

Our approach to the assessment has been to select key transaction and financial reporting processes in our largest operating units and a number of specialist areas such as financial consolidation and reporting, treasury operations and taxation so that, in aggregate, we have covered a significant proportion of each of the key line items in our Financial Statements. Each of these operating units and specialist areas has ensured that its relevant processes and controls are documented to appropriate standards, taking into account, in particular, the guidance provided by the Securities and Exchange Commission. We have also reviewed

the structure and operation of our 'entity level' control environment. This refers to the overarching control environment, including structure of reviews, checks and balances that are essential to the management of a well controlled business.

The Directors have concluded that our internal control over financial reporting is effective as at 31 December 2007 and the assessment is set out on page 116. KPMG Audit Plc have audited the effectiveness of internal control over financial reporting and, as noted on page 117, their report is unqualified.

RESULTS OF OPERATIONS – SUMMARY ANALYSIS OF YEAR TO 31 DECEMBER 2006

The tables below show our sales by therapy area and by key, patent expiry and base products and operating profit for 2006 compared to 2005.

Reported performance

Our sales grew by 11% from \$23,950 million to \$26,475 million, an increase of \$2,525 million. Operating profit increased by 26% from \$6,502 million to \$8,216 million. Earnings per share for the year were \$3.86, a rise of 33% from \$2.91 in 2005. We estimate that without

SALES BY THERAPY AREA (2006 AND 2005)

	2006		2005		2006 compared to 2005	
	\$m	Growth underlying \$m	Growth due to exchange effects \$m	\$m	Growth underlying %	Growth reported %
Cardiovascular	6,118	780	6	5,332	15	15
Gastrointestinal	6,631	297	(21)	6,355	4	4
Infection and other	875	37	(1)	839	4	4
Neuroscience	4,704	656	(11)	4,059	16	16
Oncology	4,262	470	(53)	3,845	12	11
Respiratory and Inflammation	3,151	284	(6)	2,873	10	10
Others	734	89	(2)	647	13	13
Total	26,475	2,613	(88)	23,950	11	11

SALES BY KEY, PATENT EXPIRY AND BASE PRODUCTS (2006 AND 2005)

	2006		2005		2006 compared to 2005	
	\$m	Growth underlying \$m	Growth due to exchange effects \$m	\$m	Growth underlying %	Growth reported %
Key (Arimidex, Crestor, Nexium, Seroquel, Symbicort)	13,318	2,475	(6)	10,849	23	23
Patent expiry (Losec, Nolvadex, Plendil, Seloken/Toprol-XL, Zestril)	3,837	(335)	(21)	4,193	(8)	(8)
Base	9,320	473	(61)	8,908	5	5
Total	26,475	2,613	(88)	23,950	11	11

OPERATING PROFIT (2006 AND 2005)

	2006		2005		Percentage of sales		2006 compared to 2005	
	\$m	Growth underlying \$m	Growth due to exchange effects \$m	\$m	2006 %	2005 %	Growth underlying %	Growth reported %
Sales	26,475	2,613	(88)	23,950			11	11
Cost of sales	(5,559)	(188)	(15)	(5,356)	(21.0)	(22.4)	4	4
Gross margin	20,916	2,425	(103)	18,594	79.0	77.6	13	13
Distribution costs	(226)	(15)	-	(211)	(0.9)	(0.8)	7	7
Research and development	(3,902)	(532)	9	(3,379)	(14.7)	(14.1)	16	16
Selling, general and administrative	(9,096)	(410)	9	(8,695)	(34.4)	(36.3)	5	5
Other operating income and expense	524	326	5	193	2.0	0.8	169	172
Operating profit	8,216	1,794	(80)	6,502	31.0	27.2	28	26

FINANCIAL REVIEW CONTINUED

the sales and contribution from *Toprol-XL* in the US sales growth would have been 11% and earnings per share would have been \$3.36, up 35% over 2005.

Underlying performance**Sales**

Sales for the full year increased 11% at CER with good sales growth in all regions (US up 16%; Europe up 6%; Japan up 5%; Rest of World up 11%). This growth was driven by volume improvements that were offset by price reductions (particularly in the US and parts of Europe). Excluding *Toprol-XL* sales from both 2006 and 2005, growth was 11%.

The combined sales of five key products (*Arimidex*, *Crestor*, *Nexium*, *Seroquel* and *Symbicort*) grew by 23% to \$13,318 million and now account for just over 50% of our total sales (up from 45% in 2005). Patent expiry products represented around 14% of sales, down from 18% in 2005. Base products saw growth of 5% in 2006 over 2005 although the relative percentage of sales fell.

The Gastrointestinal portfolio grew by 4% as *Nexium* growth more than offset the continuing decline in *Losec/Prilosec*. *Nexium* sales increased by 12% to \$5,182 million. Sales in the US were up 13% to \$3,527 million on continued strong volume growth offset by lower price realisation. *Nexium* sales in other markets increased 10%, as good volume growth in France and Italy helped mitigate the significant price erosion in Germany. *Losec/Prilosec* sales were down 16% to \$1,371 million.

In Cardiovascular, sales grew by 15% to \$6,118 million. *Crestor* sales exceeded \$2 billion, reaching \$2,028 million, up 59%. Sales in the US were up 57% to \$1,148 million. Sales in other markets increased by 61% on good growth in Europe and the second half launch in Japan. *Seloken/Toprol-XL* sales increased by 3% to \$1,795 million. US sales growth was restricted to 7% by the launch in November of generic *Toprol-XL* 25mg by Sandoz (formerly Eon Labs). The performances of *Crestor* and *Seloken/Toprol-XL* more than offset declines in *Zestril* and *Plendil*, down by 7% and 24%, respectively.

Respiratory and Inflammation sales increased by 10% to \$3,151 million. *Symbicort* sales were the main driver of this growth and increased 18% to \$1,184 million. Elsewhere in the therapy area, *Pulmicort* sales rose by 11% with annual sales of \$1,292 million, whilst *Rhinocort* sales declined to \$360 million, down by 7%.

Sales in the Oncology portfolio grew by 12% to \$4,262 million. *Arimidex* sales increased 29% to \$1,508 million. *Casodex* sales grew by 9% to \$1,206 million, and *Zoladex* sales exceeded \$1 billion for the second year in a row. *Iressa* sales fell by 11% to \$237 million, as growth in Asia Pacific went some way to offset declines in the US.

Neuroscience sales grew by 16% to \$4,704 million. *Seroquel* sales exceeded \$3 billion to reach \$3,416 million (up 24%).

Geographic analysis

In the US, sales were up 16%. Sales growth for *Nexium*, *Seroquel*, *Arimidex* and *Crestor* amounted to \$1,441 million, whilst there were declines in products such as *Prilosec*. *Toprol-XL* grew in the year although it faced generic competition from November. Adjusting sales to exclude *Toprol-XL* sales from both 2006 and 2005, growth was 11%.

Revenue from outside the US now accounts for 53% of our sales. In Europe, sales increased by 6% for the full year, with good volume growth partially offset by lower realised prices. Sales for the five key products combined grew by 21%. However, performance was hindered by declines in Germany, where doctors have been encouraged to prescribe generics.

Sales in Japan increased by 5% as a result of good growth for *Casodex* and *Arimidex* together with the launch of *Crestor*. Sales in China were up 19% to \$328 million on the back of strong growth in all the major therapy areas, particularly Oncology.

Operating margin and retained profit

Operating margin increased by 3.8 percentage points from 27.2% to 31.0%. Excluding the effects of currency and other income, underlying margin increased 2.9 percentage points for the full year.

Gross margin increased by 1.4 percentage points to 79.0% of sales. Slightly lower payments to Merck (4.7% of sales) benefited gross margin by 0.1 percentage points whilst currency and royalties reduced gross margin by 0.1 percentage points and 0.2 percentage points, respectively. Excluding the prior year costs for the early termination of the MedPointe *Zomig* US distribution agreement and manufacturing provisions (in total \$134 million) and the 2006 provisions made in respect of *Toprol-XL*, NXY-059 and manufacturing efficiencies (in total \$215 million), underlying margin improved by 1.5 percentage points.

R&D expenditure was up 16% to \$3,902 million (14% excluding the Cambridge Antibody Technology investment) and increased by 0.6 percentage points to 14.7% of sales. Selling, general and administrative cost increases were restricted to 5% over the last year, reaching \$9,096 million and adding 2.0 percentage points to operating margin.

Higher net other income and expense increased operating margin by 1.1 percentage points due principally to higher royalties, plus the \$109 million gain recognised in the first half of the year from the divestment of the US anaesthetics and analgesic products to Abraxis BioScience Inc., and the disposal of non-core products in Scandinavia (\$32 million) in the final quarter.

Included within cost of sales is the movement in fair value of financial instruments used to manage our transactional currency exposures; the loss for the year, net of an exchange gain on the underlying exposures, was \$11 million. Other fair value movements of \$5 million are charged elsewhere in operating profit.

Net interest and dividend income for the year was \$327 million (2005 \$165 million). The increase over 2005 is primarily attributable to higher average investment balances and yields. The reported amounts include \$43 million (2005 \$15 million) arising from employee benefit fund assets and liabilities reported under IAS 19, 'Employee Benefits'.

The effective tax rate for the twelve months was 29.0% (2005 29.1%). The decrease compared to 2005 is the net effect of tax benefits arising from a different geographical mix of profits, tax deductions relating to share-based payments and the recognition of deferred tax assets in respect of tax credit carry forwards, offset by an increase in tax provisions principally in relation to global transfer pricing issues.

Earnings per share increased by 34% from \$2.91 in 2005 to \$3.86 for the current year. We estimate that the share re-purchase scheme has added 6 cents to earnings per share (after taking account of interest income foregone).

In 2006, *Toprol-XL* contributed US sales of \$1,382 million and earnings per share of 50 cents. Since the timing of approval and launch of other proposed generic products (in addition to the 25mg launched by Sandoz) is difficult to predict, we believe that future performance can be best judged by excluding

Toprol-XL from current performance. Consequently, if *Toprol-XL* were excluded from the current and prior years, sales growth would be 11% and earnings per share growth would be 36%.

FINANCIAL POSITION, INCLUDING CASH FLOW AND LIQUIDITY – 2006

All data in this section are on an actual basis (unless otherwise stated).

The net book value of our assets increased from \$13,691 million to \$15,416 million. Net profit was distributed by dividends of \$2,217 million and share buy-backs of \$4,147 million.

Property, plant and equipment

The increase in the value of property, plant and equipment was due primarily to additions of \$822 million and exchange of \$689 million offset by depreciation and impairments of \$1,003 million. Additions were mainly driven by investment in building upgrades in the UK, Sweden and the US as well as a vehicle programme in the US.

Goodwill and intangible assets

The significant increase in the value of goodwill and intangibles was primarily due to the expansion of our externalisation programme (as described in more detail below).

The additions of \$1,360 million arising from the acquisition of Cambridge Antibody Technology were partly offset by the disposal of the Humira™ royalty stream intangible acquired with the company (\$661 million). The other major additions were from the acquisition of KuDOS Pharmaceuticals (\$297 million), the co-promotion agreement in respect of Abraxane® (\$200 million) and software (\$121 million).

Inventories

After excluding the effects of exchange of \$203 million, the value of inventories fell by \$159 million to \$2,250 million, a reduction of just over 7%. This reflected a continuation of the work to reduce our inventory levels, with reductions seen primarily in the US (including declines in the levels of Merck-related inventory) and in the UK.

Receivables and payables

Receivables grew from \$4,778 million at the end of 2005 to \$5,561 million at the close of 2006. \$270 million of this increase was due to exchange. The underlying rise of \$513 million was driven by increases in trade debtors in the US (through higher sales in the last months of the year), the UK (primarily from higher export sales) and across several European markets. The second instalment of

income due from the disposal of the anaesthetics business in the US (as described in more detail below) also contributed to the increase, which was offset by reductions in insurance balances.

There was an underlying increase in payables and provisions of \$499 million arising principally from higher payables in the US (due to increased volumes of purchases from Merck) and the deferred income from the disposal of the anaesthetics business. There were also increases from insurance payables and *Toprol-XL* related severance provisions, which were reduced by the settlement of the defined benefit pension scheme in Japan. In addition, exchange effects accounted for just over \$400 million.

Cash flow

Cash generated from operating activities in the year was \$7,693 million, \$950 million higher than in 2005. The improvement was due principally to an increase in profit before tax of \$1,876 million offset by a \$224 million increase in working capital requirements and a \$563 million increase in tax paid. Tax paid for the year was \$2,169 million compared to \$1,606 million in 2005. This increase in 2006 compared to 2005 was due to increased profits in 2006.

Net cash outflows from investing activities were \$272 million compared to \$1,182 million in 2005. Net cash from investing activities was affected by the management of Group funds, with funds being transferred between long-term deposits and liquid cash. After excluding these inflows of \$1,120 million (outflows of \$491 million in 2005), underlying cash flows associated with investing activities were an outflow of \$1,392 million in 2006 compared with \$691 million in 2005. During the year, cash of \$1,148 million was paid for the acquisition of Cambridge Antibody Technology and KuDOS Pharmaceuticals. There was a \$388 million increase in expenditure on intangible assets as a result of the new collaboration deals (as described in the section immediately below). Proceeds of \$661 million were received on disposal of the Humira™ royalty stream, an asset acquired as part of the acquisition of Cambridge Antibody Technology.

After shareholder returns of \$5,382 million (comprising net share re-purchases of \$3,162 million and \$2,220 million dividend payments), and a net \$1,148 million cash outflow from acquisitions (net of cash acquired), there was an overall increase in net funds of \$1,135 million.

Investments, divestments and capital expenditure

The commitment to strengthening our product pipeline through pursuing external opportunities (in addition to the sustained investment in internal discovery and development) bore fruit in 2006 with two major acquisitions and several other significant licensing agreements and collaborations. In January 2006, we acquired the entire share capital of KuDOS Pharmaceuticals for \$206 million to access DNA repair technology as well as several products, including the poly-ARP-ribose polymerase inhibitor in Oncology. We followed this by acquiring the total share capital of Cambridge Antibody Technology (adding to the 19.9% we have held since December 2004) to provide a foundation for establishing a significant biopharmaceuticals capability. The total cost of this acquisition of \$1,116 million was reduced by disposing of the non-core intangible asset arising from the Humira™ royalty stream for \$661 million in October 2006.

These acquisitions were complemented by significant licensing and collaboration agreements. These were led by four significant agreements with AtheroGenics, Inc., Protherics PLC, Targacept Inc., and POZEN, Inc., with combined payments (capitalised as intangible assets) in 2006 of \$151 million. With AtheroGenics we entered into a development and commercialisation agreement for AGI-1067, a novel anti-atherosclerotic agent being studied for the treatment of patients with coronary disease, paying an upfront fee of \$50 million in January 2006. Our agreement with Protherics is in respect of the anti-sepsis product CytoFab™ and involved both a 4.3% equity investment in Protherics of \$13 million and an intangible asset of \$31 million. In the case of Targacept, we have capitalised as an intangible asset payments totalling \$30 million in respect of a neuronal nicotinic partial agonist focused on cognitive disorders. The payments comprised a \$10 million upfront fee on signing and a \$20 million milestone payment when proof of concept studies commenced. The agreement with POZEN is for the co-development of a combination product comprising esomeprazole and naproxen with an upfront fee of \$40 million. In addition to these, we have entered into agreements with Schering AG, Array, Kinacia, Dynavax, Cubist and Argenta, capitalising around \$70 million in intangible assets. All of these agreements include provisions for further payments over and above the initial signing or upfront fees, depending on certain development and sales milestones. The second payment to Targacept is an example of such milestones.