



Sternal Locking Plate

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## Financial Review

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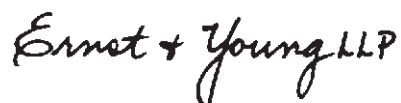
## Report of Independent Auditors

Board of Directors and Shareholders  
Synthes, Inc.

We have audited the accompanying consolidated balance sheets of Synthes, Inc. and subsidiaries (the Group) as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Group's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Group as of December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

The logo for Ernst & Young LLP is written in a stylized, cursive script. The words "Ernst & Young" are in a larger font, and "LLP" is smaller and positioned to the right of "Young".

Philadelphia, Pennsylvania  
February 19, 2007

## Synthes, Inc. and Subsidiaries

Consolidated Balance Sheets as of December 31,  
2006 and 2005

<b>Assets</b>	<b>2006</b>	<b>2005</b>
<b>Current assets</b>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Cash and cash equivalents	289,987	368,489
Accounts receivable		
Trade, less allowance of US\$ 12.5 million and US\$ 8.8 million in 2006 and 2005, respectively	437,029	356,052
Other	46,782	24,168
Inventories, net	455,376	340,691
Prepaid expenses and other current assets	9,979	7,721
Deferred income taxes	47,406	25,880
<b>Total current assets</b>	<b>1,286,559</b>	<b>1,123,001</b>
<b>Property, plant and equipment, net</b>	<b>544,983</b>	<b>506,171</b>
<b>Other assets</b>		
Intangible assets, less accumulated amortization of US\$ 94.6 million and US\$ 61.8 million in 2006 and 2005, respectively	1,743,267	893,279
Goodwill	911,633	853,577
Other assets	22,725	24,814
Deferred income taxes	40,110	39,372
<b>Total other assets</b>	<b>2,717,735</b>	<b>1,811,042</b>
<b>Total assets</b>	<b>4,549,277</b>	<b>3,440,214</b>

<b>Liabilities and stockholders' equity</b>	<b>2006</b>	<b>2005</b>
<b>Current liabilities</b>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current maturities of long-term debt	158,807	99,217
Accounts payable	44,257	43,747
Income taxes payable	66,237	67,359
Accrued expenses	281,618	311,227
Current acquisition-related liabilities	95,806	–
Deferred income taxes	26,119	34,677
<b>Total current liabilities</b>	<b>672,844</b>	<b>556,227</b>
Long-term debt, net of current maturities	14,163	225,378
Long-term acquisition-related liabilities	205,598	–
Other long-term liabilities	40,988	37,217
Deferred income taxes	236,005	226,150
Minority interests	1,029	7,827
<b>Total liabilities</b>	<b>1,170,627</b>	<b>1,052,799</b>
<b>Stockholders' equity</b>		
Common stock CHF 0.001 par value; shares authorized – 150,000,000; shares issued – 2006 – 118,675,733; 2005 – 114,946,858; shares outstanding – 2006 – 118,666,769; 2005 – 114,936,791	79	76
Additional paid-in capital	1,924,756	1,512,932
Treasury stock – at cost	(525)	(590)
Retained earnings	1,327,360	880,797
Accumulated other comprehensive income (loss)	126,980	(5,800)
<b>Total stockholders' equity</b>	<b>3,378,650</b>	<b>2,387,415</b>
<b>Total liabilities and stockholders' equity</b>	<b>4,549,277</b>	<b>3,440,214</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Synthes, Inc. and Subsidiaries

Consolidated Statements of Operations for the Years  
Ended December 31, 2006 and 2005

	2006 <i>in 1,000 US\$</i>	2005 <i>in 1,000 US\$</i>
<b>Net sales</b>	<b>2,391,595</b>	<b>2,078,150</b>
Cost of goods sold	433,731	362,653
<b>Gross profit</b>	<b>1,957,864</b>	<b>1,715,497</b>
<b>Operating expenses</b>		
Selling and promotion	704,594	592,578
General and administrative	266,418	247,817
Research and development	125,605	114,835
Royalty expense	68,837	73,249
Amortization of intangible assets	29,828	24,775
	<b>1,195,282</b>	<b>1,053,254</b>
<b>Operating income</b>	<b>762,582</b>	<b>662,243</b>
<b>Other income (expenses)</b>		
Interest expense	(9,291)	(12,848)
Interest income	9,354	7,434
Foreign exchange gains	5,766	9,149
Other, net	(4,264)	(2,281)
	<b>1,565</b>	<b>1,454</b>
<b>Earnings before minority interest and income taxes</b>	<b>764,147</b>	<b>663,697</b>
Minority interest (income) expense	(687)	1,846
<b>Earnings before income taxes</b>	<b>764,834</b>	<b>661,851</b>
Income taxes	256,037	225,813
<b>Net earnings</b>	<b>508,797</b>	<b>436,038</b>
<b>Basic and diluted earnings per share (expressed in US\$)</b>	<b>4.38</b>	<b>3.79</b>
	<i>in 1,000 of shares</i>	<i>in 1,000 of shares</i>
<b>Weighted average number of common shares outstanding</b>	<b>116,236</b>	<b>114,921</b>
<b>Weighted average number of common shares outstanding with dilutive effect</b>	<b>116,275</b>	<b>114,960</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Synthes, Inc. and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity  
for the Years Ended December 31, 2006 and 2005

	Common stock		Additional paid-in capital in 1,000 US\$	Treasury stock in 1,000 US\$	Retained earnings in 1,000 US\$	Accumulated other comprehensive income (loss) in 1,000 US\$	Total Stockhol- ders' equity in 1,000 US\$	Compre- hensive in- come (loss) in 1,000 US\$
	in 1,000 of shares	in 1,000 US\$						
<b>Balance December 31, 2004</b>	<b>114,873</b>	<b>76</b>	<b>1,504,847</b>	<b>(652)</b>	<b>511,642</b>	<b>276,501</b>	<b>2,292,414</b>	<b>-</b>
Net earnings 2005	-	-	-	-	436,038	-	436,038	436,038
Issuance of common stock	74	-	5,701	-	-	-	5,701	-
Re-issuance of treasury shares	-	-	58	62	-	-	120	-
Dividends CHF 0.7000 (US\$ 0.5819) per share	-	-	-	-	(66,883)	-	(66,883)	-
Share-based payment arrangements compensation	-	-	2,326	-	-	-	2,326	-
Minimum pension liability adjustment, net of deferred taxes of US\$ 2.227 million	-	-	-	-	-	(6,495)	(6,495)	(6,495)
Foreign currency translation adjustment 2005	-	-	-	-	-	(275,806)	(275,806)	(275,806)
<b>Balance December 31, 2005</b>	<b>114,947</b>	<b>76</b>	<b>1,512,932</b>	<b>(590)</b>	<b>880,797</b>	<b>(5,800)</b>	<b>2,387,415</b>	<b>153,737</b>
Net earnings 2006	-	-	-	-	508,797	-	508,797	508,797
Issuance of common stock in connection with asset acquisition	3,705	3	407,481	-	-	-	407,484	-
Issuance of common stock	24	-	2,717	-	-	-	2,717	-
Re-issuance of treasury shares	-	-	75	65	-	-	140	-
Dividends CHF 0.7000 (US\$ 0.5414) per share	-	-	-	-	(62,234)	-	(62,234)	-
Share-based payment arrangements compensation	-	-	1,551	-	-	-	1,551	-
Minimum pension liability adjustment, net of deferred taxes of US\$ (2.727) million	-	-	-	-	-	4,524	4,524	4,524
Cumulative adjustment to initially apply SFAS 158, net of deferred taxes of US\$ 2.475 million	-	-	-	-	-	(10,172)	(10,172)	-
Unrealized gains on foreign currency hedges	-	-	-	-	-	59	59	59
Foreign currency translation adjustment 2006	-	-	-	-	-	138,369	138,369	138,369
<b>Balance December 31, 2006</b>	<b>118,676</b>	<b>79</b>	<b>1,924,756</b>	<b>(525)</b>	<b>1,327,360</b>	<b>126,980</b>	<b>3,378,650</b>	<b>651,749</b>

The accompanying notes are an integral part of these consolidated financial statements.

## Synthes, Inc. and Subsidiaries

Consolidated Statements of Cash Flows for the Years  
Ended December 31, 2006 and 2005

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
<b>Cash flows from operating activities</b>		
Net earnings	508,797	436,038
Adjustments to reconcile net earnings to net cash provided by operating activities		
Minority interest	(687)	1,846
Share-based compensation	4,121	4,933
Inventory charge related to business acquisitions	–	2,124
Provisions for inventory obsolescence	24,398	19,910
Depreciation	167,330	137,738
Amortization	31,384	26,486
Provisions for doubtful accounts	3,272	2,674
Deferred income taxes	(37,732)	(21,483)
Losses on sale of property, plant and equipment	2,989	957
Other	(5,651)	3,660
Changes in assets and liabilities, net of effects of business acquisitions		
Accounts receivable trade	(66,187)	(52,420)
Accounts receivable other	(24,242)	(3,208)
Inventories	(119,347)	(99,474)
Prepaid expenses and other current assets	(1,424)	(324)
Accounts payable	(1,719)	(10,490)
Income taxes payable	201	32,224
Accrued expenses	39,119	52,809
<b>Net cash provided by operating activities</b>	<b>524,622</b>	<b>534,000</b>

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
<b>Cash flows from investing activities</b>		
Capital expenditures for property, plant and equipment	(190,284)	(183,968)
Contingent consideration related to a prior acquisition	(79,903)	–
Purchase of minority interest	(4,433)	–
Proceeds from sale of minority interest	798	–
Proceeds from disposal of property, plant and equipment	1,291	119
Business acquisitions, net of cash acquired	–	(13,139)
Asset acquisition	(103,919)	–
Investment in non-consolidated investments and other long-term assets	(3,815)	(8,351)
Disposals of non-consolidated investments and other long-term assets	6,248	1,458
Issuance of loans	(1,470)	(585)
Proceeds from loans	–	7,445
<b>Net cash used in investing activities</b>	<b>(375,487)</b>	<b>(197,021)</b>
<b>Cash flows from financing activities</b>		
Principal payments of debt and capital lease obligations	(174,577)	(163,066)
Proceeds from issuance of long-term debt	7,560	979
Proceeds from issuance of common stock in connection with stock options	146	3,094
Dividends paid to stockholders	(62,234)	(66,883)
Excess tax benefits from share-based arrangements	57	1,058
<b>Net cash used in financing activities</b>	<b>(229,048)</b>	<b>(224,818)</b>
Effect of exchange rate changes on cash and cash equivalents	1,411	(7,459)
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(78,502)</b>	<b>104,702</b>
Cash and cash equivalents as of January 1	368,489	263,787
<b>Cash and cash equivalents as of December 31</b>	<b>289,987</b>	<b>368,489</b>
<b>Supplemental disclosures of cash flow information</b>		
Interest paid	8,528	12,623
Income taxes paid	303,412	216,608
<b>Non cash transactions</b>		
Issuance of common stock in connection with asset acquisition	407,484	–
Accrual of future consideration in connection with asset acquisition	301,404	–
Accrual of additional contingent consideration related to business combination	–	27,040

The accompanying notes are an integral part of these consolidated financial statements.

**Synthes, Inc. and Subsidiaries**

# Notes to the Consolidated Financial Statements December 31, 2006 and 2005

**Note A – Basis of presentation**

**1 Description and nature of operations**

Synthes, Inc. and its subsidiaries (the Group) develops, manufactures, and distributes products for the operative treatment of bone fractures including both metallic and osteobiological materials in different areas of the world. Additionally, the Group has a power tools business including development, manufacturing, and distribution.

The Group is comprised of Synthes, Inc. and the companies shown in Note C19 (list of fully consolidated companies as of December 31, 2006). Synthes, Inc. is a corporation registered in Delaware, USA.

**Note B – Summary of significant accounting policies**

A summary of the Group's significant accounting policies that were applied in the preparation of the accompanying consolidated financial statements follows:

**1 Basis of the consolidated financial statements**

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP).

The consolidated financial statements include the accounts of Synthes, Inc. and all companies in which Synthes, Inc. has directly or indirectly more than a 50% voting interest or is the primary beneficiary of a variable interest entity. For those consolidated subsidiaries where ownership is less than 100%, the outside stockholders' interests are shown in minority interest in the accompanying financial statements. Subsidiaries are consolidated from the date of acquisition. Acquisitions of subsidiaries are accounted for using the purchase method of accounting. All intercompany transactions and balances between Group companies are eliminated.

**2 Foreign currency translation**

The financial statements of the holding company's subsidiaries outside the United States of America are translated into US dollars (US\$), the Group's reporting currency, as follows:

The balance sheets are translated at year-end rates.

The statements of operations are translated at the weighted average exchange rates for the period. Weighted average exchange rates are calculated based on monthly average rates for the applicable currencies. Translation adjustments are charged or credited to accumulated other comprehensive income.

Foreign currency transactions are accounted for at the exchange rates prevailing at the date of the transaction. Gains and losses resulting from the settlement of such transactions and from the remeasurement of monetary assets and liabilities denominated in foreign currencies are recognized in the consolidated statements of operations.

The following is a summary of exchange rates used in relation to US\$:

		Year-end rates at December 31		Weighted average rates for year ended December 31	
		2006	2005	2006	2005
CHF	1 =	0.8173	0.7620	0.7981	0.8027
CDN	1 =	0.8617	0.8546	0.8818	0.8268
GBP	1 =	1.9593	1.7304	1.8415	1.8175
SEK	100 =	14.5500	12.5900	13.5436	13.4007
NOK	100 =	15.9490	14.8000	15.6138	15.5210
DKK	100 =	17.6400	15.8800	16.8253	16.6780
MXN	100 =	9.1840	9.3080	9.1885	9.2026
CZK	100 =	4.7800	4.0830	4.4492	4.1790
HUF	100 =	0.5220	0.4690	0.4769	0.5019
EUR	1 =	1.3139	1.1873	1.2554	1.2428
ARS	1 =	0.3258	0.3295	0.3272	0.3431
BRL	1 =	0.4680	0.4272	0.4606	0.4143
COP	100 =	0.0460	0.0440	0.0436	0.0433
PLN	100 =	34.3230	30.7370	32.2382	30.9659
AUD	1 =	0.7872	0.7280	0.7533	0.7621
CNY	1 =	0.1281	0.1240	0.1255	0.1223
HKD	1 =	0.1286	0.1290	0.1287	0.1286
IDR	100 =	0.0110	0.0100	0.0128	0.0102
INR	1 =	0.0226	0.0222	0.0221	0.0227
JPY	100 =	0.8420	0.8520	0.8600	0.9084
KRW	100 =	0.1090	0.1000	0.1065	0.0979
MYR	1 =	0.2832	0.2644	0.2737	0.2642
NZD	1 =	0.7033	0.6783	0.6500	0.7043
RUB	100 =	3.7950	3.4730	3.6797	3.5344
SGD	1 =	0.6512	0.6001	0.6294	0.6008
THB	100 =	2.8200	2.4450	2.6427	2.4855
TWD	100 =	3.0610	3.0440	3.0720	3.1144
ZAR	1 =	0.1420	0.1575	0.1494	0.1577
PEN	1 =	0.3243	0.2919	0.3140	0.3042

**3 Reclassifications**

Certain 2005 financial information has been reclassified to conform to the current year presentation.

**4 Cash and cash equivalents**

Cash and cash equivalents consist of cash and highly liquid short-term investments with original maturities of three months or less.

**5 Accounts receivable**

The majority of the Group's accounts receivable are due from various health care facilities. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are stated at amounts due from customers net of an allowance for doubtful accounts. Payment terms vary. Accounts outstanding longer than the payment terms are considered past due. The Group determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, previous loss history, the customer's current ability to pay its obligation, and the condition of the general economy and industry as a whole. The Group writes off accounts receivable when they are determined to be uncollectible.

**6 Inventories**

Inventories are stated at the lower of cost or market, using the first-in, first-out method. The Group maintains provisions for excess and obsolete inventory. The Group estimates these provisions based on historical experience and expected future trends.

**7 Property, plant and equipment**

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method over the estimated useful life of the asset. The estimated useful lives are as follows:

Land	–
Buildings	30–40 years
Building improvements	10–20 years
Machinery and fixtures	3–12 years
Equipment/EDP	3–8 years
Loan sets and samples	3 years
Vehicles	3 years

**8 Impairment of long-lived assets**

The Group follows Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, to evaluate impairment of intangible assets subject to amortization and other long-lived assets, other than goodwill and indefinite-lived intangible assets. The Group periodically evaluates whether current facts or circumstances indicate that the carrying value of such assets to be held and used may not be recoverable. If such circumstances are determined to exist, an estimate of undiscounted future cash flows to be produced by the long-lived asset is compared to the carrying value to determine whether impairment exists. If an asset is determined to be impaired, the loss is measured based on fair value using quoted market prices in active markets, if available. If quoted market prices are not available, the estimate of fair value is

based on various valuation techniques, including discounted estimated future cash flows.

## 9 Intangible assets

Intangible assets with finite lives consist mainly of customer relationships, acquired patents and patent rights, software, product-related know-how, and licensing and marketing agreements and are amortized on a straight-line basis over their estimated useful lives, ranging from 5 to 40 years. Such assets are evaluated for impairment in accordance with SFAS No. 144 as described in Note B8.

Intangible assets with indefinite lives consist of the Synthes trade name and geographic marketing rights. Indefinite-lived assets are not amortized but are required to be tested for potential impairment at least annually, or whenever impairment indicators exist. Such assets are deemed to be impaired if book value exceeds estimated fair value.

## 10 Goodwill

The excess of cost over fair value of assets acquired in business combinations (goodwill) is assigned to specific reporting units and is tested for possible impairment at least annually, or whenever impairment indicators exist. Potential impairment is indicated when the carrying value of a reporting unit, including goodwill, exceeds its fair value. If potential for impairment exists, an impairment charge is recognized when the carrying value of a reporting unit's goodwill exceeds its implied fair value.

## 11 Other assets

Other long-term assets are primarily non-consolidated investments, loans and other deferred costs. Non-consolidated investments are stated at cost, less any impairment adjustments. Loans are long-term loans to third parties which are carried at cost.

## 12 Revenue recognition

Sales are recognized on products when the related goods have been shipped, title has passed to the customer, and there are no undelivered elements or uncertainties. For consignment inventory, revenue is recognized when the Group is notified that the product has been used.

Services revenue, which is insignificant, is recognized upon the completion of refurbishment of certain products and the shipment of that product back to the customer.

Amounts billed to customers for shipping and handling of products are included in net sales. Costs incurred related to shipping and handling are included in cost of sales.

The Group records estimated sales returns and allowances as a reduction of net sales in the same period revenue is recognized.

**13 Income taxes**

The Group follows Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Under the liability method specified by SFAS No. 109, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates that will be in effect when these differences are expected to reverse. Deferred income tax expense (benefit) is the result of changes in deferred tax assets and liabilities during the year.

**14 Equity compensation**

The Group has an equity incentive plan for directors and employees, which is a fixed employee stock-based compensation plan. Under this plan, the Group may grant options and shares for up to 1,500,000 shares of Common Stock. The exercise price of each option is equal to the market share price of the Group's stock on the date of grant. The maximum term of the options ranges from 10 to 14 years and the options vest over periods ranging from immediately to 5 years. Certain option and share awards provide for accelerated vesting if there is a change of control (as defined by the plan).

Prior to July 1, 2005, the Group accounted for those plans under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees, and Related Interpretations, as permitted by FASB Statement No. 123, Accounting for Stock-Based Compensation*. No stock-based employee compensation cost was recognized in the consolidated statements of operations for the six-month period ended June 30, 2005, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. Effective July 1, 2005, the Group adopted the fair value recognition provisions of FASB Statement No. 123(R), *Share-Based Payment*, using the modified-prospective transition method. Under that transition method, compensation cost recognized in the second half of 2005 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of July 1, 2005, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to July 1, 2005, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

As a result of adopting Statement 123(R) on July 1, 2005, the Group's earnings before income taxes and net earnings for the year ended December 31, 2005 are US\$ 2.326 million and US\$ 1.477 million lower, respectively, than if it had continued to account for share-based compensation under Opinion 25. Basic and diluted earnings per share for the year ended December 31, 2005 would have been US\$ 3.81 if the Group had not adopted Statement 123(R), compared to reported basic and diluted earnings per share of US\$ 3.79.

**15 Financial instruments**

In assessing the fair value of financial instruments, the Group uses a variety of methods and makes assumptions that are based on market conditions existing at each balance sheet date. The fair values of investments are based on quoted mar-

ket prices at the balance sheet date. Quoted market prices or dealer quotes for the specific or similar instruments are used for long-term debt. Other techniques, such as estimated discounted value of future cash flows, are used to determine fair value for the remaining financial instruments. The carrying value of financial instruments approximates fair value.

#### **16 Concentrations of credit risk**

Financial instruments that may potentially subject the Group to concentration of credit risk consist principally of cash, cash equivalents, trade accounts receivable and derivatives. All cash, cash equivalents, and derivatives are placed in financial institutions with strong credit ratings, which minimizes the risk of loss due to non-payment.

Concentration of credit risks with respect to trade accounts receivable is limited, due to the large number of customers and their dispersion across many geographic areas. Also, the Group has policies in place to ensure that sales of products and services are made to customers with an appropriate credit history. However, a significant portion of trade accounts receivable is with national health care systems in several countries. Although the Group does not currently foresee a credit risk associated with these receivables, repayment is dependent upon the financial stability of those customers.

#### **17 Derivatives**

The Group uses derivative financial instruments to manage interest rate risk and currency exchange risk. While these derivative financial instruments are subject to fluctuations in value, these fluctuations are generally offset by the value of the underlying exposures. The Group minimizes the risk of credit loss by entering into these agreements with major financial institutions that have high credit ratings. The Group accounts for its derivative financial instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, referred to as SFAS 133, as amended by SFAS 138 and SFAS 149, which requires companies to recognize all of their derivative instruments as either assets or liabilities in the balance sheet at fair value.

The Group is exposed to foreign currency fluctuations relating to its manufacturing and marketing operations throughout the world. The Group periodically enters into forward exchange contracts in order to minimize the impact of currency fluctuations on transactions and cash flows. A portion of these contracts are designated as cash flow hedges and are recorded at their fair value on the accompanying consolidated balance sheets in other current assets and accrued liabilities, while the related gain and losses are deferred by charging other comprehensive income in the equity section of the consolidated balance sheets. Amounts so deferred on these cash flow hedges are recognized when product is ultimately sold to third-party customers. All derivatives designated as cash flow hedges in 2006 had maturities of less than 6 months at inception. The remainder of these contracts have not been designated as hedges and are also valued and recorded at their fair value on the accompanying consolidated balance sheets in other current assets and accrued liabilities. Changes in the fair value of these undesignated derivative contracts are recorded currently in the consolidated statements of operations in "other, net" (Note C22).

The Group is also exposed to interest rate risks on its floating rate debt instruments. The Group has entered into interest rate swap agreements to minimize its exposure to rising interest rates on a portion of its floating rate debt. Additionally, the Group has purchased the option to cancel some of these interest rate swap agreements on March 1, 2007, June 1, 2007, and September 1, 2007 with no additional cost or cash outlay. These derivative instruments have not been designated as hedges and are valued and recorded at their fair value on the accompanying consolidated balance sheets in other assets and other short-term liabilities. Changes in the fair value of the derivative contracts are recorded currently in the consolidated statements of operations in "other, net" (Note C22).

### **18 Advertising costs**

Advertising and promotion costs are expensed as incurred, and were US\$ 38.6 million and US\$ 48.0 million in 2006 and 2005, respectively.

### **19 Use of estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from these estimates. Significant areas that require management's estimates include the allowance for doubtful accounts receivable, obsolete inventories, fair values of acquired assets and liabilities, useful lives of assets, product liability claims, commitments and contingencies, and income taxes. The Group is subject to risks and uncertainties, such as changes in the health care environment, regulatory oversight, competition and legislation that may cause actual results to differ from estimated results.

### **20 New accounting standards**

In October 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158 (SFAS 158), *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. This statement requires plan sponsors of defined benefit pension and other postretirement benefit plans (collectively, "postretirement benefit plans") to recognize, on their balance sheets, an asset or liability reflecting the funded status of their postretirement benefit plans as the difference between the projected benefit obligation and fair value of plan assets with changes continuing to be reflected in the accumulated other comprehensive income (loss) component of stockholders' equity, net of related income taxes. This statement also requires an entity to measure the fair value of plan assets and benefit obligations as of the date of the fiscal year-end statement of financial position, and provide additional disclosures. This statement will not change the calculation of the amount of net periodic benefit cost included in net earnings. On December 31, 2006, the Group adopted the recognition and disclosure provisions of SFAS 158 with the exception of SFAS 158's provisions regarding the change in the measurement date of postretirement benefit plans which become effective for fiscal years ending after December 15, 2008. The effect of adopting SFAS 158 on the Group's financial condition at December 31, 2006 has been included in the accompanying consolidated financial statements. SFAS 158 did not have an effect on the Group's consolidated financial condition

at December 31, 2005. See Note C9 for further discussion on the effect of adopting SFAS 158 on the Group's consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), an interpretation of SFAS 109, *Accounting for Income Taxes*, to create a single model to address accounting for uncertainty in tax positions. FIN 48 clarifies the accounting for income taxes, by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Group will adopt FIN 48 as of January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be recorded in retained earnings (and other accounts as applicable) and will not require restatement of prior periods. The Group is currently evaluating the potential effect of adoption of FIN 48 on its consolidated financial position and results of operations.

**Synthes, Inc. and Subsidiaries**

# Notes to the Consolidated Financial Statements

## December 31, 2006 and 2005

**Note C – Footnotes****1 Accounts receivable other**

Following is a summary of accounts receivable other at December 31:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Refundable taxes, principally value added tax (V.A.T.)	31,289	15,332
Deposits	2,245	1,053
Due from officers, directors and employees	1,979	1,551
All other	11,269	6,232
	<b>46,782</b>	<b>24,168</b>

**2 Inventories**

Inventories are summarized at December 31, as follows:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Raw materials	79,888	50,680
Work-in-progress and semi-finished products	99,197	67,690
Finished products	295,030	236,541
Customer consignment stock	33,539	28,954
<b>Gross value</b>	<b>507,654</b>	<b>383,865</b>
Less provision for obsolescence	(52,278)	(43,174)
<b>Net value</b>	<b>455,376</b>	<b>340,691</b>

**3 Property, plant and equipment**

Details of property, plant and equipment at December 31, are as follows:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Land and buildings	194,868	181,869
Machines and fixtures	297,232	260,249
Office equipment, field equipment and vehicles	661,778	523,340
	<b>1,153,878</b>	<b>965,458</b>
Less: accumulated depreciation	(639,005)	(476,761)
	<b>514,873</b>	<b>488,697</b>
Construction in progress	30,110	17,474
	<b>544,983</b>	<b>506,171</b>

Depreciation expense recorded in the consolidated statements of operations was US\$ 167.3 million and US\$ 137.7 million in 2006 and 2005, respectively.

#### 4 Intangible assets

Following is a summary of intangible assets, excluding goodwill, at the end of the year:

	December 31, 2006		
	Total <i>in 1,000 US\$</i>	Gross amount <i>in 1,000 US\$</i>	Accumulated amortization <i>in 1,000 US\$</i>
<b>Finite lived:</b>			
Product intangible assets	60,000	80,000	(20,000)
Customer relationships	659,204	713,716	(54,512)
Patents/Patent rights	191,169	195,315	(4,146)
Other intangible assets	9,105	25,029	(15,924)
Subtotal – finite lived intangible assets	919,478	1,014,060	(94,582)
<b>Indefinite lived:</b>			
Geographic marketing rights	204,325	204,325	–
Trade names	619,464	619,464	–
Subtotal – indefinite lived intangible assets	823,789	823,789	–
<b>Total – intangible assets</b>	<b>1,743,267</b>	<b>1,837,849</b>	<b>(94,582)</b>

	December 31, 2005		
	Total <i>in 1,000 US\$</i>	Gross amount <i>in 1,000 US\$</i>	Accumulated amortization <i>in 1,000 US\$</i>
<b>Finite lived:</b>			
Product intangible assets	65,333	80,000	(14,667)
Customer relationships	631,174	662,940	(31,766)
Other intangible assets	6,272	21,646	(15,374)
Subtotal – finite lived intangible assets	702,779	764,586	(61,807)
<b>Indefinite lived:</b>			
Geographic marketing rights	190,500	190,500	–
<b>Total – intangible assets</b>	<b>893,279</b>	<b>955,086</b>	<b>(61,807)</b>

The trade names, patents and patent rights were acquired in 2006 in the asset purchase transaction described in Note C21.

The increases in gross amount of customer relationships and geographic marketing rights from December 31, 2005 to December 31, 2006 results from changes in foreign currency translation rates.

Amortization expense for intangible assets, was US\$ 31.4 million and US\$ 26.5 million in 2006 and 2005, respectively. Estimated amortization expense for each of the five years through December 31, 2011 is as follows (in US\$ millions): 37.7, 36.5, 36.4, 36.3 and 35.8, respectively.

**5 Income taxes**

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

The amount of the deferred tax assets and liabilities recognized in the consolidated balance sheets as of December 31, is as follows:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
<b>Deferred income tax assets</b>		
Product liability	5,968	4,446
Net operating loss carryforwards	12,128	11,137
Inventories	49,463	36,803
Accounts receivable	3,551	2,000
Payments to employees	9,284	10,340
Other	40,644	23,511
Gross deferred income tax assets	121,038	88,237
Valuation allowance	(10,373)	(9,483)
<b>Net deferred income tax assets</b>	<b>110,665</b>	<b>78,754</b>
<b>Deferred income tax liabilities</b>		
Accelerated tax depreciation	(23,599)	(38,180)
Intangible assets	(219,195)	(194,306)
Inventories	(18,030)	(15,026)
Other	(24,449)	(26,817)
<b>Gross deferred income tax liabilities</b>	<b>(285,273)</b>	<b>(274,329)</b>
<b>Net deferred income tax liabilities</b>	<b>(174,608)</b>	<b>(195,575)</b>

At December 31, 2006, the approximate amounts and expiration of net operating loss carryforwards (primarily foreign) are as follows (in millions): 2007: US\$ 1.0, 2008–2011: US\$ 11.7, 2012 and later years: US\$ 41.0, and US\$ 6.4 have an indefinite carryforward period.

The change in net deferred income tax liabilities is as follows:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Beginning of the year	(195,575)	(253,699)
Statement of operations benefit (expense)	37,732	21,483
Currency translation adjustment	(16,765)	36,641
<b>End of the year</b>	<b>(174,608)</b>	<b>(195,575)</b>

Deferred income tax assets and liabilities are included in the consolidated balance sheets as follows:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current assets – deferred income taxes	47,406	25,880
Noncurrent assets – deferred income taxes	40,110	39,372
Current liabilities – deferred income taxes	(26,119)	(34,677)
Noncurrent liabilities – deferred income taxes	(236,005)	(226,150)
<b>Total net deferred tax liabilities</b>	<b>(174,608)</b>	<b>(195,575)</b>

Cumulative undistributed earnings of foreign subsidiaries, for which no U.S. income or foreign withholding taxes have been recorded, approximated US\$ 214 million at December 31, 2006. As the Group intends to permanently reinvest all such earnings, no provision has been made for income taxes that may become payable upon distribution of such earnings, and it is not practicable to determine the amount of the related unrecognized deferred income tax liability. While there are no specific plans to distribute the undistributed earnings in the immediate future, where economically appropriate to do so, such earnings may be remitted.

Tax expense consists of:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current taxes	293,769	247,296
Deferred tax (benefit) expense	(37,732)	(21,483)
	<b>256,037</b>	<b>225,813</b>

The following reconciles the provision for income taxes, at the U.S. statutory federal income tax rate to the provision for income taxes as reported:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Earnings before minority interest and income taxes	764,147	663,697
Minority interest (income) expense	(687)	1,846
<b>Earnings before income taxes</b>	<b>764,834</b>	<b>661,851</b>
Tax expense calculated at a statutory tax rate of 35%	267,692	231,648
Effect of non-deductible expenses	1,357	1,070
Effect of taxes in other countries	(29,364)	(14,407)
Impact of tax effect of minority interest	(240)	646
State income taxes, net of federal income tax benefit	21,074	9,738
Tax benefits relating to tax credits	(3,700)	(3,429)
Other	(782)	547
<b>Income tax expense</b>	<b>256,037</b>	<b>225,813</b>

## 6 Goodwill

Changes in the carrying amount of goodwill during 2006 and 2005, by reporting unit and in the aggregate, are summarized in the following tables:

<b>2006</b>	<b>Total</b> <i>in 1,000 US\$</i>	<b>North America</b> <i>in 1,000 US\$</i>	<b>Europe</b> <i>in 1,000 US\$</i>	<b>Asia Pacific</b> <i>in 1,000 US\$</i>	<b>Latin America</b> <i>in 1,000 US\$</i>
Balance, January 1, 2006	<b>853,577</b>	27,801	725,795	61,382	38,599
Sale of minority interest	<b>(1,976)</b>	–	–	(1,976)	–
Other	<b>(99)</b>	(99)	–	–	–
Currency translation adjustments	<b>60,131</b>	–	51,321	5,998	2,812
<b>Balance, December 31, 2006</b>	<b>911,633</b>	27,702	777,116	65,404	41,411

<b>2005</b>	<b>Total</b> <i>in 1,000 US\$</i>	<b>North America</b> <i>in 1,000 US\$</i>	<b>Europe</b> <i>in 1,000 US\$</i>	<b>Asia Pacific</b> <i>in 1,000 US\$</i>	<b>Latin America</b> <i>in 1,000 US\$</i>
Balance, January 1, 2005	<b>958,439</b>	761	841,714	71,202	44,762
Arising from contingent consideration for previously completed business combination	<b>27,040</b>	27,040	–	–	–
Currency translation adjustments	<b>(131,902)</b>	–	(115,919)	(9,820)	(6,163)
<b>Balance, December 31, 2005</b>	<b>853,577</b>	27,801	725,795	61,382	38,599

## 7 Long-term debt

Among other restrictions, the Group has agreed to maintain specified levels of working capital and certain financial performance ratios for various debt agreements. Details of long-term debt as of December 31, are as follows:

	<b>2006</b> <i>in 1,000 US\$</i>	<b>2005</b> <i>in 1,000 US\$</i>
Secured loans	839	1,013
Unsecured loans	169,287	317,568
Other, including capital lease obligations	2,844	6,014
	<b>172,970</b>	<b>324,595</b>
Less: current maturities	(158,807)	(99,217)
	<b>14,163</b>	<b>225,378</b>

Required principal payments for the next five years and thereafter are as follows:

<b>Year ended December 31</b>	<i>in 1,000 US\$</i>
2007	158,807
2008	10,959
2009	257
2010	270
2011	285
Thereafter	2,392

Details of significant debt agreements at December 31, 2006 are as follows:

Debt consists of a credit facility with a financial institution, a series of Guaranteed Senior Notes, Industrial Revenue Bonds, and capital leases.

Secured loans consist of Industrial Revenue Bonds and are collateralized by machinery, equipment and buildings and bear interest at fixed rates ranging from 3% to 5.2%.

Unsecured loans are comprised of the credit facility and Guaranteed Senior Notes.

Borrowings under the credit facility, which is a multi-currency term loan facility under which loans are denominated in both U.S. dollars and Swiss Francs, bear interest at a rate that resets quarterly and is based on a spread over 3 month LIBOR for each currency. Principal balances at December 31, 2006 and 2005 total US\$ 147.3 million and US\$ 279.9 million, respectively. As of December 31, 2006, the interest rates on the U.S. dollar and Swiss Franc loans were 5.744% and 2.315%, respectively. The credit facility is required to be paid in full in December 2007.

The Guaranteed Senior Notes have principal balances at December 31, 2006 and 2005 of US\$ 21.4 million and US\$ 32.1 million, respectively. The Guaranteed Senior Notes bear interest at a fixed rate of 6.66% and will be paid in annual installments through October 2008.

As of December 31, 2006, the Group is in compliance with the financial covenants of the credit facility and Guaranteed Senior Notes, and no situation existed which would constitute an event of default as defined by the respective agreements.

## 8 Leases

Leased assets included in property, plant and equipment, where the Group is a lessee under a capital lease, are comprised of a single building as of December 31, 2006 and buildings, office equipment and vehicles as of December 31, 2005. Following is a summary of property held under the capital lease as of December 31:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Cost – capitalized leases	3,917	5,206
Accumulated depreciation	(2,194)	(2,199)
<b>Net book amount</b>	<b>1,723</b>	<b>3,007</b>

The Group leases office buildings from an affiliate. One of the leases is classified as a capital lease with the related asset and liability recorded. The leases provide for minimum annual lease payments, in the aggregate, of US\$ 6.0 million through 2021, plus contingent annual rentals based on the change in the U.S. Consumer Price Index.

Minimum future lease payments under capital leases as of December 31, 2006 for each of the next five years and in the aggregate are:

<b>Year ended December 31</b>	<b>Amount</b> <i>in 1,000 US\$</i>
2007	399
2008	399
2009	399
2010	399
2011	399
Thereafter	3,957
Total minimum lease payments	5,952
Less: amount representing interest	(3,108)
<b>Present value of minimum lease payments</b>	<b>2,844</b>

Operating leases consist primarily of rental agreements for real estate, aircraft and office equipment expiring in various years through 2012, generally with options to renew.

Payments made under operating leases are charged to the consolidated statement of operations on a straight-line basis over the period of the lease.

The future minimum rental payments under non-cancelable operating leases having initial or remaining terms in excess of one year as of December 31, 2006 for each of the next five years and in the aggregate are:

<b>Year ended December 31</b>	<b>Amount</b> <i>in 1,000 US\$</i>
2007	6,046
2008	3,965
2009	2,188
2010	1,128
2011	270
Thereafter	917
<b>Total minimum future rental payments</b>	<b>14,514</b>

Operating lease expense for the years ended December 31, 2006 and 2005 was US\$ 12.1 million and US\$ 9.8 million, respectively.

## **9 Pensions and other postretirement benefits**

Upon retirement, employees of certain non-U.S. subsidiaries are entitled to pensions according to the laws and practices of each individual country where the employees are located.

Certain non-U.S. subsidiaries have defined benefit pension plans. The major defined benefit pension plans provide pensions consolidated with life and disability insurance mainly for subsidiaries in Switzerland.

Following are reconciliations of the pension benefit obligation and plan assets for 2006 and 2005:

	<b>2006</b> <i>in 1,000 US\$</i>	<b>2005</b> <i>in 1,000 US\$</i>
<b>Pension benefit obligation</b>		
Balance, beginning of year	(197,094)	(177,447)
Service cost	(17,713)	(16,257)
Past service cost	–	(261)
Interest cost	(5,707)	(5,324)
Curtailements/settlements	–	919
Benefits paid	2,877	3,972
New plan participants	(6,944)	–
Actuarial gains (losses)	11,307	(21,748)
Changes in foreign currency exchange rates	(14,892)	25,408
Business combinations	–	(6,356)
<b>Balance, end of year</b>	<b>(228,166)</b>	<b>(197,094)</b>
<b>Plan assets</b>		
Fair value, beginning of year	167,418	166,991
Actual return on plan assets	2,092	6,947
Company contributions	11,400	9,974
Curtailements/settlements	–	(1,161)
Contributions by plan participants	8,132	7,081
Changes in foreign currency exchange rates	12,823	(24,051)
Benefits paid to plan participants	(2,877)	(3,972)
Contributions from new plan participants	6,944	–
Business combinations	–	5,609
<b>Fair value, end of year</b>	<b>205,932</b>	<b>167,418</b>
<b>Funded status</b>	<b>(22,234)</b>	<b>(29,676)</b>
Unrecognized actuarial net losses	N/A	33,206
<b>Net asset recognized</b>	N/A	<b>3,530</b>

For 2006 and 2005, the amounts recognized in the consolidated balance sheets were classified as follows:

	<b>2006</b> <i>in 1,000 US\$</i>	<b>2005</b> <i>in 1,000 US\$</i>
Accrued benefit (liability) – non current	(22,234)	–
Additional minimum liability	–	(18,349)
Accumulated other comprehensive income	21,962	21,879

The underfunded status of the plans of US\$ 22.234 million at December 31, 2006 is recognized in the accompanying consolidated balance sheet as long-term accrued pension liability. No plan assets are expected to be returned to the Group during the fiscal year ended December 31, 2007.

The accumulated benefit obligation was US\$ 215.0 million and US\$ 186.9 million at December 31, 2006 and 2005, respectively. The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for plans with accumulated and projected benefit obligations in excess of plan assets were US\$ 226.3 million, US\$ 213.7 million and US\$ 204.4 million, respectively, as of December 31, 2006. The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for plans with accumulated and projected benefit obligations in excess of plan assets were US\$ 189.0 million, US\$ 179.9 million and US\$ 160.9 million, respectively, as of December 31, 2005.

The amounts recognized in the consolidated statements of operations, for the years ended December 31, are as follows:

	<b>2006</b> <i>in 1,000 US\$</i>	<b>2005</b> <i>in 1,000 US\$</i>
Service cost	17,713	16,257
Interest cost	5,707	5,324
Expected return on plan assets	(6,541)	(6,518)
Net actuarial losses recognized during the year	1,499	650
Employee contributions	(8,132)	(7,081)
Recognized settlement or curtailment gain or loss	–	321
Other	(57)	(255)
<b>Total pension expense, included in personnel costs</b>	<b>10,189</b>	<b>8,698</b>

The pension plan assets include bonds, stock, real estate and cash with a total fair value of US\$ 205.9 million at December 31, 2006. The Swiss pension fund complies with the provisions of the Swiss Pension Fund Act (BVG; Bundesgesetz über die berufliche Vorsorge).

The last actuarial valuation was completed December 31, 2006.

Principal actuarial assumptions (expressed as weighted averages):

	<b>2006</b> <i>in %</i>	<b>2005</b> <i>in %</i>
Discount rate	2.75	2.75
Expected return on plan assets	3.75	3.75
Future salary increases	2.00	2.00
Future pension increases	0.50	0.50

The expected return on plan assets is based on projected long-term returns for the various asset classes in which the assets are invested, weighted by the target asset allocations. The pension plan asset allocation at December 31, 2006 and 2005 and the target allocation for 2007 are as follows:

<b>Asset category</b>	<b>Target allocation</b>	<b>Percentage of plan assets at December 31</b>	
	<b>2007</b> <i>in %</i>	<b>2006</b> <i>in %</i>	<b>2005</b> <i>in %</i>
Equity securities	25.0	26.5	24.8
Debt securities	60.0	53.4	51.4
Real estate	12.0	10.8	10.8
Other	3.0	9.3	13.0
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

The maturities of debt securities at December 31, 2006, range from 1 to approximately 15 years with a weighted-average maturity of 5.4 years (Macauly). The maturities of debt securities at December 31, 2005, range from 1 to approximately 15 years with a weighted-average maturity of 5.3 years (Macauly).

#### Pension contributions

*in 1,000 US\$*

2007 (expected)	11,872
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Of the US\$ 11.9 million in cash expected to be contributed to the defined benefit pension plans during 2007, US\$ 11.9 million is estimated to be needed to satisfy minimum funding requirements, and no additional contribution is expected to be contributed at the Group's discretion.

At December 31, 2006, the following benefit payments, which reflect expected future service, are expected to be paid from the defined benefit pension plans:

Year ending December 31	<i>in 1,000 US\$</i>
2007	3,797
2008	3,905
2009	5,598
2010	6,161
2011	7,073
2012–2016	45,944

#### Adoption of SFAS 158

On December 31, 2006, the Group adopted the recognition and disclosure provisions of SFAS 158. SFAS 158 required the Group to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plans in the December 31, 2006 consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income, net of tax. The adjustment to accumulated other comprehensive income at adoption represents the net unrecognized actuarial losses, unrecognized prior service costs, and unrecognized transition obligation remaining from the initial adoption of SFAS 87.

The amounts will be subsequently recognized as net periodic pension cost pursuant to the Group's historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension costs in the same periods will be recognized as a component of other comprehensive income. Those amounts will be subsequently recognized as a component of net periodic pension cost on the same basis as amounts recognized in accumulated other comprehensive income at adoption of SFAS 158.

The incremental effects of adopting the provisions of SFAS 158 on the Group's consolidated balance sheet at December 31, 2006 are presented in the following table. The adoption of SFAS 158 had no effect on the Group's consolidated statement of operations for the year ended December 31, 2006, or for any prior period presented, and will not affect the Group's operating results in future periods. Had the Group not been required to adopt SFAS 158 at December 31, 2006, it would have recognized an additional minimum liability pursuant to the provisions of SFAS 87.

The effect of recognizing the additional minimum liability is included in the table below in the column labeled "Prior to adopting SFAS 158".

	<b>At December 31, 2006</b>		
	<b>Prior to adopting SFAS 158</b>	<b>Effect of adopting SFAS 158</b>	<b>As reported at December 31, 2006</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Pension asset	5,238	(5,238)	–
Accrued pension liability	(14,825)	(7,409)	(22,234)
Deferred income taxes	2,838	2,475	5,313
Accumulated other comprehensive income	(11,790)	(10,172)	(21,962)

Included in accumulated other comprehensive income at December 31, 2006 are the following amounts that have not yet been recognized in net periodic pension cost:

	<b>At December 31, 2006</b>		
	<b>Gross amount</b>	<b>Tax effect</b>	<b>Net of tax</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Unrecognized actuarial gains (losses)	(27,275)	5,313	(21,962)

The actuarial loss included in accumulated other comprehensive income and expected to be recognized in net periodic pension cost during the fiscal year ended December 31, 2007, is as follows:

	<b>At December 31, 2006</b>		
	<b>Gross amount</b>	<b>Tax effect</b>	<b>Net of tax</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Unrecognized actuarial losses	441	(86)	355

### **Synthes defined contribution plans**

The Group has defined contribution retirement plans, which cover substantially all North American employees. Contributions are determined annually. The expense recorded in the consolidated statements of operations for the years ended December 31, 2006 and 2005 was US\$ 27.2 million and US\$ 21.1 million, respectively.

### **10 Commitments and contingencies**

The Group must observe the laws, government orders and regulations of the countries in which it operates. Synthes, Inc. and certain subsidiaries are currently involved in legal and administrative proceedings arising out of the normal conduct of their business.

The Group has been named as a defendant in lawsuits alleging product failure or patent infringement. Product liability cases are routinely handled by in-house and external counsel, and management does not anticipate that any material losses will be sustained by the Group as a result of these claims.

On October 27, 2006, the Federal Court in Memphis, Tennessee issued a revised injunction order relating to the Group's TFN devices and a patent infringement case with Smith and Nephew in which the Group is named as a defendant. The order allows the Group to continue selling its current TFN products, however, it can no longer sell or promote the use of the present TFN products to treat intertrochanteric fractures.

On March 23, 2006, the Group received a grand jury subpoena from the United States Department of Justice United States Attorney's Office in Philadelphia. Under the subpoena, the Group was ordered to deliver certain documents and information concerning Norian XR® and related products. The Group has cooperated fully in responding to the subpoena. The document requests set forth in the subpoena suggest, among other things, that the Department of Justice is investigating the promotion, sale, and reimbursement of Norian XR® for off-label uses, i.e., outside of the scope for which it was cleared by the U.S. Food and Drug Administration (FDA). At this point in the investigation, the Group does not know when the investigation will conclude or whether a sanction will be imposed. Following an FDA inspection and a warning letter dated November 5, 2004, the Group voluntarily stopped selling Norian XR® and has had no revenues related to the product since 2004.

Based on the advice of counsel, management has provided reserves for losses that are probable and reasonably estimable. Management believes the outcome of any pending litigation will not have a material adverse impact on the financial position of the Group.

The book value of pledged assets, which includes property, plant, equipment and receivables, at December 31, 2006 and 2005 was US\$ 18.9 million and US\$ 26.2 million, respectively.

Capital expenditures for property, plant and equipment contracted for but not recognized in the consolidated financial statements are US\$ 4.0 million and US\$ 8.2 million at December 31, 2006 and 2005, respectively.

The Group has entered into a contract to purchase specific amounts of raw materials through March 2007. At December 31, 2006, the commitment under this contract was US\$ 8.2 million.

## 11 Share capital

Synthes, Inc. has 150,000,000 shares of Common Stock authorized with a par value of CHF 0.001 and a stated value of CHF 0.50. At December 31, 2006 and 2005, 118,675,733 shares and 114,946,858 shares were issued and fully paid, respectively.

Additionally, 150,000 shares of Series A junior participating Preferred Stock with a par value of CHF 0.01 and a stated value of CHF 5.00 have been authorized. None have been issued.

Preferred Stock is authorized only for issuance upon exercise of rights issued pursuant to the Synthes Shareholders' Rights plan. The rights under the plan become exercisable in certain circumstances where a person or persons acquires or agrees to acquire beneficial ownership of 33<sup>1</sup>/<sub>3</sub>% or more of the Group's Common Stock. The rights provide shareholders (except the person or persons that acquired greater than 33<sup>1</sup>/<sub>3</sub>%) the right to buy a fractional share of Preferred Stock that approximates the value of a share of Common Stock for half-price, thereby substantially diluting the value of the Group's existing Common Stock.

The holders of Synthes, Inc. Common Stock are entitled to receive dividends as declared from time to time and are entitled to one vote per share at the General Meeting of Shareholders. The stock is listed on the Swiss Stock Exchange (SWX).

#### Equity incentive plan

Under the equity incentive plan, each Common Stock option gives its holder the right to purchase one share of Synthes, Inc. Common Stock. The options vest over periods ranging from immediately to five years and expire after eight to fourteen years.

The weighted average exercise price is listed in CHF since it is payable in CHF and Synthes, Inc. shares are traded on the SWX.

Following is a summary of the status of the fixed employee stock-based compensation plan during 2006 and 2005:

	Number of option shares	Weighted average exercise price per share (CHF)	Weighted average remaining contractual term (years)	Aggregate intrinsic value (in 1,000 CHF)
<b>Outstanding at December 31, 2005</b>	<b>210,000</b>	<b>119.5</b>	<b>5.9</b>	<b>6,096</b>
Granted	50,000	140.0	–	–
Exercised	(2,500)	72.0	–	–
Forfeited/lapsed	–	–	–	–
<b>Outstanding at December 31, 2006</b>	<b>257,500</b>	<b>123.2</b>	<b>6.6</b>	<b>5,695</b>
<b>Vested at December 31, 2006</b>	<b>117,500</b>	<b>119.4</b>	<b>5.6</b>	<b>3,043</b>
<b>Exercisable at December 31, 2006</b>	<b>117,500</b>	<b>119.4</b>	<b>5.6</b>	<b>3,043</b>
<b>Nonvested at December 31, 2006</b>	<b>140,000</b>	<b>126.4</b>	<b>7.5</b>	<b>2,652</b>

	Number of option shares	Weighted average exercise price per share (CHF)	Weighted average remaining contractual term (years)	Aggregate intrinsic value (in 1,000 CHF)
<b>Outstanding at December 31, 2004</b>	<b>262,000</b>	<b>109</b>	<b>6.4</b>	<b>4,761</b>
Granted	–	–	–	–
Exercised	(52,000)	72	–	–
Forfeited/lapsed	–	–	–	–
<b>Outstanding at December 31, 2005</b>	<b>210,000</b>	<b>119.5</b>	<b>5.9</b>	<b>6,096</b>
<b>Vested at December 31, 2005</b>	<b>110,000</b>	<b>118.1</b>	<b>5.8</b>	<b>3,426</b>
<b>Exercisable at December 31, 2005</b>	<b>110,000</b>	<b>118.1</b>	<b>5.8</b>	<b>3,426</b>
<b>Nonvested at December 31, 2005</b>	<b>100,000</b>	<b>120.9</b>	<b>6.0</b>	<b>2,670</b>

The weighted-average fair value of options granted in 2006 and 2005, estimated on the date of grant using the Black-Scholes option pricing model was US\$ 56.35 and US\$ 0.00, respectively, using the following assumptions:

<b>Assumption</b>	<b>2006</b>	<b>2005</b>
Dividend yield	0.50%	n/a
Risk-free interest rate	4.53%	n/a
Expected life of options (years)	9.8	n/a
Expected volatility	37.92%	n/a

The total intrinsic value of options exercised during the years ended December 31, 2006 and 2005 was US\$ 0.162 million and US\$ 3.022 million, respectively.

The total share-based compensation cost associated with stock options, that has been recognized in results of operations, was US\$ 1.551 and US\$ 2.326 million for fiscal 2006 and 2005, respectively. The total income tax benefit recognized in results of operations for share-based compensation arrangements was US\$ 0.589 and US\$ 0.849 million for fiscal 2006 and 2005, respectively.

As of December 31, 2006, there was US\$ 3.917 million (pre-tax) / US\$ 2.428 million (net of tax) of total unrecognized compensation cost related to share-based compensation arrangements. That cost is expected to be recognized over a period of 3.9 years.

#### **Treasury shares**

Synthes, Inc. directly owned 8,964 shares and 10,067 shares of its own stock at December 31, 2006 and 2005, respectively. During 2006, zero shares were repurchased and 1,103 shares were distributed. Zero shares were repurchased and 1,053 shares were distributed during 2005. Treasury shares are recorded at cost.

#### **12 Segment reporting**

The Group's operations are classified into four reportable segments that manufacture and sell similar products in different geographic areas. The North America, Europe, Asia Pacific and Latin America reportable segments derive their revenues from the sale of medical implants. The key determining factor in identifying the reportable segments is how the Group's Chief Executive Officer routinely reviews the Group's results.

Intersegment revenues are sales made between Group companies, and are based upon transfer prices. The "Eliminations" column consists primarily of intercompany eliminations between the reportable segments. Generally, the Group evaluates performance on the basis of revenues, operating profit and net profit. The accounting policies applied by each of the segments are the same as those described in the summary of significant accounting policies (Note B).

**Reportable segments (in 1,000 US\$)**

<b>For the year ended December 31, 2006</b>	<b>North America</b>	<b>Europe</b>	<b>Asia Pacific</b>	<b>Latin America</b>	<b>Eliminations</b>	<b>Consolidated totals</b>
External revenue	1,525,091	564,531	220,129	81,844	–	2,391,595
Intersegment revenue	68,887	278,848	–	–	(347,735)	–
Interest income	6,105	2,882	171	196	–	9,354
Interest expense	6,633	2,399	100	159	–	9,291
Depreciation and amortization	107,790	84,136	19,516	4,983	(17,711)	198,714
Segment operating income	586,464	193,044	5,642	4,512	(27,080)	762,582
Income tax expense (benefit)	226,815	29,020	6,577	2,422	(8,797)	256,037
Segment net earnings	370,015	160,391	(1,756)	1,411	(21,264)	508,797
Segment total assets	1,224,001	2,893,664	417,201	123,333	(108,922)	4,549,277
Expenditures for long-lived assets	193,914	104,107	21,351	5,079	(26,433)	298,018

**Reportable segments (in 1,000 US\$)**

<b>For the year ended December 31, 2005</b>	<b>North America</b>	<b>Europe</b>	<b>Asia Pacific</b>	<b>Latin America</b>	<b>Eliminations</b>	<b>Consolidated totals</b>
External revenue	1,329,177	488,659	197,462	62,852	–	2,078,150
Intersegment revenue	33,606	274,206	–	–	(307,812)	–
Interest income	6,099	1,089	132	114	–	7,434
Interest expense	11,925	552	234	137	–	12,848
Depreciation and amortization	78,670	81,721	11,732	2,945	(10,844)	164,224
Segment operating income	496,068	182,169	9,380	5,658	(31,032)	662,243
Income tax expense (benefit)	184,863	36,677	4,848	1,753	(2,328)	225,813
Segment net earnings	325,809	139,609	3,844	2,514	(35,738)	436,038
Segment total assets	886,910	2,165,381	375,082	108,266	(95,425)	3,440,214
Expenditures for long-lived assets	135,428	61,646	17,241	6,573	(28,572)	192,316

**Geographic information**

Revenues, which are based on the location of the customer, and property, plant and equipment, net in the United States and other countries, for the years ended December 31, 2006 and 2005, respectively, are as follows:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
<b>Revenues</b>		
United States	1,479,668	1,289,779
Rest of the world	911,927	788,371
<b>Totals</b>	<b>2,391,595</b>	<b>2,078,150</b>
<b>Property, plant and equipment, net</b>		
United States	260,139	242,449
Switzerland	193,902	182,604
Rest of the world	90,942	81,118
<b>Totals</b>	<b>544,983</b>	<b>506,171</b>

**13 Personnel expense**

Personnel expenses were as follows:

	<b>For the year ended December 31</b>	
	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Wages and salaries	702,868	599,817
Social Security costs	61,189	47,991
Pension costs – defined benefit plans	10,189	8,698
Pension costs – defined contribution plans	27,191	21,104
Other, including training and education	50,455	42,264
	<b>851,892</b>	<b>719,874</b>

**14 Research and development expense**

Research and development costs are charged to operations when incurred and are included in operating expenses. For the years ended December 31, 2006 and 2005, they amounted to US\$ 125.6 million and US\$ 114.8 million, respectively, and consist of the cost of personnel, material, depreciation and related overhead cost. They are 5.25% and 5.53% of sales for the years ended December 31, 2006 and 2005, respectively.

**15 Earnings per share (EPS)**

The following is a calculation of basic and diluted earnings per share for the years ended December 31, 2006 and 2005. For the diluted earnings per share, the weighted average shares are adjusted to assume conversion of all potential dilutive ordinary shares.

	<b>For the year ended December 31</b>	
	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
<b>Net earnings</b>	<b>508,797</b>	<b>436,038</b>
	<i>in 1,000 of shares</i>	<i>in 1,000 of shares</i>
<b>Weighted average number of common shares used in basic EPS</b>	<b>116,236</b>	<b>114,921</b>
Effect of dilutive equity incentive plan stock options	39	39
<b>Weighted average number of common shares and dilutive potential common shares used in diluted EPS</b>	<b>116,275</b>	<b>114,960</b>
<b>Basic EPS of common stock (expressed in US\$)</b>	<b>4.38</b>	<b>3.79</b>
<b>Diluted EPS of common stock (expressed in US\$)</b>	<b>4.38</b>	<b>3.79</b>

**16 Total personnel**

The number of personnel employed by the Group at December 31, 2006 and 2005 was 8,451 and 7,627, respectively. The average number of personnel employed during the period was 8,039 and 7,169, for the years ended December 31, 2006 and 2005, respectively.

**17 Related party transactions**

The Group has entered into transactions in the normal course of business with related parties, including affiliated companies controlled by a major shareholder of the Group, and the AO Foundation. Transactions in 2006 and 2005 between the Group and related parties are summarized below:

1. The Group leases buildings and certain other assets from various affiliated companies, which are classified as both operating and capital leases. The operating leases provide for minimum aggregate annual rentals of US\$ 4.7 million through November 2021, plus contingent annual rental adjustments based on the United States Consumer Price Index. The capital lease, where the related assets and liabilities have been recorded, provides for minimum aggregate lease payments of US\$ 6.0 million through November 2021, plus contingent annual rental adjustments also based on the United States Consumer Price Index.

2. The Group has a non-interest-bearing loan receivable from an affiliate for approximately US\$ 8.3 million and US\$ 7.0 million at December 31, 2006 and 2005, respectively. This loan is secured by an assignment of the cash surrender value or the proceeds of insurance policies of the affiliate.

3. Following is a summary of transactions and balances with the Group's affiliates for 2006 and 2005:

	<b>2006</b>	<b>2005</b>
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Lease payments to affiliates	3,330	2,955
Due from affiliates (included in the accompanying consolidated balance sheets)	53	14
Purchases from affiliates	294	272

4. During 2005, the Group acquired Techron AG, which prior to acquisition was 20% owned by the Chairman and Chief Executive Officer of Synthes. Additionally, another Synthes Director served as Chairman of Techron AG. (See Note C20)

5. The Group paid royalties and consideration fees to the AO-ASIF Foundation ("AO"). Royalties and consideration fees paid during 2006 were US\$ 64.7 million and US\$ 8.4 million, respectively. During 2005, royalties paid to the AO were US\$ 66.8 million. See Note C21 for discussion of acquisition of assets from the AO during 2006.

**Contributions to defined contribution plans for officers and directors**

Contributions to defined contribution plans for officers and directors were US\$ 0.048 million and US\$ 0.031 million in 2006 and 2005, respectively.

**Equity compensation benefits to officers and directors**

The aggregate number of shares issued to the officers and directors of the Group during 2006 and 2005 were 72,990 shares and 73,281 shares, respectively. In 2006 and 2005, charges to operations related to the issuance of these shares were US\$ 2.7 million and US\$ 2.6 million, respectively.

The outstanding number of share options issued to the officers and directors of the Group was 50,000 options and 0 options at the end of 2006 and 2005, respectively.

**Officers' and directors' remuneration**

In 2006 and 2005, the total remuneration of the officers and directors was US\$ 12.2 million and US\$ 14.4 million, respectively.

**18 Comprehensive income**

Comprehensive income is the total of net income plus all other changes in net assets arising from nonowner sources, which are referred to as "other comprehensive income."

Changes in the components of other comprehensive income and in accumulated other comprehensive income for 2006 and 2005 are as follows (in 1,000 US\$):

	Foreign currency translation adjustment <i>US\$</i>	Minimum pension liability adjustment, net of taxes <i>US\$</i>	Defined benefit pension plans, net of taxes <i>US\$</i>	Unrealized gains on foreign currency hedges <i>US\$</i>	Accumulated other comprehensive income <i>US\$</i>
Balance at December 31, 2004	286,320	(9,819)	–	–	276,501
Change during 2005	(275,806)	(6,495)	–	–	(282,301)
Balance at December 31, 2005	10,514	(16,314)	–	–	(5,800)
Change during 2006	138,369	4,524	–	59	142,952
Adoption of SFAS 158	–	11,790	(21,962)	–	(10,172)
Balance at December 31, 2006	148,883	–	(21,962)	59	126,980

## 19 Fully consolidated companies

The following is a list of fully consolidated companies, all of which are unlisted, as of December 31, 2006:

Name, domicile	Country	Percentage held	Nominal share capital in 1,000	
Synthes Argentina S.A., Buenos Aires	Argentina	100	ARS	564
Synthes Australia Pty., Ltd., Alexandria	Australia	100	AUD	10
Synthes Oesterreich GmbH, Salzburg	Austria	100	EUR	2,000
Stratec Medical S.A., Brussels	Belgium	100	EUR	62
Synthes, Brussels	Belgium	100	EUR	250
Synthes Industria e Comercio Ltda., Rio Claro	Brazil	100	BRL	1,700
Synthes Canada, Ltd.	Canada	100	CDN	50
Synthes Colombia S.A., Bogota	Colombia	100	COP	594,000
Synthes. s.r.o., Prague	Czech Republic	100	CZK	50,100
Synthes A/S, Herlev	Denmark	100	DKK	502
Synthes Oy, Helsinki	Finland	100	EUR	34
Stratec Medical S.A.S., Paris	France	100	EUR	760
Synthes, Etupes Cedex	France	100	EUR	9,131
Spine Solutions GmbH, Tuttlingen	Germany	100	EUR	25
Synthes Deutschland Holding GmbH, Umkirch	Germany	100	EUR	1,023
Synthes GmbH, Umkirch	Germany	100	EUR	250
Synthes Medical Immobilien GmbH, Umkirch	Germany	100	EUR	900
Synthes Tuttlingen, Tuttlingen	Germany	100	EUR	103
Synthes Investment Limited, St. Peter Port	Guernsey	100	CHF	300
Synthes (Hong Kong) Ltd., Hong Kong	Hong Kong	100	HKD	5,000
Stratec Medical Kft., Budapest	Hungary	100	HUF	50,000
Synthes Medical Pvt. Ltd., New Delhi	India	100	INR	15,200
Stratec Medical S.p.A., Bologna	Italy	100	EUR	156
Synthes S.r.l., Milan	Italy	100	EUR	1,600
Synthes K.K., Tokyo	Japan	100	JPY	95,000
Synthes Korea Ltd., Seoul	Korea	100	KRW	8,050,000
Synthes Malaysia Sdn Bhd., Kuala Lumpur	Malaysia	100	MYR	200

<b>Name, domicile</b>	<b>Country</b>	<b>Percentage held</b>	<b>Nominal share capital in 1,000</b>	
Synthes S.M.P., S.A. de C.V., Mexico City	Mexico	75	MXP	86,716
Synthes B.V., Zeist	Netherlands	100	EUR	18
Synthes New Zealand Ltd., Auckland	New Zealand	100	NZD	51
Synthes AS, Oslo	Norway	100	NOK	200
Synthes (Shanghai) Medical Trading Co. Ltd., Shanghai	People's Republic of China	100	USD	500
Synthes Peru SAC., Peru	Peru	100	PEN	1,808
Synthes Poland Sp. zo.o., Warsaw	Poland	100	PLN	6,000
Synthes-Comercializaçao de dispositivos médicos, Lda., Lisbon	Portugal	100	EUR	249
ZAO Mathys Medical Russia Ltd., Moscow	Russia	100	RUB	0.5
Synthes Singapore Pte Ltd., Singapore	Singapore	100	SGD	1,050
Synthes Proprietary Ltd., Johannesburg	South Africa	100	ZAR	10
Synthes-Stratec S.A., Madrid	Spain	100	EUR	7,612
Synthes AB, Solna	Sweden	100	SEK	100
SMP AG, Oberdorf	Switzerland	100	CHF	50
Synthes Bettlach GmbH, Bettlach	Switzerland	100	CHF	2,000
Synthes Bettlach Holding GmbH, Bettlach	Switzerland	100	CHF	2,000
Synthes Finanz AG, Bettlach	Switzerland	100	CHF	1,000
Synthes GmbH, Oberdorf	Switzerland	100	CHF	1,000
Synthes Högendorf GmbH, Högendorf	Switzerland	100	CHF	350
Synthes Holding AG, Oberdorf	Switzerland	100	CHF	507,800
Synthes Mezzovico GmbH, Mezzovico	Switzerland	100	CHF	400
Synthes Raron GmbH, Raron	Switzerland	100	CHF	763
Synthes Medical Taiwan Ltd., Taipei	Taiwan	100	TWD	25,000
Synthes Ltd, Welwyn Garden City	United Kingdom	100	GBP	20
HFSC Company	USA	100	Partnership	
Norian Corporation	USA	100	USD	–
SIPC, L.P.	USA	100	Partnership	
SMGT, Inc.	USA	100	USD	–
Spine Solutions, Inc.	USA	100	USD	–
Subsidiary Canada, Inc.	USA	100	USD	–
Synthes (U.S.A.)	USA	100	Partnership	
Synthes (U.S.A.) L.P.	USA	100	Partnership	
Synthes (U.S.A.), Inc.	USA	100	USD	–
Synthes Corporate, Inc.	USA	100	USD	–
Synthes LAT, Inc.	USA	100	USD	–
Synthes North America, Inc.	USA	100	USD	–
Synthes Spine Company, L.P.	USA	100	Partnership	
Synthes Spine, Inc.	USA	100	USD	–
SYTH, Inc.	USA	100	USD	–

**20 Acquisitions**

Effective September 30, 2005, Synthes acquired 100% of the outstanding stock of Techron AG for approximately US\$17.1 million in cash. The purchase price was paid from available cash balances. Techron AG was engaged in the manufacturing of medical devices, for which Synthes was its sole customer, and stamping for the automotive industry. Techron sales to Synthes, prior to acquisition, were US\$ 6.2 million in 2005. The purpose of the acquisition was to acquire manufacturing capacity in Switzerland with experience in producing Synthes products. Prior to the acquisition, Techron AG was 20% owned by the Chairman and Chief Executive Officer of Synthes. Additionally, another Synthes Director served as Chairman of Techron AG. Synthes received an independent fairness opinion which indicated that the amount paid for Techron AG was fair from a financial point of view.

The purchase price has been allocated to the fair value of the assets acquired and liabilities assumed. Synthes used an independent appraisal firm to determine the fair value of the property and equipment acquired.

The consolidated balance sheet reflects the allocation of the total purchase price of US\$ 17.1 million based on fair values, as follows:

	<i>in 1,000 US\$</i>
Current assets, primarily cash, accounts receivable and inventory	10,392
Property and equipment	9,111
Amortizable intangible assets	938
<b>Total assets acquired</b>	<b>20,441</b>
Current liabilities	2,373
Long-term liabilities	985
<b>Total liabilities assumed</b>	<b>3,358</b>
<b>Total purchase price</b>	<b>17,083</b>

The acquisition was accounted for under the purchase method of accounting. The operating results of the acquired business are included in the Group's consolidated results of operations from the date of acquisition.

On April 4, 2003, the Group acquired all of the outstanding stock of Spine Solutions, Inc., a marketer and developer of a total artificial disc system, called the Prodisc® system. The acquisition price was approximately US\$ 179 million in cash plus additional contingent consideration of approximately US\$ 175 million to be paid based upon certain product development milestones through 2008. Through December 31, 2006, the Group has paid approximately 75% of the additional contingent consideration.

**21 Acquisition of assets**

On August 28, 2006, the Group and the AO-ASIF Foundation ("AO") closed the asset purchase agreement transaction which was previously announced on March 15, 2006. Under the agreement, the Group acquired the Synthes trade names and marks and substantially all of the intellectual property, including patents and patent rights from the AO. The acquisition cost was CHF 999.9 million (US\$ 809.3 million) including a combination of stock CHF 503.4 million (US\$ 407.5 million), cash CHF 100.00 million (US\$ 80.9 million) at closing, CHF 75.0 million (US\$ 60.7

million) due six months after closing, installment payments of CHF 300.00 million (US\$ 242.8 million), and CHF 21.5 million (US\$ 17.4 million) including the assumption of certain liabilities and transaction costs net of imputed interest. The future payments are due as follows:

<b>Year ending December 31</b>	<b>Amount</b> <i>in 1,000 US\$</i>
2007	102,163
2008	40,865
2009	40,865
2010	40,865
2011	40,865
2012	20,432
Total installment payments	286,055
Less: amount representing interest	(19,651)
<b>Present value of installment payments</b>	<b>266,404</b>

The purchase price has been allocated to the acquired assets based on their relative fair values as shown in Note C4.

The AO will continue the mission of educating surgeons, conducting basic and clinical research and providing technical services to assure the safety and efficacy of osteosynthesis products. The transaction is projected to be slightly accretive to earnings per share.

A fairness opinion has been provided by Credit Suisse to the Group.

## 22 Derivatives

The Group has entered into forward exchange contracts to minimize the impact of currency fluctuation on transactions and cash flows. Some of these contracts have been designated as cash flow hedges. The amount of deferred gains as of December 31, 2006 that will be recognized in earnings in 2007 is estimated at less than US\$ 0.1 million. The remainder of these contracts have not been designated as hedges and changes in their fair value have been recorded currently in the consolidated statements of operations in "other net." At December 31, 2006 and 2005, the net fair value of these derivatives was US\$ 3.7 million loss and US\$ 0.2 million gain, respectively.

The Group has entered into interest rate swap agreements to manage its exposure to rising interest rates on a portion of its floating rate based debt. Additionally, the Group has purchased an option to cancel a portion of these interest rate swap agreements on March 1, 2007, June 1, 2007 and September 1, 2007 with no additional cost or cash outlay. These transactions are not designated as hedges and changes in their fair value have been recorded currently in the consolidated statements of operation in "other, net." The net fair value of the interest rate derivative instruments at December 31, 2006 and 2005 was a US\$ 0.7 million gain and a US\$ 1.4 million gain, respectively.

**Synthes, Inc. and Subsidiaries**

## Note to Directors and Shareholders

Holding company financial statements and footnotes are a Swiss Stock Exchange (SWX) requirement for Swiss companies. As Synthes, Inc. is a Delaware (U.S.A.) company, and not subject to these requirements, we have elected to omit the holding company financial statements and footnotes in the 2006 annual report of Synthes, Inc.

A proposal by the Board of Directors for the dividends to be paid in 2007 follows on the next page.

## Synthes, Inc. and Subsidiaries

Proposal by the Board of Directors  
for the Dividends

	<i>in 1,000 US\$</i>
Beginning additional paid-in capital and retained earnings at December 31, 2005	2,393,729
Increase in additional paid-in capital in 2006	411,824
Profit for 2006	508,797
Dividends paid in 2006	(62,234)
Proposed dividends in 2007	(72,740)
<b>Additional paid-in capital and retained earnings after proposed dividends</b>	<b>3,179,376</b>

The proposed aggregate amount of dividends is of a preliminary nature as it is calculated on the basis of all registered shares being issued on December 31, 2006 (118,675,733 registered shares), less treasury shares (8,964). Note that due to further increases in share capital out of conditional capital, the aggregate amount of dividends will be determined on the basis of the number of shares issued as of March 29, 2007 (each and all of the outstanding shares are entitled to an individual dividend of CHF 0.7500/US\$ 0.6130 per share).

Synthes, Inc. is a Delaware (U.S.A.) company and, therefore, is permitted to include additional paid-in capital with retained earnings in its determination of surplus for paying dividends.

**Synthes, Inc. and Subsidiaries**

## Investor Key Data

### **Capital structure**

The share capital of Synthes, Inc. as of December 31, 2006 and 2005 consisted of 118,675,733 and 114,946,858 registered shares issued (118,666,769 and 114,936,791 registered shares outstanding), respectively, with par value of CHF 0.001 per share and stated capital of CHF 0.50 per share. Each share holds one vote.

The total number of shares which Synthes, Inc. is authorized to issue under the Certificate of Incorporation is 150,150,000 shares denominated in Swiss Francs divided into two classes as follows:

150,000,000 shares of Common Stock, par value CHF 0.001 per share and stated capital of CHF 0.50 per share.

150,000 shares of Preferred Stock, par value CHF 0.01 per share and stated capital of CHF 5.00 per share.

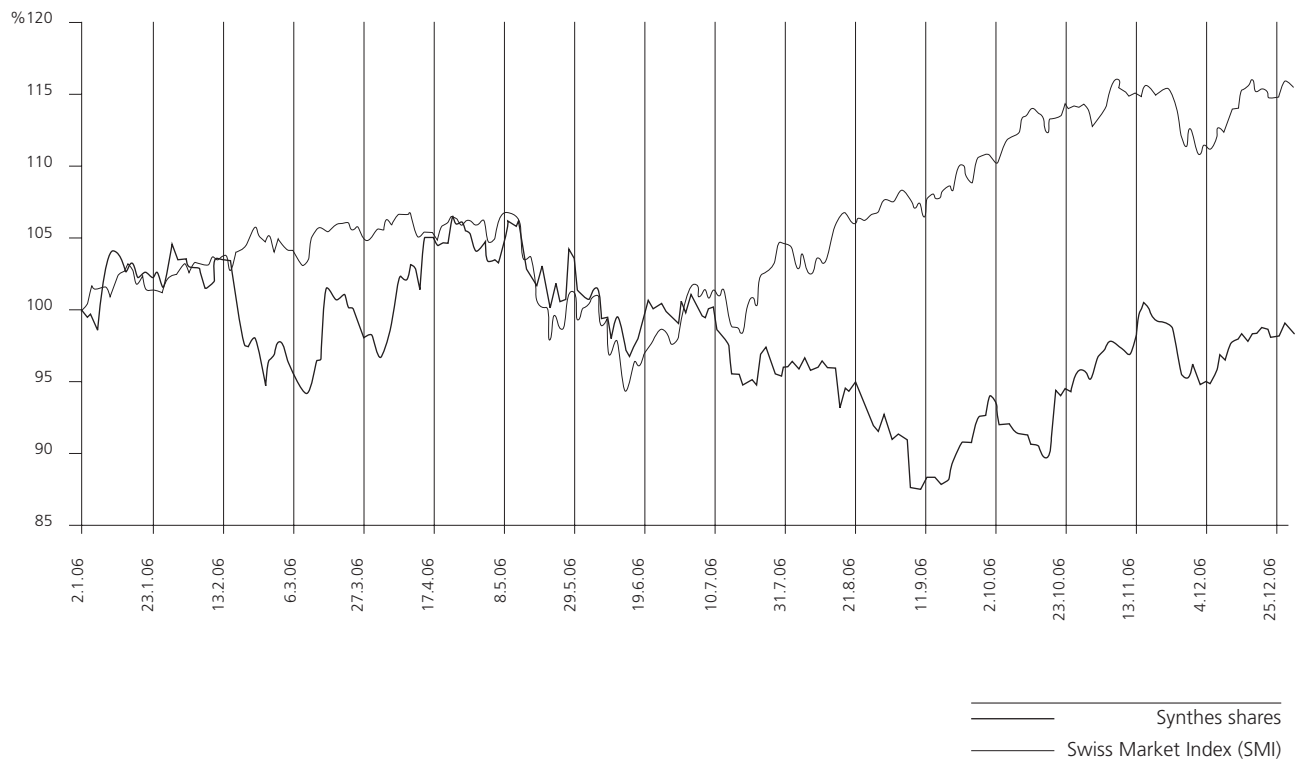
On April 4, 2000, at the first general meeting of the shareholders, an equity incentive plan was approved and adopted. This plan will allow for compensation of senior executives in accordance with international practices. Under the terms of the equity incentive plan, the company may issue up to 1,500,000 shares of Common Stock CHF 0.001 par value and CHF 0.50 stated capital per share. The shareholders waived their pre-emptive rights in this respect.

Preferred Stock is authorized only for issuance upon exercise of rights issued pursuant to the Synthes Shareholders' Rights plan, designed to protect minority shareholders in a takeover situation.

### **Development of share price**

During the year 2006, the Synthes, Inc. share price decreased by 1.6% to CHF 145.3 per share. This performance compares to the development of the Swiss Market Index (SMI) which increased by 15.9% during the same period. The share price saw its low on September 8, 2006 when it hit CHF 129.1 and reached its high of CHF 157.6 on April 21, 2006. The average share price for 2006 was CHF 144.9.

**Price comparison Synthes shares – Swiss Market Index (SMI)**



**Per share values in US\$**

	<b>2006</b>	<b>2005</b>
Net earnings	4.38	3.79

**Restrictions subject to US Securities Law**

Synthes management believes certain statements in this annual report may constitute “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include but are not limited to those with respect to the potential for Synthes to offer new products and market existing ones, as well as the expected revenues and revenue growth of Synthes. These statements are made on the basis of management’s views and assumptions regarding future events and business performance as of the time the statements are made. Actual results may differ materially from those expressed or implied. Such differences may result from the ability of Synthes to successfully develop and introduce new products and services and market existing products and services in a competitive marketplace and changes in the economic conditions that may affect the performance of the operations of Synthes. In addition, changes in competitive conditions and regulatory developments may affect future business performance, and changing market conditions may affect the valuation of Synthes securities.

In addition, it should be noted that past financial and operational performance of the company is not necessarily indicative of future financial and operational performance. Synthes undertakes no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

The securities of Synthes, Inc. have been offered and sold outside the United States and have not been and will not be registered under the U.S. Securities Act of 1933, as amended (“the Securities Act”). Such securities may not be offered, sold or transferred in the United States or to U.S. persons (as defined in regulations of the Securities Act), except pursuant to a registration statement filed under the Securities Act or under an applicable exemption under the Securities Act. Hedging transactions involving such securities may not be conducted unless in compliance with the Securities Act. The Synthes securities are deemed “restricted securities” as that term is defined in rule 144 under the Securities Act.