June 2005 remain recorded in accordance with previous UK GAAP accounting policies, and the adjustment to IAS 39 was reflected in the consolidated balance sheet at 1 July 2005. Further details of this adjustment are provided in note 34 to the consolidated financial statements. The IFRS accounting policies applied by the group to the financial information in this document are presented in 'Accounting policies of the group' in the financial statements.

2 Discontinued operations Discontinued operations under IFRS in the years ended 30 June 2007 and 30 June 2005 are in respect of the quick service restaurants business (Burger King, sold 13 December 2002) and the packaged food business (Pillsbury, sold 31 October 2001). These were not discontinued operations under US GAAP.

3 Exceptional items These are items which, in management's judgement, need to be disclosed by virtue of their size or incidence in order for the user to obtain a proper understanding of the financial information. Such items are included within the income statement caption to which they relate. Exceptional items do not represent extraordinary items under US GAAP. An analysis of exceptional items before taxation for continuing operations under IFRS is as follows:

	Year ended 30 June		
	2007 £ million	**2006** £ million	**2005** £ million
Exceptional items credited/(charged) to operating profit			
Disposal of Park Royal property	**40**	–	–
Park Royal brewery accelerated depreciation	**–**	–	(29)
Seagram integration costs	**–**	–	(30)
Thalidomide Trust	**–**	–	(149)
Disposal of other property	**–**	–	7
	40	–	(201)
Other exceptional items			
Gain on disposal of General Mills shares	**–**	151	221
(Losses)/gains on disposal and termination of businesses	**(1)**	6	(7)
	(1)	157	214
Total exceptional items	**39**	157	13

In the year ended 30 June 2006 there were exceptional tax credits of £315 million (2005 – exceptional tax credits £78 million).

4 Taxation The taxation charge deducted from income for the year in determining profit for the year ended 30 June 2007 was £678 million (2006 – £181 million; 2005 – £599 million). Included in the taxation charge were the following items: in the year ended 30 June 2007, a net tax charge of £24 million from intra group reorganisations of brand businesses, a reduction in the carrying value of deferred tax assets primarily

Historical information (continued)

following a reduction in tax rates of £74 million, and a provision for settlement of tax liabilities related to the GrandMet/Guinness merger of £64 million; in the year ended 30 June 2006, an exceptional tax credit of £315 million arose principally as a consequence of the agreement with fiscal authorities of the carrying values of certain brands, which resulted in an increase to the group's deferred tax assets of £313 million; and in the year ended 30 June 2005, there were £58 million of tax credits on exceptional operating items and £20 million of tax credits on exceptional prior year business disposals.

5 Dividends The board expects that Diageo will pay an interim dividend in April and a final dividend in October of each year. Approximately 40% of the total dividend in respect of any financial year is expected to be paid as an interim dividend and approximately 60% as a final dividend. The payment of any future dividends, subject to shareholder approval, will depend upon Diageo's earnings, financial condition and such other factors as the board deems relevant. Under IFRS, proposed dividends are not considered to be a liability until they are approved by the board for the interim dividend and by the shareholders at the annual general meeting for the final dividend. The information provided in the tables above and below represents the amounts payable in respect of the relevant financial year, and the final dividend amount included in these tables represents the dividend proposed by the directors but not approved by the shareholders and therefore is not reflected as a deduction from reserves at the balance sheet date.

The table below sets out the amounts of interim, final and total cash dividends paid by the company on each ordinary share. The dividends are translated into US dollars per ADS (each ADS representing four ordinary shares) at the noon buying rate on each of the respective dividend payment dates.

		Year ended 30 June				
		2007 pence	**2006** pence	**2005** pence	**2004** pence	**2003** pence
Per ordinary share	Interim	**12.55**	11.95	11.35	10.6	9.9
	Final	**20.15**	19.15	18.20	17.0	15.7
	Total	**32.70**	31.10	29.55	27.6	25.6
		$	**$**	**$**	**$**	**$**
Per ADS	Interim	**1.01**	0.88	0.81	0.77	0.61
	Final	**1.62**	1.42	1.30	1.24	1.06
	Total	**2.63**	2.30	2.11	2.01	1.67

Note: Subject to shareholder approval, the final dividend for the year ended 30 June 2007 will be paid on 22 October 2007 and payment to US ADR holders will be made on 26 October 2007. In the table above, an exchange rate of £1 = $2.01 has been assumed for this dividend, but the exact amount of the payment to US ADR holders will be determined by the rate of exchange on 22 October 2007.

6 US GAAP accounting changes At 30 June 2007, Diageo adopted the provisions of *SFAS No. 158 – Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. As a result, under US GAAP, the group recognised a decrease of £281 million in total assets, an increase of £132 million in total liabilities, and an additional charge of £413 million to accumulated other comprehensive income. From 1 July 2005, Diageo adopted the provisions of *SFAS No. 123(R) – Share-Based Payment* for its US GAAP reporting. On adoption of SFAS No. 123(R), Diageo revalued unvested awards in its senior executive share option plan (SESOP) and recognised a charge of £2 million net of tax in respect of the cumulative effect of the accounting change in its US GAAP financial information. Prior year information was not restated. From 1 July 2004, Diageo adopted the provisions of *FIN 46(R) – Consolidation of Variable Interest Entities*, which requires the group to consolidate the results, assets and liabilities of

Historical information (continued)

variable interest entities if the group is regarded as the primary beneficiary. Adoption of FIN 46(R) had no effect on US GAAP net income or shareholders’ equity.

7 Definitions Net borrowings are defined as total borrowings (short term borrowings and long term borrowings plus finance lease obligations) less cash and cash equivalents, interest rate fair value hedging instruments, foreign currency swaps and forwards and other liquid resources. Long term obligations are defined as long term borrowings which fall due after more than one year.

8 Share capital The called up share capital represents the par value of ordinary shares of $28^{101}¤_{108}$ pence in issue. There were 2,931 million ordinary shares in issue and fully paid up at the balance sheet date (2006 – 3,051 million; 2005 – 3,050 million; 2004 – 3,057 million; 2003 – 3,100 million). Of these, 33 million are held in employee share trusts (2006 – 42 million; 2005 – 43 million; 2004 – 43 million, 2003 – 45 million) and 281 million are held as treasury shares (2006 – 252 million; 2005 – 86 million; 2004 and 2003 – nil). These shares are deducted in arriving at equity attributable to the parent company’s equity shareholders. During the year ended 30 June 2007, the company repurchased 141 million ordinary shares for cancellation or to be held as treasury shares at a cost including fees and stamp duty of £1,405 million (2006 – 164 million shares, cost of £1,407 million; 2005 – 94 million ordinary shares, cost of £710 million; 2004 – 43 million ordinary shares, cost of £306 million; 2003 – 116 million ordinary shares, cost of £852 million) and 9 million ordinary shares to be held as treasury shares for hedging share scheme grants provided to employees during the year at a cost of £82 million (2006 – 2 million ordinary shares, cost of £21 million; 2005, 2004 and 2003 – nil). In addition the company utilised 1 million ordinary shares held as treasury shares with an historic purchase cost of £10 million to satisfy options exercised by employees during the year (2006 and 2005 – nil, £nil).

9 Exchange rates A substantial portion of the group’s assets, liabilities, revenues and expenses is denominated in currencies other than pound sterling, principally US dollars. For a discussion of the impact of exchange rate fluctuations on the company’s financial condition and results of operations, see ‘Business review – Risk management’.

The following table shows period end and average US dollar/pound sterling noon buying exchange rates, for the periods indicated, expressed in US dollars per £1.

	Year ended 30 June				
	2007	**2006**	**2005**	**2004**	**2003**
	$	$	$	$	$
Year end	**2.01**	1.85	1.79	1.81	1.65
Average rate(a)	**1.93**	1.78	1.86	1.75	1.59

Historical information (continued)

The following table shows period end, high, low and average US dollar/pound sterling noon buying exchange rates by month, for the six month period to 29 August 2007, expressed in US dollars per £1. The information in respect of the month of August is for the period up to and including 29 August 2007.

						2007
	August	**July**	**June**	**May**	**April**	**March**
	$	$	$	$	$	$
Month end	**2.02**	**2.04**	**2.01**	**1.98**	**2.00**	**1.97**
Month high	**2.04**	**2.06**	**2.01**	**2.00**	**2.01**	**1.97**
Month low	**1.98**	**2.01**	**1.97**	**1.97**	**1.96**	**1.92**
Average rate(b)	**2.01**	**2.04**	**1.99**	**1.98**	**1.99**	**1.95**

The average exchange rate for the period 1 to 12 September 2007 was £1 = $2.03 and the noon buying rate on 12th September was £1 = $2.03.

(a) The average of the noon buying rates on the last business day of each month during the year ended 30 June

(b) The average of the noon buying rates on each business day of the month

(c) These rates have been provided for information only. They are not necessarily the rates that have been used in this document for currency translations or in the preparation of the consolidated financial statements. See note 2(i)(d) to the consolidated financial statements for the actual rates used.

Business description

Overview

Diageo is the world’s leading premium drinks business with a collection of international brands. Diageo was the seventeenth largest publicly quoted company in the United Kingdom in terms of market capitalisation on 12 September 2007, with a market capitalisation of approximately £27.5 billion.

Diageo was formed by the merger of Grand Metropolitan Public Limited Company (GrandMet) and Guinness PLC (the Guinness Group) that became effective on 17 December 1997. Diageo plc is incorporated as a public limited company in England and Wales. Diageo plc’s principal executive office is located at 8 Henrietta Place, London W1G 0NB and its telephone number is +44 (0) 20 7927 5200.

Diageo is a major participant in the branded beverage alcohol industry and operates on an international scale. It brings together world class brands and a management team committed to the maximisation of shareholder value. The management team expects to invest in global brands, expand internationally and launch innovative new products and brands.

Diageo produces and distributes a leading collection of branded premium spirits, beer and wine. The wide range of premium brands it produces and distributes includes Smirnoff vodka, Johnnie Walker scotch whisky, Captain Morgan rum, Baileys Original Irish Cream liqueur, JeB scotch whisky, Tanqueray gin and Guinness stout. In addition it also has the distribution rights for the José Cuervo tequila brands in the United States and other countries.

Strategy

Diageo is the world's leading premium drinks business and operates on an international scale. It is one of a small number of premium drinks companies that operate across beer, wine and spirits. Diageo is the leading premium spirits business in the world by volume, by net sales and by operating profit and it manages 8 of the world's top 20 spirits brands as defined by Impact Databank. Diageo's beer brands include the only global stout brand, Guinness, and together these beer brands account for approximately 21% of net sales while Diageo's wine brands represent approximately 6% of Diageo's net sales.

Diageo's size provides for scale efficiencies in production, selling and marketing. This enables cost efficiencies and the dissemination of best practices in business operations across markets and brands, allowing Diageo to serve its customers and consumers better.

Diageo's business has a high return on invested capital and low capital intensity and therefore generates high levels of free cash flow.

All of the above factors enable Diageo to attract and retain talented individuals with the capabilities to contribute to the delivery of Diageo's strategy, which is to focus on premium drinks to grow its business through organic sales and operating profit growth and the acquisition of premium drinks brands that add value for shareholders.

Diageo's brands have broad consumer appeal across geographies and the company and its employees are proud of the responsible manner in which the brands are marketed and the role that moderate consumption of these brands plays in the lives of many people.

Diageo recognises, however, that excessive or irresponsible patterns of alcohol consumption may cause health or social problems for the individual or society as a whole. Diageo seeks to be at the forefront of industry efforts to promote responsible drinking and combat misuse and works with other stakeholders to combat alcohol misuse. Diageo's approach is based on two principles: set world class standards for

responsible marketing and innovation; and promote a shared understanding of what responsible drinking means in order to reduce alcohol related harm.

Market participation Diageo targets its geographical priorities in terms of the major regional economies in which it operates. As of 1 February 2007, these markets are managed under four business areas: North America, Europe, International and Asia Pacific. The North American business area comprises the United States and Canada. The European business area comprises: Great Britain; Ireland; Continental Europe; Iberia and Russia. The International business area comprises Latin America and the Caribbean, Africa, and the Global Travel and Middle East business. The Asia Pacific business area comprises: India; China, South Korea, Japan and other Asian markets; Australia and New Zealand. North America accounts for the largest proportion of Diageo's operating profit.

Product offering Diageo manages its brands in terms of global priority brands, local priority brands and category brands. Acting as the main focus for the business, global priority brands are Diageo's primary growth drivers across markets. Local priority brands have market leading positions in the markets in which they are distributed. They drive growth on a significant scale but with a narrower geographic reach than the global priority brands. Category brands comprise the smaller scale brands in Diageo's collection.

Business effectiveness Over the long term, Diageo's strategy will be continually focused on driving growth and increasing shareholder value.

Diageo has completed a number of acquisitions and disposals consistent with its strategy of focusing on its premium drinks business. In the period from the merger of GrandMet and the Guinness Group in December 1997 to 30 June 2007, the group has received approximately £10.5 billion from disposals (including £4.3 billion from the sale of Pillsbury, £1.9 billion from the sale of General Mills shares and £0.7 billion from the sale of Burger King) and spent approximately £5.0 billion on acquisitions (including £3.7 billion in relation to certain Seagram businesses).

Premium drinks

Diageo is engaged in a broad range of activities within the beverage alcohol industry. Its operations include producing, distilling, brewing, bottling, packaging, distributing, developing and marketing a range of brands in approximately 180 markets around the world. Diageo markets a wide range of recognised beverage alcohol brands including a number of the world's leading spirits and beer brands. The brand ranking information below, when comparing volume information with competitors, has been sourced from data published during 2007 by Impact Databank. Market data information is taken from industry sources in the markets in which Diageo operates. In calendar year 2006, 17 of the group's owned brands were among the top 100 premium distilled spirits brands worldwide, as ranked by Impact Databank.

References to ready to drink products below include progressive adult beverages. Ready to drink products are sold throughout the world, but progressive adult beverages are currently only sold in the United States and certain markets supplied by the United States. References to Smirnoff ready to drink include Smirnoff Ice, Smirnoff Black Ice, Smirnoff Twisted V, Smirnoff Mule, Smirnoff Spin, Smirnoff Storm, Smirnoff Caesar, Smirnoff Caipiroska, Smirnoff Signatures, Smirnoff Source, Smirnoff Fire and Smirnoff Raw Tea. References to Smirnoff Black Ice include Smirnoff Ice Triple Black in the United States.

Net sales are sales after deducting excise duties.

In the year ended 30 June 2007, Diageo sold 114 million equivalent units of spirits (including ready to drink), 24 million equivalent units of beer and 3 million equivalent units of wine. In the year ended

30 June 2007, ready to drink products contributed 7.5 million equivalent units of total volume, of which Smirnoff ready to

drink variants accounted for 5 million equivalent units. Volume has been measured on an equivalent units basis to nine litre cases of spirits. An equivalent unit represents one nine litre case of spirits, which is approximately 272 servings. A serving comprises 33ml of spirits, 165ml of wine, or 330ml of ready to drink or beer. Therefore, to convert volume of products other than spirits to equivalent units, the following guide has been used: beer in hectolitres divide by 0.9, wine in nine litre cases divide by five and ready to drink in nine litre cases divide by 10, with certain pre-mixed products that are classified as ready to drink divided by five.

The collection of premium drinks comprises brands owned by the company as a principal, and brands the company holds under agency agreements. The collection includes:

Global priority brands

Smirnoff vodka and Smirnoff ready to drink products
Johnnie Walker scotch whiskies
Captain Morgan rum
Baileys Original Irish Cream liqueur
JeB scotch whisky
José Cuervo tequila (agency brand in North America and many other markets)
Tanqueray gin
Guinness stout

Other spirits brands include:	Wine brands include:	Other beer brands include:
Crown Royal Canadian whisky	Beaulieu Vineyard wine	Harp lager
Buchanan’s De Luxe whisky	Sterling Vineyards wine	Smithwick’s ale
Gordon’s gin and vodka	Chalone Vineyards wine	Malta Guinness non-alcoholic malt
Windsor Premier whisky	Blossom Hill wine	Red Stripe lager
Bell’s Extra Special whisky	Piat d’Or wine	Tusker lager
Dimple/Pinch whisky		
Seagram’s 7 Crown American whiskey		
Old Parr whisky		
Seagram’s VO Canadian whisky		
Bundaberg rum		
Ursus vodka		
Bushmills Irish whiskey		

Diageo’s agency agreements vary depending on the particular brand, but tend to be for a fixed number of years. Diageo’s principal agency brand is José Cuervo in North America and many other markets (with distribution rights extending to 2013). There can be no assurances that Diageo will be able to prevent termination of distribution rights or rights to manufacture under licence, or renegotiate distribution rights or rights to manufacture under licence on favourable terms when they expire.

Diageo also brews and sells other companies’ beer brands under licence, including Budweiser and Carlsberg lagers in Ireland, Heineken lager in Jamaica and Tiger beer in Malaysia.

Global priority brands Diageo has eight global priority brands that it markets worldwide. Diageo considers these brands to have the greatest current and future earnings potential. Each global priority brand is marketed consistently around the world, and therefore can achieve scale benefits. The group

manages and invests in these brands on a global basis. In the year ended 30 June 2007, global priority brands accounted for 59% of total volume (83.3 million equivalent units), and contributed net sales of £4,283 million.

Figures for global priority brands include related ready to drink products, unless otherwise indicated.

Smirnoff is Diageo’s highest volume brand and achieved sales of 28.1 million equivalent units in the year ended 30 June 2007. Smirnoff is ranked, by volume, as the number one premium vodka and the number one premium spirit brand in the world.

Johnnie Walker scotch whiskies comprise Johnnie Walker Red Label, Johnnie Walker Black Label and several other brand variants. During the year ended 30 June 2007, Johnnie Walker Red Label sold 9.5 million equivalent units, Johnnie Walker Black Label sold 5.3 million equivalent units and the remaining variants sold 0.8 million equivalent units. The Johnnie Walker franchise was ranked, by volume, as the number one premium scotch whisky and the number three premium spirit brand in the world.

Captain Morgan is ranked, by volume, as the number two premium rum brand in the world with sales of 7.8 million equivalent units in the year ended 30 June 2007.

Baileys, ranked, by volume, the number one liqueur in the world, sold 7.4 million equivalent units in the year ended 30 June 2007.

Guinness is the group’s only global priority beer brand, and for the year ended 30 June 2007 achieved volume of 11.3 million equivalent units.

Other global priority brands were also ranked, by volume, among the leading premium distilled spirits brands by Impact Databank. These include: JeB scotch whisky (comprising JeB Rare, JeB Reserve, JeB Exception and JeB Jet), ranked the number two premium scotch whisky in the world; José Cuervo, ranked the number one premium tequila in the world; and Tanqueray, ranked the number five premium gin brand in the world. During the year ended 30 June 2007, JeB, José Cuervo and Tanqueray sold 5.8 million, 5.2 million and 2.1 million equivalent units, respectively.

Other brands Diageo manages its other brands by category, analysing them between local priority brands and category brands.

Local priority brands represent the brands, apart from the global priority brands, that make the greatest contribution to operating profit in a business area (North America, Europe, International or Asia Pacific), rather than worldwide. Diageo has identified 26 local priority brands. Diageo manages and invests in these brands within its business areas and, unlike the global priority brands, may not have a consistent marketing strategy around the world for such brands. For the year ended 30 June 2007, local priority brands contributed volume of 25.6 million equivalent units, representing 18% of total volume, and net sales of £1,641 million. Examples of local priority brands include Crown Royal Canadian whisky in North America, Windsor

Premier whisky in Asia Pacific, Buchanan’s De Luxe whisky in International, Gordon’s gin in Europe, Cacique rum in Europe, Bundaberg rum in Asia Pacific, Seagram’s VO whisky and Seagram’s 7 Crown whiskey in North America, Bell’s Extra Special whisky in Europe, Malta Guinness non-alcoholic malt in International and Sterling Vineyards wines in North America.

The remaining brands are grouped under category brands. Category brands include spirits, beer and wine brands and for the year ended 30 June 2007, these category brands contributed volume of 32.0 million equivalent units, representing 23% of total volume, and net sales of £1,550 million. Of this, spirits achieved volume of 23.8 million equivalent units and contributed £995 million to Diageo’s net sales in the year

ended 30 June 2007. Examples of category spirits brands are Gordon’s gin (all markets except Europe in which it is a local priority brand), Gordon’s vodka, The Classic Malt whiskies and White Horse whisky.

In the year ended 30 June 2007, Diageo sold 12.4 million equivalent units of beers other than Guinness, achieving net sales of £673 million. Other beer volume was attributable to mainly owned brands, such as Red Stripe, Pilsner, Tusker and Harp lager, with a minority being attributable to beers brewed and/or sold under licence, such as Tiger beer in Malaysia and Heineken lager in Jamaica.

In addition, Diageo produces and markets a wide selection of wines. These include well known labels such as Beaulieu Vineyard, Sterling Vineyards and Chalone Vineyards in the United States, Blossom Hill in the United Kingdom, and Barton & Guestier and Piat d’Or in Europe. For the year ended 30 June 2007, other wine volume was 2.3 million equivalent units, contributing net sales of £253 million.

Production Diageo owns production facilities including maltings, distilleries, breweries, packaging plants, maturation warehouses, cooperages, vineyards and distribution warehouses. Production also occurs at plants owned and operated by third parties and joint ventures at a number of locations internationally.

Approximately 75% of total production (including third party production) is undertaken in five Diageo production areas, namely the United Kingdom, Baileys, Guinness, Santa Vittoria and North America centres. The majority of these production centres have several production facilities. The locations, principal activities, products, packaging production capacity and packaging production volume in 2007 of these principal production centres are set out in the following table:

Production centre	Location	Principal products	Production capacity in millions of equivalent units*	Production volume in 2007 in millions of equivalent units
United Kingdom	United Kingdom	Scotch whisky, gin, vodka, rum, ready to drink	58	45
Baileys	Ireland	Irish cream liqueur, vodka	15	8
Guinness	Ireland	Beers	11	9
Santa Vittoria	Italy	Vodka, wine, rum, ready to drink	9	6
North America	United States, Canada	Vodka, gin, tequila, rum, Canadian whisky, American whiskey, progressive adult beverages, wine, ready to drink	57	38

* Capacity represents ongoing, sustainable production capacity at any production unit

Spirits are produced in distilleries located worldwide. The group owns 29 whisky distilleries in Scotland, an Irish whiskey distillery in Northern Ireland, a whisky distillery in Canada and gin distilleries in the United Kingdom and the United States. Diageo produces Smirnoff vodka internationally, Popov vodka and Gordon’s vodka in the United States and Baileys in the Republic of Ireland and Northern Ireland. Rum is blended and bottled in the United States, Canada, Italy and the United Kingdom and is distilled, blended and bottled in Australia and Venezuela. All of Diageo’s maturing scotch whisky is located in warehouses in Scotland. In February 2007, Diageo announced that it will invest £100 million in expanding malt and grain whisky distilling and expanding packaging warehousing operations in Scotland. Diageo will build a new malt distillery in the north of Scotland and expand the Cameronbridge grain distillery in Fife. Bottling capacity at the group’s Shieldhall packaging plant in Glasgow will be increased and warehousing capacity will be extended in central Scotland.

Diageo’s principal wineries are in the United States, France and Argentina. Wines are sold both in their local markets and overseas.

Diageo produces a range of ready to drink products mainly in the United Kingdom, Italy, South Africa, Australia, the United States and Canada.

Diageo’s principal brewing facilities are at the St James’s Gate brewery in Dublin and in Kilkenny, Waterford and Dundalk in the Republic of Ireland, and in Nigeria, Kenya, Ghana, Cameroon, Malaysia and Jamaica. Ireland is the main export centre for the Guinness brand. In other countries, Guinness is brewed by third parties under licence arrangements.

All Guinness Draught production is at the St James’s Gate brewery in Dublin in the Republic of Ireland. Guinness Draught in cans and bottles, which uses an in-container system to replicate the taste of Guinness Draught, is packaged at Runcorn and Belfast in the United Kingdom. The Runcorn facility performs the kegging of Guinness Draught, transported to the United Kingdom in bulk for the Great Britain market.

Property, plant and equipment Diageo owns or leases land and buildings throughout the world. The principal production facilities are described above. As at 30 June 2007, Diageo’s land and buildings were included in the group’s consolidated balance sheet at a net book value of £709 million. Diageo’s largest individual facility, in terms of net book value of property, is St James's Gate brewery in Dublin. Approximately 97% by value of the group's properties were owned and approximately 2% are held under leases running for 50 years or longer. Diageo's properties primarily are a variety of manufacturing, distilling, brewing, bottling and administration facilities spread across the group's worldwide operations, as well as vineyards in the United States. Approximately 41% and 28% of the book value of Diageo's land and buildings comprise properties located in the United Kingdom and the United States, respectively.

Raw materials The group has a number of contracts for the forward purchasing of its raw material requirements in order to minimise the effect of raw material price fluctuations. Long term contracts are in place for the purchase of significant raw materials including glass, other packaging, tequila, bulk whisky, neutral spirits, cream, rum and grapes. In addition, forward contracts are in place for the purchase of other raw materials including sugar and cereals to minimise the effects of short term price fluctuations.

Cream is the principal raw material used in the production of Irish cream liqueur and is sourced from Ireland. Grapes are used in the production of wine and are sourced from suppliers in the United States, France and Argentina. Other raw materials purchased in significant quantities for the production of spirits and beer are tequila, bulk whisky, neutral spirits, molasses, rum, cereals, sugar and a number of flavours (such as juniper berries, agave, chocolate and herbs). These are sourced from suppliers around the world.

The majority of products are supplied to customers in glass bottles. Glass is purchased from suppliers located around the world, the principal supplier being the Owens Illinois group.

Diageo has a supply agreement with Casa Cuervo SA de CV, a Mexican company, for the supply of bulk tequila used to make the José Cuervo line of tequilas and tequila drinks in the United States. The supply agreement extends to June 2013.

Diageo has a supply agreement with Destiléria Serrallés, Inc, a Puerto Rican corporation, for the supply of rum used to make the Captain Morgan line of rums and rum drinks in the United States. The supply agreement is for 10 years from 2002, with a three year notice requirement coming into effect once the original 10 year term has expired.

Marketing and distribution Diageo is committed to investing in its brands. £1,162 million was spent worldwide on marketing brands in the year ended 30 June 2007. Marketing was focused on the eight global priority brands, which accounted for 68% of total marketing expenditure in the year ended 30 June 2007.

Diageo aims to maintain and improve its market position by enhancing the consumer appeal of its brands through consistent high investment in marketing support focused around the eight global priority brands. Diageo makes extensive use of magazine, newspaper, point of sale and poster and billboard advertising, and uses radio, cinema, television and internet advertising where appropriate and permitted by law. Diageo also runs consumer promotional programmes in the on trade (for example, licensed bars and restaurants). Diageo also uses sponsorship to market its brands and is a sponsor of Team Vodafone McClaren Mercedes Formula One and the Johnnie Walker golf championship.

Diageo markets and distributes its brands under a business area organisation comprising North America, Europe, International and Asia Pacific.

Business analysis In the year ended 30 June 2007, North America, Europe, International and Asia Pacific contributed 37%, 32%, 22% and 9%, respectively, of the group's operating profit before corporate costs.

An analysis of net sales and operating profit by market for the year ended 30 June 2007 is as follows:

	Net sales £ million	Operating profit/(loss) £ million
North America	**2,472**	**850**
Europe	**2,427**	**723**
International	**1,667**	**499**
Asia Pacific	**840**	**196**
Corporate	**75**	**(109)**
Total	**7,481**	**2,159**

North America North America is the largest market for Diageo in terms of operating profit, and the largest market for premium drinks in the world. Diageo markets its products through four operating units: US Spirits, Diageo-Guinness USA, Diageo Chateau & Estate Wines Company, and Diageo Canada.

The US Spirits business, while managed as a single business unit, executes sales and marketing activities through 14 teams or clusters. National brand strategy and strategic accounts marketing are managed at the corporate North America level. The spirits clusters market the majority of Diageo's portfolio of spirits (including Smirnoff vodka, Baileys Irish Cream liqueur, José Cuervo tequila, Johnnie Walker scotch whisky, Captain Morgan rum, Tanqueray gin, JeB scotch whisky, Crown Royal Canadian whisky, Seagram's 7 Crown American whiskey, Seagram's VO Canadian whisky and Buchanan's scotch whisky) across the United States. Diageo-Guinness USA distributes Diageo's US beer portfolio (including Guinness stout, Harp lager, Red Stripe lager and Smithwick's ale) as well as the group's progressive adult beverages (including Smirnoff Ice, Smirnoff Raw Tea Flavored Malt Beverage, Captain Morgan Parrot Bay Tropical Malt Beverage and Smirnoff Source). Diageo Chateau & Estate Wines owns and operates vineyards in California and Washington State (including Beaulieu Vineyard, Sterling Vineyards, Chalone Vineyards and Hewitt Vineyards) and markets these and other wines across the United States. The Canada business unit distributes the group's spirits, wine and beer portfolio across all Canadian territories.

Within the United States, there are generally two types of regulatory environments: open states and control states. In open states, spirits companies are allowed to sell spirits, wine and beer directly to independent distributors. In these open states, Diageo generally trades through a three tier distribution system, where the product is initially sold to distributors, who then sell it to on and off trade retailers. In most control states, Diageo markets its spirits products to state liquor control boards through the bailment warehousing system, and from there to state or agency liquor stores. There are variations – for example, certain states control distribution but not retail sales. Generally, wines are treated in the same way as spirits, although most states that are control states for spirits are open states for wines. Beer distribution follows open states regulation across the entire United States. In Canada, beer and spirits distribution laws are generally consistent and similar to those of control states in the United States. Diageo, however, has some licences to direct deliver keg beer to licensed accounts, which account for approximately 25% of Diageo's beer business in Canada.

Diageo has pursued a distribution strategy focused on consolidating the distribution of Diageo's US spirits and wine brands into a single distributor or broker in each state wherever possible. The strategy is designed to provide a consolidated distribution network limiting duplication of activities between Diageo and the distributor, increasing Diageo and distributor selling capabilities and employing a number of alternative approaches to optimise product distribution. Through this strategy, Diageo has consolidated its business in 39 states plus Washington DC, representing over 80% of Diageo's US spirits and wine volume. Across the United States, Diageo's distributors and brokers have over 2,100 dedicated sales people focused on selling Diageo's spirits and wine brands. Diageo is now focussing on helping to build the capabilities and selling tools of the distributors' dedicated sales forces and creating a more efficient and effective value chain. The remaining states are franchise states that will be consolidated as opportunities arise.

Europe Diageo Europe comprises Great Britain, Ireland, Continental Europe, Iberia and Russia.

In Great Britain Diageo sells and markets its products via three business units: Diageo GB (spirits, beer and ready to drink), Percy Fox & Co (wines) and Justerini & Brooks Retail (private client wines). Products are distributed both via independent wholesalers and directly to the major grocers, convenience and specialist stores. In the on trade (for example, licensed bars and restaurants), products are sold through the major brewers, multiple retail groups and smaller regional independent brewers and wholesalers. The customer base in Great Britain has seen consolidation in recent years in both the on trade and home consumption channels. In particular, Great Britain's top four national multiple grocers together make up over 45% of home consumption total spirits volume.

Ireland comprises the Republic of Ireland and Northern Ireland. In both territories, Diageo sells and distributes directly to both the on trade and the off trade (for example, retail shops and wholesalers) through a telesales operation, extensive sales calls to outlets and third party logistics providers. The Guinness, Smirnoff and Baileys brands are market leaders in their respective categories of long alcoholic drinks, vodka and liqueurs. Budweiser and Carlsberg lagers, also major products in the Diageo collection of brands in Ireland, are brewed and sold under licence in addition to the other European local priority brands of Smithwick's ale and Harp lager.

In Russia Diageo sells and markets its products through a company in which Diageo owns a 75% interest. This company is the exclusive distributor of Diageo spirits brands in Russia.

Across the remainder of Europe, and including the majority of the markets within Continental Europe, Diageo distributes its spirits brands primarily through its own distribution companies. Exceptions to this are:

- France, where Diageo sells its spirits and wine products through a joint arrangement with Moët Hennessy, and its beer products through Brasseries Kronenbourg (part of the Scottish & Newcastle group) with effect from 1 July 2007 (previously through Inbev until 30 June 2007);
- the Baltic states, Hungary, Czech Republic, Slovakia, Romania, Bulgaria, Cyprus, Malta, various territories in the Balkans and Israel, where Diageo sells and markets its brands via local distributors; and
- the Nordic countries, where Diageo has sales offices in Sweden, Norway and Denmark, and representation through third party distributors in Finland and Iceland. In all Nordic markets except Denmark, off premise sales are controlled by state monopolies, with alcohol tax rates among the highest in the world, and border trade and duty free are important sources of purchase.

A specialist unit has been established for the distribution of Diageo's beer brands in Continental Europe in order to achieve synergies in the marketing and distribution of Guinness, Harp and Kilkenny brands. The distribution of these brands is managed by this specialist unit with particular focus on the markets in Germany, Italy, Russia and France, which are the largest Continental European beer markets by size for Diageo.

International Diageo International comprises Latin America and the Caribbean, Africa and the Global Travel and Middle East business.

In Latin America and the Caribbean, distribution is achieved through a mixture of Diageo companies and third party distributors. In addition, Diageo owns a controlling interest in Desnoes & Geddes Limited, the Jamaican brewer of Red Stripe lager.

Africa (excluding North Africa) is one of the longest established and largest markets for the Guinness brand, with the brewing of Guinness Foreign Extra Stout in a number of African countries, either through subsidiaries or under licence. Diageo has a three way joint venture with Heineken and Namibia Breweries Limited in South Africa. Diageo has a wholly-owned subsidiary in Cameroon and also has majority-owned subsidiaries in Nigeria, Kenya, Uganda, Reunion and the Seychelles. In Ghana, Diageo and Heineken amalgamated the businesses of Guinness Ghana Limited (Diageo) and Ghana Breweries Limited (Heineken) in 2005 to form Guinness Ghana Breweries Ltd to achieve a number of commercial and operational synergy benefits.

Global Travel and Middle East (GTME) encompasses a sales and marketing organisation which targets the international consumer in duty free and travel retail outlets such as airport shops, airlines and ferries around the world and distribution of Diageo brands in the Middle East and North Africa. The global nature of the travel channel and its organisation structure allows a specialist Diageo management team to apply a co-ordinated approach to brand building initiatives and to build on consumer insights in this trade channel, where consumer behaviour tends to be different from domestic markets. In the Middle East and North Africa, distribution is achieved through third party distributors. Lebanon is an exception, where a Diageo majority-owned joint venture distributes most of the Diageo brands sold there.

Asia Pacific Diageo Asia Pacific comprises India, the People's Republic of China, South Korea, Japan and other Asian markets; Australia and New Zealand.

Diageo works with a number of joint venture partners in Asia Pacific. In Singapore, Malaysia, Hong Kong, People's Republic of China, Thailand and Japan, Diageo distributes the majority of its spirits and wine brands through joint venture arrangements with Moët Hennessy. Diageo has a distribution agreement with third party distributors for the distribution of certain spirits brands in the People’s Republic of China. In South Korea, Diageo’s own distribution company distributes the majority of Diageo’s brands except that, for the period during which it is without its import licence, Soo Seok Trading Co Ltd will distribute those brands. In Japan, Guinness beer is distributed through a joint venture company with Sapporo Breweries. There is also a direct relationship with Sapporo Breweries for the distribution of Smirnoff Ice. Other spirits and wine brands, which are not distributed by the Moët Hennessy joint venture in Japan, are handled by third parties. In Malaysia, Diageo’s own and third party beers are brewed and distributed by a listed business (Guinness Anchor Berhad) in which Diageo and its partner, Asia Pacific Breweries, have a majority share through a jointly controlled joint venture company. In Singapore Diageo’s beer brands are brewed and distributed by Asia Pacific Breweries. Generally, the remaining markets in Asia are served by third party distribution networks monitored by regional offices.

In India, distribution of both imported and locally produced products is achieved through a combination of third party distributors and customers. Notably in 2007 a joint venture was formed with Radico Khaitan to manufacture and distribute certain premium local spirits, the first of which, Masterstroke, was launched in 2007.

In Australia, Diageo has its own distribution company as well as a distribution arrangement with VOK beverages, and also has licensed brewing arrangements with Carlton-United Breweries. In New Zealand, Diageo operates through third party distributors and has licensed brewing arrangements with Lion Nathan.

Seasonal impacts The festive holiday season provides the peak period for sales. Approximately 30% of annual sales volume occurs in the last three months of each calendar year.

Employees Diageo believes that sustainable business performance comes from developing its people’s skills, capabilities and contributions. Releasing the potential of every employee, one of Diageo’s core strategic imperatives, is at the heart of its Talent philosophy. As such, it permeates all Diageo’s people processes to ensure every individual has the opportunity to develop and apply their unique combination of talents and strengths, in pursuit of the group’s ambitions.

The combination of valuing and growing its people, its high performance culture and the day-to-day reality of the Diageo values is a key competitive advantage in the attraction, motivation and retention of a talented and diverse workforce. Opportunities for employment, training and career progression are determined on the basis of each individual’s ability and performance track record, irrespective of their gender, ethnic origin, nationality, age, religion, sexual orientation or disability. Reward and recognition programmes that are provided for employees are regularly benchmarked to determine their competitive positioning but also to ensure that individuals believe their personal contributions are appropriately valued.

Employee policies are designed in support of delivering business performance goals, whilst also being reflective of Diageo’s core values. They take account of both external legislation and internal codes of conduct. Of critical importance is the safety and wellbeing of Diageo employees. In addition, the role of employees as ambassadors of responsible drinking is actively promoted.

The senior leadership community is committed to open and continuous dialogue with its employees as a way to inform and engage them in the company’s strategy and business goals, as well as harnessing the ideas employees will have on improving broad areas of business performance. Diageo is committed to honouring its obligations to consult openly and regularly with employee representative forums and/or trade unions where appropriate. Above all, through authentic and inspiring leadership, Diageo seeks to energise its people and business partners to make Diageo a special and enduring company within which to work.

Diageo’s average number of employees during each of the three years ended 30 June 2007 was as follows:

	2007	2006	2005
Average number of employees			
Full time	**22,086**	21,972	22,333
Part time	**434**	647	633
	22,520	22,619	22,966

Competition Diageo competes on the basis of consumer loyalty, quality and price.

In spirits, Diageo’s major global competitors are Pernod Ricard, Bacardi and Brown-Forman, each of which has several brands that compete directly with Diageo brands. In addition, Diageo faces competition from local and regional companies in the countries in which it operates.

In beer, the Guinness brand competes in the overall beer market with its key competitors varying by market. These include Heineken in Ireland and both Heineken and SABMiller in several markets in Africa, Coors Brewing (Carling) in the United Kingdom and Carlsberg in Malaysia.

In wine, the market is fragmented with many producers and distributors.

Research and development The overall nature of the group’s business does not demand substantial expenditure on research and development. However, the group has ongoing programmes for developing new drinks products. In the year ended 30 June 2007, the group’s research and development expenditure amounted to £17 million (2006 – £18 million; 2005 – £16 million). Research and development expenditure is generally written off in the year in which it is incurred.

Trademarks Diageo produces and distributes branded goods and is therefore substantially dependent on the maintenance and protection of its trademarks. All brand names mentioned in this document are trademarks. The group also holds numerous licences and trade secrets, as well as having substantial trade knowledge related to its products. The group believes that its significant trademarks are registered and/or otherwise protected (insofar as legal protections are available) in all material respects in its most important markets.

Regulations and taxes Diageo’s worldwide operations are subject to extensive regulatory requirements regarding production, product liability, distribution, importation, marketing, promotion, labelling, advertising, labour, pensions and environmental issues. In the United States, the beverage alcohol industry is subject to strict federal and state government regulations covering virtually every aspect of its operations, including production, marketing, promotion, sales, distribution, pricing, labelling, packaging and advertising.

Spirits, wine and beer are subject to national import and excise duties in many markets around the world. Most countries impose excise duties on beverage alcohol products, although the form of such taxation varies significantly from a simple application to units of alcohol by volume, to advanced systems based on imported or wholesale value of the product. Several countries impose additional import duty on distilled spirits, often discriminating between categories (such as scotch whisky or bourbon) in the rate of such tariffs. Within the European Union, such products are subject to different rates of excise duty in each country, but within an overall European Union framework, there are minimum rates of excise duties that can be applied.

Import and excise duties can have a significant impact on the final pricing of Diageo's products to consumers. These duties have an impact on the competitive position versus other brands. The group devotes resources to encouraging the equitable taxation treatment of all beverage alcohol categories and to reducing government-imposed barriers to fair trading.

Advertising, marketing and sales of alcohol are subject to various restrictions in markets around the world. These range from a complete prohibition of alcohol in certain countries and cultures, through the prohibition of the import of spirits, wine and beer, to restrictions on the advertising style, media and messages used. In a number of countries, television is a prohibited medium for spirits brands and in other countries, television advertising, while permitted, is carefully regulated.

Spirits, wine and beer are also regulated in distribution. In many countries, alcohol may only be sold through licensed outlets, both on and off premise, varying from government or state operated monopoly outlets (for example, Canada, Norway, and certain US states) to the common system of licensed on premise outlets (for example, licensed bars and restaurants) which prevails in much of the western world (for example, most US states and the European Union). In about one-third of the states in the United States, price changes must be filed or published 30 days to three months, depending on the state, before they become effective.

Labelling of beverage alcohol products is also regulated in many markets, varying from health warning labels to importer identification, alcohol strength and other consumer information. Specific warning statements related to the risks of drinking beverage alcohol products are required to be included on all beverage alcohol products sold in the United States. Following the end of the voluntary restrictions on television advertising of spirits in the United States, Diageo and other spirits companies have been advertising products on the air on local cable television stations. Expressions of political concern signify the uncertain future of beverage alcohol products advertising on network television in the United States. Further requirements for warning statements and any prohibitions on advertising and marketing could have an adverse impact on sales of the group.

Regulatory decisions and changes in the legal and regulatory environment could increase Diageo's costs and liabilities or impact its business activities.

Business services Diageo has committed to re-engineer its key business activities with customers, consumers, suppliers and the processes that summarise and report financial performance. In that regard, global processes have been designed, built and implemented across a number of markets and global supply.

A business service centre in Budapest, Hungary performs various process tasks for markets and supply centres including Australia, Austria, Benelux, Brazil, Canada, the Canaries, Germany, Global Travel, Great Britain, Guinness Continental Europe, Guinness supply, Iberia, Ireland, Mexico, the Nordics, North America, Northern European Logistics and Switzerland. Certain central finance activities including elements of group financial control and treasury are also performed in the business service centre in Budapest. Additional markets and supply entities may transfer to Budapest during the next few years.

The costs of the business service centre and other corporate costs which cannot be directly allocated to the business areas are reported separately within Corporate costs in the analysis of business performance. Also included in Corporate are the revenues and costs related to rents receivable in respect of properties not used by Diageo in the manufacture, sale or distribution of premium drink products and the results of Gleneagles Hotel.

Associates Diageo's principal associate is Moët Hennessy. It also owns shares in a number of other associates. In the year ended 30 June 2007, the share of profits of associates after tax was £149 million (2006 – £131 million; 2005 – £121 million), of which Moët Hennessy accounted for £136 million (2006 – £122 million; 2005 – £113 million).

Diageo owns 34% of Moët Hennessy, the spirits and wine subsidiary of LVMH Moët Hennessy-Louis Vuitton SA (LVMH). LVMH is based in France and is listed on the Paris Stock Exchange. Moët Hennessy is also based in France and is a producer and exporter of a number of brands in its main business areas of champagne and cognac. Its principal champagne brands are Moët & Chandon (including Dom Pérignon), Veuve Clicquot and Mercier, all of which are included in the top 10 champagne brands worldwide by volume. Moët Hennessy also owns Hennessy, which is the top cognac brand worldwide by volume, and Glenmorangie, a malt whisky.

Since 1987, a number of joint distribution arrangements have been established with LVMH, principally covering distribution of Diageo's premium brands of scotch whisky and gin and Moët Hennessy's premium champagne and cognac brands in the Asia Pacific region and France. Diageo and LVMH have each undertaken not to engage in any champagne or cognac activities competing with those of Moët Hennessy. The arrangements also contain certain provisions for the protection of Diageo as a minority shareholder in Moët Hennessy. The operations of Moët Hennessy in France are conducted through a partnership in which Diageo has a 34% interest and, as a partner, Diageo pays any tax due on its share of the results of the partnership to the tax authorities.

Acquisitions and disposals Diageo has made a number of acquisitions and disposals of brands, distribution rights and equity interests in premium drinks businesses including the following:

In February 2005, Diageo acquired The Chalone Wine Group for $285 million (£153 million). The Chalone Wine Group is a North America based wine business with a range of premium brand wines and has been merged into Diageo's North American wine business, Diageo Chateau & Estate Wines Company.

In February 2005, Diageo acquired Ursus Vodka Holding BV, the owner of the Ursus vodka and Ursus Roter brands. The principal market, by volume, for the Ursus vodka and Ursus Roter brands is Greece. Diageo's total cash investment was €146 million (£99 million).

On 25 August 2005, Diageo completed the purchase of The "Old Bushmills" Distillery Company Limited, owner of Bushmills Irish whiskey, one of the world's leading Irish whiskey brands, from Pernod Ricard for approximately €296 million (£209 million).

On 3 July 2006, Diageo completed the purchase of the Smirnov brand in Russia through the formation of a 75% Diageo-owned joint venture company. This company unites the Smirnoff/Smirnov brands in Russia under common ownership and is the exclusive distributor of Smirnov and Diageo's spirits brands in Russia.

Business description (continued)

On 27 January 2007, Diageo completed the acquisition of a 43% equity stake in Sichuan Chengdu Quanxing Group Co Ltd (‘Quanxing’). Quanxing holds 39.48% of the equity in Sichuan ShuiJingFang Joint Stock Co Ltd (‘ShuiJingFang’) a leading maker of premium traditional Chinese liquor, or baijiu. ShuiJingFang is listed on the Shanghai Stock Exchange. The agreed purchase price for the 43% equity interest in Quanxing was RMB 517 million (£37 million).

Disposed businesses

General Mills Diageo acquired an investment in the shares of General Mills on the disposal of Pillsbury to General Mills in October 2001. On 4 October 2004, Diageo sold 50 million shares of common stock in General Mills and transferred a further 4 million shares to the Diageo UK pension fund and Diageo ceased to be an affiliate of General Mills for US federal securities laws purposes at that time. In November 2005, Diageo sold its remaining 25 million shares of common stock of General Mills.

During the year ended 30 June 2006, the group recorded dividends receivable of £5 million from General Mills (2005 – £17 million).

Burger King Diageo completed the disposal of Burger King on 13 December 2002.

Risk factors

Diageo faces competition that may reduce its market share and margins Diageo faces substantial competition from several international companies as well as local and regional companies in the countries in which it operates. Diageo competes with drinks companies across a wide range of consumer drinking occasions. Within a number of categories, consolidation or realignment is still possible. Consolidation is also taking place amongst Diageo’s customers in many countries. Increased competition and unanticipated actions by competitors or customers could lead to downward pressure on prices and/or a decline in Diageo’s market share in any of these categories, which would adversely affect Diageo’s results and hinder its growth potential.

Diageo may not be able to derive the expected benefits from its strategy to focus on premium drinks or its systems change and cost-saving programmes designed to enhance earnings Diageo’s strategy is to focus on premium drinks to grow its business through organic sales and operating profit growth and the acquisition of premium drinks brands that add value for shareholders. There can be no assurance that Diageo’s strategic focus on premium drinks will result in better opportunities for growth and improved margins.

It is possible that the pursuit of this strategic focus on premium drinks could give rise to further acquisitions (including associated financing), disposals, joint ventures or partnerships. There can be no guarantee that any such acquisition, disposal, joint venture or partnership would deliver the benefits intended.

Similarly, there can be no assurance that the systems change and cost-savings programmes implemented by Diageo in order to improve efficiencies and deliver cost-savings will deliver the expected benefits.

Systems change programmes may not deliver the benefits intended and systems failures could lead to business disruption Certain change programmes designed to improve the effectiveness and efficiency of end-to-end operating, administrative and financial systems and processes continue to be undertaken. This includes moving transaction processing from a number of markets to business service centres. There can be no certainty that these programmes will deliver the expected operational benefits. There is likely to be

Business description (continued)

disruption caused to production processes and possibly to administrative and financial systems as further changes to such processes are effected. They could also lead to adverse customer or consumer reaction. Any failure of information systems could adversely impact on Diageo’s ability to operate. As with all large systems, Diageo’s information systems could be penetrated by outside parties intent on extracting information, corrupting information or disrupting business processes. Such unauthorised access could disrupt Diageo’s business and/or lead to loss of assets. The concentration of processes in business service centres also means that any disruption arising from system failure or physical plant issues could impact on a large portion of Diageo’s global business.

Regulatory decisions and changes in the legal and regulatory environment could increase Diageo’s costs and liabilities or limit its business activities Diageo’s operations are subject to extensive regulatory requirements which include those in respect of production, product liability, distribution, importation, marketing, promotion, labelling, advertising, labour, pensions and environmental issues. Changes in laws, regulations or governmental policy could cause Diageo to incur material additional costs or liabilities that could adversely affect its business. In particular, governmental bodies in countries where Diageo operates may impose new labelling, product or production requirements, limitations on the advertising and/or promotion activities used to market beverage alcohol, restrictions on retail outlets, other restrictions on marketing, promotion and distribution or other restrictions on the locations or occasions where beverage alcohol is sold which directly or indirectly limit the sales of Diageo products. Regulatory authorities under whose laws Diageo operates may also have enforcement power that can subject the group to actions such as product recall, seizure of products or other sanctions, which could have an adverse effect on its sales or damage its reputation.

In addition, beverage alcohol products are the subject of national import and excise duties in most countries around the world. An increase in import or excise duties could have a significant adverse effect on Diageo’s sales revenue or margin, both through reducing overall consumption and by encouraging consumers to switch to lower-taxed categories of beverage alcohol.

Diageo’s reported after tax income is calculated based on extensive tax and accounting requirements in each of its relevant jurisdictions of operation. Changes in tax law (including tax rates), accounting policies and accounting standards could materially reduce Diageo’s reported after tax income.

Diageo is subject to litigation directed at the beverage alcohol industry and other litigation Companies in the beverage alcohol industry are, from time to time, exposed to class action or other litigation relating to alcohol advertising, alcohol abuse problems or health consequences from the misuse of alcohol. If such litigation resulted in fines, damages or reputational damage to Diageo or its brands, Diageo’s business could be materially adversely affected.

A number of similar putative class actions are pending in state and federal courts in the United States against Diageo plc, Diageo North America, Inc and other Diageo entities, along with a large group of other beverage alcohol manufacturers, brewers and importers. All have been brought by the same national counsel. In each action, the plaintiffs seek to pursue their claims on behalf of parents and guardians of people under the legal drinking age who illegally bought alcohol beverages during the period from 1982 to the present. Plaintiffs allege several causes of action, principally for negligence, unjust enrichment and violation of state consumer fraud statutes. Some complaints include additional claims based on conspiracy, nuisance and on other legal theories.

Demand for Diageo's products may be adversely affected by changes in consumer preferences and tastes Diageo's collection of brands includes some of the world's leading beverage alcohol brands as well as brands of local prominence. Maintaining Diageo's competitive position depends on its continued ability to offer products that have a strong appeal to consumers. Consumer preferences may shift due to a variety of factors including changes in demographic and social trends, public health regulations, changes in travel, vacation or leisure activity patterns, weather effects and a downturn in economic conditions, which may reduce consumers' willingness to purchase premium branded products. In addition, concerns about health effects due to negative publicity regarding alcohol consumption, negative dietary effects, regulatory action or any litigation or customer complaints against companies in the industry may have an adverse effect on Diageo's profitability.

The competitive position of Diageo's brands could also be affected adversely by any failure to achieve consistent, reliable quality in the product or service levels to customers.

In addition, both the launch and ongoing success of new products is inherently uncertain especially as to their appeal to consumers. The failure to launch a new product successfully can give rise to inventory write offs and other costs and can affect consumer perception of an existing brand. Growth in Diageo's business has been based on both the launch of new products and the growth of existing products. Product innovation remains a significant aspect of Diageo's plans for growth. There can be no assurance as to Diageo's continuing ability to develop and launch successful new products or variants of existing products or as to the profitable lifespan of newly or recently developed products.

Any significant changes in consumer preferences and failure to anticipate and react to such changes could result in reduced demand for Diageo's products and erosion of its competitive and financial position.

If the social acceptability of Diageo's products declines, Diageo's sales volume could decrease and the business could be materially adversely affected In recent years, there has been increased social and political attention directed to the beverage alcohol industry. Diageo believes that this attention is the result of public concern over problems related to alcohol abuse, including drink driving, underage drinking and health consequences from the misuse of alcohol. If, as a result, the general social acceptability of beverage alcohol were to decline significantly, sales of Diageo's products could materially decrease.

Diageo's operating results may be adversely affected by increased costs or shortages of raw materials or labour or disruption to production facilities or business service centres The raw materials which Diageo uses for the production of its beverage products are largely commodities that are subject to price volatility caused by changes in global supply and demand, weather conditions, agricultural uncertainty or governmental controls. If commodity price changes result in unexpected increases in the cost of raw materials, glass bottles and other packaging materials or the transportation of such materials and Diageo's beverage products, Diageo may not be able to increase its prices to offset these increased costs without suffering reduced volume, revenue and operating income. Diageo may be adversely affected by shortages of raw materials or packaging materials. Energy costs have been increasing and could continue to rise, resulting in higher transportation, freight and other operating costs.

Diageo's operating results could be adversely affected by labour or skill shortages or increased labour costs due to increased competition for employees, higher employee turnover or increased employee benefit costs. Diageo's success is dependent on the capability of its employees. There is no guarantee that Diageo will continue to be able to recruit, retain and develop the capabilities that it requires to deliver its strategy, for example in relation to sales, marketing and innovation capability within markets or in its senior management. The loss of senior management or other key personnel or the inability to identify, attract and

retain qualified personnel in the future could make it difficult to manage the business and could adversely affect operations and financial results.

Diageo would be affected if there were a catastrophic failure of its major production facilities or business service centres. See 'Business description – Premium drinks – Production' for details of Diageo's principal production areas. In addition, the maintenance and development of information systems may result in systems failures which may adversely affect business operations.

Diageo has a substantial inventory of aged product categories, principally scotch whisky and Canadian whisky, which mature over periods of up to 30 years. As at 30 June 2007, the historical cost of Diageo's maturing inventory amounted to £1,745 million. The maturing inventory is stored primarily in Scotland, and the loss through contamination, fire or other natural disaster of all or a portion of the stock of any one of those aged product categories could result in a significant reduction in supply of those products, and consequently, Diageo would not be able to meet consumer demand for these products as it arises. There can be no assurance that insurance proceeds would cover the replacement value of Diageo's maturing inventory or other assets, were such assets to be lost due to contamination, fire or natural disasters or destruction resulting from negligence or the acts of third parties. In addition, there is an inherent risk of forecasting error in determining the quantity of maturing stock to lay down in a given year for future consumption. This could lead to an inability to supply future demand or lead to a future surplus of inventory and consequent write down in value of maturing stocks.

Diageo's business may be adversely impacted by unfavourable economic conditions or political or other developments and risks in the countries in which it operates Diageo's business is dependent on general economic conditions in the United States, Great Britain and other important markets. A significant deterioration in these conditions, including a reduction in consumer spending levels, could have a material adverse effect on Diageo's business and results of operations. In addition, Diageo may be adversely affected by political and economic developments in any of the countries where Diageo has distribution networks, production facilities or marketing companies. Diageo's operations are also subject to a variety of other risks and uncertainties related to trading in numerous foreign countries, including political or economic upheaval and the imposition of any import, investment or currency restrictions, including tariffs and import quotas or any restrictions on the repatriation of earnings and capital. Political and/or social unrest, potential health issues and terrorist threats and/or acts may also occur in various places around the world, which will have an impact on tourism and travel. These disruptions can affect Diageo’s ability to import or export products and to repatriate funds, as well as affecting the levels of consumer demand (for example in duty free outlets at airports or in on trade premises in affected regions) and therefore Diageo’s levels of sales or profitability.

Part of Diageo’s growth strategy includes expanding its business in certain countries where consumer spending in general, and spending on Diageo’s products in particular, has not historically been as great but where there are prospects for growth. There is no guarantee that this strategy will be successful and some of the markets represent a higher risk in terms of their changing regulatory environments and higher degree of uncertainty over levels of consumer spending.

Diageo may also be adversely affected by movements in the value of, and returns from, the investments held by its pension funds.

Diageo may be adversely affected by fluctuations in exchange rates. The results of operations of Diageo are accounted for in pounds sterling. Approximately 30% of sales in the year ended 30 June 2007 were in US dollars, approximately 23% were in sterling and approximately 19% were in euros. Movements in exchange rates used to translate foreign currencies into pounds sterling may have a significant impact on Diageo’s reported results of operations from year to year.

Diageo may also be adversely impacted by fluctuations in interest rates, mainly through an increased interest expense. To partly delay any adverse impact from interest rate movements, the profile of fixed rate to floating rate net borrowings is maintained according to a duration measure that is equivalent to an approximate 50% fixed and 50% floating amortising profile. See ‘Business review – Risk management’.

Diageo’s operations may be adversely affected by failure to renegotiate distribution and manufacturing agreements on favourable terms Diageo’s business has a number of distribution agreements for brands owned by it or by other companies. These agreements vary depending on the particular brand, but tend to be for a fixed number of years. There can be no assurance that Diageo will be able to renegotiate distribution rights on favourable terms when they expire or that agreements will not be terminated. Failure to renew distribution agreements on favourable terms could have an adverse impact on Diageo’s revenues and operating income. In addition, Diageo’s sales may be adversely affected by any disputes with distributors of its products.

Diageo may not be able to protect its intellectual property rights Given the importance of brand recognition to its business, Diageo has invested considerable effort in protecting its intellectual property rights, including trademark registration and domain names. Diageo’s patents cover some of its process technology, including some aspects of its bottle marking technology. Diageo also uses security measures and agreements to protect its confidential information. However, Diageo cannot be certain that the steps it has taken will be sufficient or that third parties will not infringe on or misappropriate its intellectual property rights. Moreover, some of the countries in which Diageo operates offer less intellectual property protection than Europe or North America. Given the attractiveness of Diageo’s brands to consumers, it is not uncommon for counterfeit products to be manufactured. Diageo cannot be certain that the steps it takes to prevent, detect and eliminate counterfeit products will be effective in preventing material loss of profits or erosion of brand equity resulting from lower quality or even dangerous counterfeit product reaching the market. If Diageo is unable to protect its intellectual property rights against infringement or misappropriation, this could materially harm its future financial results and ability to develop its business.

It may be difficult to effect service of US process and enforce US legal process against the directors of Diageo Diageo is a public limited company incorporated under the laws of England and Wales. The majority of Diageo’s directors and officers, and some of the experts named in this document, reside outside of the United States, principally in the United Kingdom. A substantial portion of Diageo’s assets, and the assets of such persons, are located outside of the United States. Therefore, it may not be possible to effect service of process within the United States upon Diageo or these persons in order to enforce judgements of US courts against Diageo or these persons based on the civil liability provisions of the US federal securities laws. There is doubt as to the enforceability in England and Wales, in original actions or in actions for enforcement of judgements of US courts, of civil liabilities solely based on the US federal securities laws.

Cautionary statement concerning forward-looking statements

This document contains ‘forward looking statements’ within the meaning of the ‘Safe Harbor’ provisions of the United States Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations and business of Diageo and certain of the plans and objectives of Diageo. In particular, all statements that express forecasts, expectations and projections with respect to future matters, including trends in results of operations, margins, growth rates, overall market trends, the impact of interest or exchange rates, the availability of financing to Diageo, anticipated cost savings or synergies and the completion of Diageo’s strategic transactions, are forward-looking statements. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from those expressed or implied by these forward-looking statements, including factors that are outside Diageo’s control.

These factors include, but are not limited to:

- increased competitive product and pricing pressures and unanticipated actions by competitors that could impact on Diageo’s market share, increase expenses and hinder growth potential;
- the effects of future business combinations, partnerships, acquisitions or disposals, existing or future, and the ability to realise expected synergies and/or cost savings;
- Diageo’s ability to complete existing or future acquisitions and disposals;
- legal and regulatory developments, including changes in regulations regarding consumption of, or advertising for, beverage alcohol, changes in tax law (including tax rates) or accounting standards, changes in taxation requirements, such as the impact of excise tax increases with respect to the business, and changes in environmental laws, health regulations and laws governing pensions;
- developments in the alcohol advertising class actions and any similar proceedings or other litigation directed at the drinks and spirits industry;
- developments in the Colombian litigation or any similar proceedings;

- changes in consumer preferences and tastes, demographic trends or perceptions about health related issues;
- changes in the cost of raw materials and labour costs;
- changes in economic conditions in countries in which Diageo operates, including changes in levels of consumer spending;
- levels of marketing, promotional and innovation expenditure by Diageo and its competitors;
- renewal of distribution or licence manufacturing rights on favourable terms when they expire;
- termination of existing distribution or licence manufacturing rights on agency brands;
- technological developments that may affect the distribution of products or impede Diageo's ability to protect its intellectual property rights; and
- changes in financial and equity markets, including significant interest rate and foreign currency exchange rate fluctuations, which may affect Diageo's access to or increase the cost of financing or which may affect Diageo's financial results.

Business description (continued)

All oral and written forward-looking statements made on or after the date of this document and attributable to Diageo are expressly qualified in their entirety by the above factors and the 'Risk factors' above for the year ended 30 June 2007 filed with the Securities and Exchange Commission (SEC). Any forward-looking statements made by or on behalf of Diageo speak only as of the date they are made. Diageo does not undertake to update forward-looking statements to reflect any changes in Diageo's expectations with regard thereto or any changes in events, conditions or circumstances on which any such statement is based. The reader should, however, consult any additional disclosures that Diageo may make in any documents which it publishes and/or files with the SEC. All readers, wherever situated, should take note of these disclosures.

The information in this document does not constitute an offer to sell or an invitation to buy shares in Diageo plc or any other invitation or inducement to engage in investment activities.

This document includes information about Diageo's debt rating. A security rating is not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the assigning rating organisation. Each rating should be evaluated independently of any other rating.

Past performance cannot be relied upon as a guide to future performance.

Business review

Introduction

Information presented Diageo is the world's leading premium drinks business and operates on an international scale selling all types of beverage alcohol. It is one of a small number of premium drinks companies that operate across beer, wine and spirits. Diageo's brands have broad consumer appeal across geographies; as a result, the business is organised under the business areas of North America, Europe, International and Asia Pacific and the business analysis is presented on this basis. The following discussion is based on Diageo's IFRS results for the year ended 30 June 2007 compared with the year ended 30 June 2006, and the year ended 30 June 2006 compared with the year ended 30 June 2005.

There are a number of accounting differences between IFRS and US GAAP. A reconciliation of net income from IFRS to US GAAP and an explanation of the differences between IFRS and US GAAP are set out in the US GAAP information in note 35 to the consolidated financial statements.

In the discussion of the performance of the business, net sales, which is defined as sales after deducting excise duties, are presented in addition to sales, since sales reflect significant components of excise duties which are set by external regulators and over which Diageo has no control. Diageo incurs excise duties throughout the world. In some countries, excise duties are based on sales and are separately identified on the face of the invoice to the external customer. In others, it is effectively a production tax, which is incurred when the spirit is removed from bonded warehouses. In these countries it is part of the cost of goods sold and is not separately identified on the sales invoice. Changes in the level of excise duties can significantly affect the level of reported sales and cost of sales, without directly reflecting changes in volume, mix or profitability that are the variables which impact on the element of sales retained by the group.

The underlying performance on a constant currency basis and excluding exceptional items and the impact of acquisitions and disposals is referred to as 'organic' performance, and further information on the calculation of organic measures as used in the discussion of the business is included in the organic movements calculation and in the notes to that calculation.

Presentation of information in relation to the business In addition to describing the significant factors impacting on the income statement compared to the prior year for both of the years ended 30 June 2007 and 30 June 2006, additional information is also presented on the operating performance and cash flows of the group.

There are several principal key performance indicators (some of which are non-GAAP measures) used by the group's management to assess the performance of the group in addition to income statement measures of performance. These are volume, the organic movements in volume, sales, net sales and operating profit, and free cash flow. These key performance indicators are described below:

Volume has been measured on an equivalent units basis to nine litre cases of spirits. An equivalent unit represents one nine litre case of spirits, which is approximately 272 servings. A serving comprises 33ml of spirits, 165ml of wine, or 330ml of ready to drink or beer. Therefore, to convert volume of products, other than spirits, to equivalent units, the following guide has been used: beer in hectolitres divide by 0.9, wine in nine litre cases divide by five, and ready to drink in nine litre cases divide by 10, with certain pre-mixed products that are classified as ready to drink divided by five.

Organic movements in volume, sales, net sales and operating profit are measures not specifically used in the consolidated financial statements themselves (non-GAAP measures). The performance of the group is discussed using these measures.

In the discussion of the performance of the business, organic information is presented using pounds sterling amounts on a constant currency basis. This strips out the effect of exchange rate movements and enables an understanding of the underlying performance of the market that is most closely influenced by the actions of that market's management. The risk from exchange rate movements is managed centrally and is not a factor over which local managers have any control.

Exceptional items, acquisitions and disposals also impact on the reported performance and therefore the reported movement in any period in which they arise. Management adjusts for the impact of such transactions in assessing the performance of the underlying business.

Diageo's strategic planning and budgeting process is based on organic movements in volume, sales, net sales and operating profit, and these measures closely reflect the way in which operating targets are defined and performance is monitored by the group's management.

These measures are chosen for planning, budgeting, reporting and incentive purposes since they represent those measures which local managers are most directly able to influence and they enable consideration of the underlying business performance without the distortion caused by fluctuating exchange rates, exceptional items and acquisitions and disposals.

The group's management believes these measures provide valuable additional information for users of the financial statements in understanding the group's performance since they provide information on those elements of performance which local managers are most directly able to influence and they focus on that element of the core brand portfolio which is common to both periods. They should be viewed as complementary to, and not replacements for, the comparable GAAP measures.

Free cash flow is a non-GAAP measure that comprises the net cash flow from operating activities as well as the net purchase and disposal of investments and property, plant and equipment that form part of net cash flow from investing activities. The group's management believes the measure assists users of the financial statements in understanding the group's cash generating performance as it comprises items which arise from the running of the ongoing business.

The remaining components of net cash flow from investing activities that do not form part of free cash flow, as defined by the group's management, are in respect of the purchase and disposal of subsidiaries, associates and businesses. The group's management regards the purchase and disposal of property, plant and equipment as ultimately non-discretionary since ongoing investment in plant and machinery is required to support the day-to-day operations, whereas acquisitions and disposals of businesses are discretionary. However, free cash flow does not necessarily reflect all amounts which the group either has a constructive or legal obligation to incur. Where appropriate, separate discussion is given for the impacts of acquisitions and disposals of businesses, equity dividends paid and the purchase of own shares – each of which arises from decisions that are independent from the running of the ongoing underlying business.

The free cash flow measure is also used by management for their own planning, budgeting, reporting and incentive purposes since it provides information on those elements of performance which local managers are most directly able to influence.

Operating results – 2007 compared with 2006

Summary consolidated income statement

	Year ended 30 June 2007 £ million	2006 £ million
Sales	**9,917**	9,704
Excise duties	**(2,436)**	(2,444)
Net sales	**7,481**	7,260
Operating costs	**(5,322)**	(5,216)
Operating profit	**2,159**	2,044
Disposal of investments and businesses	**(1)**	157
Net finance charges	**(212)**	(186)
Associates' profits	**149**	131
Profit before taxation	**2,095**	2,146
Taxation	**(678)**	(181)
Profit from continuing operations	**1,417**	1,965
Discontinued operations	**139**	–
Profit for the year	**1,556**	1,965
Attributable to:		
Equity shareholders	**1,489**	1,908
Minority interests	**67**	57
	1,556	1,965

Sales and net sales On a reported basis, sales increased by £213 million from £9,704 million in the year ended 30 June 2006 to £9,917 million in the year ended 30 June 2007. On a reported basis, net sales increased by £221 million from £7,260 million in the year ended 30 June 2006 to £7,481 million in the year ended 30 June 2007. Exchange rate movements decreased reported sales by £358 million and reported net sales by £280 million, principally arising from the weakening of the US dollar. Acquisitions and disposals resulted in a net decrease in reported sales and reported net sales of £24 million and £10 million, respectively for the year.

Operating costs On a reported basis operating costs increased by £106 million in the year ended 30 June 2007 due to an increase in marketing costs of £35 million, from £1,127 million to £1,162 million, an increase in cost of sales of £82 million, from £2,921 million to £3,003 million, and a decrease in other operating expenses of £11 million, from £1,168 million to £1,157 million. Offset within other operating expenses in the year ended 30 June 2007 are profits on disposal of property, plant and equipment, including an exceptional gain of £40 million on the disposal of land at Park Royal in the United Kingdom. There were no exceptional items in operating costs in the year ended 30 June 2006. Excluding exceptional items, operating costs increased by £146 million from £5,216 million in the year ended 30 June 2006 to £5,362 million in the year ended 30 June 2007.

Post employment plans Post employment costs for the year ended 30 June 2007 of £56 million (2006 – £87 million) included amounts charged to operating profit of £104 million (2006 – £106 million) partly offset by finance income of £48 million (2006 – £19 million). At 30 June 2007, Diageo's deficit before taxation for all post employment plans was £419 million (2006 – £801 million).

Business review (continued)

Operating profit Reported operating profit for the year ended 30 June 2007 increased by £115 million to £2,159 million from £2,044 million in the prior year. Exceptional operating gains of £40 million were generated in the year ended 30 June 2007. There were no comparable exceptional operating gains or costs in the year ended 30 June 2006. Excluding the exceptional gain relating to Park Royal, operating profit for the year increased by £75 million from £2,044 million in the year ended 30 June 2006 to £2,119 million in the current year. Exchange rate movements reduced operating profit for the year ended 30 June 2007 by £91 million.

Disposal of investments and businesses In the year ended 30 June 2007 a loss before taxation of £1 million arose from the disposal of businesses. In the year ended 30 June 2006 gains before taxation on the disposal of businesses were £157 million, representing a gain of £151 million on the sale of the group’s remaining 25 million shares of common stock of General Mills and a gain on the sale of other businesses of £6 million.

Net finance charges Net finance charges increased by £26 million from £186 million in the year ended 30 June 2006 to £212 million in the year ended 30 June 2007.

The net interest charge increased by £58 million from £193 million in the prior year to £251 million in the year ended 30 June 2007. This increase principally resulted from the increase in net borrowings in the year and the increase in US dollar and euro interest rates. Exchange rate movements reduced net interest by £11 million.

Other net finance income of £39 million (2006 – £7 million) included income of £48 million (2006 – £19 million) in respect of the group’s post employment plans. This movement principally reflects the increase in the value of the assets held by the post employment plans between 1 July 2005 and 30 June 2006. Other finance income for the year ended 30 June 2007 of £7 million (2006 – charge of £2 million) includes income of £6 million (2006 – charge of £2 million) in respect of exchange rate translation differences on intercompany funding arrangements that do not meet the accounting criteria for recognition in equity. Other finance charges of £16 million (2006 – £15 million) in respect of the unwinding of the discount on discounted provisions were recognised during the year. Other finance income in the year ended 30 June 2006 also included £5 million dividend income in respect of the group’s interest in General Mills.

Associates The group’s share of profits of associates after interest and tax was £149 million for the year ended 30 June 2007 compared to £131 million in the prior year. Diageo’s 34% equity interest in Moët Hennessy contributed £136 million to share of profits of associates after interest and tax (2006 – £122 million).

Profit before taxation Profit before taxation decreased by £51 million from £2,146 million to £2,095 million in the year ended 30 June 2007, primarily as a result of increased operating profit in the year which was more than offset by the £151 million gain on disposal of General Mills shares in the year ended 30 June 2006.

Taxation The reported effective tax rate for the year ended 30 June 2007 is 32.4% compared with 8.4% for the year ended 30 June 2006. Factors that increased the reported effective tax rate for the year ended 30 June 2007 were a provision for the settlement of tax liabilities relating to the Guinness/GrandMet merger, lower carrying value of deferred tax assets primarily following a reduction in tax rates and the tax impact of an intragroup reorganisation of certain brand businesses. The effective tax rate in the prior year was reduced following the agreement of certain brand values with tax fiscal authorities that resulted in recognising an increase in the group’s deferred tax assets of £313 million.

Business review (continued)

Discontinued operations In the year ended 30 June 2007 profit after tax in respect of the disposal of businesses was £139 million. This profit represents a tax credit of £82 million in respect of the recognition of capital losses that arose on the disposal of Pillsbury and Burger King and a tax credit of £57 million following resolution with the tax authorities of various audit issues including prior year disposals. There was no profit or loss from discontinued operations in the year ended 30 June 2006.

Dividend The directors recommend a final dividend of 20.15 pence per share, an increase of 5.2% on last year’s final dividend. The full dividend will therefore be 32.7 pence per share, an increase of 5.1% from the year ended 30 June 2006. Subject to approval by shareholders, the final dividend will be paid on 22 October 2007 to shareholders on the register on 14 September 2007. Payment to US ADR holders will be made on 26 October 2007. A dividend reinvestment plan is available in respect of the final dividend and the plan notice date is 1 October 2007.

Exceptional items before taxation Exceptional items are those items that in management’s judgement need to be disclosed by virtue of their size or incidence in order for the user to obtain a proper understanding of the financial information.

	2007 **£ million**	**2006** **£ million**
Operating costs:		
Gain on disposal of Park Royal property	**40**	–
Disposals:		
Gain on disposal of General Mills shares	**–**	151
Other disposals	**(1)**	6
	(1)	157

Operating results – 2007 compared with 2006 – analysis by brand and business area

In order to assist the reader of the financial statements, the following comparison of 2007 with 2006 includes tables which present the exceptional items, exchange, acquisitions and disposals and organic components of the year on year movement for each of volume, sales, net sales and operating profit. Organic movements in the tables below are calculated as follows:

(a) The organic movement percentage is the amount in the column headed ‘Organic movement’ in the tables below expressed as a percentage of the aggregate of the column headed 2006 Reported, the column headed Exchange and the amounts in respect of transfers (see note (2) beneath the tables of organic movement calculations) and disposals (see note (4) beneath the tables of organic movement calculations) included in the column headed Transfers, acquisitions and disposals. The inclusion of the column headed Exchange in the organic movement calculation reflects the adjustment to exclude the effect of exchange rate movements by recalculating the prior period results as if they had been generated at the current period’s exchange rates. Organic movement percentages are calculated as the organic movement amount in £ million, expressed as the percentage of the prior period results at current year exchange rates and after adjusting for transfers, disposals and exceptional items. The