

SMITH & NEPHEW PLC  
Form 20-F  
March 01, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 20-F**

(Mark One)

- REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934  
or
- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2011  
or
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
or
- SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
Commission file number 1-14978

# Smith & Nephew plc

(Exact name of Registrant as specified in its charter)

England and Wales

(Jurisdiction of incorporation or organization)

15 Adam Street, London WC2N 6LA

(Address of principal executive offices)

## Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name on each exchange on which registered
American Depositary Shares	New York Stock Exchange
Ordinary Shares of 20¢ each	New York Stock Exchange*

\*Not for trading, but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.

Securities registered or to be registered pursuant to Section 12(g) of the Act: None.

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None.

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:  
951,021,116 Ordinary Shares of 20¢ each

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act: Yes  No

If this Report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934: Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes  No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large Accelerated Filer  Accelerated Filer  Non-accelerated filer   
Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing.

U.S. GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

If Other has been checked to the previous question indicate by check mark which financial statement item the registrant has elected to follow: Item 17  Item 18

If this is an annual report, indicated by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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Every day each one of us at **smith&nephew** helps improve the life of someone, somewhere in the world. That's something to be proud of.

Front Cover:

Smith & Nephew is a world leader in sports medicine and joint replacement technology to relieve pain and heal the body.

Important information on Smith & Nephew, Presentation,

Special note regarding forward-looking statements, Segment data and Documents on

display are set out on page 156.

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Overview

## Contents

For over 150 years, Smith & Nephew has developed advanced medical devices for healthcare professionals around the world. Our pioneering technologies enable nurses, surgeons and other medical practitioners to provide effective treatment more quickly and economically.

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Overview

Smith & Nephew at a glance

Smith & Nephew is a global medical technology business dedicated to helping improve people's lives. With leadership positions in Orthopaedic Reconstruction and Trauma, Advanced Wound Management and Endoscopy (sometimes referred to as Arthroscopy or sports medicine).

**Our strategic priorities** [Read more about our strategic priorities on page 10.](#)

Established Markets

Emerging Markets

Innovate for value

Simplify and improve our operating model

Supplement the organic growth through acquisitions

Our performance

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2 <sup>1</sup> Explanations of these non-GAAP financial measures are provided on pages 20 to 22.

<sup>2</sup> Underlying increase/decrease after adjusting for the effect of currency translation.

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In August 2011, the Group announced its new strategic priorities. Part of this framework was the implementation of an organisational change. Smith & Nephew has brought together the Orthopaedics and Endoscopy business segments, creating the Advanced Surgical Devices division, which will sit alongside the Advanced Wound Management division. These two divisions will serve the Established Markets and will support our newly created Emerging Markets (focusing on China, India, Brazil and Russia) and International Markets organisations. For reporting purposes, the two division structure will replace the three business segment structure during 2012.

**Our business segments in 2011**

<b>Revenue by business</b>		<b>\$4.3bn</b>			
		Sm			
A Orthopaedics		2,312			
B Endoscopy		939			
C Advanced Wound Management		1,019			
<b>Orthopaedics</b>		<b>Endoscopy</b>		<b>Advanced Wound Management</b>	
The Orthopaedics business segment comprises reconstruction (primarily implants including hip, knee and shoulder joints), trauma (internal and external fixation devices) and Clinical Therapies (bone growth stimulation and joint fluid therapies).		The Endoscopy business segment develops and commercialises arthroscopy (minimally invasive surgery) techniques, educational programmes and value-added services for surgeons to treat and repair soft tissue and articulating joints.		The Advanced Wound Management business segment offers a range of products from initial wound bed preparation through to full wound closure and Negative Pressure Wound Therapy. These products are targeted at chronic wounds associated with the older population and for the treatment of wounds such as burns and from invasive surgery.	
Global segment size <sup>3</sup>	Revenue	Global segment size <sup>3</sup>	Revenue	Global segment size <sup>3</sup>	Revenue
<b>\$17.8bn</b>	<b>\$2.3bn</b>	<b>\$3.8bn</b>	<b>\$0.9bn</b>	<b>\$5.5bn</b>	<b>\$1.0bn</b>
Global segment growth <sup>2,3</sup>	Revenue growth <sup>2</sup>	Global segment growth <sup>2,3,4</sup>	Revenue growth <sup>2</sup>	Global segment growth <sup>2,3</sup>	Revenue growth <sup>2</sup>
<b>+2%</b>	<b>+2%</b>	<b>+8%</b>	<b>+6%</b>	<b>+3%</b>	<b>+7%</b>
Trading profit	Trading profit margin	Trading profit	Trading profit margin	Trading profit	Trading profit margin
<b>\$492m</b>	<b>21.3%</b>	<b>\$222m</b>	<b>23.6%</b>	<b>\$247m</b>	<b>24.3%</b>
Operating profit	Operating profit margin	Operating profit	Operating profit margin	Operating profit	Operating profit margin

\$415m	17.9%	\$215m	22.9%	\$232m	22.8%
Segment share <sup>3</sup>		Segment share <sup>3</sup>		Segment share <sup>3</sup>	
11%		21%		18%	
<p>VERILAST's use of OXINIUM, oxidized Zirconium, results in a knee which has been proven to last 30 years, twice the current industry standard of 15 years.</p> <p>Read more about our Orthopaedics business on page 31.</p>		<p>The FAST-FIX 360 Meniscal Repair System offers exceptional fixation strength and enhanced control to optimise the chances of a successful meniscus repair.</p> <p>Read more about our Endoscopy business on page 35.</p>		<p>PICO is a small portable pump, providing 7 days effective Negative Pressure Wound Therapy yet is small enough to fit discreetly into a pocket.</p> <p>Read more about our Advanced Wound Management business on page 38.</p>	

<sup>3</sup> These are estimates generated by Smith & Nephew based upon public sources and internal analysis.

<sup>4</sup> Global segment data represents the Arthroscopy market which is a combination of repair and resection products. The Endoscopy business includes additional product categories.



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Where we operate

Smith & Nephew has nearly 11,000 employees and a presence in more than 90 countries.

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Chairman's statement

Sir John Buchanan

Chairman

We are striving to build a  
successful, sustainable  
business



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Overview

### Dear shareholder,

Smith & Nephew is in a transition phase. The external environment is a challenge for all businesses. With CEO succession we have taken the opportunity to review the fundamentals of what we do.

Led by our new CEO, Olivier Bohuon, the Group is embracing a new set of strategic priorities which build on established strengths, recent successes and emerging opportunities. To stimulate sales growth we are enhancing our innovation processes in both established and new markets.

The Group focuses both on what we do to create long-term sustainable value, and on how we do it. Matters of health, safety, environment, compliance, ethics and the treatment of employees, customers, suppliers and the communities in which we operate are all important to Smith & Nephew.

### Financial & business review

We are building from a strong and stable financial base, a foundation that has strengthened despite the challenges of the last three years.

In 2011, we increased revenue by 4% on an underlying basis to \$4,270m and delivered a trading profit of \$961m. Free cash flow, a key indicator of the health of any business, was good and we increased our adjusted earnings per share. The Board is pleased to recommend a proposed final dividend for the year of 10.8 cents per share, up 10% on 2010.

All of our businesses contributed to the revenue uplift. In Orthopaedics we led the market in knee growth amongst our major competitors, Endoscopy generated double-digit growth in our sports medicine repair franchise and Advanced Wound Management grew at more than double the market rate and exceeded \$1 billion in revenue for the first time.

We don't assume that the external environment will be easier in the year ahead. Nor do we expect competitive pressures to diminish. We are well positioned to deal with these challenges, building upon our performance in 2011, and we continue to seek ways to further enhance our competitive positions.

### Board changes

We were very pleased to welcome our new CEO, Olivier Bohuon, in April 2011, following the retirement of David Illingworth.

David's numerous contributions, from putting the customer-relationship at the heart of the business to the earnings and margin achievements, leave a good platform for the next stage of our journey. I am sure you will join the Board in thanking David for his important contribution.

Olivier, with his healthcare background, leadership skills and notable record, is well placed to take the Group forward. The Board is confident that we will evolve as a fitter, more focused business, ready to tackle new opportunities and challenges.

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We were also delighted to welcome Ajay Piramal to the Board in January 2012. He is one of India's most respected businessmen. Ajay's global healthcare experience and emerging markets expertise will further strengthen the Board.

### Thank you

With so much change there can be unsettling effects. The Board has been constantly impressed by the passion to serve customers and the determination to compete which our management and employees continue to exhibit wherever they are in the world.

We recognise that change can also engender uncertainties for shareholders. We will continue to enhance our record of long-term value creation and thank you for your support over recent times. I have had the opportunity to meet many of our institutional and private shareholders and have appreciated greatly their ideas and input. We are your Group, and we strive to build a sustainable, successful business.

### Sir John Buchanan

Chairman

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Strategy, KPIs & Risk management

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Chief Executive Officer's statement

Olivier Bohuon

Chief Executive Officer

We are building a business  
that is stronger, growing  
faster, better balanced  
and is fit and effective for

the future

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Strategy, KPIs & Risk management

### Dear shareholder,

Smith & Nephew delivered strong results in 2011, despite the prevailing difficult macro-economic climate. The market is not getting any easier, and we are not resting on the successes of the past. We have great ambitions for the future and are taking active measures to transform your Group.

I believe that many growth opportunities exist; that we can secure greater market-share in our Established Markets and be market leaders in the Emerging Markets. Our success will be built through innovation and efficiency, driving permanent improvements across the Group. These principles are at the heart of our new strategic priorities, announced in August 2011, which we are working tirelessly to embed across the Group.

### New strategic priorities

First, in our **Established Markets**, we believe we can build upon existing strong positions and win market share. We will do this through greater innovation and being more efficient, liberating resources for investment in those areas that will maximise both revenue and margins.

Second, in **Emerging Markets**, we will build upon our initial success in China and expand to create sustainable businesses in India, Brazil and Russia. These Emerging Markets are enjoying good GDP growth and there is an increasing demand for high quality medical products from amongst the population and an expanding surgical infrastructure to deliver these safely, the key features required to make a new market attractive to Smith & Nephew.

Our performance in the Established and Emerging Markets will be driven by an unremitting focus to **Innovate for Value**, our third strategic priority. Our future success depends upon offering new technologies designed for each market where we operate. We are accelerating our rate of innovation by increasing the research & development budget and prioritising projects that will deliver maximum value.

Next, we will **Simplify and Improve our Operating Model**, streamlining the business and reducing our cost of goods through actions such as optimising our manufacturing footprint.

Finally, we will **Augment our Organic Growth through Acquisitions**. We will continue with our successful strategy of adding complementary technologies. We will also now seek to support our Emerging Markets ambitions by acquiring local manufacturing and/or distribution businesses and we remain alert to larger opportunities to support our ambitions in advanced woundcare, minimally invasive surgery and extremities.

### Sustainability

Through our new strategic priorities we are seeking to maximise growth and revenue through building a sustainable business. We embrace the wider responsibilities this brings, and will work to protect the environment, our employees and the communities in which we work, as well as to meet our customers' high expectations and global compliance obligations, as we deliver on our action plans.

### Progress in delivery

We have made considerable progress reshaping the business in line with these priorities.

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Our management teams in our Advanced Surgical Devices and Advanced Wound Management divisions are now focused exclusively on meeting the needs of our customers in the Established Markets.

We have strong leadership to drive us into the Emerging and other International Markets. We are investing an additional \$300m over the next five years into R&D to drive our innovation agenda. And our programmes to realise efficiencies, liberate resources and reduce the cost of goods are well underway.

We are building momentum every day and I am confident that the result will be a business that is stronger, growing faster, better balanced and is fit and effective for the future.

**Olivier Bohuon**

Chief Executive Officer

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Strategy, KPIs & Risk management

Our strategic priorities and key performance indicators ( KPIs )

Smith & Nephew use a range of measures to monitor progress against our five strategic priorities and against our overall financial goal. While their relative importance changes as market conditions evolve, progress against all five priorities continues to drive our growth.

**Financial goal**

To deliver a higher return to shareholders than our peer group over the longer term.

**Strategic priorities**

**Established Markets**

In Established Markets (US, Europe, Australia, New Zealand, Canada and Japan), Smith & Nephew sees opportunities to build upon existing strong positions, to win market share through greater innovation and drive efficiencies to liberate resources. Through these actions the Group seeks to meet the challenges of subdued markets and maximise both revenue growth and profit margins.

**Emerging Markets**

Smith & Nephew believes it can secure market leadership in the Emerging Markets, building upon its initial success in China and expanding to create sustainable businesses in India, Brazil and Russia. In particular, the Group sees significant opportunities to build value through augmenting its existing portfolio with new products specifically designed for and manufactured in these markets.

**Innovate for value**

The Group's future success depends upon continuing to offer new technologies to customers around the world. Smith & Nephew is accelerating its rate of innovation by increasing the research & development budget and identifying and investing in the projects that will deliver maximum value.



## Simplify and improve our operating model

Smith & Nephew will work to ensure the business structure and processes support our innovation agenda and the Group seeks to maximise efficiency in everything it does. There are opportunities to streamline the Group's operations and manufacturing processes and to remove duplication. Smith & Nephew is building strong global functions – human capital, regulatory, quality, sustainability and legal affairs – to support its management teams in their quest to better serve the Group's markets and customers.

## Supplement organic growth through acquisitions

The Group aims to augment its organic growth through acquisitions. Smith & Nephew will continue with its successful strategy of acquiring complementary technologies, seek to support our Emerging Markets ambitions by acquiring local manufacturing and distribution businesses and remain alert to larger opportunities to support expansion in the advanced woundcare, extremities or minimally invasive surgery sectors.

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Strategy, KPIs &amp; Risk management

<b>What we will measure ( KPIs )</b>	<b>Why we will measure</b>
Total Shareholder Return	Monitor the value created for shareholders  over the longer term
Growth in statutory and adjusted earnings per share	Demonstrate the improvement in underlying  earnings per share for our shareholders
Trading cash flow	Measure the long-term cash generation of the Group excluding the impact of specific transactions or events that management considers affect the Group's short-term performance
Growth in the Established Markets versus the market	Track the relative strength of our market positions
Emerging Markets % of Group revenue	Track underlying growth of Emerging Markets to global growth
Growth of individual Emerging Markets versus the market	Monitor progress in key market segments
% of Group revenue from products launched in the last 36 months	Monitor impact from innovation

R&D expense as % of Group revenue

Monitor underlying investment in R&D

Trading profit growth

Track our underlying trading profit growth

Trading profit margin

Monitor underlying trading profitability

Waste/Recycling normalised metric

Reduce amount of waste for the Group, our customers,  
and the environment

Energy use normalised metric

Total energy consumption (volumetrically)

Return on cash invested

Monitor value created for shareholders



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Strategy, KPIs &amp; Risk management

## Risk management

## Smith & Nephew is focused on managing the principal risks facing the Group.

As an integral part of planning and review, Group management and management of each of the business segments seek to identify the risks involved in the business, the probability of those risks materialising, the impact if they do materialise and the actions being taken, and to be taken, to manage and mitigate those risks. Internal audit reviews and reports on the effectiveness of the operation of the risk management process. The Group Risk Committee meets twice a year to review the major risks identified by the business segment and Group

management and any mitigating actions being taken. As appropriate, the Risk Committee may re-categorise risks or require further information or mitigating action to be undertaken. The Risk Committee reports to the Board on an annual basis detailing all principal risks categorised by potential financial impact on profit and share price. In addition, the risks considered to be most significant to the Group are reported to the Board on a regular basis. These reports include details of new, key or significantly increased risks, the senior

Risk	Context	Specific risks we face
<b>Disruptive technologies</b>	The medical devices industry has a rapid rate of new product introduction. The Group must be adept at monitoring the landscape for technological advances, make good investment/acquisition choices, have an efficient and valuable product development pipeline and secure protection for its intellectual property.	<p>Competitors may introduce a disruptive technology, or obtain patents or other intellectual property rights, that affect the Group's competitive position</p> <p>Lack of innovation due to low R&amp;D investment, R&amp;D skills gap or poor product development execution</p> <p>Failure to successfully commercialise a pipeline product, failure to receive regulatory approval, or changes in consumer demand</p>
<b>Government action, pricing and reimbursement</b>	In most markets throughout the world, expenditure on medical devices is controlled to a large extent by governments, many of which are facing increasingly intense budgetary constraints. Funds may be made available or withdrawn from healthcare budgets depending	Reduced reimbursement levels and increasing pricing pressures

pressure

on government policy budgetary and other considerations. The Group is therefore largely dependent on governments providing increased funds commensurate with the increased demand arising from demographic trends. Reimbursement rates may be set in response to perceived economic value of the devices, based on clinical and other data relating to cost, patient outcomes and comparative effectiveness.

Reduced demand for elective surgery

Increased focus on health economics

Changes in medical device tax policy

Supply, system and site disruption

Unexpected events could disrupt the business by affecting either a key facility or system or a large number of employees. The business is also reliant on certain key suppliers of raw materials, components, finished products and packaging materials.

Competitors with higher market share and lower costs

Catastrophe could render one of the Group's production facilities out of action

A significant event could impact key leadership or a large number of employees

Issues with a single source supplier of a key component and failure to secure critical supply

A severe IT fault could disable critical systems

Product regulation, compliance and litigation

The medical device industry is highly regulated. National regulatory authorities administer and enforce a complex series of laws and regulations that govern the design, development, approval, manufacture, labelling, marketing and sale of healthcare products. Such controls have become increasingly stringent and costly to comply with and the Group believe this trend will continue. They also review data supporting the safety and efficacy of such products and regulatory requirements may entail inspections for compliance with appropriate standards, including those relating to Quality Management Systems ( QMS ) or Good Manufacturing Practice ( GMP ) regulations.

Non-compliance with regulatory policies and standards could result in fines, penalties, and prosecutions.

Product recalls, lost sales and inventory write-offs

Third party liability claims

Damage to reputation

Compliance with laws and regulations

Business practices in the healthcare industry are subject to increasing regulation and review by various government authorities. In general, the trend in many countries is towards higher expectations and increased enforcement activity by governmental authorities. The Group is also subject to increased regulation of personal information. Expansion into emerging

Violation of healthcare, data privacy or anti-corruption laws could result in fines, loss of reimbursement and impact reputation.

markets could also pose additional compliance risks.

Serious breaches could potentially prevent the Group from doing business.

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Strategy, KPIs & Risk management

management who have primary responsibility for managing each of these risks along with selected actions they have put in place to mitigate such risks. In addition, the Board considers risk as part of the development of strategy.

There are known and unknown risks and uncertainties relating to Smith & Nephew’s business. The table below provides an overview of what the Board considers to be the most significant risks that could cause the Group’s business, financial position

and results of operations to differ materially and adversely from expected and historical levels, and how these risks relate to the Group’s strategic priorities. A more detailed discussion of the Group’s risks and uncertainties can be found in the Risk factors section on pages 16 to 18. In addition, other factors not listed here, that Smith & Nephew cannot presently identify or does not believe to be equally significant, could also materially adversely affect Smith & Nephew’s business, financial position or results of operations.

Possible impacts include	Mitigation	Link to strategic priority
Loss of market share, profit and long-term growth	R&D Model: increasing productivity, prioritisation and allocation of funds	Innovate for value
	Increasing R&D investment in order to enhance clinical capability, invest in biomaterials, strengthen intellectual property rights and support an Emerging Market portfolio	Simplify and improve our operating model
	Business development to augment the portfolio	Supplement the organic growth through acquisitions
	Speed to market of new products	



<p><b>Loss of revenue, profit and cash flows</b></p>	<p>Enhanced expertise supporting reimbursement strategy and guidance</p> <p>Develop innovative economic product and service solutions for both Established and Emerging Markets</p> <p>Incorporate health economic component into design and development of new products</p> <p>Optimise cost to serve to protect margins and liberate funds for investment</p> <p>Streamline cost of goods sold and inventory</p>
<p><b>Loss of revenue, profit and cash flows</b></p>	<p>Ensure crisis response/business continuity plans at all major facilities and for key products</p> <p>Audit programme for critical suppliers and second sources for critical components</p> <p>Regular review of supply contracts with supplier consolidation and vertical integration where beneficial</p> <p>IT disaster and data recovery plans are in place and support overall business continuity plans</p>
<p><b>Loss of revenue, reduction</b></p>	<p>Enhanced leadership and resources</p>
<p><b>Simplify and improve our operating model</b></p> <p><b>Established Markets</b></p>	<p><b>Simplify and improve our operating model</b></p> <p><b>Established Markets</b></p>

<p><b>in share price and negative impact on brand/reputation</b></p>	<p>Standardise the Group's management review practice</p> <p>Maintain internal auditing programmes to assure compliance</p> <p>Group-wide robust validation practices to drive true production line performance and dependability</p> <p>Group-wide objectives for quality, operational and process yield improvements</p>	<p><b>Innovate for value</b></p>
<p><b>Loss of profit and reduction in share price</b></p>	<p>Board and Executive oversight committees supported by Compliance experts and infrastructure</p> <p>Code of Conduct/Global Policies and Procedures ( GPPs ) providing controls for significant compliance risks</p> <p>Training and e-resources to guide employees and third parties with compliance responsibilities</p> <p>Monitoring and auditing programmes to verify implementation and compliance</p> <p>Independent reporting channels for employees and third parties to report concerns with confidentiality</p>	<p><b>Simplify and improve our operating model</b></p> <p><b>Emerging Markets</b></p> <p><b>Established Markets</b></p>



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Business Review

Our business, marketplace and other factors that could affect us

We look at our business in relation to issues

in the wider marketplace in which we operate.

### **Sales and marketing**

Smith & Nephew's customers are the providers of medical and surgical services worldwide. In certain parts of the world, including the UK, much of Continental Europe, Canada and Japan, these are largely government organisations funded by tax revenues. In the US, the Group's major customers are public and private hospitals, which receive revenue from private health insurance and government reimbursement programmes. Medicare is the major source of reimbursement in the US, for knee and hip reconstruction procedures and for wound healing treatment regimes.

Competition exists among healthcare providers to gain patients on the basis of quality, service and price. Providers are under pressure to reduce the total cost of healthcare delivery. There has been some consolidation in the Group's customer base, as well as amongst the Group's competitors, and these trends are expected to continue in the long term. Smith & Nephew competes against both local and multinational corporations, including some with greater financial, marketing and other resources.

The Group's business reflects a wide range of distribution channels, purchasing agents and buying entities in over 90 countries worldwide. The largest single customers worldwide are purchasing groups in the US and the UK that represented 6% and 5% respectively of the Group's worldwide revenue in 2011.

In the US, the Group's products are marketed directly to healthcare providers, hospitals and other healthcare facilities with each business segment operating dedicated sales forces. The US sales forces consist of a mixture of independent contract workers and employees. Sales agents are contractually prohibited from selling products that compete with Smith & Nephew products. Orthopaedics and Endoscopy products are principally shipped and invoiced to healthcare providers, hospitals and other healthcare facilities. Certain Advanced Wound Management products are shipped and invoiced to wholesale distributors, others are consigned to distributors that lease the devices to healthcare providers, hospitals and other healthcare facilities and end-users. In most other Established Markets, each business segment typically manages employee sales forces directly, and also ships and invoices products both directly to healthcare providers, hospitals and other healthcare facilities and to wholesale distributors.

In Emerging Markets and International Markets the Group operates through direct selling and marketing operations, and through distributors. In these markets, Orthopaedics and Endoscopy frequently share sales resources. The Advanced Wound Management sales force may be separate where it calls on different customers.

### **Sales trends**

Smith & Nephew's business segments participate in the global medical devices market and share a common focus on the repair of the human body. Smith & Nephew's principal geographic markets are in the established healthcare economies of the US, Europe, Japan, Canada, Australia and New Zealand.

These markets are characterised by increased longevity, more active lifestyles, obesity, increased affluence and an increase in the average age of the population caused by the immediate post-World War II baby boomer generation approaching retirement. Together these factors have created significant demand for more effective healthcare products which deliver improved outcomes through technology advances. Furthermore, pressure to resist increases in overall healthcare spending has led healthcare providers to demand products which minimise the length of hospital stays and use of surgeon and nursing resources.

Increasing patient awareness of available healthcare treatments through the internet and direct-to-customer advertising has led to some increased patient influence over product purchasing decisions.

For a description of the impact on each business segment refer to the Market and competition sections under Business segment reviews on pages 30 to 40.

### Manufacturing, supply & distribution

The Group has a central Global Operations function which continues to implement Lean Manufacturing throughout the factories and the supply chain which is designed to improve and sustain higher levels of productivity, quality, service and efficiency.

Core competencies include: materials technology; high precision machining in Orthopaedics and Endoscopy; and high-volume, automated manufacturing in Advanced Wound Management.

Each business segment purchases raw materials, components, finished products and packaging materials from certain key suppliers. These principally include metal forgings and stampings for Orthopaedics, optical and electronic sub-components and finished goods for Endoscopy, active ingredients and finished goods for Advanced Wound Management and packaging materials across all businesses. Suppliers are selected, and contracts negotiated, by a centralised Group procurement team wherever possible, with a view to ensure value for money based on the total spending across the Group.

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The Group outsources manufacturing where necessary to obtain specialised expertise or where it is possible to gain lower cost without undue risk to intellectual property. Suppliers of outsourced products and services are selected based on their ability to deliver products and services to specification, and establish and maintain a quality system. Suppliers are trained and are monitored through on-site assessments and performance audits that include quality, service and delivery. Finished goods purchased for resale include screen displays, optical and electrical devices in the Endoscopy business and skincare products in the Advance Wound Management business.

The Group operates a number of central distribution facilities in the key geographical areas in which it operates. Orthopaedics and Endoscopy operate a facility in Baar, Switzerland which acts as the main holding and consolidation point for markets in Europe. Hubs serving the US are located in Memphis for Orthopaedics and Oklahoma City for Endoscopy. Products are shipped to Group companies who hold small amounts of inventory locally for immediate or urgent customer requirements. Advanced Wound Management distribution hubs include: Neunkirchen, Germany; Nottingham, UK; and Atlanta, US.

### Research and development

Smith & Nephew manage a portfolio of short and long-term product development projects designed to meet the future needs of customers and continue to provide growth opportunities for the business. The Group's research and development is directed towards each business segment. Expenditure on research and development amounted to \$167m in 2011 (2010 \$151m, 2009 \$155m), representing approximately 3.9% of Group revenue (2010 3.8%, 2009 4.1%).

The Group continues to invest in future technology opportunities for clinical needs identified from across the Smith & Nephew businesses.

Research and development is primarily carried out at the Group's principal locations, notably in Memphis, US (Orthopaedics), Mansfield, US (Endoscopy) and Hull, UK (Advanced Wound Management). There are a number of other smaller research and development units situated at other locations around the Group. In-house research is supplemented by work performed by academic institutions and other external research organisations in Europe, America and Asia.

### Intellectual property

Smith & Nephew has a policy of protecting the results of research and development carried out by the Group. Patents have been obtained in a wide range of fields, including orthopaedic reconstruction and trauma, endoscopy and advanced wound management. Patent protection for Group products is sought routinely in the Group's principal markets. Currently, the Group's patent portfolio stands at approximately 4,000 patents in force and patent applications pending.

Smith & Nephew also has a policy of protecting the Group's products by registering trademarks under local laws of markets in which such products are sold. The Group vigorously protects its trademarks against infringement.

In addition to protecting its market position by filing and enforcing patents and trademarks, Smith & Nephew may oppose third party patents and trademark filings where appropriate in those areas that might conflict with the Group's business interests.

In the ordinary course of its business, the Group enters into a number of licensing arrangements with respect to its products. None of these arrangements individually is considered material to the current operations and the financial results of the Group.

Exchange and interest rate

risk and financial instruments

The Board of Directors of the Company has established a set of policies to manage funding, currency and interest rate risks. Derivative financial instruments are used only to manage the financial risks associated with underlying business activities and their financing. See Note 16 of the Notes to the Group accounts for further details of these risks.

The Group's financial instruments are subject to changes in fair values as a result of changes in market rates of exchange and forward interest rates. Financial instruments entered to hedge sales and purchase transactions in foreign currency and interest rate exposures are accounted for as hedges. Changes in fair values of effective financial instruments would not affect the Group's income statement immediately. The movements in the fair value of financial instruments that are not accounted for as hedges offset movements in the values of assets and liabilities and are recognised through the income statement.

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# Our business, marketplace and other factors that could affect us continued

## Risk factors

There are known and unknown risks and uncertainties relating to Smith & Nephew's business. The factors listed below could cause the Group's business, financial position and results of operations to differ materially and adversely from expected and historical levels. In addition, other factors not listed here that Smith & Nephew cannot presently identify or does not believe to be equally significant could also materially adversely affect Smith & Nephew's business, financial position or results of operations.

### Highly competitive markets

The Group's business segments compete across a diverse range of geographic and product markets. Each market in which the business segments operate contains a number of different competitors, including specialised and international corporations. Significant product innovations, technical advances or the intensification of price competition by competitors could adversely affect the Group's operating results. Some of these competitors may have greater financial, marketing and other resources than Smith & Nephew. These competitors may be able to initiate technological advances in the field, deliver products on more attractive terms, more aggressively market their products or invest larger amounts of capital and research and development into their businesses.

There is a possibility of further consolidation of competitors, which could adversely affect the Group's ability to compete with larger companies due to insufficient financial resources. If any of the Group's businesses were to lose market share or achieve lower than expected sales growth, there could be a disproportionate adverse impact on the Group's share price and its strategic options.

Competition exists among healthcare providers to gain patients on the basis of quality, service and price. There has been some consolidation in the Group's customer base and this trend is expected to continue. Increased competition and unanticipated actions by competitors or customers could lead to downward pressure on prices and/or a decline in market share in any of the Group's business areas, which could adversely affect Smith & Nephew's results of operations and hinder its growth potential.

### Continual development and introduction of new products

The medical devices industry has a rapid rate of new product introduction. In order to remain competitive, each of the Group's business segments must continue to develop innovative products that satisfy customer needs and preferences or provide cost or other advantages. Developing new products is a costly, lengthy and uncertain process. A potential product may not be brought to market or not succeed in the market for any number of reasons, including failure to work optimally, failure to receive regulatory approval, failure to be cost-competitive, infringement of patents or other intellectual property rights and changes in consumer demand. The Group's products and technologies are also subject to marketing attack by competitors. Furthermore, new products that are developed and marketed by the Group's competitors may affect price levels in the various markets in which the Group's business segments operate. If the Group's new

products do not remain competitive with those of competitors, the Group's revenue could decline.

The Group maintains reserves for excess and obsolete inventory resulting from the potential inability to sell its products at prices in excess of current carrying costs. Marketplace changes resulting from the introduction of new products or surgical procedures may cause some of the Group's products to become obsolete. The Group makes estimates regarding the future recoverability of the costs of these products and records a



provision for excess and obsolete inventories based on historical experience, expiration of sterilisation dates and expected future trends. If actual product life cycles, product demand or acceptance of new product introductions are less favourable than projected by management, additional inventory write-downs may be required.

### Dependence on government and other funding

In most established markets throughout the world, expenditure on medical devices is ultimately controlled to a large extent by governments. Funds may be made available or withdrawn from healthcare budgets depending on government policy. The Group is therefore largely dependent on future governments providing increased funds commensurate with the increased demand arising from demographic trends.

Pricing of the Group's products is largely governed in most established markets by governmental reimbursement authorities. Initiatives sponsored by government agencies, legislative bodies and the private sector to limit the growth of healthcare costs, including price regulation, excise taxes and competitive pricing, are on-going in markets where the Group has operations. This control may be exercised by determining prices for an individual product or for an entire procedure. The Group is exposed to changes in reimbursement policy, tax policy and pricing which may have an adverse impact on sales and operating profit. In particular, changes to the healthcare legislation in the US are due to impose significant taxes on medical device manufacturers from 2013. There may be an increased risk of adverse changes to government funding policies arising from the deterioration in macro-economic conditions in some of the Group's markets.

The Group must adhere to the rules laid down by government agencies that fund or regulate healthcare, including extensive and complex rules in the US. Failure to do so could result in fines or loss of future funding.

### World economic conditions

Demand for the Group's products is driven by demographic trends, including the ageing population and the incidence of osteoporosis and obesity. Supply of, use of and payment for the Group's products are also influenced by world economic conditions which could place increased pressure on demand and pricing, adversely impacting the Group's ability to deliver revenue and margin growth. The conditions could favour larger, better capitalised groups, with higher market shares and margins. As a consequence, the Group's prosperity is linked to general economic conditions and there is a risk of deterioration of the Group's performance and finances during adverse macro-economic conditions.

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During 2011, economic conditions worldwide continued to create several challenges for the Group, including deferrals of joint replacement procedures, heightened pricing pressure, significant declines in capital equipment expenditures at hospitals and increased uncertainty over the collectability of European government debt, particularly those in certain parts of southern Europe. These factors tempered the overall growth of the Group's global markets and could have an increased impact on growth in the future.

### Political uncertainties

The Group operates on a worldwide basis and has distribution channels, purchasing agents and buying entities in over 90 countries. Political upheaval in some of those countries or in surrounding regions may impact the Group's results of operations. Political changes in a country could prevent the Group from receiving remittances of profit from a member of the Group located in that country or from selling its products or investments in that country. Furthermore, changes in government policy regarding import quotas, taxation or other matters could adversely affect the Group's turnover and operating profit. War, terrorist activities or other conflict could also adversely impact the Group.

### Currency fluctuations

Smith & Nephew's results of operations are affected by transactional exchange rate movements in that they are subject to exposures arising from revenue in a currency different from the related costs and expenses. The Group's manufacturing cost base is situated principally in the US, the UK, China and Switzerland, from which finished products are exported to the Group's selling operations worldwide. Thus, the Group is exposed to fluctuations in exchange rates between the US Dollar, Sterling and Swiss Franc and the currency of the Group's selling operations, particularly the Euro, Australian Dollar and Japanese Yen. If the US Dollar, Sterling or Swiss Franc should strengthen against the Euro, Australian Dollar and the Japanese Yen, the Group's trading margin could be adversely affected.

The Group manages the impact of exchange rate movements on sales and cost of goods sold by a policy of transacting forward foreign currency commitments when firm purchase orders are placed. In addition, the Group's policy is for forecast transactions to be covered between 50% and 90% for up to one year.

The Group uses the US Dollar as its reporting currency and the US Dollar is the functional currency of Smith & Nephew plc. The Group's revenues, profits and earnings are also affected by exchange rate movements on the translation of results of operations in foreign subsidiaries for financial reporting purposes. See "Financial position, liquidity and capital resources" on page 25.

### Manufacturing and supply

The Group's manufacturing production is concentrated at 11 main facilities in Memphis, Mansfield and Oklahoma City in the US, Hull, Warwick and Gilberdyke in the UK, Aarau in Switzerland, Tüttlingen in Germany, Alberta in Canada and Suzhou and Beijing in China. If major physical disruption took place at any of these sites, it could adversely

affect the results of operations. Physical loss and consequential loss insurance is carried to cover such risks but is subject to limits and deductibles and may not be sufficient to cover catastrophic loss. Management of orthopaedic inventory is complex, particularly forecasting and production planning. There is a risk that failures in operational execution could lead to excess inventory or individual product shortages.

Each of the business segments is reliant on certain key suppliers of raw materials, components, finished products and packaging materials. These suppliers must provide the materials and perform the activities to the Group's standard of quality requirements. If any of these suppliers is unable to meet the Group's needs, compromises on standards of quality or substantially increases its prices, Smith & Nephew would need to seek alternative suppliers. There can be no assurance that alternative suppliers would provide the necessary raw materials on favourable or cost-effective terms at the desired quality. Consequently, the Group may be forced to pay higher prices to obtain raw materials, which it may not be able to pass on to its customers in the form of increased prices for its finished products. In addition, some of the raw materials used may become unavailable, and there can be no assurance that the Group will be able to obtain suitable and cost-effective substitutes. Any interruption of supply caused by these or other factors could negatively impact Smith & Nephew's revenue and operating profit.

The Group uses a variety of information systems to conduct its manufacturing, supply and selling operations. An unrecoverable fault in one of these systems could disrupt trading in certain markets and locations.

The Group is in the process of outsourcing to third parties or relocating to lower cost countries certain of its manufacturing and other processes. As a result of these transfers, there is a risk of disruption to supply.

#### Attracting and retaining key personnel

The Group's continued development depends on its ability to hire and retain highly skilled personnel with particular expertise. This is critical, particularly in general management, research, new product development and in the sales forces. If Smith & Nephew is unable to retain key personnel in general management, research and new product development or if its largest sales forces suffer disruption or upheaval, its sales and operating profit would be adversely affected. Additionally, if the Group is unable to recruit, hire, develop and retain a talented, competitive workforce, it may not be able to meet its strategic business objectives.

#### Proprietary rights and patents

Due to the technological nature of medical devices and the Group's emphasis on serving its customers with innovative products, the Group has been subject to patent infringement claims and is subject to the potential for additional claims.

Claims asserted by third parties regarding infringement of their intellectual property rights, if successful, could require the Group to



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Business Review

## Our business, marketplace and other factors that could affect us continued

expend time and significant resources to pay damages, develop non-infringing products or obtain licences to the products which are the subject of such litigation, thereby affecting the Group's growth and profitability. Smith & Nephew attempts to protect its intellectual property and regularly opposes third party patents and trademarks where appropriate in those areas that might conflict with the Group's business interests. If Smith & Nephew fails to protect and enforce its intellectual property rights successfully, its competitive position could suffer, which could harm its results of operations.

### Product liability claims and loss of reputation

The development, manufacture and sale of medical devices entail risk of product liability claims or recalls. Design and manufacturing defects with respect to products sold by the Group or by companies it has acquired could damage, or impair the repair of, body functions. The Group may become subject to liability, which could be substantial, because of actual or alleged defects in its products. In addition, product defects could lead to the need to recall from the market existing products, which may be costly and harmful to the Group's reputation.

There can be no assurance that customers, particularly in the US, the Group's largest geographical market, will not bring product liability or related claims that would have a material adverse effect on the Group's financial position or results of operations in the future, or that the Group will be able to resolve such claims within insurance limits.

### Regulatory compliance in the healthcare industry

Business practices in the healthcare industry are subject to regulation and review by various government authorities. In general, the trend in many countries in which the Group does business is towards higher expectations and increased enforcement activity by governmental authorities. In the UK, a new Bribery Act was passed in 2010 and became effective in 2011, increasing the risk for companies that allow improper conduct on their behalf. While the Group is committed to doing business with integrity and welcomes the trend to higher standards in the healthcare industry, the Group and other companies in the industry have been subject to investigations and other enforcement activity that have incurred and may continue to incur significant expense. See "Legal proceedings" on page 28. Under certain circumstances, if the Group were found to have violated the law, its ability to sell its products to certain customers could be restricted.

### Regulatory approval

The international medical device industry is highly regulated. Regulatory requirements are a major factor in determining whether substances and materials can be developed into marketable products and the amount of time and expense that should be allotted to such development.

National regulatory authorities administer and enforce a complex series of laws and regulations that govern the design, development, approval, manufacture, labelling, marketing and sale of healthcare products. They also review data supporting the safety and efficacy of such products. Of

particular importance is the requirement in many countries that products be authorised or registered prior to manufacture, marketing or sale and that such authorisation or registration be subsequently maintained. The major regulatory agencies for Smith & Nephew's products include the Food and Drug Administration (FDA) in the US, the Medicines and Healthcare products Regulatory Agency in the UK, the Ministry of Health, Labour and Welfare in Japan and the State Food and Drug Administration in China. At any time, the Group is awaiting a number of regulatory approvals which, if not received, could adversely affect results of operations.

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The trend is towards more stringent regulation and higher standards of technical appraisal. Such controls have become increasingly demanding to comply with and management believes that this trend will continue. In the US, many of the Group's products are brought to market following pre-market notification to the FDA under Section 510(k) of the Food, Drug and Cosmetic Act, with a request that FDA clear the product as being substantially equivalent in terms of safety and effectiveness to a previously approved device. The FDA is considering changes in the 510(k) clearance process that might lengthen or modify the path to clearance in some circumstances.

Regulatory requirements may also entail inspections for compliance with appropriate standards, including those relating to Quality Management Systems or Good Manufacturing Practices regulations. All manufacturing and other significant facilities within the Group are subject to regular internal and external audit for compliance with national and Group medical device regulation and policies.

Payment for medical devices may be governed by reimbursement tariff agencies in a number of countries. Reimbursement rates may be set in response to perceived economic value of the devices, based on clinical and other data relating to cost, patient outcomes and comparative effectiveness. They may also be affected by overall government budgetary considerations. The Group believes that its emphasis on innovative products and services should contribute to success in this environment.

Failure to comply with these regulatory requirements could have a number of adverse consequences, including withdrawal of approval to sell a product in a country, temporary closure of a manufacturing facility, fines and potential damage to company reputation.

### Other risk factors

Smith & Nephew is subject to a number of other risks, which are common to most global medical technology groups and are reviewed as part of the Group's risk management process.

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Financial review

Adrian Hennah

Chief Financial Officer





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**Financial review continued****Chief Financial Officer highlights**

Group revenue was \$4,270m for the year ended 31 December 2011, representing an 8% growth compared to 2010. This comprised of underlying revenue growth of 4% and favourable currency translation of 4%.

Profit before taxation was \$848m in 2011, compared with \$895m in 2010. Attributable profit in 2011 was \$582m compared to \$615m in 2010. Adjusted attributable profit (calculated as set out in Selected financial data on pages 145 to 146) rose 2% to \$664m in 2011, from \$654m in 2010.

Basic earnings per Ordinary Share were 65.3¢, compared to 69.3¢ for 2010. EPSA (as set out in Selected financial data ) was 74.5¢ in 2011 compared to 73.6¢ for 2010, representing a 1% increase.

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
<b>Financial highlights (i) (iii)</b>			
Revenue	<b>4,270</b>	3,962	3,772
<i>Underlying growth in revenue (%)</i>	<b>4%</b>	4%	2%
Trading profit	<b>961</b>	969	857
<i>Underlying growth in trading profit (%)</i>	<b>(4)%</b>	11%	15%
<i>Trading profit margin (%)</i>	<b>22.5%</b>	24.5%	22.7%
Operating profit	<b>862</b>	920	723
Attributable profit for the year	<b>582</b>	615	472
<i>Adjusted attributable profit</i>	<b>664</b>	654	580
Basic earnings per Ordinary Share	<b>65.3¢</b>	69.3¢	53.4¢
EPSA	<b>74.5¢</b>	73.6¢	65.6¢
<i>Growth in EPSA (%)</i>	<b>1%</b>	12%	18%
Dividends per Ordinary Share (ii)	<b>17.40¢</b>	15.82¢	14.39¢
Cash generated from operations	<b>1,135</b>	1,111	1,030
<i>Trading cash flow</i>	<b>838</b>	825	771
<i>Trading profit to cash conversion (%)</i>	<b>87%</b>	85%	90%

(i) Items shown in italics are non-GAAP measures. Reconciliations to reported figures are on pages 21 to 22.

(ii) The Board has proposed a final dividend of 10.80 US cents per share which together with the first interim dividend of 6.60 US cents makes a total for 2011 of 17.40 US cents. The final dividend is expected to be paid, subject to shareholder approval, on 9 May 2012 to shareholders on the Register of Members at the close of business on 20 April 2012.

(iii) All items are \$ million unless otherwise indicated.

**Measuring performance**

Revenue

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Underlying growth in revenue is used to compare the revenue in a given year to the previous year on a like-for-like basis. This is achieved by adjusting for the impact of sales of products acquired in material business combinations and for movements in exchange rates. Underlying growth in revenue is not presented in the accounts prepared in accordance with International Financial Reporting Standards ( IFRS ) and is therefore a measure not in accordance with Generally Accepted Accounting Principles (a non-GAAP measure).

The Group believes that the tabular presentation and reconciliation of reported revenue growth to underlying revenue growth assists investors in their assessment of the Group's performance in each business segment and for the Group as a whole.

Underlying growth in revenue is considered by the Group to be an important measure of performance in terms of local functional currency since it excludes those items considered to be outside the influence of local management. The Group's management uses this non-GAAP measure in its internal financial reporting, budgeting and planning to assess performance on both a business segment and a consolidated Group basis. Revenue growth at constant currency is important in measuring business performance compared to competitors and compared to the growth of the market itself.

The Group considers that revenue from sales of products acquired in material business combinations results in a step-up in growth in revenue in the year of acquisition that cannot be wholly attributed to local management's efforts with respect to the business in the year of acquisition. Depending on the timing of the acquisition, there will usually be a further step change in the following year. A measure of growth excluding the effects of business combinations also allows senior management to evaluate the performance and relative impact of growth from the existing business and growth from acquisitions. The process of making business acquisitions is directed, approved and funded from the Group corporate centre in line with strategic objectives.

The material limitation of the underlying growth in revenue measure is that it excludes certain factors, described above, which ultimately have a significant impact on total revenues. The Group compensates for this limitation by taking into account relative movements in exchange rates in its investment, strategic planning and resource allocation. In addition, as the evaluation and assessment of business acquisitions is not within the control of local management, performance of acquisitions is monitored centrally until the business is integrated.

The Group's management considers that the non-GAAP measure of underlying growth in revenue and the GAAP measure of growth in revenue are complementary measures, neither of which management uses exclusively.

Underlying growth in revenue reconciles to growth in revenue reported, the most directly comparable financial measure calculated in accordance with IFRS by making two adjustments, the constant currency exchange effect and the acquisitions effect, described below.

The constant currency exchange effect is a measure of the increase/decrease in revenue resulting from currency movements on non-US Dollar sales. This is measured as the difference between the increase in revenue translated into US Dollars on a GAAP basis (i.e. current year revenue translated at the current year average rate, prior year revenue translated at the prior year average rate) and the increase measured by translating current and prior year revenue into US Dollars using the prior year closing rate.

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## Business Review

The acquisitions effect is the measure of the impact on revenue from newly acquired business combinations. This is calculated by excluding the revenue from sales of products acquired as a result of a business combination consummated in the current year, with non-US Dollar sales translated at the prior year average rate. Additionally, prior year revenue is adjusted to include a full year of revenue from the sales of products acquired in those business combinations consummated in the previous year, calculated by adding back revenue from sales of products in the period prior to the Group's ownership. These sales are separately tracked in the Group's internal reporting systems and are readily identifiable.

Reported revenue growth, the most directly comparable financial measure calculated in accordance with IFRS, reconciles to underlying growth in revenue as follows:

	2011	2010	2009
	%	%	%
Reported revenue growth	8	5	(1)
Constant currency exchange effect	(4)	(1)	3
Underlying revenue growth	4	4	2

A reconciliation of reported revenue growth to underlying revenue growth, by business segment, can be found on pages 30 to 40.

**Trading profit**

Trading profit is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affects the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. The Group has identified the following items, where material, as those to be excluded from operating profit when arriving at trading profit: acquisition and disposal related items including amortisation of acquisition intangible assets and impairments; significant restructuring events; and gains and losses resulting from legal disputes and uninsured losses.

Growth in trading profit and trading profit margin (trading profit expressed as a percentage of revenue) are measures which present the growth trend in the long-term profitability of the Group excluding the impact of specific transactions or events that management considers affect the Group's short-term profitability. The Group presents these measures to assist investors in their understanding of the trends. The Group's international financial reporting (budgets, monthly reporting, forecasts, long-term planning and incentive plans) focusses primarily on profit and earnings before these items. Trading profit and trading profit margin are not recognised measures under IFRS and are therefore non-GAAP financial measures.

The material limitation of these measures is that they exclude significant income and costs that have a direct impact on current and prior years profit attributable to shareholders. They do not, therefore, measure the overall performance of the Group presented by the GAAP financial measure of operating profit. The Group considers that no single measure enables it to assess overall performance and therefore it compensates for the limitation of the trading profit measure by considering it in conjunction with its GAAP equivalent. The gains or losses which are identified separately arise from irregular events or transactions. Such events or transactions are authorised centrally and require a strategic assessment which includes consideration of financial returns and generation of shareholder value. Amortisation of acquisition intangibles will occur each year, whilst other excluded items arise irregularly depending on the events that give rise to such items.

Operating profit, the most directly comparable financial measure calculated in accordance with IFRS, reconciles to trading profit as follows:

	2011	2010	2009
	\$ million	\$ million	\$ million
Operating profit	<b>862</b>	920	723
Acquisition related costs			26
Restructuring and rationalisation costs	<b>40</b>	15	42

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Amortisation of acquisition intangibles and impairments	<b>36</b>	34	66
Legal provision (see page 29)	<b>23</b>		
Trading profit	<b>961</b>	<b>969</b>	<b>857</b>

A reconciliation of operating profit to trading profit, by business segment, can be found on pages 30 to 40.

### Adjusted earnings per Ordinary Share

Growth in adjusted earnings per Ordinary Share ( EPSA ) is another measure which presents the trend in the long-term profitability of the Group. EPSA is not a recognised measure under IFRS and is therefore a non-GAAP financial measure. The most directly comparable financial measure calculated in accordance with IFRS is earnings per Ordinary Share.

EPSA excludes the same impact of specific transactions or events that management considers affect the Group's short-term profitability, is used by the Group for similar purposes, and is subject to the same material limitations, as set out and discussed in the above section on trading profit.

Adjusted attributable profit represents the numerator used in the EPSA calculation. Adjusted attributable profit is reconciled to attributable profit, the most directly comparable financial measure in accordance with IFRS, as follows:

	2011 \$ million	2010 \$ million	2009 \$ million
Attributable profit for the year	<b>582</b>	615	472
Acquisition related costs			26
Restructuring and rationalisation expenses	<b>40</b>	15	42
Amortisation of acquisition intangibles and impairments	<b>36</b>	34	66
Legal provision (see page 29)	<b>23</b>		
Taxation on excluded items	<b>(17)</b>	(10)	(26)
Adjusted attributable profit	<b>664</b>	654	580
Earnings per Ordinary share			
Basic	<b>65.3¢</b>	69.3¢	53.4¢
Diluted	<b>65.0¢</b>	69.2¢	53.3¢
Adjusted: Basic	<b>74.5¢</b>	73.6¢	65.6¢
Adjusted: Diluted	<b>74.2¢</b>	73.6¢	65.5¢

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**Financial review continued****Trading cash flow and trading profit to cash conversion ratio**

Growth in trading cash flow and improvement in the trading profit to cash conversion ratio are measures which present the trend growth in the long-term cash generation of the Group excluding the impact of specific transactions or events that management considers affect the Group's short-term performance.

Trading cash flow is defined as cash generated from operations less net capital expenditure but before acquisition related cash flows, restructuring and rationalisation cash flows and cash flows arising from legal disputes and uninsured losses. Trading profit to cash conversion ratio is trading cash flow expressed as a percentage of trading profit. The nature and material limitations of these adjusted items are discussed above.

The Group presents those measures to assist investors in their understanding of trends. The Group's internal financial reporting (budgets, monthly reporting, forecasts, long-term planning and incentive plans) focuses on cash generation before these items. Trading cash flow and trading profit to cash conversion ratio are not recognised measures under IFRS and are therefore considered non-GAAP financial measures.

The material limitation of this measure is that it could exclude significant cash flows that have had a direct impact on the current and prior years financial performance of the Group. It does not, therefore, measure the financial performance of the Group presented by the GAAP measure of cash generated from operations. The Group considers that no single measure enables it to assess financial performance and therefore it compensates for the limitation of the trading cash flow measure by considering it in conjunction with the GAAP equivalents. Cash flows excluded relate to irregular events or transactions including acquisition related costs, restructuring and rationalisation costs and cash flows arising from legal disputes and uninsured losses.

Trading cash flow reconciles to cash generated from operations, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Cash generated from operations	<b>1,135</b>	1,111	1,030
Less: Capital expenditure	<b>(321)</b>	(315)	(318)
Add: Cash received on disposal of fixed assets		8	
Add: Acquisition related expenditure	<b>1</b>		22
Add: Restructuring and rationalisation related expenditure	<b>20</b>	16	32
Add: Macrotecture expenditure	<b>3</b>	5	5
Trading cash flow	<b>838</b>	825	771
Trading Profit	<b>961</b>	969	857
Trading profit to cash conversion ratio	<b>87%</b>	85%	90%

**Recent developments**

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On 4 January 2012, the Group announced it had entered into an agreement with Essex Woodlands for the disposal of the Group's Clinical Therapies business. After disposal, the Group will retain a 49% investment in the newly formed company, Bioventus LLC, which will be reported as an associate. At 31 December 2011, the assets and liabilities of the Clinical Therapies business, \$125m and \$19m respectively, are disclosed as held for sale. In 2011, the Clinical Therapies business contributed \$237m to revenue and \$48m to trading profit. The Group expects to recognise a profit before tax in excess of \$250m on the transaction on completion.

### 2011 Financial highlights

The following table sets out certain income statement data for the periods indicated:

	2011 \$ million	2010 \$ million
Revenue (i)	4,270	3,962
Cost of goods sold (ii)	(1,140)	(1,031)
Gross profit	3,130	2,931
Marketing, selling and distribution expenses (iii)	(1,526)	(1,414)
Administrative expenses (iv, v, vi)	(575)	(446)
Research and development expenses	(167)	(151)
Operating profit (i)	862	920
Net interest payable	(8)	(15)
Other finance costs	(6)	(10)
Profit before taxation	848	895
Taxation	(266)	(280)
Attributable profit for the year	582	615

(i) Group revenue and operating profit are derived wholly from continuing operations and discussed on a segment basis on pages 30 to 40.

(ii) In 2011, \$7m of restructuring and rationalisation expenses were charged to cost of goods sold (2010 \$nil).

(iii) In 2011, no restructuring and rationalisation expenses were charged to marketing, selling and distribution expenses (2010 \$3m).

(iv) 2011 includes \$42m of amortisation of other intangible assets (2010 \$34m).

(v) 2011 includes \$23m relating to legal provision (2010 \$nil).

(vi) 2011 includes \$33m of restructuring and rationalisation expenses and \$36m relating to amortisation of acquisition intangibles (2010 \$12m of restructuring and rationalisation expenses and \$34m relating to amortisation of acquisition intangibles).

### Revenue

Group revenue increased by \$308m (8%) from \$3,962m in 2010 to \$4,270m in 2011. Underlying revenue growth was 4% and 4% growth was attributable to favourable currency translation.

Orthopaedics revenues increased by \$117m (5%), of which 2% was attributable to underlying growth, and 3% due to favourable currency translation. Endoscopy revenues increased by \$84m (10%), of which 6% was attributable to underlying growth, and 4% due to favourable currency translation. Advanced Wound Management revenues increased by \$107m (12%), of which 7% was attributable to underlying growth and 5% due to favourable currency translation.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 30 and 40.

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### Cost of goods sold

Cost of goods sold increased by \$109m to \$1,140m from \$1,031m in 2010 which represents an 11% increase. Of this movement, 4% is due to adverse translation movements leaving an underlying movement of 7% compared to an increase in underlying revenue of 4%. The residual movement is largely attributable to continued pricing pressure across all of the Group's markets which Smith & Nephew was not able to pass on to suppliers and an adverse movement in the mix of products sold, towards lower gross margin product.

Further margin analysis is included within the Trading profit sections of the individual business segments that follow on pages 30 to 40.

### Marketing, selling and distribution expenses

Marketing, selling and distribution expenses increased by \$112m (8%) to \$1,526m from \$1,414m in 2010. After adjusting for an unfavourable currency movement of 3% the underlying movement of 5% is broadly in line with increased Group revenues.

### Administrative expenses

Administrative expenses increased by \$129m (29%) to \$575m from \$446m in 2010. Unfavourable currency movements contributed towards 5% of this increase. The factors contributing to the underlying movement of 24% were; the non-recurrence of the one-off benefit of \$25m arising from the BlueSky settlement in 2010, a charge of \$23m relating to legal provision, an increase of \$21m in restructuring and rationalisation expenses, an increase of \$12m in the bad debt expense and an \$8m increase in the amortisation charge on intangible assets. Other factors contributing to this increase included the additional investment in China and Emerging Markets during the year.

### Research and development expenses

Expenditure as a percentage of revenue increased by 0.1% to 3.9% in 2011 (2010 3.8%). Actual expenditure was \$167m in 2011 compared to \$151m in 2010. The Group continues to invest in innovative technologies and products to differentiate it from competitors.

### Operating profit

Operating profit decreased by \$58m to \$862m from \$920m in 2010 comprising a decrease of \$88m in Orthopaedics, offset by increases of \$18m in Endoscopy and \$12m in Advanced Wound Management.

### Net interest payable

Net interest payable reduced by \$7m from \$15m in 2010 to \$8m in 2011. This is a consequence of the overall reduction of borrowings within the Group and a reduction in the applicable interest rates.

### Other finance cost

Other finance costs in 2011 were \$6m compared to \$10m in 2010. This decrease is attributable to an increase in the expected return on pension plan assets.



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### Taxation

The taxation charge decreased by \$14m to \$266m from \$280m in 2010. The effective rate of tax was 31.4%, compared with 31.3% in 2010.

The tax charge was reduced by \$17m in 2011 (2010 \$10m) as a consequence of restructuring and rationalisation expenses, amortisation of acquisition intangibles and legal provision. The effective tax rate was 29.9% (2010 30.8%) after adjusting for these items and the tax thereon.

### Group balance sheet

The following table sets out certain balance sheet data as at 31 December of the years indicated:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Non-current assets	<b>2,542</b>	2,579
Current assets	<b>2,080</b>	2,154
Assets held for sale	<b>125</b>	
Total assets	<b>4,747</b>	4,733
Non-current liabilities	<b>422</b>	1,046
Current liabilities	<b>1,119</b>	914
Liabilities directly associated with assets held for sale	<b>19</b>	
Total liabilities	<b>1,560</b>	1,960
Total equity	<b>3,187</b>	2,773
Total equity and liabilities	<b>4,747</b>	4,733
<b>Non-current assets</b>		

Non-current assets decreased by \$37m to \$2,542m in 2011 from \$2,579m in 2010. This is attributable to the following:

Goodwill decreased by \$5m from \$1,101m in 2010 to \$1,096m in 2011. Goodwill totalling \$37m was transferred to assets held for sale. Following the acquisition of Tenet Medical Engineering during 2011, an amount of \$44m was capitalised as goodwill. The balance relates to unfavourable currency movements totalling \$12m.

Intangible assets decreased by \$3m from \$426m in 2010 to \$423m in 2011. Intangible assets totalling \$14m were transferred to assets held for sale. Amortisation of \$78m was charged during the year and assets with a net book value of \$2m were written-off. A total of \$92m relates to the addition of intellectual property and software. The balance relates to unfavourable currency movements totalling \$1m.

Property, plant and equipment decreased by \$4m from \$787m in 2010 to \$783m in 2011. Property, plant and equipment totalling \$3m were transferred to assets held for sale. Depreciation of \$217m was charged during 2011 and assets with a net book value of \$7m were written-off. These movements were largely offset by \$229m of additions relating primarily to instruments and other plant & machinery. The balance relates to unfavourable currency movements totalling \$6m.

Trade and other receivables decreased by \$22m to \$nil in 2011 from \$22m in 2010 due to non-current receivables switching to current receivables during the year.

Deferred tax assets and other non-current assets decreased by \$3m in the year.



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Business Review

## Financial review continued

### Current assets

Current assets decreased by \$74m to \$2,080m from \$2,154m in 2010. The movement relates to the following:

Inventories fell by \$64m to \$859m in 2011 from \$923m in 2010. Inventories totalling \$15m were transferred to assets held for sale. Of the remaining movement, \$10m related to unfavourable currency movements.

The level of trade and other receivables increased by \$13m to \$1,037m in 2011 from \$1,024m in 2010. Trade and other receivables totalling \$49m were transferred to assets held for sale. Of the movement in the year, \$18m related to unfavourable currency movements.

Cash and bank has fallen by \$23m to \$184m from \$207m in 2010. Of the movement, \$2m related to unfavourable currency movements.

### Assets held for sale

Assets held for sale totalling \$125m relate to the underlying assets of Clinical Therapies business, the proposed sale of which was announced on 4 January 2012.

### Non-current liabilities

Non-current liabilities decreased by \$624m from \$1,046m in 2010 to \$422m in 2011. This movement relates to the following items:

Long-term borrowings have fallen from \$642m in 2010 to \$16m in 2011. This decrease of \$626m is mainly attributable to the long-term loan repayable in May 2012 switching to a current liability.

The net retirement benefit obligation increased by \$25m to \$287m in 2011 from \$262m in 2010. This was largely due to actuarial losses of \$70m which were only partly offset by pension contributions.

Deferred acquisition consideration was \$8m at the end of 2011, an increase of \$8m from \$nil at the end of 2010 as a result of the acquisition of Tenet Medical Engineering during the year.

Provisions decreased from \$73m in 2010 to \$45m in 2011 which is largely due to a number of settlements during the year.

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Deferred tax liabilities decreased by \$3m in the year.

### Current liabilities

Current liabilities increased by \$205m from \$914m in 2010 to \$1,119m in 2011. This movement is attributable to:

Bank overdrafts and current borrowings have increased by \$249m from \$57m in 2010 to \$306m in 2011 mainly as a result of the long-term loan repayable in May 2012 switching to a current liability.

Trade and other payables have decreased by \$53m to \$564m in 2011 from \$617m in 2010. Trade and other payables totalling \$19m were transferred to liabilities directly associated with assets held for sale. An amount of \$8m is attributable to favourable currency movements.

Provisions have increased by \$41m from \$37m in 2010 to \$78m in 2011. The most significant item contributing to this increase is the \$23m legal provision (see Note 3).

Current tax payable is \$171m at the end of 2011 compared to \$203m in 2010. Of the \$32m reduction, \$1m is attributable to favourable currency movements.

### Liabilities directly associated with assets held for sale

Liabilities held for sale totalling \$19m relate to the underlying liabilities of the Clinical Therapies business, the proposed sale of which was announced on 4 January 2012.

### Total equity

Total equity increased by \$414m from \$2,773m in 2010 to \$3,187m in 2011. The principal movements were:

	Total equity \$ million
1 January 2011	2,773
Attributable profit	582
Currency translation losses	(36)
Hedging reserves	14
Actuarial loss on retirement benefit obligations	(70)
Dividends paid during the year	(146)
Taxation benefits on Other Comprehensive Income and equity items	22
Net share based transactions	48
31 December 2011	3,187

### Transactional and translational exchange

The Group's principal markets outside the US are, in order of significance, Continental Europe, UK, Australia and Japan. Revenues in these markets fluctuate when translated into US Dollars on consolidation. During the year, the average rates of exchange against the US Dollar used to translate revenues and profits arising in these markets changed compared to the previous year as follows: the Euro strengthened from \$1.32 to \$1.39 (5%), Sterling strengthened from \$1.54 to \$1.60 (4%), the Swiss Franc strengthened from \$0.96 to \$1.13 (18%), the Australian Dollar strengthened from \$0.92 to \$1.03 (12%) and the Japanese Yen strengthened from ¥88 to ¥80 (9%).

The Group's principal manufacturing locations are in the US (Orthopaedics and Endoscopy), Switzerland (Orthopaedics), UK (Advanced Wound Management and Orthopaedics) and China (Orthopaedics and Advanced Wound Management). The majority of the Group's selling and distribution subsidiaries around the world purchase finished products from these locations. As a result of currency movements compared with the previous year, sales from the US became relatively less profitable to all of these countries. The Group's policy of purchasing forward a proportion of its currency requirements and the existence of an inventory pipeline reduce the short-term impact of currency movements.

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**Financial position, liquidity and capital resources****Cash flow and net debt**

The main elements of Group cash flow and movements in net debt can be summarised as follows:

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Cash generated from operations	<b>1,135</b>	1,111	1,030
Net interest paid	<b>(8)</b>	(17)	(41)
Income taxes paid	<b>(285)</b>	(235)	(270)
Net cash inflow from operating activities	<b>842</b>	859	719
Capital expenditure (net of disposal of property, plant and equipment)	<b>(321)</b>	(307)	(318)
Acquisitions (net of cash acquired)	<b>(33)</b>		(25)
Plus Orthopedics settlement			137
Equity dividends paid	<b>(146)</b>	(132)	(120)
Proceeds from own shares	<b>7</b>	8	10
Issue of ordinary share capital	<b>17</b>	15	7
Treasury shares purchased	<b>(6)</b>	(5)	
Change in net debt from net cash flow (see Note 21 of the Notes to the Group accounts)	<b>360</b>	438	410
Exchange adjustment	<b>(6)</b>	13	(21)
Opening net debt	<b>(492)</b>	(943)	(1,332)
Closing net debt	<b>(138)</b>	(492)	(943)

The Group's net debt decreased from \$1,332m at the beginning of 2009 to \$138m at the end of 2011, representing an overall decrease of \$1,194m. Translation of foreign currency net debt into US Dollars had the effect of increasing net debt by \$14m in the three-year period ended 31 December 2011.

**Net cash inflow from operating activities**

Cash generated from operations in 2011 of \$1,135m (2010 \$1,111m, 2009 \$1,030m) is after paying out \$3m (2010 \$5m, 2009 \$5m) of macrotextured claim settlements unreimbursed by insurers, \$1m (2010 \$nil, 2009 \$22m) of acquisition related costs and \$20m (2010 \$16m, 2009 \$32m) of restructuring and rationalisation expenses.

**Capital expenditure**

The Group's on-going capital expenditure and working capital requirements were financed through cash flow generated by business operations and, where necessary, through short-term committed and uncommitted bank facilities. In recent years, capital expenditure on tangible and intangible fixed assets represented approximately 8% of continuing Group revenue.

In 2011, gross capital expenditure amounted to \$321m (2010 \$315m, 2009 \$318m). The principal areas of investment were the placement of orthopaedic instruments with customers, patents and licences, plant and equipment and information technology.

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At 31 December 2011, \$9m (2010 \$15m, 2009 \$7m) of capital expenditure had been contracted but not provided for which will be funded from cash inflows.

### Acquisitions and disposals

In the three-year period ended 31 December 2011, \$58m was spent on acquisitions, funded from net debt and cash inflows. This comprised, \$33m for Tenet Medical Engineering during 2011 and \$25m for Nucrust in 2009. During 2009, the Group reached an agreement with the vendors of Plus Orthopedics Holdings AG to reduce the total original purchase price to CHF927m. This resulted in a cash inflow of \$137m.

### Liquidity

The Group's policy is to ensure that it has sufficient funding and facilities in place to meet foreseeable borrowing requirements. In December 2010, the Group reviewed and replaced its principal banking facilities ahead of the maturity in May 2012. The Group reduced its \$1,000m 5 year term loan to \$500m with effect from 20 December 2010. As at 31 December 2011 the balance outstanding was \$245m. Smith & Nephew also cancelled its \$1,500m multi-currency revolving loan facility and replaced it with a new 5 year \$1,000m multi-currency revolving loan facility.

At 31 December 2011, the Group held \$184m (2010 \$207m, 2009 \$192m) in cash and balances at bank. The Group has committed and uncommitted facilities of \$1.3bn and \$0.3bn respectively. The undrawn committed facilities totalling \$1.0bn expires after two but within five years. Smith & Nephew intends to repay the amounts due within one year by using available cash and drawing down on the longer-term facilities. In addition, Smith & Nephew has finance lease commitments of \$18m (of which \$8m extends beyond five years).

The principal variations in the Group's borrowing requirements result from the timing of dividend payments, acquisitions and disposals of businesses, timing of capital expenditure and working capital fluctuations.

Smith & Nephew believes that its capital expenditure needs and its working capital funding for 2012, as well as its other known or expected commitments or liabilities, can be met from its existing resources and facilities.

The Group's planned future contributions are considered adequate to cover the current underfunded position in the Group's defined benefit plans.

Further disclosure regarding borrowings, related covenants and the liquidity risk exposures is set out in Note 15 of the Notes to the Group accounts. The Group believes that its borrowing facilities do not contain restrictions that would have significant impact on its funding or investment policy for the foreseeable future.





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Business Review

## Financial review continued

## 2010 Financial highlights

The following table sets out certain income statement data for the periods indicated:

	<b>2010</b>	2009
	<b>\$ million</b>	\$ million
Revenue (i)	<b>3,962</b>	3,772
Cost of goods sold (ii)	<b>(1,031)</b>	(1,030)
Gross profit	<b>2,931</b>	2,742
Marketing, selling and distribution		
expenses (iii)	<b>(1,414)</b>	(1,351)
Administrative expenses (iv)	<b>(446)</b>	(513)
Research and development expenses	<b>(151)</b>	(155)
Operating profit (i)	<b>920</b>	723
Net interest payable	<b>(15)</b>	(40)
Other finance costs	<b>(10)</b>	(15)
Share of results of associates		2
Profit before taxation	<b>895</b>	670
Taxation	<b>(280)</b>	(198)
Attributable profit for the year	<b>615</b>	472

(i) Group revenue and operating profit are derived wholly from continuing operations and discussed on a segment basis on pages 30 to 40.

(ii) In 2010 no restructuring and rationalisation expenses and no acquisition related costs were charged to cost of goods sold (2009 \$15m of restructuring and rationalisation expenses and \$12m of acquisition related costs).

(iii) 2010 includes \$3m of restructuring and rationalisation expenses. No acquisition related costs were charged to marketing, selling and distribution expenses in 2010. (2009 \$7m of acquisition related costs and \$10m of restructuring and rationalisation expenses).

(iv) 2010 includes \$12m of restructuring and rationalisation expenses and \$34m relating to amortisation of acquisition intangibles and impairments (2009 \$7m of acquisition related costs, \$17m of restructuring and rationalisation expenses and \$66m relating to amortisation of acquisition intangibles and impairments).

## Revenue

Group revenue increased by \$190m (5%) from \$3,772m in 2009 to \$3,962m in 2010. Underlying revenue growth was 4%, and a further 1% growth was attributable to favourable currency translation.

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Orthopaedics revenues increased by \$60m (3%), of which 2% was attributable to underlying growth, and 1% due to favourable currency translation. Endoscopy revenues increased by \$64m (8%), of which 7% was attributable to underlying growth, and 1% due to favourable currency translation. Advanced Wound Management revenues increased by \$66m (8%), of which 7% was attributable to underlying growth and 1% due to favourable currency translation.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 30 and 40.

### Cost of goods sold

Cost of goods sold increased by \$1m to \$1,031m from \$1,030m in 2009. This represents 26% of revenue compared to 27% in 2009. During 2010, the Group has continued to deliver on its efficiency commitments, including the new Advanced Wound Management manufacturing facility in China and improved inventory management in Orthopaedics. Other factors contributing to the movement were the decrease of \$15m in restructuring and rationalisation expenses and decrease of \$12m in other acquisition related costs. Currency had little impact on the year on year movement.

Further margin analysis is included within the Trading profit sections of the individual business segments that follow on pages 30 to 40.

### Marketing, selling and distribution expenses

These expenses increased by \$63m (5%) to \$1,414m from \$1,351m in 2009. In line with increased revenue there has been a 4% underlying increase in advertising, marketing and selling costs. Unfavourable currency movements have contributed to the remaining 1% movement.

### Administrative expenses

Administrative expenses decreased by \$67m (-13%) to \$446m from \$513m in 2009. The principal factors contributing to the underlying movement of -14% were a \$32m reduction in the amortisation and impairment charge of intangible assets, a \$7m reduction in acquisition related costs and a decrease of \$5m in restructuring and rationalisation expenses. This was partially offset by a 1% unfavourable movement in currency.

### Research and development expenses

Expenditure as a percentage of revenue decreased by 0.3% to 3.8% in 2010 (2009 4.1%). The Group continues to invest in innovative technologies and products to differentiate itself from competitors.

### Operating profit

Operating profit increased by \$197m to \$920m from \$723m in 2009 comprising increases of \$93m in Orthopaedics, \$28m in Endoscopy and \$76m in Advanced Wound Management.

### Net interest payable

Net interest payable reduced by \$25m from \$40m in 2009 to \$15m in 2010. This is a consequence of the overall reduction of borrowings within the Group and a reduction in the applicable interest rates.

### Other finance cost

Other finance costs in 2010 were \$10m compared to \$15m in 2009. This decrease is attributable to an increase in the expected return on pension plan assets.

### Taxation

The taxation charge increased by \$82m to \$280m from \$198m in 2009. The effective rate of tax was 31.3%, compared with 29.6% in 2009.

The tax charge was reduced by \$10m in 2010 (2009 \$26m) as a consequence of restructuring and rationalisation expenses, acquisition related costs, amortisation of acquisition intangibles and impairments. The effective tax rate was 30.8% (2009 27.9%) after adjusting for these items and the tax thereon.

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## Group balance sheet

The following table sets out certain balance sheet data as at 31 December of the years indicated:

	<b>2010</b>	2009
	<b>\$ million</b>	\$ million
Non-current assets	<b>2,579</b>	2,480
Current assets	<b>2,154</b>	2,071
Assets held for sale		14
Total assets	<b>4,733</b>	4,565
Non-current liabilities	<b>1,046</b>	1,523
Current liabilities	<b>914</b>	863
Total liabilities	<b>1,960</b>	2,386
Total equity	<b>2,773</b>	2,179
Total equity and liabilities	<b>4,733</b>	4,565
<b>Non-current assets</b>		

Non-current assets increased by \$99m to \$2,579m from \$2,480 in 2009. Intangible assets and goodwill increased by \$22m of which \$65m related to additions of intangibles, \$28m related to favourable currency translation and \$2m of transfers. These were partially offset by \$68m of amortisation and a \$4m adjustment to contingent consideration. Property, plant and equipment increased by \$34m comprising \$250m of additions and \$3m of favourable currency translation, partially offset by \$203m of depreciation charge, \$14m of disposals and \$2m of transfers. Deferred tax assets and other non-current assets increased by \$43m in the year.

## Current assets

Current assets increased by \$83m to \$2,154m from \$2,071m in 2009. This was due to an increase in trade and other receivables of \$78m and an increase in cash at bank of \$15m. These increases were partially offset by a reduction in inventories of \$10m.

## Non-current liabilities

Non-current liabilities decreased by \$477m from \$1,523m in 2009 to \$1,046m in 2010. \$448m of this decrease was due to the reduction of long-term borrowings. The net retirement benefit obligation decreased by \$60m. This was largely due to the excess of pension contributions totalling \$65m over the charge to the income statement in the year of \$35m which gave rise to a net \$30m reduction in the liability. In addition, there were actuarial gains totalling \$26m. Other movements in non-current liabilities related to a reduction in deferred acquisition consideration of \$27m due to settlement of the BlueSky Medical Group Inc. ( BlueSky ) deferred consideration, an increase of \$38m in the deferred tax liability and an increase in provisions of \$20m due to a change in the expected time frame to settlement which has resulted in a reclassification from current liabilities.

## Current liabilities

Current liabilities increased by \$51m from \$863m in 2009 to \$914m in 2010. This was due to an increase in bank overdrafts and current borrowings of \$12m, an increase in trade and other payables of \$21m and an increase in current tax payable of \$36m, offset by a decrease in provisions of \$18m.

## Total equity

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Total equity increased by \$594m from \$2,179m in 2009 to \$2,773m in 2010. The principal movements were an increase of \$615m due to attributable profit, currency translation and hedging gains of \$53m, an increase of \$26m relating to actuarial gains on retirement benefit obligations, offset by a decrease of \$7m relating to deferred taxation and a decrease of \$132m due to dividends paid during the year.

	Total equity \$ million
1 January 2010	2,179
Attributable profit	615
Currency translation gains	52
Hedging gains	1
Actuarial gain on retirement benefit obligations	26
Dividends paid during the year	(132)
Taxation on Other Comprehensive Income and equity items	(7)
Net share based transactions	39
31 December 2010	2,773

### Going concern

The Group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review section on pages 30 to 40. The financial position of the Group, its cash flows, liquidity position and borrowing facilities are described under Financial position, liquidity and capital resources within the Business Review section set out on page 25. In addition, the notes to the financial statements include the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposure to credit risk and liquidity risk.

The Group has considerable financial resources and its customers and suppliers are diversified across different geographic areas. As a consequence, the Directors believe that the Group is well placed to manage its business risk successfully despite the on-going uncertain economic outlook.

The Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis for accounting in preparing the annual financial statements.

Management also believes that the Group has sufficient working capital for its present requirements.

### Payment policies

It is the Group's and Company's policy to ensure that suppliers are paid within agreed terms. At the year-end the Company had no trade creditors.



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Business Review

## Financial review continued

### Factors affecting Smith & Nephew's results of operations

Government economic, fiscal, monetary and political policies are all factors that materially affect the Group's operation or investments of shareholders. Other factors include sales trends, currency fluctuations and innovation. Each of these factors is discussed in further in Our business, marketplace and other factors that could affect us on pages 14 to 18 and Taxation information for shareholders on pages 147 to 148.

### Critical accounting policies

The Group's significant accounting policies are set out in Notes 1 to 24 of the Notes to the Group accounts. Of those, the policies which require the most use of management's judgement are as follows:

#### Inventories

A feature of the Orthopaedics business segment (whose finished goods inventory makes up approximately 74% of the Group total finished goods inventory) is the high level of product inventory required, some of which is located at customer premises and is available for customers immediate use. Complete sets of product, including large and small sizes, have to be made available in this way. These sizes are used less frequently than standard sizes and towards the end of the product life cycle are inevitably in excess of requirements. Adjustments to carrying value are therefore required to be made to orthopaedic inventory to anticipate this situation. These adjustments are calculated in accordance with a formula based on levels of inventory compared with historical usage. This formula is applied on an individual product line basis and is first applied when a product group has been on the market for two years. This method of calculation is considered appropriate based on experience, but it does involve management judgements on customer demand, effectiveness of inventory deployment, length of product lives, phase-out of old products and efficiency of manufacturing planning systems.

#### Impairment

In carrying out impairment reviews of goodwill, intangible assets and property, plant and equipment a number of significant assumptions have to be made when preparing cash flow projections. These include the future rate of market growth, discount rates, the market demand for the products acquired, the future profitability of acquired businesses or products, levels of reimbursement and success in obtaining regulatory approvals. If actual results should differ or changes in expectations arise, impairment charges may be required which would adversely impact operating results.

#### Retirement benefits

A number of key judgements have to be made in calculating the fair value of the Group's defined benefit pension plans. These assumptions impact the Balance Sheet liability, operating profit and other finance income/costs. The most critical assumptions are the discount rate and mortality assumptions to be applied to future pension plan liabilities. For example as of 31 December 2011, a 0.5% increase in discount rate would have reduced the combined UK and US pension plan deficit by \$96m whilst a 0.5% decrease would have increased the combined deficit by \$109m. A 0.5% increase in discount rate would have decreased profit before taxation by \$5m whilst a 0.5% decrease would have increased it by \$5m. A one year increase in the assumed life expectancy of the average 60 year old male pension plan member in both the UK and US would have increased the combined deficit by \$36m. In making these judgements, management takes into account the advice of professional external actuaries and benchmarks its assumptions against external data.

The discount rate is determined by reference to market yields on high quality corporate bonds, with currency and term consistent with those of the liabilities. In particular for the UK and US, the discount rate is derived by reference to an AA yield curve derived by the Group's actuarial advisers.

See Note 19 of the Notes to the Group accounts for a summary of how the assumptions selected in the last five years have compared with actual results.

### Contingencies and provisions

The recognition of provisions for legal disputes is subject to a significant degree of estimation. Provision is made for loss contingencies when it is considered probable that an adverse outcome will occur and the amount of the loss can be reasonably estimated. In making its estimates, management takes into account the advice of internal and external legal counsel. Provisions are reviewed regularly and amounts updated where necessary to reflect developments in the disputes. The ultimate liability may differ from the amount provided depending on the outcome of court proceedings and settlement negotiations or if investigations bring to light new facts.

The Group operates in numerous tax jurisdictions around the world. Although it is Group policy to submit its tax returns to the relevant tax authorities as promptly as possible, at any given time the Group has unagreed years outstanding and is involved in disputes and tax audits. Significant issues may take several years to resolve. In estimating the probability and amount of any tax charge, management takes into account the views of internal and external advisors and updates the amount of provision whenever necessary. The ultimate tax liability may differ from the amount provided depending on interpretations of tax law, settlement negotiations or changes in legislation.

### Legal proceedings

The Company and its subsidiaries are parties to various legal proceedings, some of which include claims for substantial damages. The outcome of these proceedings cannot readily be foreseen, but management believes none of them will result in a material adverse effect on the financial position of the Group. The Group provides for outcomes that are deemed to be probable and can be reliably estimated. There is no assurance that losses will not exceed the provision or will not have a significant impact on the Group's results of operations or financial condition in the period in which they are realised.

### Product liability claims

In August 2003, the Group withdrew voluntarily from all markets the macrot textured versions of its OXINIUM femoral knee components. A number of related claims have been filed, most of which have been settled. The aggregate cost at 31 December 2011 related to this matter is approximately \$214m. The Group has sought recovery from its primary and excess insurers for costs of resolving the claims. The primary insurance carrier has paid \$60m in full settlement of its policy liability. However, the excess carriers have denied coverage, citing defences relating to the wording of the insurance policies and other matters. In December 2004, the Group brought suit against them in the US District Court for the Western District of Tennessee, and trial is expected to commence in 2013. An additional \$22m was received from a successful settlement with a third party.



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A charge of \$154m was recorded in 2004 for anticipated expenses in connection with macrotexture claims. Most of that amount has since been applied to settlements of such claims. Management believes that the \$17m provision remaining is adequate to cover remaining claims. Given the uncertainty inherent in such matters, there can be no assurance on this point.

The Group faces other claims from time to time for alleged defects in its products and has on occasion recalled products to minimise risk of harm or claims. The Group maintains product liability insurance subject to limits and deductibles that management believes are reasonable.

### Business practice investigations

In March 2005 the US Attorney's Office in Newark, New Jersey issued subpoenas to the five largest sellers of hip and knee implants to US orthopaedic surgeons, including the Group's Orthopaedic business, asking for information regarding arrangements with orthopaedic reconstructive surgeons. In September 2007, the Group (and the other four companies involved) settled the charges that could have resulted from this investigation, without admitting any wrongdoing as part of the settlement. At the same time, the Group entered into a Corporate Integrity Agreement with the Office of the Inspector General (OIG) of the US Department of Health and Human Services which requires certain compliance efforts. This agreement is in effect for five years, until September 2012. If the Group meets its terms, the OIG will not attempt to exclude it from receiving Medicare payments for its products. The Group has devoted substantial effort to comply with this agreement and to enhance its compliance programme across all of its business segments.

In September 2007, the SEC notified the Group that it was conducting an informal investigation of companies in the medical devices industry, including the Group, regarding possible violations of the Foreign Corrupt Practices Act (FCPA) in connection with the sale of products in certain countries outside of the US. The US Department of Justice (DOJ) subsequently joined the SEC's request.

During quarter four of 2011, the Group established a provision of \$23m in relation to this investigation.

On 6 February 2012, Smith & Nephew announced that it had reached settlement with the SEC and DOJ in connection with this matter. Smith & Nephew has committed to pay slightly less than \$23m in fines and profit disgorgement, and committed to maintain an enhanced compliance programme and appoint an independent monitor for at least 18 months to review and report on its compliance programme to both the SEC and DOJ. The settlement agreements impose detailed reporting, compliance and other requirements on Smith & Nephew for a three-year term. Failure to comply with these requirements, or any other violation of law, could have severe consequences for the Group.

### Intellectual property disputes

The Group is engaged, as both plaintiff and defendant, in litigation with various competitors and others over claims of patent infringement and, in some cases, breach of licence agreement. These disputes are being heard in courts in the United States and other jurisdictions and also before agencies that examine patents. Outcomes are rarely certain and costs and settlements are often significant.

Since the Group's entry into the negative pressure wound therapy business in 2007, Kinetic Concepts, Inc. (KCI) has pursued claims of patent infringement against the Group in the US, UK, Germany and other jurisdictions. In one case in the US District Court for the Western District of

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Texas a jury found that patents exclusively licensed to KCI by Wake Forest University ( Wake Forest ) were valid but not infringed by the Group. That ruling was upheld on appeal in February 2009. In a subsequent case in the same court, relating to the Group s foam product, a jury concluded in March 2010 that asserted Wake Forest patents were valid and infringed. But the court determined the relevant patent claims were invalid and entered judgement in favour of the Group. Wake Forest has appealed the court s judgement. If Wake Forest were to prevail, the Group could be prevented from selling that foam product in the US until patent expiration in 2014. KCI has also pursued patent infringement claims in certain countries relating to pumps, canisters and other negative pressure wound therapy accessories.

The Group has won jury verdicts against Arthrex Inc., ( Arthrex ) for infringement of the Group s patents relating to suture anchors (in the US District Court for Oregon) and femoral fixation devices for ACL reconstruction (in the US District Court for the Eastern District of Texas). Arthrex appealed both decisions. The Texas case was reversed on appeal with judgement entered in favour of Arthrex. The Oregon decision was reversed on appeal and remanded to the District Court for a new trial. The Group secured a jury verdict in its favour that was subsequently reversed by the Oregon court post-trial. The Group plans to proceed with an appeal of the Oregon court s ruling.

### Other matters

In April 2009, the Group was served with a subpoena by the US Department of Justice in Massachusetts requiring the production of documents from 1995 to 2009 associated with the marketing and sale of the Group s EXOGEN bone growth stimulator. Similar subpoenas have been served on a number of competitors in the bone growth stimulator market. Around the same time a qui tam or whistleblower complaint concerning the industry s sales and marketing of those products, originally filed in 2005 against the primary manufacturers of bone growth stimulation products (including Smith & Nephew), was unsealed in federal court in Boston, Massachusetts. A motion to dismiss that complaint was denied in December 2010.

In June 2010, the Group was served with a subpoena by the US Department of Justice in Massachusetts requiring the production of documents relating to the distribution of samples of the Group s SUPARTZ joint fluid therapy product.

The Group is subject to country of origin requirements under the US Buy American and Trade Agreements Acts with regard to sales to certain US government customers. The Group has voluntarily disclosed to the US Veterans Administration and the US Department of Defence that a small percentage of the products sold to the US government in the past, primarily from the Orthopaedics business, may have originated from countries that are not eligible for such sales except with government consent. Government auditors subsequently conducted an on-site visit at the Group s Orthopaedics business. In December 2008, three months after Smith & Nephew s initial voluntary disclosure, a whistleblower suit was filed in the US District Court for the Western District of Tennessee alleging these violations. Smith & Nephew s motion to dismiss the suit was denied in November 2010.



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**Business segment reviews**

In August 2011, the Group announced its new strategic priorities. Part of this framework was the implementation of an organisational change. Smith & Nephew has brought together the Orthopaedics and Endoscopy business segments, creating the Advanced Surgical Devices division ( ASD ), which will sit alongside the Advanced Wound Management division ( AWM ). These two divisions will serve the Established Markets and will support our newly created Emerging Markets (focusing on China, India, Brazil and Russia) and International Markets organisations. For reporting purposes, the two division structure will replace the current three business segment structure during 2012.

**Business segment analysis****Organisation**

During 2011, internally the Group has reported as three business segments: Orthopaedics, Endoscopy and Advanced Wound Management. Included within the Orthopaedics business segment are biologics activities, which comprise research and development projects under the direction of a committee representing all operating segments.

Revenue by business segment and geographic market and trading and operating profit by business segment are set out below:

	<b>2011</b>	2010	2009
	<b>\$m</b>	\$m	\$m
<b>Revenue by business segment</b>			
Orthopaedics	<b>2,312</b>	2,195	2,135
Endoscopy	<b>939</b>	855	791
Advanced Wound Management	<b>1,019</b>	912	846
<b>Total revenue</b>	<b>4,270</b>	<b>3,962</b>	<b>3,772</b>
<b>Revenue by geographic market</b>			
United States	<b>1,756</b>	1,707	1,664
Europe (Continental Europe			
and United Kingdom)	<b>1,409</b>	1,315	1,313
Africa, Asia, Australasia			
and other America	<b>1,105</b>	940	795
<b>Total revenue</b>	<b>4,270</b>	<b>3,962</b>	<b>3,772</b>
<b>Trading profit by business segment</b>			
Orthopaedics	<b>492</b>	536	508
Endoscopy	<b>222</b>	200	189
Advanced Wound Management	<b>247</b>	233	160

<b>Total trading profit</b>	<b>961</b>	<b>969</b>	<b>857</b>
<b>Operating profit by business segment</b>			
Orthopaedics	415	503	410
Endoscopy	215	197	169
Advanced Wound Management	232	220	144
<b>Total operating profit</b>	<b>862</b>	<b>920</b>	<b>723</b>

**Business segment revenue**

			\$m
A Orthopaedics			2,312
B Endoscopy			939
C Advanced wound management			1,019

**Geographic revenue**

			\$m
A US			1,756
B Europe			1,409
C Rest of World			1,105

A head office team in London, UK directs the overall business and supports the business segments, primarily in the areas of business development, legal, company secretarial, finance, human resources and investor relations.

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Business Review

VERILAST's use of OXINIUM, oxidized Zirconium, results in a knee

which has been proven to last 30 years, twice the current industry

standard of 15 years.

## Orthopaedics

### Overview

During 2011, the Orthopaedics business was managed worldwide from Memphis, Tennessee, the site of its main development and manufacturing facility, with a European headquarters in Baar, Switzerland. Products are also manufactured at smaller facilities in Switzerland, Germany, China and the UK as well as by third-party manufacturers.

### Products

Orthopaedic reconstruction implants include hip, knee and shoulder joints as well as ancillary products such as bone cement. Orthopaedic trauma fixation products consist of internal and external devices and other products, including various fixation and orthobiological materials used in the stabilisation of severe fractures and deformity correction procedures. Clinical therapies products are those that are applied in an orthopaedic office or a clinic setting, in particular bone growth stimulation and joint fluid therapies.

#### Knee implant systems

The Orthopaedics business offers a range of products for specialised knee procedures. The LEGION/GENESIS II Total Knee System is a comprehensive system designed to allow surgeons to address a wide range of knee procedures from primary to revision. LEGION TKS features VERILAST Technology, an advanced bearing surface. The JOURNEY Active Knee Solutions, a family of advanced, customised products designed to treat early to mid-stage osteoarthritis patients, provides more normal feeling and motion through bone ligament preservation and anatomic replication. LEGION/GENESIS II and JOURNEY also utilise VISIONAIRE Patient-Matched Instrumentation, a technology platform of patient-matched cutting blocks for total knee procedures.

#### Hip implant systems

The Orthopaedics business offers a broad range of hip replacement systems. In particular, the R3 Acetabular System includes a modular acetabular cup that provides a variety of advanced bearings within a single system. The BIRMINGHAM HIP Resurfacing System is a system for hip resurfacing, a bone conserving approach, which utilises proven low wear metal-on-metal bearing surface technology. Other hip systems include the SYNERGY Hip System, ANTHOLOGY Hip System and the SL-PLUS Hip Family System.

#### Bearing surfaces

The Orthopaedics business utilises a range of bearing surfaces in its implant systems, including its proprietary OXINIUM Technology. Oxidized Zirconium, branded OXINIUM, combines the enhanced wear resistance of a ceramic bearing with the superior durability of a metallic bearing. When combined with highly cross-linked polyethylene ( XLPE ) it results in the Group's VERILAST Technology. The LEGION Primary Knee, with VERILAST Technology, is the only knee system with a 30 year wear performance claim approved by the United States Food and Drug Administration ( FDA ) more than double the performance expectation for wear compared to conventional technologies.

## Trauma implant systems

The principal fixation products are the TRIGEN Intramedullary Nailing system, TRIGEN META-NAIL with expanded fixation and technique options, TRIGEN INTERTAN Intertrochanteric Antegrade nails for hip fractures, TRIGEN SURESHOT Distal Targeting System for Intramedullary Nailing and PERI-LOC Periarticular Locked Plating system which offers a comprehensive family of fracture specific plate and screw products for the upper and lower extremities.

For external fixation and limb restoration, Orthopaedics offers the TAYLOR SPATIAL FRAME Circular Fixation System and JET-X BAR Unilateral Fixator.

## Clinical Therapies

The principal clinical therapies products offered include the EXOGEN Ultrasound Bone Healing System which utilises low-intensity pulsed ultrasound to accelerate the healing of fresh fractures and to heal non unions. DUROLANE Joint Fluid Therapy and SUPARTZ Joint Fluid Therapy are non-surgical, non-pharmacological pain-relieving therapies for osteoarthritis of the knee.

## Strategy

Under the new ASD structure, the Group will continue to focus on product innovation, sales excellence and physician education. Whether through extending the life of implants, improving operating room efficiency, or promoting faster healing and other clinical outcomes, Smith & Nephew's innovations differentiate it and provide solutions to active patients seeking to regain quality of life while enhancing economic value for customers. For its ASD products, Smith & Nephew provides peer-to-peer medical education, through KLEOS, tailored to individual surgeon needs utilising the world's top orthopaedic specialists and key opinion leaders.

The emerging markets continue to be an important growth opportunity. China remains a focus, with further progress and growth achieved during 2011. Outside China, ASD is investing in sales teams in other emerging markets, extending physician training via KLEOS, developing tailored products to meet local needs and improving local infrastructure and logistics.

Under the ASD structure, the business aligns its organisation and develops its talent for consistent execution on the Group's plans. Compensation for executives, managers and staff are carefully aligned to the execution of their objectives.

On 4 January 2012, the Group announced it had entered into an agreement with Essex Woodlands for the disposal of the Group's Clinical Therapies business. After disposal, the Group will retain a 49% investment in the newly formed company, Bioventus LLC, which will be reported as an associate. At 31 December 2011, the assets and liabilities of the Clinical Therapies business, \$125m and \$19m respectively, are disclosed as held for sale. In 2011, the Clinical Therapies business contributed \$237m to revenue and \$48m to trading profit. The Group expects to recognise a profit before tax in excess of \$250m on the transaction on completion.





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**Business segment reviews continued****Orthopaedics continued**

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**New products**

In Trauma, Orthopaedics launched STRUCSURE CP, an advanced injectable, hard-setting bone graft substitute designed to gradually resorb while being replaced by natural bone.

Reconstructive Orthopaedics continued the extension of its VISIONAIRE Patient-Matched Instrumentation into its knee portfolio, with its roll-out of VISIONAIRE for the TC-PLUS knee system. With VISIONAIRE, the patient's MRI and X-rays are used to create customised cutting blocks that allow the surgeon to achieve optimal mechanical axis alignment as well as saving time and reducing instruments in the operating room. Also launched was the SMF Short Modular Femoral Hip System, a primary hip stem that is substantially shorter than traditional length stems, yet maintains optimal fixation and stability. The SMF Hip complements the newly launched Direct Anterior retractor set, an instrument set and technique that allows orthopaedic surgeons to enter the hip socket through the front, or anterior, which results in far less soft tissue disruption and post-operative pain than traditional techniques.

**Regulatory approvals**

During 2011, the Orthopaedics business obtained regulatory clearances/approvals for several key products.

In the US, 510(k) clearance was obtained for the TAYLOR SPATIAL FRAME V4.1 Software, TRIGEN SURESHOT Distal Targeting System V2.1, and the SMF Hip Stem Line Additions.

Several products were approved in Japan, which included the 10/12 TAPER OXINIUM Femoral Heads, LARGE COCR Femoral Heads, REFLECTION XLPE Acetabular Liners, BHR Resurfacing Hip System, BHR Modular Head System with 10/12 Taper Sleeves, SL-PLUS Hip Stems, SLR-PLUS Hip Stems, and SL-PLUS Mia Hip Stems.

**Seasonality**

Orthopaedic reconstruction and trauma procedures tend to be higher in the winter months (quarter one and quarter four) where accidents and sports related injuries are highest. Conversely, elective procedures tend to slow down in the summer months due to holidays.

**Market and competition**

Smith & Nephew estimates that the global orthopaedic segment, excluding clinical therapies, served by the Group grew by approximately 2% in 2011 and is currently worth approximately \$17.8 billion per annum. Management believes that the Smith & Nephew Orthopaedics business holds an 11% share of this segment by value. Principal global competitors in orthopaedics are Zimmer, Stryker, Johnson & Johnson and Biomet.

**Global orthopaedics competitor share (i) (ii)**

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	%
A Smith & Nephew	11

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B Zimmer	19
C Stryker	18
D DePuy/Johnson & Johnson (iii)	17
E Synthes (iii)	12
F Biomet	9
G Others	14

(i) The global orthopaedics segment served by the Group consists of orthopaedic reconstruction and orthopaedic trauma.

(ii) Competitor shares are based on estimates for selected segments and competitors, and may not be comprehensive.

(iii) Synthes is the subject of a takeover from Johnson & Johnson which is expected to complete in 2012.

In 2011, weaker economic conditions worldwide continued to create several challenges for the overall orthopaedic market, including continued deferrals of joint replacement procedures and heightened pricing pressures. These factors contributed to the lower overall growth of the worldwide orthopaedic market compared to historic comparables. However, over the medium-term, several catalysts are expected to continue to drive sustainable growth in orthopaedic device sales, including the growing and ageing population, rising rates of co-morbidities such as obesity and diabetes, technology improvements allowing surgeons to treat younger, more active patients, and the increasing strength of the demand for healthcare in emerging markets. Both the orthopaedic trauma and clinical therapies markets are expected to continue to grow due to a global population increasingly at risk from fractures due to age, osteoporosis, obesity and diabetes and also due to continuous advancements in the surgical treatment of fractures, and the need to manage pain in younger, more active patients.

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**Orthopaedics financial performance**

## Revenue

**Orthopaedics revenue**

	\$m
A Orthopaedic Reconstruction	1,618
B Orthopaedic Trauma	457
C Clinical Therapies	237

**2011**

Orthopaedics revenue increased by 5% to \$2,312m from \$2,195m in 2010. Of this increase, 2% is attributable to underlying growth and 3% is due to favourable currency movements.

Underlying growth in Orthopaedic revenue reconciles to reported growth, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

	2011 %	2010 %
Reported growth	5	3
Constant currency exchange effect	(3)	(1)
Underlying growth	2	2

In the US, revenue increased by \$28m to \$1,204m (2%), all of which was due to underlying growth. The main factor was the continued growth of the Group's knee products including VERILAST and VISIONAIRE.

Outside the US, revenue increased by \$89m to \$1,108m (9%). This movement is attributable to underlying growth of 2% and favourable foreign currency translation of 7%.

Global knee revenue increased by \$63m to \$869m (8%), representing underlying revenue growth of 5% and favourable foreign currency translation of 3%. There has been continued pressure from the challenging environment on higher specification and early intervention hip and knee implant systems. Nevertheless, the Group's knee franchise and in particular the LEGION Knee Systems delivered strong growth. This was driven by VERILAST and by VISIONAIRE Patient Matched Instrumentation sets.

Global hip revenue increased by \$16m to \$704m (2%), representing a 1% underlying revenue decline and 3% due to favourable foreign currency translation. Both traditional and new products have continued to perform well, led by the R3 Acetabular System. Sales of BIRMINGHAM HIP Resurfacing System have continued to decline.

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Global trauma revenue increased by \$23m to \$457m (5%), representing underlying revenue growth of 3% and 2% favourable foreign currency translation. Trauma underperformed in the second half of the year and the Group has taken actions to address this. The expiry of an agreement under which Smith & Nephew received royalties in the US has also had a negative impact on Trauma revenue in the second half of the year.

In Clinical Therapies, revenue grew from \$223m to \$237m (7%) which was represented by underlying growth of 6% and favourable currency movements of 1%.

### Underlying revenue growth for key product lines is:

	2011	2010
	%	%
Reconstruction		
Knees	5	5
Hips	(1)	
Trauma	3	3
Clinical therapies	6	(5)

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Business Review

## Business segment reviews continued

### Orthopaedics continued

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#### **2010**

Orthopaedics revenue increased by 3% to \$2,195m from \$2,135m in 2009. Of this increase, 2% is attributable to underlying growth and 1% is due to favourable currency movements.

In the US, revenue increased by \$22m to \$1,176m (2%), all of which was due to underlying growth. The main factors were the growth of products launched in the year including VERILAST and VISIONAIRE.

Outside the US, revenue increased by \$38m to \$1,019m (4%). This movement is attributable to underlying growth of 2% and favourable foreign currency translation of 2%.

Global knee revenue increased by \$45m to \$806m (6%), representing underlying revenue growth of 5% and favourable foreign currency translation of 1%. There was continued pressure from the challenging environment on higher specification and early intervention hip and knee implant systems. Nevertheless, the Group's knee franchise and in particular the LEGION Knee Systems delivered strong growth. This was driven by the FDA clearance to claim that VERILAST bearing technology for knee replacement provides wear performance sufficient for 30 years of actual use under typical conditions and by VISIONAIRE Patient Matched Instrumentation sets.

Global hip revenue increased by \$7m to \$688m (1%), all of which was due to favourable foreign currency translation. In the Group's hip franchise, both traditional and new products continued to perform well, led by the R3 Acetabular System. Sales of BIRMINGHAM HIP Resurfacing Systems were weaker.

Global trauma revenue increased by \$20m to \$434m (5%), representing underlying revenue growth of 3% and 2% favourable foreign currency translation. This improvement is attributable to management's actions to provide additional support and training to the sales force.

In Clinical Therapies, EXOGEN Ultrasound Bone Healing System achieved double digit revenue growth for the year. The joint fluid therapies franchise continued to perform well despite the increased competitive environment in the US. Early in 2010 the Group sold its niche pain management business and terminated the small spine distribution business in Germany, which reduced Orthopaedics revenue growth by approximately 1%.

#### Trading profit

#### **2011**

Trading profit decreased by \$44m (8%) to \$492m from \$536m in 2010. Trading profit margin decreased from 24.4% to 21.3%. This decrease is due to continuing pricing pressure, adverse mix and some delay in the execution of our efficiency programme.

#### **2010**

Trading profit increased by \$28m (6%) to \$536m from \$508m in 2009. Trading profit margin increased from 23.8% to 24.4%. This increase is due to cost management and further investment in improving the efficiency and effectiveness of the main processes.

## Operating profit

### 2011

Operating profit decreased by \$88m to \$415m. This comprises the decrease in trading profit of \$44m discussed above, an increase of \$3m in the amortisation of acquisition intangibles, an \$18m increase in restructuring and rationalisation costs and \$23m in respect of the legal provision.

Operating profit, the most directly comparable financial measure calculated in accordance with IFRS, reconciles to trading profit as follows:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Operating profit	<b>415</b>	503
Restructuring and rationalisation costs	<b>26</b>	8
Amortisation of acquisition intangibles	<b>28</b>	25
Legal provision	<b>23</b>	
Trading profit	<b>492</b>	536

Orthopaedics trading profit and operating profit as a percentage of Group trading profit and operating profit was as follows:

	<b>2011</b>	<b>2010</b>	2009
	<b>%</b>	<b>%</b>	%
Trading profit	<b>51</b>	55	59
Operating profit	<b>48</b>	55	57

### 2010

Operating profit increased by \$93m to \$503m. This comprises the increase in trading profit of \$28m discussed above, a \$26m reduction in acquisition related costs, a reduction of \$21m in the amortisation of acquisition intangibles and impairments and an \$18m reduction in costs associated with the Earnings Improvement Programme ( EIP ).

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Business Review

The FAST-FIX 360 Meniscal Repair System offers exceptional fixation strength and enhanced control to optimise the chances of a successful meniscus repair.

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## Endoscopy

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### Overview

Smith & Nephew's Endoscopy business develops and commercialises endoscopic (minimally invasive surgery) techniques, educational programmes and value-added services for surgeons to treat and repair soft tissue and articulating joints. The business focuses on the arthroscopy (sometimes referred to as sports medicine) sector of the endoscopy market. Arthroscopy is the minimally invasive surgery of joints, in particular the knee, shoulder and hip.

In 2011, the Endoscopy business was headquartered in Andover, Massachusetts and manufacturing facilities are located in Mansfield, Massachusetts, and Oklahoma City, Oklahoma. Major service centres are located in the US, UK, Germany, Japan and Australia.

### Products

The Endoscopy business offers surgeons endoscopic technologies for surgery of the joints and ligament repair, including: specialised devices and fixation systems to repair damaged tissue; fluid management equipment for surgical access; digital cameras, digital image capture, scopes, light sources and monitors to assist with visualisation; radiofrequency wands, electromechanical and mechanical blades, and hand instruments for resecting damaged tissue.

Key products in repair are the FAST-FIX family of meniscal repair systems, ENDOBUTTON for cruciate fixation, and the FOOTPRINT PK and TWINFIX Suture Anchors for rotator cuff repair. Key products in resection are the wide range of DYONICS shaver blades, ACUFEX handheld instruments, and a range of radiofrequency (RF) probes.

### Strategy

Smith & Nephew's strategic intent is to grow the business as the leading provider of endoscopic techniques and technologies for joint and ligament repair. Management believes that the business capitalises on the growing acceptance of endoscopy as a preferred surgical choice among surgeons, patients and payors, enhanced by a customer-led approach to growing the arthroscopy market.

To sustain growth and enhance its market position, the ASD business supports its strategy with investment in surgeon education programmes, global fellowship support initiatives, partnerships with professional associations and surgeon advisory boards. The emerging markets, especially China, are expected to be a major driver of growth in future, and the business is investing funds to accelerate this growth.

The business has a commitment to, and track record of, driving efficiencies, through a formal operational excellence programme as well as a culture of continuous process improvement.

The Endoscopy business aligns its organisation to ensure all employees are working on common objectives, and to ensure consistent execution against the Group's wider objectives.

### New products

In 2011, Smith & Nephew continued to expand its arthroscopic sports medicine portfolio with the launch of new repair, resection and visualisation products.

The FAST-FIX 360 Meniscal Repair System is designed to optimise the chances of a successful repair with exceptional fixation strength, small insertion points, convenient implant deployment and a built-in depth limiter. It is built on the proven FAST-FIX platform which set the standard for minimally invasive, all-inside meniscal repair.

The DYONICS PLATINUM Series Shaver Blades are single-use blades that provide superior resection, debris evacuation and sharpness.

BIORAPTOR and OSTEORAPTOR CURVED Guide Systems for Shoulder optimise anchor placement helping surgeons to overcome the challenges associated with instability repair. The systems provide increased access to the repair site in the glenohumeral joint, improve the trajectory of drilling and lead to optimised anchor placement in glenoid bone which helps surgeons operate with confidence.

### Recent regulatory approvals

During 2011, the Endoscopy business obtained regulatory clearances for the following products in most major markets, except Japan where the approval process is more lengthy: ULTRABRAID II Suture, ENDOBUTTON DIRECT, OSTEORAPTOR and BIORAPTOR CURVED Guide Systems and the ACUFEX DIRECTOR Guide System, all designed for use in the reattachment of ligaments, tendons or soft tissues to bone in knees, shoulders or other articulating joints; and various other arthroscopy instruments, devices and sterilisation trays. In addition, the Endoscopy business obtained regulatory clearance in the United States and Europe for the TRUCLEAR Operative Hysteroscopy System for use in office based procedures. In Japan, regulatory approvals included TWINFIX AB, TWINFIX TI, TWINFIX Ultra PK and FOOTPRINT Ultra PK Suture Anchors as well as BONECUTTER ELECTROBLADE and various arthroscopy surgical instruments.



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## Business segment reviews continued

## Endoscopy continued

## Seasonality

Arthroscopy procedures tend to be higher in the winter months (quarter one and quarter four) where accidents and sports related injuries are highest. Conversely, elective procedures tend to slow down in the summer months due to holidays.

## Market and competition

Smith & Nephew estimates that the global arthroscopy segment (the combination of repair and resection products) in which the business principally participates is worth approximately \$3.8 billion per annum and has recently been growing at approximately 8% annually. Arthroscopy growth rates are driven by increasing numbers of sports injuries, longer and more active lifestyles, patient desire for minimally invasive procedures, innovative technological developments and a need for cost-effective procedures. The arthroscopy segment has a particular focus on arthroscopic repair of the knee and shoulder using a broad range of technologies. The Group also expects to benefit from the demand for less invasive approaches to arthroscopic hip repair.

Management believes that Smith & Nephew has a 21% share of the global arthroscopy segment as at 31 December 2011. Smith & Nephew's main competitors were Arthrex, Mitek/Johnson & Johnson, Stryker, Arthrocare and Linvatec/ConMed.

**Global arthroscopy competitor share (i)**

	%
A Smith & Nephew	21
B Arthrex	25
C Mitek/Johnson & Johnson	16
D Stryker	11
E Linvatec/ConMed	6
F Arthrocare	5
G Others	16

(i) Competitor shares are based on estimates for selected segments and competitors, and may not be comprehensive.

Endoscopy financial performance

## Revenue

**Endoscopy revenue**

	\$m
A Arthroscopy	807
B Visualisation	107
C Other	25

**2011**

Endoscopy revenue increased by \$84m, or 10%, to \$939m in 2011 from \$855m in 2010, comprising 4% favourable currency translation and 6% underlying growth.

Underlying growth in Endoscopy revenue reconciles to reported growth, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

	2011	2010
	%	%
Reported growth	<b>10</b>	8
Constant currency exchange effect	<b>(4)</b>	(1)
Underlying growth	<b>6</b>	7

In the US, revenue increased by \$10m to \$363m in 2011 (3%), all of which represents underlying growth.

Outside the US, revenue increased by \$74m to \$576m in 2011 (15%), of which 8% was underlying growth and 7% was due to favourable foreign currency translation.

Global revenue of sports medicine repair products increased by \$57m to \$448m (15%), of which 10% was underlying growth and 5% favourable foreign currency translation. The repair business benefited from launch of the FAST-FIX 360 Meniscal Repair System and BIORAPTOR CURVED guide systems during the year.

Revenue in the global resection products sector increased by \$21m to \$303m (7%), of which 4% represents underlying revenue growth and 3% of favourable foreign currency translation. The resection franchise benefited from sales of the Group's new DYONICS PLATINUM range of speciality blades.

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Business Review

Global Visualisation revenue reduced by \$5m to \$107m (-4%), of which -7% represents negative underlying growth, partially offset by 3% of favourable foreign currency translation. This decrease reflects the Group's strategy to focus only on those capital items which are closely aligned with the core resection and repair businesses.

**Underlying revenue growth for key product lines is:**

	<b>2011</b>	<b>2010</b>
	%	%
Arthroscopy	7	9
Visualisation	(7)	(9)
<b>2010</b>		

Endoscopy revenue increased by \$64m, or 8%, to \$855m from \$791m in 2009, comprising 1% favourable currency translation and 7% underlying growth.

In the US, revenue increased by \$4m to \$353m (1%), all of which represents underlying growth.

Outside the US, revenue increased by \$60m to \$502m (14%), of which 11% was underlying growth and 3% was due to favourable foreign currency translation.

Global revenue of sports medicine repair products increased by \$46m to \$391m (13%), of which 11% was underlying growth and 2% favourable foreign currency translation.

Revenue in the global resection products sector increased by \$17m to \$282m (7%), of which 6% represents underlying revenue growth and 1% of favourable foreign currency translation. The resection franchise benefited from the introduction of a new range of radio-frequency ablation probes early in the year.

Global Visualisation revenue reduced by \$9m to \$112m (-7%), of which -9% represents negative underlying growth, partially offset by 2% of favourable foreign currency translation. This decrease reflects the Group's strategy to focus only on those capital items which are closely aligned with the core resection and repair businesses.

## Trading profit

**2011**

## Edgar Filing: SMITH & NEPHEW PLC - Form 20-F

Trading profit increased by \$22m (11%) to \$222m from \$200m in 2010. Trading profit margin increased from 23.3% to 23.6%. This is driven by strong sales and good cost-control.

### 2010

Trading profit increased by \$11m (6%) to \$200m from \$189m in 2009. Trading profit margin decreased from 23.9% to 23.3%. This reflects the increased investment in product development and in the sales force, particularly in the US.

### Operating profit

### 2011

Operating profit increased by \$18m to \$215m from \$197m in 2010. This comprises the \$22m increase in trading profit set out above, offset by an increase of \$4m in restructuring and rationalisation costs.

Operating profit, the most directly comparable financial measure calculated in accordance with IFRS, reconciles to trading profit as follows:

	<b>2011</b>	<b>2010</b>
	<b>\$ million</b>	<b>\$ million</b>
Operating profit	<b>215</b>	197
Restructuring and rationalisation costs	<b>6</b>	2
Amortisation of acquisition intangibles	<b>1</b>	1
Trading profit	<b>222</b>	200

Endoscopy trading profit and operating profit as a percentage of Group trading profit and operating profit was as follows:

	<b>2011</b>	2010	2009
	%	%	%
Trading profit	<b>23</b>	21	22
Operating profit	<b>25</b>	21	23

Operating profit increased by \$28m to \$197m from \$169m in 2009. This comprises the \$11m increase in trading profit set out above, a reduction of \$14m in amortisation of acquisition intangibles and impairments and a \$3m reduction in restructuring costs.



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Business Review

## Business segment reviews continued

PICO is a small portable pump, providing 7 days effective Negative Pressure Wound Therapy yet is small enough to fit discreetly into a pocket.

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## Advanced Wound Management

### Overview

Smith & Nephew's Advanced Wound Management business offers a range of products from initial wound bed preparation through to full wound closure. These products are targeted at chronic wounds associated with the older population, such as pressure sores and venous leg ulcers. There are also products for the treatment of wounds such as burns and from invasive surgery that impact the wider population.

The Advanced Wound Management business has its global headquarters in Hull, UK and its North American headquarters in St Petersburg, Florida. The products are manufactured at facilities in Hull and Gilberdyke, UK, Suzhou in China, and also by third party manufacturers around the world.

### Products

The main products within the Advanced Wound Management business are for exudate management, predominantly the ALLEVYN brand and the recently added DURAFIBER products, infection management, including the ACTICOAT brand and Negative Pressure Wound Therapy ( NPWT ).

The ALLEVYN hydrocellular dressings range has been considerably enhanced by new versions, introduced in recent years, which management believes provide efficient fluid management and an optimal moist wound environment that promotes faster healing of the wound, reduced risk of maceration and protection from infection. The range includes ALLEVYN Ag, a range of dressings combining the infection management capabilities of silver with ALLEVYN.

The ACTICOAT range incorporates the smallest crystallised silver used in the treatment of wounds and burns. The silver reduces the risk of bacterial colonisation and acts to kill micro-organisms that can cause infection and prevent or delay healing.

NPWT delivers vacuum-assisted pressure to help promote healing. It consists of a wound dressing, a drainage tube, and a transparent film that is connected to a suction device. Smith & Nephew offers the RENASYS EZ and RENASYS GO pump systems together with a range of foam and gauze dressing kits. The NPWT range was enhanced with the introduction of PICO, the first of its kind – a fully disposable NPWT system.

Advanced Wound Management also offers a range of other advanced products including films, such as OPSITE and IV3000, skin care treatments and gels.

### Strategy

Advanced Wound Management's strategy is to be customer-led and invest for growth by focusing on high growth, high value segments, in particular exudate and infection management, through improved wound bed preparation, moist and active healing and penetration of the NPWT market.

## Edgar Filing: SMITH & NEPHEW PLC - Form 20-F

There has been a continued focus on operational efficiency and excellence. Since 2007, efficiency improvements have been delivered through various projects including support function consolidation, outsourcing of manufacturing to low cost suppliers, distribution rationalisation projects and the start of manufacturing in Suzhou, China.

Advanced Wound Management's strategic focus builds from an understanding of the increasing tensions between clinical and financial imperatives and looks for the ground that resolves them optimally. Advanced Wound Management is committed to improving wound outcomes for patients, and at the same time conserve resources for health care systems.

An aligned approach across Advanced Wound Management is designed to ensure that employees are developed and work on common objectives to deliver consistent execution of the Group's plan.

### New products

New in 2011 was the introduction of PICO, the first fully disposable NPWT system. The innovative design provides the clinical benefits of NPWT while simplifying the functionality and presentation of the product, allowing for an entirely disposable and cost effective system. The design allows greater access to therapy, reduces service and support costs, and significantly improved cost effectiveness compared to traditional NPWT therapy.

In addition, the NPWT range was enhanced with the launch of RENASYS Soft Port to improve application and administration of therapy. Further line extensions were introduced to support customer requests for broader application of therapy.

VERSAJET II (hydro-surgery debridement) was introduced as a next generation upgrade, incorporating improved ease of use and functionality to the existing system. VERSAJET II enhances the Group's unique position in the hydro-surgical debridement market segment.

2011 saw the launch of DURAFIBER a gelling fibre dressing, which expands the footprint of the exudate management portfolio.

DURAFIBER has category leading performance and was designed to manage moderate to heavily exuding cavity wounds, working in synergy with the ALLEVYN hydrocellular dressing range.

The ALLEVYN range was further expanded with anatomically shaped dressings designed to address multiple wound sites reducing the number of products a customer needs to stock, making dressing choice simpler with the opportunity to reduce costs. This further reinforces Advanced Wound Management's position as the supplier with the most comprehensive foam dressing solution.

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Business Review

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**Recent regulatory approvals**

During 2011, Advanced Wound Management secured approval in US, Europe and Australia for PICO, single use Negative Pressure Wound Therapy System. In the US clearance was also gained for DURAFIBER Ag. Regulatory approvals were received in the EU and US for a range of NPWT dressing kits, including RENASYS Soft Port and the hydro-surgery debridement product, VERSAJET II.

Approval was received in Europe for a number of significant product changes including ALLEVYN Silver Non Adhesive for Germany and ACTICOAT Surgical. Pro Two, a two layer compression bandaging system was also cleared for sale.

Approval was secured in China for a number of existing marketed products OPSITE Incise, OPSITE Flexigrid, OPSITE POST OP, ALLEVYN Thin and ALLEVYN Adhesive.

**Seasonality**

Due to the nature of its product range there is little seasonal impact on the Advanced Wound Management business.

**Market and competition**

Management estimates that the sales value of the advanced wound management segment worldwide was \$5.5 billion in 2011, an underlying increase of around 3% from 2010. During 2011, the segment growth rate slowed slightly due to the weaker economic conditions. The advanced wound management market is focused on the treatment of chronic wounds of the older population and other hard-to-heal wounds such as burns and certain surgical wounds and is therefore also expected to benefit from demographic trends. Growth is driven by an ageing population and by a steady advance in technology and products that are more clinically efficient and cost effective than their conventional counterparts. The market for advanced wound versus traditional wound treatments is relatively un-penetrated and it is estimated that the potential for advanced wound management is significantly larger than the current market suggests. Management believes that the market will continue the trend towards advanced wound products with its ability to accelerate healing rates, reduce hospital stay times and cut the cost of clinician and nursing time as



well as aftercare in the home.

Management estimates that Smith & Nephew had an 18% share of the advanced wound management segment as at 31 December 2011. Worldwide competitors in advanced wound management in 2011 include Convatec, Mölnlycke, Systagenix and Kinetic Concepts, who are active exclusively in the NPWT market.

#### Global advanced wound management competitor share (i)

	%
A Smith & Nephew	18
B Kinetic Concepts	26
C Mölnlycke	11
D Convatec	9
E 3M	6
F Others	30

(i) Competitor shares are based on estimates for selected segments and competitors, and may not be comprehensive.

#### Advanced Wound Management financial performance

##### Revenue

##### 2011

Revenue increased by \$107m, or 12%, to \$1,019m from \$912m in 2010, comprising 5% favourable currency translation and 7% underlying growth. Exudate management grew in underlying terms by 2% and infection management by 4%, as targeted marketing investments in Europe delivered good returns. The Group's NPWT portfolio has had another good year with excellent feedback since the launch of PICO during 2011. This was launched in the US during January 2012.

Underlying growth in Advanced Wound Management revenue reconciles to reported growth, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

	2011 %	2010 %
Reported growth	12	8
Constant currency exchange effect	(5)	(1)
Underlying growth	7	7

In the US, revenue increased by \$11m to \$189m (6%), all of which is attributable to underlying revenue growth.

Outside the US, revenue increased by \$96m to \$830m (13%). This is represented by an underlying growth of 7% and 6% of favourable foreign currency translation. European revenue increased by \$39m to \$493m (9%) of which 4% was underlying growth coupled with 5% of favourable currency translation.



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**Business segment reviews continued****Advanced Wound Management continued****Underlying revenue growth for key product lines is:**

	<b>2011</b>	2010
	%	%
Exudate management	<b>2</b>	2
Infection management	<b>4</b>	3
<b>2010</b>		

Revenue increased by \$66m, or 8%, to \$912m from \$846m in 2009, comprising 1% favourable currency translation and 7% underlying growth. A significant portion of the growth came from the Group's NPWT product range, which continued to expand to offer customers a wide range of clinical options. The Exudate and Infection Management franchises continue to benefit from new products and line extensions.

In the US, revenue increased by \$17m to \$178m (11%), all of which is attributable to underlying revenue growth.

Outside the US, revenue increased by \$49m to \$734m (7%). This is represented by an underlying growth of 6% and 1% of favourable foreign currency translation. European revenue increased by \$6m to \$454m (1%) of which 5% was underlying growth partly offset by 4% of unfavourable currency translation.

**Trading profit****2011**

Trading profit increased by \$14m (6%) to \$247m from \$233m in 2010 and trading profit margin decreased from 25.6% to 24.3%. As set out below, the comparative was assisted by a \$25m settlement in respect of BlueSky. Ignoring the impact of this in the comparatives, the equivalent margin for 2010 was 22.8%. The increase in margin in 2011 is driven by the increase in underlying revenues.

**2010**

Trading profit increased by \$73m (46%) to \$233m from \$160m in 2009 and trading profit margin increased from 18.9% to 25.6%. The settlement in the year with the vendors of BlueSky Medical Group, Inc. with regard to legal expenses in defending the NPWT intellectual property position increased trading profit by \$25m. During the year, Advanced Wound Management also benefited from a full year's production

at the new manufacturing facility in China, reducing manufacturing costs.

## Operating profit

### 2011

Operating profit increased by \$12m to \$232m. This comprises an increase in trading profit of \$14m and a reduction of \$1m in the amortisation of acquisition intangibles. These were offset by an increase of \$3m in restructuring and rationalisation costs.

Operating profit, the most directly comparable financial measure calculated in accordance with IFRS, reconciles to trading profit as follows:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Operating profit	<b>232</b>	220
Restructuring and rationalisation costs	<b>8</b>	5
Amortisation of acquisition intangibles	<b>7</b>	8
Trading profit	<b>247</b>	233

Advanced Wound Management trading profit and operating profit as a percentage of Group trading profit and operating profit was as follows:

	<b>2011</b>	<b>2010</b>	2009
	%	%	%
Trading profit	<b>26</b>	24	19
Operating profit	<b>27</b>	24	20

Operating profit increased by \$76m to \$220m. This comprises the increase in trading profit of \$73m and a reduction of \$6m in restructuring and rationalisation costs partially offset by an increase of \$3m in the amortisation of acquisition intangibles following the acquisition of Nucryst in December 2009.

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## Outlook and trend information

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The discussion below contains certain forward-looking statements that may or may not prove accurate. For example, statements regarding expected revenue growth and trading margins, market trends and our product pipeline are forward looking statements. Phrases such as aim , plan , intend , anticipate , well placed , believe , estimate , target , consider , and similar expressions are generally intended to identify forward looking statements. Forward-looking statements involve known and unknown risks and uncertainties and other important factors that could cause actual results to differ materially from those projected in forward-looking statements. For Smith & Nephew, these factors include: economic and financial conditions in the markets we serve, especially those affecting health care providers, payors and customers; price levels for established and innovative medical devices; developments in medical technology; regulatory approvals; reimbursement decisions or other government actions; products defects or recalls; litigation relating to patent or other claims; legal compliance risks and related investigative, remedial or enforcement actions; strategic actions, including acquisitions and dispositions and our success in integrating acquired businesses; and numerous other matters which affect us or our markets, including those of a political, economic business or competitive nature.

For additional information on factors that could cause the Group's actual results to differ from estimates reflected in these forward-looking statements, can be found under Risk factors within the Business Review section on pages 16 to 18.

Information regarding the recent and longer term market growth trends is given for each of the Group's global business units in the relevant Market and competition sections under Business segment reviews on pages 30 to 40.

Smith & Nephew delivered a good revenue performance in 2011, set against a challenging market backdrop. The Group expects that the macro-economic climate will continue to influence both patient and payor behaviour and, as a result, it seems likely that tough market conditions will persist throughout the year ahead.

During 2012, the Group expects its sports medicine franchises to slightly outperform the market. It also expects to continue to grow at above the market rate in Advanced Wound Management. This will be driven by Smith & Nephew's substantial negative pressure portfolio and a series of innovative new product releases.

Smith & Nephew expects Orthopaedic Reconstruction to grow at close to the market rate. Strong growth in the sales of premium knee implant products will continue to annualise and on-going negative metal-on-metal perceptions will affect hip implant sales.

In Orthopaedic Trauma, the Group expects the continuing 2% headwind from the reduction in royalty income in the US to lead to growth slightly below market growth.

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Finally, Smith & Nephew expects to complete the transaction to create Bioventus LLC in the first half of 2012. This will be modestly earnings dilutive.

The Group delivered on its trading profit margin expectation for the last quarter of 2011 and consequently the full year Group trading profit margin was 22.5%. Smith & Nephew expects to achieve a modest increase in trading profit margin in 2012.

In August 2011, Smith & Nephew set out the five strategic priorities designed to drive the Group's future success. Smith & Nephew is reshaping its business to deliver against these priorities. The Group is targeting structural efficiency savings of at least \$150 million per annum as part of this process. The costs of achieving this are anticipated to be approximately \$160 million in cash and \$40 million in non-cash costs. It is expected that more than half the costs and approximately half the benefits will be achieved by the end of 2012, with the full costs and benefits being realised within three years.

From the first quarter of 2012, Smith & Nephew intends to report as two divisions, Advanced Surgical Devices global and Advanced Wound Management global. Advanced Surgical Devices global will comprise the current Orthopaedics and Endoscopy business units. This structure will provide visibility on progress in the Emerging and International Markets, as well as the performance of its product franchises in the Established Markets.

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## Sustainability

# Smith & Nephew's commitment to people, the planet and sustainable profitability.

## Highlights and strategy

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Smith & Nephew is proud of much of its sustainability performance in 2011. The Group achieved continued improvements in its sustainability KPIs: energy, CO<sub>2</sub>, waste and water reduction and increased recycling. The employee accident rate increased 1% year-on-year.

The Group's on-going success is also recognised by a number of highly regarded third party organisations. Smith & Nephew had another year of strong ranking in the Dow Jones Sustainability Index ( DJSI ) and FTSE4Good, achieved a top 20% ranking in the UK Carbon Reduction Commitment ( CRC ) obligation and third party verification by the Carbon Trust Standard.

Smith & Nephew constantly strives to improve its performance year-on-year. This year, the appointment of the Group's new Chief Executive Officer, Olivier Bohuon, and the focus of the business around new strategic priorities, provided an opportunity to take a further step in defining our sustainability vision and developing multi-year targets.

### Sustainability vision and strategy

Smith & Nephew has been measuring, improving and reporting its sustainability performance since 2001. During this time the Group has made good progress, and is proud of what has been achieved.

Adapting and accelerating sustainability performance is an important element of the Group's overall business strategy. During 2011, Smith & Nephew invested considerable effort re-evaluating the fundamental issues that underpin its approach to sustainability.

### Sustainability vision

Collaborate with external and internal customers to develop efficient and innovative sustainable business solutions to help differentiate and grow the business

### Top priorities

Sustainability is a multi-faceted subject and developing an executable strategy requires focus on the issues of greatest importance to the Group. To assist with this, the Group conducted extensive consultation with a diverse array of internal and external stakeholders to obtain their insights on topics of importance. These included employees throughout the business, customers, industry peers, investor rating agencies, community partners, and sustainability thought leaders. The Group also evaluated these topics in terms of their potential impact on the business. This materiality analysis identified the focus areas for the sustainability strategy. Those key focus areas are outlined below.

### Materiality Analysis

### Strategic development

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The Group is in the process of refining its strategy for sustainability and the priorities for the next five years, incorporating the materiality analysis work. The Board has actively participated in this discussion and supports the further development of Smith & Nephew's sustainability agenda. Once the Board has agreed the priorities, they will be detailed in the 2011 Sustainability Report to be published later this year.

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Smith & Nephew Annual Report 2011





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## Hazardous waste

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25%

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Close attention to improved manufacturing processes and better sorting of waste streams

## 2011 Progress

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### Environmental, health and safety performance

In 2011, the Group accelerated the sustainability commitment by incorporating Group-wide energy, waste and water reduction best practices throughout its operations.

While the Group collects absolute performance data, in this document, data is normalised for changes related to cost of production (using 2010 as base year) to facilitate better year-on-year comparisons. 2011 performance relative to the previous year for the key sustainability parameters is illustrated in the chart below.

### 2011 Key Performance Indicators

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Smith & Nephew is achieving continued improvements in its sustainability KPIs: energy, CO<sub>2</sub>, waste and water reduction, and recycling.

% change compared to 2010

\*LTAFR Lost time accident frequency rate

Energy consumption for the Group decreased by over 3% in 2011. This was largely attributable to a focus at all sites on energy efficiency projects and despite opening a substantial new commercial building in Memphis and additional production in the new Beijing plant.

The Group's carbon dioxide emissions were reduced by slightly more than 1% over the previous year. This figure is calculated from both direct emissions from the combustion of fossil fuels on Smith & Nephew's sites and secondary emissions from utility company power generation for Smith & Nephew's energy needs. The decrease was linked directly to reduced energy consumption, but the magnitude of the decrease was less than for energy because of the composition of the energy sources – some of which are more carbon intensive than others.

The business's total waste production in 2011 declined by nearly 4% over the previous year. This was attributable to disciplined waste reduction projects at all sites. Importantly, within the Group's total waste stream, the hazardous waste output was 25% less than 2010, resulting from close attention to improved manufacturing processes and better sorting of waste streams. Of additional encouragement was the Group's almost 6% increase in waste directed to recycling. As of the end of 2011, the Group is now directing almost 48% of all waste to recycling efforts.

Water consumption, while not substantial, showed a modest decline (-1%) relative to 2010 despite the opening of a significant new commercial building in Memphis.

The one area where the Group fell short in the key measures of performance was in workplace safety, after demonstrating improved performance in 2010. The Lost Time Accident Frequency Rate ( LTAFR ) increased marginally (1%) over 2010, but the numbers of days lost was higher than last year reflecting a higher accident severity. While quite a number of these accidents were related to unusually severe winter weather, the Group also experienced more accidents within its manufacturing facilities. Considering this, in the fourth quarter of 2011, the Group developed a new workplace safety training protocol that is being implemented in 2012 to help drive improved, long-term safety performance.

## People

Smith & Nephew's vision is to be the best at improving people's lives. This vision includes its own employees. In 2011, the Smith & Nephew employee workforce included nearly 11,000 people in approximately 32 countries worldwide.

The management is firmly committed to the benefits of a diverse and balanced workforce across the Group. It appoints on merit and values diversity in its broadest sense, whilst highlighting that the percentage of women Executive Officers in the Group has increased and is now 20%. Additionally, as noted elsewhere in this Report, the Board recognises the importance of diversity. The Board is currently comprised of 20% women and the Group aspire to increase the number of women on the Board to around 25% by 2015.

During 2011, Smith & Nephew introduced a new strategy and operating model to increase its competitiveness in the face of changing economies and health care environments. The Group continues to pursue this strategy, which includes simplifying its operating model, whilst at the same time ensuring all employees are engaged in its future and success.

Smith & Nephew is committed to attracting, retaining and developing talented employees who are dedicated to its core values of Performance, Innovation and Trust. These values represent the foundation of the Group's culture.

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## Sustainability continued

## Suzhou manufacturing facility focuses on energy use reduction.

Despite working in a relatively new facility, our advanced wound product team in China is constantly exploring opportunities for continuous improvement. A wide array of energy efficiency projects including HVAC enhancements and building management protocols were established that resulted in a 27% decrease in energy used in 2011.

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## 2011 Progress continued

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### We perform

Smith & Nephew and its employees set ambitious goals and seek to achieve them. The Group fosters this through a rigorous performance management process. Feedback to employees is not an annual event but instead an on-going discussion between supervisor and employee. Using a combination of face to face discussion and online tools, objectives are set and aligned at the beginning of each year to support the overall Group strategy, so that every employee can see the link between his or her work and the Group's overall success. CEO Forums are held twice a year and are designed to develop key talent by providing exposure to the broader business and also the opportunity to interact with senior leadership in a small group setting. An Annual General Managers meeting ensures that those closest to Smith & Nephew's markets and customers are fully engaged in the Group's strategy and goals from the start of each year. In 2011, Smith & Nephew initiated annual CEO Awards to reward exceptional contributions to the Group's strategy. This award is open to all employees throughout the Group below executive level.

### We innovate

Smith & Nephew encourages and supports new ideas. The Group always seeks solutions to the challenges of its customers and their patients by offering valuable and effective health care products and services. This same innovation applies to Smith & Nephew's practices to recruit, engage and develop its employees. The application process is facilitated through online application. New employees are welcomed through an online global induction program, shortening their learning curve and maximising their opportunities for success. Smith & Nephew believes diversity fuels innovation and is committed to providing equal opportunity to all employees without discrimination. This includes support of employees who are disabled or have become disabled during the course of their employment. In these cases, it is Group policy to provide continuing employment wherever practical in the same or a suitable alternative position.

Each year, Smith & Nephew conducts a comprehensive talent review to identify employees with high potential and ensure they receive the development needed for their success and also develop future leaders for critical roles. As a measure of this success the percentage of vacancies filled by internal applicants in 2011 averaged 35% (2010 32%). The Group's target for all employees continues to be 40% including management positions.

### We earn trust

Trust is the foundation on which Smith & Nephew is built and it is the hall-mark of its interactions with stakeholders both inside and outside the Group. A Code of Conduct defines the standards of behaviour for the Group's employees as well as suppliers, contractors and distributors authorised to do business on the Group's behalf. In 2011, Smith & Nephew continued to strengthen its comprehensive compliance program

which includes both annual and on-going training for its employees around the world. Smith & Nephew also initiated its first global ethics and compliance survey to serve as a benchmark for on-going improvement efforts.

Smith & Nephew fosters trust through open communication and a collaborative environment where ideas are encouraged, recognised and rewarded. Formal communication channels include Group-wide and divisional newsletters and intranet platforms as well as variety of forums for open dialogue including quarterly reports from the CEO and quarterly employee meetings on the state of the Group and important initiatives.

### Ensuring a healthy and safe work environment

Smith & Nephew is committed to a healthy, supportive and safe work environment for its employees. Smith & Nephew does not use any form of forced, compulsory or child labour. The Group's global risk management process ensures that potential issues are identified and mitigated. Smith & Nephew adheres to all local and country regulations and employs a range of applicable health, safety and security measures. Smith & Nephew protects the health of its employees through work-based strategies such as safety and ergonomics, minimising the risk of work-related injury and ensuring that sufficient resources and systems are in place to address health and safety matters. The Group involves all employees in continuous improvement including applicable training, reporting and review of health and safety matters.

### Measuring our progress

Smith & Nephew monitors its own internal culture through Employee Engagement Surveys. The Group uses the results of these surveys to identify areas of opportunity and develop and execute action plans to address them. Regular reporting is maintained on some key metrics of engagement. One of the key measures is the average voluntary labour turnover rate. The Group's US and UK employee population (approximately 60% of total employees) have the most established and robust data collection processes in place.

During 2011, the voluntary labour turnover rate in these regions was 8.8%, a slight increase from 7.2% in 2010. Average involuntary labour turnover was 6.3% (2010: 5.1%), which reflects organisational changes taken as part of Smith & Nephew's new strategy and operating model. The average voluntary turnover for employees leaving the Group within two years of joining was 3.7% for 2011, compared to 10.9% in 2010.

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<b>Investment</b>	<b>Investment</b>
<b>in communities</b>	<b>in R&amp;D</b>

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**\$14m**

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\$14m was given in support for community charitable causes, grants, sponsorships, medical education and disaster relief.

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**\$167m**

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The Group invested \$167m (2010 \$151m) in Research and Development to develop improved products and services.

**Employee numbers**

The average numbers of full-time equivalent employees in 2011 was 10,743, of whom 1,670 were located in the UK, 4,404 were located in the US and 4,669 were located in other countries. The Group does not employ a significant number of temporary employees.

The average number of employees for the past three years by business segment was:

	<b>2011</b>	2010	2009
Orthopaedics	<b>5,280</b>	5,045	4,853
Endoscopy	<b>2,331</b>	2,134	1,888
Advanced Wound Management	<b>3,132</b>	2,993	3,023
	<b>10,743</b>	10,172	9,764

Where the Group has collective bargaining arrangements in place with labour unions, these reflect local market circumstances.

Smith & Nephew operates share option plans that are available to the majority of employees (for further information see Note 24 of the Notes to the Group accounts). The Group has no share plans in which shares have rights with regard to control of the Company that are not exercisable directly by employees.

**Our communities**

Smith & Nephew is committed to being a strong corporate citizen across its sphere of influence and in particular, in the communities where we work and live. This includes monetary support (cash and donated products) and support of its employees to volunteer for community causes. In 2011, Smith & Nephew's support for community charitable causes, grants, sponsorships, medical education and disaster relief totalled \$13,640,000, comprised of \$9,101,000 in cash and \$4,539,000 in product donations. As a matter of policy, Smith & Nephew makes no political contributions.

Smith & Nephew is committed to establishing mutually beneficial relationships with its suppliers, customers and business partners. The Group works only with partners it believes adhere to business principles and health, safety, social and environmental standards consistent with its own. In 2011, the Group commenced implementation of a formal sustainability performance questionnaire for a sub-set of its supply chain partners.

The Group has also continued to promote diversity objectives through long-term relationships with local or small business enterprises and minority-owned and women-owned business enterprises.

### Economic contribution

Sustainability by definition includes positive economic performance. The Group is committed to providing innovative, cost-effective healthcare solutions benefiting patients, healthcare professionals, reimbursement agencies and their patients through improved treatment, ease and speed of product use. The Group's business policies are designed to achieve long-term growth and profits which in turn bring continued economic benefits to shareholders, employees, suppliers and local communities. Highlights for 2011 included:

Group revenue in 2011 amounted to \$4.3 billion (2010 \$4.0 billion);

Smith & Nephew's employment of nearly 11,000 people globally is a substantial economic-generator; total wages and salaries in 2011 amounted to \$930m (2010 \$817m); and

The Group invested \$167m (2010 \$151m) in Research and Development to develop improved products and services.

### Looking ahead

A more complete analysis of Smith & Nephew's 2011 sustainability performance will be included in the 2011 Sustainability Report to be published later this year.

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Corporate Governance

Chairman's introduction  
to corporate governance

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Sir John Buchanan

Chairman

Smith & Nephew is a  
Group which takes great  
pride not only in what we

do, but in how we do it

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Smith & Nephew Annual Report 2011



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Corporate Governance

### Dear shareholder,

Smith & Nephew is a Group which takes great pride not only in what we do, but in how we do it. The Board of Smith & Nephew is committed to this principle and leads from the top in setting a tone that we expect from all employees across the Group.

Seeking best practice in corporate governance is important to us. All Board members are active contributors to the proper and responsible way of running the Group. The Corporate Governance Statement that follows explains in technical detail how we, as a Board, comply with the corporate governance principles.

However, we feel there is value in highlighting those particular aspects of governance we have dealt with during the year. This gives our shareholders an insight into what governance means at Smith & Nephew.

### Board changes

Olivier Bohuon joined the Board on 1 April 2011 and took over as Chief Executive Officer on 14 April following last year's Annual General Meeting, when David Illingworth retired. I have paid tribute to David elsewhere in this Annual Report.

This year, at our Annual General Meeting, Rolf Stomberg will be retiring from the Board after 14 years' service. We are truly indebted to Rolf for his enormous contribution and commitment during his time on the Board. He served as Chairman of the Remuneration Committee for 10 years, Senior Independent Director for 9 years and played a major part in the CEO succession process. We have benefited greatly from his experience and wisdom.

We were delighted to welcome Ajay Piramal to the Board in January 2012. Ajay is one of India's most respected businessmen and brings both a wealth of global healthcare experience and, of course, expertise in the emerging markets. It is a major achievement to have attracted Ajay to Smith & Nephew.

### Development of strategy

You will have read elsewhere in this Annual Report how Olivier has been redefining our strategic priorities. His work is making a positive impact on the business, our customers, the definition of our KPIs, the analysis of the risks we face and the way we choose to pay and incentivise our employees. Olivier works closely with the Board in this process. We debated the issues extensively at our Strategy Review in September, including analysing the risks that might prevent us meeting our strategic priorities.

### Diversity in the Boardroom

We value the diversity of views in our Boardroom. My Board colleagues all come from different backgrounds and each brings unique capabilities and perspectives to our discussions. We have a wide geographical spread and a mix of professional backgrounds. We are committed to maintaining a diverse Board and whilst it is our expectation that 25% of the Board will be female by 2015, we will appoint on merit and value diversity in its broadest forms.

## Directors development and effectiveness

The Board and I value the opportunity to visit our multiple locations, learning first-hand about the specific challenges our business faces in different parts of the world. Visiting our manufacturing, distribution, training or sales and marketing offices and sites gives us a more detailed perspective and interacting with our talented people stimulates ideas. The visits to Shanghai, York and Hull in 2011 gave us valuable insights into these Group operations.

The Board evaluates its own effectiveness. In 2011, Richard De Schutter, our Senior Independent Director led this evaluation process. We felt that in a year of such change, we would benefit more from an internally facilitated evaluation, with an external evaluation scheduled for 2012. The review's conclusions are summarised on page 55.

## Director independence

We value the independence of our Non-Executive Directors. It is important that the Chief Executive Officer and the Chief Financial Officer are challenged in the Boardroom, leading to wider debate and better proposals and decisions. This leads to an improved articulation of strategy and enhanced assessment of risk and opportunities.

This can only be done effectively if the Non-Executive members of the Board are prepared to ask the difficult questions, to insist on sound responses and to spend time understanding the key drivers and challenges faced by the Group. Our Non-Executive Directors do this both at formal Board meetings and, on occasion, between meetings.

We value the longevity of our long-serving members, who have a deep understanding of the Group. However, we are also mindful of our need to plan for the future and the need to refresh our Board structure. We shall continue to look for new Non-Executive Directors to ensure that we have a balanced Board with the capabilities fit for taking us into the future and its new challenges.

## Ethics and Compliance

You will note that we have a specific Board Committee focused on Ethics and Compliance. This is an area of intense focus for us, given our responsibility to our healthcare customers and their patients and the close scrutiny that the industry faces from regulators. We believe that all our employees should act appropriately and ethically. We have detailed policies and training programmes in force covering all employees in all the territories in which we operate and also our third party sellers.

It is important to set the tone from the top and our Ethics and Compliance Committee therefore reviews all Group activities in this area and takes a lead in enforcing compliance and encouraging good practice.

Finally, while governance sets the vital framework, we are aware that the Board's prime responsibility is to promote the long-term success of the Company for the benefit of customers, employees and shareholders.

## Sir John Buchanan

Chairman

22 February 2012



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Corporate Governance

**The Board of Directors****1 Sir John Buchanan****Chairman**

Joined the Board as an Independent Non-Executive Director in 2005, appointed Chairman and Chairman of Nominations Committee in April 2006.

Sir John has broad international experience gained in large and complex international businesses. He has substantial experience in the petroleum industry and knowledge of the international investor community. He has held various leadership roles in strategic, financial, operational and marketing positions, including executive experience in different countries. He is a former Executive Director and Group Financial Officer of BP, serving on the BP Board for six years.

**Other Directorships**

Senior Independent Director and Deputy Chairman of Vodafone Group Plc

Senior Independent Director of BHP Billiton Plc

Chairman of International Chamber of Commerce (UK) Ltd

Member of Advisory Board of Ondra Bank

Chairman of UK Trustees for the Christchurch Earthquake appeal

**Board Committee Membership**

Nominations Committee

**3 Adrian Hennah****Chief Financial Officer**

Joined the Board as Chief Financial Officer in June 2006.

Adrian has had extensive financial and management experience in a number of companies including GlaxoSmithKline and Invensys, where he held the position of Chief Financial Officer. His role at Smith & Nephew is strategic as well as financial and he is responsible for driving margin performance and addressing operational improvements.

**Other Directorships**

Non-Executive Director of Reed Elsevier PLC

Member of Supervisory Board of Reed Elsevier NV

**Board Committee Membership**

None

**4 Ian Barlow****Independent Non-Executive Director****Chairman of Audit Committee**

Appointed Non-Executive Director in March 2010 and Chairman of Audit Committee in May 2010.

**5 Geneviève Berger****Independent Non-Executive Director**

Appointed Non-Executive Director in March 2010.

Geneviève is a scientist with a PhD in Physics and Biology as well as being an MD, and has held a number of senior business roles as Chairman of the Health Advisory Board for the European Commission and Professor at the University of Paris, Le Pitié-Sapêtrière Teaching Hospital and Director General of the French Centre National de La Recherche Scientifique. She is currently, Chief Research & Development Officer at Unilever plc and NV which she originally joined as a Non-Executive Director.

**Other Directorships**

None

**Board Committee Membership**

Ethics & Compliance Committee

**6 Richard De Schutter****Senior Independent Non-Executive Director**

Appointed Non-Executive Director in January 2001 and Senior Independent Director in April 2011.

## 2 Olivier Bohuon

### Chief Executive Officer

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Joined the Board and appointed Chief Executive Officer in April 2011.

Olivier has had extensive international experience within a number of pharmaceutical and healthcare companies. Prior to joining Smith & Nephew, he was President of Abbott Pharmaceuticals, a division of Abbott Laboratories based in the US, where he was responsible for the entire business, including R&D, Global Manufacturing and global support functions.

### Other Directorships

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Non-Executive Director of Virbac Group

### Board Committee Membership

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Nominations Committee

Ian is a Chartered Accountant and has had extensive financial experience both internationally and in the UK. Prior to his retirement in 2008, he was Senior Partner, London at KPMG and previously Head of their UK tax and legal operations. During his career with KPMG, he acted as Lead Partner for many large international organisations operating extensively in North America, Europe and Asia.

### Other Directorships

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Chairman of WSP Group plc

Non-Executive Director and Chairman of the Audit Committee of the PA Consulting Group

Non-Executive Director and Chairman of the Audit Committee of Brunner Investment Trust

Chairman of The Racecourse Association

Non-Executive Director of the Board of Her Majesty's Revenue and Customs

### Board Committee Membership

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Audit Committee

Richard has had extensive US corporate experience at Chief Executive and Chairman level in a number of major corporations with primarily a scientific, chemical, engineering or pharmaceutical focus including GD Searle, Monsanto, Pharmacia Corporation and DuPont Pharmaceuticals.

### Other Directorships

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Non-Executive Chairman of Incyte Corporation

Non-Executive Director of Navicure Inc

Non-Executive Director of Sprout Pharmaceuticals

### Board Committee Membership

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Nominations Committee

Audit Committee

Ethics & Compliance Committee

Remuneration Committee

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Corporate Governance

**7 Pamela Kirby****Independent Non-Executive Director****Chairman of the Ethics &****Compliance Committee**

Appointed Non-Executive Director in March 2002 and Chairman of Ethics and Compliance Committee in April 2011.

Pamela has extensive commercial and product development experience within the international pharmaceutical and healthcare industry. Her last executive position was Chief Executive of Quintiles Transnational Corp in the USA, having previously held senior positions in various pharmaceutical companies including AstraZeneca and F. Hoffmann- La Roche. She is now a Non-Executive Director of a number of international companies.

**Other Directorships**

Non-Executive Chairman of Scynexis Inc.

Non-Executive Director of Informa plc

Non-Executive Director of Victrex plc

Non-Executive Member of the Board of Simmons & Simmons LLP

**Board Committee Membership**

Ethics & Compliance Committee

Remuneration Committee

**9 Joseph Papa****Independent Non-Executive Director****Chairman of the Remuneration Committee**

Appointed Non-Executive Director in August 2008 and Chairman of Remuneration Committee in April 2011.

Joseph has had nearly 30 years experience in the pharmaceutical industry working for a number of companies both in the US and Switzerland. He is now Chairman and Chief Executive of Perrigo, one of the largest over the counter pharmaceutical companies in the US, having held senior positions at Novartis, Cardinal Health Inc. and Pharmacia.

**Other Directorships**

Chairman and Chief Executive of Perrigo Company

**Board Committee Membership**

Remuneration Committee

Audit Committee

Ethics and Compliance Committee

**10 Ajay Piramal****Independent Non-Executive Director**

Appointed Non-Executive Director in January 2012.

**11 Rolf Stomberg****Independent Non-Executive Director**

Appointed Non-Executive Director in 1998. Retiring from the board following the Annual General Meeting on 14 April 2012.

Rolf has a wide board experience within a range of diverse international industries. He held a number of leadership positions at BP over a number of years until his retirement in 1997, when he was Chief Executive Officer of BP Oil and a member of the BP Board. He is now a Non-Executive Director of a number of international companies.

**Other Directorships**

Chairman of Lanxess AG

Non-Executive Director of Hoyer GmbH,

Non-Executive Director of Biesterfeld AG

Non-Executive Director of Severstal OAU

Non-Executive Director of Ruspetro Plc

**Board Committee Membership**

Nominations Committee

Audit Committee

Remuneration Committee

**12 Susan Henderson****Company Secretary**

## 8 Brian Larcombe

### Independent Non-Executive Director

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Appointed Non-Executive Director in March 2002.

Brian spent his career in private equity with 3i Group. After leading the UK investment business for a number of years, he became Finance Director and then Chief Executive of the Group following its flotation. He is well known in the City and has held a number of Non-Executive Directorships.

### Other Directorships

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Non-Executive Director of gategroup Holdings AG

Non-Executive Director of Incisive Media Holdings Limited

### Board Committee Membership

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Audit Committee

Remuneration Committee

Ajay is one of India's most respected businessmen. He enabled the Piramal Group to transform from a textile centric group to a \$2.0bn conglomerate in diversified areas. He has extensive industry and market knowledge and international experience particularly in India and China. He has held a number of global healthcare leadership positions in both India and internationally.

### Other Directorships

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Chairman of Piramal Healthcare, Piramal Glass, Allergan India Limited, IndiaREIT fund advisors and IndiaVentures Advisors

Chairman of Board of Governors of Indian Institute of technology, Indore

Member of Board of Dean's Advisors at Harvard Business School

Chairman of Pratham India

### Board Committee Membership

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None

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Appointed Company Secretary in May 2009.

Susan has nearly 30 years' experience as a company secretary in a wide range of companies including Prudential plc, Amersham plc and RMC Group plc. Her work has covered Board support, corporate governance, corporate transactions, share registration, listing obligations, corporate social responsibility, pensions, insurance and employee and executive share plans. Susan is a member of the GC100 Group Executive Committee and the CBI Companies Committee and is a frequent speaker on corporate governance related matters.





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Corporate Governance

## Executive Officers

Olivier Bohuon is supported in the day-to-day management of the Group by a strong team of Executive Officers:

### Mike Frazzette

#### **President, Advanced Surgical Devices**

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Joined Smith & Nephew in July 2006 as President of the Endoscopy business. Since July 2011, he has headed up our Advanced Surgical Devices division and is responsible for the Orthopaedic, Trauma and Endoscopy business in Established Markets. He is based in Andover, Massachusetts.

#### **Previous Experience**

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Mike has held a number of senior positions within the US medical devices industry. He was President and Chief Executive Officer of Micro Group, a US manufacturer of medical devices and spent 15 years at Tyco Healthcare becoming President of each of the Patient Care and Health Systems divisions.

Mark Augusti

Helen Maye

**President, Clinical Therapies/Biologics**

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Joined Smith & Nephew in 2003 and since January 2008, has led the Clinical Therapies and Biologics businesses. He is based in Raleigh, North Carolina. He will leave the Group on completion of the Clinical Therapies disposal announced on 4 January 2012.

**Previous Experience**

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Mark has held a number of senior positions within the Orthopaedics and Biologics businesses of Smith & Nephew. Prior to joining Smith & Nephew, he worked for GE Medical Systems in the US and Asia. Mark is also a Non-Executive Director of Hutchinson Technology Inc.

**Head of Group Human Resources**

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Joined Smith & Nephew in July 2011. She is based in London and leads the Global Human Resources and Internal Communications functions.

**Previous Experience**

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Helen has more than 30 years' experience across a variety of international and global roles in medical devices and pharmaceuticals, including manufacturing, supply chain and human resources. Previously, she was Divisional Vice President of Human Resources at Abbott Laboratories.

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Corporate Governance

### **Roger Teasdale**

#### **President, Advanced Wound Management**

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Joined Smith & Nephew in 1989 within the Wound Management business. He was appointed President of Advanced Wound Management in May 2009. He is based in Hull.

#### **Previous Experience**

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Roger has held a number of key roles within the Smith & Nephew Group in both the UK and the US and has been responsible for leading the transformation of the wound business in recent years.

### **Francisco Canal Vega**

#### **President, Emerging Markets**

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Joined Smith & Nephew in January 2012. He is based in Dubai and leads the Emerging Markets division, focusing particularly on achieving market leading growth in Brazil, Russia, China and India.

#### **Previous Experience**

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Francisco has held senior management positions in global companies including Gambro AB, Excelsior and Baxter International and has lived and worked in many countries including China, Japan, US and Spain. Francisco was also formerly a Board Member of EUCOMED.

### **Kelvin Johnson**

#### **President, International Markets**

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Joined Smith & Nephew in 1980 and was appointed to lead the International Markets division, covering all countries outside the Established and Emerging Markets in 2011. He is based in Dubai.

#### **Previous Experience**

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Kelvin has held a number of key international roles with Smith & Nephew, firstly in South Africa and then leading the Emerging Market strategy. He has spent some time leading the Group's increased focus in China.

### **Ros Rivaz**

#### **Chief Technology Officer**

Joined Smith & Nephew in November 2011. She is responsible for global operations, IT systems, Corporate Sustainability and Regulatory and Quality Affairs and is focused on improving efficiency in Smith & Nephew's processes. Ros is based in London.

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**Previous Experience**

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Ros has held senior management positions in global companies in the areas of supply chain management, logistics, manufacturing, procurement and systems, including, Imperial Chemical Industries, Tate & Lyle, Diageo and Premier Foods. She has 30 years' experience across all areas of operational excellence.

**Gordon Howe**

**Senior Vice President,**

**Global Planning and Development**

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Joined Smith & Nephew in 1998 and, since August 2007, has headed up the Global Planning and Business Development teams. He is based in Memphis, Tennessee.

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**Previous Experience**

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Gordon has held a number of senior management positions within the Smith & Nephew Group firstly in the Orthopaedics division and more recently at Group Level. Prior to joining the Company, he held senior roles at United Technologies Corporation.

**Jack Campo**

**Chief Legal Officer**

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Joined Smith & Nephew in June 2008 and heads up the Global Legal function. Since late 2011 he has been based in Andover, Massachusetts.

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**Previous Experience**

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Prior to joining Smith & Nephew, Jack held a number of senior legal roles within the General Electric Company including 7 years at GE Healthcare (GE Medical Systems) in the US and Asia.



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Corporate Governance

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## Corporate Governance Statement

### Compliance Statement

We are committed to the highest standards of corporate governance and comply with all the provisions of the UK Corporate Governance Code ( the Code ). The Company s American Depositary Shares are listed on the NYSE and we are therefore subject to the rules of the NYSE as well as to the US securities laws and the rules of the SEC applicable to foreign private issuers. We comply with the requirements of the SEC and NYSE except that the Nominations Committee is not comprised wholly of independent Directors, as required by the NYSE, but consists of a majority of independent Directors in accordance with the Code. We shall explain in this Corporate Governance Statement and in the Directors Remuneration Report how we have applied the provisions and principles of the FSA Listing Rules, the Disclosure & Transparency Rules ( DTR ), and the Code throughout the year.

### Board

The Board is responsible for determining the strategy of the Chief Executive Officer and his Executive team implement that strategy. The chart on the next page gives more detail about the structure of the Board, the matters we deal with and the key activities we undertook in 2011.

### Roles of Directors

Whilst we all share collective responsibility for the activities of the Board, some of our roles have been defined in greater detail. In particular, the roles and responsibilities of the Chairman and Chief Executive Officer are clearly defined.

#### Chairman

Building a well balanced Board

Chairing Board meetings and setting Board agenda

Ensuring effectiveness of the Board and ensuring annual review undertaken

Encouraging constructive challenge and facilitating effective communication in the Board

Promoting effective Board relationships

Ensuring appropriate induction and development programmes

Ensuring effective two way communication and debate with shareholders

Setting the tone at the top with regard to compliance and sustainability matters

Promoting high standards of corporate governance

Maintaining appropriate balance between stakeholders

#### **Chief Executive Officer**

Developing and implementing Group strategy

Recommending the annual budget and five year strategic and financial plan

Ensuring coherent leadership of the Group

Managing the Group's risk profile and establishing effective internal controls

Regularly reviewing organisational structure, developing executive team and planning for succession

Ensuring the Chairman and Board are kept advised and up to date regarding key matters

Maintaining relationships with shareholders and advising the board accordingly

Setting the tone at the top with regard to compliance and sustainability matters

The Non-Executive Directors meet regularly prior to each Board meeting without management in attendance. The roles of Non-Executive Directors and in particular the Senior Independent Non- Executive Director are defined as follows:

#### **Non-Executive Directors**

Providing effective challenge to management

Assist in development of strategy

Serve on the Board Committees

#### **Senior Independent Non-Executive Director**

Chairing meetings in the absence of the Chairman

Acting as sounding board for the Chairman on Board related matters

Acting as an intermediary for the other Directors where necessary

Available to shareholders on matters which cannot otherwise be resolved

Leading annual evaluation into the Board's effectiveness

Leading search for a new Chairman, as necessary

#### **Independence of Non-Executive Directors**

We are sensitive to the need for our Non-Executive Directors to remain independent from management in order to exercise our independent oversight and effectively challenge management as necessary. The Board has determined that all Non-Executive Directors are independent in accordance with both UK and US requirements. None of our Non-Executive Directors or their immediate families has ever had a material relationship with the Group either directly as an employee or as a partner, shareholder or officer of an organisation that has a relationship with the Group. None of them receive additional remuneration apart from Directors' fees, nor do they participate in the Group's share option plans, performance related pay schemes or pension schemes. Nor do they serve as Directors of any companies or affiliates in which any other Director is a Director.

Now that Olivier Bohuon has settled into his new role and we are beginning to implement our new strategy, we are in a position to analyse the appropriate Board balance and structure for the future. We know that we will need different skills and experiences and, in particular, we would like to have a greater representation from Emerging Markets, which is a key Strategic Priority for us. The appointment of Ajay Piramal at the beginning of 2012 goes some way towards achieving this.



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Rolf Stomberg has served on the Board for 14 years and will be retiring from the Board following this year's Annual General Meeting. We are continuing to look for suitable Non-Executive Directors and, in due course, other longer serving Directors will step down.

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Smith & Nephew Annual Report 2011



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Corporate Governance

Board Membership

**Non-Executive Chairman Sir John Buchanan**

**Chief Executive Officer Olivier Bohuon** (appointed on 1 April 2011)

**Chief Financial Officer Adrian Hennah**

**8 Independent Non-Executive Directors**

Richard De Schutter (Senior Independent Director)

Ian Barlow

Geneviève Berger

Pamela Kirby

Brian Larcombe

Joseph Papa

Ajay Piramal (appointed 1 January 2012)

Rolf Stomberg (to retire on 12 April 2012)

(David Illingworth retired as Chief Executive on 14 April 2011)

Role of the Board as set out in the schedule of matters reserved to the Board

**Strategy**

Approving the Group strategy including major changes to corporate and management structure, acquisitions, mergers, disposals, capital transactions over \$10m, annual budget, financial plan, business plan, major borrowings and finance and banking arrangements

Approving changes to the size and structure of the Board, overseeing succession planning and the appointment and removal of Directors and the Company Secretary

Approving Group policies relating to corporate social responsibility, health and safety, Code of Conduct and Code of Share Dealing and other matters

**Performance**

Reviewing performance against strategy, budgets and financial and business plans

Overseeing Group operations and maintaining a sound system of internal control

Determining dividend policy and dividend recommendations

Approving the appointment and removal of the auditors and other professional advisors and approving significant changes to accounting policies or practices

Approving the use of the Company's shares in relation to employee and executive incentive plans

**Risk**

Determining risk appetite, regularly reviewing risk register and risk management processes

**Shareholder Communications**

Approving preliminary announcement of annual results, annual report, half yearly report, quarterly interim management statements, the release of price sensitive announcements and any listing particulars, circulars or prospectuses

Maintaining relationships and continued engagement with shareholders

Key activities in 2011 (in addition to regular annual activities)

Appointment of Olivier Bohuon as Chief Executive Officer

Approval of new strategy and updated organisational structure

Approval of risk management programme

Approval of five year plan

Review of effectiveness of Board

Review of on-going Board composition

9 Scheduled meetings

3 Telephone Update Calls

4 Day Strategy Review and visit to our China operations

2 Day visit to our York and Hull operations

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Corporate Governance

**Corporate Governance Statement continued****Board and Committee attendance**

The table below details attendance of Directors at Board and Committee meetings held throughout the year:

	<b>Board</b>	<b>Remuneration Committee</b>	<b>Audit Committee</b>	<b>Nominations Committee</b>	<b>Ethics and Compliance Committee</b>
	<b>9 meetings</b>	<b>4 meetings</b>	<b>6 meetings</b>	<b>4 meetings</b>	<b>4 meetings</b>
Sir John Buchanan	9			4	
Olivier Bohuon (i)	7		3		
David J. Illingworth (ii)	3			1	
Adrian Hennah	9				
Ian Barlow	9		6		
Geneviève B. Berger (iii, iv)	8				2
Pamela J. Kirby	9	4			4
Brian Larcombe	9	4	6		
Joseph C. Papa	9	4	6		4
Richard De Schutter	9	4	6	4	4
Rolf W. H. Stomberg	9	4	6	4	

(i) Appointed to the Board on 1 April 2011.

(ii) Retired from the Board on 14 April 2011.

(iii) Appointed to the Ethics and Compliance Committee on 14 April 2011.

(iv) Attended all scheduled meetings and was unable to attend some meetings arranged at short notice because of prior commitments. From time to time Directors also attend Committee meetings at the invitation of the Committee Chairman, even if they are not members of the Committee, in order to gain a better understanding of the activities of that Committee.

Board development programme

## Edgar Filing: SMITH & NEPHEW PLC - Form 20-F

In 2011, the Board development programme focused on continuing to increase our understanding of the business and markets in which the Group operates. Throughout the year, we receive regular updates from our business operations across the world. It is however very much more real to visit these operations, to view the processes and to meet the people running and working in the businesses. This gives us an in-depth understanding of the opportunities and challenges employees face on a daily basis and helps to inform our decisions. Meeting our key employees around the world also helps us with succession planning.

We have commenced an induction programme for Ajay Piramal who joined the Board on 1 January 2012. He has received a briefing on the responsibilities and duties of a Director of a UK Listed company as well as a number of key corporate documents. A programme of events is being planned for his first visit to London as a member of our Board, when he will meet with senior employees and have the opportunity to visit some of our key UK locations.

<b>Month</b>	<b>Activity</b>
<b>September</b>	Visit to Advanced Wound Management Factory in Suzhou, China Visit to Emerging Markets Head Office in Shanghai, China Presentation on the opportunities and challenges of doing business in China Presentation on the challenges of developing a Strategy in emerging markets
<b>November</b>	Visit to Surgical Skills Centre in York Visit to Advanced Wound Manufacturing factory and Head Office in Hull

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Corporate Governance

### Board evaluation

Towards the end of 2011, Richard De Schutter, the Senior Independent Director led a review into the effectiveness of the Board and its Committees as a whole as well as reviewing individual contributors. He asked us to complete an online questionnaire and then interviewed each of us individually. With the appointment of a new Chief Executive Officer during the year and the subsequent development of the updated Strategic Priorities and organisational structure, we felt that it would be more beneficial to use an external facilitator for our effectiveness review in 2012, once some of the changes have had time to settle. Richard De Schutter reported back to us on his findings, which we discussed in detail in February 2012.

The review concluded that the Board works effectively and has an appropriate balance of experience and skills. Non-Executive Directors particularly valued receiving regular reports from Olivier Bohuon between meetings and having meetings with myself without management present prior to each Board meeting. We were also satisfied with the positive start made by Olivier Bohuon as Chief Executive Officer and welcomed the progress he was making in implementing the new strategy and in building a strong team.

We identified certain areas for continued improvement throughout 2012:

Ensuring that we spend more time in Board meetings on key strategic issues and not allowing time to be spent on operational matters that impact that priority

Implementing a more streamlined process for the appointment of Non-Executive Directors

Gaining a better understanding of succession planning below Board level

Taking more time to review our competitors and their strategies better

Reviewing our past decisions on a systematic basis

### Company Secretary and Independent Advice

The Company Secretary, Susan Henderson, is responsible to the Board for ensuring that we comply with all corporate governance requirements and are kept updated on our responsibilities. We all have access to her, individually and collectively.

We may also, from time to time, obtain independent professional advice, at the Company's expense, if we judge it necessary in order to fulfil our responsibilities as Directors. If we are unable to attend a Board meeting or Board Committee meeting, we ensure that we are familiar with the matters to be discussed and make our views known to the Chairman or the Chairman of the relevant Committee prior to the meeting.

## Management of Conflicts of Interest

None of us nor our connected persons has any family relationship with any other Director or officer nor has a material interest in any contract to which the Company or any of its subsidiaries are or were a party during the year or up to 21 February 2012.

Each of us has a duty under the Companies Act 2006 to avoid a situation in which we have or may have a direct or indirect interest that conflicts or possibly may conflict with the interests of the Company. This duty is in addition to the existing duty that we owe to the Company to disclose to the Board any transaction or arrangement under consideration by the Company. If we become aware of any situation which may give rise to a conflict of interest, we inform the rest of the Board immediately and the Board is then permitted under the articles of association to authorise such conflict. The information is recorded in the Company's Register of Conflicts together with the date on which authorisation was given. In addition, we certify, on an annual basis, that the information contained in the Register is correct.

When the Board decides whether or not to authorise a conflict, only the Directors who have no interest in the matter are able to participate in the discussion and a conflict is only authorised if we believe that it would not have an impact on our ability to promote the Company's success in the long-term. Additionally, we may, as a Board determine that certain limits or conditions must be imposed when giving authorisation. We have identified no actual conflicts which have required approval by the Board. We have, however, identified seven situations which could potentially give rise to a conflict and these have been duly approved by the Board and are reviewed on an annual basis.

## Re-appointment of Directors

In accordance with the Code, with effect from the Annual General Meeting held in 2011, all Directors, including Ajay Piramal who was appointed on 1 January 2012, offer ourselves to shareholders for re-election annually. In 2012 Rolf Stomberg will be retiring from the Board and will not offer himself for re-election as noted previously. Retiring Directors retain office until the conclusion of the Annual General Meeting. In addition, each Director may be removed at any time by the Board or the shareholders.



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## Corporate Governance Statement continued

### Directors Indemnity Arrangements

Each Director is covered by appropriate directors and officers liability insurance and there are also Deeds of Indemnity in place between the Company and each Director. These Deeds of Indemnity mean that the Company indemnifies Directors in respect of any proceedings brought by third parties against them personally in their capacity as Directors of the Company. The Company would also fund on-going costs in defending a legal action as they are incurred rather than after judgement has been given. In the event of an unsuccessful defence in an action against them, individual Directors would be liable to repay the Company for any damages and to repay defence costs to the extent funded by the Company.

### Liaison with shareholders

The Executive Directors meet regularly with investors to discuss the Company's business and financial performance both at the time of the announcement of results and at industry investor events. During 2011, the Executive Directors held meetings with institutional investors, including investors representing approximately 47% of the share capital as at December 2011.

As part of this programme of investor meetings, during 2011, as Chairman of the Company, I met with investors representing 13.5% of the share capital. Over the last three years, I have met investors representing in aggregate 22.8% of the share capital. Also during 2011, Joseph Papa met with shareholders holding 14.3% of the share capital to discuss remuneration policies and plans and to introduce himself as the new Chairman of the Remuneration Committee.

We receive a short report at every Board meeting reviewing our major shareholders and any significant changes in their holdings since the previous meeting. Olivier Bohuon and Adrian Hennah routinely advise us of any concerns or issues that shareholders have raised with them in their meetings. We also receive copies of analysts' reports on the Company and our peers between Board meetings.

The Company's website ([www.smith-nephew.com](http://www.smith-nephew.com)) contains information of interest to both institutional investors and private shareholders, including financial information and webcasts of the results presentations to analysts for each quarter, as well as specific information for private shareholders relating to the management of their shareholding.

### Share capital

As at 21 February 2012, the Company's total issued share capital with voting rights consisted of 895,845,540 Ordinary Shares of 20 US cents each. 60,322,610 Ordinary Shares are held in treasury and are not included in the above figure.

As at 21 February 2012, notification had been received from the undernoted investors under the DTR in respect of interests in 3% or more of the issued Ordinary Shares with voting rights of the Company.

	Number of Shares	%
Invesco	44,901,016	5.02
BlackRock, Inc.	44,811,205	5.02
Newton Investment Management Limited	44,337,465	4.98
Legal and General Group plc	35,675,739	3.99

In addition to the above the Company is aware that Walter Scott & Partners Limited hold approximately 38m Ordinary Shares (4.2%). Otherwise, the Company is not aware of any person who has a significant direct or indirect holding of securities in the Company and is not aware of any persons holding securities which may control the Company. There are no securities in issue which have special rights as to the control of the Company.

### Dividend

The Board has proposed a final dividend of 10.80 US cents per share which, together with the interim dividend of 6.60 US cents, makes a total for 2011 of 17.40 US cents. The final dividend is expected to be paid, subject to shareholder approval, on 9 May 2012 to shareholders on the register of Members at the close of business on 20 April 2012.

### Annual General Meeting

The Company's Annual General Meeting is to be held on 12 April 2012 at 2pm at The Royal Society, 6-9 Carlton House Terrace, London, SW1Y 5AG. Registered shareholders have been sent either a Notice of Annual General Meeting or notification of availability of the Notice of Annual General Meeting, as appropriate.

### Code of Ethics for senior financial officers

We have adopted a Code of Ethics for senior financial officers, which is available on the Group's website ([www.smith-nephew.com](http://www.smith-nephew.com)) and on request. This applies to the Chief Executive Officer, Chief Financial Officer, Group Financial Controller and the Group's senior financial officers. There have been no waivers to any of the Code's provisions nor any amendments made to the Code during 2011 or up until 21 February 2012.

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Corporate Governance

**Evaluation of internal controls procedures**

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934.

We, as a Board, are responsible overall for reviewing and approving the adequacy and effectiveness of internal controls operated by the Group, including financial, operational and compliance controls and risk management. We have delegated responsibility for the review of financial, ethical compliance and quality management systems controls to the Audit Committee, which reviews the internal control process, on an annual basis and evaluates its effectiveness to ensure that it remains robust and to identify any control weaknesses. The latest review covered the financial year to 31 December 2011 and included the period up to the approval of this Annual Report. The main elements of this annual review are as follows:

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Group's disclosure controls and procedures as at 31 December 2011. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded on 22 February 2012 that the disclosure controls and procedures were effective as at 31 December 2011.

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the effectiveness of the Group's internal control over financial reporting as at 31 December 2011 in accordance with the requirements in the US under s404 of the Sarbanes-Oxley Act. In making this assessment, they used the criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission in Internal Control-Integrated Framework. Based on their assessment, management concluded and reported that, as at 31 December 2011, the Group's internal control over financial reporting is effective based on those criteria.

Having received the report from management, the Audit Committee reports to the Board on the effectiveness of controls.

Ernst & Young LLP, an independent registered public accounting firm issued an audit report on the Group's internal control over financial reporting as of 31 December 2011. This report appears on page 83.

There is an established system of internal control throughout the Group and our divisions. The main elements of the internal control framework are as follows:

The management of each Division is responsible for the establishment and review of effective internal financial controls within their Division. The Group Finance Manual sets out, amongst other things, financial and accounting policies and minimum internal financial control standards. The Internal Audit function agrees an annual work plan and scope of work with the Audit Committee.

The Audit Committee reviewed reports from the internal auditors on their findings on internal financial controls.

The Audit Committee reviews the Group Whistleblower procedures.

The Audit Committee reviews regular reports from the Group Financial Controller and the Taxation and Treasury functions.

This system of internal control has been designed to manage rather than eliminate material risks to the achievement of our strategic and business objectives and can provide only reasonable, and not absolute, assurance against material misstatement or loss. Because of inherent limitations, our internal controls over financial reporting may not prevent or detect all mis-statements. In addition, our projections of any evaluation of effectiveness in future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of

compliance with the policies or procedures may deteriorate. This process complies with the Turnbull working party guidance, revised October 2005 and additionally contributes to our compliance with the obligations under the Sarbanes-Oxley Act 2002 and other internal assurance activities. There has been no change in the Group's internal control over financial reporting during the period covered by this Annual Report that has materially affected, or is reasonably likely to materially affect, the Group's internal control over financial reporting.

### Principal accountant fees and services

Fees for professional services provided by Ernst & Young LLP, the Group's independent auditors in each of the last two fiscal years, in each of the following categories were:

	2011	2010
	\$ million	\$ million
Audit	3	3
Audit related fees		
Tax	2	2
Other		
	<b>5</b>	<b>5</b>

Audit fees include fees associated with the annual audit and local statutory audits required internationally. A more detailed breakdown of audit fees may be found in Note 3 of the Notes to the Group accounts.

### Disclosure of information to the auditors

In accordance with Section 418 of the Companies Act 2006, the Directors serving at the time of approving the Directors' Report confirm that, to the best of their knowledge and belief, there is no relevant audit information of which the auditors, Ernst & Young LLP, are unaware and the Directors also confirm that they have taken reasonable steps to be aware of any relevant audit information and, accordingly, to establish that the auditors are aware of such information.

### Auditors

Ernst & Young LLP have expressed their willingness to continue as auditors and resolutions proposing their reappointment and to authorise the Directors to determine their remuneration will be proposed at the Annual General Meeting as approved by the Audit Committee.

### Directors' Report

The Directors' Report includes the following sections; Business Review (pages 14 to 45), Corporate Governance (pages 46 to 76) and Investor Information (pages 137 to 150).

### Corporate headquarters and registered office

The corporate headquarters is in the UK and the registered office address is: Smith & Nephew plc, 15 Adam Street, London WC2N 6LA, UK. Registered in England and Wales No. 324357. Tel: +44 (0) 20 7401 7646. Website: www.smith-nephew.com.



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Corporate Governance

## Corporate Governance Statement continued

### Committees of the Board

We delegate some of the Board's detailed work to four Committees. Each of these has their own terms of reference, which may be found on the Group's website at [www.smith-nephew.com](http://www.smith-nephew.com). The Company Secretary or her designate is secretary to each of the Committees. The Chairman of each Committee reports orally to the Board and minutes of the meetings are circulated to all members of the Board.

#### **Audit Committee**

Ian Barlow

#### **Membership**

Ian Barlow (Chairman) (Independent and financial expert)

Brian Larcombe (Independent)

Joseph Papa (Independent)

Richard De Schutter (Independent)

Rolf Stomberg (Independent)

#### **Six Meetings**

#### **Main Responsibilities**

Ensure Integrity of financial statements, reviewing significant financial reporting judgments and compliance with accounting standards, policies and practices ensuring compliance with UK and US statutory requirements

Monitor announcements relating to Group's financial performance

Monitor effectiveness of internal controls and compliance with s404 Sarbanes Oxley

Review operation of Group s risk management processes and the control environment mitigating compliance and quality management system risk

Recommend the re-appointment of the external auditors, monitor and review their performance, and the effectiveness of the audit process

Receive reports on fraud and whistleblowing

Agree internal audit plans and review internal audit reports

Monitor the effectiveness of the internal audit function

**Key Activities in 2011 (in addition to main responsibilities)**

Reviewed plans for reformatting the Annual Report

Reviewed the risk management process

Assumed responsibility for the review of the audit of Quality Management Systems

Considered the management of strategic risk by the Tax function

Reviewed the operations of the Disclosures Committee

Received and considered a report from the Treasury function

Received and considered an external report on the effectiveness of the internal audit function

**Remuneration Committee**

Joseph Papa

**Membership**

Joseph Papa (Chairman) (Independent)

Brian Larcombe (Independent)

Pamela Kirby (Independent)

Richard De Schutter (Independent)

Rolf Stomberg (Independent)

**Four Meetings**

**Three matters agreed by written resolution**

**Main Responsibilities**

Determine remuneration policy for Executive Directors and senior executives

Approve individual remuneration packages for Executive Directors and Executive Officers at least annually and any major changes to individual packages throughout the year

Determine the use of long-term incentive plans and oversee the use of shares in all executive and employee plans

Approve appropriate performance measures for short-term and long-term incentive plans for Executive Directors and senior executives

Determine pay-outs under short-term and long-term incentive plans for Executive Directors and senior executives

Approve Directors Remuneration Report ensuring compliance with related governance provisions



Maintain constructive engagement on remuneration issues with shareholders

Have regard to remuneration policies and practices across the Group

**Key Activities in 2011 (in addition to main responsibilities)**

Approved package for incoming Chief Executive Officer and retirement arrangements for outgoing Chief Executive

Approved joining and leaving packages for all direct reports to Chief Executive Officer

Undertook comprehensive review of remuneration arrangements for top 70 senior executives to align remuneration with the updated Group strategy

Undertook engagement programme with major shareholders to explain new remuneration arrangements

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Corporate Governance

**Ethics & Compliance Committee**

Pamela Kirby

**Membership**

Pamela Kirby (Chairman) (Independent)

Joseph Papa (Independent)

Richard De Schutter (Independent)

Geneviève Berger (Independent)

**Four Meetings**

**Main Responsibilities**

Review ethics and compliance programmes

Review policies and training programmes

Review compliance performance based on monitoring auditing and investigations data

Review hotline issues and calls

Review Group's internal and external communications relating to ethical and compliance issues

Review external developments and compliance activities

Receive reports from the Executive ethics and compliance meetings and from the Chief Compliance Officer and the Chief Legal Officer  
**Key Activities in 2011 (in addition to main responsibilities)**

Reviewed implications of UK Bribery Act and approved updates to processes as appropriate

Reviewed updates on compliance programme for distributors

Reviewed internal reports into the effectiveness of our compliance arrangements in China

#### **Nominations Committee**

Sir John Buchanan

#### **Membership**

Sir John Buchanan (Chairman) (Independent on appointment)

Olivier Bohuon

Richard De Schutter (Independent)

Rolf Stomberg (Independent)

#### **Four Meetings**

**One matter agreed by written resolution**

**Main Responsibilities**

Review size and composition of Board

Oversee Board succession plans

Recommend Director appointments

**Key Activities in 2011 (in addition to main responsibilities)**

Undertook the search for a new Chief Executive Officer and recommended the appointment of Olivier Bohuon

Reviewed and updated the parameters for the search for additional Non-Executive Directors. Recommended changes to the composition and chairmanship of Board Committees

Recommended the appointment of Ajay Piramal as Non-Executive Director

Considered the implications of the Davies Report and revised policy on building a diverse Board

Reviewed our use of search firms



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Corporate Governance

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## Corporate Governance Statement continued

### Audit Committee

Dear shareholder,

I am pleased to present my report on the activities of the Audit Committee in 2011. The membership and the principal duties of the Committee are set out in the table on page 58 of this report.

The members are all independent Directors and bring relevant expertise to the committee from their current or prior roles as Chief Executives of substantial businesses both in the UK and USA and from their roles as Non-Executive Directors at other corporations. I myself am the designated finance expert being a Chartered Accountant and former senior partner at KPMG UK, retiring in 2008.

In addition to the usual matters, which fall to the Audit Committee, such as approving the financial results for the year, half year and the quarterly interim management statements and the review of applicable accounting policies and going concern assumptions, the Audit Committee reviewed a number of topics during 2011.

#### Review of format of Annual Report

As you will have noticed, we undertook a thorough review of the style and format of the Annual Report during 2011. We wanted to present our Group to you in a clearer more user friendly manner, so that you could find your way more easily around the document to the information you need. We have explained our Strategic Priorities and their relation to our Key Performance Indicators, risk and remuneration policies. We have included more tables, charts and pictures and adopted a more personal style in explaining our approach to governance. We are mindful of proposals from the Department of Business Innovation And Skills regarding Narrative Reporting and regard the work done in refocusing the Annual Report this year, as being a good base on which to build the report of the future.

#### Review of accounting policies

As noted we reviewed and concluded on the appropriateness of the Group's principal accounting policies, practices and accounting judgments concentrating on the critical accounting policies requiring management's judgement, namely the valuation of inventory, review of the carrying value of goodwill, intangible and tangible assets and the valuation of retirement benefits, contingencies and provisions.

#### Compliance

We reviewed compliance with accounting standards, accounting policies and practices, accounting and reporting issues, going concern assumptions and the UK Corporate Governance Code and section 404 of the Sarbanes Oxley Act. No concerns were raised with us in 2011 about possible improprieties in matters of financial reporting or other matters.

#### Review of Internal Audit function

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We reviewed the Internal Audit function, its programme of work and its resourcing requirements, specifically in the area of internal controls over financial reporting, ethical compliance, quality management systems (see below), assessing the effectiveness of the risk management process and the prevention and detection of fraud. We were assisted in this by an external review carried out by PricewaterhouseCoopers. This concluded that the internal audit function was effective and respected across the Group having adapted successfully to an expanding remit to address the changing needs of the business.

### Quality Management Systems audit

In 2010, our Internal Audit function assumed responsibility for the review of our quality management systems, for our systems that monitor our manufacturing activities for compliance with standards set by regulatory authorities, including the FDA in the US, the MHRA in the UK and other comparable bodies worldwide. We continued to review the work of the Internal Audit function in this area in 2011. This work included monitoring controls that mitigate quality management system risk.

### Review of risk management process

We examined and updated the way we manage risk within the organisation and undertook a mapping exercise to link the key risks identified within our businesses with the key risks identified by the Board at our Strategy Review. We then linked these risks back to our

Strategic Priorities and identified the mitigating action in place to control these risks. This will assist the Board and senior management to concentrate on the key strategic risks and their management faced by the Group. These are both downside risks (something going wrong) and upside risk (missed opportunities).

We continued to review the Group's approach to internal financial control and the operation of the risk management process. We also evaluated the effectiveness of the Group's systems to identify and manage material risks.

### Receipt of functional reports

During the year, we received reports from the Tax and Treasury functions including how they manage risk.

### Review of the work of the external auditors

We assessed the performance of Ernst & Young, our external auditors. This was done throughout the year through review of their regular reports on the scope and outcomes of their work. These reports included accounting matters, governance and control and accounting developments. In addition we utilised formal year-end feedback from all our operating units as a result of which we asked for improvements to be made in two operating locations. We reviewed the inspection reports from the Auditor Oversight Boards in the UK and the US. We also ensured that the audit-related, tax and other services received from the external auditors were pre-approved in accordance with the Auditor Independence Policy described below. Finally we reviewed the fees of the auditors using benchmarking against groups of comparable size and complexity. Our conclusions were that the external audit was carried out effectively and with the necessary objectivity and independence and this is the basis for our recommendation to the Board and shareholders that Ernst & Young be reappointed.

### Auditor Independence Policy

We have determined a schedule of approved non-audit services for the Group external auditors to undertake. Our Auditor Independence Policy prohibits the external auditors from performing services which would result in the auditing of their own work, participating in activities normally undertaken by management, acting as advocates for the Group and creating a mutuality of interest between the auditors and the Group by, for example, being remunerated through a success fee structure. On an annual basis, we pre-approve the budget for fees relating to audit and non-audit work, including taxation compliance services, in accordance with a listing of particular services. In the event that limits for these services are expected to be exceeded or the Group wants the external auditors to perform services that have not been pre-approved, my approval is required. The Committee is subsequently advised of any such services and fees. In this way all services provided by the external auditors during the year were pre-approved by the Audit Committee. The Auditor Independence Policy also governs the policy regarding the audit partner rotation in accordance with the Auditing Practices Board Ethical Standards in the UK and the SEC rules in the US. During the year the second partner on the account was replaced under these rules, a transition that was handled well by Ernst & Young. Partners and senior audit staff may not be recruited by the Group unless two years have expired since their previous involvement with the Group. No such recruitment has occurred.

### Internal control and risk management

On behalf of the Board, we reviewed the system of internal financial control and satisfied ourselves that we are meeting required standards both for the year ended 31 December 2011 and up to the date of approval of this Annual Report.

Ian Barlow

Chairman of Audit Committee

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Corporate Governance

## Nominations Committee

### Dear shareholder,

I am pleased to present my report on the activities of the Nominations Committee in 2011. The membership and the principal duties of the Committee are set out in the table on page 59 of this report.

We dealt with the following important matters in 2011.

### Appointment of Olivier Bohuon

We completed the search for a new Chief Executive Officer, recommending to the Board in February that Olivier Bohuon be appointed. Olivier joined the Board in April and became Chief Executive Officer on 14 April 2011 following the Annual General Meeting.

### Review of Board composition

We reviewed the composition of the Board, recognising that whilst stability was important through a period of change, it was also important to refresh and build a Board for the future.

We have identified that Rolf Stomberg, Richard De Schutter, Pamela Kirby and Brian Larcombe have all served on the Board for over 9 years and that, therefore, some may consider their independence to be impaired. We have analysed the skills that the Board would lose when these Directors leave the Board and the skills we will need to ensure we have the most effective Board to see us into the future. We have identified that the Board needs the following skills and experience:

Emerging market experience, ideally in China or India

US medical devices experience

European healthcare experience

Our search, is therefore focusing on these three key areas. As and when we find suitable candidates willing to join our Board, we can replace some of the longer serving Directors. We are reluctant to release hard working and experienced colleagues who are active contributors to our boardroom discussions until we appoint suitable Directors to take their place.

### Appointment of Ajay Piramal

We completed the search for an additional Non-Executive Director and recommended to the Board in December that Ajay Piramal be appointed. We approached Ajay directly to consider joining our Board, because of his well-established and renowned track record both in the Healthcare industry and specifically in the Emerging Markets of India and China, which we identified as one of our Strategic Priorities.

#### Use of search firms

During the year, we reviewed our use of search firms. When briefing search firms, we explain the importance to us of building a diverse board and request that shortlists include candidates from a wide range of backgrounds.

#### Consideration of diversity issues

We also considered the Davies Report into Women on Boards and our response to the issues it raised.

We are strongly committed to diversity in its broadest sense and over the years have attempted to recruit Board members from a wide range of backgrounds.

We already have two female Directors – Pamela Kirby and Geneviève Berger and aspire to increase the number of women on the Board to around 25% by 2015.

We will, however, continue to recruit on merit and for us gender is only one diversity measure. We welcome the existing diversity on our Board where we enjoy a broad perspective given our differing skills and experiences. This includes professionals, with backgrounds ranging from UK and US corporate careers to notable scientists who are vital in bringing understanding of the importance of innovation and the scientific challenges we face as a business. We also have a broad range of nationalities represented on our Board, from UK, US, India, Europe and New Zealand.

#### Sir John Buchanan

Chairman of Nominations Committee



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Corporate Governance

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## Corporate Governance Statement continued

### Ethics & Compliance Committee

#### Dear shareholder,

I am pleased to present my report on the activities of the Ethics & Compliance Committee in 2011. The membership and the principal duties of the Committee are set out in the table on page 59 of this report.

The following are some of the key issues we have focused on in 2011.

#### UK Bribery Act

We considered the implications of the UK Bribery Act on our operations and practices. We already had a well-developed global compliance programme in accordance with laws such as the US Foreign Corrupt Practices Act (FCPA) but recognised the need to make various changes to adapt our programme to reflect the requirements of the UK Bribery Act. We therefore discussed and approved applicable changes to our existing processes.

#### Compliance activities in Emerging Markets

We received regular reports from the Chief Compliance Officer on our compliance programme in China, the specific compliance challenges faced by our people in this region and the measures taken to address these challenges, particularly our work with third party sellers.

#### Oversight of ethics and compliance programmes

We continued to monitor the effectiveness of our global ethics and compliance programmes. This included reviewing Group policies in this area and considering compliance, monitoring and audit reports. We also received regular reports on the number and nature of investigations conducted and calls to our hotline.

#### Communication and training

In addition, we continued to monitor the Group's internal communications and training in relation to ethics and compliance policies and reviewed the materials used to train our third party sellers. All employees have received a copy of the Code of Conduct which sets out the basic legal and ethical principles for carrying out business and applies both to employees and those who act on the Group's behalf. It sets out in detail how persons covered by the Code of Conduct are expected to interact ethically with healthcare professionals and government officials. It also covers the broader issues of ethics and compliance throughout the business and includes a code of business principles. A copy of the Code of Conduct can be found on the Group's website ([www.smith-nephew.com](http://www.smith-nephew.com)).

The Code of Conduct includes our whistle-blowing policy, which enables employees and members of the public to contact us anonymously through an independent provider. All calls and contacts are investigated and the appropriate action taken, including reports to senior management, or the Board, where warranted.

#### Settlement with US Securities and Exchange Commission (SEC) and US Department of Justice (DOJ)

In January 2012, we reviewed and approved the final terms of the settlement between the Company and the SEC and DOJ in connection with their FCPA investigation of the medical devices industry. This has been a matter that we, as a Committee have monitored closely since the

formation of the Committee in 2008.

**Pamela Kirby**

Chairman of Ethics & Compliance Committee

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Corporate Governance

## Other Committees

### Executive Risk Committee

Olivier Bohuon chairs our Executive Risk Committee which includes the Executive Directors and Executive Officers of the Group. As an integral part of our planning and review process, the management of each of our divisions identifies the risks applicable to their business, the probability of those risks occurring, the impact if they do occur and the actions required and being taken to manage and mitigate those risks. The Executive Risk Committee meets twice-a-year to review the major risks they identify across the Group and the mitigation processes and plans. As appropriate, the Executive Risk Committee may re-categorise risks or require further information or mitigating action to be undertaken. We receive an annual report from the Executive Risk Committee, which details the significant risks categorised by potential financial impact on profit and share price and by likelihood of occurrence. Details of new, key or significantly increased risks, along with actions put in place to mitigate such risks, are also reported to us as appropriate. We have provided further information on the principal risks identified through this process in Risk factors on pages 16 to 18 of this Annual Report.

### Disclosures Committee

Olivier Bohuon chairs the Disclosures Committee which includes the Chief Financial Officer and various additional senior executives. The Committee meets as required and approves the release of all major communications to investors, to the UK Listing Authority and to the London and New York Stock Exchanges.

Sir John Buchanan

Chairman

22 February 2012



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Corporate Governance

Directors Remuneration Report

Joseph Papa

Chairman of Remuneration Committee

We are building a remuneration framework to reinforce a new strategy and to drive performance for the benefit of our shareholders



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Corporate Governance

**Directors Remuneration Report**

Dear shareholder,

I am pleased to present the report on the activities of the Smith & Nephew Remuneration Committee throughout 2011. This was a year of many changes for Smith & Nephew. I took over from Rolf Stomberg as Chairman of the Committee at the Annual General Meeting, the same day as Olivier Bohuon assumed the role of Chief Executive Officer. Elsewhere in this annual report, you will have read about the new strategy which Olivier is implementing across the Group. I shall now explain how the Remuneration Committee are building the remuneration framework for the Executive Directors and other senior executives that will reinforce that new strategy and drive performance for the benefit of you, our shareholders.

Our review has been driven by the following principles:

**Restraint** the total reward at target under the 2012 framework is broadly the same as under the 2011 framework.

**Transparency** the new framework is simpler and clearer to understand by all stakeholders.

**Alignment with strategy** the measures and targets in all our plans are linked back to our business goals. The membership and the principal duties of the Committee are set out in the table on page 58 of this Annual Report. The formal Directors Remuneration Report that follows explains the technical details of our remuneration arrangements in 2011 and also looks forward to explain our remuneration strategy for 2012 and beyond. Firstly however, I should like to explain some of the main activities of the Committee in 2011 and the reasoning behind the new remuneration structure we are proposing.

**New remuneration arrangements for the Executive Directors and Senior Executives**

The main work of the Remuneration Committee this year has been the development of a remuneration strategy for our Executive Directors and Senior Executives which supports and reinforces the new strategy Olivier is pursuing. We want to put in place a remuneration framework that will focus our key executives to drive the new strategy over the short, medium and long-term which in turn will drive performance for our shareholders.

Following a review of our existing arrangements, which included feedback from our senior executives, it was felt that the plans previously in place were too complex and really did not work as effective incentives for the performance and behaviours we wished to drive. As a result, we are proposing a revised framework, which seeks to simplify remuneration at Smith & Nephew, provide a clear link to the business goals and strengthen the line of sight between reward and performance. The changes we are proposing have consciously been designed to be broadly neutral in value: for target performance the quantum available to our Executive Directors and Executive Officers will not change. However, we have rebalanced the package across the short, medium and long-term varying by level, to improve the link with our business strategy.

We have moved away from two long-term incentive arrangements to a simple performance share plan linked to the delivery of Total Shareholder Return relative to our peers and growth in free cash flow.

We have also amended the short-term incentive arrangements. The cash element will be linked to the achievement of business and strategic performance measures with an equity incentive linked to individual and business performance over the medium-term.

We have introduced measures to enable us to clawback payments and awards already made should a serious financial mis-statement come to light or a participant is found to have engaged in misconduct. We have also strengthened the rules around share ownership for our executives.

In December, I visited a number of our largest shareholders and UK Institutional bodies to discuss our new proposals. They were all broadly supportive of our moves towards increased transparency, simplification and alignment with our changing corporate strategy and most importantly shareholder interests. The suggestions made by these shareholders have been most useful in developing our final proposals.

#### Retirement arrangements for David Illingworth

Consideration was given to the retirement arrangements for David Illingworth who stepped down from the Board in April. We followed the provisions in his service contract and saw no need to make discretionary adjustments. David was employed for seven months of the year and will receive a bonus in respect of this employment period. Since his retirement David has continued to provide consultancy advice to Olivier and has received a consultancy fee in respect of this. Details of David's retirement and consultancy arrangements can be found in the report that follows.

#### UK and International ShareSave Plans

We have operated an all-employee ShareSave Plan in the UK for 30 years. In 2002 we introduced an International ShareSave Plan which now operates in 27 countries. The UK and International ShareSave Plans approved in 2002 have now expired and need to be renewed at the Annual General Meeting. These plans are very popular amongst our employees who are able to save on a regular basis and then buy shares in the Company. We have around 2,500 employees participating in the current plans around the world and are currently exploring ways of extending these arrangements to China and other emerging markets to enable us to attract and retain talent in these key areas.

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Corporate Governance

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## Directors Remuneration Report continued

### Compliance statement

We have prepared this Directors Remuneration Report (the Report) in accordance with The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the Regulations). It also meets the relevant requirements of the Financial Services Authority (FSA) Listing Rules. As required by the Regulations, a resolution to approve the Report will be proposed at the Annual General Meeting on 12 April 2012.

As set out on page 58 of this Annual Report, my fellow members of the Remuneration Committee are Pamela Kirby, Brian Larcombe, Richard De Schutter and Rolf Stomberg who will be retiring from the Board on 12 April 2012. We would like to thank Rolf for all the work he did as Chairman of the Remuneration Committee for 10 years. Details concerning the number of meetings held and the scope and role of our duties may be found on this page. From time to time, we are advised by Olivier Bohuon, Chief Executive Officer, Susan Henderson, Company Secretary, Helen Maye, Head of Group Human Resources and Elizabeth Sohn, SVP Compensation and Benefits, who attend some or all of our meetings, except for when their personal remuneration is being discussed.

### Independent advice

During the year, we conducted a review of our remuneration consultants. We felt that with a new Chief Executive Officer, a new Chairman of the Remuneration Committee and a new Head of Group Human Resources, it would also be appropriate to appoint a new Remuneration Consultant. Given our global business, we wanted a firm with an international presence and in particular one with an internal data service. After considering a number of firms, the Remuneration Committee appointed Towers Watson in September 2011. They have assisted us in developing the new remuneration packages in line with our new strategy. Throughout 2011, we were also advised by Deloitte LLP relating to long-term comparative performance and Towers Watson, Aon Hewitt, Mercer Limited relating to salary data. Towers Watson also provided other human resources and compensation advice to the Company for levels below Board level and Deloitte also provided taxation advice to the Group. All of these consultants have complied with the Code of Conduct for Remuneration Consultants and we are satisfied that their advice is objective and independent.

### Remuneration policy

Our policy is designed to attract talent that will drive the strategy over the short, medium and long-term, which in turn will lead to performance for our shareholders. This report describes the remuneration arrangements which were in force during 2011, but it also looks forward to describe the remuneration arrangements we are applying in 2012 and beyond. We therefore thought that it would be helpful to provide a summary of these arrangements before focusing on the detail later in the report.

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Smith & Nephew Annual Report 2011



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	2011	2012	Objective	Link to Business Strategy
<b>Base Salary and Benefits</b>	Base salary benchmarked to median for relevant geographic market.		To attract and retain high performing talent to the Group by setting base salary and benefits at rates comparable to what would be paid in an equivalent position elsewhere.	Ensure we have a strong team of executives to drive performance.  Reflects responsibility of role and breadth of leadership of the Group.
	<b>Executive Directors</b>			
	Non pensionable, non bonusable salary supplement of 30% base salary paid in lieu of pension contributions. Death in service cover of 7 times base salary, of which 4 times salary payable as lump sum.			
	<b>Executive Officers</b>			
	Pension plan entitlement based on local defined benefit and defined contribution arrangements.			
<b>Annual Cash Incentive</b>	<b>Executive Directors</b>	<b>Executive Directors</b>	<b>Executive Directors</b>	
One year	Target: 100% of salary Maximum: 150% of salary	Target: 100% of salary Maximum: 150% of salary	Target: To motivate and reward the achievement of annual Group objectives.	Drives annual performance on our financial, operating and strategic KPIs.
	<b>Executive Officers</b>	<b>Executive Officers</b>	<b>Executive Officers</b>	
	Target: 70% of salary Maximum: 140% of salary	Target: 55% of salary Maximum: 110% of salary	Focuses on reward for performance against specific Group goals.	Reinforces individual performance and accountability on the immediate annual goals which will provide a solid base for delivering sustained year on year

				growth over the longer-term.
<b>Equity Incentive Award</b>	<b>Not applicable</b>	<b>Executive Directors and Executive Officers</b>	To motivate and reward sustained individual performance.	Weighted heavily towards financial performance at individual and Group level. Reinforces the Smith & Nephew principles of what and how to ensure that executives are delivering results in the right way, having regard for our people, reputation and ethics.
One-three years		Target: 50% of salary  Maximum: 65% of salary	To provide a strong retention element over the medium-term and reinforce the longer term view.	
		Vesting in equal annual tranches over three years, subject to sustained individual performance.		Underscores individual performance and accountability to deliver results focusing on near-term milestones to provide the base for future growth.
<b>Long-Term Incentives</b>	<b>Performance Share Plan</b>	<b>Performance Share Plan</b>	Reward for strong performance over the longer-term.	Awards continue to be linked to strong relative returns to shareholders and to maintaining long-term cash generation.
Three years				
	<b>Executive Directors</b>	<b>Executive Directors</b>		
	Max Face value: 150% of salary + 1.5x multiplier, or 225% of salary	Target value: 95% of salary  Max value: 190% of salary	From 2012, vesting depends on relative TSR ranking and free cash flow.	
	<b>Executive Officers</b>	<b>Executive Officers</b>		
	Max Face value: 75% of salary + 1.5x multiplier or 112.5% of salary	Target value: 55% of salary  Max value: 110% of salary		
	<b>Executive Option Plan</b>	Removed	Removed	Removed
	<b>Executive Directors and Executive Officers</b>			
	Face value: 100% of salary			

These arrangements are described in greater detail on pages 68 to 71.





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**Directors Remuneration Report** continued**Base salary and benefits (including pensions)**

We aim to pay base salaries taking into account the scope and responsibility of the position and performance potential of the individual by reference to the median salary for the relevant geographical market. We review salaries on an annual basis with effect from 1 April each year.

With effect from 1 April 2011, we approved the following base salaries for the Executive Directors:

Olivier Bohuon	1,050,000
Adrian Hennah	£ 580,000

In February 2012, we reviewed the base salaries of the Executive Directors having regard to average salary increases across the Group which will be around 3%. We considered increasing the salaries paid to the Executive Directors by a similar amount given their outstanding performance and contribution. The Executive Directors have however requested that at a time when we are driving cost efficiencies across the Group and a number of positions are being eliminated, no increase be made to Olivier Bohuon's salary and that Adrian Hennah's salary be increased by 1%. Their base salaries with effect from 1 April 2012 will therefore be:

Olivier Bohuon	1,050,000
Adrian Hennah	£585,800

We also provide benefits in line with local market practice in the countries in which we operate. Typically, these benefits include private healthcare, company car or allowance and where appropriate relocation expenses.

**Pensions**

We provide pension arrangements for employees across the Group. The nature of the arrangements differ depending on their location and in some cases their length of service depending on the arrangements in place when they first joined the Company.

Olivier Bohuon and Adrian Hennah both receive a salary supplement of 30% of basic salary to apply towards their retirement savings in lieu of membership of a company run pension scheme. Base salary is the only element of remuneration that is pensionable. They also receive death in service cover of seven times basic salary, of which four times salary is payable as a lump sum. Executive Officers who joined the company in 2003 or later are also entitled to receive a salary supplement or to join one of the Company's Defined Contribution Pension Plans depending on local practice.

Different arrangements are in place for employees and Executive Officers who joined the Company prior to 2003 as follows:

In the UK, such Executive Officers participate in the Smith & Nephew UK Pension Fund or the UK Executive Pension Scheme, under which pensions have been accrued in the year at an annual rate of one-thirtieth of final pensionable salary up to a limit based on service of two-thirds of final pensionable salary, subject to HM Revenue & Customs (HMRC) constraints. The normal retirement age is 62. Pensions in payment are guaranteed to increase by 5% per annum or the rate of inflation in the UK, if lower. Death in service cover of four times salary and a spouse's pension at the rate of two thirds of the member's pension are provided on death. A salary supplement partially compensates for the HMRC

earnings cap on final pensionable salary which continues to apply in the defined benefit plans.

In the US such Executive Officers participate in either the defined benefit Smith & Nephew US Pension Plan or the defined contribution US Savings plan 401 (K) Plus. Under the US Pension Plan, pensions accrue at an annual rate of approximately one sixty-sixth of final pensionable salary up to a limit based on service of 53% of final pensionable salary. The plan also provides for a spouse's pension at

the rate of one half of the member's pension on death. Normal retirement age under the plan is 65. For executives in the defined benefit and defined contribution plans, a supplementary plan is used to provide additional retirement benefits and to compensate for the earnings cap imposed by the US Internal Revenue Code.

### Short-term incentive arrangements

As I explained in my introductory letter, we reviewed all our remuneration arrangements in 2011. This review has resulted in a change to our short-term incentive arrangements. As you will have seen elsewhere in this Annual Report, our strategy has a number of near term goals, particularly in improving efficiencies and reducing costs in our established markets. We need to achieve these short-term goals before we can achieve our longer term objectives of investing in emerging markets and innovating for value. We therefore need a remuneration framework which incentivises our executives to drive short-term performance which will enable the Group to achieve the long term performance we want for our shareholders.

A proportion of Annual Incentive earned by Executive Directors and Executive Officers prior to 2011 was deferred into share awards. For 2012, we are moving away from a single Annual Incentive Plan, with a deferred element to two distinct elements comprising an Annual Cash Incentive and an Equity Incentive Award. The bonuses earned in 2011 have therefore been paid entirely in cash and a new short-term Equity Incentive Award will be made later in March 2012.

The arrangements which applied in 2011 and those which will apply from 2012 onwards are both described below.

#### Annual Incentive Plan in 2011

During 2011, we operated an Annual Incentive Plan across the Group. Executive Directors and Executive Officers participated in the same Annual Incentive Plan although the opportunities varied, reflecting their differing roles and levels of responsibility:

	Performance at target	Performance at maximum
Executive Directors	100%	150%
Executive Officers	70%	140%

The performance measures for the Annual Incentive Plan were linked to the four strategic pillars for success which drove our Strategy in 2011, namely Customer Led, Efficient, Investing for Growth and Aligned. All employees across the Group were set performance objectives that linked back to these strategic pillars.

The incentive bonus in 2011 for Executive Directors was subject to performance measures relating to revenue (30% of incentive), trading profit/margin (30%) and trading cash flow (15%). The remaining 25% of the incentive payable was dependent on personal objectives.

Over the period, underlying revenue growth was 4%, underlying trading profit fell by 4%, trading margin fell by 200 bps and trading profit to cash conversion was 87%. Collectively these financial performance measures were just below target. The remaining part of the incentive bonus reflects the Executive Directors' performance against their personal objectives. The Remuneration Committee reviewed the performance of Olivier Bohuon and Adrian Hennah against their agreed individual objectives for 2011 and determined that Olivier Bohuon had consistently exceeded his objectives for the year (in building a strong team and launching the new strategy) and that Adrian Hennah had consistently met his objectives for the year.

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The overall cash incentive bonuses were as follows:

	Total Cash Bonus
Olivier Bohuon(i)	807,709
Adrian Hennah	£548,680
David Illingworth(i)	\$497,199

- (i) Prorated to reflect active service with the Company.  
(Olivier Bohuon appointed CEO in April 2011; David Illingworth retired in August 2011).

**Annual Cash Incentive in 2012**

From 2012 onwards, the Annual Incentive for Executive Directors and Executive Officers is divided into two parts: a) an Annual Cash Incentive and b) an Equity Incentive Award, which is a conditional award over ordinary shares, vesting in equal annual tranches over three years, provided that individual performance is sustained. The payment of the Annual Cash Incentive and the award and subsequent vesting of the Equity Incentive Award are dependent upon the same performance measures.

The Annual Cash Incentive is designed to reward employees for the annual achievement of Company financial and non-financial business goals. The level of Equity Incentive Award is governed by these same annual goals and vests only if an acceptable level of performance against these same goals is sustained in each of the following three years.

The performance measures for Executive Directors are based on a mix of financial goals and non-financial goals as follows:

<b>Financial Goals</b>	Revenue (30%)		
	Trading Profit (30%)		70%
	Trading Cash (10%)		
<b>Non-Financial Goals</b>	<b>Olivier Bohuon</b>	<b>Adrian Hennah</b>	
	R&D investment	R&D investment	
	Development of product portfolio	Shared Services	
	Succession Planning	Succession Planning	30%
	Employee engagement	Employee engagement	
	Compliance	Compliance	

The performance measures for Executive Officers and for all other employees in the Group are cascaded down from these goals, so that all employees are aligned with the same business goals.

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For each of the above measures, we have determined the precise measurements for the achievement at threshold, target and maximum, which are directly linked with the Financial Plan for 2012. As such, these measurements are commercially sensitive. In next year's Report, we will disclose levels of performance against the measures.

The maximum Cash Incentive payable depends upon level within the Company. Maximum and target awards for Executive Directors and Executive Officers are as follows:

	Performance at target	Performance at maximum
Executive Directors	100%	150%
Executive Officers	55%	110%

### Equity Incentive Award in 2012

#### Grant Conditions

We measure achievement against the goals in two different ways. Firstly we look at what the employee has achieved in the year and secondly we look at how they have performed in the year. It is important to us that as well as achieving their financial targets, our employees are displaying the right behaviours and values, that they are customer focused, operating compliantly and ethically and are treating their fellow employees fairly. Executive Directors and Executive Officers will receive an Annual Equity Incentive Award provided that they consistently meet the goals described above on both the how and what bases. If they fail to meet either of these ratings, they will receive no award and if they exceed their objectives on both measures, they will receive a higher award. The level of awards for Executive Directors and Executive Officers is as follows:

	Consistently meets how and what objectives	Consistently exceeds how and what objectives
Executive Directors	50% base salary	65% base salary
Executive Officers	50% of base salary	65% of base salary

#### Vesting Conditions

The Equity Award will be a conditional award over ordinary shares. This award will vest in equal annual tranches over three years subject to continued achievement of objectives. Each tranche will only vest if the Executive Director or Executive Officer has consistently met their objectives on both the how and the what basis in each year since the grant of the award. In the event that objectives in subsequent years are not met, the unvested portion of the Equity Incentive Awards granted in previous years will lapse.

### Long term incentives

As I mentioned earlier, we have made changes to the overall remuneration framework for 2012. Prior to 2012, Executive Directors and Executive Officers received share option grants and performance share awards. From 2012, we shall only be making performance share awards. The arrangements which applied in 2011 and those which will apply from 2012 onwards are both described below.

#### Performance Share Awards prior to 2012

During 2011, we made conditional share awards to Executive Directors, Executive Officers and senior executives. Awards to Executive Directors were made under the 2004 Performance Share Plan and awards to other employees were made under the Global Share Plan 2010. In respect of the Performance Share Awards, these two plans operate in the same way. The level of the awards made to Executive Directors and Executive Officers were as follows:

	Market value of award as % of base salary
Executive Directors	150%
Executive Officers	75%

These share awards are subject to performance conditions measured over a three-year period. These awards will only vest if pre-determined levels of adjusted Earnings Per Share ( EPSA ) growth are achieved. The number of shares delivered to executives may then be increased subject to the achievement of superior Total Shareholder Return ( TSR ) measured against the major companies in the medical devices industry.

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Corporate Governance

**Directors Remuneration Report** continued

The required EPSA levels used for the awards made in 2011 were as follows:

Growth in EPSA over the three years ending 31 December 2013	Percentage of award vesting
EPSA growth of 15% (approximately 4.5% compounded annually over three years)	25% Threshold
EPSA growth of 20% (approximately 6% compounded annually over three years)	50% Target
EPSA growth of 30% (approximately 9% compounded annually over three years)	100% Maximum

None of the awards will vest if the growth in EPSA over three years is less than threshold. For EPSA performance falling between the points given in the table above, awards will vest on a straight-line basis up to a maximum of 100%.

In addition, if the Company's TSR is positioned above median when compared with the TSR of medical devices companies, then the number of vested shares delivered to participants following the achievement of the EPSA targets will be increased by a multiplier as follows:

TSR Ranking within comparator group	Multiplier
Below or at Median	1.0x
Upper quartile	1.3x
Upper decile or above	1.5x

The multiplier increases on a straight line basis between the above points.

TSR is measured in a common currency, with values averaged over three months prior to the start and end of the performance period. We compare the Company's performance against a tailored sector peer group of medical devices companies. The companies in the comparator group for the awards made in 2011 are:

Arthrocare	KCI
Bard	Medtronic
Baxter	Nobel Biocare
Becton Dickinson	Nuvasive
Boston Scientific	Orthofix
Coloplast Group	Stryker
Conmed	St Jude Medical
Covidien	Synthes
Edwards Life Sciences Corp	Wright Medical
Johnson & Johnson	Zimmer

The Group's TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee. The awards made in 2009 were subject to performance conditions determined at that time which were based on a relative EPSA measure with a relative TSR multiplier.

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The targets for growth in EPSA were related to growth of relevant markets, taking into account both volume and price changes in each of our major markets, and weighted according to our relative turnover in these markets to provide an estimate of global market growth calculated on an annual basis for each year of the plan. The actual EPSA growth over the three years was then compared to the compounded EPSA growth targets to calculate the level of vesting. Global market growth is derived from a range of publicly available sources including individual competitor company press releases, quarterly results and analyst reports, as well as data purchased from a variety of industry surveys.

EPSA growth over the three years ending 31 December 2011 was 34% against the compounded market growth rate of 13%. Over the same period the Company was ranked 6th out of 20 companies in the medical devices comparator group which meant that a multiplier of 1.28 was applied to the number of shares vesting under the EPSA target. As a result the following awards will vest on 13 August 2012:

	Number of shares under 2009 award	Number of shares vesting in 2012
David Illingworth(i)(ii)	177,855	156,510
Adrian Hennah	161,273	141,920

(i) The award granted to David Illingworth will be settled prior to 15 March 2012 in accordance with S409A of the US Internal Revenue Code.

(ii) The number of shares under the 2009 award has been pro-rated for service during the performance period.

Share Options Grants prior to 2012

During 2011, we granted share options to Executive Directors, Executive Officers, senior executives and to certain high performing managers. Option grants to Executive Directors were made under the 2004 Executive Share Option Plan and option grants to other employees were made under the Global Share Plan 2010. Executive Directors and Executive Officers received options at market value of 100% of base salary.

Options granted to Executive Directors are subject to performance conditions measured over a three year period. These awards will only vest if pre-determined levels of TSR rank are achieved measured against the major companies in the medical devices industry.

The performance measurement for grants made in 2011 to Executive Directors was based on Total Shareholder Return. TSR is calculated on the same basis as for the Performance Share Awards. If the Company's TSR is positioned at or above median when compared with the TSR of those companies in our tailored sector peer group over a three year period commencing 1 January 2011, then the options become exercisable as follows:

TSR Ranking within comparator group	Percentage of options vesting
Below Median	Nil
Median	33%
Upper Quartile	100%

Options vest on a straight line basis between these points. If the Company's TSR performance is below median, no options vest. The comparator group is the same for the Performance Share Awards outlined above.

Options granted to Executive Officers and other employees in 2011 are not subject to performance conditions.

The options granted to Executive Directors in 2009 were subject to the same performance conditions as described above for options granted in 2011.

The Company's TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by Towers Watson.





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## Corporate Governance

Over the three year period ending 31 December 2011 the Company was ranked 6th out of 20 companies in the medical devices comparator group which meant that 96% of the options granted to Executive Directors in 2009 will vest on 13 August 2012 as follows:

	Number of options granted in 2009	Number of options vesting in 2012
David Illingworth(i)	118,570	113,825
Adrian Hennah	107,515	103,214

(i) The option granted in 2009 has been pro-rated for service during the performance period.

**Long term incentive arrangements in 2012**

In 2012, no share options will be granted to Executive Directors or Executive Officers. We will however make performance share awards to Executive Directors and Executive Officers under the Global Share Plan 2010. The level of the awards made to Executive Directors and Executive Officers will be as follows:

	Market value of award vesting at maximum as a % of base salary	Market value of award vesting at target as a % of base salary
Executive Directors	190%	95%
Executive Officers	110%	55%

These share awards will be subject to performance conditions measured over a three year period.

50% of the Award will vest depending on the Company's TSR performance relative to a selection of comparator companies and 50% of the award will vest subject to the achievement of the free cash flow target over a three year performance period.

The threshold, target and maximum levels for the 50% of the Award subject to TSR performance are based on the position of the Company's TSR ranking when compared with the TSR of a bespoke peer group of companies in the medical devices sector over a three year period commencing 1 January 2012 as follows:

TSR Ranking within comparator group	Percentage of Award vesting
Below Median	Nil
Median	25%
Upper Quartile	100%

Awards will vest on a straight line basis between these points. If the Company's TSR performance is below median, none of this part of the award will vest.

TSR will be measured relative to a bespoke peer group of companies operating in the medical devices sector. For the awards to be made in 2012, these companies are:

Arthrocare	Medtronic
Bard	Nobel Biocare
Baxter	Nuvasive
Becton Dickinson	Orthofix
Boston Scientific	Stryker
Coloplast Group	St Jude Medical
Conmed	Synthes
Covidien	Wright Medical
Edwards Life Sciences Corp	Zimmer

This group is slightly different from the group of companies used for plans in previous years, because of various corporate actions and acquisitions in the market over recent years. TSR will be calculated on the same basis as in 2011.

The Group's TSR performance and its performance relative to the comparator group will be independently monitored and reported to the Remuneration Committee by Towers Watson.

The cash flow target is a cumulative performance target over the three-year performance period. The inclusion of a cash measure in both the annual and long term plans reflects its importance over both timescales. The measure for the long-term target is free cash flow, which is defined as net cash inflows from operating activities, less capital expenditure. Free cash flow is considered to be the most appropriate measure of cash flow performance because it relates to the cash generated to finance additional investment in business opportunities, debt repayments and distributions to shareholders. This measure includes significant elements of operational and financial performance and helps to align executives rewards with shareholder value creation.

The threshold, target and maximum levels for the 50% of the award subject to free cash flow performance are as detailed below:

Cumulative Free Cash Flow	Percentage of Award vesting
Below \$1.41 billion	Nil
\$1.41 billion	25%
\$1.62 billion	50%
\$1.83 billion or more	100%

Awards will vest on a straight line basis between these points.

It is intended that the Committee should have the discretion to adjust, but on an exceptional basis only, the free cash flow target during the performance period for material factors that would otherwise distort the performance measure in either direction. For example, adjustments may be required to reflect exchange rate movements, significant acquisitions or divestments, or major legal and taxation settlements. Any major adjustments to the calculation will be disclosed to shareholders. There is no retesting of performance.

We feel that these changes to the long-term element of our remuneration framework simplify the previous arrangements, whilst continuing to drive strong cash flow performance and the delivery of superior relative returns to our shareholders.

### Shareholding requirements

We believe that one of the best ways our senior executives can act and feel like shareholders is for them to hold a significant number of shares in Company. We therefore expect our Executive Directors and Executive Officers to build up a holding of shares in the Company. In order to reinforce this expectation, we require them to retain 50% of all shares vesting under Company share plans (after tax) until this holding has been met. We will take into account their progress towards this shareholding requirement when determining whether they will be allocated awards in the future. We require Executive Directors to hold shares equivalent in value to two times their base salary and for Executive Officers to hold shares equivalent in value to one and a half times their base salary. When calculating whether or not this requirement has been met, we will include Ordinary Shares or ADSs held by the individual or their immediate family and the intrinsic value of any vested but unexercised options.

As at 21 February 2012, Olivier Bohuon holds no shares, Adrian Hennah holds 167,968 shares to the value of 181% of his base salary.



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**Directors Remuneration Report** continued**Total reward**

The following chart shows the split between the different pay elements of the Executive Directors remuneration packages on an expected value basis in both 2011 and 2012:

**Service contracts**

We employ Executive Directors on service contracts with notice periods of 12 months from the Company and six months from the Executive Director. On termination of the contract, we may require the Executive Director not to work their notice period and as such pay them an amount equivalent to the salary, pension and benefits they would have received if they had been required to work their notice period. In addition, we may also, in exceptional circumstances, exercise our discretion to pay the Executive Director a proportion of the bonus that they would have received had they been required to work their notice period. The Executive Director will also be required, where possible, to mitigate the loss. We will also seek to enforce the non-compete clause in Executive Directors contracts. In the event that we dismiss an Executive Director for cause, no payment will be made as we have a policy of not rewarding failure.

In the case of a change in control which results in the termination of an Executive Director or a material alteration to their responsibilities or duties within 12 months of the change in control the Executive Directors would be entitled to receive 12 months base salary and 12 months bonus at target plus pension and benefits.

Executive Director	Date of Service Contract	Effective Date	Expiry Date	Notice period from company
Olivier Bohuon	9 February 2011	1 April 2011	3 January 2017	12 months
Adrian Hennah	1 February 2006	1 June 2006	12 November 2019	12 months

We encourage our Executive Directors to serve as a Non-Executive Director of a maximum of one external company. Such appointments are subject to the approval of the Nominations Committee and any fees earned are retained by the Executive Director. Currently Olivier Bohuon is a Non-Executive Director of Virbac and Adrian Hennah is a non-executive Director of Reed Elsevier. During 2011, Olivier Bohuon received 19,000 and Adrian Hennah received £38,475 in respect of these appointments.

**Non-Executive Directors**

Non-Executive Directors are engaged by the Company on the basis of letters of appointment. They are normally appointed for terms of three years, terminable at will, without notice by either the Group or the Director and without compensation. The Board reviews the pay of the Non-Executive Directors and aims to set fees that are competitive with other companies of equivalent size and complexity. Non-Executive Directors are not entitled to receive awards under the Company's long term incentive plans and no part of their fees is paid in shares.

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Non-Executive Director fees were reviewed and increased in August 2011. Non-Executive Directors are paid a basic annual fee and the Chairmen of the Audit, Remuneration and Ethics and Compliance Committees and the Senior Independent Director each receive an extra fee in recognition of their additional responsibilities. An additional fee is also payable to Non-Executive Directors in cases where intercontinental travel is necessary to attend Board and Committee meetings. The fees currently paid to Non-Executive Directors are as follows:

	Fee in UK Sterling	Fee in US Dollars	Fee in Euros
Basic Annual Fee	£63,000	\$120,000	84,250
Committee Chairman and Senior Independent Director Fee	£15,000	\$27,000	20,000
Intercontinental Travel fee (per meeting)	£3,500	\$7,000	5,000

The Remuneration Committee reviews the fee of the Chairman. The Chairman's fee was last reviewed in August 2011 and increased to £400,000, an increase of 6.7%, in recognition of his outstanding work in leading the Company through the period of searching and appointing a new Chief Executive Officer and mentoring him in his new role. The Chairman is engaged on a letter of appointment and has a six month notice period.

We also require our Non-Executive Directors to hold a personal stake in the Company equivalent to their basic annual fee. These shares may be held as Ordinary Shares or as ADSs held either by themselves or their immediate family.

### Special issues in 2011

During 2011, we considered, reviewed and approved the proposed remuneration package for Olivier Bohuon, joining the Company as the new Chief Executive Officer and the retirement arrangements for David Illingworth. The key elements of these arrangements are as follows:

We employed Olivier on a standard package, participating in the same incentive plans and on the same basis as Adrian Hennah. As explained last year, on joining the Company, he also received a cash payment of \$1,400,000 and a conditional award over 200,000 shares vesting in three equal tranches over three years. The first tranche of this award will vest on 1 April 2012.

David Illingworth worked a period of six months' notice and retired from the Company on 10 August 2011 receiving pay and benefits in accordance with his service contract. He has also received a bonus in respect of the period he worked in 2011. The outstanding awards under the Company's long-term incentive plans have been pro-rated for time and vest at their normal vesting date subject to the applicable performance conditions. At the end of his period of employment, we continued to engage David in a consultancy capacity up to 10 February 2012 for a total fee of \$180,000.

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Corporate Governance

**Directors' emoluments and pensions**

The following sections of the Report up to Total Shareholder Return have been audited by Ernst & Young LLP in accordance with the Regulations.

**a) Salaries and Fees**

	Salaries and fees	Benefits (i)	Annual Incentive	Salary Supplement in lieu of pensions Thousands	Total 2011 (iii)	Total 2010 (iii)
Chairman (Non-Executive)						
Sir John Buchanan	£389	£31			£420	£373
Executive Directors						
Olivier Bohuon (iv)	788	(v) 1,675	808	236	3,507	
Adrian Hennah	£568	£21	£549	£170	£1,308	£1,157
David Illingworth (vi)	\$893	\$168	\$497	(ii) \$258	\$1,816	\$2,742
Non-Executive Directors						
Ian Barlow	£80				£80	£70
Geneviève Berger	87				87	83
Pamela Kirby	£75				£75	£64
Brian Larcombe	£65				£65	£64
Joseph Papa	\$173				\$173	\$134
Richard De Schutter	\$181				\$181	\$158
Rolf Stomberg	98				98	125

(i) Benefits shown in the table above include cash allowances and benefits in kind.

(ii) The amount provided under an international pension plan for David Illingworth is disclosed below.

(iii) Total Executive and Non-Executive Directors' emoluments for 2011 amounted to \$10,423,000 (2010: \$6,044,000).

(iv) Appointed on 1 April 2011.

(v) Includes amounts for relocation expenses in first year of appointment and 1,400,000 received on appointment.

(vi) Retired on 9 August 2011.

**b) Pensions**

	Accrued Pension as at	Increase in	Increase in accrued	Accrued pension at	Transfer value of contribution	Director's	Increase in	Transfer value of
--	-----------------------	-------------	---------------------	--------------------	--------------------------------	------------	-------------	-------------------

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	1 Jan 2011	accrued pension excluding inflation	pension due to inflation	31 Dec 2011	accrued pension at 1 Jan 2011	during 2011	transfer value less Director s contribution	accrued pension at 31 Dec 2011
	\$ thousands per annum						\$ thousands	
David Illingworth	3			3	20		3	23

\$nil (2010 - \$318,198) was provided under an International pension plan for David Illingworth.

No amounts have been paid to third parties in respect of Executive Directors' services and no excess retirement benefits or compensation has been paid to past Executive Directors.

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**Directors Remuneration Report** continued**c) Directors Share Options**

	Options as at 1 January 2011 (number)	Granted during 2011 (number)	Exercise price of options granted	Exercised during 2011 (number)	Lapsed during 2011 (number)	Options as at 31 December 2011 (number)	Average exercise price	Range of exercisable dates of options held at 31 December 2011 (vi) (date)
Olivier Bohuon								
(i)		151,698	607.00p			151,698	607.00p	09/2014-09/2021
Adrian Hennah								
(i)	346,679	95,551	607.00p		(58,682)	383,548	525.18p	06/2009-09/2021
(ii)	43,814					43,814	626.50p	03/2010-03/2017
(iv)	3,351					3,351	461.00p	11/2015-04/2016
Total	393,844	95,551			(58,682)	430,713		
David Illingworth								
(i)	293,332				(82,155)	211,177	578.67p	02/2012
(ii)	83,435					83,435	627.25p	02/2012
(iii)	343,990					343,990	\$ 40.90 (v)	08/2012-03/2013
Total	720,757				(82,155)	638,602		

(i) Options over Ordinary Shares granted under Executive Share Option Plans at prices below the market price at 31 December 2011 of 625.50p.

(ii) Options over Ordinary Shares granted under Executive Share Option Plans at prices above the market price at 31 December 2011 of 625.50p.

(iii) Options over ADSs granted under 2004 Executive Share Option Plans. Figures in the above table show the equivalent number of Ordinary Shares.

(iv) Options granted under the UK ShareSave Scheme.



(v) Per ADS.

(vi) Or date of retirement if earlier.

The range in the market price of the Company's Ordinary Shares during the year was 521.00p to 742.00p and the market price at 31 December 2011 was 625.50p. The notional gain made by Adrian Hennah on his exercise of options during the year was £nil (2010 £2,781). In 2011 the gain made by David Illingworth on exercising share options was \$nil, (2010 \$nil). On 2 February 2012, 4% of the options granted to David Illingworth and Adrian Hennah under the 2004 Executive Share Option plan lapsed following completion of the performance period. The remainder of options will vest and become capable of being exercised on the third anniversary of their grant in August 2012.

#### d) Long-Term Incentive Plan Awards

	Award type	Number of shares awarded at 1 January 2011 (number)	Awards during the year (number)	Market price on award	Vested award (number)	Market price on vesting	Lapsed award (number)	Number of shares awarded at 31 December 2011 (iv) (number)	Latest performance period (date)
Olivier Bohuon									
(i)	RSA		200,000	709.00p				200,000	03/2014
(ii)	PSP		227,547	607.00p				227,547	12/2013
Total			427,547					427,547	
Adrian Hennah									
(ii)	PSP	428,259	143,327	607.00p	(32,556)	558.57p	(88,022)	451,008	12/2013
Total		428,259	143,327		(32,556)		(88,022)	451,008	
David Illingworth									
(ii)	PSP	517,640						517,640	12/2012
(iii)	PSP	168,810					(123,232)	45,578	12/2011
Total		686,450					(123,232)	563,218	

(i) Award made over Ordinary Shares under Listing Rule 9.

(ii) Awards made over Ordinary Shares under the 2004 Performance Share Plan.

(iii) Awards made over ADSs under the 2004 Performance Share Plan. Figures in the above table show the equivalent number of Ordinary Shares.

(iv) Or date of retirement if earlier.

On 2 February 2012, 12% of the awards granted to David Illingworth and Adrian Hennah in 2009 under the 2004 Performance Share Plan lapsed following completion of the performance period. The remainder of the awards will vest on the third anniversary of their grant in August 2012. In accordance with S409A of the US Internal Revenue Code the remainder of David Illingworth's award will be paid out prior to 15 March 2012.

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**e) Deferred Bonus Plan**

The vesting of awards under the Deferred Bonus Plan is dependent upon continued employment within the Group throughout the three-year vesting period. Provided the condition of continued employment is met, one third of the total award will vest in each of the three years, on the award's anniversary.

	Total as at 1 January 2011	Awarded during 2011	Vested during 2011	Total as at 31 December 2011 (i)
David Illingworth	95,341	54,055	(37,517)	111,879
Adrian Hennah	57,873	32,947	(23,413)	67,407

(i) Or date of retirement if earlier.

All outstanding awards vested following David Illingworth's retirement on 9 August 2011, generating a gain of \$966,874 and £111,996.

**Senior Management Remuneration**

The Group's administrative, supervisory and management body (the senior management) is comprised, for US reporting purposes, of Executive Directors and Executive Officers. Details of the current Executive Directors and Executive Officers are given on pages 48 to 51.

In respect of the financial year 2011, the total compensation (excluding pension emoluments but including cash payments under the performance related incentive plans) paid to the senior management for the year was \$17,403,000 (2010 \$11,689,000, 2009 \$11,456,000), the total compensation for loss of office was \$1,161,000 (2010 \$nil, 2009 \$nil), the aggregate increase in accrued pension benefits was \$387,000 (2010 increase of \$16,000, 2009 increase of \$9,000) and the aggregate amounts provided for under the supplementary schemes was \$711,000 (2010 \$1,141,000, 2009 \$1,179,000).

During 2011, senior management were granted options over 653,375 shares under the 2004 Executive Share Option Plans, Global Share Plan 2010 and employee ShareSave plans. Performance share awards were granted to senior management over 520,909 shares and 39,165 ADSs under the 2004 Performance Share Plan and the Global Share Plan 2010, 65,931 shares and 20,908 ADSs under the Deferred Bonus Plan and conditional share awards over a total of 374,803 shares and 38,038 ADSs. As of 21 February 2012, the Senior Management (11 persons) owned 195,233 shares and 34,765 ADSs, constituting less than 0.1% of the issued share capital of the Company. Senior Management also held as of this date, options to purchase 1,959,199 shares, conditional share awards over 345,479 shares and 29,192 ADSs, performance share awards over 884,337 shares and 101,889 ADSs awarded under the 2004 Performance Share Plan and the Global Share Plan 2010; and awards over 100,317 shares and 16,751 ADSs under the Deferred Bonus Plan.

**Directors' interests**

Beneficial interests of the Directors in the Ordinary Shares of the Company are as follows:

Numbers	1 January 2011		31 December 2011		21 February 2012 (i)	
	(Or at date of appointment) Shares	Options	(Or at date of retirement) Shares	Options	Shares	Options
Sir John Buchanan	156,977		159,483		159,483	
Olivier Bohuon (ii)				151,698		151,698
Adrian Hennah	140,698	393,844	167,968	430,713	167,968	426,412
Ian Barlow	10,000		18,000		18,000	
Geneviève Berger			1,750		1,750	
Pamela Kirby	8,500		15,000		15,000	

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Brian Larcombe	20,000		40,000		40,000	
Joseph Papa	5,000		5,000		5,000	
Ajay Piramal						
Richard De Schutter	250,000		250,000		250,000	
Rolf Stomberg	13,100		13,100		13,100	
David Illingworth	326,828	720,757	339,618	638,602		
Total	931,103	1,114,601	1,009,919	1,221,013	670,301	578,110

(i) The latest practicable date for this Annual Report.

(ii) In addition, Olivier Bohuon holds 50,000 Deferred Shares. Following the redenomination of Ordinary Shares into US dollars on 23 January 2006, the Company issued 50,000 Deferred Shares. These shares are normally held by the Chief Executive Officer and are not listed on any Stock Exchange and have extremely limited rights attached to them.

The total holdings of the Directors represent less than 1% of the Ordinary share capital of the Company.

The register of Directors' interests, which is open to inspection at the Company's registered office, contains full details of Directors' shareholdings and share options.



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## Directors Remuneration Report continued

### Total shareholder return

A graph of the Company's TSR performance compared to that of the TSR of the FTSE100 index is shown below in accordance with Schedule 8 to the Regulations.

#### **Smith & Nephew - Five year Total Shareholder Return**

(measured in UK sterling, based on monthly spot values)

However, as we compare the Company's performance to a tailored sector peer group of medical devices companies (see page 70), when considering TSR performance in the context of the 2004 Performance Share Plan and Global Share Plan 2010, we feel that the following graph showing the TSR performance of this peer group is also of interest.

#### **Smith & Nephew - Five year Total Shareholder Return**

(measured in US dollars, based on monthly spot values)

### Joseph Papa

Chairman of Remuneration Committee

22 February 2012

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Accounts and other information

### Directors' responsibilities for the accounts

The Directors are responsible for preparing the Group and Company accounts in accordance with applicable United Kingdom law and regulations. As a consequence of the Company's Ordinary Shares being traded on the New York Stock Exchange (in the form of American Depositary Shares) the Directors are responsible for the preparation and filing of an annual report on Form 20-F with the US Securities and Exchange Commission.

The Directors are required to prepare Group accounts for each financial year, in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union which present fairly the financial position of the Group and the financial performance and cash flows of the Group for that period. In preparing those Group accounts, the Directors are required to:

Select suitable accounting policies in accordance with IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors and then apply them consistently;

Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;

Provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Group's financial position and financial performance; and

State that the Group has complied with IFRS, subject to any material departures disclosed and explained in the accounts. Under United Kingdom law the Directors have elected to prepare the Company accounts in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), which are required by law to give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing the Company accounts, the Directors are required to:

Select suitable accounting policies and then apply them consistently;

Make judgements and estimates that are reasonable and prudent;

State whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the accounts; and

Prepare the accounts on a going concern basis unless it is inappropriate to presume that the Company will continue in business. The Directors confirm that they have complied with the above requirements in preparing the accounts.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Group and the Company and enable them to ensure that the accounts comply with the Companies Act 2006 and, in the case of the Group accounts, Article 4 of the IAS Regulation. They are also responsible for safeguarding the assets of the Group and the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.



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The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. It should be noted that information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

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Accounts and other information

# Directors responsibility statement pursuant to disclosure and transparency Rule 4

The Directors confirm that, to the best of each person's knowledge:

the Group accounts in this report, which have been prepared in accordance with IFRS as adopted by the European Union and those parts of the Companies Act 2006 applicable to companies reporting under IFRS, give a true and fair view of the assets, liabilities, financial position and profit of the Group taken as a whole;

the Company accounts in this report, which have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice and the Companies Act 2006, give a true and fair view of the assets, liabilities, financial position and profit of the Company; and

the Business Review and Risk management sections contained in the accounts includes a fair review of the development and performance of the business and the financial position of the Company and the Group taken as a whole, together with a description of the principal risks and uncertainties that they face.

By order of the Board, 22 February 2012

**Susan Henderson**

Company Secretary

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# Independent auditor's UK Report

## Independent Auditor's Report to the Members of Smith & Nephew plc

We have audited the Group accounts of Smith & Nephew plc for the year ended 31 December 2011 which comprise the Group Income Statement, the Group Statement of Comprehensive Income, the Group Balance Sheet, the Group Cash Flow Statement, the Group Statement of Changes in Equity and the related notes 1 to 24. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

## Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibility Statement set out on page 79 the directors are responsible for the preparation of the Group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the Group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

## Scope of the audit of the accounts

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

## Opinion on financial statements

In our opinion the Group financial statements:

give a true and fair view of the state of the Group's affairs as at 31 December 2011 and of its profit for the year then ended;  
have been properly prepared in accordance with IFRSs as adopted by the European Union; and  
have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

## Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the financial year for which the Group financial statements are prepared is consistent with the Group financial statements.

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## Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

certain disclosures of directors' remuneration specified by law are not made; or

we have not received all the information and explanations we require for our audit.  
Under the Listing Rules we are required to review:

the directors' statement, set out on page 27, in relation to going concern; and

the part of the Corporate Governance Statement relating to the Company's compliance with the nine provisions of the UK Corporate Governance Code; and

certain elements of the report to shareholders by the Board on directors' remuneration.

## Other matter

We have reported separately on the Company financial statements of Smith & Nephew plc for the year ended 31 December 2011 and on the information in the Directors' Remuneration Report that is described as having been audited.

## Separate Opinion in Relation to IFRSs

As explained in Note 1 to the Group financial statements, the Group in addition to complying with its legal obligation to comply with IFRS as adopted by the European Union, has also compiled with IFRS as issued by the International Accounting Standards Board.

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In our opinion the Group financial statements give a true and fair view, in accordance with IFRS, of the state of the Group's affairs as at 31 December 2011 and of its profit for the year then ended.

**Les Clifford (Senior statutory auditor)**

for and on behalf of Ernst & Young LLP, Statutory Auditor

London

22 February 2012

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## Independent auditor's US Reports

### Report of Independent Registered Public Accounting Firm to the Board of Directors and Shareholders of

#### Smith & Nephew plc

We have audited the accompanying Group balance sheets of Smith & Nephew plc as of 31 December 2011 and 2010, and the related Group income statements, Group statements of comprehensive income, Group cash flow statements and Group statements of changes in equity for each of the three years in the period ended 31 December 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall account presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Smith & Nephew plc at 31 December 2011 and 2010, and the consolidated results of its operations and cash flows for each of the three years in the period ended 31 December 2011, in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and International Financial Reporting Standards as adopted by the European Union.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Smith & Nephew plc's internal control over financial reporting as of 31 December 2011, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organisations of the Treadway Commission and our report dated 22 February 2012 expressed an unqualified opinion thereon.

#### **Ernst & Young LLP**

London, England

22 February 2012



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**Report of Independent Registered Public Accounting Firm to the Board of Directors and Shareholders  
of Smith & Nephew plc**

We have audited Smith & Nephew plc's internal control over financial reporting as of 31 December 2011, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Smith & Nephew plc's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorisations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Smith & Nephew plc maintained, in all material respects, effective internal control over financial reporting as of 31 December 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Group balance sheets of Smith & Nephew plc as of 31 December 2011 and 2010, and the related Group income statements, Group statements of comprehensive

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income, Group cash flow statements and Group statements of changes in equity for each of the three years in the period ended 31 December 2011 and our report dated 22 February 2012 expressed an unqualified opinion thereon.

**Ernst & Young LLP**

London, England

22 February 2012

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**Group Income Statement**

		<b>Year ended</b> <b>31 December 2011</b>	Year ended 31 December 2010	Year ended 31 December 2009
	Notes	<b>\$ million</b>	\$ million	\$ million
<b>Revenue</b>	2	<b>4,270</b>	3,962	3,772
Cost of goods sold		<b>(1,140)</b>	(1,031)	(1,030)
Gross profit		<b>3,130</b>	2,931	2,742
Selling, general and administrative expenses	3	<b>(2,101)</b>	(1,860)	(1,864)
Research and development expenses		<b>(167)</b>	(151)	(155)
<b>Operating profit</b>	2 & 3	<b>862</b>	920	723
Interest receivable	4	<b>4</b>	3	2
Interest payable	4	<b>(12)</b>	(18)	(42)
Other finance costs	4	<b>(6)</b>	(10)	(15)
Share of results of associates	11			2
<b>Profit before taxation</b>		<b>848</b>	895	670
Taxation	5	<b>(266)</b>	(280)	(198)
<b>Attributable profit for the year (i)</b>		<b>582</b>	615	472
<b>Earnings per Ordinary Share (i)</b>	6			
Basic		<b>65.3¢</b>	69.3¢	53.4¢
Diluted		<b>65.0¢</b>	69.2¢	53.3¢

**Group Statement of Comprehensive Income**

		<b>Year ended</b> <b>31 December 2011</b>	Year ended 31 December 2010	Year ended 31 December 2009
		<b>\$ million</b>	\$ million	\$ million
<b>Attributable profit for the year (i)</b>		<b>582</b>	615	472
Other comprehensive income:				
Cash flow hedges – interest rate swaps				
losses arising in the year		<b>(1)</b>	(1)	(3)
losses transferred to income statement for the year		<b>1</b>	4	13
Cash flow hedges – forward foreign exchange contracts				
gains/(losses) arising in the year		<b>1</b>	(3)	(15)
losses transferred to inventories for the year		<b>13</b>	1	7
Exchange differences on translation		<b>(32)</b>	66	63
Exchange on borrowings classified as net investment hedges		<b>(4)</b>	(14)	(3)

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	Actuarial (losses)/gains on retirement benefit obligations	(70)	26	41
	Taxation on items relating to components of other comprehensive income			
(ii)		24	(7)	(12)
	<b>Other comprehensive income/(expense) for the year, net of taxation</b>	<b>(68)</b>	72	91
	<b>Total comprehensive income for the year (i)</b>	<b>514</b>	687	563

(i) Attributable to equity holders of the Company and wholly derived from continuing operations.

(ii) Taxation on items relating to components of other comprehensive income comprises a credit of \$27m related to retirement benefit obligations (2010 charge of \$7m, 2009 charge of \$12m) partly offset by a charge of \$3m related to cash flow hedges (2010 \$nil, 2009 \$nil). The Notes on pages 88 to 128 are an integral part of these accounts.



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**Group Balance Sheet**

	Notes	At 31 December 2011 \$ million	At 31 December 2010 \$ million
<b>Assets</b>			
<b>Non current assets:</b>			
Property, plant and equipment	7	783	787
Goodwill	8	1,096	1,101
Intangible assets	9	423	426
Investments	10	4	6
Investments in associates	11	13	13
Deferred tax assets	17	223	224
Trade and other receivables	13		22
		2,542	2,579
<b>Current assets:</b>			
Inventories	12	859	923
Trade and other receivables	13	1,037	1,024
Cash and bank	15	184	207
		2,080	2,154
Assets held for sale	22	125	
<b>Total assets</b>		<b>4,747</b>	<b>4,733</b>
<b>Equity and liabilities</b>			
<b>Equity attributable to equity holders of the parent:</b>			
Share capital	20	191	191
Share premium		413	396
Treasury shares	20	(766)	(778)
Other reserves		91	116
Retained earnings		3,258	2,848
<b>Total equity</b>		<b>3,187</b>	<b>2,773</b>
<b>Non-current liabilities:</b>			
Long-term borrowings	15	16	642
Retirement benefit obligations	19	287	262
Other payables	14	8	
Provisions	18	45	73
Deferred tax liabilities	17	66	69
		422	1,046
<b>Current liabilities:</b>			
Bank overdrafts and loans	15	306	57
Trade and other payables	14	564	617
Provisions	18	78	37
Current tax payable		171	203
		1,119	914
Liabilities directly associated with assets held for sale	22	19	

<b>Total liabilities</b>	<b>1,560</b>	1,960
<b>Total equity and liabilities</b>	<b>4,747</b>	4,733

The accounts were approved by the Board and authorised for issue on 22 February 2012 and are signed on its behalf by:

**Sir John Buchanan**

Chairman

**Olivier Bohuon**

Chief Executive Officer

**Adrian Hennah**

Chief Financial Officer

The Notes on pages 88 to 128 are an integral part of these accounts.

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**Group Cash Flow Statement**

		<b>Year ended</b>	Year ended	Year ended
		<b>31 December 2011</b>	31 December 2010	31 December 2009
	Notes	\$ million	\$ million	\$ million
<b>Cash flows from operating activities</b>				
Profit before taxation		848	895	670
Net interest payable	4	8	15	40
Depreciation, amortisation and impairment		297	273	298
Loss on disposal of property, plant and equipment and software		9	15	14
Share based payments expense		30	21	18
Share of results of associates				(2)
Decrease in retirement benefit obligations		(44)	(31)	(2)
Decrease/(Increase) in inventories		40	21	(17)
(Increase)/Decrease in trade and other receivables		(47)	(100)	46
(Decrease)/Increase in trade and other payables and provisions		(6)	2	(35)
Cash generated from operations (i) (ii)		1,135	1,111	1,030
Interest received		4	3	2
Interest paid		(12)	(20)	(43)
Income taxes paid		(285)	(235)	(270)
Net cash inflow from operating activities		842	859	719
<b>Cash flows from investing activities</b>				
Acquisitions (net of \$2m of cash received in 2011)	22	(33)		(25)
Cash received from Plus settlement	22			137
Capital expenditure		(321)	(315)	(318)
Proceeds on disposal of property, plant and equipment and software			8	
Net cash used in investing activities		(354)	(307)	(206)
<b>Cash flows from financing activities</b>				
Proceeds from issue of ordinary share capital		17	15	7
Treasury shares purchased		(6)	(5)	
Proceeds of borrowings due within one year	21	78	17	
Settlement of borrowings due within one year	21	(330)		(66)
Proceeds on borrowings due after one year	21	92	277	526
Settlement of borrowings due after one year	21	(232)	(714)	(814)
Proceeds from own shares		7	8	10
Settlement of currency swaps	21	(1)	(3)	(12)
Equity dividends paid	20	(146)	(132)	(120)



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Net cash used in financing activities		(521)	(537)	(469)
Net (decrease)/increase in cash and cash equivalents		(33)	15	44
Cash and cash equivalents at beginning of year	21	195	174	122
Exchange adjustments	21	(1)	6	8
<b>Cash and cash equivalents at end of year</b>	<b>21</b>	<b>161</b>	<b>195</b>	<b>174</b>

(i) Includes \$20m (2010 \$16m, 2009 \$32m) of outgoings on restructuring and rationalisation expenses.

(ii) Includes \$1m (2010 \$nil, 2009 \$22m) of acquisition related costs and \$3m (2010 \$5m, 2009 \$5m) unreimbursed by insurers relating to macrotextured knee revisions.

The Notes on pages 88 to 128 are an integral part of these accounts.

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**Group Statement of Changes in Equity**

	Share capital \$ million	Share premium \$ million	Treasury shares (ii) \$ million	Other reserves (iii) \$ million	Retained earnings \$ million	Total equity \$ million
At 1 January 2009	190	375	(823)	1	1,956	1,699
Total comprehensive income (i)				62	501	563
Equity dividends declared and paid					(120)	(120)
Share based payments recognised					18	18
Deferred taxation on share based payments					2	2
Cost of shares transferred to beneficiaries			29		(19)	10
Issue of ordinary share capital (iv)		7				7
At 1 January 2010	190	382	(794)	63	2,338	2,179
Total comprehensive income (i)				53	634	687
Equity dividends declared and paid					(132)	(132)
Purchase of own shares			(5)			(5)
Share based payments recognised					21	21
Cost of shares transferred to beneficiaries			21		(13)	8
Issue of ordinary share capital (iv)	1	14				15
At 1 January 2011	191	396	(778)	116	2,848	2,773
Total comprehensive income (i)				(25)	539	514
Equity dividends declared and paid					(146)	(146)
Purchase of own shares			(6)			(6)
Share based payments recognised					30	30
Deferred taxation on share based payments					(2)	(2)
Cost of shares transferred to beneficiaries			18		(11)	7
Issue of ordinary share capital (iv)		17				17
<b>At 31 December 2011</b>	<b>191</b>	<b>413</b>	<b>(766)</b>	<b>91</b>	<b>3,258</b>	<b>3,187</b>

(i) Attributable to equity holders of the Company and wholly derived from continuing operations.

(ii) Refer to Note 20 of the Group Financial Statements for further information.

(iii) Other reserves comprise gains and losses on cash flow hedges, exchange differences on translation of foreign operations and the difference arising as a result of translating share capital and share premium at the rate ruling on the date of redenomination instead of the rate at the

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balance sheet date. The cumulative translation adjustments within Other Reserves at 31 December 2011 were \$87m (2010 \$123m, 2009 \$71m).

(iv) Issue of Ordinary Share Capital as a result of options being exercised.  
The Notes on pages 88 to 128 are an integral part of these accounts.

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# Notes to the Group accounts

## 1 Basis of preparation

Smith & Nephew plc (the Company) is a public limited company incorporated in England and Wales. In these accounts, Group means the Company and all its subsidiaries. The principal activities of the Group are to develop, manufacture, market and sell medical devices in the sectors of Orthopaedics, Endoscopy and Advanced Wound Management.

As required by the European Union's IAS Regulation and the Companies Act 2006, the Group has prepared its accounts in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) effective as at 31 December 2011. The Group has also prepared its accounts in accordance with IFRS as issued by the International Accounting Standards Board (IASB) effective as at 31 December 2011. IFRS as adopted by the EU differs in certain respects from IFRS as issued by the IASB. However, the differences have no impact for the periods presented.

The preparation of accounts in conformity with IFRS requires management to use 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. The accounting policies requiring management to use significant estimates and assumptions; inventories, impairment, retirement benefits and contingencies and provisions, are discussed under Critical Accounting Policies within the Business Review section on page 28. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates.

The Directors continue to adopt the going concern basis for accounting in preparing the annual financial statements. The Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future.

### Consolidation

The Group accounts include the accounts of Smith & Nephew plc (the Company) and its subsidiaries for the periods during which they were members of the Group.

A subsidiary is an entity controlled by the Group. Control comprises the power to govern the financial and operating policies of the investee so as to obtain benefit from its activities and is achieved through direct or indirect ownership of voting rights. Subsidiaries are consolidated in the Group accounts from the date that the Group obtains control, and continue to be consolidated until the date that such control ceases. Intercompany transactions, balances and unrealised gains and losses on transactions between group companies are eliminated on consolidation. All subsidiaries have year ends which are co-terminus with the Group's.

### Recognition of financial assets and liabilities

Financial assets and liabilities are recognised on a trade date basis in the Group's balance sheet when the Group becomes party to the contractual provisions of the instrument. The Group carries borrowings in the Balance Sheet at amortised cost.

### Foreign currencies

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Balance sheet items of foreign operations and foreign currency borrowings are translated into US Dollars on consolidation at year-end rates of exchange. Income statement items and the cash flows of overseas subsidiary undertakings and associated undertakings are translated at average rates as an approximation to actual transaction rates, with actual transaction rates used for large one off transactions.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

Transactions in foreign currencies are recorded at the exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date.

The following are recorded as movements in Other reserves within other comprehensive income: exchange differences on the translation at closing rates of exchange of non-US Dollar opening net assets; the differences arising between the translation of profits into US Dollars at average and closing exchange rates; to the extent that the hedging relationship is effective, the difference on translation of foreign currency borrowings or swaps that are used to finance or hedge the Group's net investments in foreign operations; and the movement in the fair value of forward foreign exchange contracts used to hedge forecast foreign exchange cash flows. All other exchange differences are taken to the income statement.

The exchange rates used for the translation of currencies into US Dollars that have the most significant impact on the Group results were:

	2011	2010	2009
<b>Average rates</b>			
Sterling	1.60	1.54	1.56
Euro	1.39	1.32	1.39
Swiss Franc	1.13	0.96	0.92
<b>Year-end rates</b>			
Sterling	1.55	1.57	1.61
Euro	1.29	1.34	1.43
Swiss Franc	1.06	1.07	0.97

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### **New IFRS accounting standards**

The following IFRS standard, which is relevant to the Group, has been issued by the International Accounting Standards Board ( IASB ) but is not yet effective or has not yet been adopted by the Group. Unless otherwise listed below, no other standard, amendment or interpretation is likely to have a material effect on the Group's results of operations or financial position.

In November 2009, the IASB issued IFRS 9 Financial Instruments. This standard specifies how the Group should classify and measure financial assets. It requires all financial assets to be either classified on the basis of the entity's business model and the contractual cash flow characteristics of the financial asset or initially measured at fair value. This standard has not been endorsed by the EU.

No standard or interpretation coming into effect during the year had a significant effect on the reported results or the financial position of the Group.

The significant accounting policies adopted in the preparation of the Group's accounts are explained with the relevant notes to the accounts.

## **2 Business segment information**

For management purposes, the Group is organised into business segments according to the nature of its products and has three business segments Orthopaedics, Endoscopy and Advanced Wound Management. The types of products and services offered by each business segment are:

Orthopaedic reconstruction implants include hip, knee and shoulder joints as well as ancillary products such as bone cement and mixing systems used in cemented reconstruction joint surgery. Orthopaedic trauma fixation products consist of internal and external devices and other products, including shoulder fixation and orthobiological materials used in the stabilisation of severe fractures and deformity correction procedures. Clinical therapies products are those that are applied in an orthopaedic office or clinic setting and include bone growth stimulation, joint fluid therapies and outpatient spine products.

Smith & Nephew's Endoscopy business develops and commercialises endoscopic (minimally invasive surgery) techniques, educational programmes and value-added services for surgeons to treat and repair soft tissue and articulating joints. The business focuses on the arthroscopy sector of the endoscopy market. Arthroscopy is the minimally invasive surgery of joints, in particular the knee, shoulder and hip.

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Smith & Nephew's Advanced Wound Management business offers a range of products from initial wound bed preparation through to full wound closure. These products are targeted at chronic wounds associated with the older population, such as pressure sores and venous leg ulcers. There are also products for the treatment of wounds such as burns and invasive surgery that impact the wider population. Management monitors the operating results of its business segments separately for the purposes of making decisions about resource allocation and performance assessment. Group financing (including interest receivable and payable) and income taxes are managed on a group basis and are not allocated to business segments.

The following tables present revenue, profit, asset and liability information regarding the Group's operating segments. The share of results of associates is segmentally allocated to Orthopaedics.

### 2.1 Revenue by business segment and geography

#### Accounting policy

Revenue comprises sales of products and services to third parties at amounts invoiced net of trade discounts and rebates, excluding taxes on revenue. Revenue from the sale of products is recognised upon transfer to the customer of the significant risks and rewards of ownership. This is generally when goods are delivered to customers. Sales of inventory located at customer premises and available for customers' immediate use are recognised when notification is received that the product has been implanted or used. Appropriate provisions for returns, trade discounts and rebates are deducted from revenue. Rebates comprise retrospective volume discounts granted to certain customers on attainment of certain levels of purchases from the Group. These are accrued over the course of the arrangement based on estimates of the level of business expected and adjusted at the end of the arrangement to reflect actual volumes.

#### Business segment

	2011 \$ million	2010 \$ million	2009 \$ million
<b>Revenue by business segment</b>			
Orthopaedics	2,312	2,195	2,135
Endoscopy	939	855	791
Advanced Wound Management	1,019	912	846
	<b>4,270</b>	3,962	3,772

There are no material sales between business segments.





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## Notes to the Group accounts continued

## Geographic

	2011 \$ million	2010 \$ million	2009 \$ million
<b>Revenue by geographic market</b>			
United Kingdom	291	283	286
Continental Europe	1,118	1,032	1,027
United States	1,756	1,707	1,664
Africa, Asia, Australasia and Other America	1,105	940	795
	<b>4,270</b>	3,962	3,772

Revenue has been allocated by basis of origin. No revenue from a single customer is in excess of 10% of the Group's revenue.

## 2.2 Trading and operating profit by business segment

Trading profit is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affects the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. The Group has identified the following items, where material, as those to be excluded from operating profit when arriving at trading profit: acquisition and disposal related items including amortisation of acquisition intangibles and impairments; significant restructuring events; gains and losses arising from legal disputes; and uninsured losses. Operating profit reconciles to trading profit as follows:

	Notes	2011 \$ million	2010 \$ million	2009 \$ million
Operating profit		862	920	723
Acquisition related costs	3			26
Restructuring and rationalisation expenses	3	40	15	42
Amortisation of acquisition intangibles and impairments	8 & 9	36	34	66
Legal provision	3	23		
Trading profit		961	969	857
<b>Trading profit by business segment</b>				
Orthopaedics		492	536	508
Endoscopy		222	200	189
Advanced Wound Management		247	233	160
		<b>961</b>	969	857

**Operating profit by business segment reconciled to****attributable profit for the year**

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Orthopaedics	415	503	410
Endoscopy	215	197	169
Advanced Wound Management	232	220	144
Operating profit	862	920	723
Net interest payable	(8)	(15)	(40)
Other finance costs	(6)	(10)	(15)
Share of results of associates			2
Taxation	(266)	(280)	(198)
<b>Attributable profit for the year</b>	<b>582</b>	<b>615</b>	<b>472</b>

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**2.3 Assets and liabilities by business segment and geography**

## Business segment

	2011 \$ million	2010 \$ million	2009 \$ million
<b>Balance sheet</b>			
Assets:			
Orthopaedics	2,550	2,778	2,656
Endoscopy	846	769	705
Advanced Wound Management	819	755	810
Operating assets by business segment	4,215	4,302	4,171
Assets held for sale (relating to Orthopaedics business segment)	125		
Unallocated corporate assets	407	431	394
<b>Total assets</b>	<b>4,747</b>	4,733	4,565
Liabilities:			
Orthopaedics	398	457	426
Endoscopy	128	124	111
Advanced Wound Management	169	146	194
Operating liabilities by business segment	695	727	731
Liabilities directly associated with assets held for sale (relating to Orthopaedics business segment)	19		
Unallocated corporate liabilities	846	1,233	1,655
<b>Total liabilities</b>	<b>1,560</b>	1,960	2,386
Unallocated corporate assets and liabilities comprise the following:			
	2011 \$ million	2010 \$ million	2009 \$ million
Deferred tax assets	223	224	202
Cash and bank	184	207	192
Unallocated corporate assets	407	431	394
Long-term borrowings	16	642	1,090
Retirement benefit obligations	287	262	322
Deferred tax liabilities	66	69	31
Bank overdrafts and loans due within one year	306	57	45
Current tax payable	171	203	167
Unallocated corporate liabilities	846	1,233	1,655
<b>Capital expenditure</b>			
	2011 \$ million	2010 \$ million	2009 \$ million
Orthopaedics	241	227	235
Endoscopy	93	58	41
Advanced Wound Management	31	30	63
	<b>365</b>	315	339
Capital expenditure segmentally allocated above comprises:			
	2011 \$ million	2010 \$ million	2009 \$ million
Additions to property, plant and equipment	229	250	216
Additions to intangible assets	92	65	102
Capital expenditure as per cash flow statement	321	315	318
Acquisitions Goodwill	44		3
Acquisitions Intangible assets			12

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Acquisitions	Property, plant and equipment			6
Capital expenditure		365	315	339

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## Notes to the Group accounts continued

	2011 \$ million	2010 \$ million	2009 \$ million
<b>Depreciation, amortisation and impairment</b>			
Orthopaedics	209	195	206
Endoscopy	50	41	52
Advanced Wound Management	38	37	40
	<b>297</b>	273	298

Amounts comprise depreciation of property, plant and equipment, amortisation of other intangible assets, impairment of investments and amortisation of acquisition intangibles and impairments as follows:

	2011 \$ million	2010 \$ million	2009 \$ million
Impairment of intangibles and goodwill			32
Amortisation of acquisition intangibles	36	34	34
	<b>36</b>	34	66
Depreciation of property, plant and equipment	217	203	206
Amortisation of other intangible assets	42	34	26
Impairment of investments	2	2	
	<b>297</b>	273	298

Impairments of \$2m were recognised within operating profit in 2011 and included within the administrative expenses line (2010 \$2m, 2009 \$32m). This is segmentally allocated to Orthopaedics (2010 Orthopaedics, 2009 Orthopaedics \$19m and Endoscopy \$13m).

## Geographic

	2011 \$ million	2010 \$ million
<b>Assets by geographic location</b>		
United Kingdom	283	301
Continental Europe	837	891
United States	920	942
Africa, Asia, Australasia and Other America	279	221
Non-current operating assets by geographic location	<b>2,319</b>	2,355
United Kingdom	190	176
Continental Europe	569	543
United States	762	873
Africa, Asia, Australasia and Other America	375	355
Current operating assets by geographic location	<b>1,896</b>	1,947
Assets held for sale	125	
Unallocated corporate assets (see page 91)	407	431
<b>Total assets</b>	<b>4,747</b>	4,733

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**2.4 Other business segment information**

Other significant expenses recognised within operating profit

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Orthopaedics	<b>26</b>	8	22
Endoscopy	<b>6</b>	2	2
Advanced Wound Management	<b>8</b>	5	6
	<b>40</b>	15	30

The \$40m incurred in 2011 relates to restructuring and rationalisation expenses (2010 \$15m relates to restructuring and rationalisation expenses, 2009 \$30m relates to acquisitions related costs and restructuring and rationalisation expenses).

	<b>2011</b>	2010	2009
	<b>numbers</b>	numbers	numbers
<b>Average number of employees</b>			
Orthopaedics	<b>5,280</b>	5,045	4,853
Endoscopy	<b>2,331</b>	2,134	1,888
Advanced Wound Management	<b>3,132</b>	2,993	3,023
	<b>10,743</b>	10,172	9,764

**3 Operating profit****Accounting policies**

## Research and development

The Group considers that the regulatory, technical and market uncertainties inherent in the development of new products means that development costs should not be capitalised as intangible assets until products receive approval from the appropriate regulatory body. Substantially all development expenditure is complete by the time the product is submitted for regulatory approval. Consequently the majority of expenditure on research and development is expensed as incurred.

## Advertising costs

Expenditure on advertising costs is expensed as incurred.

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Revenue	<b>4,270</b>	3,962	3,772
Cost of goods sold (i)	<b>(1,140)</b>	(1,031)	(1,030)
Gross profit	<b>3,130</b>	2,931	2,742
Research and development expenses	<b>(167)</b>	(151)	(155)
Selling, general and administrative expenses:			
Marketing, selling and distribution expenses (ii)	<b>(1,526)</b>	(1,414)	(1,351)
Administrative expenses (iii) (iv) (v)	<b>(575)</b>	(446)	(513)

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<b>Operating profit</b>	<b>(2,101)</b>	(1,860)	(1,864)
	<b>862</b>	920	723

- (i) In 2011, \$7m of restructuring and rationalisation expenses related to cost of goods sold (2010 – no restructuring and rationalisation expenses or acquisition related costs, 2009 – \$15m of restructuring and rationalisation expenses and \$12m of acquisition related costs).
- (ii) 2011 includes \$nil of restructuring and rationalisation expenses (2010 – \$3m of restructuring and rationalisation expenses, 2009 – \$7m of acquisition related costs and \$10m of restructuring and rationalisation expenses).
- (iii) 2011 includes \$42m of amortisation of other intangible assets (2010 – \$34m, 2009 – \$26m).
- (iv) 2011 includes \$33m of restructuring and rationalisation expenses and \$36m of amortisation acquisition intangibles (2010 – \$12m of restructuring and rationalisation expenses and \$34m of amortisation acquisition intangibles, 2009 – \$7m of acquisition related costs, \$17m of restructuring and rationalisation expenses and \$66m of amortisation of acquisition intangibles and impairments).
- (v) 2011 includes \$23m relating to legal provision (2010 – \$nil, 2009 – \$nil).
- (vi) Items detailed in (i), (ii), (iv) and (v) are excluded from the calculation of trading profit.



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## Notes to the Group accounts continued

Operating profit is stated after charging the following items:

	\$million123456	\$million123456	\$million123456	\$million123456
		<b>2011</b>	2010	2009
		\$ million	\$ million	\$ million
Amortisation of acquisition intangibles		<b>36</b>	34	34
Amortisation of other intangible assets		<b>42</b>	34	26
Impairment of intangible assets and goodwill				32
Depreciation of property, plant and equipment		<b>217</b>	203	206
Loss on disposal of property, plant and equipment and software		<b>9</b>	15	14
Impairment of investments		<b>2</b>	2	
Minimum operating lease payments for land and buildings		<b>33</b>	31	27
Minimum operating lease payments for other assets		<b>32</b>	28	28
Advertising costs		<b>90</b>	83	71

**3.1 Staff costs**

Staff costs during the year amounted to:

	Notes	<b>2011</b>	2010	2009
		\$ million	\$ million	\$ million
Wages and salaries		<b>930</b>	817	768
Social security costs		<b>99</b>	91	86
Pension costs (including retirement healthcare)	19	<b>64</b>	60	64
Share based payments	24	<b>30</b>	21	18
		<b>1,123</b>	989	936

**3.2 Audit Fees Information about the nature and cost of services provided by auditors**

	<b>2011</b>	2010	2009
	\$ million	\$ million	\$ million
Audit services: Group accounts	<b>1</b>	1	1
Other services:			
Local statutory audit pursuant to legislation	<b>2</b>	2	2

Taxation services:			
Compliance services	1	1	1
Advisory services	1	1	1
<b>Total auditors remuneration</b>	<b>5</b>	<b>5</b>	<b>5</b>
Arising:			
In the UK	2	2	2
Outside the UK	3	3	3
	<b>5</b>	<b>5</b>	<b>5</b>

### 3.3 Restructuring and rationalisation expenses

In 2011, restructuring and rationalisation costs of \$40m (2010 \$15m, 2009 \$42m) were incurred in the twelve month period to 31 December 2011. Charges of \$14m (2010 \$15m, 2009 \$42m) related to the earnings improvement programme which was completed in the year. Charges of \$26m (2010 \$nil) were also incurred, relating mainly to people costs associated with the structural and process changes announced in August 2011.

### 3.4 Legal provision

In 2011, the Group has established a provision of \$23m in connection with the previously disclosed investigation by the U.S. Securities and Exchange Commission ( SEC ) and Department of Justice ( DOJ ) into potential violations of the U.S. Foreign Corrupt Practices Act in the medical devices industry.

On 6 February 2012, Smith & Nephew announced that it had reached settlement with the SEC and DOJ in connection with this matter. Smith & Nephew has committed to pay slightly less than \$23m in fines and profit disgorgement, maintain an enhanced compliance programme, and appoint an independent monitor for at least 18 months to review and report on its compliance programme.

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**4 Interest and Other finance costs****4.1 Interest (payable)/receivable**

	\$million123456 2011 \$ million	\$million123456 2010 \$ million	\$million123456 2009 \$ million
Interest receivable	4	3	2
Interest payable:			
Bank borrowings	(6)	(7)	(16)
Other	(6)	(11)	(26)
	(12)	(18)	(42)
<b>Net interest payable</b>	<b>(8)</b>	<b>(15)</b>	<b>(40)</b>

Interest receivable includes net interest receivable of \$1m (2010 \$nil, 2009 \$nil) on interest rate and currency swaps and interest payable includes \$nil (2010 \$5m, 2009 \$23m) of net interest payable on currency and interest rate swaps. The gross interest receivable on these swaps was \$4m (2010 \$4m, 2009 \$14m) and the gross interest payable was \$3m (2010 \$9m, 2009 \$37m).

**4.2 Other finance costs**

	\$million123456 Notes	\$million123456 2011 \$ million	\$million123456 2010 \$ million	\$million123456 2009 \$ million
Retirement benefits: Interest cost	19	(66)	(64)	(61)
Retirement benefits: Expected return on plan assets	19	59	55	48
Other		1	(1)	(2)
<b>Other finance costs</b>		<b>(6)</b>	<b>(10)</b>	<b>(15)</b>

Foreign exchange gains or losses recognised in the income statement arose primarily on the translation of intercompany and third party borrowings and amounted to a net \$3m gain in 2011 (2010 net \$8m gain, 2009 net \$14m gain). These amounts were fully matched in the income statement by the fair value gains or losses on currency swaps (carried at fair value through profit and loss) held to manage this currency risk.

**5 Taxation****Accounting policy**

The charge for current taxation is based on the results for the year as adjusted for items which are non-assessable or disallowed. It is calculated using rates that have been enacted or substantively enacted by the balance sheet date. The accounting policy for deferred taxation is set out in Note17.

The Group operates in multiple tax jurisdictions around the world and records provisions for taxation liabilities and tax audits when it is considered probable that a tax charge will arise and the amount can be reliably estimated. Although Group policy is to submit its tax returns to the relevant tax authorities as promptly as possible, at any time the Group has unagreed years outstanding and is involved in disputes and tax audits. Significant issues may take many years to resolve. In estimating the probability and amount of any tax charge management takes into account the views of internal and external advisors and updates the amount of the provision whenever necessary. The ultimate tax liability may differ from the amount provided depending on interpretations of tax law, settlement negotiations or changes in legislation.

**5.1 Taxation charge attributable to the Group**

	\$million123456 2011 \$ million	\$million123456 2010 \$ million	\$million123456 2009 \$ million
Current taxation:			
UK corporation tax at 26.5% (2010 28%, 2009 28%)	56	52	50
Overseas tax	214	238	189
Current income tax charge	270	290	239
Adjustments in respect of prior periods	(16)	(18)	(31)
<b>Total current taxation</b>	<b>254</b>	<b>272</b>	<b>208</b>
Deferred taxation			
Origination and reversal of temporary differences	18	4	(7)
Changes in tax rates	(3)	(2)	
Adjustments to estimated amounts arising in prior periods	(3)	6	(3)
<b>Total deferred taxation</b>	<b>12</b>	<b>8</b>	<b>(10)</b>
Total taxation as per the income statement	266	280	198
Deferred taxation in other comprehensive income	(24)	7	12
Deferred taxation in equity	2		(2)
<b>Taxation attributable to the Group</b>	<b>244</b>	<b>287</b>	<b>208</b>

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## Notes to the Group accounts continued

The tax charge was reduced by \$17m in 2011 (2010 \$10m, 2009 \$26m) as a consequence of restructuring and rationalisation expenses, acquisition related costs, amortisation of acquisition intangibles and legal provision.

The applicable tax for the year is based on the United Kingdom standard rate of corporation tax of 26.5% (2010 28%, 2009 28%). Overseas taxation is calculated at the rates prevailing in the respective jurisdictions. The average effective tax rate differs from the applicable rate as follows:

	\$million 2011	\$million 2010	\$million 2009
	%	%	%
UK standard rate	26.5	28.0	28.0
Non-deductible/non-taxable items	(0.5)	0.2	1.2
Prior year items	(1.6)	(1.5)	(4.8)
Tax losses incurred not relieved/(utilised not previously recognised)	0.3	(0.2)	(0.1)
Overseas income taxed at other than UK standard rate	6.7	4.8	5.3
<b>Total effective tax rate</b>	<b>31.4</b>	<b>31.3</b>	<b>29.6</b>

During the year the enacted UK tax rate applicable from 1 April 2012 was reduced to 25% and the UK Government announced policy to reduce the tax rate to 23% across the following three years. It is expected that if the stated policy is enacted deferred tax credits will arise.

## 6 Earnings per Ordinary Share

### Accounting policy

#### Earnings per share

Basic earnings per share is calculated by dividing the profit attributable to equity holders by the weighted average number of Ordinary Shares in issue during the year, excluding shares held by the Company in the Employees' Share Trust or as treasury shares.

#### Adjusted earnings per share

Adjusted earnings per share is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affects the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. Adjusted attributable profit is the numerator used for this measure. The Group has identified the following items, where material, as those to be excluded when arriving at adjusted attributable profit: acquisition and disposal related items including amortisation of acquisition intangible assets and impairments; significant restructuring events; gains and losses arising from legal disputes and uninsured losses; and taxation thereon.

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The calculations of the basic, diluted and adjusted earnings per Ordinary Share are based on the following earnings and numbers of shares:

	2011 \$ million	2010 \$ million	2009 \$ million
<b>Earnings</b>			
Attributable profit for the year	582	615	472
Adjusted attributable profit (see below)	664	654	580
<b>Adjusted attributable profit</b>			

Attributable profit is reconciled to adjusted attributable profit as follows:

	Notes	2011 \$ million	2010 \$ million	2009 \$ million
Attributable profit for the year		582	615	472
Acquisition related costs	3			26
Restructuring and rationalisation expenses	3	40	15	42
Amortisation of acquisition intangibles and impairments	8 & 9	36	34	66
Legal provision		23		
Taxation on excluded items	5	(17)	(10)	(26)
<b>Adjusted attributable profit</b>		<b>664</b>	<b>654</b>	<b>580</b>

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The numerators used for basic and diluted earnings per Ordinary Share are the same. The denominators used for all categories of earnings for basic and diluted earnings per Ordinary Share are as follows:

	2011	2010	2009
<b>Number of shares (millions)</b>			
Basic weighted average number of shares	891	888	884
Dilutive impact of share options outstanding	4	1	1
Diluted weighted average number of shares	895	889	885
<b>Earnings per Ordinary Share</b>			
Basic	65.3¢	69.3¢	53.4¢
Diluted	65.0¢	69.2¢	53.3¢
Adjusted: Basic	74.5¢	73.6¢	65.6¢
Adjusted: Diluted	74.2¢	73.6¢	65.5¢

Share options not included in the diluted EPS calculation because they were non dilutive in the period totalled 12.9m (2010 2.5m, 2009 21.4m).

## 7 Property, plant and equipment

### Accounting policies

#### Property, plant and equipment

Property, plant and equipment is stated at cost less depreciation and provision for impairment where appropriate. Freehold land is not depreciated. Freehold buildings are depreciated on a straight-line basis over lives ranging between 20 and 50 years. Leasehold land and buildings are depreciated on a straight-line basis over the shorter of their estimated useful economic lives and the terms of the leases.

Plant and equipment is depreciated over lives ranging between three and 20 years by equal annual instalments to write down the assets to their estimated residual value at the end of their working lives. Assets in course of construction are not depreciated until they are brought into use.

The useful lives and residual values of all property, plant and equipment are reviewed each financial year-end, and where adjustments are required, these are made prospectively.

Finance costs relating to the purchase or construction of property, plant and equipment and intangible assets that take longer than one year to complete are capitalised based on the Group weighted average borrowing costs. All other finance costs are expensed as incurred.

#### Impairment of assets

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The carrying values of property, plant and equipment are reviewed for impairment when events or changes in circumstances indicate the carrying value may be impaired. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of impairment loss. Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which it belongs.

An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value-in-use. In assessing value-in-use, its estimated future cash flow is discounted to its present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the asset.



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## Notes to the Group accounts continued

	<b>Freehold</b>	<b>Land and buildings</b>	<b>Leasehold Instruments</b>	<b>Plant and equipment</b>	<b>Assets in course of construction</b>	<b>Total</b>
	<b>\$ million</b>	<b>\$ million</b>	<b>\$ million</b>	<b>Other \$ million</b>	<b>\$ million</b>	<b>\$ million</b>
<b>Cost</b>						
At 1 January 2010	129	52	889	784	27	1,881
Exchange adjustment	(2)		9			7
Additions	1	1	145	48	55	250
Disposals	(8)		(81)	(43)	(3)	(135)
Transfers	11		2	(3)	(12)	(2)
At 31 December 2010	131	53	964	786	67	2,001
Exchange adjustment		(1)	(13)	(7)		(21)
Additions	4	2	144	32	47	229
Disposals	(2)	(2)	(86)			(90)
Transfers				72	(72)	
Transferred to assets held for sale				(5)		(5)
At 31 December 2011	133	52	1,009	878	42	2,114
<b>Depreciation and impairment</b>						
At 1 January 2010	29	22	575	502		1,128
Exchange adjustment	(1)		7	(2)		4
Charge for the year	4	4	130	65		203
Disposals	(5)	(1)	(74)	(41)		(121)
Transfers	14			(14)		
At 31 December 2010	41	25	638	510		1,214
Exchange adjustment			(9)	(6)		(15)
Charge for the year	4	3	139	71		217
Disposals	(2)	(1)	(80)			(83)
Transferred to assets held for sale				(2)		(2)
At 31 December 2011	43	27	688	573		1,331
<b>Net book amounts</b>						
At 31 December 2011	90	25	321	305	42	783
At 31 December 2010	90	28	326	276	67	787

Land and buildings includes land with a cost of \$14m (2010 \$10m) that is not subject to depreciation. Assets held under finance leases with a net book amount of \$12m (2010 \$14m) are included within land and buildings and \$8m (2010 \$10m) are included within plant and equipment.

Group capital expenditure relating to property, plant and equipment contracted but not provided for amounted to \$9m (2010 \$15m).

## 8 Goodwill

### Accounting policy

Goodwill is not amortised but is reviewed for impairment annually. Goodwill is allocated to the cash-generating unit ( CGU ) that is expected to benefit from the acquisition. The recoverable amount of CGUs to which goodwill has been allocated is tested for impairment annually. For purposes of impairment testing, goodwill is allocated to the related CGUs monitored by management, being the business segment level, Orthopaedics, Endoscopy and Advanced Wound Management.

In carrying out impairment reviews of goodwill a number of significant assumptions have to be made when preparing cash flow projections. These include the future rate of market growth, discount rates, the market demand for the products acquired, the future profitability of acquired businesses or products, levels of reimbursement and success in obtaining regulatory approvals. If actual results should differ, or changes in expectations arise, impairment charges may be required which would adversely impact operating results. If the recoverable amount of the cash-generating unit is less than its carrying amount then an impairment loss is determined to have occurred. Any impairment losses that arise are recognised immediately in the income statement and are allocated first to reduce the carrying amount of goodwill and then to the carrying amounts of the other assets.

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	Notes	2011 \$ million	2010 \$ million
<b>Cost</b>			
At 1 January		1,108	1,100
Exchange adjustment		(12)	12
Acquisitions	22	44	
Transferred to assets held for sale	22	(44)	
Adjustment to contingent consideration			(4)
At 31 December		1,096	1,108
<b>Impairment</b>			
At 1 January		7	7
Transferred to assets held for sale	22	(7)	
At 31 December			7
<b>Net book amounts</b>		<b>1,096</b>	<b>1,101</b>

Each of the Group's business segments represent a CGU and include goodwill as follows:

	2011 \$ million	2010 \$ million
Orthopaedics	549	582
Endoscopy	323	280
Advanced Wound Management	224	239
	<b>1,096</b>	<b>1,101</b>

In September 2011 and 2010 impairment reviews were performed by comparing the recoverable amount of each CGU with its carrying amount, including goodwill. These are updated during December, taking into account significant events that occurred between September and December.

For each CGU, the recoverable amounts are based on value-in-use which is calculated from pre-tax cash flow projections for five years using data from the Group's budget and strategic planning process, the results of which are reviewed and approved by the Board. These projections exclude any estimated future cash inflows or outflows expected to arise from future restructurings. The five-year period is in line with the Group's strategic planning process.

The calculation of value-in-use for the three identified CGUs is most sensitive to discount and growth rates as set out below:

The discount rate reflects management's assessment of risks specific to the assets of each CGU. The pre-tax discount rate used in the Orthopaedics business is 10% (2010 11%), for the Endoscopy businesses it is 11% (2010 15%) and for the Advanced Wound Management business it is 9% (2010 10%).

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In determining the growth rate used in the calculation of the value-in-use, the Group considered the annual sales growth and trading profit margins. Projections are based on anticipated volume and value growth in the markets served by the Group and assumptions as to market share movements. Each year the projections for the previous year are compared to actual results and variances are factored into the assumptions used in the current year. Growth rates for the five year period for the Orthopaedics business vary up to 6% (2010 - 9%), for the Endoscopy business up to 13% (2010 - 10%) and for the Advanced Wound Management business up to 8% (2010 - 8%).

Specific considerations and strategies taken into account in determining the sales growth and trading profit margin for each CGU are:

**Orthopaedics** In the Orthopaedic CGU management intends to deliver growth through continuing to focus on the customer, high quality customer service and innovative product development, and through continuing to improve efficiencies.

**Endoscopy** It is management's intent to maintain and grow this CGU as the leading provider of endoscopic techniques and technologies for joint and ligament repair. This is driven partly through the growing acceptance of Endoscopy as a preferred surgical choice amongst physicians and patients, product innovation, high quality customer service, and supporting surgeon educational programmes.

**Advanced Wound Management** Management intends to develop this CGU by focusing on the higher added value sectors of exudate and infection management through improved wound bed preparation, moist and active healing and negative pressure wound therapy, and by continuing to improve efficiency.

A long-term growth rate of 4% (2010 - 4%) in pre-tax cash flows is assumed after five years in calculating a terminal value for the Group's CGUs. Management considers this to be an appropriate estimate based on the growth rates of the markets in which the Group operates.

Capital expenditure represents the Group's expected annual investment in property, plant and equipment and other intangible assets. This is approximately 8% (2010 - 8%) of annual revenue.

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# Notes to the Group accounts continued

Management has considered the following sensitivities:

**Growth of market and market share** Management has considered the impact of a variance in market growth and market share. The value-in-use calculation shows that if the assumed long-term growth rate was reduced to nil, the recoverable amount of all of the CGUs independently would still be greater than their carrying values.

**Discount rate** Management has considered the impact of an increase in the discount rate applied to the calculation. The value-in-use calculation shows that for the recoverable amount of the CGU to be less than its carrying value, the discount rate would have to be increased to 31% (2010 31%) for the Orthopaedics business, 43% (2010 43%) for the Endoscopy business and 51% (2010 53%) for the Advanced Wound Management business.

## 9 Intangible assets

### Accounting policies

#### Intangible assets

Intangible assets acquired separately from a business combination (including purchased patents, know-how, trademarks, licences and distribution rights) are initially measured at cost. The cost of intangible assets acquired in a material business combination (referred to as acquisition intangibles) is the fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. All intangible assets are amortised on a straight line basis over their estimated useful economic lives. The estimated useful economic life of an intangible asset ranges between three and 20 years depending on its nature. Internally generated intangible assets are expensed in the income statement as incurred.

Purchased computer software and certain costs of information technology projects are capitalised as intangible assets. Software that is integral to computer hardware is capitalised as plant and equipment.

#### Impairment of assets

The carrying values of intangible assets are reviewed for impairment when events or changes in circumstances indicate the carrying value may be impaired. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of impairment loss. Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which it belongs.

An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and its value-in-use. In assessing value-in-use, its estimated future cash flow is discounted to its present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the asset.

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In carrying out impairment reviews of intangible assets a number of significant assumptions have to be made when preparing cash flow projections. These include the future rate of market growth, discount rates, the market demand for the products acquired, the future profitability of acquired businesses or products, levels of reimbursement and success in obtaining regulatory approvals. If actual results should differ, or changes in expectations arise, impairment charges may be required which would adversely impact operating results.

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	Acquisition intangibles \$ million	Software \$ million	Distribution Rights \$ million	Patents & Intellectual Property \$ million	Total \$ million
<b>Cost</b>					
At 1 January 2010	417	111	67	91	686
Exchange adjustment	23	1			24
Additions		32	11	22	65
Disposals		(1)	(25)		(26)
Transfers		2			2
At 31 December 2010	440	145	53	113	751
Exchange adjustment	(4)	1			(3)
Additions		32	7	53	92
Disposals		(5)		(1)	(6)
Transferred to assets held for sale		(3)		(22)	(25)
At 31 December 2011	436	170	60	143	809
<b>Amortisation and impairment</b>					
At 1 January 2010	159	29	35	51	274
Exchange adjustment	7	1			8
Charge for the year	34	17	14	3	68
Disposals			(25)		(25)
At 31 December 2010	200	47	24	54	325
Exchange adjustment	(2)				(2)
Charge for the year	36	22	10	10	78
Disposals		(3)		(1)	(4)
Transferred to assets held for sale		(1)		(10)	(11)
At 31 December 2011	234	65	34	53	386
<b>Net book amounts</b>					
At 31 December 2011	202	105	26	90	423
At 31 December 2010	240	98	29	59	426
<b>Commitments</b>					

The Group is contractually committed to four milestone payments, which total \$60m (2010 -\$60m), related to the US approval and commercialisation of DUROLANE which may become payable under the terms of the agreement with Q-MED AB signed in June 2006. This commitment will transfer to the Group's new associate as detailed in Note 22.

**10 Investments**

## Accounting policy

Investments, other than those related to associates, are initially recorded at fair value plus transaction costs on the trade date. The Group has an investment in an entity that holds mainly unquoted equity securities, which by their very nature have no fixed maturity date or coupon rate. The investment is classed as available-for-sale and carried at fair value. The fair value of the investment is based on the underlying fair value of the equity securities: marketable securities are valued by reference to closing prices in the market; non-marketable securities are estimated considering factors including the purchase price, prices of recent significant private placements of securities of the same issuer and estimates of liquidation value. The Group assesses whether there is objective evidence that the investment is impaired. Any objective evidence would include a significant or prolonged decline in the fair value of the investment below its cost. Changes in fair value are recognised in other comprehensive income except where management considers that there is objective evidence of an impairment of the underlying equity securities, whereupon an impairment is recognised as an expense immediately.

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
At 1 January	<b>6</b>	7
Impairment	<b>(2)</b>	(1)
At 31 December	<b>4</b>	6



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**Notes to the Group accounts continued****11 Investments in associates****Accounting policy**

Investments in associates, being those entities over which the Group has a significant influence and which is neither a subsidiary or a joint venture, are accounted for using the equity method, with the Group recording its share of the associate's net income and equity. The Group's share in the results of its associates is included in one separate income statement line and is calculated after deduction of their respective taxes.

The Group holds 49% of the Austrian entities Plus Orthopedics GmbH and Intraplant GmbH and 20% of the German entity Intercus GmbH. The following table summarises the financial position of the Group's investment in these associates.

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Share of results of associates:		
Revenue	<b>11</b>	11
Operating costs and taxation	<b>(11)</b>	(11)
Profit after taxation recognised in the income statement		
Dividends paid		(1)
Net (loss)/profit attributable to the Group		(1)
Investments in associates at 1 January	<b>13</b>	13
Exchange adjustment		1
Investments in associates at 31 December	<b>13</b>	13
Investments in associates is represented by:		
Assets	<b>10</b>	11
Liabilities	<b>(1)</b>	(2)
Net assets	<b>9</b>	9
Goodwill	<b>4</b>	4
	<b>13</b>	13

**12 Inventories****Accounting policy**

Finished goods and work-in-progress are valued at factory cost, including appropriate overheads, on a first-in first-out basis. Raw materials and bought-in finished goods are valued at purchase price. All inventories are reduced to net realisable value where lower than cost. Inventory acquired as part of a business acquisition is valued at selling price less costs of disposal and a profit allowance for selling efforts.

Orthopaedic instruments are generally not sold but provided to customers and distributors for use in surgery. They are recorded as inventory until they are deployed at which point they are transferred to plant and equipment and depreciated over their useful economic lives of between three and five years.

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A feature of the orthopaedic business is the high level of product inventory required, some of which is located at customer premises and is available for customers' immediate use (referred to as consignment inventory). Complete sets of product, including large and small sizes, have to be made available in this way. These outer sizes are used less frequently than standard sizes and towards the end of the product life cycle are inevitably in excess of requirements. Adjustments to carrying value are therefore required to be made to orthopaedic inventory to anticipate this situation. These adjustments are calculated in accordance with a formula based on levels of inventory compared with historical or forecast usage. This formula is applied on an individual product line basis and is first applied when a product group has been on the market for two years. This method of calculation is considered appropriate based on experience but it involves management judgements on effectiveness of inventory deployment, length of product lives, phase-out of old products and efficiency of manufacturing planning systems.

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Raw materials and consumables	<b>140</b>	159	157
Work-in-progress	<b>24</b>	23	28
Finished goods and goods for resale	<b>695</b>	741	748
	<b>859</b>	923	933

Reserves for excess and obsolete inventories were \$322m (2010 \$322m, 2009 \$303m). During 2011, \$65m was recognised as an expense within cost of goods sold resulting from the write down of excess and obsolete inventory (2010 \$66m, 2009 \$92m). The cost of inventories recognised as an expense and included in cost of goods sold amounted to \$991m (2010 \$909m, 2009 \$866m).

No inventory is carried at fair value less costs to sell in any year.

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**13 Trade and other receivables****Accounting policy**

Loans and receivables are carried at amortised cost, less any allowances for uncollectible amounts. They are included in current assets, except for maturities greater than 12 months after the balance sheet date. These are classified as non-current assets. Loans and other receivables are classified as Trade and other receivables in the balance sheet.

The Group manages credit risk through credit limits which require authorisation commensurate with the size of the limit and which are regularly reviewed. Credit limit decisions are made based on available financial information and the business case. Significant receivables are regularly reviewed and monitored at Group level. The Group has no significant concentration of credit risk, with exposure spread over a large number of customers. Furthermore the Group's principal customers are backed by government and public or private medical insurance funding, which historically represent a lower risk of default. The maximum exposure to credit risk at the reporting date is the fair value of each class of receivable. The Group does not hold any collateral as security.

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Trade receivables	<b>936</b>	952	843
Less: provision for bad and doubtful debts	<b>(36)</b>	(49)	(47)
Trade receivables net (loans and receivables)	<b>900</b>	903	796
Derivatives forward foreign exchange contracts	<b>21</b>	23	13
Other receivables	<b>50</b>	55	71
Amounts owed by associates			2
Prepayments and accrued income	<b>66</b>	65	64
	<b>1,037</b>	1,046	946
Less non-current portion: Trade receivables		(22)	
Current portion	<b>1,037</b>	1,024	946

All non-current receivables are due within five years from the balance sheet date.

Management considers that the carrying amount of trade and other receivables approximates to the fair value.

The provision for bad and doubtful debts is based on specific assessments of risk and reference to past default experience. The bad debt expense (excluding the macrot textured claim) for the year was \$42m (2010 \$30m, 2009 \$33m). Amounts due from insurers in respect of the macrot textured claim of \$136m (2010 \$133m, 2009 \$128m) are included within other receivables and have been provided in full.

The amount of trade receivables that were past due but not impaired were as follows:

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Past due not more than three months	<b>198</b>	168	202
Past due more than three months and not more than six months	<b>51</b>	52	56
Past due more than six months and not more than one year	<b>59</b>	57	46
Past due more than one year	<b>94</b>	59	80
	<b>402</b>	336	384
Neither past due nor impaired	<b>534</b>	616	459

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Provision for bad and doubtful debts	(36)	(49)	(47)
Trade receivables net (loans and receivables)	<b>900</b>	903	796

Movements in the provision for bad and doubtful debts were as follows:

At 1 January	49	47	40
Exchange adjustment	(1)		1
Receivables provided for during the year	42	30	33
Utilisation of provision	(34)	(28)	(27)
Provision transferred to assets held for sale	(20)		
At 31 December	<b>36</b>	49	47

In 2011, no trade receivables from third parties are held under factoring agreements with recourse (2010 \$11m, 2009 \$20m). The amounts disclosed in prior years did not qualify for de-recognition as the Group retains part of the credit risk. The associated liability amounted to \$4m in 2010 and \$12m in 2009 and were accounted for as a part of current payables.

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Trade receivables include amounts denominated in the following major currencies:

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
US Dollar	<b>238</b>	282	281
Sterling	<b>75</b>	72	55
Euro	<b>317</b>	283	280
Other	<b>270</b>	266	180
Trade receivables net (loans and receivables)	<b>900</b>	903	796

**14 Payables**

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
<b>Trade and other payables due within one year</b>		
Trade and other payables	<b>549</b>	584
Derivatives forward foreign exchange contracts	<b>12</b>	33
Acquisition consideration	<b>3</b>	
	<b>564</b>	617
<b>Other payables due after one year:</b>		
Acquisition consideration	<b>8</b>	
The acquisition consideration due after more than one year is expected to be payable as follows: \$8m in 2014 (2010 \$nil).		

**15 Cash and borrowings****15.1 Net debt**

Net debt comprises borrowings and credit balances on currency swaps less cash and bank.

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Bank overdrafts and loans due within one year	<b>306</b>	57
Long-term borrowings	<b>16</b>	642
Borrowings	<b>322</b>	699
Cash and bank	<b>(184)</b>	(207)
Net debt	<b>138</b>	492

Borrowings are repayable as follows:

	<b>Within one year or on demand \$ million</b>	<b>Between one and two years \$ million</b>	<b>Between two and three years \$ million</b>	<b>Between three and four years \$ million</b>	<b>Between four and five years \$ million</b>	<b>After five years \$ million</b>	<b>Total \$ million</b>
At 31 December 2011:							
Bank loans	280	1					281
Bank overdrafts	23						23
Finance lease liabilities	3	1	2	2	2	8	18
	306	2	2	2	2	8	322
At 31 December 2010:							
Bank loans	41	498		126			665
Bank overdrafts	12						12
Finance lease liabilities	4	2	2	2	2	10	22
	57	500	2	128	2	10	699

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**15.2 Assets pledged as security**

Assets are pledged as security under normal market conditions. Secured borrowings and pledged assets are as follows:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Finance lease liabilities due within one year	<b>3</b>	4
Finance lease liabilities due after one year	<b>15</b>	18
Total amount of secured borrowings	<b>18</b>	22
Total net book value of assets pledged as security:		
Property, plant and equipment	<b>20</b>	22
	<b>20</b>	22

**15.3 Currency swap analysis**

All currency swaps are stated at fair value. Gross US Dollar equivalents of \$112m (2010 \$61m) receivable and \$112m (2010 \$61m) payable have been netted. Currency swaps comprise foreign exchange swaps and were used in 2011 and 2010 to hedge intragroup loans and other monetary items.

Currency swaps mature as follows:

	<b>Amount receivable</b>	<b>Amount payable</b>
	<b>\$ million</b>	<b>Currency million</b>
At 31 December 2011		
Within one year:		
Euro	1	EUR 1
Japanese Yen	20	JPY 1,500
Canadian Dollar	33	CAD 34
	54	
	<b>Amount receivable</b>	<b>Amount payable</b>
	<b>Currency million</b>	<b>\$ million</b>
At 31 December 2011		
Within one year:		
Swiss Franc	CHF 18	19
Swedish Krona	SEK 20	3

Australian Dollar	AUD 36	36
		58
	<b>Amount</b>	<b>Amount</b>
	<b>receivable</b>	<b>payable</b>
		<b>Currency</b>
At 31 December 2010	<b>\$ million</b>	<b>million</b>
Within one year:		
Japanese Yen	18	JPY 1,500
Canadian Dollar	25	CAD 24
	43	
	<b>Amount</b>	<b>Amount</b>
	<b>receivable</b>	<b>payable</b>
	<b>Currency</b>	<b>payable</b>
	<b>million</b>	<b>\$ million</b>
<b>At 31 December 2010</b>		
Within one year:		
New Zealand Dollar	NZD 5	4
Australian Dollar	AUD 14	14
		18



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**Notes to Group accounts continued****15.4 Liquidity risk exposures**

The Board has established a set of policies to manage funding and currency risks. The Group uses derivative financial instruments only to manage the financial risks associated with underlying business activities and their financing.

Liquidity risk is the risk that the Group is not able to settle or meet its obligations on time or at a reasonable price. The Group's policy is to ensure that there is sufficient funding and facilities in place to meet foreseeable borrowing requirements. The Group manages and monitors liquidity risk through regular reporting of current cash and borrowing balances and periodic preparation and review of short and medium term cash forecasts having regard to the maturities of investments and borrowing facilities.

Bank loans and overdrafts represent drawings under total committed facilities of \$1,259m (2010 \$1,511m) and total uncommitted facilities of \$375m (2010 \$332m). The Group has undrawn committed facilities of \$1,003m (2010 \$884m). Of the undrawn committed facilities, \$1,000m expires after two but within five years (2010 \$7m expired within one year and \$877m after two but within five years). The interest payable on borrowings under committed facilities is at floating rate and is typically based on the LIBOR interest rate relevant to the term and currency concerned. Borrowings are shown at book value which approximates to fair value.

In December 2010, the Company reviewed and replaced its principal banking facilities ahead of their maturity in May 2012. The Company reduced its \$1 billion 5-year term loan to \$245m as at 31 December 2011. The interest rate for this multi-currency facility, at 20 basis points over LIBOR, is unchanged. Smith & Nephew also has an undrawn 5 year \$1 billion multi-currency revolving facility with an initial interest rate of 70 basis points over LIBOR. The commitment fee on the undrawn amount of the revolving facility is 24.5 basis points. The Company is subject to restrictive covenants under the facility agreement requiring the Group's ratio of net debt to EBITDA to not exceed 3.0 to 1 and the ratio of EBITA to net interest to not be less than 3.0 to 1, with net debt, EBITDA, EBITA and net interest all being calculated as defined in the agreement. These financial covenants are tested at the end of each half year for the 12 months ending on the last day of the testing period. As of 31 December 2011, the Company was in compliance with these covenants. The facility is also subject to customary events of default, none of which are currently anticipated to occur.

**15.5 Year-end financial liabilities by contractual maturity**

The table below analyses the Group's year-end financial liabilities by contractual maturity date, including interest payments and excluding the impact of netting arrangements:

	<b>Within one year or on demand \$ million</b>	<b>Between one and two years \$ million</b>	<b>Between two and five years \$ million</b>	<b>After five years \$ million</b>	<b>Total \$ million</b>
<b>At 31 December 2011</b>					
<b>Non-derivative financial liabilities:</b>					
Bank overdrafts and loans	305				305
Trade and other payables	549				549

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Finance lease liabilities		4	3	9	9	25
<b>Derivative financial liabilities:</b>						
Currency swaps/forward foreign exchange contracts	outflow	1,053				1,053
Currency swaps/forward foreign exchange contracts	inflow	(1,052)				(1,052)
		859	3	9	9	880
<b>At 31 December 2010</b>						
<b>Non-derivative financial liabilities:</b>						
Bank overdrafts and loans		59	500	130		689
Trade and other payables		584				584
Finance lease liabilities		5	4	9	12	30
<b>Derivative financial liabilities:</b>						
Currency swaps/forward foreign exchange contracts	outflow	1,008				1,008
Currency swaps/forward foreign exchange contracts	inflow	(1,000)				(1,000)
Interest rate basis swaps	gross outflow	2				2
Interest rate basis swaps	gross inflow	(2)				(2)
		656	504	139	12	1,311

The amounts in the tables above are undiscounted cash flows, which differ from the amounts included in the balance sheet where the underlying cash flows have been discounted.

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**15.6 Finance leases****Accounting policy**

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards of ownership to the Group. All other leases are classified as operating leases.

Assets held under finance leases are capitalised as property, plant or equipment and depreciated accordingly. The capital element of future lease payments is included in borrowings and interest is charged to profit before taxation on a reducing balance basis over the term of the lease.

Future minimum lease payments under finance leases together with the present value of the minimum lease payments are as follows:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Within one year	<b>4</b>	5
After one and within two years	<b>3</b>	4
After two and within three years	<b>3</b>	3
After three and within four years	<b>3</b>	3
After four and within five years	<b>3</b>	3
After five years	<b>9</b>	12
Total minimum lease payments	<b>25</b>	30
Discounted by imputed interest	<b>(7)</b>	(8)
Present value of minimum lease payments	<b>18</b>	22

Present value of minimum lease payments can be split out as: \$3m (2010 \$4m) due within one year, \$7m (2010 \$8m) due between one to five years and \$8m (2010 \$10m) due after five years.

**16 Financial instruments and risk management****Accounting policy****Derivative Financial Instruments**

Derivative financial instruments are initially recognised at fair value on the date a derivative contract is entered into and are subsequently remeasured at their fair value at subsequent balance sheet dates. The fair value of forward foreign exchange contracts is calculated by reference to current forward exchange rates for contracts with similar maturity profiles. The fair value of interest rate swap contracts is determined by reference to market values for similar instruments and includes counterparty credit risk.

Changes in the fair value of derivative financial instruments that are designated and effective as cash flow hedges of forecast third party and intercompany transactions are recognised in other comprehensive income until the associated asset or liability is recognised. Amounts taken to other comprehensive income are transferred to the income statement when the hedged transaction affects profit and loss. Where the hedged item is the cost of a non-financial asset, the amounts taken to other comprehensive income are transferred to the initial carrying value of the asset.

Currency swaps to match foreign currency net assets with foreign currency liabilities are fair valued at year-end. Changes in the fair values of currency swaps that are designated and effective as net investment hedges are matched in other comprehensive income against changes in value of the related net assets.

Interest rate swaps transacted to fix interest rates on floating rate borrowings are accounted for as cash flow hedges and changes in the fair values resulting from changes in market interest rates are recognised in other comprehensive income. Amounts taken to other comprehensive income are transferred to the income statement when the hedged transaction affects profit and loss.

Any ineffectiveness on hedging instruments and changes in the fair value of derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement within other finance income/(costs) as they arise.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, any cumulative gain or loss on the hedging instrument recognised in other comprehensive income is retained there until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in other comprehensive income is transferred to the income statement for the period.

### 16.1 Foreign exchange exposures

The Group operates in over 90 countries and as a consequence has transactional and translational foreign exchange exposure. The Group's policy is to limit the impact of foreign exchange movements on equity by holding liabilities where practical in the same currencies as the Group's non US Dollar assets. These liabilities take the form of either borrowings or currency swaps. The Group designates a portion of foreign currency borrowings in non-operating units as net investment hedges. As at 31 December 2011, CHF32m (2010 CHF125m) of Group borrowings were designated as net investment hedges; the movement in the fair value of these hedges attributable to changes in exchange rates is recognised directly in reserves. The fair value of these hedges at 31 December 2011 was \$34m (2010 \$134m). It is Group policy for operating units not to hold material unhedged monetary assets or liabilities other than in their functional currencies.



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Foreign exchange variations affect trading results in two ways. Firstly, on translation of overseas sales and profits into US Dollars and secondly, transactional exposures arising where some or all of the costs of sale are incurred in a different currency from the sale. The principal transactional exposures arise as the proportion of costs in US Dollars, Sterling and Swiss Francs exceed the proportion of sales in each of these currencies and correspondingly the proportion of sales in Euros exceeds the proportion of costs in Euros.

The impact of currency movements on the cost of purchases is partly mitigated by the use of forward foreign exchange contracts. The Group uses forward foreign exchange contracts, designated as cash flow hedges, to hedge forecast third party and intercompany trading cash flows for forecast foreign currency inventory purchases for up to one year. When a commitment is entered into, forward foreign exchange contracts are normally used to increase the hedge to 100% of the exposure. Cash flows relating to cash flow hedges are expected to occur within twelve months of inception and profits and losses on hedges are expected to enter into the determination of profit (within cost of goods sold) within a further twelve month period. The principal currencies hedged by forward foreign exchange contracts are US Dollars, Euros and Sterling. At 31 December 2011, the Group had contracted to exchange within one year the equivalent of \$940m (2010 \$944m).

Based on the Group's borrowings as at 31 December 2011, if the US Dollar were to weaken against all currencies by 10%, the Group's net borrowings would increase by \$11m (2010 \$24m). In respect of borrowings held in a different currency to the relevant reporting entity, if the US Dollar were to weaken by 10% against all other currencies, the Group's borrowings would increase by \$16m (2010 \$35m). Excluding borrowings designated as net investment hedges, the increase would be \$13m (2010 \$21m); this increase would be fully offset by corresponding movements in group loan values.

If the US Dollar were to weaken by 10% against all other currencies, then the fair value of the forward foreign exchange contracts as at 31 December 2011 would have been \$17m lower (2010 \$20m), which would be recognised through the hedging reserve. Similarly, if the Euro were to weaken by 10% against all other currencies, then the fair value of the forward foreign exchange contracts as at 31 December 2011 would have been \$24m higher (2010 \$19m).

A 10% strengthening of the US Dollar or Euro against all other currencies at 31 December 2011 would have had the equal but opposite effect to the amounts shown above, on the basis that all other variables remain constant.

Since it is the Group's policy to hedge all actual foreign exchange exposures and the Group's forward foreign exchange contracts are designated as cash flow hedges, the net impact of transaction related foreign exchange on the income statement from a movement in exchange rates on the value of forward foreign exchange contracts is not significant.

**16.2 Interest rate exposures**

The Group is exposed to interest rate risk on cash, borrowings and currency swaps which are all at floating rates. The Group uses floating to fixed interest swaps to meet its objective of protecting borrowing costs within parameters set by the Board. Interest rate swaps are accounted for as cash flow hedges and, as such, changes in fair value resulting from changes in market interest rates are recognised in other comprehensive income, with the fair value of the interest rate swaps recorded in the balance sheet. The cash flows resulting from interest rate swaps match cash flows on the underlying borrowings so that there is no net cash flow from movements in market interest rates on the hedged items. At 31 December 2011 the Group had no interest rate swaps, at 31 December 2010 interest rates had been fixed on borrowings totalling \$98m for a period of six months and \$112m for a period of one year.

Based on the Group's gross borrowings as at 31 December 2011, if interest rates were to increase by 100 basis points in all currencies then the annual net interest charge would increase by \$4m (2010 \$5m). Excluding the impact of the Group's interest rate hedges, the increase in the interest charge would be \$4m (2010 \$7m). A decrease in interest rates by 100 basis points in all currencies would have an equal but opposite effect to the amounts shown above.

### 16.3 Credit risk exposures

The Group limits exposure to credit risk on counterparties used for financial instruments through a system of internal credit limits which, with certain minor exceptions due to local market conditions, require counterparties to have a minimum A rating from one of the major ratings agencies. The financial exposure of a counterparty is determined as the total of cash and deposits, plus the risk on derivative instruments, assessed as the fair value of the instrument plus a risk element based on the nominal value and the historic volatility of the market value of the instrument. The Group does not anticipate non-performance of counterparties and believes it is not subject to material concentration of credit risk as the Group operates within a policy of counterparty limits designed to reduce exposure to any single counterparty.

The maximum credit risk exposure on derivatives at 31 December 2011 was \$21m (2010 \$23m), being the total debit fair values on forward foreign exchange contracts, interest rate swaps and currency swaps. The maximum credit risk exposure on cash and bank at 31 December 2011 was \$184m (2010 \$207m). The Group's exposure to credit risk is not material as the amounts are held in a wide number of banks in a number of different countries.

Credit risk on trade receivables is detailed in Note 13.

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**16.4 Currency and interest rate profile of interest bearing liabilities and assets**

Short-term debtors and creditors are excluded from the following disclosures.

Currency and Interest Rate Profile of Interest Bearing Liabilities:

	<b>Gross borrowings</b>	<b>Currency swaps</b>	<b>Total liabilities</b>	<b>Floating rate liabilities</b>	<b>Fixed liabilities</b>	<b>Weighted average interest rate</b>	<b>Fixed rate liabilities Weighted average time for which rate is fixed</b>
	<b>\$ million</b>	<b>\$ million</b>	<b>\$ million</b>	<b>\$ million</b>	<b>\$ million</b>	<b>%</b>	<b>Years</b>
At 31 December 2011:							
US Dollar	85	58	143	126	17	7.1	5
Swiss Franc	35		35	35		3.0	2
Euro	126	1	127	126	1	5.0	2
Other	76	53	129	129			
<b>Total interest bearing liabilities</b>	<b>322</b>	<b>112</b>	<b>434</b>	<b>416</b>	<b>18</b>		
At 31 December 2010:							
US Dollar	294	18	312	244	68	2.5	2
Swiss Franc	137		137	80	57	0.6	1
Euro	167		167	100	67	1.0	1
Other	101	43	144	104	40	0.9	1
<b>Total interest bearing liabilities</b>	<b>699</b>	<b>61</b>	<b>760</b>	<b>528</b>	<b>232</b>		

At 31 December 2011, \$18m (2010 \$22m) of fixed rate liabilities relate to finance leases and \$nil (2010 \$210m) relate to hedged borrowings under the \$245m term facility. In 2011, the Group also had liabilities due for deferred acquisition consideration (denominated in US Dollars, Euro and Yen) totalling \$11m (2010 \$nil, 2009 \$46m) on which no interest was payable (see Note 14). There are no other significant interest bearing financial liabilities.

Floating rates on liabilities are typically based on the one or three-month LIBOR interest rate relevant to the currency concerned. The weighted average interest rate on floating rate borrowings as at 31 December 2011 was 2% (2010 1%).

Currency and Interest Rate Profile of Interest Bearing Assets:



	<b>Cash and bank \$ million</b>	<b>Currency swaps \$ million</b>	<b>Total assets \$ million</b>	<b>Floating rate assets \$ million</b>
At 31 December 2011:				
US Dollars	56	56	112	112
Other	128	56	184	184
<b>Total interest bearing assets</b>	<b>184</b>	<b>112</b>	<b>296</b>	<b>296</b>
At 31 December 2010:				
US Dollars	46	43	89	89
Other	161	18	179	179
<b>Total interest bearing assets</b>	<b>207</b>	<b>61</b>	<b>268</b>	<b>268</b>

Floating rates on assets are typically based on the short-term deposit rates relevant to the currency concerned. There were no fixed rate assets at 31 December 2011 or 31 December 2010.

### 16.5 Fair value of financial assets and liabilities

For cash and cash equivalents, short-term loans and receivables, overdrafts and other short-term liabilities which have a maturity of less than three months the book values approximate the fair values because of their short-term nature.

Forward foreign exchange contracts are recorded at fair value. These are regarded as Level 2 financial instruments measured at fair value. Level 2 financial investments are defined as: Valuation techniques for which all observable inputs have a significant effect on the recorded fair values, either directly or indirectly. The Group only has Level 2 financial instruments measured at fair value.

The Group enters into derivative financial instruments with financial institutions with investment grade credit ratings. Derivatives valued using valuation techniques with market observable inputs are mainly interest rate swaps and forward foreign exchange contracts. The most frequently applied valuation techniques include forward pricing and swap models, using present value calculations. The models incorporate various inputs including the credit quality of counterparties, foreign exchange spot and forward rates, interest rate curves and forward rate curves.



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**Notes to the Group accounts continued**

As at 31 December 2011 and 31 December 2010, the mark-to-market value of a derivative asset position is net of a credit valuation adjustment attributable to derivative counterparty default risk. The changes in counterparty credit risk had no material effect on the hedge effectiveness for derivatives designated in hedge relationships and other financial instruments recognised at fair value.

Long-term borrowings are measured in the balance sheet at amortised cost. As the Group's long-term borrowings are not quoted publicly and as market prices are not available their fair values are estimated by discounting future contractual cash flows to net present values at the current market interest rates available to the Group for similar financial instruments as at the year-end. At 31 December 2011 and 31 December 2010, the fair value of the Group's long-term borrowing was not materially different from amortised cost.

**17 Deferred taxation****Accounting policy**

Deferred taxation is accounted for using the balance sheet liability method in respect of temporary differences arising between the carrying amount of assets and liabilities in the accounts and the corresponding tax bases used in computation of taxable profit.

Deferred tax liabilities are recognised for all taxable temporary differences except in respect of investments in subsidiaries where the Group is able to control the timing of the reversal of the temporary difference and it is probable that this will not reverse in the foreseeable future; on the initial recognition of non-deductible goodwill; and on the initial recognition of an asset or liability in a transaction that is not a business combination and that, at the time of the transaction, does not affect the accounting or taxable profit.

Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary difference can be utilised. Their carrying amount is reviewed at each balance sheet date on the same basis.

Deferred tax is measured on an undiscounted basis, and at the tax rates that have been enacted or substantively enacted by the balance sheet date that are expected to apply in the periods in which the asset or liability is settled. It is recognised in the income statement except when it relates to items credited or charged directly to other comprehensive income or equity, in which case the deferred tax is also dealt with in other comprehensive income or equity respectively.

Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority, when the Group intends to settle its current tax assets and liabilities on a net basis and that authority permits the Group to make a single net payment.

	<b>2011</b>	<b>2010</b>
	<b>\$ million</b>	<b>\$ million</b>
Deferred tax assets	<b>223</b>	<b>224</b>

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Deferred tax liabilities	(66)	(69)
Net position at 31 December	157	155

The movement in the year in the Group's net deferred tax position was as follows:

	Notes	2011 \$ million	2010 \$ million
At 1 January		155	171
Exchange adjustment		(1)	(1)
Movement in income statement - current year		(15)	(4)
Movement in income statement - prior years		3	(4)
Movement in other comprehensive income		24	(7)
Movement in shareholders' equity		(2)	
Transfers		(7)	
At 31 December		157	155

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Movements in the main components of deferred tax assets and liabilities were as follows:

	<b>Retirement benefit obligation \$ million</b>	<b>Macro- textured claim \$ million</b>	<b>Other \$ million</b>	<b>Total \$ million</b>
<b>Deferred tax assets:</b>				
At 1 January 2010	54	52	96	202
Exchange adjustment			1	1
Movement in income statement – current year	(5)		18	13
Movement in income statement – prior years			(1)	(1)
Movement in other comprehensive income	6			6
Transfers	(1)		4	3
At 31 December 2010	54	52	118	224
Exchange adjustment			(2)	(2)
Movement in income statement – current year	(7)		(11)	(18)
Movement in income statement – prior years			(2)	(2)
Movement in other comprehensive income	31			31
Charge to equity			(1)	(1)
Transfers	1		(10)	(9)
At 31 December 2011	79	52	92	223

The Group has unused tax losses of \$29m (2010 – \$21m) available for offset against future profits. A deferred tax asset has been recognised in respect of \$1m (2010 – \$1m) of such losses. No deferred tax asset has been recognised on the remaining unused tax losses as these are not expected to be realised in the foreseeable future.

	<b>Accelerated tax depreciation \$ million</b>	<b>Intangible assets \$ million</b>	<b>Other \$ million</b>	<b>Total \$ million</b>
<b>Deferred tax liabilities:</b>				
At 1 January 2010	(35)	(34)	38	(31)
Exchange adjustment	2	(1)	(3)	(2)
Movement in income statement – current year	2	4	(23)	(17)
Movement in income statement – prior years	1	1	(5)	(3)
Movement in other comprehensive income			(13)	(13)
Transfers	5	(3)	(5)	(3)
At 31 December 2010	(25)	(33)	(11)	(69)

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Exchange adjustment	1			1
Movement in income statement - current year	3	5	(5)	3
Movement in income statement - prior years	(2)		7	5
Movement in other comprehensive income			(7)	(7)
Charge to equity			(1)	(1)
Transfers	(5)	1	6	2
At 31 December 2011	(28)	(27)	(11)	(66)

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**Notes to the Group accounts continued****18 Provisions and contingencies****Accounting policy**

In the normal course of business the Group is involved in numerous legal disputes. Provision is made for loss contingencies when it is deemed probable that an adverse outcome will occur and the amount of the loss can be reasonably estimated. Where the Group is the plaintiff in pursuing claims against third parties legal and associated expenses are charged to the income statement as incurred. Contingent assets are not recognised in the accounts unless they are virtually certain of being realised.

The recognition of provisions for legal disputes is subject to a significant degree of estimation. In making its estimates management takes into account the advice of internal and external legal counsel. Provisions are reviewed regularly and amounts updated where necessary to reflect developments in the disputes. The ultimate liability may differ from the amount provided depending on the outcome of court proceedings and settlement negotiations or as new facts emerge.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract. For the purposes of calculating any onerous lease provision, the Group has taken the discounted future lease payments, net of expected rental income. Before a provision is established, the Group recognises any impairment loss on the assets associated with that contract.

**18.1 Provisions**

	<b>Rationalisation provisions \$ million</b>	<b>Legal and other provision \$ million</b>	<b>Total \$ million</b>
At 1 January 2011	14	96	110
Charge to income statement	22	44	66
Utilisation/Released	(10)	(43)	(53)
At 31 December 2011	26	97	123
Provisions due within one year	26	52	78
Provisions due after one year		45	45
At 31 December 2011	26	97	123
Provisions due within one year	14	23	37
Provisions due after one year		73	73
At 31 December 2010	14	96	110

The principal provisions within rationalisation provisions relate to the rationalisation of operational sites (mainly severance and legal costs) arising from the legacy earnings improvement programme and people costs associated with the structural and process changes announced in August 2011.

Included within the legal and other provision is:

\$17m (2010 \$20m) relating to the declination of insurance coverage for macrot textured knee revisions (see Note 18.2).

\$23m (2010 \$nil) in connection with the previously disclosed investigation by the U.S. Securities and Exchange Commission ( SEC ) and Department of Justice ( DOJ ) into potential violations of the U.S. Foreign Corrupt Practices Act in the medical devices industry. On 6 February 2012, Smith & Nephew announced that it had reached settlement with the SEC and DOJ in connection with this matter. Smith & Nephew has committed to pay approximately \$23m in fines and profit disgorgement, maintain an enhanced compliance programme, and appoint an independent monitor for at least 18 months to review and report on its compliance programme.

The remaining balance largely represents provisions for various litigation and patent disputes. All provisions are expected to be substantially utilised within three years of 31 December 2011 and none are treated as financial instruments.

## 18.2 Contingencies

The Company and its subsidiaries are parties to various legal proceedings, some of which include claims for substantial damages. The outcome of these proceedings cannot readily be foreseen, but management believes none of them will result in a material adverse effect on the financial position of the Group. The Group provides for outcomes that are deemed to be probable and can be reliably estimated. There is no assurance that losses will not exceed provisions or will not have a significant impact on the Group's results of operations in the period in which they are realised.



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In August 2003, the Group withdrew voluntarily from all markets the macrotextured versions of its OXINIUM femoral knee components. A number of related claims have been filed, most of which have been settled. The aggregate cost at 31 December 2011 related to this matter is approximately \$214m. The Group has sought recovery from its primary and excess insurers for costs of resolving the claims. The primary insurance carrier has paid \$60m in full settlement of its policy liability. However, the excess carriers have denied coverage, citing defences relating to the wording of the insurance policies and other matters. In December 2004, the Group brought suit against them in the US District Court for the Western District of Tennessee, and trial is expected to commence in 2013. An additional \$22m was received from a successful settlement with a third party.

A charge of \$154m was recorded in 2004 for anticipated expenses in connection with macrotexture claims. Most of that amount has since been applied to settlements of such claims. Management believes that the \$17m provision remaining is adequate to cover remaining claims. Given the uncertainty inherent in such matters, there can be no assurance on this point.

The Group is engaged, as both plaintiff and defendant, in litigation with various competitors and others over claims of patent infringement and, in some cases, breach of licence agreement. These disputes are being heard in courts in the United States and other jurisdictions and also before agencies that examine patents. Outcomes are rarely certain with costs and settlements often significant.

## 19 Retirement benefit obligations

### Accounting policy

The Group's major pension plans are of the defined benefit type. For these plans, the employer's portion of past and current service cost is charged to operating profit, with the interest cost net of expected return on assets in the plans reported within other finance income/(costs). Actuarial gains or losses are recognised in full directly in other comprehensive income such that the balance sheet reflects the plan's surpluses or deficits as at the balance sheet date.

The defined benefit obligation is calculated annually by external actuaries using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash flows using interest rates that reference high-quality corporate bonds that are denominated in the currency in which the benefits will be paid and have terms to maturity approximating to the terms of the related pension liability.

A number of key assumptions have to be made in calculating the fair value of the Group's defined benefit pension plans. These assumptions impact the balance sheet assets and liabilities, operating profit and finance income/(costs). The most critical assumptions are the discount rate, the rate of inflation and mortality assumptions to be applied to future pension plan liabilities. The most important assumption for the plan assets is the future expected return. In determining these assumptions management takes into account the advice of professional external actuaries and benchmarks its assumptions against external data.

Where defined contribution plans operate, the contributions to these plans are charged to operating profit as they become payable.

## 19.1 Retirement benefit obligations

The Group's retirement benefit obligations comprise:

	2011 \$ million	2010 \$ million
Funded Plans:		
UK Plan	24	59
US Plan	168	110
Other Plans (i)	33	36
	<b>225</b>	<b>205</b>
Unfunded Plans:		
Other Plans (i)	24	22
Retirement Healthcare	38	35
	<b>287</b>	<b>262</b>

(i) The analysis in this note for "Other Plans" combines both the funded and unfunded retirement benefit obligations.

The Group sponsors pension plans for its employees in most of the countries in which it has major operating companies. Pension plans are established under the laws of the relevant country. Funded plans are funded by the payment of contributions to, and the assets held by, separate trust funds or insurance companies. In those countries where there is no company-sponsored pension plan, state benefits are considered adequate. Employees' retirement benefits are the subject of regular management review. The Group's major defined benefit pension plans in the UK and US were closed to new employees in 2003 and replaced by defined contribution plans.

Defined benefit plans provide employees with an entitlement to retirement benefits varying between 1.3% and 66.7% of final salary on attainment of retirement age. The level of entitlement is dependent on the years of service of the employee.

The present value of the defined benefit obligation and the related current service cost are measured using the projected unit method. Under the projected unit method, the current service cost will increase as the members of the defined benefit plans approach retirement. The principal actuarial assumptions used by the independent qualified actuaries in valuing the major plans in the United Kingdom ("UK Plan"), the United States ("US Plan") and all other plans ("Other Plans") and a breakdown of the pension costs charged to income are as follows:



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## Notes to the Group accounts continued

## 19.2 Principal actuarial assumptions:

	2011	2010 % per annum	2009
UK Plan:			
Discount rate	4.9	5.5	5.7
Expected return on plan assets (i)	5.1	5.9	6.4
Expected rate of salary increases	5.1	5.5	5.6
Future pension increases	3.1	3.5	3.6
Inflation (RPI)	3.1	3.5	3.6
Inflation (CPI)	2.1	3.0	N/A
Life expectancy of male aged 60 (in years)	28.6	28.2	28.1
Life expectancy of male aged 60 in 20 years time (in years)	31.0	31.5	31.3
US Plan:			
Discount rate	4.6	5.6	6.0
Expected return on plan assets (i)	7.1	7.5	7.5
Expected rate of salary increases	4.5	4.7	4.7
Future pension increases			
Inflation	2.5	2.7	2.7
Life expectancy of male aged 60 (in years)	22.8	22.8	23.0
Life expectancy of male aged 60 in 20 years time (in years)	24.5	24.7	25.8
Other Plans:			
Discount rate (ii)	3.9	4.2	4.6
Expected return on plan assets (i) (ii)	4.5	5.1	5.0
Expected rate of salary increases (ii)	3.3	3.0	3.3
Future pension increases (ii)	2.2	2.3	1.9
Inflation (ii)	1.9	2.1	1.0

(i) The assumption for the expected return on plan assets has been determined using a combination of past experience and market expectations.

(ii) Other Plans actuarial assumptions are presented on a weighted average basis and include all funded and unfunded plans.

## 19.3 Pension costs (including retirement healthcare):

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Current service cost – employer’s portion	<b>28</b>	26	26
Other finance cost	<b>66</b>	64	61
Expected return on assets in the plan	<b>(59)</b>	(55)	(48)
Net defined benefit pension costs	<b>35</b>	35	39
Net defined contribution pension costs	<b>29</b>	25	25
Total pension costs charged to profit before taxation	<b>64</b>	60	64

Of the \$64m (2010 \$60m, 2009 \$64m) net cost for the year, \$57m (2010 \$51m, 2009 \$51m) was charged to operating profit. The interest cost and expected return on plan assets are reported as other finance costs.

The total cost charged to income in respect of the Group’s defined contribution plans represents contributions payable to these plans by the Group at rates specified in the rules of the plans. As at 31 December 2011, there were \$nil outstanding payments due to be paid over to the plans (2010 \$nil, 2009 \$nil).

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**19.4 Actuarial (losses)/gains recognised in Group Statement of Comprehensive Income:**

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Experience gains in pension scheme assets	<b>9</b>	34	71
Experience gains on scheme liabilities		21	17
Losses due to changes in assumptions underlying scheme liabilities	<b>(79)</b>	(29)	(47)
	<b>(70)</b>	26	41

The actuarial losses of \$70m (2010 gain of \$26m, 2009 gain of \$41m) were reported in the statement of other comprehensive income making the cumulative charge to date \$298m (2010 \$228m, 2009 \$254m).

The contributions made in the year in respect of defined benefit plans were: UK Plan \$37m (2010 \$37m, 2009 \$19m); US Plan \$30m (2010 \$20m, 2009 \$14m); and Other Plans \$9m (2010 \$8m, 2009 \$8m). The agreed contributions for 2012 in respect of the Group's defined benefit plans are: \$37m for the UK Plan (including \$29m of supplementary payments), \$27m for the US Plan and \$7m for other defined benefit plans.

**19.5 Scheme assets**

The amount included in the balance sheet arising from the Group's obligations in respect of its defined benefit retirement plans and the expected rates of return on investments were:

	<b>UK Plan</b>		<b>US Plan</b>		<b>Other Plans</b>	
	<b>Rate of</b>	<b>Value</b>	<b>Rate of</b>	<b>Value</b>	<b>Rate of</b>	<b>Value</b>
	<b>Return %</b>	<b>\$ million</b>	<b>Return %</b>	<b>\$ million</b>	<b>Return %</b>	<b>\$ million</b>
31 December 2011						
Equities	7.2	248	8.8	196	8.2	6
Bonds	3.2	353	3.0	93	3.3	42
Other	6.7	55	2.3	9	4.5	61
Market value of assets		656		298		109
Present value of defined benefit obligations		(680)		(466)		(166)
Deficit: non-current liability recognised in the balance sheet		(24)		(168)		(57)

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31 December 2010

Equities	7.4	324	8.4	192	8.3	33
Bonds	4.0	262	4.2	70	4.5	33
Property					5.8	5
Other	4.1	9	2.8	10	4.1	29
Market value of assets		595		272		100
Present value of defined benefit obligations		(654)		(382)		(158)
Deficit: non-current liability recognised in the balance sheet		(59)		(110)		(58)

The following tables set out the pension plan asset allocations in the funded UK, US and Other Plans as at 31 December for the last two years:

%	<b>UK Plan</b>		<b>US Plan</b>		<b>Other Plans</b>	
	<b>2011</b>	2010	<b>2011</b>	2010	<b>2011</b>	2010
Asset Category:						
Equity securities	<b>38</b>	55	<b>66</b>	71	<b>6</b>	33
Debt securities	<b>54</b>	44	<b>31</b>	26	<b>38</b>	33
Property						5
Other	<b>8</b>	1	<b>3</b>	3	<b>56</b>	29
<b>Total</b>	<b>100</b>	100	<b>100</b>	100	<b>100</b>	100

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## Notes to Group accounts continued

A reconciliation of the fair value of plan assets is shown in the following tables:

	<b>UK Plan \$ million</b>	<b>US Plan \$ million</b>	<b>Other Plans \$ million</b>	<b>Retirement Healthcare \$ million</b>	<b>Total \$ million</b>
Fair value of plan assets at 1 January 2010	534	234	87		855
Expected return on plan assets	33	17	5		55
Settlements to members			(2)		(2)
Experience gains/(losses) on plan assets	26	11	(3)		34
Plan participant contributions	2		6		8
Company contributions	37	20	8		65
Benefits paid	(21)	(10)	(5)		(36)
Exchange adjustment	(16)		4		(12)
Fair value of plan assets at 31 December 2010	595	272	100		967
Expected return on plan assets	35	19	5		59
Experience gains/(losses) on plan assets	20	(12)	1		9
Plan participant contributions	1		3		4
Company contributions	37	30	9		76
Benefits paid	(23)	(11)	(6)		(40)
Exchange adjustment	(9)		(3)		(12)
Fair value of plan assets at 31 December 2011	656	298	109		1,063

**19.6 Present value of defined benefit obligations**

A reconciliation of the present value of defined benefit obligations is shown in the following tables:

	<b>UK Plan \$ million</b>	<b>US Plan \$ million</b>	<b>Other Plans \$ million</b>	<b>Retirement Healthcare \$ million</b>	<b>Total \$ million</b>
Present value of defined benefit obligations at 1 January 2010	668	343	137	29	1,177
Current service cost	9	8	9		26
Settlements to members			(2)		(2)
Other finance cost	36	20	6	2	64



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Experience (gains)/losses on plan liabilities	(21)	2	(2)		(21)
Losses on change of assumptions	1	19	4	5	29
Plan participant contributions	2		6		8
Benefits paid	(21)	(10)	(5)	(1)	(37)
Exchange adjustment	(20)		5		(15)
Present value of defined benefit obligations at 31 December 2010	654	382	158	35	1,229
Current service cost	10	9	9		28
Other finance cost	36	21	7	2	66
Experience losses/(gains) on plan liabilities	6	(1)	(3)	(2)	
Losses on change of assumptions	6	66	2	5	79
Plan participant contributions	1		3		4
Benefits paid	(23)	(11)	(6)		(40)
Benefits paid directly by employer	(1)			(2)	(3)
Exchange adjustment	(9)		(4)		(13)
Present value of defined benefit obligations at 31 December 2011	680	466	166	38	1,350

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**19.7 History of experience adjustments**

The history of experience adjustments is as follows:

	Present value		Experience (losses)/gains on plan liabilities		Experience gains/(losses) on plan assets		
	of Defined benefit obligations \$ million	Fair value of plan assets \$ million	Deficit in \$ million	Amount of plan gain/(loss) \$ million	Percentage of plan liabilities %	Amount of gain/(loss) \$ million	Percentage of plan assets %
At 31 December 2011:							
UK Plan	(680)	656	(24)	(6)	1	20	3
US Plan	(466)	298	(168)	1		(12)	4
Other Plans	(166)	109	(57)	3	2	1	1
At 31 December 2010:							
UK Plan	(654)	595	(59)	21	3	26	4
US Plan	(382)	272	(110)	(2)		11	4
Other Plans	(158)	100	(58)	2	1	(3)	3
At 31 December 2009:							
UK Plan	(668)	534	(134)	10	2	36	7
US Plan	(343)	234	(109)			34	15
Other Plans	(137)	87	(50)	7	5	1	1
At 31 December 2008:							
UK Plan	(516)	416	(100)	1		(126)	30
US Plan	(337)	180	(157)	(5)	1	(100)	56
Other Plans	(141)	76	(65)	5	4	(10)	13
At 31 December 2007:							
UK Plan	(753)	673	(80)			8	1
US Plan	(283)	256	(27)	1		(5)	2
Other Plans	(145)	98	(47)	(1)	1	12	12

The Group recharges the UK pension plan with the costs of administration and independent advisers. The amount recharged in the year was \$2m (2010 \$2m, 2009 \$2m). The amount receivable at 31 December 2011 was \$nil (2010 \$nil, 2009 \$nil).

## 19.8 Retirement healthcare

The cost of providing healthcare benefits after retirement is determined by independent actuaries. The principal actuarial assumptions in determining the cost of providing healthcare benefits are those in the UK and the US and are as follows:

% per annum	2011		2010		2009	
	UK	US	UK	US	UK	US
Discount rate	<b>4.9</b>	<b>4.6</b>	5.5	5.6	5.7	6.0
Medical cost inflation	<b>7.0</b>	<b>8.0</b>	7.0	8.0	7.0	8.0

A one percentage point change in the rate of medical cost inflation would not affect the accumulated retirement benefit obligations, or the aggregate of the current service and interest costs, of the UK or US plans in 2011 by more than \$2m (2010 more than \$2m, 2009 more than \$2m).

For the US the retirement healthcare cost trend for 2012 is expected to be 3.4% above the discount rate. Thereafter the healthcare cost trend rate is assumed to decrease by 0.5% per year to an ultimate rate of 5%. For the UK it will remain flat at 7%.

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## Notes to Group accounts continued

## 20 Equity

## 20.1 Share capital

	Ordinary Shares (20¢)		Deferred Shares (£1.00)		Total \$ million
	Thousand	\$ million	Thousand	\$ million	
<b>Authorised</b>					
At 31 December 2009	1,223,591	245	50		245
At 31 December 2010	1,223,591	245	50		245
At 31 December 2011	1,223,591	245	50		245
<b>Allotted, issued and fully paid</b>					
At 1 January 2009	949,890	190	50		190
Share options	1,131				
At 31 December 2009	951,021	190	50		190
Share options	1,816	1			1
At 31 December 2010	952,837	191	50		191
Share options	1,991				
At 31 December 2011	954,828	191	50		191

The deferred shares were issued in 2006 in order to comply with English Company law. They are not listed on any stock exchange and have extremely limited rights and effectively have no value. These rights are summarised as follows:

The holder shall not be entitled to participate in the profits of the Company;

The holder shall not have any right to participate in any distribution of the Company's assets on a winding up or other distribution except that after the return of the nominal amount paid up on each share in the capital of the Company of any class other than the Deferred Shares and the distribution of a further \$1,000 in respect of each such share there shall be distributed to a holder of a Deferred Share (for each Deferred Share held by him) an amount equal to the nominal value of the Deferred Share;

The holder shall not be entitled to receive notice, attend, speak or vote at any general meeting of the Company; and

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The Company may create, allot and issue further shares or reduce or repay the whole or any part of its share capital or other capital reserves without obtaining the consent of the holders of the Deferred Shares.

The Group's objectives when managing capital are to ensure the Group has adequate funds to continue as a going concern and sufficient flexibility within the capital structure to fund the on-going growth of the business and to take advantage of business development opportunities including acquisitions.

The Group determines the amount of capital taking into account changes in business risks and future cash requirements. The Group reviews its capital structure on an on-going basis and uses share buy-backs, dividends and the issue of new shares to adjust the retained capital.

The Group considers the capital that it manages to be as follows:

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Share capital	<b>191</b>	191	190
Share premium	<b>413</b>	396	382
Treasury shares	<b>(766)</b>	(778)	(794)
Retained earnings and other reserves	<b>3,349</b>	2,964	2,401
	<b>3,187</b>	2,773	2,179

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**20.2 Treasury shares**

Treasury shares represents the holding of the Company's own shares in respect of the Smith & Nephew Employee's Share Trust and shares bought back as part of the share buy-back programme, which was suspended in 2008.

The Smith & Nephew 2004 Employees' Share Trust (Trust) was established to hold shares relating to the long-term incentive plans referred to in the Directors' Remuneration Report. The Trust is administered by an independent professional trust company resident in Jersey and is funded by a loan from the Company. The cost of the Trust is charged to the income statement as it accrues. A partial dividend waiver is in place in respect of those shares held under the long-term incentive plans. The trust only accepts dividends in respect of nil-cost options and deferred bonus plan shares. The waiver represents less than 1% of the total dividends paid.

The movements in Treasury shares and the Employees' Share Trust are as follows:

	<b>Treasury</b>	<b>Employees</b>	<b>Total</b>
	<b>\$ million</b>	<b>Share</b>	<b>\$ million</b>
		<b>Trust</b>	
		<b>\$ million</b>	
At 1 January 2010	793	1	794
Shares purchased		5	5
Shares transferred from treasury	(19)	19	
Shares transferred to group beneficiaries	(5)	(16)	(21)
At 31 December 2010	769	9	778
Shares purchased		6	6
Shares transferred from treasury	(14)	14	
Shares transferred to group beneficiaries	(5)	(13)	(18)
At 31 December 2011	750	16	766
	<b>No of shares</b>	<b>No of shares</b>	<b>No of shares</b>
	<b>million</b>	<b>million</b>	<b>million</b>
At 1 January 2010	64.7	0.1	64.8
Shares purchased		0.6	0.6
Shares transferred from treasury	(1.6)	1.6	
Shares transferred to group beneficiaries	(0.4)	(1.5)	(1.9)
At 31 December 2010	62.7	0.8	63.5
Shares purchased		0.6	0.6
Shares transferred from treasury	(1.1)	1.1	
Shares transferred to group beneficiaries	(0.4)	(1.1)	(1.5)
At 31 December 2011	61.2	1.4	62.6

**20.3 Dividends**

	74.00 <b>2011</b> \$ million	74.00 2010 \$ million	74.00 2009 \$ million
The following dividends were declared and paid in the year:			
Ordinary final of 9.82¢ for 2010 (2009 8.93¢, 2008 8.12¢) paid 19 May 2011	<b>88</b>	79	72
Ordinary interim of 6.6¢ for 2011 (2010 6.00¢, 2009 5.46¢) paid 1 November 2011	<b>58</b>	53	48
	<b>146</b>	132	120

A final dividend for 2011 of 10.80 US cents per Ordinary Share was proposed by the Board on 1 February 2012 and will be paid, subject to shareholder approval, on 9 May 2012 to shareholders on the Register of Members on 20 April 2012. The estimated amount of this dividend on 22 February 2012 was \$96m.

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## Notes to Group accounts continued

## 21 Cash Flow Statement

## Accounting policy

In the Group Cash Flow Statement, cash and cash equivalents includes cash in hand, deposits held with banks, other short-term liquid investments with original maturities of three months or less and bank overdrafts. In the Group Balance Sheet, bank overdrafts are shown within bank overdrafts and loans under current liabilities.

## Analysis of net debt

	Cash	Overdrafts	Borrowings		Net currency	Total
	\$ million	\$ million	due within one year \$ million	due after one year \$ million	swaps \$ million	\$ million
At 1 January 2009	145	(23)	(92)	(1,358)	(4)	(1,332)
Net cash flow	38	6	66	288	12	410
Exchange adjustment	9	(1)	(1)	(20)	(8)	(21)
At 31 December 2009	192	(18)	(27)	(1,090)		(943)
Net cash flow	9	6	(17)	437	3	438
Exchange adjustment	6		(1)	11	(3)	13
At 31 December 2010	207	(12)	(45)	(642)		(492)
Net cash flow	(21)	(12)	252	140	1	360
Other non-cash changes			(517)	517		
Exchange adjustment	(2)	1	27	(31)	(1)	(6)
At 31 December 2011	184	(23)	(283)	(16)		(138)

## Reconciliation of net cash flow to movement in net debt

	2011 \$ million	2010 \$ million	2009 \$ million
Change in cash net of overdrafts in the year	(33)	15	44
Settlement of currency swaps	1	3	12
Net change in borrowings	392	420	354
Change in net debt from net cash flow	360	438	410
Exchange adjustment	(6)	13	(21)
Change in net debt in the year	354	451	389



Opening net debt	(492)	(943)	(1,332)
Closing net debt	(138)	(492)	(943)
Cash and cash equivalents			

For the purposes of the Group Cash Flow Statement cash and cash equivalents at 31 December comprise cash at bank and in hand net of bank overdrafts.

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Cash at bank and in hand	<b>184</b>	207	192
Bank overdrafts	<b>(23)</b>	(12)	(18)
Cash and cash equivalents	<b>161</b>	195	174

## 22 Acquisitions and assets held for sale

### Accounting policy

On acquisition, identifiable assets and liabilities (including contingent liabilities) of subsidiaries and associates are measured at their fair values at the date of acquisition using the acquisition method. The fair value of assets includes the taxation benefits resulting from amortisation for income taxation purposes from which a third party separately acquiring the assets would reasonably be expected to benefit. Goodwill, representing the excess of purchase consideration over the Group's share of the fair value of net assets acquired, is capitalised.

No acquisition related costs were incurred in 2011 or 2010. In 2009, \$26m of acquisition costs related to the integration of the Plus business.

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**22.1 Acquisitions**

## Year ended 31 December 2011

On 23 June 2011, Smith & Nephew acquired 100% of the voting rights of Tenet Medical Engineering, Inc. for an initial payment of \$35m, a further payment of \$2.5m, deferred for 18 months, and up to \$14.5m based on the achievement of future revenue milestones. The cost is assessed as \$46m, being the fair value of the probable consideration.

	Pre-acquisition carrying amounts \$ million	Fair value adjustments \$ million	Fair value to Group \$ million
Trade and other receivables	2		2
Inventories	1		1
Trade and other payables	(3)		(3)
Cash	2		2
Net assets	2		2
Goodwill on acquisition			44
Cost of acquisition			46
Discharged by:			
Cash			35
Deferred consideration			3
Contingent consideration			8
<b>Total consideration</b>			<b>46</b>

As the Group was the only material customer of Tenet Medical Engineering Inc., no contribution to revenue was achieved in 2011. The post-acquisition contribution to attributable profit for 2011 was immaterial.

## Year ended 31 December 2010

In the year ended 31 December 2010 there were no acquisitions.

## Year ended 31 December 2009

**Plus Orthopedics Holdings AG**

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In January 2009, the Group reached an agreement with the vendors of Plus to reduce the total original purchase price by CHF159m. As part of the agreement the Group dropped all its claims and released the vendors from substantially all of the remaining warranties under the original purchase agreement as well as resolving the contractual price adjustments.

### **Nucryst Pharmaceuticals, Corp.**

On 22 December 2009, the Group acquired substantially all of the assets and liabilities of Nucryst Pharmaceuticals, Corp, which manufactures and licences exclusively to the Group our range of ACTICOAT products, using its nanocrystalline silver technology, SILCRYST.

Under the agreement the Group acquired the manufacturing assets from Nucryst's operations in Canada and intellectual property rights relating to the nanocrystalline silver technology used in the manufacture of ACTICOAT product range. Nucryst has manufactured ACTICOAT products for Smith & Nephew since the Group's acquisition of the product right in 2001.

	<b>Pre-acquisition carrying amounts \$ million</b>	<b>Fair value adjustments \$ million</b>	<b>Fair value to Group reported in 2009 \$ million</b>
Property, plant and equipment	10	(4)	6
Intangible assets – acquisition intangibles		12	12
Inventories	4		4
Trade and other payables	(1)		(1)
Deferred taxation		1	1
Net assets	13	9	22
Goodwill on acquisition			3
Cost of acquisition			25
Discharged by:			
Cash			25



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Management believes that goodwill represents the value of the workforce and synergies that are expected to arise from the combined group.

As the Group was the only material customer of Nucryst Pharmaceuticals, Corp., no contribution to revenue was achieved in 2009. The post-acquisition contribution to attributable profit for 2009 was immaterial.

**22.2 Assets held for sale**

The Group has classified following assets as held for sale:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Goodwill	<b>37</b>	
Intangible assets	<b>14</b>	
Property, plant and equipment	<b>3</b>	
Deferred tax assets	<b>7</b>	
Inventory	<b>15</b>	
Trade and other receivables	<b>49</b>	
	<b>125</b>	
Liabilities directly associated with assets held for sale	<b>19</b>	

The Group has announced its intention to dispose of the Clinical Therapies business to an entity in which Smith & Nephew will retain an investment as an associate. The assets and liabilities of the Clinical Therapies business have been classified as held for sale, their net realisable value is estimated to be greater than their net book value. In 2011, this business contributed \$237m to revenue and \$48m to trading profit. The transaction is expected to complete during the first half of 2012. On completion of this transaction, the Group expects to recognise a profit before taxation in excess of \$250m.

As part of this disposal the Group commitment of \$60m detailed in Note 9 will be transferred to the associate.

**23 Operating leases****Accounting policy**

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards of ownership to the Group. All other leases are classified as operating leases.

Rentals payable under operating leases are expensed in the income statement on a straight line basis over the term of the relevant lease.

Future minimum lease payments under non-cancellable operating leases fall due as follows:

	<b>2011</b>	2010
	<b>\$ million</b>	\$ million
Land and buildings:		
Within one year	<b>31</b>	30
After one and within two years	<b>22</b>	25
After two and within three years	<b>18</b>	19
After three and within four years	<b>15</b>	18
After four and within five years	<b>11</b>	14
After five years	<b>13</b>	21
	<b>110</b>	127
Other assets:		
Within one year	<b>19</b>	23
After one and within two years	<b>12</b>	10
After two and within three years	<b>6</b>	5
After three and within four years	<b>2</b>	1
	<b>39</b>	39

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**24 Other Notes to the accounts****24.1 Share based payments****Accounting policy**

The Group operates a number of equity-settled executive and employee share plans. For all grants of share options and awards, the fair value at the grant date is calculated using appropriate option pricing models and the corresponding expense is recognised over the vesting period.

**Employee plans**

The Smith & Nephew Sharesave Plan (2002) (adopted by shareholders on 3 April 2002) (the Save As You Earn ( SAYE ) plan) is available to all employees in the UK employed by participating Group companies, subject to three months' service. The scheme provides for employees to save up to £250 per month and gives them an option to acquire shares based on the committed amount to be saved. The option price is not less than 80% of the average of middle market quotations of the Ordinary Shares on the three dealing days preceding the date of invitation. The Smith & Nephew International Sharesave Plan (2002) is offered to employees in Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Hong Kong, Japan, South Korea, Mexico, New Zealand, Norway, Poland, Portugal, Puerto Rico, Singapore, South Africa, Spain, Sweden, Switzerland and the United Arab Emirates. Employees in Italy, the Netherlands and France are able to participate respectively in the Smith & Nephew Italian Sharesave Plan (2002), the Smith & Nephew Dutch Sharesave Plan (2002) and the Smith & Nephew France Sharesave Plan (2002). Participants in Ireland are able to participate in the Smith & Nephew Irish Employee Share Option Scheme. These plans operate on a substantially similar basis to the Smith & Nephew Sharesave Plan (2002). Together all of the plans referred to above are termed the Employee Plans . These plans have now reached the end of their ten year life and resolutions will be put to shareholders at the Annual General Meeting on 12 April 2012 to renew these plans.

Employees in the US are able to participate in the Employee Stock Purchase Plan, which gives them the opportunity to acquire shares, in the form of ADSs, at a discount of 15% (or more if the shares appreciate in value during the plan's quarterly purchase period) to the market price, through a regular savings plan.

**Executive plans**

The Smith & Nephew 2001 UK Approved Share Option Plan, the Smith & Nephew 2001 UK Unapproved Share Option Plan, the Smith & Nephew 2001 US Share Plan (adopted by shareholders on 4 April 2001), the Smith & Nephew 2004 Executive Share Option Plan (adopted by shareholders on 6 May 2004) and the Smith & Nephew Global Share Plan 2010 (adopted by shareholders on 6 May 2010) are together termed the Executive Plans .

Under the terms of the Executive Plans, the Remuneration Committee, consisting of Non-Executive Directors, may at their discretion approve the grant of options to employees of the Group to acquire Ordinary Shares in the Company. Options granted under the Smith & Nephew 2001 US Share Plan (the US Plan ) and the Smith & Nephew 2004 Executive Share Option Plan are to acquire ADSs or Ordinary Shares. For Executive Plans adopted in 2001 and 2004, the market value is the average quoted price of an Ordinary Share for the three business days preceding the date of grant or the average quoted price of an ADS or Ordinary Share, for the three business days preceding the date of grant or the quoted price on the date of grant if higher. For the Global Share Plan adopted in 2010 the market value is the closing price of an Ordinary Share or ADS on the last trading day prior to the grant date. With the exception of options granted under the 2001 US Plan and the Global Share

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Plan 2010, the vesting of options granted from 2001 are subject to achievement of a performance condition. Options granted under the 2001 US Plan and the Global Share Plan 2010 are not subject to any performance conditions. Prior to 2008, the 2001 US Plan options became cumulatively exercisable as to 10% after one year, 30% after two years, 60% after three years and the remaining balance after four years. With effect from 2008, options granted under the 2001 US Plan became cumulatively exercisable as to 33.3% after one year, 66.7% after two years and the remaining balance after the third year. The 2001 UK Unapproved Share Option Plan was open to certain employees outside the US and the US Plan is open to certain employees in the US, Canada, Mexico and Puerto Rico. The Global Share Plan 2010 is open to employees globally. The 2004 Plan is open to Executive Directors only.

The maximum term of options granted, under all plans, is 10 years from the date of grant. All share option plans are settled in shares.



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## Notes to the Group accounts continued

At 31 December 2011 27,316,000 (2010 25,753,000, 2009 23,383,000) options were outstanding under share option plans as follows:

	Number of shares Thousand	Range of option exercise prices Pence		Weighted average exercise price Pence
<b>Employee Plans:</b>				
Outstanding at 1 January 2009	3,533	321.0	640.0	427.4
Granted	1,563	380.0	519.0	381.6
Forfeited	(680)	321.0	640.0	436.1
Exercised	(1,029)	321.0	507.0	362.7
Expired	(4)	321.0	600.5	427.9
Outstanding at 31 December 2009	3,383	348.0	640.0	422.7
Granted	986	459.0	556.0	462.2
Forfeited	(364)	348.0	609.0	439.8
Exercised	(625)	348.0	576.5	435.2
Expired	(22)	348.0	640.0	431.7
Outstanding at 31 December 2010	3,358	348.0	640.0	430.1
Granted	1,090	452.0	585.0	454.8
Forfeited	(122)	348.0	609.0	427.6
Exercised	(602)	348.0	576.5	454.7
Expired	(144)	380.0	609.0	450.7
Outstanding at 31 December 2011	3,580	348.0	640.0	432.8
Options exercisable at 31 December 2011	122	348.0	640.0	470.8
Options exercisable at 31 December 2010	87	425.0	576.5	466.5
Options exercisable at 31 December 2009	109	348.0	498.0	362.4
<b>Executive Plans:</b>				
Outstanding at 1 January 2009	18,148	183.5	680.5	592.5
Granted	5,849	448.0	595.0	477.0
Forfeited	(1,348)	409.5	680.5	565.9
Exercised	(1,754)	183.5	637.8	428.3
Expired	(895)	185.8	574.5	492.8
Outstanding at 31 December 2009	20,000	265.0	637.5	547.1
Granted	6,249	424.0	675.0	520.9
Forfeited	(977)	479.0	680.5	581.3
Exercised	(2,386)	265.0	637.5	479.2
Expired	(491)	418.0	637.8	575.6
Outstanding at 31 December 2010	22,395	409.5	680.5	544.9
Granted	5,706	580.0	703.0	599.4
Forfeited	(763)	479.0	637.8	565.5
Exercised	(2,369)	445.0	680.5	536.6
Expired	(1,233)	445.0	637.8	549.7
Outstanding at 31 December 2011	23,736	409.5	703.0	561.2
Options exercisable at 31 December 2011	7,979	409.5	680.5	595.6
Options exercisable at 31 December 2010	5,153	409.5	627.0	548.3

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Options exercisable at 31 December 2009 6,668 265.0 637.5 532.0  
The weighted average remaining contractual life of options outstanding at 31 December 2011 was 6.6 (2010 6.1 years, 2009 5.9 years) years for Executive Plans and 2.6 (2010 2.7 years, 2009 2.7 years) years for Employee Plans.

	<b>2011</b>	2010	2009
Weighted average share price	<b>pence</b> <b>639.9</b>	pence 619.3	pence 504.0

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Options granted during the year were as follows:

	<b>Options granted Thousand</b>	<b>Weighted average fair value per option at grant date Pence</b>	<b>Weighted average share price at grant date Pence</b>	<b>Weighted average exercise price Pence</b>	<b>Weighted average option life Years</b>
Employee Plans	1,090	189.2	591.0	454.8	3.9
Executive Plans	5,706	176.1	609.0	599.4	10.0

The weighted average fair value of options granted under employee plans during 2010 was 170.2p (2009 212.0p) and those under executive plans during 2010 was 173.7p (2009 147.9p).

Options granted under the executive plans are valued using a binomial model. Options granted under employee plans are valued using the Black-Scholes option model as management consider that options granted under these plans are exercised within a short period of time after the vesting date. Options granted under each plans are valued separately and a weighted average fair value calculated.

The binomial model is used for executive plans so that proper allowance is made for the possibility of early exercise. At the 2011 grant management expected 90% of the options granted under the Global Share Plan 2010 to vest (2010 90%, 2009 n/a), 90% of the 2004 Executive Scheme to vest (2010 90%, 2009 60%). Each year an assessment is made of the current vesting estimates and they are updated to reflect revised expectations of the number of grants that will vest.

For all plans the inputs to the option pricing models are reassessed for each grant. The following assumptions were used in calculating the fair value of options granted:

	<b>Employee plans</b>			<b>Executive plans</b>		
	<b>2011</b>	2010	2009	<b>2011</b>	2010	2009
Dividend yield (%)	<b>1.5</b>	1.5	1.5	<b>1.5</b>	1.5	1.5
Expected volatility (%) (i)	<b>30.0</b>	30.0	30.0	<b>30</b>	30.0	30.0
Risk free interest rate (%) (ii)	<b>2.0</b>	2.5	3.3	<b>2.0</b>	2.5	3.3
Expected life in years (iii)	<b>3.9</b>	3.9	3.9	<b>10.0</b>	9.8	6.8

(i) Volatility is assessed on a historic basis primarily based on past share price movements over the expected life of the options.

(ii) The risk free interest rate reflects the yields available on zero coupon government bonds over the option term and currency.

(iii) An assessment of an Executive Plan's option life is based on an exercise model. This is based on a mixture of historic experience and generally accepted behavioural traits. 5% (2010 5%, 2009 5%) of Executive Plan option holders are assumed to leave and exercise their options (or forfeit them if under water) each year after vesting. In addition, 50% (2010 50%, 2009 50%) of Executive Plan option holders are assumed to exercise by choice per annum providing the gain available is at least 50% for the options granted to executives and 25% for other recipients under the Global Share Plan 2010 (2010 50% for the 2004 Plan and 50% for the options granted to executives and 25% for other recipients under the Global Share Plan 2010, 2009 50% for the 2004 Plan and 25% for the 2001 Plans).

Summarised information about options outstanding under the share option plans at 31 December 2011 is as follows:

	<b>Number outstanding Thousand</b>	<b>Weighted average remaining contract life Years</b>
Employee Plans:		
348.0p to 639.9p*	3,577	2.6
639.9p* to 640.0p	3	0.3
	<b>3,580</b>	<b>2.6</b>
Executive Plans:		
409.5p to 639.9p*	23,628	6.6
639.9p* to 703.0p	108	3.0
	<b>23,736</b>	<b>6.6</b>

\* The split has been determined based on the weighted average share price of 639.9p.

As at 31 December 2011 nil (2010 nil, 2009 77,669) options remain outstanding under the 1999 and 2000 Stock Appreciation Rights Plan. The fair value liability related to these schemes was \$nil in 2011, 2010 and 2009. This was materially the same as intrinsic value.



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**Notes to the Group accounts continued****Share based payments – long-term incentive plans**

In 2004, a share based incentive plan was introduced for Executive Directors, executive officers and the next level of senior executives, which replaced the Long-term Incentive Plan (LTIP). The plan includes a Performance Share Plan (PSP) and a Bonus Co-Investment Plan (CIP).

Vesting of the PSP award shares is dependent upon performance relative to the FTSE 100 and an index based on major international companies in the medical devices industry.

Under the CIP, participants could elect to use up to a maximum of one-half of their annual bonus to purchase shares. If the shares are held for three years and the Group's EPSA growth targets are achieved participants receive an award of matching shares for each share purchased.

From 2009, the CIP was replaced by the Deferred Bonus Plan. This plan is designed to encourage executives to build up and maintain a significant shareholding in the Company. Under the plan, up to one third of any bonus earned at target level or above by an eligible employee will be compulsorily deferred into shares which vest, subject to continued employment, in equal annual tranches over three years (i.e. one third each year). No further performance conditions will apply to the deferred shares.

From 2010, Performance Share awards are granted under the Global Share Plan 2010 for all executives other than Executive Directors. Awards granted under both plans are combined to provide the figures below. Vesting of the share awards is dependent upon performance relative to the FTSE 100 and an index based on major international companies in the medical devices industry.

The fair values of awards granted under long-term incentive plans are calculated using a binomial model. The exercise price for all awards granted under the long term incentive plans is \$nil. Performance Share awards under both the PSP and Global Share Plan 2010 contain vesting conditions based on TSR versus a comparator group which represent market-based performance conditions for valuation purposes and an assessment of vesting probability is therefore factored into the award date calculations. The assumptions include the volatilities for the comparator groups. Given the wide range of companies within the FTSE 100 a correlation of 40% (2010 35%, 2009 30%) has been assumed with the constituents of the group. A correlation of 40% (2010 35%, 2009 30%) has also been assumed for the companies in the medical devices sector as they are impacted by similar factors. The Performance Target for the Global Share Plan 2010 is a combination of EPSA growth and the Group's Total Shareholder Return (TSR) performance over the three year performance period.

The other assumptions used are consistent with the executive scheme assumptions disclosed in Note 24.1 (a).

At 31 December 2011 the maximum number of shares that could be awarded under the Group's long-term incentive plans was:

	<b>Other Awards</b>	<b>PSP</b>	<b>CIP</b>	<b>Deferred Bonus Plan</b>	<b>Total</b>
	<b>Number of shares in thousands</b>				
Outstanding at 1 January 2009		3,817	750		4,567
Awarded		2,372		305	2,677
Vested		(334)	(99)	(7)	(440)
Forfeited		(975)	(206)	(6)	(1,187)

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Outstanding at 31 December 2009		4,880	445	292	5,617
Awarded		2,386		338	2,724
Vested		(501)	(116)	(101)	(718)
Forfeited		(753)	(132)	(7)	(892)
Outstanding at 31 December 2010		6,012	197	522	6,731
Awarded	838	2,282		351	3,471
Vested	(44)	(366)		(375)	(785)
Forfeited		(1,660)	(197)	(6)	(1,863)
Outstanding at 31 December 2011	794	6,268		492	7,554

Other Awards mainly comprises of conditional share awards granted under the Global Share Plan 2010.

The weighted average remaining contractual life of awards outstanding at 31 December 2011 was 1.2 years (2010 1.8 years, 2009 1.8 years) for the PSP, 1.7 years (2010 1.9 years, 2009 2.2 years) for the Deferred Bonus Plan and 1.5 years for the other awards. There were no awards outstanding under the CIP, the remaining contractual life of awards under the CIP was 0.2 years for 2010 and 0.7 years for 2009.

### Share based payments charge to income statement

The expense charged to the income statement for share based payments is as follows:

	<b>2011</b>	2010	2009
	<b>\$ million</b>	\$ million	\$ million
Granted in current year	<b>9</b>	5	2
Granted in prior years	<b>21</b>	16	16
<b>Total share based payments expense for the year</b>	<b>30</b>	21	18

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Under the Executive Plans, PSP and CIP the number of Ordinary Shares over which options and share awards may be granted is limited so that the number of Ordinary Shares issued or that may be issued during the ten years preceding the date of grant shall not exceed 5% of the Ordinary Share capital at the date of grant. The total number of Ordinary Shares which may be issuable in any ten-year period under all share plans operated by the Company may not exceed 10% of the Ordinary Share capital at the date of grant.

**24.2 Related party transactions**