

Group directors' report

Principal activities

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

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

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

Business review

Our business review can be found, titled Operating and financial review on pages 12 to 29 of this Annual report. This is a review of the development and performance of the business of the Group, including the financial performance during the period ended 5 August 2006, key performance indicators and a description of the principal risks and uncertainties facing the Group.

Results and dividends

The results for the period to 5 August 2006 are set out in the Consolidated income statement on page 50. Sales for the period amounted to £3,523m, against £3,005m in 2005. The profit for the period after taxation amounted to £24m (2005: £272m). Note: The 2006 financial statements comply with International Financial Reporting Standards, as adopted by the EU (IFRS): the comparisons with the 2005 financial statements have been restated under IFRS.

An interim dividend of 9.85p per ordinary share of 25p was paid on 21 April 2006. The directors recommend for payment on 24 November 2006 a final cash dividend on each ordinary share of 21.5p, making a total dividend of 31.35p for the period.

The retained profit of £24m was transferred to Reserves.

Research and development

£352m was spent on research and development during the period, of which £193m was funded by the Company and the balance by customers. Each business carries out research and development programmes to suit its own particular market and product needs. Interchange of technology and technical information between Smiths manufacturing businesses is centrally co-ordinated.

Changes in the Company and its interests during the period

On 1 August 2005 the Company transferred the issued share capital of Smiths Heimann Biometrics GmbH to Cross Match Technologies, Inc. in exchange for 43% of the issued share capital of Cross Match Technologies, Inc.

Also on 1 August 2005 the Company acquired the business and assets of Farnam Custom Products, Inc. for £4m.

On 8 August 2005 the Company sold the issued share capital of EBTEC Corporation for a cash consideration of £2m.

On 22 September 2005 the Company sold the issued share capital of pvb Critical Care GmbH for £6m.

On 22 September 2005 the Company also acquired the issued share capital of Millitech, Inc. for a cash consideration of £19m.

On 28 October 2005 the Company acquired the issued share capital of Livewave, Inc. for a cash consideration of £10m.

On 30 December 2005 the Company acquired the minority shareholding in John Crane Tianjin Limited for £1.5m in cash.

On 4 January 2006 the Company acquired the issued share capital of Lorch Microwave LLC for a cash consideration of £15m.

On 23 February 2006 the Company acquired the minority shareholding in Smiths Detection Montreal Inc. for £2m in cash.

On 5 May 2006 the Company sold the issued share capital of Beagle Aircraft Limited for £3m.

Post balance sheet events

On 8 August 2006 the Company acquired all the issued share capital of Comet Costruzioni Metalliche S.r.l. for £4m in cash.

On 15 August 2006 the Company completed the sale of the bearing lubrication business of John Crane Safematic Oy for £16m.

On 15 September 2006 the Company secured the commutation of certain insurance policies that relate to the John Crane, Inc. litigation, as described on page 24 of the Operating and financial review.

Future developments

The Company will pursue its existing international activities and continue to seek business opportunities in both the UK and overseas.

Charitable and political donations

During the period the Company made donations of £754,000 for charitable purposes including payments totalling £300,000 for the Smiths Medical Chair of Anaesthesia and Critical Care and £11,000 to charities with selected medical objectives. Other donations were made by the Company's businesses worldwide to miscellaneous charities. No political donations were made.

Directors

Lord Robertson of Port Ellen resigned from the Board on 27 February 2006. The directors at the end of the financial year, with the exception of Mr R W O'Leary, who sadly died on 14 August 2006, and Mr A M Thomson, who retired on 6 September 2006, are shown on page 30. Apart from Sir Kevin Tebbit, who was appointed as a non-executive director on 14 June 2006, all these directors served throughout the financial year. Mr J Langston assumed the role of Finance Director on 6 September 2006. Sir Julian Horn-Smith, who has been a non-executive director since February 2000, will retire at the conclusion of the Annual General Meeting on 21 November 2006.

Reappointment of directors

Mr K O Butler-Wheelhouse and Dr J Ferrie have served more than 30 months since they were last reappointed as directors. In accordance with Article 57 of the Company's Articles of Association, they will retire from office at the Annual General Meeting on 21 November 2006. Sir Kevin Tebbit will also retire from office at the Annual General Meeting, having been appointed by the Board since the Annual General Meeting in 2005.

The Board has reviewed the effectiveness of Sir Kevin as a non-executive director and has concluded that his wide ranging experience is of great benefit to the Company. Sir Kevin is a member of the Audit Committee and the Nomination Committee.

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

Directors' remuneration report

The Directors' remuneration report is on pages 40 to 47. An ordinary resolution to approve the report will be put to shareholders at the Annual General Meeting.

Directors' interests in contracts

Details of the executive directors' service contracts are as disclosed in the service contracts section of the Directors' remuneration report on page 44. 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 45 to 47.

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 period ended 5 August 2006 and, at the date of this report, are in force for the benefit of the current directors in relation to certain losses and liabilities which they may incur (or have incurred) to third parties in the course of their professional duties.

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

Interests in shares

As at 26 September 2006 the Company had been notified, pursuant to the Companies Act 1985, of the following material or notifiable interests in its issued share capital:

	No. of shares	Percentage of issued share capital†
FMR Corp/Fidelity International Limited	62.8m	11.1%
Franklin Resources, Inc.	39.4m	6.9%
Legal & General Group plc	20.7m	3.6%
Barclays PLC	17.0m	3.0%

†Percentage of share capital in issue on 26 September 2006.

The Company has not acquired or disposed of any interests in its own shares.

The interests of the directors, their families and any connected persons in the issued share capital of the Company are shown on page 43.

Corporate governance

The report on corporate governance is on pages 36 to 39. PricewaterhouseCoopers LLP has reviewed the Company's statements as to compliance with the July 2003 issue of the Combined Code, to the extent required by the UK Listing Authority Listing Rules. The results of its review are set out on page 49.

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 20 of the Group financial statements.

Going concern

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

Policy on payment of creditors

The Company's policy and practice is to pay creditors promptly in accordance with agreed terms of business. The average time taken to pay an invoice was 35 days (2005: 35) for the parent Company and 48 days (2005: 48) for the Group as a whole (calculated in compliance with the Companies Act 1985 (Directors' Report)(Statement of Payment Practice) Regulations 1997).

Corporate responsibility

The Company has implemented across the Group policies on environmental, health and safety matters and operates a Code

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

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

Further information on environmental and employee health and safety matters, including key performance indicators, is contained in the Corporate responsibility summary in the Operating and financial review, or the full Corporate responsibility report, available online at www.smiths.com.

Authority to issue shares

At the Annual General Meeting shareholders will be asked to renew the authority, given to the directors at the last Annual General Meeting, to allot relevant securities for the purposes of Section 80 of the Companies Act 1985, so as to reflect the increase in the Company's issued share capital since the last Annual General Meeting. In compliance with recently published guidelines and market practice, the authority proposed will expire at the conclusion of the next Annual General Meeting of the Company or, if earlier, on 20 February 2008. The amount of relevant securities to which this authority relates (£47,297,545 nominal of share capital) represents one third of the share capital in issue on 26 September 2006. The ordinary resolution is set out in the Notice of Annual General Meeting.

Also in the Notice is the special resolution to renew the power granted to directors under Section 95 of the Companies Act 1985. The new authority sought will be on substantially similar terms to those attaching to the existing authority and, in compliance with current practice, will expire at the conclusion of the next Annual General Meeting of the Company or, if earlier, on 20 February 2008. 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 £7,094,632 (approximately 5% of the issued share capital on 26 September 2006).

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 53 week period ended 5 August 2006, the following ordinary shares in Smiths Group plc were issued:

- 3,173,737 shares pursuant to the terms of the Company's shareholder-approved share option schemes; and
- 593,061 shares pursuant to the terms of TI Group share option schemes.

Authority to purchase shares

At the Annual General Meeting the Company will seek to renew the authority, granted at the last Annual General Meeting to the directors, to purchase the Company's shares in the market. The authority will be limited to 10% of the share capital in issue on 26 September 2006 and will be renewed annually. The price that may be paid for the shares will be not less than the nominal amount of 25p per share and not more than the higher of 5% above the average of the middle market quotations of the Company's 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 29 September 2006 options over approximately 20.2m shares were outstanding under the Company's share option schemes, representing approximately 3.6% of the then issued share capital. If the existing authority to purchase shares and the new authority being sought at the Annual General Meeting were to be used in full, then the outstanding options would represent approximately 4.5% 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.

No shares have ever been purchased or contracted for or are the subject of any option under the expiring or any prior authority.

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.

Annual General Meeting

The 2006 Annual General Meeting will be held at The Banqueting Suite, Lord's Cricket Ground, Grace Gate, St John's Wood Road, London NW8 8QN on Tuesday 21 November 2006 at 12.00 noon. In addition to the items of business which shareholders are usually asked to approve at the Annual General Meeting, there is a further proposal which requires some explanation, as set out below.

Articles of Association

A special resolution will be proposed at the Annual General Meeting to replace the Company's Articles of Association. The current Articles were adopted in 2002, before the implementation of IFRS accounting: the directors propose that new Articles be adopted to reflect the new reporting standards and to comply with current best practice. The principal change involves the restatement of the Company's borrowing powers in a format that is consistent with IFRS. The proposed new borrowing power will increase the borrowing limit from £3.6 billion, based on the balance sheet at 31 July 2005 under UK GAAP, to £4.0 billion, based on the same balance sheet re-stated under IFRS. There is also a change to increase the aggregate limit on fees payable to non-executive directors from the current maximum of £500,000 per annum, which was established in 2002, to £750,000 per annum, which is comparable with the limits of other major listed companies. In addition, the definition of treasury shares will be changed so as to suspend all rights attached thereto; an express provision for the appointment of proxies by electronic means will be included; and, following changes in legislation, the power to lend to directors the cost of defending claims against them will be incorporated.

A summary of the principal differences between the existing Articles and the proposed new Articles is appended to the Notice of Annual General Meeting.

Copies of the current Articles of Association and the proposed new Articles of Association are available for inspection at the registered office of the Company and at the offices of Allen & Overy LLP, One Bishops Square, London E1 6AO during normal business hours until the conclusion of the Annual General Meeting on 21 November 2006 and, on the day of the meeting, from 11.45 a.m. at the place of the Meeting until the close of the Meeting.

Auditor

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

Disclosure of information to the auditor

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

Summary Financial Statement

The Company has produced the Summary Financial Statement 2006. Shareholders will be automatically sent Summary Financial Statements alone each year unless they elect in writing to receive the Statutory Reports and Accounts. Shareholders who wish to receive the Statutory Reports and Accounts (free of charge) in future years should write to Lloyds TSB Registrars, The Causeway, Worthing, West Sussex BN99 6DA, quoting Reference 0282. The publication of Summary Financial Statements results in significant savings in the cost of producing the accounts each year.

Electronic proxy voting

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

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

Shareholders who will not be able to attend the Annual General Meeting on 21 November 2006 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 Lloyds TSB Registrars not later than 48 hours before the Annual General Meeting in order to be valid.

www.smiths.com

Electronic copies of the Annual Report and Accounts 2006, the Summary Financial Statement 2006 and the Notice of Annual General Meeting will be posted on the Company's website, www.smiths.com. The Company's announcements to the Stock Exchange and press releases are available online through the website. Shareholding details and practical help on share transfers and changes of address can be found at www.shareview.co.uk.

Important information

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

Recommendation

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

By Order of the Board

David P Lillycrop
Director and Secretary

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29 September 2006