

## Audit committee report

The audit committee consists of four independent non-executive Directors, Neil Cross (committee Chairman), Adrian Loader, Patrick Ponsolle and Manfred Stach. The Group Finance Director, the Director of Internal Audit, the Group Financial Controller and representatives from the external auditors are normally invited to attend meetings as appropriate. The committee met four times during 2005, the attendance record of members being shown in the table on page 51. In accordance with the requirements of the Code, Paolo Scaroni resigned as a member of the committee on his appointment as Chairman of the Company.

The Director of Internal Audit has the right of direct access to the committee and the Chairman of the Company. The committee has the right to seek and receive any information it requires to fulfil its duties and all Directors and employees are directed to co-operate with any request made by the committee and to attend on demand any meeting of the committee to answer questions.

At each meeting in 2005 the committee met the Director of Internal Audit and representatives from the external auditor without executive management present. Attendance of members at committee meetings is shown in the Board report on corporate governance. The Chairman of the committee attends the AGM to respond to any shareholder questions that might be raised on the committee's activities. Following each committee meeting, the Chairman of the committee reports material matters to the Board at the next available opportunity.

Neil Cross has a background in investment analysis and corporate finance, is a Chartered Secretary and currently chairs two PLC audit committees. The Board is satisfied that he has both current and relevant financial experience.

### Terms of reference

The terms of reference of the committee, which are available on the Company's website, were reviewed and updated during 2005. The main responsibilities of the committee, which are set out in the terms of reference, are to:

- review the effectiveness of systems for internal financial control, financial reporting and risk management;
- monitor, review and challenge where necessary the integrity of financial statements and formal announcements relating to the financial performance of the Group;
- consider the appointment, re-appointment and/or removal of the external auditor;
- consider any change to the independence of, objectivity of and fees to the external auditor;
- consider the effectiveness of the external audit process taking into consideration relevant UK professional and regulatory requirements;
- maintain and monitor a policy on the engagement of the external auditor to supply non-audit services;
- agree with the external auditor the scope and nature of their audit, review their quality control procedures, ensure co-ordination of audits, review their management letter and management's response, and discuss any issues arising from their audit;
- review the programme, resourcing, effectiveness and results of the internal audit function and approve any change to the Director of Internal Audit;
- oversee the process for dealing with complaints received by the Group regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- review the consistency of accounting policies;
- monitor compliance with the Group's borrowing limits; and
- monitor compliance with the principles of good boardroom practice.

### Operation of the audit committee

During the year, the business considered and discussed by the committee included:

- a review of the financial disclosures contained in the Interim and Annual Reports to shareholders, together with the associated interim and preliminary announcements;
- a review of the Company's compliance with the Code, including disclosures required to be included in the Annual Report;
- a review of the appropriateness and financial impact of accounting policy changes arising from the adoption of IFRS. This included a review of choices made under the first time adoption transition arrangements;
- a review of the preliminary comparative financial information prepared in accordance with IFRS for the six months ended 30 June 2004 and year ended 31 December 2004, together with detailed income statements and balance sheet reconciliations to UK GAAP. This information was published on 18 July 2005;
- proposals from the external auditor about their independent review of the financial information contained within the Interim Report 2005 and their audit programme for the 2005 financial statements;
- the amounts of audit and non-audit fees paid to the external auditor. (The amounts for 2005 are set out in note 9 to the financial statements.) The Company's policy on non-audit services provided by the external auditor is set out on page 53;
- a review of the objectivity, independence and effectiveness of the external auditor. The committee, after considering a paper on the independence, objectivity and effectiveness of the external auditor, unanimously agreed to recommend the re-appointment of Deloitte & Touche LLP as the Company's external auditor at the 2006 AGM;

- a review of internal controls, accounting policies and practices and risk management procedures including an annual risk review. The committee monitored and reviewed the effectiveness of the Group's internal control systems, accounting policies and practices and risk management procedures, as well as the Company's statement on internal controls. The Board retains overall responsibility for internal control and the identification and management of risks;
- proposals from the internal audit function about its audit programme for 2006;
- the results of audits conducted by the internal audit function and management's response to issues raised;
- an annual review of the effectiveness of the internal audit function. The committee considered that the function had been effective throughout 2005 based on an external assessment conducted in the second half of 2005;
- a review of the arrangements for employees to raise concerns, in confidence, about possible wrongdoing in financial reporting or other matters, further details of which are set out below; and
- a review of the committee's effectiveness which concluded that it had discharged its responsibilities as set out in its terms of reference.

#### Policy on non-audit services

As part of its remit, the committee keeps under review the nature and extent of audit and non-audit services provided to the Group by the external auditor. The committee has approved a policy for the approval of non-audit services provided by the external auditor. Under this policy, the external auditor cannot be engaged to perform any of the following services:

- bookkeeping for underlying accounting records or preparation of financial statements to be audited and used outside the Group;
- appraisals or other valuation services where the results may be incorporated in audited financial statements;
- actuarial or pension advisory services;
- management functions including human resources;

- investment advisory services, including broking or investment banking;
- legal services;
- internal audit (on an outsourced basis);
- design and/or implementation of financial information systems; and
- any other services that a listed company's external auditors are prohibited from providing under UK or US regulations.

This list of prohibited non-audit services may only be varied by the audit committee.

Under this policy it has been agreed that, due to their significant understanding of the Group's business and therefore ensuring cost efficiency, the external auditors may be engaged for the following non-audit services:

- assistance in tax compliance activities including tax advisory services;
- due diligence activities associated with potential acquisitions or disposals of businesses;
- accountants reports for any Stock Exchange purposes and ad hoc reporting on historical financial information; and
- any other services which are not prohibited and are authorised by the audit committee.

The policy requires the fees for these permitted non-audit services to be approved in advance by the committee. Where such services are considered to be recurring in nature, such as for tax and due diligence, approval may be sought for the full financial year at the beginning of that year. Approval for other permitted non-audit services has to be sought on a case by case basis. Where no committee meeting is scheduled within an appropriate time frame, the approval is to be sought from the Chairman of the committee. The fee threshold for pre-approved services during 2005 was £0.6 million in total for taxation services and £0.5 million in total for due diligence and related services. In accordance with this policy, during 2005 the committee approved the appointment of the external auditor to prepare a synergy report, a working capital report and to carry out due diligence work in connection with the Company's proposed merger with Boots.

#### Policy on employment of former employees of the external auditor

As part of its remit, the committee keeps under review the objectivity, independence and effectiveness of the external auditor. During 2005 the committee approved a policy on the employment by the Group of former employees or partners of the external auditor. Under this policy:

- no member of the external audit team can be recruited into a Group role in the Company for a period of two years following their association with the audit;
- no current or former partner of the external auditor may be appointed as a Director of the Company for three years after the termination of their employment with the external auditor; and
- no current or former partner or employee of the external auditor may be appointed as a Director of the Company or join its executive committee at any time without the prior approval of the Chairman of the audit committee.

Each year, the Group Director of Human Resources is required to satisfy compliance with this policy to the audit committee.

#### Whistleblowing

A 24 hour helpline, managed by a third party, was introduced in the UK in 2004. This helpline, which will be introduced in The Netherlands in 2006, provides reports to designated officers of the Company, including the Company Secretary, who in turn report cases to the committee. Throughout the rest of the Group, the Company's whistleblowing policy sets out arrangements whereby employees can report to the Company Secretary any concerns or suspicions about possible wrongdoing in financial reporting or other matters, which are reported to the committee.

#### Neil Cross

Chairman of the audit committee  
28 February 2006