

# Business review

## Business review

### Group activities

Smiths is a global applied technology business serving detection, medical devices and specialty engineering markets.

### Strategy

Smiths is committed to creating long-term value for shareholders by building and sustaining strong businesses in growth sectors.

The Group's objective is to create value from organic growth and from reinvestment of self-generated cash-flow. Adjustments are made to the business mix through both acquisitions and disposals to enhance value for shareholders.

### Changes in Group composition

In line with the strategy of enhancing value for shareholders, in May 2007 Smiths Aerospace and Times Microwave Systems Inc. (previously reported as part of Specialty Engineering) were sold to General Electric Company (GE). See page 14 for details of this disposal. These businesses are treated as discontinued and disclosed as such in the Consolidated income statement with comparative figures adjusted accordingly.

Details of other changes in Group composition in the year are set out in the relevant divisional paragraphs below.

### Performance of continuing operations

The continuing operations comprise the Detection, Medical and Specialty Engineering divisions.

The key Smiths performance indicators, which are closely monitored throughout the year and measured against pre-set targets, are:

- sales and headline profits;
- cash generation; and
- return on investment.

The table below shows the overall performance of continuing operations.

	2007 £m	2006 £m	Movement
Sales	<b>2,161</b>	2,180	{1}%
Headline:			
– operating profit	<b>348</b>	345	1%
– pre-tax profit	<b>344</b>	316	9%
– earnings per share	<b>47.0p</b>	41.5p	13%
Cash generation	<b>75%</b>	82%	
Return on shareholders' funds (page 14)	<b>14.9%</b>		

Compared with sterling, the average exchange rate of the US dollar fell by 9% year-on-year and the average euro exchange rate fell by 1.5%.

### Headline figures

Headline profit is presented because Smiths believes it provides valuable additional information on underlying trends. It is used by management to monitor the performance of the business. Normal restructuring costs are charged against headline profit, while the following items are excluded:

- exceptional items (including impairments);
- amortisation of intangible assets acquired in a business combination;
- profit or loss on disposal of businesses; and
- other financing gains and losses.

### Sales

Sales were £2,161m, 1% lower than the £2,180m recorded in 2006.

The translation of sales of overseas business units at this year's average exchange rates reduced sales by £120m. On an underlying basis excluding the effect of acquisitions and disposals (£9m) and currency translation, sales increased by 5%.

The United States remains the Group's largest market. By destination, it accounted for 44% of sales while UK/Europe accounted for 31% and the rest of the world for 25%.

Details of sales by division are given in the divisional paragraphs.

### Profit

Headline operating profit increased by £3m to £348m. Headline operating margin increased to 16.1% (2006: 15.8%).

The net impact of acquisitions and disposals on headline operating profit was £1m. The effect of currency translation held back year-on-year headline profit growth by £21m. The growth excluding the effect of acquisitions, disposals and currency translation is 7%.

The operating profit of the continuing business on a statutory basis, after taking account of the items excluded from headline figures, is £257m (2006: loss of £8m).

Headline pre-tax profit increased by £28m to £344m. This was largely due to a £17m reduction in net interest charges and a £9m increase in the net finance credit from the pension schemes.

Profit before tax for continuing operations on a statutory basis is £256m (2006: loss of £37m).

### Cash generation

Generation of above-average free cash-flow contributes to additional growth by providing resources for the growth of the business both organically and by acquisition. Performance is evaluated by measuring the ratio of operating cash-flow to headline operating profit. For this purpose, operating cash-flow is measured before the cash impact of exceptional items and special pension payments and after expenditure on property, equipment, software and development costs. Following sale of the aerospace business, a target conversion rate of approximately 90% was set for the remaining business in a normal year.

The operating cash-flow on this basis was £259m, representing 75% of headline operating profit. This compares to operating cash of £283m in 2006 and cash generation of 82%. The cash generation outcome this year reflects investment in capital projects and increased working capital to support business growth in the new year.

On a statutory basis, net cash inflow from continuing operations was £205m (2006: £139m).

Cash expenditure on exceptional items was £27m, compared with £17m in the previous year. The Group made special pension contributions of £56m (2006: £61m) mainly relating to Aerospace. Free cash-flow from continuing operations (after interest and tax but before acquisitions and dividends) was £101m.

Dividends paid in the year on ordinary shares amounted to £182m, compared with £167m in 2006. Details of the return of £2.1 billion to shareholders are set out in the aerospace disposal section (page 14).

Aerospace in total, net of the return of cash, contributed £337m cash inflow. During the year, the continuing Group spent £35m (2006: £54m) on acquisitions.

### Earnings per share

Basic headline earnings per share from continuing activities were 47.0p (2006: 41.5p), a rise of 13%.

On a statutory basis, the basic earnings per share from continuing activities were 36.9p (2006: loss of 18.2p).

These measures are distorted this year by the effect of the share consolidation in June following the disposal of the aerospace business. The average number of shares in issue during the year was a reflection of the capital structure appropriate to both the continuing and the discontinued business.

### Interest and other financing costs

For continuing operations, interest payable on debt, less interest on cash deposits, was £36m, compared with £53m in 2006. The £17m movement reflects the cash inflow following the aerospace sale. Net interest costs were 9.5 times covered by headline operating profits.

The Group accounts for pensions using IAS19. As required by this standard, a finance credit is recognised reflecting the expected return on pension scheme assets and a finance charge is recognised reflecting the unwinding of the discount on the future pension liability. The net financing income for continuing operations was £34m in 2007, compared with £25m in 2006.

### Exceptional and other items relating to continuing activities excluded from headline profits

These items were £88m, compared with £353m in 2006. These comprised:

- £9m for integration costs associated with the Medex acquisition (2006: £19m);
- Impairment of goodwill and other assets (£10m) principally in respect of the automotive seals business and a loss on disposal of businesses of £5m (2006: profit of £18m);
- £13m in respect of costs written off following the decision not to proceed with the detection joint venture with GE;
- £43m proceeds from insurance commutation (see litigation paragraph on page 16);
- £101m provision for John Crane litigation costs and net £3m provision for other litigation (see litigation paragraph on page 16);
- A profit of £24m in respect of TI Automotive shares;
- Amortisation of intangible assets acquired in business combinations of £15m (2006: £13m). The amortisation relates principally to technology and customer relationships.

Exceptional items in 2006 included £325m in respect of the write down of TI Automotive shares and £12m for the settlement of a product liability class action.

Financing gains amounted to £1m (2006: loss of £2.3m). These represent the results of derivatives and other financing instruments which are not hedge accounted under IFRS. Of this sum, £1.5m (2006: £1.8m) was charged to operating profit.

### Net debt

Net debt at year end was £588m, down from £923m at the start. Contributing to the net debt reduction were the Aerospace disposal and the related return of cash.

### Research and development

Investment in research and development (R&D) drives future performance and is a measure of the Group's commitment to the future organic growth of the business.

Smiths invested a total of £79m in R&D on continuing operations, equivalent to 4% of sales. Of that total, £8m was funded by customers. The comparative figures for the continuing activities in 2006 were £80m and £12m. Under IFRS, certain of these development costs are capitalised. The gross capitalisation is shown as an intangible asset. Where customers contribute to the costs of development, the contribution is included as deferred income and disclosed within trade and other payables.

R&D is discussed further in the divisional paragraphs below.

## Divisional developments and performance

### Smiths Detection



**Group Managing Director**  
Stephen Phipson

#### Description

Smiths Detection is a prime contractor which designs and manufactures equipment to detect and identify explosives, weapons, contraband and dangerous substances.

It has a vast range of advanced technologies, including trace detection, x-ray, millimetre wave, infra-red and biological agent analysis.

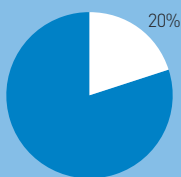
#### Employees

2,100

#### Principal operating regions

Manufacturing is concentrated in North America, Germany, France and the UK.

#### Contribution to 2007 Group sales



#### Key customers

Some 85% of sales are influenced by governments around the world including homeland security authorities, customs authorities, first responders and the military.

#### Markets

Homeland security is a top priority in western countries, with 10% per annum market growth expected. The worldwide market addressed by Smiths Detection products and services is estimated to be worth £3 billion.

Smiths Detection's products serve the transportation, critical infrastructure, ports and borders, military and first responder markets. The Group also adapts technology developed for these markets for carefully selected industrial applications.

The transportation sector, which includes airports, is the largest representing 38% of total sales. The airport security market is expected to grow in response to:

- the projected growth in air traffic;
- new security threats; and
- customer demand to improve passengers' experience and increase throughput at checkpoints. The HI-SCAN 6040aTiX is focused on this issue and is the first system that will be deployed that will allow automatic explosives detection at security checkpoints. It uses several, independent multi-energy generators, each of which is connected to its own sophisticated and state-of-the-art X-ray sensor technology.

The critical infrastructure market is diversified with varying growth rates in the different segments. Smiths Detection is focusing on three key areas: mass transit, sports and events and government and military facilities. Smiths has a growing involvement in helping protect a number of important metro systems in both the US and Europe. A good example of a sporting event is the Asian Games held in Doha late last year for which Smiths supplied chemical detection equipment.

Sales to the ports and borders sector doubled, with new business in Russia, Italy and Nigeria. The market is a rapidly expanding sector driven by government objectives of enhancing security screening and preventing tax evasion. Customers require mobile and fixed units capable of detecting explosives, weapons, radioactive materials and narcotics. In Russia, working closely with the relevant authorities, Smiths Detection's new manufacturing facility in St Petersburg is now fully operational.

The military market for UK and US technology is restricted by export controls, and these two governments form a large part of the market. This market is influenced by tendering opportunities for large individual contracts that typically run for several years. Late in the financial year, Smiths Detection was awarded an important contract to supply the US Department of Defense with new-generation lightweight chemical agent detectors under its Joint Chemical Agent Detector (JCAD) programme.

Smiths Detection intends to develop new business by expanding systems integration activity, offering improved functionality in protective shelters and introducing new technologies through government funded partnerships.

The first responder market is smaller than the other markets, with US sales accounting for more than 50% of global addressable demand. This market is characterised by more localised purchasing decisions and steadier growth.

The markets served by Smiths Detection are particularly influenced by specific events and the perception of the threat of terrorist activity or other security issues. This perception itself has been and is likely to remain variable.

#### Performance

	2007 £m	2006 £m	Movement
Sales	<b>438</b>	412	6%
Headline operating profit	<b>79</b>	74	6%

#### Sales

Sales increased by 6% to £438m. Adverse exchange rate movements reduced reported sales by 4%. Excluding acquisitions, disposals and the effect of exchange translation, sales have increased 10%.

The transportation sector grew at 11%, and new products were launched giving prospects of strong growth ahead.

The military sector saw sales reduce by 11%, with some major contracts reaching a conclusion and the new Joint Chemical Agent Detector (JCAD) programme not yet in full production.

#### Headline operating profit

Headline operating profit increased 6% to £79m and the operating margin of 18% was sustained in 2007. At constant currency operating profit growth of 10% matched sales growth. On a statutory basis, operating profit was £65m (2006: £79m).

### Research and development

Products are being continually upgraded to provide greater levels of threat detection, working closely with customers to meet their most demanding requirements. Smiths is particularly investing in new products for detecting improvised explosive devices, bio-terrorism and radiation.

R&D expenditure increased by 9% to £33m, including £7m of capitalised projects. Major projects included the aTiX machine which provides enhanced detection capability including the automatic detection of explosive. Other projects included bio-terrorism and radiation detection, together with enhancements to the EDtS multi-beam X-ray machines for automatic inspection of airport checked baggage. Future technology developments include millimetre wave and video systems.

### Forward-looking issues

Smiths strategy is to build a global business in order to offer customers a range of different solutions for the threats they are facing. The outlook for Smiths in the detection sector is positive.

The investment levels in 2007 were high, with increases in inventory and capital investment, in order to meet the sales demand ahead. Capital investment is being made to ensure the rapid build up of production of the aTiX machine to meet expected demand from airports around the world.

BAA has selected Smiths as its long-term strategic partner to enhance security at every passenger checkpoint at its seven major UK airports. The agreement, which is Detection's largest ever UK airport contract, includes an initial roll-out potentially worth £20m. Smiths will supply aTiX machines, automated tray return systems, enhanced trace detection systems and archway metal detectors, all designed to smooth the process of screening carry-on bags while strengthening security at checkpoints.

Contracts for the initial supply and second increment of JCAD detectors have been secured and will underpin growth in Military sales in the US.

## Smiths Medical



**Group Managing Director**  
Srin Seshadri

### Description

Smiths Medical focuses on improving medical outcomes by providing specialist medical devices to global markets. Smiths helps its customers:

- deliver medication, for example by providing equipment to deliver chemotherapy, pain relief and insulin;
- provide vital care, for example, by providing equipment and devices which manage patients' airways and temperature, monitor vital signs before, during and after surgical procedures, and help treat longer-term respiratory conditions;
- keep people safe, through safety devices that prevent needle-stick injuries and reduce cross-infections when drawing blood samples, giving injections and delivering intravenous drugs.

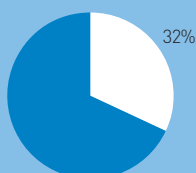
### Employees

8,200

### Principal operating regions

Manufacturing is concentrated in Mexico, the US, the UK, Italy and Germany.

### Contribution to 2007 Group sales



### Key customers

Smiths Medical's end customers are hospitals and other healthcare providers worldwide. Most territories are serviced through local wholly-owned sales and distribution companies.

### Business developments

Smiths Medical continues with a major integration and rationalisation programme which includes the integration of Medex.

Manufacturing rationalisation has continued and the cessation of manufacturing at Hythe, announced in July 2006, remains on track for completion by January 2008. A smaller rationalisation of German manufacturing arrangements was announced during the year. The reorganisation of distribution facilities also reported last year has continued.

The implementation of a common global computer platform continued with the UK launch in February 2007. This, together with the manufacturing restructuring, has caused some temporary disruption to the internal supply chain, now resolved.

Internationally, Smiths Medical has acquired distributors in many of its key territories. Most recently in December 2006 the Spanish distributor, Tecnicas Medicas, was acquired for £12m. This strategy provides effective routes to market when countries adopt clinical best practices many of which, like the use of safety devices, have originated in the USA.

## Markets

Smiths Medical's product ranges serve three main markets – medication delivery, vital care and safety. Healthcare spending continues to increase worldwide, driven by demographics. The overall world market for devices and equipment of the type supplied by Smiths Medical is estimated to be worth £3.5 billion and growing consistently at an average rate of 5% per annum.

In the US Smiths Medical is benefiting from the move towards treatment of illnesses in their chronic, rather than acute stages. A number of airway management products and ambulatory pumps already address this trend – such as the CADD ambulatory infusion pump range and the Acapella respiratory therapy system – and it is becoming a focus for our vital care products.

The global market for medication delivery products is estimated to be worth £1.5 billion and growing at around 6% per annum. This growth is due to the increase in treatment of chronic conditions, integrating medication delivery devices with hospital IT systems, and the move to treating patients outside hospitals.

The market for vital care products is showing annual growth of around 4%, partly due to a steady increase in chronic respiratory diseases and obesity. Demand is increasing for single use devices such as Portex airway management products. The market is expected to continue growing as the number of operations and intensive care beds both increase. This market is currently worth about £1.5 billion a year.

The global market for safety products is estimated to be worth £500m and growing at 6% per annum. The advantages of using safety devices are well understood in the US, and there is now greater recognition of the contribution safety devices make to improving the safety and productivity of healthcare employees. In other geographic markets, conversion to safety products is in its infancy, with opportunities for rapid future growth. Demand for the Jelco ProtectIV range of intravenous catheters continues to grow and the product is seen as leading the field in Europe and the US. Since the acquisition of Medex, product launches have included a new range of Jelco AdvantIV passive safety catheters and an extended needle safety portfolio. Safety products are also being introduced into other areas of healthcare, such as dentistry.

Smiths Medical has respected brands including CADD, Medfusion, Portex, Level 1, Medex and Jelco, competitive positions, considerable expertise in design and manufacture and a worldwide sales network.

## Performance

	2007 £m	2006 £m	Movement
Sales	691	737	(6)%
Headline operating profit	127	133	(5)%

## Sales

Sales fell 6% in the period. Adverse movements in exchange rates are responsible for £45m of the total £46m reduction.

In this period Smiths Medical failed to match market growth and sales declined by 1% on an underlying basis. The shortfall was due to temporary supply disruption arising from the substantial change programme underway. Production moves from Hythe (UK), and Kircheseon (Germany) to plants in lower cost regions are now nearly complete. New integrated computer systems have been introduced, and manufacture of high volume products is now concentrated at highly automated plants close to the principal market.

These major changes in the structure of the internal supply chain resulted in a faster utilisation of safety stocks and a slower ramp up of production than was required to satisfy demand. Action was taken to increase capacity, in terms of the workforce in Mexico and investment in plant and machinery. Customers' requirements can now be met in full and inventory levels are being rebuilt.

At the same time, cost savings were achieved across the business, enabling the margin to advance even while sales were not growing.

In the US, group purchasing organisations are important customers and in the year a number of sizeable agreements were reached with Premier, Novation and Broadlane covering a wide range of products.

The Japanese business, which represents about 7% of total sales, has been held back by pricing pressure from the government reimbursement programme and a drive for improved efficiencies in the public sector. However, there are also some important areas of growth, including a Government initiative to improve cancer treatment, which is already benefiting the infusion business.

## Headline operating profit

Headline operating profit fell 5% in the year. The translation of overseas earnings at weaker average exchange rates reduced profit by 7%. Underlying profit growth excluding acquisitions, disposals and the effect of exchange translation was £2m. On a statutory basis, operating profit was £106m (2006: £104m).

The decline in sales is not reflected directly in operating profit because underlying profit benefited from:

- increased manufacturing in low-cost countries; and
- the incremental gain from the continued integration of Medex.

## Research and development

Investment in R&D remained steady at £25m. Of this, £15m (2006: £16m) was charged against headline operating profit, with the balance being capitalised.

Recent new products which will help to drive future growth include: power-injectable ports and needles for improved cancer treatment; a comprehensive range of safety syringes; a broad range of respiratory devices; consumables and software upgrades for infusion pumps including a Chinese language variant of our insulin delivery pump.

Smiths Medical has also been investing in process technology. Moving to high-volume, high-speed automated production will help to improve margins and increase market share, particularly for one-time-use consumable products.

## Forward-looking issues

Smiths Medical will focus on premium products with strong brands in growing niche markets. The year ahead will bring further significant product launches in key market segments. The industry remains relatively unconsolidated, with opportunities to add adjacent product lines.

## Smiths Specialty Engineering



**Group Managing Director**  
Paul Cox

### Description

Smiths Specialty Engineering serves the international energy, communications and industrial markets: John Crane designs and manufactures seals and associated products mainly for the oil & gas, chemical, pharmaceutical, pulp & paper and mining sectors; Smiths Interconnect designs and manufactures specialised electronic products and systems for the wireless telecommunications, aerospace, defence, space and medical markets; Flex-Tek designs and manufactures engineered components which heat and move fluids and gases for aerospace, domestic appliances, and medical devices; Marine Systems is smaller and supplies marine electronics and navigation charts.

### Employees

11,000

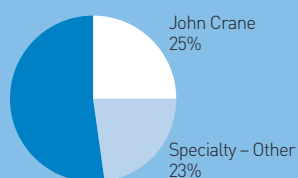
### Principal operating regions

John Crane is a global business with a presence in more than 50 countries.

Interconnect is a global business with manufacturing in the US, the UK, France, Germany, Italy, Costa Rica, Mexico and China.

Flex-Tek conducts a majority of business in the US, but also in the UK, France, Malaysia and Mexico.

### Contribution to 2007 Group sales



### Key customers

John Crane serves oil and gas companies, refineries, pump and compressor manufacturers, chemical and other process industries.

Interconnect sells to aircraft manufacturers, defence and wireless telecoms companies.

Flex-Tek serves mainly domestic appliance manufacturers and the US construction industry.

In March 2007 Smiths purchased CDI Energy Services and Global Energy Products for US\$38m. These two closely linked US-based businesses supply artificial lift systems and maintenance services to the oil and gas industry. They complement the John Crane Performance Plus logistics management programme and expand our presence in the growing upstream segment.

In August 2006 John Crane's bearing lubrication business in Finland was sold for £15m. On 31 July 2007 Smiths finalised the disposal of its automotive seals manufacturing businesses to Cyclam Holdings LLC for a contingent consideration of £3m.

Within Interconnect, Times Microwave Systems Inc. was sold as part of the Aerospace transaction. This will not affect the performance of the remaining Interconnect business because it was a discrete business unit.

At the year end the Marine Systems which represents less than 6% of total divisional sales was being actively marketed for sale and the assets and liabilities of that business are disclosed as 'held for sale' on the balance sheet.

### Markets

Smiths Specialty Engineering's principal businesses – John Crane, Interconnect and Flex-Tek – each address distinct markets. High capital spending on energy production and communications networks is expected to deliver average annual growth of 7% in these markets.

John Crane is experiencing strong demand for its products and services, particularly in the oil, gas and petrochemical sector, which is its largest market. At this stage in the capital investment cycle, the growth is in the sale of original equipment for new production facilities. This will provide aftermarket opportunities in the future which are expected to generate attractive margins. Global capital spending in the energy sector is projected to continue growing in the long term in response to increasing energy consumption. The acquisition of CDI Energy Services enhances John Crane's presence in all aspects of oil and gas production – upstream and downstream. For example, liquefied natural gas (LNG) produced in Qatar and ultimately drawn from the UK gas grid by consumers will have passed through John Crane seals and other technology at every point in its journey.

The largest markets for Interconnect are aerospace, defence and wireless telecommunications. Interconnect provides technology for un-manned aerial vehicles, next generation ground vehicles, communications systems, surveillance systems and self-protection systems. The aerospace and defence product range includes antenna systems, connectors and frequency sources. A good example of this includes five new component design contracts that Interconnect has won on Raytheon Company's surveillance radar programme which will be deployed in Taiwan. Another is the work that Interconnect business TRAK has subcontracted from Northrop Grumman and Lockheed Martin for the Advanced Hawkeye naval surveillance aircraft. These typify areas of spending that are expected to grow despite an overall long-term outlook of declining military budgets.

In the wireless telecommunications sector, Interconnect supplies devices to protect base stations from power surges and niche microwave components. The wireless infrastructure sector is growing strongly, driven by the demand for increased capacity on the existing networks and for new infrastructure in Asia. In China, Interconnect business Transtector is providing key components (including surge protection) for the TD-SCDMA wireless base station antennas, helping to achieve a high-level and reliable performance for mobile phone customers. Growth in this area is expected to continue as subscriber numbers increase and subscribers demand greater coverage, better connectivity and increased functionality.

### Business developments

In response to increasing customer demand, John Crane has been adding production capacity and locating manufacturing closer to its customers. Some of these facilities have been located in low-cost manufacturing locations, particularly in India and China. Locating in these countries has generated incremental sales from local customers.

Other applications for Interconnect products include medical equipment such as MRI scanners and railway signalling systems, both of which are seeing good growth at present.

Flex-Tek supplies engineered flow and heat technology equipment for construction, consumer products and aerospace applications. Its products include proprietary hose and tubing technology, natural gas delivery systems, rigid tubing assemblies in high ferrous metals and open coil convection heating. The main customers are domestic appliance manufacturers and the US construction industry. Demand is normally a function of overall economic growth and the strength of the US construction industry.

Flex-Tek is strong in customer-focused product development. For example it has developed an air duct called 'Thermaflex' which has obtained certification for use in applications where children are present, including day care centres – the first company to have obtained this certification. The product reduces the amount of chlorofluorocarbons and other hazardous materials that are expelled into the atmosphere and is being used extensively in the US.

## Performance

	2007 £m	2006 £m	Movement
<b>Sales</b>			
John Crane	<b>532</b>	518	3%
Specialty – Other	<b>500</b>	513	(3)%
	<b>1,032</b>	1,031	1%
<b>Headline operating profit</b>			
John Crane	<b>75</b>	66	13%
Specialty – Other	<b>66</b>	71	(6)%
	<b>141</b>	137	3%

### Sales

Sales rose by 1%, driven by the sales growth at John Crane and Interconnect. Adverse movements in exchange rates have reduced John Crane sales 5% and Specialty – Other sales by 6%. Excluding acquisitions, disposals and the effect of exchange translation, John Crane sales rose by 9% and Specialty – Other sales by 3%.

In oil and gas John Crane had a 25% increase in its supply of seals to Original Equipment Manufacturers, well in line with the positive market trend. Projects contributing to this growth were:

- new ethylene cracker plants in China;
- gas extraction and processing in the UAE; and
- ethane cracker and petrochemical plants in Saudi Arabia.

The performance of Specialty – Other has been mixed. Interconnect had a very good year with double digit sales growth after adjusting for acquisitions, disposals and the effect of exchange transactions. Flex-Tek suffered from a reduction in demand for products serving the US domestic construction industry. Marine's financial performance was similar to the previous year.

Interconnect benefited from increased military spending on network-centric systems to provide effective battlefield communications. Interconnect provides a range of microwave components which are developed specifically for each project. Smiths equipment is vital to the operation of the Eurofighter Typhoon, for example, generating healthy sales in this period.

### Headline operating profit

Headline operating profit rose by 3%, with growth of 13% at John Crane off set by a 6% decline at Specialty – Other. The translation of the overseas results at weaker exchange rates reduced the division's profit by 7%.

The benefit of volume, together with cost savings, generated strong profit growth at John Crane. Excluding acquisitions, disposals and the effect of exchange translation, headline operating profit for John Crane increased by 22%. Margins rose to 14.1%.

Raw materials prices, particularly for stainless steel, nickel and copper, have been rising. However, strong demand enabled John Crane to pass on commodity price increases.

Excluding acquisitions, disposals and the effect of exchange translation, headline operating profit for Specialty – Other reduced by 1%. Reflecting the mixed sales performance, Interconnect had double digit headline operating profit growth on this basis while Flex Tek suffered from demand being significantly down. In addition, Flex-Tek had to absorb commodity cost increases.

Higher raw materials prices also adversely affected working capital management for Specialty Engineering as a whole, leading to higher carrying values for inventory.

On a statutory basis, operating profit was £1m for John Crane (2006: £71m) and £61m for Specialty – Other (2006: £63m).

### Research and development

R&D expenditure for the division is £21m, £3m lower than previous years. This decline partly reflects weaker US dollar exchange rates in the period. R&D expenditure is 2% of revenue.

### Forward-looking issues

Smiths strategy is to grow each of the principal Specialty Engineering businesses. In pursuit of this strategy, Smiths aims to broaden the customer or market base where the application of its technological expertise and engineering skills are most appropriate, for example the development of Interconnect products for the medical equipment market.

Smiths Specialty Engineering's outlook is for further growth in the year ahead, helped by the continued upturn in the investment cycles for oil & gas and telecoms infrastructure.

### **Aerospace disposal**

On 4 May 2007 Smiths completed the sale of its aerospace business and Times Microwave Systems Inc. (TMS) to General Electric Company. Smiths received proceeds of £2.6 billion on completion. This disposal was approved by shareholders at an EGM on 20 February 2007. It generated a profit on sale of £1.5 billion.

### **Aerospace**

Smiths Aerospace comprised two principal business units – Aerospace Systems and Aerospace Components. Aerospace Systems designed, manufactured and provided in-service support for digital, electrical power and mechanical systems for both the military and commercial markets. Aerospace Components supplied high-value components to the principal aircraft engine manufacturers. In addition TMS, previously reported within Specialty Engineering, was included as part of the sale. TMS products included components for military and commercial aerospace, shipboard and wireless applications.

Smiths Aerospace, headquartered in London, had approximately 11,500 employees and operated manufacturing facilities in five countries. Smiths Aerospace developed organically and through the acquisition of Lear Siegler in 1987 and the merger with TI Group in 2000.

### **Background to the sale**

The Board decided that the agreed price recognised the high quality of the business of Smiths Aerospace together with Smiths substantial investment in aerospace technology. The sale accelerated the delivery of value to shareholders.

Smiths continuing businesses serve strong and growing markets. The Board believes that the continuing Group has enhanced financial characteristics and is well positioned to generate substantial returns.

### **Return of cash to shareholders**

Following completion of this sale, the Board returned £2.1 billion to shareholders. This cash return was approved by shareholders at an EGM on 11 June 2007.

The return of cash was carried out using a B share scheme, giving Shareholders a choice as to the form in which they receive their proceeds from the return and the timing of such return. The B shares have been admitted to trading on the London Stock Exchange.

B shareholders were able to elect between receiving a single dividend of 365p per B share, accepting an offer to sell their B shares for 365p per B share or retaining their B shares. B shares on which a dividend payment was made converted into deferred shares which have a negligible value. It is currently expected that JPMorgan Cazenove, acting as principal, will make a final purchase offer to acquire the 4.9 million retained B shares for 365p each, free of all dealing expenses and commissions, on or around 17 April 2008, although there can be no guarantee that such an offer will be made.

Immediately after the allotment of the B shares, a capital reorganisation was undertaken. Existing ordinary shares were subdivided and consolidated so that Shareholders received two new ordinary shares for every three existing ordinary shares they owned at 5.00 p.m. on 15 June 2007.

## **Financial review**

### **Accounting policies**

The accounts in this report are prepared under International Financial Reporting Standards (IFRS), as adopted by the European Union (EU). The accounting policies used in preparing these accounts are set out on pages 49 to 54.

The 2007 financial year ended on 31 July. The 2006 financial year ended on 5 August 2006.

### **Significant judgements, key assumptions and estimates**

Applying accounting policies requires the use of certain judgements, assumptions and estimates. The most important of these are set out on page 49.

The uncertainty affecting the estimation of provisions has increased following the commutation of certain insurance policies in respect of product liability. See legal issues section (page 16) for details.

### **Taxation**

The tax charge for the year represented an effective rate for continuing operations of 25.1% on the headline profit before taxation, compared to 25.6% in 2006. The rate reduced due to taking advantage of global tax incentives, the tax-efficient use of capital and active tax compliance management. On a statutory basis, the tax charge on continuing activities was £53m.

The fundamental tenets of the Smiths approach to taxation are to enhance the Company's competitive position on a global basis, while engaging with tax authorities around the world on a basis of full disclosure, full co-operation and full legal compliance. The Board considers and approves the management of the Company's tax affairs in the context of the Company's commercial objectives.

Accordingly, Smiths seeks to build open relationships with tax authorities to bring about timely agreement of tax affairs and to remove uncertainty on business transactions.

In summary, the Company's taxation strategy is to mitigate the burden of taxation in a responsible manner for competitive advantage, and, in this way, to enhance long-term shareholder value.

### **Cost of capital and return on shareholders' funds**

Smiths uses its weighted average cost of capital as one measure to appraise both internally-generated investment opportunities and acquisitions. During 2007, the Company's weighted average cost of capital (WACC) increased from 8% to 9%.

The after-tax headline return on shareholders' funds for continuing operations, including goodwill set-off against reserves, was 14.9%. In order to adjust for the Aerospace disposal, this ratio has been calculated using the closing net assets adjusted for movements in goodwill set-off against reserves relating to the continuing operations. The 2006 Group return on shareholders' funds was 13.6%.

## Retirement benefits

As required by IFRS the balance sheet reflects the net surplus or deficit in retirement benefit plans, taking assets at their market values at 31 July 2007 and evaluating liabilities at year-end AA corporate bond interest rates.

The year-end retirement benefit position was:

	2007	2006
Funded plans:		
UK plans – funding status	<b>113%</b>	105%
US plans – funding status	<b>92%</b>	84%
Other plans – funding status	<b>83%</b>	68%
	£m	£m
Surplus/(deficit):		
Funded plans	<b>297</b>	75
Unfunded plans	<b>(114)</b>	(127)
Total surplus/(liability)	<b>183</b>	(52)

Company contributions to the funded pension plans were £103m (2006: £110m). In 2007 special contributions were made totalling £56m, including £21m in respect of the aerospace disposal. In 2006 a £61m special payment was made to facilitate UK scheme mergers.

Full details of the retirement benefits are shown in note 10.

## Exchange rates

The results of overseas operations are translated into sterling at average exchange rates. The net assets are translated at year-end rates. The principal exchange rates, expressed in terms of the value of sterling, are shown in the following table.

	2007	2006	
Average rates:			
US Dollar	<b>1.95</b>	1.79	Dollar weakened 9.0%
Euro	<b>1.48</b>	1.46	Euro weakened 1.5%
Year-end rates:			
US Dollar	<b>2.04</b>	1.91	Dollar weakened 6.7%
Euro	<b>1.49</b>	1.48	Euro weakened 0.4%

## Dividend policy

An interim dividend of 10.5p per share was paid on 27 April 2007. A final dividend of 23.5p per share is proposed.

Information on the return of cash to shareholders is set out in the aerospace disposal section (page 14).

The 31 July 2007 balance sheet includes a £18m liability, and a matching cash balance, in respect of the B Shares whose redemption has been deferred.

Smiths objective is to increase dividends annually when trading results and prospects justify it, and, in the long term, for dividend cover relative to headline earnings of 1.8.

## Goodwill and intangibles

Goodwill on acquisitions has been capitalised since 1998. Until 1 August 2004 it was amortised over a maximum 20-year period. Under IFRS goodwill is no longer amortised but instead is subject to annual reviews to test for impairment.

The goodwill balance was tested for impairment in 2007 and 2006.

## Treasury

The aim of Treasury management in Smiths is to ensure a robust and prudent financial profile while driving value throughout the Company to attain the business's full potential. With this goal in mind, Treasury aims to reduce the cost of capital by optimising financial liabilities with the support of world-class banks.

Smiths continues to apply centralised treasury management over its financial risks, operating within a strong control environment. The Company uses financial instruments to raise money for its operations and to manage the related financial risks. Smiths neither speculates nor trades in derivative financial instruments and all financial instruments are properly recognised on the balance sheet. The Board has approved a Treasury Policy, which governs the financial risk profile, and a treasury compliance report is presented annually to the Audit Committee.

The objectives of the treasury function remain the same as in previous years and are explained in further detail below.

### 1. To deliver the liquidity requirements of the businesses cost-effectively.

The Group aims to minimise the level of surplus cash but, where surpluses arise, tight controls apply to ensure that they are securely placed with highly-rated counterparties and are available for redeployment at short notice. The Company is required under IFRS to show gross borrowings and cash under its cash pooling arrangements, despite these balances being netted for interest purposes, which exaggerates the Company's surplus cash balance. Local working capital needs and capital expenditure requirements are typically funded by local bank facilities.

### 2. To manage the central funding demands and provide a low cost of debt.

The Company's funding requirements are largely driven by acquisition activity and met by centrally arranged debt finance. Smiths has net debt as at 31 July 2007 of £588m (2006: £923m) with average maturity of 4.5 years (2006: 5 years) and at an average effective interest rate after interest and currency swaps of 5.8% (2006: 5.6%). Through the use of interest rate swaps, Smiths maintains a broadly even mix of fixed and floating rate debt.

Credit ratings are BBB+/Baa2 with Standard & Poor's and Moody's respectively. The ratings fell after the aerospace disposal and consequential return of cash to shareholders, reflecting Smiths increased exposure to industrial products with short sales order cycles and higher relative anticipated gearing. The ratings are stable.

### 3. To develop and maintain strong and stable banking relationships and services.

Smiths has a core group of eleven leading global banks and financial institutions that competitively tender for treasury business. Credit exposures to any one bank are carefully controlled. All business transacted with the banks is on consistent terms and is fairly allocated.

### 4. To provide reasonable protection from the effect of foreign currency volatility.

Material cross-border sales or purchase contracts in foreign currencies are hedged at their inception by appropriate derivative financial instruments, principally forward foreign exchange contracts and swaps, with the Group's core banks as counterparties. Whilst the trends of foreign currency movements cannot be eliminated, this hedging programme reduces volatility, protecting cash-flow and margins.

Smiths has adopted hedge accounting for the majority of the Group's business at its larger sites, thereby mitigating the impact of transactional exposures in the income statement.

Smiths protects its reserves from foreign currency fluctuations by ensuring that at least 75% of the total net overseas operational assets are offset either by borrowings in the respective currency or by currency swaps. This excludes goodwill which is only partly hedged.

Overseas earnings are translated at average currency rates for the year, which smoothes the effect of currency volatility.

The Group's strategy is to continue to take a risk-averse approach to managing and controlling financial risks, be it hedging currency and interest rate risk, liquidity or management of refinancing risk.

#### **Financial controls**

While the Group's decentralised organisation delegates day-to-day control to local management, Smiths has comprehensive control systems in place with regular reporting to the Board. The Group has continuous formalised business risk management processes operating at each business unit.

The internal audit department reviews all units over a rolling three-year cycle, and its findings are reported to the Audit Committee. All acquisitions are reviewed within 12 months of acquisition, to verify compliance with Group procedures.

Further information regarding the Group's procedures to maintain strict controls over all aspects of risk, including financial risk, are set out in the Corporate governance report on pages 28 to 32.

## **Legal issues**

Smiths is committed to operating within the law in all applicable jurisdictions, and seeks to benefit from the rights and protections afforded by relevant laws. The Company aims to anticipate and meet the changing requirements of the markets it serves, as legal and regulatory reforms impact those markets.

Smiths faces different types of legal issues in different jurisdictions. The high level of activity in the US, for example, exposes the Company to the likelihood of various types of litigation commonplace in that country, such as 'mass tort' and 'class action' litigation, proceedings threatened (and sometimes begun) as an aid to negotiated settlement of disputes, and legal challenges to the scope and validity of patents.

In addition, contracting with the US Government subjects a company to numerous stringent regulatory obligations, calling for an active programme of compliance, reporting and communication. By contrast, the Company's activities in some countries with less developed legal systems pose challenges for the protection of corporate assets such as real estate and intellectual property rights.

In order to address the challenges and exploit the opportunities arising from these and other legal issues, Smiths employs suitably experienced lawyers in head office and certain operations, and retains the services of law firms around the world.

#### **John Crane, Inc. litigation**

John Crane, Inc. (John Crane) a subsidiary of the Company, is one of many co-defendants in numerous lawsuits pending in the USA in which plaintiffs are claiming damages arising from exposure to, or use of, products containing asbestos. The John Crane products generally referred to in these cases are ones in which the asbestos fibres were encapsulated in such a manner that, according to tests conducted on behalf of John Crane, the products were safe. John Crane ceased manufacturing products containing asbestos in 1985.

John Crane has resisted every case in which it has been named and will continue its robust defence of all asbestos-related claims based upon this 'safe product' defence. As a result of its defence policy, John Crane has been dismissed before trial from cases involving approximately 148,000 claims over the last 28 years. John Crane is currently a defendant in cases involving approximately 144,000 claims. Despite these large numbers of claims, John Crane has had final judgments against it, after appeals, in only 64 cases, amounting to awards of some US\$55.5m over the 28-year period.

Whilst this represents a very low proportion of claims that has historically resulted in final judgment against John Crane, the incidence of such judgments in the future cannot be meaningfully estimated and, accordingly no provision is made for such awards.

In previous years, the awards, the related interest and all material defence costs were met directly by insurers. During the period, John Crane has secured the commutation of certain insurance policies in respect of product liability, resulting in proceeds of £43m. While substantial insurance remains in place, John Crane has begun to meet defence costs directly, seeking appropriate contribution from insurers thereafter. No account has been taken of recoveries from insurers as their nature and timing are not yet sufficiently certain to permit recognition. The 2007 interim report noted that John Crane had established a provision for £44m for defence costs and that this was part of an ongoing assessment of John Crane's asbestos exposures. Having completed a detailed review of these exposures, the Board has decided to make a further provision of £57m. This is based upon an assessment of the probable costs of defending known and expected future claims.

## Risks and uncertainties

Smiths operates globally in varied markets and manages the risks inherent in its activities. The Group seeks to mitigate exposure to all forms of risk, both external and internal, where practicable, and to transfer risk to insurers, where cost-effective.

### Principal risks

#### Foreign exchange

The Group is exposed to two types of currency risk: transaction risk in respect of products manufactured in one currency region and sold in another currency; and translation risk in that the results of non-UK businesses will translate into differing pounds sterling values depending on the exchange rate. The Group's practices for managing currency risk generally mitigate transaction risk in the short term. Over the longer term, Smiths remains exposed to both transaction and translation risk.

Longer-term transaction risks are partially mitigated by manufacturing or sourcing components in the same currency as that of the sale.

#### Raw material prices

Smiths products contain various raw materials or purchased components including electronic components, metals and plastics. Any increases or volatility in prices and shortages in supply can affect the Group's performance. The diversity of operations both geographically and in terms of product area reduces the dependence on any single item or supplier. Purchasing policies take into account and seek to mitigate such risks where practicable.

#### Pension funding

The Group operates significant pension plans. The average funding level of the funded plans at 31 July 2007 was 110% measured by IAS 19 methodology. Funding of pension liabilities at that date was some 55% by equities and 45% by other assets. Smiths is subject to various funding risks, principally poor performance of the equity investments and other investments, and increased longevity of members.

#### Litigation

Smiths is subject to litigation from time to time in the ordinary course of business, and makes provision for the expected cost based on appropriate professional advice. In particular, John Crane, Inc., a subsidiary of Smiths, is currently one of many defendants in litigation relating to products previously manufactured which contained asbestos and in respect of which a provision for defence costs has been made.

The outcome of legal action is always uncertain and there is always the risk that it may prove more costly and time consuming than expected. There is a risk that additional litigation could be instigated in the future which could have a material impact on the Group. In some liability cases, legal expenses are covered by insurance.

#### Other risks

In addition to the principal risks, other external risks include global political and economic conditions; natural catastrophe; actions of competitors; the effect of legislation or other regulatory action; credit and environmental issues.

Internal risks include investment in new products, projects and technology; acquisitions; controls failure; inability to supply and business continuity.

#### External risks

##### Global political and economic conditions

Smiths operates in over 50 countries, although some 90% of the Group's employees are located in North America, the EU and Japan. The Group is exposed to political risk, natural catastrophe and possible terrorist action.

Some 45% of total sales are to customers in the US, and the Group is therefore particularly affected by US economic conditions. Demand for products from the detection business is mainly dependent on spending by governments and government agencies.

Smiths may be adversely impacted by changes in general economic conditions including interest rates, exchange rates and inflation.

The diverse nature of the Group's products, services and customers helps mitigate the effects of adverse changes in political and economic risk on the demand that Smiths experiences.

##### Natural catastrophe

Because of the location of operations, Smiths is exposed to a number of natural catastrophe risks, such as earthquake, flood and windstorm. Where cost-effective, such risks are mitigated through physical measures designed to counter the impact of a catastrophe. The value of assets and associated profits are also protected by insurance.

##### Actions of competitors

Smiths operates in highly competitive markets. Product innovations or technical advances by competitors could adversely affect the Group. The diversity of operations reduces the possible effect of action by any single competitor.

The Group invests some 4% of revenues in research and development in order to sustain competitive advantage, and works continually to ensure that the cost base is competitive.

##### Effect of legislation or other regulatory action

Smiths is subject to a broad range of laws, regulations and standards in the jurisdictions in which it operates. Unexpected changes in these laws or regulations could significantly impair performance; equally a failure to comply with these laws, regulations or standards could damage the reputation of the Group.

The Detection and Medical businesses are particularly subject to regulation, with certain customers and regulatory or other enforcement bodies routinely inspecting the Group's practices, processes and premises. Certain legal liability risks, such as product liability and employer's liability, are transferred to insurers, subject to policy limits and conditions. However, the Group and its subsidiaries have been in business for many years and there is a risk of latent injury claims which may not be fully covered by insurance.

##### Credit

Smiths is exposed to credit risk in relation to customers, banks and insurers. Credit control practices take into account the perceived risk. The customer base is relatively diverse.

Where appropriate, Smiths seeks to insure business risks with insurers of good standing. The insurance industry is, however, subject to credit risk, particularly in the event of catastrophe or where an insurer has substantial exposure to a specific risk. Occasionally insurer credit risk may be mitigated through policy commutation.

##### Environmental issues

The environmental laws of the jurisdictions in which Smiths operates impose actual and potential obligations on the Group to remediate contaminated sites, including some sites no longer owned by Smiths. The Group makes provision for the expected cost of remediation based on independent professional advice. There is a risk that remediation could prove more costly than expected and that further contamination could be discovered.

### Internal risks

#### Investment in new products, projects and technology

Smiths develops new technologies and introduces new products, in some cases contracting to supply the products to the customer before the design is established or proven. All new technologies and products involve business risk both in terms of possible abortive expenditure, reputational risk, and potential customer claims or onerous contracts. The same is true for investment in new facilities, in transferring production and in information systems. Such risks may have a material impact on the Group.

#### Security

Smiths information systems, personnel and facilities are subject to security risk; failure to adequately mitigate this risk could have a material impact on the Group and its reputation.

#### Taxation

In recent times Smiths has had an effective tax rate of approximately 26%. There can be no guarantee that Smiths effective tax rate will remain below the prevailing tax rate applicable in the territories in which it operates.

#### Acquisitions

Smiths is an active acquirer of other businesses and companies: acquisitions may involve risks that might have a material impact on the Group. These risks are mitigated by extensive due diligence, and, where practicable, by representations and warranties and indemnities from the vendors.

#### Controls failure

Smiths operates various corporate governance controls. Failures in these controls might have a material impact on the Group.

#### Inability to supply and business continuity

Inability to supply against contractual commitments is a risk, which could be material in relation to larger contracts. Smiths mitigates this risk by implementing effective business continuity plans throughout the Group and, where practicable, transferring them through business interruption insurance.

#### Sale of Smiths Aerospace

The sale and purchase agreement governing the sale of the aerospace business to GE Aviation UK contains certain warranties and indemnities in favour of GE Aviation UK. If Smiths should incur costs under any of these warranties or indemnities, these costs could have an adverse effect on its business, financial condition and results of operation.

## Corporate responsibility

Smiths has six fundamental strengths. Corporate responsibility for Smiths is enshrined in the sixth strength: 'doing business the right way'. Smiths defines 'the right way' in the Code of Corporate Responsibility and Business Ethics ('the Code'), which is based on 12 principles:

- 1 compliance with national laws and regulations;
- 2 fair and vigorous competition in the marketplace;
- 3 integrity and ethical conduct as the standard of individual and corporate business behaviour;
- 4 fair and honest treatment of suppliers and customers;
- 5 proper and respectful treatment of employees;
- 6 high standards for health and safety in the workplace;
- 7 respect for the environment;
- 8 contributions to the communities in which we live and work;
- 9 straightforward public information and activities;
- 10 respect for human rights;
- 11 prudent and transparent public accounting and reporting; and
- 12 a culture of compliance throughout the entire Smiths organisation – from the Chief Executive to the newest employee.

Translated into 13 languages, the Code applies to all Smiths businesses and employees worldwide and provides the framework for policies, programmes and procedures for a range of corporate responsibility issues. It is endorsed and fully supported by the Board.

Code compliance support to Smiths businesses worldwide is provided through a number of channels (including via the legal, human resources and internal audit functions) which provide advice, export control policies, education, training, guidance materials and risk assessment tools.

### Managing corporate responsibility

The Code is set by the Board and monitored by the Code Compliance Council, chaired by the General Counsel, which reports at least twice a year to the Audit Committee of the Board. Responsibility for managing specific issues, however, lies at different levels within the Group, depending on the nature of the issue and how it can most effectively be managed:

- health, safety and environment issues are managed through a Group-wide steering committee and organisation;
- employee issues are managed through the human resources function and by line management;
- supplier and customer programmes are managed by each business; and
- community programmes are principally managed locally, although there is also some Group-level activity.

### Environment

Smiths is committed to ensuring that, as far as is reasonably practicable, any detrimental effects of its activities, products and services upon the environment are minimised. In practice, this means using performance-based environmental management systems to drive improvement throughout the business.

#### Performance against targets

Target (set July 04)	2007 result	2006 result	Comment
<b>ISO14001 certification</b> for all sites except small offices, with new acquisitions achieving certification within two years	<b>74 out of 75 currently eligible sites certified</b>	83 out of 104 eligible sites certified	All originally targeted sites have been certified. Ongoing programme in place for certification of new sites
<b>Energy consumption</b> target set at 180MWh/£m sales (5% reduction over three years)	<b>145 MWh/£m sales</b>	176MWh/£m sales	Target achieved
<b>Waste to landfill</b> target set at 3.5 Tonnes/£m sales (6% reduction over three years)	<b>3.39 Tonnes/£m sales</b>	2.93 Tonnes/£m sales	Target achieved
<b>Air emissions</b> target set at 112kg/£m sales (6% reduction over three years)	<b>106kg/£m sales</b>	100kg/£m sales	Target achieved
<b>Water consumption</b> target set at 411m <sup>3</sup> /£m sales (12% reduction over three years)	<b>258m<sup>3</sup>/£m sales</b>	398m <sup>3</sup> /£m sales	Target achieved

\*Note that the 2004 baseline data includes Smiths Aerospace whereas 2007 does not. Whilst normalisation against sales makes the figures directly comparable, the changed mix of manufacturing processes can exaggerate to some extent an already positive level of achievement.

### Health and safety

Smiths is committed to conducting all its activities in a manner which achieves the highest practicable standards of health and safety. This year, attention has been focused on the underperforming sites and improving cross-divisional sharing of good practice.

#### Performance against targets

Target (set July 04)	2007 results	2006 result	Comment
<b>Recordable incident rate</b> no target set	<b>1.96/200,000 man-hours</b>	2.58/200,000 man-hours	Ongoing year-on-year improvement achieved
<b>Lost days rate</b> no target set	<b>25.61/200,000 man-hours</b>	27.91/200,000 man-hours	Ongoing year-on-year improvement achieved
<b>Lost time incident rate</b> 1 incident/200,000 man-hours	<b>0.92/200,000 man-hours</b>	1.15/200,000 man-hours	Target achieved

### **New targets**

We are pleased that the three-year targets set in 2004 have been achieved and new targets have been developed to drive improvement still further.

### **Environment**

The major current public environmental issue worldwide is greenhouse gas emissions and their impact on climate change. Smiths most significant emissions source is from the generation of electrical energy purchased by and consumed in our facilities. We have in recent publications converted our energy consumption to carbon dioxide equivalent values and for the next three-year period it is appropriate to target our overall greenhouse gas emissions. This will include emissions from energy usage and VOC emissions and thus replace these former targets.

Formal international greenhouse regulatory systems do not consider normalisation. Instead, they target based on a fixed cap. It is appropriate that Smiths follows this trend and establishes a target of the same level of emissions or better in FY 2009 to 2010 as FY 2006 to 2007 for each individual facility.

Additionally, total waste (net of recycled waste) and water consumption will continue to be targeted with an overall 9% improvement normalised against sales.

### **Health and safety**

Building on the successful drive to reduce lost time incidents it has been decided to target 'recordable incidents'. This measure includes incidents that do not necessarily lead to lost time and thus is more challenging. Good practice is acknowledged as a recordable incident rate of better than 1.5 per 100 employees per year and this target has been set as the goal for the Group. Many parts of Smiths are already performing at this level but we will focus on those that do not whilst striving to maintain progress at all sites.

The implementation of the ISO14001 Environmental Management System plays a significant part in ensuring that our businesses have robust systems in place for managing environmental performance. Thus it has been decided to target implementation of the comparable OHSAS18001 Health and Safety Management System. At this stage the target has been set for external certification at two-thirds of our manufacturing sites with 50 or more employees within the next three years.

### **Employees**

The Group's policy is to provide equal opportunities for employment. Smiths recruits, selects and promotes employees on the basis of their qualifications, skills, aptitude and attitude. In employment-related decisions, Smiths complies with anti-discrimination requirements in the relevant jurisdictions concerning matters of race, colour, national origin, gender, marital status, sexual orientation, religious belief, age, or physical or mental disability. Disabled people are given full consideration for employment and subsequent training, career development and promotion on the basis of their aptitudes and abilities.

All Smiths employees are treated with respect and dignity. Accordingly, any harassment or bullying is unacceptable. Smiths respects the right of each employee to join or not to join a trade union or other bona fide employee representative organisation. Smiths believes in good communications with employees and in promoting consultation, co-operation and teamwork on matters of mutual concern.

Smiths offers all employees in the US and UK share schemes that enable employees to acquire an interest in the Company's shares and to align their interests more closely with those of shareholders.

### **Reaching Full Potential**

Smiths invests in employees' skills and capabilities to help them reach their own Full Potential, which in turn helps the Company and its businesses to do likewise. Current priorities for Smiths to achieve full potential across the Group are talent development, succession planning and employee engagement.

### **Talent development**

Smiths Group and the individual businesses continue to invest in identifying and developing the talents of our people. Smiths provides employees with challenging work that stretches their capabilities, backing that up with training and development activities tailored to individual needs. In 2006, Smiths introduced a new process for the most senior people, integrating the performance review with the overall 'Full Potential' goals of the business.

Smiths continues to be actively involved in all aspects of training and developing young people, including initiatives designed to ease the transition from school to work. Horizons is a two-year programme for new and recently appointed graduates. It provides an understanding of the Group and the business world in general, and develops personal and teamworking skills.

### **Succession planning**

Smiths has a systematic succession management process for senior leadership roles. The Group identifies leadership talent and development needs, and follows this up with individual development plans that are monitored by senior management.

### **Employee engagement**

Smiths provides information to and communicates with employees as an important part of doing business. Employees are regularly provided with a wide range of information concerning the performance and prospects of the business in which they are involved by means of employee councils, information and consultation forums, and other consultative bodies that allow their views to be taken into account.

### **Communities**

Smiths is committed to contributing to the communities in which we operate. In addition to providing employment opportunities, we focus on community involvement through charitable giving, regeneration and education initiatives.

Smiths supports national and international charitable organisations from a central budget administered by the Charity and Donations Committee. This year's beneficiaries include the Royal Academy of Engineering, which helped to set up a new collaborative education initiative with Smiths in the UK – the Smiths Technology Education Programme (STEP) – which aims to provide able young people with the information and financial support they need to explore a career in technology. Individual businesses also support charity projects in a number of areas. For example, Smiths Medical supports medical research via the Smiths Medical Chair of Anaesthesia and Critical Care at University College London.

In addition to corporate donations, Smiths businesses devote a time to local community projects around the world. For example, Smiths Medical recently participated in St Mungo's Putting Down Roots scheme, a gardening project for London's homeless.

*For further information, please see the Corporate Responsibility Report 2007 at [www.smiths.com/responsibility](http://www.smiths.com/responsibility).*