

NOTES TO THE ACCOUNTS

1. Accounting Policies

The accounts have been prepared under the historical cost convention and in accordance with applicable UK accounting standards, include the disclosures required by Financial Reporting Standard 17 ("FRS 17") and comply with Urgent Issues Task Force Abstract 38 ("UITF 38").

Consolidation

The Group accounts include the accounts of Smith & Nephew plc (the "Company") and all the subsidiaries and associated undertakings during the year ended 31 December 2003 for the periods during which they were members of the Group. In these financial statements, "Group" means the Company and all its subsidiaries.

Entities in which the Group holds an interest on a long-term basis and which are controlled by the Group and one other under a contractual agreement are joint ventures. Joint ventures are included in the consolidated accounts under the gross equity method.

Entities 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 are associated undertakings. Associates are included in the consolidated accounts under the equity method.

Turnover

Turnover comprises sales of products and services to third parties at amounts invoiced net of trade discounts and rebates, excluding turnover taxes. Turnover from the sale of products and services is recognised upon transfer to the customer of the significant risks and rewards of ownership. This is generally when goods are dispatched to, or services performed for, customers except that sales of stock located at customer premises and available for customers' immediate use are recognised on notification that the product has been implanted or used. Appropriate provisions for returns, trade discounts and other allowances are deducted from turnover. Other turnover is recorded as earned or as services are performed.

Foreign Currencies

Balance sheet items of overseas companies and foreign currency borrowings are translated into sterling at the year-end rates of exchange. Profit and loss items and the cash flows of overseas subsidiary undertakings and associated undertakings are translated at the average rates for the year.

Forward currency contracts in respect of contracted and anticipated amounts payable on purchase transactions are accounted for as hedges with the hedge transaction recorded at the rate implicit in the contract. Changes in the fair value of these forward contracts are recognised in the profit and loss account on the ultimate sale of the item purchased.

The following are recorded as movements in reserves: exchange differences on the translation at closing rates of exchange of overseas opening net assets, including acquisition goodwill; the difference on translation of foreign currency borrowings or swaps that are used to finance or hedge Group equity investments; and the differences arising between the translation of profits at average and closing exchange rates. All other exchange differences are dealt with in arriving at profit before taxation.

Intangible Fixed Assets

Prior to 1 January 1998, goodwill representing the excess of purchase consideration over fair value of net assets acquired was set-off against reserves in the year of acquisition. Goodwill acquired since 31 December 1997 and other acquired intangibles are capitalised and amortised on a straight line basis over their estimated useful economic lives, between 3 and 20 years, except for goodwill arising on the formation of the BSN Medical joint venture and acquisition of the Group's share of the AbilityOne associated undertaking, which is not amortised but is subject to an annual impairment review. This treatment, which is a departure from the requirement of the Companies Act 1985 of Great Britain (the "Companies Act") to amortise goodwill, is adopted in order to show a true and fair view (See Note 16 and Note 17). Where applicable, goodwill previously set-off against reserves is deducted in the calculation of gains on disposal.

1. Accounting Policies — (continued)

The carrying value of goodwill and acquired intangibles is reviewed for impairment at the end of the first full financial year following acquisition and in other periods if significant events or changes in circumstances indicate the carrying value may be impaired.

Purchased patents, know-how, trademarks, licences and distribution rights are capitalised and amortised over their estimated useful lives of periods between 3 and 15 years.

The carrying values of intangibles are reviewed for impairment when events or changes in circumstances indicate the carrying value may be impaired.

Research and Development

Revenue expenditure on research and development is written off as incurred.

Tangible Fixed Assets

Tangible fixed assets are stated at cost less depreciation and provision for impairment where appropriate. Freehold land is not depreciated. Freehold and long leasehold buildings are depreciated on a straight-line basis at between 1% and 5% per annum. Short leasehold land and buildings (leases of under 50 years) are depreciated by equal annual instalments over the term of the lease. Plant and equipment is depreciated over lives ranging between three and 20 years by equal annual instalments to write down the assets to their estimated disposal value at the end of their working lives.

Finance costs relating to the purchase of fixed assets are not capitalised.

Leasing Commitments

Assets held under finance leases are capitalised as tangible fixed assets and depreciated accordingly. The capital element of future lease payments is included in borrowings and interest is charged to profit before taxation on a reducing balance basis over the term of the lease.

Rentals payable under operating leases are charged to the profit and loss account as incurred.

Investments

Trade investments are stated at cost less provision for any permanent diminution in value.

Stocks

Finished goods and work-in-progress are valued at factory cost, including appropriate overheads, on a first-in first-out basis. Raw materials are valued at purchase price. All stocks are reduced to net realisable value where lower than cost.

Orthopaedic instruments are generally not sold but loaned to customers and distributors for use in orthopaedic surgery. They are recorded as stock until they are deployed at which point they are transferred to fixed assets and depreciated over their useful lives.

Financial Instruments

Currency swaps to match foreign currency net assets with foreign currency liabilities are translated into Sterling at year-end exchange rates. Changes in the principal values of currency swaps are matched in reserves against changes in the values of the related assets. Interest rate swaps to protect interest costs and income are accounted for as hedges. Changes in the values of interest rate swaps are recognised against interest in the period relating to the hedge.

Deferred Taxation

Deferred taxation is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events have occurred at that date that will result in an obligation to pay more, or a right to pay less or to receive more, tax.

No provision is made for deferred tax that would arise on the remittance of the retained earnings of overseas subsidiaries, associates and joint ventures except to the extent that, at the balance sheet date, dividends have been accrued as receivable.

1. Accounting Policies — (continued)

Deferred tax assets are recognised only to the extent that the directors consider that it is likely that taxable income will be available against which future reversals of the underlying timing differences can be made.

Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences are expected to reverse. These are based on tax rates and laws substantively enacted at the balance sheet date.

Post-Retirement Benefits

The Group's major pension plans are of the defined benefit type. For these plans, costs are charged to operating profit so as to spread the expense of providing future pensions to employees over their working lives with the Group. For defined contribution plans, contributions are charged to operating profit as they become payable. Where the Group provides healthcare benefits after retirement, the expected cost of these is charged to operating profit over the employees' working lives with the Group.

Use of Estimates

The preparation of accounts requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2(a). Segmental Analysis — Information Required Under UK GAAP

	2003	2002	2001
		(£ million)	
Group turnover by activity			
Orthopaedics	525.4	470.2	404.6
Endoscopy	300.0	291.8	252.8
Advanced wound management	353.5	321.7	285.6
Ongoing operations	1,178.9	1,083.7	943.0
Operations contributed to the joint venture	—	—	35.3
Continuing operations	1,178.9	1,083.7	978.3
Discontinued operations	—	26.2	103.4
	<u>1,178.9</u>	<u>1,109.9</u>	<u>1,081.7</u>

Discontinued operations in 2002 comprise the results of the rehabilitation business up until its disposal in March 2002. In 2001 discontinued operations comprise the results of the rehabilitation business and the results of the ear, nose and throat business until its disposal in June 2001.

On 1 April 2001, the Group's casting and bandaging and traditional woundcare businesses were contributed to a joint venture with Beiersdorf AG called BSN Medical in return for a 50% equity interest. The results of these businesses prior to contribution represent operations contributed to the joint venture.

2(a). Segmental Analysis — Information Required Under UK GAAP — (continued)

	2003	2002	2001
	(£ million)		
Group turnover by geographic origin			
United Kingdom	196.9	179.6	162.9
Continental Europe	302.4	250.7	199.6
United States	723.5	702.1	641.3
Other America	33.4	28.6	31.8
Africa, Asia and Australasia	166.5	144.3	133.5
Ongoing operations	1,422.7	1,305.3	1,169.1
Operations contributed to the joint venture	—	—	35.3
Continuing operations	1,422.7	1,305.3	1,204.4
Discontinued operations	—	26.2	103.4
	1,422.7	1,331.5	1,307.8
Less: intragroup sales	(243.8)	(221.6)	(226.1)
	<u>1,178.9</u>	<u>1,109.9</u>	<u>1,081.7</u>
Group turnover by geographic market			
United Kingdom	98.7	87.3	77.5
Continental Europe	271.2	231.4	190.9
United States	595.6	579.4	502.1
Other America	36.7	31.1	32.8
Africa, Asia and Australasia	176.7	154.5	139.7
Ongoing operations	1,178.9	1,083.7	943.0
Operations contributed to the joint venture	—	—	35.3
Continuing operations	1,178.9	1,083.7	978.3
Discontinued operations	—	26.2	103.4
	<u>1,178.9</u>	<u>1,109.9</u>	<u>1,081.7</u>
Group operating profit by activity			
Orthopaedics	118.7	98.2	87.9
Endoscopy	59.5	53.8	46.8
Advanced wound management	42.5	44.0	36.1
Amortisation of goodwill	(18.5)	(17.5)	(10.4)
Exceptional items	(22.4)	(29.9)	(19.3)
Ongoing operations	179.8	148.6	141.1
Operations contributed to the joint venture: operating profit	—	—	3.6
Operations contributed to the joint venture: exceptional items	—	—	(1.8)
Continuing operations	179.8	148.6	142.9
Discontinued operations	—	2.1	11.1
	<u>179.8</u>	<u>150.7</u>	<u>154.0</u>

Items between Group operating profit of £179.8m (2002 — £150.7m, 2001 — £154.0m) and profit on ordinary activities before taxation of £230.1m (2002 — £177.9m, 2001 — £193.6m) comprise share of operating profit of the joint venture £20.0m (2002 — £17.0m, 2001 — £7.8m), share of operating profit of the associated undertaking of £4.8m (2002 — £4.9m, 2001 — nil), net profit on disposals of £31.5m (2002 — £18.0m, 2001 — £49.2m) and net interest payable of £6.0m (2002 — £12.7m, 2001 — £17.4m) which are not allocated segmentally.

Exceptional costs within Ongoing operations are allocated as follows: Orthopaedics £17.6m (2002 — £0.8m, 2001 — £0.6m), Endoscopy £4.8m (2002 — £7.6m, 2001 — £0.3m) and Advanced wound management nil (2002 — £21.5m, 2000 — £18.4m). Amortisation of goodwill of £18.5m (2002 — £17.5m, 2001 — £10.4m) within Ongoing operations arose as follows: Orthopaedics £4.1m (2002 — £4.7m, 2001 — £4.1m), Endoscopy £8.5m (2002 — £7.1m, 2001 — £1.0m) and Advanced wound management £5.9m (2002 — £5.7m, 2001 — £5.3m).

2(a). Segmental Analysis — Information Required Under UK GAAP — (continued)

	2003	2002	2001
	(£ million)		
Group operating profit by geographic origin			
United Kingdom	26.7	21.7	19.6
Continental Europe	35.3	21.1	18.0
United States	131.5	129.8	113.3
Other America	1.1	(0.7)	0.9
Africa, Asia and Australasia	26.1	24.1	19.0
Amortisation of goodwill	(18.5)	(17.5)	(10.4)
Exceptional items	(22.4)	(29.9)	(19.3)
Ongoing operations	179.8	148.6	141.1
Operations contributed to the joint venture: operating profit	–	–	3.6
Operations contributed to the joint venture: exceptional items	–	–	(1.8)
Continuing operations	179.8	148.6	142.9
Discontinued operations	–	2.1	11.1
	<u>179.8</u>	<u>150.7</u>	<u>154.0</u>

Ongoing operations exceptional costs of £22.4m were incurred as follows: £17.6m in the United Kingdom and £4.8m in the United States in 2003 (2002 — £29.9m: United Kingdom £1.5m, Continental Europe £2.4m, United States £25.8m, Other America £0.1m and Africa, Asia and Australasia £0.1m, 2001 — £19.3m: United Kingdom £11.7m, Continental Europe £5.1m, United States £1.5m and Africa, Asia and Australasia £1.0m). Nil was charged to Operations contributed to the joint venture in 2003 (2002 — nil, 2001 — £1.8m).

Amortisation of goodwill of £18.5m (2002 — £17.5m, 2001 — £10.4m) within Ongoing operations arose as follows: £1.3m (2002 — £1.2m, 2001 — £0.9m) in the United Kingdom, £2.6m (2002 — £2.1m, 2001 — £2.1m) in Continental Europe, £14.1m (2002 — £13.7m, 2001 — £6.9m) in the United States and £0.5m (2002 — £0.5m, 2001 — £0.5m) in Africa, Asia and Australasia.

	2003	Restated 2002	Restated 2001
	(£ million)		
Group operating assets by activity			
Orthopaedics	319.7	309.6	304.8
Endoscopy	248.9	275.0	130.9
Advanced wound management	233.5	222.5	223.2
Continuing operations	802.1	807.1	658.9
Discontinued operations	–	–	22.0
	<u>802.1</u>	<u>807.1</u>	<u>680.9</u>
Group operating assets by geographic origin			
United Kingdom	161.6	153.2	134.8
Continental Europe	72.4	70.6	69.4
United States	487.6	511.3	383.2
Other America	14.2	13.0	15.0
Africa, Asia and Australasia	66.3	59.0	56.5
Continuing operations	802.1	807.1	658.9
Discontinued operations	–	–	22.0
	<u>802.1</u>	<u>807.1</u>	<u>680.9</u>

Operating assets for 2002 and 2001 have been restated for the impact of UITF 38 (see Note 27).

Operating assets comprise fixed assets, stocks and debtors less creditors and provisions other than investment in the joint venture, investment in the associated undertaking, net debt, taxation and dividends.

2(b). Segmental Analysis — Information Required Under US GAAP

The following business and geographic segmental information is required by SFAS 131 — Disclosures about Segments of an Enterprise and Related Information and has been derived from the Group's management reports.

Group management reviews and monitors business unit performance by use of key performance indicators which differ in certain respects from the way results are reported in the Group Accounts which are determined by UK and US GAAP.

Business units report sales of Ongoing Operations only and at constant rates of exchange throughout a particular year. The effects of currency movements are excluded by setting at the beginning of each year exchange rates which remain constant throughout the year. These are termed the Management Rates ("MR") for the year. These are reset each year and prior year comparative data re-translated to the new rates. Additional sales brought in by acquisitions, for which there are no prior year comparatives, are excluded from the calculation of underlying sales growth which is management's key indicator of sales performance. In the tables below, underlying sales growth can be calculated by dividing current year turnover at MR by comparative prior year turnover at MR.

Business units report operating profit of Ongoing Operations before goodwill amortisation and exceptional items and at constant rates of exchange during the year.

Management believes its internal reporting measures are the most appropriate since they focus on underlying business performance and exclude the distorting effects of exchange rate translation and non-operating items. These measures are used in all financial reporting, budgets, planning and incentive plans.

Results in the Group Accounts are reported at the average rates for each year ("AR") (see Note 1 and Note 29).

The Group's business segments are the same as the activities analysed in Note 2(a).

	<u>Orthopaedics</u>	<u>Endoscopy</u>	<u>Advanced wound management</u>	<u>Ongoing Operations</u>
	(£ million)			
Turnover by business segment				
2003:				
Turnover at 2003 MR	524.1	291.7	345.3	1,161.1
Adjustment for 2002 acquisitions	–	6.9	–	6.9
Exchange difference	1.3	1.4	8.2	10.9
Turnover at 2003 AR	<u>525.4</u>	<u>300.0</u>	<u>353.5</u>	<u>1,178.9</u>
2002:				
Turnover at 2003 MR	451.0	281.0	316.8	1,048.8
Exchange difference	19.2	10.8	4.9	34.9
Turnover at 2002 AR	<u>470.2</u>	<u>291.8</u>	<u>321.7</u>	<u>1,083.7</u>
2002:				
Turnover at 2002 MR	476.2	274.7	308.8	1,059.7
Adjustment for 2002 acquisitions	–	21.5	–	21.5
Adjustment for 2001 acquisitions	–	–	10.9	10.9
Exchange difference	(6.0)	(4.4)	2.0	(8.4)
Turnover at 2002 AR	<u>470.2</u>	<u>291.8</u>	<u>321.7</u>	<u>1,083.7</u>
2001:				
Turnover at 2002 MR	398.4	249.7	278.3	926.4
Exchange difference	6.2	3.1	7.3	16.6
Turnover at 2001 AR	<u>404.6</u>	<u>252.8</u>	<u>285.6</u>	<u>943.0</u>

2(b). Segmental Analysis — Information Required Under US GAAP — (continued)

	Europe(i)	US and other America	Africa, Asia and Australasia	Ongoing Operations
	(£ million)			
Turnover by geographic market				
2003:				
Turnover at 2003 MR	356.2	636.1	168.8	1,161.1
Adjustment for 2002 acquisitions	—	6.9	—	6.9
Exchange difference	13.7	(10.7)	7.9	10.9
Turnover at 2003 AR	<u>369.9</u>	<u>632.3</u>	<u>176.7</u>	<u>1,178.9</u>
2002:				
Turnover at 2003 MR	323.7	572.7	152.4	1,048.8
Exchange difference	(5.0)	37.8	2.1	34.9
Turnover at 2002 AR	<u>318.7</u>	<u>610.5</u>	<u>154.5</u>	<u>1,083.7</u>
2002:				
Turnover at 2002 MR	301.8	608.7	149.2	1,059.7
Adjustment for 2002 acquisitions	—	21.5	—	21.5
Adjustment for 2001 acquisitions	7.1	2.9	0.9	10.9
Exchange difference	9.8	(22.6)	4.4	(8.4)
Turnover at 2002 AR	<u>318.7</u>	<u>610.5</u>	<u>154.5</u>	<u>1,083.7</u>
2001:				
Turnover at 2002 MR	268.3	530.0	128.1	926.4
Exchange difference	0.1	4.9	11.6	16.6
Turnover at 2001 AR	<u>268.4</u>	<u>534.9</u>	<u>139.7</u>	<u>943.0</u>

(i) Europe includes Continental Europe and the UK.

	Orthopaedics	Endoscopy	Advanced wound management	Ongoing Operations
	(£ million)			
Operating profit by business segment				
2003:				
Operating profit at 2003 MR	119.7	60.0	40.9	220.6
Exchange difference	(1.0)	(0.5)	1.6	0.1
Operating profit at 2003 AR	<u>118.7</u>	<u>59.5</u>	<u>42.5</u>	<u>220.7</u>
2002:				
Operating profit at 2003 MR	93.8	51.6	43.5	188.9
Exchange difference	4.4	2.2	0.5	7.1
Operating profit at 2002 AR	<u>98.2</u>	<u>53.8</u>	<u>44.0</u>	<u>196.0</u>
2002:				
Operating profit at 2002 MR	101.9	54.8	43.3	200.0
Exchange difference	(3.7)	(1.0)	0.7	(4.0)
Operating profit at 2002 AR	<u>98.2</u>	<u>53.8</u>	<u>44.0</u>	<u>196.0</u>
2001:				
Operating profit at 2002 MR	86.8	46.0	35.8	168.6
Exchange difference	1.1	0.8	0.3	2.2
Operating profit at 2001 AR	<u>87.9</u>	<u>46.8</u>	<u>36.1</u>	<u>170.8</u>

2(b). Segmental Analysis — Information Required Under US GAAP — (continued)

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Capital expenditure by activity			
Orthopaedics	42.0	47.4	42.6
Endoscopy	14.8	17.2	16.2
Advanced wound management	16.4	20.4	12.9
Ongoing operations	73.2	85.0	71.7
Operations contributed to the joint venture	—	—	1.0
Continuing operations	73.2	85.0	72.7
Discontinued operations	—	0.2	2.0
	<u>73.2</u>	<u>85.2</u>	<u>74.7</u>

Capital expenditure comprises additions of tangible and intangible fixed assets. In addition, in 2003, £0.6m of additions to trade investments related to Orthopaedics (2002 — £1.3m, 2001 — £2.4m).

Depreciation and amortisation by activity			
Orthopaedics	36.7	35.5	29.8
Endoscopy	22.5	19.8	11.3
Advanced wound management	19.1	18.3	16.0
Ongoing operations	78.3	73.6	57.1
Operations contributed to the joint venture	—	—	1.0
Continuing operations	78.3	73.6	58.1
Discontinued operations	—	0.6	2.2
	<u>78.3</u>	<u>74.2</u>	<u>60.3</u>

Amounts comprise depreciation of tangible fixed assets and amortisation of other intangible fixed assets and goodwill as follows:

Depreciation of tangible fixed assets	54.8	51.6	48.1
Amortisation of other intangible fixed assets	5.0	5.1	1.8
	59.8	56.7	49.9
Amortisation of goodwill	18.5	17.5	10.4
	<u>78.3</u>	<u>74.2</u>	<u>60.3</u>

3. Operating Profit

	2003		
	Continuing operations	Discontinued operations	Total
		(£ million)	
Turnover	1,178.9	–	1,178.9
Cost of sales	(345.1)	–	(345.1)
Gross profit	833.8	–	833.8
Marketing, selling and distribution	(440.1)	–	(440.1)
Administration	(125.5)	–	(125.5)
Research and development	(66.8)	–	(66.8)
BSN agency and management fees	19.3	–	19.3
Amortisation of goodwill	(18.5)	–	(18.5)
Exceptional items	(22.4)	–	(22.4)
Group operating profit	<u>179.8</u>	<u>–</u>	<u>179.8</u>

Exceptional items of £22.4m were incurred as follows: cost of sales £4.8m and administration £17.6m.

	2002		
	Continuing operations	Discontinued operations	Total
Turnover	1,083.7	26.2	1,109.9
Cost of sales	(313.6)	(16.3)	(329.9)
Gross profit	770.1	9.9	780.0
Marketing, selling and distribution	(408.5)	(5.6)	(414.1)
Administration	(125.0)	(2.1)	(127.1)
Research and development	(61.2)	(0.1)	(61.3)
BSN agency and management fees	20.6	–	20.6
Amortisation of goodwill	(17.5)	–	(17.5)
Exceptional items	(29.9)	–	(29.9)
Group operating profit	<u>148.6</u>	<u>2.1</u>	<u>150.7</u>

Exceptional items of £29.9m were incurred as follows: cost of sales £2.8m, marketing, selling and distribution £2.5m, administration £22.6m and research and development £2.0m.

	2001		
	Continuing operations	Discontinued operations	Total
Turnover	978.3	103.4	1,081.7
Cost of sales	(294.9)	(55.3)	(350.2)
Gross profit	683.4	48.1	731.5
Marketing, selling and distribution	(365.4)	(26.7)	(392.1)
Administration	(114.3)	(8.7)	(123.0)
Research and development	(49.3)	(1.6)	(50.9)
BSN agency and management fees	20.0	–	20.0
Amortisation of goodwill	(10.4)	–	(10.4)
Exceptional items	(21.1)	–	(21.1)
Group operating profit	<u>142.9</u>	<u>11.1</u>	<u>154.0</u>

Exceptional items of £21.1m were incurred as follows: cost of sales £9.5m, marketing, selling and distribution £6.6m, administration £4.6m and research and development £0.4m.

3. Operating Profit — (continued)

Operating profit is stated after charging/(crediting) the following items:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Amortisation of other intangible fixed assets	5.0	5.1	1.8
Depreciation of tangible fixed assets	54.8	51.6	48.1
Loss/(profit) on sale of fixed assets	1.9	2.7	(0.7)
Operating lease rentals for land and buildings	11.2	11.0	8.3
Operating lease rentals for other assets	10.9	9.8	9.7
Advertising costs	18.9	15.1	15.6

4. Exceptional Items

In 2003, operating exceptional items within continuing operations of £22.4m comprise £17.6m of costs, net of a break fee of £10.8m, written off as a consequence of the unsuccessful public offers to purchase Centerpulse AG and Incentive Capital AG and £4.8m of acquisition integration costs. The Group's share of exceptional items of the joint venture relates to its share of manufacturing rationalisation costs.

In 2002, operating exceptional items of £29.9m comprised £17.5m for the write-down of the Group's trade investment in the common stock of Advanced Tissue Sciences, Inc., £8.4m for the acquisition integration of ORATEC and Dermagraft and £4.0m for further rationalisation consequent on the contribution of businesses to BSN Medical in 2001. The Group's share of exceptional items of the joint venture related to its share of manufacturing rationalisation costs.

In 2001, operating exceptional items within Ongoing operations of £19.3m comprised £2.9m manufacturing rationalisation, £7.5m rationalisation consequent on the contribution of the businesses to BSN Medical and £8.9m integration in connection with the acquisition of the Advanced Woundcare business from Beiersdorf AG. Operating exceptional items of £1.8m within Operations contributed to the joint venture represented manufacturing rationalisation costs of operations subsequently contributed to BSN Medical. The Group's share of exceptional items of the joint venture related to its share of manufacturing rationalisation costs.

5. Net Profit and Loss on Disposals

Net cash consideration of £52.4m was received on the disposal of the 21.5% equity interest in AbilityOne Corporation (AbilityOne) to Patterson Dental Inc. in September 2003. A net profit of £31.5m arose after writing off £8.2m of acquisition goodwill previously set-off against reserves and £1.1m of adjustments in respect of previous disposals.

A net profit of £17.2m arose on the disposal of the rehabilitation business in March 2002 for a net cash consideration of £71.3m and a 21.5% equity interest in AbilityOne. The net profit consists of a gain of £47.2m less £30.0m of acquisition goodwill previously set-off against reserves. In addition, a net gain of £0.8m arose on adjustments in respect of previous disposals.

The net profit on disposal in 2001 of £49.2m related to the sale of the ear, nose and throat business in June 2001 for a net cash consideration of £61.7m.

6. Interest

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Interest payable:			
On bank borrowings	(14.2)	(16.2)	(17.5)
Other borrowings	<u>(0.6)</u>	<u>(0.6)</u>	<u>(1.5)</u>
	(14.8)	(16.8)	(19.0)
Interest receivable	11.0	6.6	2.5
Share of joint venture's net interest payable	(1.5)	(1.6)	(0.9)
Share of associated undertaking's net interest payable	<u>(0.7)</u>	<u>(0.9)</u>	<u>—</u>
Net interest payable	<u>(6.0)</u>	<u>(12.7)</u>	<u>(17.4)</u>

Interest payable on currency swaps of £18.5m (2002 — £23.3m, 2001 — £22.2m) has been set off against interest receivable.

7. Employees

The average number of employees during the year was:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(Number)		
United Kingdom	1,600	1,740	1,810
Continental Europe	1,317	1,279	1,281
United States	3,177	3,090	3,057
Other America	200	201	253
Africa, Asia and Australasia	<u>1,157</u>	<u>1,196</u>	<u>1,525</u>
	<u>7,451</u>	<u>7,506</u>	<u>7,926</u>

Staff costs during the year amounted to:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Wages and salaries	260.0	261.1	245.0
Social security costs	27.2	25.1	25.7
Other pension costs — (Note 33)	<u>21.6</u>	<u>14.3</u>	<u>10.4</u>
	<u>308.8</u>	<u>300.5</u>	<u>281.1</u>

Of the other pension costs £16.9m (2002 — £11.0m, 2001 — £7.8m) relates to defined benefit plans and £4.7m (2002 — £3.3m, 2001 — £2.6m) relates to defined contribution plans.

8. Directors' Emoluments

Aggregate emoluments of the directors, including pension entitlements of £126,000 (2002 — £106,000, 2001 — £81,000), were £2,119,000 (2002 — £1,823,000, 2001 — £1,685,000). The emoluments of the highest paid director excluding pension entitlement were £1,030,000 (2002 — £856,000, 2001 — £770,000). The accrued pension of the highest paid director at the end of the year was £195,000 (2002 — £153,000, 2001 — £119,000).

Information concerning individual directors' emoluments pension entitlements, shareholdings and share options is shown in the "Remuneration Report" on pages 56 to 58.

9. Taxation

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Current taxation:			
UK corporation tax at 30% (2002 — 30%, 2001 — 30%)	6.8	8.9	9.5
UK adjustments in respect of prior years	<u>0.5</u>	<u>(2.3)</u>	<u>(1.5)</u>
	7.3	6.6	8.0
Overseas tax	53.9	38.5	51.4
Overseas adjustments in respect of prior years	<u>3.6</u>	<u>(3.0)</u>	<u>3.6</u>
	57.5	35.5	55.0
Share of joint venture's tax charge	6.0	4.5	3.3
Share of associated undertaking's tax charge	<u>1.3</u>	<u>1.0</u>	<u>—</u>
Total current taxation	72.1	47.6	66.3
Deferred taxation:			
Origination and reversal of timing differences	17.1	14.6	(0.3)
Adjustments to estimated amounts arising in prior periods	(7.2)	3.0	(1.2)
Share of joint venture's deferred taxation	<u>—</u>	<u>0.6</u>	<u>(0.8)</u>
Total deferred taxation	9.9	18.2	(2.3)
	<u>82.0</u>	<u>65.8</u>	<u>64.0</u>

The tax charge was reduced by £4.3m in 2003, of which £0.8m arose in the joint venture, as a consequence of the exceptional costs relating to the rationalisation and acquisition integration costs and the unsuccessful public offers to purchase Centerpulse AG and Incentive Capital AG and increased by £16.1m as a result of the exceptional profit on disposal of the associated undertaking, leaving the tax charge on profits before exceptional items at £70.2m.

The tax charge was reduced by £12.7m in 2002, of which £0.6m arose in the joint venture, as a consequence of the exceptional costs of the write-off of the Advanced Tissue Sciences, Inc., investment and rationalisation and acquisition integration costs and increased by £16.9m as a result of the exceptional profit on disposal, leaving the tax charge on profits before exceptional items at £61.6m.

The tax charge was reduced by £6.0m in 2001, of which £1.4m arose in the joint venture, as a consequence of the exceptional costs of rationalisation and acquisition integration costs and increased by £17.7m as a result of the exceptional profit on disposal, leaving the tax charge on profits before exceptional items at £52.3m.

The standard rate of tax for the year is based on the United Kingdom standard rate of corporation tax of 30% (2002 — 30%, 2001 — 30%). The current and total tax charges differ from the standard rate as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(%)		
UK standard rate	30.0	30.0	30.0
Non-deductible/non-taxable items	(4.0)	3.1	(3.9)
Prior year items	1.8	(3.0)	1.1
Overseas income taxed at other than UK standard rate	7.8	6.9	5.8
Fixed asset timing differences	(2.7)	(3.3)	0.2
Other timing differences	<u>(1.6)</u>	<u>(6.9)</u>	<u>1.0</u>
Effective total current tax rate	31.3	26.8	34.2
Fixed asset timing differences	2.7	3.3	(0.2)
Other timing differences	<u>1.6</u>	<u>6.9</u>	<u>(1.0)</u>
Total tax rate	<u>35.6</u>	<u>37.0</u>	<u>33.0</u>

9. Taxation — (continued)

Factors that may Affect Future Total Tax Charges

Tax rates on the Group's overseas profits are generally higher than the UK corporation tax rate so changes in the proportion of profits earned overseas will affect the Group's effective tax rate over time. The current tax charge may also be affected by differences between tax allowances and book depreciation.

No deferred tax is recognised on unremitted earnings of overseas subsidiaries, associates and joint ventures. No significant additional tax charges are expected to arise on amounts that are planned to be remitted in the foreseeable future.

No provision has been made for deferred tax on gains recognised on the sale of assets where potentially taxable gains have been rolled over into replacement assets. Such tax would become payable only if the assets were sold without it being possible to claim rollover relief. The total amount unprovided for is £31.4m (2002 — £31.4m, 2001 — £31.4m). At present, it is not envisaged that any tax will become payable in the foreseeable future.

Deferred tax has not been recognised on approximately £26m of unrelieved losses (2002 — nil, 2001 — nil) due to the likelihood of insufficient future taxable profits.

10. Dividends

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Ordinary interim of 1.85p (2002 — 1.8p, 2002 — 1.75p) paid 12 September 2003	17.2	16.7	16.1
Ordinary final of 3.1p (2002 — 3.0p, 2001 — 2.9p) payable 14 May 2004	<u>28.9</u>	<u>27.9</u>	<u>26.8</u>
	<u>46.1</u>	<u>44.6</u>	<u>42.9</u>

Non-equity preference dividends amounting to £14,000 were paid in 2003 (2002 — £15,000, 2001 — £15,000).

11. Results Before Goodwill Amortisation and Exceptional Items

In order to provide a trend measure of underlying performance, profit before taxation is adjusted below to exclude goodwill amortisation and exceptional items, and earnings per share has been recalculated as set out in Note 12.

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Profit on ordinary activities before taxation	230.1	177.9	193.6
Adjustments:			
Continuing operations: goodwill amortisation	18.5	17.5	10.4
Continuing operations: exceptional items	22.4	29.9	21.1
Share of joint venture exceptional items	2.7	2.6	5.0
Discontinued operations: net profit on disposals	—	(18.0)	(49.2)
Net profit on disposal of associated undertaking	<u>(31.5)</u>	<u>—</u>	<u>—</u>
Profit before taxation, goodwill amortisation and exceptional items	242.2	209.9	180.9
Taxation on profit before goodwill amortisation and exceptional items — (Note 9)	<u>(70.2)</u>	<u>(61.6)</u>	<u>(52.3)</u>
Earnings before goodwill amortisation and exceptional items	<u>172.0</u>	<u>148.3</u>	<u>128.6</u>

12. Earnings per Ordinary Share

The calculation of basic earnings per Ordinary Share of 15.92p (2002 — 12.11p, 2001 — 14.07p) is based on profit on ordinary activities after taxation and preference dividends of £148.1m (2002 — £112.1m, 2001 — £129.6m) and on 930m Ordinary Shares (2002 — 926m, 2001 — 921m) being the weighted average number of shares in issue during the year. The calculation of diluted earnings per Ordinary Share is as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(Shares million, except per Ordinary Share amounts)		
Basic weighted average number of shares	930	926	921
Weighted average number of shares under option	19	19	20
Number of shares that would have been issued at fair value	<u>(13)</u>	<u>(12)</u>	<u>(12)</u>
Diluted weighted average number of shares	<u>936</u>	<u>933</u>	<u>929</u>
Diluted earnings per Ordinary Share	<u>15.82p</u>	<u>12.02p</u>	<u>13.95p</u>

The calculation of adjusted basic earnings per Ordinary Share is as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million, except per Ordinary Share amounts)		
Basic earnings	148.1	112.1	129.6
Continuing operations: goodwill amortisation	18.5	17.5	10.4
Continuing operations: exceptional items	22.4	29.9	21.1
Share of joint venture: exceptional items	2.7	2.6	5.0
Discontinued operations: net profit on disposals	—	(18.0)	(49.2)
Net profit on disposal of associated undertaking	(31.5)	—	—
Taxation on exceptional items	11.8	4.2	11.7
Adjusted basic earnings	<u>172.0</u>	<u>148.3</u>	<u>128.6</u>
Adjusted basic earnings per Ordinary Share	<u>18.49p</u>	<u>16.02p</u>	<u>13.96p</u>
Adjusted diluted earnings per Ordinary Share	<u>18.38p</u>	<u>15.89p</u>	<u>13.84p</u>

13. Intangible Fixed Assets

	<u>Goodwill</u>	<u>Other</u>	<u>Total</u>
	(£ million)		
Cost			
At 1 January 2002	177.2	45.3	222.5
Exchange adjustment	(27.0)	(4.5)	(31.5)
Acquisitions	167.7	9.7	177.4
Additions	–	4.2	4.2
Discontinued operations	–	(2.4)	(2.4)
At 31 December 2002	<u>317.9</u>	<u>52.3</u>	<u>370.2</u>
Exchange adjustment	(19.8)	(4.7)	(24.5)
Fair value adjustments — (Note 30)	2.4	(1.7)	0.7
Acquisitions — (Note 30)	0.1	0.3	0.4
Additions	–	1.5	1.5
Write back of deferred consideration — (Note 30)	(8.5)	–	(8.5)
At 31 December 2003	<u><u>292.1</u></u>	<u><u>47.7</u></u>	<u><u>339.8</u></u>
Amortisation			
At 1 January 2002	19.5	15.2	34.7
Exchange adjustment	(1.6)	(1.7)	(3.3)
Charge for the year	17.5	5.1	22.6
Discontinued operations	–	(1.0)	(1.0)
At 31 December 2002	<u>35.4</u>	<u>17.6</u>	<u>53.0</u>
Exchange adjustment	(2.6)	(2.2)	(4.8)
Charge for the year	18.5	5.0	23.5
Write back of deferred consideration — (Note 30)	(1.3)	–	(1.3)
At 31 December 2003	<u><u>50.0</u></u>	<u><u>20.4</u></u>	<u><u>70.4</u></u>
Net book amounts			
At 31 December 2003	<u><u>242.1</u></u>	<u><u>27.3</u></u>	<u><u>269.4</u></u>
At 31 December 2002	<u><u>282.5</u></u>	<u><u>34.7</u></u>	<u><u>317.2</u></u>

14. Tangible Fixed Assets

	Group		Group	Group	Group	Parent
	Land and buildings		Plant and equipment	In course of construction	Total	Plant and equipment
	Freehold	Leasehold				
	(£ million)					
Cost						
At 1 January 2002	62.1	11.9	450.0	24.6	548.6	22.0
Exchange adjustment	(3.6)	(0.2)	(20.9)	(2.1)	(26.8)	–
Acquisitions	–	0.1	4.8	0.4	5.3	–
Additions	0.1	0.1	38.1	42.7	81.0	1.6
Disposals	(1.8)	(0.2)	(21.1)	(0.1)	(23.2)	(3.5)
Transfers	5.3	2.3	27.5	(35.1)	–	–
Discontinued operations	(1.3)	(4.0)	(15.5)	(0.1)	(20.9)	–
At 31 December 2002	60.8	10.0	462.9	30.3	564.0	20.1
Exchange adjustment	(4.2)	(0.3)	(22.0)	(1.5)	(28.0)	–
Acquisitions	–	–	0.3	–	0.3	–
Additions	0.3	0.3	45.3	25.8	71.7	2.3
Disposals	(1.4)	(0.2)	(23.4)	–	(25.0)	(4.2)
Transfers	12.5	–	24.8	(37.3)	–	–
At 31 December 2003	<u>68.0</u>	<u>9.8</u>	<u>487.9</u>	<u>17.3</u>	<u>583.0</u>	<u>18.2</u>
Depreciation						
At 1 January 2002	14.7	4.3	284.6	–	303.6	13.8
Exchange adjustment	(0.9)	(0.2)	(13.3)	–	(14.4)	–
Charge for the year	1.3	0.3	50.0	–	51.6	1.5
Disposals	(1.7)	(0.2)	(17.5)	–	(19.4)	(3.2)
Transfers	(1.6)	0.5	1.1	–	–	–
Discontinued operations	(0.2)	(0.8)	(12.2)	–	(13.2)	–
At 31 December 2002	11.6	3.9	292.7	–	308.2	12.1
Exchange adjustment	(0.9)	(0.2)	(15.8)	–	(16.9)	–
Charge for the year	1.8	0.5	52.5	–	54.8	2.7
Disposals	(0.2)	(0.2)	(20.3)	–	(20.7)	(3.6)
At 31 December 2003	<u>12.3</u>	<u>4.0</u>	<u>309.1</u>	<u>–</u>	<u>325.4</u>	<u>11.2</u>
Net book amounts						
At 31 December 2003	<u>55.7</u>	<u>5.8</u>	<u>178.8</u>	<u>17.3</u>	<u>257.6</u>	<u>7.0</u>
At 31 December 2002	<u>49.2</u>	<u>6.1</u>	<u>170.2</u>	<u>30.3</u>	<u>255.8</u>	<u>8.0</u>

Group fixed assets include land with a cost of £5.9m (2002 — £6.0m) that is not subject to depreciation. The net book value of leases with less than 50 years to run amounted to £5.8m (2002 — £6.1m). Included in the amounts above are assets held under finance leases with a net book amount of £3.0m (2002 — £2.3m). There are no properties for resale in the Group (2002 — one property with a net book value of £1.1m).

15. Investments (restated — see note 27)

	Group	Parent
	Trade investments	Subsidiary undertakings
	(£ million)	
At 1 January 2002	23.2	413.9
Exchange adjustment	(1.5)	—
Additions	1.3	1,558.1
Disposals	—	(1,215.2)
Impairment	(18.0)	—
At 31 December 2002	<u>5.0</u>	<u>756.8</u>
Exchange adjustment	(0.6)	—
Additions	0.6	—
At 31 December 2003	<u><u>5.0</u></u>	<u><u>756.8</u></u>

The balance of £5.0m (2002 — £5.0m) comprises cost of £5.0m (2002 — £23.0m) less accumulated impairment of nil (2002 — £18.0m).

Principal subsidiary undertakings are listed on page 129. Trade investments are US dollar denominated. There is no material difference between the fair value and the carrying value of trade investments.

16. Investment in Joint Venture (BSN Medical)

	Group
	(£ million)
At 1 January 2002	114.0
Retained profit for the financial year	6.4
Debt repaid by the joint venture	(5.7)
Exchange adjustment	0.3
At 31 December 2002	<u>115.0</u>
Retained profit for the financial year	5.7
Exchange adjustment	0.9
At 31 December 2003	<u><u>121.6</u></u>

The investment in joint venture is represented by:

	2003	2002
	(£ million)	
Share of gross assets:		
Fixed	28.4	28.2
Current	76.4	78.0
Share of gross liabilities:		
Due within one year	(49.2)	(52.6)
Due after one year	(4.7)	(8.9)
	<u>50.9</u>	<u>44.7</u>
Goodwill	70.7	70.3
	<u><u>121.6</u></u>	<u><u>115.0</u></u>

Goodwill arising on the formation of the joint venture is considered to have an indefinite useful economic life and is capable of separate measurement since the joint venture operates independently of the Group. It operates in a mature sector of the medical devices industry, has high market shares, and long product life cycles. Significant barriers to entry exist in terms of technology, manufacturing know-how, regulatory compliance, market reputation and customer relationships. If the goodwill had been amortised over 20 years, operating profit would have been lower by £3.6m (2002 — £3.2m) and the investment in the joint venture would have been lower by £9.4m (2002 — £5.8m).

17. Investment in Associated Undertaking (AbilityOne)

	Group (£ million)
At 1 January 2002	—
Initial investment in associated undertaking	7.5
Retained profit for the financial year	3.0
Exchange adjustment	(2.0)
At 31 December 2002	8.5
Exchange adjustment	0.3
Retained profit for the financial year	2.8
Disposals	(11.6)
At 31 December 2003	—

The investment was disposed of in September 2003. At 31 December 2002 the investment of £8.5m consisted of goodwill of £15.4m less share of net liabilities of £6.9m.

Goodwill in the associated undertaking was considered to have an indefinite useful economic life and to be capable of separate measurement since the associated undertaking operated independently of the Group. It operated in the rehabilitation industry, had high market shares, and long product life cycles. Significant barriers to entry existed in terms of breadth of the product range, sales force size, physical distribution capabilities, key customer and professional relationships and market reputation. If the goodwill had been amortised over 20 years, operating profit would have been lower in 2003 by £0.6m and the profit on disposal of the associated undertaking would have been higher by £1.2m (2002 — operating profit and the investment in associated undertaking lower by £0.6m).

18. Stocks

	Group	
	2003	2002
	(£ million)	
Raw materials and consumables	37.8	42.0
Work-in-progress	10.3	12.9
Finished goods and goods for resale	182.5	174.6
	<u>230.6</u>	<u>229.5</u>

19. Debtors

	Group		Parent	
	2003	2002	2003	2002
	(£ million)			
Amounts falling due within one year:				
Trade and other debtors — gross debts	265.9	240.9	1.1	1.9
Less: non-returnable proceeds	(19.9)	(18.3)	—	—
Trade and other debtors — net	246.0	222.6	1.1	1.9
Amounts owed by subsidiary undertakings	—	—	1,483.3	1,418.5
Amounts owed by joint venture	2.4	2.3	0.5	0.5
Amounts owed by associated undertaking	—	0.5	—	—
Prepayments and accrued income	20.3	22.4	2.1	2.8
Debit balances on currency swaps	31.4	8.5	30.8	8.4
	<u>300.1</u>	<u>256.3</u>	<u>1,517.8</u>	<u>1,432.1</u>
Amounts falling due after more than one year:				
Deferred taxation	4.4	4.0	—	—
Pension prepayments — (Note 33)	7.1	5.3	—	—
Other debtors	1.5	2.3	—	—
Debit balances on currency swaps	21.4	12.8	20.8	12.6
	<u>334.5</u>	<u>280.7</u>	<u>1,538.6</u>	<u>1,444.7</u>

19. Debtors — (continued)

The Group utilises a debt factoring facility in Italy. The finance provider's agreement states that it cannot seek recourse in any form from the Group in the event of non-payment by the debtors. The Group is not obliged, and currently does not intend, to support any such losses. The gross amount of trade debtors factored without recourse is £19.9m (2002 — £18.3m). £0.9m (2002 — £0.9m) of factoring charges were recognised in the period.

Trade and other debtors are stated after deducting provisions for bad and doubtful debts of £7.3m (2002 — £7.0m).

Deferred tax assets of £4.4m (2002 — £4.0m) represent recoverable short-term timing differences.

Other debtors falling due after more than one year are non-interest bearing and denominated in various currencies. The fair value of these debtors is the same as book value.

20. Borrowings

	Group		Parent	
	2003	2002	2003	2002
	(£ million)			
Borrowings:				
Due within one year or on demand	96.9	151.9	67.2	127.2
Due after one year	99.6	164.2	98.3	162.3
	196.5	316.1	165.5	289.5
Cash and bank	(26.0)	(22.5)	(3.1)	(9.1)
Debit balances on currency swaps	(52.8)	(21.3)	(51.6)	(21.0)
Credit balances on currency swaps	9.4	4.6	9.4	4.6
Net debt	127.1	276.9	120.2	264.0

Borrowings are analysed as follows:

	Group		Parent	
	2003	2002	2003	2002
	(£ million)			
Bank loans and overdrafts	195.2	315.1	165.5	289.5
Other loans wholly repayable within five years	1.3	1.0	—	—
	196.5	316.1	165.5	289.5

20. Borrowings — (continued)

Borrowings are repayable as follows:

	Group	
	2003	2002
	(£ million)	
Within one year or on demand:		
Bank loans and overdrafts	96.4	151.5
Other loans	<u>0.5</u>	<u>0.4</u>
Total within one year or on demand	96.9	151.9
After one year:		
Bank loans and overdrafts:		
after one and within two years	25.6	57.2
after two and within three years	–	86.4
after three and within four years	73.2	–
after four and within five years	<u>–</u>	<u>20.0</u>
	98.8	163.6
Other loans:		
after one and within two years	0.4	0.3
after two and within three years	0.2	0.3
after three and within four years	0.1	–
after four and within five years	<u>0.1</u>	<u>–</u>
	0.8	0.6
Total after one year	<u>99.6</u>	<u>164.2</u>
	<u>196.5</u>	<u>316.1</u>

In addition to the above borrowings, other financial liabilities are nil (2002 — £0.3m, being 5 ½% cumulative preference shares without a fixed maturity as set out in Note 24).

The Board has established a set of policies to manage funding and currency risks. The Group only uses derivative financial instruments to manage the financial risks associated with underlying business activities and their financing. The Group's policy is to ensure that there is sufficient funding and facilities in place to meet foreseeable borrowing requirements.

Bank loans and overdrafts represent drawings under committed and uncommitted facilities of £358m and £231m, respectively. Of the undrawn committed facilities of £198m, £9m expire within one year and £189m after two but within five years (2002 — undrawn committed facilities: £199m of which £3m expire within one year and £196m after two but within five years). Borrowings secured on fixed and current assets were £1.2m (2002 — £0.9m). Balances on currency swaps and borrowings are shown at book value which is the same as fair value.

The Group and parent company have currency swaps which have maturities ranging from 2004 to 2006 and are translated at year end exchange rates. For the Group, gross sterling equivalents of £603.4m (2002 — £579.9m) receivable and £560.0m (2002 — £563.2m) payable have been netted. £52.8m is reported as debit balances on currency swaps and £9.4m as credit balances on currency swaps the net of which is a debit balance of £43.4m (2002 — £21.3m as debit balances on currency swaps and £4.6m as credit balances on currency swaps the net of which is a debit balance of £16.7m). For the parent company, gross sterling equivalents of £593.1m (2002 — £564.4m) receivable and £550.9m (2002 — £548.0m) payable have been netted. £51.6m is reported as debit balances on currency swaps and £9.4m as credit balances on currency swaps the net of which is a debit balance of £42.2m. (2002 — £21.0m as debit balances on currency swaps and £4.6m in credit balances on currency swaps the net of which is a debit balance of £16.4m). Currency swaps include forward foreign exchange contracts and are used for hedging foreign investments.

20. Borrowings — (continued)

Currency swaps mature as follows:

	Amount receivable (£ million)	Amount payable (Currency million)
At 31 December 2003		
Within one year:		
US Dollar	252.7	US\$397.8
Australian Dollar	18.2	Aus\$42.7
Euro	63.0	€95.8
Japanese Yen	20.9	Yen3,821
New Zealand Dollar	2.8	NZ\$8.0
Canadian Dollar	7.9	C\$17.5
	<u>365.5</u>	
After one year and within two years:		
US Dollar	49.7	US\$75.0
Euro	34.2	€50.0
	<u>83.9</u>	
After two years and within three years:		
US Dollar	119.9	US\$196.0
Euro	34.1	€50.0
	<u>154.0</u>	
	<u>603.4</u>	
At 31 December 2002:		
Within one year:		
US Dollar	151.2	US\$230.6
Australian Dollar	15.2	Aus\$42.7
Euro	90.1	€142.9
Japanese Yen	13.3	Yen2,571
New Zealand Dollar	2.5	NZ\$8.0
Canadian Dollar	7.1	C\$17.5
	<u>279.4</u>	
After one year and within two years:		
US Dollar	179.8	US\$273.2
Euro	37.8	€60.0
	<u>217.6</u>	
After two years and within three years (US Dollar)	53.4	US\$83.2
After three years and within four years (US Dollar)	29.5	US\$46.0
	<u>579.9</u>	

The majority of the Group's financial assets and liabilities, including currency swaps, are at floating interest rates relating to the currencies concerned. The Group uses simple floating to fixed rate contract interest rate swaps to protect borrowing costs and the differentials between borrowing and deposit rates. 79% of the interest costs and 84% of the interest income are protected through 31 December 2004, with some protection carrying over into 2005.

21. Financial Instruments

The Group's policy is to protect shareholders' funds by matching foreign currency assets, including acquisition goodwill, with foreign currency liabilities where practicable. These liabilities take the form of either borrowings or currency swaps. The Group also hedges forward its interest rate risk for up to two years using interest rate swap contracts.

21. Financial Instruments — (continued)

Short-term debtors and creditors are excluded from the following disclosures:

Currency and Interest Rate Profile of Interest Bearing Liabilities:

	Gross borrowings	Currency swaps	Total liabilities (£ million)	Floating rate liabilities	Fixed rate liabilities	Fixed rate liabilities	
						Weighted average interest rate (%)	Weighted average time for which rate is fixed (Years)
At 31 December 2003:							
US Dollar	152.9	373.6	526.5	50.0	476.5	2.3	1
Euro	7.9	138.0	145.9	23.3	122.6	2.9	1
Other	35.7	48.4	84.1	84.1	—	—	—
Total interest bearing liabilities	<u>196.5</u>	<u>560.0</u>	<u>756.5</u>	<u>157.4</u>	<u>599.1</u>		
At 31 December 2002:							
US Dollar	263.8	393.1	656.9	93.5	563.4	3.7	1
Euro	4.8	132.3	137.1	37.4	99.7	3.7	1
Other	47.5	37.8	85.3	85.3	—	—	—
Total interest bearing liabilities	<u>316.1</u>	<u>563.2</u>	<u>879.3</u>	<u>216.2</u>	<u>663.1</u>		

In addition to the above, the Group has a liability due after one year for deferred acquisition consideration (denominated in Euro) totalling £4.0m (2002 — £5.0m) on which no interest is paid (see Note 22).

Currency and Interest Rate Profile of Interest Bearing Assets:

	Cash and bank	Currency swaps	Total assets (£ million)	Floating rate assets	Fixed rate assets	Fixed rate assets	
						Weighted average interest rate (%)	Weighted average time for which rate is fixed (Years)
At 31 December 2003:							
Sterling	4.3	603.4	607.7	80.7	527.0	4.2	1
Other	21.7	—	21.7	21.7	—	—	—
Total interest bearing assets	<u>26.0</u>	<u>603.4</u>	<u>629.4</u>	<u>102.4</u>	<u>527.0</u>		
At 31 December 2002:							
Sterling	0.9	579.9	580.8	77.8	503.0	5.1	1
Other	21.6	—	21.6	21.6	—	—	—
Total interest bearing assets	<u>22.5</u>	<u>579.9</u>	<u>602.4</u>	<u>99.4</u>	<u>503.0</u>		

The above interest rate analysis includes the effect of interest rate swaps.

Floating rates on both assets and liabilities are typically based on the three-month LIBOR interest rate relevant to the currency concerned.

21. Financial Instruments — (continued)

At 31 December 2003, notional principal balances by currency and related interest rates under interest rate swap agreements were:

	Expected to mature in years ending 31 December		Fair value (£ million)
	2004	2005	
	(Currency million, except interest rates)		
At 31 December 2003			
Principal (Sterling)	£527	£188	(2.1)
Fixed rate receivable	3.9%	4.8%	
Variable rate payable	4.4%	4.8%	
Principal (US Dollar)	US\$853	US\$300	(3.3)
Fixed rate payable	2.0%	3.1%	
Variable rate receivable	1.4%	2.8%	
Principal (Euro)	€174	—	(0.8)
Fixed rate payable	2.9%	—	
Variable rate receivable	2.3%	—	

The fair values for interest rate swaps are calculated as the net present value of the future cash flows as at 31 December 2003, discounted at market rates of interest at that date.

At 31 December 2002, notional principal balances by currency and related interest rates under interest rate swap agreements were:

	Expected to mature in years ending 31 December		Fair value (£ million)
	2003	2004	
	(Currency million, except interest rates)		
At 31 December 2002:			
Principal (Sterling)	£503	£103	6.5
Fixed rate receivable	5.1%	4.8%	
Variable rate payable	3.9%	4.2%	
Principal (US Dollar)	US\$907	US\$180	(14.2)
Fixed rate payable	3.8%	3.0%	
Variable rate receivable	1.4%	2.4%	
Principal (Euro)	€153	€40	(1.1)
Fixed rate payable	3.4%	4.5%	
Variable rate receivable	2.7%	3.0%	

The fair values for interest rate swaps are calculated as the net present value of the future cash flows as at 31 December 2002, discounted at market rates of interest at that date.

Foreign Exchange

The Group uses forward foreign exchange contracts to hedge trading creditors and an element of anticipated purchases over the following 12 months. The principal currencies hedged by forward foreign exchange contracts are sterling and US Dollars. At 31 December 2003, the Group had contracted to exchange within one year the equivalent of £199m.

The Group's operating units hold no material unhedged monetary assets or liabilities other than in their functional operating currency. Therefore, there are no currency exposures on monetary assets and liabilities that could give rise to material gains or losses in the profit and loss account.

21. Financial Instruments — (continued)

Fair Value of Financial Assets and Liabilities

Forward foreign exchange contracts and interest rate swap contracts, taken out as hedges, are not marked to market. Gains and losses thereon are recognised only when the exposure that is being hedged is itself recognised. The following table sets out the book and fair values of the Group's derivative financial instruments. Market rates have been used to determine the fair values of interest rate swaps, currency swaps and forward contracts.

Derivative financial instruments held to manage interest rate and currency risk:

	31 December 2003		31 December 2002	
	Book value	Fair value	Book value	Fair value
	(£ million)			
Interest rate swaps	–	(6.2)	–	(8.8)
Forward foreign exchange contracts	–	(5.7)	–	(5.8)
Unrecognised gains and losses on hedges	–	(11.9)	–	(14.6)
Currency swaps	<u>43.4</u>	<u>43.4</u>	<u>16.7</u>	<u>16.7</u>

The fair value of primary financial instruments comprising cash and borrowings which are set out in Note 20 is the same as book value.

The following table shows the amount of unrecognised gains and losses which have been included in the profit and loss account for the year and those gains and losses which are expected to be included in next year's or later profit and loss accounts.

	Unrecognised gains	Unrecognised losses	Total net unrecognised gains/losses
	(£ million)		
Unrecognised gains and losses on hedges at 1 January 2002	8.9	(13.5)	(4.6)
Less: gains and losses arising in previous years that were expected to have been recognised in 2002	<u>(8.2)</u>	<u>13.2</u>	<u>5.0</u>
Gains and losses arising before 31 December 2001 that were not recognised in 2002	0.7	(0.3)	0.4
Gains and losses arising in 2002 that were not recognised in 2002	<u>7.9</u>	<u>(22.9)</u>	<u>(15.0)</u>
Unrecognised gains and losses on hedges at 31 December 2002	8.6	(23.2)	(14.6)
Less: gains and losses arising in previous years that were expected to have been recognised in 2003	<u>(8.1)</u>	<u>22.1</u>	<u>14.0</u>
Gains and losses arising before 31 December 2002 that were not recognised in 2003	0.5	(1.1)	(0.6)
Gains and losses arising in 2003 that were not recognised in 2003	<u>3.0</u>	<u>(14.3)</u>	<u>(11.3)</u>
Unrecognised gains and losses on hedges at 31 December 2003	<u>3.5</u>	<u>(15.4)</u>	<u>(11.9)</u>
Of which:			
Gains and losses expected to be recognised in 2004	3.5	(15.0)	(11.5)
Gains and losses expected to be recognised in 2005 or later	–	(0.4)	(0.4)
	<u>3.5</u>	<u>(15.4)</u>	<u>(11.9)</u>

22. Other Creditors

	Group		Parent	
	2003	2002	2003	2002
	(£ million)			
Amounts falling due within one year:				
Trade creditors	132.8	141.4	3.0	3.3
Amounts owed to subsidiary undertakings	–	–	1,741.7	1,467.9
Amounts owed to joint venture	3.4	4.2	–	–
Social security costs and other taxes	13.6	11.1	–	–
Accruals and deferred income (restated — Note 27)	52.7	51.2	7.6	11.9
Acquisition consideration	3.0	10.8	–	–
Current taxation	69.4	56.9	12.2	18.0
Ordinary share dividends	28.9	27.9	28.9	27.9
Credit balances on currency swaps	4.6	3.3	4.6	3.3
	<u>308.4</u>	<u>306.8</u>	<u>1,798.0</u>	<u>1,532.3</u>
Amounts falling due after one year:				
Acquisition consideration	4.0	5.0	–	–
Credit balances on currency swaps	4.8	1.3	4.8	1.3
	<u>8.8</u>	<u>6.3</u>	<u>4.8</u>	<u>1.3</u>

Group amounts falling due after more than one year are payable as follows: £5.6m in 2005 and £3.2m in 2006 (2002 — £2.8m in 2004, £1.7m in 2005 and £1.8m in 2006). Parent amounts falling due after one year are payable as follows: £3.6m in 2005 and £1.2m in 2006 (2002 — £1.3m payable in 2004).

23. Provisions for Liabilities and Charges

	Deferred	Rationalisation	Retirement	Other	Total
	taxation	and integration	healthcare	liability	
	(£ million)				
Group					
At 1 January 2002	55.4	21.3	9.2	9.4	95.3
Exchange adjustments	(2.3)	(0.3)	(0.5)	(0.5)	(3.6)
Profit and loss account — current year	14.6	13.4	0.8	2.2	31.0
Profit and loss account — prior years	3.0	–	–	–	3.0
Acquisitions	(15.2)	–	–	3.9	(11.3)
Movement in deferred tax asset	0.5	–	–	–	0.5
Utilisation	–	(22.8)	(0.1)	(3.9)	(26.8)
At 31 December 2002	56.0	11.6	9.4	11.1	88.1
Exchange adjustments	(2.7)	(0.3)	(0.4)	(0.6)	(4.0)
Profit and loss account — current year	17.1	6.0	1.1	2.6	26.8
Profit and loss account — prior years	(7.2)	–	–	–	(7.2)
Fair value adjustments — (Note 30)	(1.7)	–	–	2.8	1.1
Movement in deferred tax asset	0.4	–	–	–	0.4
Utilisation	–	(10.3)	(1.3)	(3.4)	(15.0)
At 31 December 2003	<u>61.9</u>	<u>7.0</u>	<u>8.8</u>	<u>12.5</u>	<u>90.2</u>

At 31 December 2003, rationalisation and integration provisions include acquisition integration of £2.6m (2002 — £3.9m). The deferred taxation and retirement healthcare provisions are long-term in nature, as is the timing of their utilisation. Rationalisation and integration and other liability provisions are expected to be substantially utilised within two years. There are no provisions for contractual amounts and hence none are treated as financial instruments.

The movement in provisions for liabilities and charges within the parent company during the year from £2.6m to £1.2m represents utilisation of provisions and changes in deferred taxation.

23. Provisions for Liabilities and Charges — (continued)

The provision for deferred taxation is made up as follows:

	Group		Parent	
	2003	2002	2003	2002
	(£ million)			
Goodwill timing differences	42.6	45.8	–	–
Other fixed asset timing differences	38.5	34.8	1.4	1.4
Other timing differences	(19.2)	(24.6)	(0.8)	(0.5)
	<u>61.9</u>	<u>56.0</u>	<u>0.6</u>	<u>0.9</u>

See Note 9 for information on deferred tax assets and liabilities for which no provision has been made.

24. Called Up Share Capital

	2003 Shares ('000)	2003 (£ million)	2002 Shares ('000)	2002 (£ million)	2001 Shares ('000)	2001 (£ million)
Authorised:						
Ordinary Shares 12½%p	1,223,591	149.5	1,223,591	149.5	1,223,591	149.5
5½% cumulative preference shares £1	–	–	450	0.5	450	0.5
		<u>149.5</u>		<u>150.0</u>		<u>150.0</u>
Allotted, issued and fully paid:						
Equity Capital: Ordinary Shares 12½%p:						
At 1 January	928,760	113.5	924,812	113.1	919,189	112.4
Share options	4,766	0.6	3,948	0.4	5,623	0.7
At 31 December	<u>933,526</u>	<u>114.1</u>	<u>928,760</u>	<u>113.5</u>	<u>924,812</u>	<u>113.1</u>
Non-equity capital: 5½% cumulative preference shares £1.00:						
At 1 January	269	0.3	269	0.3	269	0.3
Cancellation	(269)	(0.3)	–	–	–	–
At 31 December	<u>–</u>	<u>–</u>	<u>269</u>	<u>0.3</u>	<u>269</u>	<u>0.3</u>
Total called up share capital at 31 December		<u>114.1</u>		<u>113.8</u>		<u>113.4</u>

On 23 June 2003 the 5½% £1.00 cumulative preference shares were cancelled and in consideration the preference shareholders were paid £1.38 per share on 7 July 2003. The 5½% cumulative preference shares were denominated in sterling, were non-voting and carried preferential rights to dividends and distribution on winding up.

25 Share Option Plans

The Smith & Nephew Sharesave Plan (2002) (adopted by shareholders on 3 April 2002) is available to all employees in the UK employed by participating Group companies, subject to three months' service. The scheme provides for employees to save up to £250 per month and are given an option to acquire a set number of shares based on the committed amount to be saved. The option price is the higher of the nominal value and not less than 80% of the middle market quotation of the Ordinary Shares on the three dealing days preceding the date of invitation. The Smith & Nephew International Sharesave Plan (2002) is offered to employees in Australia, Austria, Canada, Denmark, Finland, Germany, Hong Kong, Italy, South Korea, Mexico, New Zealand, Norway, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland and the United Arab Emirates. Employees in Belgium, Italy, the Netherlands and France are able to participate respectively in the Smith & Nephew Belgian Sharesave Plan (2002), the Smith & Nephew Italian Sharesave Plan (2002), the Smith & Nephew Dutch Sharesave Plan (2002) and the Smith & Nephew France Sharesave Plan (2002). Participants in Ireland are able to participate in the Smith & Nephew Irish Employee Share Option Scheme. These plans operate on a substantially similar basis to the Smith & Nephew Sharesave Plan (2002). Options are no longer issued under the Smith & Nephew Employee Share Option Scheme (adopted by shareholders on 14 May 1981) and the Smith & Nephew 1991 Overseas Employee Share Option Scheme (adopted by shareholders on 25 May 1990) but options remain to be exercised under these two schemes. Together all of the plans referred to above are termed the "Employee Schemes".

The Smith & Nephew 1985 Share Option Scheme (adopted by shareholders on 9 May 1985), the Smith & Nephew 1990 International Executive Share Option Scheme (adopted by shareholders on 15 May 1990), the Smith & Nephew 2001 UK Approved Share Option Plan, the Smith & Nephew 2001 UK Unapproved Share Option Plan and the Smith & Nephew 2001 US Share Plan (adopted by shareholders on 4 April 2001), together termed the "Executive Schemes", are operated at the discretion of the Board of Directors.

Under the terms of the Executive Schemes, the Remuneration Committee, consisting of Non-Executive Directors, may select full-time employees of the Group for the grant of options to acquire Ordinary Shares in the Company. Options granted under the Smith & Nephew 2001 US Share Plan (the "US Plan") are to acquire ADSs. The option price will not be less than the market value of an Ordinary Share, or the nominal value if higher. The market value will be the quoted price on the business day preceding the date of grant or the quoted price on the date of grant. For Executive Schemes adopted in 2001, the market value will be the average quoted price of an Ordinary Share for the three business days preceding the date of grant or, for the US Plan, the average quoted price of an ADS for the three business days preceding the date of grant or the quoted price on the date of grant. With the exception of options granted under the 2001 US Plan, the exercise of options granted from 1997 are subject to achievement of a performance condition. Options granted under the 2001 US Plan are not subject to performance conditions but become exercisable as to 10% after one year, 30% after two years, 60% after three years and the remaining balance after four years. The 1990 International Executive Share Option Scheme and the 2001 UK Unapproved Share Option Plan are open to senior managers outside the UK and the 1990 International Executive Share Option Scheme and the US Plan are open to senior managers in the US, Canada, Mexico and Puerto Rico.

Under the Executive Schemes, the number of Ordinary Shares over which options may be granted is limited so that the number of shares issued or that may be issued under the Executive Schemes during the ten years preceding the date of grant shall not exceed 5% of the Ordinary Share capital at the date of grant. The total number of Ordinary Shares which may be issuable in any ten-year period under all employee share schemes operated by the Company may not exceed 10% of the Ordinary Share capital at the date of grant.

Employees in the US are able to participate in the Employee Stock Purchase Plan, which gives them the opportunity to acquire shares, in the form of ADSs, at a discount of 15% (or more if the shares appreciate in value during the plan's quarterly purchase period) to the market price, through a regular savings plan.

25. Share Option Plans — (continued)

At 31 December 2003 17,455,000 (2002 — 19,819,000) options outstanding under share option schemes were as follows:

<u>Employee Schemes</u>	<u>Number of shares</u> (000's)	<u>Range of option prices</u> (Pence)	<u>Weighted average option price</u> (Pence)
Outstanding at 1 January 2001	5,299	124.0 – 221.2	151.8
Granted	836	289.2	289.2
Exercised	(1,567)	124.0 – 156.0	141.4
Lapsed or cancelled	<u>(798)</u>	124.0 – 289.2	160.8
Outstanding at 31 December 2001	3,770	124.0 – 289.2	184.7
Granted	1,760	296.0 – 372.7	300.0
Exercised	(1,017)	124.0 – 304.0	144.2
Lapsed or cancelled	<u>(267)</u>	124.0 – 304.0	208.1
Outstanding at 31 December 2002	4,246	124.0 – 372.7	240.7
Granted	1,026	321.0 – 403.0	324.1
Exercised	(998)	124.0 – 304.0	154.7
Lapsed or cancelled	<u>(212)</u>	124.0 – 389.0	278.8
Outstanding at 31 December 2003	<u>4,062</u>	124.0 – 403.0	280.9
Of which options exercisable at 31 December 2003	<u>56</u>	124.0 – 221.2	184.3

Weighted average fair value of options granted:

During 2001	117.7
During 2002	109.1
During 2003	127.6

<u>Executive Schemes</u>	<u>Number of shares</u> (000's)	<u>Range of option prices</u> (Pence)	<u>Weighted average option price</u> (Pence)
Outstanding at 1 January 2001	16,563	133.0 – 270.0	152.1
Granted	2,846	326.0 – 375.0	361.6
Exercised	<u>(3,944)</u>	133.0 – 195.5	165.0
Outstanding at 31 December 2001	15,465	133.0 – 375.0	214.9
Granted	3,266	359.0 – 409.5	380.4
Exercised	(2,841)	143.0 – 327.7	161.6
Lapsed or cancelled	<u>(317)</u>	133.0 – 409.5	197.1
Outstanding at 31 December 2002	15,573	143.0 – 409.5	255.9
Granted	3,459	347.2 – 418.0	391.7
Exercised	(3,775)	143.0 – 382.3	191.3
Lapsed or cancelled	<u>(1,864)</u>	143.0 – 418.0	219.1
Outstanding at 31 December 2003	<u>13,393</u>	145.0 – 418.0	304.0
Of which options exercisable at 31 December 2003	<u>5,155</u>	145.0 – 331.8	208.5

Weighted average fair value of options granted:

During 2001	105.6
During 2002	106.2
During 2003	114.2

The weighted average fair values of options granted in 2003, 2002 and 2001 were calculated using the Black-Scholes option pricing model for traded options.

25. Share Option Plans — (continued)

The following assumptions were used in calculating the fair values of options granted for Employee Schemes: dividend yield of 1.1% (2002 — 1.3%, 2001 — 1.1%), expected volatility of 23.3% (2002 — 19.6%, 2001 — 19.4%), risk free interest rate of 4.6% (2002 — 4.5%, 2001 — 5.0%) and expected life of 3.6 years (2002 — 3.6 years, 2001 — 5.0 years).

The following assumptions were used in calculating the fair values of options granted for Executive Schemes: dividend yield of 1.1% (2002 — 1.3%, 2001 — 1.1%), expected volatility of 22.0% (2002 — 19.6%, 2001 — 19.4%), risk free interest rate of 4.6% (2002 — 5.2%, 2001 — 4.9%) and expected life of 5.6 years (2002 — 5.6 years, 2001 — 10.0 years).

Because options vest over several years and there are restrictions as to exercise and additional options grants are expected, the effects of these hypothetical calculations are not likely to be representative of similar future calculations.

Summarised information about options outstanding under the share option schemes at 31 December 2003 is as follows:

	Options outstanding			Options exercisable		
	Number outstanding (Thousand)	Weighted average remaining contract life (Years)	Weighted average option price (Pence)	Number exercisable (Thousand)	Weighted average option price (Pence)	Exercisable in stages up to
Employee Schemes:						
124.0p to 289.2p	1,413	2.6	227.8	56	184.3	2004
296.2p to 403.0p	2,649	3.3	309.3	—	—	—
	<u>4,062</u>			<u>56</u>		
Executive Schemes:						
145.0p to 296.1p	5,971	5.0	219.0	5,155	208.5	2004 to 2010
306.2p to 418.0p	7,422	6.3	372.3	—	—	—
	<u>13,393</u>			<u>5,155</u>		

As the employee schemes are UK Inland Revenue approved Save As You Earn schemes or similar schemes, the Company is exempt from accounting for the difference between the share option price and the market value at the grant date.

Until 31 December 2002 the Company used a qualifying employee share ownership trust ("QUEST") to acquire Smith & Nephew plc Ordinary Shares for the transfer to employees exercising options under the Smith & Nephew Employee Share Option Scheme. The QUEST was not used in 2003 and the Company does not intend to use it in the future. The trustee of the QUEST was Smith & Nephew Employees Trustees Limited, a wholly-owned subsidiary of the Company. During 2002, the QUEST subscribed for 950,317 shares at a cost of £2.3m and transferred a total of 950,317 shares to employees on the exercise of options for consideration of £1.4m. All employees of UK Group subsidiary companies, including Executive Directors of the Company, were potential beneficiaries under the QUEST.

26. Reserves

Group	2003		2002		2001	
	Share premium	Profit and loss account	Share premium	Profit and loss account	Share premium	Profit and loss account
	(£ million)					
At 1 January	143.8	262.5	135.8	158.3	125.4	29.9
Adjustment on adoption of UITF 38	–	–	–	–	–	3.0
Translation differences on foreign currency net investments	–	3.8	–	9.1	–	(8.8)
Retained profit for the year	–	102.0	–	67.5	–	86.7
Goodwill on disposals	–	8.2	–	30.0	–	–
Goodwill on operations contributed to the joint venture	–	–	–	–	–	17.9
Unrealised gain on formation of joint venture	–	–	–	–	–	31.8
Share based expense recognised in the profit and loss account	–	2.7	–	1.6	–	1.5
Cost of shares transferred to beneficiaries	–	(2.4)	–	(1.7)	–	(1.6)
Share options	8.2	–	8.0	–	10.4	–
Movements relating to the QUEST (Note 25)	–	–	–	(2.3)	–	(2.1)
At 31 December	<u>152.0</u>	<u>376.8</u>	<u>143.8</u>	<u>262.5</u>	<u>135.8</u>	<u>158.3</u>

Net exchange gains of £45.7m (2002 — gains of £68.2m) arising on foreign currency net borrowings are included within the £3.8m (2002 — £9.1m) translational differences on foreign currency net investments. The cumulative amount of goodwill charged to reserves is £275.8m (2002 — £292.3m) against which £116.0m of merger relief has been offset. The decrease is due to goodwill written back on the disposal of AbilityOne of £8.2m and exchange movements of £8.3m.

Parent Company	2003		2002		2001	
	Share premium	Profit and loss account	Share premium	Profit and loss account	Share premium	Profit and loss account
	(£ million)					
At 1 January	143.8	138.5	135.8	182.3	125.4	136.8
Adjustment on adoption of UITF 38	–	–	–	–	–	3.0
Retained (loss)/profit for the year	–	(67.2)	–	(40.8)	–	44.7
Share based expense recognised in the profit and loss account	–	2.4	–	1.0	–	1.5
Cost of shares transferred to beneficiaries	–	(1.7)	–	(1.7)	–	(1.6)
Share options	8.2	–	8.0	–	10.4	–
Movements relating to the QUEST (Note 25)	–	–	–	(2.3)	–	(2.1)
At 31 December	<u>152.0</u>	<u>72.0</u>	<u>143.8</u>	<u>138.5</u>	<u>135.8</u>	<u>182.3</u>

26. Reserves — (continued)

In accordance with the exemption permitted by Section 230(3) of the Companies Act 1985, the Parent Company has not presented its own profit and loss account. The attributable loss for the year dealt with in the accounts of the Parent Company is £21.1m (2002 — profit of £3.8m).

The profit and loss account in 2001 and 2002 in the Group and Parent Company have been restated for the adoption of UITF 38 (Note 27).

On 23 June 2003, following the cancellation of the 5½% £1.00 cumulative preference shares (Note 24), a capital redemption reserve of £0.3m was established in the Parent Company. This reserve was extinguished during 2003.

27. Own Shares

Own shares represent the holding of the parent company's own shares in respect of the Smith & Nephew Employees' Share Trust (Note 35).

	Group	Parent
	(£ million)	
At 1 January 2002	2.5	2.5
Shares purchased	2.4	2.4
Shares transferred to Group beneficiaries	(1.7)	(1.7)
At 31 December 2002	3.2	3.2
Shares purchased	1.3	1.3
Shares transferred to Group beneficiaries	(2.4)	(2.4)
At 31 December 2003	<u>2.1</u>	<u>2.1</u>

Adoption of UITF 38

The adoption of UITF 38 has required the investment in own shares and related long-term incentive plan ("LTIP") accrual to be reclassified in the balance sheet as a result of which prior period amounts have been restated as follows:

	Investments	Creditors: amounts falling due within one year	Profit and loss account	Shareholders' funds
	(£ million)			
<u>Group</u>				
2002 as previously reported	8.2	(309.6)	259.7	517.3
Adoption of UITF 38 at 1 January 2002	(2.5)	2.9	2.9	0.4
During year ended 31 December 2002	(0.7)	(0.1)	(0.1)	(0.8)
Adoption of UITF 38 at 31 December 2002	(3.2)	2.8	2.8	(0.4)
2002 restated	<u>5.0</u>	<u>(306.8)</u>	<u>262.5</u>	<u>516.9</u>

27. Own Shares — (continued)

	Investments	Creditors: amounts falling due within one year (£ million)	Profit and loss account	Shareholders' funds
<u>Parent</u>				
2002 as previously reported	760.0	(1,534.5)	136.3	393.9
Adoption of UITF 38 at 1 January 2002	(2.5)	2.9	2.9	0.4
During year ended 31 December 2002	(0.7)	(0.7)	(0.7)	(1.4)
Adoption of UITF 38 at 31 December 2002	(3.2)	2.2	2.2	(1.0)
2002 restated	<u>756.8</u>	<u>(1,532.3)</u>	<u>138.5</u>	<u>392.9</u>

There is no significant effect on the Group and Parent profit and loss accounts on adoption of UITF 38 so no restatements have been made.

28. Cash Flow Statement

Reconciliation of operating profit to net cash flow from operating activities

	2003	2002	2001
	(£ million)		
Group operating profit	179.8	150.7	154.0
Depreciation and amortisation	78.3	74.2	60.3
Loss/(profit) on sale of tangible fixed assets	1.9	2.7	(0.7)
Write-off of investment in Advanced Tissue Sciences, Inc.	–	17.5	–
Increase in stocks	(9.8)	(11.5)	(40.0)
Increase in debtors	(24.5)	(21.1)	(17.9)
(Decrease)/increase in creditors and provisions ⁽ⁱ⁾	(11.2)	(1.5)	37.8
Net cash inflow from operating activities ⁽ⁱⁱ⁾	<u>214.5</u>	<u>211.0</u>	<u>193.5</u>

(i) Includes £9.6m (2002 — £19.3m, 2001 — £23.5m) of outgoings on rationalisation, acquisition integration and divestment costs.

(ii) After £17.0m of Centerpulse costs in 2003.

Analysis of Net Debt

	Cash	Overdrafts	Borrowings due within one year	Borrowings due after one year	Net currency swaps	Total
	(£ million)					
At 1 January 2001	23.6	(7.2)	(61.6)	(165.1)	(26.0)	(236.3)
Net cash flow	4.1	3.3	(30.2)	7.4	14.0	(1.4)
Exchange adjustments	(1.3)	0.2	1.5	(3.5)	(2.7)	(5.8)
At 31 December 2001	26.4	(3.7)	(90.3)	(161.2)	(14.7)	(243.5)
Net cash flow	(4.0)	(8.9)	(70.6)	(18.1)	–	(101.6)
Exchange adjustments	0.1	0.3	21.3	15.1	31.4	68.2
At 31 December 2002	22.5	(12.3)	(139.6)	(164.2)	16.7	(276.9)
Net cash flow	3.0	0.8	47.4	52.9	–	104.1
Exchange adjustments	0.5	(0.1)	6.9	11.7	26.7	45.7
At 31 December 2003	<u>26.0</u>	<u>(11.6)</u>	<u>(85.3)</u>	<u>(99.6)</u>	<u>43.4</u>	<u>(127.1)</u>

28. Cash Flow Statement — (continued)

Reconciliation of Net Cash Flow to Movement in Net Debt

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Change in cash net of overdrafts in the year	3.8	(12.9)	7.4
Change in net currency swaps	—	—	14.0
Change in borrowings	<u>100.3</u>	<u>(88.7)</u>	<u>(22.8)</u>
Change in net debt from net cash flow	104.1	(101.6)	(1.4)
Exchange adjustments	<u>45.7</u>	<u>68.2</u>	<u>(5.8)</u>
Change in net debt in the year	149.8	(33.4)	(7.2)
Opening net debt	<u>(276.9)</u>	<u>(243.5)</u>	<u>(236.3)</u>
Closing net debt	<u><u>(127.1)</u></u>	<u><u>(276.9)</u></u>	<u><u>(243.5)</u></u>

29. Currency Translation

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

	Average rates		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
US Dollar	1.65	1.51	1.44
Euro	1.45	1.59	1.61
	Year-end rates		
	<u>2003</u>	<u>2002</u>	<u>2001</u>
US Dollar	1.79	1.61	1.46
Euro	1.42	1.53	1.64

30. Acquisitions

Acquisitions in 2003

There were no acquisitions in the year. The impact of additional and deferred consideration in the respect of previous years' acquisitions was:

	(£ million)
Tangible fixed assets	0.3
Intangible assets	<u>0.3</u>
	0.6
Goodwill	<u>0.1</u>
Additional consideration in respect of previous year's acquisitions	0.7
Deferred consideration in respect of previous acquisitions	<u>3.6</u>
Total cost of acquisitions	<u><u>4.3</u></u>

There was no material difference between the fair value and book value of net assets acquired.

£7.2m of deferred consideration, net of amortisation, relating to the Collagenase acquisition in 2000 has been written back to goodwill as it is no longer payable (Note 13).

30. Acquisitions — (continued)

Acquisitions in 2002

On 28 March 2002, the Group acquired ORATEC Interventions, Inc., ("ORATEC"), at a net cost of £191.2m in cash. Further fair value adjustments have been made in the first full financial period after acquisition.

Fair values of net assets acquired as reported in 2002 and as adjusted in 2003 including explanations for these changes are set out below:

	Net book value on acquisition	Fair value adjustments 2002	Provisional fair values 2002	Adjustment revaluation	Adjustment other	Final Fair values 2003
	(£ million)					
Net assets at date of acquisition:						
Fixed assets	6.5	(1.8)	4.7	—	—	4.7
Intangibles	2.4	—	2.4	(1.7) ⁽ⁱ⁾	—	0.7
Stock	4.5	0.3	4.8	—	—	4.8
Debtors	6.1	(0.2)	5.9	0.4 ⁽ⁱⁱ⁾	—	6.3
Creditors due within one year	(4.2)	0.6	(3.6)	—	—	(3.6)
Provisions	(3.9)	—	(3.9)	—	(2.8) ⁽ⁱⁱⁱ⁾	(6.7)
Deferred taxation	—	15.2	15.2	—	1.7 ^(iv)	16.9
Net assets	<u>11.4</u>	<u>14.1</u>	<u>25.5</u>	<u>(1.3)</u>	<u>(1.1)</u>	<u>23.1</u>
Goodwill arising on acquisition			<u>165.7</u>			<u>168.1</u>
			<u>191.2</u>			<u>191.2</u>
Discharged by:						
Cash consideration			222.5			
Cash acquired in ORATEC			(39.1)			
Costs associated with acquisition			7.8			
			<u>191.2</u>			

(i) Book value was used for the provisional fair value of certain intellectual property rights. On final evaluation it was considered that fair value was lower than book value at acquisition.

(ii) Adjustment to bad debt provision on final evaluation of debtors.

(iii) Change in estimate relating to the expected outcome of legal disputes.

(iv) Finalisation of tax losses brought forward and deferred tax on additional fair value adjustments.

The fair value adjustments in 2002 reflect the adoption of Group accounting policies and deferred taxation arising from available trading losses in the acquired entity.

The impact of other acquisitions, including deferred consideration in respect of previous year's acquisitions in the year was:

	Net book value
	(£ million)
Tangible fixed assets	0.6
Intangible assets	7.3
Current assets	3.7
Current liabilities	<u>(3.8)</u>
	7.8
Goodwill	<u>2.0</u>
Consideration	9.8
Associated undertaking formation costs	1.8
Deferred consideration in respect of previous year's acquisitions	<u>5.5</u>
Total cost of acquisition	<u>17.1</u>

£2.0m consideration was accrued in 2002 and paid in cash in 2003. There was no material difference between the fair value and book value of net assets acquired.

30. Acquisitions — (continued)

Acquisitions in 2001

The principal acquisitions during the year were Beiersdorf's advanced woundcare business acquired in April 2001 and the Acticoat business acquired in May 2001. The impact on the Group balance sheet of all acquisitions in the year was:

	Net book value
	(£ million)
Tangible fixed assets	3.1
Intangible assets	3.5
Current assets	3.3
	<u>9.9</u>
Goodwill	39.4
Consideration	49.3
Deferred consideration in respect of previous year's acquisitions	<u>20.0</u>
Total cost of acquisition	<u>69.3</u>

There was no material difference between the fair value and book value of net assets acquired.

31. Financial Commitments

Group capital expenditure contracted but not provided for amounted to £2.6m (2002 — £4.3m).

Under the Group's acquisition and joint development agreements with NUCRYST Pharmaceuticals Corp., amounts of up to £4.2m (2002 — £4.7m) could become payable on achievement of certain milestones related to regulatory and reimbursement approvals with a further £25.1m (2002 — £28.0m) contingent on achievement of sales milestones.

At 31 December 2003, the Group was committed to making the following payments during 2004:

	Land and buildings		Other assets	
	2003	2002	2003	2002
	(£ million)			
Operating leases which expire:				
Within one year	2.0	1.6	2.6	1.8
After one and within five years	3.4	3.6	7.0	7.2
After five years	<u>4.9</u>	<u>5.0</u>	<u>—</u>	<u>—</u>
	<u>10.3</u>	<u>10.2</u>	<u>9.6</u>	<u>9.0</u>

32. Contingent Liabilities

	Group 2003	Group 2002	Parent 2003	Parent 2002
	(£ million)			
Guarantees in respect of subsidiary undertakings	<u>—</u>	<u>—</u>	<u>9.9</u>	<u>30.8</u>

The parent has given guarantees to banks to support liabilities under foreign exchange contracts and cross guarantees to support overdrafts. Such guarantees are not considered to be liabilities as all subsidiary undertakings are trading as going concerns.

The Group is party to legal proceedings, in the normal course of business, which it is considered will not result in any material adverse effect on the Group's results of operations or financial position.

33. Post-Retirement Benefits

The Group sponsors pension plans for its employees in most of the countries in which it has major operating companies. Pension plans are established under the laws of the relevant country, funded by the payment of contributions to, and the assets held by, separate trust funds or insurance companies. In those countries where there is no company-sponsored pension plan, state benefits are considered adequate. Employees' retirement benefits are the subject of regular management review.

For many years, the Group's major pension plans in the United Kingdom ("UK Plan") and the United States ("US Plan") were of the defined benefit type. However, from 2003 all new employees were provided with a defined contribution pension plan. Existing employees were given the opportunity to choose whether to remain in their existing plan or change to the new arrangements.

The pension cost for the UK Plan and the US Plan has been determined by independent qualified actuaries, using the projected unit method. Under the projected unit method, the current service cost will increase as the members of the defined benefit plans approach retirement. The market related actuarial assumptions at the valuation dates and a breakdown of the pension costs are as follows:

Actuarial assumptions:

	UK Plan	US Plan
	(% per annum, except service lives)	
Increase in pensionable earnings	4.3	5.0
Increase in pensions	2.3	Nil
Inflation	2.3	3.0
Return on investments	6.8	8.0
Average remaining service lives	10 years	13 years

Pension costs:

	2003	2002	2001
	(£ million)		
Principal plans in the UK and the US:			
Regular cost	8.3	9.8	8.6
Variations from regular cost ⁽ⁱ⁾	5.1	(1.9)	(2.9)
Cost of former employees	–	–	(1.0)
Notional interest on prepayment	0.8	(0.1)	(0.2)
	14.2	7.8	4.5
Other plans	7.4	6.5	5.9
	<u>21.6</u>	<u>14.3</u>	<u>10.4</u>

(i) Variations from regular costs arise from the surplus/deficit in the two principal plans and are amortised using the percentage of payroll method over the weighted average of expected pensionable payroll and remaining service lives of current employees in the plans.

At the dates of the most recent actuarial valuations for the purposes of SSAP 24 in September and December 2002, the aggregate market value of the assets of the UK Plan and the US Plan was £230m (2002 — £268m: valuations in September and December 2001) representing 78% of plan liabilities for accrued benefits, including allowance for projected future increases in salaries, resulting in a net deficit of £64.5m (2002 — 93% and a net deficit of £19.8m). The estimated deficit of these plans at 31 December 2003 was £55m (2002 — £80m).

The unamortised balance of the UK Plan and US Plan deficits was £70.1m (2002 — deficit £20.8m).

The contributions made to the UK Plan and the US Plan in the accounting period were £8.5m (2002 — £2.6m) and £10.4m (2002 — £5.2m), respectively. The agreed contribution rates for 2004 and 2005 are 11% of pensionable earnings plus a supplementary payment of £4.3m in each year to the UK Plan and 7% of pensionable earnings plus a supplementary payment of £10m in 2004 to the US Plan.

33. Post-Retirement Benefits — (continued)

Included in debtors due after more than one year are prepayments of £7.1m (2002 — £5.3m) and included in creditors are accruals due within one year of £4.0m (2002—£6.4m) relating to the funding of certain Group pension plans.

The Group recharges the UK pension plan with the costs of administration and independent advisers. The amount recharged in the year was £0.6m (2002 — £0.4m, 2001 — £0.7m). The amount receivable at 31 December 2003 was £0.1m (2002 — £0.1m).

The cost of providing healthcare benefits after retirement of £1.1m (2002 — £0.8m, 2001 — £0.1m) are determined by independent qualified actuaries. The unfunded liability of £8.8m (2002 — £9.4m) in respect of the accrued healthcare benefits is included in provisions. The principal actuarial assumptions in determining the cost of providing healthcare benefits are those in the UK and the US:

	2003		2002	
	UK	US	UK	US
	(% per annum)			
Interest rate	5.4	6.0	5.6	7.0
Medical cost inflation	6.4	7.5	6.6	8.0

34. Post-Retirement Benefits (FRS 17)

The disclosures below show the effect on the Group's financial statements had FRS 17 been adopted and relate to the major defined benefit retirement plans in the UK and the US. Other plans are not material.

The principal assumptions used by the independent qualified actuaries in valuing the UK and US plans at 31 December for FRS 17 purposes were:

	2003		2002		2001	
	UK Plan	US Plan	UK Plan	US Plan	UK Plan	US Plan
	(% per annum)					
Increase in pensionable earnings	4.8	5.0	4.3	5.0	4.0	5.0
Increase in pensions	2.6	Nil	2.3	Nil	2.5	Nil
Inflation	2.8	3.0	2.3	3.0	2.5	3.0
Discount rate	5.4	6.0	5.6	7.0	6.0	7.1

The assets and liabilities in the plans and the expected rates of return on investments were:

	31 December 2003			
	UK Plan		US Plan	
	Rate of Return	Value	Rate of Return	Value
	(%)	(£ million)	(%)	(£ million)
Equities	7.8	143.7	9.0	48.2
Government bonds	4.8	32.4	5.7	6.9
Corporate bonds	5.4	—	6.6	6.1
Property	6.6	10.1	—	—
Other	5.1	6.9	3.7	1.8
Market value of assets		193.1		63.0
Present value of liabilities		(253.0)		(124.3)
Deficit		(59.9)		(61.3)
Post-retirement healthcare		(3.6)		(6.4)
		(63.5)		(67.7)
Related deferred tax asset		19.0		25.7
Net retirement benefit liability		(44.5)		(42.0)

34. Post-Retirement Benefits (FRS 17) — (continued)

	31 December 2002			
	UK Plan		US Plan	
	Rate of Return	Value	Rate of Return	Value
	(%)	(£ million)	(%)	(£ million)
Equities	7.8	114.3	8.7	34.4
Government bonds	4.5	34.0	5.8	8.0
Corporate bonds	5.6	—	7.0	7.0
Property	6.2	9.6	—	—
Other	5.0	7.0	4.2	1.1
Market value of assets		164.9		50.5
Present value of liabilities		(221.4)		(105.2)
Deficit		(56.5)		(54.7)
Post-retirement healthcare		(3.3)		(7.0)
		(59.8)		(61.7)
Related deferred tax asset		17.9		23.4
Net retirement benefit liability		(41.9)		(38.3)

	31 December 2001			
	UK Plan		US Plan	
	Rate of return	Value	Rate of return	Value
	%	(£ million)	%	(£ million)
Equities	9.0	149.1	10.0	42.8
Government bonds	4.9	36.0	5.5	8.4
Corporate bonds	6.0	—	7.1	6.8
Property	6.9	9.4	—	—
Other	5.8	6.6	2.5	4.8
Market value of assets		201.1		62.8
Present value of liabilities		(190.2)		(103.8)
Surplus/(deficit) of pension plans		10.9		(41.0)
Post-retirement healthcare		(3.1)		(7.4)
		7.8		(48.4)
Related deferred tax (liability)/asset		(2.3)		18.4
Net retirement benefit asset/(liability)		5.5		(30.0)

The Group's shareholders' funds and profit and loss account at 31 December would have been as follows:

	2003		2002	
	Shareholders' funds	Profit and loss account	Shareholders' funds	Profit and loss account
		(£ million)		
As reported (restated — Note 27)	640.8	376.8	516.9	262.5
Provided under SSAP 24	2.8	2.8	7.8	7.8
Less: related deferred tax	(1.1)	(1.1)	(3.0)	(3.0)
	642.5	378.5	521.7	267.3
FRS 17 net retirement liability above	(86.5)	(86.5)	(80.2)	(80.2)
As adjusted for FRS 17	556.0	292.0	441.5	187.1

34. Post-Retirement Benefits (FRS 17) — (continued)

The following amounts would have been charged to operating profit:

	2003			2002		
	UK Plan	US Plan	Total	UK Plan	US Plan	Total
	(£ million)					
Current service cost — employer's portion . . .	6.5	4.6	11.1	5.9	5.2	11.1
Past service cost	—	—	—	0.1	—	0.1
Total operating charge	<u>6.5</u>	<u>4.6</u>	<u>11.1</u>	<u>6.0</u>	<u>5.2</u>	<u>11.2</u>

The following amounts would have been charged/(credited) to other finance costs:

	2003			2002		
	UK Plan	US Plan	Total	UK Plan	US Plan	Total
	(£ million)					
Interest cost	12.3	7.1	19.4	11.4	7.1	18.5
Expected return on assets in the plan	(11.4)	(4.2)	(15.6)	(16.2)	(5.3)	(21.5)
Net finance cost/(credit)	<u>0.9</u>	<u>2.9</u>	<u>3.8</u>	<u>(4.8)</u>	<u>1.8</u>	<u>(3.0)</u>

The combined operating and finance costs that would have been charged in 2003 under FRS 17 of £14.9m compares with the cost under SSAP 24 of £14.2m (2002 — FRS 17 amount of £8.2m compares with the cost under SSAP 24 of £7.8m).

The following amounts would have been included in the statement of total recognised gains and losses:

	2003		2002	
	UK Plan	US Plan	UK Plan	US Plan
Differences between expected and actual return on assets				
Amount (£ million)	16.9	7.5	(47.9)	(13.9)
Percentage of plan assets	8.8%	11.9%	29.0%	27.5%
Experience gains and losses on the plan liabilities				
Amount (£ million)	0.2	(1.7)	(2.5)	(1.1)
Percentage of plan liabilities	0%	1.4%	1.1%	1.0%
Effects of changes in demographic and financial assumptions underlying the present value of the plan liabilities				
Amount (£ million)	(21.6)	(21.9)	(18.6)	(1.9)
Actuarial loss recognised in the statement of total recognised gains and losses				
Amount (£ million)	<u>(4.5)</u>	<u>(16.1)</u>	<u>(69.0)</u>	<u>(16.9)</u>
Percentage of plan liabilities	<u>1.8%</u>	<u>13.0%</u>	<u>31.2%</u>	<u>16.1%</u>

The following table reconciles the movement in the plans' surplus/(deficit):

	2003		2002	
	UK Plan	US Plan	UK Plan	US Plan
	(£ million)			
(Deficit)/surplus in the plan at 1 January	(56.5)	(54.7)	10.9	(41.0)
Movement in the year:				
Current service cost (employees and employers)	(9.2)	(4.6)	(8.6)	(5.2)
Past service cost	—	—	(0.1)	—
Other finance (cost)/income	(0.9)	(2.9)	4.8	(1.8)
Actuarial loss	(4.5)	(16.1)	(69.0)	(16.9)
Contributions paid (including by employees)	11.2	10.4	5.5	5.2
Currency adjustment	—	6.6	—	5.0
Deficit in the plan at 31 December	<u>(59.9)</u>	<u>(61.3)</u>	<u>(56.5)</u>	<u>(54.7)</u>

34. Post-Retirement Benefits (FRS 17) — (continued)

The cost of providing healthcare benefits after retirement under FRS 17 of £0.8m (£1.1m charge under SSAP 24) is determined by independent actuaries and would be charged to operating profit in 2003 (2002 — £0.8m charged in 2002 compared with a £0.8m charge under SSAP 24). The principal actuarial assumptions in determining the cost of providing healthcare benefits are those in the UK and the US and would be as follows:

	2003		2002		2001	
	UK	US	UK	US	UK	US
	(% per annum)					
Interest rate	5.4	6.0	5.6	7.0	6.0	7.1
Medical cost inflation	6.4	7.5	6.6	8.0	7.0	9.0

35. Smith & Nephew Employees' Share Trust

	2003	2002
	(£ million)	
At 1 January	3.2	2.5
Shares acquired	1.3	2.4
Shares vested	(2.4)	(1.7)
At 31 December	<u>2.1</u>	<u>3.2</u>

The Smith & Nephew Employees' Share Trust (the "Trust") was established to hold shares relating to the long-term incentive plan referred to in the "Remuneration Report". Holdings of the Parent Company's Own Shares in respect of the Trust are disclosed in Note 27. The Trust is administered by an independent professional trust company resident in Jersey and is funded by a loan from the Parent Company. The costs of the Trust are charged to the profit and loss account as they accrue. A dividend waiver is in place in respect of those shares held under the long-term incentive plan that are yet to vest. The waiver represents less than 1% of the total dividends paid.

At 31 December 2003, the Trust held 1.6m (2002 — 1.5m) Ordinary Shares at an aggregate cost of £5.6m (2002 — £5.2m). 1.1m (2002 — 0.6m) shares, with an original cost of £3.5m (2002 — £2.0m), have vested and are held under option for the benefit of directors and employees. 0.5m shares, at an aggregate cost of £2.1m, are included within shareholders' funds on the Group and Parent balance sheets. The market value of these shares at 31 December 2003 was £2.3m (2002 — £3.4m).

36. Related Party Transactions with Joint Venture and Associated Undertaking

In the course of normal operations, the Group traded on an arm's-length basis with its joint venture BSN Medical from 1 April 2001 and associated undertaking AbilityOne from 27 March 2002 until 12 September 2003. The aggregated transactions, which have not been disclosed elsewhere in the financial statements, are summarised below:

	With BSN Medical	With BSN Medical	With BSN Medical	With AbilityOne	With AbilityOne
	2003	2002	2001	2003	2002
	(£ million)				
Sales to the joint venture/associate	0.9	6.9	6.5	0.1	0.4
Profit/(loss) made on sales	0.4	(0.3)	(0.4)	—	0.1
Agency fees received	18.2	19.0	19.2	—	—
Management charges received	1.1	1.6	0.8	—	—
Purchases from the joint venture/associate	12.2	13.2	11.2	3.0	5.3
(Loss)/profit made by the joint venture on purchases	(0.3)	(0.1)	0.5	—	—
Interest payable to the joint venture	—	—	(0.7)	—	—
Interest receivable from the joint venture	—	0.4	1.7	—	—

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

	2003	2002	2001
	(£ million)		
Audit services:			
Group accounts	1.0	0.9	0.8
Local statutory audit	0.3	0.3	0.3
Statutory audit	1.3	1.2	1.1
Audit-related regulatory reporting	0.1	0.1	–
	1.4	1.3	1.1
Further assurance services	1.9	0.9	0.5
Tax services:			
Compliance services	0.2	0.3	0.2
Advisory services	2.5	1.5	1.5
	2.7	1.8	1.7
Other services	–	–	–
Total auditors' remuneration	<u>6.0</u>	<u>4.0</u>	<u>3.3</u>
Arising:			
In the UK	4.5	2.1	1.7
Outside the UK	1.5	1.9	1.6
	<u>6.0</u>	<u>4.0</u>	<u>3.3</u>
Relating to capital transactions (included above)	–	1.6	1.3
Audit fees incurred by Group pension schemes (not included above)	<u>0.1</u>	<u>0.1</u>	<u>0.1</u>

Of the total auditors' remuneration £2.3m (2002—£1.3m, 2001—£0.8m) relates to statutory and other certifications and services. Also, of the total auditors' remuneration in 2003 £3.7m relates to the unsuccessful public offers to purchase Centerpulse AG and InCentive Capital AG.

38. Post Balance Sheet Events

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.

39. New Accounting Standards

New Accounting Standards in the UK — FRS 17

FRS 17 — Retirement Benefits was issued in November 2000. Full implementation has been deferred until 1 January 2005. Some disclosure requirements are effective for periods prior to this date. The standard requires that financial statements reflect at fair value the assets and liabilities arising from an employer's retirement benefit obligations and related funding. Current and past service costs are charged to operating expense in the period in which they are earned, the interest cost on accrued liabilities less expected return on assets is charged as net finance costs and changes in the value of the related assets and liabilities are taken to reserves in the period. Had FRS 17 been implemented at 31 December 2003, the Group would have reported a retirement liability, net of related deferred tax, of £86.5m (2002 — £80.2m), which compares with £1.7m (2002 — £4.8m) recorded in the balance sheet under the existing rules. The impact of FRS 17 on retained earnings for 2003 would have been to reduce retained earnings by £84.8m (2002 — £75.4m) (Note 34).

New Accounting Standards in the US — FIN 46

FIN 46 — Consolidation of Variable Interest Entities was issued in January 2003 and subsequently revised in December 2003. It requires additional disclosures to be made in financial statements issued after January 2003 and becomes fully effective for accounting periods ending after 15 March 2004. FIN 46 requires entities to be consolidated if their financial affairs are being supported by a third party even if that third party is not an equity holder. Management does not believe that this standard will result in any additional entities being consolidated into the Group.

40. Differences Between Accounting Principles Generally Accepted in the UK and US

The Group accounts are prepared in accordance with UK GAAP which differ in certain respects from US GAAP. Those differences which have a significant effect on the Group's profit for the financial year and shareholders' funds are as follows:

Goodwill and Other Intangible Assets

Prior to 1998, goodwill arising on acquisitions was set off against reserves. On disposal of such businesses, goodwill previously set off against reserves is charged to profit or loss on disposal. Since 1998, goodwill and other intangible fixed assets purchased by way of acquisition have been capitalised and written off over a period not exceeding 20 years. Under US GAAP, goodwill and other intangible fixed assets purchased prior to 2002 would have been capitalised and amortised over their expected useful lives. Commencing 2002, goodwill would not be amortised and would be subject to an annual impairment review, whereas other intangible assets would continue to be capitalised and amortised over their useful lives.

Fair value adjustments to goodwill may be made in the first full financial period after acquisition. Under US GAAP, these may only be made within one year of acquisition. Thus, any adjustments post this period would be taken to the profit and loss account for the year.

Goodwill arising on the formation of the joint venture is not amortised but is subject to annual impairment review. Under US GAAP, prior to 2002 this goodwill would be amortised. Commencing 2002, this goodwill would not be amortised.

Joint Venture and Associated Undertaking

One of the components of the goodwill in the joint venture is the difference between the fair value of consideration given and the book value of net assets acquired in the joint venture by the Group. Under US GAAP, this gain would be unrealised and would not be recognised.

The results of the joint venture are included within turnover, operating profit, interest and taxation. The results of the associated undertaking are included within operating profit, interest and taxation. Under US GAAP, the Group's share of the after tax profits of the joint venture and associated undertaking would be reflected in the income statement as a single line item and its net investment in the joint venture would be included as a single line item in the balance sheet with the investment in the Group's associated undertaking.

Post-Retirement Benefits

Projected benefit liabilities are discounted using long-term investment returns and surpluses and deficits are amortised over the employees' service lives. Under US GAAP, pension liabilities would be discounted using corporate bond rates and surpluses and deficits within 10% limits would not be amortised and would thus have no immediate impact on pension costs. In addition, under US GAAP where the value of plan assets is below the value of the liabilities valued on an accumulated benefit obligation basis, the deficit would be recognised immediately through other comprehensive income.

Trade Investments

Trade investments are stated in the balance sheet at cost less provision for any permanent diminution in value and any movements in provisions are taken to the profit and loss account for the year. Under US GAAP, trade investments would be stated at market value and movements in market value would be taken to shareholders' equity via comprehensive income for the year.

Factoring of Debts

Trade debtors are stated in the balance sheet net of non-returnable proceeds received. Under US GAAP, trade debtors would be stated gross and proceeds received would be included in borrowings.

Derivative Instruments and Hedging Activities

Derivative instruments in respect of anticipated future transactions, interest rate risks and intragroup equity investments are accounted for as hedges. Under US GAAP, all derivative instruments (including

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

those embedded in other contracts) are recognised as either assets or liabilities in the consolidated balance sheet at their fair values. US GAAP prescribes requirements for designation and documentation of hedging relationships and ongoing assessments of effectiveness in order to qualify for hedge accounting. Changes in the fair value of derivatives that are designated and qualify as part of a hedge transaction would be recorded each period in current earnings or other comprehensive income, depending on the type of hedge transaction. Changes in the fair value of derivatives that do not qualify for hedge accounting would be recognised each period in profit for the financial year.

Forward Foreign Exchange Contracts

Forward foreign exchange contracts in respect of anticipated future transactions are treated as hedges and not marked to market. Gains and losses thereon are recognised only when the exposure that is being hedged is itself recognised. Under US GAAP, such contracts would be valued at the forward rates at the balance sheet date with the gains and losses included in profit for the financial year. On maturity of the contract the gain/loss not recognised to date would be recognised in profit for the financial year.

Interest Rate Swaps

Interest rate swaps used to fix interest rates on the Group's major exposures are treated as hedges and not marked to market. Gains and losses thereon are recognised only when the exposure that is being hedged is itself recognised. Under US GAAP, these swaps would not be treated as hedges, due to the additional documentation requirement, and gains and losses on valuing such contracts at the balance sheet date would be included in profit for the financial year.

Currency Rate Swaps

Currency swaps are used to hedge intra Group equity investments. Realised and unrealised gains/losses are not recognised in profit for the year but are recorded as movements in reserves. Receivables and payables on currency swaps are included within debtors and creditors respectively. Under US GAAP, these swaps would be separately classified into current asset derivatives, current liabilities derivatives and non-current liabilities derivatives.

Dividends

Dividends are provided in the period to which they relate and, in the case of proposed final dividends, on the basis of proposals by the Directors. Under US GAAP, dividends would be provided for in the accounts for the period in which they are declared.

Taxation

Deferred taxation is recognised on most timing differences. This is generally consistent with US GAAP, except that deferred taxation is provided on goodwill acquired prior to 1998, which has been set off against reserves and on which taxation benefits have been received. Under US GAAP, as goodwill acquired prior to 1998 would not have been set off against reserves, the deferred taxation provided under UK GAAP would not be required. Furthermore, under US GAAP, a deferred tax liability would be provided on intangible assets acquired subject to book amortisation where no tax relief is available.

Acquired in-Process Research and Development

Acquired in-process research and development is not separately identified and therefore forms part of the goodwill arising on acquisition. Under US GAAP, acquired in-process research and development would be identified separately from goodwill and charged to the profit and loss account on the date of acquisition.

Leases

The criteria for capitalising leases under UK GAAP differ from those under US GAAP. As a result, certain leases which are classified as operating leases under UK GAAP would have been capitalised under US GAAP.

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Discontinued Activities

Under UK GAAP, the results of operations arising from discontinued operations are presented in the profit and loss account under the relevant captions and the profit/(loss) on their disposal is reported as a separate line item after operating income and before interest. Under US GAAP, the results of operations from discontinued operations and the profit/(loss) on their disposal are reported as separate line items immediately before net income.

Exceptional Items

Items classified as exceptional under UK GAAP do not meet the definition of extraordinary under US GAAP and therefore under US GAAP these would be classified as operating expenses.

Staff Costs

Under UK GAAP, the Group does not account for stock based compensation. Under US GAAP, stock based compensation would be recognised under the fair value recognition provisions of FAS 123 — Accounting for Stock Based Compensation and charged to the profit and loss account for the year.

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Effect of Differences

The effect of the adjustments to attributable profit for the year and to shareholders' funds that would be required if US GAAP were to be applied instead of UK GAAP is summarised as follows. The condensed consolidated income presented below reflects the adjustments to attributable profit for the year.

	2003	2002	2001
	(£ million)		
Profit for the Financial Year			
Attributable profit for the year as reported under UK GAAP	148.1	112.1	129.6
Adjustments:			
Amortisation of goodwill	18.5	17.5	(10.5)
Amortisation of other intangible fixed assets	(9.9)	(9.0)	(3.9)
Amortisation of goodwill on joint venture	—	—	(1.2)
Goodwill fair value adjustments on acquisition	(2.4)	—	—
Gain on disposals: goodwill and other intangible assets previously written off	7.6	15.2	—
Pension expense	(8.5)	(3.7)	(1.7)
Staff costs	(4.5)	(3.4)	(1.6)
Unrecognised forward foreign exchange gains/(losses)	0.1	(7.9)	1.4
Unrecognised gains/(losses) on interest rate swaps	2.6	(1.4)	(7.4)
Acquired in-process research and development	—	(4.2)	—
Other adjustments	(0.3)	(0.3)	—
Deferred taxation — on adjustments	2.0	4.4	2.4
Deferred taxation — methodology	14.1	9.1	(0.2)
Profit for the financial year as adjusted to accord with US GAAP	<u>167.4</u>	<u>128.4</u>	<u>106.9</u>
Condensed Consolidated Income Statement			
Net sales	1,178.9	1,083.7	978.3
Cost of goods sold	(345.0)	(321.5)	(293.5)
Other operating costs and expenses	(22.4)	(29.9)	(21.1)
Selling, general and administrative expenses	(639.2)	(595.1)	(538.3)
Interest expense net	(0.7)	(11.2)	(23.9)
Income before income tax expense and equity in earnings of associated companies	171.6	126.0	101.5
Income tax expense	(42.5)	(28.5)	(37.4)
Equity in earnings of associated companies	15.3	13.3	4.4
Income from continuing operations	<u>144.4</u>	<u>110.8</u>	<u>68.5</u>
Discontinued operations:			
Income net of tax of nil (2002 — £0.8m, 2001 — £4.2m)	—	1.3	6.9
Gain on sale net of tax of £16.1m (2002 — £16.9m, 2001 — £17.7m)	23.0	16.3	31.5
	<u>23.0</u>	<u>17.6</u>	<u>38.4</u>
Net income	<u>167.4</u>	<u>128.4</u>	<u>106.9</u>

(i) The estimated amortisation of intangible assets as at 31 December 2003 for the next five years under US GAAP is as follows: 2004 — £14.7m, 2005 — £14.7m, 2006 — £14.1m, 2007 — £13.3m and 2008 — £13.3m.

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

	2003	2002	2001
		(pence)	
Basic earnings as so adjusted — Per Ordinary Share:			
Continuing operations	15.53p	11.97p	7.44p
Discontinued operations	2.47p	1.90p	4.16p
Total	<u>18.00p</u>	<u>13.87p</u>	<u>11.60p</u>
Diluted earnings as so adjusted — Per Ordinary Share:			
Continuing operations	15.42p	11.86p	7.36p
Discontinued operations	2.46p	1.89p	4.13p
Total	<u>17.88p</u>	<u>13.75p</u>	<u>11.49p</u>
Basic earnings as so adjusted — Per ADS (i):			
Continuing operations	77.6p	59.9p	37.2p
Discontinued operations	12.4p	9.5p	20.8p
Total	<u>90.0p</u>	<u>69.4p</u>	<u>58.0p</u>
Diluted earnings as so adjusted — Per ADS (i):			
Continuing operations	77.1p	59.3p	36.8p
Discontinued operations	12.3p	9.5p	20.7p
Total	<u>89.4p</u>	<u>68.8p</u>	<u>57.5p</u>

(i) Per ADS amounts have been restated to reflect the change in 2003 in the number of Ordinary Shares per ADS from 10 to 5.

Comprehensive Income

The consolidated statement of comprehensive income under US GAAP is as follows:

	2003	2002	2001
		(£ million)	
Profit for the financial year as adjusted to accord with US GAAP	167.4	128.4	106.9
<i>Other comprehensive income:</i>			
Minimum pension liability	(5.4)	(69.4)	—
Tax on minimum pension liability	2.0	22.3	—
<i>Other comprehensive income (net of related tax of nil):</i>			
Cumulative effect on prior year on adoption of FAS 133 in 2002	—	—	(0.7)
Derivative financial instruments	—	—	0.7
Revaluation of investments	—	3.2	4.3
Translation adjustment arising on consolidation	(5.7)	(3.5)	(5.1)
Comprehensive income	<u>158.3</u>	<u>81.0</u>	<u>106.1</u>

Movements in other comprehensive income amounts (net of related tax) are as follows:

	Minimum pension liability	Derivative financial instruments	Revaluation of investments (£ million)	Currency translation differences	Total
At 1 January 2001	—	—	(7.5)	(38.4)	(45.9)
Effect on adoption of FAS 133 in 2002	—	(0.7)	—	—	(0.7)
Movement in the year	<u>—</u>	<u>0.7</u>	<u>4.3</u>	<u>(5.1)</u>	<u>(0.1)</u>
At 31 December 2001	—	—	(3.2)	(43.5)	(46.7)
Movement in the year	<u>(47.1)</u>	<u>—</u>	<u>3.2</u>	<u>(3.5)</u>	<u>(47.4)</u>
At 31 December 2002	(47.1)	—	—	(47.0)	(94.1)
Movement in the year	<u>(3.4)</u>	<u>—</u>	<u>—</u>	<u>(5.7)</u>	<u>(9.1)</u>
At 31 December 2003	<u>(50.5)</u>	<u>—</u>	<u>—</u>	<u>(52.7)</u>	<u>(103.2)</u>

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Shareholders' Funds

	2003	2002
	(£ million)	
Shareholders' funds as reported in the Group balance sheet under UK GAAP (i)	640.8	516.9
Adjustments:		
Goodwill		
Cost	(0.9)	(0.3)
Amortisation	50.0	35.4
	<u>49.1</u>	<u>35.1</u>
Other intangible fixed assets		
Cost	198.8	220.7
Amortisation	(104.5)	(105.3)
	<u>94.3</u>	<u>115.4</u>
Investment in joint venture		
Cost	(38.3)	(38.1)
Amortisation	(1.2)	(1.2)
	<u>(39.5)</u>	<u>(39.3)</u>
Fixed assets — capital lease		
Cost	10.8	11.5
Depreciation	(1.1)	(0.5)
	<u>9.7</u>	<u>11.0</u>
Debtors: debit balances on currency swaps	(52.8)	(21.3)
Debtors: pension assets	(5.6)	(4.1)
Debtors: non-returnable proceeds received from debt factor	19.9	18.3
Current asset derivatives	56.3	29.9
	<u>17.8</u>	<u>22.8</u>
Creditors: Holiday pay	(2.5)	(2.2)
Creditors: Proposed final dividend	28.9	27.9
Creditors: Pension liability	(88.0)	(79.7)
Credit balances on currency swaps	4.6	3.3
Borrowings due within one year: non-returnable proceeds received from debt factor	(19.9)	(18.3)
Borrowings due within one year: capital lease payments	(0.2)	(0.2)
Current liabilities derivatives	(19.6)	(25.4)
	<u>(96.7)</u>	<u>(94.6)</u>
Credit balances on currency swaps	4.8	1.3
Non-current liabilities derivatives	(5.2)	(2.4)
Borrowings due after one year: capital lease payments	(9.4)	(10.7)
Deferred taxation — on adjustments	35.6	31.6
Deferred taxation — methodology	8.6	(4.8)
Shareholders' funds as adjusted to accord with US GAAP	<u>709.9</u>	<u>582.3</u>

(i) 2002 figures have been restated for the adoption of UITF 38 (see Note 27)

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Reconciliation of Changes in Shareholders' Funds Under US GAAP

	2003	2002	2001
	(£ million)		
Profit for the financial year under US GAAP	167.4	128.4	106.9
Dividends paid	(45.1)	(43.5)	(41.8)
Currency translation	(5.7)	(3.5)	(5.1)
Issue of shares	8.5	6.1	9.0
Stock based expense recognised in the profit and loss account	7.2	5.0	3.1
Cost of shares transferred to beneficiaries	(1.3)	(2.4)	(1.2)
Revaluation of investments	—	3.2	4.3
Minimum pension liability	(3.4)	(47.1)	—
Net addition to shareholders' funds	<u>127.6</u>	<u>46.2</u>	<u>75.2</u>
Opening shareholders' funds	<u>582.3</u>	<u>536.1</u>	<u>460.9</u>
Closing shareholders' funds	<u><u>709.9</u></u>	<u><u>582.3</u></u>	<u><u>536.1</u></u>

Consolidated Statement of Cash Flows

The US GAAP cash flow statement reports changes in cash and cash equivalents, which includes short-term highly liquid investments. Under UK GAAP, cash flows are presented separately for operating activities, dividends from joint ventures, returns on investments and servicing of finance, taxation, investing activities and financing activities. US GAAP requires only three categories of cash flow activity to be reported: operating, investing and financing. Cash flows from taxation and returns on investments and servicing of finance shown under UK GAAP would be included as operating activities under US GAAP. The payment of dividends would be included as a financing activity under US GAAP.

The categories of cash flow activity under US GAAP are summarised as follows:

	2003	2002	2001
	(£ million)		
Cash flows from operating activities	165.3	152.4	100.8
Cash flows from investing activities	(23.3)	(214.2)	(68.0)
Cash flows from financing activities	<u>(139.0)</u>	<u>57.8</u>	<u>(28.7)</u>
Increase/(decrease) in cash and cash equivalents	3.0	(4.0)	4.1
Exchange adjustments	0.5	0.1	(1.3)
Cash and cash equivalents at beginning of year	<u>22.5</u>	<u>26.4</u>	<u>23.6</u>
Cash and cash equivalents at end of year	<u><u>26.0</u></u>	<u><u>22.5</u></u>	<u><u>26.4</u></u>

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Additional Information Required by US GAAP in Respect of Earnings Per Share

The following table sets out the computation of basic and diluted earnings per Ordinary Share from continuing operations under US GAAP:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Numerator:			
Profit for the financial year as adjusted to accord with US GAAP	167.4	128.4	106.9
Numerator for diluted earnings per Ordinary Share	<u>167.4</u>	<u>128.4</u>	<u>106.9</u>
	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(Shares million)		
Denominator:			
Denominator for basic earnings per Ordinary Share	930	926	921
Effect of dilutive securities: Share option schemes	<u>6</u>	<u>8</u>	<u>9</u>
Denominator for diluted earnings per Ordinary Share	<u>936</u>	<u>934</u>	<u>930</u>
Basic earnings per Ordinary Share from continuing operations	15.53p	11.97p	7.44p
Basic earnings per Ordinary Share from discontinued operations	2.47p	1.90p	4.16p
Diluted earnings per Ordinary Share from continuing operations	15.42p	11.86p	7.36p
Diluted earnings per Ordinary Share from discontinued operations	2.46p	1.89p	4.13p

Additional Information Required by US GAAP in Respect of Deferred Taxation

The analysis of the deferred taxation (liability)/asset required by US GAAP is summarised as follows:

	<u>2003</u>	<u>2002</u>
	(£ million)	
Deferred taxation liabilities:		
Excess of book value over taxation value of fixed assets	(34.4)	(29.3)
Other temporary differences	<u>(51.9)</u>	<u>(45.8)</u>
	(86.3)	(75.1)
Deferred taxation assets:		
Taxation effect of losses carried forward	5.1	18.4
Other temporary differences	<u>67.9</u>	<u>31.5</u>
	73.0	49.9
	<u>(13.3)</u>	<u>(25.2)</u>
Of which:		
Current	63.1	18.0
Non-current	<u>(76.4)</u>	<u>(43.2)</u>
	<u>(13.3)</u>	<u>(25.2)</u>

The losses carried forward have expiration dates that range from 2008 to 2020.

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Additional Information Required by US GAAP in Respect of the Group's Two Principal Pension Plans

The two principal pension plans are those in the UK and the US. The pension cost for these plans computed in accordance with the requirements of US GAAP comprises:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(£ million)		
Service cost	11.3	10.9	9.6
Interest cost	20.1	19.1	18.1
Expected return on plan assets	(16.0)	(21.2)	(21.9)
Amortisation of transition obligation	—	—	(0.1)
Amortisation of prior service cost	0.6	2.3	2.6
Amortisation of net actuarial loss/(gain)	6.6	0.6	(0.8)
Curtailement gain	—	—	(1.0)
Net periodic pension cost	<u>22.6</u>	<u>11.7</u>	<u>6.5</u>

The major assumptions used in computing the pension cost under US GAAP for the two principal plans are:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	(%)		
UK:			
Expected long-term rate of return on plan assets for net benefit costs	6.9	6.9	8.1
Discount rate for net benefit costs	5.6	6.0	6.0
Discount rate for year end benefit obligations	5.4	5.6	6.0
Expected long-term rate of earnings increases for net benefit costs	4.3	4.0	4.0
Expected long-term rate of earnings increases for year end benefit obligations	4.8	4.3	4.0
US:			
Expected long-term rate of return on plan assets for net benefit costs	8.8	8.8	9.3
Discount rate for net benefit costs	7.0	7.0	8.0
Discount rate for year end benefit obligations	6.0	7.0	7.0
Expected long-term rate of earnings increases for net benefit costs	5.0	5.0	5.0
Expected long term rate of earnings increases for year end benefit description	5.0	5.0	5.0

The assumption for the expected long-term rate of return on assets is based on separate long-term assumptions for each of the major assets classes weighted by the asset allocation. The long-term assumptions for bonds are based on long-term market yields at the accounting date. The long-term rate of return on equities is the Group's best estimate of future returns with consideration having been given to long-term historic real returns achieved on equities.

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

The following table sets out the funded status and amounts that would be recognised under US GAAP in the balance sheet at 31 December 2003 and 2002 for the Group's two principal plans:

	2003		2002	
	UK Plan	US Plan	UK Plan	US Plan
	(£ million)			
Fair value of plan assets	192.1	63.0	164.1	50.5
Projected benefit obligation	(265.5)	(124.4)	(231.7)	(105.2)
Projected benefit obligation in excess of plan assets	(73.4)	(61.4)	(67.6)	(54.7)
Unrecognised prior service cost	0.9	0.2	1.4	0.3
Unrecognised net loss	67.3	50.9	65.6	42.0
	(5.2)	(10.3)	(0.6)	(12.4)
Deficit on accumulated benefit obligation basis	(51.0)	(21.4)	(52.0)	(17.9)
(Accrued)/prepaid pension cost	(56.2)	(31.7)	(52.6)	(30.3)

The following table sets out the accumulated benefit obligation and market value of assets for the Group's two principal plans:

	2003		2002	
	UK	US	UK	US
	(£ million)			
Accumulated benefit obligation	(248.3)	(94.7)	(216.7)	(80.8)
Market value of assets	192.1	63.0	164.1	50.5

The measurement date for the UK Plan and the US Plan is 31 December.

In the UK Plan, the assets principally comprise UK and other listed equities, bank deposits and UK Government index-linked stocks. In the US Plan, the assets principally comprise US equities, other listed equities and fixed income securities.

The following table sets out the Company's pension plan asset allocation in the UK for the last two fiscal years, together with the target allocation for 2004:

Asset Category	Target allocation	Percentage of plan assets at 31 December	
	2004	2003 (%)	2002
Equity securities	60 – 80	74.5	69.4
Debt securities	15 – 25	16.8	20.6
Property	0 – 8	5.2	5.8
Other	0 – 5	3.5	4.2
Total		100	100

The long-term investment strategy for the Smith & Nephew UK Pension Fund ("the UK Plan") is for significant index linked and fixed interest investments to be held so that in the short to medium term the income from them exceeds the excess of benefits over contributions. The balance of the UK Plan's investments will be invested in equities and property.

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

The UK Plan is not allowed to have a direct shareholding in Smith & Nephew plc or associated companies.

The following table sets out the Company's pension plan asset allocation in the US for the last two fiscal years, together with the target allocation for 2004:

Asset Category	Target allocation	Percentage of plan assets at 31 December	
	2004	2003 (%)	2002
Equity securities	68-80	76.4	68.1
Debt securities	20-26	20.7	29.6
Other	0-5	2.9	2.3
Total		<u>100</u>	<u>100</u>

The long-term investment strategy for the Smith & Nephew US Pension Plan ("the US Plan") is a long-term rate of return on assets that is at least 5% to 6% greater than the rate of inflation as measured by the Consumer Price Index. This target rate of return for the Plan is based upon the assumption that future real rates of return will be close to the historical long run rates of return experienced for each asset class. Market performance varies and a real rate of return of between 5% and 6% may not be achievable during some periods.

The US Plan is not allowed to have a direct shareholding in Smith & Nephew plc or associated companies.

A reconciliation of the projected benefit obligation and the fair value of plan assets is shown in the following tables:

	2003		2002	
	UK Plan	US Plan	UK Plan	US Plan
	(£ million)			
Projected benefit obligation at beginning of year	231.7	105.2	202.1	105.6
Service cost	6.7	4.6	6.1	4.8
Interest cost	13.0	7.1	12.1	7.0
Plan participant contributions	2.7	–	2.7	–
Actuarial loss	22.6	23.5	18.7	2.3
Benefits and expenses paid	(11.2)	(2.9)	(10.0)	(3.8)
Exchange adjustment	–	(13.1)	–	(10.7)
Projected benefit obligation at end of year	<u>265.5</u>	<u>124.4</u>	<u>231.7</u>	<u>105.2</u>
Fair value of plan assets at beginning of year	164.1	50.5	200.1	74.1
Actual return on assets	28.0	11.6	(31.5)	(18.9)
Company contributions	8.5	10.4	2.8	5.2
Plan participant contributions	2.7	–	2.7	–
Benefits and expenses paid	(11.2)	(2.9)	(10.0)	(3.8)
Exchange adjustment	–	(6.6)	–	(6.1)
Fair value of plan assets at end of year	<u>192.1</u>	<u>63.0</u>	<u>164.1</u>	<u>50.5</u>

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

The following table sets out the benefit payments used in the calculation of the expected benefit obligation:

	United Kingdom	United States
	(£ million)	
Actual Payments		
2002	10.0	3.1
2003	11.2	2.9

Additional information required by US GAAP in respect of the Group's healthcare benefits after retirement in the UK and the US

The movement in the accumulated post-retirement benefit obligation under the Group's post-retirement healthcare schemes is as follows:

	2003		2002	
	UK	US	UK	US
	(£ million)			
At beginning of year	3.4	7.0	3.2	6.2
Service cost	0.1	0.1	0.1	0.1
Interest cost	0.2	0.4	0.2	0.5
Change in assumptions	—	—	—	1.0
Actuarial loss/(gain)	0.2	—	0.1	0.4
Benefits paid	(0.2)	(0.4)	(0.2)	(0.6)
Exchange adjustment	—	(0.7)	—	(0.6)
At end of year	<u>3.7</u>	<u>6.4</u>	<u>3.4</u>	<u>7.0</u>
	2003		2002	
	UK	US	UK	US
	(£ million)			
Accumulated benefit obligation	3.7	6.4	3.4	7.0
Unrecognised net loss/(gain)	(0.1)	(1.5)	0.2	(1.7)
Prior service loss/(gain)	—	0.1	—	0.1
Accrued healthcare cost	<u>3.6</u>	<u>5.0</u>	<u>3.6</u>	<u>5.4</u>

The effect of a one percentage point change in the rate of medical cost inflation would increase/(decrease) the accumulated post-retirement benefit obligation as follows:

	2003		2002	
	UK	US	UK	US
	(£ million)			
1% increase	0.1	0.5	0.1	0.6
1% decrease	(0.1)	(0.4)	(0.1)	(1.0)

40. Differences Between Accounting Principles Generally Accepted in the UK and US — (continued)

Additional Information Required by US GAAP Relating to Leases

Future lease payments under US GAAP at 31 December 2003 are as follows:

	Operating leases		Capital leases	
	Land and buildings	Other assets	Land and buildings	Other assets
	(£ million)			
Within one year	9.4	9.6	1.0	0.3
After one and within two years	7.3	5.6	1.0	0.2
After two and within three years	6.0	1.6	0.9	0.2
After three and within four years	5.4	0.3	1.0	0.1
After four and within five years	5.7	—	1.0	0.1
After five years	27.3	—	12.2	—
	<u>61.1</u>	<u>17.1</u>	17.1	0.9
Less: imputed interest			(7.2)	(0.1)
Present value of future lease payments			<u>9.9</u>	<u>0.8</u>

Additional Information Required by the SEC Regarding Provisions for Bad and Doubtful Debts

	Balance at beginning of year	Additions charged to costs and expenses	Exchange differences	Deductions(i)	Balance at end of year
			(£ million)		
Year ended 31 December 2003	7.0	1.3	(0.2)	(0.8)	7.3
Year ended 31 December 2002	7.3	0.5	(0.4)	(0.4)	7.0
Year ended 31 December 2001	7.0	1.9	—	(1.6)	7.3

(i) Represents the excess of amounts written off over recoveries.