

SMITH & NEPHEW PLC  
Form 20-F  
March 03, 2011

**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, 2010

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**

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(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

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:

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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

## INTRODUCTION AND FINANCIAL SUMMARY

The Smith & Nephew Group (the Group) is a global medical devices business operating in the markets for orthopaedic reconstruction and trauma, endoscopy (which includes arthroscopic procedures referred to as sports medicine) and advanced wound management, with revenue of approximately \$4 billion in 2010. Smith & Nephew plc (the Company) is the parent company of the Group. It is an English public limited company with its shares listed on the premium list of the UK Listing Authority and traded on the London Stock Exchange. Shares are also traded on the New York Stock Exchange in the form of American Depositary Shares (ADSs).

This is the Annual Report of Smith & Nephew plc for the year ended 31 December 2010. It comprises, in a single document, the Annual Report and Accounts of the company in accordance with UK requirements and the Annual Report on Form 20-F in accordance with the regulations of the United States Securities and Exchange Commission (SEC).

Smith & Nephew's corporate website, [www.smith-nephew.com](http://www.smith-nephew.com), gives additional information on the Group, including an electronic version of this Annual Report. Information made available on this website, or other websites mentioned in this Annual Report, are not, and should not be regarded as being, part of or incorporated into this Annual Report.

For the convenience of the reader, a Glossary of technical and financial terms used in this document is included on page 152. The product names referred to in this document are identified by use of capital letters and are trademarks owned by or licensed to members of the Group.

### Financial Summary

|  | 2010       | 2009       | 2008       |
|--|------------|------------|------------|
| Financial Highlights (i) (iii)                 | \$ million | \$ million | \$ million |
| Revenue  | 3,962      | 3,772      | 3,801      |
| <i>Underlying growth in revenue (%)</i>        | 4%         | 2%         | 6%         |
| Trading profit                                 | 969        | 857        | 776        |
| <i>Underlying growth in trading profit (%)</i> | 11%        | 15%        | 6%         |
| <i>Trading profit margin (%)</i>               | 24.5%      | 22.7%      | 20.4%      |
| Operating profit                               | 920        | 723        | 630        |
| Attributable profit for the year               | 615        | 472        | 377        |
| <i>Adjusted attributable profit</i>            | 654        | 580        | 493        |
| Basic earnings per Ordinary Share              | 69.3¢      | 53.4¢      | 42.6¢      |
| EPSA   | 73.6¢      | 65.6¢      | 55.6¢      |
| <i>Growth in EPSA (%)</i>                      | 12%        | 18%        | 7%         |
| Dividends per Ordinary Share (ii)              | 15.82¢     | 14.39¢     | 13.08¢     |
| Cash generated from operations                 | 1,111      | 1,030      | 815        |
| <i>Trading cash flow</i>                       | 825        | 771        | 612        |
| <i>Trading profit to cash conversion (%)</i>   | 85%        | 90%        | 79%        |

(i) Items shown in italics are non-GAAP measures. Reconciliations to reported figures are on pages 24 to 27.

(ii)

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The Board has proposed a final dividend of 9.82 US cents per share which together with the first interim dividend of 6.00 US cents makes a total for 2010 of 15.82 US cents. The final dividend is expected to be paid, subject to shareholder approval, on 19 May 2011 to shareholders on the Register of Members at the close of business on 3 May 2011.

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

### Key Performance Indicators

The Directors' Report includes a number of measures that management use as key performance indicators including those financial performance indicators set out in the Financial Summary above. A discussion of the reasons for, calculation and limitations of the key financial performance indicators is set out below.

The Group is focused on continued delivery of sustainable profitable growth through four strategic pillars: Customer led, Efficient, Investing for growth and Aligned as explained on page 4 of this document.

From these four strategic pillars, a scorecard has been developed which identifies the specific functional strategic imperatives for each part of the Group. The performance against the scorecard is evaluated against a series of financial and non-financial indicators and measures.

The principal key financial performance indicators used in the scorecard, which measure performance against the Group's strategic pillars, are:

*(i) Underlying growth in revenue*

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 not a Generally Accepted Accounting Principle (a non-GAAP measure). An explanation of how this non-GAAP measure is calculated is presented in the Business Overview on page 24.

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.

*(ii) Trading profit and trading profit margin*

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 trends. The Group's internal financial reporting (budgets, monthly reporting, forecasts, long-term planning and incentive plans), focuses 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.

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The Group has identified the following items, where material, as those to be adjusted and identified separately: 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. An explanation of how trading profit is calculated is presented in Business Overview on page 25.

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 measures of earnings per share and operating profit. The Group considers that no single measure enables it to assess overall performance and therefore it compensates for the limitation of the adjusted earnings per share and trading profit measures by considering them in conjunction with their GAAP equivalents. 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.

*(iii) Adjusted earnings per ordinary share*

Growth in adjusted earnings per ordinary shares ( EPSA ) is another measure which presents the trend growth in the long-term profitability of the Group. EPSA is not a recognised measure under IFRS and is therefore a non-GAAP financial measure.

EPSA excludes the same impact of specific transactions or events that management considers affect the Group's short-term profitability as set out and discussed in the section on trading profit above, including the material limitations of such measures. A reconciliation of adjusted attributable profit, which represents the numerator used in the EPSA calculation, to attributable profit is presented in *Business Overview* on page 26.

*(iv) 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 adjusting items are discussed in the sections above.

The Group presents these 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. A reconciliation of trading cash flow to cash generated from operations is presented in *Business Overview* on page 27.

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.

## Presentation

The Group's fiscal year end is 31 December. References in this Annual Report to a particular year are to the fiscal year unless otherwise indicated. Except as the context otherwise requires, *Ordinary Share* or *share* refer to the Ordinary Shares of Smith & Nephew plc of 20 US cents each.



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The results of the Group, as reported in US Dollars, are affected by movements in exchange rates between US Dollars and other currencies. The Group applied the average exchange rates prevailing during the year to translate the results of companies with functional currency other than US Dollars. The currencies which most influenced these translations in the years covered by this report were Sterling, Swiss Franc and the Euro.

The Group Accounts of Smith & Nephew in this Annual Report are presented in US Dollars. Solely for the convenience of the reader, certain parts of this Annual Report contain translations of amounts in US Dollars into Sterling at specified rates. These translations should not be construed as representations that the US Dollar amounts actually represent such Sterling amounts or could be converted into Sterling at the rate indicated. Except as where stated otherwise, the translation of US Dollars and cents to Sterling and pence appearing in this Annual Report has been made at the Bank of England exchange rate on the date indicated. On 23 February 2011, the Bank of England rate was US\$1.6238 per £1.

The Accounts of the Group in this Annual Report are presented in millions ( m ) unless otherwise indicated.

## Special Note Regarding Forward-Looking Statements

The Group's reports filed with, or furnished to, the US Securities and Exchange Commission (SEC), including this document and written information released, or oral statements made, to the public in the future by or on behalf of the Group, contain forward-looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995, that may or may not prove accurate. In particular, statements regarding expected revenue growth and trading margins discussed under Outlook and Trend Information, market trends and our product pipeline are forward-looking statements. Phrases such as aim, plan, intend, anticipate, well-placed, believe, estimate, expect, target, consider and similar expressions are generally intended to identify forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause actual results, to differ materially from what is expressed or implied by the 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; product 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 that affect us or our markets, including those of a political, economic, business or competitive nature. Specific risks faced by the Group are described under Risk Factors on page 18 of this Annual Report. Any forward-looking statement is based on information available to Smith & Nephew as of the date of the statement. All written or oral forward-looking statements attributable to Smith & Nephew are qualified by this caution. Smith & Nephew does not undertake any obligation to update or revise any forward-looking statement to reflect any change in circumstances or in Smith & Nephew's expectations.

## Market Data

Market data and market share estimates throughout this report are derived from a variety of sources including publicly available competitors' information, internal management information and independent market research reports.

## Documents on Display

It is possible to read and copy documents referred to in this Annual Report at the Registered Office of the Company. Documents referred to in this Annual Report that have been filed with the Securities and Exchange Commission in the US may be read and copied at the SEC's public reference room located at 450 Fifth Street, NW, Washington DC 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms and their copy charges. The SEC also maintains a web site at [www.sec.gov](http://www.sec.gov) that contains reports and other information regarding registrants that file electronically with the SEC. This Annual Report and some of the other information submitted by the Group to the SEC may be accessed through the SEC website.

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## DESCRIPTION OF THE GROUP

This section discusses the activities, resources and operating environment of the business under the following headings:

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Discussion of the Group's operating and financial performance, liquidity and financial resources for 2010 and 2009 is given in the Business Review, Liquidity and Prospects section (pages 23 to 44).

Discussion of the Group's management structure and corporate governance procedures is set out in the Corporate Governance Statement section (pages 45 to 57).

The Directors' Remuneration Report gives details of the Group's policies on senior management's remuneration in 2010 (pages 59 to 71).

Details of the structure of the Company's share capital and securities, persons with significant shareholdings in the Company and a summary of the articles of association are incorporated into the Directors' Report and are given in Investor Information (pages 135 to 149).

## THE BUSINESS

### HISTORY AND DEVELOPMENT

#### Group Strategy

Smith & Nephew's overall vision is to help improve people's lives by repairing and healing the human body. To achieve this, the Group is focused on continued delivery of sustainable profitable growth, through four strategic pillars:

**Customer led** : outperforming our served markets by focusing on our customers; anticipating and innovating to deliver on their needs.

**Efficient** : delivering operating margin improvement and freeing up resources to invest in the business, through streamlining process and systems re-engineering.

**Investing for growth** : driving additional sales from new opportunities such as emerging markets, biologics and adjacent technologies.

**Aligned** : aligning objectives across the business and developing our talent and organisation for consistent execution, through leveraging core functions and sharing best practices.

#### Group History

The Group has a history dating back over 150 years to the family enterprise of Thomas James Smith who opened a small pharmacy in Hull, England in 1856. On his death in 1896, his nephew Horatio Nelson Smith took over the management of the business.

By the late 1990s, Smith & Nephew had expanded into being a diverse healthcare conglomerate with operations across the globe, including various medical devices, personal care products and traditional and advanced woundcare treatments. In 1998, Smith & Nephew announced a major restructuring to focus management attention and investment on three global business units – advanced wound management, endoscopy and orthopaedics – which offered high growth and margin opportunities.

Smith & Nephew was incorporated and listed on the London Stock Exchange in 1937 and in 1999 the Group was also listed on the New York Stock Exchange. In 2001, Smith & Nephew became a constituent member of the FTSE-100 index in the UK. This means that Smith & Nephew is included in the top 100 companies traded on the London Stock Exchange measured in terms of market capitalisation.

Today, Smith & Nephew is a public limited company incorporated and headquartered in the UK and carries out business around the world.

## Recent Developments

On 10 February 2011, the Group announced that David Illingworth will retire from the Board and as Chief Executive, at the Annual General Meeting on 14 April 2011. It was also announced that Olivier Bohuon will join the Board as an executive director on 1 April 2011. He will offer himself for re-election by the shareholders at the Annual General Meeting and, subject to his re-appointment, shall assume the position of Chief Executive Officer at the conclusion of the Annual General Meeting on 14 April 2011.

In December 2010, the Group reviewed and replaced its principal banking facilities ahead of their maturity in May 2012. The Group has reduced its \$1 billion 5 year term loan to \$500 million with effect from 20 December 2010. Smith & Nephew has also cancelled its \$1.5 billion multi-currency revolving loan facility and replaced it with a new 5-year \$1 billion multi-currency revolving loan facility.

## BUSINESS DESCRIPTION

### Organisation

Smith & Nephew is organised into three primary Global Business Units ( GBUs ), which are also our reporting segments: Orthopaedics, Endoscopy and Advanced Wound Management. Included within the Orthopaedics segment are our biologics activities, which comprise research and development projects under the direction of a Committee representing all GBUs.

Smith & Nephew operates on a worldwide basis and has distribution channels in over 90 countries. In the more established countries by revenue, the Group's business operations are organised by GBU. In the majority of the remaining markets, operations are managed by country managers who are responsible for sales and distribution of the Group's product range. These comprise the emerging markets unit.

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



## Orthopaedics

### *Overview*

Orthopaedics comprises reconstruction, trauma and clinical therapies products.

The Orthopaedics business is 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, and the UK as well as by third-party manufacturers. A new facility has been constructed in Beijing, China.

### *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 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 a clinic setting and include 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. Other knee systems include the PLUS Solution Knee Family and PROFIX Knee. Our LEGION/GENESIS II and JOURNEY also utilise VISONAIRE Patient-Matched Instrumentation, a new 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. Oxidised 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 our VERILAST Technology. 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.

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**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 extremity.

For external fixation and limb restoration, Orthopaedics offers the TAYLOR SPATIAL FRAME Circular Fixation System and JET-X 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*

Orthopaedics maintains its commitment to being customer-led by focusing on product innovation, sales excellence and physician education. Whether through extending the life of implants, improving operating room efficiency, or promoting faster healing, Smith & Nephew's innovations differentiate it and provide solutions to active patients seeking to regain quality of life while enhancing economic value for customers. Orthopaedics provides peer-to-peer medical education, through KLEOS, tailored to individual surgeon needs utilising the world's top orthopaedic specialists and key opinion leaders. KLEOS is a medical education platform which offers seminars, fellowships, instructional videos and literature reviews.

The Orthopaedics business efficiency programmes continue to deliver savings to the business. The current programmes are focused on improving inventory utilisation, reducing sourcing costs, improving manufacturing efficiency, reducing overhead costs and ensuring continual efficiency improvement.

The emerging markets continue to be an important component of investing for growth, China in particular remains a focus with several milestones achieved in 2010 including opening a new manufacturing facility near Beijing, integration of product development teams into the franchises, and opening of three surgical training centres. Outside China, Orthopaedics 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.

The Orthopaedics 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.

### *New Products*

In Trauma, Orthopaedics launched the TRIGEN SURESHOT Distal Targeting System for Intramedullary Nailing which simplifies the surgical technique, reducing surgery time and fluoroscopic X-ray exposure. The VLP Foot and Ankle plating system, a comprehensive plate and screw system to manage fractures in the foot and ankle was also launched in the year bringing the advantages of variable angle plating to a rapidly growing segment of the market.

Reconstructive Orthopaedics continued the commercialisation of its VISIONAIRE Patient-Matched Instrumentation. 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.

### *Regulatory Approvals*

In 2010, several significant regulatory product and claims approvals were obtained around the globe.

In the US the SURESHOT Distal Targeting System for TAN Intramedullary Nails and accessories was approved. In Japan, the LEGION TKS Posterior Stabilized and Revision Systems, 12/14 Taper OXINIUM Femoral Heads, the PERI-LOC Titanium Plating System, and ECHELON Titanium Hip Stems were all approved. In the EU, we also received approval for the SURESHOT Distal Targeting System and VISIONAIRE Patient Matched Cutting Blocks. Also, in the EU, DUROLANE was approved for treatment of mild to moderate osteoarthritis in a broader range of joints and following joint arthroscopy.

In the US, the Orthopaedics business received 510(k) clearance from the FDA for VERILAST Technology wear claims for an estimated 30 years of normal use for the LEGION Primary Knee system.

Around the globe, 20 additional approvals and clearances were obtained, including amongst others: BHR instrument upgrades, R3 Acetabular system additions, VLP FOOT Plating Screw System and accessories, the JOURNEY Select Knee System and LEGION Porous Plus HA primary Femoral Components.

In Europe, regulatory approval was secured for EXOGEN for use on all osseous defects and DUROLANE for osteoarthritis pain relief in all synovial joints and for pain relief post arthroscopic surgery.

### *Seasonality*

Orthopaedic reconstruction revenues are lower in the third quarter of any year due to fewer elective surgeries in the summer and higher in the fourth quarter as elective surgeries increase. Reconstructive trauma revenues are generally highest in the fourth quarter caused to a large extent by the relatively high number of accidents and sports related injuries which occur in the autumn and winter seasons in North America and Europe.

*Market and Competition*

Smith & Nephew estimates that the worldwide orthopaedic market, excluding clinical therapies, served by the Group grew by approximately 4% in 2010 and is currently worth approximately \$17 billion per annum worldwide. Management believes that the Smith & Nephew Orthopaedics business holds an 11% share of this market by value. Principal global competitors in orthopaedics are Zimmer, Stryker, DePuy/Johnson & Johnson, Synthes and Biomet.

In 2010, weaker economic conditions worldwide continued to create several challenges for the overall orthopaedic market, including increased 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, 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.

Management estimates that the worldwide market for clinical therapies increased by 6% in 2010 and is currently worth more than \$1.7 billion per annum. Smith & Nephew's primary market for clinical therapies is in the US. In the US long bone stimulation market management estimates Smith & Nephew's share to be 40%. Principal competitors are Biomet, DJ Ortho and Orthofix. In the US joint fluid therapies market, management estimates that Smith & Nephew maintains a share of 14%. The principal competitors are Genzyme, Sanofi Aventis, DePuy/Johnson & Johnson and Ferring Pharmaceuticals.

## Endoscopy

### *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 or sports medicine sector of the endoscopy market. Arthroscopy is the minimally invasive surgery of joints, in particular the knee, shoulder and hip.

The Endoscopy business is headquartered in Andover, Massachusetts and manufacturing facilities are currently located in Mansfield, Massachusetts, and Oklahoma City, Oklahoma. Major service centres are located in the US, the 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 FAST-FIX for meniscal repair, ENDOBUTTON for cruciate fixation, and the FOOTPRINT Suture Anchor for rotator cuff repair. Key products in resection are the wide range of DYONICS shaver blades, ACUFEX handheld instruments, and a range of radiofrequency probes. The key product in Visualisation is the DYONICS 560 HD camera.

### *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 physicians, patients and payors, enhanced by a customer-led approach to growing the arthroscopy market.

To sustain growth and enhance its market position, the Endoscopy 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 also 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 2010, Smith & Nephew continued to expand its arthroscopic sports medicine portfolio with the launch of several new repair and resection products.

The BIORAPTOR Knotless Suture Anchor is a device used to repair a torn labrum in the hip and shoulder. The ease of use provided by this knotless arthroscopic device provides surgeons with full control over suture tension – a critical element in the procedure.

BIOSURE SYNC Tibial Fixation System is designed to address the need for strong fixation on the tibial side of ACL reconstruction. It employs a sheath and screw to achieve a 360° graft-to-bone contact throughout the tibial tunnel and can accommodate a variety of arthroscopic ligament reconstruction techniques.

The TWINFIX and FOOTPRINT suture anchor product lines were enhanced through the incorporation of ULTRABRAID suture, which provides stronger knot strength and a low profile knot stack. Both are designed to provide easy, secure and strong repairs with precise control over final tensioning and are available in a wide variety of materials and sizes.

#### *Recent Regulatory Approvals*

During 2010, the Endoscopy business obtained regulatory clearances for the following products in most major markets, except Japan where the approval process is more lengthy: FOOTPRINT Ultra PK, BIOSURE SYNC, TWINFIX Ultra HA, and TWINFIX Ultra Ti, all designed for 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 Japan, regulatory approvals included ENDOBUTTON CL Ultra, Ultra FAST-FIX KINSA RC and various TWINFIX suture anchors.

#### *Seasonality*

Smith & Nephew's Endoscopy revenues are generally at their highest in the fourth quarter of any year. This is caused to a large extent by the relatively high number of accidents and sports related injuries which occur in the autumn and winter seasons in North America and Europe.

#### *Market and Competition*

Management estimates that the global arthroscopy market in which the business principally participates is worth more than \$3 billion a year and has recently been growing between 8% and 12% 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 market has a particular focus on arthroscopic repair of the knee and shoulder using a broad range of technology. The Group also expects to benefit from the demand for less invasive approaches to arthroscopic hip repair.

Management believes that Smith & Nephew has a 22% share of the global arthroscopy market as at 31 December 2010. Smith & Nephew's main competitors in the global arthroscopy market in 2010 were Arthrex, Mitek/Johnson & Johnson, Stryker, Arthrocare and Linvatec/Conmed.

## **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 invasive surgery that impact the wider population.

The Advanced Wound Management business has its global headquarters in Hull, England and its North American headquarters in St Petersburg, Florida. The products are manufactured at facilities in Hull and Gilberdyke, England, 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, 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. NPWT 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.



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.

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.

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

### *New Products*

During 2010, the ALLEVYN hydrocellular dressings range was extended further, reinforcing our position as the company offering what we believe is the most comprehensive foam dressing solutions with the addition of ALLEVYN Lite. This new addition has the efficient fluid management properties of the existing ALLEVYN dressings and reduces pain on dressing removal for the patient, whilst improving comfort and wear through anatomical design.

The infection management portfolio was expanded in Japan in 2010, with further improvements to the already successful CADEX product and our first silver dressing entry in the market with ALGISITE Ag, giving a strong portfolio for future growth in the region.

### *Recent Regulatory Approvals*

During 2010, Advanced Wound Management secured approval for a new formulation of No Sting SKIN PREP, ALGISITE Ag in Japan, OPSITE Visible Drain dressing and NPWT dressing kits with ports in the EU and US. A new more conformable version of ALLEVYN Gentle Border, ALLEVYN Gentle Border Lite, was also approved in the EU and the US.

Approval was obtained in the EU and US for the manufacture of the complete range of ACTICOAT dressings at Advanced Wound Management's Hull facility following transfer of conversion and packaging from Alberta and for the manufacture of OPSITE Post Op Visible in Suzhou.

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We secured our first licence to sell domestically manufactured products in China following the transfer of ALLEVYN Adhesive manufacture to the Suzhou facility.

### *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 market worldwide was \$5.2 billion in 2010, an underlying increase of just under 4% from 2009. During 2010, the market 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 treatments is relatively unpenetrated and it is estimated that the potential market is significantly larger than the current market. 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 a 18% share of the advanced wound management market as at 31 December 2010. Worldwide competitors in advanced wound management in 2010 include Convatec, Mölnlycke, Systagenix and Kinetic Concepts, who are active exclusively in the NPWT market.

## OPERATING ACTIVITIES

### 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 specialised and multinational corporations, including some with greater financial, marketing and other resources.

The Group's customers reflect the wide range of distribution channels, purchasing agents and buying entities in over 90 countries worldwide. The largest single customers worldwide are the National Health Service in the UK and the Health Trust Purchasing Group in the US. These represented 6% and 5% respectively of the Group's worldwide revenue in 2010.

In the US, the Group's products are marketed directly to care givers, hospitals and other healthcare facilities with each business unit operating a separate specialised sales force. The US sales forces consist of a mixture of independent commissioned sales agents and direct employees. The independent agents are contractually not permitted to sell products that compete with Smith & Nephew's. Orthopaedics and Endoscopy products are principally shipped and invoiced directly to the ultimate customer. Advanced Wound Management products are marketed directly to the ultimate customer. The products are shipped and invoiced to a number of wholesale distributors. In most other direct markets, the business units typically manage employee sales forces directly, and also ship and invoice products both directly to the ultimate customer and to wholesale distributors.

The emerging markets unit comprises direct selling and marketing operations, directly and through distributors, in India, China, Hong Kong, South Korea, Malaysia, Singapore, Thailand, the United Arab Emirates and South Africa. 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. In countries not covered by the emerging markets unit, Smith & Nephew typically sells to third party distributors which market the Group's products locally.

### MANUFACTURING, SUPPLY AND 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 unit 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 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 SUPARTZ and DUROLANE joint fluid therapy products in the Orthopaedics business and screen displays, optical and electrical devices in the Endoscopy 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, US for Orthopaedics and Oklahoma City, US 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, England; and Atlanta, US.

## PROPERTY, PLANT AND EQUIPMENT

The table below summarises the main properties which the Group uses and their approximate areas.

|  | <b>Approximate area<br/>(Square feet 000 s)</b> |
|--|---|
| Group head office in London, England   | 15  |
| Group research facility in York, England   | 83  |
| Orthopaedics headquarters and manufacturing facilities in Memphis, Tennessee, US                             | 1,052   |
| Orthopaedics distribution facility in Memphis, Tennessee, US   | 210   |
| Orthopaedics manufacturing facility in Aarau, Switzerland  | 117   |
| Orthopaedics manufacturing facility in Beijing, China (Linhe)  | 21  |
| Orthopaedics manufacturing facility in Beijing, China  | 192   |
| Orthopaedics manufacturing and warehouse facility in Warwick, England  | 90  |
| Orthopaedics manufacturing and warehouse facility in Tuttlingen, Germany                                     | 63  |
| Orthopaedics and Endoscopy distribution facility and Orthopaedics European headquarters in Baar, Switzerland | 63  |
| Orthopaedics Biologics/ Global Operations headquarters in Durham, North Carolina, US                         | 27  |
| Endoscopy headquarters in Andover, Massachusetts, US   | 144   |
| Endoscopy manufacturing facility in Mansfield, Massachusetts, US   | 98  |
| Endoscopy manufacturing and distribution facility in Oklahoma City, Oklahoma, US                             | 155   |
| Advanced Wound Management headquarters and manufacturing facility in Hull, England                           | 439   |
| Advanced Wound Management manufacturing facility in Gilberdyke, England                                      | 70  |
| Advanced Wound Management manufacturing facility in Suzhou, China  | 144   |
| Advanced Wound Management manufacturing facility in Alberta, Canada  | 76  |
| Advanced Wound Management US headquarters in St. Petersburg, Florida, US                                     | 44  |

The Group Global Operations strategy includes ongoing assessment of the optimal facility footprint. The Orthopaedics headquarters and manufacturing facilities in Memphis, Tennessee are largely freehold, a portion of Tuttlingen and the Advanced Wound Management facilities in Hull and Gilberdyke are freehold while other principal locations are leasehold. The Group has freehold and leasehold interests in real estate in other countries throughout the world, but no other is individually significant to the Group. Where required, the appropriate governmental authorities have approved the facilities.

In 2010, Orthopaedics purchased a building in Cordova, Tennessee which will be its new headquarters and sales training building, and is exiting a smaller leasehold office facility in 2011. The Group closed the manufacturing facility in Largo, Florida during 2009 and outsourced or relocated its manufacturing output the building was sold in 2010. The Orthopaedics business has opened the new factory in Beijing, China, and the facility in Linhe is expected to close at the end of 2011. The Beijing factory will supply implants to the local market and orthopaedic instruments for export.

## RESEARCH AND DEVELOPMENT

The global business units each 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 all three operating segments. Expenditure on research and development amounted to \$151m in 2010 (2009 \$155m, 2008 \$152m), representing approximately 4% of Group revenue (2009 4%, 2008 4%).

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

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The Group's principal research facility located in York, England is now managed in conjunction with the Group's research facility in Durham, North Carolina, to provide research programmes that seek to underpin the longer-term technology requirements for its businesses and to provide a flow of innovative products. In-house research is supplemented by work performed by academic institutions and other external research organisations in Europe, America and Asia.

Product development is primarily carried out at the Group's principal locations, notably in Memphis, Tennessee and Aarau, Switzerland (Orthopaedics), Mansfield, Massachusetts (Endoscopy) and Hull, England (Advanced Wound Management).

## INTELLECTUAL PROPERTY

Smith & Nephew has a policy of protecting, with patents, 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, clinical therapies, 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. Currently, the Group's trademark portfolio consists of approximately 4,000 trademarks, trademark applications and design rights.

For each major product, Smith & Nephew's goal is to provide a collection of intellectual property, which may include patents, trade secrets and licences, that reduces the risk associated with failure of any individual piece of intellectual property. Most individual pieces of intellectual property protect a relatively small proportion of the Group's annual revenue. As a result, the Group tries to ensure that its overall business is not sensitive to the loss (however caused) of any single piece of intellectual property.

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.

## REGULATION

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.

The trend is towards more effective regulation and higher standards of technical appraisal. 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 delay 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 audit for compliance with national and Group medical device regulation and policies.

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Payment for medical devices is governed by reimbursement tariff agencies in various 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.

Management believes that the Group's operations currently comply in all material respects with applicable environmental laws and regulations. Although the Group continues to make capital expenditures for environmental compliance, it is not currently aware of any significant expenditure that would be required as a result of such laws and regulations that would have a material adverse impact upon the Group's financial position.



## THE BUSINESS AND THE COMMUNITY

### OUR COMMITMENT TO SUSTAINABILITY

#### Approach

Smith & Nephew recognises that companies have a wide responsibility to the community, the environment and the quality of life enjoyed by society at large. As a leader in its markets, Smith & Nephew believes it should also be a leader in setting and meeting standards of sustainable development. The Group monitors progress and views sustainable development as an integral part of the way the Group does business. We believe this because:

It reinforces our commitment to meeting regulatory obligations and reduces our risks.

It helps us to retain and recruit talented employees by demonstrating that we care about our people and our planet.

It enhances our reputation as a partner with our health care customers, collaboratively developing innovative solutions in the form of products and services.

It enables us to improve our operational efficiencies, thereby reducing costs as well as improving environmental outcomes.

It enables us to anticipate and prepare for over the horizon issues that will affect our customers and society at large.

It reinforces our role as a strong corporate citizen in the communities where we work and live.

It provides real value to our shareholders.

To further advance its commitment to sustainability, Smith & Nephew created a new executive position in 2010, the Senior Vice-President of Corporate Sustainability.

Smith & Nephew's approach to sustainability is governed by the policies and principles it has developed to cover four key areas of corporate and social responsibility, namely: corporate governance and business integrity; health, safety and environment; social responsibility and economic contribution. These policies and principles are available at [www.smith-nephew.com](http://www.smith-nephew.com).

## 2010 Highlights

Continued strong ranking in the Dow Jones Sustainability Index ( DJSI ) and membership of FTSE4Good.

Commenced registration for the UK Carbon Reduction Commitment.

Became an invited member of the World Environment Center as the first representative of the Health Care and Technology industry.

The Group has published a Sustainability Report since 2001. The 2011 Sustainability Report, which provides more comprehensive information on the actions and performance in the four key reporting areas during the last year, will be published on the Group's website in mid 2011 at [www.smith-nephew.com](http://www.smith-nephew.com).

## Corporate Governance and Business Integrity

See the Corporate Governance Statement section on pages 45 to 57 for a discussion of Smith & Nephew's governance structures and procedures.

Smith & Nephew aims to be honest and fair in all aspects of its business and expects the same from those with whom it does business. The Group's Code of Conduct and Business Principles governs the way it operates so that it respects stakeholders and seeks to build open, honest and constructive relationships. The Group takes account of ethical, social, environmental, legal and financial considerations as part of its operating methods. The Group has an independently operated whistle-blowing service in all jurisdictions in which the Group operates where such service is allowed.

## Our Environment

The Group's health, safety and environmental ( HSE ) commitment is to:

give due regard to the effects of its operations on the environment and community to create a sustainable business;

provide and maintain a safe and healthy work environment for employees, contractors and visitors;

require each of the Group's businesses to achieve the HSE standards specified by the HSE policy;

seek to improve HSE performance through continuous evaluation and development of measures to control risk, conserve resources and minimise waste; and

recognise, promote and reinforce the responsibility of employees, contractors and visitors to work safely and follow procedures.

Smith & Nephew recognises the importance of minimising the environmental impact arising from all aspects of the business and places emphasis on controlling its waste streams, use of energy and overall carbon emissions. Activities at a local and Group level remain key to ensuring our overall HSE performance. Annual targets are set and initiatives put in place to meet these performance goals.

Throughout 2010, operations continued to develop in China and Canada. Results associated with these locations are included for the first time this year.

While we report absolute performance data, we also provide data normalised for changes related to cost of production (using 2010 as the base year) to facilitate better year-on-year comparisons. Performance against the published targets for the key HSE parameters is also shown in the table below.

|  | 2010 actual | 2009 actual | 2010 target change | 2010 actual change (normalised) (iv) | Change over last 5 years (normalised) (iv) |
|--|-------------|-------------|--------------------|--------------------------------------|--|
| Energy Consumption (GWh)               | 168.9       | 157.4       | -5%                | 6.5%                                 | -1.9%                                      |
| Carbon Emissions (tonnes)              | 76,638      | 74,603      | No target          | 1.1%                                 | -10.9%                                     |
| Non-hazardous waste (tonnes)           | 3,297       | 4,917       | (i)                | -33.3%                               | -42.0%                                     |
| Hazardous waste (tonnes)               | 481         | 517         | (i)                | -9.7%                                | 61.5%                                      |
| Recycled waste (tonnes)                | 3,081       | 2,334       | (i)                | -                                    | -  |
| Total waste incl. recycled (tonnes)    | 6,859       | 7,768       | -5%                | -11.2%                               | -5.8%                                      |
| Water (1,000m <sup>3</sup> )           | 629         | 621         | No target          | -0.2%                                | -13.7%                                     |
| Lost time accidents incident rate (ii) | 0.53        | 0.57        | -5%                | -7.0%                                | 6.0%                                       |
| OSHA recordable incident rate (iii)    | 0.89        | 1.20        | -10%               | -26.0%                               | -36.0%                                     |

(i) There was no target for the reduction of specific waste streams. The Group target was for a 5% reduction in total waste.

(ii) Lost Time Accident Frequency Rate is measured as the number of accidents resulting in the loss of a day or more per 200,000 hours worked.

(iii) Occupational Safety & Health Administration ( OSHA ) definition measured as the number of incidents resulting in lost time, medical treatment (other than simple first aid), or modification to the persons work, per 200,000 hours worked.

(iv) Normalisation is based on Cost of Production which is defined as the Cost of Goods Sold adjusted for opening and closing inventory levels.

Energy consumption for the Group increased by over 6% in 2010, but this was largely attributable to 2010 representing the first full year of energy use reporting for the major global distribution centre in Memphis and the newly acquired facility in Alberta, Canada. Energy efficiency initiatives were effected at a number of locations, with particularly notable accomplishments at the Hull Advanced Wound Management site and Endo operations in Massachusetts and Oklahoma.

The Group emission of carbon dioxide was 76,638 tonnes. 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 electricity needs. While carbon dioxide emissions increased

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by approximately 1% in 2010, this was almost entirely related to the addition of the Memphis distribution facility and Alberta, Canada operations as noted above.

The business generated 3,297 tonnes of non-hazardous waste in 2010. While this represented a substantial decline (33%) from 2009 levels, 2009 represented an anomaly related to increased waste production associated with new construction and closure of a facility.

Over the last year, the amount of hazardous waste has reduced by 10% to 481 tonnes. The largest percentage reductions were achieved at the Advanced Wound Management site in Hull and the Research Centre in York.

Smith & Nephew continues to demonstrate a commitment to recycling; in 2010, our percentage of total waste that was recycled increased to 45% relative to 30% in the previous year. While these recycling initiatives were evident at many sites, the Memphis Orthopaedic facilities were noteworthy for their focus on scrap metals that resulted in diminished landfill costs and improved recycling revenue generation.

Water consumption throughout the Group remained largely unchanged relative to 2009. All sites continue to explore opportunities to minimise water use.

Workplace accidents decreased in 2010. Improvements were notable both in terms of lost time accident frequency rate (-7%) and the number of lost time accidents (46 relative to 58 in 2009). The OSHA recordable rate for the Group also continued to improve (26%). Both indicators of occupational accidents are below published industry average levels. The local HSE training plans continue to drive and promote safe working practices at all sites.

HSE audits were undertaken at six locations in 2010. These audits are a continuation of our protocol of assessing each of our facilities on a bi-annual schedule.

A full analysis of these measurements and key health and safety performance measures will be included in the 2011 Sustainability Report on the Group's website when it is published in mid 2011.

## Social Responsibility

### *Our People*

The Group's employment policies are based on equality of opportunity regardless of colour, creed, race, national origin, sex, age, marital status, sexual orientation, or mental or physical disability unrelated to the ability of the person to perform the essential functions of the job.

Smith & Nephew is committed to providing a healthy and safe working environment and operates a set of policies that ensure flexible, family-friendly practices and non-discrimination. It aims to provide an open environment based on constructive relationships and regular and timely dissemination of Group information and encourages feedback and ideas. Smith & Nephew carries out employee opinion surveys across the business. The aim of the surveys is to assess how aligned staff are to the Group's, and local GBU's strategy, to determine what we, as a business, do well and identify what could be improved. We also take the opportunity to test the effectiveness of Performance, Innovation and Trust as the declared company values.

The Human Resources (HR) Policy Framework provides a framework of key HR policies, values, behaviours and management principles that provide the structure within which the business units and global functions plan and deliver successful results. There is also an HR strategy which provides direction on how the Group intends to attract, retain and develop the right talent to meet business needs and create a culture that is aligned to Smith & Nephew values and deliver the Group's long term strategic plans.

### *Other employee engagement indicators*

In 2010, the Group continued to assess indicators of employee engagement. These measurements are a useful monitoring tool and alert mechanism for action as well as giving trend indicators of improved performance. The data below relates to the Group's US and UK population (approximately 60% of the total employees) as these regions have the most established and robust data collection processes in place.

**Positions filled by internal candidates through promotions** This measure is an indicator of how well the Group believes it is developing its employees and the success of the Group's internal recruitment policy. In 2010, the percentage of vacancies filled by internal applicants averaged 32% (2009 32%). The total for non-management positions was 29% (2009 29%) and for management positions was 52% (2009 51%). The Group target for all employees continues to be 40% (including management positions), which management believes is challenging but achievable. The Group has a policy of open advertising and providing opportunities for existing employees wherever possible, while recognising the need to bring in new ideas and approaches that external recruitment brings.

**Labour turnover** The Group measures various labour turnover rates. The average voluntary labour turnover rate during 2010 was 7.2%, a slight increase from the 2009 equivalent rate of 6.5%. The average involuntary labour turnover rate was 5.1% (2009 10.7%), which management believe is indicative of the Group's continuing management programme of efficiency improvements. This is aligned to continued investment in new markets and skills. An indicator of this is that the Group's headcount remained broadly unchanged on the prior year. In addition, the Group measures labour turnover relating specifically to employees who have been with the business for less than two years. This measure is an indication of how well the Group recruits and then retains its employees so that they can make a contribution to the business. The average voluntary turnover for employees leaving the Group within two years of joining was 10.9%, compared to 10.1% in 2009.

The Group is committed to providing training and information so that all employees can make the best contribution possible. To ensure that the Group continues to improve in this important area, the central global organisational development team continued their programmes to lead talent management, performance management and learning and development across the whole of the Group. Learning and development programmes are used to attract, retain and develop employees. These programmes are linked to formal performance appraisal and development planning. The Group operates training programmes under the banner of Management Excellence. These provide the key management skills required to be successful managers and leaders, covering the requirements of both new and experienced individuals. Additionally the Group has rolled out a global on-line learning resource and in 2011 will be expanding the programmes available to all employees.

The legal frameworks governing employee relations vary from country to country, as does custom and practice. Relations with trade unions are nationally determined and managed locally in line with the applicable legal framework and standards of good practice. The well-developed arrangements for interactions with trade union and worker councils provide the forum for productive discussion and collaborations with regard to collective bargaining agreements and other employment issues. It is the Group's policy to conform to the nationally determined arrangements. The Group does not use any form of forced, compulsory or child labour.

### *Our Communities*

Smith & Nephew values community involvement; it is an active member of its local communities and supports employees who undertake community work. The Group's principles for charitable giving are based on criteria relevant to its business, with priority given to medical education. Individual company sites support their local communities in a range of charitable causes giving donations of money, gifts in kind and employee time.

The Group realises that its technologies and products do not reach everyone. Project Apollo is a charitable and humanitarian service programme of the Orthopaedics business. This links up with physicians and non-profit groups engaged in medical philanthropy that receive donations of Smith & Nephew products through sponsorship and help from the Group's employees. By working in collaboration with these individuals and organisations, Smith & Nephew considers that this is a way of increasing the impact of its charitable giving and work it undertakes.

More examples of community support programmes supported by the Group are given in the Sustainability Report.

In 2010, direct donations to charitable and community activities totalled \$5,644,000 comprised of \$1,736,000 in cash and \$3,908,000 in product donations, primarily for Haiti earthquake relief efforts. This compares with \$1,866,000 of cash donations in 2009 and \$1,498,000 in 2008. 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. Additional work continues each year to improve the monitoring of supplier standards for service quality and activities relevant to their corporate responsibility including a diversity programme to promote long-term relationships with local or small business enterprises and minority-owned and women-owned business enterprises.

## **Economic Contribution**

Sustainability by definition includes economic success. 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 and reduced healthcare costs. 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 2010 included:

Our net sales in 2010 amounted to \$4.0 billion (2009 \$3.8 billion);

Smith & Nephew's employment of over 10,000 people globally is a substantial economic generator; our total wages and salaries in 2010 amounted to \$817m (2009 \$768m); and

We invested \$151m (2009 \$155m) in Research and Development to develop improved products and services.

## Looking Ahead

The Group is fulfilling an important role in the healthcare sector. Increased demands are being placed on healthcare systems by the demographic trends of an ageing population and as the problems with obesity become more widespread. More active lifestyles and the increased incidence of diabetes and other diseases also increase the demand for Smith & Nephew's products. In addition, developing and newly industrialised countries are increasing their demands for advanced products driven by similar demographic and health issues as developed nations.

Smith & Nephew's vision is to be the best in helping people regain their lives by improving and healing the human body. The Group believes that it can achieve this by setting and meeting ambitious performance targets, by constant innovation in products and services and by earning the trust of its stakeholders. The Group considers sustainability a journey, not an end point and is committed to that journey as an essential part of its long-term strategy.



## EMPLOYEES

The average number of full-time equivalent employees in 2010 was 10,172, of whom 1,625 were located in the UK, 4,247 were located in the US and 4,300 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:

|                           | 2010   | 2009  | 2008  |
|---------------------------|--------|-------|-------|
| Orthopaedics              | 5,045  | 4,853 | 4,840 |
| Endoscopy                 | 2,134  | 1,888 | 1,849 |
| Advanced Wound Management | 2,993  | 3,023 | 3,068 |
|                           | 10,172 | 9,764 | 9,757 |

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 25 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.

## RISK

### Management of Risk

As an integral part of planning and review, Group management and management of each of the GBUs 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 GBUs 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 management who have primary responsibility for managing each of these risks along with actions they have put in place to mitigate such risks.

### 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.

### Strategic Risk

#### *Highly Competitive Markets*

The Group's business units compete across a diverse range of geographic and product markets. Each market in which the business units 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 companies, 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 units 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 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 units operate. If the Group's new products do not remain competitive with those of competitors, the Group's sales revenue could decline.

There is a risk that a major disruptive technology could be introduced into one or more of the Group's markets and adversely affect its ability to achieve business plans and targets.

## External Risk

### *Dependence on Government and Other Funding*

In most 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 governed in most major markets largely 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 ongoing 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, recent changes to the health care 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 health care, 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, 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.

During 2010, economic conditions worldwide continued to create several challenges for the Group, including deferrals of joint replacement procedures, heightened pricing pressures and significant declines in capital equipment expenditures at hospitals. 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*

The Group uses the US Dollar as its reporting currency and the US Dollar is the functional currency of Smith & Nephew plc. In 2010, 43% (2009 44%) of Group revenue arose in the US, 26% (2009 27%) in Continental Europe, 24% (2009 21%) in Africa, Asia, Australia, Canada, New Zealand and Latin America, and 7% (2009 8%) in the UK.

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 currencies 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.

### *Stock Market Valuations*

Changing market conditions, both within the medical devices sector and in stock prices in general, may lead to volatility in the share price, or a stock market valuation of the Group which is materially less than the Group's intrinsic value. This may lead to difficulties in making acquisitions, an increased vulnerability to takeovers at below intrinsic value, and loss of value for our shareholders.

## Operational Risk

### *Manufacturing and Supply*

The Group's manufacturing production is concentrated at 11 main facilities in Memphis, Tennessee, Mansfield, Massachusetts and Oklahoma City, Oklahoma in the US, Hull, Warwick and Gilberdyke in the UK, Aarau in Switzerland, Tuttlingen 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 units 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 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 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.

## Compliance and Reporting Risk

### *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 adopted in 2010 that will increase risks 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](#). 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 Approvals and Controls*

The 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. The Group is required to comply with a wide range of regulatory controls over the manufacturing, testing, distribution, marketing and sale of its products, particularly in the US, Europe and China. Such controls have become increasingly demanding and costly to comply with and management believes that this trend will continue. At any time, the Group is awaiting a number of regulatory approvals which, if not received, could adversely affect results of operations. Regulatory approval of new products and new materials is required in most countries in which the Group operates, although a single approval may be obtained for all countries within the European Union. Regulatory approval of new products may entail a lengthy process, particularly if materials are employed which have not previously been used in similar products. In the US, the 510(k) process by which many of the Group's products are cleared for sale may be revised in ways that could lead to delays or increased costs. See [Regulation](#).

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.

## 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 20 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 into 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. The net impact of these changes in fair value on the Group's income statement is not significant.

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## BUSINESS REVIEW, LIQUIDITY AND PROSPECTS

The Business Review, Liquidity and Prospects discusses the operating and financial performance of the Group, including the financial outlook and the financial resources of the Group, under the following headings:

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| <u>2010 Year</u>   | 29 |
| <u>2009 Year</u>   | 34 |
| <u>Financial Position, Liquidity and Capital Resources</u> | 39 |
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The results for each year are compared primarily with the results for the preceding year.

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## BUSINESS OVERVIEW

Smith & Nephew's operations are organised into three primary business units that operate globally: Orthopaedics, Endoscopy and Advanced Wound Management. Smith & Nephew believes that its businesses have opportunities for strong growth due to its markets benefiting from an ageing population, an increase in active lifestyles, trends toward less invasive medical procedures and the increasing demand in emerging markets.

Revenue by business segment as a percentage of total revenue was as follows:

|                           | 2010 | 2009 | 2008 |
|---------------------------|------|------|------|
|                           | %    | %    | %    |
| Orthopaedics              | 55   | 57   | 57   |
| Endoscopy                 | 22   | 21   | 21   |
| Advanced Wound Management | 23   | 22   | 22   |
| Total revenue             | 100  | 100  | 100  |

Revenue by geographic market as a percentage of total revenue was as follows:

|  | 2010 | 2009 | 2008 |
|--|------|------|------|
|  | %    | %    | %    |
| United States                                  | 43   | 44   | 44   |
| Europe (Continental Europe and United Kingdom) | 33   | 35   | 36   |
| Africa, Asia and Australia and Other America   | 24   | 21   | 20   |
| Total revenue                                  | 100  | 100  | 100  |

## Underlying Growth in Revenue

Underlying growth in revenue is a non-GAAP financial measure which is a key performance indicator used by the Group's management in order to compare the revenue in a given year to that of the previous year on a like-for-like basis. This is achieved by adjusting for the impact both of sales of products acquired in material business combinations and for movements in exchange rates. 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.

Underlying growth in revenue reconciles to growth in revenue reported in accordance with IFRS by making two adjustments, the constant currency exchange effect and the acquisitions effect, described below. The material limitation of the underlying growth in revenue measure is that it excludes certain factors, described above, which do ultimately have a significant impact on total revenues. The Group measures the performance of local managers using underlying growth in revenue whilst the Group's management additionally considers GAAP revenue each quarter and further assesses the excluded items by monitoring against internal budget amounts.

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.

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.

Underlying growth in revenue in 2010 by business segment reconciles to reported growth, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

|                           | <b>Reported<br/>growth</b> | <b>Constant<br/>currency<br/>exchange<br/>effect</b> | <b>Underlying<br/>growth</b> |
|---------------------------|----------------------------|--|------------------------------|
|                           | <b>%</b>                   | <b>%</b>   | <b>%</b>                     |
| Orthopaedics              | 3                          | (1)  | 2                            |
| Endoscopy                 | 8                          | (1)  | 7                            |
| Advanced Wound Management | 8                          | (1)  | 7                            |
| Total revenue             | 5                          | (1)  | 4                            |

Underlying growth in revenue by business segment reconciles to reported growth in 2009 as follows:

|                           | <b>Reported<br/>growth</b> | <b>Constant<br/>currency<br/>exchange<br/>effect</b> | <b>Underlying<br/>growth</b> |
|---------------------------|----------------------------|--|------------------------------|
|                           | <b>%</b>                   | <b>%</b>   | <b>%</b>                     |
| Orthopaedics              | (1)                        | 2  | 1                            |
| Endoscopy                 | (1)                        | 2  | 1                            |
| Advanced Wound Management | -                          | 6  | 6                            |
| Total revenue             | (1)                        | 3  | 2                            |

## 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 affect 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.

Trading profit in 2010 reconciles to operating profit, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

|                           | <b>Operating<br/>profit</b> | <b>Restructuring<br/>and<br/>rationalisation<br/>costs</b> | <b>Amortisation<br/>of acquisition<br/>intangibles<br/>and<br/>impairments</b> | <b>Trading profit</b> |
|---------------------------|-----------------------------|--|--|-----------------------|
|                           | <b>\$ million</b>           | <b>\$ million</b>  | <b>\$ million</b>  | <b>\$ million</b>     |
| Orthopaedics              | 503                         | 8  | 25   | 536                   |
| Endoscopy                 | 197                         | 2  | 1  | 200                   |
| Advanced Wound Management | 220                         | 5  | 8  | 233                   |
| Total                     | 920                         | 15   | 34   | 969                   |



Trading profit reconciles to operating profit in 2009 as follows:

|                           | Operating<br>profit<br>\$ million | Acquisition<br>related costs<br>\$ million | Restructuring<br>and<br>rationalisation<br>costs<br>\$ million | Amortisation<br>of acquisition<br>intangibles<br>and<br>impairments<br>\$ million | Trading<br>profit<br>\$ million |
|---------------------------|-----------------------------------|--|--|---|---------------------------------|
| Orthopaedics              | 410                               | 26   | 26   | 46  | 508                             |
| Endoscopy                 | 169                               | -  | 5  | 15  | 189                             |
| Advanced Wound Management | 144                               | -  | 11   | 5   | 160                             |
| Total                     | 723                               | 26   | 42   | 66  | 857                             |

Trading profit by business segment as a percentage of total trading profit was as follows:

|                           | 2010 % | 2009 % | 2008 % |
|---------------------------|--------|--------|--------|
| Orthopaedics              | 55     | 59     | 62     |
| Endoscopy                 | 21     | 22     | 21     |
| Advanced Wound Management | 24     | 19     | 17     |
| Total trading profit      | 100    | 100    | 100    |

Operating profit by business segment as a percentage of total operating profit was as follows.

|                           | 2010 % | 2009 % | 2008 % |
|---------------------------|--------|--------|--------|
| Orthopaedics              | 55     | 57     | 61     |
| Endoscopy                 | 21     | 23     | 23     |
| Advanced Wound Management | 24     | 20     | 16     |
| Total operating profit    | 100    | 100    | 100    |

## Adjusted Earnings per Ordinary Share

Adjusted earnings per Ordinary Share is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affect the Group's short-term profitability. The most comparable financial measure calculated in accordance with IFRS is earnings per Ordinary share. The Group presents this measure to assist investors in their understanding of trends. Adjusted attributable profit is the numerator used for this measure.

Adjusted attributable profit is reconciled to attributable profit as follows:

|   | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million |
|---|--------------------|--------------------|--------------------|
| Attributable profit for the year                        | 615                | 472                | 377                |
| Acquisition related costs                               | -                  | 26                 | 61                 |
| Restructuring and rationalisation expenses              | 15                 | 42                 | 34                 |
| Amortisation of acquisition intangibles and impairments | 34                 | 66                 | 51                 |
| Taxation on excluded items                              | (10)               | (26)               | (30)               |
| Adjusted attributable profit                            | 654                | 580                | 493                |



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| <b>Earnings per Ordinary share</b> |       |       |       |
|------------------------------------|-------|-------|-------|
| Basic                              | 69.3¢ | 53.4¢ | 42.6¢ |
| Diluted                            | 69.2¢ | 53.3¢ | 42.4¢ |
| Adjusted: Basic                    | 73.6¢ | 65.6¢ | 55.6¢ |
| Adjusted: Diluted                  | 73.6¢ | 65.5¢ | 55.4¢ |

## 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 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 non-GAAP financial measures.

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

|  | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|--|-------------------|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Cash generated from operations                             | 1,111             | 1,030             | 815               |
| Less: Capital expenditure                                  | (315)             | (318)             | (292)             |
| Add: Cash received on disposal of fixed assets             | 8                 | -                 | 3                 |
| Add: Acquisition related expenditure                       | -                 | 22                | 48                |
| Add: Restructuring and rationalisation related expenditure | 16                | 32                | 28                |
| Add: Macrotecture expenditure                              | 5                 | 5                 | 10                |
| Trading cash flow  | 825               | 771               | 612               |
| Trading Profit   | 969               | 857               | 776               |
| Trading profit to cash conversion ratio (%)                | 85%               | 90%               | 79%               |

## Factors Affecting Smith & Nephew's Results of Operations

### *Sales Trends*

Smith & Nephew's business units participate in the global medical devices market and share a common focus on the repair of human tissue. Smith & Nephew's principal geographic markets are in the well-developed healthcare economies of the US, Europe, Japan and Australia.

These markets are characterised by an increase in the average age of the population caused by the immediate post-World War II 'baby boomer' generation approaching retirement, increased longevity, more active lifestyles, obesity and increased affluence. 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

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spending has led healthcare providers to demand products which minimise the length of hospital stays and use of surgeon and nursing resources.

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

For a description of the impact on each business unit refer to the Market and Competition sections under "Business Description" on pages 4 to 9.

### *Innovation*

The Group must continually develop its existing and new technologies and bring new products to its customers to drive sales growth. Expenditure on research and development in 2010 represented approximately 4% (2009 - 4%) of Group revenue. The focus of Smith & Nephew's innovation is to create new products and surgical techniques with distinct advantages in clinical performance and cost-effectiveness benefits for clinicians, patients and healthcare providers.

### *Currency Movements*

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 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'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. This exposure is offset partly because the Group incurs interest in currencies other than US Dollars on its indebtedness denominated in currencies other than US Dollars. See Financial Position, Liquidity and Capital Resources on page 39.

Governmental economic, fiscal, monetary and political policies and factors that materially affect the Group's operations or investments of shareholders are discussed in Regulation, External Risk, Compliance and Reporting Risk, Taxation information for shareholders on pages 12, 19, 21 and 145-146, respectively, and elsewhere in this Annual Report.

## **Critical Accounting Policies**

The Group's significant accounting policies are set out in Note 2 of the Notes to the Group Accounts. Of those, the policies which require the most use of management's judgment are as follows:

### *Inventories*

A feature of the Orthopaedics business (whose finished goods inventory makes up approximately 78% 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 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, 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 2010, a 0.5% increase in discount rate would have reduced the combined UK and US pension plan deficit by \$84m whilst a 0.5% decrease would have increased the combined deficit by \$93m. A 0.5% increase in discount rate would have decreased profit before taxation by \$2m whilst a 0.5% decrease would have increased it by \$2m. 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 \$33m. 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 a AA yield curve derived by the Group's actuarial advisers.

See Note 33 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.

## **2010 YEAR**

The following discussion and analysis is based upon, and should be read in conjunction with, the Group Accounts of Smith & Nephew included elsewhere in this Annual Report.

### **Financial Highlights of 2010**

Group revenue was \$3,962m for the year ended 31 December 2010, representing a 5% growth compared to 2009. This comprised of underlying revenue growth of 4% and favourable currency translation of 1%.

Profit before taxation was \$895m in 2010, compared with \$670m in 2009. Attributable profit was \$615m compared to \$472m in 2009. Adjusted attributable profit (calculated as set out in Selected Financial Data ) rose 13% to \$654m in 2010, from \$580m in 2009.

Basic earnings per Ordinary Share were 69.3¢, compared to 53.4¢ for 2009. EPSA (as set out in Selected Financial Data ) was 73.6¢ in 2010 compared to 65.6¢ for 2009, representing a 12% increase.

### **Fiscal 2010 Compared with Fiscal 2009**

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

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

- (i) Group revenue and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 32 to 34.
- (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 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).

### *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 decreased from \$1.39 to \$1.32 (5%), Sterling decreased from \$1.56 to \$1.54 (1%), the Swiss Franc increased from \$0.92 to \$0.96 (4%), the Australian Dollar increased from \$0.78 to \$0.92 (18%) and the Japanese Yen increased from ¥94 to ¥88 (6%).

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, purchases from the US became relatively more expensive for Europe and the UK and relatively less expensive for Australia, Japan and Switzerland. The Group's policy of purchasing forward a proportion of its currency requirements mitigated the impact of these movements.

### *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.

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 32 and 34.

### *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 our 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 32 to 34.

### *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.

*Group Balance Sheet*

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

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

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.

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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 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 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 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.

*Business Segment Analysis*

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

|  | <b>2010</b>       | <b>2009</b>       |
|--|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> |
| <b>Revenue by business segment</b>             |                   |                   |
| Orthopaedics                                   | 2,195             | 2,135             |
| Endoscopy                                      | 855               | 791               |
| Advanced Wound Management                      | 912               | 846               |
| Total revenue                                  | 3,962             | 3,772             |
| <b>Revenue by geographic market</b>            |                   |                   |
| United States                                  | 1,707             | 1,664             |
| Europe (Continental Europe and United Kingdom) | 1,315             | 1,313             |
| Africa, Asia, Australasia and other America    | 940               | 795               |
| Total revenue                                  | 3,962             | 3,772             |
| <b>Trading profit by business segment</b>      |                   |                   |
| Orthopaedics                                   | 536               | 508               |
| Endoscopy                                      | 200               | 189               |
| Advanced Wound Management                      | 233               | 160               |
| Total trading profit                           | 969               | 857               |
| <b>Operating profit by business segment</b>    |                   |                   |
| Orthopaedics                                   | 503               | 410               |
| Endoscopy                                      | 197               | 169               |
| Advanced Wound Management                      | 220               | 144               |
| Total operating profit                         | 920               | 723               |

## Orthopaedics

### *Revenue*

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 continued 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 has been continued pressure from the challenging environment on higher specification and early intervention hip and knee implant systems. Nevertheless, our knee

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franchise and in particular our 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 our 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 our hip franchise, both our traditional and new products have continued to perform well, led by the R3 Acetabular System. Sales of BIRMINGHAM HIP Resurfacing Systems have been weaker, but we are confident that our programme of reinforcing the superior clinical data with surgeons and patients will be effective.

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. Our joint fluid therapies franchise continues to perform well despite the increased competitive environment in the US. Early in 2010 we sold our niche pain management business and terminated our small spine distribution business in Germany, which reduced our Orthopaedics revenue growth by approximately 1%.

### *Trading profit*

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, primarily in the cost of sales area.

### *Operating profit*

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 ).

## **Endoscopy**

### *Revenue*

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 knee and shoulder 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 only focus on those capital items which are closely aligned with our core resection and repair businesses.

### *Trading profit*

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*

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.

## **Advanced Wound Management**

### *Revenue*

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 our Negative Pressure Wound Therapy ( NPWT ) product range, which we have continued to expand to offer customers a wide range of clinical options. Our 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 partially offset by 4% of unfavourable currency translation.

### *Trading profit*

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 our 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*

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.

## **2009 YEAR**

The following discussion and analysis is based upon, and should be read in conjunction with, the Group Accounts of Smith & Nephew included elsewhere in this Annual Report.

### **Financial Highlights of 2009**

Group revenue was \$3,772m for the year ended 31 December 2009, representing a 1% decline compared to 2008. Unfavourable currency translation of -3% was partly offset by underlying revenue growth of 2%.

Profit before taxation was \$670m in 2009, compared with \$564m in 2008. Attributable profit was \$472m compared with \$377m in 2008. Adjusted attributable profit (calculated as set out in Selected Financial Data ), rose 18% to \$580m in 2009, from \$493m in 2008.

Basic earnings per Ordinary Share were 53.4¢, compared to 42.6¢ for 2008. EPSA (as set out in Selected Financial Data ) was 65.6¢ in 2009 compared, to 55.6¢ for 2008, representing an 18% increase.

### **Fiscal 2009 Compared with Fiscal 2008**

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



|  | <b>2009</b>       | <b>2008</b>       |
|--|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> |
| Revenue (i)  | 3,772             | 3,801             |
| Cost of goods sold (ii)                            | (1,030)           | (1,077)           |
| Gross profit                                       | 2,742             | 2,724             |
| Marketing, selling and distribution expenses (iii) | (1,351)           | (1,416)           |
| Administrative expenses (iv)                       | (513)             | (526)             |
| Research and development expenses                  | (155)             | (152)             |
| Operating profit (i)                               | 723               | 630               |
| Net interest payable                               | (40)              | (66)              |
| Other finance costs                                | (15)              | (1)               |
| Share of results of associates                     | 2                 | 1                 |
| Profit before taxation                             | 670               | 564               |
| Taxation   | (198)             | (187)             |
| Attributable profit for the year                   | 472               | 377               |

- (i) Group revenue and operating profit are derived wholly from Continuing Operations and discussed on a segment basis on pages 37 to 38.
- (ii) 2009 includes \$15m of restructuring and rationalisation expenses and \$12m of acquisition related costs (2008 \$15m in respect of the utilisation of Plus inventory stepped-up to fair value on acquisition, \$18m of restructuring and rationalisation expenses and \$8m of acquisition related costs).
- (iii) 2009 includes \$7m of acquisition related costs and \$10m of restructuring and rationalisation expenses (2008 \$7m of acquisition related costs and \$3m of restructuring and rationalisation expenses).
- (iv) 2009 includes \$7m of acquisition related costs, \$17m of restructuring and rationalisation expenses and \$66m relating to amortisation of acquisition intangibles and impairments (2008 \$31m of acquisition related costs, \$13m of restructuring and rationalisation expenses and \$51m amortisation of acquisition intangibles and impairments).

### *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 weakened from \$1.46 to \$1.39 (-5%), Sterling weakened from \$1.84 to \$1.56 (-15%), the Swiss Franc remained flat at \$0.92, the Australian Dollar weakened from \$0.84 to \$0.78 (-7%) and the Japanese Yen strengthened from ¥103 to ¥94 (+9%).

The Group's principal manufacturing locations are in the US (Orthopaedics and Endoscopy), Switzerland (Orthopaedics) and UK (Advanced Wound Management and Orthopaedics). 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, purchases from the US became relatively more expensive. The Group's policy of purchasing forward a proportion of its currency requirements mitigates the impact of these movements.

### *Revenue*

Group revenue decreased by \$29m (-1%) from \$3,801m in 2008 to \$3,772m in 2009. Underlying revenue growth was 2%, offset by -3% attributable to unfavourable currency translation.

Orthopaedics revenues decreased by \$23m (-1%), of which 1% was attributable to underlying growth, offset by -2% due to unfavourable currency translation. Endoscopy revenues decreased by \$9m (-1%), of which 1% was attributable to underlying growth, offset by -2% due to unfavourable currency translation. Advanced Wound Management revenues increased by \$3m (nil%), of which 6% was attributable to underlying growth, offset by -6% due to unfavourable currency translation.

A more detailed analysis is included within the Revenue sections of the individual business segments that follow on pages 37 and 38.

### *Cost of goods sold*

Cost of goods sold decreased by \$47m to \$1,030m from \$1,077m in 2008. The main drivers of this decrease are continuing focus on cost efficiency, cost effectiveness and the impact of currency. Other factors contributing to the movement were the decrease of \$15m in utilisation of the Plus inventory stepped up to fair value on the acquisition, a decrease of \$3m in restructuring and rationalisation expenses, offset by an increase of \$4m in other acquisition related costs.

Further margin analysis is included within the Trading profit sections of the individual business segments that follow on pages 37 to 38.

### *Marketing, selling and distribution expenses*

These expenses decreased by \$65m to \$1,351m from \$1,416m in 2008. The decrease was largely driven by continuing focus on cost management, efficiencies achieved through the Earnings Improvement Programme and the impact of currency. These were partly offset by an increase in restructuring and rationalisation expenses of \$7m.

*Administrative expenses*

Administrative expenses decreased by \$13m to \$513m from \$526m in 2008, largely as a result of the focus on cost management and efficiency and the impact of currency. Other factors contributing to the movement were the decrease of \$24m in other acquisition related costs, offset by an increase in the amortisation and impairment charge of intangible assets by \$15m and an increase of \$4m in restructuring and rationalisation expenses.

*Research and development expenses*

Expenditure as a percentage of revenue increased by 0.1% to 4.1% in 2009 (2008 4.0%). The Group continues to invest in innovative technologies and products to differentiate itself from competitors.

*Operating profit*

Operating profit increased by \$93m to \$723m from \$630m in 2008 comprising, increase of \$28m in Orthopaedics, \$23m in Endoscopy and \$42m in Advanced Wound Management.

*Net interest payable*

Net interest payable decreased by \$26m from \$66m in 2008 to \$40m in 2009. 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 2009 were \$15m compared to \$1m in 2008. This increase is attributable to a decrease in the expected return on pension plan assets.

*Taxation*

The taxation charge increased by \$11m to \$198m from \$187m in 2008. The effective rate of tax was 29.6%, compared with 33.2% in 2008.

The tax charge was reduced by \$26m in 2009 (2008 \$30m) as a consequence of restructuring and rationalisation expenses, acquisition related costs, amortisation of acquisition intangibles and impairments. The effective tax rate was 27.9% (2008 30.6%) after adjusting for these items and the tax thereon. This is a lower rate than expected due to favourable progress in, and resolution of, certain historic issues.

*Group Balance Sheet*

The following table sets out certain balance sheet data for the years ended indicated:

|                              | <b>2009</b>       | <b>2008</b>       |
|------------------------------|-------------------|-------------------|
|                              | <b>\$ million</b> | <b>\$ million</b> |
| Non-current assets           | 2,480             | 2,523             |
| Current assets               | 2,071             | 1,985             |
| Assets held for sale         | 14                | -                 |
| Total assets                 | 4,565             | 4,508             |
| Non-current liabilities      | 1,523             | 1,841             |
| Current liabilities          | 863               | 968               |
| Total liabilities            | 2,386             | 2,809             |
| Total equity                 | 2,179             | 1,699             |
| Total equity and liabilities | 4,565             | 4,508             |

Non-current assets decreased by \$43m to \$2,480m from \$2,523 in 2008. Intangible assets and goodwill decreased by \$60m of which \$112m related to the Plus settlement, \$92m to amortisation and impairments and \$4m to disposals. These were offset by \$102m of additions, \$15m relating to the acquisition of Nucryst and \$31m relating to favourable currency translation. Property, plant and equipment increased by \$28m comprising \$216m of additions, \$30m of favourable currency

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translation and \$6m relating to the acquisition of Nucryst. This was offset by \$206m of depreciation charge, \$10m of disposals and \$8m of assets transferred to held for sale. Deferred tax assets decreased by \$12m in the year, primarily due to the decrease in post retirement obligations.

Current assets increased by \$86m to \$2,071m from \$1,985m in 2008. This was due to an increase in inventory of \$54m and an increase in cash at bank of \$47m. These increases were partially offset by a reduction in trade and other receivables of \$15m.

Non-current liabilities decreased by \$318m from \$1,841m in 2008 to \$1,523m in 2009. \$268m of this decrease was due to the reduction of long-term borrowings. The net retirement benefit obligation decreased by \$28m. This was due to experience gains on plan assets and liabilities totalling \$88m. These gains were offset by a \$47m increase in the defined obligation attributable to changes in actuarial assumptions and \$16m of unfavourable currency movements.

Current liabilities decreased by \$105m from \$968m in 2008 to \$863m in 2009. This was due to a decrease in bank overdrafts and current borrowings of \$70m, a decrease in trade and other payables of \$11m and decrease in current tax payable of \$25m.

Total equity increased by \$480m from \$1,699m in 2008 to \$2,179m in 2009. The principal movements were an increase of \$472m due to attributable profit, an increase in currency translation and hedging gains of \$62m, an increase of \$41m relating to actuarial gains on retirement benefit obligations, offset by \$10m relating to deferred taxation and \$120m due to dividends paid during the year.

*Business Segment Analysis*

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

|  | 2009<br>\$ million | 2008<br>\$ million |
|--|--------------------|--------------------|
| <b>Revenue by business segment</b>             |                    |                    |
| Orthopaedics                                   | 2,135              | 2,158              |
| Endoscopy                                      | 791                | 800                |
| Advanced Wound Management                      | 846                | 843                |
| Total revenue                                  | 3,772              | 3,801              |
| <b>Revenue by geographic market</b>            |                    |                    |
| Europe (Continental Europe and United Kingdom) | 1,313              | 1,398              |
| United States                                  | 1,664              | 1,657              |
| Africa, Asia, Australasia and other America    | 795                | 746                |
| Total revenue                                  | 3,772              | 3,801              |
| <b>Trading profit by business segment</b>      |                    |                    |
| Orthopaedics                                   | 508                | 481                |
| Endoscopy                                      | 189                | 166                |
| Advanced Wound Management                      | 160                | 129                |
| Total trading profit                           | 857                | 776                |
| <b>Operating profit by business segment</b>    |                    |                    |
| Orthopaedics                                   | 410                | 382                |
| Endoscopy                                      | 169                | 146                |
| Advanced Wound Management                      | 144                | 102                |
| Total operating profit                         | 723                | 630                |

## Orthopaedics

### *Revenue*

Orthopaedics revenue decreased by 1% to \$2,135m from \$2,158m in 2008. Of this decrease, 1% is attributable to underlying growth and -2% is due to unfavourable currency movements. The principal factors in the underlying growth in revenue were the continuing expansion in global orthopaedic markets and the growth of recently launched products.

In the US, revenue increased by \$27m to \$1,154m (2%), all of which was due to underlying growth. The main factors were the continued growth of products launched in recent years including the LEGION and JOURNEY knees.

Outside the US, revenue decreased by \$50m to \$981m (-5%), attributable to unfavourable foreign currency translation of -5% and flat underlying revenue growth.

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Global knee revenue increased by \$3m to \$761m (nil%), representing underlying revenue growth of 3% offset by -3% of unfavourable foreign currency translation.

Global hip revenue decreased by \$7m to \$681m (-1%) of which 1% was due to underlying revenue growth offset by -2% unfavourable foreign currency translation.

### *Trading profit*

Trading profit increased by \$27m (6%) to \$508m from \$481m in 2008. Trading profit margin increased from 22.3% to 23.8%. This increase is due to good cost management and further investment in improving the efficiency and effectiveness of the main processes, primarily in the cost of sales area.

### *Operating profit*

Operating profit increased by \$28m to \$410m. This largely comprises the increases in trading profit of \$27m. A decrease in acquisition related costs of \$35m were offset by increases of \$17m in costs associated with Earnings Improvement Programme ( EIP ) and \$17m in the amortisation of acquisition intangibles and impairments.

## Endoscopy

### *Revenue*

Endoscopy revenue decreased by \$9m, or 1%, to \$791m from \$800m in 2008, comprising -2% unfavourable currency translation and 1% underlying growth.

In the US, revenue decreased by \$23m to \$349m (-6%), all of which represents negative underlying growth. This is largely attributable to the decrease in demand for capital equipment due to the current economic market conditions.

Outside the US, revenue increased by \$14m to \$442m (3%), of which 9% was underlying growth offset by -6% of unfavourable foreign currency translation.

Global revenue of knee and shoulder repair products increased by \$13m to \$325m (4%), of which 12% was underlying growth offset by -8% unfavourable foreign currency translation.

Revenue in the global resection products sector decreased by \$29m to \$248m (-11%), of which -2% represents negative underlying revenue growth in addition to -9% of unfavourable foreign currency translation.

Global Visualisation revenue decreased by \$29m to \$121m (-19%), of which -20% represents negative underlying growth offset by 1% of favourable foreign currency translation.

### *Trading profit*

Trading profit increased by \$23m (14%) to \$189m from \$166m in 2008 resulting in a trading profit margin increase from 20.8% to 23.9%. This improvement was mainly due to a greater focus on managing costs and a favourable product mix benefit.

### *Operating profit*

Operating profit increased by \$23m to \$169m from \$146m in 2008. This comprises the \$23m increase in trading profit.



## Advanced Wound Management

### *Revenue*

Revenue increased by \$3m, or nil%, to \$846m from \$843m in 2008, comprising -6% unfavourable currency translation and 6% underlying growth. Within the infection management and exudate management markets, growth was driven by the extension of the Group's ALLEVYN brand to new products.

In the US, revenue increased by \$3m to \$161m (2%), all of which is attributable to underlying revenue growth.

Outside the US, revenue remained constant at \$685m. This is represented by an underlying growth of 7% offset by -7% of unfavourable foreign currency translation. European revenue decreased by 2% of which -8% was unfavourable currency translation and 6% was underlying growth.

### *Trading profit*

Trading profit increased by \$31m (24%) to \$160m from \$129m in 2008 and trading profit margin increased from 15.3% to 18.9%. This improvement was mainly due to a greater focus on cost management and overall process improvement.

### *Operating profit*

Operating profit increased by \$42m to \$144m. This largely comprises the increase in trading profit of \$31m and a reduction of \$10m in restructuring and rationalisation costs.

## 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:

|  | 2010       | 2009       | 2008       |
|--|------------|------------|------------|
|  | \$ million | \$ million | \$ million |
| Cash generated from operations   | 1,111      | 1,030      | 815        |
| Net interest paid  | (17)       | (41)       | (63)       |
| Income taxes paid  | (235)      | (270)      | (186)      |
| Net cash inflow from operating activities  | 859        | 719        | 566        |
| Capital expenditure (net of disposal of property, plant and equipment)                 | (307)      | (318)      | (289)      |
| Acquisitions (net of cash acquired)  | -          | (25)       | (16)       |
| Plus settlement  | -          | 137        | -          |
| Equity dividends paid  | (132)      | (120)      | (109)      |
| Proceeds from own shares   | 8          | 10         | 4          |
| Issue of ordinary share capital  | 15         | 7          | 19         |
| Treasury shares purchased  | (5)        | -          | (193)      |
| Change in net debt from net cash flow (see Note 27 of the Notes to the Group Accounts) | 438        | 410        | (18)       |
| Facility fee   | -          | -          | 2          |
| Exchange adjustment  | 13         | (21)       | (6)        |
| Opening net debt   | (943)      | (1,332)    | (1,310)    |
| Closing net debt   | (492)      | (943)      | (1,332)    |

The Group's net debt decreased from \$1,310m at the beginning of 2008 to \$492m at the end of 2010, representing an overall decrease of \$818m. 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 2010. Closing net debt includes no currency swap liabilities (2009 nil, 2008 \$4m).

### Net Cash Inflow from Operating Activities

Cash generated from operations in 2010 of \$1,111m (2009 \$1,030m, 2008 \$815m) is after paying out \$5m (2009 \$5m, 2008 \$10m) of macrotextured claim settlements unreimbursed by insurers, \$nil (2009 \$22m, 2008 \$48m) of acquisition related costs and \$16m (2009 \$32m, 2008 \$28m) of restructuring and rationalisation expenses.

### Capital Expenditure

The Group's ongoing 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 2010, gross capital expenditure amounted to \$315m (2009 \$318m, 2008 \$292m). The principal areas of investment were the placement of orthopaedic instruments with customers, patents and licences, plant and equipment and information technology.

At 31 December 2010, \$15m (2009 \$7m, 2008 \$27m) 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 2010, \$41m was spent on acquisitions, funded from net debt and cash inflows. This comprised \$25m for Nucrust, \$14m for BlueSky and \$2m for Plus. 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 an additional 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 their maturity in May 2012. The Group has reduced its \$1,000m 5 year term loan to \$500m with effect from 20 December 2010. Smith & Nephew has 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 2010, the Group held \$207m (2009 \$192m, 2008 \$145m) in cash and balances at bank. The Group has committed and uncommitted facilities of \$1,511m and \$332m respectively. Of the undrawn committed facilities totalling \$884m, \$7m expires in 2011 and \$877m 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 \$22m (of which \$10m 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, the share buy-back programme (announced as suspended in November 2008), timing of capital expenditure and working capital fluctuations.

Smith & Nephew believes that its capital expenditure needs and its working capital funding for 2011, 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 under funded position in the Group's defined benefit plans.

Further disclosure regarding borrowings, related covenants and the liquidity risk exposures is set out in Note 19 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.

## 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 Description of the Group section on pages 3 to 21. The financial position of the Group, its cash flows, liquidity position and borrowing facilities are described in the Business Review, Liquidity and Prospects section set out on pages 23 to 40. 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 ongoing 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.

## 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.

## 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 with the possible exception of those detailed below, 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 to date related to this matter is approximately \$212m. The Group has sought recovery from its insurers.

To date the primary insurance carrier has paid \$60m in full settlement of its policy liability. An additional \$22m was received from a successful legal settlement. At 31 December 2010, at least \$133m remains due, and the Group has sought coverage from five excess insurance carriers. However, these 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 2012.

A charge of \$154m was recorded in 2004 for anticipated expenses in connection with macrot texture claims. Most of that amount has since been applied to settlements of such claims. Management believes that the \$20m 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 units.

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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 foreign countries. The US Department of Justice subsequently joined the SEC's request. The Group is cooperating fully with the US Department of Justice and the SEC regarding these matters, has conducted a broader review on its own initiative, and has disclosed to them information indicating that at least one independent distributor of its products may have made payments that could have FCPA implications. The Group is engaged in discussions to resolve these matters which might include a settlement by which the Group would pay certain amounts and submit to compliance reporting and oversight obligations. There is no assurance that a settlement will be reached, however.

### 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 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 Texas a jury found that KCI's patents 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 KCI's asserted patents were valid and infringed. But the court determined the relevant patent claims were invalid and entered judgement in favour of the

Group. KCI has appealed the court's judgement. If KCI 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 Oregon decision was reversed on appeal and remanded to the District Court for a new trial, scheduled to begin in June 2011.

In a case filed in September 2008 in the US District Court for the Western District of Tennessee against the Group's US subsidiary, three individuals are seeking substantial royalty and other damages in connection with sales of certain products within the Group's Orthopaedics business based on various legal theories including alleged breach of contracts entered into in 1988-1999 and patent infringement. The Group disputes these claims. Trial is expected to commence in 2012.

## 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 another 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 Defense 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 our initial voluntary disclosure, a whistleblower suit was filed in the US District Court for Massachusetts alleging these violations. Smith & Nephew's motion to dismiss the suit was denied in November 2010.



## OUTLOOK AND TREND INFORMATION

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 this document.

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 Description on pages 4 to 9.

The Group has delivered another strong performance, with the majority of businesses outperforming their respective markets. The current market challenges are well understood. The Group is meeting them by supplying innovative products which offer clinical and cost benefit for our customers and continuing to execute efficiency programmes across our businesses. The long-term growth drivers underpinning the Group's industry including demographics, emerging markets and patients desire to return to an active life remain strong.

During 2011, the Group expects Orthopaedic Reconstruction to grow at above the market rate, as the momentum in our knee franchise is expected to continue. In Orthopaedic Trauma the Group made substantial improvements in 2010 and are committed to sustaining this performance. In Endoscopy the Group expects to achieve above market growth in Arthroscopy (sports medicine), driven by the repair product segment. In Advanced Wound Management the Group believes it will continue to grow at above the market rate.

The Group made further trading margin progress during 2010, achieving a trading profit margin of 23.9% (before the benefit of the BlueSky settlement), and continues to see many areas in our businesses which offer further efficiencies. The Group also sees an increasing number of investment opportunities to drive top line growth, both geographically and in new products. The Group is taking advantage of these opportunities and anticipates that in the short to medium term the cost of these investments will broadly offset our further efficiency savings.

The Group believes it has a clear, balanced, plan for the future, based on the same strategic pillars which have maintained growth and investment during the recent global cyclical downturn, while delivering significant margin improvement. We are confident that, by offering our customers the right product, at the right time with the right value proposition, we are positioned to continue to deliver long term growth.

## CONTRACTUAL OBLIGATIONS

Contractual obligations at 31 December 2010 were as follows:

|                               | <b>Total<br/>\$ million</b> | <b>Payments due by period</b>    |                                 |                                 |                               |
|-------------------------------|-----------------------------|----------------------------------|---------------------------------|---------------------------------|-------------------------------|
|                               |                             | <b>Less than</b>                 |                                 | <b>More than</b>                |                               |
|                               |                             | <b>1 year<br/>\$<br/>million</b> | <b>1-3 years<br/>\$ million</b> | <b>3-5 years<br/>\$ million</b> | <b>5 years<br/>\$ million</b> |
| Debt obligations              | 677                         | 53                               | 498                             | 126                             | -                             |
| Finance lease obligations     | 22                          | 4                                | 4                               | 4                               | 10                            |
| Operating lease obligations   | 166                         | 53                               | 59                              | 33                              | 21                            |
| Retirement benefit obligation | 75                          | 75                               | -                               | -                               | -                             |
| Purchase obligations          | -                           | -                                | -                               | -                               | -                             |
| Capital expenditure           | 15                          | 15                               | -                               | -                               | -                             |
| Other                         | 33                          | 33                               | -                               | -                               | -                             |
|                               | 988                         | 233                              | 561                             | 163                             | 31                            |

Other contractual obligations represent \$33m of foreign exchange contracts. Provisions that do not relate to contractual obligations are not included in the above table.

The agreed contributions for 2011 in respect of the Group's defined benefits plans are: \$38m for the UK (including \$29m of supplementary payments), \$30m for the US plan and \$7m for other funded defined benefit plans. The table above does not include amounts payable in respect of 2012 and beyond as these are subject to future agreement and amounts cannot be reasonably estimated.

There are a number of agreements that take effect, alter or terminate upon a change in control of the Company or the Group following a takeover, such as bank loan agreements and Company share plans. None of these are deemed to be significant in terms of their potential impact on the business of the Group as a whole. In addition, there are service contracts between the Company and its executive directors which provide for the automatic payment of a bonus following loss of office or employment occurring because of a successful takeover bid. Further details on page 66.

The company does not have contracts or other arrangements which individually are essential to the business.

## OFF-BALANCE SHEET ARRANGEMENTS

Management believes that the Group does not have any off-balance sheet arrangements, as defined by the SEC in item 5E of Form 20-F, that have or are reasonably likely to have a current or future effect on the Group's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

## RELATED PARTY TRANSACTIONS

Except for transactions with associates (see Note 34 of Notes to the Group Accounts), no other related party had material transactions or loans with Smith & Nephew over the last three financial years.

## CORPORATE GOVERNANCE STATEMENT

This section discusses Smith & Nephew's structures and governance procedures.

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## THE BOARD AND EXECUTIVE OFFICERS

The Board of directors of Smith & Nephew as at 23 February 2011 comprised:

| <b>Director</b>         | <b>Position</b>                             | <b>Initially elected or appointed</b> |
|-------------------------|---|---------------------------------------|
| John Buchanan           | Independent Non-Executive Chairman          | 3 February 2005                       |
| David J. Illingworth    | Executive Director, Chief Executive         | 8 February 2006                       |
| Adrian Hennah           | Executive Director, Chief Financial Officer | 15 June 2006                          |
| Ian E. Barlow           | Independent Non-Executive Director          | 5 March 2010                          |
| Geneviève B. Berger     | Independent Non-Executive Director          | 5 March 2010                          |
| Dr. Pamela J. Kirby     | Independent Non-Executive Director          | 1 March 2002                          |
| Brian Larcombe          | Independent Non-Executive Director          | 1 March 2002                          |
| Joseph C. Papa          | Independent Non-Executive Director          | 1 August 2008                         |
| Richard De Schutter     | Independent Non-Executive Director          | 1 January 2001                        |
| Dr. Rolf W. H. Stomberg | Independent Non-Executive Director          | 1 January 1998                        |

### Directors Biographies

John Buchanan, Independent non-executive Chairman. John was appointed independent non-executive Deputy Chairman in 2005 and became Chairman in April 2006 and is Chairman of the Nominations Committee. He is Deputy Chairman of Vodafone Group Plc and a non-executive director of BHP Billiton. He was formerly Group Chief Financial Officer of BP plc.

David J. Illingworth, Chief Executive, joined the Group in May 2002 as President of Orthopaedics and was appointed a director and Chief Operating Officer in February 2006. In July 2007 he was appointed Chief Executive. He is a member of the Nominations Committee. Prior to joining the Group he held posts within GE Medical, as Chief Executive Officer of a publicly traded medical devices company, President of a respiratory/critical care company and President of a technology incubator company. He will be retiring from the Board at the end of the Annual General Meeting to be held on 14 April 2011.

Adrian Hennah, Chief Financial Officer, joined the Group and was appointed a director in June 2006. He was previously Chief Financial Officer of Invensys plc and held various senior positions within GlaxoSmithKline. Adrian will be appointed as a member of the Supervisory Board of Reed Elsevier NV and as a non-executive director of Reed Elsevier PLC, subject to shareholder approval at their respective Annual General Meetings, on 19 and 20 April 2011.

Ian E. Barlow, Independent non-executive director. Ian was appointed a director on 5 March 2010 and is Chairman of the Audit Committee. He is a non-executive director and Chairman of the Audit Committees of the PA Consulting Group and the Brunner Investment Trust, Chairman of Think London and the Racecourse Association and a non-executive director of Candy & Candy. Previously he was Senior Partner, London at KPMG.

Prof. Geneviève B. Berger, Independent non-executive director. Geneviève was appointed a director on 5 March 2010. She is Chief Research & Development Officer at Unilever plc and Unilever NV having previously served as a non-executive director. Previously, she has been Chairman of the Health Advisory Board for the European Commission and a Professor at the University of Paris and Le Pitié-Sapêtrière Teaching Hospital and Director General of the French Centre National de La Recherche Scientifique. Subject to her re-appointment by the shareholders, she will join the Ethics and Compliance Committee on 14 April 2011.

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Dr. Pamela J. Kirby, Independent non-executive director. Pamela was appointed a director in March 2002 and is a member of the Remuneration and Ethics and Compliance Committees. She is non-executive Chairman of Scynexis Inc and a non-executive director of Informa plc, Novo Nordisk A/S and Victrex plc. Subject to her re-appointment by the shareholders, she will be appointed Chairman of the Ethics and Compliance Committee on 14 April 2011.

Brian Larcombe, Independent non-executive director. Brian was appointed a director in March 2002 and is a member of the Audit and Remuneration Committees. He is a non-executive director of gategroup Holding AG and Incisive Media Holdings Limited. Previously he was Chief Executive Officer of 3i Group plc.

Joseph C. Papa, Independent non-executive director. Joe was appointed a director in August 2008 and is a member of the Ethics and Compliance, Audit and Remuneration Committees. He is Chairman and Chief Executive of Perrigo Company. Previously he was Chairman and Chief Executive Officer of the Pharmaceutical and Technology Services segment of Cardinal Health Inc., and President and Chief Operating Officer of Watson Pharmaceuticals Inc. Subject to his re-appointment by the shareholders, he will be appointed Chairman of the Remuneration Committee on 14 April 2011.

Richard De Schutter, Independent non-executive director. Richard was appointed a director in January 2001 and is Chairman of the Ethics and Compliance Committee and a member of the Audit, Nominations and Remuneration Committees. He is non-executive Chairman of Incyte Corporation and a non-executive director of Navicure Inc. and Slate Pharmaceuticals. Subject to his re-appointment by the shareholders, he will be appointed Senior Independent Director and cease to be Chairman of the Ethics and Compliance Committee on 14 April 2011.

Dr. Rolf W. H. Stomberg, Independent non-executive director and Senior Independent Director. Rolf was appointed a director in 1998 and is Chairman of the Remuneration Committee and a member of the Audit and Nominations Committees. He is Chairman of Lanxess AG and a non-executive director of Hoyer GmbH, Biesterfeld AG and Severstal OAO. He will cease to be Senior Independent Director and Chairman of the Remuneration Committee on 14 April 2011.

## Executive Officers

The Chief Executive of Smith & Nephew and other senior executives are responsible for the day-to-day management of the Group. In addition to the executive directors, the following are executive officers of Smith & Nephew:

Naseem Amin, Chief Scientific Officer. Naseem joined the Group in 2009 prior to which he held a number of senior business development and research posts, most recently Senior VP of Business Development at Biogen Idec.

Mark Augusti, President of Biologics & Clinical Therapies. Mark joined the Group in 2003 as Vice President of Global Marketing for the Trauma Division, became President of Orthopaedic Trauma and Clinical Therapies in February 2006 and was appointed to his current role in January 2008. He previously worked for GE Medical Systems in the US and Asia. In 2009 Mark was also appointed to the board of Hutchinson Technology Inc. as an independent director.

John W. Campo, Chief Legal Officer. Jack joined the Group in June 2008. Prior to joining the Group he was employed by General Electric Company for 14 years in a variety of roles, including seven years with GE Healthcare (successor to GE Medical Systems) in the US and Asia.

Joseph DeVivo, President of Orthopaedics. Joe joined the Group in June 2007 as President of Orthopaedic Reconstruction and was appointed to his current role in May 2008. Prior to joining the Group, he held senior executive positions with RITA Medical Systems Inc., Computer Motion Inc. and United States Surgical, a division of Tyco Healthcare.

Michael Frazzette, President of Endoscopy. Mike joined the Group as President of Endoscopy in July 2006. Previously he was President and Chief Executive Officer of a US manufacturer of medical devices and spent 15 years at Tyco Healthcare becoming President of the Patient Care, THC Canada and Health Systems divisions.

R. Gordon Howe, Senior Vice President Global Planning and Development. Gordon joined the Group in 1998, and served in planning and business development roles in the Orthopaedics division. He was appointed to his current role in August 2007. Prior to joining the Group, he held management positions with United Technologies Corporation.

Kelvin Johnson, National Executive of China/President of Emerging Markets. Kelvin joined the Group in 1980 and has held a number of key roles within Smith & Nephew. His role as President of Emerging Markets was expanded during 2010 to lead the Group's increased focus in China. Prior to joining Smith & Nephew, Kelvin worked at the Ford Motor Company.

Roger Teasdale, President of Advanced Wound Management. Roger joined the Group in 1989 and has held a number of key roles in businesses within Smith & Nephew, most recently as Senior Vice President of Advanced Wound Management. Roger was appointed to his current role on 1 May 2009.

## Company Secretary

Susan Henderson, Company Secretary. Susan joined the Group in May 2009, prior to which she held a number of senior company secretarial positions at Amersham plc and Prudential plc.



## GOVERNANCE AND POLICY

### Introduction

The Board continues to be committed to the highest standards of Corporate Governance and this report together with the Directors' Remuneration Report explains how the provisions and principles of the FSA Listing Rules, Disclosure & Transparency Rules ( DTR ), the Combined Code on Corporate Governance (the Code ) and the UK Corporate Governance Code (the New Code ) have been applied throughout the year. The Company's American Depositary Shares are listed on the NYSE and the Company is therefore subject to the rules of the NYSE as well as the US securities laws and the rules of the SEC applicable to foreign private issuers.

The Board considers that it has complied with all relevant provisions of the Code, the New Code, and the requirements of the SEC and NYSE throughout the year, 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.

With effect from the Annual General Meeting in 2011, all directors will submit themselves for re-election at each Annual General Meeting in accordance with the New Code. Whilst the remaining provisions of the New Code do not currently apply to the Company, the Board considers that it does comply with the provisions of the New Code except that, although the Chairman and entire Board have endorsed and approved this corporate government statement, none of our directors use any part of the annual report to make personal statements.

In accordance with the Code, the following paragraphs describe Smith & Nephew's Corporate Governance policies and procedures and how it applies the main Principles set out in section one of the Code.

### The Board

The Board of directors of Smith & Nephew consists of a non-executive Chairman, two executive directors and seven independent non-executive directors. In 2010, the Board met on 10 occasions and individual attendance together with attendance at Board Committee meetings, is shown in the table on page 53. In addition to formal Board meetings, informal telephone updates are held between Board meetings to ensure that directors are kept up to date with matters affecting the Group.

Geneviève Berger and Ian Barlow joined the Board as independent non-executive directors on 5 March 2010.

On 10 February 2011, it was announced that Olivier Bohuon will be joining the Board as an Executive Director on 1 April 2011. He will offer himself for re-election by the shareholders at the Annual General Meeting and, subject to his re-appointment, will assume the position of Chief Executive Officer at the conclusion of the Annual General Meeting on 14 April 2011. David Illingworth will retire from the Board at the conclusion of the Annual General Meeting.

### The Scope of the Board

The Board is responsible for the strategic direction, overall management of the Group and the long-term success of the Company. There is a formal schedule of matters reserved for its decisions which include the approval of certain policies, budgets, financing plans, large capital expenditure projects, acquisitions, divestments and treasury arrangements. Otherwise, it delegates the executive management of the Group to the Chief Executive and certain specific responsibilities to Board Committees, as described on pages 50 to 53. It reviews the key activities and performance of the businesses and considers and reviews the work undertaken by the Committees. Succession planning is regularly reviewed and appropriate measures are taken to ensure the Board has the appropriate balance of skills and experience necessary for a major global medical devices company.

Non-executive directors meet regularly prior to each Board meeting without management in attendance. The Senior Independent Director meets with the other non-executive directors annually to evaluate the performance of the Chairman. All directors have access to the advice and services of the Company Secretary, who is also responsible to the Board for ensuring that board and governance procedures are complied with. The appointment and removal of the Company Secretary is a matter for the Board as a whole. Board members individually and Board Committees may obtain independent professional advice, at the Company's expense, where they judge it necessary in order to fulfil their responsibilities as directors. If directors are unable to attend a Board meeting or Board Committee meeting, they are advised of matters to be discussed and have an opportunity to make their views known to the Chairman or the Chairman of the relevant Committee prior to the meeting.

## The Role of Individual Directors

Whilst the Chairman and Chief Executive collectively are responsible for the leadership of the Group, there is a clear division of respective responsibilities which has been agreed by the Board. The Chairman's primary responsibility is leading the Board including setting its agenda and ensuring its effectiveness, by encouraging constructive challenge. The Chief Executive is responsible for the performance, management and supervision of the Group in accordance with the strategy, policies, budgets and business plans approved by the Board. The Senior Independent Director is currently Rolf Stomberg, whose role includes consulting with members of the Board on issues relating to the Chairman and chairing meetings of the Nominations and Audit Committee in the absence of the Chairman or Chairman of the Audit Committee. He is available to shareholders if they have concerns that cannot be resolved through the normal channels of contact with the Chairman or Chief Executive. Rolf Stomberg will cease to be the Senior Independent Director on 14 April 2011, when Richard De Schutter will, subject to his re-appointment by shareholders, be appointed in his place. The role of the independent non-executive directors is to provide constructive challenge and to help develop proposals on strategy.

## Independence of Non-Executive Directors

The Board has determined that all the non-executive directors are independent in accordance with UK and US requirements. None of the 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. They do not receive additional remuneration apart from directors' fees, do not participate in the Group's share option plans or performance related pay schemes, and are not members of the Group's pension schemes nor do they serve as a director of a company or an affiliate in which any other director of Smith & Nephew is a director.

The Board recognises that a number of the independent non-executive directors have served on the Board for a period of time that might be considered to impact on their independence. The Board has thoroughly considered the independence of each of these long serving directors (Rolf Stomberg, Richard De Schutter, Pamela Kirby and Brian Larcombe) and has concluded that each continues to provide effective challenge both within and outside Board meetings. In 2010, Ian Barlow and Geneviève Berger were appointed non-executive directors on 5 March 2010, and the search for additional directors continued throughout 2010 and into 2011. It is intended that as and when new directors are appointed and have spent some time settling into the Company, some of the longer serving non-executive directors will step down. The Board believes that to provide continuity, it is useful for some non-executive directors to remain on the Board to assist in the period of transition.

## Management of Conflicts of Interest

None of the directors or their 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 23 February 2011.

Each director has a duty under the Companies Act 2006 to avoid a situation in which he or she has or can 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 a director owes to the Company to disclose to the Board any transaction or arrangement under consideration by the Company. The Company's articles of association permit directors to authorise conflicts and potential conflicts in accordance with the Companies Act 2006 and to approve such situations. Directors inform the Board of any situations which may give rise to a conflict of interest as they arise and this information is recorded in the Company's Register of Conflicts together with the date on which authorisation was given. On an annual basis, directors certify that the information contained in the register is correct. The Board has a procedure when deciding whether to authorise a conflict or potential conflict of interest. Firstly, only directors who have no interest in the matter under consideration are able to take the relevant decision. Secondly, in taking the decision the directors must act in a way they consider, in good faith, will be most likely to promote the Company's success. In addition, the directors may

impose limits or conditions when giving authorisation if they think this is appropriate. During the year, one director identified situations which could give rise to conflicts of interest. Each of these situations was authorised by the Board, although no actual conflicts were identified.

## Re-appointment of Directors

Under the Company's articles of association, any director who has been appointed by the Board since the previous Annual General Meeting of shareholders, either to fill a casual vacancy or as an additional director, holds office only until the conclusion of the next Annual General Meeting at which they are eligible for re-appointment by the shareholders. In accordance with the New Code, with effect from the Annual General Meeting to be held in 2011, all directors will retire with effect from the conclusion of each Annual General Meeting and offer themselves for re-election at that meeting. However, David Illingworth will not seek re-election at the Annual General Meeting to be held on 14 April 2011. The directors are subject to removal with or without cause by the Board or the shareholders.

## Board Development Programme

A number of training and development opportunities were identified for the Board during 2010. As in previous years, training focused mainly on increasing the Board's understanding of the business and markets in which the Company operates. Throughout the year, each global business unit presented to the Board on its business and the current challenges it faced. These themes were explored in greater depth during the two day Strategy Review held in September. In November, the Board visited the headquarters of the Endoscopy business based in Andover, Massachusetts, meeting with the senior management team and major customers and receiving presentations on our products and processes. Two formal Board development sessions were also held which gave the Board technical briefings on, amongst other things, UK corporate governance requirements, the UK Bribery Act and remuneration trends and governance matters. Tailored induction programmes were also held for Geneviève Berger and Ian Barlow who joined the Board in 2010. These programmes included a series of site visits to some of our principal sites and one to one meetings with members of the senior management teams in the global business units and head office functions. All directors are encouraged to visit our principal sites and to meet with key members of staff to gain a more detailed understanding of particular areas of interest. The Chairman continues to keep the training and developmental needs of each director under review.

## Review into the Effectiveness of the Board

Towards the end of 2010, the Board undertook a review of its effectiveness and the effectiveness of its key Committees. The review was led by the Chairman and facilitated by the Company Secretary and took the form of a series of one to one discussions between the Company Secretary and individual Directors. These discussions focused on certain areas identified in the previous effectiveness review.

The review concluded that the Board operated well under the effective leadership of the Chairman. There was constructive debate within the Boardroom and directors were kept well advised of and consulted on relevant matters arising between meetings. The Board welcomed the opportunity to meet and engage with members of the management team at site visits and at the Strategy Review. The Effectiveness Review recognised that a number of improvements had been made to processes and communications during the year and has identified further improvements to be made throughout 2011.

## Committees of the Board

The Board is assisted by the Audit, Remuneration, Nominations and Ethics and Compliance Committees, each of which has its 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. For each of the Committees the Chairman of the Committee reports orally to the Board and minutes of the meetings are circulated to all members of the Board.

### Audit Committee

The principal duties of the Audit Committee are:

#### Finance and Accounting :

- to monitor the integrity of the Group's accounts, ensuring that they meet statutory and associated legal and regulatory requirements; this includes reviewing significant financial reporting judgments contained in them, reports on compliance with accounting standards, appropriate accounting policies and practices and any changes to these, accounting and reporting issues, going concern assumptions and anti fraud programmes and controls;

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- to monitor announcements relating to the Group's financial performance;

### Internal Controls:

- to monitor the effectiveness of internal financial controls and review compliance with s404 of the Sarbanes-Oxley Act 2002;
- to review the operation of the Group's risk management process;
- to monitor the control environment mitigating compliance and quality management system risk

### Audit:

- to monitor and review the effectiveness of the Group's internal audit function;
- to monitor and review the external auditors' performance, the effectiveness of the audit process and their independence, approving their terms of engagement, remuneration and ability to supply non-audit services and recommending for shareholder approval the appointment, re-appointment or removal of the external auditors, as appropriate;

Whistleblowing:

- to review the arrangements by which staff may raise complaints against the Group regarding financial reporting or other matters.

The members of the Audit Committee are Ian Barlow (Chairman and designated financial expert), Brian Larcombe, Richard De Schutter, Rolf Stomberg and Joseph Papa. Warren Knowlton served as Chairman of the Audit Committee up to 6 May 2010, when he retired from the Board. All members of the Audit Committee are considered to be independent in accordance with the Code and are qualified as financial experts as defined by the DTR, SEC and NYSE rules. The Chairman, Chief Executive and the Chief Financial Officer attend meetings of the Audit Committee by invitation but are not members of the Audit Committee.

The Audit Committee met five times during the year including discussions with the auditors, without management present.

For 2010, the Audit Committee considered quarterly reporting, the preliminary results and the Annual Report. Due consideration was given to compliance with accounting standards, appropriate accounting policies and practices, accounting and reporting issues, going concern assumptions and Section 404 of the Sarbanes-Oxley Act. The Audit Committee has also reviewed the appropriateness of the Group's principal accounting policies, practices and judgments, including the identification of critical accounting policies which are those requiring the most use of management's judgment which includes the valuation of inventories, impairment review of goodwill, intangible and tangible assets and the valuation of retirement benefits, contingencies and provisions. The Audit Committee also received a presentation from the Group Treasurer. During the year, the Audit Committee additionally took on responsibility for monitoring controls that mitigate quality management system risk.

During the year, no concerns were raised with the Audit Committee about possible improprieties in matters of financial reporting or other matters.

The Audit Committee reviewed the activities of the Internal Audit department, its programme of work and resourcing requirements. Specific activities of the Internal Audit department include; review of the internal controls over financial reporting (compliance with Section 404 of the Sarbanes-Oxley Act), assessing the operating effectiveness of the risk management process and review of other internal control processes, including regulatory compliance, quality management systems and the prevention and detection of fraud. The Audit Committee reviewed the Group's approach to internal financial control, its processes, outcomes and disclosures and considered the Group's risk management processes.

The Audit Committee also reviewed the work of the external auditors, Ernst & Young LLP, and received reports on the scope and outcome of the annual audit and management's response. These reports included accounting matters, governance and control and accounting developments. In addition, the Audit Committee reviewed the audit, audit-related, tax and other services provided by the external auditors and ensured that all services provided by the external auditors were pre-approved in accordance with the Auditor Independence policy explained in greater detail on page 55. As part of the review into the services provided by the auditors, the Audit Committee reviewed the independence, objectivity and effectiveness of the external auditors and was satisfied that it was appropriate to recommend to the Board their reappointment.

### **Remuneration Committee**

The members of the Remuneration Committee are Rolf Stomberg (Chairman), Pamela Kirby, Brian Larcombe (appointed to the Remuneration Committee on 7 September 2010), Richard De Schutter and Joseph Papa. Warren Knowlton also served on the Remuneration Committee up to 6 May 2010, when he retired from the Board. With effect from 14 April, Rolf Stomberg will cease to be Chairman of the Remuneration Committee and Joseph Papa will, subject to his

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re-appointment by the shareholders, be appointed Chairman in his place. All members of the Remuneration Committee are considered to be independent in accordance with the Code, the New Code and SEC and NYSE requirements.

The Remuneration Committee met four times during the year. The principal duties of the Remuneration Committee are reviewing:

the remuneration, including pension entitlements, of executive directors and executive officers;

the relationship between the remuneration of executive directors and that of other employees;

the competitiveness of executive remuneration using data from independent consultants on companies of similar size, technologies and international complexity;

the performance targets for the incentive plan and long-term incentive plans and the performance against these targets; and

the operation of the long-term incentive plans, share option plans and performance related incentive plan, determining the participants and overall grant levels.

The activities of the Remuneration Committee throughout 2010 are described in greater detail in the Directors Remuneration Report on pages 59 to 71.



## **Nominations Committee**

The members of the Nominations Committee are John Buchanan (Chairman), David Illingworth, Rolf Stomberg and Richard De Schutter. Rolf Stomberg and Richard De Schutter are considered to be independent in accordance with the Code, the New Code and SEC and NYSE requirements. David Illingworth will cease to be a member of the Nominations Committee when he retires from the Board on 14 April 2011 and Olivier Bohuon will, subject to his re-appointment by the shareholders, be appointed in his place.

The Nominations Committee met eight times during the year and those meetings were attended by all members.

The principal duties of the Nominations Committee are:

to review the Board structure, size and composition and to make recommendations to the Board accordingly;

to identify and nominate suitable candidates to the Board to fill any Board vacancies as they arise, evaluating the balance of skills, knowledge and experience currently on the Board and which may be required in the future;

to make recommendations to the Board on the continuation in office, or otherwise, of any executive director or non-executive director;

to make recommendations to the Board regarding membership of the Board Committees and the fees paid to non-executive directors; and

to consider and if thought fit approve the appointment of any executive director as a non-executive director of another company.

The principle work of the Nominations Committee in 2010 was to search for a Chief Executive Officer to replace David Illingworth, who had indicated his desire to retire as and when a suitable successor could be found. A thorough search was undertaken using the services of an external firm of headhunters and internal candidates were also considered. A number of meetings were held to define the role and the type of Chief Executive Officer required, to discuss potential candidates and, in 2011, finally to consider making a recommendation to the Board to appoint Olivier Bohuon.

The Nominations Committee also continued the process commenced in 2009 to search for new non-executive directors, recognising that a number of non-executive directors have served on the Board for periods of time which could give rise to questions about their continued independence. Ian Barlow and Geneviève Berger were appointed to the Board as non-executive directors in March 2010. The search however has continued for additional directors to fit the profiles prepared by the full Board in 2009. The services of a headhunting firm were utilised in this process and whilst a number of candidates were considered, no further appointments were made. The search will continue into 2011.

Should the need arise, the Senior Independent Director would oversee the process for the appointment of a new Chairman.

## **Ethics and Compliance Committee**

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The members of the Ethics and Compliance Committee are Richard De Schutter (Chairman), Pamela Kirby and Joseph Papa. All members of the Committee are considered to be independent in accordance with the Code, the New Code and SEC and NYSE requirements. David Illingworth, Chief Executive, attends every meeting. With effect from 14 April 2011, subject to their re-appointment by shareholders, Pamela Kirby will replace Richard De Schutter as Chairman of the Ethics and Compliance Committee and Geneviève Berger will join the Committee as an additional member.

The Ethics and Compliance Committee met four times during the year.

The principal duties of the Ethics and Compliance Committee are:

to review and approve Group policies as they relate to ethics and compliance matters;

to receive reports and review activities from executive and specialist groups managing ethical and compliance matters across the Group's operations;

to review and approve implementation of ethics and compliance programmes;

to receive and review reports of audits and monitoring of ethics & compliance procedures and processes;

to review ethics and compliance best practice and continuous improvement programmes by reference to appropriate external reports and benchmarking;

to review, where appropriate, the Group's internal communications and training in relation to ethics and compliance policies and procedures;

to review the Group's external communication and reporting in respect of ethics and compliance programmes and the operation of the Committee;

to review the integration of ethics and compliance procedures with the business risk management programme; and

to review and approve ethics and compliance strategy and plans.

During the year, the Ethics and Compliance Committee has:

monitored the continued roll-out of the Enhanced Global Compliance Programme;

reviewed progress in enhancing precautions with regard to third party sellers;

received reports from management in relation to progress made under the Enhanced Global Compliance Programme, the activities of the US and Global Compliance programmes and concerns raised through the Group's hotline and other channels; and

considered the impact of the UK Bribery Act.

## Board and Committee Attendance

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

|                          | <b>Board<br/>10 meetings</b> | <b>Remuneration<br/>Committee<br/>4<br/>meetings</b> | <b>Audit<br/>Committee<br/>5 meetings</b> | <b>Nominations<br/>Committee<br/>8<br/>meetings</b> | <b>Ethics<br/>and<br/>Compliance<br/>Committee<br/>4<br/>meetings</b> |
|--------------------------|------------------------------|--|---|---|---|
| John Buchanan            | 10                           | -  | -   | 8   | -   |
| David J. Illingworth     | 10                           | -  | -   | 8   | -   |
| Adrian Hennah            | 10                           | -  | -   | -   | -   |
| Ian Barlow (i)           | 8                            | -  | 3   | -   | -   |
| Geneviève B. Berger (i)  | 8                            | -  | -   | -   | -   |
| Pamela J. Kirby          | 10                           | 4  | -   | -   | 4   |
| Brian Larcombe (ii)      | 10                           | 2  | 5   | -   | -   |
| Warren D. Knowlton (iii) | 2                            | 1  | 3   | -   | -   |
| Joseph C. Papa (iv)      | 9                            | 4  | 5   | -   | 4   |
| Richard De Schutter      | 10                           | 4  | 5   | 8   | 4   |
| Rolf W. H. Stomberg (iv) | 8                            | 4  | 5   | 8   | -   |

(i) Joined the Board on 5 March 2010.

- (ii) Appointed to the Remuneration Committee on 7 September 2010.
- (iii) Resigned from the Board on 6 May 2010
- (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 the Committee.

## 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 2010, the executive directors held meetings with institutional investors, including investors representing approximately 54% of the share capital as at December 2010. As part of this programme of investor meetings, during 2010, John Buchanan, the Chairman, met with investors representing 11% of the share capital. Over the last three years, he has met investors representing in aggregate 35% of the share capital. 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.

## Directors Indemnity Arrangements

Appropriate directors and officers liability insurance is in place and Deeds of Indemnity have been entered into between the Company and directors and certain directors of some subsidiary companies. The Deeds of Indemnity allow for indemnification of directors in respect of proceedings brought by third parties and for the Company to provide funds for directors' ongoing costs in defending a legal action as they are incurred rather than after judgement has been given. Individual directors would still be liable to pay any damages awarded to the Company in an action against them and to repay their defence costs to the extent funded by the Company if their defence were unsuccessful.

## Share Capital

As at 23 February 2011, the Company's total issued share capital with voting rights consisted of 892,091,804 Ordinary Shares of 20 US cents each. 61,720,798 Ordinary Shares are held in treasury and are not included in the above figure.

As at 23 February 2011, notification had been received from the undernoted persons under the DTR in respect of interests in 3% or more of the issued Ordinary Shares of the Company.

|                                      | Number of Shares | %    |
|--------------------------------------|------------------|------|
| Capital Group of Companies Inc       | 44,594,320       | 5.05 |
| Legal and General Group plc          | 44,704,245       | 5.02 |
| Newton Investment Management Limited | 44,337,465       | 4.98 |
| BlackRock, Inc                       | 42,101,761       | 4.73 |

Other than disclosed above, 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 9.82 US cents per share which, together with the first interim dividend of 6.00 US cents, makes a total for 2010 of 15.82 US cents. The final dividend is expected to be paid, subject to shareholder approval, on 19 May 2011 to shareholders on the register of Members at the close of business on 3 May 2011.

## Annual General Meeting

The Company's Annual General Meeting is to be held on 14 April 2011 at 2pm at The Royal Society, 6-9 Carlton House Terrace, London, SW1Y 5AG. Notice of the meeting has been sent to all registered shareholders with an accompanying letter from the Chairman.

## Directors Report

The Directors Report includes the following sections: Description of the Group (pages 3 to 21), Business Review, Liquidity and Prospects (pages 23 to 44), Corporate Governance Statement (pages 45 to 57), Directors Remuneration Report (pages 59 to 71) and Investor Information (pages 135 to 142).

## 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](http://www.smith-nephew.com).

## ACCOUNTABILITY, AUDIT AND INTERNAL CONTROL FRAMEWORK

### Internal Control and Risk Management

The Board has overall responsibility for ensuring that the Group maintains an adequate system of internal control and risk management and for reviewing its effectiveness. The Internal Audit function and the Group Risk Committee consider and test effectiveness and report to the Audit Committee and to the Board respectively on their findings. The Board has reviewed the system of internal control, including financial control for the year ended 31 December 2010 and up to the date of approval of this Annual Report and Accounts. The Group's system of internal control is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

### Risk Committee

The members of the Risk Committee are the executive directors, certain senior executives and the Company Secretary. The Chairman of the Committee is the Chief Executive. As an integral part of planning and review, the management of each of the Global Business Units identifies the risks involved in their business, the probability of those risks occurring, the impact if they do occur and the actions being taken to manage and mitigate those risks. The Risk Committee meets twice a year to review the major risks identified by the Global Business Units 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 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 reported to the Board as appropriate. The principal risks identified through this process are detailed in Risk Factors to be found on pages 18 to 21.

### Audit Committee

The activities of the Audit Committee are described in greater detail in pages 50 to 51.

The Audit Committee reviews the Group's approach to internal financial control and the operation of the risk management process. During 2010, the effectiveness of the Global Business Units' systems to identify and manage material risks was evaluated and the findings were reported to the Audit Committee. No material weaknesses were identified in these systems.

### Auditor Independence Policy

The Audit Committee has adopted an Auditor Independence Policy which forms part of the Committee's Terms of Reference. This policy governs the conduct of non-audit work by the external auditors. This prohibits the auditors from performing services which would result in the auditing of their own work, participating in activities normally undertaken by management, acting as advocate for the Group and creating a mutuality of interest between the auditors and the Group, for

example being remunerated through a success fee structure. Each year, the Audit Committee pre-approves the budget for fees relating to audit and non-audit work, including taxation 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, approval by the Chairman of the Audit Committee is required, together with a notification to the Audit Committee of the service and the fees involved. All services provided by the independent 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. Partners and senior audit staff may not be recruited by the Group unless two years have expired since their previous involvement with the Group.

## Management's Report on Internal Control over Financial Reporting

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.

Because of inherent limitations, internal controls over financial reporting may not prevent or detect all mis-statements. In addition, 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.



In accordance with the requirement in the US under s404 of the Sarbanes-Oxley Act, management assessed the effectiveness of the Group's internal control over financial reporting as at 31 December 2010. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission in Internal Control-Integrated Framework. Based on its assessment, management has concluded and hereby reports that, as at 31 December 2010, the Group's internal control over financial reporting is effective based on those criteria.

Ernst & Young LLP, an independent registered public accounting firm, has issued an audit report on the Group's internal control over financial reporting as of 31 December 2010. This report appears on page 79.

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.

## Disclosures Committee and Evaluation of Disclosure Controls and Procedures

The Disclosures Committee is chaired by the Chief Executive and comprises the Chief Financial Officer and various additional senior executives. The secretary is the Company Secretary or her designate. The Committee meets as required and approves the release of all major communications to investors, to the UK Listing Authority and the London and New York Stock Exchanges.

The Chief Executive 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 2010. Based upon, and as at the date of that evaluation, the Chief Executive and Chief Financial Officer concluded that the disclosure controls and procedures were effective.

## Code of Conduct

The revised Code of Conduct approved by the Ethics and Compliance Committee was issued to all employees during 2010. The Code of Conduct 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 a whistle blowing policy which enables persons in all jurisdictions where the Group operates to contact the Group 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.

## Code of Ethics for Senior Financial Officers

The Board of directors has 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. It applies to the Chief Executive, 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 2010 or up until 23 February 2011.

## 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:

|                    | 2010       | 2009       |
|--------------------|------------|------------|
|                    | \$ million | \$ million |
| Audit              | 3          | 3          |
| Audit related fees | -          | -          |
| Tax                | 2          | 2          |
| Other              | -          | -          |
|                    | 5          | 5          |

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 35 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.

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## DIRECTORS REMUNERATION REPORT

The Directors Remuneration Report (the Report) has been prepared in accordance with The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the Regulations) and 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 14 April 2011.

### The Remuneration Committee Membership and Meetings

The members of the Remuneration Committee are Rolf Stomberg (Chairman) Pamela Kirby, Brian Larcombe (appointed to the Remuneration Committee on 7 September 2010), Joseph Papa and Richard de Schutter. Warren Knowlton also served as a member of the Remuneration Committee up to 6 May 2010, when he retired from the Board. With effect from 14 April 2011, Rolf Stomberg will cease to be Chairman of the Remuneration Committee and will be replaced by Joseph Papa. All members of the Committee are non-executive directors and are considered by the Board to be independent in accordance with the Combined Code, the UK Corporate Governance Code and the requirements of the SEC and the NYSE. The Company Secretary acts as secretary to the Remuneration Committee.

The Remuneration Committee met four times during the year and each meeting was attended by all members. In addition, the Remuneration Committee agreed on certain resolutions by e-mail when unable to meet physically.

At the request of the Remuneration Committee, the Chairman, John Buchanan, the Chief Executive, David Illingworth and various members of the Human Resources function were invited to attend meetings of the Remuneration Committee throughout the year. David Illingworth and the Human Resources function advise the Remuneration Committee on all aspects of the Group's reward structures and policies and John Buchanan offers a valuable perspective given his experience on the Boards of other companies. None of these directors or officers is present for any discussion concerning their own remuneration.

During the year, the Remuneration Committee received information from a number of independent consultants appointed by the Company: Deloitte LLP on a broad range of remuneration issues and on long-term incentive plan comparative performance and Towers Watson and Mercer Limited on salary data when considering base salaries of executive directors and executive officers. Deloitte LLP also provided taxation advice to the Group, while Towers Watson and Mercer Limited have provided general salary data and advised on various compensation matters below Board level. None of these advisors advised any director in respect of their own remuneration.

### The Role of the Remuneration Committee

The terms of reference of the Remuneration Committee are available on the Group's website at [www.smith-nephew.com](http://www.smith-nephew.com).

The Remuneration Committee reviews:

The remuneration, including pension entitlements, of executive directors and executive officers;

The relationship between the remuneration of executive directors and that of other employees;

The competitiveness of executive remuneration using data from independent consultants on companies of similar size, technologies and international complexity;

The performance targets for the bonus plan and long-term incentive plans and the performance against these targets; and

The operation of the long-term incentive plans, share option plans and performance related bonus plan, determining the participants and overall grant levels.

## Remuneration Policy

The remuneration policy as approved by the Remuneration Committee and the Board is designed to ensure that remuneration is sufficiently competitive to attract, retain and motivate executive directors and executive officers of a calibre that meets the Group's needs to achieve its business objectives. The policy is designed to ensure that remuneration is firmly linked with the success of the Group and achievement against the Group's key performance indicators, so that executive directors and executive officers are suitably incentivised to generate long-term and sustainable value for shareholders.

The Remuneration Committee has responsibility for determining the individual remuneration packages for the executive directors and executive officers of the Company, as detailed on page 51 of this Annual Report. In determining these remuneration packages, the Remuneration Committee has regard to the levels of pay and the structure of remuneration packages across the entire Group. The shape of the remuneration packages for the executive directors and executive officers is broadly similar to the remuneration packages for other

executives in the Group. The salary levels and multiples used in the various incentive plans differ according to level of seniority. This is explained in greater detail within the discussion on each incentive plan.

Across the Group, base pay and benefits are referenced to median competitive levels for acceptable performance whilst incentive plans, both short and long-term, are designed to motivate and reward out-performance. Total remuneration packages are benchmarked by reference to appropriate UK and US companies and where relevant other local markets. Individual remuneration levels are based on measurable performance against fair and open objectives and there are no automatic pay adjustments unless required by law or local protocol.

The policies described in this Report have been applied throughout 2010 and it is intended that they will continue to apply throughout 2011. The Remuneration Committee will however continue to monitor its policies against evolving market practice and relevant guidance which is particularly relevant in the current economic climate.

The Remuneration Committee has a policy to consult with the Company's major shareholders and relevant stakeholders prior to implementing any significant change to the remuneration policy and places great value in developing a transparent relationship on such matters.

## Principal Components of Remuneration

The remuneration package for the Company's senior executives, which includes the executive directors and executive officers, comprises the following elements:

Basic salary and benefits;

Annual incentive with a deferred element under the Deferred Bonus Plan;

Long-term incentives, comprising Performance Shares and Share Options; and

Pension entitlements.

As disclosed in last year's Report, a full and detailed review of remuneration arrangements was carried out in 2009. A further detailed review was therefore not considered to be appropriate in 2010 as the Remuneration Committee wanted the opportunity to assess the effectiveness of the changes introduced in 2009, some of which were only implemented in 2010. During 2010 therefore, the Remuneration Committee continued to have regard to the latest developments in the economic and corporate governance environment, but proposed no further change to the overall structure of remuneration packages. The Remuneration Committee continues to aim for incentive arrangements which are firmly linked to the long-term success of the business and based on balanced measures of corporate performance. The Remuneration Committee believes that the changes implemented in 2009 and retained in 2010 continue to meet these objectives.

### a) Base Salary and Benefits

Across the Group, base salary is determined both by the scope and the responsibility of the position and performance potential of the individual. Salaries are reviewed annually with effect from 1 April each year. Base salary is benchmarked by reference to the median for the relevant geographic market and employees

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are paid in a currency related to their home market. The Group also provides certain benefits such as private healthcare and a company car or allowance in line with competitive practice for the applicable geographic market. The Remuneration Committee also considers any pension consequences and costs to the Company when determining base salary increases for executive directors and executive officers.

With effect from 1 April 2010, the Remuneration Committee agreed the following base salaries for the executive directors:

|                   |              |
|-------------------|--------------|
| David Illingworth | \$ 1,407,000 |
| Adrian Hennah     | £530,000     |

Following the annual review conducted in February 2011, the Remuneration Committee determined that with effect from 1 April 2011, David Illingworth's base salary would remain unchanged in view of his impending retirement on 10 August 2011.

Adrian Hennah continues to make, what the Board considers, an excellent contribution as Chief Financial Officer. During 2010, he additionally took on responsibility for a number of significant aspects of the day to day handling of operational matters, beyond the remit of a conventional Chief Financial Officer. In particular:

Management of a number of initiatives to drive and achieve the Group strategy;

Responsibility for addressing operational improvements, including field efficiencies and inventory levels in the Orthopaedics global business unit;

Key role in establishing and driving margin improvement performance.



He also continues to deliver outstanding individual performance and contribution to the Group. Following a review of market positioning and in light of his enhanced role, the Remuneration Committee believes that a re-rating of his base salary is appropriate. With effect from 1 April 2011, his base salary will therefore be £580,000, which is an increase of 9.4%.

On 10 February 2011, the appointment of Olivier Bohuon as an Executive Director from 1 April 2011 and Chief Executive Officer with effect from 14 April 2011 was announced. Olivier Bohuon's base salary will be 1,050,000. Further details of his remuneration package are disclosed on page 66.

In common with our practice across the Group, the executive directors are each paid in their home currency.

The committee is mindful of salary increase for all employees when considering salaries for executive directors.

Average salary increases across the Group as a whole in 2011 will range between 2.5% and 3%.

## **b) Annual Incentive with Deferred Element under the Deferred Bonus Plan**

An Annual Incentive Plan is operated across the Group. The plan is designed to encourage outstanding performance without promoting excessive risk taking in order to achieve a short term incentive opportunity.

Senior executives also participate in the Deferred Bonus Plan under which a proportion of their annual incentive (dependent upon their seniority in the organisation) is compulsorily deferred into shares which vest in equal annual tranches over three years, subject to the participant's continued employment. No further performance conditions apply to these deferred shares. The Deferred Bonus Plan is designed to encourage executives to build up and maintain a significant shareholding in the Company to encourage them to behave and act like shareholders.

Executive directors and officers participate in the same Annual Incentive Plan and Deferred Bonus Plan although the targets and maximum levels are different reflecting their differing roles and levels of responsibility.

During 2010, the maximum annual incentive opportunity for executive directors was 150% of annual base salary with an incentive of 100% for on target performance. For executive officers, the maximum annual incentive opportunity was 140%. A proportion of the annual incentive earned at and above target is compulsorily deferred into shares as explained above. For executive directors, the amount deferred is one third and for executive officers it is one quarter. The maximum cash incentive opportunity is therefore 100% of salary for executive directors. There is no deferral of incentive for below target level performance. The maximum and target incentive awards for executive directors will remain unchanged in 2011.

The performance measures for the Annual Incentive Plan are linked to the four strategic pillars for success set out on page 4 of this Annual Report:

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**Customer led** : outperforming our served markets by focusing on our customers; anticipating and innovating to deliver on their needs.

**Efficient** : delivering operating margin improvement and freeing up resources to invest in the business, through streamlining processes and systems re-engineering.

**Investing for growth** : driving additional sales from new opportunities such as biologics, emerging markets and adjacent technologies.

**Aligned** : aligning objectives across the business and developing our talent and organisation for consistent execution, through leveraging core functions and sharing best practices.

From these four strategic pillars, a scorecard has been developed for each Global Business Unit, which identifies the strategic imperatives for each part of the business. Employees across the Group have performance objectives which link into the business scorecard and ultimately into these four strategic pillars.

The incentive bonus in 2010 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. In respect of 2010, the annual incentives earned by the executive directors were as follows:

|                   | <b>Incentive paid in cash</b> | <b>Incentive deferred into an award over shares</b> | <b>Total Incentive as percentage of base salary</b> |
|-------------------|-------------------------------|---|---|
| David Illingworth | \$1,202,985                   | \$602,196   | 128.3%  |
| Adrian Hennah     | £453,150                      | £226,840  | 128.3%  |

Over the period, underlying revenue growth was 4%, underlying trading profit growth was 11%, trading margin improved by 180 bps and trading profit to cash conversion was 85%. Collectively, these performance measures triggered 60.5% of the maximum incentive and personal objectives triggered 25% of the maximum incentive for David Illingworth and 25% of the incentive for Adrian Hennah.

In 2011, the Annual Incentive Plan will remain linked to the four strategic pillars for success and the business scorecard. The performance measures will comprise revenue (30%), trading profit (30%) and trading cash flow (15%). The remaining 25% of the total incentive will be dependent on individual personal objectives.

## c) Long-Term Incentives

The Group operates two main long-term incentive plans for executive directors: the 2004 Performance Share Plan and the 2004 Executive Share Option Plan. Annual awards of 150% of salary are made under the 2004 Performance Share Plan and annual grants of options at 100% of salary are made under the 2004 Executive Share Option Plan. In addition, there are some outstanding awards that were made under legacy plans no longer in operation. Performance shares are also awarded and options granted to executive officers and other senior executives under the 2010 Global Share Option Plan which was approved by shareholders in 2010.

### (i) 2004 Performance Share Plan (PSP)

Under the 2004 Performance Share Plan, awards over shares are currently made to executive directors in the second half of the year. Awards are made to executive officers and other senior executives at the same time under the Global Share Plan 2010 and further details of this plan are given below.

The initial market value of awards made to executive directors in 2010 was equivalent to 150% of their base. The Remuneration Committee has agreed that for 2011 the level of these awards will remain the same.

Share awards under the 2004 Performance Share Plan will only vest if pre-determined levels of EPSA growth are achieved. In addition, in order to drive enhanced shareholder value and maintain close alignment of executive and shareholder interests, the number of shares delivered to executives may be increased subject to the achievement of superior Total Shareholder Return ( TSR ) measured against the major companies in the medical devices industry. There is no retesting. The Remuneration Committee believes that the combination of EPSA and TSR measures encourages executives to achieve outstanding performance both in absolute terms looking at the EPSA measurement and also in relative terms compared to our peers looking at the TSR measurement.

A relative EPSA measure was used for awards made in 2009 and 2010. The targets for growth in EPSA are 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 each of those 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 will then be 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.

The following table sets out the performance measure used for awards made in 2010.

#### Annual Growth in EPSA over the three years ending 31 December 2012

Market Growth +2% per annum  
Market Growth +5% per annum

#### Percentage of award vesting

25% Threshold  
50% Target

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Market Growth +8% per annum

100% Maximum

None of the award will vest if the growth in EPSA over three years is less than Threshold and the award will vest pro rata on a straight line basis between the points given in the table above if growth in EPSA is between these levels.

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:

| <b>TSR Ranking within comparator group</b> | <b>Multiplier</b> |
|--|-------------------|
| 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 will be measured relative to a tailored sector peer group of medical devices companies. The companies in the comparator group for the awards made in 2010 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 by Deloitte LLP.

The performance measures to be used for the awards to be made in 2011 to executive directors under the 2004 Performance Share Plan will be on the basis of absolute measures of EPSA growth.

The following table sets out the performance measure which will be used for awards to be made in 2011.

| <b>Growth in EPSA over the three years ending 31 December 2013</b>           | <b>Percentage of award vesting</b> |
|--|------------------------------------|
| 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 award will vest if the growth in EPSA over three years is less than Threshold and the award will vest pro rata on a straight line basis between the points given in the table above if growth in EPSA is between these levels.

In addition, as in previous years, if the Company's TSR is positioned above median when compared with the TSR of medical devices companies listed above, then the number of vested shares delivered to participants following the achievement of the EPSA targets will be increased by the multiplier as detailed in the table above.

The awards made in 2008 were subject to performance conditions determined in 2008. EPSA growth over the three years ending 31 December 2010, adjusted to take account of the suspension of the share buy back programme in 2008, was 45% and this meant that 27% of the award will vest on the third anniversary of the award, being 15 August 2011. Over the same period the Company was ranked 11th out of 21 companies in the medical devices comparator group which meant that a multiplier of 1 was applied to the number of shares vesting under the EPSA target with the result that the following awards will vest on 15 August 2011:

**Number of shares under award**

**Number of shares vesting**

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|                   |         |        |
|-------------------|---------|--------|
| David Illingworth | 168,810 | 45,578 |
| Adrian Hennah     | 120,578 | 32,556 |

### *ii) Executive Share Options*

Under the 2004 Executive Share Option Plan, share options are granted to executive directors in the second half of the year at the same time as awards are made under the 2004 Performance Share Plan. Share options are granted to executive officers and other senior executives at the same time under the Global Share Plan 2010 and further details of this plan are given below.

Under the rules of the 2004 Executive Share Option Plan, the maximum market value of options which may be granted in each year is equivalent to the base salary of the participant. These options are granted at an option price no less than the market value at the date of grant and would vest on a change of control.

Share options are exercisable up to ten years from the date of grant and are only exercisable if the performance conditions over a three year performance period are achieved, beginning with the year in which the share option is granted.

The performance measurement for grants made in 2010 was based on Total Shareholder Return. If the Company's TSR is positioned above median when compared with the TSR of certain medical devices companies over a three year period commencing 1 January 2010, then the options become exercisable as follows:

| <b>TSR Ranking within comparator group</b> | <b>Percentage of option vesting</b> |
|--|-------------------------------------|
| Below or at 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 2004 Performance Share Plan, outlined above.

The Company's TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by Deloitte LLP.

Options granted in 2008 were subject to performance conditions determined in 2008. EPSA growth over the three years ended 31 December 2010, adjusted to take account of the suspension of the share buy-back programme in 2008, was 45% and this meant that 27% of the options granted will vest on 15 August 2011 as follows:

|                   | <b>Number of options granted</b> | <b>Number of options vesting</b> |
|-------------------|----------------------------------|----------------------------------|
| David Illingworth | 112,540                          | 30,385                           |
| Adrian Hennah     | 80,385                           | 21,703                           |

### *iii) 2004 Co-Investment Plan*

The 2004 Co-Investment Plan was replaced by the Deferred Bonus Plan described above in 2009. No awards were therefore made in 2009, 2010 or will be made in future.

The 2004 Co-Investment Plan enabled executive directors, executive officers and certain senior executives to take part of their annual bonus in the form of shares. Under this plan, the participant elected the level of bonus to be used for this purpose up to a maximum of one half of the annual gross bonus capped at 20% of base salary. The net amount of the gross amount elected was then used to purchase shares. The shares were then matched by the Company depending on growth in EPSA performance over a three year period, provided the shares are held for three years and the participant remains employed. For awards made in 2008, the Remuneration Committee determined that no matching shares will vest for each share acquired with bonus as EPSA growth amounted to 45% over the three year performance period, which was below the threshold hurdle for this award.

### *iv) Restricted Stock Awards*

No issues of restricted stock awards were made to executive directors in 2010. Restricted stock awards over a total of 82,305 shares were made to two executive officers in 2010 on their appointment to the Company or their promotion to executive officer level.

### *v) Global Share Plan 2010*

The Global Share Plan 2010 was approved by shareholders at the Annual General Meeting held in 2010. Certain executives and key employees below executive directors are eligible to participate in this plan. The plan operates on the same basis across the world with a separate tax efficient schedule in the UK. The plan is flexible and capable of delivering performance shares with performance conditions mirroring those of the 2004 Performance Share Plan and share options without performance conditions, both on an annual basis. Restricted stock awards may also be granted under the plan on a one-off basis in particular circumstances. Executive directors are not generally able to participate in this plan.

Executive share options under all plans are offered at no less than the market value at the date of grant. These options would vest on a change of control.

## d) Pensions

### *Pensions UK*

UK based executive directors and executive officers have a normal retirement age of 62. Those in service pre-2003 participate in the Smith & Nephew UK Pension Fund and 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. 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 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.

Those commencing employment post-2002 either participate in the defined contribution plan to which the Company contributes 30% of basic salary or they receive a non-pensionable, non-bonusable salary supplement of 30% of basic salary. Death in service cover of seven times basic salary, of which four times salary is payable as a lump sum, is also provided. The non-pensionable salary supplement is also available to any executive director or executive officer who wishes to opt out of the defined pension plans for future service.

#### *Pensions US*

US based executive directors and 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 US pension plan, a supplementary plan is used to enable benefits to be payable from age 62 without reduction for early retirement. A supplementary defined contribution plan is used to compensate for the earnings cap imposed by the US Internal Revenue Code and to provide additional retirement benefits.

## Shareholding Requirements

Across the Group, senior executives are expected to build up and maintain a personal equity stake in the Company. Executive directors are required to accumulate a personal holding equivalent to 2 times their base salary and executive officers are required to accumulate a personal holding equivalent to 1.5 times their base salary. Senior executives are also required to accumulate a personal holding at differing levels depending upon their seniority. These holdings are expected to be accumulated within five years of the later of the date of their joining the company or the date they became eligible to join Senior Executive Share Plans. The personal equity stake includes ordinary shares or ADRs held by the senior executive or their immediate family members as well as the gain element in any vested but unexercised share options. The Remuneration Committee will take account of the extent to which these guidelines have been met when making future awards. Non-executive directors are expected to accumulate a personal holding in the Company equivalent to their annual basic fee within three years of their appointment.

As at 23 February 2011, David Illingworth holds shares to the value of 269% of his base salary and Adrian Hennah holds shares to the value of 190% of his base salary.

## Total Reward Composition

The split between fixed and variable pay for the executive directors and executive officers in 2010 was as follows:

| Base Pay (fixed) | Annual Incentive (variable) | Present economic value of |
|------------------|-----------------------------|---------------------------|
|------------------|-----------------------------|---------------------------|

|                     |     | <b>earned in<br/>respect of<br/>2010</b> | <b>long-term<br/>incentives<br/>(variable)</b> |
|---------------------|-----|--|--|
| Executive directors | 25% | 32%                                      | 43%  |
| Executive officers  | 31% | 32%                                      | 37%  |

## Retirement Arrangements for David Illingworth

On 10 February 2011 it was announced that David Illingworth would retire from the Board and as Chief Executive at the conclusion of the Annual General Meeting to be held on 14 April 2011. In accordance with the terms of his service contract he will continue to remain an employee of the Company up to 10 August 2011 and will receive the pay and benefits he currently receives. At the end of his period of employment, the Remuneration Committee will determine the level of bonus payable (if any) in respect of his service during 2011.

The treatment of David Illingworth's outstanding awards under the Company's annual and long-term incentive plans will be in accordance with the terms of the relevant scheme rules. Therefore, they will be 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, it is envisaged that David Illingworth will continue to be engaged by the Company in a consultancy capacity, advising and supporting Olivier Bohuon, on specific matters, as required. It is initially expected that this consultancy arrangement will be in place for a period of six months to 10 February 2012 for a fee of \$90,000 per quarter. Such arrangement will be terminable on 30 days notice from either David Illingworth or the Company.

## Remuneration Terms for Olivier Bohuon

On 10 February 2011, it was also announced that Olivier Bohuon would join the Board with effect from 1 April 2011 and would be appointed Chief Executive Officer at the conclusion of the Annual General Meeting to be held on 14 April 2011. Olivier Bohuon will receive a base salary of 1,050,000 and will participate in the Annual Incentive Plan, the 2004 Performance Share Plan and the 2004 Executive Share Option Plan on the same basis as Adrian Henna, his fellow executive director, as detailed elsewhere in this Directors Remuneration Report. In addition, he will receive similar benefits and a contribution of 30% of his base pay into his pension arrangements. He will be employed under a service contract with a notice period of twelve months from the Company and six months from Olivier Bohuon on the same basis as described below.

On leaving his previous employment, Olivier Bohuon is required to repay a cash amount and forfeit unvested restricted stock. On joining the Company therefore, Olivier Bohuon will also receive a restricted stock award over 200,000 shares and a cash payment of 1,400,000 to enable him to repay the cash amount and to compensate him partially for the forfeited unvested shares. The restricted stock award will not be subject to performance conditions and will vest in three equal tranches over a period of three years following the date of award, subject to continued employment. In the event that he leaves the Company within 12 months of joining, he will be required to pay back the cash payment.

## Service Contracts

Details of the service contracts for each of the executive directors, including their notice periods, are set out below. The notice period under executive directors service contracts is twelve months from the Company and six months from the executive director. No payment will be made in the case of dismissal for cause. On termination of the contract, the Company may require the executive director not to work his notice period and pay him an amount equivalent to the salary, pension and benefits he would have received had he been required to work his notice period. In addition, the Remuneration Committee has discretion to pay the executive director a proportion of the bonus he would have received had he been required to work his notice period. This discretion will only be exercised in exceptional circumstances and the Remuneration Committee will take into account their policy of not rewarding failure and the executive director will be required, where possible, to mitigate the loss. The Remuneration Committee may also enforce the non-compete clause in the executive director's contract.

Following a change of control, in the event that an executive director's employment is terminated or his responsibilities or duties are materially diminished, or there is a reduction in their overall salary and benefits package or a change in the location of his or her place of work within 12 months following such a change of control, the executive directors are 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 |
|--------------------|--------------------------|----------------|------------------|----------------------------|
| David Illingworth  | 29 June 2007             | 1 July 2007    | 27 October 2015  | 12 months                  |
| Adrian Henna       | 1 February 2006          | 1 June 2006    | 12 November 2019 | 12 months                  |

Executive directors may 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 neither executive director holds such an appointment. Adrian Henna will be proposed for election to the Boards of Reed Elsevier NV and Reed Elsevier PLC at their Annual General Meetings to be held on 19 and 20 April 2011 respectively.

## Non-Executive Directors

Non-executive directors do not have service contracts but instead have letters of appointment. Non-executive directors are normally appointed for terms of three years, terminable at will, without notice by either the Group or the director and without compensation. The Chairman has a six month notice period. The Nominations Committee determines the remuneration 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 are paid in shares.

Non-executive director fees were reviewed and increased in May 2010. 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 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                                       | £60,000            | \$110,000         | 80,250       |
| Committee Chairman and Senior Independent Director Fee | £15,000            | \$27,000          | 20,000       |
| Intercontinental Travel fee (per meeting)              | £3,000             | \$6,000           | 4,500        |

The Chairman receives an all-inclusive fee of £375,000.

## 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  |              | Annual Incentive (ii) | Salary Supplement   | Total 2010 (iv) | Total 2009 (iv) |
|---------------------------------|-----------|--------------|-----------------------|---------------------|-----------------|-----------------|
|                                 | and fees  | Benefits (i) |                       | in lieu of pensions |                 |                 |
|                                 | Thousands |              |                       |                     |                 |                 |
| <b>Chairman (non-executive)</b> |           |              |                       |                     |                 |                 |
| John Buchanan                   | £373      | -            | -                     | -                   | £373            | £350            |
| <b>Executive directors</b>      |           |              |                       |                     |                 |                 |
| David Illingworth               | \$1,407   | \$28         | \$1,203               | (iii) \$104         | \$2,742         | \$2,667         |
| Adrian Hennah                   | £526      | £21          | £453                  | £157                | £1,157          | £1,128          |
| <b>Non-executive directors</b>  |           |              |                       |                     |                 |                 |
| Ian Barlow (v)                  | £70       | -            | -                     | -                   | £70             | -               |
| Geneviève Berger (v)            | 83        | -            | -                     | -                   | 83              | -               |
| Pamela Kirby                    | £64       | -            | -                     | -                   | £64             | £54             |
| Warren Knowlton (vi)            | \$65      | -            | -                     | -                   | \$65            | \$163           |
| Brian Larcombe                  | £64       | -            | -                     | -                   | £64             | £54             |
| Joseph Papa                     | \$134     | -            | -                     | -                   | \$134           | \$146           |
| Richard de Schutter             | \$158     | -            | -                     | -                   | \$158           | \$158           |
| Rolf Stomberg                   | 125       | -            | -                     | -                   | 125             | 93              |

(i) Benefits shown in the table above include cash allowances and benefits in kind.

(ii) The amount shown is the cash element of the Annual Incentive Plan. A further amount, as shown on page 61 will be deferred into an award over shares in 2011. The total amount for 2009 is presented on the same basis.

(iii) The amount provided under an international pension plan for David Illingworth is disclosed below.

(iv) Total executive and non-executive directors' emoluments for 2010 amounted to \$6,044,000 (2009 \$5,740,000), excluding portion of incentive deferred.

- (v) Appointed on 5 March 2010.
- (vi) Retired on 6 May 2010.

## b) Pensions

|                   | Accrued Pension as at 1 Jan 2010 | Increase in accrued pension excluding inflation | Increase in pension due to inflation | Accrued pension at 31 Dec 2010 | Transfer value of accrued pension at 1 Jan 2010 | Director s contribution during 2010 | Increase in transfer value over year less directors contribution | Transfer value of accrued pension at 31 Dec 2010 |
|-------------------|----------------------------------|---|--------------------------------------|--------------------------------|---|-------------------------------------|--|--|
|                   | \$ thousands                     |   |                                      |                                | \$ thousands                                    |                                     |  |  |
| David Illingworth | 3                                | -   | -                                    | 3                              | 19  | -                                   | 1  | 20   |

\$318,198 (2009 \$422,100) 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.

## c) Directors Share Options

|                   | Options as at 1 January 2010 (number) | Granted during 2010 (number) | Exercise price of options granted | Exercised during 2010 (number) | Lapsed during 2010 (number) | Options as at 31 December 2010 (number) | Average exercise price | Range of exercisable dates of options held at 31 December 2010 (date) |
|-------------------|---------------------------------------|------------------------------|-----------------------------------|--------------------------------|-----------------------------|---|------------------------|---|
| David Illingworth |                                       |                              |                                   |                                |                             |   |                        |   |
| (i)               | 419,865                               | -                            | -                                 | -                              | (43,098)                    | 376,767                                 | 599p                   | 05/07-08/18   |
| (ii)              | 177,875                               | 166,115                      | (iv) \$42.35                      | -                              | -                           | 343,990                                 | \$40.90                | 08/12-08/20   |
| Total             | 597,740                               | 166,115                      |                                   | -                              | (43,098)                    | 720,757                                 |                        |   |
| Adrian Hennah     |                                       |                              |                                   |                                |                             |   |                        |   |
| (i)               | 320,901                               | 97,605                       | 543p                              | -                              | (28,013)                    | 390,493                                 | 534p                   | 06/09-08/20   |
| (iii)             | 2,107                                 | 3,351                        | 461p                              | (2,107)                        | -                           | 3,351                                   | 461p                   | 11/13-04/14   |
| Total             | 323,008                               | 100,956                      |                                   | (2,107)                        | (28,013)                    | 393,844                                 |                        |   |

All options above were granted at prices below the market price at 31 December 2010 of 676.5p.

- (i) Options over Ordinary shares granted under 2004 Executive Share Option Plans.
- (ii) Options over ADSs granted under 2004 Executive Share Option Plans. Figures in the above table show the equivalent number of ordinary shares.
- (iii) Options granted under the UK ShareSave Scheme.
- (iv) Per ADS.

The range in the market price of the Company s Ordinary Shares during the year was 537.5p to 696.5p and the market price at 31 December 2010 was 676.5p. The notional gain made by Adrian Hennah on his exercise of options during the year was £2,781 (2009 £nil). In 2009 the gain made by David Illingworth on exercising share options was \$347,820, no gain was made by David Illingworth in 2010.

On 11 February 2011, 73% 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 2011.



## d) Long-Term Incentive Plan Awards

| Award type        | Maximum number of shares awarded at 1 January 2010 | Awards during the year | Market price on award | Vested award     | Market price on vesting | Lapsed award    | Number of shares awarded at 31 December 2010 | Latest performance period |
|-------------------|--|------------------------|-----------------------|------------------|-------------------------|-----------------|--|---------------------------|
|                   | (number)   | (number)               |                       | (number)         |                         | (number)        | (number)                                     | (date)                    |
| David Illingworth |  |                        |                       |                  |                         |                 |  |                           |
| (i) PSP           | 347,670  | 250,830                | (iii) \$42.07         | (56,600)         | (iii) \$50.85           | (24,260)        | 517,640                                      | 2012                      |
| (ii) PSP          | 252,346  | -                      | -                     | (58,475)         | 674.5p                  | (25,061)        | 168,810                                      | 2010                      |
| RSA               | 81,300   | -                      | -                     | (81,300)         | 651.5p                  | -               | -  | -                         |
| <b>Total</b>      | <b>681,316</b>                                     | <b>250,830</b>         |                       | <b>(196,375)</b> |                         | <b>(49,321)</b> | <b>686,450</b>                               |                           |
| Adrian Hennah     |  |                        |                       |                  |                         |                 |  |                           |
| (ii) PSP          | 389,591  | 146,408                | 543.0p                | (75,417)         | 676.5p                  | (32,323)        | 428,259                                      | 2012                      |
| <b>Total</b>      | <b>389,591</b>                                     | <b>146,408</b>         |                       | <b>(75,417)</b>  |                         | <b>(32,323)</b> | <b>428,259</b>                               |                           |

- (i) Awards made over ADSs under the 2004 Performance Share Plan and Performance Share Agreements. Figures in the above table show the equivalent number of ordinary shares.
- (ii) Awards made over ordinary shares under the 2004 Performance Share Plan and Performance Share Agreements.
- (iii) Per ADS.

On 11 February 2011, 73% of the awards granted to David Illingworth and Adrian Hennah in 2008 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 2011.

## e) 2004 Co-Investment Plan Awards

The number of matched shares to be allocated to each executive director is subject to growth in EPSA over a three-year period. Details of the Plan can be found on page 64.

|                   | Total matched awards as at 1 January 2010 | Matched award vested during the year | Lapsed award | Total matched award at 2 x gross bonus held at 31 December 2010 |
|-------------------|---|--------------------------------------|--------------|---|
| David Illingworth | 16,170                                    | (8,085)                              | (8,085)      | -   |
| Adrian Hennah     | 58,298                                    | (13,521)                             | (13,521)     | 31,256  |

No awards were made under this plan in 2010 or 2009.

100% of the Award granted to Adrian Hennah in 2008 under the 2004 Co-Investment Plan has lapsed.

## f) 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.

|                   | <b>Total as at<br/>1 January 2010</b> | <b>Awarded during<br/>2010</b> | <b>Vested during 2010</b> | <b>Total as at<br/>31 December 2010</b> |
|-------------------|---------------------------------------|--------------------------------|---------------------------|---|
| David Illingworth | 51,658                                | 60,900                         | (17,217)                  | 95,341                                  |
| Adrian Hennah     | 37,119                                | 33,125                         | (12,371)                  | 57,873                                  |

## 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.

In respect of the financial year 2010, 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 \$11,689,000 (2009 \$11,456,000, 2008 \$9,919,000), the aggregate increase in accrued pension benefits was \$16,000 (2009 increase of \$9,000, 2008 increase of \$12,000) and the aggregate amounts provided for under the supplementary schemes was \$1,141,000 (2009 \$1,179,000, 2008 \$507,000).

During 2010, senior management were granted options over 608,389 shares and 33,223 ADSs under the 2004 Executive Share Option Plans, Global Share Plan 2010 and employee ShareSave plans. Performance share awards were granted to senior management over 246,036 shares and 92,523 ADSs under the 2004 Performance Share Plan and the Global Share Plan 2010, 46,986 shares and 22,953 ADSs under the Deferred Bonus Plan and restricted stock awards over a total of 82,305 shares. As of 23 February 2011, the Senior Management (10 persons) owned 284,053 shares and 75,147 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 1,917,581 shares and 77,298 ADSs, restricted stock awards over 82,305 shares and 5,549 ADSs, performance share awards over 544,086 shares and 196,736 ADSs awarded under the 2004 Performance Share Plan and the Global Share Plan 2010; and awards over 115,495 shares and 29,717 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 2010 |         | 31 December 2010 |           | 23 February 2011 (i) |         |
|------------------------|----------------|---------|------------------|-----------|----------------------|---------|
|                        | Shares         | Options | Shares           | Options   | Shares               | Options |
| John Buchanan          | 154,531        | -       | 156,977          | -         | 156,977              | -       |
| David Illingworth (ii) | 172,005        | 597,740 | 326,828          | 720,757   | 326,828              | 638,602 |
| Adrian Hennah          | 78,898         | 323,008 | 140,698          | 393,844   | 140,698              | 335,162 |
| Ian Barlow             | -              | -       | 10,000           | -         | 13,000               | -       |
| Geneviève Berger       | -              | -       | -                | -         | -                    | -       |
| Pamela Kirby           | 8,500          | -       | 8,500            | -         | 8,500                | -       |
| Brian Larcombe         | 20,000         | -       | 20,000           | -         | 20,000               | -       |
| Joseph Papa            | 5,000          | -       | 5,000            | -         | 5,000                | -       |
| Richard De Schutter    | 250,000        | -       | 250,000          | -         | 250,000              | -       |
| Rolf Stomberg          | 13,100         | -       | 13,100           | -         | 13,100               | -       |
| Total                  | 702,034        | 920,748 | 931,103          | 1,114,601 | 934,103              | 973,764 |

(i) The latest practicable date for this Annual Report.

(ii) In addition, David Illingworth 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 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.



## Total Shareholder Return

Schedule 8 to the Regulations requires a graph to be published showing the Company's TSR against the TSR performance of a broad equity market index. As a component of the FTSE100 index, a graph of the Company's TSR performance compared to that of the TSR of the FTSE100 index is shown below.

The Remuneration Committee, however, compares the company's performance to a tailored sector peer group of medical devices companies (see page 63), when considering TSR performance in the context of the 2004 Performance Share Plan.

The following graph therefore also shows the TSR performance of this peer group over a comparable period.

By order of the Board, 24 February 2011

**Susan Henderson**

Company Secretary

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## GROUP ACCOUNTS

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## 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.



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

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.

## **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, Liquidity and Prospects 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, 24 February 2011

**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 2010 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 36. 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 75 the directors are responsible for the preparation of the group accounts and for being satisfied that they give a true and fair view. Our responsibility is to audit the group accounts 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 accounts sufficient to give reasonable assurance that the accounts 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 accounts.

### Opinion on accounts

In our opinion the group accounts:

give a true and fair view of the state of the group s affairs as at 31 December 2010 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 accounts are prepared is consistent with the group accounts.

**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 40, 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 June 2008 Combined Code specified for our review.

**Other matter**

We have reported separately on the Company accounts of Smith & Nephew plc for the year ended 31 December 2010 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 accounts, 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.

In our opinion the group accounts give a true and fair view, in accordance with IFRS, of the state of the Group's affairs as at 31 December 2010 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

24 February 2011

## 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 2010 and 2009, 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 2010. These accounts are the responsibility of the Company s management. Our responsibility is to express an opinion on these accounts 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 accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the accounts, 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 accounts referred to above present fairly, in all material respects, the consolidated financial position of Smith & Nephew plc at 31 December 2010 and 2009, and the consolidated results of its operations and cash flows for each of the three years in the period ended 31 December 2010, 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 2010, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organisations of the Treadway Commission and our report dated 24 February 2011 expressed an unqualified opinion thereon.

#### Ernst & Young LLP

London, England

24 February 2011

**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 2010, 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 2010, 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 2010 and 2009, 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 2010 and our report dated 24 February 2011 expressed an unqualified opinion thereon.

**Ernst & Young LLP**

London, England

24 February 2011





## GROUP INCOME STATEMENT

|  | Notes | Years ended 31 December |            |            |
|--|-------|-------------------------|------------|------------|
|  |       | 2010                    | 2009       | 2008       |
|  |       | \$ million              | \$ million | \$ million |
| <b>Revenue</b>                               | 3     | 3,962                   | 3,772      | 3,801      |
| Cost of goods sold                           |       | (1,031)                 | (1,030)    | (1,077)    |
| Gross profit                                 |       | 2,931                   | 2,742      | 2,724      |
| Selling, general and administrative expenses | 4     | (1,860)                 | (1,864)    | (1,942)    |
| Research and development expenses            |       | (151)                   | (155)      | (152)      |
| <b>Operating profit</b>                      | 3 & 4 | 920                     | 723        | 630        |
| Interest receivable                          | 7     | 3                       | 2          | 5          |
| Interest payable                             | 7     | (18)                    | (42)       | (71)       |
| Other finance costs                          | 8     | (10)                    | (15)       | (1)        |
| Share of results of associates               | 15    |                         | 2          | 1          |
| <b>Profit before taxation</b>                |       | 895                     | 670        | 564        |
| Taxation                                     | 9     | (280)                   | (198)      | (187)      |
| <b>Attributable profit for the year (i)</b>  |       | 615                     | 472        | 377        |
| <b>Earnings per Ordinary Share (i)</b>       | 11    |                         |            |            |
| Basic  |       | 69.3¢                   | 53.4¢      | 42.6¢      |
| Diluted                                      |       | 69.2¢                   | 53.3¢      | 42.4¢      |

## GROUP STATEMENT OF COMPREHENSIVE INCOME

|   | Years ended 31 December |            |            |
|---|-------------------------|------------|------------|
|   | 2010                    | 2009       | 2008       |
|   | \$ million              | \$ million | \$ million |
| <b>Attributable profit for the year (i)</b>                               | 615                     | 472        | 377        |
| Other comprehensive income:   |                         |            |            |
| Cash flow hedges – interest rate swaps                                    |                         |            |            |
| losses arising in the year  | (1)                     | (3)        | (13)       |
| losses transferred to income statement for the year                       | 4                       | 13         | 2          |
| Cash flow hedges – forward foreign exchange contracts                     |                         |            |            |
| (losses)/gains arising in the year  | (3)                     | (15)       | 21         |
| losses/(gains) transferred to inventories for the year                    | 1                       | 7          | (6)        |
| Exchange differences on translation                                       | 66                      | 63         | (57)       |
| Exchange on borrowings classified as net investment hedges                | (14)                    | (3)        | (42)       |
| Actuarial gains/(losses) on retirement benefit obligations                | 26                      | 41         | (215)      |
| Taxation on items relating to components of other comprehensive income    | (7)                     | (12)       | 71         |
| <b>Other comprehensive income/(expense) for the year, net of taxation</b> | 72                      | 91         | (239)      |
| <b>Total comprehensive income for the year (i)</b>                        | 687                     | 563        | 138        |

(i) Attributable to equity holders of the Company and wholly derived from continuing operations.

The Notes on pages 84 to 128 are an integral part of these accounts.

## GROUP BALANCE SHEET

|   | Notes | At 31 December     |                    |
|---|-------|--------------------|--------------------|
|   |       | 2010<br>\$ million | 2009<br>\$ million |
| <b>ASSETS</b>   |       |                    |                    |
| <b>Non-current assets:</b>                                  |       |                    |                    |
| Property, plant and equipment                               | 12    | 787                | 753                |
| Goodwill  | 16    | 1,101              | 1,093              |
| Intangible assets   | 13    | 426                | 412                |
| Investments   | 14    | 6                  | 7                  |
| Investments in associates                                   | 15    | 13                 | 13                 |
| Deferred tax assets   | 23    | 224                | 202                |
| Trade and other receivables                                 | 18    | 22                 | -                  |
|   |       | 2,579              | 2,480              |
| <b>Current assets:</b>                                      |       |                    |                    |
| Inventories   | 17    | 923                | 933                |
| Trade and other receivables                                 | 18    | 1,024              | 946                |
| Cash and bank   | 19    | 207                | 192                |
|   |       | 2,154              | 2,071              |
| Assets held for sale  | 30    | -                  | 14                 |
| <b>TOTAL ASSETS</b>   |       | 4,733              | 4,565              |
| <b>EQUITY AND LIABILITIES</b>                               |       |                    |                    |
| <b>Equity attributable to equity holders of the parent:</b> |       |                    |                    |
| Share capital   | 24    | 191                | 190                |
| Share premium   |       | 396                | 382                |
| Treasury shares   | 26    | (778)              | (794)              |
| Other reserves  |       | 116                | 63                 |
| Retained earnings   |       | 2,848              | 2,338              |
| Total equity  |       | 2,773              | 2,179              |
| <b>Non-current liabilities:</b>                             |       |                    |                    |
| Long-term borrowings  | 19    | 642                | 1,090              |
| Retirement benefit obligations                              | 33    | 262                | 322                |
| Other payables  | 21    | -                  | 27                 |
| Provisions  | 22    | 73                 | 53                 |
| Deferred tax liabilities                                    | 23    | 69                 | 31                 |
|   |       | 1,046              | 1,523              |
| <b>Current liabilities:</b>                                 |       |                    |                    |
| Bank overdrafts and loans                                   | 19    | 57                 | 45                 |
| Trade and other payables                                    | 21    | 617                | 596                |
| Provisions  | 22    | 37                 | 55                 |
| Current tax payable   |       | 203                | 167                |
|   |       | 914                | 863                |
| <b>Total liabilities</b>                                    |       | 1,960              | 2,386              |
| <b>TOTAL EQUITY AND LIABILITIES</b>                         |       | 4,733              | 4,565              |

The accounts were approved by the Board and authorised for issue on 24 February 2011 and are signed on its behalf by: **John Buchanan** Chairman **David J. Illingworth** Chief Executive **Adrian Hennah** Chief Financial Officer

The Notes on pages 84 to 128 are an integral part of these accounts.



## GROUP CASH FLOW STATEMENT

|  | Notes     | Years ended 31 December |            |            |
|--|-----------|-------------------------|------------|------------|
|  |           | 2010                    | 2009       | 2008       |
|  |           | \$ million              | \$ million | \$ million |
| <b>Net cash inflow from operating activities</b>                   |           |                         |            |            |
| Profit before taxation   |           | 895                     | 670        | 564        |
| Net interest payable   | 7         | 15                      | 40         | 66         |
| Depreciation, amortisation and impairment                          |           | 273                     | 298        | 275        |
| Loss on disposal of property, plant and equipment and software     |           | 15                      | 14         | 12         |
| Share based payments expense                                       |           | 21                      | 18         | 24         |
| Utilisation of Plus inventory stepped-up on acquisition            |           | -                       | -          | 15         |
| Share of results of associates                                     |           | -                       | (2)        | (1)        |
| Decrease in retirement benefit obligations                         |           | (31)                    | (2)        | (14)       |
| Decrease/(Increase) in inventories                                 |           | 21                      | (17)       | (117)      |
| (Increase)/Decrease in trade and other receivables                 |           | (100)                   | 46         | (54)       |
| Increase/(Decrease) in trade and other payables and provisions     |           | 2                       | (35)       | 45         |
| Cash generated from operations (i) (ii)                            |           | 1,111                   | 1,030      | 815        |
| Interest received  |           | 3                       | 2          | 5          |
| Interest paid  |           | (20)                    | (43)       | (68)       |
| Income taxes paid  |           | (235)                   | (270)      | (186)      |
| Net cash inflow from operating activities                          |           | 859                     | 719        | 566        |
| <b>Cash flows from investing activities</b>                        |           |                         |            |            |
| Acquisitions   | 29        | -                       | (25)       | (16)       |
| Cash received from Plus settlement                                 | 29        | -                       | 137        | -          |
| Capital expenditure  |           | (315)                   | (318)      | (292)      |
| Proceeds on disposal of property, plant and equipment and software |           | 8                       | -          | 3          |
| Net cash used in investing activities                              |           | (307)                   | (206)      | (305)      |
| <b>Cash flows from financing activities</b>                        |           |                         |            |            |
| Proceeds from issue of ordinary share capital                      |           | 15                      | 7          | 19         |
| Treasury shares purchased  |           | (5)                     | -          | (193)      |
| Proceeds/(settlement) of borrowings due within one year            | 27        | 17                      | (66)       | (49)       |
| Proceeds on borrowings due after one year                          | 27        | 277                     | 526        | 1,108      |
| Settlement of borrowings due after one year                        | 27        | (714)                   | (814)      | (1,028)    |
| Proceeds from own shares   |           | 8                       | 10         | 4          |
| Settlement of currency swaps                                       | 27        | (3)                     | (12)       | 5          |
| Equity dividends paid  | 10        | (132)                   | (120)      | (109)      |
| Net cash used in financing activities                              |           | (537)                   | (469)      | (243)      |
| <b>Net increase in cash and cash equivalents</b>                   |           |                         |            |            |
|  |           | 15                      | 44         | 18         |
| Cash and cash equivalents at beginning of year                     | 27        | 174                     | 122        | 109        |
| Exchange adjustments   | 27        | 6                       | 8          | (5)        |
| <b>Cash and cash equivalents at end of year</b>                    | <b>27</b> | <b>195</b>              | <b>174</b> | <b>122</b> |

(i) Includes \$16m (2009 \$32m, 2008 \$28m) of outgoings on restructuring and rationalisation expenses.

(ii) Includes \$nil (2009 \$22m, 2008 \$48m) of acquisition related costs and \$5m (2009 \$5m, 2008 \$10m) unreimbursed by insurers relating to macrot textured knee revisions.

The Notes on pages 84 to 128 are an integral part of these accounts.



## GROUP STATEMENT OF CHANGES IN EQUITY

|   | Share<br>capital<br>\$ million | Share<br>premium<br>\$ million | Treasury<br>shares (ii)<br>\$<br>million | Other<br>reserves (iii)<br>\$ million | Retained<br>earnings<br>\$ million | Total<br>equity<br>\$ million |
|---|--------------------------------|--------------------------------|--|---------------------------------------|------------------------------------|-------------------------------|
| At 1 January 2008                           | 190                            | 356                            | (637)                                    | 96                                    | 1,811                              | 1,816                         |
| Total comprehensive income (i)              | -                              | -                              | -  | (95)                                  | 233                                | 138                           |
| Equity dividends declared and paid          | -                              | -                              | -  | -                                     | (109)                              | (109)                         |
| Share based payments recognised             | -                              | -                              | -  | -                                     | 24                                 | 24                            |
| Treasury shares purchased                   | -                              | -                              | (193)                                    | -                                     | -                                  | (193)                         |
| Cost of shares transferred to beneficiaries | -                              | -                              | 7  | -                                     | (3)                                | 4                             |
| Issue of ordinary share capital (iv)        | -                              | 19                             | -  | -                                     | -                                  | 19                            |
| 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<br>payment | -                              | -                              | -  | -                                     | 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 31 December 2010                         | 191                            | 396                            | (778)                                    | 116                                   | 2,848                              | 2,773                         |

(i) Attributable to equity holders of the Company and wholly derived from continuing operations.

(ii) Refer to Note 26 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 on the date of redenomination instead of the rate at the balance sheet date. The cumulative translation adjustments within Other Reserves at 31 December 2010 were \$123m (2009 \$71m, 2008 \$11m).

(iv) Issue of ordinary share capital as a result of options being exercised.

The Notes on pages 84 to 128 are an integral part of these accounts.

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## NOTES TO THE GROUP ACCOUNTS

### 1. General Information

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.

#### *Presentation of financial information*

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 2010. 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 2010. *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.

### 2(a). Accounting Policies

The *Group* has adopted *IFRS* 3 (Revised) Business Combinations and *IAS* 27 (Revised) Consolidated and Separate Financial Statements. These standards are being applied prospectively and have no impact on the current presentation or disclosure of information, and therefore no comparative amounts require restatement. No other 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 set out below:

#### *Basis of Preparation*

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, Liquidity and Prospects* section on pages 28 to 29. 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*.

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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-terminous with the Group's.

### *Business Combinations and Goodwill*

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. Goodwill is not amortised but is reviewed for impairment annually. For purposes of impairment testing, goodwill is allocated to the related cash-generating units monitored by management, being the operating segment level, Orthopaedics, Endoscopy and Advanced Wound Management.



**2(a). Accounting Policies (continued)**

***Investments in Associates***

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.

***Revenue***

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.

***Foreign Currencies***

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.

***Taxation***

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.

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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.

**2(a). Accounting Policies (continued)**

***Advertising Costs***

Expenditure on advertising costs is expensed as incurred.

***Intangible Assets***

Intangible assets acquired separately (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.

***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.

***Property, Plant and Equipment***

Property, plant and equipment are 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 at between 2% and 5% per annum. 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 recoverable amount of cash-generating units to which goodwill has been allocated is tested for impairment annually or when events or changes in circumstances indicate that it might be impaired.

The carrying values of property, plant and equipment, and 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.

In carrying out impairment reviews of goodwill and intangible assets a number of significant assumptions have to be made when preparing cash flow projections. These include annual sales growth, trading margins, capital utilisation and anticipated volume and value growth in the markets served by the Group. If actual results should differ, or changes in expectations arise, impairment charges may be required which would adversely impact operating results.

## 2(a). Accounting Policies (continued)

### *Leases*

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.

Rentals payable under operating leases are expensed in the income statement on a straight line basis over the term of the relevant lease.

### *Investments and Other Financial Assets*

Investments, other than those related to associates, are initially recorded at fair value plus transaction costs on the trade date. The Group holds an investment in an entity that holds mainly unquoted equity securities, which 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. 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.

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.

### *Inventories*

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.

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.

*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 currency 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.

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.

**2(a). Accounting Policies (continued)**

*Derivative Financial Instruments (continued)*

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.

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.

*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.

*Retirement Benefits*

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 of high-quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability.

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, inflation and mortality assumptions to be applied to future pension plan liabilities. The most critical 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.

*Share Based Payments*

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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.

### *Contingencies and Provisions*

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.

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.



## 2(a). Accounting Policies (continued)

### *Contingencies and Provisions (continued)*

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 reasonably 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.

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.

### *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 affect the Group's short-term profitability. Adjusted attributable profit is the numerator used for this measure, reconciliation from attributable profit to adjusted attributable profit is included in Note 11 of the Notes to the Group Accounts. 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.

## 2(b). New Accounting Standards

### *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.

## 3(a). Operating Segment Information

For management purposes, the Group is organised into business units according to the nature of its products and has three operating segments – Orthopaedics, Endoscopy and Advanced Wound Management. The types of products and services offered by each operating unit 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

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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.
- 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.

**3(a). Operating Segment Information (continued)**

Management monitors the operating results of its business units 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 operating 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.

|                                     | 2010       | 2009       | 2008       |
|-------------------------------------|------------|------------|------------|
|                                     | \$ million | \$ million | \$ million |
| <b>Revenue by operating segment</b> |            |            |            |
| Orthopaedics                        | 2,195      | 2,135      | 2,158      |
| Endoscopy                           | 855        | 791        | 800        |
| Advanced Wound Management           | 912        | 846        | 843        |
|                                     | 3,962      | 3,772      | 3,801      |

There are no material sales between operating segments.

Trading profit is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affect 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   | 2010       | 2009       | 2008       |
|---|---------|------------|------------|------------|
|   |         | \$ million | \$ million | \$ million |
| Operating profit  |         | 920        | 723        | 630        |
| Acquisition related costs                               | 5       | -          | 26         | 61         |
| Restructuring and rationalisation expenses              | 6       | 15         | 42         | 34         |
| Amortisation of acquisition intangibles and impairments | 13 & 16 | 34         | 66         | 51         |
| Trading profit  |         | 969        | 857        | 776        |

**Trading profit by operating segment**

|                           |     |     |     |
|---------------------------|-----|-----|-----|
| Orthopaedics              | 536 | 508 | 481 |
| Endoscopy                 | 200 | 189 | 166 |
| Advanced Wound Management | 233 | 160 | 129 |
|                           | 969 | 857 | 776 |

**Operating profit by operating segment reconciled to attributable profit for the year**

|                                  |       |       |       |
|----------------------------------|-------|-------|-------|
| Orthopaedics                     | 503   | 410   | 382   |
| Endoscopy                        | 197   | 169   | 146   |
| Advanced Wound Management        | 220   | 144   | 102   |
| Operating profit                 | 920   | 723   | 630   |
| Net interest payable             | (15)  | (40)  | (66)  |
| Other finance costs              | (10)  | (15)  | (1)   |
| Share of results of associates   | -     | 2     | 1     |
| Taxation                         | (280) | (198) | (187) |
| Attributable profit for the year | 615   | 472   | 377   |



**3(a). Operating Segment Information (continued)**

|  | 000 | 000<br>2010<br>\$ million | 000<br>2009<br>\$ million | 000<br>2008<br>\$ million |
|--|-----|---------------------------|---------------------------|---------------------------|
| <b>Capital expenditure</b>                                 |     |                           |                           |                           |
| Orthopaedics   |     | 227                       | 235                       | 219                       |
| Endoscopy  |     | 58                        | 41                        | 29                        |
| Advanced Wound Management                                  |     | 30                        | 63                        | 45                        |
|  |     | 315                       | 339                       | 293                       |
| Capital expenditure segmentally allocated above comprises: |     |                           |                           |                           |
| Additions to property, plant and equipment                 |     | 250                       | 216                       | 259                       |
| Additions to intangible assets                             |     | 65                        | 102                       | 33                        |
| Capital expenditure as per cash flow statement             |     | 315                       | 318                       | 292                       |
| Acquisitions Goodwill                                      |     | -                         | 3                         | -                         |
| Acquisitions Intangible assets                             |     | -                         | 12                        | 1                         |
| Acquisitions Property, plant and equipment                 |     | -                         | 6                         | -                         |
| Capital expenditure  |     | 315                       | 339                       | 293                       |
| <b>Depreciation, amortisation and impairment</b>           |     |                           |                           |                           |
| Orthopaedics   |     | 195                       | 206                       | 177                       |
| Endoscopy  |     | 41                        | 52                        | 57                        |
| Advanced Wound Management                                  |     | 37                        | 40                        | 41                        |
|  |     | 273                       | 298                       | 275                       |

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:

|   | 000 | 000<br>2010<br>\$ million | 000<br>2009<br>\$ million | 000<br>2008<br>\$ million |
|---|-----|---------------------------|---------------------------|---------------------------|
| Impairment of intangibles and goodwill        |     | -                         | 32                        | 14                        |
| Amortisation of acquisition intangibles       |     | 34                        | 34                        | 37                        |
| Depreciation of property, plant and equipment |     | 34                        | 66                        | 51                        |
| Amortisation of other intangible assets       |     | 203                       | 206                       | 204                       |
| Impairment of investments                     |     | 34                        | 26                        | 18                        |
|   |     | 2                         | -                         | 2                         |
|   |     | 273                       | 298                       | 275                       |

Impairments of \$2m were recognised within operating profit in 2010 and included within the administrative expenses line (2009 \$32m, 2008 \$16m). This is segmentally allocated to Orthopaedics (2009 Orthopaedics \$19m and Endoscopy \$13m, 2008 Orthopaedics \$2m and Endoscopy \$14m).

**Other significant non-cash expenses recognised within operating profit**

|              | 000 | 000<br>2010<br>\$ million | 000<br>2009<br>\$ million | 000<br>2008<br>\$ million |
|--------------|-----|---------------------------|---------------------------|---------------------------|
| Orthopaedics |     | 8                         | 22                        | 23                        |
| Endoscopy    |     | 2                         | 2                         | -                         |

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|                           |    |    |    |
|---------------------------|----|----|----|
| Advanced Wound Management | 5  | 6  | 6  |
|                           | 15 | 30 | 29 |

The \$15m incurred in 2010 relates to restructuring and rationalisation expenses (2009 \$30m relates to acquisitions related costs and restructuring and rationalisation expenses). In 2008, the \$29m relates to the utilisation of Plus inventory stepped-up on acquisition, acquisition related costs and restructuring and rationalisation expenses.

**3(a). Operating Segment Information (continued)**

|                                    | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|------------------------------------|-------------------|-------------------|-------------------|
|                                    | <b>numbers</b>    | <b>numbers</b>    | <b>numbers</b>    |
| <b>Average number of employees</b> |                   |                   |                   |
| Orthopaedics                       | 5,045             | 4,853             | 4,840             |
| Endoscopy                          | 2,134             | 1,888             | 1,849             |
| Advanced Wound Management          | 2,993             | 3,023             | 3,068             |
|                                    | 10,172            | 9,764             | 9,757             |
|                                    | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|                                    | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| <b>Balance Sheet</b>               |                   |                   |                   |
| <b>Assets:</b>                     |                   |                   |                   |
| Orthopaedics                       | 2,778             | 2,656             | 2,755             |
| Endoscopy                          | 769               | 705               | 690               |
| Advanced Wound Management          | 755               | 810               | 704               |
| Operating assets by segment        | 4,302             | 4,171             | 4,149             |
| Unallocated corporate assets       | 431               | 394               | 359               |
| Total assets                       | 4,733             | 4,565             | 4,508             |
| <b>Liabilities:</b>                |                   |                   |                   |
| Orthopaedics                       | 457               | 426               | 448               |
| Endoscopy                          | 124               | 111               | 107               |
| Advanced Wound Management          | 146               | 194               | 189               |
| Operating liabilities by segment   | 727               | 731               | 744               |
| Unallocated corporate liabilities  | 1,233             | 1,655             | 2,065             |
| Total liabilities                  | 1,960             | 2,386             | 2,809             |

Unallocated corporate assets and liabilities comprise the following:

|   |       |       |       |
|---|-------|-------|-------|
| Deferred tax assets   | 224   | 202   | 214   |
| Cash and bank   | 207   | 192   | 145   |
| Unallocated corporate assets                                      | 431   | 394   | 359   |
| Long-term borrowings  | 642   | 1,090 | 1,358 |
| Retirement benefit obligations                                    | 262   | 322   | 350   |
| Deferred tax liabilities  | 69    | 31    | 46    |
| Current liability derivatives – credit balances on currency swaps | -     | -     | 4     |
| Bank overdrafts and loans due within one year                     | 57    | 45    | 115   |
| Current tax payable   | 203   | 167   | 192   |
| Unallocated corporate liabilities                                 | 1,233 | 1,655 | 2,065 |

**3(b). Geographic Information**

|   | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|---|-------------------|-------------------|-------------------|
|   | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| <b>Revenue by geographic market</b>         |                   |                   |                   |
| United Kingdom                              | 283               | 286               | 321               |
| Continental Europe                          | 1,032             | 1,027             | 1,077             |
| United States                               | 1,707             | 1,664             | 1,657             |
| Africa, Asia, Australasia and Other America | 940               | 795               | 746               |
|   | 3,962             | 3,772             | 3,801             |

Revenue has been allocated by basis of origin. No revenue from a single customer is in excess of 10% of the group's revenue.

#### 4. Operating Profit

|   | 2010       | 2009       | 2008       |
|---|------------|------------|------------|
|   | \$ million | \$ million | \$ million |
| Revenue   | 3,962      | 3,772      | 3,801      |
| Cost of goods sold (i)                            | (1,031)    | (1,030)    | (1,077)    |
| Gross profit                                      | 2,931      | 2,742      | 2,724      |
| Research and development expenses                 | (151)      | (155)      | (152)      |
| Selling, general and administrative expenses:     |            |            |            |
| Marketing, selling and distribution expenses (ii) | (1,414)    | (1,351)    | (1,416)    |
| Administrative expenses (iii) (iv)                | (446)      | (513)      | (526)      |
|   | (1,860)    | (1,864)    | (1,942)    |
| Operating profit                                  | 920        | 723        | 630        |

- (i) In 2010, no restructuring and rationalisation expenses or acquisition related costs related to cost of goods sold (2009 \$15m of restructuring and rationalisation expenses and \$12m of acquisition related costs, 2008 \$15m in respect of the utilisation of Plus inventory stepped-up to fair value on acquisition, \$18m of restructuring and rationalisation expenses and \$8m of acquisition related costs).
- (ii) 2010 includes \$3m of restructuring and rationalisation expenses (2009 \$7m of acquisition related costs and \$10m of restructuring and rationalisation expenses, 2008 \$7m of acquisition related costs and \$3m of restructuring and rationalisation expenses).
- (iii) 2010 includes \$34m of amortisation of other intangible assets (2009 \$26m, 2008 \$18m).
- (iv) 2010 includes \$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, 2008 \$31m of acquisition related costs, \$13m of restructuring and rationalisation expenses and \$51m of amortisation of acquisition intangibles and impairments).
- (v) Items detailed in (i), (ii) and (iv) are excluded from the calculation of trading profit.

Operating Profit is stated after charging the following items:

|  | 2010       | 2009       | 2008       |
|--|------------|------------|------------|
|  | \$ million | \$ million | \$ million |
| Amortisation of acquisition intangibles                        | 34         | 34         | 37         |
| Amortisation of other intangible assets                        | 34         | 26         | 18         |
| Impairment of intangible assets and goodwill                   | -          | 32         | 14         |
| Depreciation of property, plant and equipment                  | 203        | 206        | 204        |
| Loss on disposal of property, plant and equipment and software | 15         | 14         | 12         |
| Impairment of investments                                      | 2          | -          | 2          |
| Minimum operating lease payments for land and buildings        | 31         | 27         | 28         |
| Minimum operating lease payments for other assets              | 28         | 28         | 29         |
| Advertising costs  | 83         | 71         | 56         |

Staff costs during the year amounted to:

|   | Notes | 2010       | 2009       | 2008       |
|---|-------|------------|------------|------------|
|   |       | \$ million | \$ million | \$ million |
| Wages and salaries                              |       | 817        | 768        | 795        |
| Social security costs                           |       | 91         | 86         | 87         |
| Pension costs (including retirement healthcare) | 33    | 60         | 64         | 53         |
| Share based payments                            | 25    | 21         | 18         | 24         |
|   |       | 989        | 936        | 959        |





**5. Acquisition Related Costs**

During the year no acquisition related costs were incurred. In 2009 and 2008 (2009 \$26m, 2008 \$61m) acquisition costs related to the integration of the Plus business. For 2008, this includes \$15m relating to the utilisation of the stepped-up Plus inventory to fair value on acquisition.

**6. Restructuring and Rationalisation Expenses**

In 2010, restructuring and rationalisation costs comprised \$15m (2009 \$42m, 2008 \$34m) relating to the Earnings Improvement Programme and mainly comprise costs associated with the rationalisation of operational sites.

**7. Interest (Payable)/Receivable**

|                      | 2010       | 2009       | 2008       |
|----------------------|------------|------------|------------|
|                      | \$ million | \$ million | \$ million |
| Interest receivable  | 3          | 2          | 5          |
| Interest payable:    |            |            |            |
| Bank borrowings      | (7)        | (16)       | (62)       |
| Other                | (11)       | (26)       | (9)        |
|                      | (18)       | (42)       | (71)       |
| Net interest payable | (15)       | (40)       | (66)       |

Interest receivable includes net interest receivable of \$nil (2009 \$nil, 2008 \$1m) on interest rate and currency swaps and interest payable includes \$5m (2009 \$23m, 2008 \$7m) of net interest payable on currency and interest rate swaps. The gross interest receivable on these swaps was \$4m (2009 \$14m, 2008 \$5m) and the gross interest payable was \$9m (2009 \$37m, 2008 \$11m).

**8. Other Finance Costs**

|   | Notes | 2010       | 2009       | 2008       |
|---|-------|------------|------------|------------|
|   |       | \$ million | \$ million | \$ million |
| Retirement benefits: Interest cost                  | 33    | (64)       | (61)       | (66)       |
| Retirement benefits: Expected return on plan assets | 33    | 55         | 48         | 66         |
| Other   |       | (1)        | (2)        | (1)        |
| Other finance costs                                 |       | (10)       | (15)       | (1)        |

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 \$8m gain in 2010 (2009 net \$14m gain, 2008 net \$4m loss). 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.

**9. Taxation**

|   | 2010       | 2009       | 2008       |
|---|------------|------------|------------|
|   | \$ million | \$ million | \$ million |
| Current taxation:   |            |            |            |
| UK corporation tax at 28% (2009 28%, 2008 28%)            | 52         | 50         | 45         |
| Overseas tax  | 238        | 189        | 178        |
| Current income tax charge                                 | 290        | 239        | 223        |
| Adjustments in respect of prior periods                   | (18)       | (31)       | (14)       |
| Total current taxation                                    | 272        | 208        | 209        |
| Deferred taxation   |            |            |            |
| Origination and reversal of temporary differences         | 4          | (7)        | (19)       |
| Changes in tax rates                                      | (2)        | -          | -          |
| Adjustments to estimated amounts arising in prior periods | 6          | (3)        | (3)        |
| Total deferred taxation                                   | 8          | (10)       | (22)       |
| Total taxation as per the income statement                | 280        | 198        | 187        |
| Deferred taxation in other comprehensive income           | 7          | 12         | (71)       |
| Deferred taxation in equity                               | -          | (2)        | -          |
| Taxation attributable to the Group                        | 287        | 208        | 116        |

The tax charge was reduced by \$10m in 2010 (2009 \$26m, 2008 \$30m) as a consequence of restructuring and rationalisation expenses, acquisition related costs, amortisation of acquisition intangibles and impairments.

The applicable tax for the year is based on the United Kingdom standard rate of corporation tax of 28% (2009 28%, 2008 28.5%). Overseas taxation is calculated at the rates prevailing in the respective jurisdictions. The average effective tax rate differs from the applicable rate as follows:

|   | 2010  | 2009  | 2008  |
|---|-------|-------|-------|
|   | %     | %     | %     |
| UK standard rate  | 28.0  | 28.0  | 28.5  |
| Non-deductible/non-taxable items                                      | 0.2   | 1.2   | 1.4   |
| Prior year items  | (1.5) | (4.8) | (3.3) |
| Tax losses (utilised not previously recognised)/incurred not relieved | (0.2) | (0.1) | 1.1   |
| Overseas income taxed at other than UK standard rate                  | 4.8   | 5.3   | 5.5   |
| Total effective tax rate  | 31.3  | 29.6  | 33.2  |

During the year the enacted UK tax rate applicable from 1 April 2011 was reduced to 27% and the UK Government announced policy to reduce the tax rate to 24% across the following three years. The impact of the enacted change to 27% results in a deferred tax credit of \$2m in the year ended 31 December 2010. It is expected that if the stated policy is enacted further credits will arise.

**10. Dividends**

|   | 2010       | 2009       | 2008       |
|---|------------|------------|------------|
|   | \$ million | \$ million | \$ million |
| The following dividends were declared and paid in the year:                         |            |            |            |
| Ordinary second interim of 8.93¢ for 2009 (2008 8.12¢, 2007 7.38¢) paid 12 May 2010 | 79         | 72         | 66         |
| Ordinary interim of 6.00¢ for 2010 (2009 5.46¢, 2008 4.96¢) paid 2 November 2010    | 53         | 48         | 43         |

A final dividend for 2010 of 9.82 US cents per Ordinary Share was proposed by the Board on 9 February 2011 and will be paid on 19 May 2011 to shareholders on the Register of Members on 3 May 2011. The estimated amount of this dividend on 23 February 2011 was \$87m.

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**11. Earnings per Ordinary Share**

The calculations of the basic, diluted and adjusted earnings per Ordinary Share are based on the following earnings and numbers of shares:

|  | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million |
|--|--------------------|--------------------|--------------------|
| <b>Earnings</b>                          |                    |                    |                    |
| Attributable profit for the year         | 615                | 472                | 377                |
| Adjusted attributable profit (see below) | 654                | 580                | 493                |

**Adjusted attributable profit**

Adjusted earnings per Ordinary Share is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affect 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.

Attributable profit is reconciled to adjusted attributable profit as follows:

|   | Notes   | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million |
|---|---------|--------------------|--------------------|--------------------|
| Attributable profit for the year                        |         | 615                | 472                | 377                |
| Acquisition related costs                               | 5       | -                  | 26                 | 61                 |
| Restructuring and rationalisation expenses              | 6       | 15                 | 42                 | 34                 |
| Amortisation of acquisition intangibles and impairments | 13 & 16 | 34                 | 66                 | 51                 |
| Taxation on excluded items                              | 9       | (10)               | (26)               | (30)               |
| Adjusted attributable profit                            |         | 654                | 580                | 493                |

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:

|  | 2010  | 2009  | 2008  |
|--|-------|-------|-------|
| <b>Number of shares (millions)</b>           |       |       |       |
| Basic weighted average number of shares      | 888   | 884   | 886   |
| Dilutive impact of share options outstanding | 1     | 1     | 4     |
| Diluted weighted average number of shares    | 889   | 885   | 890   |
| <b>Earnings per Ordinary share</b>           |       |       |       |
| Basic  | 69.3¢ | 53.4¢ | 42.6¢ |
| Diluted                                      | 69.2¢ | 53.3¢ | 42.4¢ |
| Adjusted: Basic                              | 73.6¢ | 65.6¢ | 55.6¢ |
| Adjusted: Diluted                            | 73.6¢ | 65.5¢ | 55.4¢ |

Share options not included in the diluted EPS calculation because they were non-dilutive in the period totalled 2.5 million (2009 21.4 million, 2008 18.7 million).

**12. Property, Plant and Equipment**

|                                    | Land and buildings |            | Plant and equipment |            | Assets in    | Total      |
|------------------------------------|--------------------|------------|---------------------|------------|--------------|------------|
|                                    | Freehold           | Leasehold  | Instruments         | Other      | course of    |            |
|                                    | \$ million         | \$ million | \$ million          | \$ million | construction | \$ million |
| <b>Cost</b>                        |                    |            |                     |            |              |            |
| At 1 January 2009                  | 153                | 54         | 767                 | 669        | 59           | 1,702      |
| Exchange adjustment                | 5                  | 2          | 35                  | 32         | 2            | 76         |
| Acquisitions (Note 29)             | -                  | -          | -                   | 6          | -            | 6          |
| Additions                          | 4                  | 3          | 133                 | 75         | 1            | 216        |
| Disposals                          | -                  | (2)        | (57)                | (26)       | -            | (85)       |
| Transfer to assets held for sale   | (34)               | -          | -                   | -          | -            | (34)       |
| Transfers                          | 1                  | (5)        | 11                  | 28         | (35)         | -          |
| At 31 December 2009                | 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      |
| <b>Depreciation and Impairment</b> |                    |            |                     |            |              |            |
| At 1 January 2009                  | 44                 | 20         | 472                 | 441        | -            | 977        |
| Exchange adjustment                | 1                  | 1          | 22                  | 22         | -            | 46         |
| Charge for the year                | 10                 | 4          | 131                 | 61         | -            | 206        |
| Disposals                          | -                  | (1)        | (52)                | (22)       | -            | (75)       |
| Transfer to assets held for sale   | (26)               | -          | -                   | -          | -            | (26)       |
| Transfers                          | -                  | (2)        | 2                   | -          | -            | -          |
| At 31 December 2009                | 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      |
| <b>Net book amounts</b>            |                    |            |                     |            |              |            |
| At 31 December 2010                | 90                 | 28         | 326                 | 276        | 67           | 787        |
| At 31 December 2009                | 100                | 30         | 314                 | 282        | 27           | 753        |

Land and buildings includes land with a cost of \$10m (2009 \$14m) that is not subject to depreciation. Assets held under finance leases with a net book amount of \$14m (2009 \$15m) are included within land and buildings and \$10m (2009 \$10m) are included within plant and equipment.

**13. Intangible Assets**

|                                    | Acquisition<br>intangibles<br>\$ million | Software<br>\$ million | Distribution<br>Rights<br>\$ million | Patents<br>&<br>Intellectual<br>Property<br>\$ million | Total<br>\$ million |
|------------------------------------|--|------------------------|--------------------------------------|--|---------------------|
| <b>Cost</b>                        |  |                        |                                      |  |                     |
| At 1 January 2009                  | 387                                      | 68                     | 33                                   | 66   | 554                 |
| Exchange adjustment                | 18                                       | 3                      | -                                    | 1  | 22                  |
| Acquisitions (Note 29)             | 12                                       | -                      | -                                    | -  | 12                  |
| Disposals                          | -  | (4)                    | -                                    | -  | (4)                 |
| Additions                          | -  | 44                     | 34                                   | 24   | 102                 |
| At 31 December 2009                | 417                                      | 111                    | 67                                   | 91   | 686                 |
| Exchange adjustment                | 23                                       | 1                      | -                                    | -  | 24                  |
| Disposals                          | -  | (1)                    | (25)                                 | -  | (26)                |
| Additions                          | -  | 32                     | 11                                   | 22   | 65                  |
| Transfers                          | -  | 2                      | -                                    | -  | 2                   |
| At 31 December 2010                | 440                                      | 145                    | 53                                   | 113  | 751                 |
| <b>Amortisation and Impairment</b> |  |                        |                                      |  |                     |
| At 1 January 2009                  | 103                                      | 15                     | 26                                   | 34   | 178                 |
| Exchange adjustment                | 9  | 1                      | 1                                    | -  | 11                  |
| Charge for the year                | 34                                       | 13                     | 8                                    | 5  | 60                  |
| Impairment                         | 13                                       | -                      | -                                    | 12   | 25                  |
| At 31 December 2009                | 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                 |
| <b>Net book amounts</b>            |  |                        |                                      |  |                     |
| At 31 December 2010                | 240                                      | 98                     | 29                                   | 59   | 426                 |
| At 31 December 2009                | 258                                      | 82                     | 32                                   | 40   | 412                 |

In 2009, the Group incurred \$25m of impairment charges against certain intangible assets arising from the acquisition of Osteobiologics Inc. and the pain management business (2010 \$nil).

**14. Investments**

|                | 2010<br>\$ million | 2009<br>\$ million |
|----------------|--------------------|--------------------|
| At 1 January   | 7                  | 7                  |
| Impairment     | (1)                | -                  |
| At 31 December | 6                  | 7                  |

The investment is an available-for-sale investment of a non-controlling interest in an entity that holds mainly unquoted equity securities which by their very nature have no fixed maturity date or coupon rate. The 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. At year-end, 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.

**15. Investments in Associates**

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.

|  | 2010<br>\$ million | 2009<br>\$ million |
|--|--------------------|--------------------|
| Share of results of associates:                          |                    |                    |
| Revenue  | 11                 | 10                 |
| Operating costs and taxation                             | (11)               | (8)                |
| Profit after taxation recognised in the income statement | -                  | 2                  |
| Dividends paid   | (1)                | (1)                |
| Net (loss)/profit attributable to the Group              | (1)                | 1                  |
| Investments in associates at 1 January                   | 13                 | 12                 |
| Exchange adjustment                                      | 1                  | -                  |
| Investments in associates at 31 December                 | 13                 | 13                 |
| Investments in associates is represented by:             |                    |                    |
| Assets   | 11                 | 14                 |
| Liabilities  | (2)                | (5)                |
| Net assets   | 9                  | 9                  |
| Goodwill   | 4                  | 4                  |
|  | 13                 | 13                 |

**16. Goodwill**

|  | Notes | 2010<br>\$ million | 2009<br>\$ million |
|--|-------|--------------------|--------------------|
| <b>Cost</b>                            |       |                    |                    |
| At 1 January                           |       | 1,100              | 1,189              |
| Exchange adjustment                    |       | 12                 | 20                 |
| Acquisitions                           | 29    | -                  | 3                  |
| Plus settlement                        | 29    | -                  | (112)              |
| Adjustment to contingent consideration |       | (4)                | -                  |
| At 31 December                         |       | 1,108              | 1,100              |
| <b>Impairment</b>                      |       |                    |                    |
| At 1 January                           |       | 7                  | -                  |
| Impairment in the year                 |       | -                  | 7                  |
| At 31 December                         |       | 7                  | 7                  |
| <b>Net book amounts</b>                |       | 1,101              | 1,093              |

Goodwill arising on acquisition is not amortised but reviewed for impairment on an annual basis. Goodwill is allocated to the cash-generating unit that is expected to benefit from the acquisition. 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.



**16. Goodwill (continued)**

Each of the Group's operating segments represent a cash-generating unit and include goodwill as follows:

|                           | <b>2010</b>       | <b>2009</b>       |
|---------------------------|-------------------|-------------------|
|                           | <b>\$ million</b> | <b>\$ million</b> |
| Orthopaedics              | 582               | 562               |
| Endoscopy                 | 280               | 280               |
| Advanced Wound Management | 239               | 251               |
|                           | 1,101             | 1,093             |

In September 2010 and 2009 impairment reviews were performed by comparing the recoverable amount of each operating segment with its carrying amount, including goodwill. These are updated during December, taking into account significant events that occurred between September and December.

In 2009, an impairment was made for the goodwill relating to the pain management business (contained within the Orthopaedics cash generating unit), which was held for sale.

For each cash generating unit (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. Growth rates for the five year period for the Orthopaedics business vary up to 9% (2009 8%), for the Endoscopy business up to 10% (2009 9%) and for the Advanced Wound Management business up to 8% (2009 8%).

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 11% (2009 11%), for the Endoscopy businesses it is 15% (2009 12%) and for the Advanced Wound Management business it is 10% (2009 9%).

In determining the growth rate used in the calculation of the value-in-use, the Group considered the annual sales growth and trading 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.

Specific considerations and strategies taken into account in determining the sales growth and trading 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 growth rate of 4% (2009 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% (2009 8%) of annual revenue.

**16. Goodwill (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% (2009 31%) for the Orthopaedics business, 43% (2009 37%) for the Endoscopy business and 53% (2009 39%) for the Advanced Wound Management business.

**17. Inventories**

|                                     | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|-------------------------------------|-------------------|-------------------|-------------------|
|                                     | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Raw materials and consumables       | 159               | 157               | 131               |
| Work-in-progress                    | 23                | 28                | 32                |
| Finished goods and goods for resale | 741               | 748               | 716               |
|                                     | 923               | 933               | 879               |

Reserves for excess and obsolete inventories were \$322m (2009 \$303m, 2008 \$232m). During 2010, \$66m was recognised as an expense within cost of goods sold resulting from the write down of excess and obsolete inventory (2009 \$92m, 2008 \$69m). The cost of inventories recognised as an expense and included in cost of goods sold amounted to \$909m (2009 \$866m, 2008 \$922m).

No inventory is carried at fair value less costs to sell in any year.

**18. Trade and Other Receivables**

|  | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|--|-------------------|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Trade receivables  | 952               | 843               | 826               |
| Less: provision for bad and doubtful debts                   | (49)              | (47)              | (40)              |
| Trade receivables net (loans and receivables)                | 903               | 796               | 786               |
| Current asset derivatives forward foreign exchange contracts | 23                | 13                | 38                |
| Other receivables  | 55                | 71                | 73                |
| Amounts owed by associates                                   | -                 | 2                 | 2                 |
| Prepayments and accrued income                               | 65                | 64                | 62                |
|  | 1,046             | 946               | 961               |
| Less non-current portion: Trade receivables                  | (22)              | -                 | -                 |
| Current portion  | 1,024             | 946               | 961               |

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.

**18. Trade and Other Receivables (continued)**

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 macrotextured claim) for the year was \$30m (2009 \$33m, 2008 \$30m). Amounts due from insurers in respect of the macrotextured claim of \$133m (2009 \$128m, 2008 \$124m) are included within other receivables and have been provided in full.

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 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.

The amount of trade receivables that were past due but not impaired were as follows:

|  | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|--|-------------------|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Past due not more than three months                          | 168               | 202               | 242               |
| Past due more than three months and not more than six months | 52                | 56                | 47                |
| Past due more than six months and not more than one year     | 57                | 46                | 41                |
| Past due more than one year                                  | 59                | 80                | 91                |
|  | 336               | 384               | 421               |
| Neither past due nor impaired                                | 616               | 459               | 405               |
| Provision for bad and doubtful debts                         | (49)              | (47)              | (40)              |
| Trade receivables net (loans and receivables)                | 903               | 796               | 786               |

Movements in the provision for bad and doubtful debts were as follows:

|  |      |      |      |
|--|------|------|------|
| At 1 January                             | 47   | 40   | 22   |
| Exchange adjustment                      | -    | 1    | -    |
| Receivables provided for during the year | 30   | 33   | 30   |
| Utilisation of provision                 | (28) | (27) | (12) |
| At 31 December                           | 49   | 47   | 40   |

Trade receivables include amounts denominated in the following major currencies:

|   |     |     |     |
|---|-----|-----|-----|
| US Dollar                                     | 282 | 281 | 299 |
| Sterling                                      | 72  | 55  | 52  |
| Euro  | 283 | 280 | 273 |
| Other   | 266 | 180 | 162 |
| Trade receivables net (loans and receivables) | 903 | 796 | 786 |

Trade receivables of \$11m (2009 \$20m, 2008 \$23m) are under a factoring agreement with third parties. The arrangement does not qualify for de-recognition as the Group retains part of the credit risks the associated liability amounts to \$4m (2009 \$12m, 2008 \$20m) and is accounted for as a part of current payables.

**19. Cash and Borrowings**

Net debt comprises borrowings and credit balances on currency swaps less cash and bank.

|   | 2010       | 2009       |
|---|------------|------------|
|   | \$ million | \$ million |
| Bank overdrafts and loans due within one year | 57         | 45         |
| Long-term borrowings                          | 642        | 1,090      |
| Borrowings                                    | 699        | 1,135      |
| Cash and bank                                 | (207)      | (192)      |
| Net debt                                      | 492        | 943        |

Borrowings are repayable as follows:

|                           | Within one<br>year or on<br>demand | Between one<br>and two<br>years | Between two<br>and three<br>years | Between<br>three and<br>four years | Between<br>four and five<br>years | After five<br>years | Total      |
|---------------------------|------------------------------------|---------------------------------|-----------------------------------|------------------------------------|-----------------------------------|---------------------|------------|
|                           | \$<br>million                      | \$ million                      | \$ million                        | \$<br>million                      | \$ million                        | \$<br>million       | \$ million |
| 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        |
| At 31 December 2009:      |                                    |                                 |                                   |                                    |                                   |                     |            |
| Bank loans                | 24                                 | 1                               | 1,066                             | -                                  | -                                 | -                   | 1,091      |
| Bank overdrafts           | 18                                 | -                               | -                                 | -                                  | -                                 | -                   | 18         |
| Finance lease liabilities | 3                                  | 3                               | 3                                 | 3                                  | 2                                 | 12                  | 26         |
|                           | 45                                 | 4                               | 1,069                             | 3                                  | 2                                 | 12                  | 1,135      |

Assets are pledged as security under normal market conditions. Secured borrowings and pledged assets are as follows:

|   | 2010       | 2009       |
|---|------------|------------|
|   | \$ million | \$ million |
| Finance lease liabilities due within one year       | 4          | 3          |
| Secured bank overdrafts and loans                   | -          | 1          |
| Finance lease liabilities due after one year        | 18         | 23         |
| Secured long-term borrowings                        | -          | 1          |
| Total amount of secured borrowings                  | 22         | 28         |
| Total net book value of assets pledged as security: |            |            |
| Property, plant and equipment                       | 22         | 28         |
|   | 22         | 28         |

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All currency swaps are stated at fair value. Gross US Dollar equivalents of \$61m (2009 \$95m) receivable and \$61m (2009 \$95m) payable have been netted and the difference of \$nil (2009 \$nil) is reported as a \$nil balance on currency swaps. Currency swaps comprise foreign exchange swaps and were used in 2010 and 2009 to hedge intragroup loans.

**19. Cash and Borrowings (continued)**

Currency swaps mature as follows:

|                            | Amount            | Amount            |
|----------------------------|-------------------|-------------------|
|                            | receivable        | payable           |
|                            | Currency          | Currency          |
| <b>At 31 December 2010</b> | <b>\$ million</b> | <b>million</b>    |
| Within one year:           |                   |                   |
| Japanese Yen               | 18                | Yen 1,500         |
| Canadian Dollar            | 25                | C\$24             |
|                            | 43                |                   |
|                            | Amount            | Amount            |
|                            | receivable        | payable           |
|                            | Currency          | Currency          |
| <b>At 31 December 2010</b> | <b>million</b>    | <b>\$ million</b> |
| Within one year:           |                   |                   |
| New Zealand Dollar         | NZ\$5             | 4                 |
| Australian Dollar          | AUS\$14           | 14                |
|                            |                   | 18                |
|                            | Amount            | Amount            |
|                            | receivable        | payable           |
|                            | Currency          | Currency          |
| <b>At 31 December 2009</b> | <b>\$ million</b> | <b>million</b>    |
| Within one year:           |                   |                   |
| Australian Dollar          | 28                | Aus\$31           |
| Japanese Yen               | 17                | Yen 1,500         |
| Canadian Dollar            | 35                | C\$37             |
| Swiss Franc                | 6                 | CHF6              |
| New Zealand Dollar         | 1                 | NZ\$1             |
|                            | 87                |                   |
|                            | Amount            | Amount            |
|                            | receivable        | payable           |
|                            | Currency          | Currency          |
| <b>At 31 December 2009</b> | <b>million</b>    | <b>\$ million</b> |
| Within one year:           |                   |                   |
| Sterling                   | £5                | 8                 |



## 19. Cash and Borrowings (continued)

### 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 \$1,511m (2009 \$2,503m) and total uncommitted facilities of \$332m (2009 \$415m). The Group has undrawn committed facilities of \$884m (2009 \$1,436m). Of the undrawn committed facilities, \$7m expires within one year and \$877m after two but within five years (2009 \$1m expired within one year and \$1,435m 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 is the same as fair value.

In December 2010 the Company reviewed and replaced its principal banking facilities ahead of their maturity in May 2012. The Company has reduced its \$1 billion 5-year term facility to \$500 million with effect from 20 December 2010. The interest rate for this multi-currency facility, at 20 basis points over LIBOR, is unchanged. Smith & Nephew has also cancelled its \$1.5 billion multi-currency revolving facility and replaced it with a new 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 2010, 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.

**19. Cash and Borrowings (continued)**

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:

|   | Within<br>one year<br>or<br>on demand | Between one<br>and<br>two years | Between two<br>and<br>five years | After<br>five years | Total      |
|---|---------------------------------------|---------------------------------|----------------------------------|---------------------|------------|
|   | \$ million                            | \$ million                      | \$ million                       | \$<br>million       | \$ million |
| At 31 December 2010:                                      |                                       |                                 |                                  |                     |            |
| Non-derivative financial liabilities:                     |                                       |                                 |                                  |                     |            |
| Bank overdrafts and loans                                 | 59                                    | 500                             | 130                              | -                   | 689        |
| Trade and other payables                                  | 584                                   | -                               | -                                | -                   | 584        |
| Finance lease liabilities                                 | 5                                     | 4                               | 9                                | 12                  | 30         |
| Derivative financial liabilities:                         |                                       |                                 |                                  |                     |            |
| 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      |
| At 31 December 2009:                                      |                                       |                                 |                                  |                     |            |
| Non-derivative financial liabilities:                     |                                       |                                 |                                  |                     |            |
| Bank overdrafts and loans                                 | 48                                    | 7                               | 1,069                            | -                   | 1,124      |
| Trade and other payables                                  | 547                                   | -                               | -                                | -                   | 547        |
| Acquisition consideration                                 | 19                                    | 28                              | -                                | -                   | 47         |
| Finance lease liabilities                                 | 5                                     | 5                               | 10                               | 15                  | 35         |
| Derivative financial liabilities:                         |                                       |                                 |                                  |                     |            |
| Currency swaps/forward foreign exchange contracts outflow | 1,033                                 | -                               | -                                | -                   | 1,033      |
| Currency swaps/forward foreign exchange contracts inflow  | (1,023)                               | -                               | -                                | -                   | (1,023)    |
| Interest rate basis swaps gross outflow                   | 10                                    | -                               | -                                | -                   | 10         |
| Interest rate basis swaps gross inflow                    | (5)                                   | -                               | -                                | -                   | (5)        |
|   | 634                                   | 40                              | 1,079                            | 15                  | 1,768      |

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.

**20. Financial Instruments and Risk Management****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 2010, CHF125m (2009 CHF261m) of Group borrowings and nil (2009 \$6m) of currency swaps 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 2010 was \$134m (2009 \$252m). 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.

## 20. Financial Instruments and Risk Management (continued)

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 2010, the Group had contracted to exchange within one year the equivalent of \$944m (2009 \$933m).

Based on the Group's borrowings as at 31 December 2010, if the US Dollar were to weaken against all currencies by 10%, the Group's net borrowings would increase by \$24m (2009 \$52m). 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 \$35m (2009 \$63m). Excluding borrowings designated as net investment hedges, the increase would be \$21m (2009 \$37m); 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 2010 would have been \$20m lower (2009 \$19m), 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 2010 would have been \$19m higher (2009 \$19m).

A 10% strengthening of the US Dollar against all other currencies at 31 December 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.

### 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 2010 the Group had fixed future interest rates on borrowings totaling \$98m for a period of six months and \$112m for a period of one year (2009 \$515m for a period of one year).

Based on the Group's gross borrowings as at 31 December 2010, if interest rates were to increase by 100 basis points in all currencies then the annual net interest charge would increase by \$5m (2009 \$6m). Excluding the impact of the Group's interest rate hedges, the increase in the interest charge would be \$7m (2009 \$11m). Similarly if interest rates were to increase by 100 basis points in all currencies, the fair value of the Group's interest rate swaps would increase equity by \$2m (2009 \$5m). A decrease in interest rates by 100 basis points in all currencies would have an equal but opposite effect to the amounts shown above.

### Credit Risk Exposures

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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 2010 was \$23m (2009 \$13m), 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 2010 was \$207m (2009 \$192m). 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 18 of the Notes to the Group Accounts.

**20. Financial Instruments and Risk Management (continued)****Currency and Interest Rate Profile of Interest Bearing Liabilities and Assets**

In 2010, the Group entered into a series of interest rate swaps to fix the monthly interest payable on \$98m for a period of six months and \$112m for a period of one year (2009 \$515m for a period of one year) of the Group's floating rate borrowings. The swaps are denominated in US Dollars, Euros and Swiss Francs. Short-term debtors and creditors are excluded from the following disclosures.

## Currency and Interest Rate Profile of Interest Bearing Liabilities:

|                                    | Gross borrowings<br>\$ million | Currency swaps<br>\$ million | Total liabilities<br>\$ million | Floating rate liabilities<br>\$ million | Fixed rate liabilities<br>\$ million | Weighted average interest rate<br>% | Fixed rate liabilities<br>Weighted average time for which rate is fixed<br>Years |
|------------------------------------|--------------------------------|------------------------------|---------------------------------|---|--------------------------------------|-------------------------------------|--|
| 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  |
| Total interest bearing liabilities | 699                            | 61                           | 760                             | 528                                     | 232                                  |                                     |  |
| At 31 December 2009:               |                                |                              |                                 |   |                                      |                                     |  |
| US Dollar                          | 462                            | -                            | 462                             | 292                                     | 170                                  | 2.5                                 | 2  |
| Swiss Franc                        | 257                            | 6                            | 263                             | 93                                      | 170                                  | 0.8                                 | 1  |
| Euro                               | 306                            | -                            | 306                             | 105                                     | 201                                  | 1.8                                 | 1  |
| Other                              | 110                            | 89                           | 199                             | 199                                     | -                                    | -                                   | -  |
| Total interest bearing liabilities | 1,135                          | 95                           | 1,230                           | 689                                     | 541                                  |                                     |  |

\$22m (2009 \$26m) of fixed rate liabilities relate to finance leases and \$210m (2009 \$515m) relate to hedged borrowings under the \$500m term facility. In 2009, the Group also had liabilities due for deferred acquisition consideration (denominated in US Dollars, Euro and Yen) totalling \$46m on which no interest was payable (see Note 21 of the Notes to the Group Accounts). 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 2010 was 1% (2009 1%).

## Currency and Interest Rate Profile of Interest Bearing Assets:

|                               | Cash and bank<br>\$ million | Currency swaps<br>\$ million | Total assets<br>\$ million | Floating rate assets<br>\$ million |
|-------------------------------|-----------------------------|------------------------------|----------------------------|------------------------------------|
| At 31 December 2010:          |                             |                              |                            |                                    |
| US Dollars                    | 46                          | 43                           | 89                         | 89                                 |
| Other                         | 161                         | 18                           | 179                        | 179                                |
| Total interest bearing assets | 207                         | 61                           | 268                        | 268                                |

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At 31 December 2009:

|                               |     |    |     |     |
|-------------------------------|-----|----|-----|-----|
| US Dollars                    | 41  | 87 | 128 | 128 |
| Other                         | 151 | 8  | 159 | 159 |
| Total interest bearing assets | 192 | 95 | 287 | 287 |

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 2010 or 31 December 2009.

**20. Financial Instruments and Risk Management (continued)****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 that are taken out as hedges are fair valued. 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.

As at 31 December 2010 and 31 December 2009, 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 2010 and 31 December 2009, the fair value of the Group's long-term borrowing was not materially different from amortised cost.

**21. Payables**

|  | 2010       | 2009       |
|--|------------|------------|
|  | \$ million | \$ million |
| <b>Trade and other payables due within one year</b>                |            |            |
| Trade and other payables   | 584        | 547        |
| Current liability derivatives - forward foreign exchange contracts | 33         | 24         |
| Current liability derivatives - interest rate swaps                | -          | 6          |
| Acquisition consideration  | -          | 19         |
|  | 617        | 596        |
| <b>Other payables due after one year:</b>                          |            |            |
| Acquisition consideration  | -          | 27         |

The amount of \$27m due after more than one year in the prior year was settled early during 2010. Trade payables are not interest bearing and are stated at their nominal value. Management considers that the carrying amount of trade payables approximates the fair value.





**22. Provisions**

|                                | <b>Rationalisation<br/>and integration<br/>\$ million</b> | <b>Legal and other<br/>provision<br/>\$ million</b> | <b>Total<br/>\$ million</b> |
|--------------------------------|---|---|-----------------------------|
| At 1 January 2010              | 18  | 90  | 108                         |
| Charge to income statement     | 7   | 18  | 25                          |
| Utilisation                    | (11)  | (12)  | (23)                        |
| At 31 December 2010            | 14  | 96  | 110                         |
| Provisions due within one year | 14  | 23  | 37                          |
| Provisions due after one year  | -   | 73  | 73                          |
| At 31 December 2010            | 14  | 96  | 110                         |
| Provisions due within one year | 16  | 39  | 55                          |
| Provisions due after one year  | 2   | 51  | 53                          |
| At 31 December 2009            | 18  | 90  | 108                         |

The principal provisions within rationalisation and integration provisions relate to the rationalisation of operational sites (mainly severance and legal costs) arising from the Earnings Improvement Programme, integration expenses relating to severance, legal and onerous leases arising from the acquisition of Plus and an onerous lease obligation on the exit from the tissue engineering operation.

Included within the legal and other provision is \$20m (2009 \$25m) relating to the declination of insurance coverage for macrotextured knee revisions (see Note 32 of the Notes to the Group Accounts). The remaining balance largely represents provisions for various litigation and patent disputes.

All provisions are expected to be substantially utilised within four years of 31 December 2010 and none are treated as financial instruments.

**23. Deferred Taxation**

|                             | <b>2010<br/>\$ million</b> | <b>2009<br/>\$ million</b> |
|-----------------------------|----------------------------|----------------------------|
| Deferred tax assets         | 224                        | 202                        |
| Deferred tax liabilities    | (69)                       | (31)                       |
| Net position at 31 December | 155                        | 171                        |

The movement in the year in the Group's net deferred tax position was as follows:

|   | <b>Notes</b> | <b>2010<br/>\$ million</b> | <b>2009<br/>\$ million</b> |
|---|--------------|----------------------------|----------------------------|
| At 1 January                                |              | 171                        | 168                        |
| Exchange adjustment                         |              | (1)                        | 4                          |
| Movement in income statement - current year |              | (4)                        | 7                          |
| Movement in income statement - prior years  |              | (4)                        | 3                          |
| Acquisitions                                | 29           | -                          | 1                          |
| Other intangible assets                     |              | -                          | (2)                        |
| Movement in other comprehensive income      |              | (7)                        | (12)                       |
| Movement in shareholders' equity            |              | -                          | 2                          |
| At 31 December                              |              | 155                        | 171                        |



## 23. Deferred Taxation (continued)

Movements in the main components of deferred tax assets and liabilities were as follows:

|   | Retirement<br>benefit<br>obligation<br>\$ million | Macro-<br>textured<br>claim<br>\$ million | Other<br>\$ million | Total<br>\$ million |
|---|---|---|---------------------|---------------------|
| <b>Deferred tax assets:</b>                 |   |   |                     |                     |
| At 1 January 2009                           | 66  | 52  | 96                  | 214                 |
| Exchange adjustment                         | 2   | -   | 3                   | 5                   |
| Movement in income statement - current year | (1)   | -   | 2                   | 1                   |
| Movement in income statement - prior years  | 1   | -   | 3                   | 4                   |
| Movement in other comprehensive income      | (20)  | -   | -                   | (20)                |
| Movement in shareholders' equity            | -   | -   | 1                   | 1                   |
| Acquisitions                                | -   | -   | 1                   | 1                   |
| Other intangible assets                     | -   | -   | (2)                 | (2)                 |
| Transfers                                   | 6   | -   | (8)                 | (2)                 |
| At 31 December 2009                         | 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                 |

The Group has unused tax losses of \$21m (2009: \$25m) available for offset against future profits. A deferred tax asset has been recognised in respect of \$1m (2009: \$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.

|   | Accelerated<br>tax<br>depreciation<br>\$ million | Intangible<br>assets<br>\$ million | Other<br>\$ million | Total<br>\$ million |
|---|--|------------------------------------|---------------------|---------------------|
| <b>Deferred tax liabilities:</b>            |  |                                    |                     |                     |
| At 1 January 2009                           | (41)   | (34)                               | 29                  | (46)                |
| Exchange adjustment                         | (1)  | (2)                                | 2                   | (1)                 |
| Movement in income statement - current year | 2  | 2                                  | 2                   | 6                   |
| Movement in income statement - prior years  | 5  | (2)                                | (4)                 | (1)                 |
| Movement in other comprehensive income      | -  | -                                  | 8                   | 8                   |
| Movement in shareholders' equity            | -  | -                                  | 1                   | 1                   |
| Transfers                                   | -  | 2                                  | -                   | 2                   |
| At 31 December 2009                         | (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)                |



**24. Share Capital**

|  | Ordinary Shares   |            | Deferred Shares     |            | Total<br>\$ million |
|--|-------------------|------------|---------------------|------------|---------------------|
|  | Thousand<br>(20¢) | \$ million | Thousand<br>(£1.00) | \$ million |                     |
| <b>Authorised</b>                      |                   |            |                     |            |                     |
| At 31 December 2008                    | 1,223,591         | 245        | 50                  | -          | 245                 |
| At 31 December 2009                    | 1,223,591         | 245        | 50                  | -          | 245                 |
| At 31 December 2010                    | 1,223,591         | 245        | 50                  | -          | 245                 |
| <b>Allotted, issued and fully paid</b> |                   |            |                     |            |                     |
| At 1 January 2008                      | 947,508           | 190        | 50                  | -          | 190                 |
| Share options                          | 2,382             | -          | -                   | -          | -                   |
| At 31 December 2008                    | 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                 |

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
- 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 ongoing 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 ongoing 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:

|                 | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million |
|-----------------|--------------------|--------------------|--------------------|
| Share capital   | 191                | 190                | 190                |
| Share premium   | 396                | 382                | 375                |
| Treasury shares | (778)              | (794)              | (823)              |

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|                                      |       |       |       |
|--------------------------------------|-------|-------|-------|
| Retained earnings and other reserves | 2,964 | 2,401 | 1,957 |
|                                      | 2,773 | 2,179 | 1,699 |

**25(a). Share Based Payments – Share Options Plans****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 Belgium, Italy, the Netherlands and France are able to participate respectively in the Smith & Nephew Belgian Sharesave Plan (2002), 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). Employees in Belgium participated in the Smith & Nephew International Sharesave Plan (2002) from September 2010 onwards. Together all of the plans referred to above are termed the Employee 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 1985 Share Option Scheme (adopted by shareholders on 9 May 1985), the Smith & Nephew 1990 International Executive Share Option Scheme (adopted by shareholders on 15 May 1990), 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 . The Smith & Nephew 1985 Share Option Scheme and the Smith & Nephew 1990 International Executive Share Option Scheme expired during 2010 and no options remain outstanding as at 31 December 2010.

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 options granted prior to 2001, the option price was not less than the market value of an Ordinary Share, or the nominal value if higher (the market value being the quoted price on the business day preceding the date of grant or the quoted price on the date of grant). 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 Plan 2010, the vesting of options granted from 1997 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.



**25(a). Share Based Payments Share Options Plans (continued)**

The maximum term of options granted, under all plans, is 10 years from the date of grant. All share option plans except for the Stock Appreciation Rights Plan (detailed on page 116) are settled in shares.

At 31 December 2010 25,753,000 (2009 23,383,000, 2008 21,681,000) options were outstanding under share option plans as follows:

|   | Number of shares<br>Thousand | Range of option<br>exercise prices<br>Pence |       | Weighted average<br>exercise price<br>Pence |
|---|------------------------------|---|-------|---|
| <b>Employee Plans:</b>                  |                              |   |       |   |
| Outstanding at 1 January 2008           | 3,678                        | 296.0                                       | 600.5 | 397.9                                       |
| Granted                                 | 906                          | 507.0                                       | 640.0 | 509.3                                       |
| Forfeited                               | (359)                        | 296.0                                       | 581.0 | 408.7                                       |
| Exercised                               | (633)                        | 296.0                                       | 526.0 | 368.2                                       |
| Expired                                 | (59)                         | 296.0                                       | 498.0 | 379.9                                       |
| Outstanding at 31 December 2008         | 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                                       |
| 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                                       |
| Options exercisable at 31 December 2008 | 168                          | 321.0                                       | 526.0 | 398.3                                       |
| <b>Executive Plans:</b>                 |                              |   |       |   |
| Outstanding at 1 January 2008           | 17,350                       | 145.0                                       | 637.7 | 525.0                                       |
| Granted                                 | 5,129                        | 465.5                                       | 680.5 | 615.1                                       |
| Forfeited                               | (1,073)                      | 409.5                                       | 637.5 | 559.5                                       |
| Exercised                               | (2,696)                      | 265.0                                       | 637.5 | 584.1                                       |
| Expired                                 | (562)                        | 145.0                                       | 637.7 | 575.3                                       |
| Outstanding at 31 December 2008         | 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                                       |
| Options exercisable at 31 December 2010 | 5,153                        | 409.5                                       | 627.0 | 548.3                                       |
| Options exercisable at 31 December 2009 | 6,668                        | 265.0                                       | 637.5 | 532.0                                       |
| Options exercisable at 31 December 2008 | 5,049                        | 183.5                                       | 672.5 | 593.2                                       |

25(a). Share Based Payments Share Options Plans (continued)

The weighted average remaining contractual life of options outstanding at 31 December 2010 was 6.1 (2009 5.9 years, 2008 5.8 years) years for Executive Plans and 2.7 (2009 2.7 years, 2008 1.7 years) years for Employee Plans.

|                              | 2010<br>pence | 2009<br>pence | 2008<br>pence |
|------------------------------|---------------|---------------|---------------|
| Weighted average share price | 619.3         | 504.0         | 579.5         |

Options granted during the year were as follows:

|                 | Options granted<br>Thousand | Weighted<br>average fair<br>value per option<br>at grant date<br>Pence | Weighted<br>average share<br>price at grant<br>date Pence | Weighted average<br>exercise price<br>Pence | Weighted<br>average option<br>life<br>Years |
|-----------------|-----------------------------|--|---|---|---|
| Employee Plans  | 986                         | 170.2  | 566.0   | 462.2                                       | 3.9   |
| Executive Plans | 6,249                       | 173.7  | 553.2   | 528.1                                       | 9.8   |

The weighted average fair value of options granted under employee plans during 2009 was 212.0p (2008 192.0p) and those under executive plans during 2009 was 147.9p (2008 191.3p).

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 2010 grant management expected 90% of the options granted under the 2001 Executive Scheme to vest (2009 95%, 2008 95%) and 90% of the 2004 Executive Scheme to vest (2009 60%, 2008 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:

|                                  | Employee plans |      |      | Executive plans |      |      |
|----------------------------------|----------------|------|------|-----------------|------|------|
|                                  | 2010           | 2009 | 2008 | 2010            | 2009 | 2008 |
| Dividend yield (%)               | 1.5            | 1.5  | 1.0  | 1.5             | 1.5  | 1.0  |
| Expected volatility (%) (i)      | 30.0           | 30.0 | 25.0 | 30              | 30.0 | 25.0 |
| Risk free interest rate (%) (ii) | 2.5            | 3.3  | 4.5  | 2.5             | 3.3  | 4.5  |

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|                              |     |     |     |     |     |     |
|------------------------------|-----|-----|-----|-----|-----|-----|
| Expected life in years (iii) | 3.9 | 3.9 | 3.9 | 9.8 | 6.8 | 6.5 |
|------------------------------|-----|-----|-----|-----|-----|-----|

- (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% (2009 - 5%, 2008 - 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% (2009 - 50%, 2008 - 50%) of Executive Plan option holders are assumed to exercise by choice per annum providing the gain available is at least 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, 2008 - 50% for the 2004 Plan and 25% for the 2001 Plans).

**25(a). Share Based Payments - Share Options Plans (continued)**

Summarised information about options outstanding under the share option plans at 31 December 2010 is as follows:

|                         | Number outstanding<br>Thousand | Weighted average<br>remaining contract life<br>Years |
|-------------------------|--------------------------------|--|
| <b>Employee Plans:</b>  |                                |  |
| 348.0p to 619.3p*       | 3,355                          | 2.7  |
| 619.3p* to 640.0p       | 3                              | 1.3  |
|                         | 3,358                          | 2.7  |
| <b>Executive Plans:</b> |                                |  |
| 409.5p to 619.3p*       | 15,527                         | 6.6  |
| 619.3p* to 680.5p       | 6,868                          | 4.8  |
|                         | 22,395                         | 6.1  |

\* The split has been determined based on the weighted average share price of 619.3p.

As at 31 December 2010 nil (2009 77,669, 2008 85,135) options remain outstanding under the 1999 and 2000 Stock Appreciation Rights Plan. The fair value liability related to these schemes was nil in both 2009 and 2008, this was materially the same as intrinsic value.

**25(b). 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 35% (2009 30%, 2008 15%) has been assumed with the constituents of the group. A correlation of 35% (2009 30%, 2008 15%) 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 25(a) of the Notes to the Group Accounts.

**25(b). Share Based Payments Long-Term Incentive Plans (continued)**

At 31 December 2010 the maximum number of shares that could be awarded under the Group's long-term incentive plans were:

|                                 | PSP                           | CIP   | Deferred Bonus Plan | Total   |
|---------------------------------|-------------------------------|-------|---------------------|---------|
|                                 | Number of shares in thousands |       |                     |         |
| Outstanding at 1 January 2008   | 3,323                         | 760   | -                   | 4,083   |
| Awarded                         | 1,588                         | 384   | -                   | 1,972   |
| Vested                          | (135)                         | (89)  | -                   | (224)   |
| Forfeited                       | (959)                         | (305) | -                   | (1,264) |
| Outstanding at 31 December 2008 | 3,817                         | 750   | -                   | 4,567   |
| Awarded                         | 2,372                         | -     | 305                 | 2,677   |
| Vested                          | (334)                         | (99)  | (7)                 | (440)   |
| Forfeited                       | (975)                         | (206) | (6)                 | (1,187) |
| 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   |

The weighted average remaining contractual life of awards outstanding at 31 December 2010 was 1.8 years (2009 1.8 years, 2008 1.5 years) for the PSP, 0.2 years (2009 0.7 years, 2008 1.3 years) for the CIP and 1.9 years (2009 2.2 years) for the Deferred Bonus Plan.

**25(c). Share Based Payments Charge to Income Statement**

The expense charged to the income statement for share based payments is as follows:

|  | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million |
|--|--------------------|--------------------|--------------------|
| Granted in current year                | 5                  | 2                  | 4                  |
| Granted in prior years                 | 16                 | 16                 | 20                 |
| Total share based expense for the year | 21                 | 18                 | 24                 |

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.

**26. Treasury Shares**

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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.

**26. Treasury Shares (continued)**

The movements in Treasury shares and the Employees Share Trust are as follows:

|   | Treasury<br>\$ million | Employees<br>Share Trust<br>\$ million | Total<br>\$ million |
|---|------------------------|--|---------------------|
| At 1 January 2009                         | 816                    | 7                                      | 823                 |
| Shares transferred from treasury          | (14)                   | 14                                     | -                   |
| Shares transferred to group beneficiaries | (9)                    | (20)                                   | (29)                |
| At 31 December 2009                       | 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                 |

  

|   | No of Shares<br>(million) | No of Shares<br>(million) | No of Shares<br>(million) |
|---|---------------------------|---------------------------|---------------------------|
| At 1 January 2009                         | 66.6                      | 0.5                       | 67.1                      |
| Shares transferred from treasury          | (1.1)                     | 1.1                       | -                         |
| Shares transferred to group beneficiaries | (0.8)                     | (1.5)                     | (2.3)                     |
| At 31 December 2009                       | 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                      |

**27. Cash Flow Statement****Analysis of Net Debt**

|                        | Cash<br>\$ million | Overdrafts<br>\$ million | Borrowings<br>due within<br>one<br>year<br>\$ million | due after<br>one year<br>\$ million | Net currency<br>swaps<br>\$ million | Total<br>\$ million |
|------------------------|--------------------|--------------------------|---|-------------------------------------|-------------------------------------|---------------------|
| At 1 January 2008      | 170                | (61)                     | (1,381)   | (36)                                | (2)                                 | (1,310)             |
| Net cash flow          | (16)               | 34                       | 49  | (80)                                | (5)                                 | (18)                |
| Other non-cash changes | -                  | -                        | 1,248   | (1,248)                             | -                                   | -                   |
| Facility fee (i)       | -                  | -                        | -   | 2                                   | -                                   | 2                   |
| Exchange adjustment    | (9)                | 4                        | (8)   | 4                                   | 3                                   | (6)                 |
| At 31 December 2008    | 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)               |

(i) During 2008, \$2m of the facility fee prepayment was reclassified as borrowings following the term-out of the loan.





**27. Cash Flow Statement (continued)****Reconciliation of Net Cash Flow to Movement in Net Debt**

|  | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|--|-------------------|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Change in cash net of overdrafts in the year | 15                | 44                | 18                |
| Settlement of currency swaps                 | 3                 | 12                | (5)               |
| Net change in borrowings                     | 420               | 354               | (31)              |
| Change in net debt from net cash flow        | 438               | 410               | (18)              |
| Facility fee paid                            | -                 | -                 | 2                 |
| Exchange adjustment                          | 13                | (21)              | (6)               |
| Change in net debt in the year               | 451               | 389               | (22)              |
| Opening net debt                             | (943)             | (1,332)           | (1,310)           |
| Closing net debt                             | (492)             | (943)             | (1,332)           |

**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>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|---------------------------|-------------------|-------------------|-------------------|
|                           | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Cash at bank and in hand  | 207               | 192               | 145               |
| Bank overdrafts           | (12)              | (18)              | (23)              |
| Cash and cash equivalents | 195               | 174               | 122               |

**28. Currency Translation**

The exchange rates used for the translation of currencies into US Dollars that have the most significant impact on the Group results were:

|             | <b>2010</b> | <b>Average rates</b><br><b>2009</b>  | <b>2008</b> |
|-------------|-------------|--------------------------------------|-------------|
| Sterling    | 1.54        | 1.56                                 | 1.84        |
| Euro        | 1.32        | 1.39                                 | 1.46        |
| Swiss Franc | 0.96        | 0.92                                 | 0.92        |
|             | <b>2010</b> | <b>Year-end rates</b><br><b>2009</b> | <b>2008</b> |
| Sterling    | 1.57        | 1.61                                 | 1.44        |
| Euro        | 1.34        | 1.43                                 | 1.39        |
| Swiss Franc | 1.07        | 0.97                                 | 0.94        |

**29. Acquisitions**

**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***

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.

**29. Acquisitions (continued)*****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.

|   | Pre-acquisition<br>carrying amounts<br>\$ million | Fair<br>value<br>adjustments<br>\$ million | Fair value to Group<br>reported in<br>2009<br>\$ million |
|---|---|--|--|
| 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   |

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.

**Year ended 31 December 2008**

The aggregate impact of acquisitions that occurred during 2008 is set out below. The acquisitions primarily relate to minority interest and distributor buyouts, as a result of the Plus acquisition concluded in 2007. There is no material difference between the fair value and book value of the net assets acquired.

|                            | \$ million |
|----------------------------|------------|
| Deferred taxation          | 1          |
| Intangible assets          | 1          |
| Assets acquired            | 2          |
| Goodwill (i)               | (2)        |
| Cost of acquisition        | -          |
| Discharged by              |            |
| Cash                       | 2          |
| Deferred consideration (i) | (2)        |
|                            | -          |

- (i) Relating to the reversal of goodwill allocated previously on the basis of contingent consideration.

In 2008, deferred consideration of \$14m in respect of the previous years' acquisitions was paid.

**30. Assets held for sale**

The Group has classified following assets as held for sale:

|                               | 2010<br>\$ million | 2009<br>\$ million |
|-------------------------------|--------------------|--------------------|
| Property, plant and equipment | -                  | 8                  |
| Inventory                     | -                  | 6                  |
|                               | -                  | 14                 |

In 2009, the Group closed the Largo manufacturing site. The property, plant and equipment was disposed of in 2010. The property was valued at the net realisable value less any costs to sell.

The Group had committed to the disposal of its pain management business at 31 December 2009, which occurred during 2010. The related goodwill and intangible assets were impaired by \$19m to their estimated net realisable value. As part of this disposal, inventory to the value of \$6m was held for sale.

**31. Financial Commitments**

Group capital expenditure relating to property, plant and equipment contracted but not provided for amounted to \$15m (2009 \$7m).

The Group is contractually committed to four milestone payments, which total \$60m (2009 \$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.

Future minimum lease payments under non-cancellable operating leases fall due as follows:

|                                   | 2010<br>\$ million | 2009<br>\$ million |
|-----------------------------------|--------------------|--------------------|
| Land and buildings:               |                    |                    |
| Within one year                   | 30                 | 28                 |
| After one and within two years    | 25                 | 20                 |
| After two and within three years  | 19                 | 17                 |
| After three and within four years | 18                 | 12                 |
| After four and within five years  | 14                 | 11                 |
| After five years                  | 21                 | 17                 |
|                                   | 127                | 105                |
| Other assets:                     |                    |                    |
| Within one year                   | 23                 | 25                 |
| After one and within two years    | 10                 | 18                 |
| After two and within three years  | 5                  | 6                  |
| After three and within four years | 1                  | 2                  |
|                                   | 39                 | 51                 |

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Future minimum lease payments under finance leases together with the present value of the minimum lease payments are as follows:

|   | <b>2010</b>       | <b>2009</b>       |
|---|-------------------|-------------------|
|   | <b>\$ million</b> | <b>\$ million</b> |
| Within one year                         | 5                 | 5                 |
| After one and within two years          | 4                 | 5                 |
| After two and within three years        | 3                 | 4                 |
| After three and within four years       | 3                 | 3                 |
| After four and within five years        | 3                 | 3                 |
| After five years                        | 12                | 15                |
| Total minimum lease payments            | 30                | 35                |
| Discounted by imputed interest          | (8)               | (9)               |
| Present value of minimum lease payments | 22                | 26                |

Present value of minimum lease payments can be split out as: \$4m (2009 \$3m) due within one year, \$8m (2009 \$11m) due between one to five years and \$10m (2009 \$12m) due after five years.

### 32. 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 with the possible exception of those detailed below, 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.

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 to date related to this matter is approximately \$212m. The Group has sought recovery from its insurers.

To date the primary insurance carrier has paid \$60m in full settlement of its policy liability. An additional \$22m was received from a successful legal settlement. At 31 December 2010, at least \$133m remains due, and the Group has sought coverage from five excess insurance carriers. However, these 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 2012.

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 \$20m provision remaining is adequate to cover remaining claims. Given the uncertainty inherent in such matters, however, there can be no assurance on this point.

In September 2007, the US Securities and Exchange Commission ( 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 foreign countries. The US Department of Justice subsequently joined the SEC's request. The Group is cooperating fully with the US Department of Justice and the SEC regarding these matters, has conducted a broader review on its own initiative, and has disclosed to them information indicating that at least one independent distributor of the Group's products may have made payments that could have FCPA implications. The Group is engaged in discussions to resolve these matters, which might include a settlement by which the Group would pay certain amounts, and submit to compliance reporting and oversight obligations. There is no assurance that a settlement will be reached, however.

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 are often significant.

### 33. Retirement Benefit Obligations

The Group's retirement benefit obligations comprise:

|                       | 2010<br>\$ million | 2009<br>\$ million |
|-----------------------|--------------------|--------------------|
| Funded Plans:         |                    |                    |
| UK Plan               | 59                 | 134                |
| US Plan               | 110                | 109                |
| Other Plans (i)       | 36                 | 28                 |
|                       | 205                | 271                |
| Unfunded Plans:       |                    |                    |
| Other Plans (i)       | 22                 | 22                 |
| Retirement Healthcare | 35                 | 29                 |



- (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.

**33. Retirement Benefit Obligations (continued)**

In July 2010, the UK Government announced that it would, in future, link the statutory minimum pension indexation to the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI). In December 2010, the Government issued statutory orders for the indexation of benefits in 2011 based on CPI. The Group has assessed that this change will reduce the UK pension liabilities. To reflect this, in 2010 the Group has recognised an actuarial gain of \$13m outside profit and loss through Other Comprehensive Income.

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:

Principal actuarial assumptions:

|   | 2010        | 2009 | 2008 |
|---|-------------|------|------|
|   | % per annum |      |      |
| <b>UK Plan:</b>   |             |      |      |
| Discount rate   | 5.5         | 5.7  | 6.1  |
| Expected return on plan assets (i)                          | 5.9         | 6.4  | 6.5  |
| Expected rate of salary increases                           | 5.5         | 5.6  | 5.2  |
| Future pension increases                                    | 3.5         | 3.6  | 3.2  |
| Inflation   | 3.5         | 3.6  | 3.2  |
| Life expectancy of male aged 60 (in years)                  | 28.2        | 28.1 | 28.6 |
| Life expectancy of male aged 60 in 20 years time (in years) | 31.5        | 31.3 | 31.9 |
| <b>US Plan:</b>   |             |      |      |
| Discount rate   | 5.6         | 6.0  | 5.9  |
| Expected return on plan assets (i)                          | 7.5         | 7.5  | 8.2  |
| Expected rate of salary increases                           | 4.7         | 4.7  | 5.0  |
| Future pension increases                                    | -           | -    | -    |
| Inflation   | 2.7         | 2.7  | 2.7  |
| Life expectancy of male aged 60 (in years)                  | 22.8        | 23.0 | 23.0 |
| Life expectancy of male aged 60 in 20 years time (in years) | 24.7        | 25.8 | 25.8 |
| <b>Other Plans:</b>   |             |      |      |
| Discount rate (ii)  | 4.2         | 4.6  | 3.5  |
| Expected return on plan assets (i) (ii)                     | 5.1         | 5.0  | 5.2  |
| Expected rate of salary increases (ii)                      | 3.0         | 3.3  | 2.2  |
| Future pension increases (ii)                               | 2.3         | 1.9  | 0.8  |
| Inflation (ii)  | 2.1         | 1.0  | 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.

Pension costs (including retirement healthcare):

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|   | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|---|-------------------|-------------------|-------------------|
|   | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Current service cost – employer’s portion             | 26                | 26                | 29                |
| Other finance cost                                    | 64                | 61                | 66                |
| Expected return on assets in the plan                 | (55)              | (48)              | (66)              |
| Net defined benefit pension costs                     | 35                | 39                | 29                |
| Net defined contribution pension costs                | 25                | 25                | 24                |
| Total pension costs charged to profit before taxation | 60                | 64                | 53                |

**33. Retirement Benefit Obligations (continued)**

Actuarial gains/(losses) recognised in Group Statement of Comprehensive Income:

|  | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million |
|--|--------------------|--------------------|--------------------|
| Experience gains/(losses) in pension scheme assets                         | 34                 | 71                 | (236)              |
| Experience gains on scheme liabilities                                     | 21                 | 17                 | 1                  |
| (Losses)/gains due to changes in assumptions underlying scheme liabilities | (29)               | (47)               | 20                 |
|  | 26                 | 41                 | (215)              |

Of the \$60m (2009 \$64m, 2008 \$53m) net cost for the year, \$51m (2009 \$51m, 2008 \$53m) was charged to operating profit. The interest cost and expected return on plan assets are reported as other finance costs. The actuarial gains of \$26m (2009 gain of \$41m, 2008 loss of \$215m) were reported in the statement of other comprehensive income making the cumulative charge to date \$228m (2009 \$254m, 2008 \$295m).

The contributions made in the year in respect of defined benefit plans were: UK Plan \$37m (2009 \$19m, 2008 \$23m); US Plan \$20m (2009 \$14m, 2008 \$11m); and Other Plans \$8m (2009 \$8m, 2008 \$9m). The agreed contributions for 2011 in respect of the Group's defined benefit plans are: \$38m for the UK Plan (including \$29m of supplementary payments), \$30m for the US Plan and \$7m for other defined benefit plans.

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 2010 there were nil outstanding payments due to be paid over to the plans (2009 nil, 2008 nil).

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:

|  | Rate<br>of Return<br>% | UK Plan<br>Value<br>\$ million | Rate<br>of Return<br>% | US Plan<br>Value<br>\$ million | Rate<br>of Return<br>% | Other Plans<br>Value<br>\$ million |
|--|------------------------|--------------------------------|------------------------|--------------------------------|------------------------|------------------------------------|
| <b>31 December 2010</b>  |                        |                                |                        |                                |                        |                                    |
| 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)                               |
| <b>31 December 2009</b>  |                        |                                |                        |                                |                        |                                    |
| Equities   | 7.7                    | 310                            | 8.7                    | 161                            | 7.1                    | 29                                 |
| Bonds  | 4.7                    | 203                            | 4.2                    | 68                             | 4.1                    | 34                                 |
| Property   | 6.2                    | 16                             | -                      | -                              | 5.0                    | 5                                  |
| Other  | 4.1                    | 5                              | 3.3                    | 5                              | 5.3                    | 19                                 |
| Market value of assets   |                        | 534                            |                        | 234                            |                        | 87                                 |
| Present value of defined benefit obligations                   |                        | (668)                          |                        | (343)                          |                        | (137)                              |
| Deficit: non-current liability recognised in the balance sheet |                        | (134)                          |                        | (109)                          |                        | (50)                               |



**33. Retirement Benefit Obligations (continued)**

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:

| % Asset Category: | UK Plan |      | US Plan |      | Other Plans |      |
|-------------------|---------|------|---------|------|-------------|------|
|                   | 2010    | 2009 | 2010    | 2009 | 2010        | 2009 |
| Equity securities | 55      | 58   | 71      | 69   | 33          | 33   |
| Debt securities   | 44      | 38   | 26      | 29   | 33          | 39   |
| Property          | -       | 3    | -       | -    | 5           | 6    |
| Other             | 1       | 1    | 3       | 2    | 29          | 22   |
| Total             | 100     | 100  | 100     | 100  | 100         | 100  |

A reconciliation of the present value of defined benefit obligations is shown in the following tables:

|  | UK Plan<br>\$ million | US Plan<br>\$ million | Other<br>Plans<br>\$ million | Retirement<br>Healthcare<br>\$ million | Total<br>\$ million |
|--|-----------------------|-----------------------|------------------------------|--|---------------------|
| Present value of defined benefit obligations at 1 January 2009   | 516                   | 337                   | 141                          | 28                                     | 1,022               |
| Current service cost   | 8                     | 9                     | 9                            | -                                      | 26                  |
| Settlements to members   | -                     | -                     | (3)                          | -                                      | (3)                 |
| Other finance cost   | 34                    | 20                    | 6                            | 1                                      | 61                  |
| Experience gains on plan liabilities                             | (10)                  | -                     | (7)                          | -                                      | (17)                |
| Losses/(gains) on change of assumptions                          | 73                    | (14)                  | (11)                         | (1)                                    | 47                  |
| Plan participant contributions                                   | 2                     | -                     | 3                            | -                                      | 5                   |
| Benefits paid  | (22)                  | (9)                   | (11)                         | (1)                                    | (43)                |
| Exchange adjustment  | 67                    | -                     | 10                           | 2                                      | 79                  |
| Present value of defined benefit obligations at 31 December 2009 | 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                  |
| 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               |

**33. Retirement Benefit Obligations (continued)**

A reconciliation of the fair value of plan assets is shown in the following tables:

|   | UK<br>Plan<br>\$ million | US<br>Plan<br>\$ million | Other<br>Plans<br>\$ million | Retirement<br>Healthcare<br>\$ million | Total<br>\$ million |
|---|--------------------------|--------------------------|------------------------------|--|---------------------|
| Fair value of plan assets at 1 January 2009   | 416                      | 180                      | 76                           | -                                      | 672                 |
| Expected return on plan assets                | 29                       | 15                       | 4                            | -                                      | 48                  |
| Settlements to members                        | -                        | -                        | (3)                          | -                                      | (3)                 |
| Experience gains on plan assets               | 36                       | 34                       | 1                            | -                                      | 71                  |
| Plan participant contributions                | 2                        | -                        | 3                            | -                                      | 5                   |
| Company contributions                         | 19                       | 14                       | 8                            | -                                      | 41                  |
| Benefits paid                                 | (22)                     | (9)                      | (11)                         | -                                      | (42)                |
| Exchange adjustment                           | 54                       | -                        | 9                            | -                                      | 63                  |
| Fair value of plan assets at 31 December 2009 | 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                 |

The history of experience adjustments is as follows:

|                      | Present<br>value of<br>Defined<br>benefit<br>obligations<br>\$ million | Fair value<br>of plan<br>assets<br>\$ million | Deficit<br>in plan<br>\$ million | Experience (losses)/<br>gains on plan liabilities |   | Experience gains/(losses)<br>on plan assets |                                      |
|----------------------|--|---|----------------------------------|---|---|---|--------------------------------------|
|                      |  |   |                                  | Amount<br>gain/(loss)<br>\$ million               | Percentage<br>of plan<br>liabilities<br>% | Amount<br>gain/(loss)<br>\$ million         | Percentage<br>of plan<br>assets<br>% |
| 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                                   |
| At 31 December 2006: |  |   |                                  |   |   |   |                                      |
| UK Plan              | (661)  | 617   | (44)                             | 15  | 2   | 20  | 3                                    |
| US Plan              | (295)  | 238   | (57)                             | 3   | 1   | 14  | 6                                    |
| Other Plans          | (60)   | 36  | (24)                             | 1   | 2   | 1   | 3                                    |

The Group recharges the UK pension plan with the costs of administration and independent advisers. The amount recharged in the year was \$2m (2009 \$2m, 2008 \$3m). The amount receivable at 31 December 2010 was \$nil (2009 \$nil, 2008 \$nil).





**33. Retirement Benefit Obligations (continued)****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            | 2010 |     | 2009 |     | 2008 |     |
|------------------------|------|-----|------|-----|------|-----|
|                        | UK   | US  | UK   | US  | UK   | US  |
| Discount rate          | 5.5  | 5.6 | 5.7  | 6.0 | 6.1  | 5.9 |
| Medical cost inflation | 7.0  | 8.0 | 7.0  | 8.0 | 6.5  | 8.7 |

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 2010 by more than \$2m (2009 more than \$2m, 2008 more than \$1m).

For the US the retirement healthcare cost trend for 2011 is expected to be 2.4% above the discount rate. Thereafter the healthcare cost trend rate is assumed to decrease by 0.5% per year to an ultimate rate of 5.0%. For the UK it will remain flat at 7%.

**34. Related Party Transactions****Trading Transactions**

In the course of normal operations, the Group traded with its associates detailed in Note 15 of the Notes to the Group Accounts. The aggregated transactions, which have not been disclosed elsewhere in the financial statements, are summarised below:

|                               | 2010       | 2009       | 2008       |
|-------------------------------|------------|------------|------------|
|                               | \$ million | \$ million | \$ million |
| Sales to the associates       | 8          | 7          | 4          |
| Purchases from the associates | 4          | 4          | 4          |

All sale and purchase transactions occur on an arm's length basis.

**Key Management Personnel**

The remuneration of executive officers (including non-executive directors) during the year is summarised below:

|                              | 2010       | 2009       | 2008       |
|------------------------------|------------|------------|------------|
|                              | \$ million | \$ million | \$ million |
| Short-term employee benefits | 13         | 14         | 12         |

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|  |    |    |    |
|--|----|----|----|
| Share-based payment                              | 3  | 6  | 9  |
| Pension and post employment benefit entitlements | 1  | 1  | 1  |
| Termination benefits                             | -  | -  | 1  |
|  | 17 | 21 | 23 |

**35. Information About the Nature and Cost of Services Provided by Auditors**

|   | <b>2010</b>       | <b>2009</b>       | <b>2008</b>       |
|---|-------------------|-------------------|-------------------|
|   | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Audit services: Group accounts                | 1                 | 1                 | 1                 |
| Other services:                               |                   |                   |                   |
| Local statutory audit pursuant to legislation | 2                 | 2                 | 3                 |
| Other services pursuant to legislation        | -                 | -                 | 1                 |
| Taxation services:                            |                   |                   |                   |
| Compliance services                           | 1                 | 1                 | 1                 |
| Advisory services                             | 1                 | 1                 | 2                 |
| Corporate finance transactions                | -                 | -                 | 1                 |
| Total auditors remuneration                   | 5                 | 5                 | 9                 |
| Arising:                                      |                   |                   |                   |
| In the UK                                     | 2                 | 2                 | 5                 |
| Outside the UK                                | 3                 | 3                 | 4                 |
|   | 5                 | 5                 | 9                 |

**36. Principal Subsidiary Undertakings**

The information provided below is given for principal trading and manufacturing subsidiary undertakings, all of which are 100% owned, in accordance with Section 410 of the Companies Act 2006. A full list will be appended to Smith & Nephew's next annual return to Companies House:

| <b>Company Name</b>                                 | <b>Activity</b> | <b>Country of operation and incorporation</b> |
|---|-----------------|---|
| <b>United Kingdom:</b>                              |                 |   |
| Smith & Nephew Healthcare Limited                   | Medical Devices | England & Wales                               |
| Smith & Nephew Medical Limited                      | Medical Devices | England & Wales                               |
| T. J. Smith & Nephew, Limited                       | Medical Devices | England & Wales                               |
| <b>Continental Europe:</b>                          |                 |   |
| Smith & Nephew GmbH                                 | Medical Devices | Austria                                       |
| Smith & Nephew SA-NV                                | Medical Devices | Belgium                                       |
| Smith & Nephew A/S                                  | Medical Devices | Denmark                                       |
| Smith & Nephew OY                                   | Medical Devices | Finland                                       |
| Smith & Nephew SAS                                  | Medical Devices | France  |
| Smith & Nephew Orthopedics GmbH                     | Medical Devices | Germany                                       |
| Smith & Nephew Orthopedics Hellas SA                | Medical Devices | Greece  |
| Smith & Nephew Limited                              | Medical Devices | Ireland                                       |
| Smith & Nephew Srl                                  | Medical Devices | Italy   |
| Smith & Nephew Nederland CV                         | Medical Devices | Netherlands                                   |
| Smith & Nephew A/S                                  | Medical Devices | Norway  |
| Smith & Nephew Sp Zoo                               | Medical Devices | Poland  |
| Smith & Nephew Lda                                  | Medical Devices | Portugal                                      |
| Smith & Nephew SA                                   | Medical Devices | Spain   |
| Smith & Nephew AB                                   | Medical Devices | Sweden  |
| Smith & Nephew Orthopaedics AG                      | Medical Devices | Switzerland                                   |
| <b>USA:</b>   |                 |   |
| Smith & Nephew Inc.                                 | Medical Devices | United States                                 |
| <b>Africa, Asia, Australasia and Other America:</b> |                 |   |
| Smith & Nephew Pty Limited                          | Medical Devices | Australia                                     |
| Smith & Nephew Inc.                                 | Medical Devices | Canada  |
| Smith & Nephew Medical (Shanghai) Co Limited        | Medical Devices | China   |
| Smith & Nephew Limited                              | Medical Devices | Hong Kong                                     |
| Smith & Nephew Healthcare Private Limited           | Medical Devices | India   |
| Smith & Nephew KK                                   | Medical Devices | Japan   |
| Smith & Nephew Limited                              | Medical Devices | Korea   |
| Smith & Nephew Healthcare Sdn Berhad                | Medical Devices | Malaysia                                      |
| Smith & Nephew SA de CV                             | Medical Devices | Mexico  |
| Smith & Nephew Limited                              | Medical Devices | New Zealand                                   |
| Smith & Nephew Inc.                                 | Medical Devices | Puerto Rico                                   |
| Smith & Nephew Pte Limited                          | Medical Devices | Singapore                                     |
| Smith & Nephew (Pty) Limited                        | Medical Devices | South Africa                                  |
| Smith & Nephew Limited                              | Medical Devices | Thailand                                      |
| Smith & Nephew FZE                                  | Medical Devices | United Arab Emirates                          |

## COMPANY AUDITOR S REPORT

### Independent Auditor s Report to the Members of Smith & Nephew plc

We have audited the parent company accounts of Smith & Nephew plc for the year ended 31 December 2010 which comprise the Parent company balance sheet and the related notes A to G. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

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 75, the directors are responsible for the preparation of the parent company accounts and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the parent company accounts 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 accounts sufficient to give reasonable assurance that the accounts are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the parent company 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 accounts.

### Opinion on accounts

In our opinion the parent company accounts:

give a true and fair view of the state of the company s affairs as at 31 December 2010;

have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and

have been prepared in accordance with the requirements of the Companies Act 2006.

**Opinion on other matters prescribed by the Companies Act 2006**

In our opinion:

the part of the Directors Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and

the information given in the Directors Report for the financial year for which the accounts are prepared is consistent with the parent company accounts.

**Matters on which we are required to report by exception**

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or

the parent company accounts and the part of the Directors Remuneration Report to be audited are not in agreement with the accounting records and returns; or

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.

**Other matter**

We have reported separately on the group accounts of Smith & Nephew plc for the year ended 31 December 2010.

**Les Clifford (Senior statutory auditor)**

for and on behalf of Ernst & Young LLP Statutory Auditor

London

24 February 2011

## COMPANY BALANCE SHEET

|  | Notes | At 31 December |           |
|--|-------|----------------|-----------|
|  |       | 2010           | 2009      |
|  |       | \$million      | \$million |
| <b>Fixed assets:</b>                                   |       |                |           |
| Investments  | B     | 3,598          | 3,598     |
| <b>Current assets:</b>                                 |       |                |           |
| Debtors  | C     | 2,523          | 2,337     |
| Cash and bank  | D     | 21             | 3         |
|  |       | 2,544          | 2,340     |
| <b>Creditors: amounts falling due within one year:</b> |       |                |           |
| Borrowings   | D     | (1)            | (8)       |
| Other creditors  | E     | (1,675)        | (1,086)   |
|  |       | (1,676)        | (1,094)   |
| <b>Net current assets</b>                              |       | 868            | 1,246     |
| <b>Total assets less current liabilities</b>           |       | 4,466          | 4,844     |
| <b>Creditors: amounts falling due after one year:</b>  |       |                |           |
| Borrowings   | D     | (623)          | (1,065)   |
| <b>Total assets less total liabilities</b>             |       | 3,843          | 3,779     |
| <b>Capital and reserves</b>                            |       |                |           |
| Equity shareholders funds:                             |       |                |           |
| Called up equity share capital                         | F     | 191            | 190       |
| Share premium account                                  | F     | 396            | 382       |
| Capital reserve  | F     | 2,266          | 2,266     |
| Treasury shares  | F     | (778)          | (794)     |
| Exchange reserve                                       | F     | (52)           | (52)      |
| Profit and loss account                                | F     | 1,820          | 1,787     |
| <b>Shareholders funds</b>                              |       | 3,843          | 3,779     |

The accounts were approved by the Board and authorised for issue on 24 February 2011 and signed on its behalf by: **John Buchanan** Chairman **David J. Illingworth** Chief Executive **Adrian Hennah** Chief Financial Officer

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## NOTES TO THE COMPANY ACCOUNTS

### A. Accounting Policies

The separate accounts of the Company are presented as required by the Companies Act 2006. The accounts have been prepared under the historical cost convention, modified to include revaluation to fair value of certain financial instruments as described below, and in accordance with applicable UK accounting standards. As consolidated financial information has been disclosed under IFRS 7, Financial Instruments: Disclosures, the Company is exempt from FRS 29, Financial Instruments: Disclosures. The Group accounts have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and are presented on pages 80 to 128.

The Company has taken advantage of the exemption in FRS 8, Related Party Disclosures not to present its related party disclosures as the Group accounts contain these disclosures. In addition, the Company has taken advantage of the exemption in FRS 1, Cash Flow Statements not to present its own cash flow statement as the Group accounts contain a consolidated cash flow.

In applying these policies management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates.

#### *Foreign Currencies*

Transactions in foreign currencies are initially 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. All exchange differences are dealt with in arriving at profit before taxation.

#### *Investments*

Investments in subsidiaries are stated at cost less provision for impairment.

#### *Financial Instruments*

Currency swaps are used to match foreign currency net assets with foreign currency liabilities. They are initially recorded at fair value and then for reporting purposes remeasured to fair value at exchange rates and interest rates at subsequent balance sheet dates.

Changes in the fair value of derivative financial instruments are recognised in the profit and loss account as they arise.

#### *Deferred Taxation*

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



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Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences are expected to reverse. These are based on tax rates and laws substantively enacted at the balance sheet date.

### *Share Based Payments*

The Company operates a number of equity-settled executive and employee share plans. For all grants of share options and awards, the fair value as at the date of grant is calculated using an appropriate option pricing model and the corresponding expense is recognised over the vesting period. Subsidiary companies are recharged for the fair value of share options that relate to their employees.

The disclosure relating to the Company is detailed in Note 25 of the Notes to the Group accounts.

**B. Investments**

At 1 January 2010 and 31 December 2010

**\$ million**  
3,598

Investments represent holdings in subsidiary undertakings.

The information provided below is given for the principal direct subsidiary undertakings, all of which are 100% owned and, in accordance with Section 410 of the Companies Act 2006, a full list will be appended to Smith & Nephew's next annual return to Companies House.

| <b>Company Name</b>               | <b>Activity</b> | <b>Country of operation and incorporation</b> |
|-----------------------------------|-----------------|---|
| Smith & Nephew UK Limited         | Holding Company | England & Wales                               |
| Smith & Nephew (Overseas) Limited | Holding Company | England & Wales                               |

Refer to Note 36 of the Notes to the Group accounts for the principal trading and manufacturing subsidiary undertakings of the Group.

**C. Debtors**

|  | <b>2010</b>       | <b>2009</b>       |
|--|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> |
| Amounts falling due within one year:                           |                   |                   |
| Amounts owed by subsidiary undertakings                        | 2,514             | 2,335             |
| Prepayments and accrued income                                 | 6                 | 2                 |
| Current asset derivatives – forward foreign exchange contracts | 3                 | -                 |
|  | <b>2,523</b>      | <b>2,337</b>      |

**D. Cash and Borrowings**

|  | <b>2010</b>       | <b>2009</b>       |
|--|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> |
| Bank loans and overdrafts due within one year or on demand | 1                 | 8                 |
| Bank loans due after one year                              | 623               | 1,065             |
| Borrowings   | 624               | 1,073             |
| Cash and bank  | (21)              | (3)               |
| Net debt   | <b>603</b>        | <b>1,070</b>      |

All currency swaps are stated at fair value. Gross US Dollar equivalents of \$61m (2009 – \$95m) receivable and \$61m (2009 – \$95m) payable have been netted. Currency swaps comprise foreign exchange swaps and were used in 2010 and 2009 to hedge Intragroup loans.

**E. Other Creditors**

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|  | <b>2010</b>       | <b>2009</b>       |
|--|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> |
| Amounts falling due within one year:                             |                   |                   |
| Amounts owed to subsidiary undertakings                          | 1,646             | 1,067             |
| Other creditors  | 14                | 5                 |
| Current taxation   | 12                | 8                 |
| Current liability derivatives interest rate swaps                | -                 | 6                 |
| Current liability derivatives forward foreign exchange contracts | 3                 | -                 |
|  | 1,675             | 1,086             |

**F. Equity and Reserves**

|  | 2010             |                  |                     |                    |                      | Profit and<br>loss<br>account | Total share-<br>holders<br>funds | 2009<br>Total<br>share-<br>holders<br>funds |
|--|------------------|------------------|---------------------|--------------------|----------------------|-------------------------------|----------------------------------|---|
|  | Share<br>Capital | Share<br>Premium | Capital<br>reserves | Treasury<br>Shares | Exchange<br>reserves |                               |                                  |   |
|  | \$ million       | \$<br>million    | \$<br>million       | \$ million         | \$<br>million        |                               |                                  |   |
| At 1 January                                   | 190              | 382              | 2,266               | (794)              | (52)                 | 1,787                         | 3,779                            | 3,751                                       |
| Attributable profit for the year               | -                | -                | -                   | -                  | -                    | 157                           | 157                              | 113   |
| Equity dividends paid in the year              | -                | -                | -                   | -                  | -                    | (132)                         | (132)                            | (120)                                       |
| Share-based payments recognised                | -                | -                | -                   | -                  | -                    | 21                            | 21                               | 18  |
| Cost of shares transferred to beneficiaries    | -                | -                | -                   | 21                 | -                    | (13)                          | 8                                | 10  |
| New shares issued on exercise of share options | 1                | 14               | -                   | -                  | -                    | -                             | 15                               | 7   |
| Treasury shares purchased                      | -                | -                | -                   | (5)                | -                    | -                             | (5)                              | -   |
| At 31 December                                 | 191              | 396              | 2,266               | (778)              | (52)                 | 1,820                         | 3,843                            | 3,779                                       |

Further information on the share capital of the Company can be found in Note 24 of the Notes to the Group Accounts.

The total distributable reserves of the Company are \$990m (2009 \$941m). In accordance with the exemption permitted by Section 408 of the Companies Act 2006, the Company has not presented its own profit and loss account. The attributable profit for the year dealt with in the accounts of the Company is \$157m (2009 \$113m).

Fees paid to Ernst & Young LLP for audit and non-audit services to the Company itself are not disclosed in the individual accounts because group financial statements are prepared which are required to disclose such fees on a consolidated basis. The fees for the consolidated Group are disclosed in Note 35 of the Notes to the Group Accounts.

**G. Contingencies**

|  | 2010       | 2009       |
|--|------------|------------|
|  | \$ million | \$ million |
| Guarantees in respect of subsidiary undertakings | 33         | 27         |

The Company has given guarantees to banks to support liabilities under foreign exchange and other contracts and cross guarantees to support overdrafts. Such guarantees are not considered to be liabilities as all subsidiary undertakings are trading as going concerns.

The Company operated defined benefit pension plans in 2004 but at the end of 2005 its pension plan obligations were transferred to Smith & Nephew UK Limited. The Company has provided guarantees to the Trustees of the pension plans to support future amounts due from participating employers (see Note 33 of the Notes to the Group Accounts).

## INVESTOR INFORMATION

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\* A graph showing total shareholder return can be found in the Directors Remuneration Report on page 71.

The report and financial statements, share and ADR price information, company presentations, the financial calendar, Corporate Governance Statement, contact details and other investor information on the Group are available in the Investor Centre section of the Company's website at [www.smith-nephew.com](http://www.smith-nephew.com).

## SHAREHOLDER RETURN

### Dividends

#### Dividend History

Smith & Nephew has paid dividends on its Ordinary Shares in each year since 1937. Following the capital restructuring and dividend reduction in 2000 the Group adopted a policy of increasing its dividend cover (the ratio of EPSA, as set out in the Selected Financial Data, to ordinary dividends declared for the year). This was intended to increase the financing capability of the Group for acquisitions and other investments. From 2000 to 2004 the dividend increased in line with inflation and, in 2004, dividend cover stood at 4.1 times. Having achieved this level of dividend cover the Board changed its policy, from that of increasing dividends in line with inflation, to that of increasing dividends for 2005 and after by 10%. Following the redenomination of the Company's share capital into US Dollars the Board re-affirmed its policy of increasing the dividend by 10% a year in US Dollar terms.

An interim dividend in respect of each fiscal year is normally declared in August and paid in November. Up to 2004 a final dividend for each year was recommended by the Board of Directors in the following February and paid in May after approval by shareholders at the Company's Annual General Meeting. Following shareholder approval in December 2005, the directors were able to declare and pay interim dividends. The second interim dividend replaced the final dividend and was usually payable in May and accordingly in 2008 and 2009 shareholders received two interim dividends. From 2010, the Company is reverting to paying an interim and final dividend each year; a final dividend will be recommended by the Board of Directors and paid subject to approval by shareholders at the Company's Annual General Meeting.

Future dividends of Smith & Nephew will be dependent upon: future earnings; the future financial condition of the Group; the Board's dividend policy; and the additional factors that might affect the business of the Group set out in Special Note Regarding Forward-Looking Statements and Risk Factors.

### Dividends per Share

The table below sets out the dividends per Ordinary share in the last five years.

|                           | Years ended 31 December |        |        |        |        |
|---------------------------|-------------------------|--------|--------|--------|--------|
|                           | 2010                    | 2009   | 2008   | 2007   | 2006   |
| Pence per share:          |                         |        |        |        |        |
| Interim                   | 4.233                   | 3.650  | 3.194  | 2.450  | 2.456  |
| Final/Second interim (ii) | (i) 6.720               | 6.494  | 6.194  | 4.059  | 3.789  |
| Total                     | 10.953                  | 10.144 | 9.388  | 6.509  | 6.245  |
| US cents per share:       |                         |        |        |        |        |
| Interim                   | 6.667                   | 6.067  | 5.511  | 5.011  | 4.556  |
| Final/Second interim (ii) | 10.911                  | 9.922  | 9.022  | 8.200  | 7.456  |
| Total                     | 17.578                  | 15.989 | 14.533 | 13.211 | 12.012 |

(i) Translated at the Bank of England rate on 23 February 2011.

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(ii) 2006 to 2009 Second interim, 2010 Final

Dividends above include the associated UK tax credit of 10%, but exclude the deduction of withholding taxes. All dividends, up to the second interim dividend for 2005, were declared in pence per Ordinary Share and translated into US cents per Ordinary Share at the Noon Buying Rate on the payment date. Since the second interim dividend for 2005 all dividends have been declared in US cents per Ordinary Share.

The 2010 final dividend will be payable on 19 May 2011, subject to shareholder approval.

The Ordinary Shares will trade ex-dividend on the London Stock Exchange from 27 April 2011. The ADSs will trade ex-dividend on the New York Stock Exchange from 29 April 2011. In respect of the final dividend for the year ended 31 December 2010 of 9.82 US cents per Ordinary Share, the record date will be 3 May 2011 and the payment date will be 19 May 2011. The Sterling equivalent per Ordinary Share will be set following the record date. Shareholders may elect to receive their dividend in either Sterling or US Dollars and the last day for election will be 3 May 2011.

## Share Prices

The table below sets out, for the periods indicated, the highest and lowest middle market quotations for the Company's Ordinary Shares (as derived from the Daily Official List of the UK Listing Authority) and the highest and lowest sales prices of its ADSs (as reported on the New York Stock Exchange composite tape).

|  | Ordinary Shares |          | ADSs         |             |
|--|-----------------|----------|--------------|-------------|
|  | High<br>£       | Low<br>£ | High<br>US\$ | Low<br>US\$ |
| <b>Year ended 31 December:</b>                 |                 |          |              |             |
| 2006   | 5.71            | 4.00     | 52.65        | 36.95       |
| 2007   | 6.50            | 5.33     | 67.84        | 51.54       |
| 2008   | 6.91            | 4.13     | 68.87        | 30.39       |
| 2009   | 6.42            | 4.20     | 51.38        | 30.57       |
| 2010   | 6.97            | 5.38     | 53.94        | 41.29       |
| <b>Quarters in the year ended 31 December:</b> |                 |          |              |             |
| 2009:  |                 |          |              |             |
| 1 <sup>st</sup> Quarter                        | 5.53            | 4.22     | 39.63        | 30.57       |
| 2 <sup>nd</sup> Quarter                        | 4.84            | 4.20     | 38.91        | 31.00       |
| 3 <sup>rd</sup> Quarter                        | 5.66            | 4.39     | 46.93        | 35.82       |
| 4 <sup>th</sup> Quarter                        | 6.42            | 5.27     | 51.38        | 42.55       |
| 2010:  |                 |          |              |             |
| 1 <sup>st</sup> Quarter                        | 6.97            | 6.25     | 53.23        | 48.98       |
| 2 <sup>nd</sup> Quarter                        | 6.95            | 6.05     | 53.94        | 43.26       |
| 3 <sup>rd</sup> Quarter                        | 6.16            | 5.38     | 47.45        | 41.29       |
| 4 <sup>th</sup> Quarter                        | 6.86            | 5.43     | 52.55        | 43.09       |
| 2011:  |                 |          |              |             |
| 1 <sup>st</sup> Quarter (to 23 February 2011)  | 7.42            | 6.50     | 60.19        | 50.83       |
| <b>Last Six Months:</b>                        |                 |          |              |             |
| August 2010                                    | 5.78            | 5.41     | 45.88        | 41.29       |
| September 2010                                 | 5.81            | 5.38     | 45.60        | 41.52       |
| October 2010                                   | 5.83            | 5.43     | 46.23        | 43.09       |
| November 2010                                  | 5.97            | 5.50     | 48.14        | 43.93       |
| December 2010                                  | 6.86            | 5.94     | 52.55        | 46.41       |
| January 2011                                   | 7.14            | 6.50     | 56.83        | 50.83       |
| February 2011 (to 23 February 2011)            | 7.42            | 7.02     | 60.19        | 56.57       |



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## INFORMATION FOR SHAREHOLDERS

### Financial Calendar

|  |                     |
|--|---------------------|
| Annual General Meeting                 | 14 April 2011       |
| Quarter One results                    | 5 May 2011          |
| Payment of 2010 final dividend         | 19 May 2011         |
| Half year results announced            | 5 August 2011 (i)   |
| Quarter Three results announced        | 4 November 2011     |
| Payment of 2011 first interim dividend | November 2011       |
| Full year results announced            | February 2012 (i)   |
| Annual Report available                | February/March 2012 |
| Annual General Meeting                 | April/May 2012      |

(i) Dividend declaration dates.

### Ordinary Shareholders

#### Registrar

All general enquiries concerning shareholdings, dividends, changes to shareholders' personal details and the AGM should be addressed to:

Equiniti, Aspect House, Spencer Road, Lancing, West Sussex BN99 6DA

Tel: 0871 384 2081 inside the UK \*

Tel: +44 (0) 121 415 7072 outside the UK.

Website: [www.shareview.co.uk](http://www.shareview.co.uk)

\* Calls to this number are charged at 8p per minute from a BT landline; other telephony providers' costs may vary.

#### Shareholder facilities:

*Shareview*

Equiniti's online enquiry and portfolio management service for shareholders. To view information about your shareholdings online, register at [www.shareview.co.uk](http://www.shareview.co.uk). Once registered for Shareview, you will also be able to register your proxy instructions online and elect to receive future shareholder communications via the Company's website ([www.smith-nephew.com](http://www.smith-nephew.com)).

*E-communications*

In line with developing practice we encourage shareholders to elect to receive communications via e-mail as this has significant environmental and cost benefits. Shareholders may register for this service through Equiniti, at [www.shareview.co.uk](http://www.shareview.co.uk). Shareholders will receive a confirmation letter from Equiniti at their registered address, containing an Activation Code for future use.

*Payment of dividends direct to your bank or building society account*

Shareholders who wish to avoid the risk of their dividend payments getting lost or mislaid can arrange to have their cash dividends paid directly to a bank or building society account. This facility is available to UK resident shareholders who receive sterling dividends. If you do not live in the UK you may be able to register for the overseas payment service. Further Information is available at [www.shareview.co.uk](http://www.shareview.co.uk) or by contacting Equiniti (UK and overseas helpline numbers as above).

*Dividend re-investment plan (DRIP)*

The Company offers shareholders (except those in North America) the opportunity to participate in a DRIP. This enables shareholders to reinvest their cash dividends in further Ordinary shares of Smith & Nephew plc. These are purchased in the market at competitive dealing costs. For further details plus an application form to re-invest future dividends, contact Equiniti (as above).

*Individual savings account (ISA)*

Shareholders who are UK resident may hold Smith & Nephew plc shares in an Individual Savings Account (ISA), which is administered by the Company's registrar. For information about this service please contact Equiniti (as above).

## Shareholder Communications

The Company makes quarterly financial announcements which are made available through Stock Exchange announcements and on the Group's website ([www.smith-nephew.com](http://www.smith-nephew.com)). Copies of recent Annual Reports, press releases, institutional presentations and audio webcasts are also available on the website.

Following shareholder approval in 2007, the Company sends paper copies of the Annual Report only to those shareholders that have elected to receive shareholder documentation by post. ADS holders will also not receive a paper copy unless they have elected to do so. Electronic copies of the Annual Report are available on the Group's website at [www.smith-nephew.com](http://www.smith-nephew.com). Both Ordinary shareholders and ADS holders can request paper copies of the Annual Report, which the Company provides free of charge. The Company will continue to send to Ordinary shareholders by post the notice of the Annual General Meeting and an accompanying letter. The letter states that the Annual Report is available on the Group's website. Shareholders who elect to receive the notice of Annual General Meeting electronically are informed by e-mail of the documents' availability on the Group's website. ADS holders receive the form of proxy by post but will not receive a paper copy of the notice of Annual General Meeting.

## Investor Communications

The Company maintains regular dialogue with individual institutional shareholders, together with results presentations. To ensure that all members of the Board develop an understanding of the views of major investors, the executive directors review significant issues raised by investors with the Board. Non-executive directors are sent copies of analysts' and brokers' briefings. There is an opportunity for individual shareholders to question the directors at the AGM and the Company regularly responds to letters from shareholders on a range of issues.

## UK Capital Gains Tax

For the purposes of UK capital gains tax the price of the Company's Ordinary Shares on 31 March 1982 was 35.04p.

## Smith & Nephew Share Price

The Company's Ordinary Shares are quoted on the LSE under the symbol SN. The Company's share price is available on the Smith & Nephew website [www.smith-nephew.com](http://www.smith-nephew.com) and at [www.londonstockexchange.com](http://www.londonstockexchange.com) where it is updated at intervals throughout the day.

## ShareGift

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Shareholders with only a small number of shares, which would cost more to sell than they are worth, may wish to consider donating them to the charity ShareGift (registered charity 1052686) which specialises in accepting such shares as donations. There may be no implications for Capital Gains Tax purposes (no gain or loss) and it may also be possible to obtain income tax relief. The relevant stock transfer form may be obtained from Equiniti at the above address.

Further information about ShareGift is available at [www.sharegift.org](http://www.sharegift.org) or by contacting ShareGift at:

ShareGift, 17 Carlton House Terrace, London SW1Y 5AH. Tel: (+44) (0) 20 7930 3737.

## American Depositary Shares ( ADSs ) and American Depositary Receipts ( ADRs )

In the US, the Company's Ordinary Shares are traded in the form of ADSs, evidenced by ADRs, on the NYSE under the symbol SNN. Each American Depositary Share represents five Ordinary Shares. The Bank of New York Mellon is the authorised depositary bank for the Company's ADR programme.

### ADS Enquiries

All enquiries regarding ADS holder accounts and payment of dividends should be addressed to:

BNY Mellon Shareholder Services, PO Box 358516, Pittsburgh, PA 15252-8516, USA;

Tel: +1-866-259-2287 inside the US (toll free)

Tel: +1-201-680-6825 internationally

Email: [shrrelations@bnymellon.com](mailto:shrrelations@bnymellon.com).

A Global BuyDIRECT plan is available for US residents, enabling investment directly in ADSs with reduced brokerage commissions and service costs. For further information on Global BuyDIRECT contact: The Bank of New York Mellon (as above) or visit [www.bnymellon.com/shareowner](http://www.bnymellon.com/shareowner).

The Company provides The Bank of New York Mellon, as depositary, with copies of Annual Reports containing Consolidated Financial Statements and the opinion expressed thereon by its independent auditors. Such financial statements are prepared under IFRS. The Bank of New York Mellon will send these reports to recorded ADS holders who have elected to receive paper copies. The Company also provides to The Bank of New York Mellon all notices of shareholders meetings and other reports and communications that are made generally available to shareholders of the Company. The Bank of New York Mellon makes such notices, reports and communications available for inspection by recorded holders of ADSs and sends forms of proxy by post to all recorded holders of ADSs.

### Smith & Nephew ADS price

The Company's ADS price can be obtained from the official New York Stock Exchange website at [www.nyse.com](http://www.nyse.com), the Smith-Nephew website [www.smith-nephew.com](http://www.smith-nephew.com) and is quoted daily in the Wall Street Journal.

### ADS payment information

The Company hereby discloses ADS payment information for the year ended 31 December 2010 in accordance with the Securities and Exchange Commission rules 12.D.3 and 12.D.4 relating to Form 20-F filings by foreign private issuers.

The depositary collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. The depositary collects fees for making distributions to investors, including payment of dividends by the Company by deducting those fees from the amounts distributed or by selling a portion of distributable property to pay the fees. The depositary may collect its annual fee for depositary services by deductions from cash distributions or by directly billing investors or by charging the book-entry system accounts of participants acting for them. The depositary may generally refuse to provide fee-attracting services until its fee for those services are paid.

*Persons depositing or withdrawing shares must pay:*  
\$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)

*For:*  
Issuance of ADSs, including issuances resulting from a distribution of shares or rights or other property

\$0.02 (or less) per ADS

Cancellation of ADSs for the purpose of withdrawal, including if the deposit agreement terminates

A fee equivalent to the fee that would be payable if securities distributed to holders had been shares and the shares had been deposited for issuance of ADSs

Any cash distribution to ADS registered holders, including payment of dividend

\$0.02 (or less) per ADS per calendar year

Distribution of securities distributed to holders of deposited securities which are distributed by the depositary to ADS registered holders

Registration or transfer fees

Depositary services

Taxes and other governmental charges the depositary or the custodian have to pay on any ADS or share underlying an ADS, for example, stock transfer taxes, stamp duty or withholding taxes

Transfer and registration of shares on our share register to or from the name of the depositary or its agent when shares are deposited or withdrawn

Any charges incurred by the depositary or its agents for servicing the deposited securities

As necessary

As necessary

A fee of 2 US cents per ADS was paid on the 2009 second interim dividend and a fee of 1 US cent per ADS was deducted from the 2010 first interim dividend paid in November. In the period 1 January 2010 to 23 February 2011 the total reimbursed by The Bank of New York Mellon was \$170,772.



## SHARE CAPITAL

The principal trading market for the Ordinary Shares is the London Stock Exchange. The Ordinary Shares were listed on the New York Stock Exchange on 16 November 1999, trading in the form of ADSs evidenced by ADRs. Each ADS represents five Ordinary shares. The ADS facility is sponsored by The Bank of New York Mellon acting as depository.

All the Ordinary Shares, including those held by directors and executive officers, rank pari passu with each other. On 23 January 2006 the Ordinary Shares of 12 2/9 pence were redenominated as Ordinary Shares of US 20 cents (following approval by shareholders at the extraordinary general meeting in December 2005). The new US Dollar Ordinary Shares carry the same rights as the previous Ordinary Shares. The share price continues to be quoted in Sterling and the ADSs continue to represent five Ordinary Shares. In 2006 the Company issued £50,000 of shares in Sterling in order to comply with English law. These were issued as Deferred Shares, which are not listed on any stock exchange. They have extremely limited rights and therefore effectively have no value. These shares were allotted to the Chief Executive, although the Board reserves the right to transfer them to another member of the Board should it so wish.

### Shareholdings

As at 23 February 2011, 6,910,750 ADSs equivalent to 34,553,750 Ordinary Shares or approximately 3.9% of the total Ordinary Shares in issue, were outstanding and were held by 91 registered holders.

As at 23 February 2011, to the knowledge of the Group, there were 20,410 registered holders of Ordinary Shares, of whom 83 had registered addresses in the US and held a total of 214,806 Ordinary Shares (less than 0.1% of the total issued). Because certain Ordinary Shares are registered in the names of nominees, the number of shareholders with registered addresses in the US is not representative of the number of beneficial owners of Ordinary Shares resident in the US.

### Major Shareholders

As far as is known to Smith & Nephew, the Group is not directly or indirectly owned or controlled by another corporation or by any government and the Group has not entered into arrangements, the operation of which may at a subsequent date result in a change in control of the Group.

As at 23 February 2011, no persons are known to Smith & Nephew to have any interest (as defined in the Disclosure and Transparency Rules of the FSA) in 3% or more of the Ordinary Shares, other than as shown below. The following tables show changes over the last three years in the percentage and numbers of the issued share capital owned by shareholders holding 3% or more of Ordinary Shares, as notified to the Company under the Disclosure and Transparency Rules:

| 23 February 2011 | As at 31 December |      |      |
|------------------|-------------------|------|------|
| %                | 2010              | 2009 | 2008 |
| %                | %                 | %    | %    |

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|                                      |     |     |     |     |
|--------------------------------------|-----|-----|-----|-----|
| Capital Group of Companies Inc       | 5.1 | 5.1 | 5.1 | 5.1 |
| Newton Investment Management Limited | 5.0 | 5.0 | 5.1 | 5.0 |
| Legal and General Group plc          | 5.0 | 5.0 | 4.0 | 4.5 |
| BlackRock, Inc                       | 4.7 | 5.0 | -   | -   |
| Thornburg Investment Management Inc  | -   | 4.1 | 4.8 | -   |
| FMR LLC                              | -   | -   | 3.9 | 3.9 |
| Prudential plc                       | -   | -   | -   | 3.1 |

|                                      | <b>23 February<br/>2011<br/>000</b> | <b>2010<br/>000</b> | <b>As at 31 December<br/>2009<br/>000</b> | <b>2008<br/>000</b> |
|--------------------------------------|-------------------------------------|---------------------|---|---------------------|
| Capital Group of Companies Inc       | 44,594                              | 44,594              | 44,594                                    | 44,594              |
| Newton Investment Management Limited | 44,338                              | 44,735              | 45,129                                    | 44,168              |
| Legal and General Group plc          | 44,704                              | 44,704              | 35,329                                    | 40,040              |
| BlackRock, Inc                       | 42,102                              | 44,322              | -   | -                   |
| Thornburg Investment Management Inc  | -                                   | 36,164              | 44,852                                    | -                   |
| FMR LLC                              | -                                   | -                   | 34,101                                    | 34,101              |
| Prudential plc                       | -                                   | -                   | -   | 26,945              |

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.



## Purchase of Ordinary Shares on behalf of the Company

The share buy-back programme was suspended in November 2008, in light of conditions in the financial markets. The programme is kept under review and, although there is no current intention to re-instate the programme, the Company will seek a renewal of its permission from shareholders to purchase up to 10% of its own shares at the AGM on 14 April 2011. As at 31 December 2010, 68,240,200 (2009 68,240,200) ordinary shares had been purchased under the share buy-back programme that commenced in February 2007. No shares were purchased in 2010 and 2009. The cost of the shares purchased in 2008 was \$193m.

## Exchange Controls and Other Limitations Affecting Security Holders

There are no UK governmental laws, decrees or regulations that restrict the export or import of capital or that affect the payment of dividends, interest or other payments to non-resident holders of Smith & Nephew's securities, except for certain restrictions imposed from time to time by Her Majesty's Treasury of the United Kingdom pursuant to legislation, such as the United Nations Act 1946 and the Emergency Laws Act 1964, against the government or residents of certain countries.

There are no limitations, either under the laws of the UK or under the articles of association of Smith & Nephew, restricting the right of non-UK residents to hold or to exercise voting rights in respect of Ordinary Shares, except that where any overseas shareholder has not provided to the Company a UK address for the service of notices, the Company is under no obligation to send any notice or other document to an overseas address. It is, however, the current practice of the Company to send every notice or other document to all shareholders regardless of the country recorded in the register of members, with the exception of details of the Company's dividend re-investment plan, which are not sent to shareholders with recorded addresses in the US and Canada.

## SELECTED FINANCIAL DATA

|  | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million | 2007<br>\$ million | 2006<br>\$ million |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|
| <b>Income Statement</b>  |                    |                    |                    |                    |                    |
| Revenue  | 3,962              | 3,772              | 3,801              | 3,369              | 2,779              |
| Cost of goods sold   | (1,031)            | (1,030)            | (1,077)            | (994)              | (769)              |
| Gross Profit   | 2,931              | 2,742              | 2,724              | 2,375              | 2,010              |
| Selling, general and administrative expenses   | (1,860)            | (1,864)            | (1,942)            | (1,740)            | (1,353)            |
| Research and development expenses  | (151)              | (155)              | (152)              | (142)              | (120)              |
| Operating profit   | 920                | 723                | 630                | 493                | 537                |
| Net interest (payable)/receivable  | (15)               | (40)               | (66)               | (30)               | 10                 |
| Other finance (costs)/income   | (10)               | (15)               | (1)                | 6                  | 3                  |
| Share of results of associates   | -                  | 2                  | 1                  | -                  | -                  |
| Profit before taxation   | 895                | 670                | 564                | 469                | 550                |
| Taxation   | (280)              | (198)              | (187)              | (153)              | (156)              |
| Profit from continuing operations  | 615                | 472                | 377                | 316                | 394                |
| Discontinued operations – net profit on disposal and share of results of joint venture | -                  | -                  | -                  | -                  | 351                |
| Attributable profit for the year   | 615                | 472                | 377                | 316                | 745                |
| <b>Earnings per Ordinary Share</b>   |                    |                    |                    |                    |                    |
| Including discontinued operations:   |                    |                    |                    |                    |                    |
| Basic  | 69.3¢              | 53.4¢              | 42.6¢              | 34.2¢              | 79.2¢              |
| Diluted  | 69.2¢              | 53.3¢              | 42.4¢              | 34.1¢              | 78.9¢              |
| Continuing operations:   |                    |                    |                    |                    |                    |
| Basic  | 69.3¢              | 53.4¢              | 42.6¢              | 34.2¢              | 41.9¢              |
| Diluted  | 69.2¢              | 53.3¢              | 42.4¢              | 34.1¢              | 41.7¢              |
| Discontinued operations:   |                    |                    |                    |                    |                    |
| Basic  | -                  | -                  | -                  | -                  | 37.3¢              |
| Diluted  | -                  | -                  | -                  | -                  | 37.2¢              |
| <b>Adjusted attributable profit</b>  |                    |                    |                    |                    |                    |
| Attributable profit for the year   | 615                | 472                | 377                | 316                | 745                |
| Acquisition related costs  | -                  | 26                 | 61                 | 111                | 20                 |
| Restructuring and rationalisation expenses   | 15                 | 42                 | 34                 | 42                 | -                  |
| Legal settlement   | -                  | -                  | -                  | 30                 | -                  |
| Amortisation of acquisition intangibles and impairments                                | 34                 | 66                 | 51                 | 30                 | 14                 |
| Loss on hedge of the sale proceeds of the joint venture                                | -                  | -                  | -                  | -                  | 3                  |
| Net profit on disposal of the joint venture  | -                  | -                  | -                  | -                  | (351)              |
| Taxation on excluded items   | (10)               | (26)               | (30)               | (49)               | (6)                |
| Adjusted attributable profit   | 654                | 580                | 493                | 480                | 425                |
| Adjusted basic earnings per Ordinary Share ( EPSA ) (i)                                | 73.6¢              | 65.6¢              | 55.6¢              | 52.0¢              | 45.2¢              |
| Adjusted diluted earnings per Ordinary Share (ii)                                      | 73.6¢              | 65.5¢              | 55.4¢              | 51.7¢              | 45.0¢              |

|   | 2010<br>\$ million | 2009<br>\$ million | 2008<br>\$ million | 2007 (iv)<br>\$ million | 2006<br>\$ million |
|---|--------------------|--------------------|--------------------|-------------------------|--------------------|
| <b>Group Balance Sheet</b>  |                    |                    |                    |                         |                    |
| Non-current assets  | 2,579              | 2,480              | 2,523              | 2,542                   | 1,586              |
| Current assets  | 2,154              | 2,071              | 1,985              | 1,919                   | 1,645              |
| Held for sale   | -                  | 14                 | -                  | -                       | -                  |
| Total assets  | 4,733              | 4,565              | 4,508              | 4,461                   | 3,231              |
| Share capital   | 191                | 190                | 190                | 190                     | 189                |
| Share premium   | 396                | 382                | 375                | 356                     | 329                |
| Treasury shares   | (778)              | (794)              | (823)              | (637)                   | (1)                |
| Retained earnings and other reserves  | 2,964              | 2,401              | 1,957              | 1,907                   | 1,657              |
| Total equity  | 2,773              | 2,179              | 1,699              | 1,816                   | 2,174              |
| Non-current liabilities   | 1,046              | 1,523              | 1,841              | 357                     | 241                |
| Current liabilities   | 914                | 863                | 968                | 2,288                   | 816                |
| Total liabilities   | 1,960              | 2,386              | 2,809              | 2,645                   | 1,057              |
| Total equity and liabilities  | 4,733              | 4,565              | 4,508              | 4,461                   | 3,231              |
| <b>Group Cash Flow</b>  |                    |                    |                    |                         |                    |
| Cash generated from operations  | 1,111              | 1,030              | 815                | 693                     | 506                |
| Net interest (paid)/received  | (17)               | (41)               | (63)               | (30)                    | 10                 |
| Income taxes paid   | (235)              | (270)              | (186)              | (225)                   | (144)              |
| Net cash inflow from operating activities   | 859                | 719                | 566                | 438                     | 372                |
| Capital expenditure (including trade investments and net of disposals of property, plant and equipment) | (307)              | (318)              | (289)              | (194)                   | (222)              |
| Acquisitions and disposals  | -                  | (25)               | (16)               | (781)                   | 454                |
| Cash received from Plus settlement  | -                  | 137                | -                  | -                       | -                  |
| Loan Notes issued   | -                  | -                  | -                  | -                       | (15)               |
| New finance leases  | -                  | -                  | -                  | (7)                     | -                  |
| Facility fee paid   | -                  | -                  | 2                  | (6)                     | -                  |
| Borrowings and finance leases acquired  | -                  | -                  | -                  | (181)                   | -                  |
| Proceeds from own shares  | 8                  | 10                 | 4                  | -                       | -                  |
| Equity dividends paid   | (132)              | (120)              | (109)              | (105)                   | (96)               |
| Issue of ordinary capital and treasury shares purchased   | 10                 | 7                  | (174)              | (612)                   | 16                 |
|   | 438                | 410                | (16)               | (1,448)                 | 509                |
| Exchange adjustments  | 13                 | (21)               | (6)                | (72)                    | 7                  |
| Opening (net debt)/net cash   | (943)              | (1,332)            | (1,310)            | 210                     | (306)              |
| Closing (net debt)/net cash   | (492)              | (943)              | (1,332)            | (1,310)                 | 210                |
| <b>Selected Financial Ratios</b>  |                    |                    |                    |                         |                    |
| Gearing (closing net debt as a percentage of total equity)  | 18%                | 43%                | 78%                | 72%                     | n/a                |
| Dividends per Ordinary Share (iii)  | 15.82¢             | 14.39¢             | 13.08¢             | 11.89¢                  | 10.81¢             |
| Research and development costs to Revenue   | 3.8%               | 4.1%               | 4.0%               | 4.2%                    | 4.3%               |
| Capital expenditure (including intangibles but excluding goodwill) to Revenue                           | 8.0%               | 8.4%               | 7.7%               | 5.9%                    | 8.3%               |

(i) Adjusted basic earnings per Ordinary Share is calculated by dividing adjusted attributable profit by the average number of shares.

(ii) Adjusted diluted earnings per Ordinary Share is calculated by dividing adjusted attributable profit by the diluted number of shares.

(iii) The Board has proposed a final dividend of 9.82 US cents per share which together with the first interim dividend of 6.00 US cents makes a total for 2010 of 15.82 US cents.

(iv) Restated due to Plus opening balance sheet adjustments.

## TAXATION INFORMATION FOR SHAREHOLDERS

The comments below are of a general and summary nature and are based on the Group's understanding of certain aspects of current UK and US federal income tax law and practice relevant to the ADSs and Ordinary Shares not in ADS form. The comments address the material US and UK tax consequences generally applicable to a person who is the beneficial owner of ADSs or Ordinary Shares and who, for US federal income tax purposes, is a citizen or resident of the United States, a corporation (or other entity taxable as a corporation) created or organised in or under the laws of the United States, or an estate or trust the income of which is included in gross income for US federal income tax purposes regardless of its source (each a "US Holder"). The comments set out below do not purport to address all tax consequences of the ownership of ADSs or Ordinary Shares which may be material to a particular holder and in particular do not deal with the position of shareholders who directly or indirectly own 10% or more of the Company's issued Ordinary Shares. This discussion does not apply to persons whose holding of ADSs or Ordinary Shares is effectively connected with or pertains to either (i) a permanent establishment in the United Kingdom through which a US Holder carries on a business in the United Kingdom, (ii) a fixed base from which a US Holder performs independent personal services in the United Kingdom, or (iii) whose registered address is inside the UK. This discussion does not apply to certain investors subject to special rules, such as certain financial institutions, tax-exempt entities, insurance companies, broker-dealers, traders in securities that elect to mark to market, partnerships or other entities treated as partnerships for US federal income tax purposes, US Holders holding ADSs or Ordinary Shares as part of a hedging, conversion or other integrated transaction or whose functional currency for US federal income tax purposes is other than the US Dollar and investors liable for alternative minimum tax. In addition, the comments below do not address US state, local or non-US (other than UK) taxes. The summary deals only with US Holders who hold ADSs or Ordinary Shares as capital assets. The summary is based on current UK and US law and practice which is subject to change, possibly with retroactive effect. US Holders are recommended to consult their own tax advisors as to the particular tax consequences to them of the ownership of ADSs or Ordinary Shares.

The Company believes, and this discussion assumes, that the Company was not a passive foreign investment company for its taxable year ended 31 December 2010.

This discussion is based in part on representations by the depositary and assumes that each obligation under the deposit agreement and any related agreement will be performed in accordance with its terms. For purposes of US federal income tax law, US Holders of ADSs will generally be treated as owners of the Ordinary Shares represented by the ADSs. However, the US Treasury has expressed concerns that parties to whom depositary shares are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by owners of depositary shares. Such actions would also be inconsistent with the claiming of the reduced rate of tax, described below, applicable to dividends received by certain non-corporate US Holders. Accordingly, the availability of the reduced tax rate for dividends received by certain non-corporate US Holders could be affected by actions that may be taken by parties to whom ADSs are pre-released.

### Taxation of Dividends in the United Kingdom and the United States

The UK does not currently impose a withholding tax on dividends paid by a UK corporation, such as the Company.

Distributions paid by the Company will be treated for US federal income tax purposes as foreign source ordinary dividend income to a US Holder to the extent paid out of the Company's current or accumulated earnings and profits as determined for US federal income tax purposes. Such dividends will not be eligible for the dividends-received deduction generally allowed to corporate US Holders.

Dividends paid to certain non-corporate US Holders of Ordinary Shares or ADSs in taxable years beginning before 1 January 2013 may be subject to US federal income tax at lower rates than other types of ordinary income if certain conditions are met. Non-corporate US Holders should consult their own tax advisors to determine whether they are subject to any special rules that limit their ability to be taxed at these favourable rates.

## Taxation of Capital Gains

US Holders, who are not resident or ordinarily resident for tax purposes in the UK, will not generally be liable for UK capital gains tax on any capital gain realised upon the sale or other disposition of ADSs or Ordinary Shares unless the ADSs or Ordinary Shares are held in connection with a trade carried on in the UK through a permanent establishment (or in the case of individuals, through a branch or agency). Furthermore, UK resident individuals who acquire ADSs or Ordinary Shares before becoming temporarily non-UK residents, may remain subject to UK taxation of capital gains on gains realised while non-resident.

For US federal income tax purposes, gains or losses realised upon a taxable sale or other disposition of ADSs or Ordinary Shares by US Holders generally will be US source capital gains or losses and will be long-term capital gains or losses if the ADSs or Ordinary Shares were held for more than one year. The amount of the US Holder's gain or loss will be equal to the difference between the amount realised on the sale or other disposition and such holder's tax basis in the ADSs, or Ordinary Shares, determined in US Dollars.

## Inheritance and Estate Taxes

The HM Revenue & Customs imposes inheritance tax on capital transfers which occur on death, and in the seven years preceding death. The HM Revenue & Customs considers that the US/UK Double Taxation Convention on Estate and Gift Tax applies to inheritance tax. Consequently, a US citizen who is domiciled in the United States and is not a UK national or domiciled in the United Kingdom will not be subject to UK inheritance tax in respect of ADSs and Ordinary Shares. A UK national who is domiciled in the United States will be subject to both UK inheritance tax and US federal estate tax but will be entitled to a credit for US federal estate tax charged in respect of ADSs and Ordinary Shares in computing the liability to UK inheritance tax. Conversely, a US citizen who is domiciled or deemed domiciled in the United Kingdom will be entitled to a credit for UK inheritance tax charged in respect of ADSs and Ordinary Shares in computing the liability for US federal estate tax. Special rules apply where ADSs and Ordinary Shares are business property of a permanent establishment of an enterprise situated in the United Kingdom.

## US Information Reporting and Backup Withholding

A US Holder may be subject to US information reporting and backup withholding on dividends paid on or the proceeds of sales of ADSs or Ordinary Shares made within the US or through certain US-related financial intermediaries, unless the US Holder is an exempt recipient or, in the case of backup withholding, provides a correct US taxpayer identification number and certain other conditions are met. US backup withholding may also apply if there has been a notification from the US Internal Revenue Service of a failure to report all interest or dividends.

Any backup withholding deducted may be credited against the US Holder's US federal income tax liability, and, where the withholding tax exceeds the actual liability, the US Holder may obtain a refund by timely filing the appropriate refund claim with the US Internal Revenue Service.

## UK Stamp Duty and Stamp Duty Reserve Tax

UK stamp duty is charged on documents and in particular instruments for the transfer of registered ownership of Ordinary Shares. Transfers of Ordinary Shares in certificated form will generally be subject to UK stamp duty at the rate of  $1/2\%$  of the consideration given for the transfer with the duty rounded up to the nearest £5.

UK stamp duty reserve tax (SDRT) arises when there is an agreement to transfer shares in UK companies for consideration in money or money's worth, and so an agreement to transfer Ordinary Shares for money or other consideration may give rise to a charge to SDRT at the rate of  $1/2\%$  (rounded up to the nearest penny). The charge of SDRT will be cancelled, and any SDRT already paid will be refunded, if within six years of the agreement an instrument of transfer is produced to HM Revenue & Customs and the appropriate stamp duty paid.

Transfers of Ordinary Shares into CREST (an electronic transfer system) are exempt from stamp duty so long as the transferee is a member of CREST who will hold the Ordinary Shares as a nominee for the transferor and the transfer is in a form that will ensure that the securities become held in uncertificated form within CREST. Paperless transfers of Ordinary Shares within CREST for consideration in money or money's worth are liable to SDRT rather than stamp duty. SDRT on relevant transactions will be collected by CREST at  $1/2\%$ , and this will apply whether or not the transfer is effected in the United Kingdom and whether or not the parties to it are resident or situated in the United Kingdom.

A charge of stamp duty or SDRT at the rates of  $1\ 1/2\%$  of the consideration (or, in some circumstances, the value of the shares concerned) will arise on a transfer or issue of Ordinary Shares to the Depositary or to certain persons providing a clearance service (or their nominees or agents) for the conversion into ADRs and will generally be payable by the Depositary or person providing clearance service. In accordance with the terms of the Deposit Agreement, any tax or duty payable

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by the Depositary on deposits of Ordinary Shares will be charged by the Depositary to the party to whom ADRs are delivered against such deposits.

No liability for stamp duty or SDRT will arise on any transfer of, or agreement to transfer, an ADS or beneficial ownership of an ADS, provided that the ADS and any instrument of transfer or written agreement to transfer remains at all times outside the United Kingdom, and provided further that any instrument of transfer or written agreement to transfer is not executed in the United Kingdom and the transfer does not relate to any matter or thing done or to be done in the United Kingdom (the location of the custodian as a holder of Ordinary Shares not being relevant in this context). In any other case, any transfer of, or agreement to transfer, an ADS or beneficial ownership of an ADS could, depending on all the circumstances of the transfer, give rise to a charge to stamp duty or SDRT.

## ARTICLES OF ASSOCIATION

The following summarises certain material rights of holders of the Company's Ordinary Shares under the material provisions of the Company's articles of association and English law. This summary is qualified in its entirety by reference to the Companies Act and the Company's articles of association. In the following description, a "shareholder" is the person registered in the Company's register of members as the holder of an Ordinary Share.

The Company is incorporated under the name Smith & Nephew plc and is registered in England and Wales with registered number 324357.

The Company's Ordinary Shares may be held in certificated or uncertificated form. No holder of the Company's shares will be required to make additional contributions of capital in respect of the Company's shares in the future. In accordance with English law the Company's Ordinary Shares rank equally.

### Directors

Under the Company's articles of association, a director may not vote in respect of any contract, arrangement, transaction or proposal in which he, or any person connected with him, has any material interest other than by virtue of his interests in securities of, or otherwise in or through, the Company. This is subject to certain exceptions relating to proposals (a) indemnifying him in respect of obligations incurred on behalf of the Company, (b) indemnifying a third party in respect of obligations of the Company for which the director has assumed responsibility under an indemnity or guarantee, (c) relating to an offer of securities in which he will be interested as an underwriter, (d) concerning another body corporate in which the director is beneficially interested in less than one percent of the issued shares of any class of shares of such a body corporate, (e) relating to an employee benefit in which the director will share equally with other employees and (f) relating to any insurance that the Company is empowered to purchase for the benefit of directors of the Company in respect of actions undertaken as directors (and/or officers) of the Company.

A director shall not vote or be counted in any quorum present at a meeting in relation to a resolution on which he is not entitled to vote.

The directors are empowered to exercise all the powers of the Company to borrow money, subject to the limitation that the aggregate amount of all monies borrowed after deducting cash and current asset investments by the Company and its subsidiaries shall not exceed the sum of \$6,500,000,000.

Any director who has been appointed by the directors since the previous Annual General Meeting of shareholders, either to fill a casual vacancy or as an additional director, holds office only until the conclusion of the next Annual General Meeting and then shall be eligible for re-election by the shareholders. The other directors retire and are eligible for re-appointment at the third Annual General Meeting after the meeting at which they were last re-appointed. If not re-appointed a director retiring at a meeting shall retain office until the meeting appoints someone in his place, or if it does not do so, until the conclusion of the meeting. The directors are subject to removal with or without cause by the Board or the shareholders. Directors are not required to hold any shares of the Company by way of qualification.

Under the Company's articles of association and English law, a director may be indemnified out of the assets of the Company against liabilities he may sustain or incur in the execution of his duties.



## Rights Attaching to Ordinary Shares

Under English law, dividends are payable on the Company's Ordinary Shares only out of profits available for distribution, as determined in accordance with accounting principles generally accepted in the United Kingdom and by the Companies Act 2006. Holders of the Company's Ordinary Shares are entitled to receive final dividends as may be declared by the directors and approved by the shareholders in general meeting, rateable according to the amounts paid up on such shares, provided that the dividend cannot exceed the amount recommended by the directors.

The Company's Board of Directors may declare such interim dividends as appear to them to be justified by the Company's financial position. If authorised by an ordinary resolution of the shareholders, the Board may also direct payment of a dividend in whole or in part by the distribution of specific assets (and in particular of paid up shares or debentures of the Company).

Any dividend unclaimed after 12 years from the date the dividend was declared, or became due for payment, will be forfeited and will revert to the Company.

There were no material modifications to the rights of shareholders under the Articles during 2010.

## Voting Rights of Ordinary Shares

Voting at any general meeting of shareholders is by a show of hands unless a poll, which is a written vote, is duly demanded and held. On a show of hands, every shareholder who is present in person at a general meeting has one vote regardless of the number of shares held. On a poll, every shareholder who is present in person or by proxy has one vote for each Ordinary Share held by that shareholder. A poll may be demanded by any of the following:

the chairman of the meeting;

at least five shareholders present or by proxy entitled to vote on the resolution;

any shareholder or shareholders representing in the aggregate not less than one-tenth of the total voting rights of all shareholders entitled to vote on the resolution; or

any shareholder or shareholders holding shares conferring a right to vote on the resolution on which there have been paid-up sums in aggregate equal to not less than one-tenth of the total sum paid up on all the shares conferring that right.

A form of proxy will be treated as giving the proxy the authority to demand a poll, or to join others in demanding one, as above.

The necessary quorum for a general meeting is two shareholders present in person or by proxy carrying the right to vote upon the business to be transacted.

Matters are transacted at general meetings of the Company by the processing and passing of resolutions of which there are two kinds; ordinary or special resolutions:

Ordinary resolutions include resolutions for the re-election of directors, the approval of financial statements, the declaration of dividends (other than interim dividends), the appointment and re-appointment of auditors or the grant of authority to allot shares. An Ordinary resolution requires the affirmative vote of a majority of the votes of those persons voting at the meetings at which there is a quorum.

Special resolutions include resolutions amending the Company's articles of association, disapplying statutory pre-emption rights or changing the Company's name; modifying the rights of any class of the Company's shares at a meeting of the holders of such class or relating to certain matters concerning the Company's winding up. A special resolution requires the affirmative vote of not less than three-quarters of the votes of the persons voting at the meeting at which there is a quorum.

Annual General Meetings must be convened upon advance written notice of 21 days. Other general meetings must be convened upon advance written notice of at least 14 clear days. The days of delivery or receipt of notice are not included. The notice must specify the nature of the business to be transacted. Meetings are convened by the Board of directors. Members with 5% of the Ordinary Share capital of the Company may requisition the Board to convene a meeting.

## Variation of Rights

If, at any time, the Company's share capital is divided into different classes of shares, the rights attached to any class may be varied, subject to the provisions of the Companies Act, with the consent in writing of holders of three-quarters in nominal value of the issued shares of that class or upon the adoption of a special resolution passed at a separate meeting of the holders of the shares of that class. At every such separate meeting, all the provisions of the articles of association relating to proceedings at a general meeting apply, except that the quorum is to be the number of persons (which must be two or more) who hold or represent by proxy not less than one-third in nominal value of the issued shares of the class and at any such meeting a poll may be demanded in writing by any person or their proxy who hold shares of that class. Where a person is present by proxy or proxies, he is treated as holding only the shares in respect of which the proxies are authorised to exercise voting rights.

## Rights in a Winding-Up

Except as the Company's shareholders have agreed or may otherwise agree, upon the Company's winding up, the balance of assets available for distribution:

after the payment of all creditors including certain preferential creditors, whether statutorily preferred creditors or normal creditors; and

subject to any special rights attaching to any other class of shares;

is to be distributed among the holders of Ordinary Shares according to the amounts paid-up on the shares held by them. This distribution is generally to be made in US Dollars. A liquidator may, however, upon the adoption of any extraordinary resolution of the shareholders and any other sanction required by law, divide among the shareholders the whole or any part of the Company's assets in kind.

## Limitations on Voting and Shareholding

There are no limitations imposed by English law or the Company's articles of association on the right of non-residents or foreign persons to hold or vote the Company's ordinary shares or ADSs, other than the limitations that would generally apply to all of the Company's shareholders.

## Transfers of Shares

The Board may refuse to register the transfer of shares held in certificated form which:

are not fully paid (provided that it shall not exercise this discretion in such a way as to prevent stock market dealings in the shares of that class from taking place on an open and proper basis);

are not duly stamped or duly certified or otherwise shown to the satisfaction of the Board to be exempt from stamp duty, lodged at the Transfer Office or at such other place as the Board may appoint and (save in the case of a transfer by a person to whom no certificate was issued in respect of the shares in question) accompanied by the certificate for the shares to which it relates, and such other evidence as the Board may reasonably require to show the right of the transferor to make the transfer and, if the instrument of transfer is executed by some other person on his behalf, the authority of that person so to do;

are in respect of more than one class of shares; or

are in favour of more than four transferees.

## Deferred Shares

Following the redenomination of share capital on 23 January 2006 the Ordinary Shares' nominal value became 20 US cents each. There were no changes to the rights or obligations of the Ordinary Shares. In order to comply with the Companies Act 2006, a new class of Sterling shares was created, Deferred Shares, of which £50,000 were issued and allotted in 2006 as fully paid to the Chief Executive though the Board reserves the right to transfer them to another member of the Board should it so wish. These Deferred Shares have no voting or dividend rights and on winding up only are entitled to repayment at nominal value only if all ordinary shareholders have received the nominal value of their shares plus an additional \$1,000 each.

## Amendments

The Company does not have any special rules about amendments to its articles of association beyond those imposed by law.



## CROSS REFERENCE TO FORM 20F

This table has been provided as a cross reference from the information included in this Annual Report to the requirements of Form 20-F.

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## GLOSSARY OF TERMS

Unless the context indicates otherwise, the following terms have the meanings shown below:

| <b>Term</b>               | <b>Meaning</b>   |
|---------------------------|--|
| ACL                       | The anterior cruciate ligament (ACL) is one of the four major ligaments in the human knee.   |
| ADR                       | In the US, the Company's Ordinary Shares are traded in the form of ADSs evidenced by American Depository Receipts ( ADRs ).  |
| ADS                       | In the US, the Company's Ordinary Shares are traded in the form of American Depository Shares ( ADSs ).  |
| Advanced Wound Management | A product group comprising products associated with the treatment of skin wounds, ranging from products that provide moist wound healing using breathable films and polymers to products providing active wound healing by biochemical or cellular action.   |
| AGM                       | Annual General Meeting of the Company.   |
| Arthroscopy               | Endoscopy of the joints is termed arthroscopy , with the principal applications being the knee and shoulder.   |
| Basis Point               | One hundredth of one percentage point.   |
| Chronic wounds            | Chronic wounds are those with long or unknown healing times including leg ulcers, pressure sores and diabetic foot ulcers.   |
| Company                   | Smith & Nephew plc or, where appropriate, the Company's Board of Directors, unless the context otherwise requires.   |
| Companies Act             | Companies Act 2006, as amended, of England and Wales.  |
| DUROLANE                  | DUROLANE is a registered trademark of Q-MED AB.  |
| EBITA                     | Earnings before interest, tax and amortisation.  |
| EBITDA                    | Earnings before interest, tax, depreciation and amortisation.  |
| EIP                       | Earnings Improvement Programme, the objective of which is to enhance short and medium term performance, to liberate resources for investment and to establish a culture of continuous improvement.   |
| EPSA                      | 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 affect 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. |
| Endoscopy                 | Endoscopy allows surgeons to operate through small openings in the body, rather than large incisions.  |
| Endoscopy products        | A product group comprising specialised viewing and access devices, surgical instruments and powered equipment used in minimally invasive surgical procedures. Through a small incision surgeons are able to see inside the body using a monitor and identify and repair defects.   |
| Euro or                   | References to the common currency used in the majority of the countries of the European Union.   |
| External fixation         | The use of wires or pins transfixing through bone to hold a frame to the position of a fracture.   |
| FDA                       | US Food and Drug Administration.   |
| Financial statements      | Refers to the consolidated Group Accounts of Smith & Nephew plc.   |
| FTSE 100                  | Index of the largest 100 listed companies on the London Stock Exchange by market capitalisation.   |
| Group or Smith & Nephew   | Used for convenience to refer to the Company and its consolidated subsidiaries, unless the context otherwise requires.   |
| IFRIC                     | International Financial Reporting Interpretations as adopted by the EU and as issued by the International Accounting Standards Board.  |



| <b>Term</b>                             | <b>Meaning</b>   |
|---|--|
| IFRS                                    | International Financial Reporting Standards as adopted by the EU and as issued by the International Accounting Standards Board.  |
| Intramedullary nail system              | Stainless steel or titanium implants shaped like a nail implanted in the intramedullary canal in diaphyseal fractures.   |
| Labrum                                  | Another name for cartilage found in the hip joint and shoulder joint.  |
| LSE                                     | London Stock Exchange.   |
| Metal-on-metal hip resurfacing          | A less invasive surgical approach to treating arthritis in younger patients whereby only the surfaces of the hip joint are replaced leaving the hip head substantially preserved.  |
| Negative Pressure Wound Therapy         | A technology used to treat chronic wounds such as diabetic ulcers, pressure sores and post operative wounds through the application of sub-atmospheric pressure to an open wound.  |
| NYSE                                    | New York Stock Exchange.   |
| Orthobiologic products                  | Any product that is primarily intended to act as a scaffold and/or actively stimulates bone growth.  |
| Orthopaedic products                    | Orthopaedic reconstruction products include joint replacement systems for knees, hips and shoulders and support products such as computer assisted surgery and minimally invasive surgery techniques. Orthopaedic trauma devices are used in the treatment of bone fractures including rods, pins, screws, plates and external frames. Clinical therapies products include joint fluid therapy for pain reduction of the knee and an ultrasound treatment to accelerate the healing of bone fractures.   |
| OXINIUM                                 | OXINIUM material is an advanced load bearing technology. It is created through a proprietary manufacturing process that enables zirconium to absorb oxygen and transform to a ceramic on the surface, resulting in a material that incorporates the features of ceramic and metal. Management believes that OXINIUM material used in the production of components of knee and hip implants exhibits unique performance characteristics due to its hardness, low-friction and resistance to roughening and abrasion.  |
| Parent                                  | Smith & Nephew plc.  |
| Pound Sterling, Sterling, £, pence or p | References to UK currency. 1p is equivalent to one hundredth of £1.  |
| Repair                                  | A product group within endoscopy comprising specialised devices, fixation systems and bio-absorbable materials to repair joints and associated tissue.   |
| Resection                               | Products that cut or ablate tissue within endoscopy comprising mechanical blades, radio frequency wands, electromechanical and hand instruments for resecting tissue.  |
| SUPARTZ                                 | SUPARTZ is a registered trademark of Seikagaku Corp.   |
| Trading profit                          | Trading profit is a trend which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affect 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. |
| Traditional woundcare                   | Product group comprising medical textile products, adhesive tapes and fixative sheets to secure wound management products to the body.   |
| UK                                      | United Kingdom of Great Britain and Northern Ireland.  |
| UK GAAP                                 | Accounting principles generally accepted in the United Kingdom   |
| US                                      | United States of America.  |
| US Dollars, US \$ or cents              | References to US currency. 1 cent is equivalent to one hundredth of US\$1  |

| <b>Term</b>   | <b>Meaning</b>  |
|---------------|---|
| US GAAP       | Accounting principles generally accepted in the United States of America.   |
| Visualisation | Products within endoscopy comprising digital cameras, light sources, monitors, scopes, image capture, central control and multimedia broadcasting systems for use in endoscopic surgery with visualisation. |
| Wound bed     | An area of healthy dermal and epidermal tissue of a wound.  |

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**SIGNATURE**

The Registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and has duly caused and authorized the undersigned to sign this Annual Report on its behalf.

**Smith & Nephew plc**  
(Registrant)

By: /s/ Susan Henderson  
Susan Henderson  
Company Secretary

London, England

March 3, 2011

## EXHIBIT INDEX

| Exhibit No. | Description of Document  | Incorporated Herein by Reference To   | Filed Herewith |
|-------------|--|---|----------------|
| 1           | (a) Memorandum of Association  | Form 20-F for the year ended December 31, 2000 filed on April 26, 2001 (File No. 1-14978) |                |
|             | (b) Articles of Association  | Form 20-F for the year ended December 31, 2008 filed on March 27, 2009 (File No. 1-14978) |                |
| 4           | (a) (i) Material Contract: Facility Agreement and Appendices dated 9 December 2010 by and among Barclays Capital, BNP Paribas SA, Deutsche Bank AG, JP Morgan Chase, Lloyds Banking Group, Royal Bank of Scotland, Société Générale SA and others and Smith & Nephew plc |   | X              |
|             | (ii) Material contract: Share Purchase Agreement and Appendices dated 12 March 2007 by and among Hyos Invest Holding AG, Dr. U Sigg, Dr. R Riedweg, Active Investor AG, and Smith & Nephew International BV and Smith & Nephew plc                                       | Form 20-F for the year ended December 31, 2006 filed on March 28, 2007 (File No. 1-14978) |                |
| 4           | (c) (i) Service Agreement of David J Illingworth   | Form 20-F for the year ended December 31, 2007 filed on March 27, 2008 (File No. 1-14978) |                |
|             | (ii) Service Agreement of Adrian Hennah  | Form 20-F for the year ended December 31, 2006 filed on March 28, 2007 (File No. 1-14978) |                |
|             | (iii) Letter of appointment of Joseph Papa   | Form 20-F for the year ended December 31, 2008 filed on March 27, 2009 (File No. 1-14978) |                |
|             | (iv) Letter of appointment of Ian Barlow   | Form 20-F for the year ended December 31, 2009 filed on March 26, 2010 (File No. 1-14978) |                |
|             | (v) Letter of appointment of Geneviève Berger  | Form 20-F for the year ended December 31, 2009 filed on March 26, 2010 (File No. 1-14978) |                |
|             | (vi) Service Agreement of Olivier Bohuon   |   | X              |
|             | (vii) Retirement provisions for David J Illingworth  |   | X              |
|             | (viii) The Smith & Nephew 2001 UK Approved Share Option Plan   | Form 20-F for the year ended December 31, 2004 filed on March 16, 2005 (File No. 1-14978) |                |



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| Exhibit No. | Description of Document   | Incorporated Herein by Reference To   | Filed Herewith |
|-------------|---|---|----------------|
| 4           | (c)(ix) The Smith & Nephew 2001 UK Unapproved Share Option Plan | Form 20-F for the year ended December 31, 2004 filed on March 16, 2005 (File No. 1-14978)       |                |
|             | (x) The Smith & Nephew 2001 US Share Plan                       | Registration Statement on Form S-8 No. 333-13694 filed on July 9, 2001 (File No. 1-14978)       |                |
|             | (xi) The Smith & Nephew Sharesave Plan (2002)                   | Form 20-F for the year ended December 31, 2002 filed on April 25, 2003 (File No. 1-14978)       |                |
|             | (xii) The Smith & Nephew International Sharesave Plan (2002)    | Form 20-F for the year ended December 31, 2004 filed on March 16, 2005 (File No. 1-14978)       |                |
|             | (xiii) The Smith & Nephew Italian Sharesave Plan (2002)         | Form 20-F for the year ended December 31, 2002 filed on April 25, 2003 (File No. 1-14978)       |                |
|             | (xiv) The Smith & Nephew Dutch Sharesave Plan (2002)            | Form 20-F for the year ended December 31, 2002 filed in April 25, 2003 (File No. 1-14978)       |                |
|             | (xv) The Smith & Nephew Belgian Sharesave Plan (2002)           | Form 20-F for the year ended December 31, 2002 filed on April 25, 2003 (File No. 1-14978)       |                |
|             | (xvi) The Smith & Nephew French Sharesave Plan (2002)           | Form 20-F for the year ended December 31, 2002 filed on April 25, 2003 (File No. 1-14978)       |                |
|             | (xvii) Smith & Nephew Irish Employee Share Option Scheme        | Form 20-F for the year ended December 31, 2003 filed on March 26, 2004 (File No. 1-14978)       |                |
|             | (xviii) Smith & Nephew 2004 Executive Share Option Plan         | Registration statement on Form S-8 No. 333-122801 filed on February 14, 2005 (File No. 1-14978) |                |
|             | (xix) Smith & Nephew 2004 Performance Share Plan                | Registration statement on Form S-8 No. 333-122801 filed on February 14, 2005 (File No. 1-14978) |                |
|             | (xx) Smith & Nephew 2004 Co-investment Plan                     | Registration statement on Form S-8 No. 333-122801 filed on February 14, 2005 (File No. 1-14978) |                |
|             | (xxi) Smith & Nephew U.S. Employee Stock Purchase Plan          | Registration statement on Form S-8 No. 333-12052 filed on May 30, 2000 (File No. 1-14978)       |                |
|             | (xxii) Smith & Nephew Long Service Award Scheme                 | Registration Statement on Form S-8 No. 33-39814 filed on April 5, 1991 (File No. 1-14978)       |                |
|             | (xxiii) Smith & Nephew 2004 Performance Share Plan              | Registration statement on Form S-8 No. 333-155172 filed on November 7, 2008 (File No. 1-14978)  |                |
|             | (xxiv) Smith & Nephew 2001 US Share Plan                        | Registration statement on Form S-8 No. 333-155173 filed on November 7, 2008 (File No. 1-14978)  |                |
|             | (xxv) Smith & Nephew plc Deferred Bonus Plan                    | Registration statement on Form S-8 No. 333-158239 filed on March 27, 2009 (File No. 1-14978)    |                |

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| Exhibit No. | Description of Document   | Incorporated Herein by Reference To  | Filed Herewith |
|-------------|---|--|----------------|
| 4           | (c)(xxvi) Smith & Nephew Global Share Plan 2010   | Registration statement on Form S-8 No. 333-168544 filed on August 5, 2010 (File No. 1-14978) |                |
| 8           | Principal Subsidiaries  |  | X              |
| 12          | (a) Certification of David Illingworth, filed pursuant to Securities Exchange Act of 1934 as amended (the Exchange Act ), Rule 13a -14(a) |  | X              |
|             | (b) Certification of Adrian Hennah filed pursuant to Securities Exchange Act of 1934 as amended (the Exchange Act ), Rule 13a -14(a)      |  | X              |
| 13          | (a) Certification of David Illingworth and Adrian Hennah furnished pursuant to Exchange Act Rule 13a -14(b)                               |  | X              |
| 15.1        | Consent of Independent Registered Public Accounting Firm  |  | X              |