

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

the settlement of the Partial Retirement and the true-up, Merck will settle the loan note receivable by paying us \$1.4 billion.

Second Option

A Second Option exists whereby we have the option to re-purchase Merck's interests in *Prilosec* and *Nexium* in the US. This option is exercisable by us two years after the exercise of the First Option, whether the First Option is exercised in either 2008 or 2010. Exercise of the Second Option by us at a later date is also provided for in 2017 or if combined annual sales of the two products fall below a minimum amount provided, in each case, that the First Option has been exercised. The exercise price for the Second Option is the net present value of the future annual contingent payments on *Prilosec* and *Nexium* as determined at the time of exercise.

If the Second Option is exercised, Merck will then have relinquished all its interests in the partnership and the agreement products including rights to contingent payments.

General

The precise timing and amount of settlements with Merck under the Partial Retirement, the First Option and the true-up cannot be determined at the date of this review. For example, the payment of the First Option is contingent upon Merck (or us) exercising the First Option. Similarly, the timing and amount of the Second Option cannot be determined at this time as the amount of the true-up, the Partial Retirement and the Appraised Value have been estimated but are subject to finalisation. However, the total payments in respect of the Partial Retirement, the true-up and the First Option will not exceed the minimum of \$4.7 billion referred to above should the First Option be exercised. We estimate the amount of the Partial Retirement will be approximately \$4.3 billion, the amount of the Appraised Value will be approximately \$0.6 billion and the amount of the true-up (a payment from Merck to us) will be approximately \$0.2 billion.

If Merck were to exercise the First Option in 2008, the net minimum payment to be made to Merck, being the combined payments of \$4.7 billion less the repayment of the loan note of \$1.4 billion, would be \$3.3 billion. In accounting for the Restructuring in 1998, the loan note was included in the determination of the fair values of the assets and liabilities that were acquired. At that time, the loan note was ascribed a fair value of zero on acquisition and on the balance sheet because we estimated that the net minimum payment of \$3.3 billion equated to the fair value of

the rights to be acquired under the Partial Retirement, true-up and First Option.

We anticipate that the benefits that accrue to us under all the termination arrangements arise:

- > Currently, from the substantial freedom over products acquired or discovered post-merger.
- > On occurrence of each stage of such arrangements, from enhanced contributions from, and substantial freedom over, those products that have already been launched (for example, *Pulmicort*, *Symbicort*, *Rhinocort* and *Atacand*) and those that are in development.

Economic benefits include relief from contingent payments, anticipated cost savings from cessation of manufacturing arrangements and other cost efficiencies together with the strategic advantages of increased freedom to operate.

Accounting treatments

Annual contingent payments

The annual contingent payments on agreement products are expensed as incurred.

Payment in the event of a business combination

The Lump Sum Payment was expensed at the point of merger since it caused no incremental benefits over the prior years' aggregate Astra and Zeneca performance to accrue to the merged AstraZeneca entity.

Termination arrangements

We consider that the termination arrangements described above represent the acquisition, in stages, of Merck's interests in the partnership and agreement products (including their rights to contingent payments) and depend, in part, on the exercise of the First and Second Options. The effects will only be reflected in the Financial Statements as these stages are reached. If and when all such payments are made, we will have unencumbered discretion in our operations in the US market.

The Advance Payment has been accounted for as an intangible asset and is being amortised over 20 years. This approach reflects the fact that, under the Agreements, we have acquired rights relieving us of potential obligations and restrictions in respect of Astra products with no existing or pending patents at the time of merger. Although these rights apply in perpetuity, the period of amortisation of 20 years has been chosen to reflect the typical timescale of development and marketing of a product.

The net payments we expect to make in 2008 (\$2.7 billion, or \$3.3 billion if Merck exercises the First Option) will be capitalised as intangible assets representing acquired product rights.

The economic benefits that attach to these acquired product rights range from (a) relief from the obligation to make future contingent payments on agreement products (other than *Nexium* and *Prilosec*) to (b) the ability to pursue value-adding opportunities to fully exploit our resources and products within our Gastrointestinal, Cardiovascular, Neuroscience and Respiratory therapy area portfolios. The intangible assets will therefore be amortised over a variety of lives to reflect the periods over which we expect to receive these economic benefits. For instance, intangible assets relating to relief from contingent payments will be amortised over the expected sales lives of the products concerned whereas assets relating to the ability to fully exploit our product portfolios will be amortised over 20 years, a period which reflects the typical timescale of developing and marketing a product.

The intangible assets will be subject to impairment testing and would be impaired if a product is withdrawn or if activity in any of the affected therapy areas is significantly curtailed. Similarly, because payment for the assets relating to the ability to fully exploit our product portfolios are made through the Partial Retirement and true-up whilst certain benefits arise at the time of settlement of the First and Second Options, some of these payments will be held as non-refundable deposits. Should either the First Option or the Second Option not be exercised, all or some of these latter payments will be expensed immediately.

Our ongoing monitoring of the projected payments to Merck and the value to us of the related rights takes full account of changing business circumstances and the range of possible outcomes to ensure that the payments to be made to Merck are covered by the economic benefits expected to be realised, including those attributable to the strategic benefits of being relieved from some or all of the restrictions of the partnership with Merck. Should our monitoring reveal that these payments exceed the economic benefits expected to be realised, we would recognise a provision for an onerous contract.

Taxation

We face a number of transfer pricing audits in jurisdictions around the world and, in some cases, are in dispute with the tax authorities. The issues under discussion are often complex and can require many years to resolve.

FINANCIAL REVIEW CONTINUED

CONTRACTUAL OBLIGATIONS

Payments due by period	Less than 1 year \$m	1-3 years \$m	3-5 years \$m	Over 5 years \$m	Total \$m
Bank loans and other borrowings	4,892	2,924	2,773	13,228	23,817
Operating leases	103	118	77	184	482
Merck arrangements	4,677	–	–	–	4,677
Other	571	–	–	–	571
Total	10,243	3,042	2,850	13,412	29,547

Accruals for tax contingencies require us to make estimates and judgements with respect to the ultimate outcome of a tax audit, and actual results could vary from these estimates. The international tax environment presents increasingly challenging dynamics for the resolution of transfer pricing disputes. These disputes usually result in taxable profits being increased in one territory and correspondingly decreased in another. Our balance sheet positions for these matters reflect appropriate corresponding relief in the territories affected. We consider that at present such corresponding relief will be available but, given the challenges in the international tax environment, will keep this aspect under careful review. The total net accrual included in the financial statements to cover the worldwide exposure to transfer pricing audits is \$1,322 million, an increase of \$327 million due to a number of new audits, revisions of estimates relating to existing audits, offset by a number of negotiated settlements. For transfer pricing audits where we are in dispute with the tax authorities, we estimate the potential for reasonably possible additional losses above and beyond the amount provided to be up to \$400 million; however, we believe that it is unlikely that these additional losses will arise. Of the remaining tax exposures, we do not expect material additional losses. It is not possible to estimate the timing of tax cash flows in relation to each outcome; however, it is anticipated that a number of significant disputes may be resolved over the next one to two years.

POST-EMPLOYMENT BENEFITS

We offer post-retirement benefit plans which cover many of our employees around the world. In keeping with local terms and conditions, most of these plans are defined contribution in nature where the resulting income statement charge is fixed at a set level or is a set percentage of employees' pay. However, several plans, mainly in the UK (which has by far the largest single scheme), the US and Sweden, are defined benefit plans where benefits are based on employees' length of service and final salary (typically averaged over one, three or five years). The UK and US defined benefit schemes were closed to new entrants

in 2000. All new employees in these countries are offered defined contribution schemes.

In applying IAS 19 'Employee Benefits', we recognise all actuarial gains and losses immediately through reserves. This methodology results in a less volatile income statement charge than under the alternative approach of recognising actuarial gains and losses over time. Investment decisions in respect of defined benefit schemes are based on underlying actuarial and economic circumstances with the intention of ensuring that the schemes have sufficient assets to meet liabilities as they fall due, rather than meeting accounting requirements. The trustees follow a strategy of awarding mandates to specialist, active investment managers which results in a broad diversification of investment styles and asset classes. The investment approach is intended to produce less volatility in the plan asset returns.

The overall recognised deficit in the Group's defined benefit schemes increased from \$1,842 million at 31 December 2006 to \$1,998 million at 31 December 2007. This was principally due to net actuarial losses (gains from changes in obligation assumptions, offset by experience losses on assets and obligations) and exchange. In assessing the discount rate applied to the obligations, we have used rates on AA corporate bonds with durations corresponding to the maturities of those obligations. At the last full actuarial valuation at 31 March 2006, the market value of the UK fund's assets was £3,070 million, representing a solvency ratio of 97% on the fund's liabilities.

INTERNATIONAL ACCOUNTING TRANSITION

On transition to using adopted IFRS in the year ended 31 December 2005, we took advantage of several optional exemptions available in IFRS 1 'First-time Adoption of International Financial Reporting Standards' and we discuss the major effects below.

> Business combinations – IFRS 3 'Business Combinations' has been applied from 1 January 2003, the date of transition, rather than being applied fully retrospectively.

As a result, the combination of Astra and Zeneca is still accounted for as a merger, rather than through purchase accounting. If purchase accounting had been adopted, Zeneca would have been deemed to have acquired Astra. Under this scenario the purchase costs of Astra would have been \$34 billion. Intangible assets amounting to approximately \$12 billion would have been recognised and property, plant and equipment would have been fair valued upwards by about \$288 million offset by deferred tax amounting to \$4 billion. Goodwill of \$15 billion would have arisen. The recognition of intangible assets and higher property, plant and equipment would have resulted in increased amortisation and depreciation charges to income, net of tax, of approximately \$1 billion in 2007.

- > Employee benefits – the provisions of IAS 19 have been applied from the date of transition when the full actuarial deficit was recognised as opposed to being applied retrospectively. Since we have adopted the amendment to IAS 19 allowing actuarial gains and losses to be recognised immediately directly in equity, the adoption of this exemption makes no difference to our reported results or net assets.
- > Cumulative exchange differences – we have chosen to set the cumulative exchange difference reserve at 1 January 2003 to zero.

NEW ACCOUNTING STANDARDS

New International Financial Reporting Standards which have been issued (both adopted and not yet adopted) are discussed on pages 121 and 123 (Accounting Policies).

SARBANES-OXLEY ACT SECTION 404

As a consequence of our listing on the New York Stock Exchange, AstraZeneca is required to comply with those provisions of the US Sarbanes-Oxley Act applicable to foreign issuers. Section 404 of this legislation requires companies annually to assess and make public statements about the quality and effectiveness of their internal control over financial reporting.