

SMITH & NEPHEW PLC  
Form 20-F  
March 06, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 20-F**

(Mark One)

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**or**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2013**

**or**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**or**

**SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file number 1-14978**

**Smith & Nephew plc**

**(Exact name of Registrant as specified in its charter)**

**England and Wales**

**(Jurisdiction of incorporation or organization)**

**15 Adam Street, London WC2N 6LA**

**(Address of principal executive offices)**

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

| <b>Title of each class</b>         | <b>Name on each exchange on which registered</b> |
|------------------------------------|--|
| <b>American Depositary Shares</b>  | <b>New York Stock Exchange</b>                   |
| <b>Ordinary Shares of 20¢ each</b> | <b>New York Stock Exchange*</b>                  |

**\* 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: 918,167,367 Ordinary Shares of 20¢ each

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

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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:

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  Other  
International Accounting Standards Board

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

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

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Smith & Nephew is a global medical technology business. This success is built upon our three values of:

We have leadership positions in our four chosen specialities:

**Innovation**

Orthopaedic Reconstruction

**Trust**

Advanced Wound Management

**Performance**

Sports Medicine

Trauma & Extremities

\*These sections and pages 95, 97 and 99 form the Directors' Report.

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SMITH & NEPHEW ANNUAL REPORT 2013 1

Our mission

Delivering advanced medical technologies that help healthcare professionals, **our customers**, improve the quality of life for their patients

**\$4.4bn**

Revenue <sup>1</sup> up 4%

**\$987m**

Trading profit <sup>1,2</sup> up 5%

**\$810m**

Operating profit <sup>1</sup> up 1%

**76.9¢**

Adjusted earnings per share <sup>2</sup> up 3%

**61.7¢**

Earnings per share down 23%

**27.4¢**

Dividends per share up 5%

1 The underlying percentage increases/decreases are after adjusting for the effect of currency translation and the inclusion of the comparative impact of acquisitions and exclusion of disposals.

2 Explanations of these non-GAAP financial measures are provided on pages 161 to 163.

You can read more about our financial performance in the **financial review** on page 36

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We are investing more in R&D to provide  
our customers with greater **innovation**

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Financial highlights

We delivered a **good**  
**performance** in 2013

TRADING PROFIT<sup>2</sup>

MARGIN

-60bps

22.7%

TRADING PROFIT

TO CASH CONVERSION<sup>2</sup>

89%

OPERATING PROFIT

MARGIN

-180bps

18.6%

OPERATING PROFIT

AS A PERCENTAGE OF

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CASH GENERATED

FROM OPERATIONS

71%

- 1 The underlying percentage increases/decreases are after adjusting for the effects of currency translation and the inclusion of the comparative impact of acquisitions and exclusion of disposals.
- 2 Explanations of these non-GAAP financial measures are provided on pages 161 to 163.
- 3 Earnings per share and adjusted earnings per share have been restated following the adoption of the revised IAS 19 Employee Benefits standard. See Note 1 of the Notes to the Group accounts.

You can read more about our financial performance in the [financial review](#) on page 36

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Chairman's statement

Dear Shareholder,

In 2013, Smith & Nephew generated good underlying revenue and trading profit growth.

We continued to focus investment on growth opportunities and returned significant value to Shareholders through increased dividends and a share buy-back programme. Momentum increased throughout the year as we delivered on our strategy to reshape Smith & Nephew for the future.

Our revenue was \$4,351 million, up 4% on an underlying basis. Advanced Wound Management delivered strong growth, led by Healthpoint Biotherapeutics, our major 2012 acquisition. Sports Medicine Joint Repair had another successful year, and we improved our performance in Orthopaedic Reconstruction.

Almost 13% of our revenues now come from emerging market countries, up from just over 8% in 2010. We were one of the first companies in our sector to focus on these markets. We are building sustainable businesses through the strategy of establishing direct relationships with customers, as well as developing tailored products. In 2013, we invested further in our existing teams and made acquisitions in Brazil, India and Turkey to strengthen our platform.

Our trading profit was up 5% on an underlying basis at \$987 million. The trading profit margin of 22.7% met our expectations as we invested more in the emerging markets and in research & development, and cost of the US medical device excise tax (\$24 million in 2013).

**Ethics, compliance & governance**

We give high priority to compliance and ethics, as well as health, safety and the environment. The Board continues to encourage management in their drive to ensure all of Smith & Nephew's programmes are world-class.

The Board also places great emphasis on governance and is mindful of its responsibility to promote the long-term interests of the Company for all our stakeholders. This is described in detail in the Corporate Governance section of this Annual Report (pages 44–85).

**Creating sustainable value**

Smith & Nephew has a long track record of creating value for Shareholders. For instance, we have paid a dividend every year since 1937. Since 2006, during my tenure as Chairman, it is pleasing to report that we have delivered a compound annual growth rate in adjusted earnings per share of 8% against a FTSE 100 average of 6%, along with a dividend compound growth rate of 14%. And the share price is up more than 90% in that time. The Group generated trading cash flow of \$5.9 billion between 1 January 2006 and 31 December 2013, demonstrating our vitality over the long-term.

In 2013, we set out a Capital Allocation Framework that will govern how we prioritise the use of the strong cash flow we generate. This framework will guide our continued

investment in organic growth, and maintenance of a progressive dividend. It also gives us headroom to make further acquisitions and includes a commitment to return any excess capital to Shareholders. It is underpinned by a desire to maintain a strong balance sheet to ensure solid investment grade credit metrics.

Following these principles, we spent \$226 million on a share buy-back programme during the year. This, together with the 2012 dividend increase, resulted in a total distribution to Shareholders in 2013 of \$465 million, two and a half times the level of the prior year.

The Board is pleased to propose a final dividend for the year of 17.0¢ per share, giving a total dividend for 2013 of 27.4¢, up 5% year-on-year.

#### Board changes

I will step down as Chairman of Smith & Nephew at the Annual General Meeting in April 2014. Roberto Quarta joined the Board as Non-executive Director in December 2013 and will take over as Chairman. Roberto has impressive business and board experience and is chairman of IMI plc, a FTSE 100 listed engineering business and of Clayton, Dubilier & Rice, Europe, a private equity firm.

Our Senior Independent Non-executive Director, Richard De Shutter, and Non-executive Director Ajay Piramal, will also both retire at the Annual General Meeting. I would like to thank them for their service. In particular, Richard's contribution in this most important role has been invaluable. We are fortunate to have as replacement the highly experienced Brian Larcombe, who will become Senior Independent Non-executive Director.

In 2013, we welcomed to the Board Julie Brown as Chief Financial Officer and Michael Friedman as Non-executive Director. Julie has quickly established herself as an effective Executive Director and her influence is already seen in many areas, including the Capital Allocation Framework. Michael's expertise in the US healthcare system and experience leading a major research and treatment institution has enhanced the Board.

#### Setting Smith & Nephew apart

During 2013, I was reminded of the quality of our people as we reviewed our responses to natural disasters, providing resources to aid recovery in the Philippines and in our own offices and communities, under Olivier Bohuon's leadership, responding to a major flood at the Advanced Wound Management site in Hull, UK and to a tornado near our facility in Oklahoma City, US. The tenacity and compassion sets Smith & Nephew apart, as it has throughout our history of supporting healthcare professionals for more than 150 years.

It has indeed been a privilege working with the people at Smith & Nephew and to serve the interests of customers, employees and Shareholders. The Company has shown great resilience in the recent economic environment, building services for customers and value for Shareholders. There is an excellent team in place, both Executive and Non-executive.

I wish the Company well for a promising future.

Yours sincerely,

Sir John Buchanan

Chairman

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Smith & Nephew today

We are operating in [growth markets](#)

TOTAL SEGMENT VALUE  
ADVANCED SURGICAL DEVICES  
[\\$23.2bn](#)  
GLOBAL POPULATION

+4%

TOTAL SEGMENT VALUE  
ADVANCED WOUND MANAGEMENT  
[\\$7.0bn](#)

+4%

Source: United Nations World Population Prospects, The 2012 Revision.

You can read more about our financial performance in the [marketplace review](#) on page 16

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With a business model  
that **creates value**

OUR MISSION STATEMENT

**Delivering advanced medical technologies that help healthcare  
professionals, our customers, improve the quality of life for their patients**

OUR VALUES



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Smith & Nephew today *continued*

We are organised by  
our areas of **expertise**

**Advanced Surgical Devices**

ORTHOPAEDIC RECONSTRUCTION  
Specialist hip and knee implant systems.

REVENUE<sup>1</sup>

\$1,518m

-1%

2012 \$1,540m

TRAUMA & EXTREMITIES

Internal and external devices used in the stabilisation of severe fractures and deformity correction procedures.

REVENUE<sup>1,2</sup>

\$486m

+4%

2012 \$474m

SPORTS MEDICINE JOINT REPAIR

Instruments, technologies and implants necessary to perform minimally invasive surgery of joints.

REVENUE<sup>1,2</sup>

\$496m

+7%

2012 \$474m

#### ARTHROSCOPIC ENABLING TECHNOLOGIES

Cutting, visualisation and fluid management technologies necessary for Sports Medicine Joint Repair.

REVENUE<sup>1,2</sup>

\$441m

-2%

2012 \$458m

#### OTHER ASD

Including gynaecological instrumentation.

REVENUE<sup>1,2</sup>

\$74m

+14%

2012 \$162m

#### Advanced Wound Management

#### ADVANCED WOUND CARE

Products for the treatment of acute and chronic wounds, including leg, diabetic and pressure ulcers, burns and post-operative wounds.

REVENUE<sup>1</sup>

\$843m

+1%

2012 \$849m

#### ADVANCED WOUND DEVICES

Traditional and single-use Negative Pressure Wound Therapy ( NPWT ) and hydrosurgery systems.

REVENUE<sup>1</sup>

\$213m

+20%

2012 \$180m

#### ADVANCED WOUND BIOACTIVES

Bioactive technologies that provide unique approaches to debridement and dermal repair and regeneration.

REVENUE<sup>1</sup>

\$280m

+47%

2012 N/A

- 1 The underlying percentage increases/decreases are after adjusting for the effect of currency translation and the inclusion of the comparative impact of acquisitions and exclusion of disposals.
- 2 The 2012 revenue by franchise has been restated to 2013 product franchises.

You can read more about our franchise areas in the [segment analysis](#) on pages 24 to 33

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With over 11,000 employees  
supporting healthcare  
professionals globally

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Chief Executive Officer's review of strategy

We are successfully

reshaping and rebalancing

Smith & Nephew

OUR STRATEGIC PRIORITIES

**1 ESTABLISHED MARKETS**

Build upon existing strong positions, win market share through greater innovation and drive efficiencies to liberate resources.

**2 EMERGING & INTERNATIONAL MARKETS**

Deliver market leadership in the Emerging & International Markets by building strong, direct customer relationships and developing products specifically designed for these populations.

**3 INNOVATE FOR VALUE**

Accelerate our rate of innovation by investing more in research & development to support projects that will move clinical and cost boundaries and deliver maximum value.

#### 4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL

Pursue maximum efficiency in everything we do, streamline our operations and manufacturing, remove duplication and build strong global functions to support our commercial teams.

#### 5 SUPPLEMENT ORGANIC GROWTH WITH ACQUISITIONS

Build our platform by acquiring complementary technologies, manufacturing and distribution in the emerging markets and complementary products or businesses in our higher growth segments.

You can read more about our [strategy in action](#) throughout the report in boxed out case studies.

[Dear Shareholder,](#)

For more than 150 years Smith & Nephew has supported healthcare professionals as they improve the quality of life for patients. Today we do this by providing advanced medical technologies that move clinical boundaries and reduce economic costs.

We focus where we see developing needs and invest in new products and techniques to improve outcomes and expand access. Through these actions we are at the forefront of fast growing segments such as Sports Medicine and Advanced Wound Bioactives, are leaders in the emerging markets, and continue to develop in our more mature segments. We are building a sustainable business to best support surgeons, nurses and healthcare managers in the future.

In 2013, I am pleased to report that we made significant progress, expanding our product portfolio, building our platform, growing in the emerging markets and embedding a culture of perpetual efficiency.

[Accelerating innovation](#)

In 2013, we maintained a high rate of innovation, launching major new products such as the natural-motion JOURNEY<sup>®</sup> II BCS Total Knee System and, in Sports Medicine, HEALICOIL<sup>®</sup> REGENESORB<sup>®</sup>, an innovative next generation bio-composite suture anchor. We also delivered 23 new Advanced Wound Management products, such as the DURAFIBER<sup>®</sup> Ag antimicrobial dressing.

Looking ahead, we have a strong product pipeline, particularly in Trauma & Extremities and Sports Medicine. Overall we increased research & development ( R&D ) investment to \$231 million in 2013, representing 5.3% of revenue, and are committed to maintaining these high levels of investment and innovation going forward. We were proud to be named one of Forbes Magazine's Most Innovative Companies of 2013.

We are also investing in medical education to ensure that our customers continue to have access to the best training on our products and techniques. This includes significant online resources such as *Education and Evidence*. Launched in 2013, this is a powerful new e-learning platform for surgeons to access and share peer-to-peer education.

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so that ever more of  
our business comes from  
areas of **higher growth**

**Healthpoint acquisition delivers**

Our major acquisition at the end of 2012, Healthpoint Biotherapeutics, has given us a leading position in bioactives, the fastest growing segment of Advanced Wound Management. This business has out-performed our expectations, increasing its revenue by 47% in 2013. With its unique portfolio, excellent sales execution and expertise in product research and development, it is an outstanding addition to Smith & Nephew.

deliver long-term benefits. In 2013, we maintained our commitment to our customers, patients, employees, communities and Shareholders. This was again recognised in our inclusion in the FTSE4Good and Dow Jones Sustainability indices.

**Sir John Buchanan**

Sir John Buchanan will step down as Chairman of the Board in April 2014. I wish to thank Sir John for his leadership, counsel and dedication over the past nine years. As Chairman he has overseen a number of significant changes and has given me tremendous support in my role as Chief Executive Officer. We are confident that in Roberto Quarta we have found another excellent Chairman.

**Leaders in emerging markets**

Throughout 2013, we have built upon our leading position in the emerging markets, generating strong revenue growth. We enhanced our platform, investing in the sales force and infrastructure in markets such as Mexico and the Middle East, as well as acquiring distributors in Turkey and Brazil.

**Acquisition of ArthroCare Corp**

By having a direct relationship with our customers we are able to offer them a fuller range of products and services.

We see a major opportunity to create portfolios for patients in the economic mid-tier across the emerging markets, and launched our first products and acquired the Sushrut-Adler Indian trauma business in 2013.

### Perpetual efficiency

These strategic investments and many other initiatives have been made possible through our continued drive to be more efficient, to reduce cost, and to simplify and improve our operating model. In 2011, we announced an initial programme to generate annual savings of \$150 million and this will be largely complete by the end of 2014. We are now a leaner business, and, as importantly, we are embedding a culture of perpetual efficiency into our processes and future thinking.

### Sustainability

Our mission at Smith & Nephew is to help our customers improve people's lives. I can think of nothing more intrinsic to this mission than operating sustainably and responsibly to

In February 2014, we announced our intention to acquire ArthroCare, an innovative medical devices company with a highly complementary sports medicine franchise. Based in Austin, Texas, ArthroCare's technology and products will significantly strengthen our portfolio and we will use our global footprint to drive substantial new revenue growth. We expect to complete this acquisition in the middle of 2014 for a net cost of approximately \$1.5 billion.

### Rebalancing Smith & Nephew

Smith & Nephew made excellent progress in 2013, delivering both revenue and earnings growth and generating strong cash flow. I would like to thank our employees for their contribution during the year. It was their dedication and focus that achieved these results, and importantly, are enabling us to accomplish our programmes to make the Group fit and effective for the future.

We are successfully reshaping and rebalancing Smith & Nephew so that even more of our business comes from areas of higher growth. In this way we will continue to deliver the best support for our customers and the greatest value for our Shareholders.

Yours sincerely,

Olivier Bohuon

Chief Executive Officer





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Strategic performance

This is how we **measure**

**our performance**

**1 ESTABLISHED MARKETS**

PERFORMANCE

Our businesses in the Established Markets grew by 5% in the US and was flat in the Other Established Markets, where the macro-economic environment in Europe continues to be weak.

Our performance in the second half of 2013 was better than the first half, as a result of our investments in marketing, medical education and new products.

For more detail on the market and competition see pages 16 to 18.

By franchise, our performance relative to estimated global segment growth was slightly below in hip and knee reconstruction and trauma, around market in the higher growth joint repair segment of sports medicine and well above in advanced wound management. Hip and Knee Implant performance in 2013 was held back by our relatively high exposure to the weak European market, our position in the product cycle and metal-on-metal hip headwinds.

GLOBAL OUTLOOK

Established Markets for Smith & Nephew are the US, Europe, Japan, Australia, New Zealand and Canada.

In these markets we expect the challenging economic conditions to continue, requiring realigned business models and focused investment, albeit that there are some signs of improvement in the US.

**2 EMERGING & INTERNATIONAL MARKETS**

## PERFORMANCE

The Emerging & International Markets grew at 18%, exceeding Established Markets rates and contributing half of annual revenue growth for the Group.

These geographies now represent 13% of the Group's overall revenue.

During 2013:

Our success in China continued with growth of over 30% and now it is our 6th largest country by revenue

Significant investment to drive growth organically (e.g. Mexico and Saudi Arabia) and through acquisitions (Brazil, Turkey, India)

We put in place our strategy to address the mid-tier market.

## GLOBAL OUTLOOK

Emerging & International Markets represent those outside of the Established Markets including Brazil, China, India and Russia.

The healthcare environment in these markets is rapidly expanding and with the right investments offers significant opportunities for the Group.

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**3 INNOVATE FOR VALUE**

PERFORMANCE

R&D investment now represents 5.3% of revenue, an increase in spending of 35% in reported terms. We have maintained our strong momentum of introducing new products:

In ASD, we successfully launched the JOURNEY II BCS Knee System and our Sports Medicine franchise expanded through a next generation HEALICOIL suture anchor range and we also expanded our Extremities offering

Over 20 new AWM products launched

In our Emerging & International Markets we launched a low-cost camera to drive market expansion and access to minimally invasive joint repair

Launched new medical education websites to support healthcare professionals.

GLOBAL OUTLOOK

Innovation offers the key to meeting the realities of healthcare and economic paradigm in both Established and Emerging & International Markets. New products, technologies and surgical techniques hold the potential of reducing the overall cost of healthcare.

**4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL**

PERFORMANCE

Trading profit grew by 5% and trading profit margin decreased

GLOBAL OUTLOOK

By simplifying and improving our operating model we can liberate

slightly to 22.7% as expected. Targeted investments, increased R&D and the new US Medical Device tax were partially off-set by efficiency and cost initiatives

resources to invest in growth opportunities and meet the persistent price pressure. A simpler and more efficient organisation allows us to make faster and better decisions.

Key initiatives included:

Continuing to deliver our \$150 million per annum efficiency savings programme

Expansion of the Suzhou facility continues on track

Started roll-out of major Europe-wide single IT and business intelligence platform.

## 5 SUPPLEMENT ORGANIC GROWTH WITH ACQUISITIONS

### PERFORMANCE

2013 has been another active year from a business development perspective, mainly focused on supporting our Emerging & International Markets strategy:

Acquisition of distributors in Brazil and Turkey

Acquisition of a mid-tier trauma business in India

### GLOBAL OUTLOOK

Acquisitions and partnerships are important elements which supplement organic investment and provide increased opportunity for high growth and value creation.

Successful integration of  
Healthpoint Biotherapeutics  
which we acquired in 2012.

- 1 The underlying percentage increases/decreases are after adjusting for the effect of currency translation and the inclusion of the comparative impact of acquisitions and exclusion of disposals.
- 2 Explanations of these non-GAAP financial measures are provided on pages 161 to 163.

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SMITH & NEPHEW ANNUAL REPORT 2013

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Chief Financial Officer's overview

We have delivered good **revenue and**

**earnings growth**

**Dear Shareholder,**

When I joined Smith & Nephew in February 2013 I found a business with a unified sense of purpose – helping customers to improve the quality of life of patients – and a clear strategy to deliver this in a sustainable manner across our Established and Emerging & International Markets. The management team were making choices about where to invest to maximise our impact today and to ensure Smith & Nephew has the products and platform for the future.

For me, the role of Finance is as a strategic partner, enabling and supporting the business as it makes investments and drives efficiencies, and ensuring we can maintain our financial strength and discipline. I believe Smith & Nephew has made significant progress in 2013 and that judicious financial management has been and remains central to our success.

**Strong revenue and earnings**

For the full year 2013, we generated good underlying revenue and trading profit growth and met our margin expectations. Revenue was \$4,351 million, an underlying 4% increase. Trading profit was \$987 million, up 5% underlying. The trading profit margin was 22.7% a reduction of 60bps. Our adjusted earnings per share were 76.9¢, up 3%. The trading cash flow was \$877 million, reflecting a trading profit to cash conversion ratio of 89%.

**Capital Allocation Framework**

We consider that the efficient use of capital on behalf of Shareholders is an important objective. We have delivered good revenue and earnings growth and strong cash generation in the challenging markets of the last few years.

During 2011, we announced our Strategic Priorities, focusing our business on liberating resources to invest in driving greater growth. In order to support this strategy, the Board believes in maintaining an efficient, but prudent, capital structure, while retaining the flexibility to make value enhancing acquisitions. This approach was set out in the new Capital Allocation Framework announced in May 2013.

The Capital Allocation Framework will be used to prioritise the use of cash and ensure an appropriate capital structure. Our commitment, in order of priority, is to:

1. continue to invest in the business to drive organic growth;
2. maintain our progressive dividend policy;
3. realise acquisitions in-line with strategy; and
4. return any excess capital to Shareholders.

This is underpinned by maintaining leverage ratios commensurate with solid investment grade credit metrics.



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GROUP STRATEGIC REPORT 15

and strong

**cash generation**

In-line with the above framework, and reflecting our confidence in the successful execution of our Strategic Priorities, we commenced a \$300 million share buy-back programme in May 2013. As of 31 December 2013 we had spent \$226 million. This programme was suspended following our agreement to acquire ArthroCare, announced on 3 February 2014.

**Liberating resources**

In August 2011, Smith & Nephew announced a programme to drive structural efficiencies in order to liberate the resources needed to fund investment in the emerging markets and R&D, targeting savings of at least \$150 million per annum. The cost of the currently identified programmes is expected to be \$160 million in cash and \$40 million in non-cash costs.

To date the Group has realised annualised benefits of \$131 million and we expect to complete the programme in early 2015 and realise slightly more than the anticipated benefits. The costs are on track.

**Outlook**

We anticipate the market conditions seen in the second half of 2013 to continue in 2014. We expect the US to be stable with some signs of improvement, Europe to remain challenging and the emerging markets to continue to offer opportunities for higher growth.

In terms of revenue growth by franchise, we expect:

Orthopaedic Reconstruction, continuing its recent improved performance, to grow at approaching the market rate;

Trauma & Extremities, building upon our recent investments, to grow overall at the market rate, but with a stronger second half to the year;

As a result of this programme and other actions, a culture of continuously looking to be more efficient is being embedded across the Group.

Sports Medicine, with its strong product pipeline, to deliver growth above the market rate; and

### Acquisitions

During the year the Group has completed acquisitions of manufacturing and distribution businesses in Turkey, Brazil and India. The aggregate cost was \$126 million. Through these acquisitions, we are implementing a number of our Strategic Priorities: to build leadership positions in the Emerging & International Markets; to supplement our organic growth through acquisitions; and to bring forward mid-tier portfolios to these countries.

Advanced Wound Management, with its unique mix of leading products, to deliver another year of growth above the market. Within this, we expect Advanced Wound Bioactives to grow at a rate in the mid-teens.

In terms of trading profit margin, we expect to exceed our 2013 performance.

I am confident that our continuing focus on efficiency, coupled with further investments to drive growth and the disciplined use of our strong cash flow will generate greater value for our Shareholders.

Yours sincerely,

Julie Brown

Chief Financial Officer

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Our marketplace

We operate in

dynamic markets

Market trends

Demand for healthcare continues to increase worldwide influenced by the following trends:

Increased longevity and average age

As a result of improvements in healthcare and living conditions, life expectancy across the world has increased in modern times and this increase is expected to continue.

The Organisation for Economic Co-operation and Development ( OECD ) calculates the average life expectancy at birth in 2010 as 79.7, a significant rise from the 70.3 calculated in 1970.

As a consequence of longer life expectancy and the falling birth rates in many developed countries, there is an expanding gap between the demand for healthcare and the ability of governments to supply healthcare.

More active lifestyles

Demand for healthcare is also increasing because people now expect to maintain active lifestyles longer into retirement and to return to activity sooner after treatment. This has resulted in a desire for less invasive surgery and quicker recovery times. Patients also desire products with a better replication of natural movement and an ability to cope with more rigorous activity over a longer period.

Obesity and associated chronic diseases

Obesity is an increasing global problem which causes more wear on the joints of the human body and increases demand for orthopaedic reconstruction.

Across the OECD countries, an average of 18% of the population is obese; this has increased from 13% in 2000.

Demand for healthcare will increase because of the ageing world population but at the same time the changing balance of age in the population means that, relatively speaking, there is potentially an accompanying decrease in funds available for healthcare raised through taxation of the working population.

Obesity also increases the risk of diabetes which can lead to other medical conditions and complications. In 2012, the International Diabetes Federation estimated that 8.3% of the world's population (371 million people) suffer from diabetes and this is projected to rise to 9.9% (552 million people) by 2030.

There is a proven link between diabetes and a higher risk of surgical site infections which increases the risk of surgical procedures on diabetic patients. This risk can be minimised with the use of specialist wound care products designed to lower the risk of infection.

It is estimated that up to 10% of people with diabetes also suffer from diabetic foot ulcers. These ulcers are prone to infection, causing an increased risk of amputation, increased morbidity and are a significant burden on the health system.

#### Increased affluence in emerging markets

The emerging markets are becoming more affluent and therefore more able to afford medical treatments. However, the cost of many medical devices restricts access by the wider population.

#### Patient awareness

In certain countries, patients are becoming increasingly aware, from the internet and direct-to-customer advertising, of the various healthcare options and treatments available. This has led to some increased patient influence over the product purchasing decisions of medical service providers.

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GROUP STRATEGIC REPORT 17

**Regulatory standards and compliance in the healthcare industry**

Global economic crisis

The supply of healthcare in many of our markets is funded by governments. The global economic crisis in recent years has placed increased pressure on governments around the world to reduce or constrain healthcare expenditure.

The international medical device industry is highly regulated. Regulatory requirements are important 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.

In summary

The increased demand for healthcare products and the limitation of available resources is widening the funding gap. Providing technologies that deliver value by improving clinical outcomes while reducing the consumption of overall healthcare resources is vital for the success and sustainability of medical device businesses.

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 China Food and Drug Administration.

In general, the trend in many countries in which we do business is towards higher expectations and increased enforcement activity by governmental authorities.

We are committed to doing business with integrity and welcome the trend to higher standards in the healthcare industry. We and other companies in the industry have been subject to investigations and other enforcement activity that have incurred and may continue to incur significant expense. See Legal proceedings on page 130.

## RESPONDING TO THE MARKET

Smith & Nephew is committed to developing products that respond to the demand and supply pressures faced by the healthcare industry. Some examples are set out below.

Our VERILAST<sup>à</sup> Technology has been laboratory tested to demonstrate wear performance sufficient for 30 years of use enabling a total replacement option for younger, more active patients.

PICO<sup>à</sup> is our single use NPWT product which brings the wound healing benefits of NPWT to a wider audience due to its discrete size and portability. Research is also proving the benefits of NPWT products to reduce recovery times after major surgery, such as caesarean sections.

VISIONAIRE<sup>à</sup>, our patient matched instrumentation, uses the patient's MRI and X-rays to design cutting blocks specific to each patient. This may reduce surgery time by eliminating several sizing and alignment steps and improves precision in fitting the implant.

We are developing products targeting the middle economic tier of the emerging markets to capitalise on their forecast growth. This will enable doctors and nurses to deliver quality products to new patient communities around the world.



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Our marketplace *continued*

**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 as a result of government policy. We are therefore largely dependent on future governments providing increased funds commensurate with the increased demand arising from demographic trends.

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

**Competitors**

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. In order to achieve this there has been some consolidation in our customer base, as well as amongst our competitors, and these trends are expected to continue in the long term. We compete against both local and multinational corporations, including some with greater financial, marketing and other resources.

Our competitors include Arthrex, Biomet, DePuy Synthes, Stryker and Zimmer in our Advanced Surgical Devices division and Coloplast, Convatec, Kinetic Concepts and Molnlycke in our Advanced Wound Management division.

**Customers**

In certain parts of the world, including the UK, much of Continental Europe, Canada and Japan, the healthcare providers are largely government organisations funded by tax revenues. In the US, our 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 treatment regimes.

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GROUP STRATEGIC REPORT 19

Our business

Our mission is to deliver

advanced medical technologies

Improving quality of life

Smith & Nephew's business model, set out on page 7, supports our mission to deliver advanced medical technologies to help healthcare professionals, our customers, improve the quality of life for their patients.

Through it we:

invest in **research & development** to create innovative new solutions that improve clinical outcomes and reduce the economic burden on healthcare systems;

rigorously enforce **regulatory and compliance** standards, conducting business ethically everywhere we operate;

ensure our **manufacturing**, supply and distribution footprint is lean and efficient;

Research and development

We have a deep knowledge of the needs of surgeons and nurses, we understand the economic pressures healthcare payers work under, and we recognise that patients are demanding better treatment options to restore quality of life. These factors inform our research and development ( R&D ) strategy, which is at the heart of our business model.

In 2013, we again delivered many new and innovative products. These included a major new knee platform, the JOURNEY II BCS; the first sports medicine product to use Smith & Nephew's proprietary advanced biocomposite material in the HEALICOIL REGENESORB Suture Anchor; and DURAFIBER Ag, combining a highly absorbent, gelling fibre dressing with the antimicrobial benefits of silver.

We have a strong new product pipeline for 2014, with many innovations scheduled, in particular in Sports Medicine Joint Repair, Trauma and Advanced Wound Management.

provide **medical education** and product training to healthcare professionals to help ensure safe and effective treatment for patients; and

support our **sales and marketing** teams to guarantee our customers have the advanced technologies and supporting services they need to treat their patients.

Our business model is underpinned by our **values** and **Capital Allocation Framework**:

our values of Innovation, Trust and Performance focus **our people** on being responsive to the needs of our customers; energetic, creative and passionate in our work; and building lasting and close relationships with our stakeholders; and

Our Capital Allocation Framework enables us to invest for the future, both in organic growth and through acquisitions, whilst also generating value for Shareholders today through a progressive dividend policy and commitment to return any excess capital.

By implementing our **Strategic Priorities** we increase momentum throughout the business model to:

build on our strong position in the Established Markets;

realise the significant opportunities in the Emerging & International Markets;

maintain an unremitting focus to innovate for value;

These new products, and many more currently in development, are a result of our focus on R&D. We invested \$231 million in this area in 2013. At 5.3% of revenue this is an increase from the 4.1% spent in the previous year. We expect to maintain our investment level at around 5% of revenue going forward.

We are highly disciplined in project selection. Our R&D experts in the UK, US, Europe, China and India have extensive customer and sector knowledge, which is augmented by ongoing interaction with our marketing teams. Strict criteria are applied to ensure new products fulfil an unmet clinical need, have a strong commercial case, and are technologically feasible. Our R&D teams also work closely with manufacturing and supply chain management to ensure we can produce new products to clinical, cost and time specification.

#### Open Innovation

As part of our R&D strategy, Smith & Nephew supports and works with numerous small companies looking for help with developing and commercialising new technologies.

As supporters of NASA's TecFusion Open Innovation programme we access and support companies developing highly creative, often disruptive, technologies that are funded by the US federal government.

We are a primary sponsor of the Massachusetts Medical Device Development Center ( M2D2 ) New Venture Competition, supporting entrepreneurial product development by early-stage medical device companies.

simplify and improve our operating model to maximise efficiency; and

supplement our organic growth through acquisitions.

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Our business *continued*

We are the commercial partner in SWAN-iCare, an EU-funded initiative to bring multidisciplinary European research teams together to deliver a next generation integrated autonomous solution for monitoring and adapting personalised therapy of foot and leg ulcers.

InVentures

Smith & Nephew also welcomes new product concepts from surgeons. Through our InVentures programme we collaborate to bring ideas to reality. InVentures evaluates surgeon concepts for technical and market viability and our development team works hand-in-hand with surgeons to deliver new products that advance healing. Commercialised products benefit from the global selling power of Smith & Nephew.

In 2013, we introduced a new MODULAR RAIL SYSTEM for deformity correction and limb restoration that was designed in collaboration with Dror Paley MD through the InVentures programme. This new treatment option highlights our increased investment in extremities and limb restoration, and our commitment to working directly with surgeon inventors.

Intellectual property

We protect the results of our research and development through patents and other forms of intellectual property. The Group's patent portfolio currently includes in excess of 5,000 patents and patent applications. Patent protection for our products is sought routinely in our principal markets.

We also have a policy of protecting our products by registering trademarks under the local laws of markets in which such products are sold. We vigorously protect our trademarks against infringement.

3 INNOVATE FOR VALUE

New treatment for venous leg ulcers

HP802-247 is an investigational human cell therapy for the treatment of venous leg ulcers currently in Phase III trials. Results from Phase IIb trials investigating the efficacy of HP802-247 were previously published in *The Lancet*.

Based on in vitro studies, HP802-247 is believed to release various growth factors and cytokines into the micro-environment of the wound. These living cells are anticipated to interact with the patient's own cells to stimulate wound healing. HP802-247 has been designed to deliver a defined cell ratio (keratinocyte:fibroblasts) to support optimal tissue regeneration.

Venous leg ulcers are increasingly common and costly to healthcare systems and a cause of prolonged suffering for patients. These wounds are caused by swelling and inflammation secondary to blockage or backflow in the veins of the legs. Many venous ulcers fail to heal even after three months of standard treatment and develop into chronic, non-healing wounds.

Based on an estimated figure of 2.5 million venous leg ulcers in the United States alone and a study of actual direct treatment costs of \$9,685 per person, the annual cost of treating these wounds is likely to be in the many billions of dollars. Accordingly, the availability of innovative and more effective treatment strategies for such high-risk wounds could provide tremendous benefits to both patients and society.

In addition to protecting our market position by filing and enforcing patents and trademarks, we may oppose third party patents and trademark filings where appropriate in those areas that might conflict with our business interests.

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

## Regulatory and compliance

### Code of conduct and business principles

Smith & Nephew earns trust with patients, customers, healthcare professionals, authorities and the public by acting in an honest and fair manner in all aspects of its operations. We expect the same from those with whom we do business, including distributors and independent agents that sell our products, as well as vendors that interact with others on our behalf. Our Code of Conduct and Business Principles ( Code ) governs the way we operate to achieve these objectives.

Smith & Nephew takes into account ethical, social, environmental, legal and financial considerations as part of its operating methods. We have a robust whistle-blowing system in all jurisdictions in which Smith & Nephew operates. We are committed to upholding our promise in our Code that we will not retaliate against anyone who makes a report in good faith.

New employees receive training on our Code, and we assign annual compliance training to employees. In 2013, we created two additional courses: a refresher course on Preventing Bribery and Corruption and Effective Communication .

### Global compliance programme

Smith & Nephew has implemented what we believe is a world-class Global Compliance Programme that helps our businesses manage risk and comply with laws and regulations. In 2013, Smith & Nephew continued to strengthen its

comprehensive compliance programme, which includes global policies and procedures, on-boarding and annual training for its employees, managers, independent agents and key employees of distributors and high risk vendors around the world, monitoring and auditing processes, and reporting channels. Through a global intranet website, we provide resources and tools to guide employees to make decisions that comply with the law and our Code and earn trust. We conduct advance review and approval for any significant interactions with healthcare professionals or government officials. New distributors are subject to due diligence and are contractually obligated to comply with applicable laws and our Code. Their management are required to take compliance training and certify that they will ensure their employees and agents comply with the law and our Code. In 2013, we launched a compliance programme toolkit, in multiple languages, for our distributors to provide them with the resources to establish their own compliance programme. The toolkit includes draft policies, training materials and approval forms.

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In 2012, under the terms of the Company's Foreign Corrupt Practices Act (FCPA) settlement (see Note 17.3 of the Notes to the Group accounts), we retained an independent monitor to review the effectiveness of our compliance programme and make recommendations, as appropriate, for further enhancements to the programme. In collaboration with the independent monitor, our programme has been enhanced even further. In late 2013, the monitor completed his 18-month review and concluded that Smith & Nephew's compliance programme is reasonably designed and implemented to detect and prevent violations of the anti-corruption laws and is functioning effectively. Smith & Nephew will report directly to the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) for the remainder of the three-year settlement agreement.

**Manufacturing**

We continue to implement Lean Manufacturing throughout our factories and the supply chain to improve and sustain higher levels of service, quality, productivity and efficiency.

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

4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL

Perpetual efficiency

The significant investments undertaken in 2013 have been possible through our successful drive to be more efficient, reduce cost, and simplify and improve our operating model.

In 2011, we announced a programme to generate annual savings of \$150 million. As a result of our work to date, we have annualised benefits of \$131 million. The programme will be largely complete by the end of 2014.

Significant actions included a major reorganisation when we created the Advanced Surgical Devices division, the opening of an extension to our Advanced Wound Management factory in Suzhou, China, and the introduction of a major new IT platform.



We are now a leaner business, and, as importantly, we are embedding a culture of perpetual efficiency into our processes and future thinking.

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

We outsource manufacturing where necessary to obtain specialised expertise or where it is possible to gain lower cost without undue risk to intellectual property. Suppliers of outsourced products and services are selected based on their ability to deliver products and services to specification, and establish and maintain a quality system. Suppliers are trained and are monitored through on-site assessments and performance audits that include quality, service and delivery.

Finished goods purchased for resale include screen displays, optical and electrical devices in the Advanced Surgical Devices division and skincare products in the Advanced Wound Management division.

We operate a number of manufacturing facilities around the globe, which are predominantly division specific, and a number of central distribution facilities in the key geographical areas in which we operate. Products are shipped to Group companies which hold small amounts of inventory locally for immediate or urgent customer requirements.

#### Advanced Surgical Devices

The Advanced Surgical Devices division's largest manufacturing operation is based in Memphis (Tennessee, US), with additional production and assembly plants based in Mansfield (Massachusetts, US), Oklahoma City (Oklahoma, US), Aarau (Switzerland), Tuttlingen (Germany), Beijing (China), Calgary (Canada), Warwick (UK) and Sangameshwar (India).

The Memphis facilities produce key products and instrumentation in our Knee Implants, Hip Implant and Trauma franchises. These include the JOURNEY II BCS and LEGION<sup>®</sup> knees, the ANTHOLOGY<sup>®</sup> Primary Hip System and key Trauma products such as the PERI-LOC<sup>®</sup> Ankle Fusion Plating System and TRIGEN<sup>®</sup> Intramedullary Nails. In addition to this, Memphis is the home to the design and manufacturing process of the VISIONAIRE Patient Matched Instrumentation Sets.

The Mansfield facility focuses on sports medicine related products for minimally invasive surgery including the FAST FIX<sup>®</sup> 360 Meniscal Repair System, FOOTPRINT<sup>®</sup> PK Suture Anchor, DYONICS<sup>®</sup> Platinum Shaver Blades, ENDOBUTTON<sup>®</sup> CL Ultra and the HEALICOIL PK suture anchor.

The Aarau, Tuttlingen, Beijing and Warwick facilities produce a large number of products including key Trauma products, the PLUS<sup>®</sup> knee and hip range and the BIRMINGHAM<sup>®</sup> Hip Resurfacing System. The facility in Oklahoma City deals mainly with the assembly of surgical digital equipment, such as HD560 Camera.

A distribution facility in Baar (Switzerland) serves as the main holding and consolidation point for markets in Europe. In the US, the distribution hub is located in Memphis.

#### Advanced Wound Management

Advanced Wound Management is headquartered in Hull (UK) which is home to a large proportion of the division's manufacturing activities. There are also manufacturing facilities in Gilberdyke (UK), Suzhou (China), Curaçao (Dutch Caribbean), Alberta (Canada) and Oklahoma City.

The products made at the Hull site cover the therapies of Exudate Management (Foam products principally ALLEVYN<sup>®</sup>), Burns treatment (ACTICOAT<sup>®</sup>) and Wound Closure (OPSITE<sup>®</sup> film products). Several brands produced in Hull, such as JELONET<sup>®</sup> and BACTIGRAS<sup>®</sup>, will be transitioning to Suzhou in 2014.

A key base material used in the production of a large number of dressings is the intermediate bulk rolls of film which are manufactured in the Gilberdyke (UK) facility. The facility in Alberta (Canada) provides specific expertise in the addition of silver coatings onto the ACTICOAT burns range prior to shipping to Hull for the final conversion process into finished dressings.

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Our business *continued*

The Suzhou facility opened in 2009 initially to manufacture some Foam products within Exudate Management. It has since expanded to take on production of some Film Wound Closure products.

NPWT is an area of the business which is growing strongly. The majority of the NPWT components are bought in from third parties and assembled in the Advanced Surgical Devices Oklahoma City facility, with the exception of the dressings used for the PICO product which are manufactured in Hull.

Manufacturing for Advanced Wound Bioactives takes place in Curacao, and at various third party facilities in the US. The products are distributed from a third party logistics facility in San Antonio, Texas.

Advanced Wound Management distribution hubs are located in Neunkirchen (Germany) and Derby (UK) for international distribution, Bedford (UK) for UK domestic distribution and Lawrenceville (Georgia, US) for US distribution.

**Medical education**

Smith & Nephew is dedicated to helping healthcare professionals improve the quality of care for patients. We are proud to support the professional development of surgeons and nurses by providing them with medical education and training on our Advanced Surgical Devices and Advanced Wound Management products.

Every year thousands of customers attend our state-of-the-art training centres in the US, UK and China and Smith & Nephew courses at multiple hospitals and facilities around the world. Working under expert guidance, attendees refine techniques and learn new skills, whilst experiencing the safe and effective use of our products. We also support healthcare professionals through our online resources such as the Global Wound Academy and, for surgeons, our Education and Evidence website.

**1 ESTABLISHED MARKETS**

**Pioneering e-learning**

We have extended our commitment to medical education in 2013 with the launch of Education and Evidence, a new e-learning platform for surgeons to access and share peer-to-peer educational resources. It follows the success of our Global Wound Academy ([www.globalwoundacademy.com](http://www.globalwoundacademy.com)) which has more than 46,000 registered users.

Education and Evidence supports joint repair and replacement, extremities and trauma specialties. The member-based service at [www.smith-nephew.com/education/](http://www.smith-nephew.com/education/) hosts more than 1,000 videos, articles, surgical techniques, podcasts, training courses, tablet PC apps and iBooks™. It uses an innovative search engine and self-profiling to tailor content to users, while also enabling the sharing of resources with colleagues.

Through these powerful e-learning tools we are delivering on our Strategic Priorities, reinforcing our position in the Established Markets and extending our reach in the Emerging & International Markets.

### Sales and marketing

Our customers are the providers of medical and surgical treatments and services in over 90 countries worldwide. The largest single customer worldwide is a purchasing group based in the UK that represented 6% of our worldwide revenue in 2013.

In our Established Markets, our Advanced Surgical Devices are principally shipped and invoiced directly to healthcare providers, hospitals and other healthcare facilities. Certain Advanced Wound Management products are shipped and invoiced to wholesale distributors and others are consigned to distributors that lease the devices to healthcare providers, hospitals and other healthcare facilities and end-users.

Each division operates its own dedicated sales force as the customer for the divisions' products are usually different. Our US sales forces consist of a mixture of independent contract workers and employees. Sales agents are contractually prohibited from selling products that compete with our products. In most Other Established Markets, each division typically manages employee sales forces directly.

In our Emerging & International Markets we operate through direct selling and marketing operations, and through distributors. In these markets, our Advanced Surgical Devices franchises frequently share sales resources. The Advanced Wound Management sales force may be separate where it calls on different customers.

### Our people

Smith & Nephew had over 11,000 employees in 2013. We are committed to attracting, engaging, developing and retaining employees as well as to being a responsible corporate citizen.

Our employees are dedicated to our core values of Innovation, Trust and Performance which represent the foundation of our culture.

Investing in our people and communities helps ensure the long-term sustainability of our business. In 2013, we executed actions to address employee feedback from our Global Survey and also participated in the Great Places to Work survey in many of our markets.

Attracting the best talent and developing and engaging our employees is critical to achieving and sustaining our business objectives and overall performance. Our appointments are made on merit and in alignment with a core set of competencies and values of which ethics and integrity are central. We prioritise the development and promotion of our employees whenever possible.



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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## GROUP STRATEGIC REPORT 23

Each year, Smith & Nephew conducts a comprehensive global development and capability review process to identify high-potential employees and ensure they have career development plans in place. Talented employees are provided with opportunities to develop and grow their skills and career. Current programmes include the CEO Forum, designed to develop talent and provide exposure to the broader business, and the General Managers Meeting, held annually to align these key leaders with the Group's strategy and goals. In addition, the Board reviews succession plans for key executive roles. We have succession plans for critical positions across our business and have taken proactive steps to recruit specialist and leadership talent to augment our current team.

Our performance management process ensures all employees set objectives which align to our overall business goals. Reward systems are focused on promoting high-performance and ethical behaviour. Our Code of Conduct is an important measure of individual performance. All employees are required each year to complete training and certify their adherence to this Code.

Smith & Nephew strives to create a more engaged and productive workforce and focuses on measures to drive employee engagement. These include an understanding of the Group's mission and direction, sense of employee involvement, focus and adaptability to customers and market place. We continue to listen to our employees, via regular surveys and focus groups, and we value their opinions.

## Diversity at Smith &amp; Nephew

Smith & Nephew believes that diversity fuels innovation. We are committed to employment practices 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.

The Board and Executive Officers continue to recognise the importance of diversity and over the last two years have expanded their own diversity profile. Three of our 12 Board members are female.

At 31 December 2013, Smith & Nephew had the following breakdown of employees:

|  | Number of Employees <sup>1</sup> |
|--|----------------------------------|
| Directors                              |                                  |
| Male                                   | 9                                |
| Female                                 | 3                                |
| <b>Total</b>                           | <b>12</b>                        |
| Senior Managers and above <sup>2</sup> |                                  |
| Male                                   | 484                              |

|                 |               |
|-----------------|---------------|
| Female          | 140           |
| <b>Total</b>    | <b>624</b>    |
| Total employees |               |
| Male            | 7,203         |
| Female          | 4,821         |
| <b>Total</b>    | <b>12,024</b> |

1 Number of employees as at 31 December 2013 including part time employees and employees on leave of absence.

2 Senior managers and above includes all employees classed as Directors, Senior Directors, Vice Presidents and Executive Officers and includes all statutory Directors of our subsidiary companies.

We aim to provide an open, challenging, productive and participative environment based on constructive relationships. We maintain good communications with employees through regular and timely information and consultation.

We provide clearly communicated goals and performance standards, and the training, information and authority needed to do a good job. We provide fair recognition and reward based on performance. Our annual CEO Award recognises employees who deliver exceptional results in-line with our core values, encouraging innovation and a spirit of continuous improvement at all levels. We are committed to working with employees to develop each individual's talents, skills and abilities. We provide encouragement to learn and progress and to participate fully in the quest for continuous improvement. We recruit, employ and promote employees on the sole basis of the qualifications and abilities needed for the work to be performed. We do not tolerate discrimination on any grounds and provide equal opportunity based on merit.

We are committed to building diversity in a working environment where there is mutual trust and respect and where everyone feels responsible for the performance and reputation of our Company. We are committed to providing healthy and safe working conditions for all employees. We achieve this by ensuring that health and safety and the working environment are managed as an integral part of the business, and we recognise employee involvement as a key part of that process.

We do not use any form of forced, compulsory or child labour. We support the Universal Declaration of Human Rights of the United Nations. This means we respect the human rights, dignity and privacy of the individual and the right of employees to freedom of association, freedom of expression and the right to be heard.

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Segment performance: Advanced Surgical Devices

Advanced Surgical Devices



- 1 The underlying percentage increases/decreases are after adjusting for the effect of currency translation and the inclusion of the comparative impact of acquisitions and exclusion of disposals.
- 2 Explanation of these non-GAAP financial measures are provided on pages 161 to 163.
- 3 The 2012 revenue by franchise has been restated to 2013 product franchises.



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GROUP STRATEGIC REPORT 25

The Emerging &  
International Markets have  
become an increasingly  
important opportunity  
for our products

Overview

Knee Implants

In Advanced Surgical Devices ( ASD ) we develop, manufacture and sell products in the following franchise areas:

Orthopaedic Reconstruction

Smith & Nephew offers a range of specialist products for orthopaedic reconstruction in its Knee Implants and Hip Implants franchises.

Implant bearing surfaces such as the proprietary OXINIUM<sup>a</sup> Oxidized Zirconium continue to be a point of differentiation for Smith & Nephew. OXINIUM Technology combines the enhanced wear resistance of a ceramic bearing with the superior toughness of a metallic bearing. When

Smith & Nephew offers a range of products for specialised knee procedures. The JOURNEY II BCS Total Knee System was launched in the US in 2013. It is designed to restore the normal kinematic motion by replicating the anatomic shapes of a normal, healthy knee.

The LEGION/GENESIS<sup>a</sup> II Total Knee System is a comprehensive system designed to allow surgeons to address a wide range of knee procedures from primary to revision.

These systems also feature VERILAST Technology, our advanced bearing surface and also utilised VISIONAIRE Patient-Matched Instrumentation.

combined with highly cross-linked polyethylene (XLPE) it results in our proprietary VERILAST Technology. In Hip Implants, the combination of a ceramicised metal head and a polyethylene lined cup have been shown in joint registry data to have superior five-year survivorship (97.9%) compared to implants made from any other material. In Knee Implants, the LEGION Primary Knee with VERILAST Technology is the only knee implant with a 30-year wear performance claim more than double the length of wear performance testing of conventional technologies.

With VISIONAIRE Instrumentation, a patient's MRI and X-rays are used to create customised cutting blocks that allow the surgeon to achieve optimal mechanical axis alignment of the new implant. In addition, VISIONAIRE also helps save time by reducing the number of steps and instruments needed in the operating room.

## 5 SUPPLEMENT GROWTH WITH ACQUISITIONS

### Leadership in India

The Emerging & International Markets have become an increasingly important opportunity for our products. The acquisition of India's Sushrut-Adler, a leader in trauma products, greatly enhanced our portfolio for this fast growing segment.

Sushrut-Adler has a long and distinguished history, a reputation for quality products and a loyal customer base. Its trauma portfolio strongly complements our established positions in orthopaedic reconstruction and sports medicine in India. From our enhanced platform we can develop further products for the mid-tier in India and for export. We are delivering on our Strategic Priorities to build leadership positions in the Emerging & International Markets and to bring forward products for these countries.

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SMITH & NEPHEW ANNUAL REPORT 2013

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Segment performance: Advanced Surgical Devices *continued*

Hip Implants

For Hip Implants, core systems include the ANTHOLOGY Hip System, SYNERGY<sup>®</sup> Hip System, the SMF Short Modular Femoral Hip System, the R3 Acetabular System, the POLARCUP<sup>®</sup> Dual Mobility Hip System and the SL-PLUS Hip Family System.

In 2013, we launched the SMF Monolithic Hip Stem which is intended to capitalise on the clinically proven flat taper cementless primary stem. The SMF Monolithic Stem family of products allows the surgeon to use the convenience of a one piece stem and the advantage of a short stem.

We also introduced the POLARSTEM<sup>®</sup> HA Cementless Stem System in the US for state-of-the-art minimally invasive surgical techniques that preserve bone and soft tissue, with good functionality and reproducible results.

Trauma & Extremities

Our Trauma & Extremities franchise offers both internal and external devices, as well as other products used in the stabilisation of severe fractures and deformity correction procedures.

During 2013, the US business refined its commercial model to increase the focus and resources addressing the opportunities in the high-growth trauma and extremities markets.

For Trauma, the principal internal fixation products are the TRIGEN<sup>®</sup> family of IM nails (TRIGEN META-NAIL<sup>®</sup> System, TRIGEN Humeral Nail System, TRIGEN SURESHOT<sup>®</sup>, and TRIGEN INTERTAN<sup>®</sup>) and the PERI-LOC<sup>®</sup> Plating System. For extremities and limb restoration, the franchise offers the TAYLOR SPATIAL FRAME<sup>®</sup> Circular Fixation System as well as a range of plates, screws, arthroscopes, instrumentation, resection, and suture anchor products for foot, ankle, hand and wrist surgeons.

2013 saw the introduction of the MODULAR RAIL SYSTEM ( MRS ) which is designed to correct bone deformities, malunions, non-unions and limb length discrepancies. The MRS takes advantage of the body's ability to grow new bone tissue.

In Extremities during 2013 we expanded our ALL28<sup>®</sup> Foot and Ankle portfolio to include ankle instability and Achilles tendon repair. Ankle instability builds upon our successful TWINFIX<sup>®</sup> titanium anchor technology in a new system specifically designed for foot & ankle surgeons. It allows the surgeon to re-attach or repair the anterior talofibular ligament ( ATFL ) to the fibula. The Achilles tendon repair solution uses our FOOTPRINT<sup>®</sup> Ultra PK Suture Anchor to address traumatic avulsion of the tendon. This technology allows for tension adjustment after anchor insertion up until the inserter is removed, as well as eliminating knot stack on the heel that may cause irritation to the

patient post procedure.

#### Sports Medicine Joint Repair

The Sports Medicine Joint Repair franchise offers surgeons a broad array of instruments, technologies and implants necessary to perform minimally invasive surgery of the joints, including knee, hip and shoulder repair.

Significant launches during the year included the HEALICOIL REGENESORB Biocomposite Suture Anchor, Active Heel Traction Boot and CLANCY<sup>®</sup> Depth Gauge.

The HEALICOIL Suture Anchor's distinctive, open-architecture differs from solid-core implants by eliminating the material between anchor threads, allowing blood and bone marrow from the surrounding cancellous bone to enter the implant. Our proprietary REGENESORB Material is an advanced biocomposite.

#### Arthroscopic Enabling Technologies ( AET )

Our Arthroscopic Enabling Technologies franchise offers healthcare providers a variety of technologies such as fluid management equipment for surgical access; high definition cameras, digital image capture, scopes, light sources and monitors to assist with visualisation inside the joints; radio frequency ( RF ) probes, electromechanical and mechanical blades, and hand instruments for removing damaged tissue.

Key AET products include DYONICS shaver blades, ACUFEX<sup>®</sup> handheld instruments, and a wide range of radio frequency probes. The DYONICS Platinum Series Shaver Blades are single-use blades that provide superior resection due to their unequalled sharpness and virtually eliminate clogging through their improved debris evacuation capabilities.

The new LED 3000 Light Source launched in 2013 is designed to optimise the HD visualisation experience by providing brilliant illumination through a compact and intuitive interface.

#### Other ASD

The Other ASD franchise includes smaller businesses such as Gynaecology.

The main Gynaecology product is the TRUCLEAR<sup>®</sup> System, a first-of-its-kind hysteroscopic morcellator that pairs continuous visualisation capabilities with minimally invasive tissue removal providing safe and efficient removal of endometrial polyps and submucosal fibroids. The business also sells a hysteroscopic fluid management system, which provides uterine distension and clear visualisation during hysteroscopic procedures.

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GROUP STRATEGIC REPORT 27

**3 INNOVATE FOR VALUE**

**Natural-motion Journey II**

**BCS Total Knee System**

JOURNEY II BCS sets a new standard in knee implant performance by restoring more normal motion. This is achieved through the reproduction of both the shapes of the joint's hard surfaces and the normal force behaviour of the soft tissues, such as ligament and muscle firing patterns. As a result, the soft tissue's re-adjustment to new shapes and forces after surgery is minimised, helping to return the patient's stride to its natural rhythm.

This latest innovation is the result of intense research and design, and the development of new **PHYSIOLOGICAL MATCHING<sup>à</sup>** Technology. Using our **LifeMOD<sup>à</sup>** human simulation software, Smith & Nephew

engineers were able to conduct proprietary analysis of the bone, ligament and muscle forces that impact the knee, and then account for those forces within the design of an implant that restores anatomic shapes and normal motion.

JOURNEY II BCS is made from Smith & Nephew's **VERILAST** Technology. The combination of two wear reducing materials proprietary **OXINIUM** alloy and a highly cross-linked plastic liner, **VERILAST** Technology generates a significant reduction in implant wear compared to traditional bearing couples on the market.

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SMITH & NEPHEW ANNUAL REPORT 2013

28 GROUP STRATEGIC REPORT

Segment performance: Advanced Surgical Devices *continued*

**Market and competition**

In 2013, weaker economic conditions worldwide continued to create several challenges for the overall surgical devices market, including continued deferrals of joint replacement procedures and heightened pricing pressures.

These factors contributed to the lower overall growth of the worldwide surgical devices market versus historic comparables. However, over the medium term, several catalysts are expected to continue to drive sustainable growth in surgical device procedures, including the growing and ageing population with active lifestyles, rising rates of co-morbidities such as obesity and diabetes, patient desire for minimally invasive procedures, technology improvements allowing surgeons to treat younger, more active patients, and the increasing demand for healthcare in emerging markets.

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

Global orthopaedic reconstruction segment

Smith & Nephew estimates that the global orthopaedic reconstruction segment is worth approximately \$14 billion and the segment served by Smith & Nephew increased by approximately 3% in 2013. Competitors in the orthopaedic reconstruction segment include Biomet, DePuy Synthes (a division of Johnson & Johnson), Stryker and Zimmer.

Global orthopaedic trauma segment

Smith & Nephew estimates that the global orthopaedic trauma segment is worth approximately \$5 billion and the segment served by Smith & Nephew grew by approximately 7% in 2013. Competitors in the orthopaedic trauma segment include Biomet, DePuy Synthes (a division of Johnson & Johnson), Stryker and Zimmer.

Global sports medicine segment

Smith & Nephew estimates that the global sports medicine segment (representing access, resection and repair products) is worth approximately \$4 billion and the segment served by Smith & Nephew grew by approximately 6% in 2013. Competitors in the sports medicine segment include Arthrex, DePuy Mitek (a division of Johnson & Johnson) and Stryker.

## Regulatory approvals

In 2013, regulatory clearances/approvals were obtained for several key products and instrumentations.

In the US, 510(k) clearance was obtained for Disposable Knee Instruments, SURESHOT<sup>®</sup> Distal Targeting System v3.0 (added drill depth measurement functionality), HEALICOIL REGENESORB Suture Anchor, TWINFIX Ti 3.5mm SL Anchor, FOOTPRINT Ultra 4.5mm & 5.5mm SL Anchors, SUTUREFIX<sup>®</sup> Ultra Suture Anchors and ULTRATAPE<sup>®</sup> Suture.

In Europe, we obtained renewals for LEGION Narrow Femoral Components (CE mark approval), ULTRA FAST-FIX<sup>®</sup> AB (indications expansion to include meniscal allograft transplantation), Round ENDOBUTTON<sup>®</sup>, SCREWBUTTON<sup>®</sup> and ULTRA FAST-FIX AB (CE Renewal).

In Canada, the TWINFIX Ti 3.5mm SL Anchor and FOOTPRINT Ultra 4.5mm & 5.5mm SL Anchors were approved.

In Australia, the OSTEORAPTOR<sup>®</sup> Curved 2.3 system was approved.

In Japan, we received approvals for SURESHOT Distal Targeting System (two approvals obtained in 2013, including approval of current software version, 3.0), JOURNEY II BCS Knee System, R3 Acetabular System (XLPE Liners and Shells), JOURNEY Uni Knee System (OXINIUM femoral components and all-poly tibial baseplates), JOURNEY Uni Knee System (Articular inserts and tibial baseplates), VISIONAIRE Patient-Matched Cutting Blocks, JOURNEY II CR Knee System, XTENDOBUTTON<sup>®</sup>, HEALICOIL PK Suture Anchor, Beaver Blade, TRUCLEAR Hysteroscopic Morcellator system, BIOSURE HA Interference Screw, BIORAPTOR Knotless Anchor and TWINFIX ULTRA HA Suture Anchor.

In our Emerging & International Markets, we obtained a number of regulatory clearances/approvals for several core product lines, as follows:

In China, we received approvals for Ultra FASTFIX and Ultra FASTFIX AB Meniscal Repair System, SURESHOT Distal Targeting Systems, TWINFIX ULTRA HA Suture Anchor, SPYROMITE and DYNAMITE Extremities Suture Anchors and LEGION Primary Knee System POROUS Femoral Component with HA Coating.

In Russia, we obtained approval to market our Multiple Knee Systems including JOURNEY UNI, GENESIS II, LEGION and TC\_PLUS.

In Mexico, the OXINIUM Femoral Components, R3 Acetabular System, REDAPT Instruments, Cannulated Screw Systems were approved for distribution.

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GROUP STRATEGIC REPORT 29

Segment performance: Advanced Wound Management

Advanced Wound Management

- 1 The underlying percentage increases/decreases are after adjusting for the effect of currency translation and the inclusion of the comparative impact of acquisitions and exclusion of disposals.
- 2 Explanation of these non-GAAP financial measures are provided on pages 161 to 163.



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SMITH & NEPHEW ANNUAL REPORT 2013

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Segment performance: Advanced Wound Management *continued*

**Overview**

In Advanced Wound Management ( AWM ) we offer 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 acute wounds such as burns and invasive surgery that impact the wider population.

The main products within the AWM business are for Exudate management, Infection management, NPWT and Bioactives.

AWM has its global headquarters in Hull, UK and its North American headquarters in St Petersburg, Florida.

**Advanced Wound Care**

Exudate management

Exudate management products focus on effectively and efficiently locking away wound fluid and creating an optimal healing environment to ensure better healing outcomes. Our key brands in this space are ALLEVYN

**4 SIMPLIFY & IMPROVE OUR OPERATING MODEL**

Expanding Suzhou

In April distinguished guests from Suzhou Industrial Park and Jiangsu Province attended the official opening of the major extension to Smith & Nephew's Advanced Wound Management manufacturing facility in Suzhou, China.

The expansion more than doubled the size of the Suzhou facility, and is enabling Smith & Nephew to continue to develop its product portfolio both for the Chinese market and for export. Those manufactured at Suzhou include ALLEVYN, Smith & Nephew's leading foam dressing brand, which is used in the treatment of hard to heal wounds such as leg ulcers, as well as new portfolios for the mid-tier across the Emerging & International Markets.

Completed on time, to budget, and without a lost-time incident, the extension takes the total floor area to 27,000 square meters and doubles the production capacity to over 100 million wound dressings a year. We are delivering on our Strategic Priority to Simplify and Improve our Operating Model by optimising our global manufacturing footprint.

foam dressings and DURAFIBER gelling fibre dressings.

During 2013, we continued to invest in the commercialisation of ALLEVYN Life, our latest innovation in foam dressings, designed to provide a better quality of life to the patient during the healing process. In several studies this has resulted in better patient satisfaction, longer wear times and overall reduced healthcare management costs. One recent article published in the Journal of Community Nursing stated

In employing a design intended to combat the common problems of living with a wound, such as exudate leakage and conformability, the dressing has the potential to improve wound management practice and reduce the use of associated resources, such as nursing time . The article concluded that around 2,500 working days could be saved annually as a result of using ALLEVYN Life.

DURAFIBER has continued to grow over the course of 2013, with customers switching from other products within the gelling fibre segment.

#### Infection management

AWM has two significant technologies in its infection management portfolio, silver (ACTICOAT, DURAFIBER Ag and ALLEVYN Ag) and iodine (IODOSORB<sup>à</sup>). The iodine-based IODOSORB product has continued to gain interest as biofilms become a more important topic in wound care.

We launched DURAFIBER Ag in 2013 and with it entered the silver gelling fibre market, one of the largest segments of the infection management market.

China is of great strategic importance to Smith & Nephew. We are proud of what we have achieved here and are investing for the long term. We now have more than 900 people in China, working across manufacturing and commercial operations. We have built our success upon a sustainable and ethical approach to business, and are bringing this long-term commitment to our work, our employees and our communities.

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GROUP STRATEGIC REPORT 31

Other

We also offer a wide range of other wound care products, which means we have one of the most comprehensive ranges of wound care solutions in the industry. These products include our film and post-operative dressings, skincare products and gels.

**ADERMA:** Following the acquisition and integration of ADERMA pressure relieving technology in 2012, the launch in the UK and increase in ADERMA sales activity has seen it firmly established as the market leader. The UK government's targeting of Pressure Ulcer Prevention and the known cost to the UK health system has driven the adoption of ADERMA in both the Acute and Community sectors. Due to the success in the UK, plans are in place to launch ADERMA as Dermapad in 2014 into other healthcare markets with equally strong Pressure Ulcer Prevention drivers. With our Skincare portfolio, ADERMA/ Dermapad and ALLEYVN Life, we are well placed to deliver a strong and comprehensive Pressure Ulcer Prevention and treatment solution through a tested and validated value proposition into the Established Markets.

**IV 3000:** AWM's specialist breathable premium IV dressing, utilising REALTI<sup>®</sup>film technology and unique patterned adhesive, continues to perform well, particularly driven by emerging markets. Success in these markets and elsewhere has identified an opportunity for a mid-tier offering.

**OPSITE POST OP VISIBLE:** This is our innovative dressing that combines the qualities of a premium dressing with the ability to see the incision. This unique product continues to deliver strong growth in both our Established and Emerging & International Markets as its adoption becomes more widespread backed by good clinical evidence.

**Advanced Wound Devices**

Advanced Wound Devices consists of two categories of products; NPWT and VERSAJET<sup>®</sup>.

**NPWT**

Our NPWT solutions include traditional NPWT products (RENASYS<sup>®</sup> products) and the single-use portfolio (PICO and KALYPTO<sup>®</sup> products).

In its sixth year on the market, our RENASYS traditional NPWT brand has seen continuous improvement and innovation. Product updates in 2013 enhanced both function and user experience with our RENASYS systems as a whole. The RENASYS product offering now includes multiple device options, a choice of foam or gauze dressings, along with a range of drains and specialty kits.

The PICO system, our single-use, canister-free solution is revolutionising NPWT. As familiar and easy to use as an advanced wound dressing, PICO provides an active intervention to help promote optimal healing for early discharge and enhanced outcomes in complex cases. PICO simplifies NPWT.

#### VERSAJET

The VERSAJET Hydrosurgery system is a mechanical debridement device used by surgeons to excise and evacuate non-viable tissue, bacteria and contaminants from wound, burns and soft tissue injuries.

#### Advanced Wound Bioactives

Bioactives represent the fastest growing category of chronic wound therapeutics. Our diversified biotherapeutic portfolio offers novel, cost-effective solutions for tissue repair and healing, addressing the full spectrum of hard-to-heal wounds.

Currently, our leading product is Collagenase SANTYL<sup>®</sup> Ointment, the only FDA-approved biologic enzymatic debriding agent for chronic dermal ulcers and severe burns. Other products include: REGRANEX<sup>®</sup> Gel, a FDA-approved platelet-derived growth factor; and the OASIS<sup>®</sup> family of naturally-derived, extracellular matrix replacement products indicated for the management of both chronic and traumatic wounds.

Additionally, the lead candidate in our bioactive pipeline is HP802-247, an investigational allogeneic living cell bioformulation containing keratinocytes and fibroblasts. HP802-247 is currently in Phase III for the treatment of venous leg ulcers following positive Phase IIb clinical trial results, which were recently published in *The Lancet*.

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Segment performance: Advanced Wound Management *continued*

**Market and competition**

The AWM market is focused on the treatment of chronic wounds of the older population and other acute hard-to-heal wounds such as burns and certain surgical wounds and is therefore 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 their 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.

Smith & Nephew estimates that the global wound management segment is worth approximately \$7 billion and the segment served by Smith & Nephew grew by 4% in 2013. Global competitors vary across the various product areas and include Coloplast, Convatec, Kinetic Concepts and Molnlycke.

The 2013 Global NPWT market was flat versus 2012. Price pressures continue to offset the increase in patient therapy volumes. Price pressures have increased in some key markets due to competition, competitive bidding and reimbursement changes. Market size is estimated to be \$2 billion.

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

**Regulatory approvals**

In 2013, regulatory clearance was obtained for ALLEVYN Life Heel in the EU, US and Australia. ELECT<sup>à</sup> Super absorber was also approved in Europe. The complete range of DURAFIBER Ag sized dressings was approved in Europe and the US.

ALLEVYN Ag Gentle and ALLEVYN Ag Gentle Border were both approved in Japan. ALLEVYN Gentle Border and ALLEVYN Gentle were approved for import into China.

PICO Single Use Negative Wound Therapy System was approved in Brazil, Russia, Mexico and Korea.

The next generation VERSAJET II system was approved in Japan, China as well as several other Emerging & International Markets.

The RENASYS<sup>à</sup> EZ PLUS pump and RENASYS Foam and Gauze dressing kits were approved in China.

RENASYS EZ MAX Negative Pressure Wound Therapy pump also received clearance in the US, EU and Australia.

RENASYS EZ PLUS and RENASYS GO were both certified as compliant with the third edition of IEC 60601 an important standard for the safety of electro-medical devices.

## 2 EMERGING & INTERNATIONAL MARKETS

### Building our product portfolio and commercial platform

We are building strong businesses in the Emerging & International Markets by having close, direct relationships with our customers and by developing product portfolios that meet the needs of patients in the economic mid-tier.

In 2013 we furthered this strategy. Our first mid-tier product, a low cost camera system, was launched. We also acquired a portfolio of orthopaedic trauma products in India. By developing and manufacturing in the Emerging & International Markets we are able to deliver both quality and value.

We also completed acquisitions of distributors in Turkey and Brazil. Both these markets are fast-growing and offer exciting opportunities. These are important investments which will create a significant platform from which we can grow.

Smith & Nephew is delivering on its strategic priority to build a sustainable business in the Emerging & International Markets.

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Sustainability

Our sustainability strategy supports our **five Strategic Priorities**

Smith & Nephew promotes sustainability to our stakeholders through addressing economic, social and environmental considerations. In turn, our sustainability strategy is aligned with the strategic priorities.

**1 ESTABLISHED MARKETS**

Making best environmental choices and manufacturing and supply chain efficiencies all contribute to reducing our cost base, facilitating access to our products and helping our customers meet their sustainability ambitions.

**2 EMERGING & INTERNATIONAL  
MARKETS**

Cost base reductions facilitate wider access to our products. Specifically our focus on mid-tier products is aimed at supporting fundamental and affordable healthcare in the Emerging & International Markets.

**3 INNOVATE FOR VALUE**

Building sustainability into our New Product Development processes, including reducing packaging and waste, helps us innovate to meet our customers' expectations, deliver mutual value and optimise patient care.

**4 SIMPLIFY AND IMPROVE  
OUR OPERATING MODEL**



Incorporating sustainability into our business processes and optimising our facilities and supply chain to reduce our resource consumption and environmental impact help meet the expectations of our customers and society. Protecting our employees through the implementation of global HSE standards and responsible behaviours is not only right but also adds value to our business.

## 5 SUPPLEMENT ORGANIC GROWTH

### WITH ACQUISITIONS

Our due diligence approach includes sustainability considerations, our global policies and standards to ensure we protect the integrity and reputation of our business. Specifically our acquisition of Sushrut-Adler in India is aimed at providing fundamental and affordable healthcare into the emerging markets.

#### Sustainability strategy and targets

Progress towards the 2015 targets has been indexed to the baseline year 2011.

Target by 2015

Reduce non-renewable energy use by 15%

-0.6%

Energy consumption is decreasing but not in line with expectations. This is largely influenced by higher energy use in China as we scale up for expansion. The increased production levels at our Suzhou, China plant have given rise to an underlying increase in Group energy usage of 2.6%.

Reduce CO<sub>2</sub> emissions by 15%

+0.8%

CO<sub>2</sub> emissions reflect different carbon footprints of energy production in different geographic locations. Increasing production capacity at the Suzhou plant has contributed to an underlying increase in the carbon emissions of 3.6%. The carbon footprint in China is roughly twice that of the UK.

Reduce water use by 15%

+11.9%

Water usage continues to rise as new facilities are commissioned and we make operational choices based on best environmental options. For example, as we have expanded at Suzhou we have chosen to use a cooling system based on evaporation to reduce energy consumption.

+7.6%

Water consumption at Memphis and Suzhou account for 84% of our total water usage and when excluded the increase was 7.6%.

Reduce packaging materials by 15%

We are evaluating all the options for reducing packaging whilst maintaining product safety and protection. This is a challenging area and details and examples of projects will be available in our Sustainability Report.

Reduce total waste by 15%

+15.1%

In 2013, there were two exceptional waste sources that contributed to the increase in total waste generated by the business. Specifically these were from the validation of manufacturing start-up in China and the disposal of obsolete stock in the US. We continue to focus on waste reduction at source and recycling opportunities.

-21.7%

The landfill component of our total waste was reduced by 21.7%.

Increase % of total waste recycled by 15%

+21.2%

Recycling of wastes continues to rise as more opportunities are exploited. We are now reporting separately the waste that is diverted for energy recovery.

(Excludes waste

to energy)

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

GROUP STRATEGIC REPORT 35

**Safety performance**

| Safety Reporting  | 2013        | 2012 | 2011 |
|---|-------------|------|------|
| OSHA recordable incidents per 200,000hrs worked (TIR)               | <b>1.11</b> | 1.09 | 1.16 |
| Lost time incidents per 200,000hrs worked (LTIFR)                   | <b>0.48</b> | 0.51 | 0.58 |
| Number of lost time incidents arising from manufacturing facilities | <b>25</b>   | 37   | 42   |

There were no fatalities. Lost time injuries in our manufacturing facilities decreased by 32% over the previous year. However, the number of injuries in our non-manufacturing and supply chain operations increased mainly due to car accidents. Improving driving safety is a particular priority in 2014. We are making significant progress with the deployment of risk based control processes and our new HSE Integrated Management System.

**Greenhouse gases**

## Methodology, materiality and scope

We are reporting on the emission sources required under the Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013. These sources fall within our consolidated financial statement. We have used the Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard (Revised Edition) as guidance for this process.

The focus of our data collection has been on the areas of the business that have the most influence on our environmental impacts and provide stakeholders with a level of detail that enables them to monitor emissions data, sustainability management and trends. Wherever possible, primary data from energy suppliers has been used.

The largest proportion of our environmental impacts is from manufacturing, warehousing and research. Sales locations are included however some smaller, leased or shared offices are not reported. We estimate that these exclusions represent less than 2% of our overall emissions.

The Biotherapeutics business (acquired at the end of 2012) is excluded from these figures along with other more recent acquisitions during 2013. This is in line with our established policy for integration of acquired assets.

Our emissions have been calculated by using specific emissions factors for each country outside the US and regional factors within the US. We have used the US EPA Emissions & Generation Resource Integrated Database (eGRID) for US regions and the UK Government DEFRA Conversion Factors for Greenhouse Gas Reporting for elsewhere. We believe that these factors are the most appropriate to use for our business and give more accurate conversion rates than the conversion factors we have used in previous Sustainability Reports. The emissions from 2011, our baseline year for the sustainability targets, have therefore been recalculated using consistent rates. Fugitive emissions are included from the manufacturing and research locations and arise from the losses of refrigerant gases.

During the year, we have continued to make progress in reducing our energy consumption at many of our operational facilities. CO<sub>2</sub> emissions have not reduced in line with energy due to the different carbon footprints of energy production in different geographic locations, particularly China.

|   | 2013   | 2012   | 2011   |
|---|--------|--------|--------|
| Global GHG emissions data for current reporting year and comparisons  |        |        |        |
| CO <sub>2</sub> e emissions (tonnes) from:                            |        |        |        |
| Combustion of fuel and operation of facilities (process and fugitive) | 10,102 | 10,922 | 10,894 |
| Purchased electricity, heat and steam                                 | 66,659 | 64,991 | 65,241 |
| Total   | 76,761 | 75,913 | 76,135 |
| Intensity Ratio   |        |        |        |
| Emissions (total) normalised to:                                      |        |        |        |
| CO <sub>2</sub> e (t) per \$m revenue (i)                             | 18.9   | 18.3   | 17.8   |
| CO <sub>2</sub> e (t) per full-time employee (ii)                     | 7.3    | 7.2    | 7.1    |
| Notes   |        |        |        |

2013 data adjusted to exclude Healthpoint.

(i) Revenue data: 2013: \$4,071m, 2012: \$4,137m, 2011: \$4,270m.

(ii) Full-time employee data: 2013: 10,520, 2012: 10,477, 2011: 10,743.

### Support for community

In 2013, Smith & Nephew's support for community charitable causes, grants, sponsorships and third party medical education was \$10m.

For more information on sustainability see our Website [www.smith-nephew.com/sustainability](http://www.smith-nephew.com/sustainability)

Our 2013 Sustainability Report will be published in spring 2014.

**References**

Emission factors have been taken from the following source:

UK Government DEFRA Conversion Factors for Greenhouse Gas Reporting,  
<http://www.ukconversionfactorscarbonsmart.co.uk/>

Emission factors for electricity from locations in the US have been taken from the following source:

US EPA Emissions & Generation Resource Integrated Database (eGRID)  
<http://www.epa.gov/cleanenergy/energy-resources/egrid/index.html>

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SMITH & NEPHEW ANNUAL REPORT 2013

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Financial review and principal risks

Judicious financial management

has been and remains central to

our success

- 1 The underlying percentage increases/decreases are after adjusting for the effect of currency translation and the inclusion of the comparative impact of acquisitions and execution of disposals.
- 2 The 2012 revenue by franchise has been restated to 2013 product franchises.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## GROUP STRATEGIC REPORT 37

## Revenue by market

The underlying increase in each division's revenues, by market, reconciles to reported growth, the most directly comparable financial measure calculated in accordance with IFRS, as follows:

|                                  | 2013         | 2012  | Reported growth in revenue | Constant currency exchange effect | Acquisition /Disposal effect | Underlying growth in revenue |
|----------------------------------|--------------|-------|----------------------------|-----------------------------------|------------------------------|------------------------------|
|                                  | \$m          | \$m   | %                          | %                                 | %                            | %                            |
| Advanced Surgical Devices        |              |       |                            |                                   |                              |                              |
| US                               | <b>1,391</b> | 1,449 | (4)                        |                                   | 5                            | 1                            |
| Other Established Markets        | <b>1,204</b> | 1,298 | (7)                        | 2                                 | 2                            | (3)                          |
| Established Markets              | <b>2,595</b> | 2,747 | (6)                        | 1                                 | 4                            | (1)                          |
| Emerging & International Markets | <b>420</b>   | 361   | 16                         | 2                                 |                              | 18                           |
| <b>Advanced Surgical Devices</b> | <b>3,015</b> | 3,108 | (3)                        | 1                                 | 3                            | 1                            |
| Advanced Wound Management        |              |       |                            |                                   |                              |                              |
| US                               | <b>471</b>   | 202   | 133                        |                                   | (111)                        | 22                           |
| Other Established Markets        | <b>722</b>   | 705   | 3                          | 1                                 | (1)                          | 3                            |
| Established Markets              | <b>1,193</b> | 907   | 32                         | 1                                 | (23)                         | 10                           |
| Emerging & International Markets | <b>143</b>   | 122   | 17                         | 3                                 |                              | 20                           |
| <b>Advanced Wound Management</b> | <b>1,336</b> | 1,029 | 30                         | 1                                 | (20)                         | 11                           |

## Advanced Surgical Devices

## Revenue

ASD revenue decreased by \$93m (-3% on a reported basis) from \$3,108m in 2012 to \$3,015m in 2013. The underlying increase of 1% is after adjusting for a net 3% adverse impact from the disposal of the Clinical Therapies business in 2012 and the acquisitions completed in quarter four 2013, and a 1% unfavourable foreign currency translation.

In the US, revenue decreased by \$58m to \$1,391m in 2013 from \$1,449m in 2012 (-4% on a reported basis). The underlying increase of 1% is after adjusting 5% for the adverse impact of the Clinical Therapies disposal in 2012. In Other Established Markets, revenue was \$1,204m in 2013, a decrease of \$94m from \$1,298m in 2012 (-7% on a reported basis). The underlying decrease was 3% after adjusting for the adverse impact of 2% on the Clinical Therapies disposal in 2012, and 2% from unfavourable foreign currency translation. Our Emerging & International Markets revenue increased by \$59m to \$420m in 2013 from \$361m in 2012 (16% increase on a reported basis). The underlying increase was 18% after adjusting 2% for unfavourable foreign currency translation.

In the global Knee Implant franchise, revenue decreased by \$9m from \$874m in 2012 to \$865m in 2013 (-1% on a reported basis), representing flat underlying revenue performance after 1% of unfavourable currency translation. Growth has been impacted by exposure to a weakening European market with conditions continuing to deteriorate in Germany, our largest European market, and our position in the product life cycle versus our peers. Growth improved in the second half of the year driven by sales of the Journey II BCS Knee System and benefits from the VERILAST bearing surface TV advertising campaign in the US.

Global revenue from the Hip Implant franchise decreased by \$13m from \$666m in 2012 to \$653m in 2013 (-2% on a reported basis), which represented an underlying revenue decline of 1% after 1% unfavourable foreign currency translation. Continuing metal-on-metal headwinds have contributed to this decline.

Trauma & Extremities revenue increased by \$12m from \$474m in 2012 to \$486m in 2013 (3% on a reported basis). This represents underlying revenue growth of 4% after 1% of unfavourable foreign currency translation. During 2013, benefits were seen from the additional extremities US sales representatives recruited earlier in the year.

Sports Medicine Joint Repair revenue increased by \$22m from \$474m in 2012 to \$496m in 2013 (5% on reported basis), representing underlying revenue growth of 7% and 2% of unfavourable foreign currency translation. This reflects a strong contribution across all key joint types and geographies.

Global revenue from Arthroscopic Enabling technologies decreased by \$17m from \$458m in 2012 to \$441m in 2013 (-4% on a reported basis). This decrease represents an underlying revenue decline of 2% and 2% of unfavourable foreign currency translation.

The revenue in the Other ASD franchise fell by \$88m from \$162m in 2012 to \$74m in 2013 following the disposal of the Clinical Therapies business in 2012. Excluding the impact of this disposal, underlying revenue in the Other ASD franchise, which includes gynaecology, grew by 14% with the remaining Clinical Therapies geographies contributing \$9m.



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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 38 GROUP STRATEGIC REPORT

Financial review and principal risks *continued*

Trading and operating profit

Operating profit, the most directly comparable financial measure under IFRS, reconciles to trading profit as follows:

|   | <b>2013</b> | 2012 |
|---|-------------|------|
|   | <b>\$m</b>  | \$m  |
| Operating profit  | <b>620</b>  | 632  |
| Acquisition related costs                               | <b>7</b>    |      |
| Restructuring and rationalisation costs                 | <b>44</b>   | 57   |
| Amortisation of acquisition intangibles and impairments | <b>41</b>   | 39   |
| Trading profit  | <b>712</b>  | 728  |

Trading profit margin increased from 23.4% to 23.6%. Trading profit decreased by \$16m to \$712m from \$728m in 2012. This decrease reflects the impact of the CT disposal in May 2012, the impact of the US medical device excise tax and the cost of planned investments in the Knee Implants and Trauma franchises and Emerging & International Markets offset by benefits from our structural efficiency programme.

Operating profit decreased by \$12m from \$632m in 2012 to \$620m in 2013. This comprises the decrease in trading profit of \$16m discussed above, an increase in acquisition related costs of \$7m, an increase in amortisation of acquisition intangibles of \$2m, partially offset by a decrease in restructuring and rationalisation costs of \$13m.

**Advanced Wound Management**

Revenue

AWM revenue increased by \$307m (30% on a reported basis), from \$1,029m in 2012 to \$1,336m in 2013. The underlying increase of 11% is after adjusting for an increase of 20% for the acquisitions completed in the year and a 1% unfavourable foreign currency translation.

In the US, revenue increased by \$269m to \$471m in 2013 from \$202m in 2012 (133% on a reported basis). The underlying increase of 22% is after adjusting 111% for the impact of acquisitions. In Other Established Markets, revenue was \$722m in 2013, an increase of \$17m from \$705m in 2012 (3% on a reported basis). The underlying revenue increase was also 3% with the 1% impact of acquisitions offset by 1% of unfavourable foreign currency translation. Our Emerging & International Markets revenue increased by \$21m in 2012 (17% on a reported basis). The underlying increase was 20% after adjusting 3% for unfavourable foreign currency translation.

Advanced Wound Care revenue decreased by \$6m (-1% on a reported basis) from \$849m in 2012 to \$843m in 2013. The underlying growth of 1% is after adjusting for foreign currency translations. Conditions across many European markets remain challenging but the introduction of the ALLEVYN Life range continues to make good progress across Europe following product introductions and investment in marketing.

Advanced Wound Devices revenue increased from \$180m in 2012 to \$213m in 2013, a reported increase of \$33m and 18%. The underlying growth of 20% is after adjusting for unfavourable foreign currency translations of 2%. This growth was impacted by continued gain in market share in NPWT, and our recent expansion into the emerging markets.

Advanced Wound Bioactives revenue of \$280m in 2013 (2012 \$nil) relates to Healthpoint acquired in December 2012. The underlying increase, adjusted to include the results of Healthpoint for the commensurate period in 2012, was 47%.

#### Trading and operating profit

Operating profit, the most directly comparable financial measure under IFRS, reconciles to trading profit as follows:

|   | 2013 | 2012 |
|---|------|------|
|   | \$m  | \$m  |
| Operating profit  | 190  | 214  |
| Acquisition related costs                               | 24   | 11   |
| Restructuring and rationalisation costs                 | 14   | 8    |
| Amortisation of acquisition intangibles and impairments | 47   | 4    |
| Trading profit  | 275  | 237  |

Trading profit margin decreased from 23.1% to 20.6%. Trading profit increased by \$38m to \$275m from \$237m in 2012. The increase in the year is primarily attributable to the full year benefit of the Healthpoint acquisition and growth in the Emerging & International Markets, partially offset by additional investment in R&D and sales and marketing. The decrease in trading margin reflects these same investments, combined with price and mix changes at a gross margin level.

Operating profit decreased by \$24m from \$214m in 2012 to \$190m in 2013. This comprises of the increase in trading profit of \$38m discussed above, offset by an increase of \$43m in amortisation of acquisition intangibles and an increase in acquisition related costs of \$13m, both due to the Healthpoint acquisition which completed in December 2012, and an increase in restructuring and rationalisation costs of \$6m.

#### Principal risks and risk management

As an integral part of planning and review Group, business area and functional management seek to identify the significant risks involved in the business, and to review the risk management action plans for those risks. The Group Risk Committee, which is comprised of the Chief Executive Officer and Senior Executives, meets twice a year to review the risks identified by the businesses and corporate functions and any risk management actions being taken. As appropriate, the Risk Committee may re-categorise risks or require further information on the risk management action plans. The Risk Committee reports to the Board on an annual basis detailing all principal risks. In addition, the Board considers risk as part of the development of strategy. Internal audit reviews and the Audit Committee reports on the

effectiveness of the operation of the risk management process.

There are known and unknown risks and uncertainties relating to Smith & Nephew's business. The following pages provide an overview of what the Board considers the most significant risks that could cause the Group's business, financial position and results of operations to differ materially and adversely from expected and historical levels, and how these risks relate to the Group's strategic priorities. 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.

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GROUP STRATEGIC REPORT 39

**Disruptive technologies**

The medical devices industry has a rapid rate of new product introduction. The Group must be adept at monitoring the landscape for technological advances, make good investment/acquisition choices, have an efficient and valuable product pipeline and secure protection for its intellectual property.

| <b>Specific risks we face</b>  | <b>Risk management actions</b>  | <b>Possible impacts</b>                                     |
|--|---|---|
| Competitors may introduce a disruptive technology, or obtain patents or other intellectual property rights, that affect the Group's competitive position | Processes focused on identifying new products and potential disruptive technologies (internal and external) | Loss of market share, profit and long-term growth.          |
|  |   | <b>Link to Strategic Priority</b>                           |
| Claims by third parties regarding infringement of their intellectual property rights   | Increasing productivity, prioritisation and allocation of R&D funds   | <b>3 INNOVATE FOR VALUE</b>                                 |
| Lack of innovation due to low R&D investment, R&D skills gap or poor product development execution for Established and Emerging & International Markets  | Increasing R&D investment in order to enhance clinical capability, invest in biomaterials                   | <b>4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL</b>           |
|  | Strengthen intellectual property rights   | <b>5 SUPPLEMENT THE ORGANIC GROWTH THROUGH ACQUISITIONS</b> |
| Failure to successfully commercialise a pipeline product, or failure to receive regulatory approval  | Support an emerging market portfolio  |   |

Ineffective acquisition due diligence, valuation, purchase terms or integration.

Business development resources and processes and investments to augment the internal product development

Increasing speed to market of new products.



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SMITH & NEPHEW ANNUAL REPORT 2013

40 GROUP STRATEGIC REPORT

Financial review and principal risks *continued*

**Country risk, pricing and reimbursement pressure**

In most markets throughout the world, expenditure on medical devices is controlled to a large extent by governments, many of which are facing increasingly intense budgetary constraints. The Group is therefore largely dependent on governments providing increased funds commensurate with the increased demand arising from demographic trends. Reimbursement rates may be set in response to perceived economic value of the devices, based on clinical and other data relating to cost, patient outcomes and comparative effectiveness. Political upheaval in the countries where the Group operates or surrounding regions could adversely affect Group operations or turnover.

Group operations are affected by transactional exchange rate movements. The Group's manufacturing cost base is situated in the US, UK, China and Switzerland and finished products are exported worldwide.

| Specific risks we face  | Risk management actions   | Possible impacts                        |
|---|---|---|
| Reduced reimbursement levels and increasing pricing pressures   | Develop innovative economic product and service solutions for both Established and Emerging & International Markets | Loss of revenue, profit and cash flows. |
| Reduced demand for elective surgery   | Incorporate health economic component into design and development of new products                                   | <b>Link to Strategic Priority</b>       |
| Increased focus on health economics   | Enhanced expertise supporting reimbursement strategy and guidance   |   |
| Government policies favouring lower priced and locally sourced products   | Optimise cost to serve to protect margins and liberate funds for investment   |   |
| Political upheavals prevent selling of products, receiving remittances of profit from a member of the Group or future investments in that country |   |   |

1 ESTABLISHED MARKETS

2 EMERGING & INTERNATIONAL MARKETS

The Group is exposed to fluctuations in exchange rates. If the manufacturing country currencies strengthen against the selling currencies, the trading margin may be affected

Streamline COGS, SKUs, and inventory management

The Group may transact forward foreign currency commitments when firm purchase orders are placed to reduce exposure to currency fluctuations.

Economic downturn impacts demand and collections

Increased generic and low cost products could impact revenue and profits.

3 INNOVATE FOR VALUE

4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL

### Supply, system and site disruption

Unexpected events could disrupt the business by affecting either a key facility or system or a large number of employees.

The business is also reliant on certain key suppliers of raw materials, components, finished products and packaging materials.

| Specific risks we face  | Risk management actions   | Possible impacts                           |
|---|---|--|
| Catastrophe could render one of the Group's production facilities out of action                   | Ensure crisis response/business continuity plans at major facilities and for key products and key suppliers | Loss of revenue, profit and cash flows.    |
| A significant event could impact key leadership or a large number of employees                    | Audit programme for critical suppliers and second sources or increased inventories for critical components  | <b>Link to Strategic Priority</b>          |
| Issues with a single source supplier of a key component and failure to secure critical supply     | Implement enhanced travel security and protection programme   | 1 ESTABLISHED MARKETS                      |
| A severe IT fault or cyber crime could disable critical systems and cause loss of sensitive data. | IT disaster and data recovery plans are in place and support overall business continuity plans              | 4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL |
|   | Mobile device and cyber security protection plan implementation.  |  |

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SMITH & NEPHEW ANNUAL REPORT 2013

GROUP STRATEGIC REPORT 41

**Product safety, regulation, and litigation**

National regulatory authorities 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 and may also inspect for compliance with appropriate standards, including those relating to Quality Management Systems ( QMS ) or Good Manufacturing Practice ( GMP ) regulations. Design or manufacturing defects in products could result in product recalls and liability claims and impact revenues, profits and reputation.

| <b>Specific risks we face</b>   | <b>Risk management actions</b>   | <b>Possible impacts</b>                               |
|---|--|---|
| Defective products supplied to Smith & Nephew or failure in design or manufacturing process                     | Standardise the Group's quality management and practice  | Loss of revenue, profit and reduction in share price. |
| New technology, product or processes changed by Smith & Nephew or supplier do not identify product deficiencies | Monitoring and auditing programmes to assure compliance  | Negative impact on brand/reputation.                  |
| Failure to implement programmes and supporting resources to manage quality and regulatory compliance            | Group-wide product complaint and registration systems<br>Group-wide practices to drive design, and production line performance and dependability | <a href="#">Link to Strategic Priority</a>            |
| Failure to manage, process and analyse customer complaints and adverse event data.                              | Design for manufacture in product development  |   |

3 INNOVATE FOR VALUE  
4 SIMPLIFY AND



Post launch review of product safety and complaint data.

IMPROVE OUR OPERATING MODEL

Compliance with laws and regulations

Business practices in the healthcare industry are subject to increasing scrutiny by government authorities. The trend in many countries is towards increased enforcement activity. The Group is also subject to increased regulation of personal information. Acquisitions and expansion into emerging markets could also require additional compliance resources.

| Specific risks we face   | Risk management actions   | Possible impacts   |
|--|---|--|
| <p>Violation of healthcare, data privacy or anti-corruption laws could result in fines, loss of reimbursement and impact reputation</p> <p>Serious breaches could potentially prevent the Group from doing business in a certain market</p> <p>Failure to conduct adequate due diligence or to integrate appropriate internal controls into acquired businesses could result in fines and impact return on investment.</p> | <p>Strong Group oversight bodies with supporting global compliance resources</p> <p>Code of Conduct/Global Policies and Procedures ( GPPs ) providing controls for significant compliance risks</p> <p>Training and e-resources to guide employees and third parties with compliance responsibilities</p> <p>Monitoring and auditing programmes to verify implementation</p> <p>Independent reporting channels for employees and third parties to report concerns with confidentiality</p> <p>Additional controls for interactions with healthcare professionals and government officials and for distributors and agents</p> <p>Due diligence reviews and integration plans required for acquisitions.</p> | <p>Loss of profit and reduction in share price.</p> <p>Negative impact on brand/reputation.</p> <p><b>Link to Strategic Priority</b></p> |
|  |   | <p>1 ESTABLISHED MARKETS</p> <p>2 EMERGING &amp; INTERNATIONAL MARKETS</p> <p>4 SIMPLIFY AND IMPROVE OUR OPERATING MODEL</p>             |

By order of the Board, 26 February 2014

Susan Swabey

Company Secretary

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Corporate governance

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We have built our reputation by supporting healthcare professionals for more than 150 years and are proud of the **trust** they place in us.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 44 CORPORATE GOVERNANCE

## Our Board of Directors

Our Board has the depth and breadth of experience necessary to help the business take full advantage of the opportunities and challenges ahead.

**Sir John Buchanan (70)****Chairman**

Sir John was appointed Independent Non-executive Director in 2005 and was appointed Chairman and Chairman of the Nomination & Governance Committee in April 2006. He will retire from the Board following the Annual General Meeting on 10 April 2014.

Sir John has broad international experience gained in large and complex international businesses, with extensive former board experience at Vodafone Group Plc, AstraZeneca PLC and Boots Group PLC. He has substantial experience in the petroleum industry and knowledge of the international investor community. He has held various leadership roles in strategic, financial, operational and marketing positions, including executive experience in different countries. He is a former Executive Director and Group Financial Officer of BP, serving on the BP Board for six years until 2003.

**Olivier Bohuon (55)****Chief Executive Officer**

Olivier was appointed Chief Executive Officer in April 2011. He is a member of the Nomination & Governance Committee.

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

**Other Directorships**

Non-executive Director of Virbac group

**Julie Brown (51)****Chief Financial Officer**

Julie was appointed Chief Financial Officer on 4 February 2013 and elected by Shareholders at the Annual General Meeting on 11 April 2013.

Julie is a Chartered Accountant and Fellow of the Institute of Taxation with international experience and a deep understanding of the healthcare sector. She trained with KPMG and then worked for AstraZeneca PLC, where she served as Vice President Group Finance, and more recently, as Interim Chief Financial Officer. Prior to that she held commercial roles as Regional Vice President Latin America, Marketing Company President AstraZeneca Portugal, and Vice President Corporate Strategy and R&D Chief Financial Officer. She has previously held Vice President Finance positions in all areas of the healthcare value chain including

|  |  |   |
|--|--|---|
| <p><b>Other Directorships</b></p> <p>Chairman of ARM Holdings plc (until 1 March 2014)</p> <p>Senior Independent Director of BHP Billiton Plc</p> <p>Chairman of International Chamber of Commerce UK</p> <p>Chairman of the Trustees for The Christchurch Earthquake Appeal (UK)</p> <p><b>Nationality</b></p> <p>British/New Zealand</p>   | <p><b>Nationality</b></p> <p>French</p>  | <p>commercial, operations, R&amp;D and business development.</p> <p><b>Nationality</b></p> <p>British</p>   |
| <p><b>Roberto Quarta (64)</b></p> <p><b>Independent Non-executive Director and Chairman Elect</b></p> <p>Roberto was appointed Non-executive Director and Chairman Elect on 4 December 2013. He is a member of the Nomination &amp; Governance Committee.</p> <p>Roberto has significant management experience spanning a broad range of manufacturing and service businesses in both the UK and internationally. He is Chairman of IMI plc, a FTSE 100 listed engineering business, Chairman of Clayton, Dubilier &amp; Rice and Chairman of the Supervisory Board of</p> | <p><b>Richard De Schutter (73)</b></p> <p><b>Senior Independent Director and Non-executive Director</b></p> <p>Richard was appointed Non-executive Director in January 2001 and Senior Independent Director in April 2011. He is a member of the Nomination &amp; Governance, Ethics &amp; Compliance, Audit and Remuneration Committees. He will retire from the Board following the Annual General Meeting on 10 April 2014.</p> <p>Richard has had extensive US corporate experience at Chief Executive and Chairman level in a number of major corporations with</p> | <p><b>Ian Barlow (62)</b></p> <p><b>Independent Non-executive Director</b></p> <p><b>Chairman of the Audit Committee</b></p> <p>Ian was appointed Non-executive Director in March 2010 and Chairman of the Audit Committee in May 2010.</p> <p>Ian is a Chartered Accountant and has had considerable financial experience both internationally and in the UK. Prior to his retirement in 2008, he was a Partner at KPMG, latterly Senior Partner, London. During his career with KPMG, he was Head of their UK tax and legal</p> |

Rexel SA. Previously, he was Chief Executive and then Chairman of BBA Group plc.

**Other Directorships**

Chairman of IMI plc

Chairman of Clayton, Dubilier & Rice

Chairman of the Supervisory Board of Rexel SA

**Nationality**

American/Italian

primarily a scientific, chemical, engineering or pharmaceutical focus including G.D. Searle & Co., Monsanto Company, Pharmacia Corporation and DuPont Pharmaceuticals Company.

**Other Directorships**

Non-executive Chairman of Incyte Corporation

Non-executive Chairman of Durata Therapeutics, Inc.

Non-executive Director of Navicure, Inc.

Non-executive Director of Sprout Pharmaceuticals, Inc.

**Nationality**

American

operations, and he acted as Lead Partner for many large international organisations operating extensively in North America, Europe and Asia.

**Other Directorships**

Lead Non-executive Director chairing the Board of Her Majesty's Revenue & Customs

Non-executive Director of The Brunner Investment Trust PLC

Non-executive Director of Foxtons Group plc

Board Member of the China-Britain Council

Chairman of The Racecourse Association

**Nationality**

British

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## CORPORATE GOVERNANCE 45

**The Rt. Hon Baroness Virginia Bottomley (65)****Independent Non-executive Director**

Baroness Virginia Bottomley was appointed Non-executive Director in April 2012. She is a member of the Remuneration Committee.

Baroness Virginia Bottomley has extensive experience and understanding of healthcare. She was appointed a Life Peer in 2005 following her career as a Member of Parliament between 1984 and 2005. She served successively as Secretary of State for Health and then National Heritage. She holds a number of positions within the public and private healthcare sector.

**Other Directorships****Michael Friedman (70)****Independent Non-executive Director**

Michael was appointed Non-executive Director and elected by Shareholders at the Annual General Meeting on 11 April 2013. He is a member of the Ethics & Compliance Committee.

Michael was formerly Chief Executive Officer of City of Hope, the prestigious cancer research and treatment institution in California and is now Executive for Special Projects and Emeritus Cancer Center Director. He has also served as director of the institution's comprehensive cancer centre and held the Irell & Manella Cancer Center Director's Distinguished Chair. He was formerly senior vice president of research, medical and public policy for Pharmacia Corporation and has served as Deputy Commissioner and Acting

**Pamela Kirby (60)****Independent Non-executive Director****Chairman of the Ethics & Compliance Committee**

Pamela was appointed Non-executive Director in March 2002 and Chairman of the Ethics & Compliance Committee in April 2011. She is a member of the Remuneration Committee

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



Director of International Resources Group Limited

Member of the International Advisory Board of Chugai Pharmaceutical Co.,

Chancellor of University of Hull and Sheriff of Hull

Pro Chancellor of the University of Surrey

Governor of the London School of Economics

Trustee of The Economist Newspaper

**Nationality**

British

Commissioner at the US Food and Drug Administration. He has also served on a number of Boards in a Non-executive capacity, including RiteAid Corporation.

**Other Directorships**

Non-executive Director of Celgene Corporation

Non-executive Director of MannKind Corporation

**Nationality**

American

companies.

**Other Directorships**

Non-executive Chairman of Scynexis, Inc.

Senior Independent Non-executive Director of Informa plc

Non-executive Director of DCC plc

Non-executive Director of Victrex plc

**Nationality**

British

**Brian Larcombe (60)**

**Independent Non-executive Director**

Brian was appointed Non-executive Director in March 2002. He is a member of the Nomination & Governance, Audit and Remuneration Committees. He will become Senior Independent Director following the Annual General Meeting on 10 April 2014.

Brian spent his career in private equity with 3i Group. After leading the UK investment business for a number of years, he became Finance

**Joseph Papa (58)**

**Independent Non-executive Director**

**Chairman of the Remuneration Committee**

Joseph was appointed Non-executive Director in August 2008 and Chairman of the Remuneration Committee in April 2011. He is a member of the Ethics & Compliance and Audit Committees.

Joseph has had over 30 years experience in the pharmaceutical industry working for a number of

**Ajay Piramal (58)**

**Independent Non-executive Director**

Ajay was appointed Non-executive Director in January 2012. He will retire from the Board following the Annual General Meeting on 10 April 2014.

Ajay is one of India's most respected businessmen. He enabled the Piramal Group to transform from a textile-centric group to a conglomerate in diversified areas. He has extensive industry and market knowledge and international

Director and then Chief Executive of the Group following its flotation. He is well known in the City and has held a number of Non-executive Directorships.

**Other Directorships**

Non-executive Director of gategroup Holding AG

Non-executive Director of Incisive Media Holdings Limited

**Nationality**

British

companies both in the US and Switzerland. He is now Chairman and Chief Executive of Perrigo Company plc, one of the largest over the counter pharmaceutical companies in the US, having previously held senior positions at Novartis International AG, Cardinal Health, Inc. and Pharmacia Corporation.

**Other Directorships**

Chairman and Chief Executive of Perrigo Company plc

**Nationality**

American

experience. He has held a number of global healthcare leadership positions in both India and internationally.

**Other Directorships**

Chairman of Piramal Enterprises Limited, Piramal Glass Limited, Allergan India Pvt. Limited, and IndiaREIT Fund Advisers Pvt. Ltd.

Chairman of the Board of Governors of the Indian Institute of Technology, Indore

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

Chairman of Pratham India

**Nationality**

Indian

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 46 CORPORATE GOVERNANCE

## Our Executive Officers

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

**Julie Brown (51)****Chief Financial Officer**

Julie joined the Board on 4 February 2013 as Chief Financial Officer. She is a Chartered Accountant and Fellow of the Institute of Taxation with international experience and a deep understanding of the healthcare sector.

**Previous Experience**

Julie trained with KPMG and then worked for AstraZeneca PLC, where she served as Vice President Group Finance, and more recently, as Interim Chief Financial Officer. Prior to that she held commercial roles as Regional Vice President Latin America, Marketing Company President AstraZeneca Portugal, and Vice President Corporate Strategy and R&D Chief Financial Officer. She has previously held Vice President Finance positions in all areas of the healthcare value chain including commercial, operations,

**Mike Frazzette (52)****President, Advanced Surgical Devices**

Mike joined Smith & Nephew in July 2006 as President of the Endoscopy Global Business Unit. Since July 2011, he has headed up the Advanced Surgical Devices division and is responsible for the Orthopaedic Reconstruction, Trauma and Endoscopy business. He is based in Andover, Massachusetts.

**Previous Experience**

Mike has held a number of senior positions within the global medical devices industry. He was President and Chief Executive Officer of Micro Group, a US manufacturer of medical devices, and spent 15 years at Tyco Healthcare (Covidien) in various commercial roles eventually becoming President of the Patient Care and Health Systems divisions.

R&D and business development.

**Nationality**

British

**Nationality**

American

**Roger Teasdale (46)**

**President, Advanced Wound Management**

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

**Previous Experience**

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

**Nationality**

British

**Rodrigo Bianchi (54)**

**President, IRAMEA**

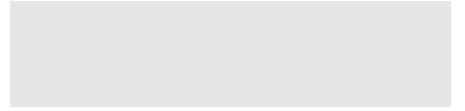
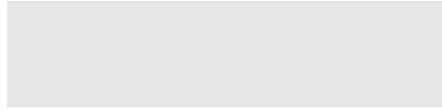
Rodrigo joined Smith & Nephew in July 2013 with responsibility for Greater China, India, Russia, Asia, Middle East and Africa, focusing on continuing our strong momentum in these regions. He is based in Dubai.

**Previous Experience**

Rodrigo's experience in the healthcare industry includes 26 years with Johnson & Johnson in progressively senior roles. Most recently, he was Regional Vice President for Medical Devices and Diagnostics division in the Mediterranean region and prior to that President of Mitek and Ethicon. He started his career at Procter & Gamble, Italy.

**Nationality**

Italian



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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## CORPORATE GOVERNANCE 47

**Francisco Canal Vega (52)****President, Latin America**

Francisco joined Smith & Nephew in January 2012 and now leads the Latin American region, focusing on driving the substantial opportunities we see in this region.

**Previous Experience**

Francisco has held senior management positions in global companies including Gambro AB and Baxter International. He has lived and worked in many countries including Switzerland, Germany, China, Japan, the US and Spain. Francisco was also formerly a board member of EUROMED.

**Nationality****Jack Campo (59)****Chief Legal Officer**

Jack joined Smith & Nephew in June 2008 and heads up the Global Legal function. Initially based in London, he has been based in Andover, Massachusetts since late 2011.

**Previous Experience**

Prior to joining Smith & Nephew, Jack held a number of senior legal roles within the General Electric Company, including seven years at GE Healthcare (GE Medical Systems) in the US and Asia. He began his career with Davis Polk & Wardwell.

**Nationality**

American

**Gordon Howe (51)****President, Global Operations**

Gordon joined Smith & Nephew in 1998 and, since 2013, is responsible for manufacturing, supply chain and procurement, IT systems and Regulatory and Quality Affairs. Prior to that, he headed up the Global Planning and Business Development teams. He is based in Memphis, Tennessee.

**Previous Experience**

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

**Nationality**

Spanish

American

**Helen Maye (54)**

**Chief Human Resources Officer**

Helen joined Smith & Nephew in July 2011 and leads the Global Human Resources and Internal Communications functions. Since 2013, she has also led the Sustainability, Health, Safety & Environment functions. She is based in London.

**Previous Experience**

Helen has more than 35 years experience across a variety of international and global roles in medical devices and Pharmaceuticals, including manufacturing, supply chain and human resources. Previously, she was Divisional Vice President of Human Resources at Abbott Laboratories.

**Nationality**

Irish

**Cyrille Petit (43)**

**Chief Corporate Development Officer**

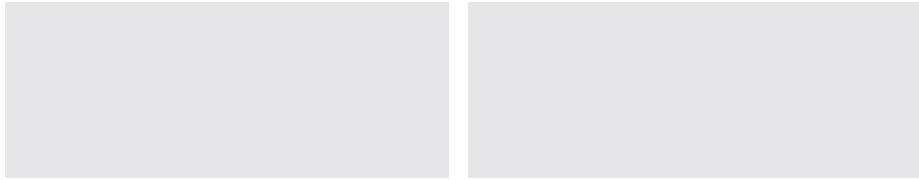
Cyrille joined Smith & Nephew in May 2012 and leads the Corporate Development function. He is based in London.

**Previous Experience**

Cyrille spent the previous 15 years of his career with General Electric Company, where he held progressively senior positions beginning with GE Capital, GE Healthcare and ultimately as the General Manager, Global Business Development of the Transportation Division. Cyrille's career began in investment banking at BNP Paribas and then Goldman Sachs.

**Nationality**

French





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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 48 CORPORATE GOVERNANCE

## Corporate Governance Statement

## BOARD GENDER

## BOARD NATIONALITY

## BOARD BALANCE

## BOARD COMMITTEE MEMBERSHIP AND ATTENDANCE

|                             | Audit<br>Board | Nomination &<br>Governance<br>Committee | Ethics &<br>Compliance<br>Committee | Remuneration<br>Committee |            |
|-----------------------------|----------------|---|-------------------------------------|---------------------------|------------|
|                             | 8 meetings     | 8 meetings                              | 5 meetings                          | 4 meetings                | 5 meetings |
| Sir John Buchanan           | 8              |   | 5                                   |                           |            |
| Olivier Bohuon              | 8              |   | 5                                   |                           |            |
| Ian Barlow                  | 8              | 8                                       |                                     |                           |            |
| Julie Brown (i)             | 8              |   |                                     |                           |            |
| Michael Friedman (ii)       | 6              |   |                                     |                           |            |
| Baroness Virginia Bottomley | 8              | –                                       | –                                   | –                         | 5          |
| Pamela Kirby                | 8              | –                                       | –                                   | 4                         | 5          |
| Brian Larcombe (iii)        | 8              | 8                                       | 5                                   |                           | 4          |
| Joseph Papa                 | 8              | 8                                       |                                     | 4                         | 5          |
| Ajay Piramal (iv)           | 3              |   |                                     |                           |            |
| Roberto Quarta (v)          | 1              |   |                                     |                           |            |
| Richard De Schutter         | 8              | 8                                       | 5                                   | 4                         | 5          |

(i) Appointed to the Board on 4 February 2013.

(ii) Appointed to the Board on 11 April 2013.

(iii) Unable to attend one Remuneration Committee meeting due to an unforeseen commitment.

(iv) Unable to attend some meetings due to other commitments. To retire from the Board following the Annual General Meeting on 10 April 2014.

(v) Appointed to the Board on 4 December 2013.

**COMPANY SECRETARY****Susan Swabey (52)**

Susan was appointed Company Secretary in May 2009.

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

With effect from 1 March 2014, she will be a trustee of ShareGift, the share donation charity.

**Nationality**

British

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CORPORATE GOVERNANCE 49

**Compliance statement**

We are committed to the highest standards of corporate governance and comply with all the provisions of the UK Corporate Governance Code 2012 (the Code). The Company's American Depositary Shares are listed on the NYSE and we are therefore subject to the rules of the NYSE as well as to the US securities laws and the rules of the SEC applicable to foreign private issuers. We comply with the requirements of the SEC and NYSE except that the Nomination & Governance Committee is not comprised wholly of Independent Directors, as required by the NYSE, but consists of a majority of Independent Directors in accordance with the Code. We shall explain in this corporate governance statement and the Reports of the Audit and Remuneration Committees, how we have applied the provisions and principles of the Financial Conduct Authority's (FCA) Listing Rules, Disclosure & Transparency Rules (DTR) and the Code throughout the year.

**Board**

The Board is responsible for determining the strategy of the Company. The Chief Executive Officer and his Executive team implement that strategy. More detail about the structure of the Board, the matters we deal with and the key activities we undertook in 2013 is on pages 49 and 50.

**Changes to Board composition**

We are making a number of changes to the composition of our Board at the Annual General Meeting:

Sir John Buchanan will be retiring from the Board, having joined the Board in 2005 and assumed the role of Chairman in April 2006

Roberto Quarta, who joined the Board as Non-executive Director and Chairman Elect on 4 December 2013, will become Chairman, assuming that he is elected as a Director by shareholders at the meeting

Richard De Schutter will retire from the Board. Richard has served on the Board since January 2001 as a Non-executive Director and a member of a number of the Board Committees. He has been the Senior Independent Director since April 2011

Brian Larcombe will take over as Senior Independent Director to assist a smooth transition between Chairmen Ajay Piramal will retire from the Board. He has served on the Board since January 2012.

**Roles of Directors**

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

defined.

Chairman

Building a well balanced Board

Chairing Board meetings and setting Board agendas

Ensuring effectiveness of the Board and ensuring annual review undertaken

Encouraging constructive challenge and facilitating effective communication between the Board members

Promoting effective Board relationships

Ensuring appropriate induction and development programmes

Ensuring effective two way communication and debate with Shareholders

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

Promoting high standards of corporate governance

Maintaining appropriate balance between stakeholders.

Chief Executive Officer

Developing and implementing Group strategy

Recommending the annual budget and five-year strategic and financial plan

Ensuring coherent leadership of the Group

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

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

Ensuring the Chairman and Board are kept advised and updated regarding key matters

Maintaining relationships with shareholders and advising the Board accordingly

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

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

Non-executive Directors

Providing effective challenge to management

Assisting in development of strategy

Serving on the Board Committees.

Senior Independent Director

Chairing meetings in the absence of the Chairman

Acting as a sounding board for the Chairman on Board-related matters

Acting as an intermediary for the other Directors where necessary

Available to Shareholders on matters which cannot otherwise be resolved

Leading annual evaluation into the Board's effectiveness

Leading search for a new Chairman, as necessary.

Independence of Non-executive Directors

We require our Non-executive Directors to remain independent from management so that they are able to exercise independent oversight and effectively challenge management. We therefore continually assess the independence of each of our Non-executive Directors. The Executive Directors have determined that all our Non-executive Directors are independent in accordance with both UK and US requirements. None of our Non-executive Directors or their immediate families has ever had a material relationship with the Group. None of them receives additional remuneration apart from Directors' fees, nor do they participate in the Group's share plans or pension schemes. None of them serve as directors of any companies or affiliates in which any other Director is a director.

However, more importantly, each of our Non-executive Directors is prepared to question and challenge management, to request more information and to ask the difficult question. They insist on robust responses both within the Board room and sometimes between Board meetings. The Chief Executive Officer is open to challenge from the Non-executive Directors and uses this positively to provide more detail and to reflect further on issues.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 50 CORPORATE GOVERNANCE

Corporate Governance Statement *continued*

As explained, Richard De Schutter will retire from the Board following the Annual General Meeting. Brian Larcombe, who has served for 12 years, will remain on the Board as Senior Independent Director to ensure a smooth transition between chairmen. Pamela Kirby who has served for 12 years will remain on the Board as Chairman of the Ethics & Compliance Committee and member of the Remuneration Committee. The Board believes that the skills, diversity and experience Brian and Pamela bring to the Board with their in-depth knowledge of the Company are important for continuity in this time of transition.

We are mindful that some of our Non-executive Directors have served on the Board for a period of time that some might regard as likely to impact their independence. We do not believe this to be the case, but have reviewed the length of service of our Non-executive Board members and have taken this into consideration, when making the changes to the Board composition outlined above.

We continue to search for other suitable Non-executive Directors, whose experience will align with our strategic objectives and, in due course, our longer serving directors will step down.

**Board Membership**

Non-executive Chairman Sir John Buchanan (to retire on 10 April 2014)

Chief Executive Officer Olivier Bohuon

Chief Financial Officer Julie Brown (appointed 4 February 2013).

Nine Independent Non-executive Directors

Richard De Schutter (Senior Independent Director) (to retire on 10 April 2014)

Ian Barlow

Baroness Virginia Bottomley

Michael Friedman (appointed 11 April 2013)

Pamela Kirby

Brian Larcombe (to become Senior Independent Director on 10 April 2014)

Joseph Papa

Ajay Piramal (to retire on 10 April 2014)

Roberto Quarta (appointed on 4 December 2013. Independent on appointment) (to become Chairman on 10 April 2014).

### Role of the Board

#### Strategy

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

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

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

#### Performance

Reviewing performance against strategy, budgets and financial and business plans

Overseeing Group operations and maintaining a sound system of internal control

Determining dividend policy and dividend recommendations

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

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

#### Risk

Determining risk appetite, regularly reviewing risk register and risk management processes (see pages 38-41 for more detail).

Shareholder Communications

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

Maintaining relationships and continued engagement with Shareholders.

### Key activities in 2013

(in addition to regular annual activities)

Review and oversight of the implementation of the strategy and organisational structure

Oversight of risk management process and review of strategic risk

Approval of five-year plan

Review of Board effectiveness

Continued review of Board composition and appointment of Michael Friedman and Roberto Quarta to the Board

Consideration and approval of the acquisitions of Sushrut-Adler in India, Plato Grup in Turkey and Politec Saude and Pro Cirurgia Especializada in Brazil

Approval and oversight of European Process Optimisation programme

Six physical scheduled meetings and two scheduled telephone meetings

Four day strategy review and visit to our Tokyo headquarters

Two day visit to our US operations in Andover, Massachusetts

Considered and approved the Capital Allocation Framework

Considered and reviewed succession planning both at Board level and below

Approved the sustainability policy and report.



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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## CORPORATE GOVERNANCE 51

**Board Development Programme**

Our Board Development Programme is directed to the specific needs and interests of our Directors. We focus the development sessions on facilitating a greater awareness and understanding of our business rather than formal training in what it is to be a Director. We value our visits to the different Smith & Nephew sites around the world, where we meet with the local managers of our businesses and see the daily operations in action. Meeting our local managers helps us to understand the challenges they face and their plans to meet those challenges. We also take the opportunity to look at our products and in particular the new products being developed by our R&D teams. This direct contact with the business in the locations we operate around the world really helps us to make investment and strategic decisions. Meeting our local managers helps us when making succession planning decisions below Board level.

During the course of the year, we receive updates at the Board and Committee meetings on external corporate governance changes likely to impact the Company in the future. In 2013, we particularly focused on changes to Narrative Reporting and Reporting on Remuneration. We also looked into the implications of cyber security on the business.

New Directors receive tailored induction programmes, when they join the Board. In 2013, Michael Friedman attended a briefing on UK company law and corporate governance practices. He also attended a series of one-to-one meetings with senior members of management at our head office. Roberto Quarta has commenced his induction programme, meeting the leaders of key divisions and functions and visiting our key site in Hull. All Non-executive Directors are encouraged to visit our overseas businesses, if they happen to be travelling for other purposes. In 2013, visits of this nature were made to operations in the US, Singapore and India. Our local management teams enjoy welcoming Non-executive Directors to their business and it emphasises the interest the Board takes in all our operations.

The following development sessions were run during 2013:

| Month     | Activity  |
|-----------|---|
| April     | Presentation from Roger Teasdale, President, Advanced Wound Management on the Advanced Wound Management business and progress of the integration of the Biotherapeutics business.   |
| July      | Audit Committee Development Session (open to all the Board) covering developments in the accounting and reporting landscape including narrative reporting, the Financial Reporting Council changes to Audit Committee and Auditor reporting, cyber security and other UK and European developments. |
| September |   |

Visit to our Tokyo offices with a presentation from senior Japanese management on the local business and challenges faced.

Presentations from the entire Executive team as part of the Board's Strategy Review.

October Board discussion on Risk as part of the Board's Strategy discussions.  
Visit to Advanced Surgical Devices facility in Andover, Massachusetts.

December Series of presentations from our Advanced Surgical Devices senior executives on the challenges faced by the business, our strategy and initiatives to meet these challenges and an update on progress made since the previous year.  
Workshop on cyber security.

#### Board Effectiveness Review

We conduct an annual review into the effectiveness of the Board. In 2012, the review was facilitated externally and drew positive conclusions. In 2013 therefore, we undertook an internal review, which was led by Richard De Schutter, the Senior Independent Director.

The review in 2013 consisted of a questionnaire followed by a series of interviews with the Directors towards the end of the year. The questionnaire was based on the internal questionnaire used in 2011 enabling a comparison to be made between the two years. The interviews with the Directors were broadly based on the questionnaire but also covered any other matters the Directors wished to raise.

Mr De Schutter presented the results of his findings to the Board in early February 2014. Overall, the review concluded that the performance of the Board had improved since the previous internal review particularly in evaluating performance against the long-term strategic plan, identifying and monitoring strategic risks and gaining a better understanding of the competitive environment. Non-executive Directors also valued the meetings they held without management present, ahead of each Board and some Committee meetings as well as the opportunity to meet senior executives below Board level on site visits and at Board presentations.

The review identified the following areas that would require attention in 2014:

#### Areas for Attention

The Board was currently in transition with the retirement of Sir John Buchanan as Chairman, Richard De Schutter as Senior Independent Director and Ajay Piramal as Non-executive Director following the Annual General Meeting. It was therefore recognised that Succession Planning at Non-executive Director level would be a key priority for the new Chairman, Roberto Quarta, after the Annual General Meeting.

It was felt that the number, timing and length of the Board and Committee meetings could be reviewed to consider whether the current pattern of meetings was most effective.

It is expected that the review in 2014 will be facilitated externally.

#### Company Secretary and independent advice

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

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

#### Management of conflicts of interest

None of us, nor our connected persons, has any family relationship with any other Director or officer, nor has a material interest in any contract to which the Company or any of its subsidiaries are, or were, a party during the year or up to 24 February 2014.

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

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### SMITH & NEPHEW ANNUAL REPORT 2013

#### 52 CORPORATE GOVERNANCE

##### Corporate Governance Statement *continued*

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

##### Re-appointment of Directors

In accordance with the Code, all Directors, offer themselves to Shareholders for re-election annually, except those who are retiring following the Annual General Meeting. Roberto Quarta who was appointed to the Board on 4 December 2013 will offer himself for election. Each Director may be removed at any time by the Board or the Shareholders.

##### Directors' Indemnity Arrangements

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

##### Liaison with Shareholders

The Executive Directors meet regularly with investors to discuss the Company's business and financial performance both at the time of the announcement of results and at industry investor events. During 2013, the Executive Directors held meetings with institutional investors, including investors representing approximately 43% of the share capital as at 31 December 2013.

As part of this programme of investor meetings, during 2013, as Chairman of the Company, I met with investors representing 16% of the share capital. Over the last three years, I have met investors representing in aggregate 21% of the share capital. Also during 2013, Joseph Papa met with Shareholders holding 20% of the share capital to discuss remuneration policies and plans. In addition, we contacted a further three Shareholders representing 8% of the share capital summarising the discussions held with the Shareholders we had met.

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

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

### Share capital

As at 24 February 2014, the Company's total issued share capital with voting rights consisted of 893,814,245 ordinary shares of 20.0 US cents each. 25,122,968 ordinary shares are held in treasury and are not included in the above figure. Further information on treasury shares can be found in Note 19 of the Notes to the Group accounts.

As at 24 February 2014, notification had been received from the undernoted investors under the DTR in respect of interests in 3% or more of the issued ordinary shares with voting rights of the Company.

|                 | Number of Shares | %   |
|-----------------|------------------|-----|
| Invesco         | 66,740,225       | 7.5 |
| BlackRock, Inc. | 42,621,011       | 4.8 |

In addition to the above the Company is aware that Walter Scott & Partners Limited hold approximately 37.7 million ordinary shares (4.2%). Otherwise, the Company is not aware of any person who has a significant direct or indirect holding of securities in the Company and is not aware of any persons holding securities which may control the Company. There are no securities in issue which have special rights as to the control of the Company.

### Dividend

The Board has proposed a final dividend of 17.0 US cents per ordinary share which, together with the interim dividend of 10.40 US cents, makes a total for 2013 of 27.40 US cents. The final dividend is expected to be paid, subject to Shareholder approval, on 7 May 2014 to Shareholders on the Register of Members at the close of business on 22 April 2014.

### Annual General Meeting

The Company's Annual General Meeting is to be held on 10 April 2014 at 2:00 pm at No.11 Cavendish Square, London W1G 0AN. Registered Shareholders have been sent either a Notice of Annual General Meeting or notification of availability of the Notice of Annual General Meeting.

### Code of Ethics for Senior Financial Officers

We have adopted a Code of Ethics for Senior Financial Officers, which is available free of charge on the Group's website ([www.smith-nephew.com](http://www.smith-nephew.com)) and on request. This applies to the Chief Executive Officer, Chief Financial Officer, Vice President, Group Finance 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 2013 or up until 24 February 2014.

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CORPORATE GOVERNANCE 53

**Internal controls**

Evaluation of Internal Controls Procedures

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

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

The management of each Division is responsible for the establishment and review of effective internal financial controls within their Division.

The Group Finance Manual sets out, amongst other things, financial and accounting policies and minimum internal financial control standards.

The Internal Audit function agrees an annual work plan and scope of work with the Audit Committee.

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

The Audit Committee reviews the Group Whistle-blower procedures.

The Audit Committee reviews regular reports from the Vice President, Group Finance and the Heads of the Taxation and Treasury functions.

This system of internal control has been designed to manage rather than eliminate material risks to the achievement of our strategic and business objectives and can provide only reasonable, and not absolute, assurance against material misstatement or loss. Because of inherent limitations, our internal controls over financial reporting may not prevent or detect all misstatements. In addition, our projections of any evaluation of effectiveness in future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. This process complies with the Financial Reporting Council's Internal Control: Revised Guidance for Directors on the Combined Code and additionally contributes to our compliance with the obligations under the Sarbanes-Oxley Act 2002 and other internal assurance activities. There has been no change in the Group's internal control over financial reporting during the period covered by this Annual Report that has materially affected, or is reasonably likely to materially affect, the Group's internal control over financial reporting.

We, as a Board, are responsible overall for reviewing and approving the adequacy and effectiveness of the risk management framework and the system of internal controls over financial, operational (including quality management) and ethical compliance processes operated by the Group. We have delegated responsibility for this review to the Audit Committee. The Audit Committee, through the Internal Audit function reviews the adequacy and effectiveness of internal control procedures and identifies any weaknesses and ensures these are remediated within agreed timelines. The latest review covered the financial year to 31 December 2013 and included the period up to the approval of this Annual Report. The main elements of this annual review are as follows:

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Group's disclosure controls and procedures as at 31 December 2013. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded on 24 February 2014 that the disclosure controls and procedures were effective as at 31 December 2013.

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the effectiveness of the Group's internal control over financial reporting as at 31 December 2013 in accordance with the requirements in the US under s404 of the Sarbanes-Oxley Act. In making this assessment, they used the criteria set forth by the Committee of Sponsoring Organisations of the Treadway Commission in Internal Control-Integrated Framework. Based on their assessment, management concluded and reported that, as at 31 December 2013, the Group's internal control over financial reporting is effective based on those criteria.

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

Ernst & Young LLP, an independent registered public accounting firm issued an audit report on the Group's internal control over financial reporting as at 31 December 2013. This report appears on page 91.



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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 54 CORPORATE GOVERNANCE

Corporate Governance Statement *continued***The Auditor**

Ernst & Young LLP have expressed their willingness to continue as the Auditor. Resolutions proposing their re-appointment for 2014 and to authorise the Directors to determine their remuneration will be proposed at the Annual General Meeting, as approved by the Audit Committee.

We shall be tendering the provision of Audit services for future years during 2014. Further details are included in the Audit Committee Report.

**Disclosure of information to the Auditor**

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 Auditor, 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 Auditor is aware of such information.

**Principal accountant fees and services**

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

|                    | <b>2013</b>       | 2012       |
|--------------------|-------------------|------------|
|                    | <b>\$ million</b> | \$ million |
| Audit              | <b>3</b>          | 3          |
| Audit related fees |                   |            |
| Tax                | <b>3</b>          | 2          |
| Other              |                   |            |
|                    | <b>6</b>          | 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 3.2 of the Notes to the Group accounts.

**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)

### Committees of the Board

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

### Other Committees

#### Executive Risk Committee

Olivier Bohuon chairs our Executive Risk Committee which includes the Executive Directors and Executive Officers of the Group. As an integral part of our planning and review process, the management of each of our divisions identifies the risks applicable to their business, the probability of those risks occurring, the impact if they do occur and the actions required and being taken to manage and mitigate those risks. The Executive Risk Committee meets twice a year to review the major risks they identify across the Group and the mitigation processes and plans. As appropriate, the Executive Risk Committee may re-categorise risks or require further information or mitigating action to be undertaken. We receive an annual report from the Executive Risk Committee, which details the significant risks categorised by potential financial impact on profit and share price and by likelihood of occurrence. Details of new, key or significantly increased risks, along with actions put in place to mitigate such risks, are also reported to us as appropriate. We have provided further information on the principal risks identified through this process in Financial review and principal risks on pages 36 to 41 of this Annual Report.

#### Disclosures Committee

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

By order of the Board, on 26 February 2014

**Sir John Buchanan**

**Chairman**

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SMITH & NEPHEW ANNUAL REPORT 2013

CORPORATE GOVERNANCE 55

Nomination & Governance Committee

Sir John Buchanan

Membership

Sir John Buchanan (Chairman) (Independent on appointment)

Olivier Bohuon

Brian Larcombe (Independent)

Richard De Schutter (Independent)

Roberto Quarta (Independent) (Chairman Elect) with effect from 4 December 2013.

Five meetings

Main responsibilities

Review size and composition of the Board

Oversee the Board succession plans

Recommend Director appointments

Oversee governance aspects of the Board and its Committees

Oversee review into the Board's effectiveness

Consider and update the Schedule of Matters Reserved to the Board and the Terms of Reference of the Board Committees

Monitor external corporate governance activities and keep the Board updated

Oversee the Board Development Programme and the induction process for new Directors.

Key activities in 2013

(in addition to main responsibilities)

Recommended the appointment of Roberto Quarta as Chairman Elect  
Recommended the appointment of Michael Friedman as a new Non-executive Director  
Reviewed and approved new Terms of Reference for Board Committees and new Matters Reserved to the Board  
Continued consideration of diversity issues, independence of Non-executive Directors and potential conflicts of interests  
Received updates on corporate governance matters.

Dear Shareholder,

I am pleased to present my report on the activities of the Nomination & Governance Committee in 2013. The membership and principal duties of the Committee are set out in the table above. In 2013, we dealt with the following matters:

#### Appointment of Roberto Quarta as Chairman Elect

In April 2014, I shall have served on the Smith & Nephew plc Board for nine years. The Board agreed therefore that they should commence a search for my replacement during 2013. Richard De Schutter, Senior Independent Director led this search assisted by Brian Larcombe, member of this Committee and by the independent search firm, Russell Reynolds. They interviewed a number of candidates, who also met with Olivier Bohuon, the Chief Executive Officer and other Non-executive Directors. I did not take part in this search, but was kept updated of progress throughout. In October, the Committee recommended the

appointment of Roberto Quarta as Non-executive Director and Chairman Elect with effect from 4 December 2013. I shall retire from the Board following the Annual General Meeting and Roberto Quarta will be appointed in my place.

#### Changes to Board Composition

The Committee recommended the appointment of Michael Friedman as Non-executive Director. He joined the Board on 11 April 2013 bringing exceptional experience of the US Healthcare market with both public and private sector experience.

The Committee reviewed the composition of the Board and recommended that Brian Larcombe replace Richard De Schutter as Senior Independent Director, when he retires following the Annual General Meeting.

The Committee has continued its search for additional Non-executive Directors, focusing, in particular, on the skills, experience, independence and diversity each candidate brings to the Board. We look for candidates who will support the strategic priorities identified by the Board and in 2014 will continue to look for Non-executive Directors with experience within emerging markets or within the US and European healthcare systems.

Our focus on emerging markets experience will be particularly important after the retirement of Ajay Piramel following the Annual General Meeting on 10 April 2014.

#### Governance Matters

During the year, the Committee also addressed a number of governance matters. We reviewed the Terms of Reference of all the Board Committees in light of new regulations and guidance from the UK Government and the Financial Reporting Council on Executive Remuneration, Narrative Reporting and Audit Committee Reporting. We received updates from the Company Secretary on new developments in corporate reporting in both the UK and Europe. We reviewed the independence of our Non-executive Directors, considered potential conflicts of interest and the diversity of the Board and made recommendations concerning these matters to the Board.

Diversity

As we explained in our 2011 Annual Report, we value diversity in the Boardroom. Our directors come from different backgrounds and each brings unique capabilities and perspectives to our discussions with a wide range of professional and geographical backgrounds. We are committed to maintaining a diverse Board. In 2012, we stated that our expectation would be that by 2015, 25% of our Board would be female and we have met this expectation. When appointing new directors, we will continue to appoint on merit whilst valuing diversity in its broadest sense.

Whilst the whole Board remains responsible for ensuring that the Company is governed appropriately, the Committee carries out the more detailed work to support this.

Yours sincerely

Sir John Buchanan

Chairman of Nomination & Governance Committee

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SMITH & NEPHEW ANNUAL REPORT 2013

56 CORPORATE GOVERNANCE

Corporate Governance Statement *continued*

**Ethics & Compliance Committee**

Pamela Kirby

Membership

Pamela Kirby (Chairman) (Independent)

Michael Friedman (Independent) with effect from 4 December 2013

Joseph Papa (Independent)

Richard De Schutter (Independent).

Four Meetings

Main responsibilities

Review ethics and compliance programmes

Review policies and training programmes

Review compliance performance based on monitoring, auditing and investigations data

Review allegations of significant compliance failures

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

Review external developments and compliance activities

Receive reports from the Group's ethics and compliance meetings and from the Chief Compliance Officer and the Chief Legal Officer.

Key activities in 2013

(in addition to main responsibilities)

Held meetings with independent monitor appointed under the DOJ/SEC settlement to discuss the effectiveness of our Global Compliance programme, review his reports, and consider further enhancements

Continued to review compliance programme for third party sellers and other third parties doing business with the Company

Reviewed development of employee compliance training programmes  
Considered compliance implications relating to potential acquisitions, including due diligence findings and integration plans.

### Dear Shareholder,

I am pleased to present my report on the activities of the Ethics & Compliance Committee in 2013. The membership and the principal duties of the Committee are set out in the table. In 2013, we dealt with the following matters, among others:

#### Settlement with US Securities and Exchange

#### Commission and US Department of Justice

During the year, we continued to work closely with the independent monitor appointed as part of our settlement with the SEC and DOJ in 2012. With his help, we have continued to evaluate the effectiveness of our compliance programme and adopt further enhancements to the programme. We met individually with the monitor and collectively as a Committee and discussed our compliance programme with him. In August, the monitor submitted to the SEC, DOJ and our Board a follow-up report to his initial report from 2012. The follow-up report contained additional recommendations and observations regarding implementation of his initial recommendations. It also concluded that Smith & Nephew's programme is reasonably designed and implemented to detect and prevent violations of the anti-corruption laws and is functioning effectively. The SEC and DOJ concurred in that assessment, and in December 2013 we and the monitor submitted a final, joint report. In January 2014, the SEC and DOJ confirmed that the independent monitorship has terminated. We are now subject to self-reporting and other requirements for the remainder of the settlement agreements (that is, until at least March 2015).

#### Compliance Programme for Distributors

We continued to review our compliance programme with third party sellers (such as distributors and sales agents), particularly in higher risk markets. This programme includes due diligence, contracts with compliance terms and compliance training. To increase oversight, we are also piloting related monitoring and auditing programmes in 2014. During 2013, we required our distributors to complete expanded due diligence questionnaires and certifications and have continued to work with them to build and enhance their own compliance programmes. We provide all our distributors with a set of resources, which they can customise and brand for their own compliance programmes.

#### Compliance Programme for Other Third Parties

We have continued to strengthen our controls over other third parties engaged by us to provide services other than selling our products, such as customs, registration and travel agents. In 2014, we will increase our scrutiny on potential higher risk third parties. We have established a policy and process requiring that managers categorise third parties and take appropriate steps, including performing a risk assessment, conducting due diligence and assigning training, based on third party type and risk profile. We previously created Guidance on the Smith & Nephew Code of Conduct and Business Principles for Third Parties to highlight the areas of our Code of Conduct that apply directly to third parties and that we expect them to follow when working on our behalf.

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Employee Compliance Programme

New employees are trained on our Code of Conduct which sets out the basic legal and ethical principles for carrying out business and applies both to the employees and others 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 covered the broader issues of ethics and compliance throughout the business and includes a code of business principles. A copy of the Code of Conduct can be found on the Group's website ([www.smith-nephew.com](http://www.smith-nephew.com)).

The Code of Conduct includes our whistle-blowing policy, which enables employees and members of the public to contact us anonymously through an independent provider (where allowed by local law). Individuals can also report a concern to their direct manager or a manager in Compliance, Legal or Human Resources. All calls and contacts are investigated and the appropriate action taken, including reports for senior management or the Board, where warranted. As stated in the Code of Conduct, we also enforce our non-retaliation policy against anyone who makes a report in good faith. The Ethics & Compliance Committee is advised of any potentially significant improprieties which are reported.

In 2013, we reviewed the Group Policies and Procedures ( GPPs ) supporting the Code of Conduct, and made revisions to policies covering booths at medical meetings, free products, digital media and other areas. We continually work to enhance the employee compliance training programme. New employees receive training on our Code of Conduct, and we assign annual compliance training to employees. People managers also must complete a certification that includes content targeted to their role and the challenges they face. In 2013, we created a refresher course on Preventing Bribery and Corruption and a course on Effective Communication. The preventing bribery model gave employees an opportunity to apply their knowledge in different scenarios.

The annual bonus to senior managers can be negatively impacted if their team members have not completed the requisite training. The compliance training programme continues to evolve to focus more on tailored situations relevant to employees in specific job situations. Further support is provided through a comprehensive set of tools and resources located on our global intranet platform. These tools and resources are regularly reviewed and updated.

Compliance Infrastructure

We are mindful that an effective compliance programme requires both a culture of integrity and investment in the necessary infrastructure to give effect to that culture. As the Company grows in new markets, we continue to expand our global network of Regional Compliance Officers and they work with local management to reinforce the importance of compliance with our employees and third parties around the world. In 2013, we added regional compliance staff in Russia, Brazil, Turkey, Japan and the Middle East.



#### Compliance Implications around Acquisitions

During 2013, there has been increased acquisition activity across the Group, with the acquisition of Plato Grup in Turkey, Sushrut-Adler in India and Politec in Brazil, as well as the announcement of an agreement to acquire Pro Cirurgia Especializada, also in Brazil. We have compliance due diligence reviews and integration plans relating to each of these transactions and we monitor progress against these plans.

#### Compliance Investigations

Finally, an effective compliance programme must regularly evaluate and address emerging risks and design appropriate controls and take necessary remedial actions. These actions may include investigations about possible improprieties, which we pursue with due care.

Yours sincerely

Pamela Kirby

Chairman of Ethics & Compliance Committee

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SMITH & NEPHEW ANNUAL REPORT 2013

58 CORPORATE GOVERNANCE

Audit Committee Report

Ian Barlow

Dear Shareholder,

I am pleased to present the first Audit Committee Report prepared in accordance with the newly revised Corporate Governance Code, in which the role of the Audit Committee and its activities during the year are described in more detail than in previous years.

The role of the Audit Committee is to undertake an independent assessment of the financial affairs of the Company, to review the financial statements and to ensure that there is a sound system of financial control throughout the Group. Whilst the Board as a whole is responsible for approving the financial results, we undertake the detailed work to support that decision.

Composition of the Audit Committee

I am Chairman of the Audit Committee and Brian Larcombe, Richard De Schutter and Joseph Papa are members of the Committee. We are all independent Non-executive Directors and served on the Committee throughout 2013. Richard De Schutter will be retiring from the Board and the Audit Committee following the 2014 Annual General Meeting. The Board has determined that, as a Chartered Accountant and former Senior Partner, London at KPMG, I am the designated financial expert.

Role of the Audit Committee

Our work falls into the following five areas:

**Financial reporting**

Reviewing significant financial reporting judgements and accounting policies and compliance with accounting standards

Ensuring the integrity of the financial statements and their compliance with UK and US statutory requirements

Ensuring the Annual Report and Accounts are fair, balanced and understandable and recommending their adoption by the Board

Monitoring announcements relating to the Group's financial performance.

### Internal Controls and Risk Management

Monitoring the effectiveness of internal controls and compliance with the UK Corporate Governance Code 2012 and the Sarbanes-Oxley Act, specifically sections 302 and 404

Reviewing the operation of the Group's risk management processes and the control environment over financial, regulatory and quality risks.

### Fraud and Whistle-blowing

Receiving reports on the processes in place to prevent fraud and to enable whistle-blowing

If required, receiving reports of fraud incidents.

### Internal Audit

Agreeing internal audit plans and reviewing reports of internal audit work

Monitoring the effectiveness of the internal audit function.

### External Audit

Overseeing the Board's relationship with the external auditor

Monitoring and reviewing the independence and performance of the external auditor and evaluating their effectiveness

Making recommendations to the Board for the appointment or re-appointment of the external auditor.

The Terms of Reference of the Audit Committee describe our role and responsibilities more fully and can be found on our website at [www.smith-nephew.com](http://www.smith-nephew.com).

Activities of the Audit Committee in 2013 and since the year end

In 2013, we held five physical meetings and three meetings by telephone. Each meeting was attended by all members of the Committee. The Chief Executive Officer, Chief Financial Officer, Head of Internal Audit, the external auditor and key finance personnel also attended by invitation. We also met the external auditor without management present.

Our programme of work in 2013 is set out below and took the following format: As part of our review of the financial statements and the quarterly announcements, we reviewed management's judgements applied in a number of areas including the valuation of inventories, liability provisioning, impairment, retirement benefit obligations, trade receivables, taxation and business combinations. The matters of judgement and our processes and conclusions are described in greater detail below.

During the year we received reports from the Group Treasurer, Head of Tax, Chief Information Officer ( CIO ) and Chief Business Development Officer. All of these were focused on the risk management in these functions. The CIO's report had a particular emphasis on cyber security. The Committee was satisfied that each function has evaluated the risks it is managing and has effective processes in place to mitigate and respond to those risks. We also had reports from the Heads of Quality Assurance and of Risk Assurance and had two dedicated discussions on the Group's risk management during the year: first to review the Group's risk management procedures and risk maps as a basis for sign off on the Annual Report and Accounts; the second in September as part of the Board's annual strategy meeting to review the Board's attitude to risk and assessment of the high level strategic risks.

In light of the changes in UK reporting regulations we continued to review the style, format and content of the Annual Report and Accounts paying particular attention to the changes in the Corporate Governance Code and reporting regulations. We also revised our Terms of Reference to take account of these changes.

Since the year end, we have reviewed the Annual Report and Accounts for 2013 and have concluded that taken as a whole they are fair, balanced and understandable and have advised the full Board accordingly. In coming to this conclusion, we have considered the description of the Group's strategy and key risks, the key elements of the business model which is set out on page 7, and the key performance indicators and their link to the strategy.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## CORPORATE GOVERNANCE 59

## Significant matters related to the financial statements

We considered the following key areas of judgement in relation to the 2013 accounts and at each reporting quarter end, which we discussed in all cases with management and the external auditor:

**Area of judgement****Our action****Valuation of inventories**

A feature of the Advanced Surgical Devices division's business model (whose finished goods inventory makes up almost 80% 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.

At each quarter end we received reports from and discussed with management and the external auditor the level of provisioning and material areas at risk. Provisioning averaged 26% during the year (27% during 2012). We concluded that the proposed levels were appropriate.

**Liability provisioning**

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 or settlement negotiations or if new facts come to light.

As members of the Board, we receive regular updates from the Chief Legal Officer. These updates form the basis for the level of provisioning. These have not moved materially during the year and we determined that the proposed levels at year end of \$86m in 2013 (\$80m in 2012) were appropriate in the circumstances.

The level of provisioning for contingent and other liabilities is an issue where management and legal judgements are important.

## Impairment

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

We reviewed management's reports on the key assumptions with respect to goodwill and investment in associates particularly the forecast future cash flows and discount rates used to make these calculations. We have also considered the disclosure surrounding these reviews and concluded it was appropriate.

## Retirement Benefits Obligations

A number of key judgements have to be made in calculating the fair value of the Group's defined benefit pension plans. These assumptions affect 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. In making these judgements, management takes into

We received quarterly reports from management setting out the movement in the key assumptions for the principal pension schemes in the Group and the financial impact of these movements. Any significant movement in the assumptions or movement in the underlying scheme assets and liabilities was discussed with management. Details of the assumptions used are

account the advice of professional external actuaries and benchmarks its assumptions against external data.

set out in Note 18 of the Notes to the Group accounts. Following these discussions we concluded that the assumptions used were appropriate.

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SMITH & NEPHEW ANNUAL REPORT 2013

60 CORPORATE GOVERNANCE

Audit Committee Report *continued*

**Area of judgement**

**Our action**

Trade receivables

Guidance was issued by the Financial Reporting Council in early 2012 on responding to increased country and currency risk particularly in Southern Europe.

Each quarter we received reports from management containing key metrics with regard to receivables with additional focus on receivables in Southern Europe. We discussed the risk associated with trade receivables in Southern Europe and the level of provisioning and concluded that the stated values were appropriate.

Taxation

Provisioning for potential current tax liabilities and the level of deferred tax asset recognition in relation to accumulated tax losses are underpinned by a range of judgements.

We annually review our system and principles for management of tax risks. We review quarterly reports from management evaluating existing risks and tax provisions. We also consider reports from our external auditor before determining that the levels of provisions was appropriate.

Business combinations



The Group has identified growth through acquisitions as one of its Strategic Priorities and over the past 12 months we have made acquisitions in Turkey, India and Brazil. For completed acquisitions, we received a report from management setting out the significant assets and liabilities acquired, details of the provisional fair value adjustments applied, an analysis of the intangible assets acquired, the assumptions behind the valuation of these acquired intangible assets, and the proposed useful economic life of each intangible asset class. These reports were reviewed and, following discussion, approved.

#### External Auditor

The independence of our external auditor is critical for the integrity of the audit. We therefore have an Auditor Independence Policy which ensures that this independence is maintained, a copy of which is available on the Company's website. This governs our approach when we require our external auditor to carry out non-audit services, and all such services are strictly governed by this policy. During 2013, fees paid to Ernst & Young LLP, our external auditor, for non-audit work totalled \$3m which equates to 44% of the total audit fees. Full details are shown in Note 3.2 of the Notes to the Group accounts.

The Auditor Independence Policy also governs the policy regarding the audit partner rotation. This year marks the fifth and final year for our audit partner, Les Clifford, who will be replaced for 2014 by Andrew Walton. Partners and senior audit staff may not be recruited by the Group unless two years have expired since their previous involvement with the Group. No such recruitment has occurred. We consider the implementation of this policy helps ensure that auditor objectivity and independence is safeguarded.

We formally reviewed the effectiveness of the external audit process and the quality of the audit. The review covered the following:

The audit partners with particular focus on the lead audit engagement partner;

The skills and experience of the audit team;

The planning and scope of the audit and identification of areas of audit risk;

The execution of the audit;

The role of management in the audit process;

The quality of communication between the external auditor and the audit committee;

The quality of their regular reports on accounting matters, governance and control;

The support provided by the external auditor to the audit committee;

The contribution made by the external auditor towards insights and added value;

The reputation and standing of the external auditor;

The independence and objectivity of the external auditor; and

The quality of the formal report to Shareholders.

We conducted this review as part of the 2013 year-end process. The views of each member of the Audit Committee, the Chief Financial Officer, the Vice President Group Finance and key members of the finance management team at Group and divisional level were sought. We considered the feedback from this process and shared it with the external auditor and with management.

During the year, we considered the inspection reports from the Audit Oversight Boards in the UK and US, specifically the:

Financial Reporting Council's Audit Quality Inspections Annual Report 2012/13 and Public Report on the 2012 inspection of Ernst & Young LLP; and

The US based Public Company Accounting Oversight Board's Report on the 2012 inspection of Ernst & Young LLP.

We also reviewed the fees of the external auditor which benchmarked well against groups of comparable size and complexity.

Our conclusions were that the external audit was carried out effectively, efficiently and with the necessary objectivity and independence.

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SMITH & NEPHEW ANNUAL REPORT 2013

CORPORATE GOVERNANCE 61

Tender of External Audit Services

Ernst & Young or its predecessors have been our external auditor since we listed in 1937. We have regularly reviewed the provision of external audit services and because we have been satisfied with the quality and cost of the work undertaken by Ernst & Young, we have not considered it necessary to tender the appointment. We are however mindful of the recent changes introduced by the UK Corporate Governance Code 2012, the prospective new requirements of the Competition Commission to tender regularly, the imminent changes being progressed by the European Parliament for periodic mandatory rotation of auditors and the views of some of our Shareholders regarding the length of tenure of our external auditor. We recognise that now is the time to consider putting the external audit out to tender. We chose not to do this in 2013 given the very recent appointment of Julie Brown as Chief Financial Officer. We have however decided that following the Annual General Meeting in 2014, we will go out to tender in 2014 with a view to appointing a new external auditor, or re-appointing Ernst & Young as external auditor, for the year ending 31 December 2015.

As Chairman of the Audit Committee, I shall lead this process on behalf of the Board supported by Julie Brown and senior members of her financial management. When we have made a decision regarding the appointment of the external auditor, we shall make an appropriate announcement to the market.

Internal Audit

Our Internal Audit function reports directly to the Audit Committee and carries out work in three areas: our financial systems and processes; our systems that ensure compliance with our Code of Conduct, regulation and laws; and our quality managements systems in our manufacturing activities. In all three areas they act as a third line of defence behind operational management's front line and our own assurance activities. During the year they completed 58 reviews, the results of which were reviewed by the Committee which also oversees the effective and timely remediation of any recommendations. The Committee receives a quarterly report detailing any un-remediated and overdue control recommendations.

We are keen to ensure that this vital function develops with the increasing scale and complexity of the business. With regards to new acquisitions specifically, the function will perform an audit on the Group's Acquisition Due Diligence process followed by site specific audits on new acquisitions to ensure integration efforts are in line with approved plans. We will continue to monitor Internal Audit's scope of work and operational methods to ensure it plays a full role in providing assurance of the Group's identification and management of risk and its associated controls.

## Risk Management and Internal Control

On behalf of the Board we reviewed the system of internal financial control and satisfied ourselves that we are meeting required standards both for the year ended 31 December 2013 and up to the date of approval of this Annual Report. No concerns were raised with us in 2013 about possible improprieties in matters of financial reporting or other matters.

In coming to this conclusion:

We received regular reports from the internal audit function on their findings from the reviews undertaken throughout the year both from an internal audit perspective and also with regard to compliance with the Sarbanes Oxley Act

We requested and reviewed a report mapping Group level risks and related control assurance

We requested various reports from management relating to specific risks identified through the risk management process including the progress of the European Process Optimisation project (integration of enterprise reporting systems in Europe) and the risks inherent in our programme of business acquisitions. In addition the Board conducted a workshop on cyber security.

Our Risk Management Framework is underpinned by Business and Functional risk registers that highlight the risks identified and the probability and impact of risk to the Group, as well as mitigation plans. The most significant of these risks are considered by the Group Risk Committee for inclusion on a Group Risk Register. The effectiveness of this Framework is reviewed annually by Internal Audit and our Committee.

Yours sincerely

Ian Barlow

Chairman of the Audit Committee

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SMITH & NEPHEW ANNUAL REPORT 2013

62 CORPORATE GOVERNANCE

Directors remuneration report

Our aim is to devise remuneration packages

that drive performance

Dear Shareholder,

I am pleased to present the first Directors remuneration report prepared in accordance with the new regulations. Our remuneration arrangements have essentially remained unchanged from last year, but are now presented in a new format. We have discussed this format with a number of our major Shareholders and are very grateful for their suggestions helping us to improve the clarity of the new remuneration policy table and the remuneration policy report itself.

We made a number of decisions during the year, as follows:

Agreed to introduce a third performance measure relating to growth in Emerging & International Markets, into our Performance Share Programme.

Determined the incentive plan outcomes for long-term awards made in 2010 and the Annual Incentive Plan 2012, and set the targets and measures for the awards and plans in 2013.

Redesigned the Directors Remuneration Report in line with the new regulations.

Compliance statement

We have prepared this Directors Remuneration Report (the Report ) in accordance with The Enterprise and Regulatory Reform Act 2012-2013 (clauses 81-84) and The Large and Medium-Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (the Regulations ). The Report also meets the relevant requirements of the Financial Conduct Authority ( FCA ) Listing Rules.

As required by the regulations, the first part of the Report (pages 64 to 72) is the Directors Remuneration Policy Report (the Policy Report ). The Policy Report will be put to Shareholders for approval as a binding vote at the Annual General Meeting on 10 April 2014. The policy report describes our remuneration policy as it relates to the Directors of the Company. Once the policy report has been approved by Shareholders, all payments we make to any Director of the Company will be in accordance with this remuneration policy. We intend that this remuneration policy will remain in place unchanged for at least the next three years and will next be put to Shareholder vote at the Annual General Meeting to be held in 2017. We will bring the policy report back to Shareholders earlier in the event that we make any material change to the remuneration policy or Shareholders do not approve the annual report on remuneration.

The second part of the Report (pages 73 to 85) is the annual report on remuneration (the Implementation Report ). The Implementation Report will be put to Shareholders for approval as an advisory vote at the Annual General Meeting on 10 April 2014. The Implementation Report explains how the remuneration policy was implemented during 2013 and also how it is currently being implemented in 2014.

Pages 74, 79 to 82 have been audited by Ernst & Young LLP.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## CORPORATE GOVERNANCE 63

in line with our strategy &  
 which are simple & clear  
 to understand

As a Remuneration Committee, our aim is to devise remuneration packages that drive a performance in line with our corporate strategy and which are simple and clear to understand both for our Shareholders and for those who participate in our plans. We aim to have a clear line of sight between the performance of the Company and how our Directors and senior executives are paid. We do this by setting the fixed elements of pay, notably base salary and benefits, in line with what our Executive Directors would be paid at another company of a comparable size, complexity and geographical spread. For the variable elements of pay, we select performance measures that are linked to one or more of our Strategic Priorities as detailed on page 10 of the Annual Report as follows:

**Measures in our Variable Pay  
 Plans**
**Link to Strategic Priorities**
**Financial measures in Annual Incentive Plans**

Revenue, Trading profit, Cash

We need to generate cash in our Established Markets to be able to invest in Emerging & International Markets, innovation, organic growth and acquisitions in order to continue to grow in the future. Cash flow is therefore important and this in turn is derived from increased revenues and healthy trading profits.

**Business objectives in Annual Incentive Plans**

Re-investment

We need to release resources from the businesses through improved structures and efficiencies in order to re-invest in our higher growth

|   |   |
|---|---|
|   | areas, including emerging markets, innovation, organic growth and acquisitions.   |
| Processes   | We need to enhance our business processes in order to operate more effectively and efficiently and to improve our operating model.  |
| People  | We need to attract and retain the right people to achieve our strategy through improving our operating model, winning in Established Markets and growing in emerging markets.   |
| Customer  | Our mission is to deliver advanced medical technologies that help healthcare professionals, our customers, improve the quality of life of their patients.   |
| <b>Performance measures in our Performance Share Plan</b> |   |
| Cash flow   | Cash flow from our Established Markets is necessary in order to fund growth in emerging markets, innovation, organic growth and acquisitions.   |
| Revenue in Emerging & International markets               | Our long-term strategy depends on our ability to grow in Emerging & International Markets, to innovate for growth and to supplement organic growth through acquisitions. This depends on our ability to develop new products and to expand into new markets both geographically and by product. |
| TSR   | If we execute our strategy successfully, this will lead to an increased return for our Shareholders.  |

The following pages set out our remuneration policy in greater detail and then explain how we implement that policy. We believe that outstanding performance by our executives should be rewarded by attractive remuneration packages. We do however have measures in place which ensure that plans do not pay out where performance has not met threshold performance and to recover any amounts paid out, where subsequent events show that payments should not have been made.

We have aimed to design a remuneration package that will encourage our Executive Directors to drive performance in line with our strategy, whilst minimising risk, which will in turn deliver a healthy return to our Shareholders. We very much hope that the new style report is clearer for our Shareholders and shows how we have linked the design of our remuneration plans to our strategy.

**Joseph Papa**

**Chairman of the Remuneration Committee**



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SMITH & NEPHEW ANNUAL REPORT 2013

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Directors remuneration report *continued*

**The Policy Report**

The Remuneration Committee presents the Directors remuneration policy report, which will be put to Shareholders as a binding vote at the Annual General Meeting to be held on 10 April 2014 and subject to Shareholder approval, shall take immediate effect.

**Future policy table**

Executive Directors

The following table and accompanying notes explain the different elements of remuneration we pay to our Executive Directors:

**How the component supports the short-  
and long-term strategy of the Company**

**How the component operates**

**Base salary and benefits**

Base salary

We are a FTSE 50 listed company, operating in over 100 countries around the world. Our strategy to generate cash from Established Markets in order to invest for growth in Emerging Markets means that we are competing for international talent and our base salaries therefore need to reflect what our Executive Directors would receive if they were to work in another international company of a similar size, complexity and geographical scope.

Salaries are normally reviewed annually, with any increase applying from 1 April. Salary levels and increases take account of:

market movements within a peer group of similarly sized UK listed companies;

scope and responsibility of the position;

skill/experience and performance of the individual Director;

general economic conditions in the relevant geographic market; and

average increases awarded across the Company, with particular regard to increases in the market in which the Executive is based.

#### Payment in lieu of pension

In order to attract and retain Executive Directors with the capability of driving our corporate strategy, we need to provide market-competitive retirement benefits similar to the benefits they would receive if they were to work for one of our competitors.

Current Executive Directors receive an allowance in lieu of membership of a Company-run pension scheme.

Base salary is the only component of remuneration that is pensionable.

At the same time, we seek to avoid exposing the Company to defined benefit pension risks, and where possible will make payments in lieu of providing a pension.

#### Benefits

In order to attract and retain Executive Directors with the capability of driving our corporate strategy, we need to provide a range of market-competitive benefits similar to the benefits they would receive if they were to work for one of our competitors.

A wide range of benefits may be provided depending on the benefits provided for comparable roles in the location in which the Executive Director is based. These benefits will include, as a minimum, healthcare cover, life assurance, long-term disability, annual medical examinations, company car or car allowance. The Committee retains the discretion to provide additional benefits where necessary or relevant in the context of the Executive's location.

It is important that our Executive Directors are free to focus on the Company's business without being diverted by concerns about medical provision, risk benefit cover or, if

required, relocation issues.

Where applicable, relocation costs may be provided in line with Company's relocation policy for employees, which may include removal costs, assistance with accommodation, living expenses for self and family and financial consultancy advice. In some cases such payments may be grossed up.

## All-employee arrangements

### All-employee share plans

To enable Executive Directors to participate in all-employee share plans on the same basis as other employees.

ShareSave Plans are operated in the UK and 27 other countries internationally. In the US, an Employee Stock Purchase Plan is operated. These plans enable employees to save on a regular basis and then buy shares in the Company. Executive Directors are able to participate in such plans on a similar basis to other employees, depending on where they are located.

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CORPORATE GOVERNANCE 65

**Maximum levels of payment**

**Framework in which performance is assessed**

The base salary of the Executive Directors with effect from 1 April 2014 will be as follows:

Performance in the prior year is one of the factors taken into account and poor performance is likely to lead to a zero salary increase.

Olivier Bohuon 1,111,782

Julie Brown £514,000

The factors noted in the previous column will be taken into consideration when making increases to base salary and when appointing a new Director.

In normal circumstances, base salary increases for Executive Directors will relate to the geographic market and peer group. In addition, the average increases for employees across the group will be taken into account. The Remuneration Committee retains the right to approve higher increases when

there is a substantial change in the scope of the Executive Director's role. A full explanation will be provided in the Implementation Report should higher increases be approved in exceptional cases.

Up to 30% of base salary.

The level of payment in lieu of a pension paid to Executive Directors is not dependent on performance.

The policy is framed by the nature of the benefits that the Remuneration Committee is willing to provide to Executive Directors. The maximum amount payable will depend on the cost of providing such benefits to an employee in the location at which the Executive Director is based. Shareholders should note that the cost of providing comparable benefits in different jurisdictions may vary widely.

The level and cost of benefits provided to Executive Directors is not dependent on performance but on the package of benefits provided to comparable roles within the relevant location.

As an indication, the cost of such benefits provided in 2013 was as follows:

Olivier Bohuon 80,705

Julie Brown £14,400

The maximum amount payable in benefits to an Executive Director, in normal circumstances, will not be significantly more than amounts paid in 2013 (or equivalent in local currency). The Remuneration Committee retains the right to pay more than this should the cost of providing the same underlying benefits increase or in the event of a relocation. A full explanation will be provided in the Implementation Report should the cost of benefits provided be significantly higher.

Executive Directors may currently invest up to £250 per month in the UK ShareSave Plan. The Remuneration Committee may exercise its discretion to increase this amount up to the maximum permitted by the HM Revenue & Customs. Similar limits will apply in different locations.

The potential gains from all-employee plans are not based on performance but are linked to growth in the share price.



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SMITH & NEPHEW ANNUAL REPORT 2013

66 CORPORATE GOVERNANCE

Directors remuneration report *continued*

Future policy table Executive Directors *continued*

**How the component supports the short-**

**and long-term strategy of the Company**

**Annual incentives**

Annual Incentive Plan Cash Incentive

To motivate and reward the achievement of specific annual financial and business objectives related to the Company's strategy and sustained through a clawback mechanism explained more fully in the notes.

The objectives which determine the payment of the annual cash incentive and the level of the annual equity award are linked closely to the Group strategy.

The financial measures of revenue, trading profit and cash flow underlie our strategy for growth and the need to generate cash to fund future growth.

The business objectives are also linked to the Group strategy. These change from year to year to reflect the evolving strategy, but will typically be linked to the Strategic Priorities set out on page 10 of this Annual Report. The Implementation Report each year will explain how each objective is linked to a specific strategic priority.

**How the component operates**

The Annual Incentive Plan comprises a cash and an equity component, both based on the achievement of financial and business objectives set at the start of the year.

The cash component is paid in full after the end of the performance year.

At the end of the year, the Remuneration Committee determines the extent to which performance against these has been achieved and sets the award level.

For example, a Reinvestment objective links to the priority of improving the efficiency of the business model and investment in higher growth segments and geographies and Processes and People objectives link to developing the right organisation.

Annual Incentive Plan Equity Incentive

To drive share ownership and encourage sustained high standards through the application of a malus provision over three years, explained more fully in the notes.

The equity award component comprises conditional share awards (made at the time of the cash award), with vesting phased over the following three years.

The equity component vests  $\frac{1}{3}$ ,  $\frac{1}{3}$ ,  $\frac{1}{3}$  on successive award anniversaries, only if performance remains satisfactory over each of these three years; otherwise the award will lapse.

Participants will receive an additional number of shares equivalent to the amount of dividend payable per vested share during the relevant performance period.

Long-term incentives (awards actively being made)

Performance Share Programme

To motivate and reward longer term performance linked to the long-term strategy and share price of the Company.

The Performance Share Programme comprises conditional share awards which vest after three years, subject to the achievement of stretching performance targets linked to the Company's strategy.

The performance measures which determine the level of vesting of the Performance Share Awards are linked to our corporate strategy.

Awards may be subject to clawback in the event of material financial misstatement or misconduct.

Our strategy requires the generation of cash in order to invest for growth. Cash flow is therefore a key performance measure in our performance share plan.

Participants will receive an additional number of shares equivalent to the amount of dividend payable per vested share during the relevant performance period.

Growth in our Emerging & International Markets is a key part of our strategy. Revenue in our Emerging & International Markets is therefore included as one of our performance share plan measures.

If our strategy succeeds, the total return to our shareholders will also increase and therefore we include a relative TSR measure in our long-term share plan.



#### One-off share awards

In order to implement our Group strategy, we recognise that it is not always possible to promote from within the Company. In the event that we recruit an Executive Director who is currently employed by another company, we recognise that we might be required to compensate that Executive Director for cash or share awards, they may forfeit on leaving their former employer. Our policy regarding such awards is detailed in the notes.

One-off share awards may be made under the provisions of Listing Rule 9.4.2 to facilitate the appointment of a new Executive Director. Such awards will be made on a case-by-case basis depending on the circumstances at the time to take account of amounts forfeited elsewhere on accepting appointment.

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| Maximum levels of payment   | Framework in which performance is assessed   |
|---|--|
| <p>The total maximum payable under the Annual Incentive Plan is 215% of base salary (150% Cash Incentive and 65% Equity Incentive).</p> | <p>The cash and share awards are subject to malus and clawback as detailed in the notes following this table.</p>  |
| <p>50% salary awarded for threshold performance.</p>  | <p>70% of the cash component is based on financial performance measures, which currently include revenue, trading profit and trading cash. The Remuneration Committee retains the discretion to adopt any financial performance measure that is relevant to the Company.</p> |
| <p>100% salary awarded for target performance.</p>  |  |
| <p>150% salary awarded for maximum performance.</p>   | <p>30% of the cash component is based on other business goals linked to the Company's strategy, which could include financial and non-financial measures.</p>  |
| <p>Performance assessed against individual objectives and Group financial targets.</p>  | <p>The Remuneration Committee has the discretion to apply a multiplier, adjusting the outcome up or down by 10% to reward or penalise conduct in respect of</p>  |

leadership, corporate reputation, ethics, organisational behaviours and representing the Company both internally and externally.

The maximum opportunity shown to the left cannot be exceeded through the application of the multiplier.

0% of salary awarded for performance below target.

The Remuneration Committee will use their judgement of the individual's performance in determining the level of equity award that may be awarded within the range of 50% to 65% of salary.

50% of salary awarded for target performance.

65% of salary awarded for maximum performance.

The equity component will vest in three equal tranches over a three-year period, provided that the annual performance conditions set at the beginning of each year continue to be met.

Performance assessed against individual performance which includes an element of Group financial targets.

Annual awards:

Currently:

47.5% of salary for threshold performance.

50% of the award vests on achievement of a three-year cumulative free cashflow target

95% of salary for target performance.

25% of the award vests subject to three-year Total Shareholder Return ( TSR ) at median performance relative to industry peers

190% of salary for maximum performance.

25% of the award vests subject to the achievement of revenue targets in Emerging & International Markets

These measures are described in more detail in the notes and the targets and performance against them will be disclosed in the Implementation Report if

appropriate

The Performance Share Award will vest on the third anniversary of the date of grant, depending on the extent to which the performance conditions are met over the three year period commencing in the year the award was made

The Remuneration Committee retains the discretion to change the measures and their respective weightings to ensure continuing alignment with the Company's strategy

The cash and share awards are subject to malus and clawback as detailed in the notes following this table.

Awards made prior to 2014 were subject to TSR and cash flow targets.

Each award will be determined on a case-by-case basis. In normal circumstances such awards will be no more beneficial than the value of amounts forfeited by the Executive Director on leaving a previous company to join the Board.

The Remuneration Committee has the discretion to apply performance conditions to one-off awards if appropriate. However, if it is impossible to replicate the vesting conditions applicable to awards granted by other companies, awards may be made without performance conditions.

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SMITH & NEPHEW ANNUAL REPORT 2013

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Directors remuneration report *continued*

Notes to Future policy table Executive Directors

Changes to remuneration policy

The remuneration policy described in the future policy table Executive Directors is the same remuneration policy in respect of Executive Directors that has been in force since the beginning of 2012. It is anticipated that this policy will apply at least until the Annual General Meeting in 2017. The only change made has been to introduce a third performance measure to our Performance Share Programme.

Performance measures Annual Incentive Plan

The performance measures which apply to the Annual Incentive Plan for Executive Directors comprise 70% financial measures and 30% business goals linked to the Company's strategy, which could include financial and non-financial measures.

The financial measures may differ from year to year to provide continued alignment with the Company strategy. Measures to be used in 2014 are detailed in the Implementation Report. Each year the measures are chosen in order to relate to our Strategic Priorities and in turn to our key performance indicators, which are set out on pages 12 and 13. The performance targets are set by taking into account the strategy of the Company and are designed to be realistic yet stretching.

The business measures will differ from year to year as the evolving corporate strategy means that we will wish to set Executive Directors different business objectives in order to meet the current corporate needs. The business objectives are personal to each Executive Director, and are tailored to reflect their role and responsibilities during the year. These are set at the start of the year and reflect the most important areas of strategic focus for the Company. The Remuneration Committee sets annual measurement criteria (performance targets) that are appropriate to motivate and measure an Executive Director's performance in any one year. The factors taken into consideration include the three-year strategic plan, prior years' delivered performance and budgeted performance. In the past, measures have included R&D investment, succession planning, employee engagement, compliance, development of product portfolio, M&A activity and shared services implementation.

Performance measures

Performance Share Programme

The performance measures which apply to the Performance Share Programme awards made in 2014 relate to cumulative free cash flow, revenue in Emerging & International Markets and Total Shareholder Return. We have

chosen three measures which are relevant for the long-term success of the Company.

The free cash flow measure is important for us in a period of growth, when we need to generate cash to fund both organic and inorganic investment.

Revenue in Emerging & International Markets is important for us when we are seeking to generate profitable revenue in new markets and from new products.

The Total Shareholder Return measure, which compares our long-term performance against that of our peers, seeks to align the payout of the Performance Share Programme with the experience of our Shareholders. This helps Executive Directors relate to the Shareholder experience and ensure that vesting is aligned to the out-performance of our sector.

The Remuneration Committee will keep these performance measures under review and retains the discretion to alter the measures or their respective weightings to ensure continuing alignment to the corporate strategy.

#### Malus and clawback

The Remuneration Committee may determine that an unvested award or part of an award may not vest (regardless of whether or not the performance conditions have been met) or may determine that any cash bonus, vested shares, or their equivalent value in cash be returned to the Company in the event that any of the following matters is discovered:

A material misstatement of the Company's financial results; or

A material error in determining the extent to which any performance condition has been satisfied; or

A significant adverse change in the financial performance of the Company, or a significant loss at a general level or at the division or function in which a participant worked; or

Inappropriate conduct (for example reputational issues), capability or performance by a participant, or within a team business area or profit centre.

These provisions apply to share awards under the Global Share Plan 2010 and cash amounts under the Annual Cash Incentive Plan.

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**Illustrations of the application of the remuneration policy**

The following charts show the potential split between the different elements of the Executive Directors' remuneration under three different performance scenarios:

Data for the Chief Executive Officer assumes an exchange rate of 1 = £0.8494.

**Policy on recruitment arrangements**

Our policy on the recruitment of Executive Directors is to pay a fair remuneration package for the role being undertaken and the experience of the Executive Director appointed. In terms of base salary, we will seek to pay a salary comparable, in the opinion of the Committee, to that which would be paid for an equivalent position elsewhere. The Remuneration Committee will determine a base salary in line with the policy and having regard to the parameters set out on pages 64 and 65. Incoming Executive Directors will be entitled to pension, benefit and incentive arrangements which are the same as provided to existing Executive Directors. On that basis, awards would not exceed 405% of base salary.

We recognise that in the event that we require a new Executive Director to relocate to take up a position with the Company, we will also pay relocation and related costs as described in the Future policy table on pages 64 and 65, which is in line with the relocation arrangements we operate across the Group.

We also recognise that in many cases, an external appointee may forfeit sizeable cash bonuses and share awards if they choose to leave their former employer and join us. The Remuneration Committee therefore believes that we need the ability to compensate new hires for incentive awards they give up on joining us. The Committee will use its discretion in setting any such compensation, which will be decided on a case-by-case basis. We will only provide compensation which is no more beneficial than that given up by the new appointee and we will seek evidence from the previous employer to confirm the full details of bonus or share awards being forfeited. As far as possible, we will seek to replicate forfeited share awards using Smith & Nephew incentive plans or through reliance on 9.4.2 in the Listing Rules, whilst at the same time aiming for simplicity.

If we appoint an existing employee as an Executive Director of the Company, pre-existing obligations with respect to remuneration, such as pension, benefits and legacy share awards, will be honoured. Should these differ materially from current arrangements, these will be disclosed in the next Implementation Report.

We will supply details via an announcement to the London Stock Exchange of an incoming Executive Director's remuneration arrangements at the time of their appointment.

### Service contracts

We employ Executive Directors on rolling service contracts with notice periods of up to 12 months from the Company and six months from the Executive Director. On termination of the contract, we may require the Executive Director not to work their notice period and pay them an amount equivalent to the base salary and payment in lieu of pension and benefits they would have received if they had been required to work their notice period.

Under the terms of the Executive Director's service contract, Executive Directors are restricted for a period of 12 months after leaving the employment of the Company from working for a competitor, soliciting orders from customers and offering employment to employees of Smith & Nephew. The Company retains the right to waive these provisions in certain circumstances. In the event that these provisions are waived and the former Executive Director commences employment earlier than at the end of the notice period, no further payments shall be made in respect of the portion of notice period not worked. Directors' service contracts are available for inspection at the Company's registered office: 15 Adam Street, London WC2N 6LA.



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SMITH & NEPHEW ANNUAL REPORT 2013

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Directors remuneration report *continued*

**Policy on payment for loss of office**

Our policy regarding termination payments to departing Executive Directors is to limit severance payments to pre-established contractual arrangements. In the event that the employment of an Executive Director is terminated, any compensation payable will be determined in accordance with the terms of the service contract between the Company and the Executive Director, as well as the rules of any incentive plans.

Under normal circumstances (excluding termination for gross misconduct) all leavers are entitled to receive termination payments in lieu of notice equal to base salary, payment in lieu of pension, and benefits. In some circumstances additional benefits may become payable to cover reimbursement of untaken holiday leave, repatriation and outplacement fees, legal and financial advice.

In addition, we may also in exceptional circumstances exercise our discretion to pay the Executive Director a proportion of the annual cash incentive they would have received had they been required to work their notice period. Any entitlement or discretionary payment may be reduced in line with the Executive Director's duty to mitigate losses, subject to applying our non-compete clause.

We will supply details via an announcement to the London Stock Exchange of a departing Executive Director's termination arrangements at the time of departure.

In the case of a change of control which results in the termination of an Executive Director or a material alteration to their responsibilities or duties, within 12 months of the event, the Executive Director would be entitled to receive 12 months' base salary plus payment in lieu of pension and benefits. In addition, the Remuneration Committee has discretion to pay an Executive Director in these circumstances an annual cash incentive. For Directors appointed prior to 1 November 2012, an automatic annual cash incentive is payable at target.

In the event that an Executive Director leaves for reasons of ill-health, death, redundancy or retirement in agreement with the Company, then the vesting of any outstanding annual cash incentive and equity incentive awards will generally depend on the Remuneration Committee's assessment of performance to date. Performance share awards will be pro-rated for the time worked during the relevant performance period, and will remain subject to performance over the full performance period.

For all other leavers, the annual cash incentive will generally be forfeited and outstanding equity incentive awards and performance share awards will lapse.

One-off awards granted on appointment will normally lapse on leaving except in cases of death, retirement, redundancy, or ill-health. The Remuneration Committee has discretion to permit such awards to vest in other

circumstances and will be subject to satisfactorily meeting performance conditions if applicable.

The Remuneration Committee retains discretion to alter these provisions on a case-by-case basis following a review of circumstances and to ensure fairness for both Shareholders and Executive Directors.

We will supply details via an announcement to the London Stock Exchange of an out-going Executive Director's remuneration arrangements around the time of leaving.

### Policy on shareholding requirements

The Remuneration Committee believes that one of the best ways our Executive Directors can have a greater alignment with Shareholders is for them to hold a significant number of shares in the Company. Executive Directors are therefore expected to build up a holding of Smith & Nephew shares worth two-times their base salary. In order to reinforce this expectation, we require them to retain 50% of all shares vesting under the Company share plans (after tax) until this holding has been met recognising that differing international tax regimes affect the pace at which an Executive Director may fulfil the shareholding requirement. When calculating whether or not this requirement has been met, we will include ordinary shares or ADRs held by the Executive Director and their immediate family and the intrinsic value of any vested but unexercised options.

### Statement of consideration of employment conditions elsewhere in the Company and differences to the Executive Director Policy

All employees across the Group including the Executive Directors are incentivised in a similar manner. Although the salary levels and maximum opportunities under bonus and share plans differ, generally speaking the same targets and performance conditions relating to the Company's strategy apply throughout the organisation.

Executive Director base salaries will generally increase at a rate in line with the average salary increases awarded across the Company. Given the diverse geographic markets within which the Company operates, the Committee will generally be informed by the average salary increase in both the market local to the Executive and the UK, recognising the Company's place of listing, and will also consider market data periodically.

A range of different pension arrangements operate across the Group depending on location and/or length of service. Executive Directors and Executive Officers either participate in the legacy pension arrangements relevant to their local market or receive a cash payment of 30% of salary in lieu of a pension. Senior Executives who do not participate in a local Company pension plan receive a cash payment of 20% of salary in lieu of pension. Differing amounts apply for lower levels within the Company.

The Company has established a benefits framework under which the nature of benefits varies by geography. Executive Directors participate in benefit arrangements similar to those applied for employees within the applicable location.

All employees are set objectives at the beginning of each year, which link through to the objectives set for the Executive Directors. Annual cash incentives payable to employees across the Company depend on the satisfactory completion of these objectives as well as performance against relevant Group and divisional financial targets relating to revenue, trading profit and trading cash, similar to the financial targets set for the Executive Directors.

Executive Officers and Senior Executives (currently 72) participate in the annual Equity Incentive Programme and the Performance Share Programme. The maximum amounts payable are lower, but the performance conditions are the same as those that apply to the Executive Directors.

No specific consultation with employees has been undertaken relating to Director remuneration. However, regular employee surveys are conducted across the Group, which cover a wide range of issues relating to local employment

conditions and an understanding of Group-wide strategic matters. Currently over 4,500 employees in 32 countries participate in one or more of our global share plans.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## CORPORATE GOVERNANCE 71

**Future policy table**

## Chairman and Non-executive Directors

The following table and accompanying notes explain the different elements of remuneration we pay to our Chairman and Non-executive Directors. No element of their remuneration is subject to performance. All payments made to the Chairman are determined by the Remuneration Committee, whilst payments made to the Non-executive Directors are determined by the Directors who are not themselves Non-executive Directors, currently the Chairman, the Chief Executive Officer and the Chief Financial Officer.

**How the component supports the short-****and long-term strategy of the Company****How the component operates****Maximum levels of payment****Annual fees**

## Basic annual fee

To attract and retain Directors by setting fees at rates comparable to what would be paid in an equivalent position elsewhere.

Fees will be reviewed periodically. In future, any increase will be paid in shares until 25% of the total fee is paid in shares.

Annual fees are currently as follows:

£63,000 in cash plus £3,150 in shares; or

A proportion of the fees are paid in shares in the third quarter of each year in order to align Non-executive Directors fees with the interest of

Fees are set in line with market practice for fees paid by similarly sized UK listed companies.

\$120,000 in cash plus \$6,000 in

Shareholders.

shares.

Annual fees are set and paid in UK sterling or US dollars depending on the location of the Non-executive Director. If appropriate, fees may be set and paid in alternative currencies.

Chairman fee:

£400,000 plus £20,000 in shares (to April 2014).

£300,000 plus £100,000 in shares (from April 2014).

Whilst it is not expected to increase the fees paid to the Non-executive Directors and the Chairman by more than the increases paid to employees generally, in exceptional circumstances, higher fees might become payable.

The total maximum aggregate fees payable to the Non-executive Directors will not exceed £1.5m as set out in the Company's articles of association.

Fee for Senior Independent Director and Committee Chairmen

To compensate Non-executive Directors for the additional time spent as Committee Chairmen or as the Senior Independent Director.

A fixed fee is paid, which is reviewed periodically.

£15,000 in cash; or

\$27,000 in cash.

Whilst it is not expected that the fees paid to the Senior Independent Director or Committee Chairman will exceed the increases paid to employees generally, in exceptional circumstances, higher fees might become payable.

Intercontinental travel fee

To compensate Non-executive Directors for the time spent travelling to attend meetings in another continent.

A fixed fee is paid, which is reviewed periodically.

£3,500 in cash; or

\$7,000 in cash.

Whilst it is not expected to increase these fees by more than the increases paid to employees generally, in exceptional circumstances, higher fees might become payable.

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### SMITH & NEPHEW ANNUAL REPORT 2013

#### 72 CORPORATE GOVERNANCE

Directors remuneration report *continued*

#### Notes to Future policy table Non-executive Directors

##### Changes to remuneration policy

The Board has altered the policy regarding the payment of Non-executive Directors and to the Chairman in one respect in 2013, by introducing the payment of a proportion of the fees in the form of shares. The fees paid to the Non-executive Directors and to the Chairman were reviewed in July 2013 and it was agreed that the basic fee should be increased by 5% (there having been no increase to these fees since August 2011) and that the increase be paid in the form of shares. The amount of the increase less applicable taxes was used to purchase shares in the market on 15 August 2013. Going forward any increase in the level of fees paid to a Non-executive Director will be paid in the form of shares until 25% of the Non-executive Director's fee is paid in the form of shares. We have made this change in order to align the fees paid to Non-executive Directors with the experience of our Shareholders. With the appointment of Roberto Quarta as Chairman of the Company with effect from the Annual General Meeting, we have taken the opportunity to pay 25% of his fees in the form of shares immediately.

##### Policy on recruitment arrangements

Any new Non-executive Director shall be paid in accordance with the current fee levels on appointment, in line with the policy set out above. With respect to the appointment of a new Chairman, fee levels will take into account market rates, the individual's profile and experience, the time required to undertake the role and general business conditions. In addition, the Remuneration Committee retains the right to authorise the payment of relocation assistance or an accommodation allowance in the event of the appointment of a Chairman not based within the UK.

##### Letters of appointment

The Chairman and Non-executive Directors have letters of appointment which set out the terms under which they provide their services to the Company and are available for inspection at the Company's registered office: 15 Adam Street, London WC2N 6LA. The appointment of Non-executive Directors is not subject to a notice period, nor is there any compensation payable on loss of office, for example, should they not be re-elected at an Annual General Meeting. The appointment of the Chairman is subject to a notice period of six months.

The Chairman and Non-executive Directors are required to acquire a shareholding in the Company equivalent in value to one times their basic fee within two years of their appointment to the Board.

#### Statement of consideration of Shareholder views

This policy report sets out the remuneration policy in relation to Executive Directors, which has been in place since 2012. As this policy evolved at the end of 2011 and during 2012, we engaged actively with Shareholders to explain our remuneration arrangements and to discuss their views on our proposals. At the time, Joseph Papa, the Chairman of the Remuneration Committee and members of the Senior Executive Team met with the holders of around 30% of our shares, including collectively with a number of smaller engaged investors, as well as Shareholder advisory bodies. We discussed the structure of our remuneration package, our policies on termination, recruitment, shareholding requirements and the operation of Annual Incentive Plan. The Directors' remuneration report was approved by 96% of Shareholders who voted at the Annual General Meeting in 2013 and we received feedback from Shareholders around the time of this meeting that they understood and approved of our remuneration arrangements. Although the remuneration policy has remained essentially unchanged as in previous years, given the changes in remuneration reporting, we also conducted an engagement programme with our larger Shareholders in 2013. Joseph Papa met with the holders of around 20% of our shares, and with a number of Shareholder advisory bodies. He has also been available to discuss any aspect of our remuneration programme with Shareholders throughout the year. The Shareholders who have engaged with us have all been supportive of our approach to remuneration, recognising the link between the corporate strategy and executive reward.



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**The Implementation Report**

The Remuneration Committee presents the Annual report on remuneration, (the Implementation Report ), which together with the annual statement will be put to shareholders as an advisory vote at the Annual General Meeting to be held on 10 April 2014.

**Remuneration Committee**

The Chairman of the Remuneration Committee is Joseph Papa and the remaining members of the Remuneration Committee are Baroness Virginia Bottomley, Pamela Kirby, Brian Larcombe and Richard De Schutter, all of whom are independent Non-executive Directors and served throughout the year.

From time to time, other members of the Board attended meetings of the Remuneration Committee by invitation. In addition, the meetings are also attended by Susan Swabey, Company Secretary, Helen Maye, Chief Human Resources Officer and Bob Newcomb, SVP Global Rewards. Members of the Board and the Executive Team left any meeting at which their own remuneration was discussed.

During the year the Remuneration Committee met five times and agreed three matters by written resolution. Our main responsibilities are:

Determination of remuneration policy for Executive Directors and senior executives

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

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

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

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

Approval of Directors Remuneration Report ensuring compliance with related governance provisions

Continuance of constructive engagement on remuneration issues with Shareholders

Consideration of remuneration policies and practices across the Group.

During the year, the Remuneration Committee received information and advice from Towers Watson, an independent executive remuneration consultancy firm appointed by the Remuneration Committee in 2011 following a full tender process. They provided advice on market trends and remuneration issues in general, attended Remuneration Committee meetings, assisted in the review of the Director's Remuneration Report and in determining the third performance measure for the Performance Share Programme. The fees paid to Towers Watson for Remuneration Committee advice during 2013, charged on a time and expense basis, totalled £59,538. Towers Watson also provided other human resources and compensation advice to the Company for the level below the Board. Towers Watson comply with the Code of Conduct in relation to Executive Remuneration Consulting in the United Kingdom and the Remuneration Committee is satisfied that their advice is objective and independent.

Key activities of the Remuneration Committee in 2013 were:

Determination of remuneration packages and termination arrangement for certain Executive Officers

Development of revised reporting style on remuneration in line with the new reporting regulations

Reviewed Executive service contracts

Reviewed and revised the performance measures applying to our Performance Share Programme

Monitored the use of shares required for our employee share plans to ensure they remained within the dilution limits

Monitored adherence by executives to our shareholding guidelines

Approved the remuneration package for Roberto Quarta, our Chairman Elect

Reviewed and approved remuneration arrangements for various Executive Officers

Amended the terms of reference of the Remuneration Committee to reflect new reporting regulations

Met with key Shareholders to discuss remuneration matters.  
The Implementation Report sets out both what we have paid our Directors in 2013 and what we intend to pay them in 2014.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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Directors remuneration report *continued*

Single total figure on remuneration Executive Directors

| Director                  | Base salary | Payment in lieu of pension | Fixed pay<br>Taxable benefits | Annual variable pay<br>Annual Incentive Plan cash | Hybrid Annual Incentive Plan equity | Performance Share Plan | Long-term variable pay<br>Share Option Plan | All-Employee Share Plans | Other items in the nature of remuneration<br>One-off awards |
|---------------------------|-------------|----------------------------|-------------------------------|---|-------------------------------------|------------------------|---|--------------------------|---|
| Olivier Bohuon            |             |                            |                               |   |                                     |                        |   |                          |   |
| Appointed 1 April 2011    |             |                            |                               |   |                                     |                        |   |                          |   |
| 2013                      | \$1,425,559 | \$427,668                  | \$107,160                     | \$1,793,584                                       | \$933,410                           | \$0                    | \$0   |                          | \$4,6   |
| 2012                      | \$1,394,190 | \$418,257                  | \$482,815                     | \$1,755,285                                       | \$906,224                           |                        |   |                          | \$4,9   |
| Julie Brown               |             |                            |                               |   |                                     |                        |   |                          |   |
| Appointed 4 February 2013 |             |                            |                               |   |                                     |                        |   |                          |   |
| 2013                      | \$708,450   | \$212,536                  | \$22,510                      | \$858,978   | \$390,800                           |                        |   | \$5,684                  | \$838,266 \$3,0   |

These figures have been calculated as follows:

**Base salary:** the actual salary receivable for the year.**Payment in lieu of pension:** the value of the salary supplement paid by the Company in lieu of a pension.**Benefits:** the gross value of all taxable benefits (or benefits that would be taxable in the UK) received in the year. Prior years are restated to reflect amounts not known at the date of signing the previous annual report.**Annual Incentive Plan cash:** the value of the cash incentive payable for performance in respect of the relevant financial year.**Annual Incentive Plan equity:** the value of the equity element awarded in respect of performance in the relevant financial year, but subject to an ongoing performance test as described on pages 66 and 67 of this report.**Performance Share Plan:** the value\* of shares vesting that were subject to performance over the three-year period ending on 31 December in the relevant financial year.

**Share Option Plan:** the embedded gain\* of options vesting that were subject to performance over the three-year period ending on 31 December in the relevant financial year.

**All-Employee Share Plans:** the gain on the date of grant for SAYE awards (these are only subject to an employment condition and therefore the total value is captured in the year of grant), reflecting the 20% discount at which options are granted in the relevant financial year.

**One-off awards:** the total face value of shares awarded to Julie Brown on appointment in 2013 as described on pages 66 and 67 of this report (these awards are only subject to an employment condition and therefore the total value is captured in the year of award).

**Total:** the sum of the above elements.

\* Awards and options granted in 2011 subject to a three-year performance period ending on 31 December 2013 have lapsed.

The amounts have been converted into US\$ for ease of comparability using the exchange rates of £ to US\$1.5632 and to US\$1.3278.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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**Base salary**

With effect from 1 April in each year Executive Directors were paid the following base salaries:

|                | 2012      | 2013             |
|----------------|-----------|------------------|
| Olivier Bohuon | 1,050,000 | <b>1,081,500</b> |
| Julie Brown    | N/A       | <b>£500,000</b>  |

In February 2014, we reviewed the base salaries of the Executive Directors, having considered general economic conditions and average salary increases across the rest of the Group, which have averaged at 2.8%. The Remuneration Committee has therefore agreed that the Executive Directors' base salaries will increase by 2.8% with effect from 1 April 2014 to the following:

|                |           |
|----------------|-----------|
| Olivier Bohuon | 1,111,782 |
| Julie Brown    | £514,000  |

**Payment in lieu of pension**

In 2013, both Olivier Bohuon and Julie Brown received a salary supplement of 30% of their basic salary to apply towards their retirement savings, in lieu of membership of one of the Company's pension schemes. The same arrangement will apply in 2014.

**Benefits**

In 2013, both Olivier Bohuon and Julie Brown received death in service cover of seven times basic salary, of which four times salary is payable as a lump sum with the balance used to provide for any spouse and dependant persons. They also received health cover for themselves and their families and a car allowance. Olivier Bohuon also received financial consultancy advice and assistance with travel costs between London and Paris. The same arrangements will apply in 2014. The following table summarises the value of benefits on an element-by-element basis in respect of 2012 and 2013.

|  | Olivier Bohuon | Adrian<br>Hennah | Julie Brown |
|--|----------------|------------------|-------------|
|--|----------------|------------------|-------------|

|                              | 2012         | 2013              | 2012    | 2013           |
|------------------------------|--------------|-------------------|---------|----------------|
| Health cover                 | £16,870      | <b>£12,088(i)</b> | £1,439  | <b>£1,130</b>  |
| Car and fuel allowance       | 18,486       | <b>18,050</b>     | £21,524 | <b>£13,270</b> |
| Financial consultancy advice | £33,751      | <b>25,577</b>     |         |                |
| Travel costs                 | £15,647      | <b>£19,407</b>    | N/A     | N/A            |
| Relocation costs             | £226,893(ii) | <b>£0</b>         | N/A     | N/A            |

(i) Olivier Bohuon is a member of our international healthcare plan.

(ii) One-off relocation expense relating to relocating Olivier Bohuon from Paris to London. Prior years are restated to reflect amounts not known at the date of signing the previous annual report.

### Annual Incentive Plan

During 2013, the Annual Incentive Plan for Executive Directors was based in the achievement of specific financial and business objectives as follows:

|                      |     |
|----------------------|-----|
| Financial objectives | 70% |
|----------------------|-----|

Revenue 30%

Trading profit 30%

Trading cash 10%

|                     |     |
|---------------------|-----|
| Business objectives | 30% |
|---------------------|-----|

R&D investment

Succession planning

Employee engagement

Compliance

Development of product portfolio (Olivier Bohuon only)

Shared services (Julie Brown only)

At the end of 2013, the Remuneration Committee conducted an assessment of each Executive Director against their financial and business objectives.

Over the period, revenue was \$4,351m (ahead of target), trading profit was \$987m (ahead of target) and trading cash flow \$877m (between target and maximum).

The Board have considered whether it would be in the best interests of the Company and its Shareholders to disclose the precise targets agreed for each of the performance measures in 2013. The targets for each year are set within the context of the Group's five-year plan, which is updated at least annually. If we were to disclose the precise targets for one year of the plan, this would give information to our competitors about our long-term plans, which they could use to compete against us, for example by re-timing the launch of new products or extension into new growth areas. This could be detrimental to our commercial performance both in 2014 and going forward. The Board has concluded that even though the actual results for 2013 are known and published, it would be commercially sensitive to disclose what the precise targets determined at the beginning of 2013 were.

The Remuneration Committee reviewed the performance of Olivier Bohuon and Julie Brown against their agreed business objectives for 2013. The Committee determined that Olivier Bohuon had an outstanding year. He led the Group strongly forward in both strategic and commercial terms, building and rebalancing the business through investments and acquisitions in areas of higher growth whilst delivering growth and Shareholder value. The Committee determined that Julie Brown also performed to a high standard in 2013. In her first year as Chief Financial Officer, Julie has strengthened the Group's financial platform, processes and disciplines, introducing new frameworks and methodologies to support the sustained delivery of Smith & Nephew's strategic priorities. It is not possible to disclose the precise personal targets set as a number of the measurements continue to apply into 2014 and would be commercially sensitive if known by our competitors. The Committee did highlight a number of their achievements as follows:



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Directors remuneration report *continued*

[Commentary on 2013 performance](#)

Acquisitions and R&D investment

**Olivier Bohuon**

Significantly increased investment in organic R&D and, through successful M&A, further strengthened the Group's business and product pipeline. More closely aligned R&D to growth opportunities including meeting the needs of emerging market customers. Increased the rate of innovation to support sustainable growth and maximise long-term value to Shareholders.

**Julie Brown**

Delivered Capital Allocation Framework that ensures highly disciplined use of cash; enabling focused investment in key areas and balance sheet efficiency. Supported the completion of three emerging market deals over the year. Return on investment assessments established for R&D and Capital investments to ensure resources are allocated to areas that generate the best return for business.

Succession planning

**Olivier Bohuon**

Succession plans refreshed for all Executive Officers and top talent identified, developed and retained through significant personal engagement across the Company.

**Julie Brown**

Strengthened finance management team through providing stretching development opportunities for key individuals and placement of top talent. Completed comprehensive Finance Talent Review and established succession plans for all key finance leadership positions.

Employee engagement

**Olivier Bohuon**

**Julie Brown**

Delivered demonstrable improvements from implementation of 2012 Employee Survey actions and initiated Great places to Work in initial tranche of 12 countries.

Increased business knowledge, cross-functional alignment, empowerment and personal development across the finance function, ensured employees embrace objectives in context of Group strategy and pursue stretching goals.

Compliance

**Olivier Bohuon**

**Julie Brown**

Consistently demonstrated the highest personal ethics, held management to these same standards, and reinforced imperative in all employee communications.

Set the tone from the top with the highest personal standards and ensured timely and rigorous enactment of financial controls on all strategic plans, product development and acquisitions.

Development of product portfolio

**Olivier Bohuon**

**Julie Brown**

Delivered high cadence of new products including first portfolios for the emerging markets, major knee platform, Sports Medicine advances and 25 Advanced Wound Management launches.

Not applicable

Shared services

**Olivier Bohuon**

**Julie Brown**

Not applicable

Initiated a Finance Transformation Programme to consolidate shared services globally to leverage efficiency across the Group and strengthen KPI reporting.

The Remuneration Committee also considered whether to apply the multiplier to the annual incentive assessment of Olivier Bohuon and Julie Brown and agreed that no multiplier was appropriate in respect of 2013. In summary the

performance of the Executive Directors against the targets set for 2013 was therefore as follows:

|                       | Below threshold | Between threshold and target | Between target and maximum | Above maximum |
|-----------------------|-----------------|------------------------------|----------------------------|---------------|
| Revenue (30%)         |                 |                              | ü                          |               |
| Trading profit (30%)  |                 |                              | ü                          |               |
| Trading cash (10%)    |                 |                              | ü                          |               |
| Business objectives   |                 |                              |                            |               |
| (30%): Olivier Bohuon |                 |                              |                            | ü             |
| Business objectives   |                 |                              |                            |               |
| (30%): Julie Brown    |                 |                              | ü                          |               |
| Multiplier (+/- 10%): |                 |                              |                            |               |
| Olivier Bohuon        |                 | N/A                          |                            |               |
| Multiplier (+/- 10%): |                 |                              |                            |               |
| Julie Brown           |                 | N/A                          |                            |               |

In summary, as a result of the performance described above, the Remuneration Committee determined that the following awards be made under the Annual Incentive Plan in respect of performance in 2013:

| Executive Director | Cash component |           | Equity component |          |
|--------------------|----------------|-----------|------------------|----------|
|                    | % of salary    | Amount    | % of salary      | Amount   |
| Olivier Bohuon     | 125%           | 1,350,794 | 65%              | 702,975  |
| Julie Brown        | 110%           | £549,500  | 50%              | £250,000 |

As both Olivier Bohuon and Julie Brown achieved the targets set them in 2013, the first tranche of Equity Incentive Award made in 2013 and the second tranche of the Equity Incentive Award made in 2012 (to Olivier Bohuon only) will vest.

#### Annual Incentive Plan 2014

The Remuneration Committee has also reviewed the Annual Incentive Plan arrangements for 2014 and has determined that the following performance measures and weightings will apply to the financial objectives as in 2013. The business objectives for the Executive Directors for 2014 will therefore be as follows:

#### Financial objectives

|             | Olivier Bohuon | Julie Brown |
|-------------|----------------|-------------|
| Revenue 30% | 70%            | 70%         |

Trading profit 30%

Trading cash 10%

Business objectives

|              | <b>Olivier Bohuon</b> | <b>Julie Brown</b> |
|--------------|-----------------------|--------------------|
| Reinvestment | 5%                    | 10%                |
| Business     | 25%                   | 20%                |
| People       |                       |                    |
| Customer     |                       |                    |

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The Board has determined that the disclosure of performance targets at this time is commercially sensitive. As explained on page 75, these targets are determined within the context of a five-year plan and the disclosure of these targets could give information to our competitors about details of our strategy which would enable them to compete more effectively with us to the detriment of our performance.

For the financial performance measures, Target is set at target performance as approved by the Board in the Budget for 2014. Threshold and Maximum are set at +/- 3% from the target for revenue and trading profit measures and +/- 10% for the cash flow measure.

**Details of awards made under the Equity Incentive Programme**

Details of conditional awards over shares, granted as part of the Annual Equity Incentive Programme to Executive Directors under the rules of the Global Share Plan 2010 in 2013 are shown below. The performance conditions and performance periods applying to these awards are detailed above.

| <b>Date granted</b> | <b>Number of shares under award</b> | <b>Date of vesting</b>   |
|---------------------|-------------------------------------|--|
| Olivier Bohuon      |                                     |  |
| 7 March 2013        | 82,423 ordinary shares              | 1/3 on 7 March 2014,<br>1/3 on 7 March 2015 and<br>1/3 on 7 March 2016 |

No awards were made to Julie Brown under the Equity Incentive Programme in 2013, as she was not an employee in 2012 and did not participate in the programme in 2013. The exact awards granted in 2014 in respect of service in 2013 will be disclosed in the 2014 Annual Report.

**Performance Share Programme grants**

Performance share awards in 2013 were made to Executive Directors under the Global Share Plan 2010 to a maximum value of 190% of salary (95% for target performance). Performance will be measured over the three financial years beginning in 2013 and will vest subject to performance and continued employment in 2016.

50% of the award will vest based on the Company's Total Shareholder Return (TSR) performance relative to a bespoke peer group of companies in the medical devices sector over a three-year period commencing 1 January 2013 as follows:

| <b>Relative TSR ranking</b> | Award vesting as % of salary |
|-----------------------------|------------------------------|
| Below median                | Nil                          |
| Median                      | 23.75%                       |
| Upper quartile              | 95%                          |

Awards will vest on a straight-line basis between these points. If the Company's TSR performance is below median, none of this part of the award will vest.

The bespoke peer group for the 2013 awards comprises of the following companies: Arthrocare, Baxter, Becton Dickinson, Boston Scientific, CR Bard, Coloplast, Conmed, Covidien, Edwards LifeSciences, Medtronic, Nobel Biocare, Nuvasive, Orthofix, Stryker, St Jude Medical, Wright Medical and Zimmer.

The Group's TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by Towers Watson. TSR is calculated in common currency using a three-month averaging period at the start and end of the performance period. The Committee has established protocols for dealing with companies that cease to be listed or merger and acquisition activity within the peer group.

The remaining 50% of the award is subject to cumulative free cash flow performance. Free cash flow is defined as net cash inflows from operating activities, less capital expenditure. Free cash flow is the most appropriate measure of cash flow performance because it relates to the cash generated to finance additional investment in business opportunities, debt repayments and distributions to Shareholders. This measure includes significant elements of operational and financial performance and helps to align Executive Director awards with shareholder value creation.

The 50% of the 2013 award subject to free cash flow performance will vest as follows:

| <b>Cumulative free cash flow</b> | Award vesting as % of salary |
|----------------------------------|------------------------------|
| Below \$1.55bn                   | Nil                          |
| \$1.55bn                         | 23.75%                       |
| \$1.78bn                         | 47.5%                        |
| \$2.01bn or more                 | 95%                          |

#### Performance Share Programme 2014

Performance share awards will be made in 2014 to Executive Directors under the Global Share Plan 2010 to a maximum value of 190% of salary (95% for target performance). Performance will be measured over the three financial years beginning in 2014 and will vest subject to performance and continued employment in 2017. Vesting will be subject to three performance measures. 50% of the award will be subject to free cash flow performance, 25% to revenue in Emerging & International Markets and 25% to TSR.

Free cash flow is defined as net cash inflows from operating activities, less capital expenditure. Free cash flow is the most appropriate measure of cash flow performance because it relates to the cash generated to finance additional

investment in business opportunities, debt repayments and distributions to Shareholders. This measure includes significant elements of operational and financial performance and helps to align Executive Director awards with Shareholder value creation.

The 50% of the award that will be subject to free cash flow performance will vest as follows:

| <b>Cumulative free cash flow</b> | <b>Award vesting as % of salary</b> |
|----------------------------------|-------------------------------------|
| Below \$1.64bn                   | Nil                                 |
| \$1.64bn                         | 23.75%                              |
| \$1.88bn                         | 47.5%                               |
| \$2.12bn or more                 | 95%                                 |

Awards will vest on a straight-line basis between these points.

Revenue in Emerging & International Markets is defined as cumulative revenue over a three-year period commencing 1 January 2014 from our Emerging & International Markets.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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Directors remuneration report *continued*

The 25% of the award that will be subject to revenue in Emerging & International Market performance will vest as follows:

**Revenue in Emerging &**

| <b>International Markets</b> | Award vesting as % of salary |
|------------------------------|------------------------------|
| Below Threshold              | Nil                          |
| Threshold                    | 11.875%                      |
| Target                       | 23.750%                      |
| Maximum or above             | 47.500%                      |

It is not possible to disclose precise targets for revenue growth in Emerging & International Markets, as this will give commercially sensitive information to our competitors concerning our growth plans in Emerging & International Markets, which they could use against us to launch new products and enter new markets. This would be detrimental to our business in the Emerging & International Markets, which are key to our success overall. Target is set at target cumulative revenue from Emerging & International Markets in the corporate plan approved by the Board for the three years commencing 1 January 2014. Threshold and Maximum are set at +/- 15% from target.

25% of the award will vest based on the Company's Total Shareholder Return (TSR) performance relative to a bespoke peer group of companies in the medical devices sector over a three-year period commencing 1 January 2014 as follows:

| <b>Relative TSR ranking</b> | Award vesting as % of salary |
|-----------------------------|------------------------------|
| Below median                | Nil                          |
| Median                      | 11.875%                      |
| Upper quartile              | 47.500%                      |

Awards will vest on a straight line basis between these points. If the Company's TSR performance is below median, none of this part of the award will vest.

The bespoke peer group for the 2014 awards comprises of the following companies: Arthrocare, Baxter, Becton Dickinson, Boston Scientific, CR Bard, Coloplast, Conmed, Covidien, Edwards LifeSciences, Medtronic, Nobel Biocare, Nuvasive, Orthofix, Stryker, St Jude Medical, Wright Medical and Zimmer.

The Group's TSR performance and its performance relative to the comparator group is independently monitored and reported to the Remuneration Committee by Towers Watson. TSR is calculated in common currency using a three-month averaging period at the start and end of the performance period. The Committee has established protocols



for dealing with companies that cease to be listed or merger and acquisition activity within the peer group.

#### Vesting of share options and awards made in 2010

In 2013, the Remuneration Committee also reviewed the vesting of conditional awards made to Executive Directors under the 2004 Performance Share Plan and share options granted under the 2004 Executive Share Option Plan in 2010.

Vesting of the conditional share awards made in 2010 was linked to adjusted EPS ( EPISA ) growth, and the number of shares could then be increased subject to TSR performance relative to the major companies in the medical devices industry. EPISA growth over the three years ended 31 December 2012 was 18.7% (adjusted for the Bioventus transaction) against the compounded market growth rate of 11.7%. Over the same period, the Company was ranked 10th out of 19 companies in the medical devices comparator group, which meant that the multiplier of one was applied to the number of shares vesting under the EPISA target.

The awards made to Adrian Hennah in 2010 lapsed on his leaving the Company. The award made in 2010 to David Illingworth, a former Executive Director vested on 1 March 2013 at 26%. The current Executive Directors did not receive awards in 2010, which was prior to their appointments to the Board at the Company.

Vesting of the share options were subject to TSR performance relative to the major companies in the medical devices industry. Over the three years ended 31 December 2012, the Company was ranked 10th out of 19 companies in the medical devices comparator group, which meant that the options vested at 33%. The share option granted in 2010 to Adrian Hennah lapsed on his leaving the Company. The share option granted in 2010 to David Illingworth, a former Executive Director, vested on 9 September 2013.

#### Vesting of share options and awards made in 2011

Since the end of the year, the Remuneration Committee has reviewed the vesting of conditional awards made to Executive Directors under the 2004 Performance Share Plan and share options granted under the 2004 Executive Share Option Plan in 2011.

Vesting of the conditional awards made in 2011 was linked to EPISA growth, and the number of shares could then be increased subject to TSR performance relative to the major companies in the medical devices industry. EPISA growth over the three years ended 31 December 2013 was 4%. This was well below the threshold for awards to vest. Over the same period, the Company was ranked 12th out of 19 companies in the medical devices comparator group, which meant that no multiplier was applied to the number of shares vesting under the EPISA target. The awards made to Adrian Hennah in 2011 lapsed on his leaving the Company. The award made in 2011 to Olivier Bohuon has therefore lapsed.

Vesting of the share options were subject to TSR performance relative to the major companies in the medical devices industry. Over the three years ended 31 December 2013, the Company was ranked 12th out of 19 companies in the medical devices comparator group, which meant that the options lapsed. The share option granted to Adrian Hennah in 2011 lapsed on his leaving the Company. The share option granted in 2011 to Olivier Bohuon has therefore lapsed.

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**Remuneration arrangements for Julie Brown**

On appointment as Chief Financial Officer and Director on 4 February 2013, Julie Brown's salary was set at £500,000 with her other benefits and ongoing incentive opportunities in line with the Smith & Nephew remuneration policy.

In addition to participation in the standard Smith & Nephew incentive plans, the Remuneration Committee made a one-off award over 75,000 shares which were valued at £536,250 on the date of grant. These shares will vest in three equal tranches in February 2014, 2015 and 2016 subject to continued employment. In making this award the Committee was informed by the value of share awards that Julie Brown was forfeiting at her previous employer which had a minimum value of £505,000 and a maximum value of £1,434,000 (excluding any share price movement). The Remuneration Committee felt it was appropriate to align Julie Brown's interests with those of our Shareholders immediately and to take into account these awards forfeited on joining Smith & Nephew.

**Summary of scheme interests awarded during the financial year**

| Basis on which award is made   | Olivier Bohuon   |            | Julie Brown      |            |
|--|------------------|------------|------------------|------------|
|  | Number of shares | Face value | Number of shares | Face value |
| Annual Equity Incentive Award (see pages 66 and 67)                          |                  |            |                  |            |
| 65% base salary at maximum   | 82,423           | 682,500    |                  |            |
| 50% base salary at target  |                  |            |                  |            |
| Performance Share Award (see pages 66 and 67)                                |                  |            |                  |            |
| 190% base salary at maximum  | 240,928          | 1,995,000  | 132,866          | £950,000   |
| 95% base salary at target  | 120,464          | 997,500    | 66,433           | £475,000   |
| Share award granted on joining Company in compensation (see pages 66 and 67) |                  |            | 75,000           | £536,250   |

Compensation for shares forfeited at former employer

Please see policy table on pages 66 and 67 for details of how the above plans operate. The number of shares is calculated using the closing share price on the day before the grant which for the awards granted on 7 March 2013 was £7.15.

Details of awards made under the Performance Share Programme

Details of conditional awards over shares, granted to Executive Directors subject to performance conditions are shown below. These awards were granted under the 2004 Performance Share Plan in 2011 and under the Global Share Plan 2010 in 2012 and 2013. The performance conditions and performance periods applying to these awards are detailed on pages 66 and 67.

| <b>Director</b> | <b>Date granted</b>  | <b>Number of ordinary shares under award</b> | <b>Date of vesting</b> |
|-----------------|----------------------|--|------------------------|
| Olivier Bohuon  | 7 September 2011 (i) | 227,547                                      | 7 September 2014       |
|                 | 8 March 2012         | 267,304                                      | 8 March 2015           |
|                 | 7 March 2013         | 240,928                                      | 7 March 2016           |
| Julie Brown     | 7 March 2013         | 132,866                                      | 7 March 2016           |

(i) On 6 February 2014 100% of the award granted to Olivier Bohoun lapsed following completion of the performance period.

Details of option grants under the All-Employee ShareSave Plan

Details of options held by Directors are shown below. These options were granted under the Smith & Nephew Sharesave Plan (2012).

| <b>Director</b> | <b>Date granted</b> | <b>Number of shares under option</b> | <b>Date of vesting</b> | <b>Exercise period</b>           | <b>Option price</b> |
|-----------------|---------------------|--------------------------------------|------------------------|----------------------------------|---------------------|
| Julie Brown     | 17 September 2013   | 2,400 ordinary shares                | 1 November 2018        | 1 November 2018 to 30 April 2019 | £6.25               |

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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Directors remuneration report *continued***Details of one-off awards**

Details of awards granted to Executive Directors on joining to Company to compensate them for shares forfeited on leaving their former companies are shown below. These awards are made under Listing Rule 9. There are no performance conditions attaching to these shares other than continued service.

| <b>Director</b> | <b>Date granted</b> | <b>Number of shares under award</b> | <b>Date of vesting</b> |
|-----------------|---------------------|-------------------------------------|------------------------|
| Olivier Bohuon  | 1 April 2011        | 66,666 ordinary shares              | 1 April 2014           |
| Julie Brown     | 7 March 2013        | 25,000 ordinary shares              | 4 February 2015        |
|                 |                     | 25,000 ordinary shares              | 4 February 2016        |

**Single total figure on remuneration Chairman and Non-executive Directors**

| <b>Director</b>   | <b>Basic annual fee (i)</b> | <b>Chairman's fee</b> | <b>Intercontinental travel fee</b> | <b>Total</b> |
|-------------------|-----------------------------|-----------------------|------------------------------------|--------------|
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|                      | 2012      | 2013             | 2012     | 2013            | 2012     | 2013            | 2012      | 2013             |
|----------------------|-----------|------------------|----------|-----------------|----------|-----------------|-----------|------------------|
| Sir John Buchanan    | £400,000  | <b>£420,000</b>  | n/a      | <b>n/a</b>      | £7,000   | <b>£0</b>       | £407,000  | <b>£420,000</b>  |
| Ian Barlow           | £63,000   | <b>£66,150</b>   | £15,000  | <b>£15,000</b>  | £7,000   | <b>£7,000</b>   | £85,000   | <b>£88,150</b>   |
| Baroness Bottomley   | £45,150   | <b>£66,150</b>   | n/a      | <b>n/a</b>      | £7,000   | <b>£7,000</b>   | £52,150   | <b>£73,150</b>   |
| Michael Friedman     | n/a       | <b>\$126,000</b> | n/a      | <b>n/a</b>      | n/a      | <b>\$28,000</b> | n/a       | <b>\$154,000</b> |
| (ii)                 |           |                  |          |                 |          |                 |           |                  |
| Pamela Kirby         | £63,000   | <b>£66,150</b>   | £15,000  | <b>£15,000</b>  | £7,000   | <b>£7,000</b>   | £85,000   | <b>£88,150</b>   |
| Brian Larcombe       | £63,000   | <b>£66,150</b>   | n/a      | <b>n/a</b>      | £7,000   | <b>£7,000</b>   | £70,000   | <b>£73,150</b>   |
| Joseph Papa          | \$120,000 | <b>\$126,000</b> | \$27,000 | <b>\$27,000</b> | \$42,000 | <b>\$28,000</b> | \$189,000 | <b>\$181,000</b> |
| Ajay Piramal         | £63,000   | <b>£66,150</b>   | n/a      | <b>n/a</b>      | £10,500  | <b>£10,500</b>  | £73,500   | <b>£76,650</b>   |
| Roberto Quarta (iii) | n/a       | <b>£4,846</b>    | n/a      | <b>n/a</b>      | n/a      | <b>n/a</b>      | n/a       | <b>£4,846</b>    |
| Richard De Schutter  | \$120,000 | <b>\$126,000</b> | \$27,000 | <b>\$27,000</b> | \$42,000 | <b>\$35,000</b> | \$189,000 | <b>\$188,000</b> |

(i) The basic annual fee includes shares purchased for the Chairman and Non-executive Directors in lieu of part of their annual fees details of which can be found in the table on page 71.

(ii) Appointed 11 April 2013.

(iii) Appointed 4 December 2013.

(iv) Total Executive and Non-executive Directors' emoluments for 2013 amounted to \$7,368,000 (2012 \$7,838,000).

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**Chief Executive Officer's remuneration compared to employees generally**

The percentage change in the remuneration of the Chief Executive Officer between 2012 and 2013 compared to that of all employees generally is as follows:

|                            | <b>Base salary</b> | <b>Benefits</b> | <b>Annual cash bonus</b> |
|----------------------------|--------------------|-----------------|--------------------------|
|                            | <b>% change</b>    | <b>% change</b> | <b>% change</b>          |
|                            | <b>2013</b>        | <b>2013</b>     | <b>2013</b>              |
| Chief Executive Officer    | <b>3.0</b>         | <b>-77.8</b>    | <b>2.2</b>               |
| Average for all employees* | <b>3.0</b>         | <b>N/A</b>      | <b>N/A</b>               |

\*The average cost of wages and salaries for employees generally rose by 6.86% in 2013 (see Notes 2.4 and 3.1 of the Notes to the Group accounts). Figures for annual cash bonuses are included in the numbers.

**Payments made to past Directors**

David Illingworth received \$230,531 following the vesting of his 2010 Performance Share award on 1 March 2013 and \$83,384 following the exercise of his 2010 option which vested on 9 September 2013. No other payments have been made in 2013 to former Directors of the Company.

**Payments for loss of office**

No payments were made in respect of a Director's loss of office in 2013.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 82 CORPORATE GOVERNANCE

Directors remuneration report *continued*

Directors interests in ordinary shares

Beneficial interests of the Executive Directors in the ordinary shares of the Company are as follows:

|                                      | <b>31 December 2013</b>                          |                   | <b>Olivier Bohuon</b>                            |                   |   | <b>Julie Brown</b>   |
|--------------------------------------|--|-------------------|--|-------------------|---|----------------------|
|                                      | <b>(or date of retirement)</b>                   |                   | <b>31 December 2013</b>                          |                   |   |                      |
|                                      | 1 January 2013 (or date of appointment) if later | <b>if earlier</b> | 1 January 2013 (or date of appointment) if later | <b>if earlier</b> | <b>(or date of retirement) if earlier</b> | 24 February 2014 (i) |
| <b>Ordinary shares</b>               | 37,015   | <b>111,238</b>    | 111,238 (iii)                                    | 0                 | <b>0</b>                                  | 25,000               |
| <b>Share options (v)</b>             | 151,698  | <b>151,698</b>    | 0  | 0                 | <b>2,400</b>                              |                      |
| <b>Performance Share Awards (ii)</b> | 494,851  | <b>735,779</b>    | 508,232  | 0                 | <b>132,866</b>                            | 1,000                |
| <b>Equity Incentive Awards (ii)</b>  | 91,446   | <b>143,387</b>    | 143,387  | 0                 | <b>0</b>                                  |                      |
| <b>Other awards</b>                  | 133,333  | <b>66,666</b>     | 66,666   | 0                 | <b>75,000</b>                             |                      |

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

(ii) These share awards are subject to further performance conditions before they may vest, as detailed on pages 66 and 67.

(iii) The ordinary shares held by Olivier Bohuon on 24 February 2014 represents 120% of his base annual salary.

(iv) The ordinary shares held by Julie Brown on 24 February 2014 represents 48% of her base annual salary.

(v) This option was granted under the Smith &amp; Nephew Sharesave Plan (2012).

In addition, Olivier Bohuon holds 50,000 deferred shares. Following the redenomination of ordinary shares into US dollars on 23 January 2006, the Company issued 50,000 deferred shares. These shares are normally held by the Chief

Executive Officer and are not listed on any Stock Exchange and have extremely limited rights attached to them.

Beneficial interests of the Chairman and Non-executive Directors in the ordinary shares of the Company are as follows:

| Director            | 1 January 2013 (or date <b>31 December 2013</b><br>( <del>on</del> date of retirement)<br>appointment)<br>if later |                | 24 February 2014 (i) | Shareholding as % of (annual fee<br>for Non-executive Directors) (ii) |
|---------------------|--|----------------|----------------------|---|
|                     |  | if earlier     |                      |   |
| Sir John Buchanan   | 162,695  | <b>166,337</b> | 166,337              | 380.2   |
| Ian Barlow          | 18,000   | <b>18,232</b>  | 18,232               | 264.6   |
| Baroness Bottomley  | 17,500   | <b>17,820</b>  | 17,820               | 258.6   |
| Michael Friedman    | 0  | <b>8,624</b>   | 8,624                | 109.5   |
| Pamela Kirby        | 15,000   | <b>15,232</b>  | 15,232               | 221.1   |
| Brian Larcombe      | 40,000   | <b>40,212</b>  | 40,212               | 583.6   |
| Joseph Papa         | 12,500   | <b>12,799</b>  | 12,799               | 162.5   |
| Ajay Piramal        | 0  | <b>240</b>     | 240                  | 3.5   |
| Roberto Quarta      | 0  | <b>0</b>       | 0                    | 0   |
| Richard De Schutter | 220,000  | <b>220,299</b> | 220,299              | 1527.6  |

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

(ii) Calculated using the closing share price of 960p per ordinary shares and \$80.00 per ADS on 24 February 2014, and an exchange rate of £1/\$1.6631.

(iii) Michael Friedman, Joseph Papa and Richard De Schutter hold some of their shares in the form of ADS. The total holdings of the Directors represents 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.

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## Relative importance of spend on pay

The following table sets out the total amounts spent in 2013 and 2012 on remuneration, the attributable profit for each year and the dividends declared and paid in each year:

|                                   | <b>For the year to 31 December 2013</b> | For the year to 31 December 2012 | % change |
|-----------------------------------|---|----------------------------------|----------|
| Attributable profit for the year  | <b>\$556m</b>                           | \$721m(i)                        | -22.88   |
| Dividends paid during the year    | <b>\$239m</b>                           | \$186m                           | 28.49    |
| Share buyback                     | <b>\$226m</b>                           | N/A                              | N/A      |
| Total Group spend on remuneration | <b>\$998m</b>                           | \$886m                           | 12.64    |

(i) Attributable profit for 2012 has been restated following the adoption of the revised IAS 19 Employee Benefit standard. See Note 1 of the Notes to the Group accounts.

## Total Shareholder Return

A graph of the Company's TSR performance compared to that of the FTSE100 index is shown below in accordance with Schedule 8 to the Regulations.

However, as we compare the Company's performance to a tailored sector peer group of medical devices companies (see page 77), when considering TSR performance in the context of the 2004 Performance Share Plan and the Global Share Plan 2010, we feel that the following graph showing the TSR performance of this peer group is also of interest.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 84 CORPORATE GOVERNANCE

Directors remuneration report *continued*

Table of historic data

The following table details information about the pay of the Chief Executive Officer in the previous five years.

| Year | Chief Executive Officer | Single figure of total remuneration | Long-term incentive vesting rates against maximum opportunity |                    |         |
|------|-------------------------|-------------------------------------|---|--------------------|---------|
|      |                         |                                     | Annual cash incentive payout against maximum                  | Performance shares | Options |
|      |                         |                                     | %   | %                  | %       |
| 2013 | Olivier Bohuon          | \$4,687,381                         | 84  | N/A                | N/A     |
| 2012 | Olivier Bohuon          | \$4,956,771                         | 84  | N/A                | N/A     |
| 2011 | Olivier Bohuon (i)(iii) | \$7,442,191                         | 68  | N/A                | N/A     |
| 2011 | David Illingworth (ii)  | \$3,595,787                         | 37  | 27                 | 27      |
| 2010 | David Illingworth       | \$4,060,707                         | 57  | 70                 | 61      |
| 2009 | David Illingworth       | \$4,406,485                         | 59  | 46                 | 59      |

(i) Appointed Chief Executive Officer on 1 April 2011.

(ii) Resigned as Chief Executive Officer on 1 April 2011.

(iii) Includes recruitment award of 1,400,000 cash and a share award over 200,000 shares valued at 1,410,000 on grant.

(iv) Prior years are restated to reflect amounts not known at the date of signing the previous annual report.

**Implementation of remuneration policy in 2014**

The Remuneration Committee proposes to make no changes to the way that the remuneration policy is implemented in 2014 from how it was implemented in 2013, other than increasing base salaries in line with the salary increases across the Group as explained on page 75 and setting new targets for the Annual Incentive Plan and the Performance Share Programme as explained on page 77 to 78.

**Statement of voting at Annual General Meeting held in 2013**

At the Annual General Meeting held on 11 April 2013, votes cast by proxy and at the meeting and votes withheld in respect of the Directors remuneration were as follows:

| <b>Resolution</b>                             | Votes for   | % for | Votes against | % against | Total votes validly cast | Votes withheld |
|---|-------------|-------|---------------|-----------|--------------------------|----------------|
| Approval of the Directors remuneration report | 613,386,066 | 96.5  | 22,233,539    | 3.5       | 635,619,605              | 14,465,350     |

In future years, voting information will be provided in respect of the votes in respect of the remuneration policy report and the Annual Report on Remuneration (the Implementation Report).

In 2013, Joseph Papa, the Chairman of the Remuneration Committee, met with Shareholders holding 20% of the share capital to discuss remuneration policies and plans. In addition, we contacted a further three Shareholders representing 8% of the share capital summarising the discussions held with the Shareholders we met. Although our remuneration policies and practices have not changed materially since 2012, we wanted to discuss the impact of the new reporting regulations with our investors to ensure that we addressing the issues they wanted us to. We had some useful discussions, as a result of which, we have re-worded some sections to improve clarity. The Shareholders we met were broadly supportive of our remuneration arrangements.

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Other remuneration matters

Senior Management remuneration

The Group's administrative, supervisory and management body (the Senior Management) is comprised, for US reporting purposes, of Executive Directors and Executive Officers. Details of the current Executive Directors and Executive Officers are given on pages 44 to 47.

In respect of the financial year 2013, 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 \$13,534,000 (2012 \$15,249,000, 2011 \$17,403,000), the total compensation for loss of office was \$Nil (2012 \$Nil, 2011 \$1,161,000), the aggregate increase in accrued pension scheme benefits was \$257,000 (2012 increase of \$229,000, 2011 increase of \$387,000) and the aggregate amounts provided for under the supplementary schemes was \$414,000 (2012 \$537,000, 2011 \$711,000).

During 2013, Senior Management were granted equity incentive awards over 263,538 shares, performance share awards over 747,828 shares and conditional share awards over 140,000 shares under the Global Share Plan 2010 and options over 2,688 shares under the Employee ShareSave Plans. As of 24 February 2014, the Senior Management (10 persons) owned 251,283 shares and 55,904 ADSs, constituting less than 0.1% of the issued share capital of the Company. Senior Management as at this date also held options to purchase 557,858 shares, conditional share awards over 223,466 shares, equity incentive awards over 428,538 shares, performance shares awards over 1,300,234 shares awarded under the Global Share Plan 2010; and awards over 4,262 shares and 1,947 ADSs under the Deferred Bonus Plan.

Dilution headroom

The Remuneration Committee ensures that at all times the number of new shares which may be issued under any share based plans, including all-employee plans, does not exceed 10% of the Company's issued share capital over any rolling 10-year period (of which up to 5% may be issued to satisfy awards under the Company's discretionary plans). The Company monitors headroom closely when granting awards over shares, taking into account the number of options or shares that might be expected to lapse be forfeited before vesting or exercise. In the event that insufficient new shares are available there are processes in place to purchase shares in the market to satisfy vesting awards and to net-settle option exercises.

Over the previous 10 years (2004 to 2013), the number of new shares issued under our share plans has been as follows:

|  |  |
|--|--|
| All-employee share plans                   | 8,028,215 (0.90% of issued share capital<br>as at 24 February 2014)  |
| Discretionary share plans                  | 36,627,154 (4.10% of issued share capital<br>as at 24 February 2014) |
| By order of the Board, on 26 February 2014 |  |

Joseph Papa

Chairman of the Remuneration Committee

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We are responsive to the needs of our customers  
and deliver quality and value, creating confidence  
in our [performance](#).

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Directors' responsibilities for the accounts

The Directors are responsible for preparing the Group and Company accounts in accordance with applicable UK 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 UK law the Directors have elected to prepare the Company accounts in accordance with UK Generally Accepted Accounting Practice (UK 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.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. It should be noted that information published on the internet is accessible in many countries with different legal requirements. Legislation in the UK governing the preparation and dissemination of accounts may differ from legislation in other jurisdictions.

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**Fair, Balanced and Understandable**

As required by the UK Corporate Governance Code, the Directors confirm that they consider that the Annual Report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy. When arriving at this conclusion the Board was assisted by a number of processes including:

The Annual Report is drafted and comprehensively reviewed by appropriate senior management with overall co-ordination by the Head of Financial Reporting;

An extensive verification process is undertaken to ensure factual accuracy, with third party review by legal advisers; and

The final draft is reviewed by the Audit Committee prior to consideration by the Board.

**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 UK 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 Financial review and principal risks section and commentary on pages 36 to 41 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.

### 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 'Financial review and principal risks' section on pages 36 to 41. The financial position of the Group, its cash flows, liquidity position and borrowing facilities are described under 'Commentary on the Group cash flow statement' section set out on page 99.

In addition, the Notes to the Group accounts include the Group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposure to credit risk and liquidity risk.

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

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

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

### Directors' Report

The Directors' Report has been prepared in accordance with the requirements of the Companies Act 2006.

By order of the Board, 26 February 2014

Susan Swabey

Company Secretary

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### SMITH & NEPHEW ANNUAL REPORT 2013

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##### Critical accounting policies

The Group prepares its consolidated financial statements in accordance with IFRS as issued by the IASB and IFRS as adopted by the EU, the application of which often requires judgements to be made by management when formulating the Group's financial position and results. Under IFRS, the Directors are required to adopt those accounting policies most appropriate to the Group's circumstances for the purpose of presenting fairly the Group's financial position, financial performance and cash flows.

In determining and applying accounting policies, judgement is often required in respect of items where the choice of specific policy, accounting estimate or assumption to be followed could materially affect the reported results or net asset position of the Group; it may later be determined that a different choice would have been more appropriate.

The Group's significant accounting policies are set out in Notes 1 to 23 of the Notes to the Group accounts. Of those, the policies which require the most use of management's judgement are as follows:

##### Inventories

A feature of the Orthopaedic Reconstruction and Trauma & Extremities franchises (whose finished goods inventory makes up approximately 79% 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 products, including large and small sizes, have to be made available in this way. These sizes are used less frequently than standard sizes and towards the end of the product life cycle are inevitably in excess of requirements. Adjustments to carrying value are therefore required to be made to orthopaedic inventory to anticipate this situation. These adjustments are calculated in accordance with a formula based on levels of inventory compared with historical usage. This formula is applied on an individual product line basis and is first applied when a product group has been on the market for two years. This method of calculation is considered appropriate based on experience, but it does involve management judgements on customer demand, effectiveness of inventory deployment, length of product lives, phase-out of old products and efficiency of manufacturing planning systems.

##### Impairment

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

### Retirement benefits

A number of key judgements have to be made in calculating the fair value of the Group's defined benefit pension plans. These assumptions impact the balance sheet liability, operating profit and other finance income/costs. The most critical assumptions are the discount rate and mortality assumptions to be applied to future pension plan liabilities. For example, as of 31 December 2013, a 0.5% increase in discount rate would have reduced the combined UK and US pension plan deficit by \$112m whilst a 0.5% decrease would have increased the combined deficit by \$123m. A 0.5% increase in discount rate would have increased profit before taxation by \$6m whilst a 0.5% decrease would have decreased it by \$6m. 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 \$42m. In making these judgements, management takes into account the advice of professional external actuaries and benchmarks its assumptions against external data.

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

See Note 18 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 advisers 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.



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Independent auditor's US reports

**Report of Independent Registered Public Accounting Firm to the Board of Directors and Shareholders of Smith & Nephew plc**

We have audited the accompanying Group balance sheets of Smith & Nephew plc as of 31 December 2013 and 2012, 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 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Smith & Nephew plc at 31 December 2013 and 2012, and the consolidated results of its operations and its cash flows for each of the three years in the period ended 31 December 2013, in conformity 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 2013, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (1992 framework) and our report dated 26 February 2014 expressed an unqualified opinion thereon.

**Ernst & Young LLP**

**London, England**

**26 February 2014**

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 2013, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organisations of the Treadway Commission (1992 framework), (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 Evaluation of Internal Control Procedures. 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 2013, 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 2013 and 2012, 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 2013 of Smith & Nephew plc and our report dated 26 February 2014 expressed an unqualified opinion thereon.

Ernst & Young LLP

London, England

26 February 2014



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Independent auditor's UK report

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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## Group income statement

|  |       | <b>Year ended<br/>31 December<br/>2013</b> | Year ended<br>31 December<br>2012 | Year ended<br>31 December<br>2011 |
|--|-------|--|-----------------------------------|-----------------------------------|
|  |       | <b>2013</b>                                | Restated(i)                       | Restated(i)                       |
|  | Notes | \$ million                                 | \$ million                        | \$ million                        |
| <b>Revenue</b>                                 | 2     | <b>4,351</b>                               | 4,137                             | 4,270                             |
| Cost of goods sold                             |       | <b>(1,100)</b>                             | (1,070)                           | (1,140)                           |
| <b>Gross profit</b>                            |       | <b>3,251</b>                               | 3,067                             | 3,130                             |
| Selling, general and administrative expenses   | 3     | <b>(2,210)</b>                             | (2,050)                           | (2,101)                           |
| Research and development expenses              | 3     | <b>(231)</b>                               | (171)                             | (167)                             |
| <b>Operating profit</b>                        | 2 & 3 | <b>810</b>                                 | 846                               | 862                               |
| Interest receivable                            | 4     | <b>14</b>                                  | 11                                | 4                                 |
| Interest payable                               | 4     | <b>(10)</b>                                | (9)                               | (12)                              |
| Other finance costs                            | 4     | <b>(11)</b>                                | (11)                              | (13)                              |
| Share of results of associates                 | 11    | <b>(1)</b>                                 | 4                                 |                                   |
| Profit on disposal of net assets held for sale | 21    |  | 251                               |                                   |
| <b>Profit before taxation</b>                  |       | <b>802</b>                                 | 1,092                             | 841                               |
| Taxation                                       | 5     | <b>(246)</b>                               | (371)                             | (266)                             |
| <b>Attributable profit for the year (ii)</b>   |       | <b>556</b>                                 | 721                               | 575                               |
| <b>Earnings per ordinary share (ii)</b>        | 6     |  |                                   |                                   |
| Basic  |       | <b>61.7¢</b>                               | 80.4¢                             | 64.5¢                             |
| Diluted  |       | <b>61.4¢</b>                               | 80.0¢                             | 64.2¢                             |
| Group statement of comprehensive income        |       |  |                                   |                                   |

| Notes | <b>Year ended<br/>31 December<br/>2013</b> | Year ended<br>31 December<br>2012 | Year ended<br>31 December<br>2011 |
|-------|--|-----------------------------------|-----------------------------------|
|       | <b>2013</b>                                | Restated(i)                       | Restated(i)                       |
|       | \$ million                                 | \$ million                        |                                   |
|       |  | Restated(i)                       | Restated(i)                       |

|   |    |             | \$ million |
|---|----|-------------|------------|
| <b>Attributable profit for the year (ii)</b>                              |    | <b>556</b>  | 721        |
| Other comprehensive income:   |    |             | 575        |
| <i>Items that will not be reclassified to income statement</i>            |    |             |            |
| Actuarial gains/(losses) on retirement benefit obligations                | 18 | <b>12</b>   | (5)        |
| Taxation on other comprehensive income                                    | 5  | <b>(16)</b> | 20         |
| Total items that will not be reclassified to income statement             |    | <b>(4)</b>  | 15         |
| <i>Items that may be reclassified subsequently to income statement</i>    |    |             |            |
| Cash flow hedges – interest rate swaps losses arising in the year         |    |             | (1)        |
| losses transferred to income statement for the year                       |    |             | 1          |
| Cash flow hedges – forward foreign exchange contracts                     |    |             |            |
| gains/(losses) arising in the year  |    | <b>8</b>    | (1)        |
| (gains)/losses transferred to inventories for the year                    |    | <b>(3)</b>  | (6)        |
| Exchange differences on translation of foreign operations                 |    | <b>(6)</b>  | 36         |
| Exchange on borrowings classified as net investment hedges                |    |             | 1          |
| Total items that may be reclassified subsequently to income statement     |    | <b>(1)</b>  | 30         |
| <b>Other comprehensive (expense)/income for the year, net of taxation</b> |    | <b>(5)</b>  | 45         |
| <b>Total comprehensive income for the year (ii)</b>                       |    | <b>551</b>  | 766        |
|   |    |             | 514        |

(i) Restated for the adoption of the revised IAS 19 *Employee Benefits* standard, see Note 1.

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

The Notes on pages 101 to 149 are an integral part of these accounts.

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Commentary on the Group income statement and Group statement of comprehensive income

**Revenue**

Group revenue increased by \$214m (5% on a reported basis), from \$4,137m in 2012 to \$4,351m in 2013. The underlying increase is 4% after adjusting for the net impact of 2% on the Healthpoint acquisition and Clinical Therapies disposal and 1% attributable to the unfavourable impact of currency movements.

**Cost of goods sold**

Cost of goods sold increased by \$30m (3% on a reported basis) from \$1,070m in 2012 to \$1,100m in 2013. The underlying movement is 2% after adjusting for the net impact of 2% on the Healthpoint acquisition and Clinical Therapies disposal and 1% attributable to the favourable impact of currency movements. The movement in underlying costs of goods sold of 2% is largely attributable to the increase in underlying trading.

During 2013, \$12m of restructuring and rationalisation expenses (2012 - \$3m) and \$5m of acquisition related costs (2012 - \$nil) were charged to cost of goods sold.

**Selling, general and administrative expenses**

Selling, general and administrative expenses increased by \$160m (8% on a reported basis) from \$2,050m in 2012 to \$2,210m in 2013. The underlying movement is 6% after adjusting for the net impact of 3% on the Healthpoint acquisition and Clinical Therapies disposal and 1% attributable to the favourable impact of currency movements.

The underlying increase of 6% is due to the continuing investment in Emerging & International Markets, promotion of new products in ASD and AWM and the underlying increase in trading.

In 2013, administrative expenses included \$64m of amortisation of other intangible assets (2012 \$51m), \$46m of restructuring and rationalisation expenses (2012 \$62m), an amount of \$88m relating to amortisation of acquisition intangibles (2012 \$43m) and \$26m of acquisition related costs (2012 \$11m).

**Research and development expenses**

Research and development expenditure as a percentage of revenue increased by 1.2% to 5.3% in 2013 (2012 4.1%). Actual expenditure was \$231m in 2013 compared to \$171m in 2012. The Group continues to invest in innovative technologies and products to differentiate it from competitors. It also continues to invest in HP802-247, currently in Phase III trials, which was acquired as part of the Healthpoint acquisition in December 2012.



### Operating profit

Operating profit decreased by \$36m to \$810m from \$846m in 2012. This comprised a decrease of \$12m in Advanced Surgical Devices and a decrease of \$24m in Advanced Wound Management.

The movement in Advanced Surgical Devices is attributable to the continuing pressure on margins and its investment in the Emerging & International Markets. Advanced Wound Management has continued to invest in new products and new geographic markets throughout the year.

### Net interest receivable/(payable)

Net interest receivable increased, by \$2m, from net \$2m receivable in 2012 to a net receivable of \$4m in 2013. This increase is principally a consequence of the interest receivable on the Bioventus LLC ( Bioventus ) loan note issued following the disposal of the Clinical Therapies business which has been in place for a full year in 2013 compared to eight months in 2012.

### Other finance costs

Other finance costs in 2013 remained at \$11m and principally relate to costs associated with the Group's retirement benefit schemes.

### Taxation

The taxation charge decreased, by \$125m, to \$246m from \$371m in 2012. The rate of tax was 30.5%, compared with 33.7% in 2012.

After adjusting for specific transactions that management considers affect the Group's short-term profitability (profit on disposal of the Clinical Therapies business, restructuring and rationalisation expenses, amortisation of acquisition intangibles and acquisition-related costs) the tax rate was 29.2% (2012 29.9%).

The financial commentary on this page forms part of the business review and is unaudited.

See pages 164 to 167 for commentary on the 2012 financial year.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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## Group balance sheet

|  |       | At<br>31 December<br>2013 | At<br>31 December<br>2012 |
|--|-------|---------------------------|---------------------------|
|  | Notes | \$ million                | \$ million                |
| <b>Assets</b>  |       |                           |                           |
| <b>Non-current assets:</b>                           |       |                           |                           |
| Property, plant and equipment                        | 7     | 816                       | 793                       |
| Goodwill   | 8     | 1,256                     | 1,186                     |
| Intangible assets                                    | 9     | 1,054                     | 1,064                     |
| Investments  | 10    | 2                         | 2                         |
| Investments in associates                            | 11    | 107                       | 116                       |
| Loans to associates                                  | 11    | 178                       | 167                       |
| Retirement benefit asset                             | 18    | 5                         | 6                         |
| Deferred tax assets                                  | 5     | 145                       | 164                       |
|  |       | <b>3,563</b>              | <b>3,498</b>              |
| <b>Current assets:</b>                               |       |                           |                           |
| Inventories  | 12    | 1,006                     | 901                       |
| Trade and other receivables                          | 13    | 1,113                     | 1,065                     |
| Cash at bank   | 15    | 137                       | 178                       |
|  |       | <b>2,256</b>              | <b>2,144</b>              |
| <b>Total assets</b>                                  |       | <b>5,819</b>              | <b>5,642</b>              |
| <b>Equity and liabilities</b>                        |       |                           |                           |
| <b>Equity attributable to owners of the Company:</b> |       |                           |                           |
| Share capital  | 19    | 184                       | 193                       |
| Share premium  |       | 535                       | 488                       |
| Capital redemption reserve                           |       | 10                        |                           |
| Treasury shares                                      | 19    | (322)                     | (735)                     |
| Other reserves                                       |       | 120                       | 121                       |
| Retained earnings                                    |       | 3,520                     | 3,817                     |
| <b>Total equity</b>                                  |       | <b>4,047</b>              | <b>3,884</b>              |
| <b>Non-current liabilities:</b>                      |       |                           |                           |
| Long-term borrowings                                 | 15    | 347                       | 430                       |
| Retirement benefit obligations                       | 18    | 230                       | 266                       |
| Other payables                                       | 14    | 7                         | 8                         |
| Provisions   | 17    | 65                        | 63                        |

|                                     |    |              |       |
|-------------------------------------|----|--------------|-------|
| Deferred tax liabilities            | 5  | <b>50</b>    | 61    |
|                                     |    | <b>699</b>   | 828   |
| <b>Current liabilities:</b>         |    |              |       |
| Bank overdrafts and loans           | 15 | <b>44</b>    | 38    |
| Trade and other payables            | 14 | <b>785</b>   | 656   |
| Provisions                          | 17 | <b>60</b>    | 59    |
| Current tax payable                 |    | <b>184</b>   | 177   |
|                                     |    | <b>1,073</b> | 930   |
| <b>Total liabilities</b>            |    | <b>1,772</b> | 1,758 |
| <b>Total equity and liabilities</b> |    | <b>5,819</b> | 5,642 |

The accounts were approved by the Board and authorised for issue on 26 February 2014 and are signed on its behalf by:

**Sir John Buchanan**  
Chairman

**Olivier Bohuon**  
Chief Executive Officer

**Julie Brown**  
Chief Financial Officer

The Notes on pages 101 to 149 are an integral part of these accounts.

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Commentary on the Group balance sheet

**Non-current assets**

Non-current assets increased by \$65m to \$3,563m in 2013 from \$3,498m in 2012. This is principally attributable to the following:

Property, plant and equipment increased by \$23m from \$793m in 2012 to \$816m in 2013. Depreciation of \$209m was charged during 2013 and assets with a net book value of \$12m were disposed of. These movements were offset by \$242m of additions relating primarily to instruments and other plant & machinery and \$5m of additions arising on acquisitions in Turkey, Brazil and India. The balance relates to unfavourable currency movements totalling \$3m

Goodwill increased by \$70m from \$1,186m in 2012 to \$1,256m in 2013. Of this movement, \$37m arose on acquisitions in Turkey, Brazil and India. An additional \$16m arose on finalisation of the Healthpoint opening balance sheet. The remaining balance relates to favourable currency movements totalling \$17m

Intangible assets decreased by \$10m from \$1,064m in 2012 to \$1,054m in 2013. Intangible assets totalling \$64m arose on the acquisition in Turkey, Brazil and India. There was a reduction of \$11m on finalisation of the Healthpoint opening balance sheet. Amortisation of \$152m was charged during the year and assets with a net book value of \$11m were disposed of. A total of \$98m relates to the cost of intellectual property, distribution rights and software acquired. The balance relates to favourable currency movements totalling \$2m

Investment in associates (including a loan to an associate of \$178m in 2013, up from \$167m in 2012) has increased from \$283m in 2012 to \$285m in 2013. This movement relates to the interest of \$11m arising on the Bioventus loan note which was largely offset from the disposal of the Group's 49% interest in the Austrian entities Plus Orthopedics GmbH and Intraplant GmbH and its 20% interest in the German entity Intercus GmbH

Deferred tax assets decreased by \$19m in the year from \$164m in 2012 to \$145m in 2013.

**Current assets**

Current assets increased by \$112m to \$2,256m from \$2,144m in 2012. The movement relates to the following:

Inventories rose by \$105m to \$1,006m in 2013 from \$901m in 2012. This movement is principally attributable to an increase of \$48m in the US due to inventory build prior to the launch of JOURNEY II BCS and an increase of \$17m due to inventory build in our Hull factory prior to the transfer of part of our Wound production to China. A further increase of \$12m arose on the acquisitions in Turkey, Brazil and India. The movement also includes \$6m of unfavourable currency movements

The level of trade and other receivables increased by \$48m to \$1,113m in 2013 from \$1,065m in 2012. The movement primarily relates to the increase in underlying revenues and includes \$9m of unfavourable currency movements

Cash at bank has fallen by \$41m to \$137m from \$178m in 2012.

#### Non-current liabilities

Non-current liabilities decreased by \$129m from \$828m in 2012 to \$699m in 2013. This movement relates to the following items:

Long-term borrowings have decreased from \$430m in 2012 to \$347m in 2013

The Retirement benefit obligation decreased by \$36m to \$230m in 2013 from \$266m in 2012. This was largely due to the Group's additional pension contributions, together with net actuarial gains for the year

Deferred tax liabilities decreased by \$11m in the year from \$61m in 2012 to \$50m in 2013.

#### Current liabilities

Current liabilities increased by \$143m from \$930m in 2012 to \$1,073m in 2013. This movement is attributable to:

Bank overdrafts and current borrowings have increased by \$6m from \$38m in 2012 to \$44m in 2013

Trade and other payables have increased by \$129m to \$785m in 2013 from \$656m in 2012. This increase includes \$50m largely driven from strong sales performance in the US in quarter four and a \$23m increase in Europe associated with promotional activities in Advanced Surgical Devices. A total of \$19m of trade and other payables arose on the acquisitions in Turkey, Brazil and India and an amount of \$5m is attributable to favourable currency movements.

Current tax payable is \$184m at the end of 2013 compared to \$177m in 2012.

#### Total equity

Total equity increased by \$163m from \$3,884m in 2012 to \$4,047m in 2013. The principal movements were:

|   | Total equity<br>\$ million |
|---|----------------------------|
| 1 January 2013  | 3,884                      |
| Attributable profit                                     | 556                        |
| Currency translation gains                              | (6)                        |
| Hedging reserves  | 5                          |
| Actuarial gains on retirement benefit obligations       | 12                         |
| Dividends paid during the year                          | (239)                      |
| Purchase of own shares                                  | (231)                      |
| Taxation on Other Comprehensive Income and equity items | (16)                       |
| Net share-based transactions                            | 82                         |
| 31 December 2013  | 4,047                      |

The financial commentary on this page forms part of the business review and is unaudited.

See pages 164 to 167 for commentary on the 2012 financial year.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 98 FINANCIAL STATEMENTS

## Group cash flow statement

|   |       | Year ended<br>31 December<br>2012 | Year ended<br>31 December<br>2011 |
|---|-------|-----------------------------------|-----------------------------------|
|   |       | Restated(i)                       | Restated(i)                       |
|   | Notes | \$ million                        | \$ million                        |
| <b>Cash flows from operating activities</b>                     |       |                                   |                                   |
| Profit before taxation  |       | 802                               | 1,092                             |
| Net interest (receivable)/payable                               | 4     | (4)                               | (2)                               |
| Depreciation, amortisation and impairment                       |       | 361                               | 312                               |
| Loss on disposal of property, plant and equipment, and software |       | 23                                | 12                                |
| Share-based payments expense                                    | 23    | 28                                | 34                                |
| Share of results of associates                                  | 11    | 1                                 | (4)                               |
| Dividends received from associates                              | 11    | 1                                 | 7                                 |
| Profit on disposal of net assets held for sale                  | 21    |                                   | (251)                             |
| Decrease in retirement benefit obligations                      |       | (27)                              | (28)                              |
| (Increase)/decrease in inventories                              |       | (99)                              | 12                                |
| Increase in trade and other receivables                         |       | (70)                              | (5)                               |
| Increase/(decrease) in trade and other payables and provisions  |       | 122                               | 5                                 |
| Cash generated from operations (ii) (iii)                       |       | 1,138                             | 1,184                             |
| Interest received   |       | 4                                 | 4                                 |
| Interest paid   |       | (10)                              | (8)                               |
| Income taxes paid   |       | (265)                             | (278)                             |
| Net cash inflow from operating activities                       |       | 867                               | 902                               |
| <b>Cash flows from investing activities</b>                     |       |                                   |                                   |
| Acquisitions (net of \$2m of cash received in 2011)             | 21    | (74)                              | (782)                             |
| Proceeds on disposal of net assets held for sale                | 21    |                                   | 103                               |
| Capital expenditure   | 2     | (340)                             | (265)                             |
| Investment in associate   | 11    |                                   | (10)                              |
| Cash received on disposal of associate                          |       | 7                                 |                                   |
| Net cash used in investing activities                           |       | (407)                             | (954)                             |
| <b>Cash flows from financing activities</b>                     |       |                                   |                                   |

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|  |           |              |            |            |
|--|-----------|--------------|------------|------------|
| Proceeds from issue of ordinary share capital        |           | <b>48</b>    | 77         | 17         |
| Purchase of own shares                               |           | <b>(231)</b> |            | (6)        |
| Proceeds of borrowings due within one year           | 20        | <b>12</b>    | 40         | 78         |
| Settlement of borrowings due within one year         | 20        | <b>(6)</b>   | (296)      | (330)      |
| Proceeds on borrowings due after one year            | 20        | <b>695</b>   | 415        | 92         |
| Settlement of borrowings due after one year          | 20        | <b>(779)</b> | (1)        | (232)      |
| Proceeds from own shares                             |           | <b>3</b>     | 6          | 7          |
| Settlement of currency swaps                         | 20        | <b>(1)</b>   | (1)        | (1)        |
| Equity dividends paid                                | 19        | <b>(239)</b> | (186)      | (146)      |
| Net cash (used in)/from financing activities         |           | <b>(498)</b> | 54         | (521)      |
| Net (decrease)/increase in cash and cash equivalents |           | <b>(38)</b>  | 2          | (33)       |
| Cash and cash equivalents at beginning of year       | 20        | <b>167</b>   | 161        | 195        |
| Exchange adjustments                                 | 20        | <b>(3)</b>   | 4          | (1)        |
| <b>Cash and cash equivalents at end of year</b>      | <b>20</b> | <b>126</b>   | <b>167</b> | <b>161</b> |

(i) Restated for the adoption of the revised IAS 19 *Employee Benefits* standard, see Note 1.

(ii) Includes \$54m (2012 \$55m, 2011 \$20m) of outgoings on restructuring and rationalisation expenses.

(iii) Includes \$25m (2012 \$3m, 2011 \$1m) of acquisition-related costs and \$nil (2012 \$nil, 2011 \$3m) of costs unreimbursed by insurers relating to macrotextured knee revisions. In the year ended 31 December 2012 cash outflows included a legal settlement of \$22m.

The Notes on pages 101 to 149 are an integral part of these accounts.



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Commentary on the Group cash flow statement

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

**Net cash inflow from operating activities**

Cash generated from operations in 2013 of \$1,138m (2012 \$1,184m, 2011 \$1,135m) is after paying out \$25m (2012 \$3m, 2011 \$1m) of acquisition-related costs, \$54m (2012 \$55m, 2011 \$20m) of restructuring and rationalisation expenses and \$22m in 2012 relating to a legal settlement.

**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 2013, capital expenditure on tangible and intangible fixed assets represented approximately 8% of continuing Group revenue (2012 6%, 2011 8%).

In 2013, capital expenditure amounted to \$340m (2012 \$265m, 2011 \$321m). 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 2013, \$41m (2012 \$4m, 2011 \$9m) 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 2013, \$889m was spent on acquisitions, funded from net debt and cash inflows. This comprised, \$33m for Tenet Medical Engineering during 2011, \$782m for Healthpoint acquired in December 2012 and \$74m relating to acquisitions in Turkey, Brazil and India completed in quarter four of 2013.

During 2012, the Group completed the transfer of its Biologics and Clinical Therapies business (CT) to Bioventus for total consideration of \$367m. As part of this transaction the Group received a 49% interest in Bioventus with a value of \$104m and subsequently invested a further \$10m.

Cash proceeds of \$7m were received from the disposal of the Group's 49% interest in the Austrian entities Plus Orthopedics GmbH and Intraplant GmbH and its 20% interest in the German entity Intercus GmbH.

## Liquidity and capital resources

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 entered into a five-year \$1bn multi-currency revolving facility with an initial interest of 70 basis points over LIBOR.

At 31 December 2013, the Group held \$126m (2012 \$167m, 2011 \$161m) in cash and bank. The Group has committed and uncommitted facilities of \$1,008m and \$319m respectively. The undrawn committed facilities totalling \$672m expire after one year (2012 \$597m expiring within two to 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 \$14m (of which \$3m extends beyond five years).

In December 2013, the Group signed a private placement agreement to borrow \$325m of long-term debt. The funds, which have an average fixed rate of 3.7% and an average maturity of just over nine years, were drawn down on 21 January 2014 and used to repay existing bank debt.

Subsequent to the balance sheet date, on 3 February 2014 the Group announced the execution of a definitive agreement to acquire 100% of the shares of ArthroCare Corp. for approximately \$1.7 billion. The acquisition is subject to customary conditions, including a vote of ArthroCare's shareholders and governmental clearances. The acquisition is expected to close in mid-2014. The acquisition will be financed through existing debt facilities and cash balances, including the existing \$1 billion revolving credit facility and a new two-year \$1.4 billion term loan facility, established in February 2014.

The principal variations in the Group's borrowing requirements result from the timing of dividend payments, acquisitions and disposals of businesses, timing of capital expenditure and working capital fluctuations. Smith & Nephew believes that its capital expenditure needs and its working capital funding for 2014, as well as its other known or expected commitments or liabilities, can be met from its existing resources and facilities. The Group's net debt decreased from \$492m at the beginning of 2011 to \$253m at the end of 2013, representing an overall decrease of \$239m.

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

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

The financial commentary on this page forms part of the business review and is unaudited.

See pages 164 to 167 for commentary on the 2012 financial year.

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## Group statement of changes in equity

|   | Share<br>capital<br>\$ million | Share<br>premium<br>\$ million | Capital<br>redemption<br>reserve<br>\$ million | Treasury<br>shares (ii)<br>\$ million | Other<br>reserves (iii)<br>\$ million | Retained<br>earnings<br>\$ million | Total<br>equity<br>\$ million |
|---|--------------------------------|--------------------------------|--|---------------------------------------|---------------------------------------|------------------------------------|-------------------------------|
| At 31 December 2010                         | 191                            | 396                            |  | (778)                                 | 116                                   | 2,848                              | 2,773                         |
| Total comprehensive income (i)              |                                |                                |  |                                       | (25)                                  | 539                                | 514                           |
| Equity dividends declared and paid          |                                |                                |  |                                       |                                       | (146)                              | (146)                         |
| Share-based payments recognised             |                                |                                |  |                                       |                                       | 30                                 | 30                            |
| Deferred taxation on share-based payments   |                                |                                |  |                                       |                                       | (2)                                | (2)                           |
| Purchase of own shares                      |                                |                                |  | (6)                                   |                                       |                                    | (6)                           |
| Cost of shares transferred to beneficiaries |                                |                                |  | 18                                    |                                       | (11)                               | 7                             |
| Issue of ordinary share capital (iv)        |                                | 17                             |  |                                       |                                       |                                    | 17                            |
| At 31 December 2011                         | 191                            | 413                            |  | (766)                                 | 91                                    | 3,258                              | 3,187                         |
| Total comprehensive income (i)              |                                |                                |  |                                       | 30                                    | 736                                | 766                           |
| Equity dividends declared and paid          |                                |                                |  |                                       |                                       | (186)                              | (186)                         |
| Share-based payments recognised             |                                |                                |  |                                       |                                       | 34                                 | 34                            |
| Cost of shares transferred to beneficiaries |                                |                                |  | 31                                    |                                       | (25)                               | 6                             |
| Issue of ordinary share capital (iv)        | 2                              | 75                             |  |                                       |                                       |                                    | 77                            |
| At 31 December 2012                         | 193                            | 488                            |  | (735)                                 | 121                                   | 3,817                              | 3,884                         |
| Total comprehensive income (i)              |                                |                                |  |                                       | (1)                                   | 552                                | 551                           |
| Equity dividends declared and paid          |                                |                                |  |                                       |                                       | (239)                              | (239)                         |
| Share-based payments recognised             |                                |                                |  |                                       |                                       | 28                                 | 28                            |
| Deferred taxation on share-based payments   |                                |                                |  |                                       |                                       | 3                                  | 3                             |
| Purchase of own shares                      |                                |                                |  | (231)                                 |                                       |                                    | (231)                         |
| Cost of shares transferred to beneficiaries |                                |                                |  | 21                                    |                                       | (18)                               | 3                             |
| Cancellation of treasury shares             | (10)                           |                                | 10   | 623                                   |                                       | (623)                              |                               |
| Issue of ordinary share capital (iv)        | 1                              | 47                             |  |                                       |                                       |                                    | 48                            |
| <b>At 31 December 2013</b>                  | <b>184</b>                     | <b>535</b>                     | <b>10</b>                                      | <b>(322)</b>                          | <b>120</b>                            | <b>3,520</b>                       | <b>4,047</b>                  |

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

(ii) Refer to Note 19.2 for further information.

(iii) Other reserves comprises gains and losses on cash flow hedges, foreign exchange differences on translation of foreign operations and the difference arising as a result of translating share capital and share premium at the rate ruling on the date of redenomination instead of the rate at the balance sheet date. The cumulative translation

adjustments within Other Reserves at 31 December 2013 were \$118m (2012 \$124m, 2011 \$87m).  
(iv) Issue of ordinary share capital as a result of options being exercised.  
The Notes on pages 101 to 149 are an integral part of these accounts.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## FINANCIAL STATEMENTS 101

## Notes to the Group accounts

**1 Basis of preparation**

Smith & Nephew plc (the Company) is a public limited company incorporated in England and Wales. In these accounts, the 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 Advanced Surgical Devices and Advanced Wound Management.

As required by the European Union's IAS Regulation and the Companies Act 2006, the Group has prepared its accounts in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU) effective as at 31 December 2013. 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 2013. IFRS as adopted by the EU differs in certain respects from IFRS as issued by the IASB. However, the differences have no impact for the periods presented.

The preparation of accounts in conformity with IFRS requires management to use estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. The accounting policies requiring management to use significant estimates and assumptions are; inventories, impairment, retirement benefits, contingencies and provisions. These are discussed under Critical accounting policies on page 90. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to estimates are recognised prospectively.

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.

From 1 January 2013, the Group adopted the revised IAS 19 *Employee Benefits* standard, which was endorsed by the EU in June 2012. The previous method of including the expected income from the plan assets at an estimated asset return is replaced by applying the discount rate used to calculate the net retirement benefit obligation. The change in accounting policy has been applied retrospectively but does not impact the net retirement benefit obligation or retained earnings as at the beginning or during the years ended 31 December 2011 or 2012. The income statement and statement of comprehensive income for the years ended 31 December 2012 and 31 December 2013 have been adjusted for the change in accounting policy. These adjustments have resulted in an increase of \$8m in other finance costs and an increase of \$8m in actuarial gains on retirement benefit obligations recorded within other comprehensive income for the year ended 31 December 2012 and an increase of \$7m in other finance costs and an increase of \$7m in actuarial gains on retirement benefit obligations recorded within other comprehensive income for the year ended

31 December 2011. Due to the change in other finance costs, basic and diluted earnings per share for the year ended 31 December 2012 both decreased by 0.9¢ and for the year ended 31 December 2011 both decreased by 0.8¢.

The Group has also adopted the amendments to IAS 1 *Presentation of Items of Other Comprehensive Income*, resulting in a change to the presentation of items within other comprehensive income.

In addition, effective 1 January 2013, the Group has adopted the following new IFRS standards and amendments to standards, none of which had a material impact on the Group's net results, net assets or disclosure; IFRS 10 *Consolidated Financial Statements*,

IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities* and IFRS 13 *Fair Value Measurement*, along with consequential amendments to IAS 27 *Separate Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*, and amendments to IFRS 7 *Financial Instruments: Disclosures on Offsetting Financial Assets and Liabilities*.

A number of new standards, amendments to standards and interpretations are effective for annual periods beginning after 1 January 2013, and have not been applied in preparing these consolidated accounts. None of these is expected to have a significant effect on the consolidated accounts of the Group.

#### Consolidation

The Group accounts include the accounts of Smith & Nephew plc and its subsidiaries for the periods during which they were members of the Group.

Subsidiaries are entities controlled by the Group. The Group controls an entity when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. 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. Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated on consolidation. All subsidiaries have year ends which are co-terminus with the Group's.

When the Group loses control over a subsidiary, it derecognises the assets and liabilities of the subsidiary and any related components of equity. Any resulting gain or loss is recognised in profit or loss. Any retained interest in the former subsidiary is measured at fair value.

#### Foreign currencies

##### **Functional and presentation currency**

The Group accounts are presented in US Dollars, which is the Company's functional currency.

##### **Foreign currency transactions**

Transactions in foreign currencies are translated to the respective functional currencies of Group companies at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated to the functional currency at the exchange rate at the reporting date. Non-monetary items are not retranslated.

##### **Foreign operations**

Balance sheet items of foreign operations, including goodwill and fair value adjustments arising on acquisition are translated into US Dollars on consolidation at the exchange rates at the reporting date. Income statement items and the cash flows of foreign operations are translated at average rates as an approximation to actual transaction rates, with actual transaction rates used for large one-off transactions.

Foreign currency differences are recognised in Other comprehensive income and accumulated in Other reserves within equity. These include: 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 actual (or average, as an approximation) 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.

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Notes to the Group accounts *continued***1 Basis of preparation continued**

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

|                       | <b>2013</b> | 2012 | 2011 |
|-----------------------|-------------|------|------|
| <b>Average rates</b>  |             |      |      |
| Sterling              | <b>1.56</b> | 1.58 | 1.60 |
| Euro                  | <b>1.33</b> | 1.28 | 1.39 |
| Swiss Franc           | <b>1.08</b> | 1.07 | 1.13 |
| <b>Year-end rates</b> |             |      |      |
| Sterling              | <b>1.66</b> | 1.63 | 1.55 |
| Euro                  | <b>1.38</b> | 1.32 | 1.29 |
| Swiss Franc           | <b>1.12</b> | 1.09 | 1.06 |

**2 Business segment information**

For management purposes, the Group is organised into business segments according to the nature of its products and has two reportable business segments – Advanced Surgical Devices and Advanced Wound Management. The types of products and services offered by each business segment are:

Smith & Nephew's Advanced Surgical Devices ( ASD ) business offers the following products and technologies:

Orthopaedic Reconstruction which includes Hip Implants, Knee Implants and ancillary products such as bone cement and mixing systems used in cemented reconstruction joint surgery

Trauma & Extremities consisting of internal and external devices used in the stabilisation of severe fractures and deformity correction procedures

Sports Medicine Joint Repair, which offers surgeons a broad array of instruments, technologies and implants necessary to perform minimally invasive surgery of the joints



Arthroscopy Enabling Technologies which offer healthcare providers a variety of technologies such as fluid management equipment for surgical access, high definition cameras, digital image capture, scopes, light sources and monitors to assist with visualisation inside the joints, radio frequency wands, electromechanical and mechanical blades, and hand instruments for removing damaged tissue

Other ASD which includes gynaecological instrumentation and the remaining Clinical Therapies geographies which are in the process of being transferred to Bioventus.

Smith & Nephew's Advanced Wound Management (AWM) business offers a range of products:

Advanced Wound Care includes products for the treatment of acute and chronic wounds, including leg, diabetic and pressure ulcers, burns and post-operative wounds

Advanced Wound Devices consists of traditional and single-use Negative Pressure Wound Therapy and hydrosurgery systems

Advanced Wound Bioactives includes biologics and other bioactive technologies that provide unique approaches to debridement and dermal repair/regeneration.

Management monitors the operating results of its business segments separately for the purposes of making decisions about resource allocation and performance assessment. Group financing (including interest receivable and payable) and income taxes are managed on a Group basis and are not allocated to business segments.

The following tables present revenue, profit, asset and liability information regarding the Group's operating segments. Investments in associates and loans to associates are segmentally allocated to Advanced Surgical Devices.

## 2.1 Revenue by business segment and geography

### ACCOUNTING POLICY

Revenue comprises sales of products and services to third parties at amounts invoiced net of trade discounts and rebates, excluding taxes on revenue. Revenue from the sale of products is recognised upon transfer to the customer of the significant risks and rewards of ownership. This is generally when goods are delivered to customers. Sales of inventory located at customer premises and available for customers' immediate use are recognised when notification is received that the product has been implanted or used. Appropriate provisions for returns, trade discounts and rebates are deducted from revenue. Rebates comprise retrospective volume discounts granted to certain customers on attainment of certain levels of purchases from the Group. These are accrued over the course of the arrangement based on estimates of the level of business expected and adjusted at the end of the arrangement to reflect actual volumes.

|                                    | <b>2013</b>       | 2012       | 2011       |
|------------------------------------|-------------------|------------|------------|
|                                    | <b>\$ million</b> | \$ million | \$ million |
| <b>Revenue by business segment</b> |                   |            |            |
| Advanced Surgical Devices          | <b>3,015</b>      | 3,108      | 3,251      |
| Advanced Wound Management          | <b>1,336</b>      | 1,029      | 1,019      |
|                                    | <b>4,351</b>      | 4,137      | 4,270      |

There are no material sales between business segments.

|                                     | <b>2013</b>       | 2012       | 2011       |
|-------------------------------------|-------------------|------------|------------|
|                                     | <b>\$ million</b> | \$ million | \$ million |
| <b>Revenue by geographic market</b> |                   |            |            |
| United States                       | <b>1,862</b>      | 1,651      | 1,756      |
| United Kingdom                      | <b>293</b>        | 297        | 291        |
| Other Established Markets           | <b>1,633</b>      | 1,706      | 1,769      |
| Emerging & International Markets    | <b>563</b>        | 483        | 454        |
|                                     | <b>4,351</b>      | 4,137      | 4,270      |

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

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## 2.2 Trading and operating profit by business segment

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

|   |       | 2012         | 2011       |
|---|-------|--------------|------------|
|   |       | <b>2013</b>  |            |
|   |       | Restated     | Restated   |
|   | Notes | \$ million   | \$ million |
| Operating profit  |       | 846          | 862        |
| Acquisition-related costs                               | 3     | 31           | 11         |
| Restructuring and rationalisation expenses              | 3     | 58           | 65         |
| Amortisation of acquisition intangibles and impairments | 9     | 88           | 43         |
| Legal provision   | 3     |              | 23         |
| Trading profit  |       | <b>987</b>   | 961        |
| <b>Trading profit by business segment</b>               |       |              |            |
| Advanced Surgical Devices                               |       | <b>712</b>   | 728        |
| Advanced Wound Management                               |       | <b>275</b>   | 237        |
|   |       | <b>987</b>   | 961        |
| <b>Operating profit by business segment</b>             |       |              |            |
| <b>reconciled to attributable profit for the year</b>   |       |              |            |
| Advanced Surgical Devices                               |       | <b>620</b>   | 632        |
| Advanced Wound Management                               |       | <b>190</b>   | 214        |
| Operating profit  |       | <b>810</b>   | 862        |
| Net interest receivable/(payable)                       |       | <b>4</b>     | 2          |
| Other finance costs                                     |       | <b>(11)</b>  | (11)       |
| Share of results of associates                          |       | <b>(1)</b>   | 4          |
| Profit on disposal on net assets held for sale          |       |              | 251        |
| Taxation  |       | <b>(246)</b> | (371)      |
| <b>Attributable profit for the year</b>                 |       | <b>556</b>   | 575        |

## 2.3 Assets and liabilities by business segment and geography

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |
| <b>Balance sheet</b>   |                   |            |            |
| Assets:  |                   |            |            |
| Advanced Surgical Devices  | <b>3,684</b>      | 3,518      | 3,396      |
| Advanced Wound Management  | <b>1,848</b>      | 1,776      | 819        |
| Operating assets by business segment   | <b>5,532</b>      | 5,294      | 4,215      |
| Assets held for sale (relating to Advanced Surgical Devices business segment)                                      |                   |            | 125        |
| Unallocated corporate assets   | <b>287</b>        | 348        | 407        |
| <b>Total assets</b>  | <b>5,819</b>      | 5,642      | 4,747      |
| Liabilities:   |                   |            |            |
| Advanced Surgical Devices  | <b>609</b>        | 530        | 526        |
| Advanced Wound Management  | <b>308</b>        | 256        | 169        |
| Operating liabilities by business segment  | <b>917</b>        | 786        | 695        |
| Liabilities directly associated with assets held for sale (relating to Advanced Surgical Devices business segment) |                   |            | 19         |
| Unallocated corporate liabilities  | <b>855</b>        | 972        | 846        |
| <b>Total liabilities</b>   | <b>1,772</b>      | 1,758      | 1,560      |

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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Notes to the Group accounts *continued***2 Business segment information continued**

Unallocated corporate assets and liabilities comprise the following:

|   | <b>2013</b>       | 2012       | 2011       |
|---|-------------------|------------|------------|
|   | <b>\$ million</b> | \$ million | \$ million |
| Deferred tax assets                                 | <b>145</b>        | 164        | 223        |
| Retirement benefit asset                            | <b>5</b>          | 6          |            |
| Cash at bank  | <b>137</b>        | 178        | 184        |
| Unallocated corporate assets                        | <b>287</b>        | 348        | 407        |
| Long-term borrowings                                | <b>347</b>        | 430        | 16         |
| Retirement benefit obligations                      | <b>230</b>        | 266        | 287        |
| Deferred tax liabilities                            | <b>50</b>         | 61         | 66         |
| Bank overdrafts and loans due within one year       | <b>44</b>         | 38         | 306        |
| Current tax payable                                 | <b>184</b>        | 177        | 171        |
| Unallocated corporate liabilities                   | <b>855</b>        | 972        | 846        |
|   | <b>2013</b>       | 2012       | 2011       |
|   | <b>\$ million</b> | \$ million | \$ million |
| <b>Capital expenditure (including acquisitions)</b> |                   |            |            |
| Advanced Surgical Devices                           | <b>327</b>        | 188        | 334        |
| Advanced Wound Management                           | <b>124</b>        | 839        | 31         |
|   | <b>451</b>        | 1,027      | 365        |

Capital expenditure segmentally allocated above comprises:

|   | <b>2013</b>       | 2012       | 2011       |
|---|-------------------|------------|------------|
|   | <b>\$ million</b> | \$ million | \$ million |
| Additions to property, plant and equipment            | <b>242</b>        | 197        | 229        |
| Additions to intangible assets                        | <b>98</b>         | 68         | 92         |
| Capital expenditure (excluding business combinations) | <b>340</b>        | 265        | 321        |
| Acquisitions Goodwill                                 | <b>53</b>         | 73         | 44         |

|  |                   |            |            |
|--|-------------------|------------|------------|
| Acquisitions Intangible assets                   | <b>53</b>         | 662        |            |
| Acquisitions Property, plant and equipment       | <b>5</b>          | 27         |            |
| Capital expenditure                              | <b>451</b>        | 1,027      | 365        |
|  | <b>2013</b>       | 2012       | 2011       |
|  | <b>\$ million</b> | \$ million | \$ million |
| <b>Depreciation, amortisation and impairment</b> |                   |            |            |
| Advanced Surgical Devices                        | <b>268</b>        | 274        | 259        |
| Advanced Wound Management                        | <b>93</b>         | 38         | 38         |
|  | <b>361</b>        | 312        | 297        |

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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:

|   | <b>2013</b>       | 2012       | 2011       |
|---|-------------------|------------|------------|
|   | <b>\$ million</b> | \$ million | \$ million |
| Amortisation of acquisition intangibles       | <b>88</b>         | 43         | 36         |
| Depreciation of property, plant and equipment | <b>209</b>        | 212        | 217        |
| Impairment of goodwill in Austrian associate  |                   | 4          |            |
| Amortisation of other intangible assets       | <b>64</b>         | 51         | 42         |
| Impairment of investments                     |                   | 2          | 2          |
|   | <b>361</b>        | 312        | 297        |

No impairments were recognised within operating profit in 2013 (2012 \$6m, 2011 \$2m, both recognised within the administrative expenses line). In 2012 and 2011, the impairments were segmentally allocated to Advanced Surgical Devices.

**Geographic**

|   | <b>2013</b>       | 2012       |
|---|-------------------|------------|
|   | <b>\$ million</b> | \$ million |
| <b>Assets by geographic location</b>                |                   |            |
| United States                                       | <b>2,086</b>      | 2,122      |
| United Kingdom                                      | <b>255</b>        | 257        |
| Other Established Markets                           | <b>902</b>        | 895        |
| Emerging & International Markets                    | <b>170</b>        | 54         |
| Non-current operating assets by geographic location | <b>3,413</b>      | 3,328      |
| United States                                       | <b>1,121</b>      | 999        |
| United Kingdom                                      | <b>288</b>        | 279        |
| Other Established Markets                           | <b>486</b>        | 528        |
| Emerging & International Markets                    | <b>224</b>        | 160        |
| Current operating assets by geographic location     | <b>2,119</b>      | 1,966      |

|   |              |       |
|---|--------------|-------|
| Unallocated corporate assets (see page 104) | <b>287</b>   | 348   |
| <b>Total assets</b>                         | <b>5,819</b> | 5,642 |

## 2.4 Other business segment information

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |
| <b>Other significant expenses recognised within operating profit</b> |                   |            |            |
| Advanced Surgical Devices  | <b>51</b>         | 57         | 32         |
| Advanced Wound Management  | <b>38</b>         | 19         | 8          |
|  | <b>89</b>         | 76         | 40         |

The \$89m incurred in 2013 relates to \$58m restructuring and rationalisation expenses and \$31m acquisition-related costs (2012 \$65m relates to restructuring and rationalisation expenses and \$11m acquisition-related costs, 2011 \$40m relates to restructuring and rationalisation expenses).

|                                    | <b>2013</b>    | 2012    | 2011    |
|------------------------------------|----------------|---------|---------|
|                                    | <b>numbers</b> | numbers | numbers |
| <b>Average number of employees</b> |                |         |         |
| Advanced Surgical Devices          | <b>7,066</b>   | 7,194   | 7,611   |
| Advanced Wound Management          | <b>3,970</b>   | 3,283   | 3,132   |
|                                    | <b>11,036</b>  | 10,477  | 10,743  |



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Notes to the Group accounts *continued*

3 Operating profit

ACCOUNTING POLICIES

Research and development

Research expenditure is expensed as occurred. Internal development expenditure is only capitalised if the recognition criteria in IAS 38 *Intangible Assets* have been satisfied. The Group considers that the regulatory, technical and market uncertainties inherent in the development of new products mean that in most cases development costs should not be capitalised as intangible assets until products receive approval from the appropriate regulatory body.

Payments to third parties for research and development projects are accounted for based on the substance of the arrangement. If the arrangement represents outsourced research and development activities the payments are generally expensed except in limited circumstances where the respective development expenditure would be capitalised under the principles established in IAS 38. By contrast, the payments are capitalised if the arrangement represents consideration for the acquisition of intellectual property developed at the risk of the third party.

Capitalised development expenditures are amortised on a straight-line basis over their useful economic lives from product launch.

Advertising costs

Expenditure on advertising costs is expensed as incurred.

|   | <b>2013</b>       | 2012       | 2011       |
|---|-------------------|------------|------------|
|   | <b>\$ million</b> | \$ million | \$ million |
| Revenue                                       | <b>4,351</b>      | 4,137      | 4,270      |
| Cost of goods sold (i)(ii)                    | <b>(1,100)</b>    | (1,070)    | (1,140)    |
| Gross profit                                  | <b>3,251</b>      | 3,067      | 3,130      |
| Research and development expenses             | <b>(231)</b>      | (171)      | (167)      |
| Selling, general and administrative expenses: |                   |            |            |
| Marketing, selling and distribution expenses  | <b>(1,535)</b>    | (1,440)    | (1,526)    |
| Administrative expenses (iii) (iv) (v) (vi)   | <b>(675)</b>      | (610)      | (575)      |
|   | <b>(2,210)</b>    | (2,050)    | (2,101)    |
| <b>Operating profit</b>                       | <b>810</b>        | 846        | 862        |

(i) 2013 includes \$12m of restructuring and rationalisation expenses (2012 \$3m, 2011 \$7m).

(ii) 2013 includes \$5m of acquisition-related costs (2012 \$nil, 2011 \$nil).

(iii) 2013 includes \$64m of amortisation of other intangible assets (2012 \$51m, 2011 \$42m).

(iv) 2013 includes \$46m of restructuring and rationalisation expenses and \$88m of amortisation of acquisition intangibles (2012 \$62m of restructuring and rationalisation expenses and \$43m of amortisation of acquisition intangibles, 2011 \$33m of restructuring and rationalisation expenses and \$36m of amortisation of acquisition intangibles).

(v) 2013 includes \$nil relating to legal provision (2012 \$nil, 2011 \$23m).

(vi) 2013 includes \$26m of acquisition-related costs (2012 \$11m, 2011 \$nil).

Note that items detailed in (i), (ii), (iv), (v) and (vi) are excluded from the calculation of trading profit.

Operating profit is stated after charging the following items:

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |
| Amortisation of acquisition intangibles                        | <b>88</b>         | 43         | 36         |
| Amortisation of other intangible assets                        | <b>64</b>         | 51         | 42         |
| Impairment of goodwill in Austrian associate                   |                   | 4          |            |
| Depreciation of property, plant and equipment                  | <b>209</b>        | 212        | 217        |
| Loss on disposal of property, plant and equipment and software | <b>23</b>         | 12         | 9          |
| Impairment of investments                                      |                   | 2          | 2          |
| Minimum operating lease payments for land and buildings        | <b>32</b>         | 29         | 33         |
| Minimum operating lease payments for other assets              | <b>19</b>         | 21         | 32         |
| Advertising costs  | <b>91</b>         | 74         | 90         |



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## 3.1 Staff costs

Staff costs during the year amounted to:

|   | Notes | 2013<br>\$ million | 2012<br>Restated<br>\$ million | 2011<br>Restated<br>\$ million |
|---|-------|--------------------|--------------------------------|--------------------------------|
| Wages and salaries                              |       | 998                | 886                            | 930                            |
| Social security costs                           |       | 106                | 97                             | 99                             |
| Pension costs (including retirement healthcare) | 18    | 72                 | 72                             | 71                             |
| Share-based payments                            | 23    | 28                 | 34                             | 30                             |
|   |       | <b>1,204</b>       | 1,089                          | 1,130                          |

## 3.2 Audit Fees information about the nature and cost of services provided by auditors

|   | 2013<br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|---|--------------------|--------------------|--------------------|
| Audit services: Group accounts                | 1                  | 1                  | 1                  |
| Other services:                               |                    |                    |                    |
| Local statutory audit pursuant to legislation | 2                  | 2                  | 2                  |
| Taxation services:                            |                    |                    |                    |
| Compliance services                           | 2                  | 1                  | 1                  |
| Advisory services                             | 1                  | 1                  | 1                  |
| <b>Total auditors remuneration</b>            | <b>6</b>           | <b>5</b>           | <b>5</b>           |
| Arising:                                      |                    |                    |                    |
| In the UK                                     | 3                  | 2                  | 2                  |
| Outside the UK                                | 3                  | 3                  | 3                  |
|   | <b>6</b>           | <b>5</b>           | <b>5</b>           |

## 3.3 Acquisition-related costs

Acquisition-related costs of \$31m (2012 \$ 11m, 2011 \$nil) were incurred in the twelve month period to 31 December 2013. These costs relate to professional and adviser fees and integration costs in connection with the acquisition of Healthpoint Biotherapeutics completed in 2012 and the acquisitions in Turkey, Brazil and India during 2013.

### 3.4 Restructuring and rationalisation expenses

Restructuring and rationalisation costs of \$58m (2012 \$65m, 2011 \$40m) were incurred in the twelve month period to 31 December 2013. Charges of \$58m (2012 \$65m, 2011 \$26m) were incurred, relating mainly to people costs and contract termination costs associated with the structural and process changes announced in August 2011. During 2013, no charges (2012 \$nil, 2011 \$14m) were incurred in relation to the earnings improvement programme which was completed in 2011.

### 3.5 Legal provision

In 2011, the Group established a provision of \$ 23m in connection with the previously disclosed investigation by the US Securities and Exchange Commission ( SEC ) and Department of Justice ( DOJ ) into potential violations of the US Foreign Corrupt Practices Act in the medical devices industry.

On 6 February 2012, Smith & Nephew announced that it had reached settlement with the SEC and DOJ in connection with this matter. Smith & Nephew paid slightly less than \$23m in fines and profit disgorgement and committed to maintain an enhanced compliance programme and appoint an independent monitor for at least 18 months to review and report on its compliance programme. The monitor's final report was filed in late 2013, and the independent monitorship has now been terminated. The settlement agreements impose detailed reporting, compliance and other requirements on Smith & Nephew for a three-year term. Failure to comply with these requirements, or any other violation of law, could have severe consequences for the Group.

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Notes to the Group accounts *continued*

## 4 Interest and other finance costs

## 4.1 Interest receivable/(payable)

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |
| Interest receivable                      | <b>14</b>         | 11         | 4          |
| Interest payable:                        |                   |            |            |
| Bank borrowings                          | <b>(8)</b>        | (7)        | (6)        |
| Other                                    | <b>(2)</b>        | (2)        | (6)        |
|  | <b>(10)</b>       | (9)        | (12)       |
| <b>Net interest receivable/(payable)</b> | <b>4</b>          | 2          | (8)        |

## 4.2 Other finance costs

|   |       | <b>2013</b>       | 2012       | 2011       |
|---|-------|-------------------|------------|------------|
|   | Notes | <b>\$ million</b> | \$ million | \$ million |
| Retirement benefit net interest expense | 18    | <b>(11)</b>       | (11)       | (14)       |
| Other                                   |       |                   |            | 1          |
| <b>Other finance costs</b>              |       | <b>(11)</b>       | (11)       | (13)       |

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 \$1m gain in 2013 (2012 net \$5m loss, 2011 net \$3m gain). These amounts were fully matched in the income statement by the fair value gains or losses on currency swaps (carried at fair value through profit and loss) held to manage this currency risk.

## 5 Taxation

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 tax rates that have been enacted or substantively enacted by the balance sheet date.

The Group operates in multiple tax jurisdictions around the world and records provisions for taxation liabilities and tax audits when it is considered probable that a tax charge will arise and the amount can be reliably estimated. Although Group policy is to submit its tax returns to the relevant tax authorities as promptly as possible, at any time the Group has un-agreed 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 advisers 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.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is not recognised for: temporary differences related to investments in subsidiaries and associates 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 profits will be available against which they can be used. Deferred tax assets are reviewed at each reporting date.

Deferred tax is measured on an undiscounted basis, and at the tax rates that have been enacted or substantively enacted by the reporting 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 recognised within 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.





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## 5.1 Taxation charge attributable to the Group

|   | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|---|---------------------------|--------------------|--------------------|
| Current taxation:   |                           |                    |                    |
| UK corporation tax at 23.3% (2012 24.5%, 2011 26.5%)      | <b>50</b>                 | 53                 | 56                 |
| Overseas tax  | <b>229</b>                | 248                | 214                |
| Current income tax charge                                 | <b>279</b>                | 301                | 270                |
| Adjustments in respect of prior periods                   | <b>(5)</b>                | (17)               | (16)               |
| <b>Total current taxation</b>                             | <b>274</b>                | 284                | 254                |
| Deferred taxation:  |                           |                    |                    |
| Origination and reversal of temporary differences         | <b>(23)</b>               | 88                 | 18                 |
| Changes in tax rates                                      | <b>(4)</b>                | (3)                | (3)                |
| Adjustments to estimated amounts arising in prior periods | <b>(1)</b>                | 2                  | (3)                |
| <b>Total deferred taxation</b>                            | <b>(28)</b>               | 87                 | 12                 |
| Total taxation as per the income statement                | <b>246</b>                | 371                | 266                |
| Deferred taxation in other comprehensive income           | <b>16</b>                 | (20)               | (24)               |
| Deferred taxation in equity                               | <b>(3)</b>                |                    | 2                  |
| <b>Taxation attributable to the Group</b>                 | <b>259</b>                | 351                | 244                |

The tax charge was reduced by \$40m as a consequence of restructuring and rationalisation expenses, amortisation of acquisition intangibles and acquisition-related costs. In 2012, the tax charge was increased by \$82m as a consequence of the profit on disposal of net assets held for sale after adjusting for acquisition-related costs, restructuring and rationalisation expenses and amortisation of acquisition intangibles. In 2011, the tax charge was reduced by \$17m as a consequence of restructuring and rationalisation expenses, amortisation of acquisition intangibles and legal provision.

The applicable tax for the year is based on the UK standard rate of corporation tax of 23.3% (2012 24.5%, 2011 26.5%). Overseas taxation is calculated at the rates prevailing in the respective jurisdictions. The average effective tax rate differs from the applicable rate as follows:

|                                  | <b>2013</b><br>% | 2012<br>% | 2011<br>% |
|----------------------------------|------------------|-----------|-----------|
| UK standard rate                 | <b>23.3</b>      | 24.5      | 26.5      |
| Non-deductible/non-taxable items | <b>(1.0)</b>     | 0.4       | (0.5)     |

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|  |              |       |       |
|--|--------------|-------|-------|
| Prior year items                                     | <b>(0.5)</b> | (1.3) | (1.6) |
| Tax losses incurred not relieved                     | <b>0.9</b>   | 0.8   | 0.3   |
| Overseas income taxed at other than UK standard rate | <b>7.8</b>   | 9.3   | 6.7   |
| <b>Total effective tax rate</b>                      | <b>30.5</b>  | 33.7  | 31.4  |

The enacted UK tax rate applicable from 1 April 2013 is 23%. The UK Government have enacted legislation to reduce the tax rate to 21% from 1 April 2014 and 20% from 1 April 2015.

5.2 Deferred taxation

|                                    | <b>2013</b>       | 2012       |
|------------------------------------|-------------------|------------|
|                                    | <b>\$ million</b> | \$ million |
| Deferred tax assets                | <b>145</b>        | 164        |
| Deferred tax liabilities           | <b>(50)</b>       | (61)       |
| <b>Net position at 31 December</b> | <b>95</b>         | 103        |

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 110 FINANCIAL STATEMENTS

Notes to the Group accounts *continued*5 Taxation *continued*

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

|   | <b>2013</b>       | 2012       |
|---|-------------------|------------|
|   | <b>\$ million</b> | \$ million |
| At 1 January                                | <b>103</b>        | 157        |
| Exchange adjustment                         | <b>(4)</b>        |            |
| Movement in income statement – current year | <b>27</b>         | (85)       |
| Movement in income statement – prior years  | <b>1</b>          | (2)        |
| Movement in other comprehensive income      | <b>(16)</b>       | 20         |
| Movement in shareholders' equity            | <b>3</b>          |            |
| Arising on acquisition                      | <b>(19)</b>       | 13         |
| <b>At 31 December</b>                       | <b>95</b>         | 103        |

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 2012                           | 79  | 52  | 92                  | 223                 |
| Exchange adjustment                         |   |   | 1                   | 1                   |
| Movement in income statement – current year | (4)   |   | (85)                | (89)                |
| Movement in income statement – prior years  | 2   |   | (4)                 | (2)                 |
| Movement in other comprehensive income      | 17  |   | 1                   | 18                  |
| Acquisition                                 |   |   | 13                  | 13                  |
| Transfers                                   | (9)   |   | 9                   |                     |
| At 31 December 2012                         | 85  | 52  | 27                  | 164                 |
| Exchange adjustment                         |   |   | (3)                 | (3)                 |
| Movement in income statement – current year | 5   |   | 15                  | 20                  |
| Movement in income statement – prior years  |   |   | 1                   | 1                   |

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|  |           |           |           |            |
|--|-----------|-----------|-----------|------------|
| Movement in other comprehensive income | (32)      |           | (2)       | (34)       |
| Charge to equity                       |           |           | 2         | 2          |
| Acquisition                            |           |           | (5)       | (5)        |
| <b>At 31 December 2013</b>             | <b>58</b> | <b>52</b> | <b>35</b> | <b>145</b> |

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The Group has unused tax losses of \$31m (2012 \$61m) available for offset against future profits. A deferred tax asset has been recognised in respect of \$3m (2012 \$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 tax<br>depreciation<br>\$ million | Intangible<br>assets<br>\$ million | Other<br>\$ million | Total<br>\$ million |
|---|---|------------------------------------|---------------------|---------------------|
| <b>Deferred tax liabilities</b>             |   |                                    |                     |                     |
| At 1 January 2012                           | (28)  | (27)                               | (11)                | (66)                |
| Exchange adjustment                         | (1)   |                                    |                     | (1)                 |
| Movement in income statement – current year | 2   | 6                                  | (4)                 | 4                   |
| Movement in other comprehensive income      |   |                                    | 2                   | 2                   |
| At 31 December 2012                         | (27)  | (21)                               | (13)                | (61)                |
| Exchange adjustment                         | (1)   |                                    |                     | (1)                 |
| Movement in income statement – current year | 3   | 8                                  | (4)                 | 7                   |
| Movement in other comprehensive income      |   |                                    | 18                  | 18                  |
| Charge to equity                            |   |                                    | 1                   | 1                   |
| Acquisitions/disposals                      |   |                                    | (14)                | (14)                |
| <b>At 31 December 2013</b>                  | <b>(25)</b>                                   | <b>(13)</b>                        | <b>(12)</b>         | <b>(50)</b>         |

**6 Earnings per ordinary share**

## ACCOUNTING POLICIES

## Earnings per share

Basic earnings per share is calculated by dividing the profit attributable to equity holders by the weighted average number of Ordinary shares in issue during the year, excluding shares held by the Company in the Employees' Share Trust or as treasury shares.

#### Adjusted earnings per share

Adjusted earnings per share is a trend measure, which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affects the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. Adjusted attributable profit is the numerator used for this measure. The Group has identified the following items 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; significant gains and losses arising from legal disputes and significant uninsured losses; and taxation thereon.

The calculations of the basic, diluted and adjusted earnings per ordinary share are based on the following attributable profit and numbers of shares:

|  | <b>2013</b><br>\$ million | 2012<br>Restated<br>\$ million | 2011<br>Restated<br>\$ million |
|--|---------------------------|--------------------------------|--------------------------------|
| <b>Earnings</b>                          |                           |                                |                                |
| Attributable profit for the year         | <b>556</b>                | 721                            | 575                            |
| Adjusted attributable profit (see below) | <b>693</b>                | 671                            | 657                            |

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Notes to the Group accounts *continued***6 Earnings per ordinary share continued**

Attributable profit is reconciled to adjusted attributable profit as follows:

|   |       | <b>2013</b>       | 2012                   | 2011                   |
|---|-------|-------------------|------------------------|------------------------|
|   | Notes | <b>\$ million</b> | Restated<br>\$ million | Restated<br>\$ million |
| Attributable profit for the year                        |       | <b>556</b>        | 721                    | 575                    |
| Acquisition-related costs                               | 3     | <b>31</b>         | 11                     |                        |
| Restructuring and rationalisation expenses              | 3     | <b>58</b>         | 65                     | 40                     |
| Amortisation of acquisition intangibles and impairments | 9     | <b>88</b>         | 43                     | 36                     |
| Profit on disposal of net assets held for sale          | 21    |                   | (251)                  |                        |
| Legal provision   | 3     |                   |                        | 23                     |
| Taxation on excluded items                              | 5     | <b>(40)</b>       | 82                     | (17)                   |
| <b>Adjusted attributable profit</b>                     |       | <b>693</b>        | 671                    | 657                    |

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:

|  | <b>2013</b>  | 2012     | 2011     |
|--|--------------|----------|----------|
| <b>Number of shares (millions)</b>           |              |          |          |
| Basic weighted number of shares              | <b>901</b>   | 897      | 891      |
| Dilutive impact of share options outstanding | <b>5</b>     | 4        | 4        |
| Diluted weighted average number of shares    | <b>906</b>   | 901      | 895      |
| <b>Earnings per ordinary share</b>           |              | Restated | Restated |
| Basic  | <b>61.7¢</b> | 80.4¢    | 64.5¢    |
| Diluted                                      | <b>61.4¢</b> | 80.0¢    | 64.2¢    |
| Adjusted: Basic                              | <b>76.9¢</b> | 74.8¢    | 73.7¢    |
| Adjusted: Diluted                            | <b>76.5¢</b> | 74.5¢    | 73.4¢    |

Share options not included in the diluted EPS calculation because they were non-dilutive in the period totalled 0.5m (2012 8.2m, 2011 12.9m).

## 7 Property, plant and equipment

### ACCOUNTING POLICIES

#### Property, plant and equipment

Items of property, plant and equipment are stated at cost less accumulated depreciation and any accumulated impairment losses.

Depreciation is calculated to write off the cost of items of property, plant and equipment less their estimated residual values using the straight-line method over their estimated useful lives, and is generally recognised in profit or loss. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Group will obtain ownership by the end of the lease term. Freehold land is not depreciated. The estimated useful lives of items of property, plant and equipment is 3 – 20 years and for buildings is 20 – 50 years.

Assets in course of construction are not depreciated until they are available for use.

Depreciation methods, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

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

The carrying values of property, plant and equipment are reviewed for impairment when events or changes in circumstances indicate the carrying value may be impaired. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of impairment loss. Where it is not possible to estimate



the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which it belongs.

An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and value-in-use. In assessing value-in-use, its estimated future cash flow is discounted to its present value using a pre-tax discount rate that reflects the current market assessments of the time value of money and the risks specific to the asset.

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|                                    | <b>Freehold</b>       | <b>Land and<br/>buildings<br/>Leasehold</b> | <b>Instruments</b>    | <b>Plant and<br/>equipment<br/>Other</b> | <b>Assets in<br/>course of<br/>construction</b> | <b>Total</b>          |
|------------------------------------|-----------------------|---|-----------------------|--|---|-----------------------|
|                                    | <b>\$<br/>million</b> | <b>\$<br/>million</b>                       | <b>\$<br/>million</b> | <b>\$<br/>million</b>                    | <b>\$<br/>million</b>                           | <b>\$<br/>million</b> |
| <b>Cost</b>                        |                       |   |                       |  |   |                       |
| At 1 January 2012                  | 133                   | 52  | 1,009                 | 878                                      | 42  | 2,114                 |
| Exchange adjustment                | 2                     |   | 3                     | 15                                       | 1   | 21                    |
| Acquisitions (see Note 21.4)       | 8                     |   |                       | 7  | 12  | 27                    |
| Additions                          |                       | 1   | 122                   | 46                                       | 28  | 197                   |
| Disposals                          |                       | (1)   | (92)                  | (37)                                     |   | (130)                 |
| Transfers                          |                       |   |                       | 10                                       | (10)  |                       |
| At 31 December 2012                | 143                   | 52  | 1,042                 | 919                                      | 73  | 2,229                 |
| Exchange adjustment                | 1                     | (1)   | (16)                  | 6  |   | (10)                  |
| Acquisitions (see Note 21.1)       |                       | 1   | 2                     | 2  |   | 5                     |
| Additions                          | 2                     | 1   | 139                   | 23                                       | 77  | 242                   |
| Disposals                          | (3)                   |   | (102)                 | (80)                                     | (2)   | (187)                 |
| Transfers                          |                       |   |                       | 68                                       | (68)  |                       |
| <b>At 31 December 2013</b>         | <b>143</b>            | <b>53</b>                                   | <b>1,065</b>          | <b>938</b>                               | <b>80</b>                                       | <b>2,279</b>          |
| <b>Depreciation and impairment</b> |                       |   |                       |  |   |                       |
| At 1 January 2012                  | 43                    | 27  | 688                   | 573                                      |   | 1,331                 |
| Exchange adjustment                | 1                     |   | 2                     | 11                                       |   | 14                    |
| Charge for the year                | 2                     | 3   | 137                   | 70                                       |   | 212                   |
| Disposals                          |                       | (1)   | (89)                  | (31)                                     |   | (121)                 |
| At 31 December 2012                | 46                    | 29  | 738                   | 623                                      |   | 1,436                 |
| Exchange adjustment                | (1)                   | (1)   | (10)                  | 5  |   | (7)                   |
| Charge for the year                | 1                     | 3   | 135                   | 70                                       |   | 209                   |
| Disposals                          | (3)                   |   | (99)                  | (73)                                     |   | (175)                 |
| <b>At 31 December 2013</b>         | <b>43</b>             | <b>31</b>                                   | <b>764</b>            | <b>625</b>                               |   | <b>1,463</b>          |
| <b>Net book amounts</b>            |                       |   |                       |  |   |                       |
| <b>At 31 December 2013</b>         | <b>100</b>            | <b>22</b>                                   | <b>301</b>            | <b>313</b>                               | <b>80</b>                                       | <b>816</b>            |
| At 31 December 2012                | 97                    | 23  | 304                   | 296                                      | 73  | 793                   |

Land and buildings includes land with a cost of \$15m (2012 \$15m) that is not subject to depreciation. Assets held under finance leases with a net book amount of \$10m (2012 \$11m) are included within land and buildings.

Historically, capital expenditure represents the Group's expected annual investment in property, plant and equipment and other intangible assets. This varies between 6% and 8% (2012 7% and 8%) of annual revenue.

Group capital expenditure relating to property, plant and equipment contracted but not provided for amounted to \$20m (2012 \$4m).

The amount of borrowing costs capitalised in 2013 and 2012 was minimal.

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Notes to the Group accounts *continued*

## 8 Goodwill

## ACCOUNTING POLICY

Goodwill is not amortised but is reviewed for impairment annually. Goodwill is allocated to the cash-generating unit ( CGU ) that is expected to benefit from the acquisition. The recoverable amount of CGUs to which goodwill has been allocated is tested for impairment annually. The CGUs, monitored by management, are at the business segment level, Advanced Surgical Devices and Advanced Wound Management.

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 of the CGU.

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

|                     |       | 2013         | 2012       |
|---------------------|-------|--------------|------------|
|                     | Notes | \$ million   | \$ million |
| <b>Cost</b>         |       |              |            |
| At 1 January        |       | <b>1,186</b> | 1,096      |
| Exchange adjustment |       | <b>17</b>    | 17         |
| Acquisitions (i)    | 21    | <b>53</b>    | 73         |
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|                              |              |       |
|------------------------------|--------------|-------|
| At 31 December               | <b>1,256</b> | 1,186 |
| <b>Impairment</b>            |              |       |
| At 1 January and 31 December |              |       |
| <b>Net book amounts</b>      | <b>1,256</b> | 1,186 |

(i) Includes an adjustment of \$16m (2012: \$nil) following the finalisation of the Healthpoint acquisition balance sheet. See Note 21.4.

Each of the Group's business segments represent a CGU and include goodwill as follows:

|                           | <b>2013</b>       | 2012       |
|---------------------------|-------------------|------------|
|                           | <b>\$ million</b> | \$ million |
| Advanced Surgical Devices | <b>918</b>        | 886        |
| Advanced Wound Management | <b>338</b>        | 300        |
|                           | <b>1,256</b>      | 1,186      |

In September 2013 and 2012 impairment reviews were performed by comparing the recoverable amount of each CGU with its carrying amount, including goodwill. These are updated during December, taking into account significant events that occurred between September and December.

For each CGU, the recoverable amounts are based on value-in-use which is calculated from pre-tax cash flow projections for five years using data from the Group's budget and strategic planning process, the results of which are reviewed and approved by the Board. These projections exclude any estimated future cash inflows or outflows expected to arise from future restructurings. The five-year period is in-line with the Group's strategic planning process.

The calculation of value-in-use for the 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 Advanced Surgical Devices business is 10% (2012 10%) and for the Advanced Wound Management business it is 10% (2012 9%).

In determining the growth rate used in the calculation of the value-in-use, the Group considered the annual revenue growth and trading profit margins. Projections are based on anticipated volume and value growth in the markets served by the Group and assumptions as to market share movements. Each year the projections for the previous year are compared to actual results and variances are factored into the assumptions used in the current year. Growth rates for the five-year period for the Advanced Surgical Devices business vary up to 7% (2012 7%) and for the Advanced Wound Management business up to 18% (2012 9%).



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Specific considerations and strategies taken into account in determining the sales growth and trading profit margin for each CGU are:

**Advanced Surgical Devices** In the Advanced Surgical Devices CGU management intends to deliver growth through continuing to focus on the customer, high-quality customer service, innovative product development and through continuing to make efficiency improvements

**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, NPWT, healing of chronic wounds and tissue repair using bioactives and by continuing to improve efficiency.

A long-term growth rate of 3% for Advanced Surgical Devices business and 5% for the Advanced Wound Management business (2012 both businesses 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.

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 33% (2012 31%) for the Advanced Surgical Devices business and 65% (2012 49%) for the Advanced Wound Management business.

**9 Intangible assets**

## ACCOUNTING POLICIES

### Intangible assets

Intangible assets acquired separately from a business combination (including purchased patents, know-how, trademarks, licences and distribution rights) are initially measured at cost. The cost of intangible assets acquired in a material business combination (referred to as acquisition intangibles) is the fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. All intangible assets are amortised on a straight-line basis over their estimated useful economic lives. The estimated useful economic life of an intangible asset ranges between three and 20 years depending on its nature. Internally generated intangible assets are expensed in the income statement as incurred.

Purchased computer software and certain costs of information technology projects are capitalised as intangible assets. Software that is integral to computer hardware is capitalised as plant and equipment.

### Impairment of intangible assets

The carrying values of intangible assets are reviewed for impairment when events or changes in circumstances indicate the carrying value may be impaired. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of impairment loss. Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which it belongs.

An asset's recoverable amount is the higher of an asset's or cash-generating unit's fair value less costs to sell and 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 intangible assets a number of significant assumptions have to be made when preparing cash flow projections. These include the future rate of market growth, discount rates, the market demand for the products acquired, the future profitability of acquired businesses or products, levels of reimbursement and success in obtaining regulatory approvals. If actual results should differ, or changes in expectations arise, impairment charges may be required which would adversely impact operating results.





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Notes to the Group accounts *continued*9 Intangible assets *continued*

|                                    | Acquisition<br>intangibles<br>\$ million | Software<br>\$ million | Distribution<br>rights<br>\$ million | Patents &<br>Intellectual<br>property<br>\$ million | Total<br>\$ million |
|------------------------------------|--|------------------------|--------------------------------------|---|---------------------|
| <b>Cost</b>                        |  |                        |                                      |   |                     |
| At 1 January 2012                  | 436                                      | 170                    | 60                                   | 143   | 809                 |
| Exchange adjustment                | 11                                       | 1                      |                                      | 2   | 14                  |
| Acquisitions (i)                   | 662                                      |                        |                                      |   | 662                 |
| Additions                          |  | 37                     |                                      | 31  | 68                  |
| Disposals                          |  | (3)                    | (17)                                 |   | (20)                |
| At 31 December 2012                | 1,109                                    | 205                    | 43                                   | 176   | 1,533               |
| Exchange adjustment                | 3  |                        |                                      |   | 3                   |
| Acquisitions (ii)                  | 53                                       |                        |                                      |   | 53                  |
| Additions                          |  | 53                     | 27                                   | 18  | 98                  |
| Disposals                          |  | (29)                   |                                      |   | (29)                |
| <b>At 31 December 2013</b>         | <b>1,165</b>                             | <b>229</b>             | <b>70</b>                            | <b>194</b>  | <b>1,658</b>        |
| <b>Amortisation and impairment</b> |  |                        |                                      |   |                     |
| At 1 January 2012                  | 234                                      | 65                     | 34                                   | 53  | 386                 |
| Exchange adjustment                | 6  |                        |                                      |   | 6                   |
| Charge for the year                | 43                                       | 26                     | 10                                   | 15  | 94                  |
| Disposals                          |  |                        | (17)                                 |   | (17)                |
| At 31 December 2012                | 283                                      | 91                     | 27                                   | 68  | 469                 |
| Exchange adjustment                | 1  |                        |                                      |   | 1                   |
| Charge for the year                | 88                                       | 31                     | 14                                   | 19  | 152                 |
| Disposals                          |  | (18)                   |                                      |   | (18)                |
| <b>At 31 December 2013</b>         | <b>372</b>                               | <b>104</b>             | <b>41</b>                            | <b>87</b>   | <b>604</b>          |
| <b>Net book amounts</b>            |  |                        |                                      |   |                     |
| <b>At 31 December 2013</b>         | <b>793</b>                               | <b>125</b>             | <b>29</b>                            | <b>107</b>  | <b>1,054</b>        |
| At 31 December 2012                | 826                                      | 114                    | 16                                   | 108   | 1,064               |

(i)

The majority of this balance relates to the acquisition of the product rights for two established Healthpoint products (see Note 21.4). These product rights are amortised over 15 years.

(ii) Includes an adjustment of \$11m following the finalisation of the Healthpoint acquisition balance sheet. See Note 21.4.

Group capital expenditure relating to software contracted but not provided for amounted to \$21m (2012 \$4m).

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## 10 Investments

## ACCOUNTING POLICY

Investments, other than those related to associates, are initially recorded at fair value plus any directly attributable transaction costs on the trade date. The Group has an investment in an entity that holds mainly unquoted equity securities, which by their very nature have no fixed maturity date or coupon rate. The investment is classed as available-for-sale and carried at fair value. The fair value of the investment is based on the underlying fair value of the equity securities: marketable securities are valued by reference to closing prices in the market; non-marketable securities are estimated considering factors including the purchase price, prices of recent significant private placements of securities of the same issuer and estimates of liquidation value. 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. Objective evidence would include a significant or prolonged decline in the fair value of the investment below its cost less any impairment loss previously recognised. Impairment losses are recognised by reclassifying the losses accumulated in other reserves to profit or loss.

|                | 2013       | 2012       |
|----------------|------------|------------|
|                | \$ million | \$ million |
| At 1 January   | 2          | 4          |
| Impairment     |            | (2)        |
| At 31 December | 2          | 2          |

## 11 Investments in associates

## ACCOUNTING POLICY

Investments in associates, being those entities over which the Group has a significant influence and which is neither a subsidiary nor a joint venture, are accounted for using the equity method, with the Group recording its share of the associate's profit and loss and other comprehensive income. The Group's share of associates profit or loss is included in one separate income statement line and is calculated after deduction of their respective taxes.

At 31 December 2013 and 31 December 2012, the Group holds 49% of Bioventus LLC ( Bioventus ). Bioventus is a limited liability company operating as a partnership. The Company's headquarters is located in Durham, North Carolina, US. The Company focuses its medical product development around its core competencies of orthobiologic therapies and orthopaedic diagnostics from which it develops and markets clinically proven orthopaedic therapies and diagnostic tools, including osteoarthritis pain treatments, bone growth stimulators and ultrasound devices. The Company sells bone stimulation devices and a provider of osteoarthritis injection therapies. The loss after taxation recognised in the income statement relating to Bioventus was \$2m (2012 profit after taxation \$4m).

The carrying amount of this investment was reviewed for impairment as at the balance sheet date. For the purposes of impairment testing the recoverable amount of this investment was based on its fair value less cost to sell, estimated using discounted cash flows. The fair value measurement was categorised as a level 3 fair value based on the inputs and valuation technique used. Given the relatively short passage of time between the date of acquisition and the impairment review, the estimated recoverable amount of the investment marginally exceeded its carrying amount. Management has identified that a reasonable possible change in the key assumptions and estimated cash flows could cause the carrying amount to exceed the recoverable amount. However, any such change would not result in the recognition of a material impairment loss.

In addition to its 49% ownership interest in Bioventus, the Group holds a senior secured five year loan note with Bioventus. The loan note was created in May 2012 with a principal amount of \$160m and an annual coupon rate of LIBOR plus 5%. The loan note is carried at amortised cost. Interest receivable of \$11m was accrued during 2013 (2012: \$7m). In accordance with the terms of the agreement \$10m of interest receivable has been rolled-up into principal during 2013. As at the balance sheet date, the carrying amount of the loan note and the related interest receivable is neither past due nor impaired.

In 2013, the Group sold its 49% interest in the Austrian entities Plus Orthopedics GmbH and Intraplant GmbH and its 20% interest in the German entity Intercus GmbH. The profit after taxation recognised in the income statement prior to the disposal was \$1m (2012 \$nil).

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Notes to the Group accounts *continued***11 Investments in associates continued**

The following table summarises the financial position of the Group's investment in these associates:

|   | <b>2013</b>       | 2012       |
|---|-------------------|------------|
|   | <b>\$ million</b> | \$ million |
| Share of results of associates:   |                   |            |
| Revenue   | <b>113</b>        | 80         |
| Operating costs and taxation  | <b>(114)</b>      | (76)       |
| Share of associates (loss)/profit after taxation recognised in the income statement | <b>(1)</b>        | 4          |
| Investments in associates at 1 January  | <b>116</b>        | 13         |
| Investment of 49% in Bioventus  |                   | 104        |
| Additional investment in Bioventus  |                   | 10         |
| Dividends received  | <b>(1)</b>        | (7)        |
| Impairment of goodwill in Austrian associate  |                   | (4)        |
| Disposal of interest in Plus and Intraplant   | <b>(7)</b>        |            |
| Other non-cash movements  |                   | (4)        |
| Investments in associates at 31 December  | <b>107</b>        | 116        |
| Investments in associates is represented by:  |                   |            |
| Non-current assets  | <b>315</b>        | 310        |
| Current assets  | <b>129</b>        | 129        |
| Non-current liabilities   | <b>(194)</b>      | (167)      |
| Current liabilities   | <b>(59)</b>       | (33)       |
| Net assets (100%)   | <b>191</b>        | 239        |
| Group's share of net assets (49%)   | <b>93</b>         | 117        |
| Group adjustments (i)   | <b>14</b>         | (1)        |
| Investment in associate   | <b>107</b>        | 116        |

(i) Group adjustments primarily relate to an adjustment to the useful economic life of intangible assets.

Loans to associates:

|                                     |            |     |
|-------------------------------------|------------|-----|
| Loan note receivable from Bioventus | <b>171</b> | 160 |
|-------------------------------------|------------|-----|

|  |            |            |
|--|------------|------------|
| Accrued interest on loan note receivable | 7          | 7          |
|  | <b>178</b> | <b>167</b> |
| <b>12 Inventories</b>                    |            |            |

## ACCOUNTING POLICY

Finished goods and work-in-progress are valued at factory cost, including appropriate overheads, on a first-in first-out basis. Raw materials and bought-in finished goods are valued at purchase price. All inventories are reduced to net realisable value where lower than cost. Inventory acquired as part of a business acquisition is valued at selling price less costs of disposal and a profit allowance for selling efforts.

Orthopaedic instruments are generally not sold but provided to customers and distributors for use in surgery. They are recorded as inventory until they are deployed at which point they are transferred to plant and equipment and depreciated over their useful economic lives of between three and five years.

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.

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|                                     | <b>2013</b>       | 2012       | 2011       |
|-------------------------------------|-------------------|------------|------------|
|                                     | <b>\$ million</b> | \$ million | \$ million |
| Raw materials and consumables       | <b>151</b>        | 138        | 140        |
| Work-in-progress                    | <b>72</b>         | 45         | 24         |
| Finished goods and goods for resale | <b>783</b>        | 718        | 695        |
|                                     | <b>1,006</b>      | 901        | 859        |

Reserves for excess and obsolete inventories were \$354m (2012 \$332m, 2011 \$322m). During 2013, \$73m was recognised as an expense within cost of goods sold resulting from the write down of excess and obsolete inventory (2012 \$84m, 2011 \$65m). The cost of inventories recognised as an expense and included in cost of goods sold amounted to \$958m (2012 \$906m, 2011 \$991m).

Notwithstanding inventory acquired within acquisitions, no inventory is carried at fair value less costs to sell in any year.

**13 Trade and other receivables****ACCOUNTING POLICY**

Trade and other 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.



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 and geographies. Furthermore the Group's principal customers are backed by government and public or private medical insurance funding, which historically represent a lower risk of default. The maximum exposure to credit risk at the reporting date is the fair value of each class of receivable. The Group does not hold any collateral as security.

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |
| Trade receivables                              | <b>992</b>        | 964        | 936        |
| Less: provision for bad and doubtful debts     | <b>(57)</b>       | (49)       | (36)       |
| Trade receivables net (loans and receivables)  | <b>935</b>        | 915        | 900        |
| Derivatives forward foreign exchange contracts | <b>28</b>         | 12         | 21         |
| Other receivables                              | <b>60</b>         | 65         | 50         |
| Prepayments and accrued income                 | <b>90</b>         | 73         | 66         |
|  | <b>1,113</b>      | 1,065      | 1,037      |

Management considers that the carrying amount of trade and other receivables approximates to the fair value.

The provision for bad and doubtful debts is based on specific assessments of risk and reference to past default experience. The bad debt expense for the year was \$15m (2012 \$16m, 2011 \$42m). Amounts due from insurers in respect of the macro textured claim of \$138m (2012 \$137m, 2011 \$136m) are included within other receivables and have been provided in full.

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Notes to the Group accounts *continued***13 Trade and other receivables continued**

The amount of trade receivables that were past due were as follows:

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |
| Past due not more than three months                          | <b>206</b>        | 225        | 198        |
| Past due more than three months and not more than six months | <b>52</b>         | 52         | 51         |
| Past due more than six months and not more than one year     | <b>61</b>         | 52         | 59         |
| Past due more than one year                                  | <b>70</b>         | 80         | 94         |
|  | <b>389</b>        | 409        | 402        |
| Neither past due nor impaired                                | <b>603</b>        | 555        | 534        |
| Provision for bad and doubtful debts                         | <b>(57)</b>       | (49)       | (36)       |
| Trade receivables net (loans and receivables)                | <b>935</b>        | 915        | 900        |

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

|   |            |     |      |
|---|------------|-----|------|
| At 1 January                                  | <b>49</b>  | 36  | 49   |
| Exchange adjustment                           | <b>1</b>   |     | (1)  |
| Receivables provided for during the year      | <b>15</b>  | 16  | 42   |
| Utilisation of provision                      | <b>(8)</b> | (3) | (34) |
| Provision transferred to assets held for sale |            |     | (20) |
| At 31 December                                | <b>57</b>  | 49  | 36   |

Trade receivables include amounts denominated in the following major currencies:

|  | <b>2013</b>       | 2012       | 2011       |
|--|-------------------|------------|------------|
|  | <b>\$ million</b> | \$ million | \$ million |

|   |            |     |     |
|---|------------|-----|-----|
| US Dollar                                     | <b>293</b> | 258 | 238 |
| Sterling                                      | <b>103</b> | 100 | 75  |
| Euro  | <b>271</b> | 276 | 317 |
| Other   | <b>268</b> | 281 | 270 |
| Trade receivables net (loans and receivables) | <b>935</b> | 915 | 900 |

#### 14 Trade and other payables

|   | <b>2013</b>       | 2012       |
|---|-------------------|------------|
|   | <b>\$ million</b> | \$ million |
| <b>Trade and other payables due within one year</b> |                   |            |
| Trade and other payables                            | <b>751</b>        | 646        |
| Derivatives forward foreign exchange contracts      | <b>20</b>         | 10         |
| Acquisition consideration                           | <b>14</b>         |            |
|   | <b>785</b>        | 656        |
| <b>Other payables due after one year:</b>           |                   |            |
| Acquisition consideration                           | <b>7</b>          | 8          |

The acquisition consideration due after more than one year is expected to be payable as follows: \$4m in 2015 and \$3m in 2016 (2012 \$8m in 2014).

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**15 Cash and borrowings**

## 15.1 Net debt

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

|   | <b>2013</b>       | 2012       |
|---|-------------------|------------|
|   | <b>\$ million</b> | \$ million |
| Bank overdrafts and loans due within one year | <b>44</b>         | 38         |
| Long-term borrowings                          | <b>347</b>        | 430        |
| Borrowings                                    | <b>391</b>        | 468        |
| Cash at bank                                  | <b>(137)</b>      | (178)      |
| Debit balance on derivatives – currency swaps | <b>(1)</b>        | (2)        |
| Net debt                                      | <b>253</b>        | 288        |

Borrowings are repayable as follows:

|                           | <b>Within</b>       |                   |                   |                   |                   |                   |                   |                   |
|---------------------------|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
|                           | <b>one year</b>     | <b>Between</b>    | <b>two</b>        | <b>Between</b>    | <b>four</b>       |                   |                   |                   |
|                           | <b>or on demand</b> | <b>one and</b>    | <b>and three</b>  | <b>and three</b>  | <b>and</b>        | <b>After</b>      |                   |                   |
|                           | <b>\$ million</b>   | <b>two years</b>  | <b>years</b>      | <b>years</b>      | <b>five years</b> | <b>five years</b> | <b>\$ million</b> | <b>Total</b>      |
|                           |                     | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |                   | <b>\$ million</b> |
| At 31 December 2013:      |                     |                   |                   |                   |                   |                   |                   |                   |
| Bank loans                | 31                  | 335               |                   |                   |                   |                   |                   | <b>366</b>        |
| Bank overdrafts           | 11                  |                   |                   |                   |                   |                   |                   | <b>11</b>         |
| Finance lease liabilities | 2                   | 2                 | 2                 | 2                 | 3                 | 3                 |                   | <b>14</b>         |
|                           | <b>44</b>           | <b>337</b>        | <b>2</b>          | <b>2</b>          | <b>3</b>          | <b>3</b>          |                   | <b>391</b>        |

At 31 December 2012:

|                           |    |   |     |   |   |   |     |
|---------------------------|----|---|-----|---|---|---|-----|
| Bank loans                | 25 | 1 | 415 |   |   |   | 441 |
| Bank overdrafts           | 11 |   |     |   |   |   | 11  |
| Finance lease liabilities | 2  | 2 | 2   | 2 | 2 | 6 | 16  |
|                           | 38 | 3 | 417 | 2 | 2 | 6 | 468 |

### 15.2 Post balance sheet event

In December 2013, the Group signed a private placement agreement to borrow \$325m of long-term debt. The funds, which have a weighted average fixed rate of 3.7% and an average maturity of just over nine years, were drawn down on 21 January 2014 and used to repay existing bank debt.

Subsequent to the balance sheet date, on 3 February 2014 the Group announced the execution of a definitive agreement to acquire 100% of the shares of ArthroCare Corp. for approximately \$1.7 billion. The acquisition is subject to customary conditions, including a vote of ArthroCare's shareholders and governmental clearances. The acquisition is expected to close in mid-2014. The acquisition will be financed through existing debt facilities and cash balances, including the existing \$1 billion revolving credit facility and a new two-year \$1.4 billion term loan facility, established in February 2014.

### 15.3 Assets pledged as security

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

|   | <b>2013</b>       | 2012       |
|---|-------------------|------------|
|   | <b>\$ million</b> | \$ million |
| Finance lease liabilities due within one year       | <b>2</b>          | 2          |
| Finance lease liabilities due after one year        | <b>12</b>         | 14         |
| Total amount of secured borrowings                  | <b>14</b>         | 16         |
| Total net book value of assets pledged as security: |                   |            |
| Property, plant and equipment                       | <b>10</b>         | 11         |
|   | <b>10</b>         | 11         |

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## 15.4 Currency swap analysis

All currency swaps are stated at fair value. Gross US Dollar equivalents of \$146m (2012 \$175m) receivable and \$145m (2012 \$173m) payable have been netted. Currency swaps comprise foreign exchange swaps and were used in 2013 and 2012 to hedge intragroup loans and other monetary items.

Currency swaps mature as follows:

| At 31 December 2013 | Amount receivable<br>\$ million          | Amount payable<br>Currency<br>million    |
|---------------------|--|--|
| Within one year:    |  |  |
| Euro                | 28                                       | EUR 20                                   |
| Japanese Yen        | 13                                       | JPY 1,315                                |
| Chinese Renminbi    | 17                                       | CNY 100                                  |
| Sterling            | 11                                       | GBP 7                                    |
|                     | 69                                       |  |
| At 31 December 2013 | Amount receivable<br>Currency<br>million | Amount payable<br>\$ million             |
| Within one year:    |  |  |
| New Zealand Dollar  | NZD 9                                    | 7  |
| Swiss Franc         | CHF 14                                   | 16                                       |
| Swedish Krona       | SEK 31                                   | 5  |
| Australian Dollar   | AUD 41                                   | 36                                       |
| Canadian Dollar     | CAD 3                                    | 3  |
| Sterling            | GBP 6                                    | 10                                       |
|                     |  | 77                                       |
| At 31 December 2012 | Amount<br>receivable<br>\$ million       | Amount<br>payable<br>Currency<br>million |

|                  |     |           |
|------------------|-----|-----------|
| Within one year: |     |           |
| Euro             | 76  | EUR 58    |
| Japanese Yen     | 19  | JPY 1,500 |
| Canadian Dollar  | 17  | CAD 17    |
|                  | 112 |           |

At 31 December 2012

|                    | <b>Amount<br/>receivable<br/>Currency<br/>million</b> | <b>Amount<br/>payable<br/>\$ million</b> |
|--------------------|---|--|
| Within one year:   |   |  |
| New Zealand Dollar | NZD 1   | 1  |
| Swiss Franc        | CHF 35  | 38                                       |
| Swedish Krona      | SEK 33  | 5  |
| Australian Dollar  | AUD 14  | 15                                       |
| Japanese Yen       | JPY 335   | 4  |
|                    |   | 63                                       |

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## 15.5 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 \$1,008m (2012 \$1,017m) and total uncommitted facilities of \$319m (2012 \$341m). The Group has undrawn committed facilities of \$672m (2012 \$597m). Of the undrawn committed facilities, \$665m expires after one but within two years (2012 \$586m expiring after two but within five). 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.

In December 2010, the Company entered into a five-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 2013, the Company was in compliance with these covenants. The facility is also subject to customary events of default, none of which are currently anticipated to occur.

## 15.6 Year-end financial liabilities by contractual maturity

The table below analyses the Group's year-end financial liabilities by contractual maturity date, including interest payments and excluding the impact of netting arrangements:

| <b>Within one<br/>year or on<br/>demand</b> | <b>Between<br/>one and<br/>two years</b> | <b>Between<br/>two and<br/>five years</b> | <b>After<br/>five years</b> | <b>Total<br/>\$ million</b> |
|---|--|---|-----------------------------|-----------------------------|
|---|--|---|-----------------------------|-----------------------------|



|   | \$ million | \$ million | \$ million | \$ million |
|---|------------|------------|------------|------------|
| <b>At 31 December 2013</b>                                |            |            |            |            |
| <b>Non-derivative financial liabilities:</b>              |            |            |            |            |
| Bank overdrafts and loans                                 | 42         | 335        |            | 377        |
| Trade and other payables                                  | 751        |            |            | 751        |
| Finance lease liabilities                                 | 3          | 3          | 9          | 3          |
| Acquisition consideration                                 | 14         | 4          | 3          | 21         |
| <b>Derivative financial liabilities:</b>                  |            |            |            |            |
| Currency swaps/forward foreign exchange contracts outflow | 1,734      |            |            | 1,734      |
| Currency swaps/forward foreign exchange contracts inflow  | (1,733)    |            |            | (1,733)    |
|   | 811        | 342        | 12         | 3          |
| <b>At 31 December 2012</b>                                |            |            |            |            |
| <b>Non-derivative financial liabilities:</b>              |            |            |            |            |
| Bank overdrafts and loans                                 | 42         | 4          | 418        | 464        |
| Trade and other payables                                  | 646        |            |            | 646        |
| Finance lease liabilities                                 | 3          | 3          | 9          | 6          |
| Acquisition consideration                                 |            | 8          |            | 8          |
| <b>Derivative financial liabilities:</b>                  |            |            |            |            |
| Currency swaps/forward foreign exchange contracts outflow | 1,422      |            |            | 1,422      |
| Currency swaps/forward foreign exchange contracts inflow  | (1,424)    |            |            | (1,424)    |
|   | 689        | 15         | 427        | 6          |

The amounts in the tables above are undiscounted cash flows, which differ from the amounts included in the balance sheet where the underlying cash flows have been discounted.

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## 15.7 Finance leases

## ACCOUNTING POLICY

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards of ownership to the Group. All other leases are classified as operating leases.

The leased assets are measured initially at an amount equal to the lower of their fair value and the present value of the minimum lease payments. Assets held under finance leases are capitalised as property, plant or equipment and depreciated accordingly. Minimum lease payments are apportioned between the finance expense and the reduction in the outstanding liability. The finance expense is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

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

|                                   | <b>2013</b>       | 2012       |
|-----------------------------------|-------------------|------------|
|                                   | <b>\$ million</b> | \$ million |
| Within one year                   | <b>3</b>          | 3          |
| After one and within two years    | <b>3</b>          | 3          |
| After two and within three years  | <b>3</b>          | 3          |
| After three and within four years | <b>3</b>          | 3          |
| After four and within five years  | <b>3</b>          | 3          |
| After five years                  | <b>3</b>          | 6          |
| Total minimum lease payments      | <b>18</b>         | 21         |
| Discounted by imputed interest    | <b>(4)</b>        | (5)        |

|  |    |    |
|--|----|----|
| Present value of minimum lease payments  | 14 | 16 |
| Present value of minimum lease payments can be split out as: \$2m (2012 - \$2m) due within one year, \$9m (2012 - \$8m) due between one to five years and \$3m (2012 - \$6m) due after five years. |    |    |

## 16 Financial instruments and risk management

### ACCOUNTING POLICY

#### Derivative financial instruments

Derivative financial instruments are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value at subsequent balance sheet dates.

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 in the period in which the hedged transaction affects profit and loss. Where the hedged item is the cost of a non-financial asset, the amounts taken to other comprehensive income are transferred to the initial carrying value of the asset.

Currency swaps to match foreign currency net assets with foreign currency liabilities are fair valued at year-end. Changes in the fair values of currency swaps that are designated and effective as net investment hedges are matched in other comprehensive income against changes in value of the related net assets.

Interest rate swaps transacted to fix interest rates on floating rate borrowings are accounted for as cash flow hedges and changes in the fair values resulting from changes in market interest rates are recognised in other comprehensive income. Amounts taken to other comprehensive income are transferred to the income statement when the hedged transaction affects profit and loss.

Any ineffectiveness on hedging instruments and changes in the fair value of derivative financial instruments that do not qualify for hedge accounting are recognised in the income statement within other finance income/(costs) as they arise.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, any cumulative gain or loss on the hedging instrument recognised in other comprehensive income is retained there until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in other comprehensive income is transferred to the income statement for the period.

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## 16.1 Foreign exchange exposures

The Group operates in over 90 countries and as a consequence has transactional and translational foreign exchange exposure. It is Group policy for operating units not to hold material unhedged monetary assets or liabilities other than in their functional currencies.

Foreign exchange variations affect trading results in two ways. Firstly, on translation of overseas sales and profits into US Dollars and secondly, transactional exposures arising where some or all of the costs of sale are incurred in a different currency from the sale. The principal transactional exposures arise as the proportion of costs in US Dollars, Sterling and Swiss Francs exceed the proportion of sales in each of these currencies and correspondingly the proportion of sales in Euros exceeds the proportion of costs in Euros.

The impact of currency movements on the cost of purchases is partly mitigated by the use of forward foreign exchange contracts. The Group uses forward foreign exchange contracts, designated as cash flow hedges, to hedge forecast third party and intercompany trading cash flows for forecast foreign currency inventory purchases for up to one year. When a commitment is entered into, forward foreign exchange contracts are normally used to increase the hedge to 100% of the exposure. Cash flows relating to cash flow hedges are expected to occur within 12 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 12-month period. The principal currencies hedged by forward foreign exchange contracts are US Dollars, Euros and Sterling. At 31 December 2013, the Group had contracted to exchange within one year the equivalent of \$1.6bn (2012 \$1.3bn).

Based on the Group's net borrowings as at 31 December 2013, if the US Dollar were to weaken against all currencies by 10%, the Group's net borrowings would decrease by \$2m (2012 decrease by \$8m) as the Group held a higher amount of foreign denominated cash than foreign denominated borrowings. 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 \$4m (2012 decrease by \$4m).

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 2013 would have been \$34m lower (2012 \$23m). 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 2013 would have been \$27m higher (2012 \$30m). Movements in the fair value of forward foreign exchange contracts would be recognised in other comprehensive income and accumulated in the hedging reserve.

A 10% strengthening of the US Dollar or Euro against all other currencies at 31 December 2013 would have had the equal but opposite effect to the amounts shown above, on the basis that all other variables remain constant.

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. In addition, the movements in the fair value of other financial instruments used for hedging such as currency swaps for which hedge accounting is not applied, offset movements in the values of assets and liabilities and are recognised through the income statement.

#### 16.2 Interest rate exposures

The Group is exposed to interest rate risk on cash, borrowings and certain currency swaps which are all at floating rates. When required the Group uses interest rate 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 and accumulated in the hedging reserve, 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. During 2013 and 2012 the Group was not exposed to significant interest rate risk. As a result, interest rate swaps were not utilised in accordance with the Board approved policy.

Based on the Group's gross borrowings as at 31 December 2013, if interest rates were to increase by 100 basis points in all currencies then the annual net interest charge would increase by \$4m (2012 \$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.

#### 16.3 Credit risk exposures

The Group limits exposure to credit risk on counterparties used for financial instruments through a system of internal credit limits which, with certain minor exceptions due to local market conditions, require counterparties to have a minimum A rating from one of the major ratings agencies. The financial exposure of a counterparty is determined as the total of cash and deposits, plus the risk on derivative instruments, assessed as the fair value of the instrument plus a risk element based on the nominal value and the historic volatility of the market value of the instrument. The Group does not anticipate non-performance of counterparties and believes it is not subject to material concentration of credit risk as the Group operates within a policy of counterparty limits designed to reduce exposure to any single counterparty.

The maximum credit risk exposure on derivatives at 31 December 2013 was \$29m (2012 \$14m), being the total debit fair values on forward foreign exchange contracts and currency swaps. The maximum credit risk exposure on cash at bank at 31 December 2013 was \$137m (2012 \$178m). The Group's exposure to credit risk is not material as the amounts are held in a wide number of banks in a number of different countries.

Credit risk on trade receivables is detailed in Note 13.

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Notes to the Group accounts *continued*16 Financial instruments and risk management *continued*

## 16.4 Currency and interest rate profile of interest bearing liabilities and assets

Short-term debtors and creditors are excluded from the following disclosures.

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

|   | Gross borrowings | Currency swaps | Total liabilities | Floating rate liabilities | Weighted Fixed liabilities | Weighted average Interest rate | Fixed rate liabilities Weighted average time for which rate is fixed |
|---|------------------|----------------|-------------------|---------------------------|----------------------------|--------------------------------|--|
|   | \$ million       | \$ million     | \$ million        | \$ million                | \$ million                 | %                              | Years  |
| At 31 December 2013:                      |                  |                |                   |                           |                            |                                |  |
| US Dollar                                 | 297              | 77             | 374               | 360                       | 14                         | 7.1                            | 4  |
| Euro                                      | 59               | 28             | 87                | 87                        |                            |                                |  |
| Other                                     | 35               | 40             | 75                | 75                        |                            |                                |  |
| <b>Total interest bearing liabilities</b> | <b>391</b>       | <b>145</b>     | <b>536</b>        | <b>522</b>                | <b>14</b>                  |                                |  |
| At 31 December 2012:                      |                  |                |                   |                           |                            |                                |  |
| US Dollar                                 | 432              | 62             | 494               | 478                       | 16                         | 7.1                            | 4  |
| Euro                                      | 7                | 76             | 83                | 83                        |                            |                                |  |
| Other                                     | 29               | 35             | 64                | 64                        |                            |                                |  |
| <b>Total interest bearing liabilities</b> | <b>468</b>       | <b>173</b>     | <b>641</b>        | <b>625</b>                | <b>16</b>                  |                                |  |

At 31 December 2013, \$14m (2012 \$16m) of fixed rate liabilities relate to finance leases. In 2013, the Group also had liabilities due for deferred acquisition consideration (denominated in US Dollars and Brazilian Real) totalling \$21m (2012 \$8m, 2011 \$11m) on which no interest was payable (see Note 14). There are no other significant interest bearing financial liabilities.

Floating rates on liabilities are typically based on the one or three-month LIBOR interest rate relevant to the currency concerned. The weighted average interest rate on floating rate borrowings as at 31 December 2013 was 1% (2012 1%).

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

|                                      | Cash       | Currency   |              | Floating    |
|--------------------------------------|------------|------------|--------------|-------------|
|                                      | at bank    | swaps      | Total assets | rate assets |
|                                      | \$ million | \$ million | \$ million   | \$ million  |
| At 31 December 2013:                 |            |            |              |             |
| US Dollars                           | 8          | 69         | 77           | 77          |
| Other                                | 129        | 77         | 206          | 206         |
| <b>Total interest bearing assets</b> | <b>137</b> | <b>146</b> | <b>283</b>   | <b>283</b>  |
| At 31 December 2012:                 |            |            |              |             |
| US Dollars                           | 59         | 113        | 172          | 172         |
| Other                                | 119        | 62         | 181          | 181         |
| <b>Total interest bearing assets</b> | <b>178</b> | <b>175</b> | <b>353</b>   | <b>353</b>  |

Floating rates on assets are typically based on the short-term deposit rates relevant to the currency concerned. There were no fixed rate assets at 31 December 2013 or 31 December 2012.



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16.5 Fair value of financial assets and liabilities

ACCOUNTING POLICY

Measurement of fair values

A number of the Group's accounting policies and disclosures require the measurement of fair values, for both financial assets and liabilities and non-financial assets acquired in a business combination (see Note 21).

When measuring the fair value of an asset or liability, the Group uses market observable data as far as possible. Fair values are categorised into different levels in the fair value hierarchy based on the inputs used in the valuation techniques as follows: Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities; Level 2: inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); Level 3: inputs for the asset or liability that are not based on observable data (unobservable inputs).

The Group recognises transfers between the levels of the fair value hierarchy at the end of the reporting period during which the change has occurred.

The following table shows the carrying amounts and fair values of financial assets and financial liabilities, including their levels in the fair value hierarchy. It does not include fair value information for financial assets and financial liabilities not measured at fair value if the carrying amount is a reasonable approximation of fair value.

|   | Designated                          |             | Loans available<br>and<br>receivables | Other<br>financial<br>liabilities | Carrying amount |            | Fair value |            |
|---|-------------------------------------|-------------|---------------------------------------|-----------------------------------|-----------------|------------|------------|------------|
|   | fair value<br>fair hedging<br>value | instruments |                                       |                                   | for sale        | Total      | Level 2    | Level 3    |
| At 31 December 2013                                     | \$ million                          | million     | \$ million                            | \$ million                        | \$ million      | \$ million | \$ million | \$ million |
| <b>Financial assets measured at fair value</b>          |                                     |             |                                       |                                   |                 |            |            |            |
| Forward foreign exchange contracts                      |                                     | 28          |                                       |                                   | 28              | 28         |            | 28         |
| Investments   |                                     |             |                                       | 2                                 | 2               |            | 2          | 2          |
| Currency swaps  | 1                                   |             |                                       |                                   | 1               | 1          |            | 1          |
|   | 1                                   | 28          |                                       | 2                                 | 31              | 29         | 2          | 31         |
| <b>Financial liabilities measured at fair value</b>     |                                     |             |                                       |                                   |                 |            |            |            |
| Acquisition consideration                               | (21)                                |             |                                       |                                   | (21)            |            | (21)       | (21)       |
| Forward foreign exchange contracts                      |                                     | (20)        |                                       |                                   | (20)            | (20)       |            | (20)       |
|   | (21)                                | (20)        |                                       |                                   | (41)            | (20)       | (21)       | (41)       |
| <b>Financial assets not measured at fair value</b>      |                                     |             |                                       |                                   |                 |            |            |            |
| Trade and other receivables                             |                                     |             | 1,085                                 |                                   | 1,085           |            |            |            |
| Cash at bank  |                                     |             | 137                                   |                                   | 137             |            |            |            |
|   |                                     |             | 1,222                                 |                                   | 1,222           |            |            |            |
| <b>Financial liabilities not measured at fair value</b> |                                     |             |                                       |                                   |                 |            |            |            |
| Bank overdrafts   |                                     |             |                                       | (11)                              | (11)            |            |            |            |
| Bank loans  |                                     |             |                                       | (366)                             | (366)           |            |            |            |
| Finance lease liabilities                               |                                     |             |                                       | (14)                              | (14)            |            |            |            |
| Trade and other payables                                |                                     |             |                                       | (751)                             | (751)           |            |            |            |
|   |                                     |             |                                       | (1,142)                           | (1,142)         |            |            |            |



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|   | Designated at fair value |                     | Loans Available for sale |            | Carrying amount             |            | Fair value |            |            |
|---|--------------------------|---------------------|--------------------------|------------|-----------------------------|------------|------------|------------|------------|
|   | value                    | hedging instruments | and receivables          | for sale   | Other financial liabilities | Total      | Level 2    | Level 3    | Total      |
| At 31 December 2012                                     | \$ million               | \$ million          | \$ million               | \$ million | \$ million                  | \$ million | \$ million | \$ million | \$ million |
| <b>Financial assets</b>                                 |                          |                     |                          |            |                             |            |            |            |            |
| <b>measured at fair value</b>                           |                          |                     |                          |            |                             |            |            |            |            |
| Forward foreign exchange contracts                      |                          | 12                  |                          |            |                             | 12         | 12         |            | 12         |
| Investments   |                          |                     |                          | 2          |                             | 2          |            | 2          | 2          |
| Currency swaps  | 2                        |                     |                          |            |                             | 2          | 2          |            | 2          |
|   | 2                        | 12                  |                          | 2          |                             | 16         | 14         | 2          | 16         |
| <b>Financial liabilities</b>                            |                          |                     |                          |            |                             |            |            |            |            |
| <b>measured at fair value</b>                           |                          |                     |                          |            |                             |            |            |            |            |
| Acquisition consideration                               | (8)                      |                     |                          |            |                             | (8)        |            | (8)        | (8)        |
| Forward foreign exchange contracts                      |                          | (10)                |                          |            |                             | (10)       | (10)       |            | (10)       |
|   | (8)                      | (10)                |                          |            |                             | (18)       | (10)       | (8)        | (18)       |
| <b>Financial assets not measured at fair value</b>      |                          |                     |                          |            |                             |            |            |            |            |
| Trade and other receivables                             |                          |                     | 1,053                    |            |                             | 1,053      |            |            |            |
| Cash at bank  |                          |                     | 178                      |            |                             | 178        |            |            |            |
|   |                          |                     | 1,231                    |            |                             | 1,231      |            |            |            |
| <b>Financial liabilities not measured at fair value</b> |                          |                     |                          |            |                             |            |            |            |            |

|                           |         |         |
|---------------------------|---------|---------|
| Bank overdrafts           | (11)    | (11)    |
| Bank loans                | (441)   | (441)   |
| Finance lease liabilities | (16)    | (16)    |
| Trade and other payables  | (646)   | (646)   |
|                           | (1,114) | (1,114) |

The Group enters into derivative financial instruments with financial institutions with investment grade credit ratings. The fair value of forward foreign exchange contracts is calculated by reference to quoted market forward exchange rates for contracts with similar maturity profiles. The fair value of currency swaps is determined by reference to quoted market spot rates. As a result, foreign forward exchange contracts and currency swaps are classified as Level 2 within the fair value hierarchy.

As at 31 December 2013 and 31 December 2012, the fair value of derivatives 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.

The fair value of contingent consideration is estimated using a discounted cash flow model. The valuation model considers the present value of expected payment, discounted using a risk-adjusted discount rate. The expected payment is determined by considering the possible scenarios, which relate to the achievement of established milestones and targets, the amount to be paid under each scenario and the probability of each scenario. As a result, contingent consideration is classified as Level 3 within the fair value hierarchy.

There were no transfers between level 1, 2 and 3 during 2013 and 2012.

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.

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 2013 and 31 December 2012, the fair value of the Group's long-term borrowing was not materially different from amortised cost.

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17 Provisions and contingencies

ACCOUNTING POLICY

In the normal course of business the Group is involved in various 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.

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 or settlement negotiations or as new facts emerge.

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligations under the contract. For the purpose 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.

A provision for rationalisation is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring either has commenced or has been announced publicly. Future operating losses are not provided for.

## 17.1 Provisions

|                                  | Rationalisation<br>provisions<br>\$ million | Legal and other<br>provisions<br>\$ million | Total<br>\$ million |
|----------------------------------|---|---|---------------------|
| At 1 January 2012                | 26  | 97  | 123                 |
| Charge to income statement       | 29  | 21  | 50                  |
| Provision arising on acquisition |   | 13  | 13                  |
| Utilised                         | (30)  | (34)  | (64)                |
| At 31 December 2012              | 25  | 97  | 122                 |
| Charge to income statement       | 15  | 22  | 37                  |
| Utilised                         | (22)  | (12)  | (34)                |
| <b>At 31 December 2013</b>       | <b>18</b>                                   | <b>107</b>                                  | <b>125</b>          |
| Provisions due within one year   | <b>18</b>                                   | <b>42</b>                                   | <b>60</b>           |
| Provisions due after one year    |   | <b>65</b>                                   | <b>65</b>           |
| <b>At 31 December 2013</b>       | <b>18</b>                                   | <b>107</b>                                  | <b>125</b>          |
| Provisions due within one year   | 25  | 34  | 59                  |
| Provisions due after one year    |   | 63  | 63                  |
| At 31 December 2012              | 25  | 97  | 122                 |

The principal provisions within rationalisation provisions relate to the rationalisation of operational sites (mainly severance and legal costs) arising from the legacy earnings improvement programme and people costs associated with the structural and process changes announced in August 2011.

Included within the legal and other provisions are:

\$16m (2012 \$17m) relating to the declination of insurance coverage for macrot textured knee revisions (see Note 17.2)

A provision of \$15m (2012 \$13m) relating to the acquisition and integration of Healthpoint Biotherapeutics (see Note 21.4)

The remaining balance largely represents provisions for various patent disputes and other litigation. All provisions are expected to be substantially utilised within three years of 31 December 2013 and none are treated as financial instruments.

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## 17.2 Contingencies

The Company and its subsidiaries are parties to various legal proceedings, some of which include claims for substantial damages. The outcome of these proceedings cannot readily be foreseen, but management believes none of them are likely to 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 at 31 December 2013 related to this matter is approximately \$215m. The Group has sought recovery from its primary and excess insurers for costs of resolving the claims. The primary insurance carrier has paid \$60m in full settlement of its policy liability. However, the excess carriers have denied coverage, citing defences relating to the wording of the insurance policies and other matters. In December 2004, the Group brought suit against them in the US district court for the Western District of Tennessee. Trial has not yet begun. An additional \$22m was received during 2007 from a successful settlement with a third party.

A charge of \$154m was recorded in 2004 for anticipated expenses in connection with macrotexture claims. Most of that amount has since been applied to settlements of such claims. Management believes that the \$16m (2012 \$17m) provision remaining is adequate to cover remaining claims. Given the uncertainty inherent in such matters, there can be no assurance on this point.

## 17.3 Legal proceedings

**Product liability claims**

The Group faces other claims from time to time for alleged defects in its products and has on occasion recalled or withdrawn products from the market. Such claims are endemic to the orthopaedic device industry. The Group maintains product liability insurance subject to limits and deductibles that management believes are reasonable. All policies contain exclusions and limitations, however, and there can be no assurance that insurance will be available or adequate to cover all claims.

In recent years, there has been heightened concern about possible adverse effects of hip implant products with metal-on-metal bearing surfaces, and the Group has incurred and will continue to incur expenses to defend claims in this area. As of February 2014 approximately 650 such claims had been notified to the Group around the world, of which 310 had given rise to pending legal proceedings. Most of the pending legal proceedings are in the United States. Most



claims relate to the Group's Birmingham Hip Resurfacing ( BHR ) product and the Birmingham Hip Modular Head ( BHMH ) and R3 Metal Liner ( R3ML ) components. In 2012, the Group restricted instructions for use of the BHMH and ceased offering the R3ML. In 2013, the Group's US subsidiary agreed with lawyers representing metal-on-metal claimants to consolidate pre-trial proceedings (such as discovery) in their lawsuits in a state court in Memphis, Tennessee, and those lawsuits account for most of the US proceedings. The Group takes care to monitor the clinical evidence relating to its metal hip implant products and ensure that its product offerings and training are designed to serve patients' interests.

### **Business practice investigations**

Business practices in the healthcare industry are subject to regulation and review by various government authorities. From time to time authorities undertake investigations of the Group's activities to verify compliance. In September 2007, the SEC notified the Group that it was conducting an informal investigation of companies in the medical devices industry, including the Group, regarding possible violations of the Foreign Corrupt Practices Act ( FCPA ) in connection with the sale of products in certain countries outside of the US. The US Department of Justice ( DOJ ) subsequently joined the SEC's request.

On 6 February 2012, Smith & Nephew announced that it had reached settlement with the SEC and DOJ in connection with this matter. Smith & Nephew paid slightly less than \$23m in fines and profit disgorgement and committed to maintain an enhanced compliance programme and appoint an independent monitor for at least 18 months to review and report on its compliance programme. The monitor's final report was filed in late 2013, and the independent monitorship has now been terminated. The settlement agreements impose detailed reporting, compliance and other requirements on Smith & Nephew for a three-year term. Failure to comply with these requirements, or any other violation of law, could have severe consequences for the Group.

### **Intellectual property disputes**

The Group is engaged, as both plaintiff and defendant, in litigation with various competitors and others over claims of patent infringement and other intellectual property matters. These disputes are being heard in courts in the US and other jurisdictions and also before agencies that examine patents. Outcomes are rarely certain and costs are often significant.

The Group has won a jury verdict in the US district court for Oregon against Arthrex Inc. for infringement of the Group's patents relating to suture anchors. The verdict was initially overturned by the district court but then (in January 2013) reinstated on appeal. Arthrex continues to appeal the amount of the damages award.

### **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 whistle-blower 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.

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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 Smith & Nephew's initial voluntary disclosure, a whistle-blower suit was filed in the US district court for the Western District of Tennessee alleging these violations. Smith & Nephew's motion to dismiss the suit was denied in November 2010.

**18 Retirement benefit obligations****ACCOUNTING POLICY**

The Group's major pension plans are of the defined benefit type. A defined benefit pension plan defines an amount of pension benefit that an employee will receive on retirement, which is dependent on various factors such as age, years of service and final salary. The Group's obligation is calculated separately for each plan by discounting the estimated future benefit that employees have earned in return for their service in the current and prior periods. The fair value of any plan assets is deducted to arrive at the net liability.

The calculation of the defined benefit obligation is performed annually by external actuaries using the projected unit credit method. Re-measurements arising from defined benefit plans comprise actuarial gains and losses and the return on the plan assets net of the costs of managing the plan assets. The Group recognises these immediately in other comprehensive income (OCI) and all other expenses, such as service cost, net interest cost, administrative costs and taxes, are recognised in the income statement.

A number of key assumptions are made when calculating the fair value of the Group's defined benefit pension plans. These assumptions impact the balance sheet asset and liabilities, operating profit and finance income/costs. The most critical assumptions are the discount rate, the rate of inflation and mortality assumptions to be applied to future pension plan liabilities. The discount rate is based on the yield at the reporting date on bonds that have a credit rating of AA, denominated in the currency in which the benefits are expected to be paid and have a maturity

profile approximately the same as the Group's obligations. In determining these assumptions management take into account the advice of professional external actuaries and benchmarks its assumptions against external data.

The Group determines the net interest expense/(income) on the net defined benefit liability/(asset) for the period by applying the discount rate used to measure the defined benefit obligation at the beginning of the annual period to the net defined benefit liability/(asset).

The Group also operates a number of defined contribution plans. A defined contribution plan is a pension plan under which the Group and employees pay fixed contributions to a third party financial provider. The Group has no further payment obligations once the contributions have been paid. Contributions are recognised as an employee benefit expense when they are due.

#### 18.1 Retirement benefit net (assets)/obligations

The Group's retirement benefit obligations comprise:

|  | <b>2013</b><br>\$ million | 2012<br>\$ million |
|--|---------------------------|--------------------|
| Funded plans:                                      |                           |                    |
| UK Plan  | <b>50</b>                 | (6)                |
| US Plan  | <b>65</b>                 | 147                |
| Other Plans  | <b>28</b>                 | 38                 |
|  | <b>143</b>                | 179                |
| Unfunded Plans:                                    |                           |                    |
| Other Plans  | <b>39</b>                 | 36                 |
| Retirement Healthcare                              | <b>43</b>                 | 45                 |
|  | <b>225</b>                | 260                |
| Amount recognised on the balance sheet - liability | <b>230</b>                | 266                |
| Amount recognised on the balance sheet - asset     | <b>(5)</b>                | (6)                |

The Group sponsors pension plans for its employees in 16 countries and these are established under the laws of the relevant country. Funded plans are funded by the payment of contributions and the assets are held by separate trust funds or insurance companies. In countries where there is no Company-sponsored pension plan, state benefits are considered by management to be adequate. Employees' retirement benefits are the subject of regular management review. The Group's 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 year of service of the employee.

The Group's two major defined benefit pension plans are in the UK and US. Both these plans were closed to new employees in 2003 and defined contribution plans are offered to new joiners.

The UK Plan operates under trust law and responsibility for its governance lies with a Board of Trustees. This Board is composed of representatives of the Group, plan participants and an independent trustee who act on behalf of

members in accordance with the terms of the Trust Deed and Rules and relevant legislation. The UK Plan's assets are held by the trust. Annual increases on benefits in payment are dependent on inflation. The main uncertainties affecting the level of benefits payable under the UK Plan are future inflation levels (including the impact of inflation on future salary increase) and the actual longevity of the membership.

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Notes to the Group accounts *continued***18 Retirement benefit obligations continued**

The US Plan is governed by a US Pension Committee which is composed of both plan participants and representatives of the Group. In the US, the Pension Protection Act (2006) established both a minimum required contribution and a maximum deductible contribution. Failure to contribute at least the minimum required amount will subject the Company to significant penalties and contributions in excess of the maximum deductible have negative tax consequences. The minimum funding requirement is intended to fully fund the present value of accrued benefits over seven years.

## 18.2 Reconciliation of benefit obligations and pension assets

The movement in the Group's pension benefit obligation and pension assets is as follows:

|  | <b>Obligation</b> | <b>Asset</b>      | <b>2013</b>       |                   |                   | <b>2012</b>       |
|--|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
|  | <b>\$ million</b> | <b>\$ million</b> | <b>Total</b>      | <b>Obligation</b> | <b>Asset</b>      | <b>Total</b>      |
|  |                   |                   | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b> |
| Amounts recognised on the balance sheet at beginning of the period | (1,487)           | 1,227             | <b>(260)</b>      | (1,350)           | 1,063             | (287)             |
| Income statement expense:  |                   |                   |                   |                   |                   |                   |
| Current service cost   | (29)              |                   | <b>(29)</b>       | (29)              |                   | (29)              |
| Net interest (expense)/income, administration costs and taxes      | (62)              | 51                | <b>(11)</b>       | (63)              | 52                | (11)              |
| Costs recognised in Income statement                               | <b>(91)</b>       | 51                | <b>(40)</b>       | (92)              | 52                | (40)              |
| Re-measurements:   |                   |                   |                   |                   |                   |                   |
| Actuarial gain due to liability experience                         | 1                 |                   | <b>1</b>          | 18                |                   | 18                |
| Actuarial gain/(loss) due to financial assumptions change          | 16                |                   | <b>16</b>         | (51)              |                   | (51)              |
| Actuarial loss due to demographic assumptions                      | (42)              |                   | <b>(42)</b>       | (13)              |                   | (13)              |
| Return on plan assets greater than discount rate                   |                   | 37                | <b>37</b>         |                   | 41                | 41                |

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|   |         |       |       |         |       |       |
|---|---------|-------|-------|---------|-------|-------|
| Re-measurements recognised in OCI   | (25)    | 37    | 12    | (46)    | 41    | (5)   |
| Cash:   |         |       |       |         |       |       |
| Employer contributions  |         | 67    | 67    |         | 73    | 73    |
| Employee contributions  | (4)     | 4     |       | (4)     | 4     |       |
| Benefits paid directly by the Group, taxes and administration costs paid from scheme assets | 3       | (3)   |       | 1       |       | 1     |
| Benefits paid   | 45      | (45)  |       | 44      | (44)  |       |
| Net cash  | 44      | 23    | 67    | 41      | 33    | 74    |
| Exchange rates  | (22)    | 18    | (4)   | (40)    | 38    | (2)   |
| Amount recognised on the balance sheet  | (1,581) | 1,356 | (225) | (1,487) | 1,227 | (260) |
| Amount recognised on the balance sheet - liability  | (1,548) | 1,318 | (230) | (749)   | 483   | (266) |
| Amount recognised on the balance sheet - asset  | (33)    | 38    | 5     | (738)   | 744   | 6     |
| Represented by:   |         |       |       |         |       |       |

|              | 2013           |              |              | 2012           |              |              |
|--------------|----------------|--------------|--------------|----------------|--------------|--------------|
|              | Obligation     | Asset        | Total        | Obligation     | Asset        | Total        |
|              | \$ million     | \$ million   | \$ million   | \$ million     | \$ million   | \$ million   |
| UK Plan      | (855)          | 805          | (50)         | (738)          | 744          | 6            |
| US Plan      | (482)          | 417          | (65)         | (506)          | 359          | (147)        |
| Other Plans  | (244)          | 134          | (110)        | (243)          | 124          | (119)        |
| <b>Total</b> | <b>(1,581)</b> | <b>1,356</b> | <b>(225)</b> | <b>(1,487)</b> | <b>1,227</b> | <b>(260)</b> |

All benefits are vested at the end of each reporting period. The weighted average duration of the defined benefit obligation at the end of the reporting period is 20 years and 16 years for the UK and US plans respectively. For 2012, this was 19 years for the UK Plan and 17 years for the US Plan.

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## 18.3 Plan assets

The market value of the US, UK and Other Plans assets are as follows:

|                                    | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|------------------------------------|---------------------------|--------------------|--------------------|
| <b>UK Plan:</b>                    |                           |                    |                    |
| Assets with a quoted market price: |                           |                    |                    |
| Cash and cash equivalents          | <b>8</b>                  | 11                 | 6                  |
| Equity securities                  | <b>220</b>                | 249                | 248                |
| Government bonds fixed interest    | <b>61</b>                 | 92                 | 88                 |
| index linked                       | <b>109</b>                | 282                | 265                |
| Diversified growth funds           | <b>159</b>                | 110                | 49                 |
|                                    | <b>557</b>                | 744                | 656                |
| Other assets:                      |                           |                    |                    |
| Insurance contract                 | <b>248</b>                |                    |                    |
| Market value of assets             | <b>805</b>                | 744                | 656                |
| <b>US Plan:</b>                    |                           |                    |                    |
| Assets with a quoted market price: |                           |                    |                    |
| Cash and cash equivalents          | <b>6</b>                  | 1                  | 5                  |
| Equity securities                  | <b>181</b>                | 242                | 195                |
| Government bonds fixed interest    | <b>64</b>                 | 106                | 88                 |
| Corporate bonds                    | <b>151</b>                |                    |                    |
| Hedge funds                        | <b>15</b>                 | 10                 | 10                 |
| Market value of assets             | <b>417</b>                | 359                | 298                |
| <b>Other Plans:</b>                |                           |                    |                    |
| Assets with a quoted market price: |                           |                    |                    |
| Cash and cash equivalents          | <b>6</b>                  | 5                  | 5                  |
| Equity securities                  | <b>32</b>                 | 26                 | 24                 |
| Government bonds fixed interest    | <b>9</b>                  | 7                  | 6                  |
| index linked                       | <b>11</b>                 | 34                 | 33                 |
| Corporate bonds                    | <b>13</b>                 | 2                  | 2                  |
| Insurance contracts                | <b>24</b>                 |                    |                    |
| Property                           | <b>6</b>                  | 5                  | 5                  |
| Other quoted securities            | <b>3</b>                  | 11                 | 11                 |
|                                    | <b>104</b>                | 90                 | 86                 |
| Other assets:                      |                           |                    |                    |

|                              |              |       |       |
|------------------------------|--------------|-------|-------|
| Equities                     |              | 2     | 2     |
| Insurance contracts          | <b>29</b>    | 31    | 20    |
| Investment property          | <b>1</b>     | 1     | 1     |
| Market value of assets       | <b>134</b>   | 124   | 109   |
| Total market value of assets | <b>1,356</b> | 1,227 | 1,063 |

No plans invest directly in property occupied by the Group or in financial securities issued by the Group.

The US and UK plan assets are invested in a diversified range of industries across a broad range of geographies. These assets include liability matching assets and annuity policies purchased by the trustees of each plan, which aim to match the benefits to be paid to certain members from the plan and therefore remove the investment, inflation and demographic risks in relation to those liabilities.

In January 2013, the UK Plan, in order to minimise longevity and interest risk, purchased an insurance contract with Rothesay Life covering a subset of the UK Plan pensioner liabilities. The terms of this policy means that it exactly matches the amount and timing of the pensioner obligations covered by the contract.

In accordance with IAS19, the fair value of the insurance contract is deemed to be the present value of the related obligations which is discounted at the AA corporate bond rate.



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Notes to the Group accounts *continued***18 Retirement benefit obligations continued**

## 18.4 Expenses recognised in the income statement

The total expense relating to retirement benefits recognised for the year is \$72m (2012 \$72m, 2011 \$71m). Of this cost recognised for the year, \$40 million (2012 \$40m, 2011 \$42m) relates to the defined benefit plan and \$32m (2012 \$32m, 2011 \$29m) relates to defined contributions.

The cost charged 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. These were charged to operating profit in selling, general and administrative expenses. There were \$nil outstanding payments as at 31 December 2013 due to be paid over to the plans (2012 \$nil, 2011 \$nil).

Defined benefit plan costs comprise service cost which is charged to operating profit in selling, general and administrative expenses and net interest cost and administration costs and taxes which are reported as other finance costs.

The defined benefit pension costs charged for the UK and US plans are:

|   | <b>2013</b>    |                | 2012       |            | 2011       |            |
|---|----------------|----------------|------------|------------|------------|------------|
|   | <b>UK Plan</b> | <b>US Plan</b> | UK Plan    | US Plan    | UK Plan    | US Plan    |
|   | <b>\$</b>      | <b>\$</b>      | \$ million | \$ million | \$ million | \$ million |
|   | <b>million</b> | <b>million</b> |            |            |            |            |
| Service cost                                      | <b>7</b>       | <b>10</b>      | 8          | 11         | 10         | 9          |
| Net interest cost,<br>administration<br>and taxes | <b>1</b>       | <b>7</b>       | 1          | 7          | 3          | 6          |
|   | <b>8</b>       | <b>17</b>      | 9          | 18         | 13         | 15         |

## 18.5 Principal actuarial assumptions

The following are the principal financial actuarial assumptions used at the reporting date to determine the UK and US defined benefit obligations and expense.

|                          | 2013        | 2012        | 2011        |
|--------------------------|-------------|-------------|-------------|
|                          | % per annum | % per annum | % per annum |
| <b>UK Plan:</b>          |             |             |             |
| Discount rate            | 4.4         | 4.5         | 4.9         |
| Future salary increases  | 3.9         | 3.5         | 5.1         |
| Future pension increases | 3.4         | 3.0         | 3.1         |
| Inflation (RPI)          | 3.4         | 3.0         | 3.1         |
| Inflation (CPI)          | 2.4         | 2.2         | 2.1         |
| <b>US Plan:</b>          |             |             |             |
| Discount rate            | 4.9         | 4.0         | 4.6         |
| Future salary increases  | 3.0         | 3.0         | 4.5         |
| Inflation                | 2.5         | 2.5         | 2.5         |

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Actuarial assumptions regarding future mortality are based on mortality tables. The UK uses the S1NA with projections in line with the CMI 2011 table and the US uses the RP2000 table with scale AA. The current longevities underlying the values of the obligations in the defined benefit plans are as follows:

|   | <b>2013</b>  | 2012  | 2011  |
|---|--------------|-------|-------|
|   | <b>years</b> | years | years |
| <b>Life expectancy at age 60</b>                  |              |       |       |
| <b>UK Plan:</b>                                   |              |       |       |
| Males   | <b>29.3</b>  | 28.7  | 28.6  |
| Females   | <b>31.1</b>  | 30.2  | 30.2  |
| <b>US Plan:</b>                                   |              |       |       |
| Males   | <b>23.8</b>  | 22.9  | 22.8  |
| Females   | <b>25.5</b>  | 25.0  | 25.0  |
| <b>Life expectancy at age 60 in 20 years time</b> |              |       |       |
| <b>UK Plan:</b>                                   |              |       |       |
| Males   | <b>32.2</b>  | 31.2  | 31.0  |
| Females   | <b>33.2</b>  | 31.9  | 31.8  |
| <b>US Plan:</b>                                   |              |       |       |
| Males   | <b>23.8</b>  | 24.6  | 24.5  |
| Females   | <b>25.5</b>  | 25.0  | 25.0  |

## 18.6 Sensitivity analysis

The calculation of the defined benefit obligation is sensitive to the assumptions used. The following table summarises the increase/decrease on the UK and US defined benefit obligation and pension costs as a result of reasonably possible changes in some of the assumptions while holding all other assumptions consistent. The sensitivity to the inflation assumption change includes corresponding changes to the future salary increases and future pension increase assumptions. The analysis does not take into account the full distribution of cash flows expected under the plan.

Increase in pension obligation

Increase in pension cost

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| \$ million      | +50bps/+1yr | -50bps/-1yr | +50bps/+1 yr | -50bps/-1yr |
|-----------------|-------------|-------------|--------------|-------------|
| <b>UK Plan:</b> |             |             |              |             |
| Discount rate   | -77         | +88         | -4           | +4          |
| Inflation       | +87         | -75         | +5           | -4          |
| Mortality       | +29         | -29         | +1           | -1          |
| <b>US Plan:</b> |             |             |              |             |
| Discount rate   | -35         | +35         | -2           | +2          |
| Inflation       | +5          | -5          | +1           | -1          |
| Mortality       | +13         | -13         | +1           | -1          |

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Notes to the Group accounts *continued*

18 Retirement benefit obligations *continued*

18.7 Risk

The pension plans expose the Group to the following risks:

- Interest rate risk** Volatility in financial markets can change the calculations of the obligation dramatically as the calculation of the obligation is linked to yields on AA-rated corporate bonds. A decrease in the bond yield will increase the measure of plan liabilities, although this will be partially offset by increases in the value of matching plan assets such as bonds and insurance contracts.
- Inflation risk** The UK Plan is linked to inflation. A high rate of inflation will lead to a higher liability. This risk is managed by holding inflation-linked bonds and an inflation-linked insurance contract in respect of some of the obligation.
- Investment risk** If the return on plan assets is below the discount rate, all else being equal, there will be an increase in the plan deficit.

In the UK, this risk is partially managed by holding bonds and a bulk annuity, together with a dynamic de-risking policy to switch growth assets into bonds over time.

In 2013, the US Pension committee implemented a dynamic de-risking policy to shift plan assets into longer term stable asset classes. The policy established ten pre-determined funded status levels and when each trigger point is reached, the plan assets are re-balanced accordingly.

- Longevity risk** The present value of the plans defined benefit liability is calculated by reference to the best estimate of the mortality of the plan participants both during and after their employment. An increase in the life expectancy of plan participants above that assumed will increase the benefit obligation.

The UK Plan, in order to minimise longevity risk, entered into an insurance contract which covers a portion of pensioner obligations.

**Salary risk**

The calculation of the defined benefit obligation uses the future estimated salaries of plan participants. Increases in the salary of plan participants above that assumed will increase the benefit obligation.

18.8 Funding

A full valuation is performed by actuaries for the Trustees of each plan to determine the level of funding required. Employer contributions rates, based on these full valuations, are agreed between the trustees of each plan and the Group. The assumptions used in the funding actuarial valuations may differ from those assumptions above. Employees are required to contribute to the plans.

**UK Plan**

The most recent full actuarial valuation of the UK Plan was undertaken as at 30 September 2012. These valuations are performed every two years with the next scheduled for 30 September 2014. Contributions to the UK Plan in 2013 were \$37m (2012 \$39m, 2011 \$37m). This included supplementary payments of \$31m (2012 \$30m, 2011 \$29m).

The Group has agreed to pay the supplementary payments each year until 2017. The agreed supplementary contributions for 2014 are \$31m.

**US Plan**

Full actuarial valuations are performed annually for the US Plan with the last undertaken as at 20 September 2013. Contributions to the US Plan were \$20m (2012 \$27m, 2011 \$30m) which included supplementary payments of \$17m. The agreed contributions for 2014 are \$26m.

18.9 Post balance sheet event

On 7 February 2014, the Group announced its intention to close the US Pension Plan to future accrual with effect from 31 March 2014. The Group expects to recognise a gain in 2014 as a result of the closure, but due to the member consultation period currently underway, is unable to calculate the precise past service cost adjustment. However, it is estimated that the gain will not be material. The effect of the closure has not been recognised as at 31 December 2013.

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## 19 Equity

## ACCOUNTING POLICY

Incremental costs directly attributable to the issue of ordinary shares, net of any tax effects, are recognised as a deduction from equity.

When shares recognised as equity are repurchased, the amount of the consideration paid, which includes directly attributable costs, net of any tax effects, is recognised as a deduction from equity. Repurchased shares are classified as treasury shares and are presented in the treasury share reserve. When treasury shares are sold or reissued subsequently, the amount received is recognised as an increase in equity and the resulting surplus or deficit on the transaction is presented within share premium.

## 19.1 Share capital

|                     | Ordinary shares<br>(20¢) |            | Deferred Shares (£1.00) |            | Total<br>\$ million |
|---------------------|--------------------------|------------|-------------------------|------------|---------------------|
|                     | Thousand                 | \$ million | Thousand                | \$ million |                     |
| <b>Authorised</b>   |                          |            |                         |            |                     |
| At 31 December 2011 | 1,223,591                | 245        | 50                      |            | 245                 |
| At 31 December 2012 | 1,223,591                | 245        | 50                      |            | 245                 |

|  |                |            |           |            |
|--|----------------|------------|-----------|------------|
| At 31 December 2013                    | 1,223,591      | 245        | 50        | 245        |
| <b>Allotted, issued and fully paid</b> |                |            |           |            |
| At 1 January 2011                      | 952,837        | 191        | 50        | 191        |
| Share options                          | 1,991          |            |           |            |
| At 31 December 2011                    | 954,828        | 191        | 50        | 191        |
| Share options                          | 8,752          | 2          |           | 2          |
| At 31 December 2012                    | 963,580        | 193        | 50        | 193        |
| Share options                          | 5,587          | 1          |           | 1          |
| Shares cancelled                       | (51,000)       | (10)       |           | (10)       |
| <b>At 31 December 2013</b>             | <b>918,167</b> | <b>184</b> | <b>50</b> | <b>184</b> |

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:

|                                      | <b>2013</b>       | 2012       | 2011       |
|--------------------------------------|-------------------|------------|------------|
|                                      | <b>\$ million</b> | \$ million | \$ million |
| Share capital                        | <b>184</b>        | 193        | 191        |
| Share premium                        | <b>535</b>        | 488        | 413        |
| Capital redemption reserve           | <b>10</b>         |            |            |
| Treasury shares                      | <b>(322)</b>      | (735)      | (766)      |
| Retained earnings and other reserves | <b>3,640</b>      | 3,938      | 3,349      |



**4,047**

3,884

3,187

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Notes to the Group accounts *continued*

## 19 Equity continued

## 19.2 Treasury shares

Treasury shares represents the holding of the Company's own shares in respect of the Smith & Nephew Employees Share Trust and shares bought back as part of the share buy-back programme. On 2 May 2013, as part of the new Capital Allocation Framework, the Group announced the start of a new share buy-back programme to return \$300m of surplus capital to its Shareholders. The programme has now been suspended as a result of our agreement to acquire ArthroCare Corp. announced on 3 February 2014. As at 31 December 2013, a total of 18.2m ordinary shares (2.0%) had been purchased at a cost of \$226m and 51.0m ordinary shares (5.7%) had been cancelled. The maximum number of ordinary shares held in treasury during 2013 was 65.2m (7.3%) with a nominal value of \$13.0m.

The Smith & Nephew 2004 Employees Share Trust (Trust) was established to hold shares relating to the long-term incentive plans referred to in the Directors Remuneration Report. The Trust is administered by an independent professional trust company resident in Jersey and is funded by a loan from the Company. The cost of the Trust is charged to the income statement as it accrues. A partial dividend waiver is in place in respect of those shares held under the long-term incentive plans. The trust only accepts dividends in respect of nil-cost options and deferred bonus plan shares. The waiver represents less than 1% of the total dividends paid.

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

|   | <b>Treasury</b>   | <b>Employees<br/>Share Trust</b> | <b>Total</b>      |
|---|-------------------|----------------------------------|-------------------|
|   | <b>\$ million</b> | <b>\$ million</b>                | <b>\$ million</b> |
| <b>At 1 January 2012</b>                  | 750               | 16                               | 766               |
| Shares transferred from treasury          | (10)              | 10                               |                   |
| Shares transferred to Group beneficiaries | (10)              | (21)                             | (31)              |
| <b>At 31 December 2012</b>                | 730               | 5                                | 735               |
| Shares purchased                          | 226               | 5                                | <b>231</b>        |
| Shares transferred from treasury          | (8)               | 8                                |                   |
| Shares transferred to Group beneficiaries | (7)               | (14)                             | <b>(21)</b>       |

|                            |            |          |              |
|----------------------------|------------|----------|--------------|
| Shares cancelled           | (623)      |          | <b>(623)</b> |
| <b>At 31 December 2013</b> | <b>318</b> | <b>4</b> | <b>322</b>   |

|   | No of shares<br>million | No of shares<br>million | No of shares<br>million |
|---|-------------------------|-------------------------|-------------------------|
| <b>At 1 January 2012</b>                  | 61.2                    | 1.4                     | 62.6                    |
| Shares transferred from treasury          | (0.9)                   | 0.9                     |                         |
| Shares transferred to Group beneficiaries | (0.8)                   | (1.8)                   | (2.6)                   |
| <b>At 31 December 2012</b>                | 59.5                    | 0.5                     | 60.0                    |
| Shares purchased                          | 18.2                    | 0.4                     | <b>18.6</b>             |
| Shares transferred from treasury          | (0.6)                   | 0.6                     |                         |
| Shares transferred to Group beneficiaries | (0.6)                   | (1.2)                   | <b>(1.8)</b>            |
| Shares cancelled                          | (51.0)                  |                         | <b>(51.0)</b>           |
| <b>At 31 December 2013</b>                | <b>25.5</b>             | <b>0.3</b>              | <b>25.8</b>             |

## 19.3 Dividends

|  | 2013<br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|--|--------------------|--------------------|--------------------|
| The following dividends were declared and paid in the year:  |                    |                    |                    |
| Ordinary final of 16.20¢ for 2012 (2011 10.80¢, 2010 9.82¢)  |                    |                    |                    |
| paid 8 May 2013  | <b>146</b>         | 97                 | 88                 |
| Ordinary interim of 10.40¢ for 2013 (2012 9.90¢, 2011 6.60¢) |                    |                    |                    |
| paid 29 October 2013   | <b>93</b>          | 89                 | 58                 |
|  | <b>239</b>         | 186                | 146                |

A final dividend for 2013 of 17.0 US cents per ordinary share was proposed by the Board on 5 February 2014 and will be paid, subject to shareholder approval, on 7 May 2014 to shareholders on the Register of Members on 22 April 2014. The estimated amount of this dividend on 24 February 2014 is \$152m.



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## 20 Cash flow statement

## ACCOUNTING POLICY

In the Group cash flow statement, cash and cash equivalents includes cash at bank, other short-term liquid investments with original maturities of three months or less and bank overdrafts. In the Group balance sheet, bank overdrafts are shown within bank overdrafts and loans under current liabilities.

## Analysis of net debt

|                        | <b>Borrowings</b> |                   |                   |                   |                     |                   |
|------------------------|-------------------|-------------------|-------------------|-------------------|---------------------|-------------------|
|                        | <b>Cash</b>       | <b>Overdrafts</b> | <b>Due within</b> | <b>Due after</b>  | <b>Net currency</b> | <b>Total</b>      |
|                        | <b>\$ million</b> | <b>\$ million</b> | <b>one year</b>   | <b>one year</b>   | <b>swaps</b>        | <b>\$ million</b> |
|                        |                   |                   | <b>\$ million</b> | <b>\$ million</b> | <b>\$ million</b>   | <b>\$ million</b> |
| At 1 January 2011      | 207               | (12)              | (45)              | (642)             |                     | (492)             |
| Net cash flow          | (21)              | (12)              | 252               | 140               | 1                   | 360               |
| Other non-cash changes |                   |                   | (517)             | 517               |                     |                   |

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|                     |            |             |             |              |          |              |
|---------------------|------------|-------------|-------------|--------------|----------|--------------|
| Exchange adjustment | (2)        | 1           | 27          | (31)         | (1)      | (6)          |
| At 31 December 2011 | 184        | (23)        | (283)       | (16)         |          | (138)        |
| Net cash flow       | (10)       | 12          | 256         | (414)        | 1        | (155)        |
| Exchange adjustment | 4          |             |             |              | 1        | 5            |
| At 31 December 2012 | 178        | (11)        | (27)        | (430)        | 2        | (288)        |
| Net cash flow       | (38)       |             | (6)         | 84           | 1        | <b>41</b>    |
| Exchange adjustment | (3)        |             |             | (1)          | (2)      | <b>(6)</b>   |
| At 31 December 2013 | <b>137</b> | <b>(11)</b> | <b>(33)</b> | <b>(347)</b> | <b>1</b> | <b>(253)</b> |

Reconciliation of net cash flow to movement in net debt

|   | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|---|---------------------------|--------------------|--------------------|
| Net cash flow from cash net of overdrafts | <b>(38)</b>               | 2                  | (33)               |
| Settlement of currency swaps              | <b>1</b>                  | 1                  | 1                  |
| Net cash flow from borrowings             | <b>78</b>                 | (158)              | 392                |
| Change in net debt from net cash flow     | <b>41</b>                 | (155)              | 360                |
| Exchange adjustment                       | <b>(6)</b>                | 5                  | (6)                |
| Change in net debt in the year            | <b>35</b>                 | (150)              | 354                |
| Opening net debt                          | <b>(288)</b>              | (138)              | (492)              |
| Closing net debt                          | <b>(253)</b>              | (288)              | (138)              |

Cash and cash equivalents

For the purposes of the Group Cash Flow Statement cash and cash equivalents at 31 December 2013 comprise cash at bank net of bank overdrafts.

|                           | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|---------------------------|---------------------------|--------------------|--------------------|
| Cash at bank              | <b>137</b>                | 178                | 184                |
| Bank overdrafts           | <b>(11)</b>               | (11)               | (23)               |
| Cash and cash equivalents | <b>126</b>                | 167                | 161                |



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Notes to the Group accounts *continued*

21 Acquisitions and disposals

ACCOUNTING POLICY

The Group accounts for business combinations using the acquisition method when control is transferred to the Group. The consideration transferred in the acquisition is measured at fair value, as are the identifiable net assets acquired. Any goodwill that arises is tested annually for impairment. Any gain on a bargain purchase is recognised in profit or loss immediately. Transaction costs are expensed as incurred, except if related to the issue of debt or equity securities.

Any contingent consideration payable is measured at fair value at the acquisition date. If the contingent consideration is classified as equity, then it is not re-measured and settlement is accounted for within equity. Otherwise, subsequent changes in the fair value of the contingent consideration are recognised in profit or loss.

21.1 Acquisitions

**Year ended 31 December 2013**

On 30 September 2013, the Group acquired certain assets and liabilities in respect of a Turkish business, which distributes products related to orthopaedic reconstruction, trauma, sports medicine and arthroscopic technologies.

The acquisition is deemed to be a business combination within the scope of IFRS 3.

The estimated fair value of the consideration is \$63m and includes \$12m of contingent consideration in respect of agreed milestones and \$36m through the settlement of working capital commitments. The fair values shown below are provisional. If new information is obtained within the measurement period about facts and circumstances that existed at the acquisition date, the acquisition accounting will be revised.



The provisional estimate of goodwill arising on the acquisition is \$12m. It is attributable to the additional economic benefits expected from the transaction, including the assembled workforce, which has been transferred as part of the acquisition. The goodwill recognised is expected to be deductible for tax purposes.

The following table summarises the consideration transferred, and the recognised amounts of assets acquired and liabilities assumed at the acquisition date.

|   | \$ million |
|---|------------|
| <b>Identifiable assets acquired and liabilities assumed</b> |            |
| Property, plant and equipment                               | 4          |
| Inventories   | 8          |
| Trade receivables and prepayments                           | 24         |
| Identifiable intangible assets                              | 17         |
| Payables and accruals                                       | (2)        |
| Net assets  | 51         |
| Goodwill  | 12         |
| Cost of acquisition   | 63         |

The Group incurred acquisition-related costs of \$4m, primarily related to external legal fees and due diligence costs. These costs have been recognised in administrative expenses in the Group's income statement.

In 2013, the contribution to revenue and attributable profit from the acquisition was immaterial. If the acquisition had occurred at the beginning of the year the contribution to revenue and attributable profit would have also been immaterial.

### Other acquisitions

During the year ended 31 December 2013, the Group acquired a Brazilian distributor of its advanced wound management products and a business based in India primarily engaged in the manufacture and distribution of trauma products. These acquisitions are deemed to be business combinations within the scope of IFRS 3.

The aggregated total estimated fair value of the consideration is \$63m and includes \$2m of contingent consideration and \$2m through the settlement of working capital commitments. The fair values shown below are provisional. If new information is obtained within the measurement period about facts and circumstances that existed at the acquisition date, the acquisition accounting will be revised.

As at the acquisition date, the aggregated value of the net assets acquired was \$38 million, which included property, plant and equipment of \$1 million, inventory of \$4 million, trade receivables and prepayments of \$3 million, identifiable intangible assets of \$47 million, payables and accruals of \$3 million and deferred tax liabilities of \$14 million.



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The provisional aggregated estimate of goodwill arising on the acquisitions is \$25m. This is attributable to the additional economic benefits expected from the transactions, including the assembled workforces, which have been transferred as part of the acquisitions. The goodwill recognised is not expected to be deductible for tax purposes.

In 2013, the contribution to revenue and attributable profit from these acquisitions is immaterial. If these acquisitions had occurred at the beginning of the year their contribution to revenue and attributable profit would have also been immaterial.

#### 21.2 Post balance sheet event

Subsequent to the balance sheet date, on 3 February 2014 the Group announced the execution of a definitive agreement to acquire 100% of the shares of ArthroCare Corp. for approximately \$1.7 billion. The acquisition is subject to customary conditions, including a vote of ArthroCare's shareholders and governmental clearances. The acquisition is expected to close in mid-2014. The acquisition will be financed through existing debt facilities and cash balances, including the existing \$1 billion revolving credit facility and a new two-year \$1.4 billion term loan facility, established in February 2014. Information regarding the assets and liabilities acquired will not be available until after completion.

#### 21.3 Commitment

On 26 March 2013, the Group entered into an agreement to acquire the assets related to the distribution business for its sport medicine, orthopaedic reconstruction, and trauma products in Brazil. This acquisition is expected to close in the first half of 2014 subject to the satisfaction of conditions required for closing. The final consideration for this acquisition is subject to change based on the terms and conditions of the agreement and is not expected to be material. As at 31 December 2013 and the date of approval of these financial statements, the Group does not hold any legal ownership in, or control this business.

#### 21.4 Year ended 31 December 2012

On 21 December 2012 the Group acquired substantially all the assets of Healthpoint Biotherapeutics ( Healthpoint ), a leader in bioactive debridement, dermal repair and regeneration wound care treatments.

The acquisition is deemed to be a business combination within the scope of IFRS 3. Consideration was in the form of a single payment of \$782m. The accounting for the acquisition was completed during 2013. The fair values shown below include measurement period adjustments recognised during the period.

The goodwill arising on the acquisition is \$89m. It is attributable to the additional economic benefits expected from the transaction, including revenue synergies and the assembled workforce, which has been transferred as part of the acquisition. The goodwill recognised is deductible for tax purposes.

The following table summarises the consideration transferred, and the recognised amounts of assets acquired and liabilities assumed at the acquisition date.

|   | <b>Provisional<br/>values<br/>\$ million</b> | <b>Adjustment<br/>\$ million</b> | <b>Revised<br/>values<br/>\$ million</b> |
|---|--|----------------------------------|--|
| <b>Identifiable assets acquired and liabilities assumed</b> |  |                                  |  |
| Property, plant and equipment                               | 27   |                                  | 27                                       |
| Inventories   | 46   |                                  | 46                                       |
| Trade receivables   | 31   |                                  | 31                                       |
| Identifiable intangible assets                              | 662  | (11)                             | 651                                      |
| Deferred tax assets   | 5  | (5)                              |  |
| Payables and accruals                                       | (49)   |                                  | (49)                                     |
| Provisions  | (13)   |                                  | (13)                                     |
| Net assets  | 709  | (16)                             | 693                                      |
| Goodwill  | 73   | 16                               | 89                                       |
| Cost of acquisition   | 782  |                                  | 782                                      |

In 2012, the Group incurred acquisition-related costs of \$11m related to professional and adviser fees. These costs have been recognised in administrative expenses in the income statement. No acquisition-related costs were incurred in 2011.

In 2012, since the date of acquisition, the contribution to attributable profit from Healthpoint products was immaterial. The unaudited revenues from Healthpoint products during 2012 were \$190m.

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Notes to the Group accounts *continued*21 Acquisitions *continued*

## 21.5 Disposal of business

**Year ended 31 December 2012**

In January 2012, the Group announced its intention to sell the Clinical Therapies business to Bioventus. This was completed during May 2012 for a total consideration of \$367m and resulted in a profit on disposal before taxation of \$251m. The revenue of the Clinical Therapies business in the four-month period to disposal was \$69m and profit before taxation was \$12m. The details of the transaction are set out below.

|  | <b>\$ million</b> |
|--|-------------------|
| Loan note receivable   | 160               |
| Investment in associate  | 104               |
| Cash   | 103               |
| <b>Total consideration</b>                                     | <b>367</b>        |
| Net assets of business disposed and disposal transaction costs | (116)             |
| Profit before taxation   | 251               |
| 22 Operating leases  |                   |

## ACCOUNTING POLICY

Leases are classified as finance leases when the terms of the lease transfer substantially all the risks and rewards of ownership to the Group. All other leases are classified as operating leases.

Payments under operating leases are expensed in the income statement on a straight line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

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

|                                   | <b>2013</b>       | 2012       |
|-----------------------------------|-------------------|------------|
|                                   | <b>\$ million</b> | \$ million |
| Land and buildings:               |                   |            |
| Within one year                   | <b>30</b>         | 30         |
| After one and within two years    | <b>22</b>         | 24         |
| After two and within three years  | <b>16</b>         | 17         |
| After three and within four years | <b>13</b>         | 14         |
| After four and within five years  | <b>7</b>          | 8          |
| After five years                  | <b>5</b>          | 4          |
|                                   | <b>93</b>         | 97         |
| Other assets:                     |                   |            |
| Within one year                   | <b>15</b>         | 15         |
| After one and within two years    | <b>9</b>          | 10         |
| After two and within three years  | <b>4</b>          | 4          |
| After three and within four years | <b>2</b>          | 1          |
|                                   | <b>30</b>         | 30         |

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## FINANCIAL STATEMENTS 143

## 23 Other Notes to the accounts

## 23.1 Share-based payments

## ACCOUNTING POLICY

The Group operates a number of equity-settled executive and employee share plans. For all grants of share options and awards, the fair value at the grant date is calculated using appropriate option pricing models. The grant date fair value is recognised over the vesting period as an expense, with a corresponding increase in retained earnings.

## Employee plans

The Smith & Nephew Sharesave Plan (2002) (adopted by Shareholders on 3 April 2002) (the Save As You Earn ( SAYE ) plan), the Smith & Nephew International Sharesave Plan (2002), Smith & Nephew France Sharesave Plan (2002), Smith & Nephew Sharesave Plan (2012) (the Save As You Earn ( SAYE 2012 ) plan) (adopted by Shareholders on 12 April 2012), Smith & Nephew International Sharesave Plan (2012) (adopted by Shareholders on 12 April 2012) and Smith & Nephew France Sharesave Plan (2012) (adopted by Shareholders on 12 April 2012) are together termed the Employee Plans .

The SAYE and SAYE 2012 plans are available to all employees in the UK employed by participating Group companies, subject to three months' service. The schemes enable employees to save up to £250 per month and give 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) and Smith & Nephew International Sharesave Plan (2012) are available to employees in Australia, Austria, Belgium, Canada, Denmark, Finland, Germany, Hong Kong, India, Ireland, Italy, Japan, South Korea, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland and the United Arab Emirates. Employees in China and France participated in these plans for the first time in 2013. Puerto Rico participants were eligible to receive options under the International Plans up to 2011 and were eligible to receive phantom options in 2013. The Smith & Nephew France Sharesave Plans were available to all employees in France up to 2012. The International and French plans operate on a substantially similar basis to the SAYE plans.

Employees in the US are able to participate in the Employee Stock Purchase Plan, which gives them the opportunity to acquire shares, in the form of ADSs, at a discount of 15% (or more if the shares appreciate in value during the plan's quarterly purchase period) to the market price, through a regular savings plan.

#### Executive plans

The Smith & Nephew 2001 UK Approved Share Option Plan, the Smith & Nephew 2001 UK Unapproved Share Option Plan, the Smith & Nephew 2001 US Share Plan (adopted by Shareholders on 4 April 2001), the Smith & Nephew 2004 Executive Share Option Plan (adopted by Shareholders on 6 May 2004) and the Smith & Nephew Global Share Plan 2010 (adopted by shareholders on 6 May 2010) are together termed the Executive Plans.

Under the terms of the Executive Plans, the Remuneration Committee, consisting of Non-Executive Directors, may at their discretion approve the grant of options to employees of the Group to acquire ordinary shares in the Company. Options granted under the Smith & Nephew 2001 US Share Plan (the US Plan) and the Smith & Nephew 2004 Executive Share Option Plan are to acquire ADSs or ordinary shares. For Executive Plans adopted in 2001 and 2004, the market value is the average quoted price of an ordinary share for the three business days preceding the date of grant or the average quoted price of an ADS or ordinary share, for the three business days preceding the date of grant or the quoted price on the date of grant if higher. For the Global Share Plan adopted in 2010 the market value is the closing price of an ordinary share or ADS on the last trading day prior to the grant date. With the exception of options granted under the 2001 US Plan and the Global Share Plan 2010, the vesting of options granted from 2001 is 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 was open to Senior Executives only.

The maximum term of options granted, under all plans, is 10 years from the date of grant. All share option plans are settled in shares.

From 2012 onwards Senior Executives were granted share awards instead of share options and from 2013 executives were granted conditional share awards instead of share options. The awards vest 33.3% after one year, 66.7% after two years and the remaining balance after the third year subject to continued employment. There are no performance conditions for executives. Vesting for senior executives is subject to personal performance levels. The market value used to calculate the number of awards is the closing price of an ordinary share on the last trading day prior to the grant date.



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Notes to the Group accounts *continued*23 Other Notes to the accounts *continued*23.1 Share based payments *continued*

At 31 December 2013 13,601,000 (2012 19,690,000, 2011 27,316,000) options were outstanding under share option plans as follows:

|  | Number of<br>shares<br>Thousand | Range of option<br>exercise<br>prices<br>Pence | Weighted average<br>exercise<br>price<br>Pence |
|--|---------------------------------|--|--|
| <b>Employee Plans:</b>                         |                                 |  |  |
| Outstanding at 1 January 2011                  | 3,358                           | 348.0-640.0                                    | 430.1  |
| Granted  | 1,090                           | 452.0-585.0                                    | 454.8  |
| Forfeited                                      | (122)                           | 348.0-609.0                                    | 427.6  |
| Exercised                                      | (602)                           | 348.0-576.5                                    | 454.7  |
| Expired  | (144)                           | 380.0-609.0                                    | 450.7  |
| Outstanding at 31 December 2011                | 3,580                           | 348.0-640.0                                    | 432.8  |
| Granted  | 947                             | 535.0-535.0                                    | 535.0  |
| Forfeited                                      | (402)                           | 348.0-609.0                                    | 434.5  |
| Exercised                                      | (925)                           | 348.0-609.0                                    | 396.0  |
| Expired  | (38)                            | 348.0-640.0                                    | 496.2  |
| Outstanding at 31 December 2012                | 3,162                           | 380.0-609.0                                    | 473.1  |
| Granted  | 1,178                           | 625.0  | 625.0  |
| Forfeited                                      | (174)                           | 380.0-625.0                                    | 488.2  |
| Exercised                                      | (751)                           | 380.0-609.0                                    | 453.8  |
| Expired  | (128)                           | 380.0-625.0                                    | 490.0  |
| <b>Outstanding at 31 December 2013</b>         | <b>3,287</b>                    | <b>380.0-625.0</b>                             | <b>530.5</b>                                   |
| <b>Options exercisable at 31 December 2013</b> | 71                              | 461.0-556.0                                    | 467.8  |
| Options exercisable at 31 December 2012        | 152                             | 380.0-609.0                                    | 400.8  |
| Options exercisable at 31 December 2011        | 122                             | 348.0-640.0                                    | 470.8  |
| <b>Executive Plans:</b>                        |                                 |  |  |
| Outstanding at 1 January 2011                  | 22,395                          | 409.5-680.5                                    | 544.9  |
| Granted  | 5,706                           | 580.0-703.0                                    | 599.4  |
| Forfeited                                      | (763)                           | 479.0-637.8                                    | 565.5  |
| Exercised                                      | (2,369)                         | 445.0-680.5                                    | 536.6  |
| Expired  | (1,233)                         | 445.0-637.8                                    | 549.7  |

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|  |               |                    |              |
|--|---------------|--------------------|--------------|
| Outstanding at 31 December 2011                | 23,736        | 409.5-703.0        | 561.2        |
| Granted  | 3,046         | 642.0-650.0        | 650.0        |
| Forfeited                                      | (954)         | 479.0-703.0        | 569.0        |
| Exercised                                      | (8,740)       | 434.0-651.0        | 547.7        |
| Expired  | (560)         | 435.5-637.8        | 588.7        |
| Outstanding at 31 December 2012                | 16,528        | 409.5-680.5        | 583.3        |
| Forfeited                                      | (118)         | 514.0-650.0        | 618.8        |
| Exercised                                      | (5,540)       | 435.5-671.0        | 568.0        |
| Expired  | (556)         | 435.5-650.0        | 582.3        |
| <b>Outstanding at 31 December 2013</b>         | <b>10,314</b> | <b>409.5-680.5</b> | <b>591.1</b> |
| <b>Options exercisable at 31 December 2013</b> | <b>6,631</b>  | <b>409.5-680.5</b> | <b>571.1</b> |
| Options exercisable at 31 December 2012        | 8,512         | 409.5-680.5        | 562.7        |
| Options exercisable at 31 December 2011        | 7,979         | 409.5-680.5        | 595.6        |

The weighted average remaining contractual life of options outstanding at 31 December 2013 was 6.2 years (2012 6.6 years, 2011 6.6 years) for Executive Plans and 2.5 years (2012 2.6 years, 2011 2.6 years) for Employee Plans.

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|                              |              |       |       |
|------------------------------|--------------|-------|-------|
|                              | <b>2013</b>  | 2012  | 2011  |
|                              | <b>pence</b> | pence | pence |
| Weighted average share price | <b>764.7</b> | 640.5 | 639.9 |

Options granted during the year were as follows:

|                | <b>Options<br/>granted<br/>Thousand</b> | <b>Weighted<br/>average fair<br/>value per<br/>option at<br/>grant date<br/>Pence</b> | <b>Weighted<br/>average<br/>share price at<br/>grant date<br/>Pence</b> | <b>Weighted<br/>average<br/>exercise<br/>price<br/>Pence</b> | <b>Weighted<br/>average<br/>option life<br/>Years</b> |
|----------------|---|---|---|--|---|
| Employee Plans | <b>1,178</b>                            | <b>203.9</b>  | <b>792.5</b>  | <b>625.0</b>   | <b>3.8</b>  |

The weighted average fair value of options granted under Employee Plans during 2012 was 184.0p (2011 189.2p) and those under Executive Plans during 2012 was 148.7p (2011 176.1p).

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.

For all plans the inputs to the option pricing models are reassessed for each grant. The following assumptions were used in calculating the fair value of options granted:

|                           | <b>Employee plans</b> |      |      | <b>Executive plans</b> |      |      |
|---------------------------|-----------------------|------|------|------------------------|------|------|
|                           | <b>2013</b>           | 2012 | 2011 | <b>2013</b>            | 2012 | 2011 |
| Dividend yield %          | <b>2.0</b>            | 1.5  | 1.5  | <b>2.0</b>             | 1.5  | 1.5  |
| Expected volatility % (i) | <b>25.0</b>           | 25.0 | 30.0 | <b>25.0</b>            | 25.0 | 30.0 |

|                                |            |     |     |      |      |
|--------------------------------|------------|-----|-----|------|------|
| Risk free interest rate % (ii) | <b>1.3</b> | 1.3 | 2.0 | 1.2  | 2.0  |
| Expected life in years         | <b>3.8</b> | 3.8 | 3.9 | 10.0 | 10.0 |

(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.

Summarised information about options outstanding under the share option plans at 31 December 2013 is as follows:

|  | <b>Number<br/>outstanding<br/>Thousand</b> | <b>Weighted average<br/>remaining contract life<br/>Years</b> |
|--|--|---|
| Employee Plans:<br>380.0p to 764.7p (i)  | <b>3,287</b>                               | <b>2.5</b>  |
| Executive Plans:<br>409.5p to 764.7p (i) | <b>10,314</b>                              | <b>6.2</b>  |

(i) The split has been determined based on the weighted average share price of 764.7p.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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Notes to the Group accounts *continued*23 Other Notes to the accounts *continued*23.1 Share based payments *continued***Share-based payments long-term incentive plans**

In 2004, a share-based incentive plan was introduced for Executive Directors, Executive Officers and the next level of Senior Executives. The plan included a Performance Share Plan ( PSP ) and a Bonus Co-Investment Plan ( CIP ).

Vesting of the PSP awards 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 was 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 was compulsorily deferred into shares which vested, subject to continued employment, in equal annual tranches over three years (ie one-third each year). No further performance conditions applied to the deferred shares.

From 2010, Performance Share awards were 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.

From 2012, Deferred Bonus Plan and GSP 2010 options for Executive Directors, Executive Officers and the next level of Senior Executives were replaced by Equity Incentive Awards ( EIA ). EIA are designed to encourage Executives to build up and maintain a significant shareholding in the Company. EIA will vest, in equal annual tranches over three years (ie one-third each year), subject to continued employment and personal performance. No further performance conditions apply to the EIA.

The fair values of awards granted under long-term incentive plans are calculated using a binomial model. 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. A correlation of 40% (2012 35%, 2011 40%) 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 Free Cash Flow growth and the Group's TSR performance over the three-year performance period.

The other assumptions used are consistent with the Executive scheme assumptions disclosed in Note 23.1.

At 31 December 2013 the maximum number of shares that could be awarded under the Group's long-term incentive plans was:

|  | <b>Number of shares in Thousands</b> |                 |              |            |                   |                |
|--|--------------------------------------|-----------------|--------------|------------|-------------------|----------------|
|  | <b>Other</b>                         | <b>Deferred</b> |              |            |                   |                |
|  | <b>Awards</b>                        | <b>EIA</b>      | <b>PSP</b>   | <b>CIP</b> | <b>Bonus Plan</b> | <b>Total</b>   |
| Outstanding at January 2011            |                                      |                 | 6,012        | 197        | 522               | 6,731          |
| Awarded                                | 838                                  |                 | 2,282        |            | 351               | 3,471          |
| Vested                                 | (44)                                 |                 | (366)        |            | (375)             | (785)          |
| Forfeited                              |                                      |                 | (1,660)      | (197)      | (6)               | (1,863)        |
| Outstanding at 31 December 2011        | 794                                  |                 | 6,268        |            | 492               | 7,554          |
| Awarded                                | 187                                  | 1,060           | 2,190        |            |                   | 3,437          |
| Vested                                 | (263)                                | (49)            | (1,785)      |            | (287)             | (2,384)        |
| Forfeited                              |                                      | (82)            | (1,431)      |            | (41)              | (1,554)        |
| Outstanding at 31 December 2012        | 718                                  | 929             | 5,242        |            | 164               | <b>7,053</b>   |
| Awarded                                | 1,179                                | 785             | 1,963        |            |                   | <b>3,927</b>   |
| Vested                                 | (437)                                | (379)           | (411)        |            | (115)             | <b>(1,342)</b> |
| Forfeited                              | (11)                                 | (51)            | (1,597)      |            | (5)               | <b>(1,664)</b> |
| <b>Outstanding at 31 December 2013</b> | <b>1,449</b>                         | <b>1,284</b>    | <b>5,197</b> |            | <b>44</b>         | <b>7,974</b>   |

Other awards mainly comprises conditional share awards granted under the Global Share Plan 2010.

The weighted average remaining contractual life of awards outstanding at 31 December 2013 was 1.4 years (2012 0.8 years, 2011 1.2 years) for the PSP, 0.2 years (2012 0.9 years, 2011 1.7 years) for the Deferred Bonus Plan, 1.8 years (2012 2.2 years) for the EIA and 2.1 years (2012 0.9 years, 2011 1.5 years) for the other awards. There were no awards outstanding under the CIP in 2013, 2012 or 2011.

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Share-based payments charge to income statement

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

|  | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|--|---------------------------|--------------------|--------------------|
| Granted in current year                                | <b>10</b>                 | 9                  | 9                  |
| Granted in prior years                                 | <b>18</b>                 | 25                 | 21                 |
| <b>Total share-based payments expense for the year</b> | <b>28</b>                 | 34                 | 30                 |

Under the Executive Plans, PSP, EIA 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 10 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 10-year period under all share plans operated by the Company may not exceed 10% of the ordinary share capital at the date of grant.

## 23.2 Related party transactions

**Trading transactions**

In the course of normal operations, the Group traded with its associates detailed in Note 11. The aggregated transactions, which have not been disclosed elsewhere in the financial statements, are summarised below:

|                               | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million |
|-------------------------------|---------------------------|--------------------|--------------------|
| Sales to the associates       | <b>5</b>                  | 14                 | 8                  |
| Purchases from the associates | <b>2</b>                  | 8                  | 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:

|  | <b>2013</b><br><b>\$ million</b> | 2012<br>\$ million | 2011<br>\$ million |
|--|----------------------------------|--------------------|--------------------|
| Short-term employee benefits                     | <b>15</b>                        | 16                 | 19                 |
| Share-based payments expense                     | <b>11</b>                        | 10                 | 9                  |
| Pension and post-employment benefit entitlements | <b>1</b>                         | 1                  | 1                  |
| Termination benefits                             |                                  |                    | 1                  |
|  | <b>27</b>                        | 27                 | 30                 |



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Notes to the Group accounts *continued*23 Other Notes to the accounts *continued*

## 23.3 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>UK:</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 Orthopaedics GmbH      | Medical Devices | Germany                                       |
| Smith & Nephew GmbH                   | Medical Devices | Germany                                       |
| Smith & Nephew Orthopaedics 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 SAU                    | Medical Devices | Spain   |
| Smith & Nephew AB                     | Medical Devices | Sweden  |

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|                                 |                 |               |
|---------------------------------|-----------------|---------------|
| Smith & Nephew Manufacturing AG | Medical Devices | Switzerland   |
| Smith & Nephew Orthopaedics AG  | Medical Devices | Switzerland   |
| <b>US:</b>                      |                 |               |
| Smith & Nephew Inc.             | Medical Devices | United States |

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| <b>Company Name</b>                                      | <b>Activity</b> | <b>Country of operation and incorporation</b> |
|--|-----------------|---|
| <b>Africa, Asia, Australasia and Other America:</b>      |                 |   |
| Smith & Nephew Pty Limited                               | Medical Devices | Australia                                     |
| Smith & Nephew do Brasil Participacoes S.A.              | Medical Devices | Brazil  |
| Smith & Nephew Inc.                                      | Medical Devices | Canada  |
| Smith & Nephew (Alberta) Inc.                            | Medical Devices | Canada  |
| Tenet Medical Engineering Inc.                           | Medical Devices | Canada  |
| Smith & Nephew Medical (Shanghai) Limited                | Medical Devices | China   |
| Smith & Nephew Medical (Suzhou) Limited                  | Medical Devices | China   |
| Smith & Nephew Orthopaedics (Beijing) Limited            | Medical Devices | China   |
| Smith & Nephew Limited                                   | Medical Devices | Hong Kong                                     |
| Adler Mediequip Private Limited                          | Medical Devices | India   |
| 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                                   |
| LLC Smith & Nephew                                       | Medical Devices | Russia  |
| Smith & Nephew Pte Limited                               | Medical Devices | Singapore                                     |
| Smith & Nephew (Pty) Limited                             | Medical Devices | South Africa                                  |
| Smith & Nephew Limited                                   | Medical Devices | Thailand                                      |
| Smith ve Nephew Medikal Cihazlar Ticaret Limited Sirketi | Medical Devices | Turkey  |
| Smith & Nephew FZE                                       | Medical Devices | United Arab Emirates                          |

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### SMITH & NEPHEW ANNUAL REPORT 2013

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Independent auditor's report for the Company

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

We have audited the Parent Company financial statements of Smith & Nephew plc for the year ended 31 December 2013 which comprise the Parent Company balance sheet and the related Notes 1 to 9. The financial reporting framework that has been applied in their preparation is applicable law and UK 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 pages 88 and 89, the Directors are responsible for the preparation of the Parent Company financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the Parent Company financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

#### Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the 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 financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

#### Opinion on accounts

In our opinion the Parent Company financial statements:

give a true and fair view of the state of the Company's affairs as at 31 December 2013;

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 Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the parent company financial statements.

**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 financial statements 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 financial statements of Smith & Nephew plc for the year ended 31 December 2013.

**Les Clifford (Senior statutory auditor)**

**for and on behalf of Ernst & Young LLP, Statutory Auditor**

**London**

**26 February 2014**

The Parent Company financial statements of Smith & Nephew plc on pages 151 to 154 do not form part of the Smith & Nephew's Annual Report on Form 20-F as filed with the SEC.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## FINANCIAL STATEMENTS 151

## Company balance sheet

|  | Notes | At 31 December<br>2013<br>\$ million | At 31 December<br>2012<br>\$ million |
|--|-------|--------------------------------------|--------------------------------------|
| <b>Fixed assets:</b>                                   |       |                                      |                                      |
| Investments  | 3     | 3,597                                | 3,597                                |
| <b>Current assets:</b>                                 |       |                                      |                                      |
| Debtors  | 4     | 2,140                                | 2,679                                |
| Cash and bank  | 6     | 6                                    | 20                                   |
|  |       | 2,146                                | 2,699                                |
| <b>Creditors: amounts falling due within one year:</b> |       |                                      |                                      |
| Borrowings   | 6     | (2)                                  | (1)                                  |
| Other creditors  | 5     | (1,590)                              | (1,871)                              |
|  |       | (1,592)                              | (1,872)                              |
| <b>Net current assets</b>                              |       | 554                                  | 827                                  |
| <b>Total assets less current liabilities</b>           |       | 4,151                                | 4,424                                |
| <b>Creditors: amounts falling due after one year:</b>  |       |                                      |                                      |
| Borrowings   | 6     | (335)                                | (415)                                |
| <b>Total assets less total liabilities</b>             |       | 3,816                                | 4,009                                |
| Equity shareholders funds:                             |       |                                      |                                      |
| Called up equity share capital                         | 7     | 184                                  | 193                                  |
| Share premium account                                  | 7     | 535                                  | 488                                  |
| Capital redemption reserve                             | 7     | 10                                   |                                      |
| Capital reserve  | 7     | 2,266                                | 2,266                                |
| Treasury shares  | 7     | (322)                                | (735)                                |
| Exchange reserve                                       | 7     | (52)                                 | (52)                                 |
| Profit and loss account                                | 7     | 1,195                                | 1,849                                |
| <b>Shareholders funds</b>                              |       | 3,816                                | 4,009                                |

The accounts were approved by the Board and authorised for issue on 26 February 2014 and signed on its behalf by:

|                   |                         |                         |
|-------------------|-------------------------|-------------------------|
| Sir John Buchanan | Olivier Bohuon          | Julie Brown             |
| Chairman          | Chief Executive Officer | Chief Financial Officer |

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The Parent Company financial statements of Smith & Nephew plc on pages 151 to 154 do not form part of the Smith & Nephew's Annual Report on Form 20-F as filed with the SEC.



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### SMITH & NEPHEW ANNUAL REPORT 2013

#### 152 FINANCIAL STATEMENTS

##### Notes to the Company accounts

#### 1 Basis of preparation

Smith & Nephew plc (the Company) is a public limited company incorporated in England and Wales.

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 94 to 149.

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.

##### 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.

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.

#### 2 Results for the year

As permitted by Section 408(4) of the Companies Act 2006, the Company has not presented its own profit and loss account. Profit for the year was \$198m (2012 \$167m).

### 3 Investments

#### ACCOUNTING POLICY

Investments in subsidiaries are stated at cost less provision for impairment.

|                | <b>2013</b>       | 2012       |
|----------------|-------------------|------------|
|                | <b>\$ million</b> | \$ million |
| At 1 January   | <b>3,597</b>      | 3,598      |
| Impairment     |                   | (1)        |
| At 31 December | <b>3,597</b>      | 3,597      |

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 23.3 of the Notes to the Group accounts for the principal trading and manufacturing subsidiary undertakings of the Group.

The Parent Company financial statements of Smith & Nephew plc on pages 151 to 154 do not form part of the Smith & Nephew's Annual Report on Form 20-F as filed with the SEC.



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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## FINANCIAL STATEMENTS 153

**4 Debtors**

|  | <b>2013</b>       | 2012       |
|--|-------------------|------------|
|  | <b>\$ million</b> | \$ million |
| Amounts falling due within one year:                         |                   |            |
| Amounts owed by subsidiary undertakings                      | <b>2,091</b>      | 2,628      |
| Prepayments and accrued income                               | <b>3</b>          | 7          |
| Current asset derivatives forward foreign exchange contracts | <b>45</b>         | 20         |
| Current asset derivatives currency swaps                     | <b>1</b>          | 2          |
| Current taxation   |                   | 22         |
|  | <b>2,140</b>      | 2,679      |

**5 Other creditors**

|  | <b>2013</b>       | 2012       |
|--|-------------------|------------|
|  | <b>\$ million</b> | \$ million |
| Amounts falling due within one year:                             |                   |            |
| Amounts owed to subsidiary undertakings                          | <b>1,533</b>      | 1,832      |
| Other creditors  | <b>10</b>         | 19         |
| Current taxation   | <b>2</b>          |            |
| Current liability derivatives forward foreign exchange contracts | <b>45</b>         | 20         |
|  | <b>1,590</b>      | 1,871      |

**6 Cash and borrowings**

## ACCOUNTING POLICY

## 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.

|  | <b>2013</b>       | 2012       |
|--|-------------------|------------|
|  | <b>\$ million</b> | \$ million |
| Bank loans and overdrafts due within one year or on demand | <b>2</b>          | 1          |
| Bank loans due after one year                              | <b>335</b>        | 415        |
| Borrowings   | <b>337</b>        | 416        |
| Cash and bank  | <b>(6)</b>        | (20)       |
| Debit balance on derivatives – currency swaps              | <b>(1)</b>        | (2)        |
| Net debt   | <b>330</b>        | 394        |

All currency swaps are stated at fair value. Gross US Dollar equivalents of \$146m (2012 \$175m) receivable and \$145m (2012 \$173m) payable have been netted. Currency swaps comprise foreign exchange swaps and were used in 2013 and 2012 to hedge intragroup loans.

The Parent Company financial statements of Smith & Nephew plc on pages 151 to 154 do not form part of the Smith & Nephew's Annual Report on Form 20-F as filed with the SEC.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 154 FINANCIAL STATEMENTS

Notes to the Company accounts *continued*

## 7 Equity and reserves

|  | Share<br>capital<br>\$ million | Share<br>premium<br>\$ million | Capital<br>redemption<br>reserve<br>\$ million | Capital<br>reserves<br>\$ million | Treasury<br>shares<br>\$ million | Exchange<br>reserve<br>\$ million | Profit and<br>loss account<br>\$ million | 2013<br>Total<br>shareholders<br>funds<br>\$ million | 2012<br>Total<br>shareholders<br>funds<br>\$ million |
|--|--------------------------------|--------------------------------|--|-----------------------------------|----------------------------------|-----------------------------------|--|--|--|
| At 1 January   | 193                            | 488                            |  | 2,266                             | (735)                            | (52)                              | 1,849                                    | 4,009  | 3,911  |
| Attributable profit for<br>the year                  |                                |                                |  |                                   |                                  |                                   | 198                                      | <b>198</b>   | 167  |
| Equity dividends paid<br>in the year                 |                                |                                |  |                                   |                                  |                                   | (239)                                    | <b>(239)</b>   | (186)  |
| Share-based<br>payments recognised                   |                                |                                |  |                                   |                                  |                                   | 28                                       | <b>28</b>  | 34   |
| Cost of shares<br>transferred to<br>beneficiaries    |                                |                                |  |                                   | 21                               |                                   | (18)                                     | <b>3</b>   | 6  |
| New shares issued on<br>exercise of share<br>options | 1                              | 47                             |  |                                   |                                  |                                   |  | <b>48</b>  | 77   |
| Cancellation of<br>treasury shares                   | (10)                           |                                | 10   |                                   | 623                              |                                   | (623)                                    |  |  |
| Treasury shares<br>purchased                         |                                |                                |  |                                   | (231)                            |                                   |  | <b>(231)</b>   |  |
| At 31 December                                       | <b>184</b>                     | <b>535</b>                     | <b>10</b>                                      | <b>2,266</b>                      | <b>(322)</b>                     | <b>(52)</b>                       | <b>1,195</b>                             | <b>3,816</b>   | 4,009  |

Further information on the share capital of the Company can be found in Note 19.1 of the Notes to the Group accounts.

The total distributable reserves of the Company are \$821m (2012 \$1,062m). 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 \$198m (2012 \$167m).

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 3.2 of the Notes to the Group accounts.

## 8 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 23.1 of the Notes to the Group accounts.

## 9 Contingencies

|  | <b>2013</b>       | 2012       |
|--|-------------------|------------|
|  | <b>\$ million</b> | \$ million |
| Guarantees in respect of subsidiary undertakings | <b>25</b>         | 37         |

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 18 of the Notes to the Group accounts).

The Parent Company financial statements of Smith & Nephew plc on pages 151 to 154 do not form part of the Smith & Nephew s Annual Report on Form 20-F as filed with the SEC.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## GROUP INFORMATION 155

## Group information

**Business overview and Group history**

Smith & Nephew's operations are organised into two primary divisions that operate globally: Advanced Surgical Devices and Advanced Wound Management.

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, UK in 1856. Following 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, producing various medical devices, personal care products and traditional and advanced wound care 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. In 2011, the Endoscopy and Orthopaedics businesses were brought together to create an Advanced Surgical Devices division.

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.

**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, UK   | 20  |
| Group research facility in York, UK   | 84  |
| Advanced Surgical Devices headquarters in Andover, Massachusetts, US          | 144   |
| Advanced Wound Management headquarters and manufacturing facility in Hull, UK | 473   |
| Advanced Surgical Devices manufacturing facilities in Memphis, Tennessee, US  | 971   |
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|  |     |
|--|-----|
| Advanced Surgical Devices distribution facility in Memphis, Tennessee, US                      | 210 |
| Advanced Surgical Devices manufacturing facility in Aarau, Switzerland                         | 121 |
| Advanced Surgical Devices manufacturing facility in Beijing, China                             | 192 |
| Advanced Surgical Devices manufacturing and warehouse facility in Warwick, UK                  | 90  |
| Advanced Surgical Devices manufacturing and warehouse facility in Tuttlingen, Germany          | 64  |
| Advanced Surgical Devices distribution facility and European headquarters in Baar, Switzerland | 67  |
| Advanced Surgical Devices manufacturing facility in Mansfield, Massachusetts, US               | 98  |
| Advanced Surgical Devices manufacturing facility in Oklahoma City, Oklahoma, US                | 155 |
| Advanced Surgical Devices manufacturing facility in Calgary, Canada                            | 17  |
| Advanced Surgical Devices manufacturing facility in Sangameshwar, India                        | 39  |
| Advanced Wound Management manufacturing facility in Gilberdyke, UK                             | 51  |
| Advanced Wound Management manufacturing facility in Suzhou, China                              | 288 |
| Advanced Wound Management manufacturing facility in Fort Saskatchewan, Canada                  | 76  |
| Advanced Wound Management US headquarters in St. Petersburg, Florida, US                       | 44  |
| Advanced Wound Bioactives headquarters and laboratory space in Texas, US                       | 105 |
| Advanced Wound Bioactives manufacturing facility in Curaçao, Dutch Caribbean                   | 16  |

The Group Global Operations strategy includes ongoing assessment of the optimal facility footprint. The Advanced Surgical Devices 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.

#### 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 23.2 of Notes to the Group accounts), no other related party had material transactions or loans with Smith & Nephew over the last three financial years.

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SMITH & NEPHEW ANNUAL REPORT 2013

156 GROUP INFORMATION

Group information *continued*

**Risk factors**

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

*Highly competitive markets*

The Group's business segments compete across a diverse range of geographic and product markets. Each market in which the business segments operate contains a number of different competitors, including specialised and international corporations. Significant product innovations, technical advances or the intensification of price competition by competitors could adversely affect the Group's operating results.

Some of these competitors may have greater financial, marketing and other resources than Smith & Nephew. These competitors may be able to initiate technological advances in the field, deliver products on more attractive terms, more aggressively market their products or invest larger amounts of capital and research and development ( R&D ) into their businesses.

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

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

*Continual development and introduction of new products*

The medical devices industry has a rapid rate of new product introduction. In order to remain competitive, each of the Group's business segments must continue to develop innovative products that satisfy customer needs and preferences or provide cost or other advantages. Developing new products is a costly, lengthy and uncertain process. The Group may fail to innovate due to low R&D investment, a R&D skills gap or poor product development. A potential product may not be brought to market or not succeed in the market for any number of reasons, including failure to work optimally, failure to receive regulatory approval, failure to be cost-competitive, infringement of patents or other

intellectual property rights and changes in consumer demand. The Group's products and technologies are also subject to marketing attack by competitors. Furthermore, new products that are developed and marketed by the Group's competitors may affect price levels in the various markets in which the Group's business segments operate. If the Group's new products do not remain competitive with those of competitors, the Group's revenue could decline.

The Group maintains reserves for excess and obsolete inventory resulting from the potential inability to sell its products at prices in excess of current carrying costs. Marketplace changes resulting from the introduction of new products or surgical procedures may cause some of the Group's products to become obsolete. The Group makes estimates regarding the future recoverability of the costs of these products and records a provision for excess and obsolete inventories based on historical experience, expiration of sterilisation dates and expected future trends. If actual product life cycles, product demand or acceptance of new product introductions are less favourable than projected by management, additional inventory write-downs may be required.

#### Dependence on government and other funding

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

Pricing of the Group's products is largely governed in most Established Markets by governmental reimbursement authorities. Initiatives sponsored by government agencies, legislative bodies and the private sector to limit the growth of healthcare costs, including price regulation, excise taxes and competitive pricing, are 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 government policies favouring locally sourced products. The Group is also exposed to changes in reimbursement policy, tax policy and pricing which may have an adverse impact on revenue and operating profit. In particular, changes to the healthcare legislation in the US have imposed significant taxes on medical device manufacturers from 2013. There may be an increased risk of adverse changes to government funding policies arising from the deterioration in macro-economic conditions in some of the Group's markets.

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

#### World economic conditions

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

During 2013, economic conditions worldwide continued to create several challenges for the Group, including deferrals of joint replacement procedures, heightened pricing pressure, significant declines in capital equipment expenditures at hospitals and increased uncertainty over the collectability of European government debt, particularly those in certain parts of southern Europe. These factors tempered the overall growth of the Group's global markets and could have an increased impact on growth in the future.



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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 revenue and operating profit. War, terrorist activities or other conflict could also adversely impact the Group.

Currency fluctuations

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

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

The Group uses the US Dollar as its reporting currency and the US Dollar is the functional currency of Smith & Nephew plc. The Group's revenues, profits and earnings are also affected by exchange rate movements on the translation of results of operations in foreign subsidiaries for financial reporting purposes. See "Liquidity and capital resources" on page 99.

Manufacturing and supply

The Group's manufacturing production is concentrated at 14 main facilities in Memphis, Mansfield and Oklahoma City in the US, Hull, Warwick and Gilberdyke in the UK, Aarau in Switzerland, Tuttlingen in Germany, Fort Saskatchewan and Calgary in Canada, Sangameshwar in India, Suzhou and Beijing in China and Curaçao. If major physical disruption took place at any of these sites, it could adversely affect the results of operations. Physical loss and consequential loss insurance is carried to cover such risks but is subject to limits and deductibles and may not be sufficient to cover catastrophic loss. Management of orthopaedic inventory is complex, particularly forecasting and production planning. There is a risk that failures in operational execution could lead to excess inventory or individual product shortages.

Each of the business segments is reliant on certain key suppliers of raw materials, components, finished products and packaging materials or in some cases on a single supplier. 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 will, from time to time, outsource the manufacture of components and finished products to third parties and will periodically relocate the manufacture of product and/or processes between existing facilities. While these are planned activities, with 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 revenue 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.



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158 GROUP INFORMATION

Group information *continued*

Regulatory standards and 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. 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 Note 17 to the Group accounts. 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.

International regulation

The Group operates across the world and is subject to legislation, including anti-bribery and corruption and data protection, in each country in which we operate. Our international operations are governed by the UK Bribery Act and the US Foreign Corrupt Practices Act (FCPA) which prohibit us or our agents from making, or offering, improper payments to foreign governments and their officials for the purpose of obtaining or maintaining business or product approvals. Enforcement of such legislation has increased in recent years with significant fines and penalties being imposed on companies and individuals. Our international operations, particularly in the emerging markets, expose the Group to the risk that our employees or agents will engage in prohibited activities.

Regulatory approval

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

National regulatory authorities administer and enforce a complex series of laws and regulations that govern the design, development, approval, manufacture, labelling, marketing and sale of healthcare products. They also review data supporting the safety and efficacy of such products. Of particular importance is the requirement in many countries that products be authorised or registered prior to manufacture, marketing or sale and that such authorisation or registration be subsequently maintained. The major regulatory agencies for Smith & Nephew's products include the Food and Drug Administration (FDA) in the US, the Medicines and Healthcare products Regulatory Agency in the UK, the Ministry of Health, Labour and Welfare in Japan and the China Food and Drug Administration. At any time, the Group is awaiting a number of regulatory approvals which, if not received, could adversely affect results of operations.

The trend is towards more stringent regulation and higher standards of technical appraisal. Such controls have become increasingly demanding to comply with and management believes that this trend will continue.



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

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

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

#### Failure to make successful acquisitions

A key element of the Group's strategy for continued growth is to make acquisitions or alliances to complement its existing business. Failure to identify appropriate acquisition targets or failure to conduct adequate due diligence or to integrate them successfully would have an adverse impact on the Group's competitive position and profitability. This could result from the diversion of management resources towards the acquisition or integration process, challenges of integrating organisations of different geographic, cultural and ethical backgrounds, as well as the prospect of taking on unexpected or unknown liabilities. In addition, the availability of global capital may make financing less attainable or more expensive and could result in the Group failing in its strategic aim of growth by acquisition or alliance.

#### Relationships with healthcare professionals

The Group seeks to maintain effective and ethical working relationships with physicians and medical personnel who assist in the research and development of new products or improvements to our existing product range or in product training and medical education. If we are unable to maintain these relationships our ability to meet the demands of our customers could be diminished and our revenue and profit could be materially adversely affected.

#### Reliance on sophisticated information technology

The Group uses a wide variety of information systems, programmes and technology to manage our business. Our systems are vulnerable to a cyber-attack, malicious intrusion, loss of data privacy or any other significant disruption. Our systems have been and will continue to be the target of such threats. We have systems in place to minimise the risk and disruption of these intrusions and to monitor our systems on an ongoing basis for current or potential threats. There can be no assurance that these measures will prove effective in protecting Smith & Nephew from future interruptions and as a result the performance of the Group could be materially adversely affected.

#### 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.

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

Government economic, fiscal, monetary and political policies are all factors that materially affect the Group's operation or investments of shareholders. Other factors include sales trends, currency fluctuations and innovation. Each of these factors is discussed further in the "Our Marketplace" on pages 16 to 18, "Segment performance" on pages 24

to 33 and Taxation information for shareholders on pages 175 and 176.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## OTHER FINANCIAL INFORMATION 159

Other financial information

## Selected financial data

|  | <b>2013</b><br>\$ million | 2012(i)<br>Restated<br>\$ million | 2011(i)<br>Restated<br>\$ million | 2010(i)<br>Restated<br>\$ million | 2009(i)<br>Restated<br>\$ million |
|--|---------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
| <b>Income statement</b>                        |                           |                                   |                                   |                                   |                                   |
| Revenue  | <b>4,351</b>              | 4,137                             | 4,270                             | 3,962                             | 3,772                             |
| Cost of goods sold                             | <b>(1,100)</b>            | (1,070)                           | (1,140)                           | (1,031)                           | (1,030)                           |
| Gross Profit                                   | <b>3,251</b>              | 3,067                             | 3,130                             | 2,931                             | 2,742                             |
| Selling, general and administrative expenses   | <b>(2,210)</b>            | (2,050)                           | (2,101)                           | (1,860)                           | (1,864)                           |
| Research and development expenses              | <b>(231)</b>              | (171)                             | (167)                             | (151)                             | (155)                             |
| Operating profit                               | <b>810</b>                | 846                               | 862                               | 920                               | 723                               |
| Net interest receivable/(payable)              | <b>4</b>                  | 2                                 | (8)                               | (15)                              | (40)                              |
| Other finance (costs)/income                   | <b>(11)</b>               | (11)                              | (13)                              | (16)                              | (21)                              |
| Share of results of associates                 | <b>(1)</b>                | 4                                 |                                   |                                   | 2                                 |
| Profit on disposal of net assets held for sale |                           | 251                               |                                   |                                   |                                   |
| Profit before taxation                         | <b>802</b>                | 1,092                             | 841                               | 889                               | 664                               |
| Taxation                                       | <b>(246)</b>              | (371)                             | (266)                             | (280)                             | (198)                             |
| Attributable profit for the year               | <b>556</b>                | 721                               | 575                               | 609                               | 466                               |
| <b>Earnings per ordinary share</b>             |                           |                                   |                                   |                                   |                                   |
| Basic  | <b>61.7¢</b>              | 80.4¢                             | 64.5¢                             | 68.6¢                             | 52.7¢                             |
| Diluted  | <b>61.4¢</b>              | 80.0¢                             | 64.2¢                             | 68.5¢                             | 52.7¢                             |
| <b>Adjusted attributable profit</b>            |                           |                                   |                                   |                                   |                                   |
| Attributable profit for the year               | <b>556</b>                | 721                               | 575                               | 609                               | 466                               |
| Acquisition-related costs                      | <b>31</b>                 | 11                                |                                   |                                   | 26                                |
| Restructuring and rationalisation expenses     | <b>58</b>                 | 65                                | 40                                | 15                                | 42                                |
| Legal settlement                               |                           |                                   | 23                                |                                   |                                   |
|  | <b>88</b>                 | 43                                | 36                                | 34                                | 66                                |

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|   |              |       |       |       |       |
|---|--------------|-------|-------|-------|-------|
| Amortisation of acquisition intangibles and impairments   |              |       |       |       |       |
| Profit on disposal of net assets held for sale            |              | (251) |       |       |       |
| Taxation on excluded items                                | <b>(40)</b>  | 82    | (17)  | (10)  | (26)  |
| Adjusted attributable profit                              | <b>693</b>   | 671   | 657   | 648   | 574   |
| Adjusted basic earnings per ordinary share ( EPISA ) (ii) | <b>76.9¢</b> | 74.8¢ | 73.7¢ | 73.0¢ | 64.9¢ |
| Adjusted diluted earnings per ordinary share (iii)        | <b>76.5¢</b> | 74.5¢ | 73.4¢ | 72.9¢ | 64.9¢ |

(i) The prior periods have been restated following adoption of the revised IAS 19 Employee Benefits standard.

(ii) Adjusted basic earnings per ordinary share is calculated by dividing adjusted attributable profit by the average number of shares.

(iii) Adjusted diluted earnings per ordinary share is calculated by dividing adjusted attributable profit by the diluted number of shares

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

## 160 OTHER FINANCIAL INFORMATION

Other financial information *continued*

|   | <b>2013</b><br>\$ million | 2012<br>\$ million | 2011<br>\$ million | 2010<br>\$ million | 2009<br>\$ million |
|---|---------------------------|--------------------|--------------------|--------------------|--------------------|
| <b>Group balance sheet</b>  |                           |                    |                    |                    |                    |
| Non-current assets  | <b>3,563</b>              | 3,498              | 2,542              | 2,579              | 2,480              |
| Current assets  | <b>2,256</b>              | 2,144              | 2,080              | 2,154              | 2,071              |
| Assets held for sale  |                           |                    | 125                |                    | 14                 |
| <b>Total assets</b>   | <b>5,819</b>              | 5,642              | 4,747              | 4,733              | 4,565              |
| Share capital   | <b>184</b>                | 193                | 191                | 191                | 190                |
| Share premium   | <b>535</b>                | 488                | 413                | 396                | 382                |
| Capital redemption reserve  | <b>10</b>                 |                    |                    |                    |                    |
| Treasury shares   | <b>(322)</b>              | (735)              | (766)              | (778)              | (794)              |
| Retained earnings and other reserves  | <b>3,640</b>              | 3,938              | 3,349              | 2,964              | 2,401              |
| <b>Total equity</b>   | <b>4,047</b>              | 3,884              | 3,187              | 2,773              | 2,179              |
| Non-current liabilities   | <b>699</b>                | 828                | 422                | 1,046              | 1,523              |
| Current liabilities   | <b>1,073</b>              | 930                | 1,119              | 914                | 863                |
| Liabilities directly associated with assets held for sale   |                           |                    | 19                 |                    |                    |
| <b>Total liabilities</b>  | <b>1,772</b>              | 1,758              | 1,560              | 1,960              | 2,386              |
| <b>Total equity and liabilities</b>   | <b>5,819</b>              | 5,642              | 4,747              | 4,733              | 4,565              |
| <b>Group cash flow statement</b>  |                           |                    |                    |                    |                    |
| Cash generated from operations  | <b>1,138</b>              | 1,184              | 1,135              | 1,111              | 1,030              |
| Net interest paid   | <b>(6)</b>                | (4)                | (8)                | (17)               | (41)               |
| Income taxes paid   | <b>(265)</b>              | (278)              | (285)              | (235)              | (270)              |
| Net cash inflow from operating activities   | <b>867</b>                | 902                | 842                | 859                | 719                |
| Capital expenditure (including trade investments and net of disposals of property, plant and equipment) | <b>(340)</b>              | (265)              | (321)              | (307)              | (318)              |
| Acquisitions and disposals  | <b>(67)</b>               | (782)              | (33)               |                    | (25)               |

|   |               |        |        |        |         |
|---|---------------|--------|--------|--------|---------|
| Proceeds on disposal of net assets held for sale                              |               | 103    |        |        |         |
| Investment in associate   |               | (10)   |        |        |         |
| Cash received from Plus settlement  |               |        |        |        | 137     |
| Proceeds from own shares  | <b>3</b>      | 6      | 7      | 8      | 10      |
| Equity dividends paid   | <b>(239)</b>  | (186)  | (146)  | (132)  | (120)   |
| Issue of ordinary capital and treasury shares purchased                       | <b>(183)</b>  | 77     | 11     | 10     | 7       |
|   | <b>41</b>     | (155)  | 360    | 438    | 410     |
| Exchange adjustments  | <b>(6)</b>    | 5      | (6)    | 13     | (21)    |
| Opening (net debt)/net cash   | <b>(288)</b>  | (138)  | (492)  | (943)  | (1,332) |
| Closing net debt  | <b>(253)</b>  | (288)  | (138)  | (492)  | (943)   |
| <b>Selected financial ratios</b>  |               |        |        |        |         |
| Gearing (closing net debt as a percentage of total equity)                    | <b>6%</b>     | 7%     | 4%     | 18%    | 43%     |
| Dividends per ordinary share (i)  | <b>27.40¢</b> | 26.10¢ | 17.40¢ | 15.82¢ | 14.39¢  |
| Research and development costs to Revenue                                     | <b>5.3%</b>   | 4.1%   | 3.9%   | 3.8%   | 4.1%    |
| Capital expenditure (including intangibles but excluding goodwill) to revenue | <b>7.8%</b>   | 6.4%   | 7.5%   | 7.7%   | 8.4%    |

(i) The Board has proposed a final dividend of 17.0 US cents per share which together with the first interim dividend of 10.4 US cents makes a total for 2013 of 27.4 US cents.

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**Non-GAAP Financial Information**

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 a measure not in accordance with Generally Accepted Accounting Principles (a non-GAAP measure).

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

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

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

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

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

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

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

The acquisitions and disposals effect is the measure of the impact on revenue from newly acquired business combinations. This is calculated by comparing the current year, constant currency actual revenue (which include acquisitions and exclude disposals from the relevant date of completion) with prior year, constant currency actual revenue, adjusted to include the results of acquisitions and exclude disposals for the commensurate period in the prior year. These sales are separately tracked in the Group's internal reporting systems and are readily identifiable.

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

|                                   | <b>2013</b> | 2012 | 2011 |
|-----------------------------------|-------------|------|------|
|                                   | <b>%</b>    | %    | %    |
| Reported revenue growth           | <b>5</b>    | (3)  | 8    |
| Constant currency exchange effect | <b>1</b>    | 2    | (4)  |
| Acquisition/Disposals effect      | <b>(2)</b>  | 3    |      |
| Underlying revenue                | <b>4</b>    | 2    | 4    |

A reconciliation of reported revenue growth to underlying revenue growth, by business segment, can be found on page 37.

#### Trading profit

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

Growth in trading profit and trading profit margin (trading profit expressed as a percentage of revenue) are measures which present the growth trend in the long-term profitability of the Group excluding the impact of specific transactions or events that management considers affect the Group's short-term profitability. The Group presents these measures to assist investors in their understanding of the trends. The Group's international financial reporting (budgets, monthly reporting, forecasts, long-term planning and incentive plans) 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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Other financial information *continued*

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

|   | <b>2013</b>      | 2012      | 2011      |
|---|------------------|-----------|-----------|
|   | <b>\$million</b> | \$million | \$million |
| Operating profit  | <b>810</b>       | 846       | 862       |
| Acquisition-related costs                               | <b>31</b>        | 11        |           |
| Restructuring and rationalisation costs                 | <b>58</b>        | 65        | 40        |
| Amortisation of acquisition intangibles and impairments | <b>88</b>        | 43        | 36        |
| Legal claim (see page 130)                              |                  |           | 23        |
| Trading profit  | <b>987</b>       | 965       | 961       |

A reconciliation of operating profit to trading profit, by business segment, can be found on page 38.

## Adjusted earnings per ordinary share

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

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

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

|  | 2012             | 2011      |
|--|------------------|-----------|
|  | <b>2013</b>      | Restated  |
|  | <b>\$million</b> | \$million |
|  | Restated         | Restated  |
|  | \$million        | \$million |

|   |             |       |      |
|---|-------------|-------|------|
| Attributable profit for the year                        | <b>556</b>  | 721   | 575  |
| Acquisition-related costs                               | <b>31</b>   | 11    |      |
| Restructuring and rationalisation expenses              | <b>58</b>   | 65    | 40   |
| Amortisation of acquisition intangibles and impairments | <b>88</b>   | 43    | 36   |
| Profit on disposal of net assets held for sale          |             | (251) |      |
| Legal claim (see page 130)                              |             |       | 23   |
| Taxation on excluded items<br>(see page 109)            | <b>(40)</b> | 82    | (17) |
| Adjusted attributable profit                            | <b>693</b>  | 671   | 657  |

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

|   |              | 2012     | 2011     |
|---|--------------|----------|----------|
| <b>Earnings per Ordinary Share</b>                            | <b>2013</b>  | Restated | Restated |
| Basic   | <b>61.7¢</b> | 80.4¢    | 64.5¢    |
| Diluted   | <b>61.4¢</b> | 80.0¢    | 64.2¢    |
| Adjusted: Basic   | <b>76.9¢</b> | 74.8¢    | 73.7¢    |
| Adjusted: Diluted   | <b>76.5¢</b> | 74.5¢    | 73.4¢    |
| 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 nature and material limitations of these adjusted items are discussed above.

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

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



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

|  | <b>2013</b><br>\$million | 2012<br>\$million | 2011<br>\$million |
|--|--------------------------|-------------------|-------------------|
| Cash generated from operations                             | <b>1,138</b>             | 1,184             | 1,135             |
| Less: Capital expenditure                                  | <b>(340)</b>             | (265)             | (321)             |
| Add: Cash received on disposal of fixed assets             |                          |                   |                   |
| Add: Acquisition-related costs                             | <b>25</b>                | 3                 | 1                 |
| Add: Restructuring and rationalisation related expenditure | <b>54</b>                | 55                | 20                |
| Add: Legal settlement                                      |                          | 22                |                   |
| Add: Macrotecture expenditure                              |                          |                   | 3                 |
| Trading cash flow  | <b>877</b>               | 999               | 838               |
| Trading profit   | <b>987</b>               | 965               | 961               |
| Trading profit to cash conversion ratio                    | <b>89%</b>               | 104%              | 87%               |
| Transactional and translational exchange                   |                          |                   |                   |

The Group's principal markets outside the US are, in order of significance, Continental Europe, UK, Australia and Japan. Revenues in these markets fluctuate when translated into US Dollars on consolidation. During the year, the average rates of exchange against the US Dollar used to translate revenues and profits arising in these markets changed compared to the previous year as follows: the Euro strengthened from \$1.28 to \$1.33 (+3%), Sterling weakened from \$1.58 to \$1.56 (-1%), the Swiss Franc strengthened from \$1.07 to \$1.08 (1%), the Australian Dollar weakened from \$1.04 to \$0.96 (-7%) and the Japanese Yen weakened from ¥79.8 to ¥97.6 (-22%).

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

**Contractual obligations**

Contractual obligations at 31 December 2013 were as follows:

## Payments due by period

|                               | Total      | Less than<br>1 year | 1 3 years  | 3 5 years  | More than<br>5 years |
|-------------------------------|------------|---------------------|------------|------------|----------------------|
|                               | \$ million | \$ million          | \$ million | \$ million | \$ million           |
| Debt obligations              | 377        | 42                  | 335        |            |                      |
| Finance lease obligations     | 14         | 2                   | 4          | 5          | 3                    |
| Operating lease obligations   | 123        | 45                  | 51         | 22         | 5                    |
| Retirement benefit obligation | 72         | 72                  |            |            |                      |
| Purchase obligations          |            |                     |            |            |                      |
| Capital expenditure           | 41         | 41                  |            |            |                      |
| Other                         | 41         | 34                  | 7          |            |                      |
|                               | <b>668</b> | <b>236</b>          | <b>397</b> | <b>27</b>  | <b>8</b>             |

Other contractual obligations represent \$20m of foreign exchange contracts and \$21m of acquisition consideration. Provisions that do not relate to contractual obligations are not included in the above table.

The agreed contributions for 2014 in respect of the Group's defined benefits plans are: \$39m for the UK (including \$31m of supplementary payments), \$26m for the US Plan and \$7m for other funded defined benefit plans. The table above does not include amounts payable in respect of 2015 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 are set out on page 70.

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

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Other financial information *continued***2012 Financial highlights**

## Revenue

Group revenue decreased by \$133m (-3%) from \$4,270m in 2011 to \$4,137m in 2012. Underlying revenue growth was 2% of which -2% growth was attributable to unfavourable currency translation and -3% was attributable to the effect of disposing of the Clinical Therapies business. Advanced Surgical Devices revenues decreased by \$143m (-4%), underlying growth of 2% was offset by -2% unfavourable currency movements and -4% due to the disposal of the Clinical Therapies business. Advanced Wound Management revenues increased by \$10m (1%), underlying growth was 4% with -3% due to unfavourable currency translation.

## Cost of goods sold

Cost of goods sold decreased by \$70m to \$1,070m from \$1,140m in 2011, which represents a 6% decrease. Of this movement, 1% is due to favourable currency translation movements. The remaining movement is largely attributable to the continued focus on costs, and partly attributable to the sale of the Clinical Therapies business in May 2012 which impacted both revenue and cost of sales.

## Marketing, selling and distribution expenses

Marketing, selling and distribution expenses decreased by \$86m (-6%) to \$1,440m from \$1,526m in 2011. The underlying movement of -4% is after adjusting for favourable currency movement of -2%. Increased cost savings in Established Markets were partly offset by investment in Emerging & International Markets and promotion of new products particularly in Advanced Wound Management.

## Administrative expenses

Administrative expenses increased by \$35m (6%) to \$610m from \$575m in 2011. Favourable currency movements offset 2% of this increase. The main factors contributing to the underlying movement of 8% were an increase of \$16m in amortisation on acquisition costs.

## Research and development expenses

Expenditure as a percentage of revenue increased by 0.2% to 4.1% in 2012 (2011 3.9%). Actual expenditure was \$171m in 2012 compared to \$167m in 2011. The Group continues to invest in innovative technologies and products to differentiate it from competitors.

## Operating profit

Operating profit decreased by \$16m to \$846m from \$862m in 2011. This comprised an increase of \$2m in Advanced Surgical Devices and a decrease of \$18m in Advanced Wound Management. Advanced Surgical Devices started to see the benefits of its focus on costs (more than offsetting the additional restructuring expense) whilst Advanced Wound Management has continued to invest in new products throughout the year and also acquired Healthpoint Biotherapeutics in December 2012, both increasing costs.

#### Net interest receivable/(payable)

Net interest payable reduced by \$10m from \$8m payable in 2011 to a receivable of \$2m in 2012. This is a consequence of the overall reduction of borrowings within the Group, a reduction in the applicable interest rates and the \$7m interest receivable on the Bioventus loan note issued following the disposal of the Clinical Therapies business.

#### Other finance cost

Other finance costs, restated for the revised IAS 19 Employee Benefits accounting standard, in 2012 were \$11m compared to \$13m in 2011. This decrease is attributable to an increase in the expected return on pension plan assets.

#### Taxation

The taxation charge increased by \$105m to \$371m from \$266m in 2011. The rate of tax was 33.7%, compared with 31.4% in 2011.

The tax charge increased by \$82m in 2012 (2011 \$17m reduction) as result of the profit on disposal of the Clinical Therapies business partially offset by an increase in restructuring and rationalisation expenses, amortisation of acquisition intangibles and acquisition-related costs. The tax rate was 29.9% (2011 29.9%) 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:

|   | 2012<br>\$million | 2011<br>\$million |
|---|-------------------|-------------------|
| Non-current assets  | 3,498             | 2,542             |
| Current assets  | 2,144             | 2,080             |
| Assets held for sale                                      |                   | 125               |
| Total assets  | 5,642             | 4,747             |
| Non-current liabilities                                   | 828               | 422               |
| Current liabilities                                       | 930               | 1,119             |
| Liabilities directly associated with assets held for sale |                   | 19                |
| Total liabilities   | 1,758             | 1,560             |
| Total equity  | 3,884             | 3,187             |
| Total equity and liabilities                              | 5,642             | 4,747             |
| Non-current assets  |                   |                   |

Non-current assets increased by \$956m to \$3,498m in 2012 from \$2,542m in 2011. This is principally attributable to the following:



Goodwill increased by \$90m from \$1,096m in 2011 to \$1,186m in 2012. Of this movement \$73m arose on the acquisition of Healthpoint. The balance relates to favourable currency movements totalling \$17m

Intangible assets increased by \$641m from \$423m in 2011 to \$1,064m in 2012. Intangible assets totalling \$662m arose on the Healthpoint acquisition. Amortisation of \$94m was charged during the year and assets with a net book value of \$3m were written-off. A total of \$68m relates to the cost of intellectual property and software acquired. The balance relates to favourable currency movements totalling \$8m

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Property, plant and equipment increased by \$10m from \$783m in 2011 to \$793m in 2012. Depreciation of \$212m was charged during 2012 and assets with a net book value of \$9m were written-off. These movements were largely offset by \$197m of additions relating primarily to instruments and other plant and machinery and \$27m of additions arising on the Healthpoint acquisition. The balance relates to favourable currency movements totalling \$7m

Deferred tax assets decreased by \$59m in the year

The total investment in associates has increased from \$13m in 2011 to \$283m in 2012. This movement predominately relates to the acquisition of Bioventus during the year totalling \$114m plus \$160m in the form of a loan note to Bioventus.

Current assets

Current assets increased by \$64m to \$2,144m from \$2,080m in 2011. The movement relates to the following:

Inventories rose by \$42m to \$901m in 2012 from \$859m in 2011. Of this movement, \$46m arose on the Healthpoint acquisition and it includes \$9m relating to favourable currency movements

The level of trade and other receivables increased by \$28m to \$1,065m in 2012 from \$1,037m in 2011. This movement includes \$31m arising on the Healthpoint acquisition and \$8m related to favourable currency movements

Cash and cash equivalents have fallen by \$6m to \$178m from \$184m in 2011.

Non-current liabilities

Non-current liabilities increased by \$406m from \$422m in 2011 to \$828m in 2012. This movement relates to the following items:

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Long-term borrowings have risen from \$16m in 2011 to \$430m in 2012. This increase of \$414m is attributable to the acquisition of Healthpoint for \$728m cash in December 2012

The net retirement benefit obligation decreased by \$21m to \$266m in 2012 from \$287m in 2011. This was largely due to the Group's additional pension contributions which were partially offset by net actuarial losses for the year

Deferred acquisition consideration remains at \$8m at the end of 2012. This relates to the acquisition of Tenet Medical Engineering during 2011

Provisions increased from \$45m in 2011 to \$63m in 2012. The principal component of this movement is \$13m arising on the Healthpoint acquisition

Deferred tax liabilities decreased by \$5m in the year.

### Current liabilities

Current liabilities decreased by \$189m from \$1,119m in 2011 to \$930m in 2012. This movement is attributable to:

Bank overdrafts and current borrowings have decreased by \$268m from \$306m in 2011 to \$38m in 2012

Trade and other payables have increased by \$92m to \$656m in 2012 from \$564m in 2011. The primary cause of this increase is the acquisition of Healthpoint which increased trade and other payables by \$49m

Provisions have decreased by \$19m from \$78m in 2011 to \$59m in 2012. The most significant item contributing to this decrease is the payment of \$22m to settle the legal provision (see Note 3 of the Notes to the Group accounts)

Current tax payable is \$177m at the end of 2012 compared to \$171m in 2011.

### Total equity

Total equity increased by \$697m from \$3,187m in 2011 to \$3,884m in 2012. The principal movements were:

|                            | Total equity<br>\$million |
|----------------------------|---------------------------|
| 1 January 2012             | 3,187                     |
| Attributable profit        | 729                       |
| Currency translation gains | 37                        |
| Hedging reserves           | (7)                       |
| Table of Contents          | 379                       |

|  |       |
|--|-------|
| Actuarial loss on retirement benefit obligations                 | (13)  |
| Dividends paid during the year                                   | (186) |
| Taxation benefits on Other Comprehensive Income and equity items | 20    |
| Net share-based transactions                                     | 117   |
| 31 December 2012   | 3,884 |

### 2012 Financial performance by business segment

#### Advanced Surgical Devices

Advanced Surgical Devices revenue decreased by -4% to \$3,108m from \$3,251m in 2011. Of this decrease, underlying growth of 2% is offset by -2% unfavourable currency movements and -4% due to the disposal of the Clinical Therapies business.

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

|                                   | 2012 | 2011 |
|-----------------------------------|------|------|
|                                   | %    | %    |
| Reported growth                   | (4)  | 8    |
| Constant currency exchange effect | 2    | (4)  |
| Disposal effect                   | 4    |      |
| Underlying growth                 | 2    | 4    |

In the Established Markets, revenue decreased by \$163m to \$2,747m (-6%).

In the US revenue decreased by \$118m to \$1,449m (-8%). This movement is attributable to underlying growth of 1% and -9% due to the effect of the disposal of the Clinical Therapies business. In the Established Markets outside of the US revenue decreased by \$45m to \$1,298m (-3%). Underlying growth was 1% with -4% due to unfavourable currency movements.

In Emerging & International Markets, revenue increased by \$20m to \$361m (6%). Underlying growth was 10% with -4% due to unfavourable currency.



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Other financial information *continued*

## Franchises

Underlying revenue growth for key product lines are:

|                                    | 2012 | 2011 |
|------------------------------------|------|------|
|                                    | %    | %    |
| Reconstruction                     |      |      |
| Knee implants                      | 3    | 5    |
| Hip implants                       | (3)  | (1)  |
| Sports Medicine                    | 8    | 11   |
| Arthroscopic Enabling Technologies | (2)  |      |
| Trauma                             | 3    | 3    |

Both the knee and hip implant markets continue to experience economic pressure. Knee implant franchise revenue increased by 1% to \$874m in 2012, which represented an underlying revenue growth of 3% and unfavourable foreign currency translation of -2%. This compared to a market growth rate of 3%. Growth slowed in the second half of 2012 as a result of a weakening of the overall knee market in Europe and the division's knee product cycle. Between 2009 and 2011, when the division materially outperformed the knee market, it benefited from the launch of VERILAST Technology and VISIONAIRE Patient Matched Instrumentation. This benefit has now been annualised.

In the global Hip implant franchise revenue decreased by \$39m to \$666m (-6%) in 2012, representing a -3% underlying revenue decline in the face of the continuing metal-on-metal headwinds and -2% due to unfavourable foreign currency translation. The Hip implant franchise, led by the ANTHOLOGY Hip with VERILAST Technology, has also continued to perform well in its focus product areas.

Sales of our BIRMINGHAM Hip Resurfacing system continued to decline during the year. The BIRMINGHAM Hip Resurfacing System is a clinically proven system for hip resurfacing which preserves bone and is particularly suited for younger, more active male patients.

Global Trauma revenue increased by \$5m to \$462m (1%), representing underlying revenue growth of 3% and -2% unfavourable foreign currency translation.

Global revenue from Sports Medicine Joint Repair increased by \$30m to \$521m (6%), of which 8% was underlying growth and -2% unfavourable foreign currency translation.

AET revenue decreased by \$16m to \$409m (-4%) in 2012, which represented an underlying revenue decline of -2% and -2% of unfavourable foreign currency translation.

The revenue in this Other franchise (excluding Clinical Therapies) increased by \$2m to \$69m (5%), which represented an underlying revenue growth of 7% and -2% of unfavourable foreign currency translation.

#### Trading and operating profit

Trading profit increased by \$14m (2%) to \$728m from \$714m in 2011. Trading profit margin increased from 21.9% to 23.4%. These increases reflect the early benefits of implementing the Strategic Priorities, in particular, restructuring the Group to provide the right commercial models and cost structure.

Operating profit increased by \$2m from \$630m in 2011 to \$632m in 2012. This comprises the increase in trading profit of \$14m discussed above and the recognition of a legal claim of \$23m in 2011, offset by an increase of \$10m in the amortisation of acquisition intangibles and a \$25m increase in restructuring and rationalisation costs.

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

|   | 2012      | 2011      |
|---|-----------|-----------|
|   | \$million | \$million |
| Operating profit  | 632       | 630       |
| Restructuring and rationalisation costs                 | 57        | 32        |
| Amortisation of acquisition intangibles and impairments | 39        | 29        |
| Legal settlement  |           | 23        |
| Trading profit  | 728       | 714       |

Advanced Surgical Devices trading profit and operating profit as a percentage of Group trading profit and operating profit was as follows:

|                  | 2012 | 2011 |
|------------------|------|------|
|                  | %    | %    |
| Trading profit   | 75   | 74   |
| Operating profit | 75   | 73   |





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## Advanced Wound Management

Advanced Wound Management continues to outperform the market, with revenue growing at 4% in 2012 on an underlying basis (excluding a -3% unfavourable currency impact) to \$1,029m. Management estimates the market grew at 1%.

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

|                                   | 2012 | 2011 |
|-----------------------------------|------|------|
|                                   | %    | %    |
| Reported growth                   | 1    | 12   |
| Constant currency exchange effect | 3    | (5)  |
| Underlying growth                 | 4    | 7    |

In Established Markets, revenue increased from \$906m to \$907m in 2012. This represents an underlying growth of 4% which was offset by unfavourable currency movements of -3%.

In the US, revenue increased by 7% from \$189m to \$202m. In the Established Markets outside of the US, revenues decreased 2% from \$717m in 2011 to \$705m in 2012. This represents an underlying growth of 2% after adjusting for -4% of unfavourable currency movements.

## Franchises

Underlying revenue growth for key product lines are:

|                      | 2012 | 2011 |
|----------------------|------|------|
|                      | %    | %    |
| Exudate management   | 1    | 2    |
| Infection management | (2)  | 4    |
| Other AWM            | 7    | 10   |

Revenue in the Emerging & International Markets increased from \$113m in 2011 to \$122m in 2012 (8%). The underlying movement was 11% offset by -3% of unfavourable currency movements.

Exudate management revenues decreased by -2% from \$275m in 2011 to \$269m in 2012. This represents an underlying growth of 1% offset by -3% in unfavourable currency exchange.

Infection management revenues have fallen from \$133m in 2011 to \$127m in 2012 (-5%). This also represents an underlying decline of -2% along with 3% of unfavourable currency exchange.

#### Trading and operating profit

Trading profit reduced by \$10m to \$237m from \$247m and trading profit margin decreased 24.3% to 23.1%. The decrease in the year is primarily attributable to the additional costs arising from investment in new products throughout the year.

Operating profit decreased by \$18m to \$214m in 2012. This comprises the decrease in trading profit of \$10m discussed above and an increase of \$11m in connection with the acquisition-related costs on the purchase of Healthpoint. These costs were partially offset by a reduction of \$3m in the amortisation of acquisition intangibles.

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

|   | 2012      | 2011      |
|---|-----------|-----------|
|   | \$million | \$million |
| Operating profit  | 214       | 232       |
| Acquisition-related costs                               | 11        |           |
| Restructuring and rationalisation costs                 | 8         | 8         |
| Amortisation of acquisition intangibles and impairments | 4         | 7         |
| Trading profit  | 237       | 247       |

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

|                  | 2012 | 2011 |
|------------------|------|------|
|                  | %    | %    |
| Trading profit   | 25   | 26   |
| Operating profit | 25   | 27   |

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Information for shareholders

**Financial calendar**

|  |                     |
|--|---------------------|
| Annual General Meeting                 | 10 April 2014       |
| Quarter One results                    | 1 May 2014          |
| Payment of 2013 final dividend         | 7 May 2014          |
| Half year results announced            | 1 August 2014 (i)   |
| Quarter Three results announced        | 30 October 2014     |
| Payment of 2014 first interim dividend | November 2014       |
| Full year results announced            | February 2015 (i)   |
| Annual Report available                | February/March 2015 |
| Annual General Meeting                 | April 2015          |

(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 \*

Tel: +44 (0) 121 415 7072 from outside the UK

Website: [www.shareview.co.uk](http://www.shareview.co.uk)

\* Calls to this number are charged at 8p per minute (excluding VAT) plus network extras. Lines are open from 8.30am to 5.30pm Monday to Friday, excluding UK public holidays.

Shareholder facilities

**Shareview**

Equiniti's on-line enquiry and portfolio management service for Shareholders. To view information about your shareholdings on-line, register at [www.shareview.co.uk](http://www.shareview.co.uk). Once registered for Shareview, you will also be able to elect to receive future Shareholder communications via the Company's website ([www.smith-nephew.com](http://www.smith-nephew.com)), update your address details or dividend payment instructions and register your proxy instructions on-line.

### **E-communications**

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).

### **Duplicate accounts**

Shareholders who have more than one account due to inconsistency in account details may avoid duplicate mailings by contacting Equiniti and requesting an amalgamation of their share accounts.

### **Keep your personal details up to date**

Please remember to tell Equiniti if you move house or change bank details or there is any other change in your account information. You can update your information on-line via the Shareview portfolio if you are a Smith & Nephew Shareview member. If you do not have a portfolio you will need to write to Equiniti or complete a change of address form which can be downloaded from Shareview. If you hold 2,500 shares or fewer, you can also change your address or update your bank details quickly and easily over the phone using the contact details provided.

### **Dividend reinvestment 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 reinvest future dividends, contact Equiniti.

### **Individual savings account ( ISA )**

Shareholders who are UK resident may hold Smith & Nephew plc shares in an Individual Savings Account, which is administered by the Company's registrar. For information about this service please contact Equiniti.

### **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.

The Company sends paper copies of the Notice of Annual General Meeting and Annual Report only to those Shareholders and ADS holders that have elected to receive Shareholder documentation by post. Electronic copies of the Annual Report and Notice of Annual General Meeting 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 Form of Proxy and an accompanying letter notifying them of the availability of the Annual Report and Notice of Annual General Meeting on the Group's website. Shareholders who elect to receive the Annual Report and 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 Annual General Meeting and the Company regularly responds to letters from Shareholders on a range of issues.

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**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 London Stock Exchange 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 the live financial data is updated with a 15-minute delay.

**ShareGift**

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 address given on page 168.

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

**Unauthorised brokers (boiler room scams)**

Shareholders are advised to be very wary of any unsolicited advice, offers to buy shares at a discount or offers of free company reports. These are typically from overseas-based brokers who target UK Shareholders offering to sell them what often turn out to be worthless or high-risk shares in US or UK investments. These operations are commonly known as boiler rooms.

If you deal with an unauthorised firm, you will not be eligible to receive payment under the Financial Services Compensation Scheme if things go wrong. If you receive any unsolicited investment advice, obtain the correct name of the person and organisation and check that they are properly authorised by the FCA by visiting [www.fca.org.uk/register/](http://www.fca.org.uk/register/).

If you think you have been approached by an unauthorised firm you should contact the FCA consumer helpline on 0800 111 6768 or e-mail [consumer.queries@fca.org.uk](mailto:consumer.queries@fca.org.uk).

More detailed information can be found on the FCA website at [www.fca.org.uk/consumers/protect-yourself/unauthorised-firms](http://www.fca.org.uk/consumers/protect-yourself/unauthorised-firms).

### Social media

Smith & Nephew has a presence across a range of social media channels, including Twitter, Facebook and LinkedIn, which are linked below. Information provided by Smith & Nephew through social media channels is not incorporated by reference herein and does not form part of our annual report on Form 20-F.

<https://twitter.com/SmithNephewPLC>

[www.facebook.com/SmithNephewPlc](http://www.facebook.com/SmithNephewPlc)

<http://www.linkedin.com/company/smith-&-nephew>

### 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 New York Stock Exchange 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 Depositary Receipts, P.O. Box 43006, Providence, RI 02940-3006, US

Tel: +1-866-259-2287 inside the US (toll free)

Tel: +1-201-680-6825 internationally

E-mail: [shrrelations@cpushareownerservices.com](mailto:shrrelations@cpushareownerservices.com)

A Global Buy DIRECT plan is available for US residents, enabling investment directly in ADSs with reduced brokerage commissions and service costs. For further information on Global Buy DIRECT 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 voting instruction forms 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 where the live financial data is updated with a 15-minute delay.

#### ADS payment information

The Company hereby discloses ADS payment information for the year ended 31 December 2013 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 depository 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 depository 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 depository may collect its annual fee for depository 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 depository may generally refuse to provide fee-attracting services until its fee for those services are paid.



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Information for shareholders *continued*

**Persons depositing or withdrawing shares must pay:**

**For:**

\$5.00 (or less) per 100 ADSs (or portion of 100 ADSs)

\$0.02 (or less) per ADS

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

\$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

Depository services

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

As necessary

Registration or transfer fees

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

Any charges incurred by the depositary or its agents for servicing the deposited securities

As necessary

A fee of two US cents per ADS was paid on the 2012 final dividend and a fee of one US cent per ADS was deducted from the 2013 first interim dividend paid in October. In the period 1 January 2013 to 24 February 2014 the total reimbursed by The Bank of New York Mellon was \$134,298.50.



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**Dividend history**

Smith & Nephew has paid dividends on its ordinary shares in every 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.

On 2 August 2012, the Board announced its intention to pursue a progressive dividend policy, with the aim of increasing the US Dollar value of ordinary dividends over time broadly based on the Group's underlying growth in earnings, while taking into account capital requirements and cash flows.

From 2013, the Board will review at the time of the full year results, the appropriate level of total annual dividend each year. The Board intends that the interim dividend will be set by a formula and will be equivalent to 40% of the total dividend for the previous year. Dividends will continue to be declared in US Dollars with an equivalent amount in Sterling payable to those Shareholders whose registered address is in the UK, or who have validly elected to receive Sterling dividends.

An interim dividend in respect of each fiscal year is normally declared in August and paid in November. 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**

|  | <b>2013</b> | 2012 | 2011 | 2010 | 2009 |
|--|-------------|------|------|------|------|
|--|-------------|------|------|------|------|

|                           |                   |        |        |        |        |
|---------------------------|-------------------|--------|--------|--------|--------|
| Pence per share:          |                   |        |        |        |        |
| Interim                   | <b>7.211</b>      | 6.811  | 4.639  | 4.233  | 3.650  |
| Final/Second interim (ii) | <b>11.358 (i)</b> | 11.778 | 7.444  | 6.639  | 6.494  |
| Total                     | <b>18.569</b>     | 18.589 | 12.083 | 10.872 | 10.144 |
| US cents per share:       |                   |        |        |        |        |
| Interim                   | <b>11.556</b>     | 11.000 | 7.333  | 6.667  | 6.067  |
| Final/Second interim (ii) | <b>18.889</b>     | 18.000 | 12.000 | 10.911 | 9.922  |
| Total                     | <b>30.445</b>     | 29.000 | 19.333 | 17.578 | 15.989 |

(i) Translated at the Bank of England rate on 24 February 2014.

(ii) 2009 Second interim, 2010 to 2013 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 2013 final dividend will be payable on 7 May 2014, subject to Shareholder approval.

In respect of the proposed final dividend for the year ended 31 December 2013 of 17.0 US cents per ordinary share, the record date will be 22 April 2014 and the payment date will be 7 May 2014. 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 22 April 2014. The ordinary shares will trade ex-dividend on both the London and New York Stock Exchanges from 16 April 2014.

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Information for shareholders *continued***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).

|  | <b>Ordinary shares</b> |             | <b>ADSs</b>  |              |
|--|------------------------|-------------|--------------|--------------|
|  | <b>High</b>            | <b>Low</b>  | <b>High</b>  | <b>Low</b>   |
|  | <b>£</b>               | <b>£</b>    | <b>US\$</b>  | <b>US\$</b>  |
| <b>Year ended 31 December:</b>                 |                        |             |              |              |
| 2009   | 6.42                   | 4.20        | 51.38        | 30.57        |
| 2010   | 6.97                   | 5.38        | 53.94        | 41.29        |
| 2011   | 7.42                   | 5.21        | 60.19        | 42.17        |
| 2012   | 6.93                   | 5.80        | 56.13        | 45.13        |
| 2013   | <b>8.68</b>            | <b>6.80</b> | <b>71.85</b> | <b>52.90</b> |
| <b>Quarters in the year ended 31 December:</b> |                        |             |              |              |
| 2012:  |                        |             |              |              |
| 1st Quarter                                    | 6.43                   | 5.95        | 51.13        | 45.57        |
| 2nd Quarter                                    | 6.40                   | 5.80        | 51.23        | 45.13        |
| 3rd Quarter                                    | 6.93                   | 6.38        | 56.13        | 49.50        |
| 4th Quarter                                    | 6.92                   | 6.38        | 55.77        | 51.01        |
| 2013:  |                        |             |              |              |
| 1st Quarter                                    | 7.60                   | 6.80        | 58.00        | 52.90        |
| 2nd Quarter                                    | 7.95                   | 7.18        | 60.17        | 54.83        |
| 3rd Quarter                                    | 8.00                   | 7.30        | 63.06        | 56.01        |
| 4th Quarter                                    | 8.68                   | 7.48        | 71.85        | 60.05        |
| 2014:  |                        |             |              |              |
| 1st Quarter (to 24 February 2014)              | 9.60                   | 8.57        | 80.18        | 70.84        |
| <b>Last six months:</b>                        |                        |             |              |              |
| August 2013                                    | 8.00                   | 7.50        | 61.58        | 58.26        |
| September 2013                                 | 7.89                   | 7.61        | 63.06        | 59.19        |
| October 2013                                   | 8.03                   | 7.48        | 65.30        | 60.05        |
| November 2013                                  | 8.16                   | 8.01        | 66.88        | 64.41        |
| December 2013                                  | 8.68                   | 8.13        | 71.85        | 67.20        |
| January 2014                                   | 8.96                   | 8.57        | 74.81        | 70.84        |
| February 2014 (to 24 February 2014)            | 9.60                   | 8.74        | 80.18        | 71.69        |



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**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 Officer, although the Board reserves the right to transfer them to another member of the Board should it so wish.

As at 24 February 2014, to the knowledge of the Group, there were 18,188 registered holders of ordinary shares, of whom 89 had registered addresses in the US and held a total of 172,541 ordinary shares (0.02% 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.

**Shareholdings**

As at 24 February 2014, 7,837,412 ADSs equivalent to 39,187,060 ordinary shares or approximately 4.4% of the total ordinary shares in issue, were outstanding and were held by 88 registered holders.

**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 24 February 2014, no persons are known to Smith & Nephew to have any interest (as defined in the Disclosure and Transparency Rules of the FCA) 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:

|                                      |                         | As at 31 December |          |          |
|--------------------------------------|-------------------------|-------------------|----------|----------|
|                                      | <b>24 February 2014</b> | 2013              | 2012     | 2011     |
|                                      | <b>%</b>                | <b>%</b>          | <b>%</b> | <b>%</b> |
| Invesco                              | 7.5                     | 12.1              | 11.9     | 5.0      |
| BlackRock, Inc.                      | 4.8                     | 4.7               | 5.0      | 5.0      |
| Newton Investment Management Limited |                         |                   | 4.9      | 5.0      |
| Legal & General Group plc            |                         |                   | 3.0      | 4.0      |
| Capital Group of Companies Inc.      |                         |                   |          | 0.7      |

As at 31 December

|                                      | <b>24 February 2014</b> | 2013       | 2012       | 2011       |
|--------------------------------------|-------------------------|------------|------------|------------|
|                                      | <b>000</b>              | <b>000</b> | <b>000</b> | <b>000</b> |
| Invesco                              | 66,740                  | 107,823    | 107,823    | 44,901     |
| BlackRock, Inc.                      | 42,621                  | 41,870     | 44,811     | 44,811     |
| Newton Investment Management Limited |                         |            | 8,432      | 44,337     |
| Legal & General Group plc            |                         |            | 26,906     | 35,676     |
| Capital Group of Companies Inc.      |                         |            |            | 6,138      |

In addition to the above, the Company is aware that Walter Scott & Partners Limited held approximately 37.7 million ordinary shares (4.2%) at 24 February 2014.

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.



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Information for shareholders *continued*

## Purchase of ordinary shares on behalf of the Company

At the AGM, the Company will be seeking a renewal of its current permission from Shareholders to purchase up to 10% of its own shares. On 2 May 2013, the Company announced its intention to purchase up to \$300m of its own ordinary shares. The Company has purchased 18,210,000 ordinary shares at a cost of \$226m for the year to 31 December 2013.

|                     | Total shares<br>purchased<br>(000s) | Average price<br>paid per share<br>(p) | Total number of<br>shares purchased as<br>part of publicly<br>announced plans or<br>programmes | Approximate US\$<br>value of shares that<br>may yet be purchased<br>under the plan |
|---------------------|-------------------------------------|--|--|--|
| 2 May 2013          |                                     |  |  | 300,000,000  |
| 7-31 May 2013       | 2,434,000                           | 773.9220                               | 2,434,000  | 271,072,938  |
| 3-24 June 2013      | 3,970,000                           | 750.9677                               | 6,404,000  | 224,546,903  |
| 2-29 August 2013    | 2,750,000                           | 782.7249                               | 9,154,000  | 190,975,094  |
| 2-25 September 2013 | 3,385,000                           | 773.9235                               | 12,539,000   | 149,054,820  |
| 1-29 November 2013  | 3,791,000                           | 806.5939                               | 16,330,000   | 99,483,166   |
| 2-17 December 2013  | 1,880,000                           | 836.7099                               | 18,210,000   | 73,647,255   |

The shares were purchased in the open market by JP Morgan Cazenove Limited and UBS Limited on behalf of the Company.

## 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 reinvestment plan, which are not sent to Shareholders with recorded addresses in the US and Canada.

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## SMITH &amp; NEPHEW ANNUAL REPORT 2013

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**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 US, a corporation (or other entity taxable as a corporation) created or organised in or under the laws of the US, 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 (i) persons whose holding of ADSs or ordinary shares is effectively connected with or pertains to either a permanent establishment in the UK through which a US Holder carries on a business in the UK or a fixed base from which a US Holder performs independent personal services in the UK, or (ii) persons 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 use the mark to market method of tax accounting, 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 US Holders liable for alternative minimum tax. In addition, the comments below do not address the potential application of the provisions of the United States Internal Revenue Code, known as the Medicare contribution tax, or any 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 advisers 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 2013.

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 released before shares are delivered to the depositary (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 of ADSs could be affected by actions that may be taken by parties to whom ADSs are pre-released.

#### Taxation of dividends in the UK and the US

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 may be subject to US federal income tax at lower rates than those applicable to other types of ordinary income if certain conditions are met. Non-corporate US Holders should consult their own tax advisers 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 a 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 US and is not a UK national or domiciled in the UK will not be subject to UK inheritance tax in respect of ADSs and ordinary shares. A UK national who is domiciled in the US 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 UK 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 UK.



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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 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 backup withholding exceeds the actual liability, the US Holder may obtain a refund by timely filing the appropriate refund claim with the US Internal Revenue Service.

Certain US Holders who are individuals (and under proposed Treasury regulations, certain entities) may be required to report information relating to securities issued by a non-US person (or foreign accounts through which the securities are held), subject to certain exceptions (including an exception for securities held in accounts maintained by US financial institutions). US Holders should consult their tax advisers regarding their reporting obligations with respect to the ordinary shares or ADSs.

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  $\frac{1}{2}\%$  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  $\frac{1}{2}\%$  (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  $\frac{1}{2}\%$ , and this will apply whether or not the transfer is effected in the UK and whether or not the parties to it are resident or situated in the UK.

A charge of stamp duty or SDRT at the rate of 1  $\frac{1}{2}$ % 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 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 UK, and provided further that any instrument of transfer or written agreement to transfer is not executed in the UK and the transfer does not relate to any matter or thing done or to be done in the UK (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.

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**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 1% 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 UK 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 2012.

#### 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.

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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, dis-applying 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 re-denomination 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 Officer 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.

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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>  |
|----------------------------------|---|
| <b>ADR</b>                       | In the US, the Company's Ordinary Shares are traded in the form of ADSs evidenced by American Depositary Receipts ( ADRs ).   |
| <b>ADS</b>                       | In the US, the Company's Ordinary Shares are traded in the form of American Depositary Shares ( ADSs ).   |
| <b>Advanced Surgical Devices</b> | A product group comprising products for orthopaedic replacement and reconstruction, endoscopy devices and trauma devices. Products for orthopaedic replacement include systems for knees, hips, and shoulders. Endoscopy devices comprise of support products for orthopaedic surgery such as computer assisted surgery and minimally invasive surgery techniques using specialised viewing and access devices, surgical instruments and powered equipment. Orthopaedics trauma devices are used in the treatment of bone fractures including rods, pins, screws, plates and external frames. |
| <b>Advanced Wound Management</b> | 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.  |
| <b>AET</b>                       | Arthroscopic Enabling Technologies. Franchise offering healthcare providers a variety of technologies such as fluid management equipment for surgical access, high definition cameras, digital image capture, scope, light sources and monitors, radio frequency probes, electromechanical and mechanical blades and hand instruments for removing damaged tissue.  |
| <b>AGM</b>                       | Annual General Meeting of the Company.  |
| <b>Arthroscopy</b>               | Endoscopy of the joints is termed arthroscopy , with the principal applications being the knee and shoulder.  |
| <b>ASD</b>                       | Advanced Surgical Devices division.   |
| <b>AWM</b>                       | Advanced Wound Management division.   |
| <b>Basis Point</b>               | One hundredth of one percentage point.  |

|                                    |   |
|------------------------------------|---|
| <b>Chronic wounds</b>              | Chronic wounds are those with long or unknown healing times including leg ulcers, pressure sores and diabetic foot ulcers.  |
| <b>COGS</b>                        | Cost of Goods Sold  |
| <b>Company</b>                     | Smith & Nephew plc or, where appropriate, the Company's Board of Directors, unless the context otherwise requires.  |
| <b>Companies Act</b>               | Companies Act 2006, as amended, of England and Wales.   |
| <b>DOJ</b>                         | US Department of Justice  |
| <b>EBITA</b>                       | Earnings before interest, tax and amortisation.   |
| <b>EBITDA</b>                      | Earnings before interest, tax, depreciation and amortisation.   |
| <b>Emerging markets</b>            | Emerging markets include Greater China, India, Brazil and Russia.   |
| <b>EPSA</b>                        | Adjusted Earnings Per Share is a trend measure which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affects the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. Adjusted attributable profit is the numerator used for this measure. |
| <b>Endoscopy</b>                   | Through a small incision, surgeons are able to see inside the body using a monitor and identify and repair defects.   |
| <b>Established Markets</b>         | Established Markets include United States of America, Europe, Australia, New Zealand, Canada and Japan.   |
| <b>Euro or</b>                     | References to the common currency used in the majority of the countries of the European Union.  |
| <b>FCA</b>                         | Financial Conduct Authority   |
| <b>FDA</b>                         | US Food and Drug Administration.  |
| <b>Financial statements</b>        | Refers to the consolidated Group Accounts of Smith & Nephew plc.  |
| <b>FTSE 100</b>                    | Index of the largest 100 listed companies on the London Stock Exchange by market capitalisation.  |
| <b>GMP</b>                         | Good manufacturing practice or GMP is the guidance that outlines the aspects of production and testing that can impact the quality of a product.  |
| <b>Group or Smith &amp; Nephew</b> | Used for convenience to refer to the Company and its consolidated subsidiaries, unless the context otherwise requires.  |

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Glossary of terms *continued*

| <b>Term</b>                                    | <b>Meaning</b>  |
|--|---|
| <b>IFRS</b>                                    | International Financial Reporting Standards as adopted by the EU and as issued by the International Accounting Standards Board.   |
| <b>International markets</b>                   | International Markets include Middle East, North Africa, Southern Africa, Latin America, ASEAN, South Korea and Eastern Europe.   |
| <b>LIBOR</b>                                   | London Interbank Offered Rate   |
| <b>LSE</b>                                     | London Stock Exchange.  |
| <b>Metal-on-metal hip resurfacing</b>          | A less invasive surgical approach to treating arthritis in certain patients whereby only the surfaces of the hip joint are replaced leaving the hip head substantially preserved.   |
| <b>Negative Pressure Wound Therapy</b>         | 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.   |
| <b>NYSE</b>                                    | New York Stock Exchange.  |
| <b>Orthopaedic products</b>                    | 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.              |
| <b>OSHA</b>                                    | US Occupational Safety and Health Administration  |
| <b>OXINIUM</b>                                 | 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. |
| <b>Parent Company</b>                          | Smith & Nephew plc.   |
| <b>Pound Sterling, Sterling, £, pence or p</b> | References to UK currency. 1p is equivalent to one hundredth of £1.   |
| <b>Repair</b>                                  |   |

|                                   |  |
|-----------------------------------|--|
| <b>Resection</b>                  | A product group within ASD comprising specialised devices, fixation systems and bio-absorbable materials to repair joints and associated tissue. Products that cut or ablate tissue within ASD comprising mechanical blades, radio frequency wands, electromechanical and hand instruments for resecting tissue.   |
| <b>SEC</b>                        | US Securities and Exchange Commission  |
| <b>SKUs</b>                       | Stock Keeping Units  |
| <b>Trading profit</b>             | Trading profit is a trend which presents the long-term profitability of the Group excluding the impact of specific transactions that management considers affects the Group's short-term profitability. The Group presents this measure to assist investors in their understanding of trends. The Group has identified the following items, where material, as those to be excluded from operating profit when arriving at trading profit: acquisition and disposal related items including amortisation of acquisition intangible assets and impairments; significant restructuring events; acquisition costs; and gains and losses resulting from legal disputes and uninsured losses. |
| <b>UK</b>                         | United Kingdom of Great Britain and Northern Ireland.  |
| <b>UK GAAP</b>                    | Accounting principles generally accepted in the United Kingdom.  |
| <b>US</b>                         | United States of America.  |
| <b>US Dollars, US \$ or cents</b> | References to US currency. 1 cent is equivalent to one hundredth of US\$1.   |
| <b>US GAAP</b>                    | Accounting principles generally accepted in the United States of America.  |
| <b>Visualisation</b>              | Products within ASD comprising digital cameras, light sources, monitors, scopes, image capture, central control and multimedia broadcasting systems for use in endoscopic surgery with visualisation.  |
| <b>Wound bed</b>                  | An area of healthy dermal and epidermal tissue of a wound.   |

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#### About Smith & Nephew

The Smith & Nephew Group (the Group) is a global medical devices business operating in the markets for advanced surgical devices comprising orthopaedic reconstruction, trauma and sports medicine and advanced wound management, with revenue of approximately \$4 billion in 2013. 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 2013. 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 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 divisions. In the majority of the remaining markets, operations are managed by country managers who are responsible for sales and distribution of the Group's entire product range. These comprise the Emerging Markets & International Markets.

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 pages 181 to 182. The product names referred to in this document are identified by use of capital letters and the 0 symbol (on first occurrence) and are trademarks owned by or licensed to members of the Group.

#### 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.

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.

Unless stated otherwise, the translation of US Dollars and cents to Sterling and pence in this Annual Report has been made at the Bank of England exchange rate on the date indicated. On 24 February 2014, the Bank of England rate was US\$1.6631 per £1.

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 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. For example, statements regarding expected revenue growth and trading profit margins discussed under Outlook , Global Outlook and Strategic performance , market trends and our product pipeline are forward-looking statements. Phrases such as aim , plan , intend , anticipate , well-placed , believe , 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, payers 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 performing due diligence, valuing and integrating acquired businesses; disruption that may result from transactions or other changes we make in our business plans or organisation to adapt to market developments and numerous other matters that affect us or our markets, including those of a political, economic, business; competitive or reputational nature; relationships with healthcare professionals; reliance on information technology. Specific risks faced by the Group are described under Risk factors on pages 156 to 158 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.

### Division data

Division data and division 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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The inks used are renewable, biodegradable and emit fewer Volatile Organic Compounds (VOCs) than mineral-oil inks.

They are based on high levels of renewable raw materials such as vegetable oils and naturally occurring resin.

The inks do not contain any toxic heavy metals and therefore, do not pose a problem if placed in landfill.

Designed by Radley Yeldar.

Printed by RR Donnelley 472599.

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**Smith & Nephew plc**

**15 Adam Street**

**London WC2N 6LA**

**United Kingdom**

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**F +44 (0) 20 7960 2356**

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

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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 Swabey  
Susan Swabey

Company Secretary

London, England

March 6, 2014

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| <b>Exhibit No.</b> | <b>Description of Document</b>   | <b>Incorporated Herein by Reference To</b>  | <b>Filed Herewith</b> |
|--------------------|--|---|-----------------------|
| 1                  | Articles of Association  | Form 20-F for the year ended December 31, 2011 filed on March 1, 2012 (File No. 1-14978)  |                       |
| 2                  | Smith & Nephew plc is not party to any single instrument relating to long-term debt pursuant to which a total amount of securities exceeding 10% of Smith & Nephew plc's total assets (on a consolidated basis) is authorized to be issued. Smith & Nephew plc hereby agrees to furnish to the SEC, upon its request, a copy of any instrument defining the rights of holders of its long-term debt or the rights of holders of the long-term debt of any of its subsidiaries for which consolidated or unconsolidated financial statements are required to be filed with the SEC. |   |                       |
| 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 Smith & Nephew plc  | Form 20-F for the year ended December 31, 2010 filed on March 3, 2011 (File No. 1-14978)  |                       |
|                    | (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) |                       |
|                    | (iii)* Material contract: Transaction agreement dated November 27, 2012 by and among Smith & Nephew, Inc., Smith & Nephew Inc., Smith & Nephew Inc., Smith & Nephew Orthopaedics AG, Sudbury Acquisitions N.V., DFB Pharmaceuticals, Inc., Healthpoint, Ltd., Healthpoint International, LLC, DFB Biotech of Curaçao, N.V. and Healthpoint Canada  | Form 20-F/A for the year ended December 31, 2012 filed on May 21, 2013 (File No. 1-14978) |                       |

|       |  |   |
|-------|--|---|
|       | ULC.   |   |
| (iv)* | Material Contract: Amendment to the transaction agreement dated December 21, 2012 by and among DFB Pharmaceuticals, Inc. and Smith & Nephew, Inc.  | Form 20-F/A for the year ended December 31, 2012 filed on May 21, 2013 (File No. 1-14978) |
| (v)   | Material contract: Agreement and Appendices dated 3 February 2014 by and among Smith & Nephew plc, Barclays Bank Plc, J.P. Morgan Limited and J.P. Morgan Europe Limited.                | X   |
| (vi)  | Material contract: Agreement and Plan of Merger dated 2 February 2014 by and among Arthrocare Corporation, Smith & Nephew, Inc., Rosebud Acquisition Corporation and Smith & Nephew plc. | X   |

\* Confidential treatment has been requested. Confidential material has been redacted and filed separately with the SEC.

The exhibits and schedules to this agreement have been omitted from the filing. Smith & Nephew plc has agreed to furnish to the Securities and Exchange Commission, upon its request, a copy of any such omitted exhibits and schedules.



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| <b>Exhibit No.</b> | <b>Description of Document</b>                                   | <b>Incorporated Herein by Reference To</b>   | <b>Filed Herewith</b> |
|--------------------|--|--|-----------------------|
| 4 (c) (i)          | Service Agreement of Olivier Bohuon                              | Form 20-F for the year ended December 31, 2010 filed on March 3, 2011 (File No. 1-14978)     |                       |
| (ii)               | Retirement provisions for David J Illingworth                    | Form 20-F for the year ended December 31, 2010 filed on March 3, 2011 (File No. 1-14978)     |                       |
| (iii)              | Service Agreement of Julie Brown                                 | Form 20-F for the year ended December 31, 2012 filed on February 28, 2013 (File No. 1-14978) |                       |
| (iv)               | Side Letter to the Service Agreement of Julie Brown              | Form 20-F for the year ended December 31, 2012 filed on February 28, 2013 (File No. 1-14978) |                       |
| (v)                | 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)    |                       |
| (vi)               | Letter of Appointment of The Rt. Hon Baroness Virginia Bottomley | Form 20-F for the year ended December 31, 2012 filed on February 28, 2013 (File No.1-14978)  |                       |
| (vii)              | Letter of Appointment of Michael Friedman                        | Form 20-F for the year ended December 31, 2012 filed on February 28, 2013 (File No.1-14978)  |                       |
| (viii)             | Letter of Appointment of Ajay Piramal                            | Form 20-F for the year ended December 31, 2011 filed on March 1, 2012 (File No. 1-14978)     |                       |
| (ix)               | Letter of Re-Appointment of Rolf Stomberg                        | Form 20-F for the year ended December 31, 2012 filed on February 28, 2013 (File No.1-14978)  |                       |
| (x)                | Letter of Re-Appointment of Richard De Schutter                  |  | X                     |
| (xi)               | Letter of Re-Appointment of Pamela Kirby                         |  | X                     |
| (xii)              | Letter of Re-Appointment of Brian Larcombe                       |  | X                     |
| (xiii)             | Letter of Re-Appointment of Joseph Papa                          |  | X                     |
| (xiv)              | Letter of Appointment of Roberto Quarta                          |  | X                     |

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| <b>Exhibit No.</b> | <b>Description of Document</b>                          | <b>Incorporated Herein by Reference To</b>  | <b>Filed Herewith</b> |
|--------------------|---|---|-----------------------|
| 4 (c) (xv)         | 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)       |                       |
| (xvi)              | 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)       |                       |
| (xvii)             | 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)       |                       |
| (xviii)            | 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)       |                       |
| (xix)              | 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)       |                       |
| (xx)               | 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)       |                       |
| (xxi)              | 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)       |                       |
| (xxii)             | 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)       |                       |
| (xxiii)            | 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)       |                       |
| (xxiv)             | 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)       |                       |
| (xxv)              | Smith & Nephew 2004 Executive Share Option Scheme       | Registration statement on Form S-8 No. 333-122801 filed on February 14, 2005 (File No. 1-14978) |                       |
| (xxvi)             | Smith & Nephew 2004 Performance Share Plan              | Registration statement on Form S-8 No. 333-122801 filed on February 14, 2005 (File No. 1-14978) |                       |
| (xxvii)            | Smith & Nephew 2004 Co-investment Plan                  | Registration statement on Form S-8 No. 333-122801 filed on February 14, 2005 (File No. 1-14978) |                       |

|          |  |   |
|----------|--|---|
| (xxviii) | 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) |
|----------|--|---|

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| <b>Exhibit No.</b> | <b>Description of Document</b>  | <b>Incorporated Herein by Reference To</b>   | <b>Filed Herewith</b> |
|--------------------|---|--|-----------------------|
| 4                  | (c) (xxix) Smith & Nephew Long Service Award Scheme   | Registration Statement on Form S-8 No. 33-39814 filed on April 5, 1991 (File No. 1-14978)      |                       |
|                    | (xxx) Smith & Nephew 2004 Performance Share Plan  | Registration statement on Form S-8 No. 333-155172 filed on November 7, 2008 (File No. 1-14978) |                       |
|                    | (xxxii) Smith & Nephew 2001 US Share Plan   | Registration statement on Form S-8 No. 333-155173 filed on November 7, 2008 (File No. 1-14978) |                       |
|                    | (xxxiii) Smith & Nephew plc Deferred Bonus Plan   | Registration statement on Form S-8 No. 333-158239 filed on March 27, 2009 (File No. 1-14978)   |                       |
|                    | (xxxiiii) Smith & Nephew plc Global Share Plan 2010   | Registration statement on Form S-8 No. 333-168544 filed on August 5, 2010 (File No. 1-14978)   |                       |
|                    | (xxxv) Smith & Nephew ShareSave Plan (2012)   | Form 20-F for the year ended December 31, 2012 filed on February 28, 2013 (File No. 1-14978)   |                       |
| 8                  | Principal Subsidiaries  |  | X                     |
| 12                 | (a) Certification of Olivier Bohuon, filed pursuant to Exchange Act Rule 13a-14(a)                    |  | X                     |
|                    | (b) Certification of Julie Brown filed pursuant to Exchange Act Rule 13a-14(a)                        |  | X                     |
| 13                 | (a) Certification of Olivier Bohuon and Julie Brown furnished pursuant to Exchange Act Rule 13a-14(b) |  | X                     |
| 15.1               | Consent of Independent Registered Public Accounting Firm  |  | X                     |