SMITH & NEPHEW PLC
Form 20-F
March 26, 2004

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

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

For the fiscal year ended December 31, 2003

or

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

Commission file number 0-19003

Smith & Nephew plc

(Exact name of Registrant as specified in its charter)

England and Wales

(Jurisdiction of incorporation or organization)

15 Adam Street, London WC2N 6LA

(Address of principal executive offices)

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

Title of each class	Name on each exchange on which registered
American Depositary Shares	New York Stock Exchange
Ordinary Shares of 12 2/9p each	New York Stock Exchange*

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

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

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

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

933,525,906 Ordinary Shares of 12 2/9p each

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 x No ¨

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 ¨ Item 18 x

Dear Shareholder

As a consequence of the Company s Ordinary Shares being traded on the New York Stock Exchange (in the form of American Depositary Shares) we are required to prepare and file a Form 20-F with the US Securities and Exchange Commission. This year, in order to provide the same information to both UK and US shareholders we have decided to combine the Annual Report and Accounts and the Company s Form 20-F filing as a single document. For non-US shareholders who have previously elected to receive the full Annual Report and Accounts, the combined Annual Report and Form 20-F contains considerably more information than that previously sent to you, and you may not wish to receive such a large document in the future. If so, please complete the enclosed form of request to elect to receive the Company s Summary Financial Statement in future, which is sent to the vast majority of shareholders each year. Shareholders electing to receive the Summary Financial Statement may subsequently choose to receive the full combined Annual Report and Form 20-F. US shareholders will continue to receive the combined Annual Report and Form 20-F.

Yours sincerely,

Dudley Eustace

Chairman

16 March 2004

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INTRODUCTION

Smith & Nephew Group is an international medical devices business engaged in orthopaedics, endoscopy and advanced wound management having annual sales of £1.2 billion. Smith & Nephew plc is the parent company of the Smith & Nephew Group. It is an English public limited company with its shares listed on the official list of the UK Listing Authority and traded on the London Stock Exchange and the New York Stock Exchange.

This report is the Annual Report of Smith & Nephew plc for the year ended 31 December 2003. It comprises in a single document the Annual Report and Accounts of the company in accordance with United Kingdom requirements and the Annual Report on Form 20-F in accordance with the regulations of the Securities and Exchange Commission in the United States.

A summary report on the year, the Summary Financial Statement 2003, intended for the investor not requiring the full detail of the Annual Report, is produced as a separate document. The Summary Financial Statement includes a summary review of operations, a summary remuneration report and summary financial statements.

Over 90% of shareholders have chosen to receive only the Summary Financial Statement. The Annual Report is issued to shareholders who have elected to receive it. Both documents are available on Smith & Nephew s corporate website at www.smith-nephew.com.

The Group s fiscal year ends on 31 December of each year. 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 of 12 $^{2}/_{9}$p each.

For the convenience of the reader, a Glossary of technical and financial terms used in this document is included on page 142. The product names referred to in this document are identified by the use of capital letters and are trademarks owned by or licensed to members of the Smith & Nephew Group.

Smith & Nephew s corporate website, www.smith-nephew.com, gives additional information on the Group. Information made available on the website is not intended to be, and should not be regarded as being, part of this Annual Report.

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This Annual Report including the Report of the Directors was approved by the Board of Directors on 16 March 2004.

FINANCIAL SUMMARY

Financial Highlights

	2003 £ million	2002 £ million
Group turnover	1,178.9	1,109.9
Profit before taxation:		
Before goodwill amortisation and exceptional items	242.2	209.9
After goodwill amortisation and exceptional items	230.1	177.9
Adjusted basic earnings per Ordinary Share (EPSA)	18.49p	16.02p
Basic earnings per Ordinary Share	15.92p	12.11p
Dividends per Ordinary Share	4.95p	4.80p

2003 Dividends

The recommended final dividend of 3.10p per share together with the interim dividend of 1.85p makes a total for 2003 of 4.95p. Approval by shareholders of the 2003 final dividend will be sought at the Annual General Meeting to be held on 6 May 2004. If approved, the final dividend will be paid on 14 May 2004 to shareholders on the register at the close of business on 23 April 2004.

Presentation

Smith & Nephew believes that the reporting of profit and earnings measures before goodwill amortisation and exceptional items provides additional meaningful information on underlying returns and trends to shareholders. The Group s internal financial reporting focuses primarily on profit and earnings measures before goodwill amortisation and exceptional items which are the key performance indicators used in budgets, monthly reporting, forecasts, long-term planning and incentive plans. For this purpose exceptional items comprises operating exceptional items, share of exceptional items of joint venture and net profit on disposal of discontinued operations and associated undertaking. Throughout this document earnings per share calculated in this way is termed adjusted basic earnings per Ordinary Share (EPSA). The calculation of profit before goodwill amortisation and EPSA is set out in the Five Year Record (page 130).

Management s key indicator of sales performance is underlying growth in sales. This is calculated by excluding the effects of foreign currency translation movements and acquisitions. Management believes that sales growth on an underlying basis provides a consistent year-on-year measurement of performance without the distortions created by the translational effect of foreign currency movements and acquisitions which are separate from the Group s normal operations. Underlying sales growth is used by management in its internal financial reporting, budgeting and planning.

The Group, as an international business, operates in many countries and earns revenues and incurs costs in many currencies. The results of the Group, as reported in Sterling, are therefore affected by movements in exchange rates between Sterling and overseas currencies. The Group uses the average exchange rates prevailing during the year to translate the results of overseas companies into Sterling. The currencies which most influence these translations are the US Dollar and the Euro. During 2003 average Sterling exchange rates were stronger against the US Dollar by 9% and weaker against the Euro by 9%, compared with 2002.

The Group Accounts of Smith & Nephew in this Annual Report are presented in UK Sterling. Solely for the convenience of the reader, certain parts of this Annual Report contain translations of amounts in sterling into US dollars at specified rates. These translations should not be construed as representations that the sterling amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated. Except as where stated otherwise the translation of pounds sterling and pence to US dollars and cents appearing in this Annual Report have been made at the noon buying rate in The City of New York for cable transfers in sterling as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate) on the date indicated. On 8 March 2004, the Noon Buying Rate was US$ 1.847 per £1.

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

Special Note Regarding Forward-Looking Statements

The Group s reports filed with, or furnished to, the US Securities and Exchange Commission (SEC), including this document and written information released, or oral statements made, to the public in the future by or on behalf of the Group, may include forward-looking statements within the meaning of the US Private Securities Litigation Reform Act of 1995. In particular, statements regarding planned growth in our business and in our operating margins discussed under Outlook and Trend Information section are forward-looking statements. When used in this Annual Report, the words aim , anticipate , believe , consider , estimate , expect , intend , plan , well-placed and similar expressions are generally intended to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of Smith & Nephew, or industry results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Specific risks faced by the Group are described under Risk factors on page 20 of this Annual Report.

All forward-looking statements in this Annual Report are based on information available to Smith & Nephew as of 16 March 2004. All written and oral forward-looking statements attributable to Smith & Nephew or persons acting on behalf of Smith & Nephew are expressly qualified in their entirety by the foregoing. Smith & Nephew expressly disclaims any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained herein to reflect any change in Smith & Nephew s expectation with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Market Data

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

DESCRIPTION OF THE GROUP

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

Discussion of the Group s management structure and corporate governance procedures is set out in the Corporate Governance section (pages 43 to 50).

The Remuneration Report gives details of the Group s policies on senior management s remuneration in 2003 (pages 51 to 58).

Discussion of the Group s operating and financial performance liquidity and financial resources for 2003 and 2002 is given in the Operating and Financial Review, Liquidity and Prospects (pages 23 to 42).

THE BUSINESS

HISTORY AND DEVELOPMENT

Group Overview

Smith & Nephew is a global company engaged in the development and marketing of medical devices in the sectors of orthopaedics, endoscopy and advanced wound management. These three businesses comprise the Group s Ongoing Operations which Smith & Nephew believes have good growth prospects.

The Group has a history dating back 148 years to the family enterprise of Thomas James Smith who opened a small pharmacy in Hull, England in 1856. On his death in 1896, his nephew Horatio Nelson Smith took over the management of the business. Smith & Nephew was incorporated and listed on the London Stock Exchange in 1937. Today it is a public limited company incorporated in Great Britain registered in, and conducted under the laws of, England and Wales. Operations in countries other than the UK are under the laws of those countries. In November 1999, the Company was listed on the New York Stock Exchange. The corporate headquarters is in the UK and the registered address is:

Smith & Nephew plc

15 Adam Street

London WC2N 6LA

Tel: +44 (0) 20 7401 7646

Website: www.smith-nephew.com

In 2001, Smith & Nephew became a constituent part 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.

Recent Developments

On 20 March 2003, Smith & Nephew entered into an agreement (the Combination Agreement) with Centerpulse AG a public company incorporated under the laws of Switzerland (Centerpulse), and an agreement with InCentive Capital AG (the InCentive Agreement), a public company incorporated under the laws of Switzerland (InCentive) which held, or had the right to acquire, approximately 19% of the issued share capital of Centerpulse. Centerpulse is a leading medical technology group, serving the reconstructive joint, spinal and dental implant markets. It was contemplated by the Combination Agreement and the InCentive Agreement that Smith & Nephew Group plc (Smith & Nephew Group), a new holding company for Smith & Nephew, would seek to acquire all outstanding shares of Centerpulse and InCentive in exchange for Smith & Nephew Group shares and cash.

On 20 May 2003, Zimmer Holdings, Inc. announced its intention to make competing offers to acquire Centerpulse and InCentive and on 19 June 2003 it made formal counter offers.

On 6 August 2003, Smith & Nephew announced that following Zimmer Holdings, Inc. s counter offers Smith & Nephew would not submit revised offers to acquire Centerpulse and InCentive. On 28 August 2003 Zimmer Holdings, Inc. acquired Centerpulse and InCentive.

In September 2003, Smith & Nephew disposed of its 21.5% equity interest in AbilityOne (a company incorporated in the US) to Patterson Dental Inc. for £52m in cash.

On 16 March 2004, Smith & Nephew completed the acquisition of Midland Medical Technologies (MMT), the global market leader in metal-on-metal hip resurfacing for £67m in cash and notes. Additional payments of £33m in cash and notes are contingent upon certain regulatory and development milestones being met. MMT achieved sales in the 2003 calendar year of £20m. MMT will be integrated into the orthopaedics business unit.

BUSINESS DESCRIPTION

Group Structure

Smith & Nephew operates on a worldwide basis. This has been achieved through a series of investments and acquisitions, predominantly in the US but also in Europe, and through continued emphasis on the development and introduction of new products to the Group s principal markets.

Smith & Nephew is organised into the three global business units of orthopaedics, endoscopy and advanced wound management and a separate indirect market unit. Each of the three global business units manages its sales directly in ten international markets the US, Canada, the UK, Germany, Japan, Australia, France, Italy, New Zealand and Ireland and takes full responsibility for strategy, research and development (R&D), manufacturing, marketing, sales and financial performance. The remaining 22 markets in which the Group has selling companies are managed by country managers, with business responsibility for the whole of the Group s product range, and comprise the indirect market unit.

A head office team in London, England directs the overall business and supports the business units, primarily in the areas of business development, company secretarial, finance, human resources and investor relations, with a legal department based in Memphis, Tennessee. A central research facility in York, England is charged with the development of enabling technologies in both materials science and biology, particularly cell biology.

Orthopaedics

Overview

Orthopaedic products comprise reconstructive joint implants, trauma products and associated clinical therapies. Reconstructive implants include hip, knee and shoulder joints as well as ancillary products such as bone cement and mixing systems used in cemented reconstructive joint surgery. Trauma products consist of internal and external fixation devices, used in the stabilisation of severe fractures. Clinical therapies consist of products applied in an orthopaedic office or clinic setting and currently comprise bone growth stimulators and a joint fluid therapy product.

The orthopaedics business is managed worldwide from Memphis, Tennessee, which is also the site of its main manufacturing facility. Orthopaedic implants and trauma products are also manufactured at a small facility in Tuttlingen, Germany.

The Group s reconstructive knee business is built on two major knee systems: GENESIS II, designed to facilitate the accuracy and efficiency of the operating procedure and provide improved long-term clinical results; and PROFIX, a reconstructive knee system featuring simpler instruments and surgical technique.

Within the reconstructive hip line, the SPECTRON cemented hip system and the REFLECTION acetabular cup system have documented positive long-term clinical performance. More recently, the success of SYNERGY, a tapered titanium stem system, and ECHELON, a revision stem system, have established Smith & Nephew as a strong player in this product segment.

The Group has developed and now manufactures knee and hip implant components made from oxidised zirconium (OXINIUM) which is patent protected and which management believes has improved wear characteristics which may be of significant benefit to younger, more active patients.

Products such as the RUSSELL-TAYLOR, IMHS and TRIGEN intramedullary nail systems and the AMBI and CLASSIC compression hip screws provide trauma surgeons with a comprehensive management system for a wide variety of fractures. The ILIZAROV and the TAYLOR SPATIAL FRAME external fixator systems provide limb lengthening and deformity correction.

The EXOGEN ultrasonic bone healing stimulator and SUPARTZ hyaluronic acid joint fluid therapy are the main products in the clinical therapies sector.

To compete effectively in the growing global orthopaedic market, management believes that as well as having a leading edge product range it is important to have a skilled sales force that can build strong relationships with surgeons.

Strategy

Smith & Nephew s orthopaedics strategy is for future growth through product development in its existing core business and expansion into the fast-growing market for less invasive therapies. Management believes that the orthopaedic market will continue to grow for the foreseeable future. This is largely attributable to the increasing portion of the population aged over 65 and the increasing need for joint reconstructive products and other orthopaedic therapies in younger, more active patients.

Smith & Nephew also intends to further penetrate this market by taking advantage of its portfolio of products and services, by expanding its sales force, and by introducing less invasive and alternative therapies. Management is working to accelerate the Group s growth in the trauma market by creating greater customer and market focus through the creation of separate divisions for trauma and reconstruction with separate internal resources and specialised salesforces. The Group is also contributing to patient education and empowerment through its websites and other direct-to-consumer methodologies.

New Products

In 2003, the orthopaedics business continued the promotion and roll-out of OXINIUM technology across the knee and hip product line. OXINIUM is a material exclusive to Smith & Nephew which contains the strength of a metal with the wear properties of a ceramic material and expands the market for hip and knee implants. The introduction of OXINIUM femoral components for the ACCURIS minimally invasive unicompartmental knee system occurred in 2003 and the OXINIUM femoral head was launched in the hip market.

In 2003, the Group launched the JET-X Unilateral Fixation System which complements the external fixation product offering and brings greater breadth to the trauma range. The Group continues to focus on less invasive procedures with the introduction of mini-incision hip, knee and trauma applications as well as procedures utilising image guidance.

Recent Regulatory Approvals

In February 2003, the FDA issued 510k clearance for OXINIUM Unicompartmental (Uni) components.

Also in February 2003, FDA approved the JAX GEL Bone Graft Substitute. This product is a synthetic form of bone and is used to fill non-load bearing bone defects. It is resorbed by the body and is replaced by natural bone.

In May 2003, the Group received 510k clearance for uncemented porous coated knees for both the PROFIX and GENESIS II Knee Systems. Porous coated knees had been recently down-classified by the FDA allowing 510k submissions to be filed for the devices. In August 2003, the Group received 510k clearance for the GENESIS II HA porous coated Knee System as a result of the prior clearance of HA porous coated hip devices.

Competition

Management estimates that the worldwide orthopaedic market (excluding spine) served by the Group grew by 13% in 2003 and is currently worth more than £5.9 billion per annum. Management believes that Smith & Nephew holds an 8% share of this market by value.

Principal global competitors in the orthopaedic market and their estimated global shares, are Zimmer (21%), Stryker (19%), De Puy/Johnson & Johnson (18%), Biomet (11%) and Synthes-Stratec (9%).

Endoscopy

Overview

Smith & Nephew s endoscopy business, headquartered in Andover, Massachusetts, develops and commercialises a range of endoscopic (minimally invasive surgery) techniques, educational programmes and value-added services for surgeons to treat and repair soft tissues, articulating joints, spinal discs and vascular structures. The business focuses principally on the arthroscopy sector of the endoscopy market. Arthroscopy is the minimally invasive surgery of joints, in particular the knee, hip and shoulder.

The endoscopy business offers surgeons endoscopic technologies for surgery, including: fluid management and insufflation instruments for surgical access; digital cameras, digital image capture, central control, multimedia broadcasting, scopes, light sources and monitors to assist with visualisation; radiofrequency wands, electromechanical and mechanical blades, and hand instruments for resecting tissue; and specialised devices, fixation systems and bioabsorbable materials to repair damaged tissue.

Manufacturing facilities are located in Andover and Mansfield, Massachusetts and Oklahoma City, Oklahoma. Major service centres are located in the United States, the United Kingdom, Germany, Japan and Australia.

Jim Taylor was appointed President in November 2003, replacing Ron Sparks, who left to take up another post. Mr Taylor was formerly head of Smith & Nephew s indirect market unit.

Strategy

Smith & Nephew s strategic intent is to establish the endoscopy business as the leading provider of endoscopic tools and techniques for joint and ligament repair and to use its core capabilities to penetrate other select endoscopic markets. Management believes the endoscopy business capitalises on the growing acceptance of endoscopy as a preferred surgical choice among physicians, payors and patients.

To sustain growth and maintain its market position, the endoscopy business supports its strategy with surgeon education programmes, financing solutions, global fellowship support initiatives, partnerships with professional associations and surgeon advisory boards. The Group also enhances its reputation for surgeon-focused innovation with its proprietary InVentures Bioskills Lab programme, which enables surgeons to work directly with a Smith & Nephew multi-disciplined team to develop concepts and explore the commercialisation of their techniques or instrumentation.

In 2002, Smith & Nephew expanded its endoscopy business by acquiring ORATEC Interventions, Inc., a medical device innovator in the use of radiofrequency thermal energy to treat joint and spine disorders through the cutting, removal, ablation or modification of damaged or stretched tissue. Management believes that this will enable the Group to establish itself as a lead player in radiofrequency technology for minimally invasive surgery.

New Products

In 2003, Smith & Nephew introduced the POWERMAX motor drive unit a new lightweight arthroscopic shaver handpiece that management believes provides the benefit of additional power and torque without any compromise to ergonomics, comfort or weight. The Group also introduced several improvements and enhancements to its soft tissue repair line in the knee and shoulder, including the DURABRAID suture for TWINFIX SUTURE ANCHORS, the SURETAC fixation system, QUICK-T fixation system, an absorbable version of the FAST-FIX meniscal repair system and most recently the WHIPNOT soft tissue cinch.

In 2003, Smith & Nephew introduced a number of new offerings to its Digital Operating Room programme, an integrated and fully functional operating room suite utilising central control, information and image management, multi-media broadcast and other endoscopic equipment that management believes enables hospitals and surgical centres to maximise performance within their operating rooms. Central and voice control capability was extended to the DYONICS power shaver control box and other key endoscopic equipment. In addition, Smith & Nephew launched the 640 Image Management, a surgical documentation system used to store, access and distribute intra-operative patient reports, as well as digital surgical video clips and still images.

The acquisition of Reed Medical Designs, Inc. (Reed) was announced on 9 February 2004. Reed is a provider of audio-visual technology to hospitals and healthcare institutions and will supplement the Digital Operating Room product range.

Recent Regulatory Approvals

During 2003, the endoscopy business obtained regulatory approvals for the following products in all major markets, except Japan where the approval process is traditionally slower: the next generation integrated TRIVEX system; HERMES central control capability for the majority of product control units, including the DYONICS Power shaver system, the INTELIJET fluid management system and the 300XL light source; and expanded indications or line extensions for radio frequency probes, bioabsorbable interference screws and TWINFIX AB anchors.

Competition

Management estimates that the global arthroscopy markets in which the business principally participates is worth £743 million a year and is growing at 8% annually, driven by increasing numbers of sports injuries, longer and more active lifestyles, patient desire for minimally invasive procedures, innovative technological developments and a need for cost effective procedures. Management believes that Smith & Nephew has a 29% share of the global arthroscopy market. Smith & Nephew also participates in the growing minimally invasive spinal and minimally invasive vascular markets and continues to seek way to leverage its knowledge, experience and core capabilities in other selected endoscopic markets.

Smith & Nephew s main competitors and their estimated shares of the global arthroscopy market are: Mitek/Johnson & Johnson (17%), Linvatec/Conmed (14%), Arthrex (14%), Stryker (12%) and Arthrocare (7%).

Advanced Wound Management

Overview

Smith & Nephew s advanced wound management business is headquartered in Hull, England. It supplies a range of products and clinical support services for the treatment of chronic and acute skin wounds. It offers a range of products from initial wound bed preparation through to full wound closure. These products are targeted particularly at chronic wounds connected with the older population (such as pressure sores and venous leg ulcers), diabetic foot ulcers, burns and complex surgical wounds.

Advanced wound management products are manufactured in facilities in Hull and Gilberdyke, England; Largo, Florida; and La Jolla, California and by certain third party manufacturers.

The advanced wound management business has continued to build its sales and marketing infrastructure in the world s major markets, with expansion of its sales force and global brand development. These initiatives have led to increased levels of demand on the Group s manufacturing and the global supply chain, which are being addressed with increased investment in the facilities in Hull and Largo.

Strategy

The strategy for future advanced wound management products and sales growth focuses on wound bed preparation and moist and active healing. The formation of a joint venture with Beiersdorf AG, BSN Medical, enabled the business to contribute its traditional medical textile woundcare business to BSN Medical effective 1 April 2001, allowing the advanced wound management business to focus its attention on higher added value advanced woundcare products.

In November 2002, the Group acquired the remaining 50% of its former joint arrangements with Advanced Tissue Sciences, Inc. (ATS) for the rights to apply human tissue technology to the treatment of all skin wounds. The transaction has brought the full costs and benefits of two significant products, DERMAGRAFT and TRANSCYTE, into the Group. DERMAGRAFT is a human dermal replacement designed as a treatment for diabetic foot ulcers. TRANSCYTE is a temporary wound covering for the treatment of burns.

The business has continued to build its sales and marketing infrastructure in the world s major markets, both through investment in its existing network and through the additional sales teams gained through its acquired businesses in recent years. The integration of the acquired sales forces has increased the capability of the business throughout the world, particularly in the key markets of the United States and Germany.

New Products

Management believes that the market will continue to trend towards advanced products with their ability to accelerate healing rates, reduce hospital stay times and cut the cost of nursing and clinician time and aftercare in the home.

At the end of 2002, ACTICOAT achieved Class III medical device approval in Europe and during 2003 the product achieved a drug tariff listing in the UK. Sales have been driven by worldwide introduction of ACTICOAT. ACTICOAT, acquired from Westaim of Canada in May 2001, is an antimicrobial barrier dressing incorporating the smallest crystallised silver (nanocrystalline silver) used in the treatment of burns or wounds. The silver reduces the risk of bacterial colonisation and acts to kill micro-organisms that can cause infection and prevent or retard healing.

During 2003, the Group relaunched the expanded ALLEVYN hydrocellular dressing range. Management believes that ALLEVYN is the largest selling dressing in its category in the world and that the continued focus on the brand will aid Smith & Nephew in maintaining this position. Also during the year GLADASE, a papain urea ointment, was launched to replace SANTYL a collagenase product previously marketed in the US and Canada. GLADASE is indicated for the use in the debridement of necrotic tissue to prepare the wound bed for healing.

2003 was the first full year of DERMAGRAFT sales in the US. Sales targets were achieved and management believes that substantially all of the US outpatient population has been approved for Medicare reimbursement coverage.

In January 2004, the business announced the acquisition of VERSAJET, a fluid jet debridement system, from HydroCision Inc., to add to its growing range of advanced wound bed preparation products.

Recent Regulatory Approvals

During 2003, the business secured over 125 medical device and 100 pharmaceutical registration approvals in various markets throughout the world. Among the most significant approvals were those for ACTICOAT and ACTICOAT 7 as Class III medical devices in the European Union and the new shape range of ALLEVYN/HYDROSITE in Japan. In addition, approval to market the VISITRAK wound measurement product in Canada and the European Union was obtained. Reimbursement was secured for PROGUIDE, a patented two-layer specialised bandaging system to treat venous leg ulcers, and the ACTICOAT range on the UK drug tariff.

Competition

Management estimates that the sales value of the advanced wound management market worldwide is £1.6 billion a year, and that this grew 12% in 2003, and that Smith & Nephew has a 20% market share. Growth is driven by an ageing population and by a steady advancement in technology and products that are more clinically efficient and cost effective than their conventional counterparts. Management believes that, with approximately 50% of chronic wounds globally still treated with conventional dressings, there is a strong growth potential for advanced technology products.

Worldwide competitors in advanced wound management and their estimated market shares comprise Kinetic Concepts (18%), Johnson & Johnson (14%), the Convatec division of Bristol-Myers Squibb (12%) and 3M (10%).

Joint Ventures and Discontinued Operations

Joint Ventures, Associated Undertakings, Joint Arrangements and Other Interests

Joint ventures are those in which the Group holds an interest on a long-term basis and which are controlled by the Group and one other entity under a contractual agreement.

Smith & Nephew owns 50% of the BSN Medical joint venture, which became operational on 1 April 2001. It is owned jointly with Beiersdorf AG and is independently managed. BSN Medical comprises traditional woundcare, casting and bandaging and compression hosiery businesses. Headquartered in Hamburg, Germany it has manufacturing facilities in US, UK, Germany, France, Republic of Ireland, South Africa, Mexico and Pakistan. In certain markets, Smith & Nephew s sales forces sell BSN Medical s products on an agency basis in return for an agency commission and in some markets, mainly in Asia, Smith & Nephew distributes BSN Medical products. Results are accounted for under the gross equity method, whereby 50% of turnover, operating profit, interest, taxation and attributable profit for the year are incorporated into Smith & Nephew s profit and loss account.

On 11 December 2003, BSN Medical announced the acquisition of the fracture casting and splinting business of DePuy, Inc., a Johnson and Johnson company, funded by its own bank facilities. This acquisition furthers the Group s strategy to establish BSN Medical as a major independent medical supplies company.

Associated undertakings are those in which the Group has a beneficial interest of 50% or less in the equity capital and where the Group exercises significant influence over commercial and financial policy decisions. In March 2002, the Group acquired 21.5% of AbilityOne Corporation (AbilityOne) as part of a transaction in which it disposed of its rehabilitation business to AbilityOne. In September 2003, the Group disposed of its 21.5% interest in AbilityOne to Patterson Dental Inc. From 27 March 2002 to 12 September 2003 this interest was included in the Group s accounts as an associated undertaking and accounted for under the equity method, whereby 21.5% of operating profit, interest, taxation and attributable profit are incorporated into Smith & Nephew s profit and loss account.

The Group had an interest in two joint arrangements with ATS, relating to products for the treatment of diabetic foot ulcers (DERMAGRAFT) since 1996, and cartilage replacement (NEOCYTE) since 1994. On 25 November 2002, the Group purchased from ATS the interests it did not already own in the joint arrangements.

Operations Contributed to the Joint Venture

Operations contributed to the joint venture consist of the casting and bandaging and traditional woundcare businesses until 1 April 2001 when they were contributed to the BSN Medical joint venture.

Discontinued Operations

Discontinued operations in 2002 comprise three months of results of the rehabilitation business disposed of in March 2002. The rehabilitation business manufactured and marketed products, equipment and product systems used to increase, maintain or improve functional capabilities after surgery or stroke or of individuals with disabilities.

Discontinued operations in 2001 comprise the results of the ear, nose and throat business disposed of in June 2001 and a full year of rehabilitation results. The ear, nose and throat business comprised a wide range of products for sinus surgery, as well as products for surgical procedures of the head and neck.

OPERATING ENVIRONMENT

REGULATION

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

National regulatory authorities administer and enforce a complex series of laws and regulations that govern the testing, approval, manufacturing, labelling, marketing and sale of healthcare and pharmaceutical 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 are the Medicines and Healthcare products Regulatory Agency in the UK, the FDA in the US and the Ministry for Health Labour and Welfare in Japan. Payment for many medical device products are defined by reimbursement tariff agencies in each individual country.

The trend in recent years has been towards greater regulation and higher standards of technical appraisal, which generally entail lengthy inspections for compliance with appropriate standards, including regulations such as good manufacturing practices. Smith & Nephew believes that these recent changes will not have a material adverse effect on the Group s financial condition and the results of operations. All significant facilities within the Group are subject to regular internal audit for medical device regulatory compliance with national and Group standards and policies.

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

PRODUCT LIABILITY

The Group monitors the safety of its products from initial product development through to product use or application. In addition, the businesses of the Group analyse on a worldwide basis reports of adverse reactions and complaints relating to its products. Each business reviews these adverse reactions and complaints and any safety matters arising with independent medical advisors. These conclusions are subsequently reviewed by the Group s independent medical advisor.

Product liability is a commercial risk for the industry of which the Group is a part, particularly in the US where there are increasing numbers of claims involving medical devices. Smith & Nephew has implemented systems it believes are appropriate in respect of loss control techniques. These include reporting mechanisms to ensure early notification of complaints and a legal department which manages product liability claims and lawsuits.

The Group carries product liability insurance to cover exposure as far as practicable. To date any instances of loss to the Group arising from product liability claims have been covered either directly or by the Group or by insurance. There are currently no individual product liability claims that are expected to have a material adverse effect on the Group s financial position or results of operations.

There can be no assurance that consumers, particularly in the US or elsewhere, 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 continue to resolve such claims within insurance limits as in the past in view of changing legal doctrines and attitudes regarding such matters. See Risk Factors Product Liability Claims and Loss of Reputation .

RISK MANAGEMENT

Smith & Nephew s products are not in life support activities and in general are unlikely to threaten life. But, if they malfunction, they could damage or impair the repair of body functions. Management believes that the Group s quality, regulatory and medical controls and insurance activities are adequate and appropriate for this class of products. The Group s reputation is crucially dependent on strong performance in this area and on appropriate crisis management if a serious medical incident or product recall should occur.

The Board of Directors of Smith & Nephew is responsible for the maintenance of the Group s systems of risk management and internal control and for reviewing their effectiveness. An ongoing process was in place for the full year identifying, evaluating and managing key risks through a Risk Committee that comprises GEC members, which reports to the Board of Directors annually, and by a system of functional reports to the Board of Directors and the review of internal financial controls by the Audit Committee. These procedures are designed to identify and manage those risks that could adversely impact the achievement of the Group s objectives. While they do not provide absolute assurance against material misstatements or loss, the Directors, following a review of the systems described, are of the opinion that proper systems of risk management and internal control are in place within the Group.

The Group is insured against product, employers and directors and officers liabilities and physical and consequential loss, subject to limits and deductibles. The Group maintains liability provisions to cover known uninsured risks.

OPERATING ACTIVITIES

MARKETING AND DISTRIBUTION

Smith & Nephew s customers are the various providers of medical and surgical services worldwide. In certain parts of the world, including the UK, much of Continental Europe, Australia, Canada and South Africa, these are largely governmental organisations funded by tax revenues. In the US, the Group s major customers are public and private hospitals, many of which have combined to form large purchasing groups and receive revenue from private health insurance and governmental reimbursement programmes. In the United States, Medicare is the major source of reimbursement for knee and hip procedures and for wound healing treatment regimes.

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

The Group s customers reflect the wide range of distribution channels, purchasing agents and buying entities in over 90 countries worldwide. The largest single customers worldwide are the National Health Service in the UK and HealthTrust in the US. Sales to these customers in 2003 each represented approximately 4% of the Group s worldwide total sales.

In the US the Group s products are marketed directly to doctors, hospitals and other healthcare facilities. Each business unit operates a separate specialised sales force. Within the orthopaedics business further specialisation of the sales force is being introduced progressively for reconstructive and trauma products. In both orthopaedics and endoscopy the sales forces consist of independent commissioned sales agents who are managed by a mix of independent agents and the Group s own managers. These agents are not permitted contractually to sell products that compete with Smith & Nephew s. In both businesses products are shipped and invoiced direct to the ultimate customer. The advanced wound management business in the US operates a sales force of its own employees who market direct to the ultimate customer. Advanced wound management products are shipped and invoiced to a number of large wholesale distributors.

In the other direct markets of the UK, Ireland, France, Germany, Italy, Australia, New Zealand, Canada and Japan the business units manage separate sales forces directly. In most of these markets the sales forces comprise employees and market directly to the ultimate customer.

The indirect markets unit comprises selling and marketing operations in Austria, Belgium, Denmark, Eastern Europe, Finland, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, China, Hong Kong, Korea, Malaysia, Singapore, Taiwan, Thailand, Mexico, Puerto Rico, the United Arab Emirates and South Africa. In these markets orthopaedics and endoscopy frequently share sales resources. The advanced wound management sales force is separate since it calls on different customers. In all other countries Smith & Nephew sells to third party distributors which market the Group s products locally.

In Continental Europe, the Group operates two centralised distribution facilities. Orthopaedics operates a facility in Paris which acts as a central holding and consolidation point for Continental European stock and stock returns. Product is shipped to Group companies who hold small amounts of stock locally for immediate or urgent customer requirements. Advanced wound management operates from Veghel, in the Netherlands from where stock is shipped directly to the ultimate customer in many European markets.

MANUFACTURE AND SUPPLY

The Group has a policy of manufacturing the majority of its products to ensure quality, regulatory and cost goals are met. The Group invests in the expansion of its manufacturing facilities and equipment to meet these aims.

Each business unit purchases raw materials, components, finished products and packaging materials from certain key suppliers. These comprise principally metal forgings and stampings for orthopaedics, optical and electronic sub-components for endoscopy, active ingredients and finished goods for advanced wound management and packaging materials for all businesses. Management believes that prices of principal raw materials and finished goods purchased are not particularly volatile and that these materials are generally available from various specialist suppliers. Finished goods purchased for resale are primarily SUPARTZ joint lubricant in the orthopaedic business, monitors and electrical devices in the endoscopy business and enzyme debrider agents and ACTICOAT in the advanced wound management business. Following continuing problems relating to the supply of the SANTYL collagenase enzyme debrider product to the US, both the product and the supplier were changed in 2003.

SEASONALITY

Smith & Nephew s sales are generally at their highest in quarter four of any year and at their lowest in the first and third quarters. This is caused by the relatively high number of accidents and sports injuries which occur in the North American and European autumn and winter which increases sales of orthopaedic and endoscopy products and by the deferral of elective surgery during the peak summer holiday period in North America and Europe during the third quarter.

RESEARCH AND DEVELOPMENT

The business units each manage a portfolio of short and long-term product development projects designed to meet the future needs of their customers and to continue to provide growth opportunities for their businesses. The Group s research and development is directed towards all three business segments. The Group s expenditures on research and development amounted to £66.8m in 2003 (2002 £61.3m, 2001 £50.9m), representing approximately 6% of group turnover (2002 6%, 2001 5%).

The Group s principal research facility is located in York, England. The Group s research programme seeks to underpin the longer-term technology requirements for its businesses and to provide a flow of innovative products. The Group continues to invest in future technology opportunities, particularly bio-resorbable materials, tissue engineering and non-invasive healing devices across the Group.

Product development programmes are carried out at the Group s principal manufacturing locations, notably in Memphis, Tennessee (orthopaedics), Andover and Mansfield, Massachusetts (endoscopy) and Hull, England and La Jolla, California (advanced wound management). In-house research is supplemented by work performed by academic institutions and other external research organisations principally in the UK and the US.

INTELLECTUAL PROPERTY

Management believes that the Group s active policy concerning intellectual property rights promotes innovation in its businesses. Smith & Nephew has a policy of protecting, with patents, the results of the research and development carried out throughout the Group. Patents have been obtained for a wide range of products, including those in the fields of orthopaedic, endoscopic and advanced wound management technologies. Patent protection for Group products is sought routinely in the Group s principal markets. Currently, the Group s patent portfolio stands at over 2,500 existing patents and patent applications.

Smith & Nephew also has a policy of protecting the Group s products in the markets in which they are sold by registering trademarks as soon as possible under local laws. The Group vigorously protects its trademarks against infringement and currently is not aware of any significant infringement of its trademark registrations. The present trademark portfolio of the Group consists of over 3,300 trademarks and design rights.

Smith & Nephew s principal products are protected by intellectual property comprising patents, licences and know how, and it strives to provide a collection of intellectual property for each major product that reduces the risk associated with failure of any individual piece of intellectual property. In addition, most pieces of intellectual property protect a relatively small proportion of the Groups annual turnover. As a result, the Group tries to ensure that its overall business is not sensitive to the loss (however caused) of any single piece of intellectual property.

In addition to maintaining a policy of protecting its market position by the filing and enforcement of patents and trademarks, Smith & Nephew has a policy of opposing third party patents and trademarks in those areas that might conflict with the Group s business interests.

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

PROPERTY, PLANT AND EQUIPMENT

The Group s principal locations are as follows:

	Approximate area (Square feet 000 s)
Group Head Office in London, England	15
Group research facility in York, England	83
Orthopaedics headquarters and manufacturing facility in Memphis, Tennessee	673
Endoscopy headquarters facility in Andover, Massachusetts	92
Endoscopy manufacturing facility in Andover, Massachusetts	110
Endoscopy manufacturing facility in Mansfield, Massachusetts	90
Endoscopy manufacturing facility in Oklahoma City, Oklahoma	55
Wound management headquarters and manufacturing facility in Hull, England	546
Wound management manufacturing facility in Largo, Florida	188
Wound management manufacturing facility in La Jolla, California	69

The facilities in Memphis, Hull and Largo and the manufacturing facility in Andover are freehold while all other principal locations are leasehold. The Group also has freehold and leasehold interests in real estate in many countries throughout the world, but none is significant individually to the Group as a whole.

During 2003, the completion of a new building at Memphis increased manufacturing capacity for orthopaedic reconstructive products, the Andover facility was expanded in order to absorb the manufacturing and development operations of ORATEC, the construction phase of the Hull facility expansion was completed and the Largo facility was extended to create additional manufacturing capacity for advanced wound management products.

The Group considers its existing facilities to be adequate to meet anticipated demands for its products. Where required, the appropriate governmental authorities have approved the existing facilities.

LEGAL PROCEEDINGS

The Company and its subsidiaries are parties to various legal proceedings including product liability, which are considered to constitute ordinary and routine litigation incidental to the businesses conducted by the Company and/or the relevant subsidiary, in some of which claims for damages in substantial amounts have been asserted. The outcome of such proceedings cannot readily be foreseen, but management believes that they will not result in any material adverse effect on the financial position or results of operations of the Group.

THE BUSINESS AND THE COMMUNITY

CORPORATE AND SOCIAL RESPONSIBILITY

Smith & Nephew is committed to making continuous improvements to the management of its environmental, social and economic impacts and to developing a sustainable business.

In August 2003, Smith & Nephew launched its new corporate brand identity, which is an expression of how the Group seeks to contribute to society in the course of its daily business. The new brand reinforces the Group s focus on advanced medical devices that help healthcare professionals treat patients more effectively and patients to get back to their lives faster. The new brand emphasises the Group s core values of performance, innovation and trust and sets out a corporate culture and personality that is intended to be embraced by all Smith & Nephew people throughout the world. The aim is to be the best in helping people regain their lives by repairing and healing the human body.

The Group published its third Sustainability Report in May 2003, recording its progress in corporate social responsibility. The scope of the report was wider than 2002 and included new measurements and information on activities. At the same time, a new Code of Business Principles was published that updates a number of existing policies and broadened these to cover such areas of concern as child labour and human rights. The revised Code of Business Principles has been adopted throughout the organisation. The fourth Sustainability Report will be published on the Company s website in April 2004.

A number of independent organisations recognise Smith & Nephew s progress in sustainable development. The Company made its second submission to the Dow Jones Sustainability Index (DJSI) in 2003 and has been included in the Index for the second year running. This is the most widely recognised arbiter of good practice and is truly international in scope. The DJSI have included the company in both the World Index and the European Index. In the UK, Smith & Nephew has been included in the list of FTSE4Good companies.

Through its code of business principles, the Group respects the rights of all its stakeholders and seeks to build open, honest and constructive relationships. It takes account of ethical, social, environmental, legal and financial considerations in planning and business decisions.

Business Integrity

Smith & Nephew aims to be honest and fair in all aspects of its business and expects the same from all those with whom it does business. The Group does not give or receive improper financial inducements, either directly or indirectly, for business or financial gain. Accounting records and supporting documents are designed to accurately describe and reflect the nature of underlying transactions and conform to UK GAAP.

Environmental Management

The Group has an established environmental policy and an environmental committee comprising representatives from the business. Smith & Nephew is committed to the protection of the environment by using renewable resources wherever possible and developing manufacturing processes and products that minimise adverse effects on the environment. The Group s business units take effective action to control risks and minimise environmental impacts through systems and procedures based on a thorough understanding of the risks and provide appropriate training and support.

The Group has environmental management systems that are designed to deliver cost savings and benefits to the environment. Manufacturing processes are relatively low in environmental impact. Close control is kept on energy, water consumption and waste, the latter being the main area of impact at its manufacturing sites. Waste prevention and minimisation programmes operate and sustainable development aspects of the company s products are assessed during the research and development process. In 2002, waste increased for the first time in a number of years due to the installation of additional manufacturing plant in all three business segments. As a result, this has been an area of particular focus during 2003 with waste reduction of 10% when compared to 2002 being achieved. Energy consumption increased by only 1% in 2003 when compared to 2002 despite increased turnover of 11% for the Group.

Social responsibility

Employees

Smith & Nephew seeks to provide an open, challenging, productive and participative environment based on constructive relationships. The Group endeavours to maintain good communication with employees through regular and timely dissemination of Group information and consultation. It provides clearly communicated goals and performance standards, and the training, information and authority needed to do a good job. Smith & Nephew aims to provide fair recognition and reward based on performance. Employees are able to share in the Group s performance by participating in Sharesave and Stock Purchase Plans. Smith & Nephew welcomes disabled people and makes every effort to retain any employee who becomes disabled.

Training and Development

Appropriate learning and development programmes are in place to ensure that the company attracts, retains, and develops to their full potential the best talent at all levels where possible. It aims to fill vacancies by internal promotion, but looks to strike a balance between home-grown talent and new talent from outside the Group. It endeavours to recruit, employ and promote employees on the sole basis of qualifications and the abilities needed for the work to be performed. Discrimination is not tolerated on any grounds and the Group provides equal opportunity based on merit.

Leadership

The Group aims to develop its current and future leaders and harness their talent to improve the performance of the business. The 2003 Management Conference involving senior managers from all parts of the business with the objective to develop strategies aimed at channeling the energy and enthusiasm of the organisation into delivering a culture of superior performance in line with the company s values. Across the business, performance evaluation, coaching and attendance at high quality leadership programmes are utilised for development purposes.

Workplace

Smith & Nephew aims to provide healthy and safe working conditions for all its employees. This is achieved by ensuring that health and safety and the working environment are managed as an integral part of the business and employee involvement is recognised as a key part of this process.

The Group does not use any form of forced, compulsory or child labour. The Universal Declaration of Human Rights of the United Nations is supported and the company respects human rights, the dignity and privacy of the individual and the right of employees to freedom of association, freedom of expression and the right to be heard.

Two-way Communication

Smith & Nephew looks forward to conducting its third bi-annual global opinion survey in 2004. Improved scores have been seen as a result of actions taken in response to previous surveys and it is the intention to once again respond to the issues raised by employees in the 2004 global opinion survey. This is an important measure of how the Group meets its values in practice and achieves continuous improvement in these areas.

The communications functions at Group Head Office, group research facility and within the global business units, work closely with human resources at each site on all forms of internal communication. As part of the new corporate brand launch, the linked business unit and corporate intranets have been improved. They allow easy two-way communication worldwide and increase people s awareness of financial, economic and market factors affecting Group performance.

Society and Community

The Group works with national and local governments and other organisations to meet its legal and civic obligations, manage its impact on the environment and contribute to the development of laws and regulations that affect its business interests. Smith & Nephew strives to be a good corporate citizen by being an active member of its local communities and by encouraging and supporting employees who undertake community work.

It supports a range of charitable causes, mainly at local level, by donations of money, gifts in kind and employee time. The Group recognises a strong obligation to contribute to the communities in which it operates. Examples of the programmes supported around its manufacturing sites can be found in the Performance section of the Sustainability Report on the Company s website.

In 2003, direct donations to charitable and community activities totalled £937,000 of which £300,000 went to the Smith & Nephew Foundation to fund research by individual nurses. Smith & Nephew made no political contributions in 2003.

Customers

The Group is committed to developing and delivering innovative, cost-effective solutions to provide benefits to healthcare professionals and their patients through improved treatment, ease and speed of product use and reduced healthcare costs. To underpin this commitment, it will continue to provide education and training support for healthcare professionals and maintain significant investment in research and development.

The Group s products are designed to be safe and reliable for their intended use and comply with or exceed all legal and regulatory requirements, including those concerning packaging, labelling and user instructions. The aim is to anticipate future standards and requirements so that the health and safety of its customers and patients is enhanced.

Business Partners

Smith & Nephew is committed to establishing mutually beneficial relationships with its suppliers, customers and business partners. The Group will only work with partners who it believes adhere to business principles and health, safety, social and environmental standards consistent with its own.

Economic Contribution

The Group business policies aim to achieve long-term growth and profits which in turn bring continued economic benefits to shareholders, employees, suppliers and local communities. Smith & Nephew s sustainable development depends ultimately on its ability to provide a satisfactory economic return. In 2003, the Group generated an operating return on capital employed (ratio of operating profit before goodwill amortisation and exceptional items to the average of opening and closing capital employed plus average net debt, as set out in the Five Year Record) of 32%.

Smith & Nephew continues to invest in research and development focused on delivering better outcomes for patients and improvements in application and use for practitioners. Importantly, the Group also aims to deliver overall cost savings to healthcare systems through such benefits as reduced dressing changes and shorter surgical operating times. Through the use of its products the Group seeks to reduce patients time in hospital and return them to health faster, improving their lives and potentially bringing broader social and economic benefits.

EMPLOYEES

Smith & Nephew had an average of 7,451 full-time equivalent employees in 2003, of whom 1,600 were located in the UK, 3,177 were located in the US and 2,674 were located in other countries. The Group does not employ a significant number of temporary employees.

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

	2003	2002	2001

		(numbers)	
Orthopaedics	2,727	2,649	2,494
Endoscopy	1,635	1,677	1,449
Advanced wound management	3,089	2,951	2,621
Ongoing operations	7,451	7,277	6,564
Operations contributed to the joint venture			846
Continuing operations	7,451	7,277	7,410
Discontinued operations		229	516
	7,451	7,506	7,926

Smith & Nephew conducts a company-wide employee opinion survey every two years to track and monitor employee attitudes at all locations. In 2002, response rates were 84% and the general level of employee satisfaction was 82%. Where the Group has collective bargaining arrangements in place with labour unions, these reflect local market circumstances and operate effectively.

Further information about Smith & Nephew employees, management principles and Vision and Values is set out in the sustainability report on the Smith & Nephew corporate website.

RISK FACTORS

There are risks and uncertainties related to Smith & Nephew s business. The factors listed below are those that Smith & Nephew believes could cause the Group s financial condition or results of operations to differ materially from expected and historical results. Factors other than those listed here, that Smith & Nephew cannot presently identify, could also adversely affect Smith & Nephew s business. The factors listed below should be considered in connection with any forward-looking statements in this report and the cautionary statements contained in Financial Summary Special Note Regarding Forward-Looking Statements .

Trends in Healthcare Expenditure

In most markets throughout the world, expenditure on medical devices is to a large extent ultimately controlled 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 controlled in most major markets largely by governmental reimbursement authorities. This control may be exercised by determining prices for an individual product or for an entire procedure. The Group is exposed to changes in reimbursement policy and pricing which may have an adverse impact on sales and operating profit.

In addition, 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, as well as among the Group s competitors, and these trends are expected to continue long term. 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 units which would adversely affect Smith & Nephew s results of operations and hinder its growth potential.

Currency Fluctuations

The Group reports its results in Sterling. However based on 2003 results, only 8% of group turnover arises in the UK compared with 54% in the Americas (comprising the US, Canada and Latin America), 23% in Continental Europe and 15% in Africa, Asia and Australia. Fluctuations in the exchange rates used to translate the financial statements of operations outside the UK into Sterling may have a material effect on the Group. If the Sterling exchange rate should strengthen against the US Dollar and/or Euro then group turnover and operating profit would be lower on translation into Sterling.

The Group s manufacturing cost base is situated in the US and UK from where 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 and Sterling and the currencies of the Group s selling operations, particularly the Euro and the Japanese Yen. If the US Dollar and/or Sterling should strengthen against the Euro and the Japanese Yen then group operating margin would be adversely affected.

Product Liability Claims and Loss of Reputation

The Group s products are not in life-support activities and are therefore unlikely to threaten patients lives. Nevertheless, these products could malfunction, causing damage to or impairing the repair of body functions. Smith & Nephew may become subject to liability, which could be substantial, because of actual or alleged malfunction of products sold by the Group or by companies it has acquired. In addition, product malfunction could also lead to the need to recall from the market existing products, which may be costly and harmful to the Group s reputation which is crucially dependent on product safety and efficacy. Product liability is a growing risk in the medical devices industry, particularly in the US, the Group s largest geographic market where claims for pain and suffering and loss of earnings may involve substantial amounts. There is a risk that patients will bring product liability or related claims that would have a material adverse effect on the Group s financial position. The potential exists for claimants to join together in a class action which would have the effect of increasing the total potential liability.

The Group maintains product liability insurance, but this insurance is subject to limits and deductibles. There is a risk that this insurance could become unavailable at a reasonable cost or at all, or will be inadequate to cover specific product liability claims. Insurance premiums are relatively high, particularly for coverage in the US, and there is a risk at the medical devices industry level that insurance coverage could become increasingly costly. If Smith & Nephew or any companies it acquires do not have adequate insurance, product liability claims and costs associated with product recalls, could significantly limit Smith & Nephew s available cash flow and negatively impact product sales from any associated loss of business.

Highly Competitive Markets

The Group s principal business units compete across a diverse range of geographic and product markets. The markets in which each of the three business units operates each contain 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 the Group s competitors focus on certain specialised products, while others are large, multinational corporations. Some of these competitors may have greater financial, marketing and other resources than Smith & Nephew. These competitors may be able to deliver products on more attractive terms, more aggressively market their products or invest larger amounts of capital and research and development into their businesses.

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

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 businesses. Failure to identify appropriate acquisition targets or failure to integrate them successfully would have an adverse impact on the Group s competitive position and profitability.

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 research and new product development and in the orthopaedics and endoscopy sales forces of which the largest are in the US. If Smith & Nephew is unable to retain key personnel in research and new product development or if its largest sales forces suffer disruption or upheaval, its sales and operating profit would be adversely affected.

Regulatory Approvals and Controls

The medical device industry is highly regulated. Regulatory requirements are a major factor in determining whether substances and materials can be developed into marketable products and the amount of time and expense that should be allotted to such development. At any time the Group is awaiting a number of regulatory approvals, which if not received, could adversely affect results of operations. Regulatory approval of new products and new materials is required in each country in which the Group operates although a single approval may be obtained for all countries within the European Union. Regulatory approval of new products may entail a very lengthy process particularly if materials are employed which have not previously been used in similar products. Regulatory approvals in the US, Japan, Europe and the UK are the most critical to the Group s success in launching new products.

The Group is required to comply with a wide range of regulatory controls over the manufacturing, testing, distribution and marketing of its products particularly in US, UK and Continental Europe. Such controls have become increasingly demanding and management believes that this trend will continue. Failure to comply with such controls could have a number of adverse consequences including withdrawal of approval to sell a product in a country or temporary closure of a manufacturing facility.

Patent Infringement Claims

Due to the technological nature of medical devices, the Group is subject to the potential for patent infringement claims. Smith & Nephew attempts to protect its intellectual property and regularly opposes third party patents and trademarks in those areas that might conflict with the Group s business interests. If Smith & Nephew fails to successfully enforce its intellectual property rights, its competitive position could suffer, which could harm its operating results. Claims asserted by third parties regarding infringement of their intellectual property rights, if successful, could require the Group to expend significant resources to pay damages, develop non-infringing products or to obtain licences to the products which are the subject of such litigation.

Continual Development and Introduction of New Products

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

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

Manufacturing and Supply

The Group s manufacturing production is concentrated at seven main facilities in Memphis, Tennessee, Andover and Mansfield, Massachusetts, Oklahoma City, Oklahoma, La Jolla, California and Largo, Florida in the United States and Hull in the United Kingdom. If major physical disruption took place at any of these sites, it would 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.

Each of the three business units is reliant on certain key suppliers of raw materials, components, finished products and packaging materials. These comprise principally metal forgings and stampings for orthopaedics, optical and electronic subcomponents for endoscopy and active ingredients and finished products for advanced wound management as well as packaging materials for all businesses. If any of these suppliers is unable to meet the Group s needs or substantially increases its prices, Smith & Nephew would need to seek alternative suppliers. For example, in 2003 the advanced wound management business was negatively impacted by supply issues for SANTYL, an enzymatic wound debrider and consequently appointed a new supplier, launching a new product, GLADASE. There can be no assurance that alternative suppliers would provide the necessary raw materials or components on favourable or cost-effective terms. Consequently, the Group may be forced to pay higher prices to obtain raw materials or components, 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 or components 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 or price increases caused by these or other factors could negatively impact Smith & Nephew s turnover and operating profit.

Medical Device Company Valuations

As a growth industry, medical device companies currently have higher stock market valuations than other industrial companies. If market conditions change, or other companies in the sector fail to perform, or the Group is perceived to be performing less well than the sector, then the share price rating of the Group may be adversely affected.

Political and Economic Uncertainties

Because the Group has operations in 32 countries, political and economic upheaval in those countries or in the regions surrounding those countries may impact the Group s results of operation. 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 investments in that country. Furthermore, legislative measures in a country could result in changes in tariffs, import quotas or taxation that could adversely affect the Group s turnover and operating profit. Terrorist activities and ongoing global political uncertainties, including conflict in the Middle East, could adversely impact the Group.

Other Risk Factors

The Board considers that Smith & Nephew is subject to a number of other risks which are common to most global groups and which are reviewed as part of its risk management process.

In the financial area these include interest rate volatility, challenges by taxation authorities, failures in reporting and internal financial controls and uninsured losses.

Adverse events in the areas of corporate social responsibility, environmental management and health and safety protection could also adversely impact Group operating results.

OPERATING AND FINANCIAL REVIEW,

LIQUIDITY AND PROSPECTS

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

The results for each year are compared primarily with the results for the preceding year.

BUSINESS OVERVIEW

Smith & Nephew s operations are organised into three core business segments that operate globally: orthopaedics, endoscopy and advanced wound management. These three businesses comprise the Group s Ongoing Operations . Smith & Nephew believes that its businesses have the opportunities for strong growth due to their markets benefiting from an ageing population, an increase in active lifestyles and trends toward less invasive medical procedures.

Sales by business segment as a percentage of sales of Ongoing Operations were as follows:

	2003	2002	2001
		(%)	
Orthopaedics	45	43	43
Endoscopy	25	27	27
Advanced wound management	30	30	30
Ongoing Operations	100	100	100

Sales by geographic market as a percentage of sales of Ongoing Operations were as follows:

	2003	2002	2001
		(%)	
Europe (Continental Europe and United Kingdom)	31	30	28
United States and Other America	54	56	57
Africa, Asia and Australia	15	14	15
Ongoing Operations	100	100	100

As a result of its global sales reach, Smith & Nephew s group turnover is primarily denominated in currencies other than its reporting currency, principally US Dollars and Euros. Sales in Sterling accounted for only 8% of group turnover in 2003 (2002 8%, 2001 7%). Consequently, fluctuations in the exchange rates between Sterling and the local currencies where the Group operates have a significant affect on group turnover.

Operating profit before goodwill amortisation and exceptional items by business segment as a percentage of operating profit before goodwill amortisation and exceptional items of Ongoing Operations were as follows:

	2003	2002	2001

		(%)	
Orthopaedics	54	50	52
Endoscopy	27	27	27
Advanced wound management	19	23	21
Ongoing Operations	100	100	100

Underlying Growth in Sales

Management s key indicator of sales performance is underlying growth in sales. This is calculated by excluding the effects of foreign currency translation movements and acquisitions (see Note 2(b) of the Notes to the Accounts). Management believes that sales growth on an underlying basis provides a consistent year-on-year measurement of performance without the distortions created by the translational effect of foreign currency movements and acquisitions which are separate from the Group s normal operations. Underlying sales growth is used by management in its internal financial reporting, budgeting and planning.

Reported growth in sales by business segment reconciles to underlying growth in sales in 2003 as follows:

	Reported growth in sales	Foreign currency translation effect	Acquisitions effect	Underlying growth in sales
	(%)	(%)	(%)	(%)
Orthopaedics	12	4		16
Endoscopy	3	3	(2)	4
Advanced wound management	10	(1)		9
Ongoing Operations	9	2		11

Reported growth in sales by business segment reconciles to underlying growth in sales in 2002 as follows:

	Reported growth in sales	Foreign currency translation effect	Acquisitions effect	Underlying growth in sales
	(%)	(%)	(%)	(%)
Orthopaedics	16	4		20
Endoscopy	15	4	(9)	10
Advanced wound management	13	2	(4)	11
Ongoing Operations	15	3	(4)	14

Reported growth in sales by geographic market reconciles to underlying growth in sales in 2003 as follows:

	Reported growth in sales	Foreign currency translation effect	Acquisitions effect	Underlying growth in sales
	(%)	(%)	(%)	(%)
Europe (Continental Europe and United Kingdom)	16	(6)		10
United States and other America	4	9	(2)	11
Africa, Asia and Australia	14	(3)		11
Ongoing Operations	9	2		11

Reported growth in sales by geographic market reconciles to underlying growth in 2002 as follows:

	Reported growth in sales	Foreign currency translation effect	Acquisitions effect	Underlying growth in sales
	(%)	(%)	(%)	(%)
Europe (Continental Europe and United Kingdom)	19	(3)	(4)	12
United States and other America	14	5	(4)	15
Africa, Asia and Australia	11	6	(1)	16
Ongoing Operations	15	3	(4)	14

Factors Affecting Smith & Nephew s Results of Operations

Sales Trends

Smith & Nephew s business units all participate in the global medical devices market and share a common focus on the repair of human tissue. Smith & Nephew operates predominantly in the well-developed healthcare markets of the Americas (54% of group turnover of which 51% is in the US), Europe (31% of group turnover) and Japan and Australia (9% of group turnover).

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

A recent trend has been increasing consumer awareness of available healthcare treatments through the Internet and direct-to-customer advertising. This has led to increased consumer influence over product purchasing decisions.

In orthopaedics, improvements in technology have lengthened the effective life of reconstructive implants and have facilitated the implantation of knees and hips in relatively young patients thereby improving the quality of life for a new generation. The decision to create separate divisions for orthopaedic reconstructive and trauma was a strategic move intended to generate greater customer focus. With experienced managers responsible for sales, marketing and product development in each, management believes that divisionalisation has resulted in increased sales momentum for Smith & Nephew in trauma in the US.

The endoscopy business is expected to benefit from the continued trend worldwide towards less invasive surgery but with particular focus on arthrosopic repair of the knee, hip and shoulder using a broad range of technology. The Group also expects to benefit from the demand for less invasive approaches to spinal disc repair.

The advanced wound management business is focused on the treatment of chronic wounds of the older population and other hard-to-heal wounds such as diabetic foot ulcers, burns and certain surgical wounds and is therefore also expected to benefit from demographic trends. The market for advanced wound treatments is relatively unpenetrated and it is estimated that the potential market is significantly larger than the current market of £1.6 billion. This increased penetration is expected to be driven by improved outcomes from new technology, health economic benefits, demographics, increasing nursing shortages, quality of life expectations and education of healthcare providers to convert from traditional to advanced treatments.

Sales Force

The Group s sales force, which includes independent commissioned sales agents, increased by 5% to 2,612 during 2003. The biggest increase was 11% in orthopaedics where the most significant increases were in the focus markets of the US at 13% and Japan at 17%. The size of the endoscopy sales force remained unchanged. The advanced wound management sales force increased by 4%, the main increases being in the US. The increase in the indirect market unit was 4%, principally due to increases in Spain and South Africa. Further sales force increases are planned in the US and Japan by orthopaedics, endoscopy and advanced wound management in 2004.

Currency Movements

Smith & Nephew s results of operations are significantly affected by exchange rate movements. A substantial proportion of its sales and operating expenses are earned and paid in currencies other than Sterling, the Group s reporting currency. Accordingly, the Group is subject to exposure arising from the translation of results of operations in foreign subsidiaries into Sterling for financial reporting purposes. In addition, the Group is subject to exposures arising from sales made in a currency different from the related costs and expenses. The Group attempts to manage the impact of exchange rate movements on cost of sales by a policy of purchasing forward all its foreign currency commitments when firm purchase orders are placed. In addition, businesses are required to purchase forward at least 50% of all of their forecast foreign currency requirements on a twelve-month rolling basis. The Group also incurs interest expense on its indebtedness denominated in currencies other than Sterling to the extent that other currencies, particularly the US Dollar and Euro, decline in value against the Sterling, Smith & Nephew s turnover and operating profit may be adversely affected offset by a reduction in the effective cost of servicing debt. See Financial Position, Liquidity and

Capital Resources.

2003 YEAR

The following discussion and analysis is based upon, and should be read in conjunction with, the Group Accounts of Smith & Nephew included elsewhere in this Annual Report. The Group s Accounts are prepared in accordance with UK GAAP, which differ in certain respects from US GAAP. Reconciliations reflecting the effect of the significant differences between UK GAAP and US GAAP are set forth in Note 40 of Notes to the Accounts.

Critical Accounting Policies

The Group s most significant accounting policies are set out in Note 1 of the Notes to the Accounts. Those policies which require the most use of management judgment are as follows:

Stocks

A feature of the orthopaedic business (whose finished goods stock makes up 47% of the Group total) is the high level of finished product stock required, some of which is located at customer premises and is available for customer s immediate use. Complete sets of finished product, including large and small sizes, have to be made available in this way. The 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 stock to anticipate this situation. These adjustments are calculated in accordance with a formula based on levels of stock 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 stock deployment, length of product lives, phase-out of old products and efficiency of manufacturing planning systems.

Intangible Fixed Assets

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

Post-Retirement Benefits

The cost of the Group s defined benefit pension plans are charged to operating profit so as to spread the expense of providing future pensions to employees over their remaining working lives with the Group, in accordance with SSAP 24. In this way, actuarial variations are charged or credited to operating profit over periods of ten to thirteen years. The principal assumptions used in calculating pension costs are set out in Note 33 of the Notes to the Accounts with the most critical being the return on investments and increase in pensionable earnings for the UK and US plans. If actual results should differ from these assumptions the Group s financial position or results of operations could be adversely affected. The currently optional alternative accounting treatment, FRS 17, which requires immediate recognition of actuarial variations direct to reserves, has not been adopted because management believes that it has the effect of overstating plan deficits since a short-term rate of interest is used to discount plan liabilities which are long-term in nature. If FRS 17 had been adopted a liability, net of related deferred tax, of £86.5m would have been recognised on the balance sheet compared with £1.7m under SSAP 24.

New Accounting Policies in 2003

The Group has adopted UK Urgent Issues Task Force Abstract 38. This has required the investment in own shares to be reclassified in the balance sheet and prior periods have been restated accordingly (see Note 27 of the Notes to the Accounts).

Financial Highlights of 2003

Group turnover was £1,178.9m for the year ended 31 December 2003, representing 6% growth compared to 2002. Underlying growth in sales of continuing operations was 11%.

Profit on ordinary activities before taxation was £230.1m, compared with £177.9m in 2002. Profit before taxation goodwill amortisation and exceptional items (calculated as set out in the Five Year Record), improved 15% to £242.2m.

Basic earnings per Ordinary Share were 15.92p, a 31% increase compared to 12.11p for 2002. Adjusted basic earnings per share Ordinary Share before goodwill amortisation and exceptional items (calculated as set out in the Five Year Record) was 18.49p compared to 16.02p for 2002, representing a 15% increase.

Fiscal 2003 Compared with Fiscal 2002

The following table sets out certain profit and loss account data for the periods indicated:

	2003	2002
	(£ million)	
Group turnover (i)	1,178.9	1,109.9
Cost of sales	(345.1)	(329.9)
Gross profit	833.8	780.0
Marketing, selling and distribution	(440.1)	(414.1)
Administration	(125.5)	(127.1)
Research and development	(66.8)	(61.3)
BSN agency and management fees	19.3	20.6
Operating profit before goodwill amortisation and exceptional items (ii)	220.7	198.1
Amortisation of goodwill	(18.5)	(17.5)
Exceptional items	(22.4)	(29.9)
Group operating profit	179.8	150.7
Share of operating profit of joint venture: before exceptional items	22.7	19.6
Share of operating profit of joint venture: exceptional items	(2.7)	(2.6)
Share of operating profit of associated undertaking	4.8	4.9
Net profit on disposals	31.5	18.0
Profit on ordinary activities before interest	236.1	190.6
Net interest payable	(6.0)	(12.7)
Profit on ordinary activities before taxation	230.1	177.9
Taxation	(82.0)	(65.8)
Attributable profit for the year	148.1	112.1

(i) Group turnover comprises £1,178.9m from Ongoing Operations (2002 £1,083.7m from Ongoing Operations and £26.2m from discontinued operations).

(ii) Operating profit before goodwill amortisation and exceptional items comprises £220.7m from Ongoing Operations (2002 £196.0m from Ongoing Operations and £2.1m from discontinued operations).

Group Turnover

For the year ended 31 December 2003, group turnover totalled £1,178.9m, an increase of 6% or £69.0m compared to £1,109.9 for 2002. Underlying growth of Ongoing Operations was 11%. Translation of foreign currencies had the effect of decreasing turnover by 2%, primarily due to the depreciation of the US Dollar against the pound sterling. The loss of revenues from the Group s discontinued rehabilitation business resulted in an adverse impact to the Group s turnover of £26.2m (3%). Selling price increases accounted for approximately 2% of the underlying sales growth.

Cost of Sales

Cost of sales at £345.1m represents 29.3% of sales compared to 29.7% in 2002. This improvement arose from manufacturing cost and efficiency savings and transactional currency benefits from the decline in the value of the US Dollar reducing the product cost in many countries outside the US, notably in Europe and Australia. The reduction in cost of sales would have been greater but for the acquisition, in late 2002, of the remaining DERMAGRAFT interests not already owned which increased the Group s production costs for this product.

Marketing, selling and distribution expenses

At £440.1m these costs represented 37.3% of sales, the same percentage as in 2002.

Administration Expenses

At £125.5m, administration expenses were 1.3% lower than in 2002 and represented 10.6% of sales compared with 11.5% of sales in 2002. Administration expenses were broadly kept level despite the increased sales.

Research and Development

Expenditure on research and development increased by £5.5m (9%) compared with 2002. This represented 5.7% of sales compared with 5.5% in 2002. Smith & Nephew continues to invest in innovative technologies and products to differentiate the group from its competitors. In 2003, 20% of Smith & Nephew s sales were from products introduced in the last three years.

BSN Medical Agency and Management Fees

Agency and management fees are received in respect of services provided to BSN Medical for sales force resource, physical distribution and logistics and administration in certain countries. The calculation of the fees is designed to result in a neutral, cost-recovery position for Smith & Nephew and is for a transitional period only. In 2003, recoveries fell by £1.3m (6%) as a number of the shared service arrangements expired and BSN Medical established its own stand-alone operations. This trend of lower agency fees is expected to continue as more BSN Medical entities exit the arrangements.

Operating Profit before Goodwill Amortisation and Exceptional Items

Operating profit before goodwill amortisation and exceptional items from Ongoing Operations was £220.7m, an increase of £24.7m compared to £196.0m in 2002, resulting from profit arising from additional sales together with cost and efficiency savings. These two factors more than offset an increase in pension costs of £7.3m due to the need to amortise the deficits of the Group s principal plans and increased DERMAGRAFT costs of £7.2m following the acquisition of 50% of the joint arrangement not already owned.

Operating profit margins before goodwill amortisation and exceptional items from Ongoing Operations improved from 18.1% to 18.7% of which 1.5% points was due to cost and efficiency savings and 0.3% points was due to transactional currency benefits offset partly by 0.6% points in respect of higher pension costs and 0.6% points from the effect of acquiring DERMAGRAFT.

Goodwill Amortisation

The amortisation charge on acquisition goodwill increased by £1.0m to £18.5m. The increase was due to a full years amortisation of ORATEC goodwill compared with nine months in 2002, offset partly by the translational currency effect of a weaker US Dollar.

Exceptional Items

Operating exceptional items were a net cost of £22.4m compared to a net cost of £29.9m in 2002. In 2003, £17.6m of net costs were incurred as a consequence of Smith & Nephew s unsuccessful public offers to purchase Centerpulse AG and InCentive Capital AG and £4.8m of costs arose on the integration of the ORATEC acquisition, principally in the relocation of manufacturing and development operations. Exceptional items in 2002 consisted of £17.5m for the writedown of the Group s trade investment in the common stock of ATS following its filing for bankruptcy, £4.0m for further rationalisation due to the contribution of businesses to BSN Medical and £8.4m for integration in connection with the acquisition of ORATEC and DERMAGRAFT.

Share of Operating Profit of the Joint Venture

The Group s share of operating profit before exceptional items increased by £3.1m from £19.6m in 2002 to £22.7m in 2003. Operating profit margins improved from 12.6% in 2002 to 13.8% in 2003 as a result of cost and efficiency savings arising from continuing manufacturing rationalisation.

The Group s share of exceptional items of £2.7m comprised manufacturing rationalisation costs.

Share of Operating Profit of Associated Undertaking

The Group s share of operating profit of AbilityOne up to the date of disposal on 12 September 2003 was £4.8m. In 2002 operating profit of £4.9m arose in the nine months following formation on 27 March 2002.

Net Profit on Disposals of Associated Undertaking

A net profit of £31.5m arose on the disposal of the Group s 21.5% equity interest in AbilityOne to Patterson Dental Inc., after writing off £8.2m of acquisition goodwill previously set-off against reserves and after charging £1.1m of adjustments in respect of previous disposals.

Net Interest Payable

Interest income increased by £4.4m from £6.6m in 2002 to £11.0m in 2003. Interest expense decreased by £2.0m from £16.8m in 2002 to £14.8m in 2003. The Group s share of the joint venture s and associated undertaking s net interest expense was £1.5m and £0.7m respectively compared with £1.6m and £0.9m respectively in 2002. Interest payable on currency swaps amounting to £18.5m was set off against interest receivable on swaps. Overall interest payable decreased by £6.7m to £6.0m due to lower average net debt during the year and lower US Dollar and Euro interest rates on borrowings and swap liabilities offset in part by lower Sterling interest rates on cash balances and swap assets.

Taxation

The taxation charge increased by £16.2m to £82.0m in 2003. The taxation charge on profit before goodwill amortisation and exceptional items was £70.2m an increase of £8.6m on the 2002 charge due to higher profits. The effective rate of taxation on profit before goodwill amortisation and exceptional items was 29.0% compared with 29.3% in 2002.

The taxation charge was reduced in 2003 by £3.5m as a consequence of the exceptional costs, by £0.8m from the exceptional costs in BSN Medical and increased by £16.1m as a result of the gain on disposal of AbilityOne.

Business Segment Analysis

Group sales by business unit and geographic market and operating profit by business unit are set out below:

	2003	2002
	(£ million)	
Sales by business segment		
Orthopaedics	525.4	470.2
Endoscopy	300.0	291.8
Advanced wound management	353.5	321.7
Ongoing Operations	1,178.9	1,083.7