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. Free cash flow may not be comparable to similarly titled measures used by other companies.

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, relate to 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 – 2006 compared with 2005

Summary consolidated income statement	Year ended 30 June 2006 Before exceptional items £ million	Year ended 30 June 2006 Exceptional items £ million	Year ended 30 June 2006 Total £ million	Year ended 30 June 2005 Before exceptional items £ million	Year ended 30 June 2005 Exceptional items £ million	Year ended 30 June 2005 Total £ million
Sales	**9,704**	**—**	**9,704**	8,968	—	8,968
Excise duties	**(2,444)**	**—**	**(2,444)**	(2,291)	—	(2,291)
Net sales	**7,260**	**—**	**7,260**	6,677	—	6,677
Operating costs	**(5,216)**	**—**	**(5,216)**	(4,745)	(201)	(4,946)
Operating profit	**2,044**	**—**	**2,044**	1,932	(201)	1,731
Disposal of investments and businesses		**157**	**157**		214	214
Net finance charges	**(186)**	**—**	**(186)**	(141)	—	(141)
Associates’profits	**131**	**—**	**131**	121	—	121
Profit before taxation	**1,989**	**157**	**2,146**	1,912	13	1,925
Taxation	**(496)**	**315**	**(181)**	(677)	78	(599)
Profit from continuing operations	**1,493**	**472**	**1,965**	1,235	91	1,326
Profit after tax from disposal of businesses		**—**	**—**		73	73
Profit for the year	**1,493**	**472**	**1,965**	1,235	164	1,399
Attributable to:						
Equity shareholders	**1,436**	**472**	**1,908**	1,180	164	1,344
Minority interests	**57**	**—**	**57**	55	—	55
	1,493	**472**	**1,965**	1,235	164	1,399

Adoption of IFRS The financial statements for the year ended 30 June 2006 have been prepared in accordance with International Financial Reporting Standards as endorsed and adopted for use in the European Union (IFRS). The results for the comparative year ended 30 June 2005 are also presented in accordance with IFRS. Further information on the conversion to IFRS is set out in ‘Accounting policies of the group – Basis of preparation’ and in note 34 to the consolidated financial statements.

Sales and net sales after deducting excise duties On a reported basis, sales increased by £736 million (8%) from £8,968 million in the year ended 30 June 2005 to £9,704 million in the year ended 30 June 2006. On a reported basis, net sales, after deducting excise duties, increased by £583 million (9%) from £6,677 million in the year ended 30 June 2005 to £7,260 million in the year ended 30 June 2006. Acquisitions and disposals contributed a net increase to reported sales and net sales, after deducting excise duties, of £46 million and £27 million respectively in the year and foreign exchange rate movements also beneficially impacted reported sales by £186 million and reported net sales, after deducting excise duties, by £140 million, principally arising from strengthening of the US dollar.

Operating costs On a reported basis operating costs before exceptional items increased by £471 million, principally due to an increase in cost of goods sold of £318 million and an increase in marketing costs of 11% from £1,013 million to £1,127 million. Overall, the impact of exchange rate movements increased total operating costs before exceptional items by £165 million. There were no exceptional operating costs in the year (2005 – £201 million). In the prior year, exceptional operating costs comprised £149 million in respect

of contributions to be made to the Thalidomide Trust, £29 million of accelerated depreciation and £30 million of Seagram integration costs, less £7 million in respect of the disposal of property, plant and equipment. On a reported basis, operating costs increased by £270 million (5%) from £4,946 million in the year ended 30 June 2005 to £5,216 million in the year ended 30 June 2006.

Post employment plans Post employment costs for the year ended 30 June 2006 of £87 million (2005 – £80 million) comprised amounts charged to operating profit of £106 million (2005 – £89 million) and finance income of £19 million (2005 – £9 million). At 30 June 2006, Diageo’s deficit before taxation for all post employment plans was £801 million (2005 – £1,294 million).

Operating profit Operating profit before exceptional items for the year increased by £112 million to £2,044 million from £1,932 million in the prior year. Exchange rate movements reduced operating profit before exceptional items for the year ended 30 June 2006 by £25 million. There were no exceptional operating charges in the year ended 30 June 2006, compared to costs in respect of the year ended 30 June 2005 of £201 million.

Non-operating exceptional items Non-operating exceptional items before taxation were a gain of £157 million in the year ended 30 June 2006 compared with a gain of £214 million in the year ended 30 June 2005. The gain in the year to 30 June 2006 represents a gain of £151 million on sale of the group’s remaining 25 million shares of common stock of General Mills and a gain on sale of other businesses of £6 million. In the year ended 30 June 2005, non-operating exceptional items included a gain of £221 million on the disposal of 54 million shares of common stock of General Mills and a net charge of £7 million in respect of the disposal of other businesses.

Net finance charges Net finance charges increased by £45 million from £141 million in the year ended 30 June 2005 to £186 million in the year ended 30 June 2006.

The net interest charge increased by £43 million from £150 million in the prior year to £193 million in the year ended 30 June 2006; £23 million of this increase resulted from higher debt and higher interest rates year on year, £13 million resulted from the loss of interest income on the Burger King subordinated debt repaid in July 2005 and £10 million from the termination of certain financing arrangements. In addition, the interest charge increased by £6 million as a result of exchange rate movements. Partly offsetting these increases, net interest also includes an interest credit of £9 million related to derivative instruments arising on the application of *IAS 39 – Financial instruments: recognition and measurement*.

Other net finance income of £7 million (2005 – income of £9 million) included income in respect of the group’s post employment plans of £19 million (2005 – income of £9 million) which year on year improvement principally results from lower interest costs in the pension plans from the unwinding of discounted liabilities. In addition, other net finance charges include a charge of £15 million (2005 – £7 million) in respect of the unwinding of discounted liabilities, a £2 million charge (2005 – charge of £8 million) in respect of foreign exchange translation differences on inter company funding arrangements that do not meet the accounting criteria for recognition in equity, and investment income of £5 million (2005 – £17 million) in respect of dividends on General Mills shares.

Associates The group’s share of profits of associates after interest and tax was £131 million for the year compared to £121 million last year. Diageo’s 34% equity interest in Moët Hennessy contributed £122 million to share of profits of associates after interest and tax (2005 – £113 million).

Profit before taxation After exceptional items, profit before taxation increased by £221 million from £1,925 million to £2,146 million in the year ended 30 June 2006.

Taxation The effective tax rate before exceptional items for the year ended 30 June 2006 is 24.9% compared with 35.4% for the year ended 30 June 2005. The higher effective tax rate in the year ended 30 June 2005 mainly resulted from the reduction in the carrying value of deferred tax assets following a change in tax rate in the relevant territory.

The effective tax rate for continuing operations for the year ended 30 June 2006 after exceptional items is 8.4% compared with 31.1% for the year ended 30 June 2005. The effective tax rate in the current year has been reduced following the agreement of certain brand values with fiscal authorities that resulted in recognising an increase in the group’s deferred tax assets of £313 million. This amount has been accounted for as exceptional income. The profit arising on the sale of General Mills shares in the year and the comparative year is not subject to tax.

Profit after tax from disposal of businesses Profit after tax from the disposal of businesses in the prior year of £73 million is in respect of the release of provisions established on the disposal of Burger King and Pillsbury.

Exchange rates Diageo does not hedge the translation of its foreign currency results into sterling. Transactional exchange rate risk is hedged for those currencies in which there is an active market. The group seeks to hedge between 80% and 100% of forecast transactional exchange rate risk, for up to a maximum of 21 months forward, using forward currency exchange contracts. The gain or loss on the hedge is recognised in equity to the extent the hedge is effective and subsequently recognised in the income statement at the same time as the underlying hedged transaction affects the income statement.

Dividend The directors recommend a final dividend of 19.15 pence per share, an increase of 5% on last year’s final dividend. The full dividend would therefore be 31.1 pence per share, an increase of 5% from the year ended 30 June 2005. Subject to approval by shareholders, the final dividend will be paid on 23 October 2006 to shareholders on the register on 15 September 2006. Payment to ADR holders will be made on 27 October 2006. A dividend reinvestment plan is available in respect of the final dividend and the plan notice date is 2 October 2006.

Operating results – 2006 compared with 2005 – analysis by brand and geographical region

In order to assist the reader of the financial statements, the following comparison of 2006 with 2005 includes tables which present the exchange, acquisitions and disposals and organic components of the year-on-year movement for each of sales, net sales (after deducting excise duties) and operating profit before exceptional items.

Organic movements in the tables below are calculated as follows:

The organic movement percentage is the amount in the column headed ‘Organic movement’ expressed as a percentage of the aggregate of the columns headed 2005 Reported, Transfers, Exchange and the amounts in respect of disposals (see note 4 to the tables below) included in the column headed 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 disposals. The basis of calculation means that the results used to measure organic movement for a given period will be adjusted when used to measure organic movement in the subsequent period.

Where a business, brand, brand distribution right or agency agreement was disposed of, or terminated, in the current period, the group, in organic movement calculations, adjusts the results for the comparable prior period to exclude the amount the group earned in that period that it could not have earned in the current period (ie the period between the date in the prior period, equivalent to the date of the disposal in the current period, and the end of the prior period). As a result, the organic movement numbers reflect only comparable performance. Similarly, if a business was disposed of part way through the equivalent prior period then its contribution would be completely excluded from that prior period’s performance in the organic movement calculation, since the group recognised no contribution from that business in the current period. In the calculation of operating profit before exceptional items the overheads included in disposals were only those directly attributable to the businesses disposed, and do not result from subjective judgements of management. For acquisitions, a similar adjustment is made in the organic movement calculations. For acquisitions subsequent to the end of the equivalent