

Operating and financial review

Operating review

Group activities

Smiths is a global applied technology business serving aerospace, medical devices, detection and specialty engineering markets.

Strategy

Smiths is committed to creating long-term value for shareholders by building and sustaining strong businesses in growth sectors.

The Company's objective is to create value from organic growth and from reinvestment of self-generated cash-flow. Adjustments are made to the business mix through both acquisitions and disposals to enhance value for shareholders.

Changes in Group composition

During the period Smiths acquired four businesses for a total of £52m. These became part of the Specialty Engineering and Detection divisions. Smiths sold three businesses during the year for a total of £22m. Further details of these changes are given in the relevant divisional paragraphs below and in notes 28 and 29 to the accounts.

Included in these disposals is the sale of Smiths interests in Heimann Biometric Systems GmbH to Cross Match Technologies Inc. in exchange for 43% of the issued share capital in that company.

Performance

The key Smiths performance indicators are sales, profits and cash generation which are closely monitored throughout the year and measured against pre-set targets.

In this review, you will see references to 'headline profit' as well as to the various statutory measures of profit. This is because the Company believes that headline profit provides valuable additional information on underlying trends, and it is used by management to measure and monitor performance. Normal restructuring costs are charged against headline profit, while the following items are excluded:

- exceptional items (including impairments);
- amortisation of intangible assets acquired in a business combination;
- profit or loss on disposal of businesses; and
- other financing gains and losses.

The table below shows overall performance on a headline basis.

	2006 £m	2005 £m	Increase
Sales	3,523	3,005	17%
Headline:			
– operating profit	520	416	25%
– pre-tax profit	492	404	22%
– earnings per share	64.8p	52.8p	23%

Compared with sterling, the average exchange rate of the US dollar strengthened by 3% year-on-year, whereas the average euro exchange rate was unchanged. The effect of currency translation is identified for the Company, and for each division, in the relevant paragraphs below.

Sales

Sales were £3,523m, an increase of 17% over the £3,005m achieved in 2005.

The translation of sales of overseas business units at this year's average exchange rates increased sales by 2%.

Excluding the effect of both acquisitions and currency translation, sales grew by 9%. All four divisions contributed to the growth. Medical showed the strongest growth, assisted by the full-year contribution from Medex. Further detail of each division's growth is shown in the divisional paragraphs.

Profit

Headline operating profit increased from £416m to £520m, an increase of 25%.

Excluding the effect of both acquisitions and currency translation, headline operating profit grew by 11%, with all four divisions contributing to the growth.

The operating profit on a statutory basis, after taking account of exceptional items (including impairment), amortisation of intangible assets acquired in a business combination, profit or loss on disposal of businesses and financing losses, amounted to £161m. This compares with £382m in 2005.

The translation of the headline operating profit of overseas business units at this year's average exchange rates increased profits by 3%.

Headline pre-tax profit was £492m, a 22% increase over the £404m achieved in 2005.

Profit before tax on a statutory basis was £132m compared with £366m in 2005.

Cash generation

Smiths places considerable emphasis on cash generation, with the objective of providing resources for the growth of the business both organically and by acquisition. In 2006 the Company achieved significant organic growth in addition to acquisitive growth.

Smiths measures operating cash-flow as a ratio to headline operating profit, with a target of at least 75% depending on the level of investment in capitalised development costs. For this purpose, operating cash-flow is measured before the cash impact of exceptional items and special pension payments and after expenditure on property, equipment, software and development costs.

The operating cash-flow on this basis was £420m, representing 81% of headline operating profit; greater than the £259m reported in 2005, representing 62%. The increase reflects the timing of payments on major defence programmes, as well as organic business growth and improvements in managing working capital. On a statutory basis, net cash inflow from operations was £389m (2005: £319m).

Cash expenditure on exceptional items was £17m, compared with £10m in 2005.

During the current year the Company made a special £61m contribution to facilitate UK pension scheme mergers involving under-funded schemes.

Free cash-flow (after interest and tax but before acquisitions and dividends) was £170m, compared with £147m in 2005. The higher free cash-flow reflects the improved operating cash-flow referred to above, offset by higher tax and interest payments than in 2005. It is also stated after the special pension contribution of £61m.

Dividends paid in the year amounted to £167m, compared with £154m in 2005.

Acquisitions and disposals resulted in a net expenditure of £46m, compared with £410m in 2005.

Earnings per share

Headline earnings per share increased from 52.8p to 64.8p, an increase of 23%.

Earnings per share on a statutory basis were 4.3p, compared with 48.3p in 2005.

Interest and other financing costs

Interest payable on debt, less interest on cash deposits, was £54m, compared with £23m in 2005. The £31m increase is principally due to the cost of financing acquisitions, mainly last year's acquisition of Medex, which resulted in higher net debt during the year. Rising US interest rates also contributed to the increase. The net interest costs were 9.6 times covered by headline operating profits.

The Group accounts for pensions using IAS 19, under which the overall retirement benefit cost is analysed into two elements, one of which is treated as a financing item. This financing item was income of £28m in 2006, compared with £11m in 2005, reflecting the strengthening of the funding position of the pension schemes. Under IAS 19 the administration costs of funded pension schemes are to be treated as a component of pensions financing.

Exceptional and other items excluded from headline profits

Exceptional operating items were £340m, compared with £28m in 2005. These comprised:

- £325m in respect of the write down of TI Automotive preference shares. Recognising continued deterioration in the automotive component 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 shares being redeemed. The Board has also considered whether cash-flows could accrue from the investment in TI Automotive were the enterprise to be 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 Board has decided to write down the carrying value of the investment in the TI Automotive preference shares from £325m to nil value in the accounts. There is no cash impact from this decision;
- £19m for integration costs associated with the Medex acquisition, including provisions for the closure of manufacturing facilities (2005: £10m). Further costs of about £20m are expected for the completion of the Medex integration;
- profit on disposal of businesses of £16m (2005: £9m); and
- settlement of a product liability class action of £12m.

Bringing technology to life in 2005/06



May 2006 Explosives detectors on trial on the London Underground

Smiths took part in high-profile security trials on the Tube this year. We supplied Canary Wharf and Greenford stations with a document scanner to test Tube tickets and Oyster cards for explosives, an x-ray machine to scan passenger bags and a hand-held explosives detector.

The amortisation of intangible assets acquired in business combinations amounted to £17m (2005: £6m). The amortisation relates principally to technology and customer relationships.

Financing costs amounted to £3m (2005: £4m). These represent the results of derivatives and other financing instruments which are not hedge accounted under IFRS. Of this sum, £2.8m (2005: nil) was charged to operating profit.

Net debt

Net debt at year end was £923m, compared with £931m at July 2005.

Research and development

Investment in research and development (R&D) drives future performance and is a measure of the Company's commitment to the future organic growth of the business.

Smiths invested a total of £352m in R&D, equivalent to 10% of sales. Of that total, £159m was funded by customers. The comparative figures for 2005 were £295m and £152m. Under IFRS, certain of these development costs are capitalised. The gross capitalisation is shown as an intangible asset. Where customers contribute to the costs of development, the contribution is included as deferred income and disclosed within trade and other payables.

R&D is discussed further in the divisional paragraphs below.

Divisional developments and performance Smiths Aerospace

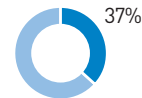
Group Managing Director: Dr John Ferrie CBE

Description: Smiths Aerospace has two business units: Smiths Aerospace Systems and Smiths Aerospace Components. The first designs, manufactures and provides in-service support for digital, electrical and mechanical systems for military and commercial aircraft; the second supplies high-value components to the principal aircraft engine manufacturers. Across the division, military sales account for 54% and commercial for 46%.

Employees: 10,900

Principal operating regions: Manufacturing is concentrated in the US and UK.

Contribution to 2006 Group sales:



Key customers: Customers include major airframe platform and engine manufacturers worldwide, and, for service and support, defence departments and airlines.

Business developments

During the year Smiths Aerospace formed a partnership with Aviall Services to distribute the complete range of Smiths commercial spare parts. This agreement is expected to cover sales totalling US\$2bn over the next 10 years, taking advantage of Aviall's specialist global network and advanced logistics, and will improve the efficiency of working capital.

Smiths Aerospace Components entered into three long-term supply agreements with GE Aviation. These include contracts to supply the full combustor assembly for the GENx family of engines; a 29.3% share of a J85 upgrade kit to be supplied to the US Air Force; and a contract to machine critical rotating parts such as disks and shafts across the full range of GE engines. In order to support the latter, a new facility was opened in North Carolina, US.

Smiths Aerospace continues to streamline business processes and use lower-cost locations or outsourcing as alternatives for lower-value-added work. During the year, progress continued on the development of shared service centres and various manufacturing site consolidations. Smiths Aerospace's facility in Suzhou, China increased its capacity during the year.

Markets

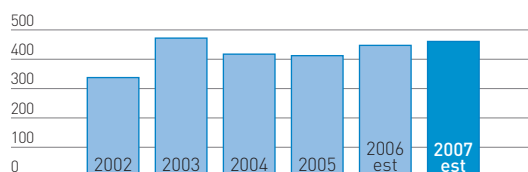
Smiths Aerospace serves both military and commercial aerospace markets. Military is the larger market for Smiths, accounting for 54% of the division's sales.



August 2006
Smiths selected to provide components on Boeing 787 Dreamliner engine
Rolls-Royce awarded Smiths Aerospace a contract worth a potential \$20m per year through 2012 for engine parts on the Trent 1000 engine for the Boeing 787 Dreamliner.

Military

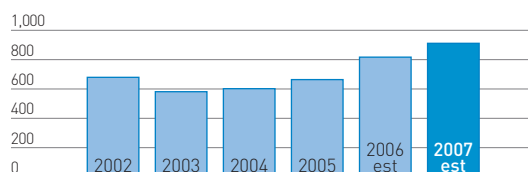
In 2006, the overall global market for advanced military aircraft continued to be stable. The chart below shows the trend in the build of fixed-wing military aircraft, expressed in units.



New major programmes such as F/A-18 E/F and Eurofighter are reaching full-rate production and are key contributors to stabilising the market.

Commercial

Demand in the commercial market followed a different trend from military. The number of commercial jets built by Airbus and Boeing is shown by the chart below.



Between 2001 and 2003, commercial jet production build rates fell by a third. 2004 saw a small increase and in 2005 the rate increased by 10%. An increase of 23% is forecast for 2006, with strong growth continuing in 2007.

As in the military market, the success of the actual aircraft and engines that have high Smiths content is a key factor. For Smiths, the most important commercial aircraft in current production are the Boeing 737, the Boeing 777 and the Airbus A320 family. The build rate for narrow-bodied jets (B737 and A320) is forecast to increase by 21% in 2006 with demand for the 737 expected to be particularly strong. In addition, production of the 777 in 2006 is expected to increase by 50%.

Aftermarket

The aftermarket for further sales and service, once aircraft are in operation, is important in both the commercial and military markets. The largest driver of aftermarket demand is aircraft utilisation.

In 2006, commercial air traffic is estimated to grow by 6%, while usage of military aircraft remains stable.

Performance

	2006 £m	2005 £m	Increase
Sales	1,300	1,146	13%
Headline operating profit	152	132	15%

Sales

Sales rose by 13%. The translation of the results of US businesses at a higher dollar exchange rate increased reported sales by 2%.

Underlying business growth varied by sector. Sales to the commercial market increased by more than 25% benefiting from increased production of Boeing 737, 777 and Airbus A320 aircraft. Particular successes were Smiths selection by Boeing to provide the Thrust Reverser Actuation System (TRAS) for the 747-8 and also an agreement to support its GoldCare service solution for Boeing 787 Dreamliner operators.

In addition, the components business secured a long-term contract from Rolls-Royce for engine components on the Trent 1000 engine for the Boeing 787 Dreamliner.

Sales of defence equipment increased by 5%. Activity on military development remained high, particularly on C130 AMP, F-35 JSF and 767 Tanker. The first flights of the C130 AMP and JSF are planned in the latter half of 2006. The 767 Tanker programme experienced some schedule changes and additional investment in meeting initial commitments for Italy and Japan. Meanwhile, the process for replacing the US KC135 tankers has now begun. Defence aftermarket sales were level with the prior year.

Key defence contracts won included the selection of Smiths to supply the new SDS-5000 large area cockpit display system for the new Future Lynx Helicopter by AgustaWestland, and to provide the next generation Health and Usage Monitoring System (HUMS) for both the Future Lynx and for the South Korean Helicopter Programme.

Headline operating profit

Headline operating profit rose by 15%. The profit increase reflects higher volume, including the initial supply of goods to Aviall, together with improved cost control. Profit improvement was, however, held back by higher R&D costs. On a statutory basis, operating profit was £146m (2005: £120m).

Research and development (R&D)

Investment in R&D, whether charged against profit or capitalised, increased to £273m (2005: £223m), including £148m (2005: £141m) funded by customers. R&D is discussed more fully in the forward-looking section below.

Queen's Award for Enterprise

Smiths won the UK Queen's Award for Enterprise 2006 in Innovation for its Remote Interface Unit (RIU) product family which has the ability to digitise signals such as voltage, current, frequency and temperature, and effectively communicate these to a large number of aircraft systems over the 'central nervous system' of a modern airliner.

Forward-looking issues

Smiths Aerospace has, for the last several years, invested increasingly in R&D and in low-cost facilities to secure positions on future programmes and drive revenue growth in future years.

Military

On the military side, Smiths has high content on the platforms which have prospects of significant sales over the years ahead. Unlike the commercial business, Smiths military sales are less concentrated in a few key programmes. Particular original equipment programmes of importance to Smiths are the F-18, F-35, Eurofighter Typhoon, Apache Longbow and Future Lynx helicopters. Update programmes include the C130 AMP.

Commercial

In the commercial business, prospects are supported by firm business: the Airbus A380; the Boeing 787; and key engine programmes, notably GENx, Trent 1000, the CFM56 for narrow bodies, and the CF34 for regional jets. Further, the value of Smiths products on the A380 and B787 is much higher than on older generation aircraft.

The last several years of high self funded investment have been dominated by three programmes: A380, 767 Tanker, and B787. The first two are now effectively complete so R&D expenditure will reduce accordingly.

The division is expecting to see further strong growth in the commercial aircraft sector during the current year. In the longer term, recent successful selection for new commercial and military programmes should ensure a positive outlook for Smiths Aerospace.

Smiths Detection

Group Managing Director: Stephen Phipson

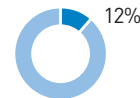
Description: Smiths Detection is a prime contractor and designs and manufactures equipment to detect and identify explosives, weapons, contraband and dangerous substances.

It has an unrivalled range of technologies, including trace detection, x-ray, millimetre wave, infra-red and biological agent analysis.

Employees: 2,000

Principal operating regions: Manufacturing is concentrated in North America, Germany, France and the UK.

Contribution to 2006 Group sales:



Key customers: Some 85% of sales are made direct to governments around the world including homeland security authorities, customs and immigration authorities, emergency responders and the military.

Business developments

Smiths Detection acquired Livewave, Inc. in October 2005 for £10m. Livewave has developed software systems which connect sensors and video cameras through a network to remote viewing stations. Livewave's technology enables Smiths Detection to provide a complete package of sensors ranging from x-ray to chemical detectors and CCTV in a single system, linked to a central command and control capability.

In June, Smiths Detection opened its first manufacturing facility in Russia. The new plant in St Petersburg will assemble x-ray equipment and is a base for both sales and technical support staff to serve the growing Russian security market.

Smiths Heimann Biometrics GmbH (SHB) was merged with Cross Match Technologies, Inc. in August 2005 in exchange for 43% of the issued share capital of that company. Smiths investment in Cross Match is accounted for on an equity basis.

Markets

Smiths Detection's products serve the transportation, critical infrastructure, ports and borders, military and emergency responder markets. The Company also adapts technology developed for these markets for carefully selected industrial applications.

Within transportation and critical infrastructure, growth is being driven by central and local governments and other agencies which are putting in place security systems, for example in airports and transport networks. Individual contracts can be large, causing the overall market to be volatile year-on-year.



July 2006
Smiths detectors deployed in New York
The New York Police Department purchased and deployed Smiths hand-held explosives detectors on the New York subway. Our detectors enable the NYPD to screen passengers for explosives quickly and non-intrusively.

The ports and borders market is experiencing growth caused both by security considerations and by authorities aiming to reduce contraband through clamping down on those avoiding payment of duty. The US Container Screening Initiative (CSI) in particular is driving growth in this sector.

The military market for UK and US technology is restricted by export controls, and these two governments form a large part of the market. The size of the market is influenced by significant contracts that are large in relation to the total market, although typically such contracts run for several years.

The emergency responder market is smaller than the other markets and is characterised by more localised purchasing decisions and steadier growth.

The markets served by Smiths Detection are particularly influenced by specific events and the perception of the threat of terrorist activity or other security issues. This perception itself has been and is likely to remain variable. Smiths Detection is working with a number of governments to deploy systems to counter the explosive threat identified in the UK in August 2006.

Performance

	2006 £m	2005 £m	Increase
Sales	412	367	12%
Headline operating profit	77	69	11%

Sales

Sales rose 12%. The translation of the results of US businesses at a higher dollar exchange rate and the effect of exchange on other non-UK businesses increased reported sales by 2%. Excluding both acquisitions and disposals and the effect of exchange translation, sales rose by 13%.

In the military sector, a number of existing military programmes have been winding down in the period, while several important new programmes including the Chem Bio Protective Shelter programme, are beginning. Smiths is well placed to benefit from new military programmes such as the US Department of Defense's requirement for a new generation of military chemical detectors.

Sales to transportation and airport authorities account for one third of the division's total, and new business secured in this period will sustain growth ahead. Elsewhere, airport operators around the world continue to acquire Smiths equipment, including in this period those in Thailand, China, Malaysia, Singapore, India, Pakistan, Japan, Australia and New Zealand. Smiths recently won a contract to supply security systems to the new terminal 3 at Dubai airport.

In addition Smiths Detection equipment is now being used on the New York and Prague subways and has been trialled at a commuter station in Maryland, US and on the London Underground.

The ports and borders business supplies large x-ray systems to check containers in transit. Turkey, Abu Dhabi and Oman placed orders for systems to screen shipments through their borders and airports. Belgian Customs are deploying new fixed and mobile scanners at Zeebrugge and Antwerp. Smiths is also under contract to provide mobile cargo x-ray systems (HCV) to the US Customs and Border Protection Agency.

Headline operating profit

Headline operating profit rose 11% with the operating margin at 18.6% compared with 18.8% in 2005. The profit increase arose principally from volume growth, with changes in the business mix leading to a slight margin reduction. On a statutory basis, operating profit was £81m (2005: £69m).

Research and development

Technology enhancement remains a high priority for Smiths Detection, whether by Company funded R&D or by acquisition, and has yielded a pipeline of new products.

A new Hi-Scan x-ray system for airport security checkpoints will help to identify and pinpoint explosives in hand luggage. A new desk-top system (500DT), able to detect drugs and explosives simultaneously, was launched and has been certified by the Transportation Security Administration.

R&D expenditure was £30m, a decrease of £1m. Company funded R&D was equivalent to 5% of sales in the year and customer funding added a further 2%. Smiths employs over 400 scientists and engineers in the Detection business who identify and develop new technologies.

Forward-looking issues

Smiths strategy is to build a global business meeting customers' needs to detect biological and chemical agents, weapons, contraband and explosives.

To fulfil this strategy Smiths Detection aims to develop technology internally and to make acquisitions of both technology start-ups and more established businesses.

Trading performance in a particular period will depend on the contracts secured, which can be large and irregular. Tendering activity is at a high level, however, and we are confident of growth in 2007.



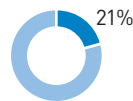
June 2006

Smiths provides life-saving medical equipment to World Cup

Smiths helped the German authorities protect football fans by supplying more than 1,000 hand-held pulse oximeters, which were carried in backpacks by first responders. The oximeters provide blood oxygen saturation and pulse rate monitoring for patients.

Smiths Medical**Group Managing Director:** Srin Seshadri**Description:** Smiths Medical focuses on improving medical outcomes. Smiths helps its customers:

- deliver medication, for example, by providing the equipment to deliver chemotherapy, pain relief and insulin;
- provide vital care, for example, by providing the equipment that manages airways and fluids during and after surgical procedures, as well as monitoring vital signs; and
- keep people safe, through safety devices for drawing blood samples, giving injections and delivering intravenous drugs.

Employees: 7,600**Principal operating regions:** Manufacturing is concentrated in the US, the UK, Mexico and Italy.**Contribution to 2006 Group sales:****Key customers:** Smiths Medical's end customers are hospitals and other healthcare providers worldwide. Most territories are serviced through wholly owned local sales and distribution companies.**Business developments**

Smiths Medical has continued to integrate the activities of Medex Inc., acquired in March 2005, which is delivering synergies to plan. Incremental synergies of £7m were achieved in 2006. In Europe and the US, the separate Medex companies have merged with existing Smiths Medical companies generating customer service and marketing synergies. R&D programmes have been aligned throughout the business.

Manufacturing integration is in progress and is expected to deliver cost reductions from 2007. During the year, Smiths Medical announced the cessation of manufacturing at three facilities – Duluth, Georgia; Wampsville, New York; and Hythe, Kent – and the expansion of facilities in Mexico and Ohio. The cessation of manufacturing in Hythe is the largest of the closures and will take two years to complete. Costs of £19m (2005: £10m) have been charged in the year in respect of the integration of Medex.

Reorganisation of the division's global distribution system is under way. Working with logistics specialists, Smiths Medical has established a European centre in The Netherlands to serve all markets outside the US, replacing six national warehouses.

In September 2005 Smiths Medical disposed of its interests in pvb Critical Care GmbH for £6m.

Markets

Smiths Medical's product ranges serve three main markets – medication delivery, vital care and safety. The two main contributors to overall market growth are ageing populations and increasing spending on healthcare. The overall world market for devices and equipment of the type supplied by Smiths Medical amounts to some US\$7bn and is growing consistently at 5-6% per annum.

Across the three Smiths Medical product groupings, markets are growing at varying rates. The global market for medication delivery products is growing at around 6%, while the market for vital care products is showing annual growth of around 4%. The global market for safety products is growing at around 8% with particularly strong growth in the US, reflecting the present 60% conversion of the market to safety needles and 95% conversion for peripheral intravenous (IV) catheters. In other geographic markets, conversion to safety products is in its infancy, with minimal sales but rapid growth. The Company has respected brands, competitive positions, considerable expertise in design and manufacture and a worldwide sales network.

Performance

	2006 £m	2005 £m	Increase
Sales	737	563	31%
Headline operating profit	138	88	57%

Sales

Sales rose by 31%, benefiting from a full 53 weeks' contribution from Medex (compared with four months in 2005) and from stronger average exchange rates used to translate the sales of overseas businesses. There was good growth across the Americas, Europe, Middle East, Africa and Asia.

During the year, sales of infusion pumps saw strong growth, especially the Medfusion™ 3500 Syringe Pump and the accompanying integrated software, PharmaGuard® Medication Safety Software.

Sales of single-use devices moved ahead of last year. In January, Smiths Medical signed a three year agreement with Novation, which offers contracting services to 2,500 hospitals throughout the US, under which the Company will be one of two suppliers of regional anaesthesia trays. These are standard or customised kits which provide all the necessary products for clinicians to perform regional anaesthesia.

**September 2006****Smiths helps NASA with launch project**

Our Hypertronics business is working with NASA on an innovative electrical connector that can withstand the intense vibrations of a rocket launch without being damaged. The connector is being developed for NASA's new sun observation craft.

In addition, Smiths Medical secured two major contracts with Premier Purchasing Partners group purchasing organisation for disposable anaesthesia and temperature management products. The temperature management product portfolio continued to increase its share of the market. During the year the temperature probe product range doubled in size and attained almost 50% market share in the US from 34% a year ago.

Safety devices continued to sell well in the US. Combining the Smiths Medical and Medex products has improved the range's competitive strength and is generating incremental sales.

Headline operating profit

Headline operating profit rose by 57% in the year. The translation of overseas earnings at stronger average exchange rates increased profit by 2%. On a statutory basis, operating profit was £109m (2005: £58m).

The increased headline operating profit is due to including a full year's activity from Medex plus an initial contribution from the synergies derived from the Medex integration and other restructuring savings, together with improvements in the product mix.

Research and development

Investment in R&D rose to £25m from £18m. Of this, £16m (2005: £14m) was charged against headline operating profit, with the balance being capitalised.

During the year there were a number of important new product launches. The ADVANTIV® safety IV catheter and the hypodermic needle/syringe Needle-Pro®EDGE™ were designed in response to continuing awareness of needle-stick injuries and consequent health risk. New respiratory products launched included the Portex® adjustable flange tracheostomy tube, the Portex®Thermovent® T2 heat and moisture exchange device, and the PressureEasy® cuff pressure controller. The line of anaesthesia offerings added a new carbon dioxide absorbent, SODASORB® LF, and a single-use bougie for difficult intubations. Smiths also launched a new range of advanced embryo replacement catheters, the Sure-Pro™ and Sure-Pro Ultra™ in response to the changing needs of fertility specialists.

Forward-looking issues

Smiths strategy is to continue to grow a global medical device business concentrating on improving medical outcomes by delivering medication, providing vital care and keeping medical practitioners safe.

Smiths Medical is well placed to make further progress in the coming year across all its business areas.

Smiths Specialty Engineering

Group Managing Director: Paul Cox

Description: Within Specialty Engineering John Crane provides mechanical rotating seals and associated equipment and services used in process industries. Interconnect supplies components and sub-systems for connecting, protecting and controlling critical electronic and radio frequency systems. Flex-Tek provides ducting and hosing for a wide range of applications, mainly for heating and ventilation and domestic equipment. Marine Systems supplies marine electronics and charts. The last three are disclosed under the heading 'Specialty – Other' in the segmental reporting in the accounts.

Employees: 11,200

Principal operating regions: John Crane and Marine Systems are global businesses. Interconnect manufactures in the US, the UK, France, Germany, Italy, Costa Rica and China. Flex-Tek manufactures mainly in the US, but also in the UK, France, Malaysia and Mexico.

Contribution to 2006 Group sales:



Key customers: John Crane serves oil and gas companies and refineries. Interconnect sells to aircraft manufacturers, defence and wireless telecoms companies. Flex-Tek serves mainly domestic appliance manufacturers and the US construction industry. Marine Systems serves the global professional marine industry.

Business developments

In February 2006, John Crane opened a £1.5m manufacturing, service and support centre in Bangalore, India. During the year, Smiths also purchased the remaining 33% minority stake in John Crane Tianjin, China for £1.5m, thereby increasing John Crane's presence in the growing wet seal sector in the region.

Smiths purchased Farnam Custom Products Inc and Millitech, Inc for £4m and £19m respectively, boosting Flex-Tek and Interconnect's presence in heating and ventilation and millimetre wave technologies respectively. The business and assets of Lorch Microwave LLC were purchased for £15m, increasing capability in microwave filters.

After the year end, the Company completed the disposal of Safematic Bearing Lubrication to SKF.

**July 2006****Explosives detectors for new Dubai terminal**

Smiths was selected to help protect passengers at the newest terminal at the Middle East's busiest airport. Around 70 x-ray screening systems will be integrated into the state-of-the-art baggage handling system in order to screen luggage for threats.

Markets

Smiths Specialty Engineering's principal businesses – John Crane, Interconnect and Flex-Tek – each address specific markets. Although each market is different, the demand for Specialty Engineering's products rose generally across all markets in 2006.

John Crane's largest markets are the oil and gas sector and the petrochemical and other process industries. Maintenance and support form a large part of total demand, with new projects providing an income stream many years after installation of equipment. John Crane's markets are driven by general economic expansion but in particular by growth within the oil and gas industry.

Interconnect's largest markets are aerospace, defence and wireless telecommunications. Within aerospace and defence, Interconnect's products include antenna systems, connectors, cable assemblies and frequency sources.

In the wireless telecommunications sector, Interconnect supplies devices to protect base stations from power surges, as well as coaxial cables and electronic components.

Flex-Tek serves mainly domestic appliance manufacturers and the US construction industry. Demand is normally a function of overall economic growth.

Performance

	2006 £m	2005 £m	Increase
Sales			
John Crane	518	463	12%
Specialty – Other	556	466	19%
	1,074	929	16%
Headline operating profit			
John Crane	69	63	11%
Specialty – Other	84	64	31%
	153	127	21%

Sales

Sales rose by 16%. The translation of the results of US businesses at the higher dollar exchange rate and the effect of exchange rates on other non-UK businesses increased sales by 3%. Excluding both acquisitions and the effect of exchange translation, sales rose by 9%.

John Crane's markets have been particularly strong in 2006, specifically within the oil and gas sector in the US, Latin America and Asia Pacific. Improved market conditions combined with the benefits of focusing on enhanced customer service produced a 12% increase in John Crane sales while tight cost controls produced a profit increase of 11%.

John Crane has won several large projects which will secure future revenue streams, including the Minatitlan process plant for Pemex in Mexico and the Qatar Gas Refinery. John Crane UK is in the process of installing a new technology centre which will be capable of testing gas seals to extreme pressure.

John Crane won a Queen's Award for its turbomachinery business in recognition of its success in expanding its business well in excess of the general levels of market growth and for its efforts in developing and marketing advanced technologies.

For the rest of Specialty, a number of major new contracts in Interconnect and a strong construction market for Flex-Tek resulted in overall sales growth of 19% and profit growth of 31%. Major contract wins include a deal to manufacture the award-winning Tarsier runway debris monitoring system in the USA won by the recently acquired Millitech and satellite communications for the new Boeing 787, won by Tecom.

Headline operating profit

Headline operating profit rose by 21%. The translation of the US results at the higher dollar exchange rate and the effect of exchange translation on other non-UK businesses increased the division's profit by 4%. On a statutory basis, operating profit was £74m for John Crane (2005: £65m) and £76m for the rest of Specialty Engineering (2005: £70m).

Research and development

R&D expenditure for the division as a whole increased by £2m to £24m.

Forward-looking issues

Smiths strategy is to grow each of the principal Specialty Engineering businesses. In pursuit of this strategy, Smiths aims to broaden the customer or market base where the application of its technological expertise and engineering skills are most appropriate, for example the development of Interconnect products for the medical equipment market.

Smiths Specialty Engineering's outlook is for further growth in the year ahead, helped by the continued upturn in the investment cycles for oil and gas and telecoms infrastructure.



February 2006
Smiths opens plant in India
Smiths is always looking for new ways to move closer to its customers and is already operating in more than 50 countries. In February, John Crane began manufacturing its high-performance seals in India.

Financial review

Accounting policies

The accounts in this report are the first annual accounts Smiths has prepared under International Financial Reporting Standards (IFRS), as adopted by the European Union (EU).

The accounting policies used in preparing these accounts are set out on pages 54 to 57. The information for the year to 31 July 2005, previously reported to shareholders under UK Generally Accepted Accounting Principles (UK GAAP) has been restated to conform to IFRS.

The significant differences between IFRS and UK GAAP have been drawn to shareholders' attention in a number of publications including the Operating and Financial Review in the Annual Report and Accounts 2005 and in a press release dated 21 November 2005 published on the Smiths website (www.smiths.com/press_2005.htm). Further information about the transition to IFRS and the key accounting policies can be found on page 90.

The accounting policies adopted include those necessary to comply with the requirements of IAS 32 and IAS 39 accounting standards that deal with the measurement and disclosure of financial instruments. These standards were adopted prospectively from 1 August 2005 and, as permitted, the comparative figures exclude the impact of the new standards. The 2006 financial year ended on 5 August. The 2005 financial year ended on 31 July.

Significant judgements, key assumptions and estimates

Applying accounting policies requires the use of certain judgements, assumptions and estimates. The most important of these are set out below. Further judgements, assumptions and estimates are set out in the accounts.

Revenue recognition

The timing of revenue recognition in complex contractual arrangements is important and is usually measured by reference to the stage of completion of contract activity at the balance sheet date. This assessment necessarily requires a high degree of judgement. For other aspects of revenue recognition, Smiths accounting policies allow revenue to be recognised only when the risks and rewards of ownership have passed to the customer.

Impairment

IFRS requires companies to carry out impairment testing on any assets that show indications of impairment, and annually on goodwill and intangibles that are not subject to amortisation. This testing involves exercising management judgement about future cash-flows and other events which are, by their nature, uncertain. The measurement of the impairment charge recorded this year against TI Automotive is an example of this judgement.

Retirement benefits

The assumptions underlying the calculation of retirement benefits are important and are based on independent advice. Changes in these assumptions could have a material impact on the measurement of our retirement benefit liabilities.

Taxation

The tax charge for the year represented an effective rate of 26% on the headline profit before taxation, the same as for 2005. This has been maintained through taking advantage of global tax incentives, the tax-efficient use of capital and active tax compliance management. Tax payments normally lag the tax charge and therefore boost free cash-flow. Current and deferred tax liabilities are recognised on the balance sheet in accordance with generally accepted accounting practice.

The fundamental tenets of the Smiths approach to taxation are to enhance the Company's competitive position on a global basis, while engaging with tax authorities around the world on a basis of full disclosure, full co-operation and full legal compliance. The Board considers and approves the management of the Company's tax affairs in the context of the Company's commercial objectives.

Smiths seeks to build open relationships with tax authorities to bring about timely agreement of tax affairs and to remove uncertainty on business transactions.

The Company's taxation strategy is to mitigate the burden of taxation in a responsible manner for competitive advantage, and, in this way, to enhance long-term shareholder value.

Cost of capital and return on investment

Smiths uses its weighted average cost of capital as one measure to appraise both internally-generated investment opportunities and acquisitions. During 2006, the Company's weighted average cost of capital (WACC) was 8%.

The after-tax headline return on average shareholder investment, including goodwill set-off against reserves (ROI), was 14% (2005: 11%).

Retirement benefits

The Company applies the full accounting requirements of International Accounting Standard (IAS) 19. These requirements are broadly similar to those previously adopted under UK GAAP.

Under IAS 19, the balance sheet reflects the net surplus/deficit in retirement benefit plans, taking assets at their market values at 5 August 2006 and evaluating liabilities at year-end AA corporate bond interest rates.



April 2006
Smiths awarded \$23 million US Government contract for mobile x-ray
Smiths was chosen to supply the US Government with high-energy mobile cargo screening systems to be deployed at several strategic ports through the country adding a new layer of security in America's defences against terrorism.

The table below gives an analysis of the year end retirement benefit liabilities.

	2006	2005
Funded plans:		
UK plans – funding status	105%	101%
US plans – funding status	84%	74%
	£m	£m
Surplus/(Deficit):		
UK/US funded plans	79	(106)
UK/US unfunded plans	(118)	(131)
Total liability	(39)	(237)

Company contributions to the funded pension plans were £110m in 2006 (2005: £52m) including a £61m special payment to facilitate UK scheme mergers involving underfunded schemes. The funds' investments achieved a return of 9% in the year. The UK AA corporate bond rate increased to 5.3%.

Mortality assumptions are reviewed at each actuarial valuation, and were updated in the current year in the UK. The present assumptions are illustrated by the life expectancy of a 65-year-old retiring in 2013. Men are assumed to have a life expectancy of 21 years and women 24 years. The change in mortality assumptions has increased UK pension liabilities by 4%. In the US, mortality assumptions were updated in 2005.

Full details of the retirement benefits accounted for under IAS are shown in note 9.

Exchange rates

The results of overseas operations are translated into sterling at average exchange rates. The net assets are translated at year-end rates. The exchange rates, expressed in terms of the value of sterling, are shown in the following table.

	2006	2005	
Average rates:			
Dollar	1.79	1.85	Dollar strengthened 3%
Euro	1.46	1.46	Euro unchanged
Year end rates:			
Dollar	1.91	1.76	Dollar weakened 8%
Euro	1.48	1.45	Euro weakened 2%

Dividend policy

Smiths operates a progressive dividend policy. The objective is to increase dividends annually when trading results and prospects justify it, and, in the long term, for dividends to be twice covered by headline earnings.

Goodwill and intangibles

Goodwill on all acquisitions since 1998 is capitalised and, under UK GAAP, was amortised over a maximum 20-year period. Under IFRS, goodwill is no longer amortised but instead is subject to annual reviews to test impairment.

On transition to IFRS, the amortised balance was tested for impairment, and subsequent tests have been performed in 2005 and 2006. Impairment of £11m was charged in 2005 in respect of the acquisition of Fairchild Defense Systems; no impairment charges have been made in the current year.

Treasury

The aim of Treasury in Smiths is to ensure a robust and prudent financial profile while driving value throughout the Company to attain the business's full potential. With this goal in mind, Treasury aims to reduce the cost of capital by optimising financial liabilities with the support of world class banks.

Smiths continues to apply centralised treasury management over its financial risks, operating within a strong control environment. The Company uses financial instruments to raise money for its operations and to manage the related financial risks. Smiths neither speculates nor trades in derivative financial instruments and all financial instruments are properly recognised on the balance sheet. The Board has approved a Treasury Policy, which governs the financial risk profile, and a treasury compliance report is presented annually to the Audit Committee.

The objectives of the treasury function remain the same as in previous years and are explained in further detail below.

1. To deliver the liquidity requirements of the businesses cost-effectively. The Company aims to minimise the level of surplus cash but, where surpluses arise, tight controls apply to ensure that they are securely placed with highly-rated counterparties and are available for redeployment at short notice. The Company is required under IFRS to show gross borrowings and cash under its cash pooling arrangements, despite these balances being netted for interest purposes, which exaggerates the Company's surplus cash balance. Local working capital needs and capital expenditure requirements



July 2006
Smiths delivers technology for Joint Strike Fighter
Smiths Aerospace delivered hardware for the first flight of the Joint Strike Fighter F-35. Our Aerospace systems on the F-35 JSF are valued at \$6-7bn, while Smiths Interconnect has been selected to provide broadband cable assemblies.

are typically funded by local bank facilities. In addition, Smiths has extensive local and cross-border cash pooling arrangements, and arm's length inter-company lending through financial centres, to optimise the global deployment of funds across its businesses in a tax-efficient manner.

2. To manage the central funding demands and provide a low cost of debt. The Company's funding requirements are largely driven by acquisition activity and met by centrally arranged debt finance. Smiths has net debt of £923m with average maturity of five years and at an average effective interest rate after interest and currency swaps of 5.6%. Through the use of interest rate swaps, Smiths maintains a broadly even mix of fixed and floating rate debt.

Credit ratings remain at A-/A3 with Standard & Poor's and Moody's respectively, reflecting the Company's strong financial profile and business outlook. The key financial measures that the ratings agencies consider are interest cover, currently standing at 9.6 times headline operating profit and the proportion of operating cash-flow to total debt, which under IFRS stands at 40%.

3. To develop and maintain strong and stable banking relationships and services. Smiths has a core and stable group of eleven leading global banks and financial institutions that competitively tender for treasury business. Credit exposures to any one bank are carefully controlled. All business transacted with the banks is on consistent terms and is fairly allocated.

4. To provide reasonable protection from the effect of foreign currency volatility. Material cross-border sales or purchase contracts in foreign currencies are hedged at their inception by appropriate derivative financial instruments, principally forward foreign exchange contracts and swaps, with the Company's core banks as counterparties. Whilst the trends of foreign currency movements cannot be eliminated, this hedging programme reduces volatility, protecting cash-flow and margins.

Smiths has adopted hedge accounting for the majority of the Company's business at its larger sites, thereby mitigating the impact of transactional exposures in the profit and loss account.

Smiths protects its reserves from foreign currency fluctuations by ensuring that at least 75% of the total net overseas operational assets are offset either by borrowings in the respective currency or by currency swaps. This excludes goodwill which is only partly hedged.

Overseas earnings are translated at average currency rates for the year, which smoothes the effect of currency volatility.

The Company's strategy is to continue to take a risk-averse approach to managing and controlling financial risks, be it hedging currency and interest rate risk, liquidity or management of refinancing risk.

Financial controls

While the Company's decentralised organisation delegates day-to-day control to local management, Smiths has comprehensive control systems in place with regular reporting to the Board. The Company has continuous formalised business risk management processes operating at each business unit.

The internal audit department reviews all units over a rolling three-year cycle, and its findings are reported to the Audit Committee. All acquisitions are reviewed within 12 months of acquisition, to verify compliance with Company procedures.

Further information regarding the Company's procedures to maintain strict controls over all aspects of risk, including financial risk, are set out in the Corporate governance report on pages 36 to 39.

Legal issues

Smiths is committed to operating within the law in all applicable jurisdictions, and seeks to benefit from the rights and protections afforded by relevant laws. The Company aims to anticipate and meet the changing requirements of the markets it serves, as legal and regulatory reforms impact those markets.

Smiths faces different types of legal issues in different jurisdictions. The high level of activity in the US, for example, exposes the Company to the likelihood of various types of litigation commonplace in that country, such as 'mass tort' and 'class action' litigation, proceedings threatened (and sometimes begun) as an aid to negotiated settlement of disputes, and legal challenges to the scope and validity of patents. An industry wide class action was settled during the year in respect of a product made by Titeflex in the Specialty Engineering division (see note 4 to the accounts).



July 2006

Smiths honoured for medical technology

With the incidence of the more serious Type 1 diabetes on the increase, there is a growing need to improve treatment. Our Cleo™ insulin infusion set received two awards for medical design excellence this year.



June 2006

Smiths supplies US military with chemical detectors

Smiths wins \$9.5m contract to supply our battle-proven Improved Chemical Agent Monitor (ICAM) units to the US military. These rugged post-attack devices quickly locate the presence of nerve and blister agents on both combat and homeland security missions.

In addition, contracting with the US Government subjects a company to numerous stringent regulatory obligations, calling for an active programme of compliance, reporting and communication. By contrast, the Company's activities in some countries with less developed legal systems pose challenges for the protection of corporate assets such as real estate and intellectual property rights.

In order to address the challenges and exploit the opportunities arising from these and other legal issues, Smiths employs suitably experienced lawyers in head office and certain operations, and retains the services of law firms around the world.

John Crane, Inc. Litigation

As previously reported, John Crane, Inc. (John Crane) a subsidiary of the Company, is one of the many co-defendants in numerous law suits pending in the USA 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 judgments 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.

Risks and uncertainties

Smiths operates globally in varied markets and manages the risks inherent in its activities. The Company seeks to mitigate exposure to all forms of risk, both external and internal, where practicable, and to transfer risk to insurers, where cost-effective.

External risks include global political and economic conditions; actions of competitors; the effect of legislation or other regulatory action; foreign exchange; raw material prices; pension funding; credit; environmental issues; and litigation.

Internal risks include investment in new products, projects and technology; acquisitions; controls failure; inability to supply and business continuity.

External risks

Global political and economic conditions

Smiths operates in over 50 countries, although some 90% of the Company's employees are located in North America, the EU and Japan. The Company is exposed to political risk, natural catastrophe and possible terrorist action.

Some 55% of total sales are to customers in the US, and the Company is therefore particularly affected by US economic conditions. Demand for products from the Detection business is mainly dependent on spending by governments and government agencies.

Political risk

The demand faced by the Company in the military aerospace sector is dependent on defence spending by governments, mainly in the US and Europe.

Natural catastrophe

Because of the location of operations, Smiths is exposed to a number of natural catastrophe risks, such as earthquake, flood and windstorm. Where cost effective, such risks are mitigated through physical measures designed to counter the impact of a catastrophe. The value of assets and associated profits are also protected by insurance.

Possible terrorist action

The demand faced by the Company in the commercial aerospace sector is a function of airline profitability, primarily driven by economic prosperity, which tends to be affected by terrorism or international tension. Commercial aerospace sales account for less than 15% of total activities.



July 2006

Smiths awarded A400 contract

Smiths Aerospace was awarded a contract to supply the in-flight refuelling probe for the Airbus A400M aircraft. The contract has a potential value of \$35m.

The diverse nature of the Company's products, services and customers helps mitigate the effects of adverse changes in political and economic risk on the demand that Smiths experiences.

Actions of competitors

Smiths operates in highly competitive markets. Product innovations or technical advances by competitors could adversely affect the Company. The diversity of operations reduces the possible effect of action by any single competitor.

The Company invests some 10% of revenues in research and development in order to sustain competitive advantage, and works continually to ensure that the cost base is competitive.

Effect of legislation or other regulatory action

Smiths is subject to a broad range of laws, regulations and standards in each of the jurisdictions in which it operates. Unexpected changes in these laws or regulations could significantly impair performance; equally, a failure to comply with these laws, regulations or standards could damage the reputation of the Company.

The Aerospace, Detection and Medical businesses are particularly subject to regulation, with certain customers and regulatory or other enforcement bodies routinely inspecting the Company's practices, processes and premises. Certain legal liability risks, such as product liability and employer's liability, are transferred to insurers, subject to policy limits and conditions. However, the Company and its subsidiaries have been in business for many years and there is a risk of latent injury claims which may not be fully covered by insurance.

Foreign exchange

The Company is exposed to two types of currency risk: 'transaction risk' in respect of products manufactured in one currency region and sold in another currency; and 'translation risk' in that the results of non-UK businesses will translate into differing sterling values depending on the exchange rate. The Company's practices for managing currency risk, as set out in the Treasury section, generally mitigate transaction risk in the short term. Over the longer term, Smiths remains exposed to both transaction and translation risk.

Longer-term transaction risks are mitigated by manufacturing or sourcing components in the same currency as that of the sale.

Net exports from the UK comprise approximately 17% of total sales.

Raw material prices

Smiths products contain various raw materials or purchased components including electronic components, metals and plastics. Any increases or volatility in prices and shortages in supply can affect the Company's performance. The diversity of operations both geographically and in terms of product area reduces the dependence on any single item or supplier. Purchasing policies take into account and seek to mitigate such risks where practicable.

Pension funding

The Company operates significant pension plans as detailed in note 9 to the accounts. The average funding level of the funded plans at 5 August 2006 was 103% measured by IAS 19 methodology. Funding of pension liabilities at that date was some 55% by equities and 45% by other assets. Smiths is subject to various funding risks, principally poor performance of the equity investments, and increased longevity of members.

Credit

Smiths is exposed to credit risk in relation to customers, banks and insurers. Credit control practices take into account the perceived risk. The customer base is relatively diverse.

Risk controls with regard to the Company's bank deposits are set out in the Treasury section.

Where appropriate, Smiths seeks to insure business risks with insurers of good standing. The insurance industry is, however, subject to credit risk, particularly in the event of catastrophe or where an insurer has substantial exposure to a specific risk. Occasionally insurer credit risk may be mitigated through policy commutation.

Environmental issues

The environmental laws of the jurisdictions in which Smiths operates impose actual and potential obligations on the Company to remediate contaminated sites, including some sites no longer owned by Smiths. The Company makes provision for the expected cost of remediation based on independent professional advice (see note 21 to the accounts). There is a risk that remediation could prove more costly than expected and that further contamination could be discovered.

Litigation

Smiths is subject to litigation from time to time in the ordinary course of business, and makes provision for the expected cost based on appropriate professional advice (see note 21 to the accounts). Details of current, material litigation are set out in the Legal Issues section.



April 2006
Smiths chemical biological protective shelters for US military
We developed this shelter for the US Department of Defense as a highly mobile, self-contained, collective protection system. It demonstrates a growing capability in Smiths for integrated systems.



May 2006
Smiths provides Thrust Reverser Actuation System for Boeing 747-8
Smiths Aerospace was selected by Boeing to supply the Thrust Reverser Actuation System (TRAS) for the new 747-8 airplane. Potential sales could exceed \$100m.

The outcome of legal action is always uncertain and there is always the risk that it may prove more costly and time consuming than expected. There is a risk that additional litigation could be instigated in the future which could have a material impact on the Company. In some liability cases, legal expenses are covered by insurance.

Internal risks

Investment in new products, projects and technology

Smiths develops new technologies and introduces new products, in some cases contracting to supply the products to the customer before the design is established or proven. All new technologies and products involve business risk both in terms of possible abortive expenditure, reputational risk, and potential customer claims or onerous contracts. Such risks may have a material impact on the Company.

Acquisitions

Smiths is an active acquirer: acquisitions may involve risks that might have a material impact on the Company. These risks are mitigated by extensive due diligence, and, where practicable, by representations and warranties and indemnities from the vendors.

Controls failure

Smiths operates controls as described in the Corporate governance report. Failures in these controls might have a material impact on the Company.

Inability to supply and business continuity

Inability to supply against contractual commitments is a risk, which could be material in relation to larger contracts. Smiths mitigates this risk by implementing effective business continuity plans throughout the Company and, where practicable, transferring them through business interruption insurance.

Corporate responsibility

Corporate responsibility for Smiths is enshrined in the sixth strength: 'doing business the right way'. Smiths defines 'the right way' in the Code of Corporate Responsibility and Business Ethics ('the Code'), which is based on 12 principles:

- (1) compliance with national laws and regulations;
- (2) fair and vigorous competition in the marketplace;
- (3) integrity and ethical conduct as the standard of individual and corporate business behaviour;
- (4) fair and honest treatment of suppliers and customers;
- (5) proper and respectful treatment of employees;
- (6) high standards for health and safety in the workplace;
- (7) respect for the environment;
- (8) contributions to the communities in which we live and work;
- (9) straightforward public information and activities;
- (10) respect for human rights;
- (11) prudent and transparent public accounting and reporting; and
- (12) a culture of compliance throughout the entire Smiths organisation – from the Chief Executive to the newest employee.

Translated into 13 languages, the Code applies to all Smiths businesses and employees worldwide and provides the framework for policies, programmes and procedures for a range of corporate responsibility issues. It is endorsed and fully supported by the Board.

Controls on defence sales

All sales of defence equipment are undertaken in accordance with government export and approval procedures and regulations, such as the International Traffic in Arms Regulation and the Export Administration Regulation in the USA. These laws prohibit export of certain items to specific countries. Smiths adheres to all relevant government guidelines designed to ensure that products are not incorporated into weapons or other equipment used for the purposes of terrorism, internal repression or abuse of human rights, with internal controls to ensure compliance with these guidelines. Compliance support to Smiths businesses worldwide is provided through a Business Ethics and Compliance team, which provides advice, export control policies, education, training, guidance materials and risk assessment tools.



June 2006
Smiths opens plant in Russia
Smiths Detection opened a production facility in St Petersburg enabling it to serve the fast-growing Russian security market.

In addition, Smiths Aerospace, together with the UK's leading defence companies and defence sector trade associations, joined the UK Defence Industry Anti-Corruption Forum, established earlier this year to promote the prevention of bribery and corruption in the international defence business.

Developments in reporting

For the first time Smiths is producing a Corporate responsibility report this year, building on the environment, health and safety reports published in previous years. Bringing the discipline of reporting and measuring progress to other Company responsibilities – employees, suppliers, communities – will help Smiths ensure that, in the long term, the principles of the Code are implemented consistently across the business.

You can find the full report on the Smiths website, www.smiths.com. Following is a summary of the main activities and progress for 2006.

Summary of Corporate responsibility report

Managing corporate responsibility

The Code is set by the Board and monitored by the Code Compliance Council, chaired by the General Counsel, which reports at least twice a year to the Audit Committee of the

Board. Responsibility for managing specific issues, however, lies at different levels within the Company, depending on the nature of the issue and how it can most effectively be managed:

- environmental issues are managed through a Group-wide steering committee and organisation;
- health and safety issues are managed likewise;
- employee issues are managed through the human resources function and by line management;
- supplier/customer programmes are managed divisionally, and
- community programmes are principally managed locally, although there is also some Group-level activity.

For the coming year, Smiths has set three main goals for managing corporate responsibility:

- to understand better the Company's corporate responsibilities as they apply to global operations;
- to capture the views and opinions of key stakeholders; and
- to continue to drive the Company's environment, health and safety programmes.

Environment

Smiths is committed to ensuring that, as far as is reasonably practicable, any detrimental effects of its activities, products and services upon the environment are minimised. In practice, this means using performance-based environmental management systems to drive improvement throughout the business.

Performance against targets

Target (set July 04)	2006 result	Comment
ISO14001 certification for all sites except small offices, with new acquisitions achieving certification within two years	83 out of 104 eligible sites certified	Programmes in place to achieve certification for the remaining sites
Energy consumption target set at 180MWh/£m sales (5% reduction over three years)	176MWh/£m sales	Target achieved one year early. Continuing with efforts to achieve further reduction
Waste to landfill target set at 3.5 Tonnes/£m sales (6% reduction over three years)	2.93 Tonnes/£m sales	Target achieved one year early. Continuing with efforts to achieve further reduction
Air emissions target set at 112kg/£m sales (6% reduction over three years)	100kg/£m sales	Target achieved one year early. Continuing with efforts to achieve further reduction
Water consumption target set at 411m ³ /£m sales (12% reduction over three years)	398m ³ /£m sales	Target achieved one year early. Continuing with efforts to achieve further reduction



June 2006
Smiths turbine plant
New Smiths Aerospace turbine engine components facility in West Jefferson, North Carolina. The new facility represents a US\$44m investment by Smiths.

Health and safety

Smiths is committed to conducting all its activities in a manner which achieves the highest practicable standards of health and safety. Smiths operates an internal health and safety management system using proprietary audit software against which all facilities are assessed once a year. This year, the overall average scores for compliance continued to improve steadily, from 70% to 73%.

Performance against targets

Target (set July 04)	2006 result	Comment
Recordable incident rate no target set	2.58/200,000 man-hours	Ongoing year-on-year improvement achieved
Lost days rate no target set	27.91/200,000 man-hours	Ongoing year-on-year improvement achieved
Lost time incident rate 1 incident/200,000 man-hours	1.15/200,000 man-hours	Target not yet achieved, additional focus on this area

Employees

Smiths and its businesses employ 31,832 people in 46 countries on six continents. 57% of employees are located in North America, and 23% in the UK. The remaining 20% is predominantly located in Germany, France and Italy.

The Company's policy is to provide equal opportunities for employment. Smiths recruits, selects and promotes employees on the basis of their qualifications, skills, aptitude and attitude. In employment-related decisions, Smiths complies with anti-discrimination requirements in the relevant jurisdictions concerning matters of race, colour, national origin, gender, marital status, sexual orientation, religious belief, age, or physical or mental disability. Disabled people are given full consideration for employment and subsequent training, career development and promotion on the basis of their aptitudes and abilities.

All Smiths employees are treated with respect and dignity. Accordingly, any harassment or bullying is unacceptable. Smiths respects the right of each employee to join or not to join a trade union or other bona fide employee representative organisation. Smiths believes in good communications with employees and in promoting consultation, co-operation and teamwork on matters of mutual concern.

Smiths offers share schemes that enable employees to acquire an interest in the Company's shares and to align their interests more closely with those of shareholders.

Reaching full potential

Smiths invests in employees' skills and capabilities to help them reach their own full potential, which in turn helps the Company and its businesses to do likewise. Current priorities for Smiths to achieve full potential across the Group are talent development, succession planning and employee engagement.

Talent development

Smiths Group and the individual businesses continue to invest in identifying and developing the talents of employees. Smiths provides employees with challenging work that stretches their capabilities, backing that up with training and development activities tailored to individual needs. In 2006, Smiths introduced a new process for the most senior people, integrating the performance review with the overall 'full potential' goals of the business.

Smiths continues to be actively involved in all aspects of training and developing young people, including initiatives designed to ease the transition from school to work. Horizons is a two-year programme for newly and recently appointed graduates and those early in their career which provides an understanding of the Company and the business world in general, and develops personal and teamworking skills.

Succession planning

Smiths has a systematic succession management process for senior leadership roles. The Company identifies leadership talent and development needs, and follows this up with



August 2006
Smiths launches new IVF catheter
We believe in talking to our customers and adapting to fit their needs. This year we launched a new range of catheters for IVF procedures after talking to fertility specialists and patients. The embryo transfer catheters are the first to be visible under ultrasound.



January 2006
Smiths in top 100 most sustainable businesses
Smiths was voted one of the world's most sustainable businesses in the Global 100. This is a listing of the global blue chip companies with the strongest sustainability performance.

individual development plans that are monitored by senior management.

Employee engagement

Smiths provides information to and communicates with employees as an important part of doing business. Employees are regularly provided with a wide range of information concerning the performance and prospects of the business in which they are involved by means of employee councils, information and consultation forums, and other consultative bodies that allow their views to be taken into account.

Suppliers

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

Smiths believes in working in partnership with its suppliers, so as to meet the expectations of customers, and to ensure quality, value and timeliness throughout the supply chain. The extent to which the Company works in partnership with suppliers varies across the Group, however, and this is therefore an area Smiths will be focusing on in the coming year in terms of understanding better the Company's corporate responsibilities as they apply to global operations.

Communities

As well as providing employment opportunities and training and development activities, Smiths seeks to contribute to the communities in which it operates by participating in and supporting community and charitable initiatives.

With long-established roots in local communities where Smiths is often a major employer, Smiths businesses take an active role in the community, in schools, universities, and hospitals. These are often small but significant initiatives involving people's time, rather than large corporate donations. Individual businesses also support charity projects, for example funding the Smiths Medical Chair of Anaesthesia and Critical Care at University College London.

Additionally, Smiths supports national and international charitable organisations from a central budget administered by the Charity and Donations Committee, for example donations to St Mungo's, a London-based charity that provides practical support for thousands of homeless and vulnerable people.

The purpose of this Annual Report is to provide information to the members of the Company. The Annual Report contains certain forward-looking statements with respect to the operations, performance and financial condition of the Group. By their nature, these statements involve uncertainty since future events and circumstances can cause results and developments to differ materially from those anticipated. The forward-looking statements reflect knowledge and information available at the date of preparation of this Annual Report and the Company undertakes no obligation to update these forward-looking statements. Nothing in this Annual Report should be construed as a profit forecast.