Independent auditors' report to the members of Smiths Group plc

We have audited the group financial statements of Smiths Group plc for the year ended 31 July 2008 which comprise the consolidated income statement, the consolidated statement of recognised income and expense, the consolidated balance sheet, the consolidated cash-flow statement, the Accounting policies and the related notes. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent company financial statements of Smiths Group plc for the year ended 31 July 2008 and on the information in the Directors' remuneration report that is described as having been audited.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of directors' responsibilities.

Our responsibility is to audit the group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the group financial statements give a true and fair view and whether the group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Group directors' report is consistent with the group financial statements. The information given in the Group directors' report includes that specific information presented in the Business review that is cross referred from the Group directors' report.

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

We review whether the Corporate governance report reflects the company's compliance with the nine provisions of the Combined Code 2006 specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited group financial statements. The other information comprises only the Summary performance, Group at a glance, Chairman's statement, the Chief Executive's statement, the Business review, Board of directors, the Group directors' report, the unaudited part of the Directors' remuneration report, the Statement of directors' responsibilities, the Group financial record and the Financial calendar. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the group financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

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

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

Opinion

In our opinion:

- the group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the Group's affairs as at 31 July 2008 and of its profit and cash flows for the year then ended;
- the group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Group directors' report is consistent with the group financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
London

23 September 2008

Notes

(a) The maintenance and integrity of the Smiths Group plc website is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

(b) Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Consolidated income statement

	Notes	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Continuing operations			
Revenue	1	**2,321.2**	2,160.9
Cost of sales		**(1,265.5)**	(1,159.1)
Gross profit		**1,055.7**	1,001.8
Sales and distribution costs		**(311.8)**	(311.5)
Administrative expenses			
– normal activities		**(396.4)**	(394.2)
– provision for John Crane, Inc. litigation	4	**(49.0)**	(100.7)
Other operating income	2		66.9
Profit/(loss) on disposal of businesses	4	**27.2**	(5.2)
Operating profit	2	**325.7**	257.1
Interest receivable		**2.2**	21.4
Interest payable		**(43.2)**	(57.8)
Other financing (losses)/gains	3	**(6.1)**	2.1
Other finance income – retirement benefits		**41.7**	33.7
Finance costs	5	**(5.4)**	(0.6)
Share of post-tax losses of associated companies	14	**(1.0)**	(0.5)
Profit before taxation		**319.3**	256.0
Comprising			
– headline profit before taxation	3	**380.3**	344.4
– exceptional items	4		
• profit/(loss) on disposal of businesses		**27.2**	(5.2)
• commutation of insurance policies			42.9
• provision for John Crane, Inc. litigation		**(53.7)**	(100.7)
• other		**(13.6)**	(35.2)
– amortisation of acquired intangible assets		**(19.2)**	(14.8)
– other financing (losses)/gains		**(1.7)**	0.6
– profit on sale of financial asset			24.0
		319.3	256.0
Taxation	6	**(75.0)**	(53.1)
Profit after taxation – continuing operations		**244.3**	202.9
Profit after taxation – discontinued operations	7	**24.5**	1,525.2
Profit for the period		**268.8**	1,728.1
Attributable to:			
Smiths Group shareholders		**268.5**	1,728.1
Minority interests		**0.3**	
		268.8	1,728.1
Earnings per share	9		
Basic		**69.3p**	314.7p
Basic – continuing operations		**63.0p**	36.9p
Diluted		**68.5p**	310.3p
Diluted – continuing operations		**62.3p**	36.4p

References in the consolidated income statement, consolidated statement of recognised income and expense, consolidated balance sheet and consolidated cash-flow statement relate to notes on pages 69 to 108, which form an integral part of the consolidated financial statements.

Consolidated statement of recognised income and expense

	Notes	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Exchange gain/(loss)		**89.5**	(72.2)
Cumulative exchange losses recycled on disposals			49.2
Fair value gain on acquisition of former associate		**0.4**	
Taxation recognised on exchange losses			
– current			2.4
Taxation recognised on share-based payment			
– current	6	**5.2**	10.3
– deferred	6	**(3.8)**	(9.4)
Actuarial (losses)/gains on retirement benefits	10	**(254.5)**	70.3
Taxation recognised on actuarial (losses)/gains – deferred	6	**75.5**	(30.1)
Fair value (losses)/gains:			
– on cash-flow hedges	21	**(0.5)**	(11.9)
– on net investment hedges	21	**(47.5)**	8.2
Net (expense)/income recognised directly in equity		**(135.7)**	16.8
Profit for the period		**268.8**	1,728.1
Total recognised income and expense	27	**133.1**	1,744.9
Attributable to:			
Smiths Group shareholders		**132.8**	1,744.9
Minority interests		**0.3**	
		133.1	1,744.9

Consolidated balance sheet

	Notes	2008 £m	2007 £m
Non-current assets			
Intangible assets	12	**1,253.2**	1,021.3
Property, plant and equipment	13	**296.3**	260.9
Investments accounted for using the equity method	14	**9.1**	12.0
Financial assets – other investments		**3.6**	0.7
Retirement benefit assets	10	**174.2**	333.7
Deferred tax assets	6	**96.2**	94.0
Trade and other receivables	16	**14.6**	14.7
Financial derivatives	22	**1.4**	0.4
		1,848.6	1,737.7
Current assets			
Inventories	15	**380.3**	319.7
Trade and other receivables	16	**565.4**	489.8
Cash and cash equivalents	17	**132.5**	186.2
Financial derivatives	22	**6.5**	13.5
		1,084.7	1,009.2
Assets of businesses held for sale	18		31.3
Total assets		**2,933.3**	2,778.2
Non-current liabilities			
Financial liabilities:			
– borrowings	20	**(720.7)**	(567.1)
– financial derivatives	22	**(0.1)**	(2.5)
Provisions for liabilities and charges	23	**(200.6)**	(143.4)
Retirement benefit obligations	10	**(184.7)**	(150.1)
Deferred tax liabilities	6	**(64.3)**	(118.0)
Trade and other payables	19	**(27.5)**	(22.5)
		(1,197.9)	(1,003.6)
Current liabilities			
Financial liabilities:			
– borrowings	20	**(182.4)**	(212.1)
– financial derivatives	22	**(21.5)**	(2.8)
Provisions for liabilities and charges	23	**(70.0)**	(90.1)
Trade and other payables	19	**(420.7)**	(412.6)
Current tax payable		**(122.6)**	(137.5)
		(817.2)	(855.1)
Liabilities of businesses held for sale	18		(16.2)
Total liabilities		**(2,015.1)**	(1,874.9)
Net assets		**918.2**	903.3
Shareholders' equity			
Share capital	26	**145.5**	144.6
Share premium account	27	**303.6**	289.0
Capital redemption reserve	27	**5.8**	5.7
Revaluation reserve	27	**1.7**	1.7
Merger reserve	27	**234.8**	234.8
Retained earnings	27	**253.7**	208.9
Hedge reserve	27	**(29.2)**	18.6
Total shareholders' equity		**915.9**	903.3
Minority interest equity		**2.3**	
Total equity		**918.2**	903.3

The accounts on pages 59 to 108 were approved by the Board of Directors on 23 September 2008 and were signed on its behalf by:

Philip Bowman
Chief Executive

John Langston
Finance Director

Consolidated cash-flow statement

	Notes	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Net cash inflow from operating activities	28	**198.1**	246.0
Cash-flows from investing activities			
Expenditure on capitalised development		**(19.8)**	(87.4)
Expenditure on other intangible assets		**(16.1)**	(29.6)
Purchases of property, plant and equipment		**(64.2)**	(118.3)
Disposals of property, plant and equipment		**2.7**	25.6
Investment in financial assets		**(3.4)**	
Proceeds from sale of financial asset		**1.1**	15.0
Acquisition of businesses	29	**(149.7)**	(34.9)
Disposal of Aerospace	7	**(6.3)**	2,495.0
Disposals of businesses	30	**43.2**	9.1
Net cash-flow (used)/generated in investing activities		**(212.5)**	2,274.5
Cash-flows from financing activities			
Proceeds from exercise of share options	27	**21.0**	77.7
Purchase of own shares		**(20.7)**	(7.0)
Dividends paid to equity shareholders	8	**(131.4)**	(182.4)
Cash paid to shareholders under B share scheme		**(16.4)**	(2,090.9)
Increase in new borrowings		**135.9**	19.0
Reduction and repayment of borrowings		**(11.0)**	(284.7)
Net cash-flow used in financing activities		**(22.6)**	(2,468.3)
Net (decrease)/increase in cash and cash equivalents		**(37.0)**	52.2
Cash and cash equivalents at beginning of period		**3.1**	(51.1)
Exchange differences		**(6.1)**	2.0
Cash and cash equivalents at end of period	17	**(40.0)**	3.1
Cash and cash equivalents at end of period comprise:			
– cash at bank and in hand		**122.5**	148.5
– short-term deposits		**10.0**	40.8
– bank overdrafts		**(172.5)**	(186.2)
		(40.0)	3.1
Included in cash and cash equivalents per the balance sheet	17	**132.5**	186.2
Included in overdrafts per the balance sheet	17	**(172.5)**	(186.2)
Included in the assets of the disposal group	18		3.1
	17	**(40.0)**	3.1

The consolidated cash-flow statement includes cash-flows relating to discontinued operations. See note 7 for details of these cash-flows.

Accounting policies

Basis of preparation

The accounts have been prepared in accordance with the Companies Act 1985 applicable to companies reporting under International Financial Reporting Standards (IFRS) and International Financial Reporting Interpretations Committee (IFRIC) interpretations, as adopted by the European Union in response to the IAS regulation (EC 1606/2002), under the historic cost convention modified to include revaluation of certain financial instruments, share options and pension assets and liabilities, held at fair value as described below. For Smiths Group plc there are no differences between IFRS as adopted for use in the European Union and full IFRS as published by the International Accounting Standards Board.

The accounting policies adopted are consistent with those of the previous financial period except that the Group has adopted 'IFRS 7: Financial instruments: Disclosures' and the amendment to 'IAS 1: Presentation of financial statements'. Adoption of these standards has required additional disclosures on the credit quality of trade receivables and capital management.

Significant judgements, key assumptions and estimates

The preparation of the accounts in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates. The key estimates and assumptions used in these consolidated financial statements are set out below.

Revenue recognition

The timing of revenue recognition on long-term funded contracts depends on the assessed stage of completion of contract activity at the balance sheet date. This assessment requires the expected total contract revenues and costs to be estimated based on the current progress of the contract.

Revenue of £63.3m (2007: £58.1m) has been recognised in respect of contracts in progress at the year end with a total expected value of £197.5m (2007: £141.5m). A 5% increase in the proportion of the contract activity recognised in the current year would have increased operating profit by an estimated £0.6m (2007: £0.5m).

Impairment

Goodwill is tested at least annually for impairment in accordance with the accounting policy for goodwill set out below. The recoverable amounts of cash generating units are determined based on value in use calculations. These calculations require the use of estimates including projected future cash flows and other future events. See note 12 for details of the critical assumptions made and disclosures on the sensitivity of the impairment testing to these key assumptions.

Provisions for liabilities and charges

The consolidated financial statements include a provision for litigation of £163.7m (2007: £121.2m).

As previously reported, John Crane, Inc., a subsidiary of the Company, is one of many co-defendants in litigation relating to products previously manufactured which contain asbestos. Provision has been made for the future legal defence costs which the Group is expected to incur and the expected costs of potential future judgments against John Crane, Inc. The actual future costs could be materially higher or lower than this estimate, depending on the progress of the claims that are ongoing. See note 23 for details.

Retirement benefits

The consolidated financial statements include costs in relation to, and provision for, retirement benefit obligations. The costs and the present value of any related pension assets and liabilities depend on such factors as life expectancy of the members, the salary progression of current employees, the returns that plan assets generate and the discount rate used to calculate the present value of the liabilities. The Group uses previous experience and impartial actuarial advice to select the values of critical estimates. The estimates, and the effect of variances in key estimates, are disclosed in note 10.

Taxation

The Group has recognised deferred tax assets relating to UK losses of £94m. The recognition of assets pertaining to these losses involves judgement by management as to the likelihood of realisation of these deferred tax assets and this is based on a number of factors, which seek to assess the expectation that the benefit of deferred tax assets will be realised, including appropriate taxable temporary timing differences and it has been concluded that there are sufficient taxable profits in future periods to support recognition.

Further detail on the Group's deferred taxation position is included in note 6.

The accounts have been prepared in accordance with the accounting policies, as described below.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and its subsidiary undertakings, together with the Group's share of the results of its associates.

Subsidiaries are all entities over which the Company has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. Subsidiaries are fully consolidated from the date on which this power is transferred to the Company. They are de-consolidated from the date that control ceases.

Associates are entities over which the Group has significant influence but does not control, generally accompanied by a share of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method.

Accounting policies continued

Foreign currencies

The Company's presentational currency is sterling. The results and financial position of all subsidiaries and associates that have a functional currency different from sterling are translated into sterling as follows:

- assets and liabilities are translated at the rate of exchange at the date of that balance sheet;
- income and expenses are translated at average exchange rates for the period; and
- all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. When a foreign operation is sold, the cumulative amount of such exchange differences is recognised in the income statement as part of the gain or loss on sale.

Exchange differences arising on transactions are recognised in the income statement. Those arising on trading are taken to operating profit; those arising on borrowings are classified as finance income or cost.

Revenue

Revenue from the sale of goods is recognised when the risks and rewards of ownership have been transferred to the customer, which is usually when title passes.

Revenue from services is recognised in accounting periods in which the services are rendered, by reference to completion of the specific transaction, assessed on the basis of the actual service provided as a proportion of the total services to be provided.

Revenue is measured at the fair value of the consideration received, net of trade discounts and sales taxes.

Long-term funded contracts

Where the outcome of a contract can be estimated reliably, revenue and costs are recognised by reference to the stage of completion of the contract activity at the balance sheet date. The Group uses the 'percentage of completion method' to determine the appropriate amount to recognise in a given period. The assessment of the stage of completion is dependent on the nature of the contract, but will generally be based on the estimated proportion of the total contract costs which have been incurred to date. If a contract is expected to be loss-making, a provision is recognised for the entire loss.

Employee benefits

Pension obligations and post-retirement benefits

The Group has both defined benefit and defined contribution plans.

For defined benefit plans the liability for each scheme recognised in the balance sheet is the present value of the defined benefit obligation at the balance sheet date less the fair value of plan assets. The defined benefit obligation is calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are recognised in full in the period in which they occur, outside of the income statement and are presented in the statement of recognised income and expense. Past service costs are recognised immediately in the income statement, unless the changes to the pension plan are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past service costs are amortised on a straight-line basis over the vesting period.

For defined contribution plans, the Group pays contributions to publicly or privately administered pension insurance plans on a mandatory, contractual or voluntary basis. Contributions are expensed as incurred.

The Group also has certain post-retirement healthcare schemes which are accounted for on a similar basis to the defined benefit plans.

Share-based compensation

The Group operates a number of equity-settled and cash-settled share-based compensation plans.

The fair value of the shares or share options granted is recognised as an expense over the vesting period to reflect the value of the employee services received.

The fair value of options granted, excluding the impact of any non-market vesting conditions, is calculated using established option pricing models, principally binomial models. The probability of meeting non-market vesting conditions, which include profitability targets, is used to estimate the number of share options which are likely to vest.

For cash-settled share-based payment a liability is recognised based on the fair value of the payment earned by the balance sheet date. For equity-settled share-based payment the corresponding credit is recognised directly in reserves.

In accordance with the transitional provisions of 'IFRS 2: Share-based Payment', no charge has been recognised for grants of equity instruments made before 7 November 2002.

Exceptional items

Items which are material either because of their size or their nature, and which are non-recurring, are presented within their relevant consolidated income statement category, but highlighted separately on the face of the income statement. The separate reporting of exceptional items helps provide a better picture of the Company's underlying performance. Items which may be included within the exceptional category include:

- profits/(losses) on disposal of businesses;
- spend on the integration of significant acquisitions and other major restructuring programmes;
- significant goodwill or other asset impairments;
- income and expenditure relating to John Crane, Inc. asbestos litigation; and
- other particularly significant or unusual items.

Exceptional items are excluded from the headline profit measures used by the Group. The basis of calculation of these measures is explained in note 3.

Discontinued operations

A discontinued operation is a component of the Group's business that represents a separate major line of business or geographical area of operations that has been disposed of, has been abandoned or meets the criteria to be classified as held for sale.

Discontinued operations are presented on the income statement as a separate line and are shown net of tax.

Assets and businesses held for sale

Assets and businesses classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale and gains or losses on subsequent re-measurements are included in the income statement. No depreciation is charged on assets and businesses classified as held for sale.

Assets and businesses are classified as held for sale if their carrying amount will be recovered or settled principally through a sale transaction rather than through continuing use. The asset or business must be available for immediate sale and the sale must be highly probable within one year.

Intangible assets

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable net assets of the acquired subsidiary at the date of acquisition.

Goodwill arising from acquisitions of subsidiaries after 1 August 1998 is included in intangible assets, tested annually for impairment and carried at cost less accumulated impairment losses. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold. Goodwill arising from acquisitions of subsidiaries before 1 August 1998 was set against reserves in the year of acquisition.

Goodwill is tested for impairment at least annually. Any impairment is recognised immediately in the income statement. Subsequent reversals of impairment losses for goodwill are not recognised.

Research and development

Expenditure on research and development is charged to the income statement in the year in which it is incurred with the exception of:

- amounts recoverable from third parties; and
- expenditure incurred in respect of the development of major new products where the outcome of those projects is assessed as being reasonably certain as regards viability and technical feasibility. Such expenditure is capitalised and amortised straight line over the estimated period of sale for each product, commencing in the year that sales of the product are first made.

Other intangible assets

The identifiable net assets acquired as a result of a business combination may include intangible assets other than goodwill. Any such intangible assets are amortised straight line over their expected future lives.

The estimated useful lives are as follows:

Patents, licences and trademarks	up to 20 years
Technology	7 to 12 years
Customer relationships	up to 7 years

The assets' useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Accounting policies continued

Property, plant and equipment
Property, plant and equipment is stated at historical cost less accumulated depreciation and any recognised impairment losses.

Land is not depreciated. Depreciation is provided on other assets estimated to write off the depreciable amount of relevant assets by equal annual instalments over their estimated useful lives. In general, the rates used are: Freehold and long leasehold buildings – 2%; Short leasehold property – over the period of the lease; Plant, machinery, etc. – 10% to 20%; Motor vehicles – 25%; Tools and other equipment – 10% to 33%.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

No borrowing costs are capitalised as part of property, plant and equipment.

Leases
Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to the income statement on a straight-line basis over the period of the lease.

Inventories
Inventories are stated at the lower of cost and net realisable value. Cost is determined using the first-in, first-out (FIFO) method. The cost of finished goods and work in progress comprises raw materials, direct labour, other direct costs and related production overheads (based on normal operating capacity). It excludes borrowing costs. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

Trade and other receivables
Trade receivables are initially recognised at fair value and subsequently measured at amortised cost, less any appropriate provision for estimated irrecoverable amounts. A provision is established for irrecoverable amounts when there is objective evidence that amounts due under the original payment terms will not be collected.

Cash and cash equivalents
Cash and cash equivalents include cash at bank and in hand and highly liquid interest-bearing securities with maturities of three months or less.

In the cash-flow statement cash and cash equivalents are shown net of bank overdrafts, which are included as current borrowings in liabilities on the balance sheet.

Provisions
Provisions for warranties and product liability, disposal indemnities, restructuring costs, vacant leasehold property and legal claims are recognised when: the Company has a legal or constructive obligation as a result of a past event; it is probable that an outflow of resources will be required to settle the obligation; and the amount has been reliably estimated. Provisions are not recognised for future operating losses.

Provisions are discounted where the time value of money is material.

Where there are a number of similar obligations, for example where a warranty provision has been given, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognised even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

Where a leasehold property is vacant, or sub-let under terms such that the rental income is insufficient to meet all outgoings, provision is made for the anticipated future shortfall up to termination of the lease, or the termination payment, if smaller.

Taxation
The charge for taxation is based on profits for the year and takes into account taxation deferred because of temporary differences between the treatment of certain items for taxation and accounting purposes.

Deferred tax is provided in full using the balance sheet liability method. A deferred tax asset is recognised where it is probable that future taxable income will be sufficient to utilise the available relief. Tax is charged or credited to the income statement except when it relates to items charged or credited directly to equity, in which case the tax is also dealt with in equity.

Deferred tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary differences is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax liabilities and assets are not discounted.

Financial assets
The classification of financial assets depends on the purpose for which the assets were acquired. Management determines the classification of an asset at initial recognition and re-evaluates the designation at each reporting date. Financial assets are classified as: loans and receivables or financial assets where changes in fair value are charged (or credited) to the income statement.

Financial assets are initially recognised at transaction price when the Group becomes party to contractual obligations. The transaction price used includes transaction costs unless the asset is being fair valued through the income statement.

Financial assets continued

The subsequent measurement of financial assets depends on their classification. Loans and receivables are measured at amortised cost using the effective interest method. Financial assets where changes in fair value are charged (or credited) to the income statement are subsequently measured at fair value. Realised and unrealised gains and losses arising from changes in the fair value of the 'financial assets at fair value through the income statement' category are included in the income statement in the period in which they arise.

Financial assets are derecognised when the right to receive cash-flows from the assets has expired, or has been transferred, and the Company has transferred substantially all of the risks and rewards of ownership.

Financial assets are classified as current if they are expected to be realised within 12 months of the balance sheet date.

Financial liabilities

Borrowings are initially recognised at the fair value of the proceeds, net of related transaction costs. These transaction costs, and any discount or premium on issue, are subsequently amortised under the effective yield method through the income statement as interest over the life of the loan, and added to the liability disclosed in the balance sheet. Related accrued interest is included in the borrowings figure.

Borrowings are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least one year after the balance sheet date.

Derivative financial instruments and hedging activities

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value. The method of recognising any resulting gain or loss depends on whether the derivative is designated as a hedging instrument and, if so, the nature of the item being hedged.

Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the income statement.

Fair value hedge

Changes in the fair values of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair values of the hedged assets or liabilities that are attributable to the hedged risk.

Cash-flow hedge

The effective portions of changes in the fair values of derivatives that are designated and qualify as cash-flow hedges are recognised in equity. The gain or loss relating to any ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled in the income statement in the periods when the hedged items will affect profit or loss (for instance when the forecast sale that is hedged takes place). If a forecast transaction that is hedged results in the recognition of a non-financial asset (for example, inventory) or a liability, the gains and losses previously deferred in equity are transferred from equity reserves and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognised when the forecast transaction is ultimately recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for similarly to cash-flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; the gain or loss relating to any ineffective portion is recognised immediately in the income statement.

When a foreign operation is disposed of gains and losses accumulated in equity related to that operation are included in the income statement.

Embedded derivatives

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contracts and the host contracts are not carried at their fair value. Unrealised gains and losses on these embedded derivatives are recognised in the income statement.

Fair value of financial assets and liabilities

The fair values of financial assets and financial liabilities are the amounts at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The following methods are used to estimate the fair values of the financial instruments:

- cash, trade receivables and payables and floating rate borrowings – the carrying value is a good approximation of the fair value;
- fixed rate borrowings – quoted market prices of equivalent instruments; and
- forward exchange contracts, currency swaps, interest rate instruments and embedded derivatives – net present value of the future cash-flows, calculated using market data at the balance sheet date (principally exchange rates and yield curves).

Borrowings are carried on the balance sheet at amortised cost adjusted for fair value interest rate hedging. The fair value of fixed rate borrowings is only used for supplementary disclosures.

Accounting policies continued

Financial guarantees
Financial guarantees are initially recognised at the fair value of the consideration received.

At each subsequent balance sheet date an estimate is made of the payments which will be required under the guarantee in accordance with 'IAS 37: Provisions, contingent liabilities and contingent assets'. The guarantee is then valued at the higher of its initial value less revenue recognised to date and the best estimate of the total payments which will be required under the contract.

Any gains or losses on the contract are recognised in the income statement.

Dividends
Dividends are recognised as a liability in the period in which they are authorised. The interim dividend is recognised when it is paid and the final dividend is recognised when it has been approved by shareholders at the Annual General Meeting.

Recent accounting developments
The following standards and interpretations have been issued by the IASB and are likely to affect future annual reports and accounts.

'IFRS 8: Operating Segments' was issued in February 2007 and will be adopted by Smiths from 1 August 2008. The new standard requires segment information to be prepared on the same basis as information reported to management for decision-making purposes. Following the restructuring of internal reporting from 1 August 2008, five divisions will be reported in the 2009 Annual report. In addition, the operating profit reported will be calculated on the basis used for management reporting and some detailed disclosures will change.

Smiths will determine an appropriate implementation date for the following standards, amendments and interpretations after they have been adopted by the European Union:

An amendment to 'IAS 23: Borrowing costs' was issued in March 2007. This eliminates the option, currently used by the Group, of expensing all borrowing costs when they are incurred. As retrospective adoption is not required, there will be no changes to the information previously reported when this standard is adopted. The impact of the new policy on future reported performance is expected to be limited because the only qualifying assets have short construction periods.

'IFRIC 12: Service concession arrangements' was issued in December 2006 and 'IFRIC 13: Customer Loyalty Programmes' was issued in June 2007. Neither interpretation is expected to have a material impact on the Group because it does not have any material contracts or programmes within the scope of these interpretations.

'IFRIC 14: The limit on a defined benefit asset, minimum funding requirements and their interaction' was issued on 6 July 2007. This interpretation provides guidance on the extent to which a pension scheme surplus should be recognised as an asset. Based on current actuarial advice, this interpretation is not expected to reduce the assets recognised at 31 July 2008 in respect of pension schemes.

'IFRIC 15: Agreements for the construction of real estate' was issued on 3 July 2008. The Group is not involved in the construction or sale of residential real estate. However a review of contract accounting is being undertaken to establish whether or not the same principles apply to any transactions undertaken by the Group. The impact of adopting this interpretation will be determined once this review has been completed.

'IFRIC 16: Hedges of a net investment in a foreign operation' was issued on 3 July 2007. An initial review of the Group's net investment hedging indicated that this interpretation is not likely to affect their accounting treatment. A detailed review of the impact of this interpretation is still in progress.

'IFRS 3: (Revised) business combinations' and 'IAS 27: (Revised) consolidated and separate financial statements' were issued in January 2008. Implementing IFRS 3 (revised) will significantly change the recognition of goodwill, acquisition costs and contingent consideration relating to acquisitions. However it only applies to acquisitions made after it has been adopted. IAS 27 (revised) requires different accounting treatment for minority interest but it is not expected to affect the Group's financial results or position materially.

An amendment to 'IFRS 2: Share based payment' was issued in January 2008. This provides a definition of vesting conditions and specifies the accounting treatment for non-vesting conditions. It is not expected to materially affect the share based payment charge recognised in the Group accounts because only a small proportion of awards under employee share schemes are affected by failures to comply with non-vesting conditions.

'IAS 1: (Revised) Presentation of financial statements' was issued in January 2008. This changes the presentation requirements for other comprehensive income and transactions with shareholders, and requires increased disclosures when there is a restatement of comparatives. Adopting this standard will not affect the recognition, measurement or disclosure of any transactions or events.

In February 2008 amendments to 'IAS 32: Financial Instruments: Presentation' and 'IAS 1: (Revised) Presentation of financial statements' were issued clarifying the treatment of puttable financial instruments. The adoption of these amendments is not expected to have any impact on the Group.

Parent company
The accounts of the parent company, Smiths Group plc, have been prepared in accordance with UK GAAP. The Company accounts are presented in separate financial statements on pages 111 to 120.

The principal subsidiaries of the parent company are listed in the above accounts.

The ultimate parent company of the Group is Smiths Group plc, a company incorporated in England, and listed on the London Stock Exchange.

Notes to the accounts

1 Segment information

Analysis by business segments

For management purposes, the Group has been organised into three business segments – Detection, Medical and Specialty Engineering. These business segments are the basis on which the Group reported its primary segment information. For reporting purposes Specialty Engineering is analysed into two segments: John Crane and Specialty – Other.

Year ended 31 July 2008	Detection £m	Medical £m	Specialty Engineering: John Crane £m	Specialty Engineering: Specialty – Other £m	Total £m
Revenue	**509.3**	**703.4**	**625.8**	**482.7**	**2,321.2**
Headline operating profit	**85.6**	**127.8**	**95.9**	**71.3**	**380.6**
Exceptional operating items (note 4)	**(0.3)**	**(10.0)**	**(51.5)**	**26.4**	**(35.4)**
Amortisation of acquired intangible assets	**(0.4)**	**(11.3)**	**(5.5)**	**(2.0)**	**(19.2)**
Financing losses	**0.1**	**(0.4)**	**(0.1)**	**0.1**	**(0.3)**
Operating profit	**85.0**	**106.1**	**38.8**	**95.8**	**325.7**
Exceptional finance costs – adjustment to discounted provision (note 4)			**(4.7)**		**(4.7)**
Net finance costs – other					**(0.7)**
Share of post-tax (losses)/profits of associated companies	**(1.4)**		**0.4**		**(1.0)**
Profit before taxation					**319.3**
Taxation					**(75.0)**
Profit for the period – continuing operations					**244.3**

Period ended 31 July 2007	Detection £m	Medical £m	Specialty Engineering: John Crane £m	Specialty Engineering: Specialty – Other £m	Total £m
Revenue	437.5	690.6	532.4	500.4	2,160.9
Headline operating profit	78.6	127.3	75.3	66.4	347.6
Exceptional operating items (note 4)	(13.0)	(9.6)	(73.2)	(2.4)	(98.2)
Amortisation of acquired intangible assets	(0.4)	(11.5)	(0.6)	(2.3)	(14.8)
Financing losses	(0.1)	(0.2)	(0.2)	(1.0)	(1.5)
	65.1	106.0	1.3	60.7	233.1
Profit on sale of financial assets					24.0
Operating profit					257.1
Net finance costs					(0.6)
Share of post-tax (losses)/profits of associated companies	(1.1)		0.6		(0.5)
Profit before taxation					256.0
Taxation					(53.1)
Profit for the period – continuing operations					202.9

The Group's revenue is analysed as follows:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Sale of goods	**2,077.8**	1,965.2
Contracts	**132.1**	98.4
Services	**111.3**	97.3
	2,321.2	2,160.9

Notes to the accounts continued

1 Segment information continued

The non-cash expenditure included in operating costs by division is shown below:

	Year ended 31 July 2008				Period ended 31 July 2007			
	Depreciation £m	**Amortisation £m**	**Goodwill and other asset impairments £m**	**Other non-cash expenses (excluding impairments) £m**	Depreciation £m	Amortisation £m	Goodwill and other asset impairments £m	Other non-cash expenses (excluding impairments) £m
Detection	**7.8**	**4.4**		**2.7**	6.2	2.5		1.8
Medical	**26.5**	**16.6**	**0.3**	**4.1**	18.3	18.9		3.6
Specialty Engineering:								
John Crane	**10.0**	**7.2**		**3.5**	8.3	2.1		2.6
Specialty – Other	**8.9**	**2.8**		**2.6**	11.0	2.4	10.3	2.4
Continuing operations	**53.2**	**31.0**	**0.3**	**12.9**	43.8	25.9	10.3	10.4
Discontinued operations					8.4	3.8		3.5
Total	**53.2**	**31.0**	**0.3**	**12.9**	52.2	29.7	10.3	13.9

Included in goodwill and other asset impairments in 2007 is £8.1m relating to disposal group impairment of assets on re-measurement to fair value less costs of sale.

Capital expenditure

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Detection	**32.3**	25.9
Medical	**37.8**	42.5
Specialty Engineering:		
John Crane	**21.8**	17.3
Specialty – Other	**8.2**	14.7
Continuing operations	**100.1**	100.4
Discontinued operations		127.7
	100.1	228.1

Included in discontinued operations for the period ended 31 July 2007 is capital expenditure of £90.9m, incurred during the period after being classified as a disposal group.

1 Segment information continued

Balance sheet

	2008 £m	2007 £m
Assets		
Detection	**711.7**	604.8
Medical	**912.1**	899.9
Specialty Engineering:		
John Crane	**490.5**	336.0
Specialty – Other	**375.1**	357.6
Operating assets by segment – continuing operations	**2,489.4**	2,198.3
Unallocated corporate assets	**311.4**	393.7
Cash and cash equivalents	**132.5**	186.2
Total assets	**2,933.3**	2,778.2
Liabilities		
Detection	**143.6**	164.2
Medical	**93.0**	136.2
Specialty Engineering:		
John Crane	**282.1**	253.4
Specialty – Other	**77.6**	93.2
Operating liabilities by segment	**596.3**	647.0
Unallocated corporate liabilities	**515.7**	448.7
Borrowings	**903.1**	779.2
Total liabilities	**2,015.1**	1,874.9

Unallocated corporate assets and liabilities include net taxation liabilities of £90.7m, retirement benefit assets of £174.2m, retirement benefit obligations of £184.7m and property, plant and equipment of £16.8m. All these assets and liabilities are not directly attributable to the operating activities.

Analysis by geographical location

The Group's revenue by destination is shown below:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
United Kingdom	**148.3**	134.6
North America	**1,107.5**	1,038.4
Europe	**586.3**	546.2
Other overseas	**479.1**	441.7
	2,321.2	2,160.9

The following analysis shows the carrying amounts of the Group's assets, and additions to intangible assets and property, plant and equipment.

	Segment assets		Additions to intangible assets and property, plant and equipment	
	2008 £m	2007 £m	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
United Kingdom	**393.8**	583.6	**16.6**	76.9
North America	**1,405.5**	1,276.4	**53.4**	118.8
Europe	**746.3**	554.0	**20.0**	13.3
Other overseas	**255.2**	178.0	**10.1**	19.1
	2,800.8	2,592.0	**100.1**	228.1
Cash and cash equivalents	**132.5**	186.2		
	2,933.3	2,778.2	**100.1**	228.1

Included in additions to intangible assets and property, plant and equipment above were the following in relation to discontinued operations: United Kingdom £nil (2007: £53.4m), North America £nil (2007: £66.7m), Europe £nil (2007: £0.6m), and Other overseas £nil (2007: £7.0m). Of the additions relating to discontinued operations in 2007, the following amounts were incurred during the period after being classified as a disposal group: United Kingdom £37.5m, North America £47.0m, Europe £nil, and Other overseas £6.4m.

Notes to the accounts continued

1 Segment information continued

Additional voluntary segment disclosure of the impact of the restructuring

As set out in the Chief Executive's statement, the roles of the divisions and the corporate centre are being restructured with the new management structure in place from 1 August 2008. The following information, which is presented with no comparatives, illustrates how the result would have been reported if the new structure had been in place for the year ended 31 July 2008.

								Year ended 31 July 2008
	Detection £m	John Crane £m	Medical £m	Interconnect £m	Flex-Tek £m	Other £m	Corporate £m	Total £m
Revenue	**509.3**	**625.8**	**703.4**	**260.6**	**206.1**	**16.0**		**2,321.2**
Headline operating profit	**93.3**	**103.8**	**139.6**	**54.0**	**24.3**	**0.8**	**(35.2)**	**380.6**
Exceptional operating items (note 4)	0.1	(51.0)	(9.4)	(1.3)	(0.1)	28.3	(2.0)	(35.4)
Amortisation of acquired intangible assets	(0.4)	(5.5)	(11.3)	(2.0)				(19.2)
Financing losses			(0.4)		0.1			(0.3)
Operating profit	**93.0**	**47.3**	**118.5**	**50.7**	**24.3**	**29.1**	**(37.2)**	**325.7**
Exceptional finance costs – adjustment to discounted provision (note 4)		(4.7)						(4.7)
Net finance costs – other								(0.7)
Share of post-tax (losses)/profits of associated companies	(1.4)	0.4						(1.0)
Profit before taxation								**319.3**
Taxation								(75.0)
Profit for the period – continuing operations								**244.3**

The assets and liabilities of the five new operating segments are set out below:

								Year ended 31 July 2008
	Detection £m	John Crane £m	Medical £m	Interconnect £m	Flex-Tek £m	Other unallocated & corporate £m	Cash & borrowings £m	Total £m
Assets	711.7	490.5	912.1	267.4	106.2	312.9	132.5	2,933.3
Liabilities	(143.6)	(282.1)	(93.0)	(47.0)	(29.2)	(517.1)	(903.1)	(2,015.1)
Net assets	**568.1**	**208.4**	**819.1**	**220.4**	**77.0**	**(204.2)**	**(770.6)**	**918.2**

2 Operating profit is stated after charging

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Cost of inventories recognised as an expense	**1,776.4**	1,582.1
Employee costs (note 11)	**662.4**	645.2
Depreciation of property, plant and equipment including impairment of £0.3m (2007: £8.1m)	**53.5**	51.9
Amortisation of intangible assets including impairment of £nil (2007: £2.2m)	**31.0**	28.1
Impairment losses recognised in the period on receivables	**0.6**	1.3
Research and development expense	**52.7**	52.3
Operating leases		
– land and buildings	**20.2**	18.9
– other	**7.9**	7.2
Fair value movements on derivatives		
– embedded		0.8
– held for trading	**0.3**	0.7

For the period ending 31 July 2007 other operating income comprises the income received following the commutation of insurance policies (£42.9m – see note 4) and the profit on sale of a financial asset.

2 Operating profit is stated after charging continued

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Audit services		
Fees payable to the Company's auditors for the audit of the parent company and consolidated accounts	**0.5**	0.4
Fees payable to the Company's auditors and its associates for other services:		
– the audit of the Company's subsidiaries, pursuant to legislation	**3.5**	3.6
– other services pursuant to legislation		0.1
	4.0	4.1
Tax services		
– compliance services	**0.1**	0.1
– advisory services	**0.1**	0.7
Services in relation to corporate acquisition and disposal transactions		
– sale of Aerospace		1.8
– aborted transaction		1.1
– B-share issue		0.3
– due diligence	**0.1**	0.9
All other services	**0.2**	0.2

Other services relate to one-off projects.

3 Headline profit measures

The Company seeks to present a measure of underlying performance which is not impacted by exceptional items or items considered non-operational in nature. This measure of profit is described as 'headline' and is used by management to measure and monitor performance.

The following items have been excluded from the headline measure:

- exceptional items, including income and expenditure relating to John Crane, Inc. asbestos litigation;
- amortisation of intangible assets acquired in a business combination – the amortisation charge is a non-cash item, and the directors believe that it should be added back to give a clearer picture of underlying performance; and
- other financing gains and losses, which represent the potentially volatile gains and losses on derivatives and other financial instruments which do not fall to be hedge accounted under IAS 39.

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Other financing gains and losses		
Financing gains and losses on financial instruments	**(1.4)**	2.1
Exceptional finance costs – adjustment to discounted provision (note 4)	**(4.7)**	
	(6.1)	2.1
Financing gains and losses reported in operating profit		
Financing gains and losses on financial instruments	**(0.3)**	(1.5)
	(6.4)	0.6

Notes to the accounts continued

4 Exceptional items

An analysis of the amounts presented as exceptional items in these financial statements is given below:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Operating items		
Restructuring of corporate and divisional headquarters	**(4.5)**	
Integration of acquisitions	**(9.1)**	(9.0)
Impairment of goodwill and other assets		(10.3)
Profit/(loss) on disposal of businesses (note 30)	**27.2**	(5.2)
Aborted transaction costs		(12.7)
Litigation:		
– Commutation of insurance policies (note 23)		42.9
– Provision for John Crane, Inc. asbestos litigation (note 23)	**(49.0)**	(100.7)
– Provision for other litigation (note 23)		(8.6)
– Class action settlement		5.4
	(35.4)	(98.2)
Financing items		
Exceptional finance costs – adjustment to discounted provision (note 23)	**(4.7)**	
	(40.1)	(98.2)

Year ended 31 July 2008

On 3 June 2008 the Company announced a number of changes to its corporate centre and divisional headquarters. The total cost of this restructuring, including redundancy, relocation and consolidation of manufacturing, is considered exceptional by virtue of its size. It is expected to amount to approximately £48m over the period to 2010, of which £4.5m has been charged in the current year.

In addition, restructuring costs in connection with the integration of Medex amounting to £9.1m have been incurred in the period. No further costs relating to this restructuring are anticipated.

The operating charge of £49.0m in respect of John Crane, Inc. asbestos litigation comprises a £40.0m provision for the expected costs of future asbestos judgments, £5.2m in respect of adverse legal judgments (net of insurer contributions previously lodged as collateral) and £3.8m arising from movements in the discounting due to changes in US interest rates (see note 23).

Period ended 31 July 2007

Restructuring costs in connection with the integration of Medex amounting to £9.0m were incurred in the period.

Impairment of goodwill and other assets includes £8.1m in respect of the impairment of a disposal group (John Crane Automotive) prior to its eventual sale.

Costs of £12.7m in relation to the proposed joint venture with GE were written off in the light of the decision not to proceed with the joint venture.

John Crane, Inc. commuted certain insurance policies and received £42.9m in cash for the period. At the same time, a provision of £100.7m in respect of legal defence costs for asbestos cases was established (note 23).

The progression of other litigation cases arising in 2007 gave rise to an exceptional charge.

The exceptional charge recognised in 2006 in respect of the class action settlement has now been finalised. That element of the provision which was surplus was therefore released.

5 Net finance costs

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Interest receivable	**2.2**	21.4
Interest payable		
– bank loans and overdrafts	**(19.6)**	(28.5)
– other loans	**(23.6)**	(29.3)
Interest payable	**(43.2)**	(57.8)
Other financing (losses)/gains		
– fair value losses on hedged debt	**(4.0)**	(1.0)
– fair value gains on fair value hedge	**4.0**	1.0
– net foreign exchange (losses)/gains	**(1.4)**	2.1
– exceptional finance costs – adjustment to discounted provision	**(4.7)**	
Other financing (losses)/gains	**(6.1)**	2.1
Retirement benefits		
– return on plan assets	**217.3**	191.2
– interest cost	**(175.6)**	(157.5)
Retirement benefits	**41.7**	33.7
Net finance costs	**(5.4)**	(0.6)

6 Taxation

	Continuing Year ended 31 July 2008 £m	Continuing Period ended 31 July 2007 £m	Discontinued Year ended 31 July 2008 £m	Discontinued Period ended 31 July 2007 £m
The taxation charge for the year comprises				
– current income taxation	**67.0**	13.6		87.6
– deferred taxation	**8.0**	39.5	**2.3**	0.6
Total taxation expense in the income statement	**75.0**	53.1	**2.3**	88.2
Current income taxation				
– UK corporation tax				
– foreign tax	**67.0**	13.6		62.6
– discontinued tax				25.0
	67.0	13.6		87.6

Notes to the accounts continued

6 Taxation continued

Reconciliation of the total tax charge

The tax expense on the profit for the period is different from the standard rate of corporation tax in the UK of 29.3% (2007: 30%). The difference is reconciled as follows:

	Continuing Year ended 31 July 2008 £m	Continuing Period ended 31 July 2007 £m	**Discontinued Year ended 31 July 2008 £m**	Discontinued Period ended 31 July 2007 £m
Profit before tax	**319.3**	256.0	**26.8**	1,613.4
Notional taxation expense at UK rate of 29.3% (2007: 30%)	**93.7**	76.8	**7.9**	484.0
Effect of overseas taxation	**8.2**	15.7		5.0
Compliance benefits	**(12.4)**	(16.5)		(4.0)
Local incentives	**(16.1)**	(16.1)		(7.0)
Sale of investment		(7.2)		
Tax effect of other non-headline items	**1.6**	0.4		
Tax effect of Aerospace sale			**(5.6)**	(389.8)
	75.0	53.1	**2.3**	88.2
Comprising				
– taxation on headline profit	**91.3**	86.4		
– tax relief on non-headline loss	**(16.3)**	(33.3)		
– taxation on discontinued profit				36.9
– tax on sale of discontinued operations			**2.3**	51.3
Total taxation expense in the income statement	**75.0**	53.1	**2.3**	88.2

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Tax on items charged/(credited) to equity		
Current tax credit		
– share-based payment	**(5.2)**	(10.3)
– exchange gains		(2.4)
	(5.2)	(12.7)
Deferred tax (credit)/charge		
– retirement benefit schemes	**(75.5)**	30.1
– share-based payment	**3.8**	9.4
	(76.9)	26.8

6 Taxation continued

Deferred taxation

	Excess tax depreciation on fixed assets and goodwill £m	Share-based payment £m	Retirement benefit obligations £m	Capitalised development expenditure £m	Other £m	Total £m
At 5 August 2006	(45.9)	24.5	32.7	(11.8)	43.1	42.6
(Charge)/credit to income statement	(41.3)	2.3	(55.6)	22.8	31.7	(40.1)
Charge to equity		(9.4)	(30.1)			(39.5)
Other					(1.5)	(1.5)
Disposals	12.0			(22.0)	27.4	17.4
Exchange adjustments	3.1	(1.7)	(2.2)	0.8	(2.9)	(2.9)
At 31 July 2007	(72.1)	15.7	(55.2)	(10.2)	97.8	(24.0)
Deferred tax assets	11.1		12.7	(4.4)	74.6	94.0
Deferred tax liabilities	(83.2)	15.7	(67.9)	(5.8)	23.2	(118.0)
At 31 July 2007	(72.1)	15.7	(55.2)	(10.2)	97.8	(24.0)
Credit/(charge) to income statement	9.7	0.3	(31.3)	(1.6)	12.6	(10.3)
Charge to equity		(3.8)	75.5			71.7
Other					6.0	6.0
Disposals					(12.8)	(12.8)
Exchange adjustments	(1.9)		0.5	(0.2)	2.9	1.3
At 31 July 2008	**(64.3)**	**12.2**	**(10.5)**	**(12.0)**	**106.5**	**31.9**
Deferred tax assets	(2.6)	0.3	19.7	(4.6)	83.4	96.2
Deferred tax liabilities	(61.7)	11.9	(30.2)	(7.4)	23.1	(64.3)
At 31 July 2008	**(64.3)**	**12.2**	**(10.5)**	**(12.0)**	**106.5**	**31.9**

Included in Other above is a deferred tax liability of £9.3m (2007: £10m) relating to unremitted overseas earnings. No additional tax liabilities have been recognised because the Group is in a position to control the timing of other temporary differences and it is probable that such differences will not reverse in the future. Other deferred tax also includes the tax benefits of losses carried forward amounting to £26.7m (2007: £15.4m).

The Group has not recognised deferred tax assets relating to tax losses of £102.2m (2007: £17.9m), due to uncertainty as to their recoverability. The expiry date of operating losses carried forward is dependent upon the law of the various territories in which the losses arise. A summary of expiry dates for losses in respect of which restrictions apply is set out below.

Restricted losses

	2008 £m	**Expiry of losses**	2007 £m	Expiry of losses
Territory				
– Americas	**10.7**	**2019-2025**	10.6	2019-2025
– Europe			5.0	2014
Total restricted losses	**10.7**		15.6	
Unrestricted losses:				
– operating losses	**91.5**	**No expiry**	2.3	No expiry
Total	**102.2**		17.9	

Notes to the accounts continued

7 Discontinued operations

On 5 May 2007, the Company sold its Aerospace operations to General Electric Company. The Aerospace operations sold comprised the Aerospace business segment as reported in previous annual reports and accounts plus the US microwave company previously reported in Specialty – Other. The revenue and profit before taxation of the US microwave company in the period ended 31 July 2007 were £32.2m and £7.6m respectively. As the Aerospace operations represented a separate business segment, the disposal group was treated as a discontinued operation in the 2007 Annual report and accounts. The post-tax result of the Aerospace operations was disclosed as a discontinued operation in the consolidated income statement. In the cash-flow statement, the operating cash-flows of the Aerospace Group for the period ended 31 July 2007 were aggregated with those of the continuing operations, but are shown separately in the note below.

Profit on disposal of operation

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Total consideration	**6.1**	2,585.4
Foreign exchange recycled to the income statement on disposal		(48.4)
Provisions and disposal costs	**17.1**	(76.0)
Pension curtailment gains		63.3
Provision for settlement loss	**3.6**	(24.3)
	26.8	2,500.0
Net assets disposed		(1,030.4)
Pre-tax profit on disposal	**26.8**	1,469.6

		£m
Cash received from disposal of Aerospace operations	**3.0**	2,585.4
Disposal costs	**(9.3)**	(31.9)
Cash and cash equivalents of subsidiaries disposed		(62.5)
Borrowings of subsidiaries disposed		4.0
Net cash (outflow)/inflow on disposal	**(6.3)**	2,495.0

The £6.1m consideration recognised in the year ended 31 July 2008 arises from the finalisation of the working capital adjustment.

The provisions and disposal costs movement for the year ended 31 July 2008 include £4.3m other finance income relating to retirement benefits and £12.7m relating to the reassessment of the carrying value of other assets and liabilities

Assets and liabilities of discontinued operations at the date of disposal

	£m
Assets	
Intangible assets	553.0
Property, plant and equipment	256.1
Retirement benefit assets	6.8
Inventories	297.0
Trade and other receivables	1,357.1
Inter-company receivables	1,024.5
Cash and cash equivalents	62.5
Financial derivatives	12.1
Total assets	3,569.1
Liabilities	
Financial liabilities	
– borrowings	(4.0)
– financial derivatives	(2.5)
Provisions for liabilities and charges	(20.6)
Retirement benefit obligations	(0.5)
Deferred tax liabilities	(17.4)
Trade and other payables	(2,493.7)
Total liabilities	(2,538.7)
Net assets	1,030.4

7 Discontinued operations continued

Financial information for the Aerospace operations after Group eliminations is presented below.

Results from discontinued operations

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Revenue		955.6
Cost of sales		(667.9)
Gross profit		287.7
Sales and distribution costs		(29.9)
Administrative expenses		(116.6)
Loss on disposal of business		
Operating profit		141.2
Interest payable		(1.2)
Other financing gains		0.7
Other finance income – retirement benefits		3.1
Profit before taxation		143.8
Taxation relating to performance of discontinued operations (note 6)		(36.9)
Profit on disposal	**26.8**	1,469.6
Attributable tax charge (note 6)	**(2.3)**	(51.3)
Profit for the period	**24.5**	1,525.2

	Year ended 31 July 2008	Period ended 31 July 2007
Earnings per share from discontinued operations – pence		
Basic	**6.3p**	277.8p
Diluted	**6.2p**	273.9p

The profit before taxation for the period ended 31 July 2007 represents the results of the operations for the period to the date of disposal.

Analysis by geographical location

The Group's revenue from discontinued operations by destination is shown below:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Revenue		
United Kingdom		125.7
North America		688.6
Europe		95.0
Other overseas		46.3
		955.6

The Group operating profit from discontinued operations was after charging:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Cost of inventories recognised as an expense		594.6
Employee costs (note 11)		342.5
Depreciation of property, plant and equipment		8.4
Amortisation of intangible assets		3.8
Impairment losses recognised in the period on receivables		0.1
Research and development costs		29.4
Operating leases		
– land and buildings		4.1
– other		1.0
Fair value movements on derivatives		
– embedded		(0.1)
– held for trading		0.7

Notes to the accounts continued

7 Discontinued operations continued

Cash-flows from discontinued operations

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Profit before taxation (including profit on disposal of Aerospace operations)	**26.8**	1,613.4
Net interest payable		1.2
Financing (gains)/losses		
– charged to financing		(0.7)
Other finance income – retirement benefits		(3.1)
Profit on disposal of discontinued operations	**(26.8)**	(1,469.6)
		141.2
Amortisation of intangible assets		3.8
Profit on disposal of property, plant and equipment		0.2
Profit on disposal of business		
Depreciation of property, plant and equipment		8.4
Share-based payment expense		3.5
Retirement benefits		(22.6)
Increase in inventories		(51.0)
(Increase)/decrease in trade and other receivables		(17.3)
(Decrease)/increase in trade and other payables		(16.4)
(Decrease)/increase in provisions		(1.1)
Cash generated from operations		48.7
Interest		(1.2)
Tax paid		(6.9)
Net cash inflow from operating activities		40.6

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Operating activities		40.6
Investing activities	**(6.3)**	2,373.1
Financing activities		14.2
	(6.3)	2,427.9

8 Dividends

The following dividends were declared and paid in the period:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Ordinary final dividend of 23.5p for 2007 (2006: 21.5p) paid 23 November 2007	**90.8**	122.3
Ordinary interim dividend of 10.5p for 2008 (2007: 10.5p) paid 25 April 2008	**40.6**	60.1
	131.4	182.4

The final dividend for the year ended 31 July 2008 of 23.5p per share was declared by the Board on 23 September 2008 and will be paid to shareholders on 21 November 2008. This dividend has not been included as a liability in these accounts and is payable to all shareholders on the register of Members at close of business on 24 October 2008.

9 Earnings per share

Basic earnings per share are calculated by dividing the profit for the period attributable to equity shareholders of the Parent Company by the average number of ordinary shares in issue during the year.

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Profit attributable to equity shareholders for the year		
– continuing	**244.0**	202.9
– total	**268.5**	1,728.1
Average number of shares in issue during the year	**387,446,186**	549,153,733

Diluted earnings per share are calculated by dividing the profit attributable to ordinary shareholders by 391,851,712 (2007: 556,934,401) ordinary shares, being the average number of ordinary shares in issue during the period adjusted by the dilutive effect of employee share schemes. For the year ended 31 July 2008 options over 1,376,331 (2007: 847,762) shares were excluded from this calculation because their effect was anti-dilutive for continuing operations.

The average number of shares in issue has reduced as a result of the share consolidation in June 2007 following the disposal of the Aerospace business. The average number of shares in issue during the period ended 31 July 2007 was a reflection of the capital structure appropriate to both the continuing and the discontinued business.

A reconciliation of basic and headline earnings per share – continuing is as follows:

	Year ended 31 July 2008		Period ended 31 July 2007	
	£m	**EPS (p)**	£m	EPS (p)
Profit attributable to equity shareholders of the Parent Company	**244.0**	**63.0**	202.9	36.9
Exclude				
– exceptional operating items (note 4)	**35.4**		98.2	
– (profit on sale)/impairment of financial asset			(24.0)	
– amortisation of acquired intangible assets	**19.2**		14.8	
– financing gains – charged to administrative expenses	**0.3**		1.5	
– exceptional finance cost – adjustment to discounted provision (note 4)	**4.7**			
– charged to financing	**1.4**		(2.1)	
	61.0		88.4	
– less tax	**(16.3)**		(33.3)	
	44.7	**11.5**	55.1	10.1
Headline	**288.7**	**74.5**	258.0	47.0
Headline EPS – diluted (p)		**73.7**		46.3

Notes to the accounts continued

10 Post-retirement benefits

Smiths operates a number of defined benefit plans throughout the world. The principal schemes are in the United Kingdom and in the United States and assets held in separate trustee-administered funds. The Group also provides a defined contribution (401K) plan for its US employees.

Pension costs are assessed in accordance with the advice of independent, professionally-qualified actuaries. The most recent actuarial valuations of the two principal UK schemes were performed using the Projected Unit Method as at 31 March 2006. The most recent valuations of the six principal US pension and post-retirement healthcare plans were performed at 1 January 2008. These valuations have been updated by independent qualified actuaries in order to assess the liabilities of the schemes as at 31 July 2008. Scheme assets are stated at their market values.

Contributions to the schemes are made on the advice of the actuaries with the objective that the benefits be fully funded during the scheme members' average working lives.

The principal assumptions used in updating the valuations are set out below:

	UK	US	2008 Other	UK	US	2007 Other
Rate of increase in salaries	**4.1%**	**3.8%**	**3.7%**	4.1%	3.8%	3.0%
Rate of increase in pensions in payment	**3.6%**	**n/a**	**1.4%**	3.1%	n/a	1.0%
Rate of increase in deferred pensions	**3.5%**	**n/a**	**0.7%**	3.1%	n/a	0.6%
Discount rate	**6.6%**	**6.8%**	**6.0%**	5.8%	6.4%	5.1%
Inflation rate	**3.6%**	**3.3%**	**2.5%**	3.1%	2.8%	1.6%
Healthcare cost increases	**5.0%**	*****	**3.8%**	5.0%	**	2.7%

*8% p.a. reducing 0.5% p.a. to 5% in 2014

**9% p.a. reducing 1% p.a. to 5% in 2012

The assumptions used are estimates chosen from a range of possible actuarial assumptions which, due to the timescale covered, may not necessarily occur in practice. For countries outside the UK and USA these are disclosed as a weighted average.

The mortality assumptions used in the UK schemes are based on the recent actual mortality experience of members within each scheme. The assumptions are based on the PA92 birth year tables with relevant scaling factors based on the experience of the schemes. The assumption also allows for future improvements in life expectancy in line with the medium cohort and a 1% underpin. The assumptions are that a member who retires next year at age 65 will live on average for a further 22 years after retirement if they are male and for a further 25 years if they are female. For a member who is currently 45, when they retire in 20 years' time they are assumed to live on average for a further 23 years after retirement if they are male and for a further 27 years if they are female.

The mortality assumptions used in the principal US schemes are based on the most recent mortality study table produced for retired pensioners in the US (RP 2000 table). The table selected allows for future mortality improvements and applies an adjustment for job classification (blue collar versus white collar). The assumptions are that a member who retires at age 65 will live on average for a further 18 years after retirement if they are male and for a further 20 years after retirement if they are female. For a member who is currently 45, when they retire in 20 years time they are assumed to live on average for a further 19 years after retirement if they are male and for a further 21 years if they are female.

The assets in the scheme and the expected rates of return as at 31 July 2008 were:

						2008
	UK schemes		US schemes		Other countries	
	Long-term rate of return	Value £m	Long-term rate of return	Value £m	Long-term rate of return	Value £m
Equities	**8.2%**	**1,165.8**	**8.8%**	**187.5**	**8.8%**	**7.1**
Government bonds	**4.8%**	**445.1**	**5.3%**	**83.8**	**6.6%**	**4.9**
Corporate bonds	**6.6%**	**258.4**	**6.8%**	**25.8**	**7.1%**	**1.8**
Insured liabilities	**6.6%**	**271.4**	**6.8%**	**1.5**	**n/a**	
Property	**7.2%**	**188.7**	**7.2%**		**3.2%**	**0.2**
Other	**5.8%**	**289.0**	**6.0%**	**17.9**	**5.0%**	**11.0**
Total market value		**2,618.4**		**316.5**		**25.0**
Present value of funded scheme liabilities		**(2,468.8)**		**(357.0)**		**(30.7)**
Surplus/(deficit)		**149.6**		**(40.5)**		**(5.7)**
Unfunded pension plans		**(34.3)**		**(3.7)**		**(16.4)**
Post-retirement healthcare		**(15.2)**		**(42.0)**		**(0.8)**
Unrecognised asset due to surplus restriction						**(1.5)**
Net pension asset/(liability)		**100.1**		**(86.2)**		**(24.4)**

During the year, the Trustees of the TI pension scheme invested £250.0m in annuities which are matched with specific liabilities of the fund, As a result, this investment category is separately analysed.

Other assets in the UK and US comprise cash and current assets.

10 Post-retirement benefits continued

	2007					
	UK schemes		US schemes		Other countries	
	Long-term rate of return	Value £m	Long-term rate of return	Value £m	Long-term rate of return	Value £m
Equities	8.2%	1,624.1	8.8%	202.9	8.2%	7.1
Government bonds	4.9%	591.6	5.0%	94.9	6.5%	3.6
Corporate bonds	5.8%	364.9	6.4%	23.8	7.7%	2.5
Property	7.2%	201.8	n/a		n/a	
Other	6.0%	186.7	5.0%	6.0	4.1%	9.0
Total market value		2,969.1		327.6		22.2
Present value of funded scheme liabilities		(2,637.6)		(355.0)		(26.6)
Surplus/(deficit)		331.5		(27.4)		(4.4)
Unfunded pension plans		(33.6)		(3.8)		(14.1)
Post-retirement healthcare		(15.9)		(45.4)		(0.9)
Unrecognised asset due to surplus restriction						(2.4)
Net pension asset/(liability)		282.0		(76.6)		(21.8)

The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, nor other assets used by, the Group. The expected rates of return on individual categories of scheme assets are determined by reference to relevant industries. The overall rate of return is calculated by weighting the individual rates in accordance with the anticipated balance in the scheme's investment portfolios.

Amounts recognised in the income statement – continuing and discontinued operations

	Year ended 31 July 2008				Period ended 31 July 2007			
	Funded defined benefit pension schemes			**Unfunded pension/post-retirement healthcare plans**	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans
	UK £m	**US £m**	**Other £m**	**£m**	UK £m	US £m	Other £m	£m
Current service cost	**11.3**	**7.6**	**1.3**	**2.4**	28.2	10.6	1.2	2.6
Past service cost		**1.0**	**0.1**		0.7	0.2		0.4
Settlement losses/(gains)	**20.7**				(0.4)	2.8		
Curtailment gains	**(1.1)**				(36.5)	(20.6)		(9.3)
Total charge/(credit)	**30.9**	**8.6**	**1.4**	**2.4**	(8.0)	(7.0)	1.2	(6.3)
Expected return on pension scheme assets	**(199.5)**	**(24.5)**	**(1.5)**		(179.6)	(24.2)	(1.2)	
Interest on pension scheme liabilities	**148.3**	**23.0**	**1.5**	**6.7**	136.3	23.5	1.4	7.0
Net return	**(51.2)**	**(1.5)**		**6.7**	(43.3)	(0.7)	0.2	7.0
Total (credited)/charged to income statement	**(20.3)**	**7.1**	**1.4**	**9.1**	(51.3)	(7.7)	1.4	0.7

The actual return on scheme assets was a loss of £124.5m (2007: gain of £300.7m).

Notes to the accounts continued

10 Post-retirement benefits continued

The operating cost is charged as follows:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Cost of sales	**6.6**	7.3
Sales and distribution costs	**5.0**	4.4
Administrative expenses	**12.1**	11.3
Discontinued operations	**20.7**	20.5
Exceptional operating items		(0.3)
Profit on disposal of business/curtailment gain	**(1.1)**	(63.3)

Actuarial losses of £254.5m (2007: gains of £70.3m) have been reported in the statement of recognised income and expense. This includes a gain of £0.9m (2007: loss of £1.9m) in respect of unrecognised assets owing to surplus restriction. Cumulative actuarial losses from 1 August 2004 reported in the statement of recognised income and expense are £113.1m (2007: cumulative gain of £141.4m).

During the year, the pension settlement relating to the active Aerospace employees was completed, resulting in a £20.7m settlement charge to discontinued operations. In 2007 a provision of £24.3m was made to cover the expected costs of this settlement. The balance of the provision has been released in the current year.

Amounts recognised in the balance sheet

	Year ended 31 July 2008				Period ended 31 July 2007			
	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans
	UK £m	US £m	Other £m	£m	UK £m	US £m	Other £m	£m
Present value of funded obligations	**(2,468.8)**	**(357.0)**	**(30.7)**		(2,637.6)	(355.0)	(26.6)	
Fair value of scheme assets	**2,618.4**	**316.5**	**25.0**		2,969.1	327.6	22.2	
	149.6	**(40.5)**	**(5.7)**		331.5	(27.4)	(4.4)	
Present value of unfunded obligations				**(112.4)**				(113.7)
Irrecoverable surplus			**(1.5)**				(2.4)	
Net asset/(liability) recognised in the balance sheet	**149.6**	**(40.5)**	**(7.2)**	**(112.4)**	331.5	(27.4)	(6.8)	(113.7)

Changes in present value of defined benefit obligations

	Year ended 31 July 2008				Period ended 31 July 2007			
	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans
	UK £m	US £m	Other £m	£m	UK £m	US £m	Other £m	£m
At beginning of period	**(2,637.6)**	**(355.0)**	**(26.6)**	**(113.7)**	(2,630.1)	(394.3)	(11.4)	(126.8)
Transfers in of territories outside UK and USA				**(0.1)**			(5.2)	(7.1)
Liabilities assumed on acquisitions			**(0.1)**	**(1.3)**				(0.2)
Liabilities transferred on disposal				**0.3**				
Current service cost	**(11.3)**	**(7.6)**	**(1.3)**	**(2.4)**	(28.2)	(10.6)	(1.2)	(2.6)
Interest on obligations	**(148.3)**	**(23.0)**	**(1.5)**	**(6.7)**	(136.3)	(23.5)	(1.4)	(7.0)
Employee contributions	**(0.2)**		**(0.2)**		(0.4)		(0.2)	
Past service cost		**(1.0)**	**(0.1)**		(0.7)	(0.2)		(0.4)
Actuarial gain/(loss) on liabilities	**66.7**	**20.3**	**0.9**	**6.7**	(14.0)	(10.4)	(9.3)	10.2
Curtailment gain	**1.1**				36.5	20.6		9.3
Liabilities extinguished on settlements	**131.3**				12.7	23.6		
Exchange adjustments	**(1.3)**	**(9.7)**	**(2.7)**	**(3.8)**		24.0	0.8	3.7
Benefits paid	**130.8**	**19.0**	**0.9**	**8.6**	122.9	15.8	1.3	7.2
At end of period	**(2,468.8)**	**(357.0)**	**(30.7)**	**(112.4)**	(2,637.6)	(355.0)	(26.6)	(113.7)

10 Post-retirement benefits continued

Changes in present value of scheme assets

	Year ended 31 July 2008				Period ended 31 July 2007			
	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans	Funded defined benefit pension schemes			Unfunded pension/post-retirement healthcare plans
	UK £m	US £m	Other £m	£m	UK £m	US £m	Other £m	£m
At beginning of period	**2,969.1**	**327.6**	**22.2**		2,770.4	332.8	7.8	
Transfers in of territories outside UK and USA							5.1	
Expected return on assets	**199.5**	**24.5**	**1.5**		179.6	24.2	1.2	
Actuarial (losses)/gains on scheme assets	**(312.1)**	**(35.4)**	**(2.5)**		67.2	20.4	8.1	
Employer contributions	**43.5**	**10.0**	**2.6**	**8.6**	86.7	13.9	1.9	7.2
Employee contributions	**0.2**		**0.2**		0.4		0.2	
Assets distributed on settlements	**(152.0)**				(12.3)	(26.4)		
Exchange adjustments	**1.0**	**8.8**	**1.9**			(21.5)	(0.8)	
Benefits paid	**(130.8)**	**(19.0)**	**(0.9)**	**(8.6)**	(122.9)	(15.8)	(1.3)	(7.2)
At end of period	**2,618.4**	**316.5**	**25.0**		2,969.1	327.6	22.2	

Cash contributions

Company contributions to the funded defined benefit pension plans for 2008 totalled £56.1m (2007: £102.5m). 2008 included special UK contributions of £17.1m (2007: £55.9m) including: £13.1 (2007: £13.1m) for special covenant payments; £4.0m (2007: £20.6m) arising from the sale of Aerospace; and £nil (2007: £22.2m) in respect of back-dated payments resulting from trustee valuations. Cash payments in 2009 are expected to be £51.7m.

History of schemes

	2008 £m	2007 £m	2006 £m	2005 £m
Balance sheet				
Present value of defined benefit obligation	**(2,968.9)**	(3,132.9)	(3,162.6)	(3,127.4)
Fair value of scheme assets	**2,959.9**	3,318.9	3,111.0	2,890.8
Unrecognised asset due to surplus restriction	**(1.5)**	(2.4)	(0.5)	
(Deficit)/surplus	**(10.5)**	183.6	(52.1)	(236.6)
Post-retirement assets	**174.2**	333.7	183.7	134.6
Post-retirement liabilities	**(184.7)**	(150.1)	(235.8)	(371.2)
(Deficit)/surplus	**(10.5)**	183.6	(52.1)	(236.6)

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Experience gains/(losses)				
Experience gains/(losses) on scheme liabilities	**(6.4)**	(57.6)	17.6	0.5
Experience (losses)/gains on scheme assets	**(350.0)**	95.7	76.6	242.9
Movement on restricted surplus	**0.9**	(1.9)	(0.5)	

The disclosures above are determined prospectively from 2005. The experience gains and losses on scheme liabilities have been represented to exclude gains and losses arising from changes in actuarial assumptions.

Notes to the accounts continued

10 Post-retirement benefits continued

Balance sheet reconciliation

The balance sheet records the retirement assets and liabilities as follows:

	2008 £m	2007 £m
UK surplus	**149.6**	331.5
US deficit	**(40.5)**	(27.4)
Other countries deficit	**(7.2)**	(6.8)
Unfunded	**(112.4)**	(113.7)
(Deficit)/surplus	**(10.5)**	183.6
Post-retirement assets	**174.2**	333.7
Post-retirement liabilities	**(184.7)**	(150.1)
(Deficit)/surplus	**(10.5)**	183.6

At 31 July 2008 the net UK funded pension surplus of £149.6m (2007: £331.5m) represented individual plan surpluses of £174.2m (2007: £333.7m) and deficits of £24.6m (2007: £2.2m).

Sensitivity

Valuation of post-retirement schemes involves judgements about uncertain future events. Sensitivities in respect of the key assumptions used to measure the principal pension schemes as at 31 July 2008 are set out below. These sensitivities show the hypothetical impact of a change in each of the listed assumptions in isolation, with the exception of the sensitivity to inflation which incorporates the impact of certain correlating assumptions such as salary increases. While each of these sensitivities holds all other assumptions constant, in practice such assumptions rarely change in isolation and the impacts may offset to some extent.

	Profit before tax for year ended 31 July 2009 £m	Increase/ (decrease) in scheme assets £m	(Increase)/ decrease in scheme liabilities £m
Rate of mortality – 1 year increase in life expectancy	(6.0)		(86.8)
Rate of mortality – 1 year decrease in life expectancy	6.3		89.8
Rate of inflation – 0.25% increase	(5.0)		(65.8)
Discount rate – 0.25% increase	1.3		100.7
Expected return on scheme assets – 0.25% increase	7.4		
Market value of scheme assets – 2.5% increase	5.0	73.9	
Healthcare cost trends – 1% increase	(0.6)		(5.4)
Healthcare cost trends – 1% decrease	0.5		4.7

The effect on profit before tax reflects the impact of current service cost, interest cost and expected return on assets.

Defined contribution plans

The Group operates a number of defined contribution plans. The total expense recognised in the income statement in respect of these plans was £13.7m (2007: £19.1m).

11 Employees

	Year ended 31 July 2008	Period ended 31 July 2007		
	Total (all continuing) £m	Continuing £m	Discontinued £m	Total £m
Staff costs during the period				
Wages and salaries	**545.8**	528.1	295.6	823.7
Social security	**67.3**	62.4	25.4	87.8
Share-based payment (note 31)	**12.9**	10.4	3.5	13.9
Pension costs (including defined contribution schemes) (note 10)	**36.4**	44.3	18.0	62.3
	662.4	645.2	342.5	987.7

The average number of persons employed was:

	Year ended 31 July 2008	Period ended 31 July 2007
Detection	**2,300**	2,100
Medical	**8,400**	8,000
Specialty Engineering:		
John Crane	**6,400**	5,600
Specialty – Other	**5,500**	5,100
Continuing operations	**22,600**	20,800
Discontinued operations		8,300
	22,600	29,100

Key management

The key management of the Group comprises Smiths Group plc Board directors and Group Managing Directors who are not Board members during the year and their aggregate compensation is shown below. Details of directors' remuneration are contained in the report of the Remuneration Committee on pages 47 to 56.

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Key management compensation		
Salaries and short-term employee benefits	**7.6**	6.6
Cost of post-retirement benefits	**1.0**	1.2
Cost of share-based incentive plans	**5.6**	2.8

No member of key management had any material interest during the period in a contract of significance (other than a service contract or a qualifying third party indemnity provision) with the Company or any of its subsidiaries. Options and awards held at the end of the period by key management in respect of the Company's share-based incentive plans were:

	Year ended 31 July 2008		Period ended 31 July 2007	
	Number of instruments '000	**Weighted average price**	Number of instruments '000	Weighted average price
CIP	**306**	**£0.00**	425	£0.00
DSS			109	£0.00
ESOS	**177**	**£8.06**	413	£8.57
PSP	**795**	**£0.00**	1,067	£0.00
SAYE	**9**	**£8.32**	14	£6.96

The disclosure above does not include options held by individuals who retired before the year end.

Notes to the accounts continued

12 Intangible assets

	Goodwill £m	Development costs £m	Acquired intangibles (see table on next page) £m	Other £m	Total £m
Cost					
At 6 August 2006	1,241.6	293.7	139.1	112.5	1,786.9
Exchange adjustments	(39.2)	(1.9)	(8.5)	(1.7)	(51.3)
Business combinations	16.8		12.1		28.9
Adjustments to prior year business combinations	0.9		(0.9)		
Additions*	2.2	44.1		18.0	64.3
Transfers to disposal group held for sale at year end		(1.2)		(1.1)	(2.3)
Transfer to disposal group sold by the year end	(301.0)	(283.5)	(10.4)	(50.2)	(645.1)
Disposals			(0.1)	(1.2)	(1.3)
At 31 July 2007	921.3	51.2	131.3	76.3	1,180.1
Exchange adjustments	65.4	2.5	5.7	3.3	76.9
Business combinations	87.0		74.5	0.7	162.2
Adjustments to prior year business combinations	(1.7)		1.3	(1.3)	(1.7)
Additions		19.8		16.1	35.9
Disposals	(0.2)			(0.8)	(1.0)
At 31 July 2008	**1,071.8**	**73.5**	**212.8**	**94.3**	**1,452.4**
Amortisation					
At 6 August 2006	133.7	39.5	20.2	62.9	256.3
Exchange adjustments	(2.9)	(0.4)	(1.3)	(1.6)	(6.2)
Charge for the period*		6.6	15.0	8.1	29.7
Impairment	2.2				2.2
Transfers to disposal groups held for sale at year end				(0.4)	(0.4)
Transfer to disposal group sold by the year end	(56.0)	(33.2)	(4.8)	(28.7)	(122.7)
Disposals				(0.1)	(0.1)
At 31 July 2007	77.0	12.5	29.1	40.2	158.8
Exchange adjustments	5.3	0.7	1.8	2.5	10.3
Adjustments to prior year business combinations			0.5	(0.5)	
Charge for the year		5.6	19.2	6.2	31.0
Disposals	(0.2)			(0.7)	(0.9)
At 31 July 2008	**82.1**	**18.8**	**50.6**	**47.7**	**199.2**
Net book value at 31 July 2008	**989.7**	**54.7**	**162.2**	**46.6**	**1,253.2**
Net book value at 31 July 2007	844.3	38.7	102.2	36.1	1,021.3
Net book value at 6 August 2006	1,107.9	254.2	118.9	49.6	1,530.6

*For the period ending 31 July 2007 the additions and amortisation include the respective costs and charge for discontinued operations and disposal groups for the period prior to becoming a disposal group.

12 Intangible assets continued

In addition to goodwill, the acquired intangible assets comprise:

	Patents, licences and trademarks £m	Technology £m	Customer relationships £m	Total acquired intangibles £m
Cost				
At 6 August 2006	38.9	58.6	41.6	139.1
Exchange adjustments	(2.8)	(3.7)	(2.0)	(8.5)
Business combinations	3.6		8.5	12.1
Adjustments to prior year business combinations	0.6	0.2	(1.7)	(0.9)
Transfer to disposal group sold by the year end			(10.4)	(10.4)
Disposals	(0.1)			(0.1)
At 31 July 2007	40.2	55.1	36.0	131.3
Exchange adjustments	1.1	1.9	2.7	5.7
Business combinations (note 29)	12.0	18.8	43.7	74.5
Adjustments to prior year business combinations		1.3		1.3
At 31 July 2008	**53.3**	**77.1**	**82.4**	**212.8**
Amortisation				
At 6 August 2006	3.4	6.9	9.9	20.2
Exchange adjustments	(0.1)	(0.6)	(0.6)	(1.3)
Charge for the period	2.3	5.6	7.1	15.0
Transfer to disposal group sold by the year end			(4.8)	(4.8)
At 31 July 2007	5.6	11.9	11.6	29.1
Exchange adjustments	0.2	0.7	0.9	1.8
Adjustments to prior year business combinations		0.5		0.5
Charge for the year	2.7	6.1	10.4	19.2
At 31 July 2008	**8.5**	**19.2**	**22.9**	**50.6**
Net book value at 31 July 2008	**44.8**	**57.9**	**59.5**	**162.2**
Net book value at 31 July 2007	34.6	43.2	24.4	102.2
Net book value at 6 August 2006	35.5	51.7	31.7	118.9

Significant cash generating units

Goodwill is not amortised but is tested for impairment at least annually. Value in use calculations are utilised to determine the recoverable amount of goodwill held within each cash generating unit (CGU). Value in use is calculated as the net present value of the projected risk-adjusted post-tax cash-flows of the CGU in which the goodwill is contained, applying a discount rate based on the Group's post-tax weighted average cost of capital of 8% adjusted where appropriate for risks specific to the CGU. This approximates to applying a pre-tax discount rate to pre-tax cash-flows. These forecast cash-flows are based on approved budgets and represent a best estimate of future performance.

The goodwill held in the Smiths Medical Critical Care and Smiths Detection Civil CGUs, with net book values of £291.5m (2007: £283.7m) and £288.8m (2007: £252.0m) respectively, is considered significant in comparison to the total carrying value of goodwill. Following a reorganisation of the management of the Detection business the allocation of goodwill to CGUs was updated. The Detection Civil CGU incorporates the business activities reported as Smiths Detection Imaging Systems in 2007. The comparative net book value has been restated to reflect the new allocation.

The following key assumptions were used in the discounted cash-flow projections for the Critical Care and Detection Civil CGUs:

- growth rates of 2.25% (2007: 2.00%) have been used for the Critical Care and Detection Civil CGUs to extrapolate beyond the most recent forecasts, representing a view of the long-term average growth rates for the industries in which the businesses operate. The growth rates used to estimate future performance beyond the periods covered by our annual planning and strategic planning processes do not exceed the long-term average growth rates for similar projects and do not reflect long-term planning assumptions used by the Group for investment planning; and
- in addition to discount rates and long-term growth rates, the key assumptions used to determine the recoverable amounts of the Critical Care and Detection Civil CGUs include future sales prices and volumes (with reference to specific customer relationships and product lines), operating margins, the cost structure of each CGU and the ability to realise planned productivity improvements.

The assumptions used in the discounted cash-flow forecasts incorporate past performance and historical growth rates and margins achievable in our key markets as a guide.

Sensitivity analysis performed around the base case assumptions has indicated that no reasonable changes in key assumptions would cause the carrying amount of the Critical Care and Detection Civil CGUs to exceed their respective recoverable amount.

The balance of the goodwill represents smaller individual amounts which have been allocated to specific operating companies and smaller CGUs. These amounts are tested for impairment at this level.

Notes to the accounts continued

13 Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Fixtures, fittings, tools and equipment £m	Total £m
Cost or valuation				
At 6 August 2006	245.1	653.0	337.3	1,235.4
Exchange adjustments	(5.0)	(13.8)	(4.6)	(23.4)
Reclassification		14.6	(14.6)	
Business combinations		1.0	1.0	2.0
Additions*	9.4	40.3	23.2	72.9
Transfers to disposal groups held for sale at year end	(0.7)		(6.6)	(7.3)
Transfer to disposal group sold by the year end	(89.1)	(338.5)	(161.5)	(589.1)
Disposals	(4.2)	(13.7)	(14.7)	(32.6)
At 31 July 2007	155.5	342.9	159.5	657.9
Exchange adjustments	8.4	18.1	10.8	37.3
Reclassification	1.0	(1.8)	0.8	
Business combinations	2.8	2.9	2.2	7.9
Additions	9.9	31.2	23.1	64.2
Disposals	(4.8)	(10.1)	(7.2)	(22.1)
Adjustments to acquisitions and disposals in prior years	(1.4)	6.7		5.3
At 31 July 2008	**171.4**	**389.9**	**189.2**	**750.5**
Depreciation				
At 6 August 2006	78.3	407.0	252.3	737.6
Exchange adjustments	(2.3)	(8.2)	(3.5)	(14.0)
Reclassification		10.4	(10.4)	
Charge for the period*	5.4	28.6	18.2	52.2
Impairment charge	5.9	2.2		8.1
Transfers to disposal groups held for sale at year end	(0.2)		(4.2)	(4.4)
Transfer to disposal group sold by the year end	(23.7)	(210.7)	(128.5)	(362.9)
Disposals	(0.3)	(10.1)	(9.2)	(19.6)
At 31 July 2007	63.1	219.2	114.7	397.0
Exchange adjustments	2.6	12.1	7.7	22.4
Reclassification	0.8	(1.1)	0.3	
Charge for the year	5.4	28.9	18.9	53.2
Impairment charge	0.3			0.3
Disposals	(3.7)	(7.3)	(6.6)	(17.6)
Adjustments to acquisitions and disposals in prior years	(7.8)	6.7		(1.1)
At 31 July 2008	**60.7**	**258.5**	**135.0**	**454.2**
Net book value at 31 July 2008	**110.7**	**131.4**	**54.2**	**296.3**
Net book value at 31 July 2007	92.4	123.7	44.8	260.9
Net book value at 6 August 2006	166.8	246.0	85.0	497.8

*For the period ending 31 July 2007 the additions and the depreciation charge include the respective costs and charge for discontinued operations and disposal groups for the period prior to becoming a disposal group.

The impairment charge of £8.1m in the period ended 31 July 2007 arose when property, plant and equipment was written down to fair value less costs to sell prior to being classified as being held for sale. The charge has been recognised in the results of John Crane.

	2008 £m	2007 £m
Capital expenditure commitments – contracted but not provided for	**11.5**	16.9

14 Investments accounted for using the equity method

	2008 £m	2007 £m
Investments in associated companies		
At start of period	**12.0**	14.0
Exchange adjustment	**2.3**	(0.3)
Share of results after tax	**(1.0)**	(0.5)
Dilution of interest	**(0.9)**	(1.2)
Acquisition of a controlling interest	**(3.3)**	
At end of period	**9.1**	12.0

The Group acquired a controlling interest in an associate on 21 December 2007, and it has been consolidated as a subsidiary since that date.

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Group share of results of associated companies		
Revenue	**17.6**	25.3
Operating costs and other income	**(18.8)**	(25.0)
Profit/(loss) before taxation	**(1.2)**	0.3
Taxation	**0.2**	(0.8)
Share of post-tax result from associated companies	**(1.0)**	(0.5)

Net assets and liabilities of associated companies

	2008 £m	2007 £m
Non-current assets	**20.1**	9.9
Current assets	**24.8**	36.9
Total assets	**44.9**	46.8
Non-current liabilities	**(6.2)**	(5.0)
Current liabilities	**(7.9)**	(16.5)
Total liabilities	**(14.1)**	(21.5)
Net assets	**30.8**	25.3

The above table principally represents the assets and liabilities of Cross Match Technologies, Inc. The Group share of those assets and liabilities attributable to Smiths Group is 34% (2007: 37%).

In 2007 the interest in Cross Match Technologies, Inc. was diluted as a result of warrants and options being exercised in the period.

15 Inventories

	2008 £m	2007 £m
Inventories comprise		
Raw materials and consumables	**149.7**	114.2
Work in progress	**68.0**	58.0
Finished goods	**173.5**	158.5
	391.2	330.7
Less: payments on account	**(10.9)**	(11.0)
	380.3	319.7

The Group consumed £1,776.4m (2007: £2,176.7m) of inventories during the period. £11.8m (2007: £13.4m) was recognised as an expense resulting from the write-down of inventory and £1.5m (2007: £4.0m) was released to the income statement from inventory provisions charged in earlier years but no longer required.

Notes to the accounts continued

16 Trade and other receivables

	2008 £m	2007 £m
Non-current		
Trade receivables	**8.8**	8.9
Prepayments and accrued income	**1.6**	0.8
Other debtors	**4.2**	5.0
	14.6	14.7
Current		
Amounts due from customers for contract work		5.3
Trade receivables	**509.1**	427.2
Other debtors	**19.8**	16.6
Prepayments and accrued income	**36.5**	40.7
	565.4	489.8

Trade receivables do not carry interest. Management considers that the carrying value of trade and other receivables approximates the fair value.

Trade and other receivables, including prepayments, accrued income and other debtors qualifying as financial instruments are classified as "loans and receivables". The maximum credit exposure arising from these financial assets is £536.7m (2007: £450.1m).

Credit risk is managed separately for each customer and, where appropriate, a credit limit is set for the customer based on previous experience of the customer and third party credit ratings.

Provision for bad and doubtful debts

Trade receivables are disclosed net of a provision for bad and doubtful debts. Movement on the provision is as follows:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Balance at the beginning of the period	**10.5**	16.3
Exchange differences	**0.8**	(0.3)
Charged	**4.4**	3.0
Utilised	**(1.4)**	(2.8)
Released	**(3.1)**	(2.9)
Disposal of businesses		(2.8)
Balance at the end of the period	**11.2**	10.5

The provision for bad and doubtful debts is based on specific risk assessment and reference to past default experience.

The Group has no significant concentration of credit risk, with exposure spread over a large number of customers. The largest single customer is the US Federal Government representing less than 7% (2007: 4%) of group turnover.

Ageing of trade receivables

	2008 £m	2007 £m
Trade receivables which are not impaired and not yet due	**412.4**	313.1
Ageing analysis of trade receivables which are overdue but not impaired:		
– less than three months	**79.2**	93.4
– more than three months	**22.6**	24.1
Gross value of partially and fully provided debtors	**14.9**	16.0
	529.1	446.6
Provision for bad and doubtful debts	**(11.2)**	(10.5)
Trade receivables	**517.9**	436.1

17 Cash and cash equivalents

	2008 £m	2007 £m
Cash at bank and in hand – including impact of cash pooling gross up: £100.6m (2007: £123.2m)	**122.5**	148.5
Short-term deposits	**10.0**	40.8
Cash and cash equivalents	**132.5**	189.3
Cash included in assets of disposal group (note 18)		(3.1)
Cash and cash equivalents per balance sheet	**132.5**	186.2
Cash and cash equivalents	**132.5**	189.3
Bank overdrafts	**(172.5)**	(186.2)
Net cash and cash equivalents	**(40.0)**	3.1

Cash and cash equivalents include highly liquid investments with maturities of three months or less.

18 Disposal group

During the second half of 2007, the Company invited offers for the purchase of its marine operations, which formed part of Specialty Engineering – Other. These operations were disposed of on 8 November 2007. The assets and liabilities of this operation were disclosed as held for sale in the consolidated balance sheet as at 31 July 2007. No impairment loss was recorded when the assets were revalued to fair value less disposal costs.

	2008 £m	2007 £m
Non-current assets		
Intangible assets		1.9
Property, plant and equipment		2.9
Deferred tax assets		0.1
		4.9
Current assets		
Inventories		7.4
Trade and other receivables		15.7
Cash and cash equivalents		3.1
Financial derivatives		0.2
Total assets of disposal group		31.3
Non-current liabilities		
Financial derivatives		(0.8)
Provisions for liabilities and charges		(0.6)
		(1.4)
Current liabilities		
Financial liabilities:		
– financial derivatives		(0.5)
Provisions for liabilities and charges		(0.6)
Trade and other payables		(12.7)
Current tax payable		(1.0)
Total liabilities of disposal group		(16.2)

Notes to the accounts continued

19 Trade and other payables

	2008 £m	2007 £m
Non-current		
Other creditors	**27.5**	22.5
Current		
Trade creditors	**156.7**	164.8
Bills of exchange payable	**1.1**	1.7
Other creditors	**51.0**	38.0
Other taxation and social security costs	**23.1**	20.5
Accruals and deferred income	**188.8**	187.6
	420.7	412.6

Trade and other payables, including accrued expenses and other creditors qualifying as financial instruments, are accounted for at amortised cost and are categorised as other financial liabilities.

20 Borrowings and net debt

This note sets out the calculation of net debt, a measure considered important in explaining our financing position. The net debt figure includes accrued interest and the fair value adjustments relating to hedge accounting.

	2008 £m	2007 £m
Cash and cash equivalents		
Net cash and deposits including assets of disposal group (note 17)	**132.5**	189.3
Short-term borrowings		
Bank overdrafts including impact of cash pooling gross up: £100.6m (2007: £123.2m)	**(172.5)**	(186.2)
Bank loans	**(0.3)**	(0.2)
Other loans	**(3.5)**	(3.1)
B shares (note 26)	**(1.7)**	(18.1)
Interest accrual	**(4.4)**	(4.5)
	(182.4)	(212.1)
Long-term borrowings		
7.875% Sterling Eurobond 2010	**(149.6)**	(149.5)
7.25% Sterling Eurobond 2016	**(148.8)**	(148.7)
5.45% US$ Private Placement 2013	**(127.4)**	(120.0)
Floating Rate Revolving Credit Facility 2012 (multi-currency)	**(210.2)**	(67.2)
EIB Sterling R. & D. Loan 2010	**(70.0)**	(70.0)
Bank and other loans	**(14.7)**	(11.7)
	(720.7)	(567.1)
Borrowings	**(903.1)**	(779.2)
Net debt	**(770.6)**	(589.9)

Borrowings are accounted for at amortised cost and are categorised as other financial liabilities.

See note 21 for a maturity analysis of borrowings. The repayment dates on borrowings repayable after five years range from 2014 to 2022.

Interest of £22.5m (2007: £22.5m) was charged to the consolidated income statement in this period in respect of public bonds.

Secured loans

Loans amounting to £13.2m (2007: £11.5m) were secured by charges on freehold properties with a book value of £11.0m (2007: £9.8m).

21 Financial risk management

The Group's international operations and debt financing expose it to financial risks including the effects of changes in foreign exchange rates, changes in debt market prices, interest rates, credit risks and liquidity risks.

Risk management policies are set by the Board. The treasury policy sets out specific guidelines to manage foreign exchange risk, interest rate risk, credit risk and the use of financial instruments to manage risk. The instruments and techniques used to manage risk exposures include foreign currency derivatives, debt and other interest rate derivatives. The central treasury function monitors financial risks and compliance with risk management policies using regular reports from all the businesses.

The management of operational credit risk is discussed in note 16.

(a) Foreign exchange risk

Transactional currency exposure

The Group is exposed to foreign currency risks arising from sales or purchases by businesses in currencies other than their functional currency. It is Group policy that, when such a sale or purchase is certain or highly probable, the net foreign exchange exposure is hedged using forward foreign exchange contracts. The net exposure is calculated by adjusting the expected cash-flow for payments or receipts in the same currency linked to the sale or purchase. This policy minimises the risk that the profits generated from the transaction will be affected by foreign exchange movements which occur after the price has been determined.

Hedge accounting documentation and effectiveness testing are only undertaken if it is cost effective. At 31 July 2008 the Group had outstanding foreign currency contracts with a nominal value of £130m (2007: £131m) which were being used to manage transactional foreign exchange exposures, but were not accounted for as cash-flow hedges.

The following table shows the currency of financial instruments. It excludes loans and derivatives designated as net investment hedges.

					At 31 July 2008
	Sterling £m	US$ £m	Euro £m	Other £m	Total £m
Financial assets and liabilities					
Financial instruments included in trade and other receivables	**40.6**	**237.4**	**162.2**	**96.5**	**536.7**
Financial instruments included in trade and other payables	**(49.9)**	**(121.4)**	**(86.9)**	**(40.1)**	**(298.3)**
Cash and cash equivalents	**32.7**	**16.5**	**48.0**	**35.3**	**132.5**
Borrowings not designated as net investment hedges	**(412.1)**	**(163.2)**	**(13.8)**	**(103.8)**	**(692.9)**
	(388.7)	**(30.7)**	**109.5**	**(12.1)**	**(322.0)**
Exclude balances held in operations with the same functional currency	**389.3**	**56.4**	**(35.6)**	**(62.0)**	**348.1**
Exposure arising from intra-group loans		**(15.5)**		**(11.2)**	**(26.7)**
Forward foreign exchange contracts	**48.9**	**(50.0)**	**(1.9)**	**3.0**	
	49.5	**(39.8)**	**72.0**	**(82.3)**	**(0.6)**

					At 31 July 2007
	Sterling £m	US$ £m	Euro £m	Other £m	Total £m
Financial assets and liabilities					
Financial instruments included in trade and other receivables	43.6	198.0	122.5	86.0	450.1
Financial instruments included in trade and other payables	(21.9)	(94.3)	(59.7)	(21.0)	(196.9)
Cash and cash equivalents	68.3	11.6	62.5	46.9	189.3
Borrowings not designated as net investment hedges	(439.2)	(140.2)	(101.6)	(30.9)	(711.9)
	(349.2)	(24.9)	23.7	81.0	(269.4)
Exclude balances held in operations with the same functional currency	350.8	54.8	(22.1)	(73.9)	309.6
Exposure arising from intra-group loans		(5.5)		(18.4)	(23.9)
Forward foreign exchange contracts	(2.4)	(39.6)	14.6	27.4	
	(0.8)	(15.2)	16.2	16.1	16.3

Financial instruments included in trade and other receivables comprise trade receivables, accrued income and other debtors which qualify as financial instruments. Similarly, financial instruments included in trade and other payables comprise trade payables, accrued expenses and other creditors which qualify as financial instruments.

In the period ended 31 July 2007 Smiths entered into a one-off hedge contract to fix the sterling equivalent of the projected net proceeds arising from the Aerospace disposal (note 7). This hedge contract had a nominal value of US$4.2 billion, a maturity date of 8 May 2007, and an effective exchange rate of 1.9791. The gain of £18.5m realised on this contract was recognised in calculating the fair value of the consideration.

Notes to the accounts continued

21 Financial risk management continued

Based on the assets and liabilities held at the year end, if the specified currencies were to strengthen 10% while all other market rates remained constant, the change in the fair value of financial instruments not designated as net investment hedges would have the following effect:

	Impact on profit for the year 31 July 2008 £m	**Gain/(loss) recognised in reserves 31 July 2008 £m**	Impact on profit for the year 31 July 2007 £m	Gain/(loss) recognised in reserves 31 July 2007 £m
US dollar	**(0.1)**	**(3.3)**	1.5	(1.7)
Euro	**4.8**	**(1.0)**	(0.7)	2.6
Sterling	**2.1**	**2.8**	1.1	2.3

These sensitivities were calculated before adjusting for tax and do not include the effect of intra-group loans which have been designated as quasi-equity.

Cash-flow hedging

The Group uses foreign currency contracts to hedge future foreign currency sales and purchases. At 31 July 2008 contracts with a nominal value of £222.2m (2007: £211.0m) were designated as hedging instruments. The fair value of the hedging instruments is disclosed in note 22.

The majority of hedged transactions will be recognised in the income statement in the same period that the cash-flows are expected to occur, with the only differences arising as a result of normal commercial credit terms on sales and purchases. Of the foreign exchange contracts designated as hedging instruments 99% are for periods of 12 months or less (2007: 93%).

The movements in the cash-flow hedge reserve during the period are summarised in the table below:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Brought forward cash-flow hedge reserve at start of period	**1.4**	13.3
Exchange adjustments	**0.2**	
Gains and losses on effective cash-flow hedges recognised in equity	**(1.0)**	4.8
Amounts removed from the hedge reserve and recognised in the following lines on the income statement:		
– Revenue	**0.2**	(2.7)
– Cost of sales	**0.3**	1.1
– Profit after taxation – discontinued operations		(15.1)
Carried forward cash-flow hedge reserve at end of period	**1.1**	1.4

21 Financial risk management continued

Translational currency exposure

The Group has a significant investment in overseas operations, particularly in America and Europe. As a result, the sterling value of the Group's balance sheet can be affected by movements in exchange rates. The Group seeks to mitigate the effect of these translational currency exposures by matching the net investment in overseas operations with borrowings denominated in their functional currencies, except where significant adverse interest differentials or other factors would render the cost of such hedging activity uneconomic. This is achieved by borrowing either directly in the local currency or indirectly through the use of rolling annual forward foreign exchange contracts.

The table below sets out the currency of loans designated as net investment hedges and cross-currency swap contracts:

					At 31 July 2008
	Sterling £m	**US$ £m**	**Euro £m**	**Other £m**	**Total £m**
Loans designated as net investment hedges		**(139.6)**	**(70.6)**		**(210.2)**
Cross currency swap contracts	**371.4**	**(150.6)**	**(163.0)**	**(57.8)**	
	371.4	**(290.2)**	**(233.6)**	**(57.8)**	**(210.2)**

					At 31 July 2007
	Sterling £m	US$ £m	Euro £m	Other £m	Total £m
Loans designated as net investment hedges			(67.3)		(67.3)
Cross currency swap contracts	255.9	(89.5)	(125.0)	(41.4)	
	255.9	(89.5)	(192.3)	(41.4)	(67.3)

The fair values of these net investment hedges are subject to exchange rate movements. Based on the hedging instruments in place at the year end a 10% increase in the value of the US dollar while all other market rates remained constant would lead to a fair value loss of £14.9m (2007: £8.2m) and a 10% increase in the value of the euro while all other market rates remained constant would lead to a fair value loss of £17.4m (2007: £19.0m). These movements would be recognised in equity and fully offset by an opposite movement on the retranslation of the net assets of the overseas subsidiaries. These sensitivities were calculated before adjusting for tax.

Net investment hedges

Cross-currency swap contracts for US dollars, Euros, Yen, Renminbi and Canadian dollars with a nominal value of £371m (2007: £238m) and foreign currency borrowings of US $277m (2007: $nil) and €90m (2007: €100m) have been designated as net investment hedges in respect of the currency translation risk arising on foreign operations. The contracts mature within twelve months. See note 22 for the fair value of the contracts.

The gains and losses that have been deferred in the net investment hedge reserve are shown in the table below:

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Brought forward net investment hedge reserve at start of period	**17.2**	13.2
Amounts deferred in the period on effective net investment hedges	**(47.5)**	8.2
Amounts removed from the hedge reserve and recognised in the income statement		(4.2)
Carried forward net investment hedge reserve at end of period	**(30.3)**	17.2

Notes to the accounts continued

21 Financial risk management continued

(b) Interest rate risk

The Group operates an interest rate policy designed to optimise interest cost and reduce volatility in reported earnings. The Group's normal policy is to require interest rates to be fixed for 30% to 70% of the level of underlying borrowings forecast to arise over a three-year horizon. This is achieved partly through fixed rate borrowings, and partly through the use of interest rate swaps. Excluding the cash pool gross up, at 31 July 2008 46% (2007: 55%) of the Group's borrowings were at fixed interest rates, after adjusting for interest rate swaps.

The weighted average interest rate on borrowings and cross currency swaps at 31 July 2008, after interest rate swaps, is 4.6% (2007: 5.3%).

Interest rate profile of financial assets and liabilities and the fair value of borrowings

The following table shows the interest rate risk exposure of cash and borrowings. The other financial assets and liabilities do not earn or bear interest and for all financial instruments except for borrowings the carrying value is not materially different from their fair value.

	Cash and cash equivalents 31 July 2008 £m	**Borrowings 31 July 2008 £m**	**Fair value of borrowings 31 July 2008 £m**	Cash and cash equivalents 31 July 2007 £m	Borrowings 31 July 2007 £m	Fair value of borrowings 31 July 2007 £m
Fixed interest (adjusted for interest rate hedging):						
Less than one year		**(3.8)**	**(4.0)**	14.1	(3.0)	(3.0)
Between one and five years		**(203.5)**	**(207.1)**		(151.1)	(157.3)
Greater than five years		**(160.1)**	**(166.2)**		(207.9)	(216.8)
Total fixed interest financial assets/(liabilities) (adjusted for interest rate hedging)		**(367.4)**	**(377.3)**	14.1	(362.0)	(377.1)
Floating rate interest financial assets/(liabilities)	**122.1**	**(535.7)**	**(535.7)**	165.6	(417.2)	(417.2)
Total interest bearing financial assets/(liabilities)	**122.1**	**(903.1)**	**(913.0)**	179.7	(779.2)	(794.3)
Non-interest bearing assets/(liabilities) in the same category	**10.4**			9.6		
Total	**132.5**	**(903.1)**	**(913.0)**	189.3	(779.2)	(794.3)

Interest rate hedging

The Group has designated US$150m interest rate swaps which mature on 28 January 2013 as fair value hedges on the US private placement which matures on the same date. This hedges the risk of variability in the fair value of borrowings arising from interest rate fluctuations. The fair value of the hedging instrument is disclosed in note 22. The effect of the interest rate swap is to convert £75.7m (2007: £73.7m) debt from fixed rate to floating rate.

Sensitivity of interest charges to interest rate movements

The Group has exposure to sterling, US dollar and Euro interest rates. However the Group does not have a significant exposure to interest rate movements for any individual currency. Based on the composition of net debt and foreign exchange rates at 31 July 2008, and taking into consideration all fixed rate borrowings and interest rate swaps in place, a one percentage point (100 basis points) change in average floating interest rates for all three currencies would have a £4.3m (2007: 3.9m) impact on the Group's profit before tax.

(c) Financial credit risk

The Group is exposed to credit-related losses in the event of non-performance by counterparties to financial instruments, but does not expect any counterparties to fail to meet their obligations. Credit risk is mitigated by the Group's Board-approved policy of only selecting counterparties with a strong investment graded long-term credit rating for cash deposits, normally at least AA- or equivalent, and assigning financial limits to individual counterparties. In the normal course of business, the Group operates notional cash pooling systems, where a legal right of set-off applies.

The maximum credit risk exposure in the event of other parties failing to perform their obligations under financial assets, excluding trade and other receivables, totals £132.5m at 31 July 2008 (2007: £189.3m). This includes cash of £100.6m (2007: £123.2m) held in interest compensation pools where Smiths has a legal right of set-off and the net pool balance at the year end was a creditor.

The maximum exposure with a single bank for deposits and cash is £12.4m (2007: £27.8m), whilst the maximum mark to market exposure for foreign exchange contracts at 31 July 2008 to a single bank is £1.5m (2007: £4.6m). These banks had credit ratings of AA and AA+ respectively.

21 Financial risk management continued

(d) Liquidity risk

Borrowing facilities

The Group actively maintains committed unused credit facilities of at least £200m (or equivalent free cash) at all times to ensure it has sufficient available funds for operations and planned expansions. In 2007 the principal £660m revolving credit facility was extended to 2012. At the balance sheet date the Group had the following undrawn credit facilities:

	2008 £m	2007 £m
Expiring within one year		50.0
Expiring between one and two years		
Expiring after two years	**449.8**	593.0
	449.8	643.0

Cash deposits

As at 31 July 2008, £10.0m (2007: £40.8m) of cash and cash equivalents was on deposit with various banks and in money market funds of which £7.2m (2007: £32.2m) was on deposit in the UK.

Gross contractual cash-flows for borrowings

	Borrowings (Note 20) 31 July 2008 £m	Fair value adjustments 31 July 2008 £m	Contractual interest payments 31 July 2008 £m	Total contractual cash-flows 31 July 2008 £m	Borrowings (Note 20) 31 July 2007 £m	Fair value adjustments 31 July 2007 £m	Contractual interest payments 31 July 2007 £m	Total contractual cash-flows 31 July 2007 £m
Less than one year	**(182.4)**		**(42.3)**	**(224.7)**	(212.1)		(37.7)	(249.8)
Between one and two years	**(150.9)**	**(0.4)**	**(41.5)**	**(192.8)**	(0.5)		(37.0)	(37.5)
Between two and three years	**(71.3)**		**(26.4)**	**(97.7)**	(149.9)	(0.5)	(36.3)	(186.7)
Between three and four years	**(210.7)**	**(0.5)**	**(25.0)**	**(236.2)**	(70.3)		(21.2)	(91.5)
Between four and five years	**(127.7)**	**1.2**	**(14.6)**	**(141.1)**	(67.6)	(0.6)	(20.4)	(88.6)
Greater than five years	**(160.1)**	**(1.2)**	**(34.4)**	**(195.7)**	(278.8)	(4.1)	(48.6)	(331.5)
Total	**(903.1)**	**(0.9)**	**(184.2)**	**(1,088.2)**	(779.2)	(5.2)	(201.2)	(985.6)

The figures presented in the borrowings column include the non-cash adjustments which are highlighted in the adjacent column. The contractual interest reported for borrowings is before the effect of interest rate swaps.

Gross contractual cash-flows for derivative financial instruments

	Receipts 31 July 2008 £m	Payments 31 July 2008 £m	Net cash-flow 31 July 2008 £m	Receipts 31 July 2007 £m	Payments 31 July 2007 £m	Net cash-flow 31 July 2007 £m
Assets						
Less than one year	**256.4**	**(247.7)**	**8.7**	398.1	(382.8)	15.3
Greater than one year	**63.9**	**(60.1)**	**3.8**	44.4	(43.6)	0.8
Liabilities						
Less than one year	**379.8**	**(400.6)**	**(20.8)**	109.3	(112.5)	(3.2)
Greater than one year	**28.1**	**(28.4)**	**(0.3)**	42.4	(45.6)	(3.2)
Total	**728.2**	**(736.8)**	**(8.6)**	594.2	(584.5)	9.7

This table presents the undiscounted future contractual cash-flows for all derivative financial instruments. For this disclosure, cash-flows in foreign currencies are translated using the spot rates at the balance sheet date. The fair values of these financial instruments are presented in note 22.

Gross contractual cash-flows for other financial liabilities

The contractual cash-flows for financial liabilities included in trade and other payables are: £285.8m (2007: £192.3m) due in less than one year, £10.9m (2007: £4.6m) due between one and five years and £1.6m (2007: £nil) due after more than five years.

Notes to the accounts continued

22 Financial derivatives

The tables below set out the nominal amount and fair value of derivative contracts held by the Group, identifying the derivative contracts which qualify for hedge accounting treatment:

At 31 July 2008	Contract or underlying nominal amount £m	Fair value Assets £m	Fair value Liabilities £m	Fair value Net £m
Foreign exchange contracts (cash-flow hedges)	**222.2**	**3.8**	**(2.9)**	**0.9**
Foreign exchange contracts (not hedge accounted)	**130.1**	**1.4**	**(0.7)**	**0.7**
Total foreign exchange contracts	**352.3**	**5.2**	**(3.6)**	**1.6**
Cross-currency swaps (net investment hedges)	**371.4**	**1.5**	**(18.0)**	**(16.5)**
Interest rate swaps (fair value hedges)	**75.7**	**1.2**		**1.2**
Total financial derivatives	**799.4**	**7.9**	**(21.6)**	**(13.7)**
Balance sheet entries:				
Non-current		**1.4**	**(0.1)**	**1.3**
Current		**6.5**	**(21.5)**	**(15.0)**
Total financial derivatives		**7.9**	**(21.6)**	**(13.7)**

At 31 July 2007	Contract or underlying nominal amount £m	Fair value Assets £m	Fair value Liabilities £m	Fair value Net £m
Foreign exchange contracts (cash-flow hedges)	211.0	2.6	(0.8)	1.8
Foreign exchange contracts (not hedge accounted)	131.4	0.9	(1.7)	(0.8)
Total foreign exchange contracts	342.4	3.5	(2.5)	1.0
Cross-currency swaps (net investment hedges)	238.2	9.0		9.0
Cross-currency swaps (not hedge accounted)	17.7	1.4		1.4
Total cross-currency swaps	255.9	10.4		10.4
Interest rate swaps (fair value hedges)	73.7		(2.8)	(2.8)
Embedded derivatives	15.8	0.2	(1.3)	(1.1)
Total financial derivatives	687.8	14.1	(6.6)	7.5
Balance sheet entries:				
Non-current		0.4	(2.5)	(2.1)
Included in assets/(liabilities) of disposal group		0.2	(1.3)	(1.1)
Current		13.5	(2.8)	10.7
Total financial derivatives		14.1	(6.6)	7.5

Accounting for other derivative contracts

Any foreign exchange contracts which are not formally designated as hedges and tested are classified as 'held for trading' and not hedge accounted.

Amounts recognised in 2007 in respect of embedded derivatives primarily represent the value of currency terms in commercial contracts between Smiths European subsidiaries and customers and suppliers outside the USA which are denominated in US dollars.

23 Provisions for liabilities and charges

	At 31 July 2007 £m	Exchange adjustments £m	Provisions charged £m	Provisions released £m	Unwind of provision discount £m	Utilisation £m	**At 31 July 2008 £m**
Warranty provision and product liability	34.5	3.8	30.0	(5.5)		(16.6)	**46.2**
Reorganisation	10.8	0.3	5.2	(0.2)		(6.3)	**9.8**
Property	6.7		0.6	(3.3)		(0.5)	**3.5**
Disposal	60.3		11.4	(3.6)		(20.7)	**47.4**
Litigation	121.2	3.3	46.8	(2.2)	4.7	(10.1)	**163.7**
	233.5	7.4	94.0	(14.8)	4.7	(54.2)	**270.6**

Analysed as:

	2008 £m	2007 £m
Current liabilities	**70.0**	90.1
Non-current liabilities	**200.6**	143.4
	270.6	233.5

Warranty provision and product liability
Warranties over the Group's products typically cover periods of between one and three years. Provision is made for the likely cost of after-sales support based on the recent past experience of individual businesses.

Reorganisation
On 3 June 2008 the Company announced a number of changes to its corporate centre and divisional headquarters. The total cost of this restructuring, including redundancy, relocation and consolidation of manufacturing, is expected to amount to approximately £48m over the period to 2010, of which £4.5m has been charged in the current year.

Reorganisation provisions include £4.7m (2007: £6.0m) costs relating to restructuring supply arrangements following the automotive seals disposal. These costs are expected to be spread over the next six years. The residual balance at 31 July 2007 related mainly to Medical, and was utilised during 2008.

Property
Where a property is vacant, or sub-let under terms such that rental income is insufficient to meet all outgoings, the Group provides for the expected future shortfall up to termination of the lease. Provision is also made for the cost of reinstatement work on leased properties where there is an obligation under the lease, and the costs can be reasonably estimated. Where evidence of contamination is found on property in the Group's occupation, provision is made for estimated remedial costs pending action on the affected site. Most of the balance is expected to be utilised within the next five years.

Disposal
A provision has been made in 2008 in respect of obligations arising from the disposal of the Group's Marine Systems business. See note 30 for details of this disposal.

The terms of the disposal of the Aerospace operations included certain obligations for which provision was made in 2007, including £24.3m in respect of costs of transferring aerospace active pensioners. In 2008 the pensioners were transferred, utilising £20.7m of this provision. The balance of £3.6m has been released to the income statement.

Most of the balance is expected to be utilised within the next five years.

Notes to the accounts continued

23 Provisions for liabilities and charges continued

Litigation

John Crane, Inc.

John Crane, Inc. ("JCI") is one of many co-defendants in litigation relating to products previously manufactured which contained asbestos. Until 2006, the awards, the related interest and all material defence costs were met directly by insurers. In 2007, JCI secured the commutation of certain insurance policies in respect of product liability. While substantial insurance remains in place, JCI has begun to meet defence costs directly, seeking appropriate contribution from insurers thereafter. Provision is made in respect of the expected costs of defending known and predicted future claims and of adverse judgments in relation thereto, to the extent that such costs can be reliably estimated. No account has been taken of recoveries from insurers as their nature and timing are not yet sufficiently certain to permit recognition as an asset for these purposes.

The JCI 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 JCI, the products were safe. JCI ceased manufacturing products containing asbestos in 1985. JCI 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, JCI has been dismissed before trial from cases involving approximately 159,000 claims over the last 29 years. JCI is currently a defendant in cases involving approximately 136,000 claims. JCI has had final judgments against it, after appeals, in only 70 cases, amounting to awards of some US$70m over the 29 year period.

The assumptions made in assessing the appropriate level of provision include:

- The periods over which the expenditure can be reliably estimated. Projections used range between 10 and 20 years.
- The future trend of legal costs allowing for 3% cost inflation.
- The rate of future claims.
- The rate of successful resolution of claims.
- The average level of judgments.

The provision is based on past history and allows for decreasing costs based on published tables of asbestos incidence projections. In the light of the significant uncertainty associated with asbestos claims, there can be no guarantee that the assumptions used to estimate the provision will be an accurate prediction of the actual costs that may be incurred and, as a result, the provision may be subject to revision from time to time as more information becomes available.

The provision shown in the table above is a discounted pre-tax provision using discount rates, being the risk-free rate on US debt instruments for the appropriate period. The deferred tax asset related to this provision is shown within the deferred tax balance (note 6). Set out below is the gross, discounted and post-tax information relating to this provision:

	2008 £m	2007 £m
Gross provision	**185.9**	142.2
Discount	**(47.0)**	(45.8)
Discounted pre-tax provision	**138.9**	96.4
Deferred tax	**(37.5)**	(36.6)
Discounted post-tax provision	**101.4**	59.8

Other litigation

The Group has on occasion been required to take legal action to protect its patents and other business intellectual property rights against infringement, and similarly to defend itself against proceedings brought by other parties. Provision is made for the expected fees and associated costs, based on professional advice as to the likely duration of each case. Provisions totalling £2.2m (2007: £8.9m) were released relating to litigation settled at less than the expected cost. Most of the balance is expected to be utilised within the next five years.

Apart from that relating to JCI, none of the other provisions is discounted.

24 Operating lease commitments – minimum lease payments

The minimum uncancellable lease payments which the Group is committed to make are:

	2008		2007	
	Land and buildings £m	**Other £m**	Land and buildings £m	Other £m
Payments due				
– not later than one year	**20.5**	**7.8**	17.5	7.3
– later than one year and not later than five years	**47.0**	**8.1**	43.1	8.0
– later than five years	**20.3**	**0.1**	24.7	0.1
	87.8	**16.0**	85.3	15.4

25 Contingent liabilities and commitments

John Crane, Inc.

As stated in note 23, John Crane, Inc. ("JCI") is involved in numerous law suits pending in the United States in which plaintiffs are claiming damages arising from exposure to, or use of, products containing asbestos. The JCI 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 JCI, the products were safe. JCI ceased manufacturing products containing asbestos in 1985.

Provision has been made for the cost of adverse judgements expected to occur. The Group anticipates that asbestos litigation will continue beyond the period covered by this provision; however, because of the uncertainty surrounding the outcome of litigation beyond this period, the cost of adverse judgments cannot be reliably estimated.

Other contingent liabilities and commitments

At 31 July 2008, contingent liabilities, comprising bonds and guarantees arising in the normal course of business, amounted to £75m (2007: £88m).

The Group is currently co-operating with the relevant authorities in investigating certain allegations of improper business conduct. Based on the work completed to date, these are not expected to give rise to any material financial exposure.

The Parent Company has arranged two letters of credit to support the Group's pension plans, one for £100.0m and one for £50.0m. At 31 July 2008, total usage of the two facilities was £124.9m (2007: £132.8m).

26 Share capital

	Number of shares	Issued capital £m	Consideration £m
Ordinary shares			
At 31 July 2007	385,498,273	144.6	
Exercise of share options	2,380,908	0.9	15.5
At 31 July 2008	**387,879,181**	**145.5**	
B shares			
At 31 July 2007	4,926,594	0.1	
Purchased and cancelled	(4,467,437)	(0.1)	
At 31 July 2008	**459,157**		
Share capital classified as equity at 31 July 2008		145.5	
Share capital classified as debt at 31 July 2008			
Total share capital at 31 July 2008		**145.5**	

On 17 April 2008 4.5 million B shares were purchased and cancelled. The remaining B shares carry annual interest of 75% of 12 month LIBOR, payable in arrears in April. Smiths may redeem and cancel the remaining B shares up to November 2008 for a consideration of 365p per share in cash or convert them to ordinary shares. B shares have no voting rights.

In 2007 the Group issued 577.6 million B shares with a nominal value of £5.8m. £4.2m of associated costs were charged to the share premium account. Of these shares 572.6 million were redeemed on 25 June 2007 for a consideration of 365p per share including 348.2 million B shares which had been converted into deferred shares.

After the allotment of the B shares in 2007 a capital reorganisation was undertaken. The shareholders received two new 37.5p ordinary shares for every three 25p ordinary shares which they previously held.

The authorised capital at 31 July 2008 consisted of:

- 533,333,333 (2007: 533,333,333) ordinary shares of 37.5p each; and
- 600,000,000 (2007: 600,000,000) non-cumulative B shares of 1p each.

At 31 July 2008 all of the issued share capital was in free issue. All issued shares are fully paid.

Notes to the accounts continued

27 Reconciliation of movements in equity

	Share capital £m	Share premium account £m	Other reserves £m	Hedge reserve £m	Retained earnings £m	Equity shareholders' funds £m	Minority interest £m	Total equity £m
At 5 August 2006	141.8	224.1	236.5	26.5	734.0	1,362.9		1,362.9
Exercises of share options	2.8	74.9				77.7		77.7
Purchase of own shares					(7.0)	(7.0)		(7.0)
Return of capital to shareholders and redemption of B shares		(10.0)	5.7		(2,104.6)	(2,108.9)		(2,108.9)
Total recognised income and expenses for the period				(7.9)	1,752.8	1,744.9		1,744.9
Dividends paid to equity shareholders					(182.4)	(182.4)		(182.4)
Dilution of interest in associated company					(1.2)	(1.2)		(1.2)
Share-based payment					17.3	17.3		17.3
At 31 July 2007	144.6	289.0	242.2	18.6	208.9	903.3		903.3
Exercises of share options	0.9	14.6			5.5	21.0		21.0
Purchase of own shares					(20.7)	(20.7)		(20.7)
Redemption of B shares			0.1		(0.1)			
Acquisition (note 29)							2.0	2.0
Total recognised income and expenses for the period				(47.8)	180.6	132.8	0.3	133.1
Dividends paid to equity shareholders					(131.4)	(131.4)		(131.4)
Dilution of interest in associated company					(0.9)	(0.9)		(0.9)
Share-based payment					11.8	11.8		11.8
At 31 July 2008	**145.5**	**303.6**	**242.3**	**(29.2)**	**253.7**	**915.9**	**2.3**	**918.2**

Other reserves comprise a capital redemption reserve of £5.8m (2007: £5.7m), a revaluation reserve of £1.7m (2007: £1.7m) and a merger reserve of £234.8m (2007: £234.8m). The movements in other reserves relate to the recognition of transfers to the capital redemption reserve required following the redemption of the B shares.

The retained earnings include the purchase of Smiths Group plc shares by the Smiths Industries Employee Benefit Trust. The consideration paid was £20.7m (2007: £7.0m). At 31 July 2008 the trust held 1,095,965 (2007: 634,274) ordinary shares with a nominal value of £0.4m (2007: £0.2m) and a market value of £11.5m (2007: £6.6m).

Capital management

Capital comprises shareholders' equity adjusted for goodwill recognised directly in reserves. For the period ended 31 July 2008 the average Group capital was £1,728.1m (2007: £1,732.3m).

The capital structure is based on the directors' judgement of the balance required to maintain flexibility while achieving an efficient cost of capital. The Group has a target gearing, calculated on a market value basis, of approximately 20%. At the balance sheet date the Group had gearing of 18% (2007: 15%). This generated a weighted average cost of capital of 8% (2007: 9%).

As part of this process the Group maintains its target of a solid investment grade credit rating by monitoring the factors utilised by ratings agencies and evaluating the impact of potential distributions and future funding requirements. At the 31 July 2008 the Group had a credit rating of BBB+/Baa2 (2007: BBB+/Baa2) with Standard & Poor's and Moody's respectively.

Hedge reserve

The hedge reserve on the balance sheet comprises:	**2008 £m**	2007 £m
Cash-flow hedge reserve	**1.1**	1.4
Net investment hedge reserve	**(30.3)**	17.2
	(29.2)	18.6

See transactional currency exposure risk management disclosures in note 21 for additional details of cash-flow hedges and translational currency exposure risk management disclosure also in note 21 for additional details of net investment hedges.

28 Cash-flow from operating activities

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m
Profit before taxation – continuing and discontinued	**346.1**	1,869.4
Net interest payable	**41.0**	37.6
Financing losses/(gains)		
– charged to administrative expenses	**0.3**	1.5
– charged to financing	**6.1**	(2.8)
Share of post-tax loss from associate	**1.0**	0.5
Other finance income – retirement benefits	**(41.7)**	(36.8)
(Profit on sale)/impairment of financial asset		(24.0)
Profit on disposal of discontinued operation	**(26.8)**	(1,469.6)
	326.0	375.8
Amortisation of intangible assets	**31.0**	29.7
Impairment of intangible assets		2.2
Profit on disposal of property, plant and equipment	**(0.3)**	(0.4)
(Profit)/loss on disposal of business	**(27.2)**	5.2
Depreciation of property, plant and equipment	**53.2**	52.2
Impairment of property, plant and equipment	**0.3**	8.2
Share-based payment expense	**12.9**	13.9
Retirement benefits	**(37.0)**	(66.2)
Increase in inventories	**(21.4)**	(84.2)
Increase in trade and other receivables	**(10.0)**	(84.8)
(Decrease)/increase in trade and other payables	**(56.9)**	29.7
Increase in provisions	**49.9**	84.5
Cash generated from operations	**320.5**	365.8
Interest	**(48.6)**	(27.0)
Tax paid	**(73.8)**	(92.8)
Net cash inflow from operating activities	**198.1**	246.0

29 Acquisitions

During the period ended 31 July 2008, the Group made a number of acquisitions: Sartorius Bearing Technology (15 October 2007), a controlling interest over an associate John Crane Japan Limited (21 December 2007), Indufil BV (28 April 2008) and Fiber Composite Company Inc. ("Fiberod") (2 May 2008), all on behalf of John Crane, Fast Heat (4 February 2008), Allrizon Tongguang (7 May 2008) and Triasx Pty. Ltd. (1 July 2008) on behalf of Specialty – Other.

From the date of acquisition to 31 July 2008, the acquisitions contributed £38.1m to revenue, £5.9m to headline profit before taxation and £1.4m to profit before taxation. If Smiths had acquired the businesses at the beginning of the financial period, the acquisitions would have contributed £92.4m to revenue and £13.8m to headline profit before tax.

The fair value adjustments in respect of intangible assets are due to the recognition of £43.7m in respect of customer relationships, £18.8m in respect of technology and £12.0m in respect of patents, licenses and trademarks. Goodwill represents the value of synergies arising from the acquisitions and the acquirees' assembled workforces. The adjustments to current assets and liabilities relate to valuation adjustments and are provisional, based on management's best estimates.

The values set out below are provisional pending finalisation of the fair values attributable, and will be finalised in the year ending 31 July 2009. Goodwill and other net assets in respect of prior year acquisitions, as previously reported, have been adjusted as a result of finalising their attributable fair values and changes in the estimated value of contingent considerations. Accordingly, goodwill has increased by £0.5m on one transaction and reduced by £2.2m on another.

The minority interest and assets accounted for using the equity method adjustment represents assets not acquired by Smiths Group plc when a controlling interest in an associate was acquired. The asset revaluation surplus represents fair value gains and losses on the associate's net assets.

Notes to the accounts continued

29 Acquisitions continued

	Indufil BV			Other acquisitions			Total
	Book value £m	Fair value adjustments £m	Provisional fair value £m	Book value £m	Fair value adjustments £m	Provisional fair value £m	Provisional fair value £m
Non-current assets							
– intangible assets	0.2	31.2	**31.4**	0.5	43.3	**43.8**	**75.2**
– property, plant and equipment	1.3		**1.3**	6.8	(0.2)	**6.6**	**7.9**
Current assets							
– cash and cash equivalents				4.0		**4.0**	**4.0**
– other current assets	14.5		**14.5**	29.0	(0.6)	**28.4**	**42.9**
Non-current liabilities							
– other liabilities		(8.1)	**(8.1)**	0.1	(5.5)	**(5.4)**	**(13.5)**
Current liabilities							
– overdrafts	(2.5)		**(2.5)**				**(2.5)**
– other current liabilities	(4.5)		**(4.5)**	(20.4)	(0.8)	**(21.2)**	**(25.7)**
Minority interest and assets accounted for using the equity method					(5.1)	**(5.1)**	**(5.1)**
Net assets acquired	**9.0**	**23.1**	**32.1**	**20.0**	**31.1**	**51.1**	**83.2**
Asset revaluation surplus						**(0.4)**	**(0.4)**
Goodwill on current year acquisitions			**38.7**			**48.3**	**87.0**
Goodwill adjustments on prior year acquisitions						**(1.7)**	**(1.7)**
Total consideration			**70.8**			**97.3**	**168.1**
Cash paid during the period – current year acquisitions			**70.5**			**76.8**	**147.3**
Direct costs relating to current year acquisitions			**0.3**			**2.5**	**2.8**
Deferred consideration accrued on current year acquisitions						**19.7**	**19.7**
Deferred consideration and costs paid/(released) on prior year acquisitions						**(1.7)**	**(1.7)**
Total consideration			**70.8**			**97.3**	**168.1**

30 Disposals

The most significant disposal transaction during the year was the sale of the Group's Marine Systems business to K H Finance Limited, a company owned by ECI Partners LLP, on 8 November 2007. In addition to the consideration recognised there is a deferred payment of £4m contingent on the terms of any future disposal of K H Finance Limited by the purchaser. The assets and liabilities held for sale at 31 July 2007 relate to the Marine Systems business.

The Group has adjusted provisions held in respect of disposals made in prior years, following determination of the warranties and other liabilities provided for at the time of disposal.

	£m
Consideration	**46.8**
Less: transaction costs	**(3.2)**
Less: disposal provisions	**(2.8)**
Net consideration received	**40.8**
Net assets disposed of:	
– intangible assets	**2.2**
– property, plant and equipment	**4.2**
– inventory	**9.5**
– trade and other receivables	**15.5**
– cash and cash equivalents	**0.9**
– liabilities	**(18.1)**
Net assets	**14.2**
Profit on disposals in the current year	**26.6**
Other disposal adjustments	**0.6**
Profit on disposal of businesses	**27.2**

31 Employee share schemes

The Group operates share schemes and plans for the benefit of employees. The nature of the principal schemes and plans, including general conditions, is set out below:

Smiths Group Sharesave Scheme (SAYE)

The SAYE scheme is an HM Revenue & Customs-approved all-employee savings-related share option scheme which is open to all UK employees, including directors, with 12 months' service or more. Participants enter into a contract to save a fixed amount per month of up to £250 in aggregate for three or five years and are granted an option over shares at a fixed option price, set at a 20% discount to market price at the date of invitation to participate. In the case of five-year savings contracts, participants can elect to delay maturity of the contract until its seventh anniversary. The number of shares comprising the option is determined by the monthly amount saved and the bonus paid on maturity of the savings contract. Options granted under the SAYE scheme are not subject to any performance conditions.

Smiths Group US Sharesave Scheme (US Sharesave)

The US Sharesave scheme is a savings-related share appreciation rights scheme which is open to all US employees with 12 months' service or more. Participants enter into a contract to save a fixed amount per month for two years and are granted share appreciation rights based on a fixed initial price determined using the market price and the US dollar exchange rate at the date of invitation to participate. The number of shares used in the calculation is based on the monthly amount saved and the bonus paid on maturity of the savings contract. Rights granted under the US Sharesave scheme are not subject to any performance conditions.

Smiths Industries 1995 Executive Share Option Scheme (95 ESOS)

Options granted under the 95 ESOS can only be exercised after three years if a performance requirement, determined by the Remuneration Committee, has been met. Options granted under the 95 ESOS up to 2001 are subject to performance testing based on total shareholder return of the Group versus the total return of the General Industrials Sector of the FTSE All-Share Index. Options granted from 2002 are subject to a performance test based on growth in the Group's earnings per share. If the performance requirement is not satisfied at the end of the third year, the performance period may be extended for up to two further years so that performance is tested over a four-year period at the end of the fourth year and a five-year period at the end of the fifth year. The performance requirement is that the growth in the Group's normalised earnings per share over the three/four/five financial years beginning immediately prior to the option grant must exceed the increase in the UK Retail Prices Index over the same period by 3% per annum (for options up to one times base salary) and by 4% per annum (for the excess up to two times base salary). Executive directors received their final grants of options under the 95 ESOS in October 2003. From 2004 senior executives, including directors, have received awards under the PSP (see below). Grants under the 95 ESOS continue to be made to other executives.

Smiths Group Performance Share Plan (PSP)

The PSP was introduced in 2004 and replaced the 95 ESOS for executive directors and senior executives. Conditional awards of up to 1.5 times salary (and exceptionally three times salary) are granted annually. The awards will be released following the third anniversary of the date of grant to the extent the PSP's performance tests have been met. One-third of the award is subject to a total shareholder return ('TSR') target relative to other FTSE 100 companies (excluding financial companies and investment trusts). For full vesting, the company's TSR must be at or above the 75th percentile over the three year performance period. 25% of the award will vest if the company's TSR is at median. Awards will vest on a straight-line pro-rata basis between median and 75th percentile. The remaining two-thirds of the award is subject to an earnings per share ('EPS') growth target (measured before exceptional items). Full vesting will occur if the compound annual growth in EPS is equivalent to 12% per annum. 25% vesting will occur if the compound annual growth in EPS is equivalent to 5% per annum, with vesting on a straight-line basis between 5% and 12%. The PSP has been replaced by the VSP (see below).

Value Sharing Plan (VSP)

The VSP is a one-off long-term incentive plan approved by the shareholders in July 2008 rewarding executives for value creation at Group and Divisional levels over three-year and four-year periods commencing with the financial year 2008/09. Corporate participants will be rewarded under the VSP for value creation at a Group level, whereas the executives with divisional responsibilities will be rewarded for value creation within the division for which they are responsible. For the Group scheme, one-third of the award will depend on the growth in Smiths' TSR over and above the median for the companies comprising the FTSE-100 (excluding financial services companies) and the remaining two thirds of each award will be determined by the growth in internal value in excess of 9.5% a year. The growth in internal value is calculated as follows: adjusted profit before tax ('PBT') times the ratio of PBT to market capitalisation determined at the date of grant plus net equity cash-flows to shareholders. The divisional awards will depend on meeting an internal value growth target set for the division in which the participant works.

The participants in the VSP will not be eligible for awards under the Performance Share Plan in 2008/09 or 2009/10.

Smiths Group Co-Investment Plan (CIP)

Under the CIP, as introduced in October 2005, the executive directors and senior executives are able, if invited, to use their after tax bonus or 25% of their basic salary after tax, whichever is the greater, to invest in the Company's shares at the prevailing market price. At the end of a three year period, if the executive is still in office and provided the performance test is passed, he will be awarded matching shares in respect of any invested shares retained for that period. The number of matching shares to be awarded is determined by the Remuneration Committee at the end of the year in which the bonus is earned by reference to annual bonus, and other corporate financial criteria. The maximum award will not exceed the value, before tax, of the bonus or salary invested in shares by the executive. Vesting of matching shares will occur and the matching shares will be released at the end of the three year period if the Group's Return on Capital Employed ('RoCE') over the Performance Period exceeds the Group's weighted average cost of capital ('WACC') over the Performance Period by an average margin of at least 1% per annum.

In July 2008 the CIP was amended. From 2009 participants will be required to invest 50% of their post tax bonus in purchased shares. The performance conditions have been expanded to include an enhanced performance condition of RoCE exceeding WACC by an average margin of 3% per annum. If the enhanced performance condition is met, two matching shares will be issued for every purchased share.

Notes to the accounts continued

31 Employee share schemes continued

	SAYE and Sharesave	ESOS (inc. SARS)	DSS and CIP	PSP	Total	Weighted average price for option plans £
Ordinary shares under option ('000)						
6 August 2006	4,283	19,307	1,363	1,934	26,887	£6.50
Granted	917	2,795	459	1,070	5,241	£6.23
Exercised	(599)	(11,789)	(363)		(12,751)	£7.03
Lapsed	(573)	(963)	(53)	(72)	(1,661)	£7.18
31 July 2007	4,028	9,350	1,406	2,932	17,716	£5.98
Granted	639	1,838	245	743	3,465	£7.32
Exercised	(2,159)	(1,455)	(235)	(645)	(4,494)	£5.67
Lapsed	(992)	(1,101)	(9)	(369)	(2,471)	£7.32
31 July 2008	**1,516**	**8,632**	**1,407**	**2,661**	**14,216**	**£6.23**

Options were exercised on an irregular basis during the period. The average closing share price over the financial year was 1,014.32p (2007: 1,012.15p). There has been no change to the effective option price of any of the outstanding options during the period.

Range of exercise prices	Total shares under option ('000)	Weighted average remaining contractual life (months)	**Options exercisable at 31 July 2008 ('000)**	Options exercisable at 31 July 2007 ('000)	**Exercisable weighted average exercise price for options exercisable at 31 July 2008**
£0.00 – £2.00	4,068	14	**19**	1	**£0.00**
£2.01 – £4.00					
£4.01 – £6.00	234	18	**2**	956	**£5.25**
£6.01 – £8.00	2,518	57	**1,735**	2,236	**£7.40**
£8.01 – £10.00	5,505	73	**587**	633	**£8.77**
£10.01 – £12.00	1,891	108	**129**	185	**£2.42**
£12.01 – £14.00				175	

For the purposes of valuing options to arrive at the share-based payment charge, the Binomial option pricing model has been used for most schemes and the Monte Carlo method is used for schemes with total shareholder return performance targets. The assumptions used in the models for 2008 and 2007 are as follows:

	Period ended 31 July 2008				Period ended 31 July 2007			
	SAYE	**95 ESOS**	**DSS/CIP**	**PSP**	SAYE	95 ESOS	DSS/CIP	PSP
Weighted average fair value (£)	**2.48**	**1.73**	**8.60**	**7.14**	2.19	1.94	7.81	6.40
Key assumptions used:								
Weighted average share price	**9.14**	**8.69**	**9.61**	**9.51**	8.25	8.32	8.72	8.66
Range of exercise prices (£)	**5.25-9.12**	**6.69-10.97**			5.25-8.68	6.69-9.01		
Range of expected volatility	**17%-33%**	**18%-30%**		**17%-20%**	17%-36%	18%-34%		16%-18%
Risk-free interest rate	**3.9%-5.6%**	**4.3%-5.2%**		**4.3%-4.8%**	3.7%-5.6%	4.3%-5.5%		4.3%-4.8%
Range of expected option term (life)	**2.2-7.2 yrs**	**5 yrs**	**3 yrs**	**3 yrs**	2.2-7.2 yrs	5 yrs	3 yrs	3 yrs
Dividend yield	**3.75%**	**3.75%**	**3.75%**	**3.75%**	3.75%	3.75%	3.75%	3.75%

Assumptions on expected volatility and expected option term have been made on the basis of historical data, wherever available, for the period corresponding with the vesting period of the option. Best estimates have been used where historical data is not available in this respect.

Included within staff costs is an expense arising from share-based payment transactions of £12.9m (2007: £19.3m), of which £11.8m (2007: £17.3m) relates to equity-settled share-based payment. The charge in respect of continuing operations is £12.9m (2007: £10.4m). The total share-based payment charge includes £nil (2007: £3.5m) relating to discontinued operations and £nil (£2007: £5.4m) relating to the accelerated vesting of share options on business disposals.

At 31 July 2008 the creditor relating to cash-settled schemes is £1.5m (2007: £1.9m).

32 Events after the balance sheet date

On 1 September 2008 the Company completed the sale of land in Basingstoke for £16m in cash. A further amount of up to £12m will be paid depending on the final terms of such amended planning permission as may be granted.

On 8 September 2008 the Trustees of the TI Pension Scheme invested £250m in annuities which are matched with specific liabilities of the fund.

Group financial record under IFRS 2005-2008

	Year ended 31 July 2008 £m	Period ended 31 July 2007 £m	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Revenue	**2,321.2**	2,160.9	2,180.3	3,005.4
Headline operating profit	**380.6**	347.6	344.8	415.7
Amortisation of acquired intangible assets	**(19.2)**	(14.8)	(13.0)	(5.7)
Exceptional items (including profit on sale/impairment of financial asset)	**(35.4)**	(74.2)	(337.8)	(28.0)
Financing losses	**(0.3)**	(1.5)	(1.8)	
Operating profit/(loss)	**325.7**	257.1	(7.8)	382.0
Net finance costs	**(5.4)**	(0.6)	(28.4)	(16.1)
Share of post-tax losses of associated companies	**(1.0)**	(0.5)	(1.1)	
Profit/(loss) before taxation	**319.3**	256.0	(37.3)	365.9
Taxation	**(75.0)**	(53.1)	(65.4)	(94.1)
Profit/(loss) after taxation – continuing operations	**244.3**	202.9	(102.7)	271.8
Profit after taxation – discontinued operations	**24.5**	1,525.2	126.9	
Shareholders' equity	**915.9**	903.3	1,362.9	1,483.8
Represented by				
– intangible assets	**1,253.2**	1,021.3	1,530.6	1,481.7
– property, plant & equipment and investments	**309.0**	273.6	512.6	831.3
– net current assets/provisions/retirement benefit liabilities	**124.3**	198.3	246.4	101.6
Net borrowings	**(770.6)**	(589.9)	(926.7)	(930.8)
Funds employed	**915.9**	903.3	1,362.9	1,483.8
Ratios				
Operating profit before amortisation of acquired intangible assets: turnover (%)	**16.4**	16.1	14.8	13.8
Effective tax rate before amortisation of acquired intangible assets and exceptional items (%)	**24.0**	25.1	25.6	26.4
Return on shareholders' funds (%)	**16.7**	14.9	13.6	11.2
Cash-flow				
Cash-flow from normal operating activities	**280.5**	265.9	437.6	277.6
Less capital expenditure (net)	**(8.0)**	(6.7)	(18.0)	(18.9)
Operating cash after capital expenditure	**272.5**	259.2	419.6	258.7
Free cash-flow (before acquisitions and dividends, after capital expenditure)	**90.6**	100.7	170.4	147.0
Free cash-flow per share (p)	**23.4**	18.3	30.1	26.1
Earnings per share before amortisation of acquired intangible assets and exceptional items (p)	**74.5**	47.0	64.8	52.8
Dividends				
Pence per share	**34.0**	34.0	31.3	29.0
Times covered before amortisation of acquired intangible assets and exceptional items	**2.2**	1.7	2.1	1.8
Number of employees (000s)				
United Kingdom	**2.2**	2.8	7.3	7.2
Overseas	**20.6**	18.6	24.5	23.4
	22.8	21.4	31.8	30.6

The return on shareholders' funds for the period ended 31 July 2007 has been calculated using the closing net assets adjusted for movements in goodwill set-off against reserves relating to continuing operations, in order to adjust for the Aerospace disposal.

The income statement for the period ended 5 August 2006 has been restated for discontinued operations; however information on shareholders' equity, ratios, cash-flow, dividends and employee numbers is presented for the entire Group.

Results for the year ended 31 July 2005 have not been restated for discontinued operations.