Managing risk in delivering our strategy

Smiths Group is exposed to a wide range of risks in running its businesses. We regularly review these risks and ensure we have the appropriate processes and policies for managing them.

Our approach to risk governance
Smiths Group is exposed to a wide range of risks in running its businesses. The Company and its divisions consider these risks on a regular basis and put in place appropriate risk management processes, policies and other measures, including insurance where appropriate.

The Board has overall responsibility for our risk management policies and ensuring we have an effective system of internal control. The Group's process for identifying, evaluating and managing significant business risks is reviewed by the Audit Committee and monitored by the Group Internal Audit Department. An outline of this year's review process by the Board and Audit Committee is set out on pages 85 to 91. A description of the Company's internal control and risk management processes is given in the Corporate governance statement on page 85.

Our approach to risk management
In delivering our strategy, it is important to understand and manage the risks that face us. We achieve this through our embedded risk management approach, combining a top-down strategic view of risks with a bottom-up divisional process.

Our top-down approach involves a review of the external and internal environment, and an assessment by the Executive Committee of the key risks that face Smiths Group. This review is formalised twice a year. A 'risk owner' is assigned to each risk and has the responsibility to monitor the risk and ensure it is managed.

These 'Group-wide' risks are categorised as either:

- Major business challenges
- Risks caused by uncontrollable external factors
- Other risks

A summary of these 'Group-wide' risks is presented for discussion at the July Board meeting. In reviewing the major risks, the Board determines the level of risk that we are prepared to accept in the pursuit of our business goals – this is our risk tolerance. Where the risk impact is greater than that which we are prepared to accept, further mitigation actions are agreed to reduce the potential impact. Where further mitigation actions are not possible or are considered to be cost prohibitive, the risk is closely monitored.

Our bottom-up divisional approach involves the identification, management and monitoring of the material risks in each of our divisions. Each division is required to maintain risk registers and monitor significant risks on an ongoing basis. Each division attends one Audit Committee a year to explain and discuss the inherent risks and challenges faced by the division. Additionally, the strategic risks are further discussed at divisional strategy presentations, which are made annually to the Group Board. The divisions are also required to provide an update regarding their risk mitigation actions at the Quarterly Business Reviews held with the Chief Executive and Finance Director.

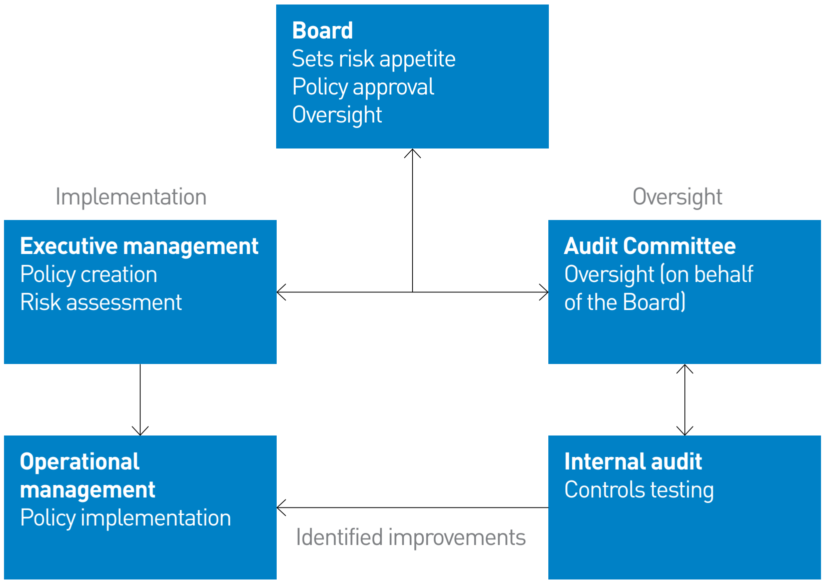
This dual process provides a framework such that the Group's strategic, financial and operational risks are adequately considered and discussed by the Executive Committee and the Board.

There can be no assurance that our approach to risk management will be effective in any particular case. If any of the risks we identify, or other unforeseen risks, materialise, they could have a significant adverse effect not only on our business and financial condition but also on our reputation and the trading prices and liquidity of our securities. This could lead to a loss for investors of part or, in a worst case scenario, all of their investment.

Managing risk

The diagram summarises how we manage risk

The Board has ultimate responsibility for our risk management policies and for ensuring we have an effective system of internal control. Our executive and operational management assess the risks facing our businesses and respectively create and implement our risk management policies. The Audit Committee ensures appropriate oversight of risk management and is supported by our internal audit function, which tests the effectiveness of our controls and identifies areas for improvement.



The risks to our strategy

The table below shows the main categories of risks we face and which of our strategic objectives they could affect.

	Strategy					
Risk	Driving top-line growth	Enhancing margins	Transforming Smiths into a world-class organisation	Promoting a culture of responsibility	Generating cash and managing the balance sheet	Allocating capital to maximise returns
Economic outlook and geopolitical environment	■	■			■	■
Financial risks	■	■			■	■
Global supply chain and business/process transformation	■	■				
Government customers	■	■			■	
Information technology/cyber security	■	■			■	
Acquisitions and disposals	■	■			■	■
Legislation and regulations	■	■		■	■	
Pension funding					■	■
Product liability and litigation	■	■			■	
Contractual liabilities	■	■			■	
Technology and innovation	■	■	■			
Talent and succession planning	■	■	■	■	■	

Although the Group faces more risks than those listed above, these are the risks that are currently of most concern to the business and have been considered at recent Board or Audit Committee meetings.

Our Group-wide risks as assessed by the Board

Risks caused by uncontrollable external factors

Economic outlook and geopolitical environment

Potential impact
High

Trend
Higher

Risk and potential impact

Global economic and financial market conditions have partly 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.

Global security concerns continue to drive uncertainty. These include the continuing situation in Syria and the Middle East, as well as the recent events in Ukraine that have led to economic and political sanctions against Russia and the devaluation of the Russian Rouble. Whilst growth is gradually returning in the Eurozone, the economic situation in Greece continues to provide uncertainty in global financial markets. There is the potential for the UK to leave the EU, which may have economic and operational considerations for the Group.

The global oil price continues to trade at levels well below the average of the past few years. This potentially represents the biggest risk to our businesses, particularly John Crane.

Mitigation

The Group has a diversified portfolio of businesses that mitigates exposure to any one country or sector.

The divisions regularly monitor their order flows and other leading indicators, where available, so that they may respond quickly to deteriorating trading conditions.

In the event of a significant economic downturn, there may be opportunities to identify and implement further cost-reduction measures to offset the impact on margins from deteriorating sales.

Compliance with legislation and regulations

Potential impact
Low to medium

Trend
No change

Risk and potential impact

There is a risk that the Group may not always be in complete compliance with laws, regulations or permits, for example concerning environmental or safety requirements. The Group could be held responsible for liabilities and consequences arising from past or future environmental damage, including potentially significant remedial costs. There can also be no assurance that any provisions for expected environmental liabilities and remediation costs will adequately cover these liabilities or costs.

The Group operates in highly regulated sectors. Smiths Detection, Smiths Interconnect and Smiths Medical are particularly subject to regulation, with certain customers, regulators or other enforcement bodies routinely inspecting the Group's practices, processes and premises.

Smiths Detection and Smiths Interconnect manufacture security products and components, which are subject to numerous export controls, technology licensing and other government regulations.

In addition, new legislation, regulations or certification requirements may require additional expense, restrict commercial flexibility and business strategies or introduce additional liabilities for the Company or directors. There also appears to be a growing trend for legislation that could be described as 'protectionist', which may affect our businesses.

Should a regulator's approval process take a particularly long time, our products may be delayed in getting to market, which could lead to a loss of revenue or benefit a competitor with a similar product.

Corruption on the part of a single employee can entail severe consequences for the Group.

Failure to comply with certain regulations may result in significant financial penalties, debarment from government contracts and/or reputational damage.

Mitigation

Environmental, health and safety data are reported to the Quarterly Business Reviews, Executive Committee and the Board, along with actions to improve performance.

Smiths Medical has dedicated staff who maintain close contact with the US Food and Drug Administration and other key regulators.

All divisions have trade compliance advice and training. This includes training on the Group's Code of Business Ethics and assessments to support compliance.

Divisional and Group General Counsel monitor legislative changes (assisted by Government Relations staff) and report and monitor actions as necessary. This may require modifications to our supply chains and customer arrangements.

Risks caused by uncontrollable external factors

Pension funding

Potential impact
Medium to high

Trend
Reduced slightly

Risk and potential impact

At 31 July 2015, the Group has legacy defined benefit pension plans, with aggregate liabilities of approximately £4.1bn on an accounting basis.

Changes in discount rates, inflation, asset returns or mortality assumptions could lead to a materially higher deficit. For example, the cost of a buyout on a discontinued basis, and therefore using more conservative assumptions, is likely to be significantly higher than the accounting deficit. In addition, there is a risk that the plan's assets, such as investments in equity and debt securities, will not be sufficient to cover the value of those benefits.

The implications of a higher pension deficit include a direct impact on the Group's valuation and credit rating, and potential additional funding requirements at subsequent triennial reviews. We have started the 2015 triennial review, which will establish future cash payments to the principal UK pension schemes when concluded.

In the event of a major disposal that generates significant cash proceeds that are returned to shareholders, the Group may be required to make additional cash payments to the schemes or provide additional security.

Mitigation

All major schemes (US/UK) have been closed to new members and future accrual.

Agreed funding plans are in place with the major UK schemes following the last triennial reviews. The Group seeks a good working relationship with the trustees through regular update meetings.

There are plans in place to reduce the mismatch between assets and liabilities, as relative outperformance of the assets versus liabilities is achieved, although there is no downside protection in place should this not occur.

Pension matters are regularly reported to the Board.

Read more in note 9 on page 148

Financial risks (foreign exchange, funding, tax and insurance)

Potential impact
Low to medium

Trend
No change

Risk and potential impact

Foreign exchange: Exchange rate fluctuations have had, and could continue to have, a material impact on the reported results. The Group is exposed to two types of currency risk: transaction and translation. The Group's reported results will fluctuate as average exchange rates change. The Group's reported net assets will fluctuate as the year-end exchange rate changes.

Funding: The Group's ability to refinance its borrowings in the bank or capital markets is dependent on market conditions and the proper functioning of financial markets. The Group may be unable to refinance its debt when due.

Tax: The Group's future profitability, particularly in the US where there are higher rates of corporation tax, may cause the headline tax rate to increase over time. Changes in tax and fiscal regulations and transfer pricing rules in the countries in which we operate could affect the Group, particularly at times when public sector debt is high. Taxation costs could rise and earnings per share could deteriorate, which could affect the Group's market valuation.

Insurance: The Group cannot be certain that it will be able to obtain insurance on acceptable terms or at all. Furthermore, the Group cannot be certain that its insurance will cover losses arising from events or that insurers will not dispute coverage. In addition, even if our coverage is sufficient, the insurance industry is subject to credit risk, particularly in the event of a catastrophe or where an insurer has substantial exposure to a specific risk. If insurance cover is inadequate or does not pay out as expected, the Group could be exposed to an unexpected material cash outflow, which may impact the Group's liquidity and/or share price.

Mitigation

Foreign exchange: The Group's hedging strategy, whereby larger transactions are hedge accounted, mitigates the risk to profitability to some extent. Net investment hedging of overseas assets of approximately 50%, through borrowing in non-sterling currencies, mitigates the impact of exchange rate fluctuations on net assets.

Funding: The Group's debt maturity is staggered so that the refinancing risk is minimised. As at 31 July 2015, the US$800m committed revolving credit facility was undrawn.

Tax: The Group's taxation staff co-ordinate tax management to mitigate possible increases in the effective tax rate. Regular reporting to the Board of tax risks and exposures provides good visibility of issues.

Insurance: Insurance risk is spread across a number of carriers to minimise individual insured risk and counterparty risk.

Read more on page 56

Business challenges / thematic risks

Product liability and litigation

Potential impact
Medium

Trend
No change

Risk and potential impact

In the ordinary course of its business, the Group is subject to litigation such as product liability claims and lawsuits, including potential class actions, alleging that the Group's products have resulted or could result in an unsafe condition or injury.

In addition, manufacturing flaws, component failures or design defects could require us to recall products. Many of our products are used in critical applications where the consequences of a failure could be extremely serious and, in some cases, potentially catastrophic.

Products sold to the aviation, security, healthcare, energy and consumer/domestic industries are particularly critical in nature.

Furthermore, over half the Group's sales are in the US, where there is potentially increased litigation risk.

Any liability claim against the Group, with or without merit, could be costly to defend and could increase our insurance premiums. Some claims might not be covered by our insurance policies, either adequately or at all.

An adverse event involving one of our products could damage our reputation and reduce market acceptance and demand for all of our products.

Mitigation

Quality assurance processes are embedded in our manufacturing locations for critical equipment, supporting compliance with industry regulations.

A global best practice programme is continuing to enhance product quality processes across the Group. This is sponsored by the Executive Committee and leverages the ongoing work in Smiths Medical and John Crane.

The divisions have procedures for dealing with product liability issues and potential product recalls. These procedures are informed by crisis management planning workshops and rehearsals.

The Group has insurance cover for certain product liability risks. 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.

Any litigation is managed under the supervision of the Group's legal function. We have detailed action plans to manage actual or threatened litigation.

Read more on page 57 and in note 23 on page 169

Global supply chain and business/process transformation

Potential impact
Medium

Trend
Reduced slightly

Risk and potential impact

The Group's business depends on the availability and timely delivery of raw materials and purchased components, and could be affected by a disruption to its supply chain. In particular, we rely on sole suppliers to provide raw materials or components for some of our products.

The Group's manufacturing facilities are exposed to a number of natural catastrophe risks that, like other external events such as terrorist attacks or a disease pandemic, could have significant adverse consequences. The Group is also affected by the social, economic, regulatory and political conditions in the countries in which it operates. These are often unpredictable and outside the Group's control, particularly in developing countries.

The concentration of manufacturing in lower cost countries, in particular in Mexico and China, increases the length of the supply chain and means that an adverse event could have more significant consequences for our ability to supply customers on time. A longer supply chain also affects transport costs, which could be exacerbated by energy cost inflation.

As part of the *Fuel for Growth* initiative, there are significant restructuring and reorganisation initiatives underway across the Group. These include site rationalisation and consolidation of manufacturing. There is a risk that these initiatives could cause disruption to the business, including manufacturing processes, supply chain, fulfilment of customer demand, and business systems and processes, or lead to industrial action. However, we are already halfway through this programme and the initiatives to date have been delivered with minimal business disruption. The risk has therefore reduced.

Mitigation

Business continuity and disaster recovery plans are in place and tested for critical locations, to reduce the impact of an event.

Single-source supplier risks are identified and, where possible, key materials or components are dual sourced to mitigate the impact of an event.

The Group regularly evaluates its key sites for a range of risk factors using externally benchmarked assessments, and takes action to improve these ratings where appropriate.

The Group has business interruption and property damage insurance.

Transformation programme and project management is in place in John Crane, Smiths Medical, Smiths Detection and Smiths Interconnect.

All transformation projects are approved by the Group Chief Executive and Finance Director. We are experienced in driving change programmes and all projects are subject to ongoing monitoring at Group and divisional levels.

Business challenges / thematic risks

Government customers

Potential impact
Medium

Trend
No change

Risk and potential impact

We derive a significant proportion of our revenues in mature Western economies and approximately 35% of the Group's revenues are directly related to government expenditure. Additionally, a high proportion of our products and services are in some way influenced by government regulation and certification.

Smiths Detection, Smiths Medical and Smiths Interconnect frequently tender for government contracts. The timing of contract awards and payments under these contracts may be uncertain and uneven over a given financial year.

Any significant disruption or deterioration in relationship with these governments could result in fewer contracts and lower revenues.

At a time when government finances are under pressure, these headwinds may lead to slower growth across the business. A decrease in spending by key government customers could materially affect the Group's results and financial condition. Delays in awarding government contracts can affect the Group's sales, margins and cash conversion in a particular reporting period.

Mitigation

The Group has a diversified portfolio of businesses that mitigates exposure to any one country or sector.

Some of our government-related business has a services or consumables component, which can be more resilient during an economic downturn.

The Group has a government relations function so that it can inform policy and maintain close relationships with customers.

Technology and innovation

Potential impact
Medium

Trend
No change

Risk and potential impact

Developing new products and improving existing products is critical to our business. There is a risk that competitors may innovate more effectively. The emergence of a disruptive technology could have an impact on a major cash-flow contributor to the Group over time.

The speed of innovation in certain markets may lead to shorter product lifecycles, increasing the need for innovation. Additionally, the entry of new competitors, the consolidation of existing competitors and changed or irrational competitor behaviour could significantly affect the Group's business.

The failure of the Group to develop its products and services, or more effective innovation by a competitor, could have a materially adverse effect on sales growth.

Mitigation

The Group has a diversified technology portfolio in a range of sectors and geographies.

Our continued investment in R&D supports new product and service development. There is an increased focus on new product development processes across the Group as part of the *Engineered for Growth* programme.

The Group looks to expand the addressable markets of its key businesses by building capabilities in adjacent markets, through organic investment and through targeted acquisitions.

Talent and succession planning

Potential impact
Medium to high

Trend
Slightly higher

Risk and potential impact

The loss of key personnel, or the failure to plan adequately for succession or develop new talent may impact the reputation of the Group, or lead to a disruption in the leadership of the business.

Competition for personnel is intense and the Group may not be successful in attracting or retaining qualified personnel, particularly engineering professionals. In addition, certain personnel may be required to receive security clearance and substantial training to work on certain programmes. The loss of key employees, the Group's inability to attract new or adequately trained employees, or a delay in hiring key personnel, could seriously harm the Group's business.

The change in executive management may lead to a transition period as they go through their induction programme, with the risk of losing key personnel.

Over time, our competitive advantage is defined by the quality of our people – should we fail to attract, develop and retain key talent, in time our competitive advantage will erode, leading to weaker growth potential or returns.

Mitigation

Each division or function holds talent and succession plan reviews at least annually. These plans are reviewed by the Nomination Committee.

Remuneration packages, including variable and long-term elements of the compensation arrangements, are evaluated regularly against market practice.

The Chief Executive assesses, on an annual basis, the Top 25 people in the organisation for performance, skills and competencies and presents development and succession plans to the Board.

Two leadership development programmes and formal career counselling support the talent pipeline.

Read more on pages 12-13 and 69-71

Business challenges / thematic risks

Programme delivery

Potential impact
Medium

Trend
No change

Risk and potential impact
Failure to deliver, in a timely fashion or at all, the products and services Smiths is obliged to deliver, or any fault in contract execution due to delays or breaches by its suppliers or other counterparties, may lead to higher costs, liquidated damages or other penalties.

Differences between the estimated costs in the Group's medium- and long-term contracts and actual costs may arise from a number of factors including production delays, cost overruns and other items.

Certain of the Group's contracts, particularly those with governments, may include terms that provide for unlimited liabilities on the part of the Group or allow the government body or counterparty to terminate unilaterally, reduce or modify the relevant contracts or seek alternative sources of supply at the Group's expense.

Mitigation
Contracts are managed and delivered by programme management teams that regularly review contract risks and take appropriate action.

A Group-level procedure for reviewing and approving high-risk contracts is in place and further enhancements to our governance processes have been implemented during 2015.

Divisional boards review significant contracts.

The diversified nature of the Group mitigates the exposure to any single contract.

Acquisitions and disposals

Potential impact
Low

Trend
Reduced

Risk and potential impact
Targeted acquisitions and selected disposals form part of the Group's growth strategy. The success of our acquisition strategy depends on identifying targets, obtaining authorisations and having available financing. Even if an acquisition is completed, the acquired products and technologies may not be successful or may require significantly greater resources and investment than anticipated.

The Group may not be able to integrate the businesses that it acquires. If integration is unsuccessful, anticipated benefits are not realised or trading by acquired businesses falls below expectations, it may be necessary to impair the carrying value of these assets.

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 indemnities and warranties given at disposal may affect our financial position.

The risk is reduced as a result of more limited activity and lower value transactions in recent years.

Mitigation
The Executive Committee and Board review the acquisition pipeline. There are monthly reviews with strategy leads for each division.

We perform comprehensive strategic and financial reviews of all opportunities. Detailed due diligence, including an assessment of the target's talent and competencies, and integration planning is undertaken and reviewed in accordance with Group policy.

The Board only authorises acquisitions after completion of due diligence, and approval is subject to meeting the capital allocation and other financial hurdles set by the Board. The Board reviews post-acquisition performance and integration.

On disposals, the Group seeks to minimise its exposure to indemnities and warranties and any that are provided are reviewed on a regular basis.

Information technology and cyber-security

Potential impact
Medium to high

Trend
Higher

Risk and potential impact
The Group's information systems, personnel and facilities are subject to security risk. The Group is dependent on information technology systems for both internal and external communications and for the day-to-day management of its operations. The incidence and sophistication of cyber-security crime is on the rise and some Group companies operate in sectors where cyber-criminals are active.

Any disruption to the information systems could have significant adverse consequences on the Group's operations or its ability to trade. It could result in the loss of confidential information and intellectual property, which could affect the Group's competitive position and cause reputational damage.

Mitigation
Extensive controls and reviews are undertaken to maintain the integrity and efficiency of IT infrastructure and data. We have continued to improve our capability to detect and respond to hostile activity early in an attack.

There are also processes to deal with significant IT security incidents.

A Group-wide information security awareness programme has been launched.