

Group directors' report

Principal activities

The principal activities of the Company and its subsidiaries (the Group) are the development, manufacture, sale and support of:

- advanced security equipment, using trace detection and x-ray imaging to detect and identify explosives, chemical and biological agents, weapons and contraband;
- medical devices aligned to specific therapies, principally airway, pain and temperature management, infusion, needle protection, critical care monitoring and vascular access; and
- mechanical seals used in industries ranging from petrochemical processing to aerospace; interconnect products to connect and protect safety-critical electrical and electronic equipment; marine navigation; ducting and hose assemblies.

The main manufacturing operations are in the UK, the Americas and Continental Europe.

Business review / future development / research and development

The business review is on pages 7 to 20 and is incorporated by reference, forming part of this directors' report. This is a review of the development and performance of the business of the Group, including the financial performance during the financial year ended 31 July 2007, key performance indicators and a description of the principal risks and uncertainties facing the Group. It also includes information on likely future developments and activities in the field of research and development. The cautionary statement set out on the inside front cover of this Annual Report forms part of this Annual Report and is incorporated by reference into the business review.

Results and dividends

The results for the financial year ended 31 July 2007 are set out in the Consolidated income statement on page 45. Sales for the year amounted to £2,161m, against £2,180m in 2006. The profit for the year after taxation amounted to £1,728.1m (2006: £24.2m).

An interim dividend of 10.5p per ordinary share of 25p was paid on 27 April 2007. The directors recommend for payment on 23 November 2007 a final cash dividend of 23.5p on each new ordinary share of 37.5p, making a total dividend of 34.0p for the financial year.

The retained profit of £1,728m was transferred to Reserves.

Changes in the Company and its interests during the financial year

On 8 August 2006 the Company acquired all the issued share capital of Comet Costruzioni Metalliche S.r.l. for £3.3m in cash.

On 15 August 2006 the Company completed the sale of the bearing lubrication business of John Crane Safematic Oy for £15m.

On 15 September 2006 the Company secured the commutation of certain insurance policies that relate to the John Crane, Inc. litigation, as described on page 8 of the business review.

On 1 December 2006 the Company acquired all the issued share capital of Tecnicas Medicas MAB SA for €17.3m in cash.

On 15 January 2007 the Company announced that it had conditionally agreed to sell the Aerospace division to GE Aviation.

At an Extraordinary General Meeting held on 20 February 2007, shareholders approved the proposal to sell the Aerospace division to GE Aviation for approximately US\$4.8 billion in cash.

On 20 March 2007 the Company acquired the issued share capital of CDI Energy Services, Inc., the membership interests in Global Energy Products LLC and the partnership interests in Global Energy Products LP for a cash consideration of US\$38m.

On 21 March 2007 the Company entered into a conditional agreement with GE to form Smiths GE Detection.

On 4 May 2007 the Company completed the sale of the issued share capital of Smiths Aerospace Group Limited and certain assets in Canada and China to GE Aviation for US\$5.1 billion in cash (including adjustments).

At an Extraordinary General Meeting held on 11 June 2007, shareholders approved a proposal to return £2.1 billion from the proceeds of sale of the Aerospace division to shareholders through a B share scheme (the Return of Cash scheme). At the same meeting new Articles of Association were approved.

On 18 June 2007 the share capital of the Company was reorganised pursuant to the Return of Cash scheme approved at the Extraordinary General Meeting. The authorised share capital was increased by the creation of 600 million non-cumulative preference shares of 1p nominal value (B shares). A bonus issue was made of one B share for every existing ordinary share of 25p held on 15 June 2007. Each existing ordinary share of 25p was subdivided into two shares of 12.5p each and then three shares of 12.5p were consolidated into a new ordinary share of 37.5p nominal value. As a result, for every three ordinary shares of 25p held on 15 June 2007, shareholders received two new ordinary shares of 37.5p plus three B shares. On 25 June 2007 the Company paid a Single B share dividend of 365p per share on 348,205,433 B shares and converted those shares into deferred shares of 1p each, which were purchased by the Company for 1 penny in aggregate and cancelled on 28 June 2007. Also on 28 June 2007, the Company completed the purchase of 224,439,118 B shares for 365p per share, in cash, and cancelled the shares.

4,926,594 B shares currently remain in issue. The Single B share dividend was not paid on the B shares purchased by the Company nor on the B shares retained by shareholders.

On 29 June 2007 the Company sold its shareholding in TI Automotive Limited for £15m in cash.

On 31 July 2007 the Company sold the issued share capitals of Cyclam SA and John Crane Ningbo and the automotive division assets of John Crane, Inc. for a contingent consideration of £2.9m.

Post balance sheet events

On 19 September 2007 the Company announced that it was no longer proceeding with the conditional agreement with GE to form Smiths GE Detection, due to differences over a strategic vision for the combined businesses.

Charitable and political donations

During the financial year the Company made donations of £389,000 for charitable purposes including payments totalling £150,000 for the Smiths Medical Chair of Anaesthesia and Critical Care and other donations made by the Company's businesses worldwide to miscellaneous charities. No political donations were made.

Directors

During the financial year, Mr R W O'Leary sadly died on 14 August 2006; Mr A M Thomson retired on 6 September 2006; Sir Julian Horn-Smith retired on 21 November 2006; Sir Nigel Broomfield retired on 31 March 2007; and Dr J Ferrie resigned on 4 May 2007. Mr S J Chambers and Mr P H Loescher were appointed as non-executive directors on 27 November 2006 and 1 June 2007, respectively. Mr J Langston assumed the role of Finance Director on 6 September 2006. Messrs D H Brydon; K O Butler-Wheelhouse; D J Challen; P J Jackson; J Langston; D P Lillycrop; and Sir Kevin Tebbit all served throughout the year.

Reappointment of directors

Messrs D H Brydon; D J Challen; P J Jackson; J Langston; and D P Lillycrop have each served more than 30 months since they were last reappointed as directors. In accordance with Article 57 of the Company's Articles of Association, they will retire from office at the Annual General Meeting on 20 November 2007. Mr S J Chambers and Mr P H Loescher will also retire from office at the Annual General Meeting, having been appointed by the Board since the Annual General Meeting in 2006.

The Board has reviewed the effectiveness of Mr Brydon, Mr Challen, Mr Chambers, Mr Jackson and Mr Loescher as non-executive directors and has concluded that their respective wide-ranging experience is, in each case, of great benefit to the Company. Mr Brydon is Chairman of the Nomination Committee and a member of the Remuneration Committee; Mr Challen is Chairman of the Audit Committee and a member of the Remuneration Committee; Mr Chambers is Chairman of the Remuneration Committee; Mr Jackson is the Senior Independent Director and a member of the Audit and Nomination Committees; and Mr Loescher is a member of the Remuneration Committee.

All seven directors are willing and eligible to stand for reappointment and resolutions will be proposed at the Annual General Meeting to reappoint them.

Directors' remuneration report

The Directors' remuneration report is on pages 33 to 42.

An ordinary resolution to approve the report will be put to shareholders at the Annual General Meeting.

Directors' interests in contracts

Details of the executive directors' service contracts are as disclosed in the service contracts section of the Directors' remuneration report on page 38. Details of the interests of the executive directors in the Company's share option schemes and plans are shown in the Directors' remuneration report on pages 33 to 42.

Qualifying third party indemnity provisions (as defined by section 309B of the Companies Act 1985) have remained in force for the directors during the financial year ended 31 July 2007 and, at the date of this report, are in force for the benefit of the current directors in relation to certain losses and liabilities which they may incur (or have incurred) to third parties in the course of their professional duties.

Apart from the exceptions referred to above, no director had an interest in any contract to which the Company or its subsidiaries was a party during the year.

Interests in voting rights

As at 24 September 2007 the Company had been notified, pursuant to the FSA's Disclosure & Transparency Rules, of the following notifiable voting rights in its issued share capital:

	No. of shares	Percentage of issued ordinary share capital*
Atlantic Investment Management	11.8m	3.0%
Barclays PLC	13.6m	3.5%
Franklin Resources, Inc.	22.3m	5.8%
Legal & General Group plc	13.1m	3.4%
Massachusetts Financial Services Company	19.9m	5.2%
Newton Investment Management Limited	19.1m	4.9%

*Percentage of ordinary share capital in issue on 24 September 2007.

The Company has not acquired or disposed of any interests in its own shares other than in connection with the Return of Cash scheme. Details of shares purchased and cancelled pursuant to that scheme are shown on page 22.

The interests of the directors, their families and any connected persons in the issued share capital of the Company are shown on page 37.

Corporate governance

The report on corporate governance is on pages 28 to 32. PricewaterhouseCoopers LLP has reviewed the Company's statements as to compliance with the July 2003 issue of the Combined Code, to the extent required by the UK Listing Authority Listing Rules. The results of its review are set out on page 44.

Financial instruments

The financial risk management objectives and policies of the Group; the policy for hedging each major type of forecasted transaction for which hedge accounting is used; and the exposure of the Group to price risk, credit risk, liquidity risk and cash-flow risk are outlined in note 22 of the Group financial statements.

Going concern

The Board's review of the accounts, budgets and forward plans, together with the internal control system, lead the directors to believe that the Company has ample resources to continue in operation for the foreseeable future. The accounts are therefore prepared on a going concern basis.

Policy on payment of creditors

The Company's policy and practice is to pay creditors promptly in accordance with agreed terms of business. The average time taken to pay an invoice was 35 days (2006: 35) for the parent Company and 43 days (2006: 48) for the Group as a whole (calculated in compliance with the Companies Act 1985 (Directors' Report)(Statement of Payment Practice) Regulations 1997).

Share capital and control

The following information is given pursuant to section 992 of the Companies Act 2006.

As at 31 July 2007, the Company's authorised share capital comprised £200,599,999.875, divided into 533,333,333 ordinary shares of 37.5p each nominal value (ordinary shares), representing 97.1% of the total share capital, and 600,000,000 non-cumulative preference shares of 1p (preference shares), representing 2.9% of the total share capital. On 31 July 2007 there were 385,498,273 ordinary shares and 4,926,594 preference shares in issue. The ordinary shares and the preference shares are listed on the London Stock Exchange.

The holders of ordinary shares are entitled to receive the Company's reports and accounts; to attend and speak at General Meetings of the Company; to appoint proxies and to exercise voting rights. The holders of preference shares are entitled to attend, speak and vote at a General Meeting only if the business of the meeting includes the winding-up of the Company or if, at the date of the notice of the meeting, the B share Continuing Dividend under Article 126 has remained unpaid for at least six months. Preference shareholders are entitled to receive the B share Continuing Dividend and have priority over ordinary shareholders on a return of capital of 365p per preference share on a winding-up. The Company has the right to purchase and thereafter cancel preference shares at any time or to convert them into ordinary shares at any time after 30 April 2008.

There are no restrictions on transfer or limitations on the holding of any class of shares and no requirements for prior approval of any transfers. None of the shares carries any special rights with regard to control of the Company. The only restrictions on voting rights are those that apply to the preference shares, as described in the preceding paragraph. There are no known arrangements under which financial rights are held by a person other than the holder of the shares and no known agreements on restrictions on share transfers or on voting rights.

Shares acquired through Company share schemes and plans rank *pari passu* with the shares in issue and have no special rights.

As far as the Company is aware, there are no persons with significant direct or indirect holdings in the Company. Information provided to the Company pursuant to the FSA's Disclosure & Transparency Rules is published on a Regulatory Information Service and on the Company's website, www.smiths.com.

The rules about the appointment and replacement of directors are contained in the Company's Articles of Association. Changes to the Articles of Association must be approved by the shareholders in accordance with the legislation in force from time to time.

The powers of the directors are determined by UK legislation and the Memorandum and Articles of Association of the Company in force from time to time. The directors have been authorised to issue and allot ordinary shares, pursuant to Articles 6, 7 and 126, and preference shares, pursuant to Article 126. The directors have authority to make market purchases of ordinary and preference shares. The powers under Articles 6 and 7 are referred to the shareholders at the Annual General Meeting for renewal. At the AGM the shareholders are also requested to renew the power to make market purchases of ordinary shares. Any ordinary shares so purchased may be cancelled or held in treasury. Article 126 authorises the purchase of preference shares.

The Company is not party to any significant agreements that would take effect, alter or terminate upon a change of control following a takeover bid.

The Company does not have agreements with any director or employee that would provide compensation for loss of office or employment resulting from a takeover except that provisions of the Company's share schemes and plans may cause options and awards granted to employees under such schemes and plans to vest on a takeover.

Corporate responsibility

The Company has implemented across the Group policies on environmental, health and safety matters and operates a Code of Corporate Responsibility and Business Ethics. The Company seeks to minimise, as far as is reasonably practicable, any detrimental effects to the environment of its operations and products. A senior corporate staff director has responsibility for environmental, health and safety matters.

All matters concerning the environment, health and safety continue to be regulated by preventative, investigatory and consultative systems, overseen by the Group Environment, Health and Safety Committee. Issues relevant to the Company pension schemes are likewise covered by means of structured committees, including representation from recognised trade unions.

Further information on environmental and employee health and safety matters, including key performance indicators, is contained in the Corporate responsibility summary in the business review on pages 19 and 20. The full Corporate responsibility report is available online at www.smiths.com/responsibility.

Annual General Meeting

The 2007 Annual General Meeting will be held at The Banqueting Suite, Lord's Cricket Ground, Grace Gate, St John's Wood Road, London NW8 8QN on Tuesday 20 November 2007 at 12.00 noon.

Authority to issue shares

At the Annual General Meeting shareholders will be asked to renew the authority, given to the directors at the last Annual General Meeting, to allot relevant securities for the purposes of Section 80 of the Companies Act 1985, so as to reflect the increase in the Company's issued share capital since the last General Meeting. In compliance with recently published guidelines and market practice, the authority proposed will expire at the conclusion of the next Annual General Meeting of the Company or, if earlier, on 19 February 2009. The amount of relevant securities to which this authority relates (£48,303,386 nominal of ordinary share capital) represents one third of the ordinary share capital in issue on 24 September 2007. The ordinary resolution is set out in the Notice of Annual General Meeting.

Also in the Notice is the special resolution to renew the power granted to directors under Section 95 of the Companies Act 1985. The new authority sought will be on substantially similar terms to those attaching to the existing authority and, in compliance with current practice, will expire at the conclusion of the next Annual General Meeting of the Company or, if earlier, on 19 February 2009. It will permit the directors to allot equity securities for cash:

- in connection with a rights issue pro rata to the rights of the existing shareholders;
- pursuant to the terms of any share scheme or plan approved by the shareholders in General Meeting; and
- for any other purpose (including the sale on a non pre-emptive basis of any shares the Company may hold in treasury for cash) provided that the aggregate nominal value of such allotments does not exceed £7,245,507 (approximately 5% of the issued ordinary share capital on 24 September 2007).

The directors intend seeking renewal of these authorities annually.

The directors have no present intention of exercising these authorities, except for allotments of shares pursuant to the Company's share option schemes, and would not seek to issue more than 7.5% of the issued share capital in the Company in any rolling three year period without prior consultation with the Investment Committees of the Association of British Insurers and National Association of Pension Funds.

During the financial year ended 31 July 2007, the following shares in Smiths Group plc were issued:

- 9,890,099 ordinary shares of 25p pursuant to the terms of the Company's shareholder-approved share option schemes; and
- 352,693 ordinary shares of 25p pursuant to the terms of TI Group share option schemes, prior to the capital reorganisation.
- a bonus issue of 577,571,145 non-cumulative preference shares of 1p (B shares) on 18 June 2007.
- 577,571,145 ordinary shares of 25p were consolidated into 385,047,430 ordinary shares of 37.5p on 18 June 2007.
- 348,205,433 B shares were converted into deferred shares of 1p which were purchased by the Company and cancelled on 28 June 2007.
- 224,439,118 B shares were purchased by the Company and cancelled on 28 June 2007. 4,926,594 B shares remain in issue.
- 412,970 ordinary shares of 37.5p pursuant to the terms of the Company's shareholder-approved share option schemes; and
- 37,873 ordinary shares of 37.5p pursuant to the terms of TI Group share option schemes, subsequent to the capital reorganisation.

Authority to purchase shares

At the Annual General Meeting the Company will seek to renew the authority, granted at the last Extraordinary General Meeting to the directors, to purchase the Company's ordinary shares in the market. The authority will be limited to 10% of the ordinary share capital in issue on 24 September 2007 and will be renewed annually. The price that may be paid for the shares will be not less than the nominal amount of 37.5p per share and not more than the higher of 5% above the average of the middle market quotations of the Company's ordinary shares, as derived from the London Stock Exchange Daily Official List, for the five business days prior to any purchase and the amount stipulated by Article 5(1) of the Buy-back and Stabilisation Regulation 2003. On 24 September 2007 options over approximately 10.4m shares were outstanding under the Company's share option schemes, representing approximately 2.7% of the then issued share capital. If the existing authority to purchase shares and the new authority being sought at the Annual General Meeting were to be used in full, then the outstanding options would represent approximately 3.4% of the reduced issued share capital.

Under the Companies Act 1985, any shares purchased under this authority may be cancelled or held as treasury shares. Treasury shares may be subsequently sold or used to satisfy applications under share schemes.

The directors will exercise the authority only if they are satisfied that any purchase will increase the earnings per share of the ordinary share capital in issue and will be in the interests of the shareholders. The directors will also give careful consideration to the gearing levels of the Company and its general financial position. It is the Company's present intention that, in the event that any shares were to be purchased under this authority, such shares would be cancelled. The directors will, however, have regard to any guidelines issued by investor groups which may be published at the time of any such purchase regarding the merits of the cancellation of such shares as against holding them as treasury shares.

Purchase of shares

In accordance with the authorities given at the Extraordinary General Meeting held on 11 June 2007 in connection with the Return of Cash to shareholders from the sale of the Aerospace division, on 28 June 2007 the Company purchased for cash and immediately cancelled the following shares:

- 348,205,433 deferred shares of 1p each (100% of the then issued deferred share capital) for an aggregate consideration of one penny; and
- 224,439,118 non-cumulative preference shares of 1p each (B shares) (98% of the then issued B share capital) for an aggregate consideration of £819,202,780.70.

Auditor

Resolutions will be proposed at the Annual General Meeting to reappoint PricewaterhouseCoopers LLP as auditor and to authorise the directors to determine the auditor's remuneration.

Disclosure of information to the auditor

As at the date of this report, as far as each director is aware, there is no relevant audit information of which the Company's auditor is unaware. Each director has taken such steps as he should have taken as a director in order to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

Electronic communications at www.smiths.com

The Companies Act 2006 recognises the growing importance of electronic communication ("e-communication") and enables companies to provide documentation and communications to shareholders via their websites, except to those shareholders who elect to receive hard (printed paper) copies by post. E-communication allows shareholders faster access to important information about the Company; saves the Company considerable overheads, by reducing its print production costs and postage; and helps the environment by saving the energy and raw materials that would otherwise be used in producing and dispatching printed documents. At the Extraordinary General Meeting held on 11 June 2007 shareholders approved the adoption of electronic communications.

Electronic copies of the Annual Report and Accounts 2007 and the Notice of Annual General Meeting will be posted on the Company's website, www.smiths.com. The Company's announcements to the Stock Exchange and press releases are available online through the website. Shareholding details and practical help on share transfers and changes of address can be found at www.shareview.co.uk.

Shareholders wishing to change their election and receive documents in hard copy form, can do so at any time by contacting the Company's Registrars, (see the inside back cover for contact details) or alternatively by logging on to www.shareview.co.uk.

Electronic proxy voting

The Company continues to provide electronic proxy voting for this year's Annual General Meeting. Shareholders who are not Crest members can appoint a proxy and vote online for or against (or consciously not vote for) the resolutions to be proposed at the Annual General Meeting by visiting the website www.sharevote.co.uk. The onscreen instructions will give details on how to complete the appointment and voting process. Crest members, Crest personal members and other Crest sponsored members should consult the Crest Manual or their sponsor or voting service provider for instructions on electronic proxy appointment and voting. The Company may treat as invalid a Crest proxy voting instruction in the circumstances set out in Regulation 35(5)(a) of the Uncertificated Securities Regulations 2001.

Paper proxy cards have been distributed to all shareholders with the Notice of Annual General Meeting, as usual.

Shareholders who will not be able to attend the Annual General Meeting on 20 November 2007 in person are encouraged to vote their shares by appointing a proxy and issuing voting instructions (either electronically or by completing and returning their proxy cards). Electronic and paper proxy appointments and voting instructions must be received by the Company's Registrars not later than 48 hours before the Annual General Meeting in order to be valid.

Registrars

On 1 October 2007 Advent International is expected to complete the acquisition, from Lloyds TSB Bank, of Lloyds TSB Registrars and change its name to Equiniti Limited. Equiniti Limited will continue to act as the Company's Registrars and provide shareholder services to the members of Smiths Group plc. The new name, address and contact details of Equiniti Limited are listed on the inside back cover of this report. Individual shareholders' access to their personal shareholder information will continue to be available online, through the www.shareview.co.uk website, and the shareholder helpline telephone number will remain unchanged at 0870 600 3970. Dividends payments will continue to be made through Lloyds TSB Bank.

Important information

If you are in any doubt as to what action you should take in relation to the resolutions being proposed at the Annual General Meeting, you are recommended to consult your stockbroker, bank manager, solicitor, accountant or other independent professional adviser authorised under the Financial Services and Markets Act 2000. If you have recently sold or transferred all your shares in Smiths Group plc please pass this document and the accompanying proxy form to the purchaser or transferee or to the agent through whom the sale or transfer was effected for transmission to the purchaser or transferee.

Recommendation

Your directors believe that all the proposals to be considered at the Annual General Meeting are in the best interests of the Company and its shareholders and recommend shareholders to vote in favour of the resolutions. The directors intend to vote in favour of the resolutions in respect of their own shareholdings.

By Order of the Board

David P Lillycrop
Director and Secretary

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27 September 2007