Independent auditor's report to the members of Smiths Group plc

We have audited the Group financial statements of Smiths Group plc for the period ended 5 August 2006 which comprise the consolidated income statement, the consolidated balance sheet, the consolidated cash-flow statement, the consolidated statement of recognised income and expense 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 period ended 5 August 2006 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 (IFRS) 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 Directors' Report is not consistent with the Group financial statements, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding director's remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code 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 Chairman's Statement, the Chief Executive's Statement, the Summary Performance Statement, the Operating and Financial Review, the Directors' Report, the Corporate Governance Statement, the Statement of Directors' Responsibilities and the Five Year Review. 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 judgments 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 IFRS as adopted by the European Union, of the state of the Group's affairs as at 5 August 2006 and of its profit and cash-flows for the period 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 Directors' Report is consistent with the Group financial statements.

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors

London

29 September 2006

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

	Note	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Revenue	1	**3,522.9**	3,005.4
Cost of sales		**(2,111.2)**	(1,814.7)
Gross profit		**1,411.7**	1,190.7
Sales and distribution costs		**(354.7)**	(283.3)
Administrative expenses			
– normal activities		**(587.8)**	(534.1)
– impairment of financial asset		**(325.0)**	
Profit on disposal of businesses	29	**16.4**	8.7
Operating profit	2	**160.6**	382.0
Interest receivable		**4.2**	15.0
Interest payable		**(58.4)**	(38.2)
Other financing losses		**(0.5)**	(4.2)
Other finance income – retirement benefits		**27.6**	11.3
Finance costs	5	**(27.1)**	(16.1)
Share of post-tax losses of associated companies		**(1.1)**	
Profit before taxation		**132.4**	365.9
Comprising			
– headline profit before taxation	3	**492.1**	403.8
– exceptional operating items	4	**(14.5)**	(28.0)
– amortisation of acquired intangible assets	11	**(16.9)**	(5.7)
– financing losses		**(3.3)**	(4.2)
– impairment of financial asset		**(325.0)**	
		132.4	365.9
Taxation	6	**(108.2)**	(94.1)
Profit for the period attributable to equity shareholders of the Parent Company		**24.2**	271.8
Earnings per share	8		
Basic		**4.3p**	48.3p
Diluted		**4.2p**	48.2p

Consolidated statement of recognised income and expense

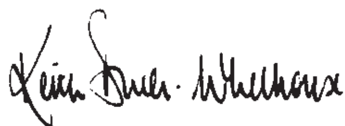
	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Exchange (loss)/gain	**(113.1)**	50.2
Taxation recognised on exchange losses		
– current		5.9
– deferred	**(7.4)**	
Actuarial gains/(losses) on retirement benefit schemes	**94.5**	(23.4)
Taxation recognised on actuarial gains/(losses) – deferred	**(24.0)**	11.8
Fair value gains/(losses):		
– on cash-flow hedges	**12.7**	
– on net investment hedges	**17.1**	
Net (cost)/income recognised directly in equity	**(20.2)**	44.5
Profit for the period	**24.2**	271.8
Total recognised income and expense for the period attributable to equity shareholders of Smiths Group plc	**4.0**	316.3
Effect of change in accounting policy (IAS 32 and IAS 39)	**2.9**	

As permitted by 'IFRS 1 First Time Adoption of International Reporting Standards', the Group has adopted 'IAS 32 Financial Instruments: Disclosure and Presentation' and 'IAS 39 Financial Instruments: Recognition and Measurement' with effect from 1 August 2005 with no restatement of comparative information. This increased shareholders equity by £2.9m at 1 August 2005.

Consolidated balance sheet

	Note	2006 £m	2005 £m
Non-current assets			
Intangible assets	11	**1,530.6**	1,481.7
Property, plant and equipment	12	**497.8**	502.8
Investment accounted for using the equity method	13	**14.0**	
Financial assets – other investments	14	**0.8**	328.5
Retirement benefit assets	9	**183.7**	134.6
Deferred tax assets	6	**92.3**	117.8
Trade and other receivables	16	**16.8**	24.7
Financial derivatives	20	**6.2**	
		2,342.2	2,590.1
Current assets			
Inventories	15	**558.4**	564.2
Trade and other receivables	16	**724.4**	720.5
Cash and cash equivalents	17	**120.6**	60.9
Financial derivatives	20	**26.1**	
Total assets		**3,771.7**	3,935.7
Non-current liabilities			
Financial liabilities:			
– borrowings	19	**(862.3)**	(937.7)
– financial derivatives	20	**(4.4)**	
Provisions for liabilities and charges	21	**(26.5)**	(26.4)
Retirement benefit obligations	9	**(235.8)**	(371.2)
Deferred tax liabilities	6	**(49.7)**	(19.9)
Trade and other payables	18	**(114.8)**	(133.2)
		(1,293.5)	(1,488.4)
Current liabilities			
Financial liabilities:			
– borrowings	19	**(185.0)**	(54.0)
– financial derivatives	20	**(4.9)**	
Provisions for liabilities and charges	21	**(81.8)**	(64.1)
Trade and other payables	18	**(699.5)**	(684.6)
Current tax payable		**(144.1)**	(160.8)
Total liabilities		**(2,408.8)**	(2,451.9)
Net assets		**1,362.9**	1,483.8
Shareholders' equity			
Share capital	24	**141.8**	140.9
Share premium account	25	**224.1**	197.5
Revaluation reserve	25	**1.7**	1.7
Merger reserve	25	**234.8**	234.8
Retained earnings	25	**734.0**	908.9
Hedge reserve	25	**26.5**	
Total shareholders' equity		**1,362.9**	1,483.8

The accounts on pages 50 to 96 were approved by the Board of Directors on 29 September 2006 and were signed on its behalf by:



Keith Butler-Wheelhouse
Chief Executive

John Langston
Finance Director

Consolidated cash-flow statement

	Note	**Period ended 5 August 2006 £m**	Year ended 31 July 2005 £m
Net cash inflow from operating activities	27	**389.1**	319.3
Cash-flows from investing activities			
Expenditure on capitalised development		**(102.0)**	(67.4)
Expenditure on other intangible assets		**(25.1)**	(14.3)
Purchases of property, plant and equipment	12	**(111.2)**	(99.9)
Disposals of property, plant and equipment		**12.2**	9.3
Acquisition of businesses	28	**(54.2)**	(410.0)
Disposals of businesses	29	**8.3**	0.5
Net cash-flow used in investing activities		**(272.0)**	(581.8)
Cash-flows from financing activities			
Proceeds from issue of ordinary share capital	26	**27.3**	14.6
Dividends paid to equity shareholders	7	**(167.0)**	(154.5)
Increase in new borrowings		**73.5**	287.7
Reduction and repayment of borrowings		**(115.9)**	(249.3)
Net cash-flow used in financing activities		**(182.1)**	(101.5)
Net decrease in cash and cash equivalents		**(65.0)**	(364.0)
Cash and cash equivalents at 1 August		**11.9**	421.0
Exchange differences		**2.0**	(45.1)
Cash and cash equivalents at end of period	17	**(51.1)**	11.9
Cash and cash equivalents at end of period comprise:			
– cash at bank and in hand		**102.3**	51.1
– short-term deposits		**18.3**	9.8
– bank overdrafts		**(171.7)**	(49.0)
		(51.1)	11.9

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, 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 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. These estimates and assumptions are based on historical experience and various other factors that are believed reasonable in the circumstances and constitute management's best judgement at the date of the financial statements. Actual results could differ from these estimates.

The accounts have been prepared in accordance with the accounting policies, as described below. These accounts are the first accounts following the implementation of IFRS as adopted by the EU. The information for the year ended 31 July 2005, previously reported to shareholders under UK Generally Accepted Accounting Principles (UK GAAP) has been restated to conform to IFRS.

'IFRS 1 First Time Adoption of International Financial Reporting Standards', permits those companies adopting IFRS for the first time to take some exemptions from the full requirements of IFRS in the transition period. The Company has adopted the following key exemptions:

- financial instruments – the Company has elected to adopt 'IAS 32 Financial Instruments: Disclosure and Presentation' and 'IAS 39 Financial Instruments: Recognition and Measurement' with effect from 1 August 2005. Financial instruments in the comparative period presented in the accounts (ie the year ended 31 July 2005) are recorded on the UK GAAP basis applicable in that year;
- business combinations – business combinations prior to the transition date (1 August 2004) have not been restated to an IFRS basis. This means consequently that the merger of Smiths Industries plc and TI Group plc in December 2000 continues to be accounted for as a merger; and
- cumulative translation differences – the Company has deemed cumulative translation differences for foreign operations to be zero at the date of transition. Any gains and losses on subsequent disposals of foreign operations will not therefore include translation differences arising prior to the transition date.

The reconciliations between the amounts previously reported under UK GAAP and the amounts reported under IFRS for:

- profit for the year ended 31 July 2005; and
- shareholders' equity at 1 August 2004 and 31 July 2005 (except in respect of IAS 32 and IAS 39)

are set out on pages 90 to 96.

A further reconciliation has been included in note 26 to illustrate the effect of adopting IAS 32 and IAS 39, as of 1 August 2005.

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.

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 in the accounts of individual companies are dealt with in their respective income statements. Those arising on trading transactions are taken to operating profit; those arising on borrowings are classified as finance income or cost.

Revenue
Revenue comprises the fair value for the sale of goods and services, net of trade discounts and sales related taxes, and the value of work undertaken during the year on long-term contracts. Revenue is recognised when the risks and rewards of the underlying sale have been transferred to the customer, which is usually where title passes.

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 extent to which the Company has obtained the right to consideration in exchange for performance under the contract. 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 Company 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 income, 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 Company operates a number of equity-settled and cash-settled share-based compensation plans. The fair value of the employee services received in exchange for the grant of shares or share options is recognised as an expense. For equity-settled share-based payments the total amount to be expensed over the vesting period is determined by reference to the fair value of the shares or share options granted, excluding the impact of any non-market vesting conditions (for example profitability and sales growth targets). For cash-settled share-based payments a liability equal to the proportion of the services received is recognised at the current fair value determined at each balance sheet date. Fair value is determined by reference to option pricing models, principally Binomial models.

The Company has applied the requirements of 'IFRS 2 Share-based Payment'. In accordance with the transitional provisions, IFRS 2 has been applied only to grants of equity instruments after 7 November 2002 that had not vested as at 1 January 2005.

Exceptional operating 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 within the line 'exceptional operating items'. 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
- significant goodwill or other asset impairments.

Intangible assets

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Company'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, is not amortised but is 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, which was set against reserves in the year of acquisition under UK GAAP, has not been reinstated and is not included in determining any subsequent profit or loss on disposal of the related entity, in accordance with IFRS 1.

Goodwill is tested for impairment at least annually or whenever there is an indication that the asset may be impaired. 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 profit and loss account 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 certain major new product projects where the outcome of those projects is assessed as being reasonably certain as regards viability and technical feasibility. Such expenditure is capitalised and amortised over the expected useful life of the development, being the estimated period of sale for each product, commencing in the year 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 over their expected future lives unless they are regarded as having an indefinite life, in which case they are not amortised, but subjected to annual impairment testing in a similar manner to goodwill.

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

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 and other receivables are stated at cost after deducting adequate provision for doubtful debts.

Cash and cash equivalents

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

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.

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

Financial assets are initially recognised at fair value (ie original cost plus transaction costs) when the Group becomes party to contractual obligations. They are no longer recognised when the right to receive cash-flows from the assets has expired or been transferred, and the Company has transferred substantially all of the risks and rewards of ownership.

The subsequent measurement of financial assets depends on their classification. They are classified as either loans and receivables; held to maturity investments; available-for-sale financial assets; or financial assets where changes in fair value are charged (or credited) to the income statement. The classification depends on the purpose for which the financial assets were acquired. Management determines the classification of financial assets at initial recognition and re-evaluates their designation at each reporting date.

Loans and receivables and held-to-maturity investments are subsequently measured at amortised cost using the effective interest method. Available-for-sale financial assets and 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 profit and loss' category are included in the income statement in the period in which they arise. Unrealised gains and losses arising from changes in the fair value of non-monetary securities classified as available-for-sale are recognised in equity. When securities classified as available-for-sale are sold or impaired, the accumulated fair value adjustments are included in the income statement as gains or losses from investment securities.

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

Financial liabilities

Borrowings made by the Company are initially recognised at fair value, 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 Company 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

The Company has adopted IAS 39 from 1 August 2005. Adjustments have been made to the opening balance sheet at 1 August 2005 for

the adoption of IAS 39; these are shown separately in the Group statement of changes in equity. Comparative figures for the year ended 31 July 2005 have not been restated to reflect IAS 39 as permitted by IFRS 1. 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 value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

Cash-flow hedge

The effective portion of changes in the fair value 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 item will affect profit or loss (for instance when the forecast sale that is hedged takes place). However, when 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.

Gains and losses accumulated in equity are included in the income statement when the foreign operation is disposed of.

Derivatives that do not qualify for hedge accounting

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

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.

IAS 32 and IAS 39 were adopted by the Company on 1 August 2005. Information relating to financial instruments for periods prior to 31 July 2005 remains as reported under UK GAAP:

- receipts and payments on interest rate instruments are recognised on an accruals basis over the life of the instruments; and
- foreign currency assets and liabilities covered by forward contracts are translated at the contract rates of exchange.

Dividends

Dividends are recognised as a liability in the period in which they are declared, and in the case of the final dividend, approved by shareholders at the Annual General Meeting.

Recent accounting developments

The following IFRS and IFRIC interpretation have been issued by the IASB and are likely to affect future Annual report and accounts.

'IFRS 7 Financial Instruments: Disclosures' was issued in August 2005 and is required to be implemented by the Company from 1 August 2007. This new standard incorporates the disclosure requirements of IAS 32, which it supersedes, and adds further quantitative and qualitative disclosures in relation to financial instruments, and is not expected to have a material effect on the Group's disclosures.

'IFRIC 4 Determining whether an Arrangement contains a lease' was issued in December 2004 and is required to be implemented by the Company from 1 August 2006. The interpretation requires arrangements which may have the nature, but not the legal form, of a lease to be accounted for in accordance with 'IAS 17 Leases'. This interpretation is not expected to have a material 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 100 to 108.

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.

Significant judgements, key assumptions and estimates

An explanation of the significant judgements, key assumptions and estimates used in producing this set of financial statements is set out in the Operating and Financial Review on page 21.

Notes to the accounts

1 Segment information

Analysis by business segment

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

Period ended 5 August 2006

				Specialty Engineering		
	Aerospace £m	Detection £m	Medical £m	John Crane £m	Specialty – Other £m	Total £m
Revenue	**1,299.7**	**411.8**	**737.0**	**518.4**	**556.0**	**3,522.9**
Headline operating profit	**152.4**	**76.5**	**137.5**	**69.4**	**84.0**	**519.8**
Exceptional operating items	**(1.7)**	**5.4**	**(17.2)**	**5.6**	**(6.6)**	**(14.5)**
Amortisation of acquired intangible assets	**(3.9)**	**(0.4)**	**(11.2)**	**(0.3)**	**(1.1)**	**(16.9)**
Financing losses	**(1.0)**	**(0.3)**	**(0.6)**	**(0.4)**	**(0.5)**	**(2.8)**
	145.8	**81.2**	**108.5**	**74.3**	**75.8**	**485.6**
Impairment of financial assets						**(325.0)**
Operating profit						**160.6**
Net finance costs						**(27.1)**
Share of post-tax losses of associated companies						**(1.1)**
Profit before taxation						**132.4**
Taxation						**(108.2)**
Profit for the period						**24.2**

Year ended 31 July 2005

				Specialty Engineering		
	Aerospace £m	Detection £m	Medical £m	John Crane £m	Specialty – Other £m	Total £m
Revenue	1,146.2	366.5	563.3	463.2	466.2	3,005.4
Headline operating profit	132.4	69.0	87.7	62.5	64.1	415.7
Exceptional operating items	(11.4)		(25.3)	2.4	6.3	(28.0)
Amortisation of acquired intangible assets	(1.1)		(4.6)			(5.7)
Operating profit	119.9	69.0	57.8	64.9	70.4	382.0
Net finance costs						(16.1)
Profit before taxation						365.9
Taxation						(94.1)
Profit for the year						271.8

The Group's revenue is analysed as follows:

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Sale of goods	**3,240.9**	2,797.4
Construction contracts	**218.0**	160.0
Services	**64.0**	48.0
	3,522.9	3,005.4

1 Segment information continued

The following table provides information relating to depreciation, amortisation and other significant non-cash expenditures (excluding impairments) included in the divisional operating costs above:

	Period ended 5 August 2006				Year ended 31 July 2005			
	Depreciation £m	Amortisation £m	Goodwill and other asset impairments £m	Other non-cash expenses (excluding impairments) £m	Depreciation £m	Amortisation £m	Goodwill impairment £m	Other non-cash expenses (excluding impairments) £m
Aerospace	**28.2**	**19.4**		**6.0**	28.9	16.8	11.4	2.4
Detection	**6.6**	**1.9**		**1.9**	6.1	1.3		0.7
Medical	**24.2**	**15.5**	**1.8**	**3.4**	15.5	7.7		15.2
Specialty Engineering:								
John Crane	**10.0**	**1.2**		**2.4**	9.8	1.2		1.0
Specialty – Other	**10.2**	**1.6**		**2.6**	11.4	0.7		1.0
	79.2	**39.6**	**1.8**	**16.3**	71.7	27.7	11.4	20.3

The table above excludes £325m of impairment charges not allocated to divisions.

Capital expenditure

(Comprises additions of property, plant and equipment and intangible assets.)

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Aerospace	**169.9**	113.7
Detection	**10.9**	14.4
Medical	**37.9**	31.8
Specialty Engineering:		
John Crane	**17.1**	11.9
Specialty – Other	**17.1**	10.5
	252.9	182.3

Balance sheet

	2006 £m	2005 £m
Assets		
Aerospace	**1,213.1**	1,177.0
Detection	**558.0**	526.9
Medical	**885.8**	978.0
Specialty Engineering:		
John Crane	**265.4**	263.7
Specialty – Other	**391.2**	354.0
Operating assets by segment	**3,313.5**	3,299.6
Unallocated corporate assets*	**337.6**	575.2
Cash and cash equivalents	**120.6**	60.9
Total assets	**3,771.7**	3,935.7
Liabilities		
Aerospace	**424.6**	425.5
Detection	**143.9**	118.6
Medical	**120.0**	139.4
Specialty Engineering:		
John Crane	**141.2**	141.1
Specialty – Other	**117.0**	91.5
Operating liabilities by segment	**946.7**	916.1
Unallocated corporate liabilities*	**414.8**	544.1
Borrowings	**1,047.3**	991.7
Total liabilities	**2,408.8**	2,451.9

*Unallocated corporate assets and liabilities comprise assets and liabilities not directly attributable to the operating activities.

1 Segment information continued

Analysis by geographical location

The Group's revenue by destination is shown below:

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
United Kingdom	**330.5**	310.0
North America	**2,062.4**	1,699.2
Europe	**617.7**	531.4
Other overseas	**512.3**	464.8
	3,522.9	3,005.4

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

	Segment assets	Segment assets	Additions to intangible assets and property, plant and equipment	
	2006 £m	2005 £m	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
United Kingdom	**831.3**	999.9	**68.5**	48.9
North America	**2,096.2**	2,236.8	**164.1**	110.5
Europe	**568.3**	512.3	**11.4**	14.2
Other overseas	**155.3**	125.8	**8.9**	8.7
	3,651.1	3,874.8	**252.9**	182.3
Cash and cash equivalents	**120.6**	60.9		
	3,771.7	3,935.7	**252.9**	182.3

2 Operating profit is after charging

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Employee costs (note 10)	**1,094.0**	971.9
Depreciation of property, plant and equipment (including impairment in 2006: £1.8m)	**81.0**	71.7
Amortisation of intangible assets	**39.6**	27.7
Impairment of goodwill		11.4
Impairment losses recognised in the period on receivables	**1.2**	1.4
Research and development expense	**108.4**	101.0
Operating leases		
– land and buildings	**22.2**	21.9
– other	**8.8**	8.1
Fair value movements on derivatives		
– embedded	**3.4**	
– held for trading	**(0.6)**	
Amounts paid to PricewaterhouseCoopers:		
Audit fees (including £0.1m (2005: £0.1m) for Parent Company)	**4.7**	4.2
Audit related services	**0.5**	0.8
Other assurance services		
– due diligence		0.9
– vendor assistance	**0.1**	
– other	**0.3**	0.4
Taxation		
– compliance services	**0.4**	0.3
– advisory services	**0.3**	0.5
Other fees	**0.1**	0.1

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. Normal restructuring costs are charged against profits.

The following items have been excluded from the headline measure:

- exceptional items including impairments (note 4);
- 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 – these represent the results of derivatives and other financial instruments which do not fall to be hedge accounted under IAS 39 and do not form part of the Group's financing strategy. These items are included either within operating profit or profit before taxation depending on the nature of the transaction. The application of IFRS accounting principles makes this item potentially volatile, and it is therefore excluded to give a clearer picture of the underlying performance.

4 Exceptional operating 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 within the line 'exceptional operating items'. 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
- significant goodwill or other asset impairments.

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

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Integration of acquisitions	**(18.7)**	(10.4)
Patent dispute settlement		(14.9)
Class action settlement	**(12.2)**	
Profit on disposal of businesses (note 29)	**16.4**	8.7
Impairment of goodwill		(11.4)
	(14.5)	(28.0)

Period ended 5 August 2006

Restructuring costs in connection with the integration of Medex amounting to £18.7m (2005: £10.4m) have been incurred in the period.

Along with three other companies, Titeflex Corporation, a US subsidiary, has settled an industry-wide class action with respect to its corrugated stainless steel tubing product in the US. The settlement is a compromise of disputed claims and does not imply any admission of liability. The company stands by the safety of this product, and has entered into this agreement solely to avoid the future expense, disruption and burden of protracted litigation. The exceptional charge of £12.2m covers all legal fees and administrative costs, and an estimate for a contribution to certain homeowners towards remedial costs connected with the tubing.

Profit on disposal of businesses includes £11.2m relating to the release of provisions and accruals made in respect of prior-year disposals, the warranties and attendant issues for which they were created having been satisfactorily resolved.

Year ended 31 July 2005

£14.9m was charged to exceptional operating items in respect of a patent dispute relating to the Cozmonitor insulin pump.

Profit on disposal of businesses of £8.7m included a total of £12.1m arising from settlement and curtailment gains in respect of pension and other retirement benefits. In addition, two small product lines with a net asset value of £2.6m were sold during 2005 for net cash proceeds of £0.5m. This gave rise to a loss of £3.4m after provisions in the year ended 31 July 2005.

£11.4m was charged to exceptional operating items in relation to the impairment of goodwill in respect of an Aerospace business acquired in 2000.

5 Net finance costs

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Interest receivable	**4.2**	15.0
Interest payable		
– bank loans and overdrafts repayable within five years	**(29.8)**	(11.1)
– other loans repayable within five years	**(1.9)**	(7.7)
– other loans repayable in more than five years	**(26.7)**	(19.4)
Interest payable	**(58.4)**	(38.2)
Other financing gains		
– fair value gain on debt	**3.1**	
– fair value losses on fair value hedge	**(3.1)**	
– net foreign exchange gains	**(0.5)**	(4.2)
Other financing gains	**(0.5)**	(4.2)
Retirement benefits		
– return on plan assets	**185.7**	170.5
– interest cost	**(158.1)**	(159.2)
Retirement benefits	**27.6**	11.3
Net finance costs	**(27.1)**	(16.1)

6 Taxation

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
The taxation charge for the year comprises		
– current income taxation	**93.5**	101.2
– deferred taxation	**14.7**	(7.1)
Total taxation expense in the income statement	**108.2**	94.1
Current income taxation		
– UK corporation tax		(7.4)
– foreign tax	**93.5**	108.6
	93.5	101.2

Reconciliation of the total tax charge
The tax expense on the profit for the year is different from the standard rate of corporation tax in the UK of 30% (2005: 30%). The difference is reconciled as follows:

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Profit before tax	**132.4**	365.9
Notional taxation expense at UK rate of 30% (2005: 30%)	**39.7**	109.8
Effect of overseas taxation	**(9.2)**	1.4
Local incentives	**(15.1)**	(15.2)
Impairment of financial asset	**97.5**	
Tax effect of other non-headline items	**(7.5)**	(1.3)
Other	**2.8**	(0.6)
Total taxation expense in the income statement	**108.2**	94.1
Comprising		
– taxation on headline profit	**126.0**	106.8
– tax relief on non-headline loss	**(17.8)**	(12.7)
	108.2	94.1

6 Taxation continued

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Tax on items charged to equity		
Current tax charge/(credit) on exchange movements offset in reserves		
– exchange gains		(5.9)
Deferred tax charge/(credit)		
– retirement benefit schemes	**24.0**	(11.8)
– share based payment	**2.6**	(16.0)
– derivatives	**7.4**	
	34.0	(27.8)

Deferred Taxation

	Excess tax depreciation on fixed assets and goodwill £m	Share based payments £m	Retirement benefit obligations £m	Capitalised development expenditure £m	Other £m	Total £m
At 1 August 2004	(58.5)	4.4	85.2	(21.9)	54.9	64.1
(Charge)/credit to income statement	(2.0)	1.9	(9.0)	(11.7)	27.9	7.1
Credit to equity		16.0	11.8			27.8
Other					(17.2)	(17.2)
Disposals			(4.1)			(4.1)
Acquisitions					15.3	15.3
Exchange adjustments	(1.6)		3.0		3.5	4.9
At 1 August 2005	(62.1)	22.3	86.9	(33.6)	84.4	97.9
Deferred tax assets	(61.1)	22.3	86.9	(33.6)	103.3	117.8
Deferred tax liabilities	(1.0)				(18.9)	(19.9)
At 1 August 2005	(62.1)	22.3	86.9	(33.6)	84.4	97.9
(Charge)/credit to income statement	10.8	4.8	(25.5)	19.9	(24.7)	(14.7)
Charge to equity		(2.6)	(24.0)		(7.4)	(34.0)
Other					(0.8)	(0.8)
Exchange adjustments	5.4		(4.7)	1.9	(8.4)	(5.8)
At 5 August 2006	**(45.9)**	**24.5**	**32.7**	**(11.8)**	**43.1**	**42.6**
Deferred tax assets	(41.3)		55.2	(1.4)	79.8	92.3
Deferred tax liabilities	(4.6)	24.5	(22.5)	(10.4)	(36.7)	(49.7)
At 5 August 2006	**(45.9)**	**24.5**	**32.7**	**(11.8)**	**43.1**	**42.6**

Included in other above is a deferred tax liability of £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.

The Group has not recognised deferred tax assets of £205m (2005: £186m) relating to tax losses, due to uncertainty as to their recoverability. The Group's capital losses and other temporary differences have no expiry date restrictions. The expiry date of operating losses carried forward is dependent upon the tax 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

	2006 £m	Expiry of losses
Territory		
– Americas	**26.0**	2018 – 2025
– Europe	**4.2**	2014 – 2024
Total restricted losses	**30.2**	
Unrestricted losses:		
– operating losses	**28.2**	No expiry
– capital losses	**128.4**	No expiry
– other	**18.4**	No expiry
Total unrestricted losses	**175.0**	
Total	**205.2**	

7 Dividends

The following dividends were declared and paid in the period:

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Ordinary final dividend of 19.75p for 2005 (2004: 18.25p) paid 18 November 2005	**111.3**	102.5
Ordinary interim dividend of 9.85p for 2006 (2005: 9.25p) paid 21 April 2006	**55.7**	52.0
	167.0	154.5

The final dividend for the period ended 5 August 2006 of 21.5p per share was declared by the Board on 27 September 2006 and will be paid to shareholders on 24 November 2006. 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 3 November 2006.

8 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 period.

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Profit for the period	**24.2**	271.8
Average number of shares in issue during the period	**565,359,484**	562,445,323

Diluted earnings per share are calculated by dividing the profit attributable to ordinary shareholders by 569,733,560 (2005: 563,667,777) ordinary shares, being the average number of ordinary shares in issue during the period adjusted by the dilutive effect of share options.

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

	Period ended 5 August 2006		Year ended 31 July 2005	
	£m	EPS (p)	£m	EPS (p)
Profit attributable to equity shareholders of the Parent Company	**24.2**	**4.3**	271.8	48.3
Exclude				
– integration of acquisitions	**18.7**		10.4	
– disposal of businesses	**(16.4)**		(8.7)	
– patent dispute settlement			14.9	
– class action settlement	**12.2**			
– impairment of goodwill			11.4	
– amortisation of acquired intangible assets	**16.9**		5.7	
– financing losses – charged to administrative expenses	**2.8**			
– charged to financing	**0.5**		4.2	
– impairment of financial asset	**325.0**			
	359.7		37.9	
– less tax	**(17.8)**		(12.7)	
	341.9	**60.5**	25.2	4.5
Headline	**366.1**	**64.8**	297.0	52.8
Headline EPS – diluted (p)		**64.3**		52.7

9 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 are of the defined benefit type, with assets held in separate trustee-administered funds.

Pension costs are assessed in accordance with the advice of independent, professionally qualified actuaries. The Group accounts for its pension and other post-retirement benefit costs, principally post-retirement healthcare, in accordance with 'IAS 19 Employee Benefits'. 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 6 principal US pension and post-retirement healthcare plans were performed at 1 January 2005. These valuations have been updated by independent qualified actuaries for the purposes of IAS 19 in order to assess the liabilities of the schemes as at 5 August 2006. Scheme assets are stated at their market values at 5 August 2006.

Contributions to these 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 Group provides a defined contribution (401K) plan for its US employees.

The disclosures relate to all defined benefit retirement plans in the United Kingdom and the United States. There are also abbreviated disclosures for other countries. Defined benefit plans in other territories which are not covered under this disclosure (on grounds of immateriality), most of which are unfunded, have net pension liabilities of £7.5m (2005: £7.1m). These are reported within other creditors.

UK and USA

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

		2006		2005
	UK	US	UK	US
Rate of increase in salaries	**3.8%**	**3.8%**	3.4%	3.75%
Rate of increase in pensions in payment	**2.7%**	**n/a**	2.5%	n/a
Rate of increase in deferred pensions	**2.8%**	**n/a**	2.4%	n/a
Discount rate	**5.3%**	**6.2%**	5.0%	5.50%
Inflation rate	**2.8%**	**2.8%**	2.4%	2.75%
Healthcare cost increases	**5.0%**	*	5.0%	**

*9% p.a. reducing 1% p.a. to 5% in 2011

**9% p.a. reducing 1% p.a. to 5% in 2010

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.

The mortality assumptions used in the UK schemes are based on the recent actual mortality experience of members within each scheme and the assumptions also allow for future mortality improvements. The assumptions are that a member who retires in 2013 at age 65 will live on average for a further 21 years after retirement if they are male and for a further 24 years after retirement if they are female.

The mortality table used for the US retirement plans is based on the most recent mortality study produced for retired pensioners in the US (the RP 2000 table). The table selected allows for future mortality improvements and applies an adjustment for job classification (blue versus white collar). If a participant retires in 2013 at age 65, it is expected that they will live 19 years if male, and 21 years if female.

The assets in the scheme and the expected rates of return as at 5 August 2006 were:

				2006				2005
		UK schemes		US schemes		UK schemes		US schemes
	Long-term rate of return	Value £m	Long-term rate of return	Value £m	Long-term rate of return	Value £m	Long-term rate of return	Value £m
Equities	**8.0%**	**1,513.2**	**8.8%**	**212.3**	8.0%	1,324.0	8.8%	215.2
Government bonds	**4.9%**	**720.2**	**5.1%**	**76.2**	4.7%	673.2	4.5%	71.7
Corporate bonds	**5.3%**	**248.1**	**6.2%**	**42.1**	5.0%	294.5	5.5%	27.3
Property	**7.0%**	**162.1**	**n/a**	**n/a**	7.0%	131.9	n/a	n/a
Other	**4.8%**	**126.8**	**5.0%**	**2.2**	4.8%	123.3	3.0%	29.7
Total market value		**2,770.4**		**332.8**		2,546.9		343.9
Present value of funded pension scheme liabilities		**(2,630.1)**		**(394.3)**		(2,529.1)		(467.2)
Surplus/(deficit)		**140.3**		**(61.5)**		17.8		(123.3)
Unfunded pension plans		**(31.9)**		**(4.3)**		(31.8)		(4.7)
Post-retirement healthcare		**(17.0)**		**(64.5)**		(17.9)		(76.7)
Net pension asset/(liability)		**91.4**		**(130.3)**		(31.9)		(204.7)

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.

9 Post-retirement benefits continued

The effect of retirement benefits calculated in accordance with IAS 19 is included in the financial statements as follows:

Amounts recognised in the income statement

	Period ended 5 August 2006			Year ended 31 July 2005		
	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	UK & US £m	UK £m	US £m	UK & US £m
Amounts charged to operating profit						
Current service cost	**33.9**	**17.5**	**2.7**	22.7	11.9	2.5
Past service cost	**0.2**	**0.1**			0.5	0.4
Settlement gains on disposal of Polymer Sealing Solutions				(6.3)		
Curtailment gains on other disposals					(1.3)	(4.5)
Total operating charge/(credit)	**34.1**	**17.6**	**2.7**	16.4	11.1	(1.6)
Amounts (credited)/charged to other finance charges						
Expected return on pension scheme assets	**(161.5)**	**(23.9)**		(148.6)	(21.9)	
Interest on pension scheme liabilities	**124.5**	**25.8**	**6.9**	129.3	22.8	7.1
Net return	**(37.0)**	**1.9**	**6.9**	(19.3)	0.9	7.1
Total charged/(credited) to income statement	**(2.9)**	**19.5**	**9.6**	(2.9)	12.0	5.5

The actual return on scheme assets was £261.9m (2005: £413.1m).

The operating cost is charged as follows:

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Cost of sales	**24.8**	23.0
Sales and distribution costs	**6.9**	4.8
Administrative expenses	**22.7**	10.2

Actuarial gains of £95.9m (2005: losses of £23.4m) have been reported in the statement of recognised income and expense. Cumulative actuarial gains from 1 August 2004 reported in the statement of recognised income and expense are £72.5m (2004: losses of £23.4m).

Amounts recognised in the balance sheet

	2006			2005		
	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	UK & US £m	UK £m	US £m	UK & US £m
Present value of funded obligations	**(2,630.1)**	**(394.3)**		(2,529.1)	(467.2)	
Fair value of scheme assets	**2,770.4**	**332.8**		2,546.9	343.9	
	140.3	**(61.5)**		17.8	(123.3)	
Present value of unfunded obligations			**(117.7)**			(131.1)
Net asset/(liability) recognised in the balance sheet	**140.3**	**(61.5)**	**(117.7)**	17.8	(123.3)	(131.1)

9 Post-retirement benefits continued

Changes in present value of defined benefit obligations

	2006			2005		
	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	UK & US £m	UK £m	US £m	UK & US £m
At 1 August	**(2,529.1)**	**(467.2)**	**(131.1)**	(2,320.0)	(366.1)	(119.2)
Current service cost	**(33.9)**	**(17.5)**	**(2.7)**	(22.7)	(11.9)	(2.5)
Interest on obligations	**(124.5)**	**(25.8)**	**(6.9)**	(129.3)	(22.8)	(7.1)
Employee contributions	**(2.5)**			(10.5)		
Past service cost	**(0.2)**	**(0.1)**			(0.5)	(0.4)
Actuarial (loss)/gain on liabilities	**(57.0)**	**65.6**	**10.8**	(191.0)	(65.5)	(9.8)
Curtailment gain					1.3	4.5
Liabilities extinguished on settlements				32.0		
Exchange adjustments	**0.2**	**34.1**	**5.8**	(0.1)	(16.8)	(2.8)
Benefits paid	**116.9**	**16.6**	**6.4**	112.5	15.1	6.2
At 5 August/31 July	**(2,630.1)**	**(394.3)**	**(117.7)**	(2,529.1)	(467.2)	(131.1)

Changes in present value of scheme assets

	2006			2005		
	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	UK & US £m	UK £m	US £m	UK & US £m
At 1 August	**2,546.9**	**343.9**		2,260.5	295.7	
Expected return on assets	**161.5**	**23.9**		148.6	21.9	
Actuarial gains on scheme assets	**77.1**	**(0.6)**		225.2	17.7	
Contributions by employer	**99.5**	**10.1**	**6.4**	40.2	11.9	6.2
Contributions by scheme participants	**2.5**			10.5		
Assets distributed on settlements				(25.7)		
Exchange adjustments	**(0.2)**	**(27.9)**		0.1	11.8	
Benefits paid	**(116.9)**	**(16.6)**	**(6.4)**	(112.5)	(15.1)	(6.2)
At 5 August/31 July	**2,770.4**	**332.8**		2,546.9	343.9	

Cash contributions

Company contributions to the funded defined benefit pension plans for 2006 totalled £109.6m (2005: £52.1m) and included a £61m special contribution to the Smiths Industries Pension Scheme. Cash payments in 2007 will be about £50m.

9 Post-retirement benefits continued

History of schemes

The history of the schemes for the current and prior year is as follows:

	2006 £m	2005 £m
Balance sheet		
Present value of defined benefit obligation	**(3,142.1)**	(3,127.4)
Fair value of scheme assets	**3,103.2**	2,890.8
Deficit	**(38.9)**	(236.6)

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Experience gains/(losses)		
Experience losses on scheme liabilities	**19.4**	(266.3)
Experience gains on scheme assets	**76.5**	242.9

The Group has early adopted the amendments to 'IAS 19 Employee Benefits'

A one percentage point change in assumed healthcare cost trend rates would have the following effects:

	One percentage point increase £m	One percentage point decrease £m
Effect on the aggregate of service cost and interest cost	0.8	(0.7)
Effect on defined benefit obligations	9.6	(8.0)

Other countries

The disclosures for other countries are reduced reflecting the materiality of the Company's obligations relative to those in the UK and USA.

The total charged to the income statement was £1.7m (2005: £1.7m). Of this, £1.1m (2005: £1.7m) was recorded as an operating charge and £0.6m (2005: £nil) as a finance charge.

Actuarial losses of £1.4m (2005: n/a) have been reported in the statement of recognised income and expense. Cumulative actuarial losses from 1 August 2004 are also £1.4m.

The amount recognised on the balance sheet was a liability of £13.2m (2005: £11.3m). This includes £4.1m (2005: £3.2m) in relation to funded schemes.

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 £16.9m (2005: £12.8m).

Balance sheet reconciliation

At 5 August 2006, the net UK funded pension surplus of £140.3m (2005: £17.8m), represented individual plan surpluses of £183.7m (2005: £134.6m) and deficits of £43.4m (2005: £116.8m).

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

	2006 £m	2005 £m
UK surplus	**140.3**	17.8
US deficit	**(61.5)**	(123.3)
Unfunded	**(117.7)**	(131.1)
Other countries*	**(13.2)**	
	(52.1)	(236.6)
Post-retirement assets	**183.7**	134.6
Post-retirement liabilities	**(235.8)**	(371.2)
	(52.1)	(236.6)

*In 2005, post-retirement obligations outside the UK and US (£11.3m) were reported as other creditors.

10 Employees

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Staff costs during the period		
Wages and salaries	**910.2**	824.9
Social security	**95.1**	83.8
Share-based payment (note 30)	**16.3**	6.3
Pension costs (including defined contribution schemes) (note 9)	**72.4**	56.9
	1,094.0	971.9

The average number of persons employed was:

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Aerospace	**10,891**	10,291
Detection	**1,909**	1,906
Medical	**7,413**	6,041
Specialty Engineering:		
Technology Group	**5,158**	4,243
John Crane Group	**5,953**	6,028
	31,324	28,509

Details of directors' remuneration are given on pages 40 to 47.

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 40 to 47.

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Key management compensation		
Salaries and short-term employee benefits	**6.5**	7.4
Cost of post-retirement benefits	**1.4**	1.5
Cost of share-based incentive plans	**4.7**	5.8

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:

	Period ended 5 August 2006		Year ended 31 July 2005	
	Number of instruments '000	Weighted average price	Number of instruments '000	Weighted average price
CIP	**333**	**£0.000**		
DSS	**274**	**£0.001**	345	£0.001
ESOS	**2,021**	**£7.096**	2,688	£7.334
PSP	**904**	**£0.000**	484	£0.000
SAYE	**11**	**£5.966**	15	£5.884
TI 90 ESOS	**153**	**£10.759**	230	£10.236
TI 99 ESOS			123	£9.072

11 Intangible assets

	Goodwill £m	Development costs £m	Acquired intangibles** (see below) £m	Other £m	Total £m
Cost					
At 1 August 2004	856.0	130.4		52.4	1,038.8
Adjustments to prior year acquisitions	1.2				1.2
Exchange adjustments	52.7	8.8	10.3	2.9	74.7
Business combinations	386.2		125.3		511.5
Additions at cost		59.5		22.9	82.4
At 31 July 2005	1,296.1	198.7	135.6	78.2	1,708.6
Adjustments to prior year acquisitions	(1.9)		1.9		
Exchange adjustments	(83.2)	(13.6)	(11.7)	(6.3)	(114.8)
Transfers		0.4		7.1	7.5
Business combinations	30.6		13.3		43.9
Additions at cost		108.2		33.5	141.7
At 5 August 2006	**1,241.6**	**293.7**	**139.1**	**112.5**	**1,786.9**
Amortisation*					
At 1 August 2004	127.8	13.8		39.8	181.4
Exchange adjustments	4.3	0.7		1.4	6.4
Charge for the year		12.5	5.7	9.5	27.7
Impairment losses	11.4				11.4
At 31 July 2005	143.5	27.0	5.7	50.7	226.9
Exchange adjustments	(9.8)	(1.2)	(2.4)	(3.1)	(16.5)
Transfers				6.3	6.3
Charge for the period		13.7	16.9	9.0	39.6
At 5 August 2006	**133.7**	**39.5**	**20.2**	**62.9**	**256.3**
Net book value at 5 August 2006	**1,107.9**	**254.2**	**118.9**	**49.6**	**1,530.6**
Net book value at 1 August 2005	1,152.6	171.7	129.9	27.5	1,481.7
Net book value at 1 August 2004	728.2	116.6		12.6	857.4

*Amortisation is included in cost of sales/administrative expenses in the income statement.

**In addition to goodwill, the acquired intangible assets comprise:

	Patents, licences and trademarks £m	Technology £m	Customer relationships £m	Total £m
Cost				
At 1 August 2004				
Exchange adjustments	3.4	4.9	2.0	10.3
Business combinations	38.2	54.3	32.8	125.3
At 31 July 2005	41.6	59.2	34.8	135.6
Adjustments to prior year acquisitions			1.9	1.9
Exchange adjustments	(3.2)	(5.0)	(3.5)	(11.7)
Business combinations (see note 28)	0.5	4.4	8.4	13.3
At 5 August 2006	**38.9**	**58.6**	**41.6**	**139.1**
Amortisation				
At 1 August 2004				
Charge for the year	0.8	1.8	3.1	5.7
At 31 July 2005	0.8	1.8	3.1	5.7
Exchange adjustments	(0.2)	(0.5)	(1.7)	(2.4)
Charge for the period	2.8	5.6	8.5	16.9
At 5 August 2006	**3.4**	**6.9**	**9.9**	**20.2**
Net book value at 5 August 2006	**35.5**	**51.7**	**31.7**	**118.9**
Net book value at 1 August 2005	40.8	57.4	31.7	129.9

The 2005 impairment charge of £11.4m in relation to the Aerospace business was calculated using value in use. The value in use calculation determined the net present value of the projected risk-adjusted, post-tax cash-flows of the cash generating unit, applying a discount rate of the Group's post-tax weighted average cost of capital of 8%. This approximates to applying a pre-tax discount rate to pre-tax cash-flows. This charge was reflected in operating profit for the Aerospace division.

11 Intangible assets continued

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 of the Group's post-tax weighted average cost of capital of 8%. 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.

Goodwill held in the Smiths Medical Critical Care and Imaging Systems CGUs, comprising £302.5m and £215.6m at net book value respectively, are considered significant in comparison to the total carrying value of goodwill at 5 August 2006. The following key assumptions were used in the discounted cash-flow projections for the Smiths Medical Critical Care and Heimann CGUs:

- growth rates of 2% have been used for the Smiths Medical Critical Care and Imaging Systems 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 precesses 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 Smiths Medical Critical Care and Imaging Systems 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 growth rates and margins used in the discounted cash-flow forecasts are based on 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 reasonably possible changes in key assumptions would cause the carrying amount of the Smiths Medical Critical Care and Imaging Systems CGUs to exceed their respective recoverable amount.

12 Property, plant and equipment

	Land and buildings £m	Plant and machinery £m	Fixtures, fittings, tools and equipment £m	Total £m
Cost or valuation				
At 1 August 2004	235.2	542.9	333.5	1,111.6
Exchange adjustments	7.4	18.4	8.3	34.1
Additions	12.4	63.0	24.5	99.9
Acquisitions	15.8	35.7	6.6	58.1
Disposals	(13.3)	(27.4)	(30.7)	(71.4)
Business disposals		(3.3)	(0.4)	(3.7)
At 31 July 2005	257.5	629.3	341.8	1,228.6
Transfers			(7.5)	(7.5)
Exchange adjustments	(10.4)	(33.8)	(12.9)	(57.1)
Additions	7.8	72.9	30.5	111.2
Acquisitions	0.2	1.1	0.3	1.6
Disposals	(6.8)	(9.7)	(11.1)	(27.6)
Business disposals	(3.2)	(6.8)	(3.8)	(13.8)
At 5 August 2006	**245.1**	**653.0**	**337.3**	**1,235.4**
Depreciation				
At 1 August 2004	75.7	375.5	249.0	700.2
Exchange adjustments	2.4	10.4	6.1	18.9
Charge for the year	9.3	36.1	26.3	71.7
Disposals	(7.3)	(26.5)	(28.6)	(62.4)
Business disposals		(2.3)	(0.3)	(2.6)
At 31 July 2005	80.1	393.2	252.5	725.8
Transfers			(6.3)	(6.3)
Exchange adjustments	(4.1)	(20.1)	(10.9)	(35.1)
Charge for the period	4.9	45.8	28.5	79.2
Impairment charge	0.5	1.0	0.3	1.8
Disposals	(2.3)	(8.2)	(9.3)	(19.8)
Business disposals	(0.8)	(4.7)	(2.5)	(8.0)
At 5 August 2006	**78.3**	**407.0**	**252.3**	**737.6**
Net book value at 5 August 2006	**166.8**	**246.0**	**85.0**	**497.8**
Net book value at 1 August 2005	177.4	236.1	89.3	502.8
Net book value at 1 August 2004	159.5	167.4	84.5	411.4

The impairment charge of £1.8m for the period ended 5 August 2006 is for the impairment of property, plant and equipment in respect of the closure of the manufacturing facility in Hythe, Kent.

	2006 £m	2005 £m
Capital expenditure commitments – contracted but not provided for	**23.6**	21.2

13 Investment accounted for using the equity method

	£m
Investments in associated companies	
At 1 August 2005	
Acquisitions	**13.8**
Other movements	**2.3**
Share of results after tax	**(1.1)**
Foreign exchange adjustment	**(1.0)**
At 5 August 2006	**14.0**

13 Investment accounted for using the equity method continued

	Period ended 5 August 2006 £m
Group share of results of associated companies	
Revenue	**23.7**
Operating costs and other income	**(24.0)**
Profit before taxation	**(0.3)**
Taxation	**(0.8)**
Share of post-tax earnings from associated companies	**(1.1)**

Additions during 2006 comprised the Group's 43% interest in Cross Match Technologies, Inc, which was acquired in exchange for the Group's interest in Heimann Biometric Systems GmbH (see note 29).

Net assets and liabilities of associated companies

	2006 £m
Non-current assets	**42.9**
Current assets	**32.5**
Total assets	**75.4**
Non-current liabilities	**(4.2)**
Current liabilities	**(13.6)**
Total liabilities	**(17.8)**
Net assets	**57.6**

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 43%.

14 Non-current financial assets

	2006 £m	2005 £m
TI Automotive Limited preference shares		
– at 1 August 2005	**325.0**	325.0
– impairment charged in period	**(325.0)**	
		325.0
Other trade investments	**0.8**	3.5
	0.8	328.5

TI Automotive Limited preference shares arose from the demerger of the former Automotive Systems division from the Group, and are held at cost. They carry a fixed cumulative preference dividend at the rate of 15% per annum. One-third of the dividend is payable on 25 July each year, subject to certain financial conditions having been met. To date, these conditions have not been met, and no dividends have been paid. The preference shares are redeemable, together with unpaid dividends, following full repayment of the outstanding liabilities of TI Automotive Limited under its bank facilities. No dividend accrual has been recognised as at 5 August 2006.

Recognising continued deterioration in the automotive market, particularly in the US, an impairment review of the preference share investment in TI Automotive has been undertaken, as required by IAS 39.

The preference shares have not yet borne any dividends and it is considered unlikely that dividends will be paid in the foreseeable future. Similarly there is no current prospect of the preference share interest being redeemed. The directors have also considered the possibility that cash flows could accrue from the investment in TI Automotive in the event that the enterprise is sold; such a sale is not currently considered sufficiently probable to take into account any cash flows which could accrue in such an event.

As a result, the directors have decided to write down the carrying value of the investment in the TI Automotive preference shares from £325m to nil value in these accounts.

The Company also holds 19.99% of the issued ordinary share capital of TI Automotive Limited. The shares confer 19.99% of the voting rights attaching to ordinary shares, and additionally confer the right to appoint the Chairman and to benefit from compulsory transfer provisions which oblige the other shareholders to sell their shares to a purchaser making an offer accepted by Smiths subject to certain conditions. The ordinary shares are recorded at nil value in these accounts.

15 Inventories

	2006 £m	2005 £m
Inventories comprise		
Raw materials and consumables	**164.7**	161.3
Work in progress	**196.3**	190.6
Finished goods	**218.8**	234.4
	579.8	586.3
Less: payments on account	**(21.4)**	(22.1)
	558.4	564.2

The Group consumed £2,348.3m (2005: £2,038.1m) of inventories during the period. £19.0m (2005: £4.5m) was recognised as an expense resulting from the write down of inventory and £5.8m (2005: nil) released to the income statement from inventory provisions charged in earlier years but no longer required.

16 Trade and other receivables

	2006 £m	2005 £m
Non-current		
Trade receivables	**9.8**	7.2
Prepayments and accrued income	**1.8**	2.3
Other debtors	**5.2**	15.2
	16.8	24.7
Current		
Long-term contract balances	**126.2**	100.5
Less: attributable progress payments	**(120.5)**	(84.9)
Amounts due from customers for contract work	**5.7**	15.6
Trade receivables	**657.3**	652.9
Other debtors	**9.5**	12.1
Prepayments and accrued income	**51.9**	39.9
	724.4	720.5

Trade receivables do not carry interest and are stated at their nominal value after deducting provisions for bad and doubtful debts of £16.3m (2005: £17.2m). 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. Management considers the carrying value of trade and other receivables approximates the fair value.

17 Cash and cash equivalents

	2006 £m	2005 £m
Cash at bank and in hand (including impact of cash pooling gross up: £83.6m)	**102.3**	51.1
Short-term deposits	**18.3**	9.8
Cash and cash equivalents per balance sheet	**120.6**	60.9
Bank overdrafts	**(171.7)**	(49.0)
Cash and cash equivalents	**(51.1)**	11.9

Cash and cash equivalents include highly liquid investments with maturities of three months or less. £10.7m of the Company's cash and cash equivalents are held as collateral for unfunded pension liabilities (see note 23 – Contingent liabilities and commitments).

18 Trade and other payables

	2006 £m	2005 £m
Non-current		
Other creditors	**114.8**	133.2
Current		
Trade creditors	**252.2**	214.7
Bills of exchange payable	**3.3**	2.7
Other creditors	**63.0**	49.9
Other taxation and social security costs	**23.0**	23.7
Accruals and deferred income	**358.0**	393.6
	699.5	684.6

19 Borrowings and net debt

This note sets out the calculation of net debt, a measure considered important in explaining our financing position. As shown below, IAS 39 requires that the carrying value of borrowing includes accrued interest, and the fair value of any interest rate or currency swaps held to hedge the borrowings. The Company's measure of 'net debt' is a non-GAAP measure and is stated before these valuation adjustments.

	2006 £m	2005 £m
Cash and cash equivalents		
Net cash and deposits	**120.6**	60.9
Short-term borrowings		
Bank loans and overdrafts (including impact of cash pooling gross up: £83.6m)	**(174.1)**	(49.7)
Other loans	**(3.6)**	(4.3)
	(177.7)	(54.0)
Long-term borrowings		
7.875% Sterling Eurobond 2010	**(149.3)**	(149.1)
7.25% Sterling Eurobond 2016	**(148.5)**	(148.4)
5.45% US$ Private Placement 2013	**(131.0)**	(142.0)
Floating Rate Revolving Credit Facility 2011 (multi-currency)	**(354.6)**	(485.8)
EIB Sterling R. & D. Loan 2010	**(70.0)**	
Bank and other loans	**(12.7)**	(12.4)
	(866.1)	(937.7)
Borrowings	**(1,043.8)**	(991.7)
Net debt	**(923.2)**	(930.8)
Borrowings – valuation adjustments		
– interest accrual	**(7.3)**	
– fair value of swapped debt	**3.8**	
Total borrowings per balance sheet	**(1,047.3)**	(991.7)

Current assets
The weighted interest rate on net cash at 5 August 2006 was approximately 3.7% with rates ranging from 0% to 14%.

Short-term borrowings
The weighted interest rate on short-term borrowings at 5 August 2006 was approximately 5.2%.

Long-term borrowings
Loans due after one year are repayable over various periods as follows:

	2006 £m	2005 £m
Between one and two years	**(0.5)**	(0.3)
Between two and three years	**(0.6)**	(0.6)
Between three and four years	**(149.9)**	(0.3)
Between four and five years	**(425.1)**	(635.2)
After five years	**(290.0)**	(301.3)
	(866.1)	(937.7)

The loans repayable after five years carry interest at effective rates between 5% and 8%. The repayment dates range from 2011 to 2022. The average effective interest rate of all public bonds at 5 August 2006 was approximately 7.6% and £23.4m was charged to the Income Statement in this period. The weighted average cost of Smiths' total borrowings after currency and interest rate swaps at 5 August 2006 was 5.6%.

19 Borrowings and net debt continued

Secured loans

Loans amounting to £11.8m (2005: £12.4m) were secured by charges on freehold properties.

Borrowing facilities

To provide adequate liquidity committed unused credit facilities of at least £100m (or equivalent free cash) are maintained at all times. Liquidity in 2006 was provided by undrawn revolving credit facilities.

	2006 £m	2005 £m
Expiring within one year	**90.0**	40.0
Expiring between one and two years		
Expiring after two years	**305.0**	244.2
	395.0	284.2

20 Financial instruments

Financial risk management

The Group's international operations and debt financing expose it to a range of financial risks that include the effects of changes in debt market prices, foreign exchange rates, credit risks, liquidity and interest rates. The Group has in place risk management policies that seek to limit the adverse effects on the financial performance of the Group by using various instruments and techniques, including foreign currency derivatives, debt and other interest rate derivatives.

Risk management policies have been set by the Board. The Central Treasury function receives regular reports from all the businesses to enable prompt identification of financial risks so that appropriate actions may be taken. The treasury policy sets out specific guidelines to manage foreign exchange risks, interest rate risk, credit risk and the use of financial instruments to manage these.

a) Foreign exchange risk

The Group has transactional currency exposure arising from sales or purchases by businesses in currencies other than their functional currency. Under the Group's foreign exchange policy, such transactional exposures are hedged once they are certain or highly probable, mainly through the use of forward foreign exchange contracts.

The Group has a significant investment in overseas operations, particularly in the Americas, but to a lesser extent Europe and the rest of the world. As a result, the sterling value of the Group's balance sheet can be affected by movements in exchange rates. The Group therefore 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 either the local domestic markets or indirectly through the use of rolling annual forward foreign exchange contracts.

Based on the composition of net debt at 5 August 2006, a 10% appreciation in sterling against major currencies would result in a reduction in the Group's net debt of approximately £48m. A 10% weakening in sterling against major currencies would result in an increase in the Group's net debt of approximately £48m.

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 the fixed rate character of the underlying debt instrument, and partly through the use of interest rate swaps. Interest rate derivative instruments are accounted for as fair value or cash-flow hedges of the relevant assets or liabilities. At 5 August 2006 38% of the Group's gross borrowings were subject to fixed interest rates, post swaps.

Based on the composition of net debt and financing arrangements at 5 August 2006, and taking into consideration all fixed rate borrowings in place, a one percentage point (100 basis points) change in average floating interest rates would have a £6m impact on the Group's profit before tax.

c) Credit risk

Financial

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 expectations. Credit risk is mitigated by the Group's Board approved policy of only selecting counterparties with a strong investment graded long-term credit rating, 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 exposure with a single bank for deposits is £11m, whilst the maximum mark to market exposure for forward foreign exchange contracts at 5 August 2006 to a single bank was £12m.

The maximum credit risk exposure in the event of other parties failing to perform their obligations under financial assets totals £772m at 5 August 2006.

Operational

As tier one suppliers to aerospace manufacturers the Group may have substantial amounts outstanding with a single customer at any one time, the largest being Boeing and the Department of Defense. There are many advantages in these relationships and the credit risk is managed at a number of levels. Debtor days and overdue accounts are reported to divisional management who co-ordinate any action required and overall divisional performance is regularly reviewed by management. At 5 August 2006, the Aerospace business had trade receivables of £229m and £65m due from these two customers representing 10% of total trade receivables for the Group.

20 Financial instruments continued

d) Liquidity risk

The Group actively maintains committed facilities that are designed to ensure the Group has sufficient available funds for operations and planned expansions. During the period, the Group extended its principal credit facility (£660m revolving credit facility) to 2011 and entered into new facilities of £190m which, when taken together, were undrawn by £395m at 5 August 2006.

As at 5 August 2006 £18m was on deposit with various banks and in money market funds of which £16m was on deposit in the UK.

Fair value of financial assets and liabilities

The table below presents the carrying amounts under IFRS and the fair values of the Group's financial assets and financial liabilities at 5 August 2006. The carrying amounts at 31 July 2005 are presented on the UK GAAP basis applicable at that date rather than in accordance with IAS 32 and IAS 39 as described later in note 20.

The fair values of financial assets and financial liabilities are included at the amount 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 and assumptions were used to estimate the fair values:

- cash and cash equivalents – approximates to the carrying amount;
- short-term loans and overdrafts – approximates to the carrying amount because of the short maturity of these instruments;
- long-term loans – approximates to the carrying amount for floating rate debt [and quoted market prices of equivalent instruments for fixed rate debt];
- forward exchange contracts – based on market valuations at the balance sheet date;
- currency swaps – based on market valuations at the balance sheet date;
- interest rate instruments – based on the net present value of discounted cash-flows;
- embedded derivatives – based on the net present values of discounted cash-flows;
- preference shares – (see note 14 regarding impairment);
- receivables and payables – approximates to the carrying amount for both long term and short term;
- provisions – approximates to the carrying amount; and
- lease obligations – approximates to the carrying value.

Fair value of financial assets and financial liabilities

Borrowings are recorded initially at fair value and subsequently recorded at amortised cost, adjusted for fair value movements in respect of related fair value hedges.

	Net carrying amount 5 August 2006 £m	Estimated fair value 5 August 2006 £m
Financial assets		
Non-current		
Investment (associate)	14.0	14.0
Financial assets	0.8	0.8
Trade and other receivables	15.0	15.0
Financial derivatives	6.2	6.2
Current		
Cash and cash equivalents	120.6	120.6
Financial derivatives	26.1	26.1
Total financial assets	182.7	182.7
Financial liabilities		
Non-current		
Borrowings	(862.3)	(885.5)
Trade and other payables	(51.9)	(51.9)
Financial derivatives	(4.4)	(4.4)
Current		
Borrowings	(185.0)	(185.0)
Financial derivatives	(4.9)	(4.9)
Total financial liabilities	(1,108.5)	(1,131.7)
Total financial assets and liabilities	(925.8)	(949.0)

The table above excludes current trade and other receivables and payables of net £24.9m which fair value is approximate to carrying amount due to their short-term nature.

20 Financial instruments continued

Interest rate profiles of financial assets and liabilities

The following tables set out the exposure of financial assets and liabilities to either fixed interest rates, floating interest rates or no interest rates. The maturity profile of financial assets and liabilities exposed to interest rate risk in the tables below indicates the contractual repricing and maturity dates of these instruments.

At 5 August 2006	Investments £m	Financial assets £m	Cash and cash equivalents £m	Non-current receivables £m	Financial derivatives £m	**Total £m**
Financial assets						
Less than one year			112.5			**112.5**
Total interest earning			112.5			**112.5**
Analysed as						
– fixed rate interest						
– floating rate interest			112.5			**112.5**
Total interest earning			112.5			**112.5**
Non-interest earning	14.0	0.8	8.1	15.0	32.3	**70.2**
Total	14.0	0.8	120.6	15.0	32.3	**182.7**

At 5 August 2006	Borrowings £m	Non-current payables £m	Financial derivatives £m	**Total £m**
Financial liabilities				
Less than one year	(185.0)			**(185.0)**
Between one and two years	(0.5)			**(0.5)**
Between two and three years	(0.6)			**(0.6)**
Between three and four years	(149.9)			**(149.9)**
Between four and five years	(425.1)			**(425.1)**
Greater than five years	(286.2)			**(286.2)**
Total interest bearing	(1,047.3)			**(1,047.3)**
Analysed as				
– fixed rate interest (post interest rate swaps)	(366.1)			**(366.1)**
– floating rate interest	(681.2)			**(681.2)**
Total interest bearing	(1,047.3)			**(1,047.3)**
Non-interest bearing		(51.9)	(9.3)	**(61.2)**
Total	(1,047.3)	(51.9)	(9.3)	**(1,108.5)**

The maturity analysis of interest earning financial assets and the maturity analysis of the interest bearing financial liabilities is equivalent to the maturity analysis presented in the interest rate profile table above.

Currency profiles of financial assets and liabilities

The table below sets out the currency exposures on financial assets and liabilities held in currencies other than the functional currencies of Group companies after the effect of currency swaps.

At 5 August 2006	Sterling £m	US$ £m	Euro £m	Other £m	**Total £m**
Financial assets					
Fixed	–	–	–	–	**–**
Floating	0.6	8.8	2.8	2.5	**14.7**
Non-interest bearing	–	22.9	–	–	**22.9**
	0.6	31.7	2.8	2.5	**37.6**
Financial liabilities					
Fixed	–	89.0	100.0	51.7	**240.7**
Floating	–	153.7	192.2	1.9	**347.8**
Non-interest bearing	–	4.3	–	–	**4.3**
	–	247.0	292.2	53.6	**592.8**

In addition to the above, there are current trade receivables net of payables held in currencies other than the functional currencies of Group companies of: Sterling £10.9m, US$ £30.7m, Euro £11.2m and other £15.3m. These net exposures have been hedged in line with Group policy.

20 Financial instruments continued

Financial derivatives

The table below sets out the net principal amount and fair value of derivative contracts held by the Group.

	Contract or underlying principal amount		Fair value		
At 5 August 2006	Assets £m	Liabilities £m	Assets £m	Liabilities £m	Net £m
Currency and interest related instruments:					
Foreign exchange contracts	366.0	(85.0)	19.0	(2.1)	16.9
Cross currency swaps		(241.2)	13.1	(0.1)	13.0
Interest rate swaps		(78.6)		(3.7)	(3.7)
Embedded derivatives	57.9		0.2	(3.4)	(3.2)
Total financial derivatives	423.9	(404.8)	32.3	(9.3)	23.0

Financial derivatives appear on the balance sheet separately as follows:

	Non-current assets £m	Current assets £m	Non-current liabilities £m	Current liabilities £m	Net £m
Financial derivatives	6.2	26.1	(4.4)	(4.9)	23.0

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

Hedge accounting

The table below sets out the principal amount and fair values of derivative contracts which qualify for hedge accounting treatment.

At 5 August 2006	Note	Contract or underlying principal amount £m	Fair value of derivative contracts £m
Cash-flow hedges – foreign exchange contracts	a	354.0	17.0
Fair value hedges – interest rate swaps	b	(78.6)	(3.7)
Net investment hedges – cross currency swaps	c	(231.8)	13.0

Foreign exchange contracts and cross currency swaps with a total gross principal amount of £106.4m with a fair value of £(0.1)m were held for trading and accordingly not hedge accounted.

a) Cash-flow hedges

At 5 August 2006, the Group had outstanding foreign currency contracts designated as cash-flow hedges having a net principal amount of £354m (31 July 2005: £288m). The majority of hedge contracts (approximately 75%) are for periods of 12 months or less, with the exception of the Aerospace business which hedges longer extending to May 2012 with long-term hedging fixing the margins of certain military contracts.

Gains and losses on cash-flow hedges that have been deferred in the cash-flow hedge reserve during the period ended 5 August 2006, in addition to those that have been recycled through the income statement, are shown in the table below.

	Period ended 5 August 2006 £m
Brought forward cash-flow hedge reserve at 1 August 2005	0.6
Amounts deferred in the period on effective cash-flow hedges	18.4
Amounts removed from the hedge reserve and recognised in the income statement	(5.7)
Carried forward cash-flow hedge reserve at 5 August 2006	13.3

No comparative information is provided as the Group elected not to restate comparatives for the year ended 31 July 2005 for IAS 32 and IAS 39.

b) Fair value hedges

The Group has designated US$150m interest rate swaps on the US private placement as fair value hedges which mature on 28 January 2013. The risk being hedged is the variability of the fair value of borrowings arising from interest rate fluctuations.

20 Financial instruments continued

c) Net investment hedges

Cross currency swap contracts and foreign currency borrowings (€275m) have been designated as net investment hedges in respect of the foreign currency translation risk arising on consolidation of the Group's net investment in its US dollar, Euro and Yen foreign operations. The contracts mature during the financial year ended 31 July 2007. Gains and losses on net investment hedges that have been deferred in the net investment hedge reserve during the period ended 5 August 2006 are shown in the table below:

	Period ended 5 August 2006 £m
Brought forward net investment hedge reserve at 1 August 2005	(3.9)
Amounts deferred in the period on effective net investment hedges	17.1
Carried forward net investment hedge reserve at 5 August 2006	13.2

The hedge reserve on the balance sheet comprises:

	£m
Cash-flow hedge reserve	13.3
Net investment hedge reserve	13.2
	26.5

Year ended 31 July 2005 – UK GAAP disclosures

The Group exercised the IFRS 1 exemption to record financial instruments in the comparative period on the existing UK GAAP basis. The following disclosures are included, as at 31 July 2005, to meet the requirements of 'FRS 13 Derivatives and Other Financial Instruments: Disclosures'.

Fair value of financial assets and liabilities

At 31 July 2005	Book value £m	Estimated fair value £m
Trade investments	3.5	3.5
Cash at bank and on deposit	60.9	60.9
Borrowings		
– short-term	(54.0)	(54.0)
– long-term	(937.7)	(987.1)
	(927.3)	(976.7)
Derivative financial instruments		
– interest rate swaps		(0.6)
– currency rate swaps	(9.8)	(3.6)
– forward currency contracts		0.3
Preference shares	325.0	325.0
Net financial liabilities – book value/fair value	(612.1)	(655.6)

Hedges

	Unrecognised gains £m	Unrecognised losses £m	Deferred total net gains £m	Total 2006 £m
Net gains/(losses) on hedges at 1 August 2004	24.7	(5.2)	6.0	25.5
Net gains/(losses) arising in previous years included in 2005 income	(20.2)	(0.2)	(2.0)	(22.4)
Net gains/(losses) not included in 2005 income arising before 1 August 2004	4.5	(5.4)	4.0	3.1
Change in market value of hedges not recognised during the year	6.2	4.6		10.8
Gains and losses arising in 2004 that were not recognised in that year	4.7	(8.7)		(4.0)
At 31 July 2005	15.4	(9.5)	4.0	9.9
Of which				
– expected to be included in 2006 income	14.0	(6.6)	1.1	8.5
– expected to be included in 2007 income or later	1.4	(2.9)	2.9	1.4

20 Financial instruments continued

Interest rate management

	2005 £m
Interest received	15.5
Financing gains	12.0
Interest paid	(47.4)
Net interest	(19.9)

The financing gains of £12m mainly relate to the Company's net investment hedging programme.

Financial liabilities

	Fixed borrowings				
	Weighted average				
	Interest rate	Years fixed	Amount £m	Floating borrowings £m	Total 2005 £m
Sterling	6.91%	8	300.1	89.8	389.9
US Dollar	5.48%	7	57.2	313.8	371.0
Euro	5.00%	17	12.4	208.5	220.9
Japanese Yen				2.2	2.2
Other				7.7	7.7
			369.7	622.0	991.7
Maturity					
On demand/under one year			3.1	50.9	54.0
One to two years			0.4		0.4
Two to five years			150.1	485.8	635.9
Over five years			216.1	85.3	301.4
			369.7	622.0	991.7

The borrowings are stated before the effect of the Company's net investment currency hedges. These hedges, totalling £296m in notional principal, mainly protect the value of its US Dollar net assets. During the year, the foreign currency losses on currency swaps used to hedge the overseas investment, totalled £11.3m.

Financial assets

	Preference shares 2005 £m	Bank balances and cash 2005 £m	Short-term deposits 2005 £m
Sterling	325.0	18.4	5.8
US Dollar		1.4	1.0
Canadian Dollar		0.1	
Euro		9.5	
Yen		2.1	
Other		19.6	3.0
	325.0	51.1	9.8
Weighted average interest rate on interest bearing balances		2.65%	6.80%

The bank balances and cash comprise £16.9m in respect of short-term balances earning interest and £34.2m in respect of balances which are non-interest earning. Short-term deposits are invested for periods with maturity under one year.

20 Financial instruments continued

Currency exposure

Transactions

The analysis below shows the net monetary assets and liabilities of Group companies that are not denominated in their functional currency and therefore give rise to exchange gains and losses in the profit and loss account. The amounts shown in the table take into account the effect of hedging instruments used to manage these exposures.

	2005 Net foreign currency monetary assets/liabilities			
	Sterling £m	US Dollar £m	Euro £m	Other £m
Sterling		11.9	(2.1)	1.0
US Dollar	0.5		1.4	1.5
Euro	0.2	(1.3)		
Other	0.4	12.3	0.1	0.9
As at 31 July 2005	1.1	22.9	(0.6)	3.4

Translation

Gains and losses arising on net investments overseas and the financial instruments used to hedge the balance sheet exposures are recognised in the statement of recognised income and expense.

21 Provisions for liabilities and charges

	At 1 August 2005 £m	Exchange adjustments £m	Provisions £m	Releases £m	Disposals £m	Utilisation £m	**At 5 August 2006 £m**
Warranty provision and product liability	51.6	(2.5)	45.4	(5.6)	(0.3)	(20.0)	**68.6**
Reorganisation	9.2		26.3	(1.2)	(0.3)	(17.3)	**16.7**
Property	12.1		1.5	(0.2)		(3.0)	**10.4**
Litigation	17.6		2.0	(1.1)		(5.9)	**12.6**
	90.5	(2.5)	75.2	(8.1)	(0.6)	(46.2)	**108.3**

Analysed as:

	2006 £m	2005 £m
Current liabilities	**81.8**	64.1
Non-current liabilities	**26.5**	26.4
	108.3	90.5

Warranty provision and product liability

Warranties over the Company'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

Significant parts of the Company's operations have been undergoing a phased restructuring programme. Full provision is made for reorganisation approved and committed by the end of each financial year. This year's residual balance relates mainly to Aerospace and Medical, and is expected to be utilised during the next financial year.

Property

As stated in the accounting policies on pages 54 to 57, where a property is vacant, or sub-let under terms such that rental income is insufficient to meet all outgoings, the Company 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 Company'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.

Litigation

The Company 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 £1.1m 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.

None of the above provisions are discounted.

22 Operating lease commitments – minimum lease payments
The minimum uncancellable lease payments which the Group is committed to make are:

	2006		2005	
	Land and buildings £m	**Other £m**	Land and buildings £m	Other £m
Payments due				
– not later than one year	**27.0**	**8.4**	30.2	9.3
– later than one year and not later than five years	**66.6**	**8.5**	52.1	9.1
– later than five years	**54.9**	**0.1**	59.2	0.3
	148.5	**17.0**	141.5	18.7

23 Contingent liabilities and commitments
In common with many other enterprises of similar size, the Company and its subsidiaries are from time to time engaged in litigation in respect of a variety of commercial issues.

As previously reported, John Crane, Inc (John Crane), a subsidiary of the Company, is one of many co-defendants 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 John Crane products generally referred to in these cases are ones in which the asbestos fibres were encapsulated in such a manner that, according to tests conducted on behalf of John Crane, the products were safe. John Crane ceased manufacturing products containing asbestos in 1985.

John Crane has resisted every case in which it has been named and will continue its robust defence of all asbestos-related claims based upon this 'safe product' defence. As a result of its defence policy, John Crane has been dismissed before trial from cases involving approximately 128,000 claims over the last 27 years. John Crane is currently a defendant in cases involving approximately 162,000 claims. Despite these large numbers of claims, John Crane has had final judgements against it, after appeals, in only 55 cases, amounting to awards of some US$52.6m over the 27 year period.

To date these awards, the related interest and all material costs of defending these claims have been met directly by insurers. Since the year end John Crane has secured the commutation of certain insurance policies, resulting in anticipated proceeds of approximately US$54m. While substantial insurance will remain in place, it is likely that John Crane will in future meet defence costs directly, seeking appropriate contribution from insurers thereafter.

No provision relating to this litigation has been made in these accounts other than as disclosed in note 21.

At 5 August 2006, contingent liabilities, comprising bonds and guarantees arising in the normal course of business, amounted to £91m (2005: £86m). At 5 August 2006 certain unfunded pension liabilities, recognised on the balance sheet, were secured by means of a fixed and floating charge over land and buildings (£25m) and cash deposits (£10.7m).

In the period the Parent Company arranged a £100m letter of credit facility to support the Group's pension plans.

The Parent Company has guaranteed the US$250m 5.45% Senior Notes 2013 privately placed by a subsidiary and the £660m revolving credit facility used by a subsidiary.

24 Share capital

	Ordinary shares	Issued capital £m	Consideration £m
At 1 August 2005	563,561,555	140.9	
Exercise of share options	3,766,798	0.9	27.3
At 5 August 2006	**567,328,353**	**141.8**	**27.3**

	5 August 2006	31 July 2005
Number of ordinary shares issuable under outstanding options	**20,582,309**	23,039,814

The authorised capital at 31 July 2005 and 5 August 2006 consisted of 800,000,000 ordinary shares of 25p each. At 5 August 2006 all of the issued share capital were in free issue. All issued shares are fully paid.

At 5 August 2006 the following options had been granted and were still outstanding:

	Year issued	Number of shares	Subscription prices	Dates normally exercisable
Smiths Sharesave Scheme	1999	15,516	721.00p	2002/2006
	2000	96,257	612.00p	2003/2007
	2001	215,908	608.00p	2004/2008
	2002	313,946	645.00p	2005/2009
	2003	814,479	554.00p	2006/2010
	2004	1,089,193	525.00p	2007/2011
	2005	774,023	704.00p	2008/2012
	2006	904,490	798.00p	2009/2013
Smiths Industries Executive Share Option Schemes	1996	62,702	823.00p	1999/2006
	1997	199,439	934.00p	2000/2007
	1998	264,443	765.00p	2001/2008
	1999	423,549	858.50p	2002/2009
	2000	421,014	750.00p	2003/2010
	2000	105,809	807.00p	2003/2010
	2001	819,327	790.00p	2004/2011
	2002	2,120,008	806.00p	2005/2012
	2002	3,080,750	654.00p	2005/2012
	2003	3,499,200	669.00p	2006/2013
	2004	2,456,850	774.00p	2007/2014
	2005	1,825,750	901.00p	2008/2015
TI Group Savings-Related Share Option Scheme	1999	12,737	805.07p	2002/2006
	2000	46,565	587.54p	2003/2007
TI Group Executive Share Option Schemes	1996	24,346	1,121.20p	2001/2006
	1997	86,812	1,097.82p	2001/2007
	1997	179,776	1,219.80p	2001/2007
	1998	182,969	1,026.66p	2001/2008
	1998	62,710	849.79p	2001/2008
	1999	54,844	943.31p	2002/2009
	1999	158,873	907.23p	2002/2009
	1999	152,226	1,103.92p	2002/2009
	2000	60,252	661.23p	2003/2010
	2000	57,546	626.16p	2003/2010

25 Share premium and other reserves

	Share premium account £m	Revaluation reserve £m	Merger reserve £m	Hedge reserve £m	Income statement £m
At 1 August 2004	183.0	1.7	234.8		721.2
Premium on allotments	14.5				(0.5)
Profit for the year					271.8
Dividends paid to equity shareholders					(154.5)
ESOP Trusts – disposal of company shares					5.4
Share-based payment					5.0
Deferred tax charge related thereto					16.0
Actuarial loss on retirement benefits					(23.4)
Deferred tax charge related thereto					11.8
Exchange rate changes (including tax on recognised gains)					56.1
At 1 August 2005	197.5	1.7	234.8		908.9
Adoption of IAS 39				(3.3)	6.2
Premium on allotments	26.6				(0.2)
Transfers to profit for the period				(5.7)	
Profit for the period					24.2
Dividends paid to equity shareholders					(167.0)
Gains taken to equity				35.5	
Share-based payment					14.5
Deferred tax credit related thereto					(2.6)
Actuarial gain on retirement benefits					94.5
Deferred tax credit related thereto					(24.0)
Exchange rate changes (including tax on recognised gains)					(120.5)
At 5 August 2006	**224.1**	**1.7**	**234.8**	**26.5**	**734.0**

26 Movements in shareholders' equity

	As at 31 July 2005 £m	As at 1 August 2004 £m
Shareholders' equity as reported under UK GAAP at 31 July	**1,204.8**	1,122.5
Amendments to inter-company swap accounting (note 1)	**35.4**	
	1,240.2	1,122.5
Adjustments to comply with IFRS as reported on 21 November 2005	**247.5**	158.5
Additional IFRS adjustments		
– amendments to creditors (note 2)	**(5.6)**	
– revisions to fair values in respect of prior year acquisitions (note 3)	**1.7**	
Shareholders' equity under IFRS at 31 July	**1,483.8**	1,281.0
Change in accounting policy in treatment of embedded derivatives (note 4)	**9.7**	
Change in accounting policy to adopt IAS 32 and IAS 39	**(6.8)**	
Shareholders' equity under IFRS at 1 August	**1,486.7**	1,281.0

Notes

1 An adjustment to the prior year has been made to amend the accounting of an inter-company swap. The adjustment results in a decrease in creditors of £35.4m and an increase in shareholders' equity of £35.4m.

2 During the period since 21 November 2005, the Company has made a minor amendment to its previously published IFRS information as a result of emerging interpretations of standards.

3 As allowed by IFRS 3, the fair values of assets and liabilities acquired in prior year acquisitions have been finalised. These adjustments result in a decrease in goodwill of £0.4m, an increase in other assets of £2.1m, and an increase in shareholders' equity of £1.7m.

4 The basis for valuing non-closely related embedded derivatives was revised in the year to better represent the contractual cash flows in the relevant contracts.

26 Movements in shareholders' equity continued

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
At 1 August	**1,486.7**	1,281.0
Profit for the period	**24.2**	271.8
Share-based payment	**14.5**	5.0
Deferred tax credit/(charge) related thereto	**(2.6)**	16.0
Dividends paid to equity shareholders	**(167.0)**	(154.5)
New share capital subscribed	**27.3**	14.6
ESOP Trusts – disposal of company shares		5.4
Exchange (losses)/gains	**(113.1)**	50.2
Taxation recognised on exchange (losses)/gains	**(7.4)**	5.9
Fair value gains/(losses)		
– on cash-flow hedges	**12.7**	
– on net investment hedges	**17.1**	
Actuarial gains/(losses) on retirement benefit schemes	**94.5**	(23.4)
Deferred taxation credit/(charge) related thereto	**(24.0)**	11.8
At 5 August/31 July	**1,362.9**	1,483.8

27 Cash-flow from operating activities

	Period ended 5 August 2006 £m	Year ended 31 July 2005 £m
Profit before taxation	**132.4**	365.9
Net interest payable	**54.2**	23.2
Financing losses – charged to administrative expenses	**2.8**	
– charged to financing	**0.5**	4.2
Share of post-tax loss from associate	**1.1**	
Other finance income – retirement benefits	**(27.6)**	(11.3)
Impairment of financial asset	**325.0**	
	488.4	382.0
Amortisation of intangible assets	**39.6**	39.1
Profit on disposal of property, plant and equipment	**(4.4)**	
Profit on disposal of business	**(16.4)**	(8.7)
Depreciation of property, plant and equipment	**81.0**	71.7
Share-based payment expense	**16.3**	6.3
Retirement benefits	**(61.5)**	(20.3)
Increase in inventories	**(34.8)**	(89.3)
Increase in trade and other receivables	**(35.6)**	(53.7)
Increase in trade and other payables	**70.7**	76.0
Other non-cash movements		14.0
Cash generated from operations	**543.3**	417.1
Interest	**(49.5)**	(19.9)
Tax paid	**(104.7)**	(77.9)
Net cash inflow from operating activities	**389.1**	319.3

28 Acquisitions

During the period of 53 weeks ended 5 August 2006, the Company made a number of acquisitions: the issued share capital of Livewave, Inc on behalf of Detection (28 October 2005), the issued share capital of Millitech, Inc (16 September 2005), together with the businesses and assets of Farnam (1 August 2005) and Lorch Microwave LLC (4 January 2006) on behalf of Specialty Engineering. In addition, the Company also acquired the minority interests in subsidiary companies operating in Canada and China.

The values set out below are provisional pending finalisation of the fair values attributable, and will be finalised in the period ending 31 July 2007. All acquisitions are wholly owned. 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. Accordingly goodwill has decreased by £0.4m and other assets have increased by £2.1m.

28 Acquisitions continued

	Book value £m	Fair value adjustments £m	Provisional fair value £m
Non-current assets			
– intangible assets	5.0	8.3	13.3
– tangible assets	1.6		1.6
Current assets			
– other current assets	7.6	(0.4)	7.2
Current liabilities			
– other current liabilities	(2.2)	(0.5)	(2.7)
Minority interests	1.8		1.8
Net assets acquired	**13.8**	**7.4**	**21.2**
Goodwill			30.6
Total consideration			**51.8**
Consideration satisfied by cash			51.8
Deferred consideration paid on prior-year acquisitions			2.4
Total consideration			**54.2**

The fair value adjustments in respect of intangible assets are due to the recognition of £1.1m in respect of trademarks, £2.1m in respect of acquired technology, £1.6m in respect of customer relationships and £3.5m in respect of other acquired intangibles. 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.

From the date of acquisition to 5 August 2006, the acquisitions contributed £21.3m to revenue, £2.2m to headline profit before taxation and £0.9m to profit before taxation. If Smiths had acquired the assets at the beginning of the financial period, the acquisitions would have contributed £27.5m to revenue and £1.1m to profit.

29 Disposals

The most significant disposal transaction during the period was the sale of the Company's interest in Heimann Biometric Systems GmbH to Cross Match Technologies, Inc. in exchange for 43% of the issued share capital in that company, which is regarded as an associate and its results are therefore accounted for on an equity basis (see note 13).

The Company has also released 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
Shares received in Cross Match Technologies, Inc. – at valuation	13.8
Net cash received	8.3
Net consideration received	22.1
Net assets excluding cash and retained liabilities at date of sale	
Tangible fixed assets	5.8
Inventory	9.9
Debtors	5.9
Creditors	(5.1)
Net assets	16.5
Provision for retained liabilities	0.4
Net assets and retained liabilities	16.9
Surplus of proceeds over net assets, costs and expenses	5.2
Disposal provisions in excess of liabilities settled – now released	11.2
Profit on disposal of businesses	16.4

30 Employee share schemes

The Group operates share schemes and plans for the benefit of employees. The nature of each scheme and plan, 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 Industries (1984) Executive Share Option Scheme (84 ESOS)

No options have been granted under this scheme since 1994. This scheme ceased to exist on 8 April 2005 following the exercise of the last remaining option.

Smiths Industries 1995 Executive Share Option Scheme (95 ESOS)

The 95 ESOS replaced the 84 ESOS in 1995. 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 Company versus the total return of the General Industrials Sector of the FTSE All Shares Index. Options granted from 2002 are subject to a performance test based on growth in the Company'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 Company'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 Industries Senior Executive Deferred Share Scheme (DSS)

Under the DSS executive directors and senior employees were able to use their after tax bonus to purchase the Company's shares at the prevailing market price. At the end of a three year period, if the participant is still in office, he can exercise an option granted to him over matching shares, in respect of any shares retained for that period. The number of matching shares awarded was determined by the Committee at the end of the year in which the bonus was earned by reference to annual bonus, and other corporate financial criteria. The last grant under the DSS was made on 7 December 2004, in respect of bonus earned in the year to 31 July 2004, and matched shares purchased in the market by the grantee on that day. The DSS has been replaced by the CIP (see below).

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%.

Smiths Group Co-Investment Plan (CIP)

In October 2005 the CIP replaced the DSS. Under the CIP 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 Company's Return on Capital Employed (RoCE) over the Performance Period exceeds the Company's weighted average cost of capital over the Performance Period by an average margin of at least 1% per annum.

TI Group (1994) Savings Related Share Options Scheme (TI SAYE)

The last invitation to participate in the TI SAYE Scheme, an HM Revenue & Customs-approved all-employee savings-related share option scheme, was issued in 2000. The extant options are held by employees of the former TI Group who elected to receive seven-year options in 1999 and 2000. No performance conditions attach to this scheme.

TI Group (1990) Executive Share Option Scheme (TI 90 ESOS)

No options have been granted under this scheme since 1999 when it was replaced by the TI 99 ESOS (see below). Executives who held options at the time of the merger of TI Group into Smiths Group were able to exercise their options at the time or to roll them over into continuing options over an equivalent number of Smiths Group shares. The performance conditions attaching to this scheme were waived as a result of the change of control of TI Group.

TI Group 1999 Executive Share Option Scheme (TI 99 ESOS)

No options have been granted under this scheme since 2000 when TI Group was merged into Smiths Group. Executives who held options at time of the merger were able to exercise their options at the time or to roll them over into continuing options over an equivalent number of Smiths Group shares. The performance conditions attaching to this scheme were waived as a result of the change of control of TI Group.

30 Employee share schemes continued

	SAYE and TI SAYE	84 ESOS and 95 ESOS	DSS	PSP	CIP	TI 90 ESOS and TI 99 ESOS	Total	Weighted average price for option plans £
Ordinary shares under option ('000)								
1 August 2004	5,583	17,556	678			2,094	25,911	
Granted	865	2,800	407	1,097			5,169	
Exercised	(672)	(1,042)	(241)			(564)	(2,519)	
Lapsed	(598)	(473)	(6)			(23)	(1,100)	
31 July 2005	5,178	18,841	838	1,097		1,507	27,461	£6.69
Granted	920	2,600		954	732		5,206	
Exercised	(1,550)	(1,945)	(172)			(382)	(4,049)	
Lapsed	(265)	(1,209)	(30)	(117)	(5)	(105)	(1,731)	
5 August 2006	**4,283**	**18,287**	**636**	**1,934**	**727**	**1,020**	**26,887**	**£6.50**

Options were exercised on an irregular basis during the period and the average closing share price was 945.2p (2005: 820.7p). 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 5 August 2006 ('000)**	Options exercisable at 31 July 2005 ('000)	**Exercisable weighted average exercise price for options exercisable at 5 August 2006**
£0.00 – £2.00	3,297	37	**35**	47	**£0.00**
£2.00 – £4.00					
£4.01 – £6.00	1,950	30			
£6.01 – £8.00	14,621	75	**1,623**	1,401	**£7.65**
£8.01 – £10.00	6,440	79	**1,068**	1,886	**£8.77**
£10.01 – £12.00	446	22	**446**	509	**£10.72**
£12.01 – £14.00	180	11	**180**	198	**£12.20**

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. The assumptions used in the model for 2005 and 2006 are as follows:

	53 weeks ended 5 August 2006			
	SAYE	**95 ESOS**	**DSS/CIP**	**PSP**
Weighted average fair value (£)	**2.17**	**1.52**	**7.34**	**6.24**
Key assumptions used:				
Weighted average share price	**6.19**	**5.81**		
Range of exercise prices (£)	**5.25-7.98**	**6.69-9.01**		
Range of expected volatility (%)	**17-33.1**	**24-33.9**		**16.5**
Risk-free interest rate (%)	**3.5-5.1**	**4.3-4.4**		
Range of expected option term (life)	**3.2-7.2 yrs**	**5 yrs**	**3 yrs**	**3 yrs**
Dividend yield (%)	**3.75**	**3.75**	**3.75**	**3.75**

	Year ended 31 July 2005			
	SAYE	95 ESOS	DSS/CIP	PSP
Weighted average fair value (£)	2.11	1.29	6.69	5.62
Key assumptions used:				
Weighted average share price	5.77	7.11		
Range of exercise prices (£)	5.25-7.04	6.69-7.74		
Range of expected volatility (%)	21-33.1	30-33.9		16.5
Risk-free interest rate (%)	3.5-5.1	4.3-4.4		
Range of expected option term (life)	3.2-7.2 yrs	5 yrs	3 yrs	3 yrs
Dividend yield (%)	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 (see note 10) is an expense arising from share-based payment transactions of £16.3m (2005: £6.3m), of which £14.5m (2005: £5.0m) relates to equity-settled share-based payment.

Transition to IFRS

Background

IFRS 1 exemptions and elections

As a consequence of the adoption by the European Union (EU) of International Financial Reporting Standards (IFRS) the Group, in common with all other companies quoted on the London Stock Exchange or other European exchanges, is required to prepare its consolidated financial statements under IFRS for all periods commencing on or after 1 January 2005.

The Smiths Group Annual Report and Accounts for the period ended 5 August 2006 is the first Annual Report and Accounts prepared under IFRS. As the year ended 31 July 2005 is the earliest year for which full IFRS financial statements are presented in the 2006 Annual Report and Accounts, the transition date for the Group is 1 August 2004.

Smiths is required to establish its IFRS accounting policies for the period ended 5 August 2006, and apply these retrospectively to determine its opening IFRS balance sheet at the transition date of 1 August 2004 and the comparative financial information for the year ended 31 July 2005. However, advantage has been taken of certain exemptions afforded by 'IFRS 1 First Time Adoption of International Financial Reporting Standards'.

Business combinations

Business combinations prior to 1 August 2004, and in particular the merger with TI Group plc, which took place on 4 December 2000, have not been restated to comply with 'IFRS 3 Business Combinations', which requires acquisition accounting for all business combinations. The merger reserve of £235m will remain as a permanent item within shareholders' equity;

Cumulative translation differences

'IAS 21 The Effects of Changes in Foreign Exchange Rates' requires annual translation differences arising on the opening net assets and net profit or loss of each foreign subsidiary to be treated as a separate component of shareholders' equity, and the cumulative net surplus/deficit for each subsidiary carried forward and added to/subtracted from any gains/losses on the future disposal of that subsidiary. Smiths has taken the option to set these cumulative gains/losses at zero as at the date of transition to IFRS. Any gains and losses recognised in the income statement on subsequent disposals of foreign operations will therefore include only those translation differences arising after 1 August 2004, the IFRS transition date;

Share-based payment

Smiths has applied 'IFRS 2 Share-based Payment' retrospectively only to equity-settled awards made after 7 November 2002 that had not vested at 1 January 2005.

Financial Instruments

Smiths has elected to adopt IAS 32 and IAS 39 from 1 August 2005 with no restatement of comparative information. Consequently, the relevant comparative financial information for the year ended 31 July 2005 will not reflect the impact of these standards, but will include financial instruments accounted for on a UK GAAP basis.

IFRS adjustments

The key differences between UK GAAP and IFRS that impact the Group are set out below.

Research and development

Under UK GAAP, Smiths wrote off research and development expenditure, other than that recoverable from third parties, in the year in which it was incurred.

Under 'IAS 38 Intangible Assets', the Company is required to capitalise the cost of developments which meet certain recognition criteria, including the technical feasibility of, and probable future economic benefits arising from, the project. This expenditure is then amortised over the anticipated future life of the economic benefits arising.

Customer-funded and unfunded development projects are treated on a similar basis, although the increased risk implicit in most funded development projects means that the criteria for capitalisation are less likely to be met. Where costs are capitalised on funded development contracts, the associated funding is held as a deferred liability on the balance sheet, and released to the income statement in step with the amortisation of the capitalised intangible asset.

Research costs, and development costs which do not meet the relevant capitalisation criteria, are written off in the year in which they are incurred.

As a result of this policy, net assets (before the associated deferred tax adjustment) have increased by £65.1m and £111.3m as at 1 August 2004 and 31 July 2005 respectively. Operating profits have increased by £36.3m for the year ended 31 July 2005, represented by the capitalisation of £67.4m of costs previously written off under UK GAAP, offset by £31.1m.

Business combinations

Under UK GAAP, the difference between the consideration paid for an acquisition and the fair value of the identifiable net assets of the acquired subsidiary at the date of acquisition is recognised as goodwill. Identifiable net assets include intangible assets which are capable of separate disposal without disposing of the related business. Under IFRS, intangible assets of an acquired subsidiary are separately recognised from goodwill if their fair value can be measured reliably. Intangible assets include trademarks, customer relationships and contracts and patented technologies.

Intangible assets recognised are amortised over their useful life. Under the transition rules, the Company is not required to identify any acquired intangible assets in respect of acquisitions completed prior to 1 August 2004. As a result of acquisitions made during the year ended 31 July 2005, intangible assets have been reclassified out of goodwill arising on acquisition, with an associated increase in the intangible asset amortisation charge of £3.4m for the year ended 31 July 2005.

Under UK GAAP, the fair value of acquired stock is stated at the lower of cost or net realisable value. Under IFRS the fair value of acquired inventory is based on selling price, less the sum of costs to complete, costs of disposal and a reasonable profit allowance for the completing and selling effort based on profit for similar finished goods. As a result an adjustment of £14.0m was made to the acquisition balance sheet of Medex. As at 31 July 2005 the uplifted inventory had been traded through the income statement, resulting in a £14.0m decrease in profit before taxation for the year ended 31 July 2005.

Goodwill

Under UK GAAP, goodwill on businesses acquired by the Group after 1 August 1998 is capitalised and amortised on a straight-line basis over its anticipated future life up to a maximum of 20 years. Goodwill in respect of businesses acquired prior to 1 August 1998 was set off against reserves in the year of acquisition. On subsequent disposal of a business acquired prior to 1 August 1998 purchased goodwill previously set off against reserves is recycled and included in the profit or loss on disposal of the business.

Under IFRS, from 1 August 2004 onwards, goodwill will no longer be amortised, but will instead be subject to annual impairment review. The amortisation charge under UK GAAP for goodwill for the year ended 31 July 2005 of £53.3m has been reversed from the income statement, resulting in a corresponding increase in the net book value of goodwill. On disposal of a business acquired before 1 August 1998 goodwill set off against reserves will no longer be recycled as part of the profit or loss on disposal of that business. The exceptional write down of goodwill on anticipated future disposals of £2.3m recognised under UK GAAP has been reversed from the income statement.

Dividends

Under UK GAAP, dividends relating to an accounting period but declared after the balance sheet date are recognised as a liability even if the approval of that dividend took place after the balance sheet date.

Under IFRS, proposed dividends do not meet the definition of a liability until such time as they have been declared, and in the case of the final dividend, approved by shareholders at the Annual General Meeting. This has resulted in a balance sheet reclassification from current liabilities to retained profit of £102.5m and £111.3m as at 1 August 2004 and 31 July 2005 respectively.

Share-based payment

Smiths operates a number of share-based incentive schemes (both awards of options and awards of shares) that are impacted by 'IFRS 2 Share-based Payment'. Under UK GAAP Smiths recognises an expense based on the intrinsic value of the options (the difference between the exercise price and the market value at the date of the award), other than for Save-As-You-Earn schemes for which UK GAAP includes an exemption from recognising an expense.

Under IFRS, the cost of all share-based payments, based on the fair value of the options or shares at the date of grant and calculated using an appropriate pricing model, is recognised over the vesting period of the award. Accordingly, an adjustment has been recognised to reflect an additional charge of £6.3m in the year ended 31 July 2005.

Retirement benefits

Under UK GAAP, the Company had already adopted 'FRS 17 Retirement Benefits'. Under FRS 17 the assets and liabilities of the Group's defined benefit pension schemes are recognised at fair value in the balance sheet and the operating and financing costs of defined benefit pension schemes are recognised in the profit and loss account as operating costs and finance costs respectively. Variations from expected costs arising from the experience of the plans or changes in actuarial assumptions are recognised immediately in the Statement of Total Recognised Gains and Losses.

The change to 'IAS 19 Employee Benefits' does not give rise to any significant change in the basis of accounting for pensions as Smiths will adopt early the option allowed under IAS 19 to take actuarial gains and losses immediately and directly to equity through the Statement of Recognised Income and Expense. Changes are largely confined to presentation, in that retirement benefit scheme surpluses and deficits must be aggregated separately on the face of the balance sheet, and shown gross, rather than net, of deferred taxation. The deferred tax balance under UK GAAP related to pensions amounted to assets of £116.4m and liabilities of £31.2m as at 1 August 2004 and assets of £127.3m and liabilities of £40.4m as at 31 July 2005.

Deferred taxation

Under UK GAAP, deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events have occurred at that date that will result in an obligation to pay more, or a right to pay less or to receive more tax.

Under IFRS, deferred tax is recognised on all taxable temporary differences between the tax base and the accounting base of balance sheet items included in the balance sheet of the Group, except to the extent that such temporary differences arise on initial recognition of an asset or liability. This means that deferred tax is recognised on certain temporary differences that would not have given rise to deferred tax under UK GAAP. The most significant differences between UK GAAP and IFRS relate to the following:

- deferred tax provisions relating to tax deductible goodwill set off against reserves prior to 1 August 1998 under UK GAAP and not reinstated under IFRS are written back. For goodwill on which deductions are still to be claimed, deferred tax assets, where recoverable, have been recognised on transition to IFRS and are being amortised to offset the timing of the tax benefit. The amortisation of the asset under IFRS corresponds to the build up of the liability under UK GAAP; and
- under IFRS, deferred tax is provided on temporary differences arising on investments in subsidiaries and associates (principally in respect of unremitted earnings), except where the Group is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

In addition to these adjustments, the carrying values of deferred tax assets and liabilities in the balance sheet have been adjusted to reflect the restatement of newly recognised assets and liabilities arising from the adoption of IFRS.

Computer software

Under UK GAAP, all capitalised computer software was classified within tangible fixed assets. IFRS requires capitalised software that is not an integral part of the hardware to be treated as an intangible asset. This has resulted in balance sheet reclassifications of approximately £12m and £23.0m respectively at 1 August 2004 and 31 July 2005.

Financial instruments

A summary of the impact of the principal differences and adjustments resulting from the adoption of IAS 32 and IAS 39 as they apply to the Group's balance sheet as at 1 August 2005 is set out below:

Forward foreign exchange contracts and currency options

Smiths uses forward foreign exchange contracts and currency options for the purposes of hedging all material contractually committed and forecast foreign currency denominated future sales and purchases. Under UK GAAP, a form of hedge accounting was applied to these forward foreign exchange contracts and currency options meaning that some derivatives were held off balance sheet for at least part of their lives. Under IFRS, the fair value of all forward foreign exchange contracts and currency options is recognised on the balance sheet. IAS 39 places significant restrictions on the use of hedge accounting and changes the hedge accounting methodology. As a result, from 1 August 2005, Smiths will recognise all forward foreign exchange contracts and currency options on the balance sheet at fair value and will apply the new hedge accounting methodology to all significant qualifying relationships. Net assets increased by £0.4m at 1 August 2005.

Interest rate swaps

Under UK GAAP, only accrued interest in respect of interest rate swaps was recognised on the balance sheet. Under IFRS, the fair value of interest rate swaps is also recognised on the balance sheet. Net assets decreased by £0.6m as at 1 August 2005.

Borrowings

Under UK GAAP, borrowings were recognised at initial proceeds received, comprising face values adjusted for issue fees, discounts and premia. Issue fees, discounts and premia were amortised over the life of the related borrowing and accrued interest was classified separately to the borrowing. Under IFRS, where hedge accounting has been applied the borrowings balance is adjusted for the fair value movement in the hedged risk and accrued interest is included within the value of the borrowing.

Embedded derivatives

Under UK GAAP, embedded derivatives were not recognised. Under IFRS, the fair value of embedded derivatives not closely related to their host contract is recognised. A net derivative financial asset of £0.2m has been recognised at 1 August 2005.

'Gross up' of cash and overdrafts

Under UK GAAP, cash and overdraft balances within Smiths' UK and Euro cash pools are presented in the consolidated accounts on a 'net' basis. This notional pooling does not meet the strict off-set rules under IAS 32, and as a result the cash and overdraft balances must be reported 'gross' on the balance sheet. This has resulted in an increase in cash and overdrafts of £664.5m.

Cash-flow statement

The move from UK GAAP to IFRS does not change any of the cash-flows of the Group. The IFRS cash-flow format is similar to UK GAAP but presents various cash-flows in different categories and in a different order from the UK GAAP cash-flow statement. All of the IFRS accounting adjustments net out within net cash inflow from operating activities except for the capitalisation of development expenditure.

IFRS consolidated income statement

	Year ended 31 July 2005		
	UK GAAP £m	Adjustments £m	IFRS £m
Revenue	3,016.8	(11.4)	3,005.4
Cost of sales	(1,804.9)	(9.8)	(1,814.7)
Gross profit	1,211.9	(21.2)	1,190.7
Sales and distribution costs	(283.3)		(283.3)
Administrative expenses	(617.4)	83.3	(534.1)
Profit on disposal of businesses	6.4	2.3	8.7
Operating profit	317.6	64.4	382.0
Interest receivable	15.0		15.0
Interest payable	(48.0)	9.8	(38.2)
Other financing gains	10.1	(14.3)	(4.2)
Retirement benefits			
– return on plan assets	174.3	(3.8)	170.5
– interest cost	(159.2)		(159.2)
Finance (costs)	(7.8)	(8.3)	(16.1)
Profit before taxation	309.8	56.1	365.9
Comprising			
– headline profit before taxation	412.6	(8.8)	403.8
– exceptional items	(51.9)	23.9	(28.0)
– amortisation of intangible assets	(61.0)	55.3	(5.7)
– financing gains/losses	10.1	(14.3)	(4.2)
	309.8	56.1	365.9
Taxation	(89.0)	(5.1)	(94.1)
Profit for the period	220.8	51.0	271.8
Profit for the period attributable to equity shareholders of the parent company	220.8	51.0	271.8
Earnings per share			
Basic	39.3p	9.0p	48.3p
Diluted	39.0p	9.2p	48.2p

Analysis of IFRS adjustments to the income statement

	Development costs £m	Goodwill amortisation and impairment £m	Share-based payment £m	Amortisation of acquired intangible assets £m	Other adjustments £m	IFRS adjustments £m
Revenue	(11.4)					(11.4)
Cost of sales	6.5				(16.3)	(9.8)
Gross profit	(4.9)				(16.3)	(21.2)
Sales and distribution costs						
Administrative expenses	41.2	47.3	(6.3)	(3.4)	4.5	83.3
Profit on disposal of businesses					2.3	2.3
Operating profit	36.3	47.3	(6.3)	(3.4)	(9.5)	64.4
Interest receivable						
Interest payable					9.8	9.8
Other financing gains					(14.3)	(14.3)
Retirement benefits						
– return on plan assets					(3.8)	(3.8)
– interest cost						
Finance (costs)					(8.3)	(8.3)
Profit before taxation	36.3	47.3	(6.3)	(3.4)	(17.8)	56.1
Comprising						
– headline profit before taxation						(8.8)
– exceptional items						23.9
– amortisation of intangible assets						55.3
– financing gains						(14.3)
						56.1
Taxation						(5.1)
Profit for the period						51.0
Profit for the period attributable to equity shareholders of the parent company						51.0

IFRS consolidated balance sheet

	31 July 2005			1 August 2004		
	UK GAAP £m	Adjustments £m	IFRS £m	UK GAAP £m	Adjustments £m	IFRS £m
Non-current assets						
Intangible assets	1,225.6	256.1	1,481.7	728.2	129.2	857.4
Property, plant and equipment	525.8	(23.0)	502.8	423.5	(12.2)	411.3
Financial assets	328.5		328.5	327.3		327.3
Retirement benefit assets	134.6		134.6	103.9		103.9
Deferred tax assets	133.6	(15.8)	117.8	116.4	(13.7)	102.7
Trade and other receivables	9.9	14.8	24.7	9.2	(0.9)	8.3
	2,358.0	232.1	2,590.1	1,708.5	102.4	1,810.9
Current assets						
Inventories	570.0	(5.8)	564.2	423.5	(3.8)	419.7
Trade and other receivables	727.2	(6.7)	720.5	620.4	5.1	625.5
Financial assets						
Cash and cash equivalents	60.9		60.9	449.2		449.2
Total assets	3,716.1	219.6	3,935.7	3,201.6	103.7	3,305.3
Non-current liabilities						
Financial liabilities						
Borrowings	(937.7)		(937.7)	(446.5)		(446.5)
Financial derivatives						
Provisions for liabilities and charges	(26.4)		(26.4)	(22.6)		(22.6)
Retirement benefit obligations	(369.4)	(1.8)	(371.2)	(351.2)	(1.8)	(353.0)
Deferred tax liabilities	(11.8)	(8.1)	(19.9)	(49.4)	10.8	(38.6)
Trade and other payables	(74.4)	(58.8)	(133.2)	(53.1)	(41.6)	(94.7)
	(1,419.7)	(68.7)	(1,488.4)	(922.8)	(32.6)	(955.4)
Current liabilities						
Financial liabilities						
Borrowings	(54.0)		(54.0)	(275.4)		(275.4)
Financial derivatives						
Provisions for liabilities and charges	(64.1)		(64.1)	(79.2)		(79.2)
Trade and other payables	(812.7)	128.1	(684.6)	(665.9)	87.4	(578.5)
Current tax payable	(160.8)		(160.8)	(135.8)		(135.8)
Total liabilities	(2,511.3)	59.4	(2,451.9)	(2,079.1)	54.8	(2,024.3)
Net assets	1,204.8	279.0	1,483.8	1,122.5	158.5	1,281.0
Shareholders' equity						
Share capital	140.9		140.9	140.3		140.3
Share premium account	197.5		197.5	183.0		183.0
Revaluation reserve	1.7		1.7	1.7		1.7
Merger reserve	234.8		234.8	234.8		234.8
Retained earnings	629.9	279.0	908.9	562.7	158.5	721.2
Total shareholders' equity	1,204.8	279.0	1,483.8	1,122.5	158.5	1,281.0

Analysis of IFRS balance sheet adjustments

1 August 2004

	Development costs £m	Share-based payment £m	Dividend reversal £m	Other £m	IFRS adjustments £m
Non-current assets					
Intangible assets	116.1			13.1	129.2
Property, plant and equipment				(12.2)	(12.2)
Financial assets					
Retirement benefit assets					
Deferred tax assets		4.3		(18.0)	(13.7)
Trade and other receivables				(0.9)	(0.9)
	116.1	4.3		(18.0)	102.4
Current assets					
Inventories				(3.8)	(3.8)
Trade and other receivables				5.1	5.1
Financial assets					
Cash and cash equivalents					
Total assets	116.1	4.3		(16.7)	103.7
Non-current liabilities					
Financial liabilities					
Borrowings					
Financial derivatives					
Provisions for liabilities and charges					
Retirement benefit obligations				(1.8)	(1.8)
Deferred tax liabilities	(21.9)			32.7	10.8
Trade and other payables	(41.4)			(0.2)	(41.6)
	(63.3)			30.7	(32.6)
Current liabilities					
Financial liabilities					
Borrowings					
Financial derivatives					
Provisions for liabilities and charges					
Trade and other payables	(9.6)		102.5	(5.5)	87.4
Current tax payable					
Total liabilities	(72.9)		102.5	25.2	54.8
Net assets	43.2	4.3	102.5	8.5	158.5
Shareholders' equity					
Share capital					
Share premium account					
Revaluation reserve					
Merger reserve					
Retained earnings	43.2	4.3	102.5	8.5	158.5
Total shareholders' equity	43.2	4.3	102.5	8.5	158.5

Analysis of IFRS balance sheet adjustments

31 July 2005

	Development costs £m	Goodwill amortisation and impairment £m	Business combinations £m	Share-based payment £m	Dividend reversal £m	Other £m	IFRS adjustments £m
Non-current assets							
Intangible assets	168.8	45.9	17.4			24.0	256.1
Property, plant and equipment			(0.3)			(22.7)	(23.0)
Financial assets							
Retirement benefit assets							
Deferred tax assets				22.3		(38.1)	(15.8)
Trade and other receivables						14.8	14.8
	168.8	45.9	17.1	22.3		(22.0)	232.1
Current assets							
Inventories			(0.1)			(5.7)	(5.8)
Trade and other receivables	(0.8)		0.9			(6.8)	(6.7)
Financial assets							
Cash and cash equivalents							
Total assets	168.0	45.9	17.9	22.3		(34.5)	219.6
Non-current liabilities							
Financial liabilities							
Borrowings							
Financial derivatives							
Provisions for liabilities and charges							
Retirement benefit obligations						(1.8)	(1.8)
Deferred tax liabilities	(36.6)		(23.3)			51.8	(8.1)
Trade and other payables	(45.4)			(1.3)		(12.1)	(58.8)
	(82.0)		(23.3)	(1.3)		37.9	(68.7)
Current liabilities							
Financial liabilities							
Borrowings							
Financial derivatives							
Provisions for liabilities and charges							
Trade and other payables	(11.3)		(3.2)		111.3	31.3	128.1
Current tax payable							
Total liabilities	(93.3)		(26.5)	(1.3)	111.3	69.2	59.4
Net assets	74.7	45.9	(8.6)	21.0	111.3	34.7	279.0
Shareholders' equity							
Share capital							
Share premium account							
Revaluation reserve							
Merger reserve							
Retained earnings	74.7	45.9	(8.6)	21.0	111.3	34.7	279.0
Total shareholders' equity	74.7	45.9	(8.6)	21.0	111.3	34.7	279.0