

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, 2005 and 2004, 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, 2005 and 2004, 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.

Ernst + Young LLP

Philadelphia, Pennsylvania
February 6, 2006

Synthes, Inc. and subsidiaries

Consolidated balance sheets as of December 31, 2005 and 2004

Assets	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current assets		
Cash and cash equivalents	368,394	263,646
Marketable securities	10	10
Accounts receivable		
Trade, less allowance of US\$ 8.8 million and US\$ 6.5 million in 2005 and 2004, respectively	356,052	326,803
Other	24,168	23,630
Inventories, net	340,691	287,999
Prepaid expenses and other current assets	7,721	7,171
Deferred income taxes	25,880	47,013
Total current assets	1,122,916	956,272
Property, plant and equipment, net	506,171	489,771
Other assets		
Non-current portion of marketable securities	85	131
Intangible assets, less accumulated amortization of US\$ 61.8 million and US\$ 39.4 million in 2005 and 2004, respectively	893,279	1,048,992
Goodwill	853,577	958,439
Other assets	24,814	29,434
Deferred income taxes	39,372	16,545
Total other assets	1,811,127	2,053,541
Total assets	3,440,214	3,499,584

Liabilities and stockholders' equity	2005	2004
Current liabilities	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current maturities of long-term debt	99,217	106,981
Accounts payable	43,747	48,287
Income taxes payable	67,359	41,064
Accrued expenses	311,227	189,189
Deferred income taxes	34,677	27,880
Total current liabilities	556,227	413,401
Long-term debt, net of current maturities	225,378	418,408
Deferred credit	–	52,953
Other long-term liabilities	37,217	27,354
Deferred income taxes	226,150	289,377
Minority interests	7,827	5,677
Total liabilities	1,052,799	1,207,170
Stockholders' equity		
Common stock CHF 0.001 par value; shares authorized – 150,000,000; shares issued – 2005 – 114,946,858; 2004 – 114,872,630; shares outstanding – 2005 – 114,936,791; 2004 – 114,861,510	76	76
Additional paid-in capital	1,512,932	1,504,847
Treasury stock – at cost	(590)	(652)
Retained earnings	880,797	511,642
Accumulated other comprehensive (loss) income	(5,800)	276,501
Total stockholders' equity	2,387,415	2,292,414
Total liabilities and stockholders' equity	3,440,214	3,499,584

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, 2005 and 2004

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Net sales	2,078,150	1,779,293
Cost of goods sold	362,653	388,094
Gross profit	1,715,497	1,391,199
Operating expenses		
Selling and promotion	592,578	491,661
General and administrative	247,817	191,244
Research and development	114,835	109,492
Royalty expense	73,249	71,237
Amortization of intangible assets	24,775	22,877
	1,053,254	886,511
Operating income	662,243	504,688
Other income (expenses)		
Interest expense	(12,848)	(15,638)
Interest income	7,434	2,758
Foreign exchange gains	9,149	8,083
Other, net	(2,281)	7,472
	1,454	2,675
Earnings before minority interest and income taxes	663,697	507,363
Minority interest	1,846	1,030
Earnings before income taxes	661,851	506,333
Income taxes	225,813	182,601
Net earnings	436,038	323,732
Basic and diluted earnings per share (expressed in US\$)	3.79	2.83
	<i>in 1,000 of shares</i>	<i>in 1,000 of shares</i>
Weighted average number of common shares outstanding	114,921	114,360
Weighted average number of common shares outstanding with dilutive effect	114,960	114,381

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, 2005 and 2004

	Common stock		Additional paid-in capital	Treasury stock	Retained earnings	Accumulated other comprehensive income (loss)	Total Stockholders' equity	Comprehensive income (loss)
	<i>in 1,000 of shares</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Balance December 31, 2003	109,759	72	1,056,912	(1,772)	249,881	124,595	1,429,688	–
Net earnings 2004	–	–	–	–	323,732	–	323,732	323,732
Issuance of common stock in connection with business acquisition	5,107	4	446,226	–	–	–	446,230	–
Issuance of common stock	7	–	344	–	–	–	344	–
Re-issuance of treasury shares	–	–	1,365	1,281	–	–	2,646	–
Treasury shares acquired in business acquisition	–	–	–	(161)	–	–	(161)	–
Dividends CHF 0.7000 (US\$ 0.5419) per share	–	–	–	–	(61,971)	–	(61,971)	–
Minimum pension liability adjustment, net of deferred taxes of US\$ 3.338 million	–	–	–	–	–	(9,819)	(9,819)	(9,819)
Foreign currency translation adjustment 2004	–	–	–	–	–	161,725	161,725	161,725
Balance December 31, 2004	114,873	76	1,504,847	(652)	511,642	276,501	2,292,414	475,638
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)
Balance December 31, 2005	114,947	76	1,512,932	(590)	880,797	(5,800)	2,387,415	153,737

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, 2005 and 2004

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Cash flows from operating activities		
Net earnings	436,038	323,732
Adjustments to reconcile net earnings to net cash provided by operating activities		
Minority interest	1,846	1,030
Share-based payment arrangements compensation	4,933	-
Inventory charge related to business acquisitions	2,124	53,438
Provisions for inventory obsolescence	19,910	17,924
Depreciation	137,738	107,434
Amortization	26,486	24,588
Provisions for doubtful accounts	2,674	3,311
Deferred income taxes	(21,483)	(11,576)
Losses on sale of property, plant and equipment	957	7,810
Realized gains from investment securities	(5)	(10)
Other	3,676	(6,427)
Changes in assets and liabilities, net of effects of business acquisitions		
Accounts receivable trade	(52,420)	(14,298)
Accounts receivable other	(3,208)	(9,329)
Inventories	(99,474)	(49,923)
Prepaid expenses and other current assets	(324)	4,346
Accounts payable	(10,490)	2,586
Income taxes payable	32,224	15,166
Accrued expenses	52,809	(3,602)
Net cash provided by operating activities	534,011	466,200

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Cash flows from investing activities		
Capital expenditures for property, plant and equipment	(183,968)	(141,326)
Proceeds from disposal of property, plant and equipment	119	459
Business acquisitions, net of cash acquired	(13,139)	(826,238)
Investment in non-consolidated investments and other long-term assets	(8,351)	(7,149)
Disposals of non-consolidated investments and other long-term assets	1,458	1,384
Issuance of loans	(585)	(1,741)
Proceeds from loans	7,445	5,729
Purchases of available-for-sale securities	–	(131)
Sales and maturities of available-for-sale securities	35	42
Net cash used in investing activities	(196,986)	(968,971)
Cash flows from financing activities		
Principal payments of debt and capital lease obligations	(163,066)	(156,270)
Proceeds from issuance of long-term debt	979	556,278
Proceeds from issuance of common stock in connection with stock options	3,094	344
Dividends paid to stockholders	(66,883)	(61,971)
Excess tax benefits from share-based arrangements	1,058	–
Payment of financing fees	–	(2,902)
Net cash (used in) provided by financing activities	(224,818)	335,479
Effect of exchange rate changes on cash and cash equivalents	(7,459)	5,212
Net increase (decrease) in cash and cash equivalents	104,748	(162,080)
Cash and cash equivalents as of January 1	263,646	425,726
Cash and cash equivalents as of December 31	368,394	263,646
Supplemental disclosures of cash flow information		
Interest paid	12,623	17,332
Income taxes paid	216,608	188,400
Non-cash transactions		
Issuance of common stock in connection with business acquisition	–	446,230
Accrual of additional 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, 2005 and 2004

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 the companies shown in note C20 (list of fully consolidated companies as of December 31, 2005). 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 period-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	
		2005	2004	2005	2004
CHF	1 =	0.7620	0.8839	0.8027	0.8052
CDN	1 =	0.8546	0.8303	0.8268	0.7694
GBP	1 =	1.7304	1.9266	1.8175	1.8319
SEK	100 =	12.5900	15.1400	13.4007	13.6227
NOK	100 =	14.8000	16.5410	15.5210	14.8500
DKK	100 =	15.8800	18.3400	16.6780	16.7030
MXN	100 =	9.3080	8.9650	9.2026	8.8759
CZK	100 =	4.0830	4.4830	4.1790	3.9020
HUF	100 =	0.4690	0.5560	0.5019	0.4947
EUR	1 =	1.1873	1.3644	1.2428	1.2426
ARS	1 =	0.3295	0.3366	0.3431	0.3421
BRL	1 =	0.4272	0.3764	0.4143	0.3423
COP	100 =	0.0440	0.0430	0.0433	0.0387
PLN	100 =	30.7370	33.3890	30.9659	27.5213
AUD	1 =	0.7280	0.7801	0.7621	0.7364
CNY	1 =	0.1240	0.1210	0.1223	0.1210
HKD	1 =	0.1290	0.1286	0.1286	0.1284
IDR	100 =	0.0100	0.0110	0.0102	0.0112
INR	1 =	0.0222	0.0229	0.0227	0.0221
JPY	100 =	0.8520	0.9700	0.9084	0.9248
KRW	100 =	0.1000	0.0980	0.0979	0.0877
MYR	1 =	0.2644	0.2637	0.2642	0.2633
NZD	1 =	0.6783	0.7190	0.7043	0.6637
RUB	100 =	3.4730	3.6030	3.5344	3.4718
SGD	1 =	0.6001	0.6108	0.6008	0.5917
THB	100 =	2.4450	2.5680	2.4855	2.4877
TWD	100 =	3.0440	3.1290	3.1144	2.9934
ZAR	1 =	0.1575	0.1775	0.1577	0.1561
PEN	1 =	0.2919	–	0.3042	–

3 Reclassifications

Certain 2004 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 Marketable securities

Trading securities are marketable securities that are carried at fair value, which are acquired principally for the purpose of generating a profit from short-term fluctuations in price. All purchases and sales of trading securities are recognized on the trade date, which is the date the Group commits to purchase or sell the asset. Realized and unrealized gains and losses arising from changes in the fair value of trading securities are included in the statement of operations in the period in which they arise.

Available-for-sale securities are recorded at fair value on the balance sheet, with the change in fair value during the period excluded from earnings and recorded net of tax as a component of accumulated other comprehensive income. Realized and unrealized gains and losses are determined based on the specific identification method.

At December 31, 2005 and 2004, the Group had no held-to-maturity securities.

6 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.

7 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.

8 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

9 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.

10 Intangible assets

Intangible assets with definite lives consist mainly of customer relationships, acquired patents, 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 B9.

Intangible assets with indefinite lives consist of geographic marketing rights. Indefinite-lived assets 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.

11 Goodwill

The excess of cost over fair value of assets acquired in business combinations (goodwill) is assigned to specific reporting units and is reviewed 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.

12 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.

13 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.

14 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.

15 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 is 8 years and the options vest over periods ranging from immediately to 4 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 statements of operations for the year ended December 31, 2004, nor 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.

The following table illustrates the effect on net earnings and earnings per share if the Group had applied the fair value recognition provisions of Statement 123(R) to options granted under the Group's stock option plan in all periods presented:

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Net earnings, as reported	436,038	323,732
Compensation cost included in reported net earnings, net of tax	1,477	–
Total compensation cost under the fair value method for all awards, net of tax	(2,930)	(185)
Pro forma net earnings	434,585	323,547
Basic and diluted earnings per share (expressed in US\$):		
As reported	3.79	2.83
Pro forma	3.78	2.83

16 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 market 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.

17 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.

18 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. These contracts have not been designated as hedges and are 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 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 these interest rate swap agreements on March 1, 2006 and quarterly thereafter 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 long-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).

19 Advertising costs

Advertising and promotion costs are expensed as incurred, and were US\$ 48.0 million and US\$ 48.7 million in 2005 and 2004, respectively.

20 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, 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.

21 New accounting standards

In December 2004, the FASB issued SFAS 123R which replaces SFAS 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion 25, *Accounting for Stock Issued to Employees*. SFAS 123R requires that all share-based payment transactions (including grants of employee stock options) be recognized in the financial statements at fair value. The adoption of this standard, which was required for the Group beginning July 1, 2005, did not have a material effect on the Group's financial statements.

In November 2004, the FASB issued SFAS 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4. SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges. The adoption of this standard, which is effective for inventory costs incurred during fiscal years beginning after June 15, 2005, is not expected to have a material effect on the Group's financial statements.

Synthes, Inc. and subsidiaries

Notes to the consolidated financial statements December 31, 2005 and 2004

Note C – Footnotes

1 Investments

The Group held investments in marketable securities classified as trading and available-for-sale as of December 31, 2005 and 2004.

During 2005 and 2004, sales proceeds and gross realized gains and losses on securities classified as available-for-sale were:

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Sale proceeds	35	42
Gross realized losses	–	(2)
Gross realized gains	5	12

2 Accounts receivable other

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

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Refundable taxes, principally value added tax (V.A.T.)	15,332	14,403
Deposits	1,053	2,609
Due from officers, directors and employees	1,551	1,520
All other	6,232	5,098
	24,168	23,630

3 Inventories

Inventories are summarized at December 31, as follows:

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Raw materials	50,680	34,949
Work in progress and semi-finished products	67,690	65,920
Finished products	236,541	208,965
Customer consignment stock	28,954	21,930
Gross value	383,865	331,764
Less provision for obsolescence and impairment	(43,174)	(43,765)
Net value	340,691	287,999

4 Property, plant and equipment

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

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Land and buildings	181,869	169,005
Machines and fixtures	260,249	248,205
Office equipment, field equipment and vehicles	523,340	418,723
	965,458	835,933
Less: accumulated depreciation	(476,761)	(379,552)
	488,697	456,381
Construction in progress	17,474	33,390
	506,171	489,771

Depreciation expense recorded in the consolidated statements of operations was US\$ 137.7 million and US\$ 107.4 million in 2005 and 2004, respectively.

5 Intangible and other long-term assets

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

	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>
Product intangible assets	65,333	80,000	(14,667)
Customer relationships	631,174	662,940	(31,766)
Geographic marketing rights	190,500	190,500	–
Other intangible assets	6,272	21,646	(15,374)
	893,279	955,086	(61,807)
	December 31, 2004		
	Total <i>in 1,000 US\$</i>	Gross amount <i>in 1,000 US\$</i>	Accumulated amortization <i>in 1,000 US\$</i>
Product intangible assets	70,667	80,000	(9,333)
Customer relationships	751,370	768,993	(17,623)
Geographic marketing rights	220,975	220,975	–
Other intangible assets	5,980	18,461	(12,481)
	1,048,992	1,088,429	(39,437)

The decrease in gross amount of customer relationships and geographic marketing rights from December 31, 2004 to December 31, 2005 results from changes in foreign currency translation rates.

Amortization expense for both intangible and other long-term assets, was US\$ 26.5 million and US\$ 24.6 million in 2005 and 2004, respectively. Estimated amortization expense for each of the five years through December 31, 2010 is US\$ 25.2, 23.0, 22.4, 22.2 and 22.1 million, respectively.

6 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:

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Deferred income tax assets		
Product liability	4,446	4,271
Net operating loss carryforwards	11,137	17,238
Inventories	36,803	33,663
Accounts receivable	2,000	2,391
Payments to employees	10,340	5,904
Other	23,511	13,582
	88,237	77,049
Valuation allowance	(9,483)	(13,491)
Net deferred income tax assets	78,754	63,558
Deferred income tax liabilities		
Accelerated tax depreciation	(38,180)	(37,642)
Intangible assets	(194,306)	(239,598)
Inventories	(15,026)	(15,784)
Other	(26,817)	(24,233)
	(274,329)	(317,257)
Net deferred income tax liabilities	(195,575)	(253,699)

At December 31, 2005, the approximate amounts and expiration of net operating loss carryforwards (primarily foreign) are as follows (in millions): 2006: US\$ 0.1, 2007–2010: US\$ 2.7, 2011 and later years: US\$ 35.8, and US\$ 13.9 have an indefinite carryforward period.

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

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Beginning of the year	(253,699)	(23,654)
Purchase accounting adjustment	–	(219,454)
Statement of operations benefit (expense)	21,483	11,576
Currency translation adjustment	36,641	(22,167)
End of the year	(195,575)	(253,699)

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

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current assets – deferred income taxes	25,880	47,013
Noncurrent assets – deferred income taxes	39,372	16,545
Current liabilities – deferred income taxes	(34,677)	(27,880)
Noncurrent liabilities – deferred income taxes	(226,150)	(289,377)
Total net deferred tax liabilities	(195,575)	(253,699)

Cumulative undistributed earnings of foreign subsidiaries, for which no U.S. income or foreign withholding taxes have been recorded, approximated US\$ 110 million at December 31, 2005. 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.

The Group evaluated the Foreign Earnings Repatriation provision within the American Jobs Creation Act of 2004 and decided not to apply it in 2005. Accordingly, no income tax expense (or benefit) is recognized with respect to such provision.

Tax expense consists of:

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Current taxes	247,296	194,177
Deferred tax (benefit) expense	(21,483)	(11,576)
	225,813	182,601

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

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Earnings before minority interest and income taxes	663,697	507,363
Minority interest	1,846	1,030
Earnings before income taxes	661,851	506,333
Tax expense calculated at a statutory tax rate of 35%	231,648	177,217
Effect of non-deductible expenses	1,070	1,694
Effect of taxes in other countries	(14,407)	(2,070)
Impact of tax effect of minority interest	646	360
State income taxes, net of federal income tax benefit	9,738	8,601
Tax benefits relating to tax credits	(3,429)	(2,000)
Other	547	(1,201)
Income tax expense	225,813	182,601

7 Goodwill

Changes in the carrying amount of goodwill during 2005 and 2004, by reporting unit and in the aggregate, are summarized in the following tables:

	Total	North America	Europe	Asia Pacific	Latin America
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
2005					
Balance, January 1, 2005	958,439	761	841,714	71,202	44,762
Arising from contingent consideration for previously completed business combination	27,040	27,040	–	–	–
Currency translation adjustments	(131,902)	–	(115,919)	(9,820)	(6,163)
Balance, December 31, 2005	853,577	27,801	725,795	61,382	38,599
2004					
Balance, January 1, 2004	570,737	761	529,154	–	40,822
Arising in completed business combinations	302,970	–	238,134	64,836	–
Currency translation adjustments	84,732	–	74,426	6,366	3,940
Balance, December 31, 2004	958,439	761	841,714	71,202	44,762

8 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:

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Secured loans	1,013	3,735
Unsecured loans	317,568	516,458
Other	6,014	5,196
	324,595	525,389
Less: current maturities	(99,217)	(106,981)
	225,378	418,408

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

Year ended December 31	<i>in 1,000 US\$</i>
2006	99,217
2007	211,112
2008	10,959
2009	257
2010	270
Thereafter	2,780

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

Debt consists of a credit facility with a financial institution, a series of Guaranteed Senior Notes, Industrial Revenue Bonds, capital leases and other notes payable in varying amounts until 2021. Interest is charged at either fixed rates or at a rate floating with prime.

Secured loans are collateralized by machinery, equipment and buildings and bear interest at variable 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 US 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, 2005, and 2004 total US\$ 279.9 million and US\$ 469.4 million, respectively. As of December 31, 2005, the interest rates on the U. S. dollar and Swiss Franc loans were 4.785% and 1.377%, respectively. The credit facility is required to be paid in full in December 2007.

The Guaranteed Senior Notes have principal balances at December 31, 2005 and 2004 of US\$ 32.1 million and US\$ 42.9 million, respectively. The Guaranteed Senior Notes bear interest at 6.66% and will be paid in annual installments through October 2008.

As of December 31, 2005, 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.

9 Leases

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

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Cost – capitalized leases	5,206	5,661
Accumulated depreciation	(2,199)	(3,373)
Net book amount	3,007	2,288

The Group leases office buildings from an affiliate. One of the leases is classified as a capital lease and the related assets and liabilities have been recorded. The leases provide for minimum annual lease payments, in the aggregate, of US\$ 6.7 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, 2005 for each of the next five years and in the aggregate are:

Year ended December 31	Amount <i>in 1,000 US\$</i>
2006	699
2007	458
2008	399
2009	399
2010	399
Thereafter	4,356
Total minimum lease payments	6,710
Less: amount representing interest	(3,441)
Present value of minimum lease payments	3,269

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

Operating leases consist primarily of rental agreements for real estate, aircraft and office equipment expiring in various years through 2011, generally with options to renew.

The future minimum rental payments under non-cancelable operating leases having initial or remaining terms in excess of one year as of December 31, 2005 for each of the next five years and in the aggregate are:

Year ended December 31	Amount <i>in 1,000 US\$</i>
2006	6,515
2007	3,622
2008	1,833
2009	1,235
2010	799
Thereafter	834
Total minimum future rental payments	14,838

Operating lease expense for the years ended December 31, 2005 and 2004 was US\$ 9.8 million and US\$ 9.8 million, respectively.

10 Pensions and other postretirement benefits

Upon retirement, employees of the former Mathys and Stratec Companies 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 of former Mathys and Stratec provide pensions consolidated with life and disability insurance mainly for former Mathys and Stratec Companies in Switzerland.

Following are reconciliations of the pension benefit obligation and plan assets for 2005 and 2004:

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Pension benefit obligation		
Balance, beginning of year	(177,447)	(70,246)
Service cost	(16,257)	(13,407)
Past service cost	(261)	–
Interest cost	(5,324)	(5,182)
Curtailements/settlements	919	–
Benefits paid	3,972	1,177
Actuarial (losses) gains recognized during the year	(21,748)	6,586
Changes in foreign currency exchange rates	25,408	(8,272)
Business combinations	(6,356)	(88,103)
Balance, end of year	(197,094)	(177,447)
Plan assets		
Fair value, beginning of year	166,991	63,698
Actual return on plan assets	6,947	(4,091)
Company contributions	9,974	9,979
Curtailements/settlements	(1,161)	–
Contributions by plan participants	7,081	5,848
Changes in foreign currency exchange rates	(24,051)	7,032
Benefits paid to plan participants	(3,972)	(1,177)
Business combinations	5,609	85,702
Fair value, end of year	167,418	166,991
Funded status	(29,676)	(10,456)
Unrecognized actuarial net losses	33,206	12,955
Net asset recognized	3,530	2,499

For 2005 and 2004, the amounts recognized in the consolidated balance sheets were classified as follows:

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Accrued benefit (liability) asset	(18,349)	(10,658)
Accumulated other comprehensive income	21,879	13,157
Net asset recognized	3,530	2,499

The accumulated benefit obligation was US\$ 186.9 million at December 31, 2005. 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 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\$ 93.0 million, US\$ 90.8 million and US\$ 79.1 million, respectively, as of December 31, 2004.

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

	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Service cost	16,257	13,407
Interest cost	5,324	5,182
Expected return on plan assets	(6,518)	(6,028)
Net actuarial losses recognized during the year	650	25
Employee contributions	(7,081)	(5,848)
Amortization of unrecognized transition asset or obligation	–	(254)
Recognized settlement or curtailment gain or loss	321	(938)
Other	(255)	46
Total pension expense, included in personnel costs	8,698	5,592

The pension plan assets include bonds, stock, real estate and cash with a total fair value of US\$ 167.4 million at December 31, 2005. 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, 2005.

Principal actuarial assumptions (expressed as weighted averages):

	2005 <i>in %</i>	2004 <i>in %</i>
Discount rate	2.75	3.25
Expected return on plan assets	3.75	4.25
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, 2005 and 2004 and the target allocation for 2006 are as follows:

Asset category	Target allocation	Percentage of plan assets at December 31	
	2006 <i>in %</i>	2005 <i>in %</i>	2004 <i>in %</i>
Equity securities	25.0	24.8	26.4
Debt securities	60.0	51.4	60.4
Real estate	12.0	10.8	4.9
Other	3.0	13.0	8.3
Total	100.0	100.0	100.0

The maturities of debt securities at December 31, 2005, range from 1 to 15 years with a weighted-average maturity of approximately 5.0 years (Macaulay). The maturities of debt securities at December 31, 2004, range from 1 to 13 years with a weighted-average maturity of 4.8 years (Macaulay).

Employer pension contributions	<i>in 1,000 US\$</i>
2006 (expected)	10,224

Of the US\$ 10.2 million expected to be contributed to the defined benefit pension plans during 2006, from employer and employees, US\$ 10.2 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. The Group anticipates that the contributions will be comprised of cash.

At December 31, 2005, 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>
2006	3,001
2007	3,425
2008	3,938
2009	4,375
2010	4,857
2011–2015	32,212

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, 2005 and 2004 was US\$ 21.1 million and US\$ 17.5 million, respectively.

11 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 records accruals for losses that are probable and reasonably estimable. In the opinion of management, the ultimate outcome of these proceedings is not expected to have a material impact on the Group's consolidated financial position.

The Group has, on occasion, 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. 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, 2005 and 2004 was US\$ 26.2 million and US\$ 30.0 million, respectively.

Capital expenditures for property, plant and equipment contracted for but not recognized in the financial statements are US\$ 8.2 million and US\$ 20.4 million at December 31, 2005 and 2004, respectively.

12 Share capital

On May 24, 2004, the Synthes, Inc. shareholders agreed to a 10-for-1 split of the outstanding shares of Common Stock. In the stock split, the existing par value of each common share was reduced from CHF 0.01 to CHF 0.001 and the stated capital from CHF 5.00 per share to CHF 0.50 per share.

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, 2005 and 2004, 114,946,858 and 114,872,630 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 $\frac{1}{3}$ % or more of the Group's Common Stock. The rights provide shareholders (except the person or persons that acquired greater than 33 $\frac{1}{3}$ %) 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 four years and expire after eight 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 2005 and 2004:

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

The weighted-average fair value of options granted in 2005 and 2004, estimated on the date of grant using the Black-Scholes option pricing model was US\$ 0.00 and US\$ 37.80, respectively, using the following assumptions:

Assumption	2005	2004
Dividend yield	n/a	0.58%
Risk-free interest rate	n/a	4.00%
Expected life of options (years)	n/a	5
Expected volatility	n/a	35%

The total intrinsic value of options exercised during the years ended December 31, 2005 and 2004 was US\$ 3.022 million and US\$ 0.328 million, respectively.

The total share-based compensation cost that has been recognized in results of operations was US\$ 2.326 million for fiscal 2005. The total income tax benefit recognized in results of operations for share-based compensation arrangements was US\$ 0.849 million for fiscal 2005.

As of December 31, 2005, there was US\$ 2.650 million (pre-tax) / US\$ 1.683 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 2.5 years.

Treasury shares

Synthes, Inc. directly owned 10,067 and 11,120 shares of its own stock at December 31, 2005 and 2004, respectively. During 2005, 0 shares were repurchased and 1,053 shares were distributed. 1,500 shares were repurchased and 25,110 shares were distributed during 2004. Treasury shares are recorded at cost.

13 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).

For the year ended December 31, 2005	Reportable segments (in 1,000 US\$)					Consolidated totals
	North America	Europe	Asia Pacific	Latin America	Elimi- nations	
External revenue	1,329,177	488,659	197,462	62,852	–	2,078,150
Intersegment revenue	33,606	274,206	–	–	(307,812)	–
Interest revenue	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

For the year ended December 31, 2004	Reportable segments (in 1,000 US\$)					Consolidated totals
	North America	Europe	Asia Pacific	Latin America	Elimi- nations	
External revenue	1,149,928	428,768	153,251	47,346	–	1,779,293
Intersegment revenue	25,661	188,857	–	–	(214,518)	–
Interest revenue	1,890	753	69	46	–	2,758
Interest expense	15,147	264	184	43	–	15,638
Depreciation and amortization	59,226	70,367	8,259	1,722	(7,552)	132,022
Segment operating income	433,442	81,795 ^(a)	10,567	3,217	(24,333)	504,688
Income tax expense (benefit)	161,454	24,119	4,278	(588)	(6,662)	182,601
Segment net earnings	282,037	54,459 ^(a)	5,878	1,111	(19,753)	323,732
Segment total assets	650,412	2,424,679	383,853	93,158	(52,518)	3,499,584
Expenditures for long-lived assets	101,972	50,486	13,820	1,981	(16,883)	151,376

^(a)Includes US\$ 53.4 million (US\$ 41.7 million after-tax) of one-time non-cash charge related to the sale of the written-up inventory resulting from the acquisition of Mathys (see Note C21).

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, 2005 and 2004, respectively, are as follows:

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Revenues		
United States	1,289,779	1,116,913
Rest of the world	788,371	662,380
Totals	2,078,150	1,779,293
Property, plant and equipment, net		
United States	242,449	210,803
Switzerland	182,604	203,926
Rest of the world	81,118	75,042
Totals	506,171	489,771

14 Personnel expense

Personnel expenses were as follows:

	For the year ended December 31	
	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Wages and salaries	599,817	507,337
Social Security costs	47,991	36,012
Pension costs – defined benefit plans	8,698	5,592
Pension costs – defined contribution plans	21,104	17,498
Other, including training and education	42,264	43,816
	719,874	610,255

15 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, 2005 and 2004 they amounted to US\$ 114.8 million and US\$ 109.5 million, respectively, and consist of the cost of personnel, material, depreciation and related overhead cost. They are 5.53% and 6.15% of sales for the years ended December 31, 2005 and 2004, respectively.

16 Earnings per share (EPS)

The following is a calculation of basic and diluted earnings per share for the years ended December 31, 2005 and 2004. For the diluted earnings per share, the weighted average shares are adjusted to assume conversion of all potential dilutive ordinary shares.

	For the year ended December 31	
	2005 <i>in 1,000 US\$</i>	2004 <i>in 1,000 US\$</i>
Net earnings	436,038	323,732
	<i>in 1,000 of shares</i>	<i>in 1,000 of shares</i>
Weighted average number of common shares used in basic EPS	114,921	114,360
Effect of dilutive equity incentive plan stock options	39	21
Weighted average number of common shares and dilutive potential common shares used in diluted EPS	114,960	114,381
Basic EPS of common stock (expressed in US\$)	3.79	2.83
Diluted EPS of common stock (expressed in US\$)	3.79	2.83

17 Total personnel

The number of personnel employed by the consolidated companies at December 31, 2005 and 2004 was 7,627 and 6,711, respectively. The average number of personnel employed during the period was 7,169 and 5,501, for the years ended December 31, 2005 and 2004, respectively.

18 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 2005 and 2004 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\$ 5.4 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\$ 6.4 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\$ 7.0 million and US\$ 6.6 million at December 31, 2005 and 2004, 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 2005 and 2004:

	2005	2004
	<i>in 1,000 US\$</i>	<i>in 1,000 US\$</i>
Lease payments to affiliates	2,955	2,901
Due from affiliates (included in the accompanying consolidated balance sheets)	14	14
Purchases from affiliates	272	370

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 C21)

5. The Group pays royalties to the AO Foundation. Royalties paid to this foundation during 2005 and 2004 were US\$ 66.8 million and US\$ 63.2 million, respectively.

Contributions to defined contribution plans for officers and directors

Contributions to defined contribution plans for officers and directors were US\$ 0.031 million and US\$ 0.046 million in 2005 and 2004, respectively.

Equity compensation benefits to officers and directors

The aggregate number of shares issued to the officers and directors of the Group during 2005 was 73,281 of which 50,000 were issued upon exercise of share options. The aggregate number of shares issued to the officers and directors of the Group during 2004 was 25,110. In 2005 and 2004, charges to operations related to the issuance of these shares were US\$ 2.6 million and US\$ 2.7 million, respectively.

The outstanding number of share options issued to the officers and directors of the Group was 0 and 50,000 at the end of 2005 and 2004, respectively.

Officers' and directors' remuneration

In 2005 and 2004, the total remuneration of the officers and directors was US\$ 14.4 million and US\$ 10.1 million, respectively.

19 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 2005 and 2004 are as follows (in 1,000 US\$):

	Foreign currency translation adjustment <i>US\$</i>	Minimum pension liability adjustment, net of taxes <i>US\$</i>	Accumulated other comprehensive income <i>US\$</i>
Balance at December 31, 2003	124,595	–	124,595
Change during 2004	161,725	(9,819)	151,906
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)

20 Fully consolidated companies

The following is a list of fully consolidated companies as of December 31, 2005:

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	60	BRL	1,700
Synthes Canada, Ltd.	Canada	100	CDN	50
Synthes Colombia S.A., Bogota	Colombia	100	COP	594,000
Synthes. s.r.o., Praha	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 S.A., Etupes Cedex	France	100	EUR	4,104
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 Italy S.R.L., Milano	Italy	100	EUR	10
Synthes S.r.l., Mailand	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

Name, domicile	Country	Percentage held	Nominal share capital in 1,000	
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	100
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	3,000
Synthes-Comercialização de dispositivos médicos, Lda., Lisboa	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	4,868
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 Hägendorf GmbH, Hägendorf	Switzerland	100	CHF	350
Synthes Holding AG, Oberdorf	Switzerland	100	CHF	507,800
Synthes Mezzovico GmbH, Mezzovico	Switzerland	100	CHF	400
Techron AG, Raron	Switzerland	100	CHF	763
Synthes Medical Taiwan Ltd., Taipei	Taiwan	100	TWD	25,000
Bangkok Unitrade Co., Ltd. Bangkok	Thailand	49	THB	1,000
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	-

21 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 is 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 and US\$ 7.1 million in 2005 and 2004, respectively. 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. We used an independent appraisal firm to determine the fair value of the property and equipment acquired. While the purchase price allocation is substantially complete and we do not expect any material adjustments, we may make adjustments to the purchase price allocation as new data becomes available.

Our 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
Total assets acquired	20,441
Current liabilities	2,373
Long-term liabilities	985
Total liabilities assumed	3,358
Total purchase price	17,083

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

On February 6, 2004, the Group purchased 100% of the outstanding stock of Mathys Medizinaltechnik AG (Mathys), a manufacturer and marketer of Osteosynthesis instruments and implants. Prior to the acquisition date, Mathys' orthopedics business was incorporated into a new entity, which was not purchased by the Group. The consolidated financial statements include the operations of Mathys from the date of acquisition. The acquisition was made for the purpose of establishing a worldwide Osteosynthesis company, optimally positioned to drive future innovation and market growth.

The acquisition price was CHF 1.6 billion (US\$ 1.3 billion) consisting of CHF 1.04 billion (US\$ 842.5 million) cash, CHF 550.8 million (US\$ 446.2 million) of the Group's common stock, and CHF 15.3 million (US\$ 12.4 million) in transaction costs. The value of the stock of CHF 107.84 (US\$ 87.3720) per share was determined based on the average market price of the shares for the period beginning two days before and ending two days after the announcement date (August 13, 2003). At the acquisition date, 500,000 of the shares were placed in escrow. These shares were released in 2005. The cash portion of the consideration was financed in part with proceeds from the credit facility described in note C8.

Under purchase accounting, the total purchase price is allocated to assets acquired and liabilities assumed based on their estimated fair values. The purchase price has been allocated to the acquired assets and liabilities based on fair values as follows:

	<i>in 1,000 US\$</i>
Inventory	129,228
Property, plant and equipment	108,022
Intangible assets	907,424
Goodwill	302,970
Other assets, including accounts receivable	192,255
Deferred tax liabilities, net	219,454
Other liabilities, including debt, accounts payable and accrued liabilities	119,272
Total consideration	1,301,173

The fair value of the Mathys customer relationships is included as an intangible asset on the consolidated balance sheet. These intangible assets acquired of CHF 870 million (US\$ 704.9 million) are being amortized over an estimated useful life of 40 years based on an analysis of customer turnover. It is not anticipated that such assets will have significant residual value. The remaining CHF 250 million (US\$ 202.5 million) of intangibles acquired represent geographic marketing rights, and are not being amortized as such rights are renewable indefinitely at little cost and the cash flows from such rights are expected to continue indefinitely. Additionally, acquired inventories and fixed assets were written up to fair value by CHF 66.4 million (US\$ 53.8 million) and CHF 23.2 million (US\$ 18.8 million), respectively. A one-time non-cash charge related to the sale of the written-up inventory is included in the 2004 consolidated results of operations. The write-up of fixed assets is being depreciated over an estimated useful life of 5 years. Goodwill of CHF 373.9 million (US\$ 303.0 million) arising in the acquisition has been allocated to the Europe and Asia Pacific reporting units and is not deductible for tax purposes. The fair values of the fixed assets, and intangible assets acquired were determined by an independent valuation.

The unaudited pro forma information that follows assumes that Mathys had been acquired at the beginning of 2004 and includes the effects of depreciation and amortization of acquired fixed assets and intangible assets that were written up to fair value, respectively, from that date. The impact of the one-time non-cash charge related to the write-up of inventory is not included in these pro forma results. The pro forma information is presented for information purposes only and is not necessarily indicative of the results of operations that would have been achieved had the acquisition taken place at the beginning of 2004.

	2004
	<i>in 1,000 US\$</i>
Net sales	1,796,371
Net earnings	362,386
Basic and diluted earnings per share (expressed in US\$)	3.17

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, 2005, the Group has either paid or recognized a liability to pay approximately 75% of the additional contingent consideration.

22 Derivatives

The Group has entered into forward exchange contracts to minimize the impact of currency fluctuations on transactions and cash flows. These transactions 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, 2005 and 2004, the net fair value of these derivatives was a US\$ 0.2 million gain and a US\$ 0.4 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, 2006 and quarterly thereafter 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 operations in "other, net." The net fair value of the interest rate derivative instruments at December 31, 2005 and 2004 was a US\$ 1.4 million gain and a US\$ 0.6 million loss, 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 2005 annual report of Synthes, Inc.

A proposal by the Board of Directors for the dividends to be paid in 2006 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, 2004	2,016,489
Increase in additional paid-in capital in 2005	8,085
Profit for 2005	436,038
Dividends paid in 2005	(66,883)
Proposed dividends in 2006	(61,307)
Additional paid-in capital and retained earnings after proposed dividends	2,332,422

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, 2005 (114,946,858 registered shares), less treasury shares (10,067). 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 21, 2006 (each and all of the outstanding shares are entitled to an individual dividend of CHF 0.7000/US\$ 0.5334 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, 2005 and 2004 consisted of 114,946,858 and 114,872,630 registered shares issued (114,936,791 and 114,861,510 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.

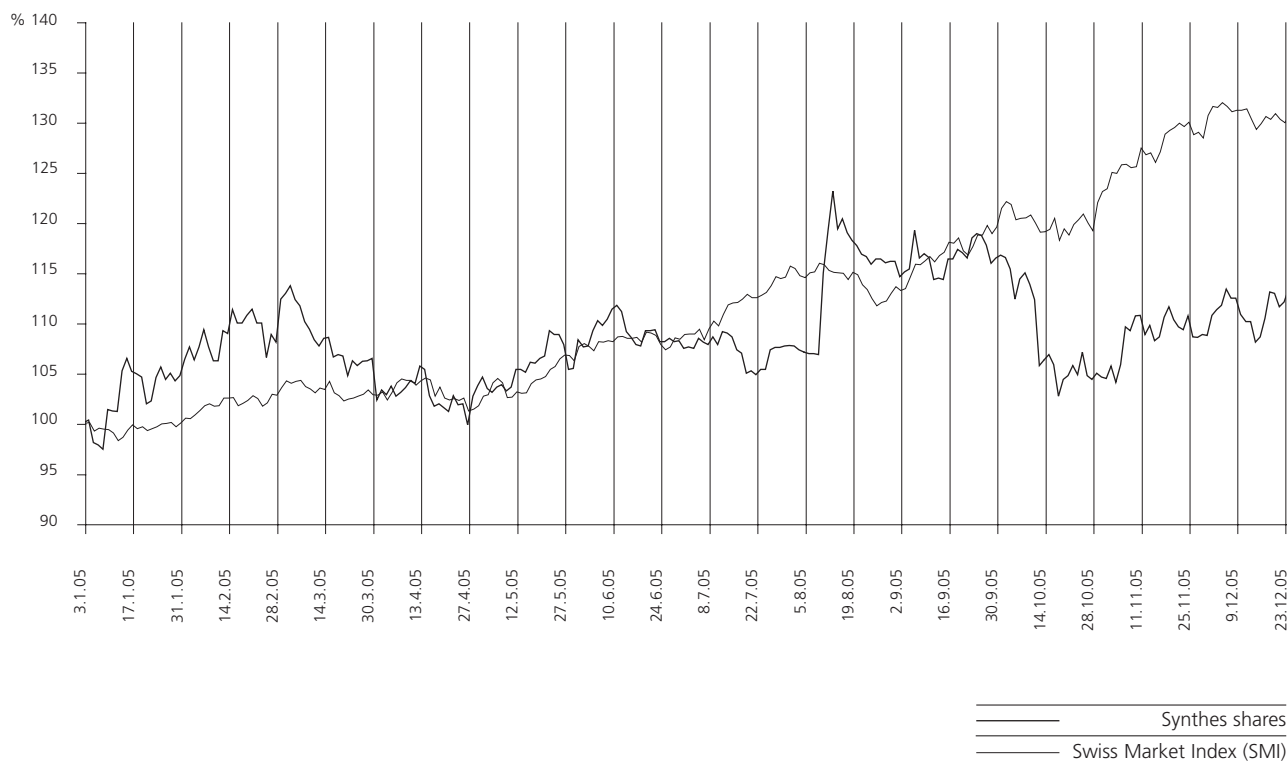
On April 4, 2000, at the first general meeting of the shareholders, an equity incentive plan was approved and adopted. This plan will allow for compensation of senior executives in accordance with international practices. Under the terms of the equity incentive plan, the company may issue up to 1,500,000 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 2005, the Synthes, Inc. share price increased by 15.8% to CHF 147.6 per share. This performance compares to the development of the Swiss Market Index (SMI) which increased by 31.5% during the same period. The share price saw its low on January 7, 2005 when it hit CHF 126.6 and reached its high of CHF 160.1 on August 15, 2005. The average share price for 2005 was CHF 141.4.

Price comparison Synthes shares – Swiss Market Index (SMI)



Per share values in US\$

	2005	2004
Operating profit	5.76	4.41
Consolidated profit	3.79	2.83

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.