The company's governing objective is to maximise the value of the company for the benefit of its shareholders

Performance measurement Our governing objective is achieved by investing in our businesses to generate strong cash flows and superior long term returns. We believe that the best overall measure of group performance and hence our success in achieving our objective is total return to shareholders. This is calculated from the movement in the share price and the value of dividends as if reinvested when paid. We monitor our performance on a rolling five year basis against ten peer companies, the results of which are shown in the table below. In a competitive year we have maintained our position at number four in the table although the relative positions of the other peer companies have in some cases altered.

Investment in our businesses is determined, not by sales growth or accounting profits, but by 'economic profit'. This is the present value cash return we expect to make for shareholders after charging an appropriate amount for the capital invested. Currently, this cost of capital for most of the group is 8.5 per cent, after tax and after discounting separately for specific risk. The cost of capital has reduced in recent years in line with long term government bond yields. We also use economic profit for some bonus schemes.

Our share price dropped from 957p at the end of last year to 895p on 31st March 1999, giving a market capitalisation of £8.2 billion. The share price ranged from a high of 1070p to a low of 836p.

Sales and operating profits from continuing operations before exceptional items increased in the year by 5.9 per cent and 4.0 per cent respectively.

The board has proposed a final dividend of 16.7p. This brings the total dividend for the year to 23.8p, an increase of 6.7 per cent over last year.

Shareholder returns of The Boots Company compared with peer companies
Returns are calculated using average listed share prices over the three months to 31st March.

	Five years to 31st March 1999	%
1	SmithKline Beecham	382.7
2	Tesco	173.3
3	Kingfisher	158.2
4	**Boots**	**117.5**
5	GUS	49.8
6	Smith & Nephew	40.3
7	W H Smith	40.1
8	Reckitt & Colman	34.7
9	J Sainsbury	18.4
10	Marks & Spencer	1.1
11	Sears	(40.2)

Cash flow The maximisation of cash flow is the key factor in value creation and cash management is one of the key performance measures used by the company to monitor businesses. The following summary of cash flows demonstrates the company's ability consistently to generate a healthy free cash flow which is defined as cash flow available to all the providers of capital.

Summary of cash flows £m	**1999**	1998
Operating cash flow before exceptionals	**616**	634
Exceptional operating cash flows	**(14)**	(28)
Acquisition of businesses	**(9)**	(181)
Disposal of businesses	**64**	(9)
Purchase of fixed assets	**(372)**	(249)
Purchase of own shares	**(160)**	(4)
Disposal of fixed assets	**74**	262
Taxation paid	**(112)**	(233)
Other items	**8**	11
Free cash flow	**95**	203
Dividends paid	**(207)**	(563)
Net interest	**(25)**	(11)
Net cash flow (see page 49)	**(137)**	(371)

The group generated cash from operating activities before exceptionals of £616 million, a decrease of £18 million on last year.

Investment in fixed assets was £123 million ahead of last year reflecting the increased investment in the business, particularly the record level of spend on new stores in BTC. The fixed asset disposal proceeds were down £188 million on last year reflecting the aggressive selling of properties last year.

The following chart shows the amounts of free cash flow generated by the group for each of the last five years.

Cash generation £m

99	**95.0**
98	203.2
97	138.5
96	147.2
95	1,161.9

The sale of Boots Pharmaceuticals is included in the cash flow for 1995.

Acquisitions and disposals of businesses BTC extended its presence in the Republic of Ireland and Northern Ireland with the acquisition of Connors Holdings Ltd, a privately owned retail pharmacy chain, for £17 million.

The group disposed of Do It All to Focus Retail Group Ltd for a consideration of £62.2 million.

QUEST During the year, the company established a qualifying employee share ownership trust ('QUEST') in connection with its existing SAYE share scheme, which is open to all UK employees. (The company ceased granting executive options in 1995). The QUEST enables the company to use existing shares to satisfy options, rather than issuing new shares, in a tax-efficient way. The QUEST has bought in the market 16.9 million shares, enough to meet all existing options, at an average price of 909p per share. The cost of these purchases, which is the difference between the option price and the price paid for the shares, was charged this year against profits as an exceptional item. In addition, interest charges have been incurred for funding the shares while they are in the QUEST. However, we could have decided to issue new shares and if so the accounting treatment would have avoided charging costs to the profit and loss account. Perhaps for this reason, most other companies issue new shares.

We believe, however, that using existing shares avoids diluting the value of existing shareholdings and helps produce a more efficient capital structure. In addition it is more transparent as the cost is shown against profits.

£60 million has been charged against profits this year as a result of acquiring shares to cover all existing SAYE options. In future, it will only be necessary to acquire shares to meet new options and the charge should be much lower.

Treasury policy and controls Boots has ready access to funds due to its strong credit ratings. Currency exposures are modest. Interest exposure is more substantial.

Treasury focus is primarily on the balance sheet, including those items such as property lease commitments, which are assets and liabilities in a real economic sense but which current accounting convention does not recognise.

Note 19 on page 67 shows further details under the disclosure requirements of Financial Reporting Standard (FRS)13 'Derivatives and Other Financial Instruments: Disclosures'.

Controls Controls seek to prevent fraud and other unauthorised transactions as well as counterparty risk. The effective operation of key controls is reviewed annually by the group's internal audit staff. Strict guidelines for cash investments apply worldwide, with cash held only in high quality bank deposits and commercial paper. Swaps, which the company uses to manage interest rates, are strictly controlled and monitored, with each transaction authorised individually by the group finance director.

Liquidity and funding The company has ready access to funds due to its strong credit ratings from Moody's and Standard and Poor's. These are A1/A+ long term and P1/A1 short term. It is policy to have credit ratings which give good access to the capital markets.

During the year the group signed committed five-year facilities totalling £540 million with nine banks, bringing the total committed lines to £600 million. These facilities remained undrawn during the year, with short term financing needs met by uncommitted facilities.

After the year end the group issued a £300 million ten-year eurobond, which was well received by investors and was swapped to produce a floating rate of funds considerably below the equivalent cost of bank borrowings. Some of the cash raised will refinance short term debt.

Lease liabilities In common with other UK retailers, the group has liabilities through its obligations to pay rents under property leases. The following table

shows the capitalised value of the committed after tax rents payable at 31st March 1999, excluding any likely increase in rents at rent reviews, discounted at the group's effective after tax cost of borrowing of 4 per cent (5.7 per cent gross). The continuing fall in long term interest rates during the year has increased the net present value of the lease liabilities.

Maturity of commitment	Rent commitment at 31st March 1999 £m	Capitalised value £m
1 to 10 years	42.7	142
10 to 20 years	92.7	739
20 to 30 years	27.3	286
Over 30 years	6.8	100
Total	169.5	1,267

The split of rent payable at the year end for businesses is:

	Rent payable £m	%
Boots The Chemists	113.0	67
Halfords	41.8	24
Other	14.7	9
Total	169.5	100

Interest Policy is to maintain an approximately equal balance between fixed and floating rates, and this is achieved with swaps. We do not, however, hedge against the impact of short term interest rate movements, since this merely reduces earnings volatility and does not increase the value of the company.

Rent commitments on property leases are the economic equivalent of fixed rate debt. The value of lease related interest rate swaps at the year end was £875 million. All of these swaps had an initial maturity of ten years, with an average maturity at 31st March 1999 of about seven years and a weighted average fixed rate receipt of 7.7 per cent.

The company's other fixed rate borrowings have all been fully swapped into floating rate.

Given the overall cash, borrowing and interest rate swap position of the group, each 1 per cent increase or decrease in short term interest rates changes the net interest figure by about £10 million.

Net interest payable for 1998/99 was £1.8 million, compared with £15.2 million receivable last year.

Currency exposure The company currently has no currency debt to match the value of its overseas businesses. When the cash flows from these businesses become more substantial, policy will be reviewed.

Modest sales and purchases are made in a range of currencies but it is not considered that hedging them into sterling adds value.

Capital structure Since 1994 we have undertaken a series of transactions to help achieve a more efficient capital structure, in line with the policy of delivering shareholder value. It is sensible to finance a proportion of capital requirements with borrowings, especially when the business consistently produces strong cash flows. The last such transaction was a £400 million special dividend, paid in June 1997. Payments to shareholders in the form of dividends and share repurchases over the last five years are shown in the following chart and total over £2 billion.

Payment to shareholders £m

Year	£m
99	**207.1**
98	563.3
97	469.8
96	154.4
95	663.4

1995 and 1997 include share repurchases of £511.3m and £300m respectively.
1998 includes the special dividend of £400.5m.

Taxation The effective tax rate, before exceptional items, for the group was 30.3 per cent, the same as last year.

Pensions The results of the actuarial valuation, based on market values of liabilities and assets, at 1st April 1998, is shown in note 26. While this shows that accrued liabilities were covered 1.2 times by the market value of assets and that no contributions to the pension fund are currently required, we believe contributions to the fund may be appropriate in the foreseeable future. We have made a charge of £5 million in the year, which has been substantially reduced by the impact of actuarial surpluses from earlier valuations.

Year 2000 During the year we have made good progress against our plans for achieving Year 2000 compliance. This has involved three strands of activity:

- implementation of changes to business systems to allow correct processing of future dates.
- confirmation that embedded logic units used within our manufacturing, testing and environmental control systems support the Millennium change and, where necessary, replacing them with compliant devices.
- working with our trading partners, both suppliers and customers, to confirm that the supply chain we depend on, and are involved in, continues to operate with minimal disruption.

In addressing our business systems we adopted a combination of modifying existing systems where they continued to meet our requirements and replacing others where there was an opportunity to enhance business process. We have now developed and tested compliant software for our key business processes and the large majority of systems are already in operation. In a couple of instances we are still in the process of implementing systems that provide new functionality and progress is in line with agreed business timescales.

Testing on embedded logic has been undertaken. We have a high degree of confidence that our key suppliers have, or will achieve, compliance and pose

no risk of disruption. We will continue to liaise, however, with our supplier base throughout the calendar year to confirm any appropriate contingency actions.

Contingency planning has been an area for consideration across our business units and will be monitored on an ongoing basis. We originally estimated the incremental costs attributable to Year 2000 systems compliance to be in the region of £14 million for the entire programme. The programme has remained largely on schedule and will be completed within these estimates. This investment has been in addition to our pre-existing systems investment plans which have continued in parallel.

Overall we believe that we have taken the appropriate steps to ensure that business operations continue throughout the Millennium change with minimal disruption. It is not possible to guarantee that no unforeseen problems will arise and we will continue to invest management attention to monitor our supplier preparedness and refine and rehearse contingency plans.

Economic and Monetary Union (EMU) The company has businesses in nine of the first wave countries and has been preparing for EMU since 1997. Since the introduction of the euro, in January 1999, we have had to handle only a small number of transactions and no difficulties have been experienced.

Our businesses in the first wave countries and in the UK have all analysed the impact of the euro and are well on track to deal with the needs of their customers and suppliers. A cost of around £7 million is being incurred as a consequence of the introduction of the euro in the first wave, the majority of which is still to be incurred. This expenditure includes IT investment that will increase the flexibility of our UK-based purchasing systems in handling foreign currencies.

In the last year we have refined our analysis of the impact on the company, if the UK were to adopt the euro. This process has highlighted the difficulty of accurately planning for the uncertain UK position. We have confirmed that substantial costs will be involved for our retail businesses. The bulk of costs will arise in training staff and changing IT systems. We continue to predict a cost of around 1 per cent of turnover, depending on our assumptions. This is in line with predictions made by many first wave retailers.

The publication of the Government's National Changeover Plan helped to reduce uncertainty. We therefore welcome this as an additional step in defining UK plans. This plan contains a commitment to further planning, and this is also welcome. We believe that further planning is needed to identify the approaches that will minimise costs to the various sectors of the UK economy. In particular we believe that work is needed which focuses on the process for exchanging sterling notes and coins for euros. It is important that all affected parties agree to the roles that might be expected of them in such a process.

Accounting standards The company fully supports the objectives of the Accounting Standards Board (ASB) in its aim to improve the quality and consistency of financial statements.

Current UK financial accounting ignores material economic costs and liabilities, particularly in relation to operating leases, pensions and employee share options. The group's internal management accounting seeks to recognise all such economic costs and liabilities and we encourage any move by the ASB to recognise these costs and liabilities properly. We have made robust representations to the ASB on accounting for both pensions and employee share options.

During the year the ASB have issued the following Financial Reporting Standards (FRSs): FRS9 'Associates and Joint Ventures', FRS10 'Goodwill and Intangible Assets', FRS11 'Impairment of Fixed Assets and Goodwill', FRS12 'Provisions, Contingent Liabilities and Contingent Assets', FRS13 'Derivatives and Other Financial Instruments: Disclosures' and FRS14 'Earnings Per Share'. The effects of these have been reflected in this year's accounts and the comparatives restated where necessary as described in the accounting policies on pages 50 to 52.

FRS15 'Tangible Fixed Assets' is effective for accounting periods ending on or after 23rd March 2000. We are currently reviewing the impact of this FRS on the company and will adopt it in next year's accounts.

David Thompson
Joint Group Managing Director and Finance Director