DIAGEO PLC
Form 20-F
September 25, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended: 30 June 2006

Commission file number: 1-10691

DIAGEO plc

(Exact name of Registrant as specified in its charter)

England

(Jurisdiction of incorporation or organisation)

8 Henrietta Place, London, W1G 0NB, England

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
American Depositary Shares	New York Stock Exchange
Ordinary shares of 28101⁄108 pence each	New York Stock Exchange*

* Not for trading, but only in connection with the registration of American Depositary Shares representing such ordinary shares, pursuant to the requirements of the Securities and Exchange Commission.

Securities registered or to be registered pursuant to Section 12(g) of the Act: **None**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: **None**

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the Annual Report: 3,050,980,245 ordinary shares of 28101⁄108 pence each.

Indicate by check mark if each registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes x No o

If this report is an annual or transition report, indicate by check mark if each registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for

the past 90 days.

Yes x No o

Indicate by check mark whether each registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark which financial statement item the Registrant has elected to follow.

Item 17 o Item 18 x

If this is an annual report, indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

This document comprises the annual report on Form 20-F and the annual report to shareholders for the year ended 30 June 2006 of Diageo plc (the 2006 Form 20-F). Reference is made to the cross reference to Form 20-F table on pages 211 to 213 hereof (the Form 20-F Cross reference table). Only (i) the information in this document that is referenced in the Form 20-F Cross reference table, (ii) the cautionary statement concerning forward-looking statements on pages 23 and 24 and (iii) the Exhibits, shall be deemed to be filed with the Securities and Exchange Commission for any purpose, including incorporation by reference into the Registration Statements on Form F-3 (File Nos. 333-10410, 333-14100, 333-110804 and 333-132732) and Registration Statements on Form S-8 (File Nos. 333-08090, 333-08092, 333-08094, 333-08096, 333-08098, 333-08102, 333-08104, 333-08106, 333-09770, 333-11460 and 333-11462), and any other documents, including documents filed by Diageo plc pursuant to the Securities Act of 1933, as amended, which purport to incorporate by reference the 2006 Form 20-F. Any information herein which is not referenced in the Form 20-F Cross reference table, or the Exhibits themselves, shall not be deemed to be so incorporated by reference.

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This is the Annual Report on Form 20-F of Diageo plc for the year ended 30 June 2006.

This document contains forward-looking statements that involve risk and uncertainty. 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 beyond Diageo's control. For more details, please refer to the cautionary statement concerning forward-looking statements on pages 23 and 24.

The market data contained in this document is taken from independent industry sources in the markets in which Diageo operates.

This report includes names of Diageo s products, which constitute trademarks or trade names which Diageo owns or which others own and license to Diageo for use. In this report, the term company refers to Diageo plc and the terms group and Diageo refer to the company and its consolidated subsidiaries, except as the context otherwise requires. A glossary of terms used in this report is included at the end of the document.

Diageo s consolidated financial statements have been prepared in accordance with International Financial Reporting Standards as endorsed and adopted for use in the European Union (IFRS), which is the group s primary reporting framework. Unless otherwise indicated, all financial information contained in this document has been prepared in accordance with IFRS. The principal differences between IFRS and US GAAP are set out in the consolidated financial statements.

Information presented

Percentage movements in this document are organic movements unless otherwise stated. These movements and operating margins are before exceptional items. Commentary, unless otherwise stated, refers to organic movements. Share, unless otherwise stated, refers to volume share. See the Operating and financial review for an explanation of organic movement calculations. The financial statements for the year ended 30 June 2006 have been prepared in accordance with IFRS.

Historical information

The following table presents selected consolidated financial data for Diageo prepared under International Financial Reporting Standards as endorsed and adopted for use in the European Union (IFRS) for the years ended 30 June 2006 and 30 June 2005 and as at the respective year ends. Consolidated financial data has been prepared in accordance with IFRS for the first time for the year ended 30 June 2006, following the implementation of IFRS by the group, and the data for the year ended 30 June 2005 has been adjusted accordingly. In addition, the following table includes selected consolidated financial data for Diageo prepared under US GAAP for the five years ended 30 June 2006 and as at the respective year ends. The IFRS data for the two years ended 30 June 2006 and US GAAP data for the five years ended 30 June 2006 have been derived from Diageo s audited consolidated financial statements.

	Year ended 30 June	
	2006	**2005**
	£ million	**£ million**
Income statement data(1)		
IFRS		
Sales	**9,704**	8,968
Operating profit before exceptional items(3)	**2,044**	1,932
Exceptional items charged to operating profit(3)		(201)
Operating profit	**2,044**	1,731
Other exceptional items for continuing operations, excluding tax(3)	**157**	214
Profit for the year		
Continuing operations	**1,965**	1,326
Discontinued operations(2)		73
Total profit for the year	**1,965**	1,399

	pence	**pence**
Per share data		
Dividend per share(4)	**31.10**	29.55
Earnings per share		
Basic		
Continuing operations	**67.2**	42.8
Discontinued operations(2)		2.4
Basic earnings per share	**67.2**	45.2
Diluted		
Continuing operations	**66.9**	42.8
Discontinued operations(2)		2.4
Diluted earnings per share	**66.9**	45.2

	million	**million**
Average shares	**2,841**	2,972

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Historical information (continued)

	Year ended 30 June 2006 £ million	2005 £ million	2004 £ million	2003 £ million	2002 £ million
Income statement data					
US GAAP(5)					
Sales	**10,031**	9,170	8,777	9,153	10,760
Operating income	**1,942**	1,768	1,928	955	3,630
Net income	**1,427**	1,470	1,700	434	2,554

	pence	pence	pence	pence	pence
Per share data					
Basic earnings per ordinary share before cumulative effect of accounting change	**50.3**	49.5	56.1	13.9	77.0
Cumulative effect of accounting change(5)	**(0.1)**				
Basic earnings per ordinary share	**50.2**	49.5	56.1	13.9	77.0
Diluted earnings per ordinary share before cumulative effect of accounting change	**50.1**	49.4	56.1	13.9	77.0
Cumulative effect of accounting change(5)	**(0.1)**				
Diluted earnings per ordinary share	**50.0**	49.4	56.1	13.9	77.0
Basic earnings per ADS	**200.8**	198.0	224.4	55.6	308.0
Diluted earnings per ADS	**200.0**	197.6	224.4	55.6	308.0

	million	million	million	million	million
Average shares	**2,841**	2,972	3,030	3,113	3,316

	As at 30 June 2006 £ million	2005 £ million
Balance sheet data(1)		
IFRS		
Total assets	**13,927**	13,921
Net borrowings(6)	**4,082**	3,706
Equity attributable to the parent company s equity shareholders	**4,502**	4,459
Called up share capital(7)	**883**	883

	As at 30 June 2006 £ million	2005 £ million	2004 £ million	2003 £ million	2002 £ million
Balance sheet data					
US GAAP(5)					
Total assets	**20,072**	21,570	23,071	24,071	26,153
Long term obligations(6)	**4,016**	3,751	3,381	3,149	3,892
Shareholders equity	**9,508**	9,853	10,287	9,344	11,316

Historical information (continued)

Notes to the selected consolidated financial data

1 IFRS accounting policies The financial statements for the year ended 30 June 2006 are the group s first financial statements published in accordance with IFRS. Extracts from the income statement and balance sheet as of and for the year ended 30 June 2005 presented here have been restated under IFRS as applied by the group from financial information previously reported in the group s consolidated financial statements as of and for the year ended 30 June 2005. The group has adopted the provisions of *IAS 39 Financial instruments recognition and measurement* from 1 July 2005. As permitted under *IFRS 1 First-time adoption of International Financial Reporting Standards*, financial instruments in the year ended 30 June 2005 remain recorded in accordance with previous UK GAAP accounting policies, and the adjustment to IAS 39 is reflected in the consolidated balance sheet at 1 July 2005. 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. In addition, there is an explanation of the primary impacts of IFRS on the group s financial results and position as previously reported under UK GAAP in note 34 to the consolidated financial statements.

2 Discontinued operations Discontinued operations in the year ended 30 June 2005 under IFRS 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 The group presents certain items separately as exceptional . 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, as presented by management, do not represent extraordinary items under US GAAP. An analysis of exceptional items for continuing operations under IFRS is as follows:

	Year ended 30 June	
	2006	**2005**
	£ million	**£ million**
Exceptional items (charged)/credited to operating profit		
Park Royal brewery accelerated depreciation		(29)
Seagram integration costs		(30)
Thalidomide Trust		(149)
Disposal of property		7
		(201)
Other exceptional items		
Gain on disposal of General Mills shares	**151**	221
Gains/(losses) on disposal and termination of businesses	**6**	(7)
	157	214
Tax exceptional items		
Tax credit in respect of exceptional items	**2**	78
Deferred tax exceptional item agreement of brand carrying values	**313**	
	315	78
Total exceptional items	**472**	91

4 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

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Historical information (continued)

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 below for the final dividend for each period 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				
		2006	**2005**	**2004**	**2003**	**2002**
		pence	**pence**	**pence**	**pence**	**pence**
Per ordinary share	Interim	**11.95**	11.35	10.6	9.9	9.3
	Final	**19.15**	18.20	17.0	15.7	14.5
	Total	**31.10**	29.55	27.6	25.6	23.8
		$	**$**	**$**	**$**	**$**
Per ADS	Interim	**0.88**	0.81	0.77	0.61	0.54
	Final	**1.42**	1.30	1.24	1.06	0.90
	Total	**2.30**	2.11	2.01	1.67	1.44

Note: Subject to shareholder approval, the final dividend for the year ended 30 June 2006 will be paid on 23 October 2006 and payment to US ADR holders will be made on 27 October 2006. In the table above, an exchange rate of £1 = $1.85 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 23 October 2006.

5 US GAAP accounting changes 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 123(R), Diageo revalued unvested awards in its senior executive share option plan (SESOP) and recognised a cumulative effect of an accounting change of £2 million net of tax in its US GAAP financial information. Prior year information has not been 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 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.

6 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.

7 Share capital The called up share capital represents the par value of ordinary shares of 28 101⁄108 pence in issue. There were 3,051 million ordinary shares in issue and fully paid up at the balance sheet date (2005 3,050 million; 2004 3,057 million; 2003 3,100 million; 2002 3,215 million). Of these, 42 million (2005 43 million; 2004 43 million; 2003 45 million; 2002 39 million) are held in employee share trusts and 250 million are held as treasury shares (2005 86 million; 2004, 2003, 2002 nil). These shares are deducted in arriving at equity attributable to the parent company s equity shareholders. During the year ended 30 June 2006, the group repurchased 164 million ordinary shares for cancellation or to be held

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Historical information (continued)

as treasury shares at a cost including fees and stamp duty 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; 2002 198 million ordinary shares, cost of £1,658 million). In addition the group repurchased 2 million ordinary shares to be held as treasury shares for hedging employee share scheme grants provided to employees during the year at a cost of £21 million.

8 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 Operating and financial review Risk management .

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

	Year ended 30 June				
	2006	**2005**	**2004**	**2003**	**2002**
	$	**$**	**$**	**$**	**$**
Year end	**1.85**	1.79	1.81	1.65	1.52
Average rate(a)	**1.78**	1.86	1.75	1.59	1.45

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 30 August 2006, expressed in US dollars per £1.

	2006					
	August	**July**	**June**	**May**	**April**	**March**
	$	**$**	**$**	**$**	**$**	**$**
Month end	**1.90**	**1.87**	**1.85**	**1.87**	**1.82**	**1.74**
Month high	**1.91**	**1.87**	**1.88**	**1.89**	**1.82**	**1.76**
Month low	**1.87**	**1.82**	**1.81**	**1.83**	**1.74**	**1.73**
Average rate(b)	**1.89**	**1.84**	**1.84**	**1.87**	**1.77**	**1.74**

The average exchange rate for the period 1 to 20 September 2006 was £1 = $1.88 and the noon buying rate on 20 September 2006 was £1 = $1.89.

(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 fourteenth largest publicly quoted company in the United Kingdom in terms of market capitalisation on 20 September 2006, with a market capitalisation of approximately £26.1 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. It produces and distributes a wide range of premium brands, including Smirnoff vodka, Johnnie Walker Scotch whiskies, Guinness stout, Baileys Original Irish Cream liqueur, Captain Morgan rum, J&B Scotch whisky and Tanqueray gin. In addition it also owns 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 manages nine of the world s top 20 spirits brands as defined by Impact database. Diageo s beer brands include the only global stout brand, Guinness, and together these beer brands account for approximately 20% of net sales while Diageo s wine brands represent approximately 5% 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

Business description (continued)

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. These markets are managed in three regions: North America, Europe and International. International markets comprise Latin America and the Caribbean, Africa, the Middle East and India, China and other Asian markets, Australia and New Zealand, and the Global Duty Free business. 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. Between the merger of Grand Met and the Guinness Group in December 1997 and 30 June 2006, 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 £4.9 billion on acquisitions (including £3.7 billion in relation to certain Seagram businesses).

Continuing operations 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 recognized 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 2006 by Impact. Market data information is taken from industry sources in the markets in which Diageo operates. Seventeen of the group s owned brands were among the top 100 premium distilled spirits brands worldwide, as ranked by Impact, in calendar year 2005.

References to ready to drink products below include flavored malt beverages. Ready to drink products are sold throughout the world, but flavored malt 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 Caipiroska, Smirnoff Signatures, Smirnoff Raw Teas, Smirnoff Storm and Smirnoff Caesar Classic. References to Smirnoff Black Ice include Smirnoff Ice Triple Black in the United States.

In the year ended 30 June 2006, Diageo sold 109 million equivalent units of spirits (including ready to drink), 22 million equivalent units of beer and 3 million equivalent units of wine. In the year ended 30 June 2006, 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

Business description (continued)

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

Guinness stout

Baileys Original Irish Cream liqueur

Captain Morgan rum

J&B Scotch whisky

José Cuervo tequila (agency brand in North America and many other markets)

Tanqueray gin

Other spirits brands include:	**Wine brands include:**	**Other beer brands include:**
Crown Royal Canadian whisky	Beaulieu Vineyard wine	Harp Irish lager
Buchanan s De Luxe whisky	Sterling Vineyards wine	Smithwick s ale
Gordon s gin and vodka	Chalone Vineyards wine	Malta non-alcoholic malt
Windsor Premier whisky	Blossom Hill wine	Red Stripe lager
Bell s Extra Special whisky	Piat d Or wine	
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 2006, global priority brands contributed 59% of total volume and achieved sales of £5,593 million.

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

Business description (continued)

Smirnoff is Diageo s highest volume brand and achieved sales of 26.9 million equivalent units in the year ended 30 June 2006. 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 2006, Johnnie Walker Red Label sold 8.5 million equivalent units and was ranked, by volume, as the number one premium Scotch whisky and the number five premium spirit brand in the world. Johnnie Walker Black Label sold 4.5 million equivalent units and the remaining variants sold 0.7 million equivalent units in the year ended 30 June 2006.

Guinness is the group s only global priority beer brand, and for the year ended 30 June 2006 achieved volume of 11.1 million equivalent units.

Baileys ranked, by volume, the number one liqueur in the world, sold 7.0 million equivalent units in the year ended 30 June 2006.

Captain Morgan is ranked, by volume, as the number two premium rum brand in the world with sales of 7.2 million equivalent units in the year ended 30 June 2006.

Other global priority brands were also ranked, by volume, among the leading premium distilled spirits brands by Impact. These include: J&B Scotch whisky (comprising J&B Rare, J&B Select, J&B Reserve, J&B 6°C and J&B 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 four premium gin brand in the world. During the year ended 30 June 2006, J&B, José Cuervo and Tanqueray sold 5.9 million, 5.1 million and 2.0 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 an individual country, rather than worldwide. Diageo has identified 30 local priority brands. Diageo manages and invests in these brands on a market by market basis 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 2006, local priority brands contributed volume of 23.1 million equivalent units, representing 17% of total volume, and sales of £1,975 million. Examples of local priority brands include Crown Royal Canadian whisky in North America, Windsor Premier whisky in South Korea, Seagram s VO whisky and Seagram s 7 Crown whiskey in North America, Cacique rum in Spain, Gordon s gin in Great Britain, Bundaberg rum in Australia, Bell s whisky in Great Britain, Smithwick s ale in Ireland, Budweiser and Carlsberg lagers in Ireland 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 2006, these category brands contributed volume of 31.8 million equivalent units, representing 24% of total volume, and sales of £2,136 million. Of this, spirits achieved volume of 24.0 million equivalent units and contributed £1,373 million to Diageo s sales in the year ended 30 June 2006. Examples of category spirits brands are Gordon s gin (all markets except Great Britain and North America in which it is reported as a local priority brand), Gordon s vodka, The Classic Malt whiskies and White Horse whisky.

In the year ended 30 June 2006, Diageo sold 5.4 million equivalent units of beers other than Guinness, achieving sales of £393 million. Other beer volume was attributable to mainly owned brands, such as Harp Irish lager (all markets except Ireland), Kilkenny Irish beer, and Smithwick s ale (all markets except

Business description (continued)

Ireland), 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 2006, other wine volume was 2.4 million equivalent units, contributing sales of £370 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 80% 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, production capacity and production volume in 2006 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 2006 in millions of equivalent units
United Kingdom	United Kingdom	Scotch whisky, gin, vodka, rum, ready to drink	58	40
Baileys	Ireland	Irish cream liqueur, vodka	15	8
Guinness	Ireland	Beers, ready to drink	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, flavored malt beverages, wine, ready to drink	65	38

Spirits are produced in distilleries located worldwide. The principal owned distilleries are 29 whisky distilleries in Scotland, 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. On 25 August 2005, Diageo acquired the Bushmills Irish whiskey distillery located in Northern Ireland.

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, Malaysia, Jamaica and

Business description (continued)

Cameroon. Ireland is the main export centre for the Guinness brand. In other countries, Guinness is brewed under licence arrangements.

In June 2005, Diageo closed its Park Royal brewery in London, England and transferred all Guinness Draught production to St James s Gate brewery in Dublin in the Republic of Ireland, to optimise utilisation and reduce ongoing costs. The Runcorn facility performs the kegging of Guinness Draught, transported to the United Kingdom in bulk for the Great Britain market. 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.

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 2006, Diageo s land and buildings were included in the group s consolidated balance sheet under IFRS 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 3% 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 39% and 27% 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, 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, 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 will expire in June 2013.

Diageo has a supply agreement with Destiléria Serrallés, Inc (Serrallés), 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. £1,127 million was spent worldwide on marketing brands in the year ended 30 June 2006. Marketing was focused on the eight global priority brands, which accounted for 68% of total marketing expenditure in the year ended 30 June 2006.

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

Business description (continued)

advertising, and uses radio, cinema and television advertising where appropriate and permitted by law. Diageo also runs consumer promotional programmes in the on trade (for example, licensed bars and restaurants).

Diageo markets and distributes its brands under a geographic organisation comprising North America, Europe and International.

Diageo North America comprises the United States and Canada.

Diageo Europe consists of the following regions and countries: Great Britain; Ireland; Northern Europe the Nordics, Germany, France, Benelux, Austria, Switzerland and the Baltics; Southern and Eastern Europe Greece, Turkey, Italy, Poland, Hungary, Czech Republic, Slovakia, the former Yugoslavia, Cyprus, Malta, Israel, Romania, Bulgaria, Albania; Iberia Spain, Portugal and the Canary Islands; and Russia (comprising former Commonwealth of Independent States countries).

Diageo International consists of the following regions and countries: Latin America and the Caribbean; Africa; the Middle East and India; China and other Asian markets; Australia and New Zealand; and Global Duty Free.

In the year ended 30 June 2006, North America, Europe and International contributed 38%, 33% and 29%, respectively, of the group s operating profit before exceptional items and corporate costs.

An analysis of sales and operating profit before exceptional items by market for the year ended 30 June 2006 is as follows:

	Sales £ million	Operating profit/(loss) before exceptional items £ million
North America	**2,968**	**829**
Europe	**3,834**	**737**
International	**2,826**	**644**
Corporate and other	**76**	**(166**)
Total	**9,704**	**2,044**

North America North America is the largest market for Diageo in terms of operating profit before exceptional items, 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 & Estates Wine 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, J&B 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 Irish lager, Red Stripe lager and Smithwick s ale) as well as the group s flavored malt beverages (including Smirnoff Ice, Smirnoff Twisted V and Captain Morgan Parrot Bay). Diageo Chateau & Estate Wines owns and operates vineyards in California and Washington State (including

Business description (continued)

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 the open states, Diageo trades through a three tier distribution system, where the product is initially sold to distributors, who then sell it to on and off premise 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 33% 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 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. In the future, Diageo will focus 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 covers Great Britain, Ireland, Northern Europe, Southern and Eastern Europe, Iberia, and Russia.

In Great Britain Diageo 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 (eg, licensed major 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 local priority brands of Smithwick s ale and Harp Irish lager.

Business description (continued)

Across the remainder of the Europe region, and including the majority of the markets within Northern Europe and Southern and Eastern 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 Interbrew;

- Hungary, Czech Republic, Slovakia, Romania, Bulgaria, Albania, Cyprus, Malta, Croatia, former Yugoslav republic of Macedonia, Bosnia-Herzegovina and Slovenia, where Diageo also sells and markets its brands via local distributors;

- Russia, where Diageo s products during the year ended 30 June 2006 were distributed via a local company, Roust. Diageo has announced the acquisition of the Smirnov brand in Russia through a company in which Diageo holds a 75% stake and a major Russian consortium, the Alfa Group, holds a 25% stake. This company will be the exclusive distributor of Diageo spirits and the Smirnov vodka brand in Russia.

- in 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 within continental Europe. The distribution of these brands is managed by this specialist unit both in the on trade and off trade, with special 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 covers Latin America and the Caribbean, Africa, the Middle East, India, China and other Asian markets, Australia and New Zealand, and Global Duty Free.

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 local 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, Réunion 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.

In the Middle East and India, distribution is achieved mainly through third party distributors. Lebanon is an exception, where a Diageo majority-owned joint venture distributes most of the Diageo brands sold there.

Elsewhere in Asia, Diageo works with a number of joint venture partners. In Singapore, Malaysia, Hong Kong, People s Republic of China, Thailand, Japan and Taiwan, Diageo distributes its spirits and wine brands through joint venture arrangements with Moët Hennessy. Diageo has a distribution agreement with Citic/Sims for the distribution by that company of certain spirits brands in the People s Republic of

Business description (continued)

China. In South Korea, Diageo s own distribution company distributes the majority of Diageo s brands. The remaining brands are distributed through third party distributors. In Japan, Guinness beer is distributed through an associated company of the group, a joint venture with Sapporo Breweries. There is also a direct relationship with Sapporo Breweries for 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 a business partner, APB Singapore. Generally, the remaining markets in Asia are served by third party distribution networks monitored by regional offices.

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.

Global Duty Free (GDF) is Diageo s 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. The global nature of this channel and the organisation structure allows a co-ordinated approach to brand building initiatives and builds on consumer insights in this trade channel, where consumer behaviour tends to be different from domestic markets.

Seasonal impacts The 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 Releasing the potential of every employee is one of Diageo s core strategic imperatives. The organisation and people strategy is focused on creating the conditions within which individuals feel both able and inspired to contribute directly to enhanced business performance, while also achieving personal growth.

Diageo s ability to attract and retain the very best talent, from the most diverse global talent pools, is fundamental to achieving its ambitious performance targets and to meeting the expectations of its various stakeholders. 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 an individual s contribution is appropriately and fairly recognised.

Employee policies are designed to support business performance goals and do so in a manner that takes account of external legislation and internal codes of conduct, as well as Diageo s values as an organisation. In particular, Diageo is committed to the safety and wellbeing of employees at work and also promotes responsible drinking behaviour among its employees. Access to such policies is enabled via an intranet website, which allows employees to be kept fully informed of all relevant information.

Diageo strives to foster a sense of pride in employees working for Diageo. The senior leadership community is committed to delivering against a range of employee engagement goals. This includes, where appropriate, honouring its obligations to consult openly and regularly with employee representative forums and/or trade unions. Specifically, Diageo s leaders seek to sustain an open and continuous dialogue with employees as a way to inform and engage them in the company s strategy and business goals, but also to elicit their ideas and suggestions for improvement opportunities.

Business description (continued)

Diageo s average number of employees during each of the three years ended 30 June 2006 was as follows:

	2006 Employees	2005 Employees	2004 Employees
Average number of employees			
Full time	**21,972**	22,333	22,548
Part time	**647**	633	1,172
	22,619	22,966	23,720

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 2006, the group s research and development expenditure amounted to £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.

Business description (continued)

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 Australia, Austria, Benelux, Brazil, Canada, the Canaries, Eurobeer, Germany, Global Duty Free, Great Britain, Guinness supply, Ireland, Mexico, the Nordics, North America, Northern European Logistics and Switzerland. Certain central finance activities including group financial control and treasury activities are in the process of being transferred to Budapest over the next 12 months. Additional markets and supply entities are scheduled to 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 geographical operating units are reported separately as Corporate costs in the geographical 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.

Business description (continued)

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

Diageo owns 34% of Moët Hennessy, the principal spirits and wine business 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 products include champagne brands, Moët & Chandon (including Dom Pérignon), Veuve Clicquot and Mercier, all of which are included in the top 10 champagne brands worldwide by volume, 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.

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 SA for approximately 296 million (£209 million).

Diageo has announced the acquisition of the Smirnov brand in Russia through a company in which Diageo holds a 75% stake and a major Russian consortium, the Alfa Group, holds a 25% stake. This company will be the exclusive distributor of Diageo spirits and the Smirnov vodka brand in Russia.

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).

Business description (continued)

Recent developments

In the period 1 July 2006 to 20 September 2006 the company acquired 20.6 million shares as part of the company s share buyback programmes to be held as treasury shares, 6.5 million shares purchased and subsequently cancelled and 1.5 million shares to be held as treasury shares for hedging share scheme grants provided to employees, for a total consideration of £267 million including expenses.

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 taking place. 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 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 regarding production, product liability, distribution, importation, marketing, promotion,

Business description (continued)

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 or other restrictions on marketing, promotion and distribution. 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.

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.

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.

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

Business description (continued)

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 increased recently, and energy costs 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 Continuing operations 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 2006, the historical cost of Diageo s maturing inventory amounted to £1,644 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 inventory 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 inventory lay down in a given year for future

Business description (continued)

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 inventories.

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. Current examples of such potential upheaval are the unrest in the Middle East, and the impact on tourism and travel of terrorist threats. 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 32% of sales in the year ended 30 June 2006 were in US dollars, approximately 23% were in sterling and approximately 20% 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 Operating and financial 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

Business description (continued)

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.

IFRS may introduce greater volatility into Diageo s financial statements These are the group s first consolidated annual financial statements prepared in accordance with IFRS. For all periods up to and including 30 June 2005, Diageo prepared its primary financial statements in accordance with UK generally accepted accounting principles (UK GAAP). It is likely that reporting under IFRS will introduce a greater degree of volatility in Diageo s reported results. This may include, but is not limited to, the potential adverse impact of accounting for changes in taxation rates and their impact on deferred tax balances, and accounting for financial instruments that do not qualify for hedge accounting. There is no assurance that further volatility in Diageo s financial statements due to IFRS will not have a significant adverse effect on financial results.

Cautionary statement concerning forward-looking statements

This document contains statements with respect to the financial condition, results of operations and business of Diageo and certain of the plans and objectives of Diageo with respect to these items. These forward-looking statements are made pursuant to the Safe Harbor provisions of the United States Private Securities Litigation Reform Act of 1995. 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.

Business description (continued)

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 business combinations, partnerships, acquisitions or disposals, existing or future, and the ability to realise expected synergies and/or costs savings;

- Diageo s ability to complete future acquisitions and disposals;

- legal and regulatory developments, including changes in regulations regarding consumption of, or advertising for, beverage alcohol, changes in accounting standards, taxation requirements, such as the impact of excise tax increases with respect to the business, environmental laws 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 rights on favourable terms when they expire;

- termination of existing distribution rights in respect of 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.

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 2006. 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 documents it files with the SEC.

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.

Operating and financial 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 regions of North America, Europe and International and the business analysis is presented on this basis. The following discussion is based on Diageo s results for the year ended 30 June 2006 compared with the year ended 30 June 2005.

The financial statements for the year ended 30 June 2006 have been prepared in accordance with IFRS. 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 after deducting excise duties is presented in addition to sales, since sales reflects 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 invoiced cost 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 costs, without directly reflecting changes in volume, mix or profitability that are the variables which impact on the element of sales retained by the group.

Percentage movements presented below in Operating results 2006 compared with 2005 analysis by brand and geographical region are organic movements unless otherwise stated. These movements and operating margins are before exceptional items. Commentary, unless otherwise stated, refers to organic movements. Share, unless otherwise stated, refers to volume share.

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 the year ended 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 that the group s management use to assess the performance of the group in addition to income statement measures of performance. These include volume, and the non-GAAP measures of the organic movements in volume, sales, net sales (after deducting excise duties) and operating profit before exceptional items and free cash flow. Non-GAAP measures are those not specifically used in the consolidated financial statements themselves. 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 after deducting excise duties and operating profit before exceptional items are measures not specifically used in the consolidated financial statements themselves. The performance of the group is discussed using these measures.

Operating and financial review (continued)

In the discussion of the performance of the business, certain 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.

Acquisitions and disposals also impact 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.

The underlying performance on a constant currency basis and excluding 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.

Diageo s strategic planning and budgeting process is based on organic movement in volume, sales, net sales after deducting excise duties and operating profit before exceptional items, 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, acquisitions and disposals.

The group s management believe 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: sales, net sales after deducting excise duties and reported movements in individual income statement captions.

Free cash flow 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 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. 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.

Operating and financial review (continued)

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	Exceptional items £ million	Total £ million	Year ended 30 June 2005 Before exceptional items £ million	Exceptional items £ million	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

Operating and financial review (continued)

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.

Operating and financial review (continued)

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.

Operating and financial review (continued)

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 prior period, the post acquisition results in the current period are excluded from the organic movement calculations. For acquisitions in the prior period, post acquisition results are included in full in the prior period but are only included from the anniversary of the acquisition date in the current period.

The organic movement calculations for volume, sales, net sales (after deducting excise duties) and operating profit before exceptional items for the year ended 30 June 2006 were as follows:

Volume	**2005 units million**	**Acquisitions units million**	**Organic movement units Million**	**20006 units million**	**Organic movement %**
North America	46.5	0.2	2.1	48.8	5
Europe	40.8	0.3	0.3	41.4	1
International	38.1	0.3	5.2	43.6	14
Total	125.4	0.8	7.6	133.8	6

Operating and financial review (continued)

	2005 Reported £ million	Transfers £ million	Exchange £ million	Acquisitions and disposals £ million	Organic movement £ million	2006 Reported £ million	Organic movement %
Sales							
North America	2,622	3	129	41	**173**	**2,968**	**6**
Europe	3,860	(23)	1	(7)	**3**	**3,834**	
International	2,424	5	56	12	**329**	**2,826**	**13**
Corporate and other	62	15			**(1)**	**76**	**(2)**
Total	8,968		186	46	**504**	**9,704**	**6**
Net sales after deducting excise duties							
North America	2,194	3	110	34	**169**	**2,510**	**7**
Europe	2,499	(23)	(1)	(16)	**(4)**	**2,455**	
International	1,922	5	31	9	**252**	**2,219**	**13**
Corporate and other	62	15			**(1)**	**76**	**(2)**
Total net sales	6,677		140	27	**416**	**7,260**	**6**
Excise duties	2,291					**2,444**	
Sales	8,968					**9,704**	
Operating profit before exceptional items							
North America	779		2	1	**47**	**829**	**6**
Europe	702	(3)	(5)	4	**39**	**737**	**6**
International	615	(3)	(23)	1	**54**	**644**	**9**
Corporate and other	(164)	6	1		**(9)**	**(166)**	**(6)**
Total	1,932		(25)	6	**131**	**2,044**	**7**

Notes

(1) Results for 2005 have been restated for the impacts of implementing IFRS.

(2) Transfers represent the movement between operating units of certain activities, the most significant of which were the reallocation of the Guinness Storehouse visitor centre in Dublin from Europe into the Corporate business segment and the transfer of the costs in respect of a global information technology project from Corporate into Europe and International.

(3) The exchange adjustments for sales, net sales after deducting excise duties, and operating profit before exceptional items are principally in respect of the US dollar.

(4) The only acquisition in the year ended 30 June 2006 was the acquisition of The Old Bushmills Distillery Company Limited. Other acquisitions impacting on the calculation of organic growth in the year were in respect of the acquisition of The Chalone Wine Group (North America), Ursus Vodka Holdings B.V. (Europe) and Ghana Breweries Limited (International). Disposals affecting the year were principally the disposal of United Beverages Limited (Europe) and contributed sales, net sales after deducting excise duties, and operating profit before exceptional items of £35 million, £35 million and £nil, respectively, in the year ended 30 June 2005.

Operating and financial review (continued)

Analysis by business	2006 Net sales(a) £ million	2006 Operating profit/(loss)(b) £ million	2005 Net sales(a) £ million	2005 Operating profit/(loss)(b) £ million
North America	**2,510**	**829**	2,194	779
Europe	**2,455**	**737**	2,499	702
International	**2,219**	**644**	1,922	615
Corporate and other	**76**	**(166)**	62	(164)
Total	**7,260**	**2,044**	6,677	1,932

(a) after deducting excise duties

(b) before exceptional items

North America

Summary:

- Top line growth across the business spirits 8%, wine 7%, beer 11% and ready to drink 3%
- Increased spend on proven marketing campaigns
- Well executed on and off trade sales programmes
- Growth of the premium beer brands supported by effective advertising and targeted product placement
- In wine, Chalone is another growth driver performing ahead of expectations

Key measures	2006 £ million	2005 £ million	Reported movement %	Organic movement %
Volume			**5**	**5**
Net sales after deducting excise duties	**2,510**	2,194	**14**	**7**
Marketing	**384**	341	**13**	**6**
Operating profit before exceptional items	**829**	779	**6**	**6**

Reported performance Net sales, after deducting excise duties, were £2,510 million in the year ended 30 June 2006, up by £316 million from £2,194 million in the prior year. Operating profit before exceptional items increased by £50 million to £829 million in the year ended 30 June 2006.

Operating and financial review (continued)

Organic performance The weighted average exchange rate used to translate US dollar sales and profits moved from £1 = $1.86 in the year ended 30 June 2005 to £1 = $1.78 in the year ended 30 June 2006. The strengthening of the US dollar resulted in a £110 million increase in net sales, after deducting excise duties. Acquisitions added £34 million of net sales, after deducting excise duties, and there was an organic increase in net sales, after deducting excise duties, of £169 million. Transfers between business segments increased prior year net sales, after deducting excise duties, by £3 million. Operating profit before exceptional items increased by £2 million as a result of foreign exchange impacts. Acquisitions increased operating profit before exceptional items by £1 million and organic growth of £47 million was achieved.

Organic brand performance	**Reported volume movement %**	**Organic volume movement %**	**Reported net sales* movement %**	**Organic net sales* movement %**
Global priority brands	**7**	**7**	**14**	**8**
Local priority brands	**2**	**2**	**10**	**5**
Category brands	**2**	**(1)**	**24**	**7**
Total	**5**	**5**	**14**	**7**
Key brands				
Smirnoff vodka		**9**	**16**	**11**
Smirnoff ready to drink		**(3)**	**1**	**(5)**
Johnnie Walker		**1**	**10**	**5**
Captain Morgan (excluding ready to drink)		**9**	**19**	**14**
Baileys		**7**	**13**	**7**
José Cuervo (excluding ready to drink)		**9**	**16**	**11**
Crown Royal		**6**	**14**	**8**
Tanqueray		**5**	**13**	**7**
Guinness		**7**	**15**	**9**
Beaulieu Vineyard			**5**	**1**
Sterling Wines		**3**	**15**	**10**

* after deducting excise duties

Diageo continued to outperform the market in an industry where the increase in the US legal drinking age population and the trend towards more premium products across all beverage alcohol categories are helping to drive growth.

The global priority brands again led the growth with volume up 7% and net sales, after deducting excise duties, up 8%.

The spirits brands, excluding ready to drink, delivered 8% growth in net sales, after deducting excise duties, reflecting strong performances from Smirnoff, Captain Morgan and José Cuervo.

Smirnoff benefited from targeted profile raising activity. In the off trade, volume was driven by concentrated activity on high visibility feature and display initiatives across Smirnoff vodka, as well as innovation in flavours. These activities and the focus on proven growth drivers, such as quality account management, delivered strong growth for Smirnoff vodka with volume up 9% and net sales, after deducting excise duties, up 11%.

Johnnie Walker continued to outperform the scotch category with volume up 1% and net sales, after deducting excise duties, up 5%. Both Johnnie Walker Red Label and Johnnie Walker Black Label grew

Operating and financial review (continued)

share. Higher marketing and public relations investment behind the successful Mentor programme and increased relationship marketing underpinned these strong results.

Captain Morgan had a good year. Excluding ready to drink, volume was up 9% and net sales, after deducting excise duties, were up 14%, benefiting from increased media spending, particularly in television to drive awareness and trial, strong display executions and the launch of Tattoo.

Baileys continued its turnaround from last year with volume and net sales, after deducting excise duties, both up 7%.

The José Cuervo Tradicional and Reserva variants delivered double-digit growth benefiting from the trend towards premium tequila. Product innovation also made a strong contribution to growth as the super premium range was further extended with the introduction of Black Medallion in February. A range of flavours was also introduced during the year. Excluding ready to drink, José Cuervo volume increased 9% and net sales, after deducting excise duties, rose 11%.

A strong second half performance from Crown Royal resulted in full year volume up 6% and net sales, after deducting excise duties, up 8% as the investment behind NASCAR was increased. The second half also saw the launch of an ultra premium offering, Crown Royal Extra Rare.

The Tony Sinclair Ready to Tanqueray campaign has reinvigorated the Tanqueray brand with volume up 5%. Price increases, taken over the year in certain markets, have led to an increase in net sales, after deducting excise duties, of 7%.

In line with the trend towards premium beers, Guinness continued to show strong performance with volume up 7%. A price increase across all variants in October 2005 meant that net sales, after deducting excise duties, grew 9%.

In wine, Beaulieu Vineyard volume was flat, but net sales, after deducting excise duties, increased 1%. Sterling Wines volume was up 3% with net sales, after deducting excise duties, up 10% as price increases were taken across a variety of labels. The Chalone wine brands are delivering ahead of expectations, as a result of a strong contribution from innovation with the introduction of new varietals.

Total ready to drink volume was up 2% led by the continued growth of José Cuervo s pre-mixed margarita offerings and the launch of the Captain Morgan s Parrot Bay ready to drink product. The introduction of new Smirnoff Twisted V flavours, strong growth of Smirnoff Ice in Canada and the regional launch of Smirnoff Raw Tea partially offset declines in the Smirnoff Ice brand in the US.

In category brands, volume decreased by 1% but net sales, after deducting excise duties, were up 7%. This reflected the decision to shift operational focus toward the more profitable reserve brands such as Cîroc and Don Julio and away from the high volume standard brands such as Popov and Gordon s vodka.

Marketing spend for the year was up 6% and excluding ready to drink, up 9%. This reflects an accelerated investment in spirits, offset by a reduction in spend on ready to drink.

Europe

Summary:

- Net sales, after deducting excise duties, were unchanged year on year as growth in core spirits offset tough market conditions in beer and ready to drink
- Spirits demonstrated healthy volume growth at 3%
- Innovation is increasing brand visibility with new and existing customers

Operating and financial review (continued)

- Marketing spend was reduced by 4% and prioritised against specific opportunities such as Johnnie Walker throughout Europe and J&B in France

Key measures	2006 £ million	2005 £ million	Reported movement %	Organic movement %
Volume			**2**	**1**
Net sales after deducting excise duties	**2,455**	2,499	**(2)**	
Marketing	**389**	403	**(4)**	**(4)**
Operating profit before exceptional items	**737**	702	**5**	**6**

Reported performance Net sales, after deducting excise duties, were £2,455 million in the year ended 30 June 2006, down by £44 million from the prior year. Operating profit before exceptional items increased by £35 million from £702 million to £737 million.

Organic performance Disposals net of the impact of acquisitions decreased net sales, after deducting excise duties, by £16 million and there was an organic decrease in net sales, after deducting excise duties, of £4 million and an adverse impact of exchange of £1 million. Transfers between business segments decreased prior year net sales, after deducting excise duties, by £23 million. Operating profit before exceptional items decreased by £5 million as a result of foreign exchange impacts. Acquisitions increased operating profit before exceptional items by £4 million and organic growth of £39 million was achieved. Transfers between business segments decreased prior year operating profit before exceptional items by £3 million.

Organic brand performance	Reported volume movement %	Organic volume movement %	Reported net sales* movement %	Organic net sales* movement %
Global priority brands	**1**	**1**	**(1)**	**(1)**
Local priority brands	**(2)**	**(2)**	**(1)**	**(1)**
Category brands	**6**	**2**	**(3)**	**2**
Total	**2**	**1**	**(2)**	
Key brands				
Smirnoff vodka		**8**	**8**	**7**
Smirnoff ready to drink		**(22)**	**(21)**	**(21)**
Johnnie Walker		**3**	**6**	**6**
Baileys		**1**		
J&B		**(3)**	**(5)**	**(5)**
Guinness		**(3)**		

* after deducting excise duties

Spirits demonstrated resilient growth with volume and net sales, after deducting excise duties, up 3%, while beer, volume down 3%, and ready to drink, volume down 22%, held back total performance. The shift from the on to the off trade in Ireland again negatively impacted overall beer performance. Wine volume grew 7% driven by Blossom Hill s robust growth in Great Britain and Ireland.

Smirnoff vodka, excluding ready to drink, continued to grow strongly, delivering volume growth of 8% and growth of net sales, after deducting excise duties, of 7%. A pan-European advertising campaign, focusing on the quality credentials of Smirnoff, continued to build the distinctiveness of the brand, although marketing spend was reduced by 9%.

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Operating and financial review (continued)

Johnnie Walker Red Label volume grew 1% while net sales, after deducting excise duties, were flat. However, very strong volume growth of Johnnie Walker Black Label, up 14%, and Johnnie Walker Super Deluxe, up 21%, delivered overall growth in Johnnie Walker, with volume up 3%, and had a positive mix impact as net sales, after deducting excise duties, increased 6%. Growth was driven mainly by increased demand in Southern Europe, Russia and Eastern Europe and the favourable impact of advertising, especially the sponsorship of Team McLaren Mercedes Formula One. Marketing spend was up 19% as a result of increased activities in sports sponsorship.

Europe accounts for over half of Baileys volume worldwide and brand volume was up a further 1% year on year, driven by growth in France, Italy, Russia and Central and Eastern Europe. Net sales, after deducting excise duties, were flat. Excluding ready to drink, both volume and net sales, after deducting excise duties, grew by 1%.

The majority of J&B s volume in Europe is sold in Spain, where the decline of the scotch category led to a 3% decrease in overall volume of J&B. However, elsewhere in Europe, especially in France and Eastern Europe, J&B performed well.

Guinness volume declined 3% although pricing offset weak volumes and net sales, after deducting excise duties, were flat year on year. Guinness sales progressed well in Russia during the year following Diageo s agreement in July 2005 with Heineken NV for the production and distribution of Guinness in Russia.

Despite a year on year decline in ready to drink, Diageo has managed costs and increased the margin on ready to drink, even though contribution in absolute terms was down.

Total local priority brand performance was negatively impacted by the decline of Diageo s beer volume in Ireland.

Marketing spend was reduced by 4%, driven by a 23% reduction in spending on ready to drink.

Great Britain

Volume was flat and net sales, after deducting excise duties, were down 1% as the decline in ready to drink continued to cause a negative mix impact.

The total spirits market in Great Britain was broadly flat as growth in the off trade offset declines in the on trade. Diageo maintained leadership across all key categories and, excluding ready to drink, grew spirits volume by 2%.

Growth in spirits was attributable to Smirnoff vodka in particular, which continued to gain share as volume grew 6% and net sales, after deducting excise duties, grew 8%. Smirnoff performance was driven by marketing programmes focused on quality and on trade activity around signature cocktails. Smirnoff ready to drink volume declined 19%, a rate similar to the prior year.

Total Baileys volume declined 2% and net sales, after deducting excise duties, declined by 4%. Excluding Baileys Glide, Baileys volume declined 1% whilst net sales, after deducting excise duties, grew 1%. The majority of Baileys is sold in the off trade where there has been increased competition from value brands, however while volume declined, the brand maintained its value share. Baileys grew in the on trade driven by distribution gains and price increases.

Total Guinness volume declined 1% whilst net sales, after deducting excise duties, grew 1% driven by a price increase on Guinness Draught. While volume in the on trade beer market in Great Britain declined

Operating and financial review (continued)

3% as consumers shifted to consumption at home, Guinness Draught gained share in the on trade, growing volume 1% and net sales, after deducting excise duties, by 4%. Media activities were focused on quality attributes and Dublin brewed Guinness, as well as the first year of a four-year sponsorship of the rugby premiership. This helped to generate growth in the second half and increase share.

Local priority brand volume declined 2% and net sales, after deducting excise duties, fell 6%, mainly due to the decline in Archers ready to drink. Gordon s volume grew 1% and net sales, after deducting excise duties, were up 4%. Bell s Extra Special volume grew 2% although net sales, after deducting excise duties, were down.

Category brand volume grew 4% and net sales, after deducting excise duties, increased 2% driven by Blossom Hill, which continued to grow strongly with volume up 13%, and the launch in May 2006 of a new product, Quinn s, an alcoholic fruit ferment blended drink, into the on and off trade.

Ireland

The performance in Ireland reflects the continuing change in market dynamics from on to off trade, high levels of competitor investment, and consumer migration to value brands. While the total beverage alcohol market grew 2%, the on trade was down 3% and the off trade was up 7%. The on trade now represents 51% of the total market.

Volume declined 3% and net sales, after deducting excise duties, were down 1%. This was due to weak performance in beer, where volumes were down 6%, partly offset by growth in wine and spirits, where volume grew 18% and 7% respectively. The impact on net sales, after deducting excise duties, of declining beer volume was partly offset by price increases.

Guinness volume declined 8% whilst net sales, after deducting excise duties, declined 3% as a result of price increases introduced in June 2005 and May 2006. Guinness was impacted by increased levels of competitor investment and the movement to the off trade where Guinness share is lower. In the year there was innovation on the Guinness brand with positive consumer response to the launch of the limited edition Brewhouse Series. In the second half, Guinness Mid-Strength, a lower alcohol by volume format, began consumer trials in 80 outlets.

The introduction of new packaging on Harp, new marketing executions on Carlsberg and Harp and increased distribution have helped reinvigorate both brands. As a result both Carlsberg and Harp have maintained volume year on year and net sales, after deducting excise duties, have increased 7% and 2% respectively.

Smirnoff continued to be the number one vodka in Ireland and outperformed the vodka category in both the on and off trade.

Baileys volume declined 2% and net sales, after deducting excise duties, fell 8% due to increased competition from lower value brands.

Iberia

In Iberia, volume and net sales, after deducting excise duties, both declined 3%. In Spain, spirits penetration is declining in all age groups versus other leisure categories and this has negatively impacted the Spanish business, whilst in Portugal trading conditions continued to be tough as a result of tightening consumer expenditure.

J&B faced increased pressure as the standard whisky segment in Spain continued to decline as consumers continued to switch to dark rums. Therefore, while J&B gained share in the Spanish on trade,

Operating and financial review (continued)

overall Iberian volume declined 7% and net sales, after deducting excise duties, fell 10%. Marketing spend increased 3% behind J&B driven by investment in Spain.

Johnnie Walker volume declined 2%, however net sales, after deducting excise duties, were up 2% driven by the growth of Johnnie Walker Black Label, Super Deluxe and price increases throughout Iberia. Johnnie Walker Black Label and Super Deluxe combined grew volume by 4% and net sales, after deducting excise duties, by 11%. Johnnie Walker Red Label volume declined 3% despite a good performance in Spain, where it is the only standard whisky brand growing volume and share in the on trade. Total Diageo share in the standard scotch segment in Spain increased by 0.3 percentage points.

Across Iberia, Baileys volume was down 6% and net sales, after deducting excise duties, declined 5% driven by contraction in the on trade. José Cuervo volume grew 13% and net sales, after deducting excise duties, were up 15% due to continued consumer interest in the tequila category.

Local priority brand volume grew 5% and net sales, after deducting excise duties, were up 7%. Dark rums grew robustly in the on and off trade with Cacique volume up 6% and net sales, after deducting excise duties, up 9% as a result of repositioning the brand.

Category brand volume declined 8% and net sales, after deducting excise duties, fell 9%. Pampero volume declined 14% with net sales, after deducting excise duties, down 12% as marketing spend was focused on Cacique. In total, Diageo s rum brands grew volume 2% and net sales, after deducting excise duties, grew 5%.

Rest of Europe

In the rest of Europe, solid performances in Italy and Central and Eastern Europe and the growth of super premium brands in Russia drove volume growth of 6% and growth in net sales, after deducting excise duties, of 4%.

Johnnie Walker Red Label volume in the rest of Europe was up 2% and net sales, after deducting excise duties, were up 1%. Johnnie Walker Black Label and Super Deluxe experienced strong growth with volume up 25% and net sales, after deducting excise duties, up 28% from key markets such as Greece, Russia and Northern Europe.

Captain Morgan delivered volume growth of 29% driven by Northern Europe and Russia with net sales, after deducting excise duties, up 23%.

J&B performed well in France, its second largest market, with volume up 9% benefiting from effective on trade advertising and promotion. Baileys enjoyed strong sales in France and Italy.

Ready to drink volume in the rest of Europe declined by 27%, as a result of the continued decline in the segment in France.

Russia continued its momentum with robust volume growth of 25% and net sales, after deducting excise duties, up 26% driven by Johnnie Walker, as the trend towards premium products in Russia continued. Johnnie Walker is the number one scotch in Russia and Baileys holds the same position in the imported liqueur category.

Diageo has announced the acquisition of the Smirnov brand in Russia through a company in which Diageo holds a 75% stake. This company will unite the Smirnoff/Smirnov brands under common ownership and will be the exclusive distributor of Diageo spirits brands and the Smirnov vodka brand in Russia.

Operating and financial review (continued)

International

Summary:

- Strong performance across all regions as investment accelerated growth
- Innovation has improved competitive positions in key categories across the region
- Performance in Nigeria, Korea and Taiwan has been turned around

Key measures	2006 £ million	2005 £ million	Reported movement %	Organic movement %
Volume			**14**	**14**
Net sales after deducting excise duties	**2,219**	1,922	**15**	**13**
Marketing	**354**	269	**32**	**28**
Operating profit before exceptional items	**644**	615	**5**	**9**

Reported performance Net sales, after deducting excise duties, were £2,219 million in the year ended 30 June 2006, up by £297 million from £1,922 million in the prior year. Operating profit before exceptional items increased by £29 million to £644 million in the year ended 30 June 2006.

Organic performance Net sales, after deducting excise duties, increased by £31 million as a result of exchange rate impacts. Acquisitions added net sales, after deducting excise duties, of £9 million and there was an organic increase in net sales, after deducting excise duties, of £252 million. Transfers between business segments increased prior year net sales, after deducting excise duties, by £5 million. Operating profit before exceptional items increased by £29 million despite unfavourable exchange rate movements of £23 million. Acquisitions increased operating profit before exceptional items by £1 million and organic growth of £54 million was achieved. Transfers between business segments reduced prior year operating profit before exceptional items by £3 million.

Organic brand performance	Reported volume movement %	Organic volume movement %	Reported net sales* movement %	Organic net sales* movement %
Global priority brands	**11**	**11**	**14**	**13**
Local priority brands	**4**	**4**	**12**	**5**
Category brands	**24**	**22**	**20**	**18**
Total	**14**	**14**	**15**	**13**
Key brands				
Smirnoff vodka		**9**	**14**	**13**
Smirnoff ready to drink		**41**	**47**	**44**
Johnnie Walker		**16**	**13**	**16**
Baileys		**11**	**8**	**6**
Guinness		**(2)**	**7**	**3**
Buchanan s		**20**	**15**	**21**
Windsor		**12**	**23**	**9**

* after deducting excise duties

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Operating and financial review (continued)

Good economic conditions in many markets, further investment in the brands and the organisation and a focus on market place execution have resulted in the International business growing strongly in all regions. Growth has been driven by the global priority brands, with Johnnie Walker in particular experiencing strong growth on the back of upweighted investment. This investment has been focused around the sponsorship of Team McLaren Mercedes Formula One, which has been particularly successful in driving growth of Johnnie Walker Black Label and Super Deluxe variants, where net sales, after deducting excise duties, grew 17%. The sponsorship has also provided a strong platform for Diageo s responsible drinking programmes.

Smirnoff vodka grew net sales, after deducting excise duties, by 13% with particularly strong growth in India and Brazil. Smirnoff ready to drink volume grew over 40%. This performance has been delivered through strengthened distribution and sales execution and advertising campaigns on Smirnoff Ice in Brazil and Australia, as well as the launch of Smirnoff Ice in Venezuela and Smirnoff Storm in South Africa.

Baileys grew volume by 11% driven by growth in Global Duty Free and Japan. Promotional activity in Global Duty Free and the decline of Baileys Glide in Australia have, however, resulted in adverse mix with net sales, after deducting excise duties, growing by 6%.

Guinness volume declined 2% whilst net sales, after deducting excise duties, were up 3%. Performance was held back as a result of a decline in Cameroon, although this was partly offset by strong performances in Nigeria and Ghana where price increases accelerated the growth of net sales, after deducting excise duties, ahead of volume. South East Asia and Japan also experienced good growth.

Local priority brand performance was led by the growth of Buchanan s in Venezuela, and the return to growth of Windsor in Korea, driven in particular by new packaging on the 12 and 17-year-old variants. Growth of Bundaberg in Australia and Bell s in South Africa were offset by declines in Dimple in Korea, and Tusker and Pilsner in Kenya.

The growth of the scotch category across the region has been the main driver of the growth in category brands. Investment behind Diageo s scotch brands has enabled the International region to capitalise on market opportunities. Amongst the successes was Old Parr, which grew significantly across Latin America with volume and net sales, after deducting excise duties, up nearly 60%. The newly launched whisky brands continued to perform strongly in Thailand and the successful relaunch of Harp in Nigeria also contributed to the overall growth in category brands.

Ready to drink grew volume by 22% and net sales, after deducting excise duties, by 21%. This was led by the growth of Smirnoff throughout International and Bundaberg and Johnnie Walker in Australia.

Asia Pacific

Increased marketing investment, growing markets in India and China, share gains in Korea and Thailand and continued growth in ready to drink in Australia led to volume up 15%, and net sales, after deducting excise duties, up 11% in Asia Pacific.

In Australia, ready to drink has driven growth of 6% in net sales, after deducting excise duties, with Smirnoff, Johnnie Walker and Bundaberg all showing good growth. Smirnoff ready to drink delivered share gains of 3.4 percentage points, boosted by the successful launch of Smirnoff Twist ready to drink. In spirits, whilst Baileys has declined in volume and lost share, Johnnie Walker Red Label, Johnnie Walker Black Label, Bundaberg and Smirnoff have all gained share in a spirits market that was up 6% in the year.

Operating and financial review (continued)

In Korea, the trading environment for spirits has stabilised as a result of improved economic conditions, however Diageo s strong performance was the result of gaining share, most notably on Windsor. The brand has been revitalised with new packaging and the introduction of a 21-year-old variant and net sales, after deducting excise duties, grew 9%. Johnnie Walker volume grew 36% and net sales, after deducting excise duties, grew 52%. Johnnie Walker Super Deluxe grew volume 58% and net sales, after deducting excise duties, by 82%, albeit off a small base, as it gained from the new focus on modern on trade outlets and marketing activities to build brand equity. Dimple volume declined by 22% in the year, as renovations on the brand failed to turn around performance.

In Japan, volume grew 3% and net sales, after deducting excise duties, grew by 1%. Strong performances from Baileys, which grew volume by 65%, and Guinness, up 14%, offset a 45% volume decline in Smirnoff ready to drink as a result of a temporary withdrawal in the first half. The brand performed well following the relaunch in the second half.

In Thailand, Diageo clearly outperformed the market and the competition, with growth in each of its brands despite the decline in the imported whisky segment. Benmore and Golden Knight together account for over 450,000 cases and have made significant share gains in the standard and economy whisky segments respectively, although this strong growth has resulted in an adverse mix. Johnnie Walker recorded volume growth of 32% and growth in net sales, after deducting excise duties, of 20% driven by Johnnie Walker Red Label.

Performance in Taiwan improved as volume and net sales, after deducting excise duties, both grew 11%. Johnnie Walker Green Label in particular has performed well, benefiting from a new campaign and a market where malt whisky is growing strongly.

Performance in China has continued strongly with volume up 57% and net sales, after deducting excise duties, up 81%, albeit from a small base. Johnnie Walker Black Label represents a significant proportion of Diageo s business in China, and has driven this growth with volume up 89% and net sales, after deducting excise duties, up 124%, supported by a significant upweight in investment. This investment included activities surrounding the sponsorship of Team McLaren Mercedes Formula One at the Shanghai Grand Prix, as well as three new local advertising executions.

The Indian business benefited from activities surrounding Johnnie Walker s sponsorship of the cricket Super Series in Australia, and the Smirnoff Life is Calling campaign. Volume grew 29% and net sales, after deducting excise duties, grew 37%. While there is increasing evidence of consumers upgrading to premium and branded products, competitive activity is becoming more intense, with evidence of increased consolidation in the sector, and an increasing number of new brand launches.

Africa

Africa delivered volume growth of 10% and growth in net sales, after deducting excise duties, of 9%. This was the result of strong performances in Nigeria and South Africa, offset by a decline in Cameroon.

In Nigeria volume grew 20% and net sales, after deducting excise duties, grew 13%. Harp was relaunched in 2005 and as a result share has increased by 3.7 percentage points. This growth has, however, led to adverse mix. Guinness delivered volume growth of 4% and net sales, after deducting excise duties, grew 9% as a result of a price increase in October 2004.

In East Africa, difficult economic conditions due to drought and rising fuel prices, together with a duty increase, saw consumers trade down to lower value brands. Volume grew 20% and net sales, after

Operating and financial review (continued)

deducting excise duties, grew 11% with Senator, a low priced beer introduced in 2005, having performed well.

South Africa saw significant mix improvement as volume grew 6% and net sales, after deducting excise duties, grew 19%. This mix improvement was the result of a strong performance by Diageo s scotch brands as Johnnie Walker volume increased by 36% and Bell s grew volume by 15%. The switch in consumer preference towards dark spirits resulted in Smirnoff vodka volume declining by 7%, although Smirnoff ready to drink grew by 48%, driven by the launch of Smirnoff Storm.

In Ghana, volume grew 6% whilst price increases and a change in invoicing arrangements agreed with the authorities following the acquisition of Ghana Breweries Ltd led net sales, after deducting excise duties, to grow by 17%. Guinness volume for the year was flat with net sales, after deducting excise duties, up 13%. Volume of Malta increased by 13% as it continued to enjoy an advantaged price position over its competitive set.

Trading in Cameroon was heavily impacted by aggressive promotional activity by a competitor. As a result, Guinness volumes were down 37% and net sales, after deducting excise duties, were down by 35%.

Latin America and the Caribbean

Diageo has continued to invest behind brand building programmes, improvements in customer relationships and sales execution to capitalise on the growth in consumer demand from buoyant economies across Latin America. Volume grew by 17% and net sales, after deducting excise duties, by 21%.

In the Brazilian hub, which includes Paraguay and Uruguay, growth was driven by scotch and ready to drink. Johnnie Walker grew net sales, after deducting excise duties, by 40%. In Brazil, Johnnie Walker benefited from investment both above and below the line as Johnnie Walker Red Label share grew 3.4 percentage points and Johnnie Walker Black Label delivered share gains of 1.8 percentage points. Smirnoff ready to drink grew net sales, after deducting excise duties, over 100% as the continued success of Smirnoff Ice has extended Smirnoff s leadership in the buoyant ready to drink segment.

Volume grew 23% and net sales, after deducting excise duties, grew 36% in Venezuela, as strong economic fundamentals have translated into increased consumer demand across all sectors. Diageo leads the super deluxe, deluxe and standard scotch segments. Johnnie Walker Red Label performed strongly with volume and net sales, after deducting excise duties, up 25% and Buchanan s delivered growth in net sales, after deducting excise duties, of 40%. A new campaign for Smirnoff Ice has driven significant growth in volume and net sales, after deducting excise duties, albeit off a small base.

In Mexico, volume grew 55% and net sales, after deducting excise duties, grew 41%. As a result Diageo gained 4.9 percentage points of share in the scotch category. Johnnie Walker Red Label grew volume 32% and Buchanan s volume increased 51% as a result of strengthened customer relationships, sustained brand building investment and a particular focus on the on trade.

Global Duty Free

The focus on sales execution and innovation within Global Duty Free has driven strong volume growth of 16% and growth in net sales, after deducting excise duties, of 18%. Packaging innovation such as the Johnnie Walker Blue Label Magnum and marketing activity around the sponsorship of Team McLaren Mercedes Formula One has led to a 21% growth in net sales, after deducting excise duties, for Johnnie Walker. Baileys delivered growth of 29% in net sales, after deducting excise duties, as major sampling activities were carried out in Europe and Asia associated with the launch of the new flavour innovations.

Operating and financial review (continued)

Corporate revenue and costs

Reported performance Net sales, after deducting excise duties, were £76 million in the year ended 30 June 2006, up by £14 million from £62 million in the prior year. Net operating costs before exceptional items increased by £2 million to £166 million in the year ended 30 June 2006.

Organic performance Transfers between business segments increased prior year net sales, after deducting excise duties, by £15 million, and there was an organic decrease in net sales, after deducting excise duties, of £1 million. Net corporate operating costs before exceptional items decreased by £6 million as a result of transfers between business segments and there was a decrease of £1 million as a result of foreign exchange impacts. An organic increase of £9 million in corporate net operating costs, before exceptional items, was driven mainly by an increase in investment behind innovation.

Trend information

The following comments were made by Paul Walsh, chief executive of Diageo, in Diageo s preliminary announcement on 31 August 2006:

Diageo s strong full year performance is the result of brand building marketing campaigns, better sales execution to build superior relationships with our customers and successful new product launches.

North America continues to deliver industry beating top line growth; a more cost effective European business is driving operating profit and margin growth; and the rate of sales growth in International has accelerated following new brand introductions and increased investment.

Strong top line growth has delivered organic operating margin expansion and organic operating profit growth in line with our guidance at the beginning of the year despite pressure on input costs. At the same time we have increased marketing investment creating a stronger platform for future growth. We have delivered another year of strong free cash flow and through our dividends and share buybacks we have returned a further £2.3 billion to our shareholders.

With well-positioned brands and a more efficient and effective organisation, we enter the new financial year with confidence. We expect that organic net sales growth will be in line with that achieved in the current year and we plan to deliver organic operating profit growth of at least 7% for the year and to return a further £1.4 billion to shareholders through our continuing buyback programme.

Operating and financial review (continued)

Liquidity and capital resources

Cash flow A summary of the cash flow and reconciliation to movement in net borrowings for the two years ended 30 June 2006 is as follows:

	Year ended 30 June 2006 £ million	2005 £ million
Profit for the year	**1,965**	1,399
Profit after tax from disposal of discontinued businesses		(73)
Taxation	**181**	599
Share of associates profits after tax	**(131)**	(121)
Net interest and other finance income and charges	**186**	141
Net non-operating exceptional gains	**(157)**	(214)
Depreciation and amortisation	**214**	241
Movements in working capital	**(192)**	89
Dividend income	**115**	134
Other items	**18**	78
Cash generated from operations	**2,199**	2,273
Interest received	**64**	146
Interest paid	**(235)**	(325)
Dividends paid to equity minority interests	**(40)**	(49)
Taxation paid	**(393)**	(320)
Net cash from operating activities	**1,595**	1,725
Net disposal/(purchase) of investments	**7**	(6)
Net investment in property, plant and equipment	**(241)**	(276)
Free cash flow	**1,361**	1,443
Disposal of shares in General Mills	**651**	1,210
Other disposals	**121**	(16)
Acquisitions	**(209)**	(258)
Proceeds from issue of share capital	**3**	6
Net purchase of own shares for share trusts	**(11)**	(29)
Own shares repurchased	**(1,428)**	(710)
Increase/(decrease) in loans	**309**	(379)
Redemption of guaranteed preferred securities		(302)
Equity dividends paid	**(864)**	(849)
Net (decrease)/increase in cash and cash equivalents	**(67)**	116
Cash flows from loans (excluding overdrafts)	**(309)**	379
Exchange differences	**15**	(136)
Non-cash items	**(18)**	91
(Increase)/decrease in net borrowings	**(379)**	450

The primary sources of the group s liquidity over the last two financial years have been cash generated from operations and cash received from disposals. A portion of these funds has been used to fund acquisitions, share repurchases, to pay interest, dividends and taxes, and to fund capital expenditure.

Free cash flow generated was £1,361 million (2005 £1,443 million). Cash generated from operations decreased by £74 million to £2,199 million in the year to 30 June 2006. There was an increase of

Operating and financial review (continued)

£566 million in profit for the year to £1,965 million for the year ended 30 June 2006, which was offset by the year-on-year impact of working capital movements on the cash flow of £281 million (an outflow of £192 million in the year to 30 June 2006 and an inflow of £89 million in the prior year). Of this year-on-year movement in working capital, £179 million reflects the presentation of exceptional non-cash charges within working capital movements in the prior year following the implementation of IFRS, thus operating working capital impact on cash flow was £102 million. The decrease in cash generated from operations was partially offset by reduced interest payments (down £8 million to £171 million) and reduced capital expenditure (down £35 million to £241 million). However, increased tax payments (up £73 million to £393 million) contributed to an overall decrease in free cash flow of £82 million to £1,361 million from £1,443 million in the prior year.

In the year ended 30 June 2006, the group generated proceeds from the disposal of shares of General Mills of £651 million (2005 £1,210 million) and issued new share capital under employee share schemes generating proceeds of £3 million (2005 £6 million). These inflows were mainly offset by payments of £1,428 million to repurchase shares to be held as treasury shares (including £21 million in respect of treasury shares to be held for hedging employee share scheme grants), the payment of £209 million to acquire Bushmills Irish whiskey in August 2005 and £864 million equity dividends paid.

Capital structure and credit rating The group s management is committed to enhancing shareholder value, both by investing in the businesses and brands so as to improve the return on investment and by managing capital structure. Diageo manages its capital structure to achieve capital efficiency, maximise flexibility and give the appropriate level of access to debt markets at attractive cost levels.

Capital repayments The company acquired 164 million (2005 86 million, 2004 nil) ordinary shares to be held as treasury shares as part of its share buyback programme during the year ended 30 June 2006, for a total consideration of £1,407 million including expenses (2005 £649 million, 2004 £nil). The company did not acquire any shares for cancellation during the year (2005 8 million shares, consideration £61 million, 2004 43 million shares, consideration £306 million). The group regularly assesses its debt and equity capital levels against its stated policy for capital structure and will continue to repurchase shares when appropriate.

In the period 1 July 2006 to 20 September 2006 the company acquired 20.6 million shares as part of the company s share buyback programmes to be held as treasury shares, 6.5 million shares purchased and subsequently cancelled and 1.5 million shares to be held as treasury shares for hedging share scheme grants provided to employees, for a total consideration of £267 million including expenses.

Operating and financial review (continued)

The number of shares purchased for settlement in each calendar month and the average price paid for the year ended 30 June 2006 were as follows:

Calendar month	Number of shares purchased(a)	Average price paid pence	Authorised purchases unutilised at month end	
July 2005	5,118,000	797	213,594,223	(b)
August 2005	5,971,000	784	207,623,223	(b)
September 2005	12,195,000	821	195,428,223	(b)
October 2005	15,580,000	826	297,061,222	(c)
November 2005	28,115,000	840	268,946,222	
December 2005	17,385,500	848	251,560,722	
January 2006	12,755,000	837	238,805,722	
February 2006	11,200,000	854	227,605,722	
March 2006	14,402,611	901	213,203,111	
April 2006	11,000,000	903	202,203,111	
May 2006	16,600,000	891	185,603,111	
June 2006	13,355,000	901	172,248,111	

Notes

(a) All shares were purchased as part of publicly announced programmes.

(b) Authorisation was given by shareholders on 20 October 2004 to purchase a maximum of 305,752,223 shares. Under the authority granted, the minimum price which may be paid is 28101⁄108 pence and the maximum price is equal to 105% of the average of the middle market quotations for an ordinary share for the five preceding business days. The expiration date for this programme was 18 October 2005.

(c) Authorisation was given by shareholders on 18 October 2005 to purchase a maximum of 305,041,222 shares. Under the authority granted, the minimum price which may be paid is 28101⁄108 pence and the maximum price is equal to 105% of the average of the middle market quotations for an ordinary share for the five preceding business days. The expiration date for the programme is 17 October 2006.

Borrowings The group policy with regard to the expected maturity profile of borrowings of group financing companies is to limit the proportion of such borrowings maturing within 12 months to 50% of gross borrowings less money market demand deposits, and the level of commercial paper to 30% of gross borrowings less money market demand deposits. In addition, it is group policy to maintain backstop facility terms from relationship banks to support commercial paper obligations.

Operating and financial review (continued)

The group s net borrowings and gross borrowings in the tables below are measured at amortised cost with the exception, in relation to the year ended 30 June 2006, of borrowings designated in a fair value hedge, interest rate fair value hedging instruments and foreign currency swaps and forwards which are measured at fair value. From 1 July 2005 the group has applied *IAS 39 Financial instruments: recognition and measurement*. The comparative figures for the year ended 30 June 2005 have not been restated for compliance with IAS 39 under the exemptions permitted under *IFRS 1 First time adoption of International Financial Reporting Standards*. Net borrowings, reported on this basis, comprise the following:

	As at 30 June 2006 £ million	2005 £ million
Overdrafts	**(48)**	(58)
Other borrowings due within one year	**(711)**	(811)
Borrowings due within one year	**(759)**	(869)
Borrowings due between one and three years	**(1,790)**	(1,744)
Borrowings due between three and five years	**(831)**	(974)
Borrowings due after five years	**(1,380)**	(959)
Interest rate fair value hedging instruments	**(44)**	
Foreign currency swaps and forwards	**(17)**	
Finance leases	**(9)**	(9)
Gross borrowings	**(4,830)**	(4,555)
Offset by:		
Cash and cash equivalents	**699**	787
Other liquid resources	**49**	30
Foreign currency swaps and forwards		32
Net borrowings	**(4,082)**	(3,706)

The effective interest rate for the year ended 30 June 2006, based on average monthly net borrowings and interest charge, excluding finance charges unrelated to net borrowings, was 4.8% (2005 4.1%).

Borrowings due within one year (including foreign currency swaps and forwards) as at 30 June 2006 were £776 million (30 June 2005 £837 million).

The group s gross borrowings were denominated in the following currencies:

	Total £ million	US dollar %	Sterling %	Euro %	Other %
Gross borrowings					
2006	**(4,830)**	**47**	**8**	**30**	**15**
2005	(4,555)	84	1	12	3

Cash and cash equivalents and other liquid resources were denominated in the following currencies:

	Total £ million	US dollar %	Sterling %	Euro %	Other %
Cash and cash equivalents and other liquid resources					
2006	**748**	**21**	**20**	**12**	**47**
2005	817	31	37	2	30

Operating and financial review (continued)

The following table summarises the group s gross borrowings, excluding overdrafts, finance leases, interest rate fair value hedging instruments and foreign currency swaps and forwards.

	As at 30 June 2006 £ million	2005 £ million
Global bonds	**(2,751)**	(2,086)
Yankee bonds		(279)
Guaranteed notes	**(216)**	(225)
Medium term notes	**(1,280)**	(930)
Commercial paper		(458)
Others	**(465)**	(510)
	(4,712)	(4,488)

During the year ended 30 June 2006, the group borrowed $250 million (£135 million) in the form of a medium term note that matures in 2008, $400 million (£216 million) in the form of a medium term note that matures in 2009, $600 million (£324 million) in the form of a global bond that matures in 2013 and $750 million (£405 million) in the form of a global bond that matures in 2015. During the year ended 30 June 2005, the group borrowed $750 million (£418 million) in the form of a global bond that matures in 2010. The proceeds of all issuances have been used in the ongoing cash management and funding activities of the group.

At 30 June 2006, the group had available undrawn committed bank facilities of £1,746 million (2005 £1,788 million). Of the facilities, £676 million expire in May 2007, £486 million expire in May 2010 and £584 million expire in May 2011. Commitment fees are paid on the undrawn portion of these facilities. Borrowings under these facilities will be at prevailing LIBOR rates plus an agreed margin, which is dependent on the period of drawdown. These facilities can be used for general corporate purposes and, together with cash and cash equivalents, support the group s commercial paper programmes. The committed bank facilities are subject to a single financial covenant, being a minimum interest cover ratio of two times (defined as the ratio of operating profit before exceptional items aggregated with share of associates profits to net interest). They are also subject to pari passu ranking and negative pledge covenants.

Any non-compliance with covenants underlying Diageo s financing arrangements could, if not waived, constitute an event of default with respect to any such arrangements, and any non-compliance with covenants may, in particular circumstances, lead to an acceleration of maturity on certain notes and the inability to access committed facilities. Diageo was in full compliance with all of its financial covenants throughout each of the periods presented.

Capital commitments not provided for at 30 June 2006 were estimated at £56 million (2005 £53 million).

Diageo management believes that it has sufficient funding for its working capital requirements.

Operating and financial review (continued)

Contractual obligations

	Payments due by period				
	Less than 1 year £ million	1-3 years £ million	3-5 years £ million	More than 5 years £ million	Total £ million
As at 30 June 2006					
Long term debt obligations	**711**	**1,790**	**831**	**1,380**	**4,712**
Operating leases	**78**	**129**	**102**	**258**	**567**
Purchase obligations	**709**	**612**	**371**	**357**	**2,049**
Provisions and other non-current payables	**48**	**69**	**28**	**123**	**268**
	1,546	**2,600**	**1,332**	**2,118**	**7,596**

Long term debt obligations comprise borrowings (excluding interest rate and foreign currency swaps) with an original maturity of greater than one year. Purchase obligations include various long term purchase contracts entered into for the supply of certain raw materials, principally grapes, cans and glass bottles. The contracts are used to guarantee supply of raw materials over the long term and to enable more accurate predictions of future costs. Provisions and other non-current payables exclude £29 million in respect of vacant properties and £102 million for onerous contracts, which are included in operating leases and purchase obligations, respectively. Deferred tax and post employment benefit liabilities are not included in the table above.

The group makes service-based cash contributions to the Diageo pension scheme in the United Kingdom. In the year ending 30 June 2007, the contribution is expected to be £52 million. In addition, the group has agreed to make payments estimated at £50 million in each of the four years to 30 June 2010 into escrow bank accounts to reduce the deficit on the Diageo pension scheme in the United Kingdom.

Off-balance sheet arrangements

In connection with the disposal of Pillsbury in October 2001, Diageo has guaranteed debt of International Multifoods Corporation, a wholly owned subsidiary of The JM Smucker Company as from 18 June 2004, to the amount of $200 million (£108 million), repayable in November 2009. The directors are not aware of any instances of default by the borrower at present, but the ability of the borrower to continue to be in compliance with the guaranteed debt instrument, and in particular remaining current on payments of interest and repayments of principal, is significantly dependent on the current and future operations of the borrower and its affiliates.

In addition, certain of the acquired Seagram businesses had pre-existing guarantees at the date of acquisition in relation to the solvency of a third party partnership. This partnership has outstanding loans of $100 million (£54 million). Vivendi has indemnified the group against any losses relating to these arrangements.

The above guarantees are unrelated to the ongoing operations of the group s business.

Save as disclosed above, neither Diageo plc nor any member of the Diageo group has any off-balance sheet financing arrangements that currently have or are reasonably likely to have a material future effect on the group s financial condition, changes in financial condition, results of operations, liquidity, capital expenditure or capital resources.

Operating and financial review (continued)

Risk management

The group s funding, liquidity and exposure to interest rate and foreign exchange rate risks are managed by the group s treasury department. The treasury department uses a combination of derivative and conventional financial instruments to manage these underlying risks.

Treasury operations are conducted within a framework of board-approved policies and guidelines, which are recommended and subsequently monitored by the finance committee. This committee is described in the corporate governance report. These include benchmark exposure and/or hedge cover levels for key areas of treasury risk. The benchmarks, hedge cover and overall appropriateness of Diageo s risk management policies are reviewed by the board following, for example, significant business, strategic or accounting changes. The framework provides for limited defined levels of flexibility in execution to allow for the optimal application of the board-approved strategies. Transactions giving rise to exposures away from the defined benchmark levels arising on the application of this flexibility are separately monitored on a daily basis using value at risk analysis. These derivative financial instruments are carried at fair value and gains or losses are taken to the income statement as they arise. At 30 June 2006 gains and losses on these transactions were not material.

The finance committee receives bi-monthly reports on the activities of the treasury department, including any exposures away from the defined benchmarks.

Currency risk The group publishes its consolidated financial statements in sterling and conducts business in many foreign currencies. As a result, it is subject to foreign currency exchange risk due to exchange rate movements which will affect the group s transaction costs and the translation of the results and underlying net assets of its foreign operations.

Hedge of net investment in foreign operations The group hedges a substantial portion of its exposure to fluctuations on the translation into sterling of its foreign operations by holding net borrowings in foreign currencies and by using foreign currency swaps and forwards. The group s policy where a liquid foreign exchange market exists is to seek to hedge currency exposure on its net operations before net borrowings at approximately the following percentages 90% for US dollars, 90% for euros and 50% for other significant currencies. This policy leaves the remaining part of the group s net operations before net borrowings subject to currency movements. Diageo introduced from 1 July 2005 additional processes to determine, monitor and document the effectiveness of these hedges in the context of the underlying exposure under IAS 39. Exchange differences arising on the retranslation of relevant foreign currency borrowings (including foreign exchange swaps and forwards), to the extent that they are in an effective hedge relationship, are recognised in the statement of recognised income and expense, in accordance with IAS 39.

Transaction exposure hedging For currencies in which there is an active market, the group seeks to hedge between 80% and 100% of forecast transactional foreign exchange rate risk, for up to a maximum of 21 months forward, using forward foreign currency exchange contracts. The effective portion of the gain or loss on the hedge is recognised in the statement of recognised income and expense to the extent it is highly effective, and recycled into the income statement at the same time as the underlying hedged transaction affects the income statement. Under IFRS, the degree of confidence in forecast future cash flows required to achieve hedge accounting has increased. This has led to a reduction in the coverage levels initially placed up to 21 months in advance, but with coverage levels being increased nearer to the forecast transaction date. Under IAS 39 hedges are documented and tested for hedge effectiveness on an ongoing basis. Diageo expects hedges entered into to continue to be highly effective and therefore does not expect the impact of ineffectiveness on the income statement to be material.

Operating and financial review (continued)

Interest rate risk The group has an exposure to interest rate risk, arising principally on changes in US dollar, sterling and euro interest rates. To manage interest rate risk, the group manages its proportion of fixed to variable rate borrowings within limits approved by the board, primarily through issuing long term fixed rate bonds, medium term notes and commercial paper, and by utilising interest rate swaps. The profile of fixed rate to floating rate net borrowings is targeted according to a duration measure that is equivalent to an approximate 50% fixed and 50% floating amortising profile. The number of years within the amortising profile depends on a template approved by the board. These practices serve to reduce the volatility of the group s reported financial performance. Following the implementation of IAS 39 from 1 July 2005 the majority of Diageo s existing interest rate hedges are designated as hedges under IAS 39. Designated hedges are expected to be highly effective, and therefore the impact of ineffectiveness on the income statement is not expected to be material.

Liquidity risk The group s policy with regard to the expected maturity profile of group financing companies borrowings is to limit the proportion of such borrowings maturing within 12 months to 50% of gross borrowings less money market demand deposits and the level of commercial paper to 30% of gross borrowings less money market demand deposits. In addition, it is group policy to maintain backstop facility terms from relationship banks to support commercial paper obligations.

Credit risk The group monitors its credit exposure to its counterparties via their credit ratings (where applicable) and through its policy, thereby limiting its exposure to any one party to ensure that they are within board approved limits and that there are no significant concentrations of credit risk. The counterparties to the financial instruments transacted by the group are major international financial institutions. Group policy is to enter into such transactions only with counterparties with a long term credit rating of A or better. The notional amounts of financial instruments used in interest rate and foreign exchange management do not represent the credit risk arising through the use of these instruments. The immediate credit risk of these instruments is generally estimated by the fair value of contracts with a positive value. The maximum exposure to credit risk for receivables and other financial assets is represented by their carrying amount.

Commodity price risk The group uses commodity futures and options to hedge against price risk in certain commodities. All commodity futures and options contracts hedge a projected future purchase of raw material. Commodity futures or options are then either closed out at the time the raw material is purchased or they are exchanged with the company manufacturing the raw material to determine the contract price. Commodity contracts are held in the balance sheet at fair value and to the extent that they are considered as an effective hedge under IAS 39, fair value movements are recognised in the statement of recognised income and expense. Gains and losses realised in the year in respect of open contracts at the balance sheet date were not significant.

Insurance The group purchases insurance for commercial or, where required, for legal or contractual reasons. In addition, the group retains insurable risk where external insurance is not considered an economic means of mitigating these risks.

Market risk sensitivity analysis

IFRS 7 sensitivity analysis The group has used a sensitivity analysis technique that measures the estimated change to the income statement and equity of either an instantaneous increase or decrease of 1% (100 basis points) in market interest rates or a 10% strengthening or weakening in sterling against all other currencies, from the rates applicable at 30 June 2006, for each class of financial instrument with all other variables remaining constant. The sensitivity analysis excludes the impact of market risks on net post

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Operating and financial review (continued)

employment benefit obligations. This analysis is for illustrative purposes only, as in practice market rates rarely change in isolation. The sensitivity analysis is based on the following assumptions:

Interest rate risks The interest rate sensitivity analysis is based on the following assumptions:

- Changes in market interest rates affect the interest income or expense of variable interest financial instruments.

- Changes in market interest rates only affect interest income or expense in relation to financial instruments with fixed interest rates if these are recognised at their fair value.

- Changes in market interest rates affect the fair value of derivative financial instruments designated as hedging instruments and all interest rate hedges are expected to be highly effective.

- Changes in the fair values of derivative financial instruments and other financial assets and liabilities are estimated by discounting the future cash flows to net present values using appropriate market rates prevailing at the year end.

Under these assumptions, a 1% increase or decrease in market interest rates for all currencies in which the group had borrowings and derivative financial instruments at 30 June 2006 would increase or decrease profit before tax by approximately £15 million and equity by £6 million before tax.

Currency risks The currency risk sensitivity analysis is based on the assumption that all net investment and cash flow hedges are highly effective.

Under this assumption, with a 10% strengthening or weakening of sterling against all exchange rates, profit before tax would have decreased by £17 million or increased by £21 million, respectively, and equity (before tax effects) would have decreased by £543 million or increased by £444 million, respectively.

Other price risks As at 30 June 2006, hypothetical changes in other risk variables would not significantly affect the price of financial instruments at that date.

Fair value sensitivity analysis The IFRS 7 sensitivity analysis has been prepared as at 30 June 2006 and expresses information about potential changes in earnings and equity based on the accounting policies applied by Diageo following the adoption of IAS 32 and IAS 39 from 1 July 2005. It is not possible to provide information on the same basis for dates prior to the adoption of IAS 32 and IAS 39. This fair value sensitivity analysis expresses information about changes in fair values of financial instruments for both 30 June 2006 and 2005 on a comparable basis.

For financial instruments held, the group has used a sensitivity analysis technique that measures the change in the fair value of the group s financial instruments from hypothetical changes in market rates.

The amounts generated from the sensitivity analysis are forward-looking estimates of market risk assuming certain adverse market conditions occur. Actual results in the future may differ materially from those projected results due to developments in the global financial markets which may cause fluctuations in interest and exchange rates to vary from the hypothetical amounts disclosed in the following table, which therefore should not be considered a projection of likely future events and losses.

The estimated changes in the fair values of borrowings and the associated derivative financial instruments are set out in the tables below. The fair values of quoted borrowings are based on year end mid-market quoted prices. The fair values of other borrowings, derivative financial instruments and other financial liabilities and assets are estimated by discounting the future cash flows to net present values using appropriate market rates prevailing at the year end. These are based on rates obtained from third parties.

Operating and financial review (continued)

The estimated changes in fair values for interest rate movements are based on an instantaneous decrease of 1% (100 basis points) in the specific rate of interest applicable to each class of financial instruments from the levels effective at 30 June, with all other variables remaining constant. The estimated changes in the fair value for foreign exchange rates are based on an instantaneous 10% weakening in sterling against all other currencies from the levels applicable at 30 June, with all other variables remaining constant. Such analysis is for illustrative purposes only as, in practice, market rates rarely change in isolation.

Sensitivity analysis table at 30 June 2006	**Estimated fair value £ million**	**Fair value changes arising from: 1% fall in interest rates £ million**	**10% weakening in sterling £ million**
Borrowings	**(4,817)**	**278**	**(512)**
Interest rate contracts	**(51)**	**(35)**	**(6)**
Foreign exchange contracts:			
Transaction	**27**		**(117)**
Balance sheet translation	**(17)**		**(7)**
Other financial net liabilities	**(251)**	**(4)**	**(16)**

Sensitivity analysis table at 30 June 2005	**Estimated fair value £ million**	**Fair value changes arising from: 1% fall in interest rates £ million**	**10% weakening in sterling £ million**
Borrowings	(4,746)	161	(505)
Interest rate contracts	51	(100)	6
Foreign exchange contracts:			
Transaction	(23)		(138)
Balance sheet translation	38		(57)
Written call options re General Mills shares	(8)		(1)
Other financial net assets	530	(4)	66

At 30 June 2004, General Mills had call options to purchase 29 million of General Mills shares held by Diageo, subject to certain limitations. On 4 October 2004, 4 million of the shares over which the options were exercisable were transferred to the group s UK pension fund, together with the relevant portion of the options. The remaining 25 million call options had a strike price of $51.56 and an expiry date in October 2005. The estimated fair value of the call options was derived using a Black Scholes model using market volatility, share price and interest rates as at 30 June 2005. It was estimated that a 5% increase in the share price of General Mills would have increased the negative fair value by £9 million.

Critical accounting policies

The consolidated financial statements are prepared in accordance with IFRS. Diageo s accounting policies are set out in the notes to the consolidated financial statements in this annual report. In applying these policies the directors are required to make estimates and subjective judgements that may affect the reported amounts of assets and liabilities at the balance sheet date and reported profit for the year. The directors base these on a combination of past experience and any other evidence that is relevant to the particular circumstance. The actual outcome could differ from those estimates. Of Diageo s accounting policies, the directors consider that policies in relation to the following areas are of greater complexity and/or particularly subject to the exercise of judgement.

Operating and financial review (continued)

Brands, goodwill and other intangibles Acquired brands are held on the consolidated balance sheet at cost. Where brands are regarded as having indefinite useful economic lives, they are not amortised. Assessment of the useful economic life of an asset, or that an asset has an indefinite life, requires considerable management judgement.

Impairment reviews are carried out to ensure that intangible assets, including brands, are not carried at above their recoverable amounts. In particular, the group performs a discounted cash flow analysis annually to compare discounted estimated future operating cash flows to the net carrying value of each acquired brand. The analysis is based on forecast cash flows with terminal values being calculated using the long term growth rate (the real GDP growth rate of the country plus its inflation rate) of the principal countries in which the majority of the profits of each brand are generated. The estimated cash flows are discounted at the group s weighted average cost of capital in the relevant country. Any impairment write downs identified are charged to the income statement.

In assessing whether goodwill is carried at above its recoverable amount, a discounted cash flow analysis is performed annually to compare the discounted estimated future operating cash flows of cash generating units of the group to the net assets attributable to the cash generating units including goodwill. The discounted cash flow review is consistent with the brand review in its use of estimated future operating cash flows, weighted average cost of capital for the cash generating unit concerned and long term growth rates.

The tests are dependent on management estimates and judgements, in particular in relation to the forecasting of future cash flows, long term growth rates and the discount rate applied to these cash flows.

Post employment benefits Diageo accounts for post employment benefits in accordance with *IAS 19 Employee benefits.* Application of IAS 19 requires the exercise of judgement in relation to various assumptions including future pay rises in excess of inflation, employee and pensioner demographics and the future expected returns on assets.

Diageo determines the assumptions to be adopted in discussion with its actuaries, and believes these assumptions to be in line with UK practice generally, but the application of different assumptions could have a significant effect on the amounts reflected in the income statement, statement of recognised income and expense and balance sheet in respect of post employment benefits. The assumptions vary among the countries in which the group operates, and there may be an interdependency between some of the assumptions. The major assumptions used by the group for the two years ended 30 June 2006 are set out in note 4 to the consolidated financial statements. It would be impracticable to give the impact of the effect of changes in all of the assumptions used to calculate the post employment charges in the income statement, statement of recognised income and expense and balance sheet, but the following disclosures are provided to assist the reader in assessing the impact of changes in the more critical assumptions.

The finance income and charges included in the income statement for post employment benefits are partly calculated by assuming an estimated rate of return on the assets held by the post employment plans. For the year ended 30 June 2006, this was based on the assumption that equities would outperform fixed interest government bonds by three and a quarter percentage points. A one percentage point decrease in this assumption would have reduced profit before taxation by approximately £40 million.

The rates used to discount the liabilities of the post employment plans are determined by using rates of return on high quality corporate bonds of appropriate currency and term. A half a percentage point decrease in the discount rate assumption used to determine the income statement charge in the year ended 30 June 2006 would have reduced profit before taxation by approximately £8 million. A half a percentage

Operating and financial review (continued)

point decrease in the discount rate assumption used to determine the post employment liability at 30 June 2006 would have increased the liabilities before tax by approximately £400 million.

The net liability for post employment benefits is partly determined by the fair value at the end of the year of the assets owned by the post employment plans. A 10% movement in worldwide equity values would increase/decrease the net post employment liability before tax at 30 June 2006 by approximately £350 million.

The mortality assumptions used in the UK plan were reassessed in 2006 and are based on the recent mortality experience of the plan and allow for future improvements in life expectancy. For example, it is assumed that members who retire in 2026 at age 65 will live on average for a further 22 years if they are male and for a further 24 years if they are female. If assumed life expectancies had been one year greater, the charge to profit before taxation would have increased by approximately £14 million and the net post employment liability before tax would have increased by approximately £180 million.

Exceptional items The group presents certain items separately as exceptional . 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. The determination of which items are separately disclosed as exceptional items requires a significant degree of judgement. Exceptional items, as reported, do not represent extraordinary items under US GAAP.

Taxation The group is required to estimate the income tax in each of the jurisdictions in which it operates. This requires an estimation of the current tax liability together with an assessment of the temporary differences which arise as a consequence of different accounting and tax treatments. These temporary differences result in deferred tax assets or liabilities which are included within the balance sheet. Deferred tax assets and liabilities are measured using substantially enacted tax rates expected to apply when the temporary differences reverse.

The group operates in many countries in the world and is subject to many tax jurisdictions and rules. As a consequence the group is subject to tax audits, which by their nature are often complex and can require several years to conclude. Management judgement is required to determine the total provision for income tax. Amounts accrued are based on management s interpretation of country specific tax law and the likelihood of settlement. However the actual tax liabilities could differ from the provision and in such event the group would be required to make an adjustment in a subsequent period which could have a material impact on the group s profit and loss and/or cash position.

Tax benefits are not recognised unless it is probable that the tax positions are sustainable. Once considered to be probable, management reviews each material tax benefit to assess whether a provision should be taken against full recognition of the benefit on the basis of potential settlement through negotiation and/or litigation. Any interest on tax liabilities is provided for in the tax charge. Deferred tax assets are not recognised where it is more likely than not that the asset will not be realised in the future. This evaluation requires judgements to be made including the forecast of future taxable income.

Differences between IFRS and US GAAP

From 1 July 2004, Diageo has prepared its consolidated financial statements in accordance with IFRS which differs in certain respects from US GAAP.

IFRS 1 First-time adoption of International Financial Reporting Standards permits certain optional exemptions from full retrospective application of IFRS accounting policies and the options adopted by Diageo are summarised below together with an indication as to their impacts.

Operating and financial review (continued)

Business combinations Business combinations prior to the date of transition have not been restated on an IFRS basis. There are two main impacts of this approach.

The merger of GrandMet and the Guinness Group in the group s primary financial statements has been accounted for under merger accounting principles (pooling of interests), where the results, cash flows and balance sheets of both entities, having made adjustments to achieve uniformity of accounting policies, were aggregated with no adjustment to fair value. Under purchase accounting, the merger would have been accounted for as an acquisition of the Guinness Group by GrandMet. Under this scenario, the group would have recognised additional intangible assets relating mainly to the fair value on acquisition of acquired brands and an adjustment upwards to the fair value of inventories. These adjustments would have been offset by the recognition of related deferred tax liabilities. Goodwill would have arisen on the acquisition. The recognition of intangible assets and higher inventory values would have resulted in increased amortisation and an increase in the charge to cost of sales as the inventories are sold, net of effects of taxation. Under US GAAP, the merger has been accounted for as a purchase accounting acquisition of the Guinness Group by GrandMet.

The group has written off goodwill and other intangible assets acquired up to 30 June 1998, direct to reserves in the period when acquired. Under IFRS 3 all separately identifiable intangible assets are required to be capitalised in the balance sheet, with subsequent annual impairment tests. Under this scenario, net assets would increase in respect of the goodwill capitalised with no change to net income in the year ended 30 June 2006 or the comparative year. Under US GAAP, the goodwill was capitalised and further information in this respect can be found in the US GAAP financial information in note 35 to the consolidated financial statements.

Cumulative translation differences The cumulative translation difference arising on consolidation has been deemed to be zero at the date of transition.

Share-based payments Full retrospective application has been adopted. This option is available to the group because the fair value of applicable equity instruments granted was previously disclosed. As a result, all years presented have a charge in respect of share-based payments on the basis of full retrospective application.

Financial instruments The group has adopted the provisions of *IAS 39 Financial instruments: recognition and measurement* from 1 July 2005. Financial instruments in the year ended 30 June 2005 remain recorded in accordance with previous UK GAAP accounting policies, and the adjustment to IAS 39 is reflected in the balance sheet at 1 July 2005. Under IFRS, prior to the adoption of IAS 39 on 1 July 2005, changes in the fair value of interest rate derivatives and derivatives hedging forecast transactions were not recognised until realised. Since 1 July 2005, all such derivatives are carried at fair value at the balance sheet date. Under IFRS, prior to 1 July 2005, for derivatives hedging the translation of net assets of overseas operations in respect of foreign exchange differences arising on translation to closing rates, changes in their fair value were taken to the statement of recognised income and expense. The impact on net income for the year ended 30 June 2005 cannot be estimated reliably. The impact on net assets at 1 July 2005 was to increase net assets by £164 million.

Reconciliations between IFRS and US GAAP, and details of the impact of the differences between IFRS and US GAAP, are set out in note 35 to the consolidated financial statements.

Operating and financial review (continued)

New accounting standards

A number of IFRS interpretations have been issued by the IASB. Those that are of relevance to the group are discussed below:

IFRIC 4 Determining whether an arrangement contains a lease In December 2004, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 4, which is effective for periods beginning on or after 1 January 2006. The interpretation requires arrangements which may have the nature, but not the legal form, of a lease to be accounted for in accordance with *IAS 17 Leases*.

This interpretation is not expected to have a material effect on the results or net assets of the group.

IFRIC 7 Applying the restatement approach under IAS 29 Financial reporting in hyperinflationary economies In November 2005, the IFRIC issued IFRIC 7, which is effective for periods beginning on or after 1 March 2006. The interpretation provides guidance on how to apply the requirements of *IAS 29 Financial reporting in hyperinflationary economies* in a reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, when that economy was not hyperinflationary in the prior period, and the entity therefore restates its financial statements in accordance with IAS 29. The group will apply the guidance of the IFRIC as and when it is appropriate to do so.

IFRIC 8 Scope of IFRS 2 In January 2006, the IFRIC issued IFRIC 8, which is effective for periods beginning on or after 1 May 2006. IFRS 2 applies to the provision of goods or services (as well as shares) as consideration for equity instruments in the issuing entity. These goods or services should be measured in accordance with *IFRS 2 Share based payments* at the grant date unless cash in which case liability should be re-measured at reporting date. If not possible to specifically identify goods received, fair value of equity instruments granted should be used. The issue addressed in the interpretation is whether IFRS 2 applies to transactions in which the entity cannot identify specifically some or all of the goods or services received. This interpretation is not expected to have a material effect on the results or net assets of the group.

IFRIC 9 Reassessment of embedded derivatives In March 2006, the IFRIC issued IFRIC 9, which is effective for periods beginning on or after 1 June 2006. *IAS 39 Financial instruments: recognition and measurement* requires an entity to assess whether any embedded derivatives contained in a contract need to be separated and fair valued. IFRIC 9 requires this assessment to be carried out only when the entity first enters into the contract and not to be reassessed subsequently unless there is a change in terms in the contract that significantly modifies the cash flows. This interpretation is not expected to have a material effect on the results or net assets of the group.

IFRIC 10 Interim financial reporting and impairment In July 2006, the IFRIC issued IFRIC 10 which is effective for annual accounting periods beginning on or after 1 November 2006. The interpretation addresses the interaction between the requirements of *IAS 34 Interim reporting* and the recognition of impairment losses on goodwill in IAS 36 and certain financial assets in IAS 39, and the effect of that interaction on subsequent interim and annual financial statements. The group will apply the interpretation of the IFRIC in respect of future interim reporting periods.

The following US GAAP standards and pronouncements have recently been issued:

SFAS No. 154 Accounting Changes and Error Corrections In May 2005, the FASB issued SFAS No. 154. This statement replaces *APB Opinion No. 20 Accounting Changes (APB 20) and SFAS No. 3 Reporting Accounting Changes in Interim Financial Statements.* APB 20 previously required that most voluntary changes in accounting principle be recognised by including, in net income of the period of the

Operating and financial review (continued)

change, the cumulative effect of changing to the new accounting principle. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in financial years beginning after 15 December 2005. The group cannot determine the impact of the adoption of SFAS No. 154 as it depends in part upon future changes to US accounting principles.

SFAS No. 155 Accounting for Certain Hybrid Financial Instruments (an amendment of FASB Statement Nos. 133 and 140) In February 2006, the FASB issued SFAS No. 155. This statement provides a fair value measurement option for certain hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation, and requires that beneficial interests in securitised financial assets be analysed to determine whether they are free standing derivatives or whether they are hybrid instruments that contain embedded derivatives requiring bifurcation. SFAS No. 155 is effective for financial years beginning after 15 September 2006. The adoption of SFAS No. 155 is not expected to have a material effect on the results or net assets of the group.

FIN 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48). This interpretation clarifies the accounting for uncertainty in income taxes recognised in an enterprise s financial statements in accordance with *FASB Statement No. 109 Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for financial years beginning after 15 December 2006. The group is currently assessing the impact of FIN 48 on the results and net assets of the group.

EITF 05-5 Accounting for Early Retirement or Postemployment Programs with Specific Features (such as terms specified in Altersteilzeit Early Retirement Arrangements) In June 2005, the FASB issued EITF 05-5 which provides guidance on how to account for specific features of early retirement programmes. It is effective for accounting periods beginning after 15 December 2005 and the application of EITF 05-5 is not expected to have a material effect on the results or net assets of the group.

EITF 04-13 Accounting for Purchases and Sales of Inventory with the Same Counterparty In September 2005, the FASB issued EITF 04-13 which provides guidance on how to account for two or more inventory purchase and sales transactions with the same counterparty and addresses circumstances under which non-monetary exchanges of inventory within the same line of business should be recognised at fair value. It is effective for new arrangements entered into, and modifications or renewals of existing arrangements beginning, in the first interim or annual reporting period beginning after 15 March 2006. The application of EITF 04-13 is not expected to have a material effect on the results or net assets of the group.

FSP FAS 123(R)-4 Classification of Options and Similar Instruments Issued as Employee Compensation that Allow for Cash Settlement upon the Occurrence of a Contingent Event In February 2006, the FASB issued FASB Staff Position FAS 123(R)-4. This position addresses the classification of options and similar instruments issued as employee compensation that allow for cash settlement upon the occurrence of a contingent event. The guidance in this FSP amends paragraphs 32 and A229 of SFAS No. 123 (revised 2004) Share-Based Payment. It is effective for accounting periods beginning after 3 February 2006 and is not expected to have a material effect on the results or net assets of the group.

Operating and financial review (continued)

FSP FIN 46(R)-6 Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R) In April 2006, the FASB issued FASB Staff Position FIN 46(R)-6. This position addresses how a reporting enterprise should determine the variability to be considered in applying *FASB Interpretation No. 46 (revised December 2003) Consolidation of Variable Interest Entities*. The variability that is considered in applying FIN 46(R) affects the determination of: (a) whether the entity is a variable interest entity (VIE); (b) which interests are variable interests in the entity; and (c) which party, if any, is the primary beneficiary of the VIE. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary. It is effective for all entities (including newly created entities) with which that enterprise first becomes involved, and to all entities previously required to be analysed under FIN 46(R) when a reconsideration event has occurred, starting from the first day of the first reporting period beginning after 15 June 2006. It is not expected to have a material effect on the results or net assets of the group.

Other recent accounting pronouncements issued by the FASB (including the Emerging Issues Task Force), the AICPA and the SEC are not believed by management to have a material impact on Diageo s present or future consolidated financial statements.

Directors and senior management

	Age	Nationality	Position (committees)
Directors			
Lord Blyth of Rowington	66	British	Chairman, non-executive director(3)*
Paul S Walsh	51	British	Chief executive, executive director(2)*
Nicholas C Rose	48	British	Chief financial officer, executive director(2)
Lord Hollick of Notting Hill	61	British	Senior non-executive director(1),(3),(4)*
Laurence Danon	50	French	Non-executive director(1),(3),(4)
Dr Franz B Humer	60	Swiss/Austrian	Non-executive director(1),(3),(4)
Maria Lilja	62	Swedish	Non-executive director(1),(3),(4)
William S Shanahan	66	American	Non-executive director(1),(3),(4)
H Todd Stitzer	54	American	Non-executive director(1),(3),(4)
Jonathan R Symonds	47	British	Non-executive director(1)*(3),(4)
Paul A Walker	49	British	Non-executive director(1),(3),(4)
Senior management			
Stuart R Fletcher	49	British	President, Diageo International(2)
James N D Grover	48	British	Global business support director(2)
Robert M Malcolm	54	American	President, global marketing, sales and innovation(2)
Ivan M Menezes	47	American	President, Diageo North America(2)
Andrew Morgan	50	British	President, Diageo Europe(2)
Timothy D Proctor	56	American/British	General counsel(2)
Gareth Williams	53	British	Human resources director(2)
Officer			
Susanne Bunn	47	British	Company secretary

Key to committees:

1. Audit
2. Executive (comprising senior management)
3. Nomination
4. Remuneration

* Chairman

Laurence Danon was appointed a non-executive director on 1 January 2006.

Information in respect of the directors and senior management is set out below:

Lord (James) Blyth of Rowington retired as chairman of The Boots Company PLC at the end of July 2000, having joined in 1987 as chief executive and become chairman in 1998. He was formerly group chief executive of the Plessey Company and head of Defence Sales at the Ministry of Defence. He was appointed a non-executive director of Diageo plc in January 1999 and chairman in July 2000. He is also a non-executive director of Anixter Inc in the United States, and a vice chairman of Greenhill & Co Inc.

Paul Walsh joined GrandMet s brewing division in 1982 and became its finance director in 1986. He held financial positions with Inter-Continental Hotels and the GrandMet Food Sector (encompassing GrandMet s worldwide packaged food and Burger King businesses) from 1987 to 1989 and was appointed division chief executive of Pillsbury in 1990, becoming chief executive officer of The Pillsbury Company in 1992. He was appointed to the GrandMet board in October 1995 and to the Diageo plc board in

Directors and senior management (continued)

December 1997. He became chief operating officer of Diageo plc in January 2000 and chief executive in September 2000. He is also a non-executive director of Centrica plc, a governor of Henley Management Centre and a non-executive director of FedEx Corporation in the United States.

Nicholas (Nick) Rose joined GrandMet in June 1992, initially as group treasurer, and became group controller in 1995. He was appointed finance director of International Distillers & Vintners in 1996 and became finance director of United Distillers & Vintners in December 1997. He was appointed to the Diageo plc board in June 1999 and became chief financial officer in July 1999. On 6 July 2005 he was appointed a member of the Main Committee of the 100 Group of Finance Directors. He is also a non-executive director of Scottish Power plc.

Lord (Clive) Hollick of Notting Hill is a partner of Kohlberg Kravis Roberts. He is also a founding trustee of the Institute of Public Policy Research, chairman of London s South Bank Centre and a non-executive director of South Bank Foundation Limited and, in the United States, Honeywell International Inc. He was formerly chief executive of United Business Media p.l.c. and a non-executive director of Channel 5 Television Limited, Logica plc, BAe Systems plc, TRW Inc and the London School of Economics. He was appointed a non-executive director of Diageo plc in December 2001 and was appointed senior non-executive director and chairman of the remuneration committee in September 2004.

Laurence Danon is chairman and chief executive officer of France Printemps. Formerly, she served with the French Ministry of Industry and Energy from 1984 to 1989 and held a number of senior management posts with Total Fina Elf from 1989 to 2001, prior to being appointed to her current office in April 2001. Ms Danon is also a non-executive director of Plastic Omnium in France. She was appointed a non-executive director of Diageo plc on 1 January 2006 and will seek election at this year s AGM.

Dr Franz Humer is chairman and chief executive of F. Hoffmann-La Roche Ltd, having previously been chief operating officer and head of the Pharmaceuticals Division. He is also a non-executive director of Allianz Versicherungs AG in Germany, chairman of the European Federation of Pharmaceutical Industries and Associations (EFPIA), chairman of the Friends of Phelophepa Foundation in Switzerland, a board member of Salzburg University, a board member of the Project Hope charity and a board member of Chugai in Japan. He was formerly chief operating director of Glaxo Holdings plc, a non-executive director of Cadbury Schweppes Public Limited Company and a non-executive director of Genentech in the United States. He was appointed a non-executive director of Diageo plc in April 2005.

Maria Lilja played a leading role in building Nyman & Schultz, a long-established Scandinavian travel management company, which was acquired by American Express in 1993. She served as head of American Express Europe from 1996 to 2000. She is a non-executive director of Observer AB and was formerly non-executive chairman of Mandator AB and a non-executive director of Bilia AB, Intrum Justitia AB and Poolia AB, all in Sweden. She was appointed a non-executive director of Diageo plc in November 1999.

William (Bill) Shanahan retired as president of The Colgate-Palmolive Company on 30 September 2005, having served with the company since 1965. On 7 April 2006 he was appointed a non-executive director of MSD Ignition, Inc. in the United States. He was appointed a non-executive director of Diageo plc in May 1999.

H Todd Stitzer is chief executive of Cadbury Schweppes Public Limited Company. He joined Cadbury Schweppes in 1983 as an assistant general counsel and subsequently held a number of marketing, sales, strategy and general management posts prior to being appointed to his current role in May 2003. He was appointed a non-executive director of Diageo plc in June 2004.

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Directors and senior management (continued)

Jonathan (Jon) Symonds is chief financial officer of AstraZeneca PLC. He is also joint chairman of the Business Tax Forum and a member of the Main Committee of the 100 Group of Finance Directors (of which he was formerly chairman). Prior to joining AstraZeneca in 1997, he was a partner at KPMG. He was appointed a non-executive director of Diageo plc in May 2004 and was appointed chairman of the audit committee in October 2004.

Paul Walker is chief executive of The Sage Group plc. He joined Sage in 1984 and was appointed finance director in 1987, then group chief executive in 1994. He was formerly a non-executive director of MyTravel Group plc. He was appointed a non-executive director of Diageo plc in June 2002.

Stuart Fletcher was appointed president, International in October 2004, having been president, Key Markets since September 2000. He joined Guinness PLC in 1986 as deputy controller of Guinness Brewing Worldwide and was appointed controller in 1987. He previously held a number of financial positions with Procter & Gamble in the United Kingdom, both in consumer goods and industrial products, and with United Glass. In 1988 he became finance and operations director, United Distillers Japan and in 1990 chief financial officer of Schenley Inc. In 1993 he was appointed regional finance director for United Distillers Asia Pacific Region and was made acting regional managing director for United Distillers Pacific Region in January 1995. In August 1995 he became finance director of Guinness Brewing Worldwide and then served as president of Guinness Americas and Caribbean region based in the United States before becoming managing director of Developing and Seed Markets for Guinness Limited in June 1999.

James (Jim) Grover was appointed global business support director in February 2004, having been strategy director since December 1997. He joined GrandMet in 1993, initially as the strategic development director of GrandMet Food Sector (encompassing GrandMet s worldwide packaged food and Burger King businesses), and subsequently, strategic development director of The Pillsbury Company. He was appointed group strategy director of GrandMet in March 1997. Previously he worked as a management consultant, initially with Booz-Allen & Hamilton Inc and subsequently with OC&C Strategy Consultants. He was the partner responsible for their consumer goods practice at OC&C and advised a broad array of multi-national food companies on a wide variety of strategic issues.

Robert (Rob) Malcolm was appointed president, global marketing, sales and innovation in September 2000. He joined United Distillers & Vintners as Scotch category director in 1999 and was appointed global marketing director later that year. Previously, he held various marketing positions with Procter & Gamble in the United States from 1975 until his appointment in 1988 as vice president and general manager, Personal Cleansing Products, USA and in 1992 as vice president and general manager for the Arabian Peninsula. From 1995 to 1999 he was vice president, general manager, Beverages, Europe Middle East Africa.

Ivan Menezes was appointed president, North America in January 2004, having been chief operating officer, North America since July 2002. He previously served as both managing director and then president, Venture Markets of Guinness United Distillers & Vintners. Before these appointments, he served as global marketing director for United Distillers & Vintners in the United Kingdom from September 1998 and as group integration director for Diageo plc from May 1997. Previously he worked across a variety of sales, marketing and strategy roles with Nestlé in Asia, Booz-Allen & Hamilton Inc in North America and Whirlpool in Europe. He is also a non-executive director of Coach Inc in the United States.

Andrew Morgan was appointed president, Europe in October 2004, having been president, Venture Markets since July 2002. He joined United Distillers in 1987 and held various positions in Europe regions,

Directors and senior management (continued)

including general manager, Greece and regional director for Southern Europe. He was appointed United Distillers, managing director of International Region in January 1995 and United Distillers & Vintners, regional managing director, International in 1997. He was appointed group chief information officer and president, New Business Ventures for Guinness United Distillers & Vintners in September 2000 having previously been director, global strategy and innovation for United Distillers & Vintners.

Timothy (Tim) Proctor was appointed general counsel of Diageo plc in January 2000, having been director, worldwide human resources of Glaxo Wellcome since 1998. Prior to this, he was senior vice president, human resources, general counsel and secretary for Glaxo s US operating company. He has over 20 years international legal experience, including 13 years with Merck and six years with Glaxo Wellcome.

Gareth Williams was appointed human resources director in January 1999. He joined the GrandMet Brewing Division in 1984 and moved through a number of personnel positions to become director of management development and resourcing for the division in 1987. From 1990 to 1994 he held a series of human resources positions in International Distillers & Vintners North American spirits and wine division, before returning to the United Kingdom to become group organisation and management development director of GrandMet. In 1996 he became human resources director for International Distillers & Vintners global business and in January 1998 took the same title in United Distillers & Vintners, following the merger of Guinness and GrandMet. Prior to joining GrandMet, he spent 10 years with Ford of Britain in a number of personnel and employee relations positions.

Susanne Bunn was appointed company secretary of Diageo plc in March 2003. She joined the group in February 1989 as assistant secretary in the GrandMet UK Foods division and since then has held various company secretarial positions within the group. She was appointed joint deputy secretary in December 1997 and became sole deputy secretary at the end of 2000.

Directors remuneration report

Dear shareholder

Since the introduction of the current executive remuneration policy in 2004, the remuneration committee has conducted regular reviews to ensure that the policy remains appropriate for both the company and shareholders. Our current policy continues to be based upon our wish to attract and retain the best global talent to deliver Diageo s strategy within a framework of good corporate governance. The key principles of the policy, which are interdependent, are:

- Our senior executive remuneration arrangements are intended to attract and retain the best global talent.
- We believe that pay should vary significantly with performance over both the short and long term.
- Our base salaries are generally set around the median of the relevant market for each role. In exceptional circumstances, base salaries may be positioned above the median if justified by the requirement to recruit or retain key executives.
- Annual bonuses are paid in cash after the end of each financial year and are determined by performance in the year against pre-set stretching business targets.
- Our long term incentives comprise a combination of share option grants and share awards in each year, and vary with three year EPS and TSR performance respectively.
- Our senior executives are required to hold shares in Diageo to participate fully in our share option and share award plans.

As a result of this year s review, the remuneration committee has carefully considered the existing executive remuneration policy and concluded that it remains appropriate, however, its application has been modified in three areas to ensure that we continue to support our stated principles.

Annual performance bonus

- Toward the end of calendar year 2005, the remuneration committee engaged independent remuneration consultants to undertake a survey of bonus scheme practices in other large companies to ensure our annual bonus scheme continued to provide relevant and stretching performance targets and measures, incentivise year on year delivery of short term performance goals and reflect current best practice. As a result of the review, the remuneration committee made a change to the profit measures used to determine annual performance bonuses, moving from profit before exceptional items and tax (PBET) only to a combination of PBET and net sales from 1 July 2006 whilst maintaining the overall proportion of profit measures of 70%.

Service contracts

- During the financial year, the service contracts for the executive directors were amended. As before, they will require 12 months notice to be given on termination. If a termination payment becomes due under the new service contracts, the remuneration committee may exercise its discretion to require half of the termination payment to be paid in monthly instalments and, upon the executive commencing new employment, to be subject to mitigation. If the board determines that the executive has failed to perform his duties competently, the remuneration committee may exercise its discretion to reduce the termination payment on the grounds of poor performance.

Directors remuneration report (continued)

Pensions

- In 2005, Diageo reviewed its UK pension strategy and as a consequence of this review, additional pension contributions were introduced for all employees. The executive directors are now required to pay contributions of 2% of pensionable pay with effect from April 2006 rising to 4% from April 2007 and 6% from April 2008 onwards.

- As a result of the changes affecting the taxation and limits on pensions introduced by the Finance Act 2004 Diageo has offered its employees whose benefits exceed the Lifetime Allowance (LTA) the option of having benefits in excess of this LTA paid from an unfunded non-registered arrangement. No compensation payments have been paid to employees for the change in taxation treatment of pensions. Further details regarding the revision of these arrangements for executive directors are provided in the body of the report.

I am confident that the committee s approach and the current executive remuneration policy aligns our executive remuneration with the interests of our shareholders as well as appropriately motivating and rewarding the highly talented and committed team that is leading this company.

Lord Hollick of Notting Hill

Senior non-executive director and chairman of the remuneration committee

Directors   remuneration report (continued)

What this report covers

This report to shareholders for the year ended 30 June 2006 covers:

- the policy under which executive and non-executive directors are remunerated; and
- tables of information showing details of the remuneration and share interests of all the directors.

The report was approved by the remuneration committee, which is a duly appointed and authorised committee of the board of directors, on 29 August 2006 and was signed on its behalf by Lord Hollick who is senior non-executive director and chairman of the remuneration committee. As required by The Directors   Remuneration Report Regulations 2002 (the Regulations), this report will be subject to an advisory shareholder vote at the Annual General Meeting.

The board has followed and complied with the requirements of the Companies Act (in particular, Schedule 7A of the Regulations) and section 1 of the Combined Code on Corporate Governance in preparing this report and in designing performance-related remuneration for senior executives. KPMG Audit Plc has audited the report to the extent required by the Regulations, being the sections headed   Directors   remuneration for the year ended 30 June 2006 ,   Long term incentive plans   and   Executive directors   pension benefits . Terms defined in this remuneration report are used solely herein.

The remuneration committee

The remuneration committee is responsible for making recommendations to the board on remuneration policy as applied to Diageo s senior executives, being the executive directors and the executive committee. The remuneration committee consists of all the independent non-executive directors: LM Danon (from 1 January 2006), Lord Hollick, Dr FB Humer, M Lilja, WS Shanahan, HT Stitzer, JR Symonds and PA Walker. Lord Hollick is chairman of the remuneration committee. The chairman of the board and the chief executive may, by invitation, attend remuneration committee meetings except when their own remuneration is discussed. Further information on meetings held and director attendance is disclosed in the corporate governance report. The remuneration committee s terms of reference are available at www.diageo.com and on request from the company secretary.

Advice

During the year ended 30 June 2006, Diageo s human resources director and director of performance and reward were invited by the remuneration committee to provide their views and advice. The remuneration committee also appointed the following independent and expert consultants:

- Deloitte & Touche LLP   who provided external market data on levels of senior executive remuneration. They also provide HR systems, accountancy and personal tax services to Diageo, including services to support the process for assessing risk management, control systems and processes.
- Kepler Associates   who reviewed and confirmed the total shareholder return of Diageo and the peer group companies for the 2003 TSR plan (the performance cycle which ended on 31 December 2005), and provided a monthly performance update on all outstanding performance cycles. They provided no other services to Diageo during the year.

Additional remuneration survey data published by Hewitt Associates, Monks Partnership, Towers Perrin and Watson Wyatt was presented to the committee during the year.

Directors remuneration report (continued)

Remuneration philosophy

Diageo s remuneration philosophy for senior executives is based on a belief in:

- Performance-related remuneration; it influences and supports performance and the creation of a high performing organisation.
- Rewarding sustainable performance; it is at the heart of Diageo s corporate strategy and is vital to meeting investors goals.
- Measuring performance over three years; it aligns with the time cycle over which management decisions are reflected in the creation of value in this business.
- Providing a balanced mix of remuneration; base salary, benefits, short term cash incentives, longer term equity incentives and pension.
- Providing a competitive total remuneration opportunity; it helps Diageo compete for the best talent among companies with global operations and global consumers.
- Simplicity and transparency.

The board of directors continues to set stretching performance targets for the business and its leaders in the context of the prevailing economic climate. To achieve these stretching targets requires exceptional business management and strategic execution to deliver performance. This approach to target setting reflects the aspirational performance environment that Diageo wishes to create.

In Diageo, annual incentive plans aim to reward the delivery of short term performance goals with commensurate levels of remuneration. Long term incentive plans aim to reward long term sustained performance. Under both sets of plans, if the stretching targets are achieved, high levels of reward may be earned. All incentives are capped to ensure that inappropriate business risk taking is neither encouraged nor rewarded.

Detailed remuneration policy for executive directors

Remuneration	Purpose	Delivery	Detailed policy
Base salary	• reflect the value of the individual and their role • reflect skills and experience	• cash • monthly • pensionable	• reviewed annually with changes usually taking effect from 1 October • benchmarked against the top 30 companies in the FTSE 100 with an international focus excluding financial services businesses • positioned appropriately against the relevant comparator group for each role

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Directors remuneration report (continued)

Annual performance bonus	• incentivise year on year delivery of short term performance goals	• performance-related • cash • annual payment • non-pensionable	• entirely based on Diageo s overall financial performance • at least 70% based on profit measures • targets set by reference to annual operating plan • up to 100% of salary can be earned for on target performance with a maximum of 200% of salary payable for outstanding performance
Share options (SESOP)	• incentivise three year real earnings growth above a minimum threshold • provide focus on increasing Diageo s share price over the medium to longer term	• share options with an exercise price set at the market value on date of grant • value subject to meeting financial performance targets and the share price increasing above the grant value • long term incentive • discretionary annual grant	• maximum annual grant of 375% of salary • EPS performance test operates on a sliding scale • re-test facility removed for options granted from October 2004
Share awards (TSR plan)	• incentivise three year total shareholder return relative to a selected peer group of companies • provide focus on delivering superior returns to shareholders	• shares • highly variable due to vesting schedule • long term incentive • discretionary annual award	• maximum annual initial award of 250% of salary • TSR performance test against a peer group of companies • none of the award vests for performance below median with a sliding scale applied to improvements in the ranking above median • for outstanding

performance, achieving first or second position, 150% of the initial award vests

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Directors remuneration report (continued)

Pension	• provide competitive post-retirement compensation and benefits	• deferred income • payable on retirement in the form of a monthly pension with the option to take part as a lump sum	• pension accrues at 1⁄30 of annual base salary • maximum pension payable will not exceed 2⁄3 of final remuneration minus retained benefits • normal retirement age (NRA) of 62 • pension at NRA will not be less than 2⁄3of base salary in prior 12 months • from 1 April 2006, employee contributions by executive directors of 2% pa, rising to 6% pa by 1 April 2008 • subject to election, benefits in excess of the LTA are provided through an unfunded non-registered arrangement • no compensation payments paid as a result of changes to taxation of pensions from April 2006

The balance between fixed and variable elements of remuneration changes with performance. The anticipated normal mix between fixed and variable remuneration is that for £100 of remuneration earned, £32 will be fixed remuneration and £68 will be performance-related remuneration, excluding pensions and other benefits. In some years, the performance-related remuneration may be higher or lower depending on the performance of the business.

Share ownership

Senior executives are required to hold shares in Diageo to participate fully in the share option and share award plans. This policy extends to the top 80 senior leaders and reflects Diageo s belief that its most senior leaders should also be shareholders. Individuals have three years to build up their shareholding from their own resources. On 1 January 2006 the executive directors met the requirement by each holding company shares equivalent to at least 225% of their base salary.

The senior executives are eligible to participate in the broad-based share and option plans Diageo operates for its employees. These are the tax approved share incentive plan and savings-related share option scheme in the United Kingdom.

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Directors remuneration report (continued)

Service contracts

The executive directors have service contracts which provide for six months notice by the director or 12 months notice by the company and contain non-compete obligations. In the event of early termination by the company without cause, the agreements provide for a termination payment to be paid, equivalent to 12 months base salary for the notice period and an equal amount in respect of all benefits. The remuneration committee may exercise its discretion to require half of the termination payment to be paid in monthly instalments and, upon the executive commencing new employment, to be subject to mitigation. If the board determines that the executive has failed to perform his duties competently, the remuneration committee may exercise its discretion to reduce the termination payment on the grounds of poor performance. PS Walsh s service contract with the company is dated 1 November 2005. NC Rose s service contract with the company is dated 14 February 2006.

External appointments

With the specific approval of the board in each case, executive directors may accept external appointments as non-executive directors of other companies and retain any related fees paid to them.

During the year ended 30 June 2006, PS Walsh served as a non-executive director of Centrica plc and of FedEx Corporation and retained the fees paid to him for his services. The total amounts of such fees paid to him in the year ended 30 June 2006 were £50,000 and $80,062, respectively. In line with the FedEx Corporation policy for outside directors, PS Walsh is eligible to be granted share options. During the year ended 30 June 2006, he was granted 5,400 options at an option price of $83.73. PS Walsh exercised 4,000 options that were granted at an option price of $35.94. Of these, 2,600 were sold at $101.73 per share, 900 were sold at $101.81 per share and 500 were retained. The fair market value on the date of exercise was $98.28.

NC Rose served as a non-executive director of Scottish Power plc during the year ended 30 June 2006 and retained the fees paid to him for this service. The total fees paid to him in the year ended 30 June 2006 were £60,400.

Chairman s terms, conditions and fees

The chairman had a letter of appointment for an initial five year term from 1 July 2000. As previously disclosed, this has been extended by the board to 30 June 2007. It is terminable on six months notice by either party or, if terminated by the company, by payment of six months fees in lieu of notice.

Diageo s policy on chairman s fees is as follows:

- the fees should be sufficient to attract, motivate and retain world-class talent;
- fee practice should be consistent with recognised best practice standards for the position of chairman;
- the chairman should not participate in any of the company s incentive plans; and
- part of the chairman s fees shall be paid in Diageo shares.

The fees of the chairman are normally reviewed every two years and any changes would normally take effect from 1 January. Fees are reviewed in the light of market practice in large UK companies and anticipated workload, tasks and liabilities. The last review of the chairman s fees was effective

Directors remuneration report (continued)

from 1 January 2005 and in accordance with the company s stated policy, the next review is due to be undertaken later this year with any changes taking effect from 1 January 2007.

Non-executive director terms, conditions and fees

The non-executive directors have letters of appointment. A summary of their terms and conditions of appointment is available at www.diageo.com

Diageo s policy on non-executive director fees is as follows:

- the fees should be sufficient to attract, motivate and retain world-class non-executive talent within the limits set by the shareholders from time to time;
- fee practice should be consistent with recognised best practice standards for non-executive directors; and
- non-executive directors should not participate in any of the company s incentive plans.

The fees of non-executive directors are normally reviewed every two years and any changes would normally take effect from 1 January. Fees are reviewed in the light of market practice in large UK companies and anticipated workload, tasks and liabilities. The last review of the non-executive directors fees was effective from 1 January 2005 and in accordance with the company s stated policy, the next review is due to be undertaken later this year with any changes taking effect from 1 January 2007.

The current annual non-executive directors fees are:		
Base fee	£	60,000
Senior non-executive director	£	20,000
Chairman of audit committee	£	20,000
Chairman of remuneration committee	£	10,000

In addition, an allowance of £3,000 is payable each time an overseas based non-executive director is required to travel to attend board and committee meetings to reflect the additional time commitment involved.

Directors remuneration report (continued)

Directors remuneration for the year ended 30 June 2006

Emoluments	2006 Base salary(b) £000	Annual performance bonus(c) £000	Share incentive plan £000	Other benefits(d) £000	Total £000	2005 Total £000
Chairman fees						
Lord Blyth(a)	**500**			**45**	**545**	532
Executive directors						
NC Rose	**559**	**798**	**3**	**32**	**1,392**	1,341
PS Walsh	**975**	**1,386**	**3**	**42**	**2,406**	2,343
	1,534	**2,184**	**6**	**74**	**3,798**	3,684
Non-executive directors fees						
LM Danon (appointed 1 January 2006)	**36**				**36**	
Lord Hollick	**90**			**1**	**91**	81
Dr FB Humer	**78**			**1**	**79**	19
M Lilja	**81**			**1**	**82**	68
WS Shanahan	**75**			**1**	**76**	65
HT Stitzer	**60**			**1**	**61**	57
JR Symonds	**80**			**1**	**81**	70
PA Walker	**60**			**1**	**61**	56
Former non-executive directors fees						
RF Chase (retired 20 October 2004)						31
JK Oates (retired 20 October 2004)						22
	560			**7**	**567**	469
Total	**2,594**	**2,184**	**6**	**126**	**4,910**	4,685

Notes

(a) £200,000 (30 June 2005 £175,000) of Lord Blyth s remuneration in the year ended 30 June 2006 must be used for monthly purchases of Diageo ordinary shares, which have to be retained until he retires from the company or ceases to be a director for any other reason.

(b) As at 30 June 2006 the annual salary payable to the chief executive was £990,000 and to the chief financial officer was £570,000. In the financial years ended 30 June 2006 and 30 June 2005, the percentage increases in base salary of the chief executive were 8% and 10% respectively, with an average increase over the two years of 9%. In the financial years ended 30 June 2006 and 30 June 2005, the percentage increases in the base salary of the chief financial officer were 9% and 8% respectively, with an average increase over the two years of 9%. These average increases are comparable with those made in companies in the pay benchmarking comparator group for these roles.

(c) The business results for the year ended 30 June 2006 are described in the operating and financial review and the level of the executive directors annual bonus payments are commensurate with this level of performance delivery.

(d) Other benefits may include company car and driver, fuel, product allowance, financial counselling, accompaniment by spouse on business travel when appropriate, medical insurance and life insurance premiums.

Directors remuneration report (continued)

Long term incentive plans payment and gains for the year ended 30 June 2006

In addition to the above emoluments, in the year the executive directors received payments and made gains under long term incentive plans as follows:

	2006				2005
	2003 TSR plan £000	Executive share option exercises £000	SEPSOS(a) £000	Total £000	Total £000
Executive directors					
NC Rose	**465**	**505**		**970**	1,527
PS Walsh	**808**	**934**	**9**	**1,751**	1,568
Total	**1,273**	**1,439**	**9**	**2,721**	3,095

(a) The Senior Executive Phantom Share Option Scheme (SEPSOS) operated within GrandMet as a share price related bonus scheme and the last grants under it were made in 1996. All remaining phantom options under SEPSOS were exercised in the previous financial year and a final payment was made to PS Walsh in November 2005.

Long term incentive plans (LTIPs)

A review of executive share incentive schemes was conducted during the year and the committee remains satisfied that existing arrangements remain appropriate for both the company and shareholders whilst providing consistency of approach and stability over the longer term.

Annual awards of LTIPs are granted under both the total shareholder return plan (TSR plan) and the senior executive share option plan (SESOP). The level of award is considered each year in light of performance and the regular review of the performance measures and the vesting schedule used in each plan ensures that the LTIPs continue to support the business objectives and are in line with current best practice.

TSR plan Under this plan, at the discretion of the remuneration committee, participants are granted a conditional right to receive shares. All conditional rights awarded vest after a three year period the performance cycle subject to achievement of two performance tests. The primary performance test is a comparison of Diageo s three year total shareholder return the percentage growth in Diageo s share price (assuming all dividends and capital distributions are reinvested) with the TSR of a peer group of 17 other companies. TSR calculations are converted to a common currency (US dollars). The second performance test requires that the remuneration committee does not recommend the release of awards unless it considers that there has been an underlying improvement in Diageo s three year financial performance, typically measured by an adjusted earnings per share measure (EPS).

For awards made before July 2005 the performance cycles began on 1 January each year. For awards made after July 2005 the performance cycle begins on 1 July each year. For the performance cycles 1 January 2003 to 31 December 2005 and 1 January 2004 to 31 December 2006, the peer group consists of Altria, Anheuser-Busch, Campbell Soup, Carlsberg, Coca-Cola, Colgate-Palmolive, Heineken, Heinz, Inbev, Kelloggs, McDonald s, Nestlé, PepsiCo, Pernod Ricard, Procter & Gamble, Unilever and Yum! Brands. There are no reserve companies remaining for the 2003 or 2004 plans.

For performance cycles from 1 January 2005, the peer group consists of Anheuser-Busch, Brown Forman, Cadbury Schweppes, Carlsberg, Coca-Cola, Colgate-Palmolive, Groupe Danone, Heineken,

Directors remuneration report (continued)

Heinz, Inbev, Nestlé, PepsiCo, Pernod Ricard, Procter & Gamble, SAB Miller, Scottish & Newcastle and Unilever. The reserve company is L Oréal.

The following table shows the percentage of the award that will normally be released at the end of the performance cycle:

	2005	2007 and subsequent performance cycles						
Ranking in peer group	1-2	3	4	5	6	7	8	9	10-18
% of award released	150	142	114	94	83	72	61	35 *	nil

* For the Jan 04 - Dec 06 performance cycle the level of vesting is 50% of the initial award.

Directors interests in TSR plan awards The following table shows the directors interests in the TSR plan. Details of executive share options are shown separately below.

	Date of award	Interests at 30 June 2005 Target award(a)	Maximum award(b)	Awards made during year Target award(a)	Maximum award(b)	Awards released during year Number(c)	Price in pence(d)	Interests at 30 June 2006(e)	Performance cycle(f)
NC Rose	21 Feb 03	**86,574**	**129,861**			**52,896**	**878**		**Jan 03 Dec 05**
	20 Feb 04	**106,661**	**159,991**					**159,991**	**Jan 04 Dec 06**
	18 Feb 05(g)	**72,816**	**109,224**					**109,224**	**Jan 05 Dec 07**
	2 Sep 05(h)			**154,237**	**231,356**			**231,356**	**Jul 05 Jun 08**
		266,051	**399,076**	**154,237**	**231,356**	**52,896**		**500,571**	
PS Walsh	21 Feb 03	**150,564**	**225,846**			**91,994**	**878**		**Jan 03 Dec 05**
	20 Feb 04	**186,377**	**279,565**					**279,565**	**Jan 04 Dec 06**
	18 Feb 05(g)	**161,234**	**241,851**					**241,851**	**Jan 05 Dec 07**
	2 Sep 05(h)			**334,858**	**502,287**			**502,287**	**Jul 05 Jun 08**
		498,175	**747,262**	**334,858**	**502,287**	**91,994**		**1,023,703**	

Notes

(a) This is the number of shares initially awarded. For the 2003 and 2004 plan cycles, 50%, and for plan cycles from 2005 onwards, 35%, of this number of shares would be released for achieving position nine in the peer group. No shares would be released for achievement of position 10 or below.

(b) This number reflects that 150% of the number of shares initially awarded would be released for achieving position one or two in the peer group.

(c) The three year performance cycle for the 2003 TSR award ended on 31 December 2005. The number of shares released was 61.1% of the initial award. This was based on a relative TSR ranking of position eight in the peer group at the end of the performance cycle. Kepler Associates independently verified the TSR increase and ranking. The remuneration committee reviewed and confirmed Diageo s EPS growth over the performance cycle exceeded the growth in the UK Retail Prices Index (RPI) over the same period and determined this represented an underlying improvement in financial performance that permitted the release of the awards.

(d) The price on 17 February 2006, the release date. The market price was 624 pence when the award was made on 21 February 2003.

(e) The directors interests at 14 August 2006 were the same as at 30 June 2006.

(f) For performance cycles ending on 31 December 2006 and 31 December 2007, the remuneration committee will normally approve the release of awards in the February following the end of the performance cycle. For awards made with effect from July 2005, the remuneration committee will normally approve their release in the August following the end of the relevant performance cycle.

(g) The timing of awards under the TSR plan was aligned with the financial year in 2004. To effect this transition, awards granted on 18 February 2005 were a one-off half size award with a performance cycle that began on 1 January 2005.

(h) The market price on 2 September 2005, the award date, was 815 pence.

Senior executive share option plan (SESOP) Options granted under SESOP cannot normally be exercised unless a performance condition is satisfied. The current performance condition is based on the increase in Diageo s EPS over a three year period. If the increase in this EPS measure is at least 15 percentage points greater than the increase in the RPI over the same period, then all the options can be exercised. If the increase in this EPS measure is at least 12 percentage points greater than that of the RPI

Directors remuneration report (continued)

but less than 15 percentage points, half of the options can be exercised. For options granted prior to October 2004, if the options fail either initial performance condition, the three year assessment period will be rolled forward by a year and a re-test carried out at that time. However, the performance condition can only be rolled forward a maximum of three times. For options granted from October 2004, no re-test is permitted.

The following table shows, for the directors who held office during the year, the number of options held under all executive share option schemes and savings-related schemes.

The mid-market price for ordinary shares at 30 June 2006 was 917 pence (30 June 2005 823 pence; 14 August 2006 941 pence). The highest mid-market price during the year was 928 pence and the lowest mid-market price was 778 pence. Exercisable options are those that have vested and can be exercised in the option period; not exercisable are those options where the minimum holding period has not been completed or the performance conditions have not yet been met. The option period starts from the earliest month in which the options may be exercised and ends with the month in which the options lapse.

		30 June 2005	Granted	Exercised	Market price in pence	30 June 2006	Option price in pence	Option period	
UK options									
NC Rose									
Exercisable		**234,716**		**(150,000)**	**861**		**687**	**Sep 04**	**Sep 11**
				(84,716)	**911**		**687**	**Sep 04**	**Sep 11**
		212,450				**212,450**	**759**	**Oct 05**	**Oct 12**
		18,292		**(18,292)**	**911**		**615**	**Mar 06**	**Mar 13**
Not exercisable	**(a)**	**274,461**				**274,461**	**649**	**Oct 07**	**Oct 13**
		278,465				**278,465**	**707**	**Oct 07**	**Oct 14**
	(b)	**2,914**				**2,914**	**567**	**Dec 09**	**May 10**
			262,269			**262,269**	**815**	**Sep 08**	**Sep 15**
		1,021,298	**262,269**	**(253,008)**		**1,030,559**			
PS Walsh									
Exercisable		**270,559**		**(50,000)**	**824**		**518**	**Dec 02**	**Dec 09**
				(50,000)	**839**		**518**	**Dec 02**	**Dec 09**
				(50,000)	**858**		**518**	**Dec 02**	**Dec 09**
				(75,000)	**879**		**518**	**Dec 02**	**Dec 09**
				(24,559)	**913**		**518**	**Dec 02**	**Dec 09**
				(21,000)	**915**		**518**	**Dec 02**	**Dec 09**
		447,189				**447,189**	**587**	**Sep 03**	**Sep 10**
		409,389				**409,389**	**687**	**Sep 04**	**Sep 11**
		370,553				**370,553**	**759**	**Oct 05**	**Oct 12**
	(b)	**3,341**		**(3,341)**	**848**		**505**	**Dec 05**	**May 06**
		30,487				**30,487**	**615**	**Mar 06**	**Mar 13**
Not exercisable	**(a)**	**479,584**				**479,584**	**649**	**Oct 07**	**Oct 13**
		493,281				**493,281**	**707**	**Oct 07**	**Oct 14**
			455,521			**455,521**	**815**	**Sep 08**	**Sep 15**
	(b)		**2,465**			**2,465**	**653**	**Dec 10**	**May 11**
		2,504,383	**457,986**	**(273,900)**		**2,688,469**			

Notes

(a) The performance conditions in respect of this SESOP grant were measured after 30 June 2006. Growth in Diageo s EPS over the three years ending 30 June 2006 did not exceed the performance condition and therefore

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Directors remuneration report (continued)

the options are not yet exercisable and the performance condition will be re-tested in 2007. The facility to re-test was removed in October 2004 and as such this is the last grant eligible for re-testing under the Rules of the Plan.

(b) Options granted under the savings-related share option scheme.

Long term incentive plans and change of control In the event of a change of control, outstanding TSR plan awards would be released and outstanding share options would become exercisable, based on the extent to which the relevant performance conditions had been met since the initial award or grant respectively, and time apportioned to reflect the shortened performance period that had elapsed, and at the remuneration committee s discretion.

Measurement of performance under IFRS For the year ended 30 June 2006, the group no longer reports its financial statements under UK GAAP and has prepared its consolidated financial statements in accordance with IFRS. The remuneration committee has reviewed the impact of the introduction of IFRS for incentive scheme purposes to ensure that performance achievement was and will be measured on a consistent basis for existing plans. For those plans impacted by this change, a review of the material differences between IFRS and UK GAAP has been conducted and, where appropriate, the 2006 results have been restated to UK GAAP.

Pension provision

Scheme details NC Rose and PS Walsh are members of the Diageo pension scheme. They accrue pension rights at the rate of one-thirtieth of base salary each year. Bonus payments and other benefits are not included in pensionable pay. The pension at NRA will not be less than two-thirds of base pay in the 12 months prior to retirement less any pension benefits accrued elsewhere. Subject to the consent of the company, no actuarial reduction is currently applied upon early retirement on or after age 57. Pensions in payment are increased each year in line with increases in the RPI subject to a maximum of 5% per annum, and a minimum of 3% per annum.

On death in service, a lump sum of four times pensionable salary would become payable, together with a spouse s pension of two-thirds of the executive director s prospective pension. Upon death after retirement, a spouse s pension of two-thirds of the executive director s pension before commutation is payable.

Employee contributions equal to 2% of base pay were introduced on 1 April 2006, increasing to 6% of base pay by 1 April 2008.

As a result of changes introduced by the Finance Act 2004 affecting the taxation of pensions from 6 April 2006, executive directors were offered the option of having benefits in excess of their personal LTA provided by an unfunded non-registered arrangement. Both directors have opted to have part of their benefits provided from this unfunded arrangement. No compensation payments were paid as a result of the change in legislation. All benefits remain subject to the Inland Revenue limits that were in force on 5 April 2006.

Directors remuneration report (continued)

Executive directors pension benefits Details of the accrued pension to which each director is entitled had they left service on 30 June 2006 and the transfer value of those accrued pensions are shown in the following table. The accrued pensions shown represent the annual pension to which each executive director would be entitled at NRA. The transfer value is broadly the cost to Diageo if it had to provide the equivalent pension benefit. The transfer values shown in the following table have been calculated in accordance with the Guidance Note published by the Institute and Faculty of Actuaries (GN11).

	Age at 30 June 2006 Years	Pensionable service at 30 June 2006 Years	Accrued pension at 30 June 2005 £000 pa	Additional pension accrued in the year(a) £000 pa	Accrued pension at 30 June 2006(b) £000 pa	Transfer value at 30 June 2005 £000	Increase in transfer value during the year(c) £000	Transfer value at 30 June 2006(b) £000
NC Rose(d)	**48**	**14**	**216**	**40**	**256**	**2,431**	**689**	**3,120**
PS Walsh(d)	**51**	**24**	**642**	**82**	**724**	**8,314**	**1,756**	**10,070**

Notes

(a) Of the additional pension accrued in the year, the increases attributable to factors other than inflation were £34,000 pa for NC Rose and £65,000 pa for PS Walsh.

(b) As at 30 June 2006 the percentages of pension benefits provided from the unfunded non-registered arrangements for NC Rose and PS Walsh were 70% (30 June 2005 71%) and 1% (30 June 2005 nil) respectively.

(c) The increases in the transfer values during the year were attributable to an additional year s service (36% for NC Rose and 25% for PS Walsh) and the salary increase in the year (36% for NC Rose and 38% for PS Walsh). The remainder of the increase is attributable to changes in market conditions, in particular, interest earned on the transfer value and changes in index-linked gilt markets over the year.

(d) Employee pension contributions were introduced from 1 April 2006. NC Rose made pension contributions during the year of £2,850 (30 June 2005 £nil) and PS Walsh made pension contributions of £4,950 (30 June 2005 £nil).

Directors remuneration report (continued)

Share and other interests

The beneficial interests of the directors in office at 30 June 2006 in the ordinary shares of the company are shown in the table below.

	Ordinary shares		
	14 August 2006	**30 June 2006**	**30 June 2005 or appointment**
Chairman			
Lord Blyth	**130,102**	**127,925**	108,299
Executive directors			
NC Rose	**294,709**	**294,669**	243,812
PS Walsh	**763,077**	**763,037**	735,062
Non-executive directors			
LM Danon (appointed 1 January 2006)	**2,000**	**2,000**	
Lord Hollick	**5,000**	**5,000**	5,000
Dr FB Humer	**3,500**	**3,500**	3,500
M Lilja	**4,532**	**4,532**	4,532
WS Shanahan	**17,155**	**17,155**	16,591
HT Stitzer	**3,216**	**2,998**	1,595
JR Symonds	**5,000**	**5,000**	5,000
PA Walker	**44,250**	**44,250**	44,250
Total	**1,272,541**	**1,270,066**	1,167,641

Notes

At 30 June 2006, there were 11,769,318 shares (30 June 2005 10,826,868; 14 August 2006 11,732,052) held by trusts to satisfy grants made under Diageo incentive plans and savings-related share option schemes, and 109,834 shares and 352,275 shares subject to call options (30 June 2005 109,834 and 352,275; 14 August 2006 109,834 and 352,275) held by a trust to satisfy grants made under ex-GrandMet incentive plans. NC Rose and PS Walsh are among the potential beneficiaries of these trusts and are deemed to have an interest in all these shares and shares subject to call options.

Performance graph

The graph below shows the total shareholder return for Diageo and the FTSE 100 Index since 30 June 2001. The FTSE 100 Index reflects the 100 largest UK quoted companies by market capitalisation and has been chosen because it is a widely recognised performance benchmark for large UK companies. The graph shows that Diageo outperformed the FTSE 100 Index over this five year period. The TSR plan, which measures TSR against a defined peer group of 17 other companies, is not based on the same performance period.

Directors   remuneration report (continued)

Additional information

Emoluments and share interests of senior management The total emoluments for the year ended 30 June 2006 of the executive directors, the executive committee and the company secretary (together, the senior management) of Diageo comprising base salary, annual performance bonus, share incentive plan and other benefits were £10,323,515. The aggregate amount of gains made by the senior management from the exercise of share options and from the vesting of awards during the year was £6,721,641 and payments under other pre-merger long term incentive plans totalled £531,075. In addition, they were granted 1,667,916 options during the year at a weighted average share price of 817 pence, exercisable by 2015. They were also initially awarded 1,069,276 shares under the TSR plan in September 2005, which will vest in three years subject to the performance tests described above.

At 14 August 2006, the senior management had an aggregate beneficial interest in 2,086,026 ordinary shares in the company and in the following options:

	Number	Weighted average exercise price in pence	Option period
Options over ordinary shares			
NC Rose	**1,030,559**	**729**	**Oct 05 Sep 15**
PS Walsh	**2,688,469**	**698**	**Sep 03 Sep 15**
Other members of the executive committee and company secretary	**4,591,316**	**684**	**Dec 99 Sep 15**
	8,310,344		

Key management personnel related party transactions Key management personnel of the group comprises the executive and non-executive directors, the members of the executive committee and the company secretary. As previously disclosed, Lord Hollick, PS Walsh and NC Rose have informed the company that they have purchased seasonal developments at Gleneagles from a subsidiary of the company, Gleneagles Resort Developments Limited. The transactions were priced on the same basis as all the external seasonal development transactions and were at arm s length. The values of the transactions were: Lord Hollick £25,000, PS Walsh £43,000, NC Rose £11,600. Each director continued to hold these seasonal developments at 30 June 2006. During the year, G Williams informed the company that he had purchased a seasonal development at Gleneagles, on a similar basis to those reported above. The value of the transaction was £19,400.

In April 2006, Diageo plc granted rolling indemnities to the directors and the company secretary, uncapped in amount, in relation to certain losses and liabilities which they may incur in the course of acting as directors or company secretary respectively, of Diageo plc or of one or more of its subsidiaries.

Directors remuneration report (continued)

The company secretary was also granted a rolling indemnity, uncapped in amount, in relation to certain losses and liabilities which she may incur in the course of acting as a director of one or more subsidiaries of Diageo plc. These indemnities replace those granted previously on similar terms (in May 2003 or, if later, at the date of appointment of the director in question) and continued to be in place at 30 June 2006.

Other than disclosed in this report, no director had any interest, beneficial or non-beneficial, in the share capital of the company. The register of directors interests (which is open to shareholders inspection) contains full details of directors share interests. Save as disclosed above, no director has or has had any interest in any transaction which is or was unusual in its nature, or which is or was significant to the business of the group and which was effected by any member of the group during the financial year, or which having been effected during an earlier financial year, remains in any respect outstanding or unperformed. There have been no material transactions during the last three years to which any director or officer, or 3% shareholder, or any relative or spouse thereof, was a party. There is no significant outstanding indebtedness to the company by any directors or officer or 3% shareholder.

Corporate governance report

UK Combined Code on Corporate Governance

Diageo s board and executive committee are committed to achieving the highest standards of corporate governance, corporate responsibility and risk management in directing and controlling the business. The principal governance rules applying to UK companies listed on the London Stock Exchange are contained in the Combined Code on Corporate Governance adopted by the Financial Reporting Council in July 2003 (the Code). The company has complied with the provisions set out in section 1 of the Code and has done so throughout the year regarding the Code provisions whose requirements are of a continuing nature.

The way in which the Code principles of good governance are applied is described below.

Board of directors

Diageo s board consists of its chairman, chief executive, chief financial officer and eight non-executive directors. The senior non-executive director is Lord Hollick, a partner of Kohlberg Kravis Roberts and former chief executive of United Business Media plc. The non-executive directors, all of whom the board has determined are independent, are experienced and influential individuals from a range of industries and countries. Their mix of skills and business experience is a major contribution to the proper functioning of the board and its committees, ensuring that matters are fully debated and that no individual or group dominates the board s decision-making processes. The board considers that ensuring individual directors participate fully and independently in decision-making is more important for the achievement of a balance of power than the precise split of executive and non-executive directors. To increase the executive presence at board meetings, members of the executive committee are invited to attend on a rotational or issue basis.

The board considers that it is beneficial for the executive directors to hold an external directorship to broaden their experience and normally this would be limited to one company. The chief executive, PS Walsh, holds both a UK and a US non-executive directorship in Centrica plc and FedEx Corporation, respectively. The board considers that, given the importance of the United States to the company s business, the FedEx directorship is of benefit to Mr Walsh in terms of market awareness, US business practices and networking and that the time commitment is not too great as the meetings can be combined with other business trips to the United States. The biographical details of the directors, together with their committee memberships, are given in Directors and senior management above. A summary of the terms and conditions of appointment of the non-executive directors is available on www.diageo.com or on request from the company secretary.

Any new directors are appointed by the board and, in accordance with the company s articles of association, they must be elected at the next Annual General Meeting (AGM) to continue in office and must retire, and may stand for re-election by the shareholders, at least every three years. There is a formal induction programme for new directors; they meet with the executive committee members individually and receive orientation training from the relevant senior executive in relation to the group and its business, for example in relation to its assurance processes, environmental policies and social responsibility policies and practices. At board meetings, the directors receive presentations on areas of the business from the regional presidents and function heads and regular updates on changes and developments in the business, legislative and regulatory environments. In addition, the non-executive directors are invited to attend the executive committee members senior leadership meetings to gain further insight into different aspects of the business.

The board meets regularly during the year and, in addition, an annual strategy conference is held off-site with the full executive committee for two days, at which the group s strategy is reviewed in depth. The board receives detailed financial information and regular presentations from executives on the business

Corporate governance report (continued)

performance, in addition to items for decision and minutes of board committees in advance of each board meeting. This enables the directors to make informed decisions on corporate and business issues under consideration. When directors are unable to attend a meeting, they are advised of the matters to be discussed and given an opportunity to make their views known to the chairman prior to the meeting.

There is a formal schedule of matters reserved to the board for decision to ensure that key policy and strategic decisions are made by the full board. This is reviewed annually and was last revised in September 2004; the review in December 2005 concluded that no revision was necessary. Otherwise, the board has delegated authority for day-to-day management of the group s affairs to the chief executive, PS Walsh, who is supported by the executive committee. The biographical details of the executive committee s members are given in Directors and senior management above.

The board makes decisions and reviews and approves key policies and decisions of the company, in particular in relation to: group strategy and operating plans; corporate governance; compliance with laws, regulations and the company s code of business conduct; business development, including major investments and disposals; financing and treasury; appointment or removal of directors; succession planning for senior management positions; risk management; financial reporting and audit; corporate citizenship, ethics and the environment; and pensions.

The board undertakes formal evaluation of its own performance and the board committees assess their respective roles, performance and terms of reference and report accordingly to the board. The board assesses the reviews of each committee. An internally produced questionnaire was used for the performance evaluation process, and the board members concluded that appropriate actions had been identified to address areas that could be improved and that overall, the board and its committees continued to operate effectively.

Each director s performance is evaluated by the chairman based on input from all other directors. An internally produced questionnaire is completed and returned to the chairman, who then meets privately with each director to review their performance. The chairman s performance is evaluated by the directors, using an internally produced questionnaire which is completed and returned to the senior non-executive director, who discusses the feedback in a meeting with the non-executive directors and then privately with the chairman. A report on the individual performance evaluation process is made to the nomination committee annually. LM Danon did not participate in the performance evaluation process, as she joined the board half way through the year.

Following the performance evaluation of individual directors, the chairman has confirmed that the non-executive directors standing for re-election at this year s AGM continue to perform effectively and demonstrate commitment to their roles. It is the board s intention to continue to review annually its performance and that of its committees and individual directors. A decision is taken each year on the performance evaluation process to be used. In respect of this year s individual performance evaluation process, the nomination committee reviewed the process in June 2005 and concluded that it was effective and that external facilitation was not necessary.

During the year, six scheduled board meetings were held, five in the United Kingdom and one in the United States. The meetings were fully attended, except that WS Shanahan and JR Symonds were each unable to attend one meeting. LM Danon attended two of the three board meetings held following her appointment on 1 January 2006. Attendance at committee meetings below relates to the period when each director held office. The non-executive directors meet independently without the chairman present, and also meet with the chairman independently of management, on a regular basis.

Corporate governance report (continued)

The chairman, Lord Blyth, is principally responsible for the effective operation and chairing of the board and for ensuring the information that it receives is sufficient to make informed judgements. He also provides support to the chief executive, particularly in relation to external affairs. He spends between two and three days each week on the company s affairs and, because of the closer relationship he has with the company as chairman, he is not considered to be an independent director. Lord Blyth s principal commitments outside Diageo are as a non-executive director of Anixter Inc and a vice chairman of Greenhill & Co, Inc. There have been no changes to these commitments during the year.

The company secretary is responsible for ensuring that board processes and procedures are appropriately followed and support effective decision-making and governance. She is appointed by, and can only be removed by, the board. She is also responsible for ensuring that new directors receive appropriate training and induction into Diageo. All directors have access to the company secretary s advice and services and there is also a formal procedure for directors to obtain independent professional advice in the course of their duties, if necessary, at the company s expense.

Board committees

The board has established several committees, each with clearly defined terms of reference, procedures, responsibilities and powers. The terms of reference of the committees are available at www.diageo.com. They are also available on request from the company secretary.

Audit committee The audit committee is chaired by JR Symonds and consists of all the independent non-executive directors. The chief financial officer, financial controller, global audit and risk director, director of technical accounting and external auditor are normally invited to attend the meeting. The audit committee is responsible for: monitoring the integrity of the financial statements, including a review of the significant financial reporting judgements contained in them; reviewing the effectiveness of the group s internal control and risk management systems and of control over financial reporting; monitoring and reviewing the effectiveness of the audit and risk function and reviewing the business risk programme; monitoring and reviewing the group s policies and practices concerning business conduct and ethics, including whistleblowing; and overseeing the company s relationship with the external auditor, including monitoring their independence.

For the purposes of the Code and the relevant rule of the US Securities Exchange Act, the board has determined that JR Symonds is independent and may be regarded as an audit committee financial expert.

Audit committee report The committee met six times during the year and reported its conclusions to the full board. The meetings were fully attended, except that LM Danon, Lord Hollick, WS Shanahan and HT Stitzer were each unable to attend one meeting and Dr FB Humer was unable to attend two meetings. At the end of four meetings, the committee met with the external auditor with no executive or staff member present (except on one occasion when the global audit and risk director was present). The committee also met on three occasions with the global audit and risk director with no executive or staff member present.

During the year, the committee formally reviewed draft interim and annual reports and associated interim results and preliminary year-end results announcements, focusing on key areas of judgement and complexity, critical accounting policies and any changes required to those; and it reviewed the group s preparation for the adoption of, and issuance of financial statements under, IFRS. The committee also reviewed the work of the filings assurance committee described below and external audit findings and was updated on litigation risks by the group s general counsel.

Corporate governance report (continued)

The committee received presentations from certain senior executives on the management of key risk and control issues in their respective business areas and reviewed the effectiveness and findings from the risk management and internal control processes described below, including review of risk mitigation plans for critical risks (the oversight of Diageo s primary risks is allocated between the committee, board and executive committee). The committee also reviewed the work of the audit and risk committee described below. To support it in this activity, it had available to it the resources of the audit and risk function which supports the processes for identifying and assessing the management of significant business risks and conducts internal audits across the whole of the group s business.

The committee reviewed at each meeting a report in respect of the compliance programme described below, and an update on preparatory work to enable the company to comply with Section 404 of the Sarbanes-Oxley Act and related SEC rules (relating to internal control over financial reporting) in the next financial year. The committee carried out an annual self-assessment in December 2005 to review its effectiveness and at the same time reviewed and confirmed to the board that no substantive revisions to its terms of reference were required, but recommended that changes be made to reflect an organisational change.

Monitoring of external auditor During the year, the audit committee reviewed the external audit strategy and the findings of the external auditor from its review of the interim announcement and its audit of the annual financial statements. As noted above, the committee also met three times with the external auditor alone. The audit committee assessed the ongoing effectiveness of the external auditor and audit process on the basis of meetings and a questionnaire-based internal review with finance and audit and risk staff. In reviewing the independence of the external auditor, the audit committee considered a number of factors. These include: the standing, experience and tenure of the external audit director; the nature and level of services provided by the external auditor; and confirmation from the external auditor that it has complied with relevant UK and US independence standards.

The group has a policy on the use of the external auditor for non-audit services, which is reviewed annually, most recently in June 2006. Under this policy the provision of any service must be approved by the audit committee, unless the proposed service is both expected to cost less than £250,000 and also falls within one of a number of service categories which the audit committee has pre-approved. These pre-approved service categories may be summarised as follows:

- accounting advice, employee benefit plan audits, and audit or other attest services required by statute or requested by management and not otherwise prohibited;

- due diligence and other support relating to acquisitions, disposals and other business initiatives; and

- certain specified tax services, including tax compliance; tax planning and related implementation advice in relation to acquisitions, disposals and other reorganisations.

Nomination committee Chaired by Lord Blyth, this committee comprises all the independent non-executive directors. The committee is responsible for keeping under review the composition of the board and succession to it. It makes recommendations to the board concerning appointments to the board, whether of executive or non-executive directors, having regard to the balance and structure of the board and the required blend of skills and experience. The committee also makes recommendations to the board concerning the re-appointment of any non-executive director at the conclusion of his or her specified term and the re-election of any director by shareholders under the retirement provisions of the company s articles of association.

Corporate governance report (continued)

The committee met twice during the year. Both the meetings were fully attended, except that LM Danon and WS Shanahan were each unable to attend one meeting. The committee reviewed its own effectiveness through a self-assessment in December 2005 and at the same time reviewed and confirmed to the board that no revisions to its terms of reference were required.

The principal activities of the committee during the year were a review of individual performance, succession planning in respect of the executive committee members and the consideration of potential non-executive directors. The committee recommended the appointment to the board of one additional non-executive director LM Danon; external search consultants assisted with this work and the chairman consulted with the executive directors before the recommendation was made.

Remuneration committee This committee is chaired by Lord Hollick and consists of all the independent non-executive directors. The role of the committee and details of how the company applies the principles of the Code in respect of directors remuneration are set out above in the directors remuneration report in relation to directors remuneration policy and practice.

The chairman and the chief executive may, by invitation, attend remuneration committee meetings, except when their own remuneration is discussed. No director is involved in determining his or her own remuneration. The committee held five meetings during the year. The meetings were fully attended, except that LM Danon, Dr FB Humer, M Lilja, WS Shanahan, HT Stitzer and JR Symonds were each unable to attend one meeting. The committee reviewed its own effectiveness through a self-assessment in December 2005 and at the same time reviewed and confirmed to the board that no revisions to its terms of reference were required.

Executive direction and control

The executive committee, appointed and chaired by the chief executive, consists of the individuals responsible for the key components of the business: North America, International and Europe markets, global supply and the global functions. It met nine times during the year, generally for two days, including an off-site executive strategy meeting and the joint annual strategy conference with the board, and spent most of its time discussing strategy, people and performance (including brands). One of these meetings was held in Africa, with the remainder in the UK. In addition, scheduled interim update meetings were held by teleconference throughout the year. Responsibility and authority (within the financial limits set by the board) are delegated by the chief executive to individual members of the executive committee who are accountable to him for the performance of their business units.

Executive direction and control procedures include approval of annual strategic plans submitted by each business unit executive and periodic business reviews. These reviews are generally attended by the regional president responsible for the market (and in certain cases additional members of the executive committee) and are held in the relevant market. The reviews focus on business performance management and specific issues around brands, people, key business decisions and risk management.

The chief executive has created several executive working groups to which are delegated particular tasks, generally with specific time spans and success criteria. He has also created committees, intended to have an ongoing remit, including the following:

Audit and risk committee Chaired by the chief executive and responsible for overseeing the approach to securing effective risk management and control in the business, reviewing and challenging the sources of assurance as to their adequacy, reviewing the effectiveness of the compliance programme and reporting periodically on the above to the audit committee or to the board.

Corporate governance report (continued)

Corporate citizenship committee Chaired by the chief executive and responsible for making decisions or, where appropriate, recommendations to the board or executive committee, concerning corporate citizenship strategy, policies and issues. This includes such matters as: corporate citizenship performance, measurement and reporting; community affairs; environmental matters; and other emerging corporate citizenship issues. Progress against these areas is reported periodically to the board and publicly through a separate corporate citizenship report, which is subject to external assurance. That report and the group s social, ethical and environmental policies are published on the Diageo website. A copy of the corporate citizenship report is available on request.

An alcohol and responsibility executive working group assists the committee with its work on specific issues linked to Diageo s commitment to responsible drinking. It brings together the key executives from the business and functional representatives involved in detailing and realising Diageo s commitment to responsible drinking.

Finance committee Chaired by the chief financial officer and including the chief executive, this committee is responsible for making recommendations to the board on funding strategy, capital structure and management of financial risks and the policies and control procedures (including financial issues relating to treasury and taxation) required to implement the company s financial strategy and financial risk management policies. In certain specific circumstances, the board has delegated authority to the finance committee to make decisions in these areas. Treasury activity is managed centrally within tightly defined dealing authorities and procedures recommended by the finance committee and approved by the board.

Filings assurance committee Chaired by the chief financial officer and including the chief executive, this committee is responsible for implementing and monitoring the processes which ensure that the company complies with relevant UK, US and other regulatory filing provisions, including those imposed by the Sarbanes-Oxley Act or deriving from it. During the previous year, the company s filing and disclosure processes were reviewed by the legal function and their recommended enhancements to the processes were implemented in the current year. These enhancements were primarily to increase direct involvement at the local business level; to facilitate a more tailored challenge to the businesses by the committee; and to integrate further the reporting processes of the group.

As at the end of the period covered by this report, the committee carried out an evaluation of the effectiveness of the design and operation of Diageo s disclosure controls and procedures. These are defined as those controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarised and reported within specified time periods. As of the date of the evaluation, the chief executive and the chief financial officer concluded that the design and operation of these disclosure controls and procedures were effective.

Risk management and internal control

The group s aim is to manage risk and to control its business and financial activities cost-effectively and in a manner that enables it to: exploit profitable business opportunity in a disciplined way; avoid or reduce risks that can cause loss, reputational damage or business failure; support operational effectiveness; and enhance resilience to external events. To achieve this, an ongoing process has been established for identifying, evaluating and managing risks faced by the group. This process, which complies with the requirements of the Code, has been in place for the full financial year and up to the date the financial statements were approved and accords with the guidance issued by the Turnbull Committee (as amended by the Flint Review).

Corporate governance report (continued)

All significant business units, groups of business units and the Diageo executive committee perform a risk assessment at least annually as an integral part of their strategic planning. Business unit risk assessments and the activities planned to manage those risks are reviewed by relevant executives, for example at periodic business reviews. The executive risk assessment and selected other risk assessments are reviewed by the audit and risk committee and by the audit committee of the board. Those committees gain assurance in relation to the effectiveness of risk management and control from: summary information in relation to the management of identified risks; detailed review of the effectiveness of management of selected key risks; and the independent work of the global audit and risk function, which supports and challenges risk assessments, supports and challenges management to improve the effectiveness of management of identified key risks and conducts internal audits.

The risk assessment and management processes described above are also applied to major business decisions or initiatives, such as systems implementations. Additional risk management activity is focused directly towards operational risks within the business including health and safety, product quality and environmental risk management.

The above risk management processes and systems of internal control are designed to manage, rather than eliminate, the risk of failure to achieve the group s strategic objectives. It should be recognised that such systems can only provide reasonable, not absolute, assurance against material misstatement or loss. Summary information and findings are regularly reported to the audit committee.

The directors acknowledge that they are responsible for the group s systems of internal control and risk management and for reviewing their effectiveness. They confirm that they have reviewed their effectiveness, based on the procedures described above, during the period.

There have been no changes in the Company s internal control over financial reporting that occurred during the period covered by this Annual Report and Form 20F Information that has materially affected, or is reasonably likely to materially affect the Company s internal control over financial reporting.

The group is continuing the work necessary to enable it to comply in due course with the SEC rules which implement section 404 of the Sarbanes-Oxley Act (relating to internal control over financial reporting). Diageo s first annual report required to comply with section 404 will be in respect of the year ending 30 June 2007, when management will be required to state their responsibility for establishing and maintaining adequate internal control over financial reporting and to annually assess the effectiveness of structure and procedures in place relating to internal control over financial reporting. The external auditor will be required to attest to and report on management s assessment.

Compliance programme

Diageo is committed to conducting its business responsibly and in accordance with all laws and regulations to which its business activities are subject. The board has a well established compliance programme to support achievement of this commitment. The code of business conduct sets out expectations of Diageo businesses and employees in relation to issues such as conflicts of interest, entertainment and gifts, confidentiality and improper payments, as well as providing the standards against which these expectations are to be met. This code was reviewed during the year and a revised code of business conduct was approved by the board in April 2006. The Diageo marketing code establishes the principles that Diageo follows in relation to advertising and promotion of its products. The full texts of the code of conduct, marketing code and other codes that comprise the compliance programme are available on the company s website at www.diageo.com.

Corporate governance report (continued)

Compliance programme guidelines specify the manner in which any potential violations of these expectations should be dealt with, including line manager reporting and an independent SpeakUp Helpline . The latter has been re-communicated to employees, is operated independently and reports to the secretary of the audit committee, head of group security and the global audit and risk director for escalation to the audit committee as required. There is an annual certification requirement for all senior management to confirm compliance with the code of conduct or to identify areas of possible non-compliance to the global audit and risk director. With respect to the 2006 certification, this was extended to an additional level of senior employees globally. Training and education (including e-learning) activities are also undertaken. Both the audit and risk committee and the audit committee review the operation of the compliance programme.

Relations with shareholders

The company values its dialogue with both institutional and private investors. The board s primary contact with institutional shareholders is through the chief executive and chief financial officer. In November 2005 the company held a two day investor conference which was attended by all the members of the executive committee.

The chief executive and chief financial officer are supported by the investor relations department, who are in regular contact with institutional shareholders and sell side analysts. Coverage of the company by sell side analysts is circulated to the board. The non-executive directors are invited to attend the meetings with analysts and institutional investors which follow the publication of the interim results and preliminary year-end results. The board also ensures that all directors develop an understanding of the views of major institutional shareholders through an independent survey of shareholder opinion which is conducted and reviewed annually. In addition, major shareholders are invited to raise any company matters of interest to them at an annual meeting with the chairman and senior non-executive director. The chief executive and chief financial officer are also present and available to take questions and the chairman reports on the meeting to the board.

Diageo produces a short-form annual review, which is sent to all shareholders, and a full annual report is available by election or on request. As an alternative to receiving shareholder documents through the post, shareholders may elect to receive e-mail notification that the documents are available to be accessed on the company s website. Shareholders can also choose to receive e-mail notification when new company information is published on www.diageo.com. The website also provides private shareholders with the facility to check their shareholdings on-line and to send any questions they may have to the company.

Private shareholders are invited to write to the chairman or any other director and express their views on any issues of concern at any time and the AGM provides an opportunity for private shareholders to put their questions in person. The company also holds an annual presentation to the UK Shareholders Association.

The chairmen of the audit, nomination and remuneration committees are normally available at AGMs to take any relevant questions and all other directors attend, unless illness or another pressing commitment precludes them from doing so. In 2005, all the directors attended the AGM.

At general meetings, a schedule of the proxy votes cast is made available to all shareholders and is published on www.diageo.com. The company proposes a separate resolution on each substantially separate issue and does not bundle resolutions together inappropriately. Resolutions on the receipt of the reports and accounts and the approval of the directors remuneration report are put to shareholders at the AGM.

Corporate governance report (continued)

Charitable and political donations

During the year, total charitable donations made by the group were £20.2 million (2005 £22.6 million). UK group companies made donations of £11.8 million (2005 £14.4 million) to charitable organisations including £0.7 million (2005 £1.4 million) to the Diageo Foundation and £6.5 million (2005 £7.2 million) to the Thalidomide Trust. In the rest of the world, group companies made charitable donations of £8.4 million (2005 £8.2 million).

The group has not given any money for political purposes in the United Kingdom. The group made no donations to EU political organisations and incurred no EU political expenditure during the year. The group made contributions to non-EU political parties totalling £0.3 million during the year (2005 £0.5 million).

Supplier payment policies and performance

Given the international nature of the group s operations, there is no group standard in respect of payments to suppliers. Operating companies are responsible for agreeing terms and conditions for their business transactions when orders for goods and services are placed, so that suppliers are aware of the terms of payment and including the relevant terms in contracts where appropriate. These arrangements are adhered to when making payments, subject to the terms and conditions being met by the supplier. Creditor days have not been calculated, as Diageo plc had no trade creditors at 30 June 2006. The company s invoices for goods and services are settled by subsidiaries acting on behalf of the company.

Statement of directors responsibilities

The directors are responsible for preparing the Annual Report and information filed with the SEC on Form 20-F and the group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare group and parent company financial statements for each financial year. Under that law they are required to prepare the group financial statements in accordance with IFRS as endorsed and adopted for use by the EU and have elected to prepare the parent company financial statements in accordance with UK Generally Accepted Accounting Standards. The directors have also presented additional information under US requirements.

The group financial statements are required by law and IFRS as endorsed and adopted for use by the EU to present fairly the financial position and the performance of the group; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation.

The parent company financial statements are required by law to give a true and fair view of the state of affairs of the parent company. In preparing each of the group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- for the group financial statements, state whether they have been prepared in accordance with IFRS as endorsed and adopted for use by the EU;

Corporate governance report (continued)

- for the parent company financial statements, state whether applicable UK Generally Accepted Accounting Standards have been followed, subject to any material departures disclosed and explained in the parent company financial statements; and prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group and the parent company will continue in business.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

Under applicable UK and US law and regulations, the directors are also responsible for preparing a directors report, directors remuneration report and corporate governance report that comply with that law and those regulations.

US Sarbanes-Oxley Act of 2002

Diageo has American Depositary Shares listed on the New York Stock Exchange (NYSE) and is subject to the reporting and other requirements of the SEC applicable to foreign private issuers. The company is subject to those provisions of the Sarbanes-Oxley Act and related SEC rules applicable to foreign private issuers.

New York Stock Exchange corporate governance rules

Under the NYSE s corporate governance rules for listed companies, Diageo must disclose any significant ways in which its corporate governance practices differ from those followed by US companies under NYSE listing standards.

Diageo s board and executive committee are committed to achieving the highest standards of corporate governance and corporate responsibility. Diageo believes the following to be the significant differences between its corporate governance practices and NYSE corporate governance rules applicable to US companies.

Basis of regulation US companies listed on the NYSE are required to adopt and disclose corporate governance guidelines. The Listing Rules of the UK Financial Services Authority require each listed company incorporated in the United Kingdom to include in its annual report and accounts a narrative statement of how it has applied the principles of the Code and a statement as to whether or not it has complied with the best practice provisions of the Code throughout the accounting period covered by the annual report and accounts. References to the Code are to the Combined Code on Corporate Governance adopted by the Financial Reporting Council in 2003. It is not mandatory for companies to follow the principles set forth in the Code, and the Code does not require companies to disclose the full range of corporate governance guidelines with which they comply. A company that has not complied with the Code provisions, however, or that complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period covered by the report, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the reporting period such non-compliance continued, and give reasons for any non-compliance. As stated above, Diageo complied throughout the year with the best practice provisions of the Code.

Corporate governance report (continued)

Director independence The Code s principles recommend that at least half of a company s board, excluding the chairman, should consist of independent non-executive directors. The NYSE listing rules applicable to US companies state that companies must have a majority of independent directors. Currently, eight of Diageo s 11 directors are non-executive directors. The NYSE rules set forth five bright-line tests for determining director independence and require in addition that the board of directors affirmatively determines that the director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) . The Code, which is followed by Diageo, prescribes a more general standard for determining director independence. The Code requires a company s board to assess director independence by affirmatively concluding that the director is independent of management and free from any business or other relationship that could materially interfere with the exercise of independent judgement. Diageo s board has determined that, in its judgement, all of the non-executive directors are independent. In doing so, however, the board did not explicitly take into consideration the NYSE s bright-line tests. In addition, as at 31 July 2006, all members of Diageo s audit committee are independent non-executive directors as per the requirements of section 301 of the Sarbanes-Oxley Act and related SEC rules.

Chairman and chief executive The Code recommends that the chairman and the chief executive should not be the same individual in order to ensure that there is a clear division of responsibility for running each company s business. There is no corresponding requirement for US companies. Diageo has a separate chairman and chief executive.

Non-executive director meetings Pursuant to NYSE listing standards, non-management directors must meet on a regular basis without management present and independent directors must meet separately at least once per year. During the year under review, Diageo s non-executive directors met four times as a group without any executive directors present.

Committees Diageo has a number of board committees which are similar in purpose and constitution to those required for US companies under NYSE standards. Diageo s audit and remuneration committees consist entirely of independent non-executive directors. The nomination committee is chaired by Lord Blyth, who is not independent. Under NYSE standards, companies are required to have a nominating/corporate governance committee, composed entirely of independent directors. In addition to identifying individuals qualified to become board members, this committee must develop and recommend to the board a set of corporate governance principles. The terms of reference for Diageo s nomination committee, which follow the requirements of the Code, do not require the committee to develop and recommend corporate governance principles for Diageo. In accordance with the requirements of the Code, Diageo discloses in its annual report how the board, its committees and the directors are evaluated and the results of the evaluation and it provides extensive information regarding directors compensation in the directors remuneration report.

Code of ethics NYSE listing standards require US companies to adopt a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. Diageo s board has established a compliance programme to support achievement of its commitment to conducting Diageo s business responsibly and in accordance with all laws and regulations to which its business activities are subject. Diageo s code of business conduct sets out expectations of Diageo businesses and employees in relation to issues such as conflicts of interest, competition law, insider trading and corrupt payments as well as illegal acts in general. This code was reviewed during the year and a revised code of business conduct was approved by the board in April 2006. A marketing code establishes the principles that Diageo follows in relation to advertising and promotion of its products. In addition, Diageo has adopted a code of ethics for senior financial officers in accordance with the requirements of

Corporate governance report (continued)

the Sarbanes-Oxley Act (and related SEC rules) and such code is available on Diageo s website (www.diageo.com).

Compliance certification In accordance with NYSE listing rules applicable to foreign private issuers, PS Walsh, Diageo s chief executive, is required to provide the NYSE with an annual compliance certification stating that he is not aware of any violation by the company of any NYSE corporate governance standards. In accordance with rules applicable to both US companies and foreign private issuers, PS Walsh is also required to notify the NYSE promptly in writing after any executive officer becomes aware of any material non-compliance with the NYSE corporate governance standards applicable to the company.

Directors report

The directors have pleasure in submitting their Annual Report for the year ended 30 June 2006.

Annual General Meeting

The AGM will be held at The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE at 2.30 pm on Tuesday, 17 October 2006.

Dividends

Diageo paid an interim dividend of 11.95 pence per share on 6 April 2006. The directors recommend a final dividend of 19.15 pence per share. Subject to approval by members, the final dividend will be paid on 23 October 2006 to shareholders on the register on 15 September 2006. Payment to US ADR holders will be made on 27 October 2006. A dividend reinvestment plan, which enables ordinary shareholders to invest their dividends in ordinary shares, is available in respect of the final dividend and the plan notice date is 2 October 2006.

Directors

The directors of the company who served during the year are listed under Directors and senior management above. Lord Hollick, HT Stitzer and PS Walsh retire by rotation at the AGM in accordance with the articles and, being eligible, offer themselves for re-election. Laurence Danon, who was appointed since the last AGM, retires in accordance with the articles and, being eligible, offers herself for election at the AGM. The non-executive directors proposed for election and re-election do not have service contracts. Further details of directors contracts, remuneration and their interests in the shares of the company at 30 June 2006 are given in the directors remuneration report above.

Auditor

The auditor, KPMG Audit Plc, is willing to continue in office and a resolution for its re-appointment as auditor of the company will be submitted to the AGM.

Disclosure of information to the auditor

The directors who held office at the date of approval of this directors report confirm that, so far as they are each aware, there is no relevant audit information of which the company s auditor is unaware; and each director has taken all the steps that they ought to have taken as a director to make themselves aware of any relevant audit information and to establish that the company s auditor is aware of that information.

Purchases of own shares

At the 2005 AGM, shareholders gave the company renewed authority to purchase a maximum of 305 million ordinary shares. During the year ended 30 June 2006, Diageo purchased 166 million ordinary shares (nominal value £48 million), representing approximately 6% of the issued ordinary share capital (excluding treasury shares) at 14 August 2006, for a consideration including expenses of £1,428 million. Of the shares purchased, 164 million were held as treasury shares under the share buyback programme and 2 million were held as treasury shares for the hedging of grants made under employee share plans.

Business review

The review of the business of the company and the description of the principal risks and uncertainties facing the company, prepared in accordance with the Companies Act 1985, comprises the following

Directors report (continued)

sections of the Annual Report: the Chief executive s review, the Business description and the Operating and financial review.

Other information

Other information relevant to the directors report may be found in the following sections of the Annual Report:

Information	Location in Annual Report
Charitable and political donations	Corporate governance report
Corporate citizenship	Corporate governance report
Directors indemnities	Directors remuneration report
Employment policies	Business description Continuing operations Employees
Events since 30 June 2006	Financial statements note 36 Post balance sheet events
Future developments	Operating and financial review Trend information
Purchase of own shares	Operating and financial review Liquidity and capital resources
Research and development	Business description Continuing operations Research and development
Shareholdings in the company	Additional information for shareholders Major shareholders
Supplier payment policies and performance	Corporate governance report

The directors report of Diageo plc for the year ended 30 June 2006 comprises this page and the sections of the Annual Report referred to under Directors , Business review and Other information above, which are incorporated into the directors report by reference.

The directors report was approved by a duly appointed and authorised committee of the board of directors on 30 August 2006 and signed on its behalf by Susanne Bunn, the company secretary.

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Report of independent registered public accounting firm

To the board of directors and shareholders of Diageo plc

We have audited the accompanying consolidated balance sheets of Diageo plc and subsidiaries as of 30 June 2006 and 30 June 2005, and the related consolidated income statements, consolidated statements of recognised income and expense and consolidated cash flow statements for each of the years in the two-year period ended 30 June 2006 presented on pages 97 to 192. These consolidated financial statements are the responsibility of the company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the aforementioned consolidated financial statements present fairly, in all material respects, the financial position of Diageo plc and subsidiaries as of 30 June 2006 and 30 June 2005 and the results of their operations and their cash flows for each of the years in the two-year period ended 30 June 2006 in conformity with International Financial Reporting Standards (IFRS), as adopted by the European Union.

As referred to in Accounting policies of the group Basis of Preparation on page 101 of the consolidated financial statements, the company has changed its method of accounting for certain financial instruments with effect from 1 July 2005.

IFRS as adopted by the European Union vary in certain significant respects from accounting principles generally accepted in the United States of America. Information relating to the nature and effect of such differences is presented in note 35 to the consolidated financial statements.

KPMG Audit Plc

Chartered Accountants
London, England

30 August 2006

Consolidated income statement

	Notes	Year ended 30 June 2006 Before exceptional items £ million	Exceptional items £ million	Total £ million	Year ended 30 June 2005 Before exceptional items £ million	Exceptional items £ million	Total £ million
Sales	2	**9,704**		**9,704**	8,968		8,968
Excise duties	3	**(2,444)**		**(2,444)**	(2,291)		(2,291)
Net sales		**7,260**		**7,260**	6,677		6,677
Cost of sales	3	**(2,921)**		**(2,921)**	(2,603)	(29)	(2,632)
Gross profit		**4,339**		**4,339**	4,074	(29)	4,045
Marketing	3	**(1,127)**		**(1,127)**	(1,013)		(1,013)
Other operating expenses	3	**(1,168)**		**(1,168)**	(1,129)	(172)	(1,301)
Operating profit	2/5	**2,044**		**2,044**	1,932	(201)	1,731
Sale of General Mills shares	5		**151**	**151**		221	221
Sale of other businesses	5		**6**	**6**		(7)	(7)
Interest receivable	6	**51**		**51**	121		121
Interest payable	6	**(244)**		**(244)**	(271)		(271)
Other finance income	6	**24**		**24**	26		26
Other finance charges	6	**(17)**		**(17)**	(17)		(17)
Share of associates profits after tax	7	**131**		**131**	121		121
Profit before taxation		**1,989**	**157**	**2,146**	1,912	13	1,925
Taxation	8	**(496)**	**315**	**(181)**	(677)	78	(599)
Profit from continuing operations		**1,493**	**472**	**1,965**	1,235	91	1,326
Discontinued operations							
Profit after tax from disposal of businesses	9					73	73
Profit for the year		**1,493**	**472**	**1,965**	1,235	164	1,399
Attributable to:							
Equity shareholders of the parent company		**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
Basic earnings per share	10						
Continuing operations				**67.2p**			42.8p
Discontinued operations							2.4p
				67.2p			45.2p
Diluted earnings per share	10						
Continuing operations				**66.9p**			42.8p
Discontinued operations							2.4p
				66.9p			45.2p
Average shares				**2,841m**			2,972m

The accompanying notes are an integral part of these consolidated financial statements.

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Consolidated statement of recognised income and expense

	Year ended 30 June 2006 £ million	Year ended 30 June 2005 £ million
Exchange differences on translation of foreign operations		
group	**24**	95
associates	**22**	21
Exchange differences on hedges of net investment in foreign operations	**(21)**	
Effective portion of changes in fair value of net investment hedges	**(49)**	
Effective portion of changes in fair value of foreign exchange cash flow hedges		
gains taken to equity	**38**	
transferred to other operating expenses for the year	**11**	
Effective portion of changes in fair value of interest rate cash flow hedges		
gains taken to equity	**1**	
transferred to interest receivable and payable for the year	**(7)**	
Fair value movement on available for sale securities		
unrealised gains arising during the year	**33**	
realised gains reclassified to profit for the year	**(181)**	
Actuarial gains/(losses) on post employment plans	**459**	(238)
Tax on items taken directly to equity	**(97)**	33
Net income/(expense) recognised directly in equity	**233**	(89)
Profit for the year		
group	**1,834**	1,278
associates	**131**	121
Profit for the year	**1,965**	1,399
Total recognised income and expense for the year	**2,198**	1,310
Impact of IAS 39 adoption on 1 July 2005 (net of tax)		
group	**170**	
associates	**(6)**	
Impact of adoption of IAS 39	**164**	
	2,362	
Attributable to:		
Equity shareholders of the parent company	**2,146**	1,250
Minority interests	**52**	60
Total recognised income and expense for the year	**2,198**	1,310

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated balance sheet

	Notes	30 June 2006 £ million	£ million	30 June 2005 £ million	£ million
Non-current assets					
Intangible assets	11	**4,534**		4,409	
Property, plant and equipment	12	**1,952**		1,919	
Biological assets	13	**13**		14	
Investments in associates	14	**1,341**		1,261	
Other investments	16	**69**		719	
Other receivables	18	**12**		44	
Other financial assets	21	**42**		32	
Deferred tax assets	25	**1,113**		778	
Post employment benefit assets	4	**14**		12	
			9,090		9,188
Current assets					
Inventories	17	**2,386**		2,347	
Trade and other receivables	18	**1,681**		1,569	
Other financial assets	21	**71**		30	
Cash and cash equivalents	19	**699**		787	
			4,837		4,733
Total assets			**13,927**		13,921
Current liabilities					
Borrowings and bank overdrafts	20	**(759)**		(869)	
Other financial liabilities	21	**(36)**			
Trade and other payables	23	**(1,803)**		(1,872)	
Corporate tax payable	8	**(681)**		(777)	
Provisions	24	**(56)**		(88)	
			(3,335)		(3,606)
Non-current liabilities					
Borrowings	20	**(4,001)**		(3,677)	
Other financial liabilities	21	**(78)**		(9)	
Other payables	23	**(37)**		(95)	
Provisions	24	**(306)**		(304)	
Deferred tax liabilities	25	**(674)**		(298)	
Post employment benefit liabilities	4	**(815)**		(1,306)	
			(5,911)		(5,689)
Total liabilities			**(9,246)**		(9,295)
Net assets			**4,681**		4,626
Equity					
Called up share capital		**883**		883	
Share premium		**1,340**		1,337	
Other reserves		**3,168**		3,181	
Retained deficit		**(889)**		(942)	
Equity attributable to equity shareholders of the parent company			**4,502**		4,459
Minority interests			**179**		167
Total equity	26		**4,681**		4,626

The accompanying notes are an integral part of these consolidated financial statements.

These consolidated financial statements were approved by a duly appointed and authorised committee of the board of directors on 30 August 2006 and were signed on its behalf by PS Walsh and NC Rose, directors.

Consolidated cash flow statement

	Notes	Year ended 30 June 2006		Year ended 30 June 2005	
		£ million	£ million	£ million	£ million
Cash flows from operating activities					
Profit for the year		**1,965**		1,399	
Profit after tax from disposal of discontinued businesses				(73)	
Taxation		**181**		599	
Share of associates profits after tax		**(131)**		(121)	
Net interest and other finance income and charges		**186**		141	
Net non-operating exceptional gains		**(157)**		(214)	
Depreciation and amortisation		**214**		241	
Movements in working capital		**(192)**		89	
Dividend income		**115**		134	
Other items	27	**18**		78	
Cash generated from operations			**2,199**		2,273
Interest received			**64**		146
Interest paid			**(235)**		(325)
Dividends paid to equity minority interests			**(40)**		(49)
Taxation paid			**(393)**		(320)
Net cash from operating activities			**1,595**		1,725
Cash flows from investing activities					
Net disposal/(purchase) of investments		**7**		(6)	
Disposal of property, plant and equipment		**16**		18	
Purchase of property, plant and equipment		**(257)**		(294)	
Disposal of shares in General Mills	28	**651**		1,210	
Disposal of businesses	28	**121**		(16)	
Purchase of subsidiaries	29	**(209)**		(258)	
Net cash from investing activities			**329**		654
Cash flows from financing activities					
Proceeds from issue of share capital		**3**		6	
Net purchase of own shares for share trusts		**(11)**		(29)	
Own shares repurchased for cancellation or holding as treasury shares		**(1,428)**		(710)	
Increase/(decrease) in loans		**309**		(379)	
Redemption of guaranteed preferred securities				(302)	
Equity dividends paid		**(864)**		(849)	
Net cash used in financing activities			**(1,991)**		(2,263)
Net (decrease)/increase in net cash and cash equivalents			**(67)**		116
Exchange differences			**(11)**		(55)
Net cash and cash equivalents at beginning of the year			**729**		668
Net cash and cash equivalents at end of the year			**651**		729
Net cash and cash equivalents consist of:					
Cash and cash equivalents	19		**699**		787
Bank overdrafts	20		**(48)**		(58)
			651		729

The accompanying notes are an integral part of these consolidated financial statements.

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Accounting policies of the group

Basis of preparation

The consolidated financial statements are prepared in accordance with International Financial Reporting Standards as endorsed and adopted for use in the European Union (IFRS).

The group is complying with IFRS for the first time for the year ended 30 June 2006 and the accounting policies applicable to the group from 1 July 2005 are set out below. Comparative information is presented for the year ended 30 June 2005 prepared under IFRS. This involved preparation of an opening IFRS balance sheet as at 1 July 2004, which is the group s date of transition to IFRS reporting.

IFRS 1 First-time adoption of International Financial Reporting Standards permits certain optional exemptions from full retrospective application of IFRS accounting policies and the following options have been adopted:

- Business combinations: Business combinations prior to the date of transition have not been restated onto an IFRS basis.

- Cumulative translation differences: The cumulative translation difference arising on consolidation has been deemed to be zero at the date of transition.

- Share-based payments: Full retrospective application has been adopted for all awards granted but not fully vested at the date of transition to maintain consistency across reporting periods.

- Financial instruments: The group has adopted the provisions of *IAS 39 Financial instruments: recognition and measurement* from 1 July 2005. Financial instruments in the year ended 30 June 2005 remain recorded in accordance with previous UK GAAP accounting policies, and the adjustment to IAS 39 is reflected in the consolidated balance sheet at 1 July 2005.

The group has adopted early the amendment to *IAS 19 Employee benefits* issued by the International Accounting Standards Board (IASB) on 16 December 2004 and applied by the group from 1 July 2004.

The disclosures required by IFRS 1 concerning the transition from UK GAAP to IFRS, and the impact of the adoption of IAS 39 on 1 July 2005, are set out in note 34 to the consolidated financial statements.

The consolidated financial statements are prepared on the historical cost basis except that the following assets and liabilities are stated at their fair value: derivative financial instruments, financial instruments held for trading, financial instruments classified as available for sale and biological assets.

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The critical accounting policies, which the directors consider are of greater complexity and/or particularly subject to the exercise of judgement, are set out with related disclosures in Critical accounting policies in the Operating and financial review.

Certain minor amounts in the 30 June 2005 consolidated balance sheet have been reclassified compared to amounts previously published. These reclassifications have no impact on total assets, total liabilities or net assets.

The information set out in these accounts does not constitute the company s statutory accounts under the UK Companies Acts for the years ended 30 June 2006 or 2005. Those accounts have been reported on

Accounting policies of the group (continued)

by the company s auditors; their reports were unqualified and did not contain a statement under section 237(2) or (3) of the Companies Act 1985. The accounts for 2005 have been delivered to the registrar of companies and those for 2006 will be delivered in due course.

Business combinations

The consolidated financial statements include the results of the company and its subsidiaries together with the group s attributable share of the results of joint ventures and associates. The results of subsidiaries sold or acquired are included in the income statement up to, or from, the date that control passes.

On the acquisition of a business, or of an interest in a joint venture or associate, fair values, reflecting conditions at the date of acquisition, are attributed to the net assets including identifiable intangible assets acquired. Adjustments to fair values include those made to bring accounting policies into line with those of the group.

Sales

Revenue from the sale of goods includes excise and import duties which the group pays as principal but excludes amounts collected on behalf of third parties, such as value added tax. Sales are recognised depending upon individual customer terms at the time of despatch, delivery or some other specified point when the risk of loss transfers. Provision is made for returns where appropriate. Sales are stated net of price discounts, allowances for customer loyalty and certain promotional activities and similar items.

Advertising

Advertising production costs are charged in the income statement when the advertisement is first shown to the public.

Research and development

Research expenditure in respect of new drinks products and package design is written off in the period in which it is incurred. Any subsequent development expenditure in the period leading up to product launch that meets the recognition criteria set out in the relevant standard is capitalised. If capitalised, any intangible asset is amortised on a straight line basis over the period of the expected benefit.

Share-based payments employee benefits

The fair value of equity-settled share options granted is initially measured at grant date based on the binomial or Monte Carlo models and is charged in the income statement over the vesting period. Shares of Diageo plc held by the company for the purpose of fulfilling obligations in respect of various employee share plans around the group are deducted from equity in the consolidated balance sheet. Any surplus or deficit arising on the sale of the Diageo plc shares held by the group is included as an adjustment to reserves.

Pensions and other post employment benefits

The group s principal pension funds are defined benefit plans. In addition the group has defined contribution plans, unfunded post employment medical benefit liabilities and other unfunded post employment liabilities. For defined benefit plans, the amount charged in the income statement is the cost of accruing pension benefits promised to employees over the year, plus any fully vested benefit improvements granted to members by the group during the year. It also includes a credit equivalent to the

Accounting policies of the group (continued)

group s expected return on the pension plans assets over the year, offset by a charge equal to the expected increase in the plans liabilities over the year. The difference between the fair value of the plans assets and the present value of the plans liabilities is disclosed as an asset or liability on the consolidated balance sheet. Any differences between the expected return on assets and that actually achieved, and any changes in the liabilities over the year due to changes in assumptions or experience within the plans, are recognised in the statement of recognised income and expense.

Contributions payable by the group in respect of defined contribution plans are charged to operating profit as incurred.

Exceptional items

Exceptional items are those that in management s judgement need to be disclosed by virtue of their size or incidence. Such items are included within the income statement caption to which they relate, and are separately disclosed either in the notes to the consolidated financial statements or on the face of the consolidated income statement.

Foreign currencies

The income statements and cash flows of overseas subsidiaries, associates and joint ventures are translated into sterling at weighted average rates of exchange, other than substantial transactions that are translated at the rate on the date of the transaction. The adjustment to closing rates is taken to reserves.

Balance sheets are translated at closing rates. Exchange differences arising on the re-translation at closing rates of the opening balance sheets of overseas subsidiaries and associates are taken to reserves, as are exchange differences arising on related foreign currency borrowings and financial instruments designated as net investment hedges, to the extent that they are effective. Tax charges and credits arising on such items are also taken to reserves. Other exchange differences are taken to the income statement.

The results, assets and liabilities of operations in hyper-inflationary economies are adjusted to reflect the changes in the purchasing power of the local market currency of the entity.

Transactions in foreign currencies are recorded at the rate of exchange at the date of the transaction. If hedged forward, the impact of hedging is recognised, where permitted, under hedge accounting (refer to accounting policy for derivative financial instruments).

Brands, goodwill and other intangible assets

When the cost of an acquisition exceeds the fair values attributable to the group s share of the net assets acquired, the difference is treated as purchased goodwill. Goodwill arising on acquisitions prior to 1 July 1998 was eliminated against reserves, and this goodwill has not been restated. Goodwill arising subsequent to 1 July 1998 has been capitalised.

Acquired brands and other intangible assets are recognised when they are controlled through contractual or other legal rights, or are separable from the rest of the business, and the fair value can be reliably measured.

Goodwill and intangible assets that are regarded as having indefinite useful economic lives are not amortised. Intangible assets that are regarded as having limited useful economic lives are amortised on a straight-line basis over those lives. Assets with indefinite lives are reviewed for impairment annually and other assets are reviewed for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable. To ensure that goodwill and intangible assets are not carried at above

Accounting policies of the group (continued)

their recoverable amounts, impairment reviews are carried out comparing the net carrying value with the recoverable amount, where the recoverable amount is the higher of value in use or fair value less cost to sell. Amortisation and any impairment write downs are charged in the income statement.

Computer software is amortised on a straight-line basis over a period of up to five years.

Property, plant and equipment

Land and buildings are stated at cost less depreciation. Freehold land is not depreciated. Leaseholds are depreciated over the unexpired period of the lease. Other property, plant and equipment are depreciated on a straight-line basis to estimated residual values over their expected useful lives, and these values and lives are reviewed each year. Subject to these reviews, the estimated useful lives fall within the following ranges: industrial and other buildings 10 to 50 years; plant and machinery 5 to 25 years; fixtures and fittings 5 to 10 years; and casks and containers 15 to 20 years.

Reviews are carried out if there is some indication that impairment may have occurred, to ensure that property, plant and equipment are not carried at above their recoverable amounts.

Leases

Where the group has substantially all the risks and rewards of ownership of an asset subject to a lease, the lease is treated as a finance lease. Other leases are treated as operating leases, with payments and receipts taken to the income statement on a straight-line basis over the life of the lease.

Agriculture

Grape cultivation by the group s wine business is accounted for as an agricultural activity. Accordingly the group s biological assets (grape vines) are carried at fair value which is computed on the basis of a discounted cash flow computation. Agricultural produce (harvested grapes) is valued at market value on transfer into inventory.

Associates and joint ventures

An associate is an undertaking in which the group has a long-term equity interest and over which it has the power to exercise significant influence. The group s interest in the net assets of associates is included in investments in the consolidated balance sheet and its interest in their results is included in the income statement below the group s operating profit. Joint ventures, where there is contractual joint control over the entity, are accounted for by including on a line-by-line basis the attributable share of the results, assets and liabilities.

Inventories

Inventories are stated at the lower of cost and net realisable value. Cost includes raw materials, direct labour and expenses, an appropriate proportion of production and other overheads, but not borrowing costs. Cost is calculated on an actual usage basis for maturing inventories and on a first in, first out basis for other inventories.

Financial assets

Trade receivables Trade receivables are non-interest bearing and are stated at their nominal amount that is usually the original invoiced amount less provisions made for bad and doubtful receivables. Estimated

Accounting policies of the group (continued)

irrecoverable amounts are based on the ageing of the receivable balances and historical experience. Individual trade receivables are written off when management deems them not to be collectable.

Cash and cash equivalents Cash and cash equivalents comprise cash in hand and deposits which are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value and have an original maturity of three months or less at acquisition.

Financial liabilities

Borrowings Borrowings are initially measured at cost (which is equal to fair value at inception), and are subsequently measured at amortised cost using the effective interest rate method. The fair value adjustments for all loans designated as hedged items in a fair value hedge are shown separately as a net figure. Any difference between the proceeds, net of transaction costs and the settlement or redemption of borrowings is recognised over the term of the borrowings using the effective interest rate method.

Trade payables Trade payables are non-interest bearing and are stated at their nominal value.

Derivative financial instruments

The group uses derivative financial instruments to hedge its exposures to fluctuations in interest and foreign exchange rates. The derivative instruments used by Diageo consist mainly of currency forwards and currency and interest rate swaps.

Year ended 30 June 2006 From 1 July 2005, derivative financial instruments are recognised in the balance sheet at fair value that is calculated using discounted cash flow techniques or option pricing models (such as Black Scholes) consistently for similar types of instruments. Both techniques take into consideration assumptions based on market data. Changes in the fair value of derivatives that do not qualify for hedge accounting treatment are charged or credited in the income statement.

The purpose of hedge accounting is to mitigate the impact on the group of changes in exchange or interest rates, by matching the impact of the hedged item and the hedging instrument in the income statement. To qualify for hedge accounting, the hedging relationship must meet several conditions with respect to documentation, probability of occurrence, hedge effectiveness and reliability of measurement. At the inception of the transaction, the group documents the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking the hedge transactions. This process includes linking all derivatives designated as hedges to specific assets and liabilities or to specific firm commitments or forecasted transactions. The group also documents its assessment, both at the hedge inception and on a quarterly basis, as to whether the derivatives that are used in hedging transactions have been, and are likely to continue to be, highly effective in offsetting changes in fair value or cash flows of hedged items.

Diageo designates derivatives which qualify as hedges for accounting purposes as either: (a) a hedge of the fair value of a recognised asset or liability (fair value hedge); (b) a hedge of a forecast transaction or the cash flow risk from a change in interest rates (cash flow hedge); or (c) a hedge of a net investment in foreign operations.

The method of recognising the resulting gains or losses from movements in fair values is dependent on whether the derivative contract is designated to hedge a specific risk and qualifies for hedge accounting.

Derivative financial instruments are used to manage the currency and/or interest rate risk to which the fair value of certain assets and liabilities are exposed. From 1 July 2005, changes in the fair value of

Accounting policies of the group (continued)

derivatives that are fair value hedges are recognised in the income statement, along with any changes in the relevant fair value of the underlying hedged asset or liability that is attributable to the hedged risk. If such a hedge relationship is de-designated, fair value movements on the derivative continue to be taken to the income statement while any fair value adjustments made to the underlying hedged item to that date are amortised through the income statement over its remaining life.

Derivative financial instruments are used to hedge the currency risk of highly probable future foreign currency cash flows, as well as the cash flow risk from changes in interest rates. From 1 July 2005, the effective part of the changes in fair value of cash flow hedges is recognised in the statement of recognised income and expense, while any ineffective part is recognised immediately in the income statement. Amounts recorded in the statement of recognised income and expense are transferred to the income statement in the same period in which the forecasted transaction or related interest cash flow affects the income statement.

Net investment hedges take the form of either foreign currency borrowings or derivatives. All foreign exchange gains or losses arising on translation of net investments are recorded in the statement of recognised income and expense and included in cumulative translation differences. Liabilities used as hedging instruments in a net investment hedge are revalued at closing exchange rates. The resulting gains or losses are taken to the statement of recognised income and expense to the extent that they are highly effective, with any ineffectiveness recognised in the income statement. Foreign exchange contracts hedging net investments in overseas businesses are revalued at fair value.

Highly effective fair value movements are taken to the statement of recognised income and expense, with any ineffectiveness recognised in the income statement.

Year ended 30 June 2005 Financial instruments in the year ended 30 June 2005 remain recorded in accordance with the previous UK GAAP accounting policies as follows.

Instruments accounted for as hedges were structured so as to reduce the market risk associated with the underlying transaction being hedged and were designated as a hedge at the inception of the contract. If the underlying transaction to a hedge ceased to exist, the hedge was terminated and the profit or loss was recognised immediately. If the hedge transaction was terminated, the profit or loss was held in the balance sheet and amortised over the life of the original underlying transaction.

Receipts and payments on interest rate instruments were recognised on an accruals basis over the life of the instrument. Foreign exchange contracts hedging net investments in overseas businesses were revalued at closing rates and exchange differences arising were taken to reserves. Gains and losses on contracts hedging forecast transactional cash flows, and on option instruments hedging the sterling value of foreign currency denominated income, were recognised in the hedged periods.

Cash flows associated with derivative financial instruments were classified in the cash flow statement in a manner consistent with those of the transactions being hedged. Finance costs associated with debt issuances were charged to the profit and loss account over the life of the issue.

The cumulative adjustment from UK GAAP to IFRS has been reflected in the consolidated balance sheet at 1 July 2005.

Deferred taxation

Full provision for deferred tax is made for temporary differences between the carrying value of assets and liabilities in the consolidated financial statements and their tax bases. The amount of deferred tax reflects

Accounting policies of the group (continued)

the expected recoverable amount and is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. No deferred tax liability is provided in respect of any future remittance of earnings of foreign subsidiaries where the group is able to control the remittance of earnings and it is probable that such earnings will not be remitted in the foreseeable future.

Discontinued operations

Disposal groups are classified as discontinued operations where they represent a major line of business or geographical area of operations. The income statement for the comparative period is re-presented to disclose the discontinued operations separate from the continuing operations.

Notes to the consolidated financial statements

1 New accounting policies

This note sets out accounting policy developments subsequent to the adoption of IFRS by the group. The transition to IFRS reporting is described in Accounting policies of the group Basis of preparation , with detailed disclosures in note 34.

In August 2005, the IASB issued *IFRS 7 Financial instruments: disclosures*, which contains new regulations concerning the disclosure of financial instruments. IFRS 7 replaces the disclosure regulations of *IAS 32 Financial instruments: disclosure and presentation* and *IAS 39 Financial instruments recognition and measurement* and must be applied to reporting periods that commence on or after 1 January 2007. Diageo has adopted IFRS 7 early in its 2006 financial statements and has applied the exemptions under IFRS 1, IFRS 7 and IAS 32 not to restate comparative information in respect of IFRS 7, IAS 32 and IAS 39. As a consequence, financial instruments included in the 2005 comparative information are still in accordance with UK GAAP, whereas they are accounted for in accordance with IFRS in the 2006 results. In accordance with the transitional provisions of IFRS, this has been treated as a change in accounting policy. The accounting policies for financial instruments under IFRS and, for the year ended 30 June 2005, under UK GAAP are detailed in Accounting policies of the group . The adjustments made to net assets as a result of adopting IAS 39 on 1 July 2005 are detailed in note 34(b). If the group had not taken this exemption, a number of financial instruments would have been recognised or revalued in the opening balance sheet at 1 July 2004 and accounted for under IAS 39 during the year ended 30 June 2005.

The following standards or interpretations, issued by the IASB or the International Financial Reporting Interpretations Committee (IFRIC), have not been adopted by the group:

Amendment to IAS 1 Presentation of financial statements: capital disclosures (effective for annual periods beginning on or after 1 January 2007, with earlier application encouraged).

IFRIC 4 Determining whether an arrangement contains a lease (effective for annual periods beginning on or after 1 January 2006).

IFRIC 5 Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds (effective for annual periods beginning on or after 1 January 2006).

IFRIC 6 Liabilities arising from participating in a specific market: waste electrical and electronic equipment (effective for annual periods beginning on or after 1 December 2005).

IFRIC 7 Applying the restatement approach under IAS 2 Financial reporting in hyperinflationary economies (effective for annual periods beginning on or after 1 March 2006).

IFRIC 8 Scope of IFRS 2 (effective for annual periods beginning on or after 1 May 2006, with early application encouraged). This interpretation has not yet been adopted for use in the EU.

IFRIC 9 Reassessment of embedded derivatives (effective for annual periods beginning on or after 1 June 2006, with early application encouraged). This interpretation has not yet been adopted for use in the EU.

IFRIC 10 Interim financial reporting and impairment (effective for annual periods beginning on or after 1 November 2006). The group will apply the interpretation of the IFRIC in respect of future interim reporting periods.

The group does not currently believe the adoption of these standards or interpretations will have a material impact on the consolidated results or financial position of the group.

Notes to the consolidated financial statements (continued)

2 Segmental information

Continuing operations Diageo is an international manufacturer and distributor of premium drinks. The group produces, markets and distributes a wide range of premium brands, including Smirnoff vodka, Johnnie Walker Scotch whiskies, Guinness stout, Baileys Original Irish Cream liqueur, Captain Morgan rum, J&B Scotch whisky and Tanqueray gin. In addition, Diageo also owns the distribution rights for the José Cuervo tequila brands in the United States and other countries.

Diageo also owns a number of investments in unconsolidated associates, the principal investment being a 34% interest in Moët Hennessy, a French partnership owned by LVMH Moët Hennessy Louis Vuitton SA. Moët Hennessy is based in France and is a leading producer and exporter of champagne and cognac.

Continuing operations comprise the following segments: Diageo North America (United States and Canada), Diageo Europe (all European countries and territories including Russia), Diageo International (Africa, Asia Pacific and Latin America), Moët Hennessy and Corporate and other.

Discontinued operations Included within discontinued operations are transactions relating to the group s quick service restaurants business (Burger King) which was sold on 13 December 2002. In connection with the transaction, Diageo guaranteed up to $850 million (£459 million) of external borrowings of Burger King. On 13 July 2005 Burger King refinanced its external borrowings on a stand-alone basis, releasing Diageo from its obligations under guarantees relating to that debt, and repaid in full the subordinated debt and associated interest owed to Diageo.

Notes to the consolidated financial statements (continued)

2 Segmental information (continued)

(i) Segmental information

	Continuing operations						
	North America £ million	Europe £ million	International £ million	Moët Hennessy £ million	Corporate and other £ million	Discontinued operations £ million	Total £ million
2006							
Sales	**2,968**	**3,834**	**2,826**		**76**		**9,704**
Operating profit/(loss)	**829**	**737**	**644**		**(166)**		**2,044**
Sale of investments and businesses		**1**			**156**		**157**
Share of associates profits after tax		**5**	**4**	**122**			**131**
Profit/(loss) before interest, net finance income and tax	**829**	**743**	**648**	**122**	**(10)**		**2,332**
Depreciation	**(31)**	**(85)**	**(65)**		**(5)**		**(186)**
Intangible asset amortisation	**(8)**	**(14)**	**(4)**		**(2)**		**(28)**
Capital expenditure on segment assets	**28**	**246**	**78**		**111**		**463**
Segment assets	**872**	**1,171**	**1,120**		**238**		**3,401**
Investments in associates		**19**	**19**	**1,303**			**1,341**
Unallocated assets					**9,185**		**9,185**
Total assets	**872**	**1,190**	**1,139**	**1,303**	**9,423**		**13,927**
Segment liabilities	**260**	**628**	**336**		**440**		**1,664**
Unallocated liabilities					**7,582**		**7,582**
Total liabilities	**260**	**628**	**336**		**8,022**		**9,246**
2005							
Sales	2,622	3,860	2,424		62		8,968
Operating profit/(loss) before exceptional items	779	702	615		(164)		1,932
Exceptional items (charged)/credited to operating profit	(30)	(26)	4		(149)		(201)
Operating profit/(loss)	749	676	619		(313)		1,731
Sale of investments and businesses	2	(8)	(1)		221	53	267
Share of associates profits after tax		3	5	113			121
Profit/(loss) before interest, net finance income and tax	751	671	623	113	(92)	53	2,119
Depreciation	(44)	(79)	(49)		(6)		(178)
Exceptional accelerated depreciation		(29)					(29)
Intangible asset amortisation	(7)	(16)	(6)				(29)
Goodwill impairment charge		(5)					(5)
Capital expenditure on segment assets	136	140	117		123		516
Segment assets	872	1,055	1,103		373		3,403
Investments in associates		19	22	1,220			1,261
Unallocated assets					9,257		9,257
Total assets	872	1,074	1,125	1,220	9,630		13,921
Segment liabilities	257	660	343		502		1,762
Unallocated liabilities					7,533		7,533
Total liabilities	257	660	343		8,035		9,295

(a) The segmental analysis of sales and operating profit/(loss) is based on the location of the third party customers.

Notes to the consolidated financial statements (continued)

2 Segmental information (continued)

(b) The group interest expense is managed centrally and is not attributable to individual activities.

(c) Segmental information for the Corporate and other segment, which includes unallocated assets and liabilities, is as follows:

- Sales, operating profit/(loss) before exceptional items, operating profit/(loss), profit/(loss) before interest, net finance income and tax, and depreciation comprise central items not readily allocable to the group s operating segments.

- Exceptional items charged to operating profit in the year ended 30 June 2005 represented the £149 million commitment for payments to the Thalidomide Trust.

- Sale of investments and businesses of £156 million (2005 £221 million) includes £151 million (2005 £221 million) from the sale of General Mills shares.

- Capital expenditure on segment assets of £111 million (2005 £123 million) includes expenditure on intangible assets and property, and equipment of £109 million (2005 £117 million) in respect of unallocated assets, relating to the worldwide supply of product which is not readily allocable to the group s operating segments.

- Segment assets of £238 million (2005 £373 million) comprise: property, plant and equipment of £64 million (2005 £108 million); inventories of £15 million (2005 £nil); and other assets of £159 million (2005 £265 million).

- Unallocated assets of £9,185 million (2005 £9,257 million) comprise: brands of £4,283 million (2005 £4,176 million); property, plant and equipment of £1,114 million (2005 £1,149 million); the net investment in General Mills of £nil (2005 £508 million); maturing inventories of £1,483 million (2005 £ 1,410 million); cash and cash equivalents of £699 million (2005 £787 million); and other assets of £1,606 million (2005 £1,227 million). Brands that are capitalised in the balance sheet are sold throughout the world and are not readily allocable to North America, Europe and International. Property, plant and equipment, maturing inventories and other assets classified as unallocated are principally located in Scotland and are not readily allocable to the group s operating segments.

- Segment liabilities of £440 million (2005 £502 million) comprise trade and other payables of £270 million (2005 £320 million) and provisions of £170 million (2005 £182 million).

- Unallocated liabilities of £7,582 million (2005 £7,533 million) comprise external borrowings of £4,760 million (2005 £4,546 million); corporate tax payable of £681 million (2005 £777 million); post employment benefit liabilities of £815 million (2005 £1,306 million); and other liabilities of £1,326 million (2005 £904 million).

(d) The weighted average exchange rates used in the translation of income statements were US dollar £1 = $1.78 (2005 £1 = $1.86) and euro £1 = 1.46 (2005 £1 = 1.46). Exchange rates used to translate assets and liabilities at the balance sheet date were US dollar £1 = $1.85 (2005 £1 = $1.79) and euro £1 = 1.45 (2005 £1 = 1.48). The group uses foreign exchange transaction hedges to mitigate the effect of exchange rate movements.

Notes to the consolidated financial statements (continued)

2 Segmental information (continued)

(ii) Geographical information

	Great Britain £ million	Rest of Europe £ million	North America £ million	Asia Pacific £ million	Latin America £ million	Rest of World £ million	Total £ million
2006							
Sales	**1,549**	**2,428**	**2,999**	**1,085**	**671**	**972**	**9,704**
Long-lived assets	**1,975**	**652**	**2,782**	**704**	**54**	**332**	**6,499**
Segment assets	**711**	**775**	**807**	**347**	**168**	**593**	**3,401**
Capital expenditure on segment assets	**70**	**247**	**64**	**17**	**13**	**52**	**463**
2005							
Sales	1,553	2,421	2,658	918	564	854	8,968
Long-lived assets	1,784	661	2,838	690	51	318	6,342
Segment assets	723	642	987	324	144	583	3,403
Capital expenditure on segment assets	83	152	158	24	8	91	516

(a) The geographical analysis of sales is based on the location of the third party customers and an allocation of certain corporate items. Certain businesses, for internal management purposes, have been reported within the appropriate region in the geographical analysis above. Corporate sales of £76 million (2005 £62 million) are included in Great Britain.

(b) Long-lived assets comprise intangible assets and property, plant and equipment after amortisation and depreciation respectively, and biological assets. Brands are included at net book value in the geographical regions in which the brands originated.

(c) The geographical analysis of segment assets and related capital expenditure is based on the geographical location of the assets and excludes investments in associates and assets and capital expenditure which are not readily allocable to the group s operating segments.

(d) Exports from the United Kingdom were £1,952 million (2005 £1,898 million).

Notes to the consolidated financial statements (continued)

3 Operating costs

	2006 £ million	2005 £ million
Excise duties	**2,444**	2,291
Cost of sales	**2,921**	2,632
Marketing	**1,127**	1,013
Other operating expenses	**1,168**	1,301
	7,660	7,237
Comprising:		
Excise duties United States	**457**	428
Other	**1,987**	1,863
Change in inventories	**(6)**	(84)
Raw materials and consumables	**1,729**	1,545
Advertising, marketing and promotion	**1,127**	1,013
Other external charges	**1,225**	1,306
Staff costs (note 4)	**952**	884
Depreciation and other amounts written off non-current assets	**214**	241
Losses/(gains) on disposal of property	**4**	(7)
Net foreign exchange (gains)/losses	**(22)**	53
Other operating income	**(7)**	(5)
	7,660	7,237

(a) Other external charges include operating lease rentals for plant and equipment of £5 million (2005 £6 million), other operating lease rentals (mainly properties) of £64 million (2005 £70 million), research and development expenditure of £18 million (2005 £16 million), and maintenance and repairs of £45 million (2005 £51 million).

(b) Exceptional operating costs There were no exceptional operating costs for the year ended 30 June 2006. Exceptional operating costs for continuing operations in the year ended 30 June 2005 amounted to £201 million as follows: other external charges £172 million, staff costs £5 million, and amounts written off assets £31 million, offset by £7 million gains on disposal of property.

(c) Auditor fees The fees of the principal auditor of the group, KPMG Audit Plc, and its affiliates were as follows:

	United Kingdom £ million	Rest of World £ million	2006 £ million	2005 £ million
Audit fees	**1.9**	**2.5**	**4.4**	4.1
Other audit-related fees	**2.5**	**0.1**	**2.6**	1.6
Tax fees	**0.3**	**1.1**	**1.4**	1.4
All other fees	**0.2**	**0.1**	**0.3**	
	4.9	**3.8**	**8.7**	7.1

Notes to the consolidated financial statements (continued)

3 Operating costs (continued)

Audit fees include £3.8 million (2005 £3.7 million) for audit of group subsidiaries and £0.6 million (2005 £0.4 million) for other audit services required by statute or regulation. A further £0.3 million (2005 £0.2 million) was charged in relation to the audit by firms other than KPMG. Other audit-related fees relate principally to: advisory services in respect of Diageo s preparedness for Sarbanes-Oxley Act section 404; due diligence and other services in relation to acquisitions and disposals; and employee pension fund and benefit plan services. Tax fees relate principally to tax compliance services and tax advice. Other fees in the year consist principally of project review costs.

4 Employees

	2006 Employees	2005 Employees
Average number of employees		
Full time	**21,972**	22,333
Part time	**647**	633
	22,619	22,966

	2006 £ million	2005 £ million
Aggregate remuneration		
Wages and salaries	**761**	708
Share-based incentive plans	**26**	28
Employer s social security	**59**	59
Employer s pension	**99**	84
Other post employment	**7**	5
	952	884

Of the charge to the consolidated income statement for the year ended 30 June 2006, in respect of post employment benefits, £45 million has been included in cost of sales and £61 million has been included in other operating expenses (2005 £41 million and £48 million, respectively), and in respect of share-based incentive plans, £5 million has been included in cost of sales and £21 million has been included in other operating expenses (2005 £6 million and £22 million, respectively).

Retirement benefits The group operates a number of pension plans throughout the world, devised in accordance with local conditions and practices.

The larger plans are generally of the defined benefit type and are funded by payments to separately administered funds or insurance companies. The principal plans are in the United Kingdom, Ireland, United States and Canada. All valuations were performed by independent actuaries using the projected unit method to determine pension costs. The most recent full valuations of the significant defined benefit pension plans were carried out as follows: United Kingdom on 31 March 2003; United States on 1 January 2006; and Ireland on 31 December 2003. The measurement dates used to calculate the disclosures in the consolidated financial statements are the respective balance sheet dates. A full valuation of the Diageo pension scheme in the United Kingdom is being carried out as at 31 March 2006, but this will not be finalised and approved by the trustees until November 2006 and the updated membership data has not been reflected in the disclosures which follow.

Notes to the consolidated financial statements (continued)

4 Employees (continued)

The group also operates a number of plans, primarily in the United States, which provide employees with post employment benefits in respect of medical costs. These plans are generally unfunded. In addition, there are a number of other schemes which provide post employment benefits other than pensions and medical benefits. These schemes are also included in the figures presented below.

(a) The following weighted average assumptions were used to determine the group s deficit/surplus in the post employment plans at 30 June in the relevant year. The assumptions used to calculate the profit and loss charge/credit for the year to 30 June are based on the assumptions disclosed as at the previous 30 June.

	United Kingdom		Ireland		United States	
	2006	2005	2006	2005	2006	2005
	%	%	%	%	%	%
Rate of general increase in salaries	**3.8**	3.9	**4.0**	4.0	**3.4**	3.0
Rate of increase to pensions in payment	**2.9**	2.6	**2.1**	2.1		
Rate of increase to deferred pensions	**2.8**	2.5	**2.0**	2.1		
Medical inflation	**n/a**	n/a	**n/a**	n/a	**9.0**	10.0
Discount rate for plan liabilities	**5.2**	4.9	**4.8**	4.0	**6.3**	5.0
Inflation	**2.8**	2.5	**2.0**	2.0	**2.4**	2.0

For the UK and US plans, there are, in addition to the above percentages, age related promotional salary increases. The 2006 assumption for medical inflation in the United States reduces by 1% per year to 5% (2005 1% per year to 5%).

In assessing the group s post retirement liabilities, the mortality assumption for the largest plan (which is in the United Kingdom) is based on the mortality experience of that plan. This mortality experience analysis was carried out in 2006 as part of the triennial funding valuation of that plan. The assumption is based on up to date mortality tables and allows for future improvements in life expectancy. The mortality assumptions for the other plans around the world are based on relevant standard mortality tables in each country.

For the UK and Irish pension funds, the table below illustrates the expected age at death of an average worker who retires currently at the age of 65, and one who is currently aged 45 and subsequently retires at the age of 65:

	United Kingdom		Ireland	
	2006	2005	2006	2005
	Age	Age	Age	Age
Retiring currently at age 65				
Male	**84.3**	83.5	**84.0**	84.0
Female	**87.1**	86.4	**86.9**	86.9
Currently aged 45, retiring at age 65				
Male	**86.7**	85.2	**84.8**	84.8
Female	**89.4**	88.1	**87.8**	87.8

Notes to the consolidated financial statements (continued)

4 Employees (continued)

(b) The amounts charged in respect of post employment plans to the consolidated income statement and consolidated statement of recognised income and expense for the two years ended 30 June 2006 are set out below:

	United Kingdom £ million	Ireland £ million	United States and other £ million	Total £ million
2006				
Operating profit				
Current service cost	**(58)**	**(22)**	**(24)**	**(104)**
Past service cost	**(1)**	**(1)**		**(2)**
Gains on curtailments	**1**			**1**
Total charge to operating profit	**(58)**	**(23)**	**(24)**	**(105)**
Net credit/(cost) to other finance income (note 6(ii))	**14**	**11**	**(6)**	**19**
Charge before taxation	**(44)**	**(12)**	**(30)**	**(86)**
Consolidated statement of recognised income and expense				
Actual return on post employment plan assets	**513**	**84**	**15**	**612**
Expected return on post employment plan assets	**(191)**	**(60)**	**(24)**	**(275)**
Actual return less expected return on post employment plan assets	**322**	**24**	**(9)**	**337**
Experience gains and losses arising on the plan liabilities	**(29)**	**(14)**	**(12)**	**(55)**
Changes in assumptions underlying the present value of the plan liabilities	**(2)**	**149**	**36**	**183**
Actuarial gain recognisable in the reconciliation of the surplus	**291**	**159**	**15**	**465**
Changes in the recognisable surplus of the plans with a surplus restriction			**(6)**	**(6)**
Actuarial gain recognisable in the consolidated statement of recognised income and expense	**291**	**159**	**9**	**459**
2005				
Operating profit				
Current service cost	(58)	(15)	(20)	(93)
Past service cost	(2)	(10)		(12)
Gains on curtailments	18		1	19
Losses on settlements			(2)	(2)
Total charge to operating profit	(42)	(25)	(21)	(88)
Net credit/(cost) to other finance income (note 6(ii))	4	9	(4)	9
Charge before taxation	(38)	(16)	(25)	(79)
Consolidated statement of recognised income and expense				
Actual return on post employment plan assets	318	129	30	477
Expected return on post employment plan assets	(194)	(62)	(24)	(280)
Actual return less expected return on post employment plan assets	124	67	6	197
Experience gains and losses arising on the plan liabilities	3	(15)	(12)	(24)
Changes in assumptions underlying the present value of the plan liabilities	(171)	(198)	(50)	(419)
Actuarial loss recognisable in the reconciliation of the surplus	(44)	(146)	(56)	(246)
Changes in the recognisable surplus of the plans with a surplus restriction			8	8
Actuarial loss recognisable in the consolidated statement of recognised income and expense	(44)	(146)	(48)	(238)
Total cumulative gain/(loss) recognised in the consolidated statement of recognised income and expense				
At 1 July 2004				
Recognised in the year	**(44)**	**(146)**	**(48)**	**(238)**
At 30 June 2005	**(44)**	**(146)**	**(48)**	**(238)**
Recognised in the year	**291**	**159**	**9**	**459**
At 30 June 2006	**247**	**13**	**(39)**	**221**

Notes to the consolidated financial statements (continued)

4 Employees (continued)

(c) The expected long term rates of return and fair values of the assets of the significant defined benefit post employment plans were as follows:

	United Kingdom Expected long term rates of return %	Fair value £ million	Ireland Expected long term rates of return %	Fair value £ million	United States and other Expected long term rates of return %	Fair value £ million	Total Expected long term rates of return %	Fair value £ million
2006								
Fair value of plan assets								
Equities	**7.8**	**2,504**	**7.6**	**759**	**8.5**	**213**	**7.8**	**3,476**
Bonds	**4.9**	**224**	**4.4**	**146**	**5.6**	**125**	**4.9**	**495**
Property	**6.8**	**389**	**6.6**	**138**	**11.6**	**10**	**6.8**	**537**
Other	**4.1**	**93**	**2.8**	**16**	**5.8**	**30**	**4.3**	**139**
		3,210		**1,059**		**378**		**4,647**
Present value of funded plan liabilities		**(3,688)**		**(1,149)**		**(363)**		**(5,200)**
Present value of unfunded plan liabilities		**(73)**				**(151)**		**(224)**
Deficit in post employment plans		**(551)**		**(90)**		**(136)**		**(777)**
Surplus restriction						**(24)**		**(24)**
Post employment benefit liabilities		**(551)**		**(90)**		**(160)**		**(801)**
2005								
Fair value of plan assets								
Equities	7.5	2,254	6.9	712	8.0	215	7.4	3,181
Bonds	4.7	128	3.4	159	5.1	112	4.3	399
Property	6.5	322	5.9	120	12.1	10	6.5	452
Other	3.8	82	2.0	9	3.5	13	3.6	104
		2,786		1,000		350		4,136
Present value of funded plan liabilities		(3,562)		(1,238)		(373)		(5,173)
Present value of unfunded plan liabilities		(76)				(163)		(239)
Deficit in post employment plans		(852)		(238)		(186)		(1,276)
Surplus restriction						(18)		(18)
Post employment benefit liabilities		(852)		(238)		(204)		(1,294)

Included in the post employment plan deficit of £777 million (2005 £1,276 million) is £101 million (2005 £95 million) in respect of post employment medical benefit liabilities and £41 million (2005 £43 million) in respect of other non pension post employment liabilities.

Included in the plan assets above is £7 million (2005 £19 million) invested in the ordinary shares of Diageo plc.

Notes to the consolidated financial statements (continued)

4 Employees (continued)

Post employment benefit assets and liabilities are recognised in the consolidated balance sheet as follows:

	2006 £ million	2005 £ million
Non-current assets	**14**	12
Non-current liabilities	**(815)**	(1,306)
	(801)	(1,294)

The expected long term rates of return for equities have been determined by reference to government bond rates (minimum risk rates) in the countries in which the plans are based. As at 30 June 2006, to reflect the additional risks associated with equities, expected long term rates of return on equities include a risk premium of 3.25% per year (2005 3.25% per year) in excess of the expected return from government bonds. This risk premium is a long term assumption which is set after taking actuarial advice and considering the assumptions used by other FTSE 100 companies. The expected long term rates of return for other assets are determined in a similar way, by using an appropriate risk premium relative to government bonds in the relevant country.

The group s investment strategy for its funded post employment plans is decided locally by the trustees of the plan and/or Diageo, as appropriate, and takes account of the relevant statutory requirements. The group s objective for the investment strategy is to achieve a target rate of return in excess of the return on the liabilities, while taking an acceptable amount of investment risk relative to the liabilities. This objective is implemented by using specific allocations to a variety of asset classes that are expected over the long term to deliver the target rate of return. Most investment strategies have significant allocations to equities, with the intention that this will result in the ongoing cost to the group of the post employment plans being lower over the long term, and will be within acceptable boundaries of risk. Each investment strategy is also designed to control investment risk by managing allocations to asset classes, geographical exposures and individual stock exposures. For the Diageo pension scheme in the United Kingdom (UK pension scheme), as at 30 June 2006 the target investment allocations were approximately 85% of the assets in equities, 5% in bonds and 10% in property. In addition the UK pension scheme uses interest rate and inflation swaps to help manage the mismatch between the pension scheme s assets and the present value of its liabilities. At 30 June 2006, approximately 40% of the UK pension scheme s liabilities were hedged against future movements in interest rates and inflation and the fair value of these swaps was £3 million. For the principal Irish pension scheme, as at 30 June 2006 the target investment allocations were approximately 70% of the assets in equities, 20% in bonds and 10% in property.

The trustees of the UK pension scheme and principal Irish pension scheme have recently reviewed their investment strategy and approved a phased approach to further increasing asset diversification and, subject to solvency triggers, a phased approach to progressively reducing risk by increasing the bond allocation.

The discount rate is based on the yields of high quality, long dated, fixed income investments of similar duration to the liabilities. For the UK pension scheme, which represents approximately 70% of total post employment benefit liabilities, the discount rate is based on the i-Boxx over 15-year non-gilt AA sterling corporate bond index at 30 June rounded to the nearest 0.1%. A similar process is used to determine the discount rate for the non-UK plans.

Notes to the consolidated financial statements (continued)

4 Employees (continued)

The percentages of investments at fair value held by the pension plans at 30 June 2006 and 30 June 2005, analysed by category, were as follows:

	United Kingdom %	Ireland %	United States and other %	Total %
2006				
Equities	**78**	**72**	**56**	**75**
Bonds	**7**	**14**	**33**	**10**
Property	**12**	**13**	**3**	**12**
Other	**3**	**1**	**8**	**3**
	100	**100**	**100**	**100**
2005				
Equities	81	71	61	77
Bonds	5	16	32	10
Property	12	12	3	11
Other	2	1	4	2
	100	100	100	100

(d) Movements in the present value of plan liabilities during the two years ended 30 June 2006:

	United Kingdom £ million	Ireland £ million	United States and other £ million	Total £ million
Present value of plan liabilities at 1 July 2004	**3,374**	**994**	**444**	**4,812**
Exchange differences		**4**	**15**	**19**
Acquisition of businesses			**3**	**3**
Current service cost	**58**	**15**	**20**	**93**
Past service cost	**2**	**10**		**12**
Interest cost	**190**	**53**	**28**	**271**
Actuarial loss	**168**	**213**	**62**	**443**
Employee contributions	**8**	**2**	**1**	**11**
Benefits paid	**(144)**	**(53)**	**(38)**	**(235)**
Curtailments	**(18)**		**(1)**	**(19)**
Settlements			**2**	**2**
Present value of plan liabilities at 30 June 2005	**3,638**	**1,238**	**536**	**5,412**
Exchange differences		**25**	**(8)**	**17**
Acquisition of businesses	**8**		**1**	**9**
Current service cost	**58**	**22**	**24**	**104**
Past service cost	**1**	**1**		**2**
Interest cost	**177**	**49**	**30**	**256**
Actuarial loss/(gain)	**31**	**(135)**	**(24)**	**(128)**
Employee contributions	**8**	**2**	**1**	**11**
Benefits paid	**(153)**	**(53)**	**(38)**	**(244)**
Curtailments	**(1)**			**(1)**
Settlements	**(6)**		**(8)**	**(14)**
Present value of plan liabilities at 30 June 2006	**3,761**	**1,149**	**514**	**5,424**

Notes to the consolidated financial statements (continued)

4 Employees (continued)

For the year ended 30 June 2006, benefits paid include £3 million in respect of post employment medical benefits in the United States and there were no subsidy receipts in respect of prescription drugs.

(e) Movements in the fair value of plan assets during the two years ended 30 June 2006:

	United Kingdom £ million	Ireland £ million	United States and other £ million	Total £ million
Fair value of plan assets at 1 July 2004	2,499	906	315	3,720
Exchange differences		6	10	16
Acquisition of businesses			3	3
Expected return on plan assets	194	62	24	280
Actuarial gain	124	67	6	197
Contributions by the group	105	10	29	144
Employee contributions	8	2	1	11
Benefits paid	(144)	(53)	(38)	(235)
Fair value of plan assets at 30 June 2005	2,786	1,000	350	4,136
Exchange differences		21	(7)	14
Acquisition of businesses	6			6
Reclassification from current assets			18	18
Expected return on plan assets	191	60	24	275
Actuarial gain/(loss)	322	24	(9)	337
Contributions by the group	56	5	47	108
Employee contributions	8	2	1	11
Benefits paid	(153)	(53)	(38)	(244)
Settlements	(6)		(8)	(14)
Fair value of plan assets at 30 June 2006	3,210	1,059	378	4,647

The group has agreed a deficit funding plan with the trustees of the Diageo pension scheme in the United Kingdom which provides for the group to fund the scheme deficit over a four year period beginning in the year ending 30 June 2007. For these purposes, the value of the deficit, calculated using the trustees actuarial valuation of the scheme, will be ascertained through the triennial valuation as at 31 March 2006. Following the completion of that valuation, the annual cash contribution that Diageo will make under this funding plan is estimated to be £50 million in each of the four years of the plan. Payments will be made into an escrow account under the joint control of the group and the trustees, with release from escrow to either the group or the trustees determined by an agreed formula in the light of the actuarial valuation of the scheme as at 31 March 2009. Investment returns on the funds held in escrow will accrue to the group. In addition to the deficit funding, Diageo will continue to make a cash contribution in respect of current service cost based on the trustees valuation; this contribution is expected to be £52 million in the year ending 30 June 2007. Funding arrangements will be reviewed and adjusted in the light of future triennial actuarial valuations.

Contributions to other plans in the year ending 30 June 2007 are expected to be approximately £37 million.

Notes to the consolidated financial statements (continued)

4 Employees (continued)

(f) The future benefits expected to be paid by the post employment plans, up to 30 June 2016, are as follows:

	Payments due in the year ending 30 June					
	2007 £ million	2008 £ million	2009 £ million	2010 £ million	2011 £ million	2012-2016 £ million
United Kingdom pension benefits	160	164	169	173	178	961
other	2	2	2	2	2	8
Ireland pension benefits	55	55	56	56	57	298
United States and Canada pension benefits	35	19	20	21	20	110
other	5	5	5	6	6	29
Other countries pension benefits	5	5	5	5	5	25
other	6	6	6	6	6	32
	268	256	263	269	274	1,463

(g) Changes in the assumptions used for determining post employment costs and liabilities may have a material impact on the income statement and balance sheet. For the significant assumptions, the following sensitivity analysis gives an estimate of these impacts for the year ended 30 June 2006:

	2006 £ million
A 0.5% decrease in the discount rate would have the following approximate effect:	
Increase in annual post employment cost	8
Increase in post employment deficit	400
A 1% decrease in the expected rates of return on plan assets would have the following approximate effect:	
Increase in annual post employment cost	40
A one year increase in life expectancy would have the following approximate effect:	
Increase in annual post employment cost	14
Increase in post employment deficit	180
A 0.5% increase in inflation would have the following approximate effect:	
Increase in annual post employment cost	31
Increase in post employment deficit	300
A 1% decrease in medical care inflation would have the following approximate effect:	
Decrease in annual post employment cost	(1)
Decrease in post employment deficit	(12)

(h) Information on transactions between the group and its pension plans is given in note 31.

Defined contribution plans The group also has a number of defined contribution plans, for which the total cost charged to the income statement of £1 million (2005 £1 million) represents contributions payable to these plans by the group at rates specified in the rules of the plans.

Notes to the consolidated financial statements (continued)

5 Exceptional items Continuing operations

IAS 1 Presentation of financial statements requires additional headings to be presented when such presentation is relevant to the understanding of the entity s financial performance. The group presents certain items separately as exceptional . 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.

In the two years ended 30 June 2006, the following exceptional items arose in respect of continuing operations:

	2006 £ million	2005 £ million
Operating items (note (i))		(201)
Sale of General Mills shares (note (ii))	**151**	221
Sale of other businesses	**6**	(7)
Exceptional items before taxation	**157**	13
(i) Operating items		
Park Royal brewery accelerated depreciation(a)		(29)
Seagram integration costs(b)		(30)
Thalidomide Trust(c)		(149)
Disposal of property		7
		(201)

(a) In the year ended 30 June 2005, the charge for accelerated depreciation of the Park Royal brewery of £29 million related to the closure of that facility in June 2005. The original announcement of this closure was in April 2004.

(b) A number of the former Seagram spirits and wine businesses were acquired on 21 December 2001. In the three and a half years to 30 June 2005, a total of £411 million was charged to the income statement for the integration of the businesses, principally in respect of Diageo North America, and 2,350 jobs were terminated. No amounts were charged to the income statement in respect of the Seagram integration in the year ended 30 June 2006.

An analysis of the movement in the Seagram integration liability since 1 July 2004 is as follows:

	Liability at 1 July 2004 £ million	Charged to income statement in year ended 30 June 2005 £ million	Cash payments £ million	Liability at 30 June 2005 £ million	Cash payments £ million	Liability at 30 June 2006 £ million
Employee related	8	5	(5)	8	**(7)**	**1**
Distributor rationalisation	1		(1)			
Lease terminations	4	4	(6)	2	**(1)**	**1**
Legal and professional	10	2	(5)	7	**(6)**	**1**
Other	5	17	(19)	3	**(2)**	**1**
	28	28	(36)	20	**(16)**	**4**
Asset write downs		2				
		30				

Notes to the consolidated financial statements (continued)

5 Exceptional items Continuing operations (continued)

(c) In the year ended 30 June 2005, exceptional operating costs included a charge of £149 million in respect of payments to the Thalidomide Trust. It is expected that the future annual payment will be around £6.5 million per annum. This amount will be index-linked and is expected to be a final settlement payable over the period to 2037. Provision has been made for the discounted value of these payments.

(ii) Sale of General Mills shares In the year ended 30 June 2006, the group made a £151 million profit on the sale of 25 million shares in General Mills (2005 £221 million profit on the disposal of 54 million shares).

(iii) Taxation Exceptional tax credits of £315 million include exceptional income of £313 million recognised following the agreement with fiscal authorities of the carrying values of certain brands that resulted in an increase in the group s deferred tax assets. In the year ended 30 June 2005, exceptional tax credits of £78 million comprised £58 million of tax credits on exceptional operating items and £20 million of tax credits on prior year business disposals.

6 Interest and other finance income and charges

	2006 £ million	2005 £ million
(i) Net interest		
Interest receivable	**27**	121
Market value gain on derivative interest rate instruments	**24**	
Total interest income	**51**	121
Interest payable on bank loans and overdrafts	**(6)**	(15)
Interest payable on all other borrowings	**(223)**	(256)
Market value loss on derivative interest rate instruments	**(15)**	
Total interest expense	**(244)**	(271)
	(193)	(150)
(ii) Other finance income		
Interest on post employment plan liabilities	**(256)**	(271)
Expected return on post employment plan assets	**275**	280
Net finance income in respect of post employment plans	**19**	9
Investment income dividends receivable from General Mills	**5**	17
	24	26
(iii) Other finance charges		
Unwinding of discounts on provisions and receivables	**(15)**	(7)
Finance charge on finance lease obligations		(1)
Other charges		(1)
Net exchange movements on short term intercompany loans	**(2)**	(8)
	(17)	(17)

Notes to the consolidated financial statements (continued)

7 Associates

	2006 £ million	2005 £ million
Share of sales	**734**	677
Share of operating costs	**(524)**	(492)
Share of operating profit	**210**	185
Share of net interest payable	**(10)**	(2)
Share of taxation	**(69)**	(62)
Share of profits attributable to equity shareholders	**131**	121
Dividends received by the group	**(106)**	(105)
Share of profits retained by associates	**25**	16

The dividends received by the group in the year ended 30 June 2006 include £39 million (2005 £41 million) of receipts from Moët Hennessy in respect of amounts payable to the tax authorities.

Information on transactions between the group and its associates is given in note 31. Summarised financial information for the group s investments in associates is presented below:

(a) Moët Hennessy Moët Hennessy prepares its financial statements under IFRS in euros to 31 December each year. Summary information for Moët Hennessy for the two years ended 30 June 2006, in each year aggregating the results for the six month period ended 31 December with that of the following six months ended 30 June, translated at £1 = 1.46 (2005 £1 = 1.46), is set out below:

	2006 million	£ million	2005 million	£ million
Sales	**2,795**	**1,914**	2,382	1,632
Profit for the year	**522**	**358**	467	320

After adjustments to align Moët Hennessy s accounting policies with those of the group, the group s 34% share of operating profit before exceptional items and of profit after tax of Moët Hennessy were £198 million and £122 million, respectively (2005 £173 million and £113 million, respectively).

(b) Other associates For all of the group s investments in associates other than Moët Hennessy, summarised financial information, aggregating 100% of the sales and results of each associate, is presented below:

	2006 £ million	2005 £ million
Sales	**399**	398
Profit for the year	**47**	36

Notes to the consolidated financial statements (continued)

8 Taxation Continuing operations

(i) Analysis of taxation charge in the year

	2006 Before exceptional items £ million	Exceptional items £ million	Total £ million	2005 Before exceptional items £ million	Exceptional items £ million	Total £ million
Current tax						
Current year	**304**	**(2)**	**302**	333	(30)	303
Benefit of previously unrecognised tax losses	**(1)**		**(1)**			
Adjustments in respect of prior periods	**(38)**		**(38)**	(15)	(12)	(27)
	265	**(2)**	**263**	318	(42)	276
Deferred tax						