

PRINCIPAL RISKS AND UNCERTAINTIES

We maintain a register of principal risks and uncertainties covering the strategic, operational, financial and compliance risks faced by the Group. We rate them according to likelihood of occurrence, potential impact and the likely 'velocity' of each risk. This measure reflects the expected time we would have to react were a risk to materialise. The 'trend' metric reflects the net position of a risk-taking into consideration both external factors and internal risk mitigation activities, when compared to the same time last year. We consider our current and target exposure to each risk, which defines our risk appetite.

We updated our register of principal risks and uncertainties following our Executive Committee workshop held during FY2017 and made the following adjustments to the principal risks disclosed in the 2016 Annual Report:

- 'Financial' risk has been removed. We consider the diversified nature of our global operations and the financial strength of the Group provide appropriate mitigation such that this risk does not require a standalone disclosure.
- 'Pension Funding' risk has been removed. We consider the increased strength of the funding level of the Group's defined benefit pension arrangements and the actions agreed on 17 November 2015 and 1 March 2016 in order to address potential funding shortfalls in the Smiths Industries Pension Scheme and TI Group Pension Scheme.

While we continue to monitor and manage a wider range of risks, the table below summarises those we feel most likely to have the greatest impact on the business if they were to materialise and the key mitigating actions taken to address them.

RISK AND POTENTIAL IMPACT

TECHNOLOGY DISRUPTION BY EXISTING OR FUTURE COMPETITOR

RISK APPETITE



Current | Target

POTENTIAL IMPACT



High

TREND



Increased

VELOCITY



Low

Developing differentiated new products and services is critical to our success. We may be unable to maintain technological differentiation or meet customers' needs, and face more effective or disruptive innovation by a competitor.

Potential impact

- Loss of market share and competitive advantage
- Materially adverse effect on profitable growth
- Erosion of our reputation as a leader in our markets and ability to attract and retain talent
- Increased speed of innovation in certain markets may lead to shorter product lifecycles, which would increase the level of R&D spend needed to maintain sales growth

KEY MITIGATING CONTROLS

- Our diversified technology portfolio serves a range of sectors and geographies, mitigating our exposure to any one sector or area
- We are actively repositioning the portfolio around our most attractive markets, where we consider we can sustainably hold a top three position based on technology leadership
- Increased and smarter investment in R&D (2017: 4.6% of revenue, 2016: 4.0%), focused on our most attractive markets
- New Group-wide innovation framework – i³ – focused on building a culture of innovation. Focus areas include process enhancements to improve innovation effectiveness, horizon-scanning to develop long-range technology roadmaps for each division and driving digitisation
- New central Innovation Fund to leverage our critical mass and accelerate key areas – first projects approved and underway
- New Head of Innovation and Group Digital Director appointed in FY2017 to spearhead the agenda
- Aligned New Product Introduction (NPI) process rolled out across divisions to accelerate time to market

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RISK AND POTENTIAL IMPACT

PEOPLE

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Medium

TREND



No change

VELOCITY



Low

People are our only truly sustainable source of competitive advantage, and competition for key skills is intense, especially around science, technology, engineering and mathematics (STEM). We may not be successful in attracting, retaining, developing, engaging and inspiring the right people with the right skills to ensure organisational effectiveness and achieve our growth ambitions.

Potential impact

- The inability to attract key talent could lead to a loss of competitive advantage and materially affect our growth prospects
- In acquisitions, losing key personnel from the newly-acquired business or making the wrong leadership appointments could significantly impact performance and value

KEY MITIGATING CONTROLS

- Building a learning organisation is a key part of our growth strategy, with a focus on culture, reward and recognition, HR infrastructure, and learning and development
- Talent and succession plan reviews are held at least annually to balance internal management continuity with external recruitment
- Remuneration packages are evaluated regularly against market trends
- The Chief Executive annually assesses the top leadership team and presents development and succession plans to the Board
- Annual performance management reviews are carried out for the majority of employees, using best practice processes such as 360 degree feedback surveys
- A clearly defined people integration plan for acquisitions ensures an effective approach to appointments and organisation design
- Launched a new leadership development programme in partnership with UCLA Anderson Executive Education in FY2017

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WRONG ACQUISITIONS
AND POOR
INTEGRATION

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Medium

TREND



No change

VELOCITY



Medium

We are focusing the portfolio around the most attractive markets where we can sustainably achieve a top three leadership position. The success of our acquisition strategy depends on identifying suitable targets, obtaining necessary authorisations and financing, and successfully integrating newly-acquired businesses.

Potential impact

- Newly-acquired products and solutions may deliver less value, fewer synergies, or require more investment than anticipated
- The Group's return on capital employed may fall if acquisition hurdle rates are not met
- The Group's financial performance may suffer from goodwill or other acquisition-related impairment charges
- Insufficient allowance for potential claims arising from indemnities and warranties given on a business disposal may detrimentally affect our financial position
- Changes to disposal provisions will affect the income statement and settlement will utilise Group funds

- Detailed due diligence and integration work is undertaken and reviewed in accordance with Group policy
- A new Acquisition and Disposals Policy has been developed for the entire transaction cycle
- Due diligence includes an assessment of the acquisition target's talent and competencies.
- Monthly reviews of the acquisition pipeline and a stage-gated M&A process ensure strong focus on and oversight of the pipeline
- The Acquisitions & Divestments sub-Committee of the Board has authority to approve smaller acquisitions and divestments, whereas larger transactions can only be approved by the full Board
- The Board reviews post-acquisition performance and integration

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RISK MANAGEMENT
CONTINUED

RISK AND POTENTIAL IMPACT

NOT OPERATING IN
THE RIGHT MARKETS

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Medium

TREND



No change

VELOCITY



Low

We are repositioning the portfolio around our most attractive markets where we can deliver above-market growth on a sustainable basis. A significant proportion of the Group's revenue comes from the US and other mature western markets, with a notable proportion coming from western governments. Failure to select the right markets and geographies could impact our strategic progress and financial performance.

Potential impact

- Smiths Detection, Smiths Medical and Smiths Interconnect frequently tender for government contracts both directly and indirectly. Any significant disruption in government budgets could result in fewer contracts being awarded and lower revenues for Smiths
- Our growth strategy places emphasis on expanding our operations in higher-growth end markets and regions that are currently underserved, including Asia, and China in particular

KEY MITIGATING CONTROLS

- A diversified portfolio of businesses mitigates exposure to any one country, sector or customer
- The Group's Government Relations function works to inform policy and collaborate with colleagues across the business to advise on developments
- Some of our government-related businesses have a services or consumables component, which can be more resilient during an economic downturn, when customers' capital expenditures on original equipment may be more constrained
- Appointment of a Group President of Asia Pacific – a new role – to help accelerate our growth in the region



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ECONOMIC OUTLOOK
AND GEOPOLITICAL
ENVIRONMENT

RISK APPETITE



Current | Target

POTENTIAL IMPACT



High

TREND



No change

VELOCITY



Medium

- Global economic and financial market conditions have stabilised after the turmoil following the 2008 financial crisis, in large part due to the various impacts of quantitative easing and austerity measures. However, there remains continued uncertainty arising from a range of geopolitical and economic issues across the world. Smiths operates in more than 50 countries and is affected by global economic and political conditions. The business is affected by government spending priorities, in particular in the US and UK, and the willingness of governments to commit substantial resources to homeland security and defence.
- The impact of the UK's decision to withdraw from the EU (Brexit) remains uncertain. Potential effects of Brexit applicable to many businesses include economic and operational uncertainty, volatility of currency exchange, regulatory changes and the imposition of tariffs on trade between the UK and the Eurozone.
- Global security concerns continue to drive uncertainty. These include the continuing situation in Syria and the Middle East, and recent events in North Korea.
- The global oil price continues to trade at levels below the average of the past few years, which impacts the medium-term capital expenditure plans of a number of our customers, predominantly within the John Crane division.
- The Group has a diversified portfolio of businesses that mitigates exposure to any one country or sector
- The divisions monitor their order flows and other leading indicators, where available, so that they may respond quickly to deteriorating trading conditions
- The Group monitors the ongoing negotiations between the UK and the EU in order to assess the potential impact of Brexit and any transitional arrangements that may be agreed
- Maintaining our competitiveness and continually improving our product offering for our customers ensures we remain resilient and well placed to take advantage of commercial opportunities

RISK AND POTENTIAL IMPACT

INTERRUPTION TO
SUPPLY CHAIN –
MANUFACTURING
CONCENTRATION

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Low

TREND



Decreased

VELOCITY



High

Timely, efficient supply of raw materials and purchased components is critical to our ability to deliver to our customers, and drive our growth.

Potential impact

- Our manufacturing continues to be exposed to the risk of a number of external events which could have significant adverse consequences. These include natural catastrophes, disease pandemics and terrorist attacks. We are also affected by the social, economic, regulatory and political conditions where we operate
- The concentration of manufacturing in lower-cost countries, in particular in Mexico, increases the length of the supply chain and means an adverse event could have more significant consequences for our ability to supply customers on time

KEY MITIGATING CONTROLS

- Supply Excellence is one of the six pillars of our SES operating model, providing an increased focus on efficient, resilient and cost-effective supply
- Business continuity and disaster recovery plans are in place and tested for critical locations
- We regularly evaluate our key sites for a range of risk factors using externally benchmarked assessments
- Business interruption and property damage insurance is in place

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INTERRUPTION TO
SUPPLY CHAIN – SOLE
SOURCE OF SUPPLY

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Low

TREND



Decreased

VELOCITY



High

We rely on sole source component suppliers to provide raw materials or purchased components for some of our products. Any failure on their part or unforeseen adverse consequences in the region or market in which they operate would impact our ability to deliver solutions to customers and drive growth.

Potential impact

- Disruption to a sole-source supplier could impact our ability to deliver solutions to customers, impacting our financial performance and reputation

- We identify sole-source supplier risks and dual source where possible
- The Procurement Leadership Team (PLT) continues to identify and monitor high-risk sole-source suppliers and puts in place mitigation plans, including qualification of alternative sources of supply where appropriate
- Our PLT is also developing a risk management system based on Failure Modes Effect Analysis in order to understand the risk of occurrence and mitigation solutions

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RISK MANAGEMENT
CONTINUED

RISK AND POTENTIAL IMPACT

PRODUCT QUALITY
ISSUE – RECALL /
LITIGATION /
CATASTROPHIC
EVENT

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Medium

TREND



Decreased

VELOCITY



High

In the ordinary course of business we are subject to litigation such as product liability claims and lawsuits, including potential class actions, alleging that our products have resulted or could result in an unsafe condition or injury. The mission-critical nature of many of our solutions makes the potential consequences of failure worse than would otherwise be the case.

Potential impact

- Manufacturing flaws, component failures and/or design defects could require us to recall products, many of which are used in critical applications where the consequences of a failure could be extremely serious and, in some cases, potentially catastrophic
- The Group, in particular Smiths Detection and Smiths Medical, may potentially be exposed to losses in the event of a cyber security breach relating to the Group's products. These include not only customers' losses, but also those of a potentially large class of third parties
- Our businesses are active in markets and product areas that are known to be of interest to cyber criminals

KEY MITIGATING CONTROLS

- We have insurance cover for product liability.
- The US SAFETY Act provides legislative protection for certain Smiths Detection products in the US; and we support efforts to implement similar legislation in other markets (eg ongoing 'third party limitation' lobbying seeks mirror legislation in the EU)
- Quality assurance processes embedded in manufacturing locations for critical equipment, supporting compliance with industry regulations (eg FAA, FDA, API, etc.)
- Material litigation is managed under the oversight of the Group General Counsel
- Our Group-wide Quality Council drives standard definitions, identifies and shares best practice, and reduces the cost of poor quality
- Risk analysis and mitigation processes relating to product cyber resilience are embedded in the product lifecycle process. Proactive steps are taken to ensure product cyber-related risks are continually monitored and managed

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FAILING TO MEET
CONTRACTUAL
OBLIGATIONS

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Low

TREND



Decreased

VELOCITY



High

There is a risk that we may fail to deliver, in a timely fashion, or at all, the products and services that we are obliged to deliver, or fail in our contractual execution due to delays or breaches by our suppliers or other counterparties.

Potential impact

- There may be differences between the estimated costs in our medium and long-term contracts and actual costs, due to factors such as production delays and cost overruns
- Some of our contracts, particularly those with governments, may include terms that provide for unlimited liabilities on our part or allow the government body or counterparty to terminate unilaterally, reduce or modify the relevant contracts or seek alternative sources of supply at our expense

- Contracts are managed and delivered by programme management teams that regularly review risks and take appropriate action
- A review and approval process for significant and higher-risk contracts is in place at Group and divisional levels
- The diversified nature of the Group mitigates the exposure to any single contract
- We are working to enhance the contract review process across the business to increase the uniformity of process, risk tolerance (where appropriate), personnel, and contract management
- In relation to government contracting in particular, legal functional policy deployment improvement targets include a specific action to determine and roll out best practice

RISK AND POTENTIAL IMPACT

SIGNIFICANT ETHICAL
OR COMPLIANCE
BREACH

RISK APPETITE



Current | Target

POTENTIAL IMPACT



Low

TREND



No change

VELOCITY



High

We operate in highly regulated markets, as well as in countries where the risks of bribery, corruption and modern slavery are high. There is a risk that a significant ethical or compliance breach may occur.

Potential impact

- A failure to comply with export regulations could lead to significant fines and a loss of export privileges
- A significant proportion of revenue stems from government contracts with strict conditions attached. Failure to meet those conditions, particularly in the US, can have serious financial and reputational consequences
- We operate in a number of relatively consolidated markets, which increases the risk of illegal anti-competitive activity such as collusion with competitors. US fines and penalties imposed for price fixing, bid rigging and other cartel type activities can exceed \$100m per violation
- Any breach could seriously harm our reputation and impact our financial performance, customer relationships and ability to attract and retain talent

KEY MITIGATING CONTROLS

- We have a network of trade compliance officers across the Group to oversee import and export activities
- Medical has dedicated staff who maintain close contact with the FDA and other key regulators
- The Group General Counsel and divisional General Counsels monitor legislative changes and report and monitor actions as necessary
- We have adopted a set of shared values across Smiths and have a comprehensive ethics and compliance programme that supports our Ethics Code. It is overseen by a dedicated Ethics and Compliance function and Business Ethics Council. We conduct Group-wide training programmes and regularly hold ethics conferences around the world
- We operate an Alertline for reporting concerns, and have strong reporting and investigation mechanisms
- A new Anti-Modern Slavery Policy and procedures are being rolled out to reduce the risk of modern slavery in Smiths and our supply chain
- Competition law training programmes have been developed to educate employees
- We regularly review our Ethics and Compliance programme to address evolving risks



CYBER SECURITY

RISK APPETITE



Current | Target

POTENTIAL IMPACT



High

TREND



Increased

VELOCITY



High

Cyber-crime levels continue to rise around the world and we operate in markets and product areas that are known to be of interest to cyber criminals. Our information assets and the systems we depend on are exposed to risks that could result in theft, corruption or breach of confidentiality.

Potential impact

- Cyber attacks could compromise the confidentiality, integrity and availability of our assets, impacting our ability to deliver to customers and ultimately, financial performance and reputation
- The Group, and especially Smiths Detection and Smiths Medical, is exposed to significant losses in the event of a cyber security breach relating to the Group's security or medical products. These include not only customers' losses, but also those of a potentially large class of third parties

- The Board provides oversight of our approach to cyber risks. We have a proactive ongoing focus on information and cybersecurity risks and have a sophisticated information security programme, which is supported by a strong governance framework
- Group-wide assessment of our most critical information assets and protection to enhance security. This follows a risk-based approach and includes information classification and handling rules
- Information Security Awareness programme, including online e-compliance training to educate employees
- Management of user privileges to ensure that users only have access to appropriate information and programmes
- Security monitoring to provide early detection of hostile activity on Smiths networks and an incident management process
- Partnership and monitoring arrangements are in place with critical third parties, including our communications service provider
- Risk analysis and mitigation processes relating to product cyber resilience are embedded in the product lifecycle process. Proactive steps are taken to ensure product cyber-related risks are continually monitored and managed