedures. Management believes that Smith & Nephew has a 23% share of the global arthroscopy market.

Smith & Nephew s main competitors and their estimated shares of the global arthroscopy market in 2007 were Arthrex (19%), Mitek/Johnson & Johnson (18%), Stryker (11%), Arthrocare (8%) and Linvatec/Conmed (7%).

Advanced Wound Management

Overview

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

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

Strategy

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

The advanced wound management business has built its sales and marketing infrastructure in the world s major markets, largely through investment in additional sales teams particularly in the key markets of the US and Europe. At the end of 2007 the global sales force was 937 of whom 181 were based in the US, the fastest growing market.

During 2007, management took part in the Group s EIP and reviewed cost and efficiency in the advanced wound management business. Savings have been delivered during 2007 in areas ranging from cost savings in support functions to the outsourcing of some manufacturing to low cost countries. During 2007 the business announced the planned closure of the Largo, Florida manufacturing facility and the intention to build and manage a manufacturing facility in Suzhou, China.

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.

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

The ALLEVYN hydrocellular dressings range has been considerably enhanced by new versions introduced in 2006 and 2007 that management believes deliver efficient fluid management and an optimal moist wound environment that can lead to promotion of faster healing of the wound, reduced risk of maceration and protection from infection. During 2007, the ALLEVYN range was extended further with the development of variants that include the addition of silver.

Sales of ACTICOAT continue to grow during 2007 with the introduction of new dressings designed for the prevention of infection in post-operative wounds and around skin punctures relating to external fixation of bones. 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.

Table of Contents

Smith & Nephew entered into an agreement with Covalon Technologies, Inc., in 2007 to distribute a range of denatured collagen dressings. Two of these products, COLACTIVE and BIOSTEP, are designed to stimulate tissue granulation. The agreement grants the business access and distribution rights to a differentiated new product development portfolio.

Recent Regulatory Approvals

During 2007, the advanced wound management business secured approvals for new variants of ALLEVYN that include the addition of silver and adhesives that minimise pain at dressing change. In addition, the IODOSORB range of cadexomer iodine dressings was transferred from regulation under pharmaceutical regulations in Europe to being a medical device, providing the potential opportunity for sale in all 27 member states. In Japan, two new products were approved including the thin version of the ALLEVYN range.

Competition

Management estimates that the sales value of the advanced wound management market worldwide was $4.7 billion in 2007, an increase of 11% from 2006 which includes the impact of the continuing expansion of the NPWT segment. Management estimates that Smith & Nephew has a 17% market share of the wider market. Growth is driven by an ageing population and by a steady advance in technology and products that are more clinically efficient and cost effective than their conventional counterparts. Management believes that there is strong growth potential for advanced technology products with approximately half of chronic wounds globally still treated with conventional dressings.

Worldwide competitors in advanced wound management and their estimated market shares in 2007 include Kinetic Concepts (27%), who are wholly in the NPWT segment, the Convatec division of Bristol-Myers Squibb (10%), Molnlycke (8%) and Johnson & Johnson (7%).

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 in 2006 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 of its intention to dispose of BSN Medical, Smith & Nephew and Beiersdorf AG announced in December 2005 that they had signed an agreement to sell BSN Medical to Montagu Private Equity for an enterprise value of 1,030m. This transaction was completed on 23 February 2006.

Table of Contents

OPERATING ACTIVITIES

SALES, MARKETING AND DISTRIBUTION

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

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

The Group s customers reflect the wide range of distribution channels, purchasing agents and buying entities in over 90 countries worldwide. The largest single customers worldwide are the National Health Service in the UK and HealthTrust in the US which represented 3% and 2% respectively of the Group s worldwide revenue in 2007.

In the US the Group s products are marketed directly to doctors, hospitals and other healthcare facilities. Each business unit operates separate specialised sales forces. 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 wholesale distributors.

In most other direct markets, the business units typically manage separate employee sales forces directly.

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

In Continental Europe, the Group operates three centralised distribution facilities. The reconstruction, trauma and endoscopy businesses operate a facility in Paris, France which acts as the main central holding and consolidation point for Continental European inventory and inventory returns. Reconstruction and trauma also operate a distribution facility at Rotkreuz, Switzerland. Product is shipped to Group companies who hold small amounts of inventory locally for immediate or urgent customer requirements. Advanced wound management operates a distribution centre at Neunkirchen, Germany 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 the fourth quarter of any year. This is caused by the relatively high number of accidents and sports injuries which occur in the North American and European autumn and winter seasons which increase revenues of trauma and endoscopy products. Reconstruction revenues are lower in the third quarter due to fewer elective surgeries in the summer and higher in the fourth quarter as elective surgeries increase.

Table of Contents

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 principally include metal forgings and stampings for orthopaedics, optical and electronic sub-components and finished goods for endoscopy, active ingredients and finished goods for advanced wound management and packaging materials for all businesses. Management believe that whilst prices of principal raw materials can be volatile the effect is not material to the Group. Finished goods purchased for resale include SUPARTZ joint 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, PLANT AND EQUIPMENT

The Group s principal locations are as follows:

	Approximate area (Square feet 000 s)
Group head office in London, England	15
Group research facility in York, England	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
Reconstruction manufacturing facility in Aarau, Switzerland	77
Reconstruction European headquarters in Rotkreuz, Switzerland	28
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. In 2007, the Aarau and Rotkreuz facilities were added as part of the Plus acquisition and are both leasehold properties. 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.

As part of the EIP programme the Group has announced its intention to close the Largo manufacturing facility by 2009 and to outsource or relocate its manufacturing output. The advanced wound management business has purchased land in Suzhou, China and intends to construct a new facility to supply certain advanced wound management products on a global basis. The reconstruction business intends to purchase land near Beijing, China and plans to construct a new facility to supply implants to the local market and orthopaedic instruments for export.

Table of Contents

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 $142m in 2007 (2006 $120m, 2005 $122m), representing approximately 4% of Group revenue (2006 4%, 2005 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 and Aarau, Switzerland (reconstruction and trauma and clinical therapies), 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 reconstruction, orthopaedic trauma and clinical therapies, endoscopy and advanced wound management. Patent protection for Group products is sought routinely in the Group s principal markets. Currently, the Group s patent portfolio stands at over 3,200 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 3,100 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 Group s annual revenue. As a result, the Group tries to ensure that its overall business is not sensitive to the loss (however caused) of any single piece of intellectual property.

In addition to 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.

Table of Contents

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.

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

Table of Contents

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. In particular Smith & Nephew offers products throughout the continuum of care for patients, not only with osteoarthritis from early intervention through primary joint replacements to revisions, but also in the wider field of injuries to knee, hip, shoulder and overall bone and skin repair.

The Group prides itself on the strength of its relationship with its clinicians and other professional healthcare customers with whom it has a reputation for product innovation and high standards of customer service. Cost effective solutions are achieved through the use of advanced technology. 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 has a low impact on the environment and is committed to improving the management of its environmental, 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 eighth Sustainability Report, which gives detailed information, will be published on the Group s website at the end of May 2008 at www.smith-nephew.com.

Smith & Nephew s progress is measured by four leading organisations that assess sustainable development. In 2007 the Group was again included in the Dow Jones Sustainability Index (DJSI) and continues to be a leader in its sector. In the UK, Smith & Nephew is a member of FTSE4Good and in France, Vigeo publishes an assessment report on Smith & Nephew used by some of the leading investment banks in Europe. In 2007 the Group was named in the German Global Challenges Index.

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

The Group s Code of Business Principles governs the way it operates so that it respects stakeholders and seeks to build open, honest and constructive relationships. This is regularly reviewed and a revised code was published on the Smith & Nephew website in March 2008. 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.

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.

Table of Contents

Health, Safety and Environment Management

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

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

In 2007, 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.

In October 2007, the advanced wound management business based in Hull, England won the UK Manufacturer of the Year award run by Manufacturer magazine. As well as the overall Manufacturer of the Year award they also won the awards for (i) World Class Manufacturing, for the sustained and progressive achievement of world class manufacturing standards, (ii) Manufacturing Operations, for achieving world class manufacturing standards through the interaction of machines, processing steps and tasks to be performed, and (iii) Skills and Productivity, in recognition of initiatives that have increased productivity through the enhancement of employee skills and improving the perception of manufacturing careers. Smith & Nephew was also a finalist in the Energy and Environment award.

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:

	2007 (i)	2006	2005	2004	2003
Emissions to air carbon dioxide (tonnes)	50,178	50,359	50,212	48,954	50,160
Waste (tonnes)	4,016	4,759	4,685	3,596	4,054
Hazardous waste (tonnes)	204	256	303	234	275
Waste recycled (tonnes)	1,496	1,189	1,009	767	646
Total energy (GwH)	140	138	139	132	145

Water usage (1,000 cu. Metres)	542	562	480	427	457
Discharges/effluent (1,000 cu. Metres)	453	485	400	384	399
Lost time accidents (ii)	0.5	0.5	0.6	1.0	0.9
Work related injuries (iii)	1.7	1.4	1.9	N/A	N/A

(i) Totals in 2007 exclude the Plus and BlueSky businesses acquired in the year.
(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 work related injuries per 200,000 hours worked which are required to be recorded under Occupation Safety and Health Administration Regulations. The same criteria have been used at all sites whether or not the regulations apply. Data was not collected in 2003 and 2004 so no information is available for these years.

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 fell slightly in 2007 despite a slight increase in total energy consumption.

The fall in non-hazardous waste arose from the waste reduction measures and greater emphasis on recycling at the advanced wound management factory in Hull, England.

The 2004 hazardous waste figure excludes a spillage of chrome plating materials which occurred at the manufacturing site in Memphis, Tennessee. Working closely with the state authorities, prompt action was taken resulting in a total of 920 tonnes of affected soil being removed from the site to eliminate any possible contamination.

Table of Contents

All parts of the Group showed a reduction in hazardous waste. The largest contribution to the reduction came from the advanced wound management in Hull, England where there has been a greater emphasis on handling and recycling of all types of waste.

The Group s lost time accident frequency rate is unchanged despite a significant increase within the advanced wound management sites. The sites concerned continue to score highly in the Health Safety and Environment Audit Scheme and the downturn is attributed to a period of great change within the Group rather than a deterioration in health and safety management. Specific programmes to address unsafe behaviours have been put in place for 2008.

In the 2007 Sustainability Report, Smith & Nephew published targets for these environmental measurements for the first time. These targets were based on figures normalised for changes in production levels rather than the absolute figures shown in the previous table. This is so that any impact arising from changes in production is taken into account. The performance against the published targets is as follows:

	Target 2008	Actual 2007	Target 2007
Energy consumption	5% reduction	8% reduction	No change
Waste	10% reduction	22% reduction	5% reduction
Lost time accidents	5% reduction	8% increase	5% reduction
Work related injuries	5% reduction	18% reduction	5% reduction

A full analysis of these measurements and key health and safety performance measures will be included in the 2008 Sustainability Report on the Group s website when it is published at the end of May 2008.

Social responsibility

Employees

The Smith & Nephew Code of Business Principles and Code of Ethics governs the Group s interactions with all of its stakeholders including employees. This sets out the values and behaviours that the Group expects from every employee. During 2007 this document has been reviewed and improved and is currently being communicated across the whole organisation.

The HR Policy Framework introduced in 2006 describes the key HR policies, values and behaviours and management principles that provide the structure within which the business units plan and deliver successful results. This has now been supplemented by the HR Strategy document which provides the direction on how the Group intends to attract, retain and develop the right talent to meet the business needs and create a culture that is aligned to Smith & Nephew values and deliver the Group s long term strategic plans.

Smith & Nephew has a policy of non-discrimination and aims to provide an open, environment based on constructive relationships. Smith & Nephew welcomes people with disabilities and makes every effort to retain any employee who has a disability. The Group is committed to engaging with employees through the regular and timely dissemination of Group information and encouraging their

feedback and ideas. An employee global opinion survey is used every two years as a catalyst for improvements and plans are already well advanced for the 2008 survey.

The 2006 Global Opinion Survey was completed towards the end of 2006 and presentations to employees were completed in early 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 foreseeable future and would recommend it 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. In response to employee feedback, projects have been initiated in all parts of the business including the development of specific training and development in the areas of coaching, employee reward, leadership, product knowledge and improved work practices.

In 2007 the Group has continued to assess indicators of employee engagement. These measurements are a useful monitoring tool and alert mechanism for action as well as giving trend indicators of improved performance. Changes in the business structure in 2007 and the Plus acquisition has impacted upon data collection. Consequently the Group has not been able to include labour turnover or internal appointments information for mainland Europe or Asia and so the information provided on page 19 for 2007 excludes these areas.

Table of Contents

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 2007 an average of 30.4% (2006 28.2%) of vacancies across all parts of the business were filled by internal applicants. The target for all employees is 40%, which the Group believes is challenging but achievable. The target for management positions is 70% and this number will be reported separately from 2008. The Group has a policy of open advertising and providing opportunities for existing employees wherever possible, while recognising the need to bring in new ideas and approaches that external recruitment brings.

Labour Turnover

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

The average turnover for employees leaving the Group within two years of joining was 10.5% (2006 6.2%) ranging from 2.3% to 18.9% across the Group s operations.

The average voluntary labour turnover for 2007 was 10.5% (2006 2.8%) ranging from 6.5% to 13.5% across the Group s operations.

The Group has investigated these results and believes that the main factors behind these increases are the significant changes in the Group operations that have occurred in 2007. These include the EIP, the integration of Plus and the transition of many countries from indirect to direct market operations. This has had the effect of unsettling some individuals and also makes year on year comparisons of the data difficult. The Group anticipated this increase in turnover and believes that this has been managed successfully which has ensured that the Group has not lost significant talent.

Training and Development Investment

The Group is committed to providing training and information so that all employees can make the best contribution possible. To ensure that the Group continues to improve in this important area, during 2007, a central global organisational development team was created to lead talent management, performance management and learning and development across the whole of Smith & Nephew. Learning and development programmes are used to attract, retain and develop employees. These programmes are linked to formal performance appraisal and development planning. The Group operates training programmes under the banner of Management Excellence. These continue to provide the key management skills required to be successful managers and leaders, covering the requirements of both new and experienced individuals. Further programmes were added in 2007 and the Group has continued to invest in on-line learning resources to further enable access to training for all employees.

Leadership

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

The Group s leadership excellence programme is a three-day purpose designed residential course facilitated by a business school coach. The programme focuses on leadership style and interaction and the programme will continue in 2008.

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.

Table of Contents

Society and Community

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

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

The Group 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 through sponsorship and help from the Group s employees. By working in collaboration with these individuals and organisations, Smith & Nephew considers that this is a way of increasing the impact of charitable giving and the work it undertakes.

The Smith & Nephew Foundation is an independent charitable trust funded by Smith & Nephew advanced wound management. The Foundation makes awards to individuals in the nursing 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 2007, direct donations to charitable and community activities totalled $1,603,000 of which $500,000 was given to the Smith & Nephew Foundation. Smith & Nephew made no political contributions in 2007.

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 invest in research and development.

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

Business Partners

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

Economic Contribution

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

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

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. Increased development of this area was evident in the 2007 Sustainability Report available at www.smith-nephew.com/sustainability2007. A description of the principles of healthcare economics and its integration into the business is given in the Sustainability Report.

Table of Contents

Looking Ahead

The Group is fulfilling an important role in its areas of expertise. Increased demands are being placed on healthcare systems as the baby boomer generation ages and problems with obesity become more widespread. More active lifestyles and the increased incidence of diabetes, and other diseases also increase the demand for Smith & Nephew s products.

Smith & Nephew s strategy is to build upon its leading technologies, build on its competitive advantage in the continuum of care for patients with osteoarthritis and the wider field of injuries to knee, hip, shoulder and overall bone and skin repair. The Group aims to 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, 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.

EMPLOYEES

The average number of full-time equivalent employees in 2007 was 9,190, of whom 1,735 were located in the UK, 3,984 were located in the US and 3,471 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:

	2007	2006	2005
Reconstruction	2,568	2,129	2,081
Trauma and Clinical Therapies	1,837	1,764	1,543
Endoscopy	1,798	1,830	1,745
Advanced Wound Management	2,987	3,107	3,249
	9,190	8,830	8,618

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

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

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.

Table of Contents

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 damage, or impair 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.

Table of Contents

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 voluntarily withdrew the macrotextured versions of its OXINIUM femoral knee components from all markets. As at that date 2,971 components had been implanted of which approximately 2,471 were in the 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 did not achieve adequate initial fixation and other patients who were 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 2007 1,029 implants required revision surgery as a result of some patients not achieving adequate fixation and settlements had been agreed with patients in respect of 977 of these revisions. The total amount paid out to 31 December 2007 in settlements, legal costs and associated expenses has been $195m 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. A further $22m was received during 2007 from a successful legal settlement. The balance of $113m is due from five other insurers who have declined coverage.

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 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.

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

Group s share price and its strategic options.

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

Failure to Make Successful Acquisitions

A key element of the Group s strategy for continued growth is to make 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.

Table of Contents

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.

Regulatory Compliance 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. In September 2007 the Group and the other four competitors involved settled the criminal and civil matters with respect to any charges against the companies that could result from this investigation.

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 June 2006 relating to possible violations of US antitrust laws, in respect of the manufacture and sale of orthopaedic implant devices. Similar enquiries were directed to a number of the Group s US competitors. In connection with this subpoena, the Group received six complaints in class action lawsuits alleging violations of the Sherman Antitrust Act. These were all subsequently withdrawn in 2007.

In September 2007 the United States Securities and Exchange Commission (SEC) wrote a letter to the Group advising that it was conducting an informal investigation into certain marketing practices in the Group s orthopaedics reconstruction business in Germany, Poland and Greece with reference to the United States statute known as the Foreign Corrupt Practices Act. The Group believes that several of its major US competitors have received a similar letter. The SEC asked the Group to voluntarily disclose to it any problems or issues. The Group has retained independent counsel and other advisors and is investigating these matters. In order to fully co-operate with the SEC the Group is investigating the three markets requested and other European markets with respect to its practices and those of Plus which it recently acquired and is integrating into its Group.

Regulatory Approvals and Controls

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

The Group is required to comply with a wide range of regulatory controls over the manufacturing, testing, distribution and marketing of its products, particularly in the US, UK and Continental Europe. Such controls have become increasingly demanding and management believes that this trend will continue. Failure to comply with

Table of Contents

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 seven main facilities in Memphis, Tennessee, Mansfield, Massachusetts, Oklahoma City, Oklahoma, and Largo, Florida in the United States, Hull and Gilberdyke in the United Kingdom and Aarau in Switzerland. 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 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.

As part of the EIP programme the Group intends over time to outsource to third parties or to relocate to lower cost countries certain of its manufacturing processes. There is a risk of disruption to supply when these transfers occur.

Currency Fluctuations

The Group uses the US Dollar as its reporting currency and the functional currency of Smith & Nephew plc. In 2007, 46% of Group revenue arose in the US, 26% in Continental Europe, 19% 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 4%.

Table of Contents

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

In 2007, the Group managed $800m of foreign currency purchase transactions by using forward foreign exchange contracts, of which the major transaction flows are from Euros into US Dollars and Sterling. The Group s policy is for firm commitments to be fully covered and forecast transactions to be covered between 50% and 90% for up to one year. If the Euro were to weaken against the US Dollar on average by 10% over the year, the fair value of forward foreign exchange contracts would increase by $8m (2006 increase by $9m).

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 2007 would have decreased by $46m (2006 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 2007 would have increased by $42m (2006 increased by $53m).

Political and Economic Uncertainties

Because the Group has operations in 32 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 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. See Note 22 of the Notes to the Group Accounts for further details of these risks.

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

Table of Contents

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.

Table of Contents

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.

Responsibility for the Group s spinal products was transferred from the endoscopy business to the trauma and clinical therapies business with effect from 1 January 2007. Spinal products are now reported within the trauma and clinical therapies segment and all comparative periods have been amended to conform to the current year presentation.

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

	2007	2006	2005
		(%)	
Reconstruction	37	33	32
Trauma and Clinical Therapies	18	18	18
Endoscopy	22	24	23
Advanced Wound Management	23	25	27
Total revenue	100	100	100

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

	2007	2006	2005
		(%)	
Europe (Continental Europe and United Kingdom)	35	31	31
United States	46	49	49
Africa, Asia and Australia and Other America	19	20	20
Total revenue	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-for-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.

Table of Contents

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

	Reported growth (%)	Constant currency exchange effect (%)	Acquisitions effect (%)	Underlying growth (%)
Reconstruction	35	(4)	(18)	13
Trauma and Clinical Therapies	20	(2)	(5)	13
Endoscopy	13	(3)		10
Advanced Wound Management	12	(6)	(1)	5
Total revenue	21	(4)	(7)	10

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

Trading Profit

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

Operating profit reconciles to trading profit in 2007 as follows:

	Operating profit	Acquisition related costs	Restructuring and rationalisation expenses	Legal settlement	Amortisation of acquisition intangibles	Trading Profit

			($ million)			
Reconstruction	131	101	9	30	24	295
Trauma and Clinical Therapies	112	10	5		1	128
Endoscopy	141		4		2	147
Advanced Wound Management	109		24		3	136
Total	493	111	42	30	30	706

Operating profit reconciles to trading profit in 2006 as follows:

	Operating profit	Acquisition related costs	Amortisation of acquisition intangibles	Trading Profit
		($ million)		
Reconstruction	200	20	13	233
Trauma and Clinical Therapies	101			101
Endoscopy	122		1	123
Advanced Wound Management	114			114
Total	537	20	14	571

Table of Contents

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

	2007	2006	2005
		(%)	
Reconstruction	42	41	40
Trauma and Clinical Therapies	18	18	18
Endoscopy	21	21	23
Advanced Wound Management	19	20	19
Total trading profit	100	100	100

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

	2007	2006	2005
		(%)	
Reconstruction	26	37	46
Trauma and Clinical Therapies	23	19	22
Endoscopy	29	23	25
Advanced Wound Management	22	21	7
Total operating profit	100	100	100

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.

The trauma and clinical therapies markets are expected to continue to grow due to a global population increasingly at risk from fractures due to age, osteoporosis, obesity and diabetes and also due to continuous advancements in the surgical treatment of fractures, and the need to manage pain in younger, more active patients.

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

The advanced wound management 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.

Table of Contents

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 2007 represented 4% of Group revenue.

Currency Movements

Smith & Nephew s results of operations are affected by transactional exchange rate movements in that they are subject to exposures arising from revenue in a currency different from the related costs and expenses. The Group manages the impact of exchange rate movements on cost of goods sold by a policy of purchasing forward foreign currency commitments when firm purchase orders are placed. In addition, 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 indebtedness denominated in currencies other than US Dollars. See Financial Position, Liquidity and Capital Resources .

Other

Other than national governments seeking to control or reduce healthcare expenditure, (see Risk Factors 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 IFRS 1 are set out in Note 2 of the Notes to the Group Accounts. Of those the policies which require the most use of management s judgment are as follows:

Inventories

A feature of the reconstruction and trauma businesses (whose finished goods inventory makes up 77% 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 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, operating 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 0.5% increase in discount rate would reduce the combined UK and US pension plan deficit by $96m whilst a 0.5% decrease would increase the combined deficit by $106m. A 0.5% increase in discount rate would decrease profit before taxation by $2m whilst a 0.5% decrease would increase it by $1m. A one year increase in the assumed life expectancy of the average 60 year old male pension plan member in both the UK and US would increase the combined deficit by $27m. In making these judgements, management takes into account the advice of professional external actuaries and benchmarks its assumptions against external data.

Table of Contents

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

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

Contingencies and Provisions

The recognition of provisions for legal disputes is subject to a significant degree of estimation. Provision is made for loss contingencies when it is 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 $40m. If the average cost of settlement of the estimated claims outstanding or not yet notified should rise by 10% the cost would increase by $4m.

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.

2007 YEAR

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

Financial Highlights of 2007

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

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

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

Table of Contents

Fiscal 2007 Compared with Fiscal 2006

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

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

(i) Group revenue and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 36 to 38.
(ii) 2007 includes $64m in respect of the utilisation of the Plus inventory stepped-up to fair value on acquisition, $7m of restructuring and rationalisation expenses and $6m of acquisition related costs.
(iii) 2007 includes $12m of acquisition related costs and $4m of restructuring and rationalisation expenses.
(iv) 2007 includes $29m of acquisition related costs, $31m of restructuring and rationalisation expenses, $30m of legal settlement, and $30m of amortisation of acquisition intangibles (2006 includes $20m of acquisition related costs and $14m of amortisation of acquisition intangibles).

Transactional and Translational Exchange

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

The Group s principal manufacturing locations are in the US (reconstruction, trauma and clinical therapies and endoscopy), Switzerland (reconstruction) and in the UK (advanced wound management). The majority of the Group s selling and distribution subsidiaries around the world purchase finished products from these locations in the currency of the manufacturer. As a result of currency movements compared with the previous year, purchases from the US and the UK became relatively cheaper. The Group s policy of purchasing forward a proportion of its currency requirements mitigated the impact of these movements to some

extent.

Revenue

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

Reconstruction revenues increased by $321m or 35%, of which 13% was underlying growth, 18% was due to the acquisition of Plus and 4% due to favourable currency translation. Trauma and clinical therapies revenues increased by $104m or 20%, of which 13% was underlying growth, 5% due to the acquisition of Plus and 2% was due to favourable currency translation. Endoscopy revenues increased by $84m or 13%, of which 10% was underlying growth and 3% was due to favourable currency translation. Advanced wound management revenues increased by $81m or 12%, of which 5% was underlying growth, 6% due to favourable currency translation and 1% due to the BlueSky acquisition.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 36 to 38.

Table of Contents

Cost of goods sold

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

Further margin analysis is included within the Trading Profit sections of the individual business segments that follow on pages 36 to 38.

Marketing, selling and distribution expenses

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

Administrative expenses

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

Research and Development expenses

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

BSN Medical agency fees

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

Operating profit

Operating profit decreased by $44m to $493m in 2007 compared with $537m in 2006, comprising decreases of $69m in reconstruction and $5m in advanced wound management and increases of $11m in trauma and clinical therapies and $19m in endoscopy.

Net interest payable

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

Other finance income

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

Taxation

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

Discontinued operations net profit on disposal of the Joint Venture

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

Table of Contents

Group Balance Sheet

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

	2007	2006
	($ million)	
Non-current assets	2,545	1,586
Current assets	1,905	1,645
Total assets	4,450	3,231
Non-current liabilities	363	241
Current liabilities	2,271	816
Total liabilities	2,634	1,057
Total equity	1,816	2,174
Total equity and liabilities	4,450	3,231

Non-current assets increased by $959m from $1,586m in 2006 to $2,545m in 2007. Intangible assets and goodwill increased by $816m of which $773m related to the acquisitions of Plus and BlueSky, $16m came from additions to other intangibles, currency translation added $73m and amortisation reduced the balance by $46m. Property, plant and equipment increased by $108m comprising $79m relating to acquisitions, additions of $202m, currency translation of $23m less depreciation of $181m and net book value of disposals of $15m.

Current assets increased by $260m from $1,645m in 2006 to $1,905m in 2007. This was mainly due to the Plus acquisition which was the principal cause of the increase in inventory of $218m and the increase in trade and other receivables of $218m. These increases were partially offset by a reduction in cash and bank of $176m.

Non-current liabilities increased by $122m from $241m in 2006 to $363m in 2007. $21m of this increase was due to increases in long term borrowings. The retirement benefit obligation increased by $30m, $22m of which was due to the Plus acquisition. Deferred tax liabilities increased by $28m and other payables increased by $44m as a result of additional long term acquisition consideration. These increases were partially offset by a decrease in provisions of $1m.

Current liabilities increased by $1,455m from $816m in 2006 to $2,271m in 2007. The main cause of this increase was the $1,323m increase in borrowings arising from the acquisition of Plus and the share buy back programme.

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

35

Table of Contents

Business Segment Analysis

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

	2007	2006
	($ million)	
Revenue by business segment		
Reconstruction	1,240	919
Trauma and Clinical Therapies	618	514
Endoscopy	732	648
Advanced Wound Management	779	698
Total revenue	3,369	2,779
Revenue by geographic market		
Europe (Continental Europe and United Kingdom)	1,177	867
United States	1,550	1,365
Africa, Asia, Australasia and other America	642	547
Total revenue	3,369	2,779
Trading profit by business segment		
Reconstruction	295	233
Trauma and Clinical Therapies	128	101
Endoscopy	147	123
Advanced Wound Management	136	114
Total trading profit	706	571
Operating profit by business segment		
Reconstruction	131	200
Trauma and Clinical Therapies	112	101
Endoscopy	141	122
Advanced Wound Management	109	114
Total operating profit	493	537

Reconstruction

Revenue

Revenue increased by $321m, or 35%, to $1,240m of which 13% was underlying growth, 4% due to favourable currency translation movements and 18% due to the effect of the acquisition of Plus. The principal factors in the underlying growth in revenue were the growth in the global orthopaedic reconstruction market which was estimated to be 9% in the year and the continued growth of products recently launched in the US.

In the US, revenue increased by $104m to $618m (20%) of which 18% was underlying growth and 2% a result of acquisitions. The main factors were the continued growth of products launched in recent years including the LEGION and JOURNEY knees and BHR. These products contributed $104m of incremental revenue in the year.

Outside the US, revenue increased by $217m to $622m (54%), of which 7% was underlying growth, 37% a result of acquisitions and 10% due to foreign currency translation. Japan revenue grew by 13% of which 1% was underlying growth, 13% due to acquisitions and 1% unfavourable currency translation. Revenue growth in Europe was 76% of which 7% was underlying growth, 56% a result of acquisitions and 13% due to foreign currency translation.

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

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

Table of Contents

Trading Profit

Trading profit rose by $62m (27%) from $233m in 2006 to $295m in 2007. This resulted in a decrease in trading margin from 25.4% to 23.8%. The principal factors were dilutions arising from the acquisition of the Plus business which caused a decline in margin of 2.1% offset by increases arising from the EIP.

Operating Profit

Operating profit decreased by $69m. This comprises an increase of $81m in acquisition related costs, $9m due to restructuring and rationalisation expenses, $30m due to the legal settlement and $11m due to an increase in the charge for amortisation of acquisition intangibles less an increase in trading profit of $62m.

Trauma and Clinical Therapies

Revenue

Revenue increased by $104m, or 20% of which 13% was underlying growth, 2% favourable currency translation and 5% from the acquisition of Plus. The translational impact of currency in this business is less than in others because it has a higher proportion of revenues arising within the US. The main factor in the underlying growth was the growth in the global trauma and clinical therapies market which was estimated to be 10% in the year. Growth in fixation products was 17% of which 10% was underlying growth, 5% due to acquisitions and 2% favourable currency translation. Growth in clinical therapies was 27%, of which 20% was underlying growth, 6% was due to acquisitions and 1% favourable currency. Sales of DUROLANE hyaluronic acid product outside the US, the rights to which were acquired in June 2006, continued to drive growth and accounted for 5% of the underlying growth.

In the US, revenue increased by $45m to $414m representing 12% growth which is in line with the US market growth. The main contributory factor in the underlying growth rate was 14% growth in clinical therapies. This above market growth in clinical therapies resulted from increases in the US sales force which has driven growth in EXOGEN revenues of 22% while SUPARTZ revenues grew by 10%. Fixation revenue growth was 11% all of which came from the continued growth of the PERI-LOC compression plate system, launched in 2006, and from the launch of the INTERTAN nail.

Outside the US, revenue increased by $59m to $204m (41%), of which 15% was underlying growth, 17% due to acquisitions and 9% due to favourable currency movements. The underlying revenue growth was mainly driven by market growth of 10% and by sales of DUROLANE which represented 6% of growth.

Trading Profit

Trading profit rose by $27m (27%) from $101m in 2006 to $128m in 2007 resulting in a trading profit margin increase from 19.6% to 20.7%. The major factor in this was the effect of the EIP which improved trading margin by 1.4**%.**

Operating Profit

Operating profit increased by $11m which comprises trading profit of $27m less acquisition related costs of $10m, $5m due to restructuring and rationalisation expenses and $1m for the amortisation of acquisition intangibles.

Endoscopy

Revenue

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

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

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

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

Table of Contents

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

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

Trading Profit

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

Operating Profit

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

Advanced Wound Management

Revenue

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

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

Trading Profit

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

Operating Profit

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

2006 YEAR

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%.

Table of Contents

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)	3	(3)
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 and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 42 to 44.
(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 acquisition related costs and $14m of amortisation of acquisition intangibles (2005 $24m of restructuring and rationalisation expenses and $11m of amortisation of acquisition intangibles).

Transactional and Translational Exchange

The Group s principal markets outside the US are, in order of significance, 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 (+2%), 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 operating profit and margin compared with the previous year.

Revenue

For the year ended 31 December 2006 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 $61m or 13%, all of which was underlying growth. Endoscopy revenues increased by $57m 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 42 to 44.

Table of Contents

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 expenses 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 42 to 44.

Marketing, selling and distribution expenses

These expenses increased by $101m to $1,092m from $991m in 2005 which included $7m of restructuring and rationalisation expenses. The increase was principally due to increases in selling and marketing costs in reconstruction in support of the 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 expenses 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, $8m in trauma and clinical therapies, $17m 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.

Table of Contents

Other finance income/(costs)

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. Excluding this item, 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.

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 acquisition 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.

Table of Contents

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	514	453
Endoscopy	648	591
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 Australia and Other America	547	493
Total revenue	2,779	2,552
Trading profit by business segment		
Reconstruction	233	206
Trauma and Clinical Therapies	101	93
Endoscopy	123	122
Advanced Wound Management	114	96
Total trading profit	571	517
Operating profit by business segment		
Reconstruction	200	196
Trauma and Clinical Therapies	101	93
Endoscopy	122	105
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.

Table of Contents

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.

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 acquisition 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 $61m, 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 $42m to $369m 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 $19m to $145m (15%), all of which was underlying growth. Revenue growth was driven by market growth and by DUROLANE which represented 2% of growth.

Trading Profit

Trading profit rose by $8m (9%) from $93m in 2005 to $101m in 2006 resulting in a trading profit margin decrease from 20.5% to 19.6%. 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 $8m all of which was trading profit.

Endoscopy

Revenue

Endoscopy revenue increased by $57m, or 10%, to $648m, 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 $24m to $343m (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.

Table of Contents

Outside the US, revenue increased by $33m to $305m (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.

Trading Profit

Trading profit increased by $1m (1%) from $122m in 2005 to $123m in 2006 resulting in a trading profit margin decline from 20.6% to 19.0%. 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 $17m of which $16m was due to the restructuring and rationalisation expenses in 2005 and the $1m increase 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.

Table of Contents

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:

	2007	2006	2005
		($ million)	
Cash generated from operations	693	506	372
Net interest (paid)/received	(30)	10	9
Income taxes paid	(225)	(144)	(112)
Net cash inflow from operating activities	438	372	269
Capital expenditure (net of disposal of property, plant and equipment)	(194)	(222)	(200)
Acquisitions (net of cash acquired)	(781)	(83)	(25)
Disposal of joint venture		537	
Dividends received from joint venture			25
Equity dividends paid	(105)	(96)	(91)
Issue of ordinary share capital	28	16	19
Treasury shares purchased	(640)		
Change in net debt from net cash flow (see Note 30 of the Notes to the Group Accounts)	(1,254)	524	(3)
Loan Notes issued		(15)	
New finance leases	(7)		
Facility fee paid	(6)		
Borrowings and finance leases acquired on acquisition	(181)		
Exchange adjustment	(72)	7	(71)
Opening net cash/(net debt)	210	(306)	(232)
Closing (net debt)/net cash	(1,310)	210	(306)

The Group s net debt increased by $1,078m from $232m at the beginning of 2005 to $1,310m at the end of 2007. Translation of foreign currency net debt into US Dollars had the effect of increasing net debt by $136m in the three-year period ended 31 December 2007. Closing net debt includes $2m of net currency swap liabilities (2006 $2m, 2005 $19m).

Net Cash Inflow from Operating Activities

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

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

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

Capital Expenditure

The Group s ongoing capital expenditure and working capital requirements have been financed through cash flow generated by business operations and, where necessary, through short-term committed and uncommitted bank facilities. In recent years capital expenditure on tangible and intangible fixed assets has represented approximately 6-8% of continuing group revenue and this trend is expected to continue in 2008.

In 2007 capital expenditure of $200m ($194m 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 2007, $5m of capital expenditure had been contracted but not provided for which will be funded from cash inflows.

Table of Contents

Acquisitions and Disposals

In the three-year period ended 31 December 2007, $889m was spent on acquisitions, funded from net debt and cash inflows. This comprised Plus $758m**,** OBI $71m, BlueSky $16m, MMT $9m, Acticoat $10m, Collagenase $9m, Versajet $6m and $10m of other acquisitions.

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

Liquidity

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

At 31 December 2007, the Group held $170m in cash and balances at bank. The Group has drawings under uncommitted facilities of $513m and committed facilities of $2,517m. Of the undrawn committed facilities of $1,270m, $91m expires within one year and $1,179m after two but within five years. In addition Smith & Nephew has finance lease commitments of $38m (of which $12m extends beyond five years). Smith & Nephew intends to repay the amounts due within one year by using available cash and drawing down on the longer-term facilities.

The principal variations in the Group s borrowing requirements result from the timing of dividend payments, acquisitions and disposals of businesses, the share buy back programme, timing of capital expenditure and working capital fluctuations. In 2007 the settlement of macrotextured patient claims was a factor which will continue in 2008. In February 2006 the Group received $537m net of costs 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 2008, 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 2007 is set out in Note 21 of the Notes to the Group Accounts. The Group believes that the borrowing facilities do not contain restrictions that are expected to impact on funding or investment policy for the foreseeable future.

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.

Table of Contents

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 did not achieve adequate initial fixation and other patients, who were 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 comprised 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. The judge originally assigned to hear the case has transferred to a different court and the case will most likely be assigned to another judge in the court where it was originally filed. It is expected that this will result in the trial being scheduled for 2009 and it will not be heard in 2008 as previously reported. A charge of $154m representing the amount outstanding from insurers and an estimate of the costs 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.

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 2007 to cover pending claims and claims in respect of future revisions, assuming no insurance cover is available, was $41m, which management believes is adequate.

As at 31 December 2007 1,029 implants required revision surgery as a result of some patients not achieving adequate fixation and settlements had been agreed with patients in respect of 977 of these revisions. The total amount paid out to 31 December 2007 in settlements, legal costs and associated expenses has been $195m 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. A further $22m was received during 2007 from a successful legal settlement. The balance of $113m is due from five other insurers who have declined coverage.

At the end of February 2008, 1,033 implants had been revised and settlements agreed with patients in respect of 983 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, six EEOC charges were filed in Memphis, Tennessee against the Group alleging that the Group s employee promotion practices are discriminatory. A seventh EEOC charge filed that same year alleges that the

Table of Contents

Group did not provide the employee with necessary training. In 2007, two persons filed EEOC charges alleging that the Group failed to hire them for discriminatory reasons. Right to sue letters have been issued by the EEOC in all but one of these charges and a law suit has been filed in the federal court in Memphis that will consider the failure to promote, failure to train, and failure to hire allegations. The charges and suit all allege discrimination based on the African American race and were filed by the same lawyers whose offices are in Washington, D.C. All request that the charges and suit be conducted as class actions. Smith & Nephew believes that it has meritorious defences to all of the allegations and it intends to defend these matters vigorously.

US Department of Justice Investigations

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. In September 2007 the Group and the other four competitors involved settled the criminal and civil matters with respect to any charges against the companies that could result from this investigation. The Group paid a civil restitution payment of $29m. It also entered into a Deferred Prosecution Agreement which obligated it to improve its existing compliance system under the scrutiny of a monitor appointed to oversee ifs efforts. This agreement is for 18 months and if the Group meets its terms, the criminal charges that are asserted in the agreement will be null and void and of no effect. The Group also entered into a Corporate Integrity Agreement with the Office of the Inspector General (OIG) of the Department of Health and Human Services which also requires certain compliance efforts. This agreement is in effect for five years. If the Group meets its terms the OIG will not attempt to exclude it from receiving Medicare payments for its products. The Group believes that it is in substantial compliance with both agreements.

In June 2006, the United States District Court for the Southern District of Indiana in Indianapolis, Indiana issued a federal grand jury subpoena to Smith & Nephew s orthopaedic reconstruction 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. All six of the class action complaints have been dismissed without prejudice and without compensation or other payment. The Group is unaware of any activity with respect to this matter.

In September 2007, the United States Securities and Exchange Commission (SEC) wrote a letter to the Group advising that it was conducting an informal investigation into certain marketing practices in the Group s orthopaedic reconstruction business in Germany, Poland and Greece with reference to the United States statute known as the Foreign Corrupt Practices Act. The Group believes that several of its major US competitors have received a similar letter. The SEC asked the Group to voluntarily disclose to it any problems or issues. The Group has retained independent counsel and other advisors and is investigating these matters. In order to co-operate fully with the SEC the Group is investigating the three markets requested and other European markets with respect to its practices and those of Plus which it recently acquired and is integrating into its Group.

In November 2007 the Group received a Civil Investigative Demand from the Office of the Attorney General of the Commonwealth of Massachusetts. The request was with respect to consultancy payments made to healthcare professionals in that state and it asked that the Group provide certain documents. The Group is cooperating with the Attorney General. The Group has provided certain documents in respect of its orthopaedic reconstruction business and is continuing its search for others responsive to the request. The Group does not believe that any of the documents that it has provided indicate any improper conduct with respect to the Group s healthcare consultants in that state.

Table of Contents

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.

The markets in which the Group concentrates continue to demonstrate robust growth and are expected to benefit in 2008 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.

In reconstruction management expects 2008 revenue growth, including revenues of Plus, to exceed market growth which was estimated at 9% in 2007.

Within trauma and clinical therapies, market growth in fixation products was estimated at 10% in 2007 and management expects that revenue growth in 2008 will be close to the market rate.

In endoscopy, market growth in arthroscopy was estimated at 12% in 2007 and management expects that revenue growth will be slightly below the market growth rate in 2008 due to the business s orientation to the slower growth resection segment. Revenue growth in the Visualisation and Digital Operating room segments are expected to be volatile from quarter to quarter.

In advanced wound management the growth rate for the market in 2007 was estimated to be 6%, excluding the negative pressure wound therapy segment. Management expects revenue growth to slightly exceed market growth in 2008. In addition, revenues from negative pressure wound therapy products are expected to grow materially following the full launch of the BlueSky product range in the first quarter of 2008.

Management expects that revenue growth in the first quarter of 2008 will be somewhat reduced and the second quarter enhanced by the incidence of the Easter holidays which fall into the first quarter in 2008 having fallen into the second quarter in 2007.

Management expects to achieve its earnings improvement target of an increase in profit margins at the trading profit level of an average of at least 1% per annum to the end of 2010, before the impact of acquisitions and assuming a neutral pricing environment. In addition the Group expects to achieve its target cost savings from the acquisition of Plus of 15% of the acquired cost base in the third full year, equivalent to $40m per annum in the same time period.

In 2008, trading margins in the first and second quarters will be diluted in comparison with the previous year by the impact of the Plus and BlueSky acquisitions which were completed during the second quarter of 2007. In the second half of the year the Plus acquisition is expected to be accretive to trading margins compared with the previous year.

The Group expects to continue its share buy back programme in 2008 and to complete it 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.

Table of Contents

CONTRACTUAL OBLIGATIONS

Contractual obligations at 31 December 2007 were as follows:

		Payments due by period			
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			($ million)		
Debt obligations	1,426	1,422	2	2	
Finance lease obligations	49	9	12	7	21
Operating lease obligations	155	47	54	23	31
Retirement benefit obligations	44	44			
Purchase obligations	9	9			
Capital expenditure	5	5			
Other	84	37	47		
	1,772	1,573	115	32	52

Other contractual obligations consist of $4m of credit balances on currency and interest swaps, $19m of foreign exchange contracts and $61m of acquisition consideration. Provisions that do not relate to contractual obligations are not included in the above table.

The agreed contributions for 2008 in respect of the Group s defined benefit plans are: $26m for the UK plan (including $14m of supplementary payments), $11m for the US plan and $7m for the other funded defined benefit plans. The table above does not include amounts payable in respect of 2009 and beyond as these are subject to future agreement and amounts cannot be reasonably estimated.

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

OFF-BALANCE SHEET ARRANGEMENTS

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

RELATED PARTY TRANSACTIONS

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

Table of Contents

CORPORATE GOVERNANCE

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

Table of Contents

THE BOARD AND EXECUTIVE OFFICERS

Board

The Board of Directors of Smith & Nephew as at 12 March 2008 comprised:

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

Directors Biographies

John Buchanan (64). Independent non-executive Chairman. He was appointed independent non-executive Deputy Chairman in 2005 and became Chairman in April 2006. He is Chairman of the Nominations Committee. He is Deputy Chairman of Vodafone Group Plc and a non-executive director of AstraZeneca PLC and BHP Billiton. He was formerly Group Chief Financial Officer of BP plc.

David J. Illingworth (54). Chief Executive. He joined the Group in May 2002 as President of Orthopaedics and was appointed a director and Chief Operating Officer in February 2006. In July 2007 he was appointed Chief Executive. Prior to joining the Group he held posts within GE Medical, as Chief Executive Officer of a publicly traded medical devices company, President of a respiratory/critical care company and President of a technology incubator company.

Adrian Hennah (50). Chief Financial Officer. He joined the Group and was appointed a director in June 2006. He was previously Chief Financial Officer of Invensys plc and held various senior positions within GlaxoSmithKline.

Dr. Pamela J. Kirby (54). 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, Curalogic A/S and Novo Nordisk A/S.

Warren D. Knowlton (61). Independent non-executive director. He was appointed a director in November 2000 and is Chairman of the Audit Committee and a member of the Remuneration Committee. He is Chairman and Chief Executive Officer of Graham

Packaging Inc. and a non-executive director of Ameriprise Financial Inc. Previously he was Group Chief Executive Officer of Morgan Crucible plc.

Brian Larcombe (54). Independent non-executive director. He was appointed a director in March 2002 and is a member of the Audit Committee. He is Chairman of Bramdean Alternatives Limited and a non-executive director of F&C Asset Management plc. Previously he was Chief Executive Officer of 3i Group plc.

Richard De Schutter (67). 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, Ecolab Inc, and Navicure Inc.

Dr. Rolf W. H. Stomberg (67). 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 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.

Sir Christopher O Donnell retired in July 2007.

Table of Contents

Executive Officers

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

Mark Augusti (42). 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.

Elizabeth Bolgiano (45). Group Human Resources Director. She joined the Group in July 2004, as Senior Vice President Human Resources for the Orthopaedics global business unit. In August 2007, she was appointed Group Human Resources Director. Previously, she was Vice President Human Resources with Bristol-Myers Squibb, where she held a variety of human resources roles during her 15 year tenure.

Joseph DeVivo (40). President of Orthopaedic Reconstruction. He joined the Group in June 2007 as President of Orthopaedic Reconstruction. Prior to joining the Group he held senior executive positions with RITA Medical Systems Inc, Computer Motion Inc and United States Surgical a division of Tyco Healthcare where he held a wide variety of roles.

Michael Frazzette (46). President of Endoscopy. He joined the Group as President Endoscopy in July 2006. Previously he was President and Chief Executive Officer of a US manufacturer of medical devices and spent 15 years at Tyco Healthcare becoming President of each of Patient Care and Health Systems divisions.

R. Gordon Howe (45). Senior Vice President Global Planning and Development. He joined the Group in 1998, and served in planning and business development roles in the Orthopaedics division. He was appointed to his current role in August 2007. Prior to joining the Group, he held management positions with United Technology Corporation.

James A. Ralston (61). 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.

Joe Woody (42). 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.

Paul M. Williams retired and Sarah Byrne-Quinn and Peter W. Huntley resigned during 2007. Dr. Peter Arnold resigned in 2008.

Group Company Secretary

Paul R. Chambers (63). Company Secretary. He joined the Group in 1994 as Assistant Company Secretary and was appointed Company Secretary in April 2002.

Table of Contents

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 2007 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 J. Illingworth, in accordance with his revised contract of employment on his appointment as Chief Executive is up to 24 months from the date of the appointment. 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 appropriate 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, two executive directors and five independent non-executive directors. In 2007, the Board met on eight occasions and individual attendance together with attendance at Board Committee meetings, is shown in the table on page 56. If directors are unable to attend a Board meeting or Board Committee meeting, they are advised of matters to be discussed and have an opportunity to make their views known to the Chairman prior to the meeting.

The Board is responsible for the strategic direction and overall management of the Group and has a formal schedule of matters reserved for its decisions which include the approval of certain policies, budgets, financing plans, large capital expenditure projects, acquisitions, divestments and treasury arrangements. Otherwise it delegates the executive management of the Group to the Chief Executive and certain specific responsibilities to Board Committees, as described on 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 quarterly Board meeting without management in attendance and the Senior Independent Director meets with the other non-executive directors annually to evaluate the performance of the Chairman. Board meetings are held at the major business units enabling directors to have a greater understanding of the business and to meet the management of these units. All directors have full and timely access to all relevant information and, if necessary, to independent professional advice. Induction programmes are provided for new directors and training is offered to all directors. In 2007, the Board was updated on the UK tax environment and recent 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. The Deeds of Indemnity allow for indemnification of directors in respect of

Table of Contents

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 the performance, management and supervision of the Group in accordance with the strategy, policies, budgets and business plans approved by the Board.

The Senior Independent Director is Dr. Rolf Stomberg, whose role includes consulting with members of the Board on issues relating to the Chairman and chairing meetings of the Nominations and Audit Committee in the absence of the Chairman or Chairman of the Audit Committee. He is available to shareholders if they have concerns that cannot be resolved through the normal channels of contact with the Chairman or Chief Executive. Following the retirement of the Chairman and Group Finance Director in 2006, Dr. Stomberg, having served nine years as a director, was asked to continue to serve as a director for up to a further three years. He brings considerable experience 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 2007, a formal evaluation of the performance of the Board commenced, conducted by an external consultant who is to report back to the Board in mid-2008.

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 2006 to 12 March 2008.

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 2007 (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 2007 is on pages 58 to 59.

Table of Contents

Remuneration Committee

The Remuneration Committee, consisting entirely of independent non-executive directors, met five times in 2007 (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 D. Knowlton and Richard De Schutter. The Remuneration Committee sets the pay and benefits of the executive directors and Executive Officers, approves their main terms of employment and determines share options and long-term incentive arrangements for the Group. It also reviews senior management succession planning. The Remuneration Report is on pages 61 to 72.

Nominations Committee

The Nominations Committee, consisting of two independent non-executive directors and the Chief Executive, met once in 2007 and its Chairman, John Buchanan, and members, Dr. Rolf Stomberg and Sir Christopher O Donnell, attended the meeting. On his appointment as Chief Executive in July 2007 David J. Illingworth replaced Sir Christopher O Donnell. 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. The process for the appointment of David J. Illingworth as Chief Executive was effected by the whole Board.

Board and Committee Attendance

	Board 8 meetings	Remuneration Committee 5 meetings	Audit Committee 6 meetings	Nominations Committee 1 meeting
John Buchanan	8	n/a	n/a	1
David J. Illingworth	8	n/a	n/a	n/a
Adrian Hennah	8	n/a	n/a	n/a
Dr. Pamela J. Kirby	7	5	n/a	n/a
Warren D. Knowlton	7	4	6	n/a
Brian Larcombe	8	n/a	6	n/a
Richard De Schutter	7	5	6	n/a
Dr. Rolf W. H. Stomberg	8	5	6	1
Sir Christopher O Donnell (i)	5	n/a	n/a	1

(i) Retired as Chief Executive in July 2007.

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.

Dr Rolf Stomberg who has served more than nine years as a director of the Company will retire at the annual general meeting to be held in May 2008 and, being eligible, will offer himself for re-election. In accordance with the articles of association, John Buchanan, Dr Pamela Kirby and Brian Larcombe will retire and, being eligible, will offer themselves for re-election at the AGM.

Table of Contents

ACCOUNTABILITY, AUDIT AND INTERNAL CONTROL FRAMEWORK

Risk Management and Internal Control

The Board has overall responsibility for the Group s systems of internal control and risk management and for reviewing their effectiveness. These systems which have been in place for 2007 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 controls over financial reporting 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 22 to 26.

In 2007 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. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In accordance with the requirement in the US under s404 of the Sarbanes-Oxley Act management assessed the effectiveness of the Group s internal control over financial reporting as at 31 December 2007. 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. The assessment excluded the internal controls over financial reporting relating to entities acquired as part of the Plus acquisition (the Plus entities) because they were acquired on 31 May 2007 as described in Note 32 of the Notes to the Accounts. As of, and for the year-ended, 31 December 2007, the Plus entities represented 8%, 13%, 6% and 17% (loss) of the Group s consolidated total assets, net assets, total revenues and attributable profit respectively.

Based on its assessment, management has concluded and hereby reports that, as at 31 December 2007, the Group s internal control over financial reporting is effective based on those criteria.

Ernst & Young LLP, an independent registered public accounting firm, has issued an audit report on the Group s internal control over financial reporting as of 31 December 2007. This report appears on page 78.

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

Disclosures Committee and Evaluation of Disclosure Controls and Procedures

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

Table of Contents

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 2007. 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/sustainability2007 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 2007 and up until 12 March 2008 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/sustainability2007 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 2007 or up until 12 March 2008.

Activities of the Audit Committee for 2007

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

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

monitoring the effectiveness of internal financial controls and reviewing compliance with s404 of the Sarbanes-Oxley Act 2002;

reviewing the operation of the risk management process; and

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

The Group has specific policies which govern:

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

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

The Chief Executive, the Chief Financial Officer and other members of management 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.

Table of Contents

The principal activities of the Audit Committee during the year ended 31 December 2007 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;
- a review of the Group s approach to internal financial control, its processes, outcomes and disclosures;
- a review of the Internal Review department s activities for the year, together with its resource requirements and findings;
- a review of whistleblowing procedures;
- a review of the reports from the auditors, Ernst & Young LLP, on their professional and regulatory compliance in order to maintain independence and objectivity, including the rotation of partners;
- a review of the audit, audit-related, tax and other services provided by Ernst & Young LLP;
- review and the pre-approval of all services provided by the auditors during the year including all non-audit work performed by the auditors together with associated fees, to ensure that the objectivity and independence of Ernst & Young LLP as auditors of the Group was not compromised. Ernst & Young LLP only provided advisory work in respect of accounting and tax related matters;
- consideration of Ernst & Young LLP s in-depth reports to the Committee on the scope and outcome of the annual audit and management s response. Their reports included accounting matters, governance and control and accounting developments;
- a review of the effectiveness of the performance of Ernst & Young LLP effected by the completion of a questionnaire by the units audited within the Group and by the members of the Committee;
- recommending the re-appointment of Ernst & Young LLP as the Group s auditors;
- confirmation that no concerns were raised with the Committee about possible improprieties in matters of financial reporting or other matters;
- reviewing the Committee s terms of reference to ensure they reflect developments in corporate governance in the UK and the US;
- consideration of the Group s risk management process; and

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

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

Principal Accountant Fees and Services

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

	2007	2006
	($ million)	
Audit	4	4
Audit-related		1
Tax	3	3
Other	1	2
	8	10

Audit fees include fees associated with the annual audit and local statutory audits required internationally. Audit-related fees in 2006 principally included 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. In 2007 other fees related to the acquisition costs for Plus. In 2006 these related to the bid costs for Biomet Inc. A more detailed breakdown of audit fees may be found in Note 38 of the Notes to the Group Accounts.

Table of Contents

Disclosure of Information to the Auditors

In accordance with s234ZA of the Companies Act 1985, 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.

Table of Contents

REMUNERATION REPORT

The Remuneration Committee

The Committee, which comprises Dr. Rolf Stomberg (Chairman), Dr. Pamela Kirby, Warren D. Knowlton and Richard De Schutter, determines the compensation of executive directors, executive officers and the broad policy for executive remuneration. The Committee is assisted by David J. Illingworth, Chief Executive and Elizabeth Bolgiano, 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. Prior to their retirement the Committee were also assisted by Sir Christopher O Donnell and Paul M. Williams.

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: Deloitte & Touche LLP on a broad range of remuneration issues; PricewaterhouseCoopers LLP on long-term incentive plan comparative performance and Towers Perrin and Hay Group on salary data when considering base salaries of executive directors and executive officers. Deloitte & Touche LLP has provided taxation advice and PricewaterhouseCoopers LLP has provided consultancy services to the Group whilst Towers Perrin and Hay Group have not provided any additional advice.

Remuneration Policy

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

Review of Remuneration Policy

During 2007, the Remuneration Committee reviewed the remuneration policy and identified a number of changes which will better support the achievement of the Group s key business drivers; and will help the retention of high performing senior executives, particularly in the context of the US talent market. The changes and the revised policy for 2008 are set out below. In accordance with Smith and Nephew s normal practice, all of the major changes have been discussed with the Group s principal shareholders.

For 2008, the following changes have been made to executive incentive arrangements:

The Co-Investment Plan will no longer be operated except as it relates to the 2007 bonus.

A new Deferred Bonus Plan will be introduced for 2008. Annual bonus opportunities (at target level and above) have been adjusted to reflect both the cessation of the Group s Co-Investment Plan and the

Table of Contents

requirement that a portion of executives bonuses will be compulsorily deferred. The cash bonus opportunity remains unchanged. Bonus deferral will only apply to bonus awards earned at target level and above.

The Performance Share Plan (PSP) has been changed to enable more effective use of performance measures. New targets will apply from 2008 onwards, which re-balance the focus on strong financial performance whilst continuing to incentivise the achievement of superior shareholder returns.

Shareholder approval is being sought at the AGM on 1 May 2008 to increase the limit of the initial market value of awards for executive directors made under the PSP to 150% of a participant s basic salary. Were upper decile total shareholder return (TSR) achieved, the maximum market value of an award (at grant) would increase to 225% of salary. This amendment is necessary to implement the change of policy which was announced in the 2006 Remuneration Report.

The level of shareholding that executive directors are required to build up and maintain has been doubled to 200% of salary, in order to strengthen further the link between executives and shareholders interests.

The Principal Components of Remuneration

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

Basic salary;

Annual bonus with a deferred element under the Deferred Bonus Plan;

Long-term incentives, comprising Performance Share Plan awards and share options; and

Pension entitlement and other benefits

(a) Basic Salary and Benefits

Basic salary reflects the responsibility of the position and individual performance. Salaries are reviewed annually with effect from 1 April each year. The basic salaries of the executive directors as at 1 January 2008 are:

David J. Illingworth	£ 675,000
Adrian Hennah	£ 475,000

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

(b) Performance Related Bonus and Deferred Bonus Plan

For executive directors, the Group operates an annual bonus scheme. The scheme is designed to encourage outstanding performance. In 2008, 75% of the annual bonus will be based on annual growth in EPSA and 25% will be based on personal objectives underpinned by asset velocity measurements.

To encourage executives to build-up and maintain a significant shareholding, a new Deferred Bonus Plan will operate from 2008. Under the plan, one third of any bonus earned at target level or above by an executive director will be compulsorily deferred into shares which vest, subject to continued employment, in equal annual tranches over three years (i.e. one third each year). No further performance conditions will apply to the deferred shares. No bonus deferral occurs for below target level performance.

The maximum annual bonus opportunity for executive directors in 2008 will be increased from 100% to 150% of annual salary, of which one third will be compulsorily deferred. The maximum cash bonus opportunity therefore remains unchanged at 100% of salary. The target bonus award for 2008 will be increased from 65% to 100% of salary. The cash bonus opportunity below target level remains broadly unchanged. Bonuses are not pensionable.

For executive officers with corporate responsibilities, the 2008 annual bonus plan will be linked to EPSA growth, and personal objectives. For those executive officers with specific business unit responsibilities, targets will be linked to EPSA growth, sales growth, trading profit and margin of their respective business unit and personal objectives. One quarter of the annual bonus earned, if at target level or above, will be compulsorily deferred into shares, which vests in equal annual tranches over three years, subject to continued employment. No further awards will be made under the voluntary 2004 Co-Investment Plan.

For 2007, for executive directors, the annual bonus targets related 75% to annual growth in EPSA and 25% was based on personal objectives underpinned by asset velocity measurements. On this basis, the actual bonus earned in 2007 by executive directors is shown in the table on page 68 and ranged from 88% to 91% of annual basic salary.

Table of Contents

(c) Long-Term Incentives

(i) Performance Share Plan

Following the review of remuneration policy, in 2008 the Remuneration Committee has amended the operation of the Performance Share Plan to make more effective use of the performance measures that apply to the awards. The new performance measures are aligned with Smith & Nephew s growth strategy, and balance an enhanced focus on strong financial performance, with the alignment of executives and shareholder interests through providing additional reward opportunity linked to the creation of shareholder value.

From 2008 onwards, annual awards over shares made under the 2004 Performance Share Plan will only vest if pre-defined levels of EPSA growth are achieved. The number of shares that are delivered may be increased if superior total shareholder returns are achieved. There is no retesting.

The Remuneration Committee considers the proposed targets to be suitably stretching to incentivise achievement of excellent financial performance. For future awards, the Remuneration Committee will continue to select performance measures in respect of each annual award at the level it considers appropriately stretching given the conditions in which the Company is operating.

The 2008 awards will vest subject to EPSA growth measured over the three-year performance period, based on the following performance targets:

25% of the award will vest if growth in EPSA over the three-year period ending 31 December 2010 is 43% (i.e. 13% per annum compounded annually).

50% of the award will vest if growth in EPSA over the three-year period ending 31 December 2010 is 64% (i.e. 18% per annum compounded annually).

100% of the award will vest if growth in EPSA over the three-year period ending 31 December 2010 is 82% (i.e. 22% per annum compounded annually).

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

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

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

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

TSR will be measured relative to a tailored sector peer group of medical devices companies. The comparator companies in the benchmark comparator group for the 2008 awards which the Committee considers appropriate to the Company are:

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

Table of Contents

In 2007, the Remuneration Committee decided to make awards to executive directors under the Performance Share Plan with a market value of 150% of basic salary. As this was in excess of the normal individual limit of 100% of salary, these awards were made under Rule 9.4.2 of the Listing Rules. This was considered necessary to deliver market competitive remuneration and retain executives, particularly in the context of pressures faced from the US medical devices industry talent market.

In order to maintain the competitive positioning of the remuneration policy, shareholder approval is being sought at the AGM to be held on 1 May 2008 to increase the individual limit of the initial market value of awards under the plan for executive directors to 150% of basic salary. Subject to shareholder approval, for 2008, the initial market value of awards made to executive directors will be equivalent to 150% of their basic annual salary. The initial market value of the awards made to executive officers will be equivalent to 75% of their basic annual salary. These values are before the application of the TSR multiplier.

The Group s TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by Deloitte & Touche LLP. Awards made in 2007 were divided equally into two tranches, so as to measure TSR relative to the FTSE 100 and major companies in the medical devices industry respectively. In relation to either tranche, if 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 centile, 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.

For awards made in 2005, 17% vested as the Company was ranked 77th in the FTSE 100 comparator group and 9th in the medical devices group.

(ii) Executive Share Options

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

The target levels of performance are set by the Remuneration Committee for each grant. For 2008, the performance targets for executive directors will be: 25% of the options will vest if growth in EPSA over the three-year period ending 31 December 2010 is 43% (i.e. 13% compounded annually) with 50% vesting if such growth is 64% (i.e. 18% compounded annually). Only if growth in EPSA over that period exceeds 82% (i.e. 22% compounded annually) will all of the options vest. Share options will vest pro rata on a straight-line basis if growth in EPSA is between these levels. There is no retesting of performance conditions.

For awards made in 2007, 25% of the options will vest if growth in EPSA over the three-year period ending 31 December 2009 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 options vest. Share options will vest pro rata on a straight-line basis if growth in EPSA is between these levels. There is no retesting of performance conditions.

To be aligned with practice in the US market, from 2008 US-based executives below executive director level will participate in the 2001 US Share Plan, which vests in equal annual tranches over three years, and will not be subject to performance conditions. Awards granted to UK senior executives below executive director level will be granted under the 2001 plan, which vests after three years subject to the achievement of appropriate EPSA targets.

For options granted in 2005 under the 2004 Executive Share Option Plan, 40% of the awards vested as EPSA growth was 39% over the three year performance period.

(iii) Co-investment Plan

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

Table of Contents

For the March 2008 award (based on executives 2007 elections), 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 60% (i.e. 17% compounded annually). At this level, the participant is entitled to one matching share for every share acquired out of the gross equivalent amount of the net bonus used to acquire shares. If growth in EPSA is 70% (i.e. 19% compounded annually) or more, the participant is entitled to two matching shares for each share acquired out of the gross equivalent amount of the net bonus used to acquire shares. There is no sliding scale or pro rata vesting of matching awards between these performance levels, nor is there any retesting.

For the 2007 award, provided such shares are held for three years and the participant remains employed within the Group, the participant will be entitled to matching shares if the Group achieves a target level of growth in EPSA over that three-year period of 40% (ie. 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 or pro rata vesting of matching awards between these performance levels, nor is there any retesting. For awards made in 2005, no matching shares were awarded as EPSA growth over the three year performance period of 39% was below the target of 48%.

(iv) Restricted stock awards

The issue of restricted stock to senior executives is considered in exceptional circumstances subject to the approval of the Remuneration Committee. During the year a restricted stock award was made to David J. Illingworth on his appointment as Chief Executive. This award was made under Rule 9.4.2 of the Listing Rules and will vest on 1 January 2010 subject to Earnings Improvement Programme performance targets. Any vested shares from this award will not be pensionable.

(d) Shareholding requirements

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

(e) Pensions

Pensions UK

UK based executive directors and executive officers have a normal retirement age of 62. Those commencing employment after 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.

Pensions US

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

Other Long-Term Incentive Plans

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.

Table of Contents

Under the 2001 UK Approved Share Option Plan, the 2001 UK Unapproved Share Option Plan and the 2001 US Share Plan the Remuneration Committee determines the maximum value of options to be granted to executives by reference to multiples of salary for those executives not eligible for the 2004 share plan.

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 2005 will vest in 2008 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. For awards made in 2008 and thereafter, options granted under the 2001 US Share Plan will vest in equal tranches over three years to keep in line with senior executives. Awards of restricted stock under the 2001 US Share Plan are not subject to performance targets but are subject to the executive remaining with the Group for a specified period, normally two years.

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

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

Total Reward Composition

The general statement on Remuneration Policy on page 61 sets out the approach taken when setting different elements of pay. In 2007, excluding pension entitlements, the composition of remuneration for both David J. Illingworth and Adrian Hennah was: base pay (fixed) 20%, annual bonus (variable) 20%, and long-term incentives (variable) 60%.

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 for 2007. 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 150% 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 50% of salary 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%

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 Remuneration Committee approved that, for the appointment of David J. Illingworth as Chief Executive, the notice period on appointment would effectively be 24 months, reducing to 12 months on the expiry of the initial term.

David J. Illingworth, appointed to the Board of Directors in February 2006, has a service agreement dated June 2007, the date of his appointment as Chief Executive 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

Table of Contents

terminable by the Company on 12 months notice. The agreements are terminable by the executive director on six months notice. There is no enhancement of termination rights on a change of control of the Group. During 2007 termination of the contract by the Group, except for cause , would have effectively entitled David J. Illingworth to 24 months basic salary reducing to 12 months after the initial 24 months and Adrian Hennah to 12 months basic salary plus a 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 Group has a policy of not rewarding failure and the Committee will review all circumstances in determining whether to invoke mitigation. Sir Christopher O Donnell, whose service agreement was due to expire in October 2008, retired in July 2007.

External Non-executive Directorships

Currently, neither 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.

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 six month notice period. The remuneration of the non-executive directors is determined by the Nominations Committee which aims to set fees that are competitive with other companies of equivalent size and complexity. Non-executive directors are expected to accumulate a personal holding in the Company equivalent to their annual basic fee, within three years.

The Chairmen of the Audit and Remuneration Committees and the Senior Independent Director receive an extra £8,500 for their additional responsibilities. In 2007, Dr. Rolf Stomberg waived his extra fee entitlement due to him as Senior Independent Director. Fee arrangements were amended in 2007 whereby an additional fee of £3,000 is paid to non-executive directors each time inter-continental travel is necessary to attend company business meetings.

Table of Contents

The information set out on pages 68 to 71 has been audited by Ernst & Young.

Directors Emoluments and Pensions

	Salaries and fees	Benefits (i)	Bonus	Salary supplement in lieu of pension	Total 2007	Total 2006
			(£ thousands)			
Chairman (non-executive):						
John Buchanan (ii)	325				325	235
Executive Directors:						
David J. Illingworth (iii)	568	67	463	101	1,199	680
Adrian Hennah (iv)	469	20	433	141	1,063	502
Non-executive Directors:						
Dr. Rolf W. H. Stomberg	62				62	56