

Group directors' report

Principal activities

The principal activities of the Company and its subsidiaries (the Group) are and, during the year ended 31 July 2008, were the development, manufacture, sale and support of:

- advanced security equipment, including trace detection, millimetre-wave, infra-red, biological detection and diagnostics, that detect and identify explosives, narcotics, weapons, chemical agents, biohazards and contraband;
- mechanical seals, seal support systems, engineered bearings, power transmission couplings, specialist filtration systems and other hardware for the oil & gas, chemical, pharmaceutical, pulp & paper and mining sectors;
- medical devices aligned to specific therapies, principally airway, pain and temperature management, infusion, needle protection, critical care monitoring and vascular access;
- specialised electronic and radio frequency products that connect, protect and control critical systems for the global wireless telecommunications, aerospace, defence, space and medical markets; and
- engineered components including ducting, hose assemblies and heating elements that move and heat fluids for the aerospace, medical, industrial, construction and domestic markets.

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

Business review/future development/research and development

The business review is on pages 12 to 35 and is incorporated by reference, forming part of this directors' report. This is a review of the development and performance of the business of the Group, including the financial performance during the financial year ended 31 July 2008; key performance indicators; and the principal risks and uncertainties facing the Group. It also includes information on likely future developments and activities in the field of research and development. The cautionary statement set out on the inside front cover of this Annual Report forms part of this Annual Report and is incorporated by reference into the business review.

Results and dividends

The results for the financial year ended 31 July 2008 are set out in the Consolidated income statement on page 59. Sales for the year amounted to £2,321m (2007: £2,161m). The profit for the year after taxation amounted to £268.8m (2007: £1,728.1m).

An interim dividend of 10.5p per ordinary share of 37.5p was paid on 25 April 2008. The directors recommend for payment on 21 November 2008 a final cash dividend of 23.5p on each ordinary share of 37.5p, making a total dividend of 34p for the financial year.

The retained profit of £268.8m was transferred to Reserves.

Changes in the Company and its interests during the financial year

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

On 3 November 2007 the Company sold the issued share capital of Kelvin Hughes Limited and its associated companies for £44m in cash, after a working capital adjustment.

On 15 October 2007 the Company acquired the issued share capital of Sartorius Bearing Technology GmbH for €19m in cash.

On 21 December the Company acquired a further 21% of the issued share capital of John Crane Japan Limited for ¥862m in cash, bringing its interest in John Crane Japan to 70%.

On 4 February 2008 the Company acquired the business and assets of Fast Heat, Inc. for US\$18m in cash.

On 17 April 2008 the Company completed the purchase of 4,467,437 B shares for 365p per share, in cash, and cancelled the shares. 459,157 B shares currently remain in issue.

On 28 April 2008 the Company acquired the issued share capital of Indufil BV for €90m in cash.

On 2 May 2008 the Company acquired the business and assets of The Fiber Composite Company, Inc. (known as Fiberod) for US\$91m in cash.

On 7 May 2008 the Company acquired the issued share capital of Allrizon Tongguang Communication Equipment (Shanghai) Co Ltd for RMB 135m in cash.

On 1 July 2008 the Company acquired the issued share capital of Triasx Pty Ltd for Aus\$29m in cash.

On 28 July 2008 the shareholders in general meeting approved the adoption of new Articles of Association, which take effect on 1 October 2008; a new share incentive plan, the Smiths Group Value Sharing Plan; and amendments to the Smiths Group Co-Investment Plan. Details of the Value Sharing Plan and the amendments to the Co-Investment Plan are included in the Directors' Remuneration Report on pages 47 to 56.

Group directors' report continued

Post balance sheet event

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.

Charitable and political donations

During the financial year the Company made donations of £469,000 for charitable purposes including payments totalling £150,000 for the Smiths Medical Chair of Anaesthesia and Critical Care and other donations made by the Company's businesses worldwide to miscellaneous charities. No political donations were made.

Directors

On 10 December 2007 Mr K.O. Butler-Wheelhouse retired as a director and Chief Executive and Mr P. Bowman was appointed in his stead. Mr P.H. Loescher resigned as a non-executive director on 4 April 2008 and Mr D.P. Lillycrop resigned as an executive director and Company Secretary on 3 June 2008. Messrs D.H. Brydon; D.J. Challen; S.J. Chambers; P.J. Jackson; J. Langston; and Sir Kevin Tebbit all served throughout the year.

Reappointment of director

Mr P. Bowman will retire from office at the Annual General Meeting (AGM), having been appointed by the Board since the AGM in 2007. Mr Bowman is willing and eligible to stand for re-election and a resolution will be proposed at the AGM to re-elect him.

Directors' remuneration report

The Directors' remuneration report is on pages 47 to 56.

An ordinary resolution to approve the report will be put to shareholders at the AGM.

Directors' interests in contracts

Details of the executive directors' service contracts are as disclosed in the service contracts section of the Directors' remuneration report on pages 52 and 53. Details of the interests of the executive directors in the Company's share option schemes and plans are shown in the Directors' remuneration report on pages 54 to 56.

Qualifying third party indemnity provisions (as defined by section 309B of the Companies Act 1985) have remained in force for the directors during the financial year ended 31 July 2008 and, at the date of this report, are in force for the benefit of the current directors in relation to certain losses and liabilities which they may incur (or may have incurred) to third parties in the course of their professional duties.

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

Interests in voting rights

As at 19 September 2008 the Company had been notified, pursuant to the FSA's Disclosure & Transparency Rules, of the following notifiable voting rights in its issued share capital:

	No. of shares	Percentage of issued ordinary share capital*
AXA S.A.	21.3m	5.5%
Legal & General Group plc	15.7m	4.1%
Massachusetts Financial Services Company	19.1m	4.9%
Newton Investment Management Limited	15.2m	3.9%

*Percentage of ordinary share capital in issue on 19 September 2008.

The Company has not acquired or disposed of any interests in its own shares other than in connection with the 2007 Return of Cash scheme. Details of shares purchased and cancelled pursuant to that scheme are shown on page 41.

The interests of the directors, their families and any connected persons in the issued share capital of the Company are shown on page 52.

Corporate governance

The report on corporate governance is on pages 43 to 46. PricewaterhouseCoopers LLP has reviewed the Company's statements as to compliance with the June 2006 issue of the Combined Code, to the extent required by the UK Listing Authority Listing Rules. The results of its review are set out on page 58.

Financial instruments

The financial risk management objectives and policies of the Group; the policy for hedging each major type of forecasted transaction for which hedge accounting is used; and the exposure of the Group to price risk, credit risk, liquidity risk and cash-flow risk are outlined in note 21 of the Group financial statements.

Going concern

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

Policy on payment of creditors

The Company's policy and practice is to pay creditors promptly in accordance with agreed terms of business. The average time taken to pay an invoice was 33 days (2007: 35) for the parent Company and 43 days (2007: 43) for the Group as a whole.

Share capital and control

As at 31 July 2008, the Company's authorised share capital was £200,228,879.995, divided into 533,333,333 ordinary shares of 37.5p each nominal value (ordinary shares), representing 99.9% of the total share capital, and 22,888,012 non-cumulative preference shares of 1p (preference shares), representing 0.1% of the total share capital. On 31 July 2008 there were 387,879,181 ordinary shares and 459,157 preference shares in issue. The ordinary shares and the preference shares are listed on the London Stock Exchange.

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

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

Shares acquired through Company share schemes and plans rank *pari passu* with the shares in issue and have no special rights. The Company operates an employee benefit trust, with an independent trustee, to hold shares pending employees becoming entitled to them under the Company's share schemes and plans. On 31 July 2008 the trust held 1,095,965 ordinary shares in the Company. The trust waives all but 0.1p per share of each dividend entitlement on its holding and abstains from voting the shares at general meetings.

The table on page 38 sets out the notifications received by the Company pursuant to the FSA's Disclosure & Transparency Rules, as at 19 September 2008, from persons with significant direct or indirect holdings in the Company's share capital.

The rules about the appointment and replacement of directors are contained in the Company's Articles of Association. Changes to the Articles of Association must be approved by the shareholders in accordance with the legislation in force from time to time. New Articles of Association were approved by the Company in general meeting on 28 July 2008. These take effect on 1 October 2008 and have been adopted primarily to take account of changes in English company law brought about by certain provisions of the Companies Act 2006 which have already come into force or which will come into force on 1 October 2008.

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

The Company has in place credit facility agreements under which a change in control would trigger prepayment clauses and has bonds in issue the terms of which would allow bondholders to exercise put options and require the Company to buy back the bonds at their principal amount plus interest if a rating downgrade occurs at the same time as a change of control takes effect. The Company's share schemes and plans contain clauses which cause options and awards to vest on a change in control. The Company is not party to any other significant agreements that would take effect, alter or terminate upon a change of control following a takeover bid.

Group directors' report continued

If there is a change in control of the Company prior to 10 December 2010, the terms of Mr Bowman's service contract allow him, at any time during the three months following the change in control, to resign and treat himself as redundant. In this event, (i) Mr Bowman would be entitled to receive the sum payable on a Company-elected termination of his employment, as described on page 52, save that his bonus entitlement for the period from the start of the bonus year in which the termination falls to the end of any unexpired notice period would be a minimum of 75% of base salary (less any amount already paid to him in respect of the bonus year) and (ii) all available discretions will be exercised under the Company's share schemes and in default the Company must indemnify Mr Bowman for the value of any awards that do not vest on the change in control.

No other director or employee is contractually entitled to compensation for loss of office or employment as a result of a change in control except that provisions of the Company's share schemes may cause options and awards granted to employees under such schemes to vest on a change in control.

*Article 126 is renumbered as Article 129 from 1 October 2008 when the new Articles of Association, approved by the Company in general meeting on 28 July 2008, take effect.

Corporate responsibility

The Company has Group policies on environmental, health and safety matters and operates a Code of Business Ethics. The Company seeks to minimise, as far as is reasonably practicable, any detrimental effects on the environment of its operations and products. The Group HR director has responsibility for environmental, health and safety matters, which are subject to preventative, investigatory and consultative systems, overseen by the Group Environment, Health and Safety Committee, and reports regularly to the Board on these matters. Issues relevant to the Company pension schemes are likewise covered by means of structured committees, including representation from recognised trade unions.

Further information on environmental and employee health and safety matters, including key performance indicators, is contained in the Corporate responsibility summary in the business review on pages 32 to 35. The full Corporate responsibility report is available online at www.smiths.com/responsibility.

Annual General Meeting

The 2008 AGM will be held at The Thomas Lord Suite, Lord's Cricket Ground, Grace Gate, St John's Wood Road, London NW8 8QN on Tuesday 18 November 2008 at 2:30 p.m.

Authority to issue shares

At the AGM shareholders will be asked to renew the authority, given to the directors at the last AGM, to allot relevant securities for the purposes of Section 80 of the Companies Act 1985. The authority proposed will expire at the conclusion of the next Annual General Meeting of the Company or, if earlier, on 17 February 2010. The amount of relevant securities to which this authority relates (£48,510,168 nominal of ordinary share capital) represents one third of the ordinary share capital in issue on 19 September 2008. The ordinary resolution is set out in the Notice of AGM.

Also in the Notice is the special resolution to renew the power granted to directors under Section 95 of the Companies Act 1985. The new authority sought will be on substantially similar terms to those attaching to the existing authority and will expire at the conclusion of the next AGM of the Company or, if earlier, on 17 February 2010. It will permit the directors to allot equity securities for cash:

- in connection with a rights issue pro rata to the rights of the existing shareholders;
- pursuant to the terms of any share scheme or plan approved by the shareholders in General Meeting; and
- for any other purpose (including the sale on a non pre-emptive basis of any shares the Company may hold in treasury for cash) provided that the aggregate nominal value of such allotments does not exceed £7,276,525 (approximately 5% of the issued ordinary share capital on 19 September 2008).

The directors intend seeking renewal of these authorities annually.

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

During the financial year ended 31 July 2008, the following shares in Smiths Group plc were issued:

- 2,268,348 ordinary shares of 37.5p pursuant to the terms of the Company's shareholder-approved share option schemes; and
- 112,560 ordinary shares of 37.5p pursuant to the terms of TI Group share option schemes.

Authority to purchase shares

At the AGM the Company will seek to renew the authority, granted at the last AGM to the directors, to purchase the Company's ordinary shares in the market. The authority will be limited to 10% of the ordinary share capital in issue on 19 September 2008 and will be renewed annually. The price that may be paid for the shares will be not less than the nominal amount of 37.5p per share and not more than the higher of 5% above the average of the middle market quotations of the Company's ordinary shares, as derived from the London Stock Exchange Daily Official List, for the five business days prior to any purchase and the amount stipulated by Article 5(1) of the Buy-back and Stabilisation Regulation 2003. On 19 September 2008 options over approximately 8.4m shares were outstanding under the Company's share option schemes, representing approximately 2.2% of the then issued share capital. If the existing authority to purchase shares and the new authority being sought at the AGM were to be used in full and the purchased shares were cancelled, then the outstanding options would represent approximately 2.7% of the reduced issued share capital.

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

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

Purchase of shares

In accordance with the authorities given at the Extraordinary General Meeting held on 11 June 2007 in connection with the Return of Cash to shareholders from the sale of the Aerospace division, on 17 April 2008 the Company purchased 4,467,437 non-cumulative preference shares of 1p each (90.7% of the then issued preference share capital) for an aggregate consideration of £16,306,145.05 and immediately cancelled them.

Political donations

A resolution will be proposed at the AGM to renew and revise the authority, granted by the shareholders in 2004 to the Company and its subsidiaries, to make donations to EU political organisations and to incur EU political expenditure. The new authority will follow the provisions of Part 14 of the Companies Act 2006 (the 2006 Act) and permit the Company and its subsidiaries, present and future, to make donations (i) to political parties; (ii) to other political organisations or independent election candidates; and (iii) to incur political expenditure. The authority will expire at the conclusion of the next AGM of the Company or, if earlier, on 17 February 2010 and will be limited to £50,000 in respect of each of items (i) to (iii) above. As was the case in 2004, the proposal of this resolution is a precautionary measure in the light of the wide definitions of political donations and expenditure contained in the 2006 Act. The resolution proposed is in general terms and does not purport to authorise particular donations. The Company has not made any political donations in the past under the expiring resolution and it is not the present intention of the Company to make any political donations or incur any political expenditure in the foreseeable future. The directors intend seeking renewal of this authority annually.

Auditor

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

Disclosure of information to the auditor

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

Electronic communications at www.smiths.com

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

Electronic copies of the Annual Report 2008 and the Notice of AGM are posted on the Company's website, www.smiths.com. The Company's announcements to the Stock Exchange and press releases are available online through the website. Shareholding details and practical help on share transfers and changes of address can be found at www.shareview.co.uk.

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

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Electronic proxy voting

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

Paper proxy cards have been distributed with the Notice of AGM to all shareholders other than those who have elected for notification by e-mail.

Shareholders who will not be able to attend the AGM on 18 November 2008 in person are encouraged to vote their shares by appointing a proxy and issuing voting instructions (either electronically or by completing and returning their proxy cards). Electronic and paper proxy appointments and voting instructions must be received by the Company's Registrar not later than 48 hours before the AGM in order to be valid.

In order to facilitate voting by corporate representatives at the meeting, arrangements will be put in place at the meeting so that (i) if a corporate shareholder has appointed the chairman of the meeting as its corporate representative with instructions to vote on a poll in accordance with the directions of all of the other corporate representatives for that shareholder at the meeting, then on a poll those corporate representatives will give voting directions to the chairman and the chairman will vote (or withhold a vote) as corporate representative in accordance with those directions; and (ii) if more than one corporate representative for the same corporate shareholder attends the meeting but the corporate shareholder has not appointed the chairman of the meeting as its corporate representative, a designated corporate representative will be nominated from those corporate representatives who attend to vote on a poll and the other corporate representatives will give voting directions to that designated corporate representative. Corporate shareholders are referred to the guidance issued by the Institute of Chartered Secretaries and Administrators on proxies and corporate representatives (www.icsa.org.uk) for further details of this procedure. The guidance includes a sample form of representation letter if the chairman is being appointed as described in (i) above.

Registrar

On 1 October 2007 Advent International acquired Lloyds TSB Registrars and changed its name to Equiniti Limited. Equiniti Limited continues to act as the Company's Registrar and to provide shareholder services to the members of Smiths Group plc. The address and contact details of Equiniti Limited are listed on the inside back cover of this report. Individual shareholders' access to their personal shareholder information continues to be available online, through the www.shareview.co.uk website. Dividend payments will continue to be made through Lloyds TSB Bank. The shareholder helpline telephone number has changed to 0871 384 2943. (Note: calls to this number are charged at 8p per minute from a UK BT landline. Other telephony providers' costs may vary.)

Important information

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

Recommendation

Your directors believe that all the proposals to be considered at the AGM are in the best interests of the Company and its shareholders as a whole and recommend shareholders to vote in favour of the resolutions. The directors intend to vote in favour of the resolutions in respect of their own beneficial holdings.

By Order of the Board

Sarah Cameron

Secretary

765 Finchley Road
London NW11 8DS

23 September 2008