

## FINANCIAL REVIEW CONTINUED

In addition to cash balances (comprising fixed deposits, cash and cash equivalents less overdrafts) of \$5,787 million, the Group has committed bank facilities of \$5.15 billion, a \$15 billion US commercial paper programme, a \$5 billion euro medium term note (EMTN) programme and an uncapped SEC-registered shelf debt programme available to manage liquidity. As at 31 December 2007, the Group has issued \$2,889 million under the EMTN programme, \$7,764 million under the SEC-registered shelf programme, \$323 million under a previous SEC-registered programme and has \$4,112 million of commercial paper outstanding. The committed facilities were undrawn as at 31 December 2007.

The Board reviews the Group's ongoing liquidity risks annually as part of the planning process. The Board considers short-term requirements against available sources of funding taking into account cash flow. In addition, this year the Board reviewed liquidity requirements as part of its consideration of the acquisition of MedImmune, and, at the January 2008 meeting, assessed the impact of the likely payments under the Merck termination agreement in March 2008.

#### Foreign exchange

The Group results are reported in US dollars, our most significant currency. In addition, surplus cash generated by the business is converted to and held centrally in US dollars. We therefore manage our currency exposures against the US dollar.

Approximately 54% of our external sales in 2007 were denominated in currencies other than the US dollar, with the euro being the main contributor and a significant proportion of our manufacturing and R&D costs were denominated in sterling or Swedish krona. Accordingly, the impact on reported earnings from a weakening in the US dollar would be to increase both sales and costs, with the net result on earnings dependent on the relative size of the exchange rate movements against the US dollar.

We manage our currency exposures centrally, based on forecast future cash flows of our major currencies. The major currencies to which we are exposed (Swedish krona, euro and sterling) have typically tended to move in a similar direction against the US dollar, mitigating significantly the impact of exchange rate movements. Accordingly, we monitor this relationship closely and we will only consider hedging if we anticipate or experience a significant breakdown in this relationship. Any such hedging activity is subject to strict internal approval procedures. We do not,

as a matter of policy, engage in speculative transactions. The Group will hold debt in non-US dollar currencies where there is an underlying net investment in the same currency. As at 31 December 2007, 4.6% of interest bearing loans and borrowings were denominated in sterling and 14.5% of interest bearing loans and borrowings were denominated in euros.

Transaction exposures arising where local subsidiaries make sales or purchases in non-local currencies are, where practicable, fully hedged using forward foreign exchange contracts.

#### Interest rate risk

Prior to the debt-financed acquisition of MedImmune, the Group's policy was to match the interest rate exposure on the Group's gross debt balance with that arising on the surplus cash position using interest rate swaps. With the move to a net debt position and the subsequent refinancing of short-term debt, a significant portion of the new debt has been held at fixed rates of interest. The balance remains at floating rates, including \$1.5 billion of the new fixed rate debt that has been swapped to floating, which is achieved through the underlying basis of the funding or through the use of interest rate swaps. The portion of fixed rate debt was approved by the Board and any variation requires Board approval.

The majority of the Group's cash balances are held with third party fund managers who return a target yield referenced to seven day US dollar LIBID. In addition to interest rate swaps, the Group uses forward rate agreements to manage any short term timing difference between the swapped debt interest expense and cash interest income.

#### Credit exposure

Exposure to financial counterparty credit risk is controlled by the treasury team centrally in establishing and monitoring counterparty limits. Centrally managed funds are invested almost entirely with counterparties whose credit rating is 'A' or better. External fund managers who manage \$4,368 million of the Group's cash are rated AAA by Standard & Poor's. There were no other significant concentrations of credit risk at the balance sheet date. All financial instruments are transacted with commercial banks, in line with standard market practice and are not backed with cash collateral. Trade receivable exposures are managed locally in the operating units where they arise. The Group is exposed to customers ranging from government-backed agencies and large private wholesalers to privately owned pharmacies, and the

underlying local economic and sovereign risks vary throughout the world. Where appropriate, the Group endeavours to minimise risks by the use of trade finance instruments such as letters of credit and insurance.

#### Sensitivity analysis

The sensitivity analysis, set out in this review on page 85, summarises the sensitivity of the market value of our financial instruments to hypothetical changes in market rates and prices. Changes to the value of the financial instruments are normally offset by our underlying transactions or assets and liabilities. The range of variables chosen for the sensitivity analysis reflects our view of changes that are reasonably possible over a one year period. Market values are the present value of future cash flows based on market rates and prices at the valuation date. Market values for interest rate risk are calculated using third party systems that model the present value of the instruments based on the market conditions at the valuation date. For long term debt, an increase in interest rates results in a decline in the fair value of debt.

The interest rate sensitivity analysis on page 85 assumes an instantaneous 100 basis point change in interest rates in all currencies from their levels at 31 December 2007, with all other variables held constant. The exchange rate sensitivity analysis on page 85 assumes an instantaneous 10% change in foreign currency exchange rates from their levels at 31 December 2007, with all other variables held constant. The +10% case assumes a 10% strengthening of the US dollar against all other currencies and the -10% case assumes a 10% weakening of the US dollar.

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our Financial Statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (adopted IFRS) and as issued by the International Accounting Standards Board and the accounting policies employed are set out under the heading 'Financial Statements – Accounting Policies' on pages 121 to 123. In applying these policies, we make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. The actual outcome could differ from those estimates. Some of these policies require a high level of judgement, either because the areas are especially subjective or complex. We believe that the most critical accounting policies and significant areas of judgement and estimation are in revenue recognition, research and development,

goodwill and intangible assets, provisions for contingent liabilities, post-retirement benefits, taxation and share-based compensation.

### Revenue recognition

Revenue represents sales of products to external third parties and excludes inter-company income and value added taxes. We also receive income from royalties and from disposals of intellectual property, brands and product lines which are included in other operating income.

Sales of products to third parties: Sales revenue is recorded at the invoiced amount (excluding sales and value added taxes) less estimated accruals for product returns and rebates given to managed care and other customers – a particular feature in the US. Cash discounts for prompt payment are also deducted from sales. Revenue is recognised at the point of delivery, which is usually when title passes to the customer either on shipment or on receipt of goods by the customer depending on local trading terms.

At the time of invoicing sales in the US, rebates and deductions that we expect to pay, generally over the following six to nine months, are estimated. These rebates typically arise from sales contracts with third party managed care organisations, hospitals, long-term care facilities, group purchasing organisations and various state programmes (Medicaid 'best price' contracts, supplemental rebates etc) and can be classified as follows:

- > Chargebacks, where we enter into arrangements under which certain parties, typically hospitals, the Department of Veterans Affairs and the Department of Defense, are able to buy products from wholesalers at the lower prices we have contracted with them. The chargeback is the difference between the price we invoice to the wholesaler and the contracted price charged by the wholesaler. Chargebacks are paid directly to the wholesalers.
- > Regulatory, including Medicaid and other federal and state programmes, where we pay rebates based on the specific terms of agreements in individual states which include product usage and information on best prices and average market prices.
- > Contractual, under which entities such as third party managed care organisations, long-term care facilities and group purchasing organisations are entitled to rebates depending on specified performance provisions, which vary from contract to contract.

Accrual assumptions are built up on a product-by-product and customer-by-customer basis taking into account specific contract provisions coupled with expected performance and are then aggregated into a weighted average rebate accrual rate for each of our products. Accrual rates are reviewed and adjusted on a monthly basis. There may be further adjustments when actual rebates are paid after the initial sale based on utilisation information submitted to us (in the case of contractual rebates) and claims/invoices (in the case of regulatory rebates and chargebacks). We believe that we have been reasonable in our estimates for future rebates using a similar methodology to that of previous years. Inevitably, however, such estimates involve judgements on aggregate future sales levels, segment mix and the respective customer contractual performance.

Cash discounts are offered to customers to encourage prompt payment. Accruals are calculated based on historical experience and are adjusted to reflect actual experience.

Industry practice in the US allows wholesalers and pharmacies to return unused stocks within six months of, and up to 12 months after, shelf-life expiry. At point of sale, we estimate the quantity and value of goods which may ultimately be returned. Our returns accruals are based on actual experience over the preceding 12 months for established products together with market related information such as estimated stock levels at wholesalers and competitor activity. For newly launched products, we use rates based on our experience with similar products or a pre-determined percentage. For products facing generic competition (such as *Toprol-XL* in the US) our experience is that we usually lose the ability to estimate the levels of returns from wholesalers with the same degree of precision that we can for products still subject to patent protection. This is because we have limited or no insight into a number of areas – the actual timing of the launch of a generic competitor following regulatory approval of the generic product (for example, a generic manufacturer may or may not have produced adequate pre-launch inventory), the pricing and marketing strategy of the competitor, the take-up of the generic and (in cases where a generic manufacturer has approval to launch just one dose size in a market of several dose sizes) the likely level of switching from one dose to another. Under our accounting policy revenue is only recognised when the amount of the revenue can be measured reliably. Our approach in meeting this condition for products facing generic competition will vary from product to product depending on the

specific circumstances; in the case of *Toprol-XL* (the only product affected in the years under review), which faced competition from several generic manufacturers from the time of launch of the first generic in 2006, we believed that revenue from all doses in the US could only be measured reliably on writing of the ultimate prescription (at which point the right of return is extinguished). Accordingly, the point of delivery is the point at which the prescription has been written. Overall, we believe that our estimates are reasonable.

The effects of these deductions on our US pharmaceuticals turnover, and the movements on accruals, are set out in the tables on page 88.

The adjustments in respect of prior years benefited reported US pharmaceuticals turnover by 1.9% and 0.4% in 2005 and 2006 respectively and decreased turnover by 0.4% in 2007. However, taking account of the following year's reversal the net impact on 2006 and 2007 was a 1.3% and a 0.8% overstatement of US pharmaceuticals turnover, respectively.

The increase in contractual rebates in 2007 was driven by the introduction into the US market of generic omeprazole, with resultant price impacts on *Nexium*.

Regulatory rebates decreased by \$341 million in 2006 compared to 2005, as a result of the automatic switch of those patients in state Medicaid programmes into Medicare Part D, classified as a contractual rebate. Contractual rebates increased by \$1,212 million compared to 2005, partly as a result of this switch, and also due to volume growth.

A further factor that significantly influenced our sales in the US market prior to 2004 was wholesaler buying patterns. Wholesalers could place orders that were significantly larger than their normal levels of demand ahead of anticipated price increases or would seek to build up or run down their stock levels for other reasons. Such speculative purchases made forecasting sales patterns more difficult and could drive variances between reported and underlying demand at quarter end. In December 2003 we entered into Inventory Management Agreements to reduce the opportunity for such speculative purchases. In 2005 we replaced the Inventory Management Agreements with Distribution Service Agreements, which served to reduce even further the speculative purchasing behaviour of the wholesalers. As a result, we believe inventory movements have been neutral across the year. We continue to track

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	2007 \$m	2006 \$m	2005 \$m
Gross sales	18,456	16,577	14,013
Chargebacks	(1,130)	(975)	(905)
Regulatory – US government and state programmes	(732)	(532)	(873)
Contractual – Managed care and group purchasing organisation rebates	(3,179)	(2,413)	(1,201)
Cash and other discounts	(356)	(329)	(405)
Customer returns	(18)	(46)	14
Other	(145)	(256)	(244)
<b>Net sales</b>	<b>12,896</b>	<b>12,026</b>	<b>10,399</b>

	Brought forward 1 January 2005 \$m	Provision for current year \$m	Adjustment in respect of prior years \$m	Returns and payments \$m	Carried forward at 31 December 2005 \$m
Chargebacks	118	927	(22)	(838)	185
Regulatory – US government and state programmes	493	970	(97)	(765)	601
Contractual – Managed care and group purchasing organisation rebates	490	1,284	(83)	(1,271)	420
Cash and other discounts	23	405	–	(401)	27
Customer returns	282	(14)	–	(101)	167
Other	80	244	–	(270)	54
	1,486	3,816	(202)	(3,646)	1,454

	Brought forward 1 January 2006 \$m	Provision for current year \$m	Adjustment in respect of prior years \$m	Returns and payments \$m	Carried forward at 31 December 2006 \$m
Chargebacks	185	1,001	(26)	(1,068)	92
Regulatory – US government and state programmes	601	597	(65)	(819)	314
Contractual – Managed care and group purchasing organisation rebates	420	2,367	46	(2,198)	635
Cash and other discounts	27	329	–	(327)	29
Customer returns	167	46	–	(53)	160
Other	54	256	–	(263)	47
	1,454	4,596	(45)	(4,728)	1,277

	Brought forward 1 January 2007 \$m	Addition in respect of MedImmune \$m	Provision for current year \$m	Adjustment in respect of prior years \$m	Returns and payments \$m	Carried forward at 31 December 2007 \$m
Chargebacks	92	2	1,115	15	(1,038)	186
Regulatory – US government and state programmes	314	69	769	(37)	(687)	428
Contractual – Managed care and group purchasing organisation rebates	635	5	3,100	79	(2,919)	900
Cash and other discounts	29	1	356	–	(348)	38
Customer returns	160	1	19	(1)	(94)	85
Other	47	–	153	–	(147)	53
	1,277	78	5,512	56	(5,233)	1,690

wholesaler stock levels by product, using our own, third party and wholesaler data and, where we believe such distortions occur, we disclose in the Annual Report for each product and in aggregate where shipments may be out of line with underlying prescription trends. We do not offer any incentives to encourage wholesaler speculative buying and attempt, where possible, to restrict shipments to underlying demand when such speculation occurs.

- > Royalty income: Royalty income is recorded under other operating income in the Financial Statements. Royalties tend to be linked to levels of sales or production by a third party. At the time of preparing the Financial Statements, we may have to estimate the third party's sales or production when arriving at the royalty income to be included. These estimates, which may differ from actual sales or production, do not result in a material impact on reported other operating income.
- > Sales of intangible assets (such as intellectual property, brands and product lines): A consequence of charging all internal R&D expenditure to the income statement in the year that it is incurred (which is normal practice in the pharmaceutical industry) is that we own valuable intangible assets which are not recorded on the balance sheet. We also own acquired intangible assets which are included on the balance sheet. As a consequence of regular reviews of product strategy, from time to time we sell such assets and generate income. Sales of product lines are often accompanied by an agreement on our part to continue manufacturing the relevant product for a reasonable period (often about two years) whilst the purchaser constructs its own manufacturing facilities. The contracts typically involve the receipt of an upfront payment, which the contract attributes to the sale of the intangible assets, and ongoing receipts, which the contract attributes to the sale of the product we manufacture. In cases where the transaction has two or more components, we account for the delivered item (for example, the transfer of title to the intangible asset) as a separate unit of accounting and record revenue on delivery of that component provided that we can make a reasonable estimate of the fair value of the undelivered component. Where the fair market value of the undelivered

component (for example, a manufacturing agreement) exceeds the contracted price for that component we defer an appropriate element of the upfront consideration and amortise this over the performance period. However, where the fair market value of the undelivered component is equal to or lower than the contracted price for that component we treat the whole of the upfront amount as being attributable to the delivered intangible assets and recognise that part of the revenue upon delivery. No element of the contracted revenue related to the undelivered component is allocated to the sale of the intangible asset. This is because the contracted revenue relating to the undelivered component is contingent on future events (such as sales) and so cannot be anticipated.

#### Research and development

Our business is underpinned by our marketed products and development portfolio. The R&D expenditure on internal activities to generate these products is generally charged to the income statement in the year that it is incurred. Purchases of intellectual property and product rights to supplement our R&D portfolio are capitalised as intangible assets. Such intangible assets are amortised from the launch of the underlying products and are tested for impairment both before and after launch. This policy is in line with practice adopted by major pharmaceutical companies.

#### Goodwill and intangible assets

We have significant investments in goodwill and intangible assets as a result of acquisitions of businesses and purchases of such assets as product development and marketing rights. Under adopted IFRS, goodwill is held at cost and tested annually for impairment, whilst intangibles are amortised over their estimated useful lives. Changes in these lives would result in different effects on the income statement. We estimate that a one year reduction in the estimated useful lives of intangible assets would increase the annual amortisation charge by \$54 million. The majority of our investments in intangible assets and goodwill arose from the restructuring of the Astra-Merck joint venture in 1998 and the acquisition of MedImmune in 2007, and we are satisfied that the carrying values are fully justified by estimated future earnings. Intangible assets are reviewed for impairment where there are indications that their carrying values may not be recoverable, and any impairments are charged to the income statement. Tests for impairment are based on discounted cash

flow projections, which require us to estimate both future cash flows and an appropriate discount rate. Such estimates are inherently subjective. Impairments to intangible assets totalling \$120 million were recognised in 2007 (2006 \$17 million, 2005 nil).

#### Contingent liabilities and commitments

In the normal course of business, contingent liabilities may arise from product-specific and general legal proceedings, from guarantees or from environmental liabilities connected with our current or former sites. Where we believe that potential liabilities have a low probability of crystallising or are very difficult to quantify reliably, we treat them as contingent liabilities. These are not provided for but are disclosed in the notes. Further details of these contingent liabilities are set out in Note 27 to the Financial Statements. Although there can be no assurance regarding the outcome of legal proceedings, we do not currently expect them to have a materially adverse effect on our financial position. We also have significant commitments that are not currently recognised in the balance sheet arising from our relationship with Merck. These are described more fully in 'Off-balance sheet transactions, contingent liabilities and commitments' below.

#### Post-employment benefits

We account for the pension costs relating to the retirement plans under IAS19 'Employee Benefits'. In applying IAS19, we have adopted the option of recognising actuarial gains and losses in full through reserves. In all cases, the pension costs are assessed in accordance with the advice of independent qualified actuaries but require the exercise of significant judgement in relation to assumptions for future salary and pension increases, long term price inflation and investment returns.

#### Taxation

Accruals for tax contingencies require management to make judgements and estimates in relation to tax audit issues and exposures. Amounts accrued are based on management's interpretation of country-specific tax law and the likelihood of settlement. Tax benefits are not recognised unless the tax positions are probable of being sustained. Once considered to be probable, management reviews each material tax benefit to assess whether a provision should be taken against full recognition of the benefit on the basis of potential settlement through negotiation and/or litigation. All such provisions are included in creditors due within one year. Any recorded exposure to interest on tax liabilities is provided for in the tax charge.

## FINANCIAL REVIEW CONTINUED

**Share-based compensation**

Through the Remuneration Committee we offer share and share option plans to certain employees as part of their compensation and benefits packages, designed to improve alignment of the interests of employees with shareholders. Details of these are given in Note 26 to the Financial Statements. The charges have been calculated principally using the Black-Scholes model as a valuation basis.

**OFF-BALANCE SHEET TRANSACTIONS, CONTINGENT LIABILITIES AND COMMITMENTS**

Details of our contingent liabilities and commitments are set out in Note 27 to the Financial Statements. We have no off-balance sheet arrangements and our derivative activities are non-speculative. The table on page 92 sets out our minimum contractual obligations at the year end.

**Arrangements with Merck****Introduction**

In 1982, Astra AB set up a joint venture with Merck & Co., Inc. for the purposes of selling, marketing and distributing certain Astra products in the US. In 1998, this joint venture was restructured (the "Restructuring"). Under the agreements relating to the Restructuring (the "Agreements"), a US limited partnership was formed, in which Merck is the limited partner and we are the general partner, and we obtained control of the joint venture's business subject to certain limited partner and other rights held by Merck and its affiliates. These rights provide Merck with safeguards over the activities of the partnership and place limitations on our commercial freedom to operate. The Agreements provide for:

- > Annual contingent payments.
- > A payment to Merck in the event of a business combination between Astra and a third party in order for Merck to relinquish certain claims to that third party's products.
- > Termination arrangements which, if and when triggered, cause Merck to relinquish its interests in our products and activities.

These elements are discussed in further detail below together with a summary of their accounting treatments.

**Annual contingent payments**

We make ongoing payments to Merck based on sales of certain of our products in the US (the "contingent payments" on the "agreement products"). As a result of the merger of Astra and Zeneca in 1999, these contingent payments (excluding those in respect of *Prilosec* and

*Nexium*) cannot be less than annual minimum sums between 2002 and 2007 ranging from \$125 million to \$225 million. Our payments have exceeded the minimum levels in all years.

**Payment in the event of a business combination**

On the merger of Astra and Zeneca, a one-time Lump Sum Payment of \$809 million was triggered. As a result of this payment, Merck relinquished any claims it may have had to Zeneca products.

**Termination arrangements**

The Agreements provided for arrangements and payments under which, subject to the exercise of certain options, the rights and interests in our activities and products held by Merck immediately prior to the merger would be terminated, including details of:

- > The Advance Payment.
- > The Partial Retirement.
- > The First Option and True-Up.
- > The Loan Note Receivable.
- > The Second Option.

**Advance Payment**

The merger between Astra and Zeneca triggered the first step in the termination arrangements. Merck relinquished all rights, including contingent payments on future sales, to potential Astra products with no existing or pending US patents at the time of the merger. As a result, we now have rights to such products and are relieved of potential obligations to Merck and restrictions in respect of those products (including annual contingent payments), affording us substantial freedom to exploit the products as we see fit.

At the time of the merger, the Advance Payment was paid. It was calculated as the then net present value of \$2.8 billion discounted from 2008 to the date of merger at a rate of 13% per annum and amounted to \$967 million. It is subject to a true-up in 2008, as discussed under 'First Option and True-Up' below.

**Partial Retirement**

In March 2008, there will be a partial retirement of Merck's limited partnership interest by payment to Merck of an amount calculated as a multiple of the average annual contingent payments from 2005 to 2007 on the relevant products, plus \$750 million. See 'General' below for our current estimate of the amount of this payment.

Upon the Partial Retirement, Merck's rights in respect of certain of the agreement products will end. The products covered by the Partial Retirement include *Toprol-XL*, *Pulmicort*, *Rhinocort* and *Symbicort*.

**First Option and True-Up**

In 2008, a calculation will be made of the Appraised Value, being the net present value of the future contingent payments in respect of all agreement products not covered by the Partial Retirement, other than *Prilosec* and *Nexium*. Payment of the Appraised Value to Merck in March 2008 will take place only if Merck exercises the First Option. Should Merck not exercise this option in 2008, we may exercise it in 2010 for a sum equal to the 2008 Appraised Value. See 'General' below for our current estimate of the amount of this payment.

Contingent payments will continue from 2008 to 2010 if we exercise in 2010.

Upon exercise of the First Option, Merck will relinquish its rights over the agreement products not covered by the Partial Retirement, other than *Nexium* and *Prilosec*. If neither Merck nor we exercise the option, the contingent payment arrangements in respect of these agreement products will continue (as will our other obligations and restrictions in respect of these products) and the Appraised Value will not be paid. Products covered by the First Option include *Atacand*, *Plendil*, *Entocort* and certain compounds still in development.

In addition, in 2008 there will be a true-up of the Advance Payment. The true-up amount will be based on a multiple of the average annual contingent payments from 2005 to 2007 in respect of all the agreement products with the exception of *Prilosec* and *Nexium* (subject to a minimum of \$6.6 billion), plus other defined amounts (totalling \$912 million). It is then reduced by the Appraised Value (whether paid or not), the Partial Retirement and the Advance Payment (at its undiscounted amount of \$2.8 billion) to determine the true-up amount. The true-up will be settled in 2008 irrespective of whether the First Option is exercised, and this could result in a further payment by us to Merck or a payment by Merck to us. See 'General' below for our current estimate of the amount of this payment.

Should Merck exercise the First Option in 2008, we will make payments in respect of the Partial Retirement, the First Option and the true-up totalling a minimum of \$4.7 billion. If we exercise the First Option in 2010, the combined effect of the amounts paid to Merck in 2008 and 2010 will total the same amount.

**Loan Note Receivable**

Included in the assets and liabilities covered by the Restructuring is a loan note receivable by us from Merck with a face value of \$1.4 billion. In 2008, at the same time as