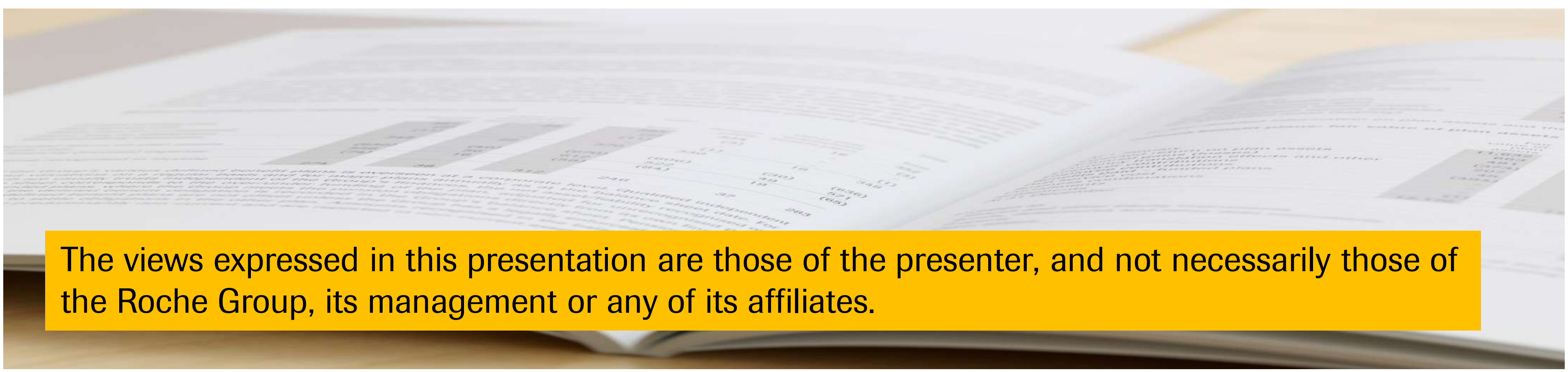
Better Communication
– Preparer's Perspective

Ian Bishop, Roche, 13 September 2023



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Philosophy on Corporate Reporting

Goodwill, Intangibles and Business Combinations

Disclosure

Alternative Performance Measures

Creating long-term value

Philosophy on Corporate Reporting
Understand who my customers are …

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Primary customers
- The owners of the company: current shareholders.
- The financers of the company: current debtholders.

Secondary customers
- Potential investors – debt and equity - and associated analysts.
- Media.

Regulators
- Financial regulators.
- Taxation authorities.
- Government bodies.

Important interested parties, but not customers
- Consumers, suppliers and employees.
- Internal management.
- Auditors.
- Standard-setters.
- Academics.

Philosophy on Corporate Reporting
… and what do my customers want ?

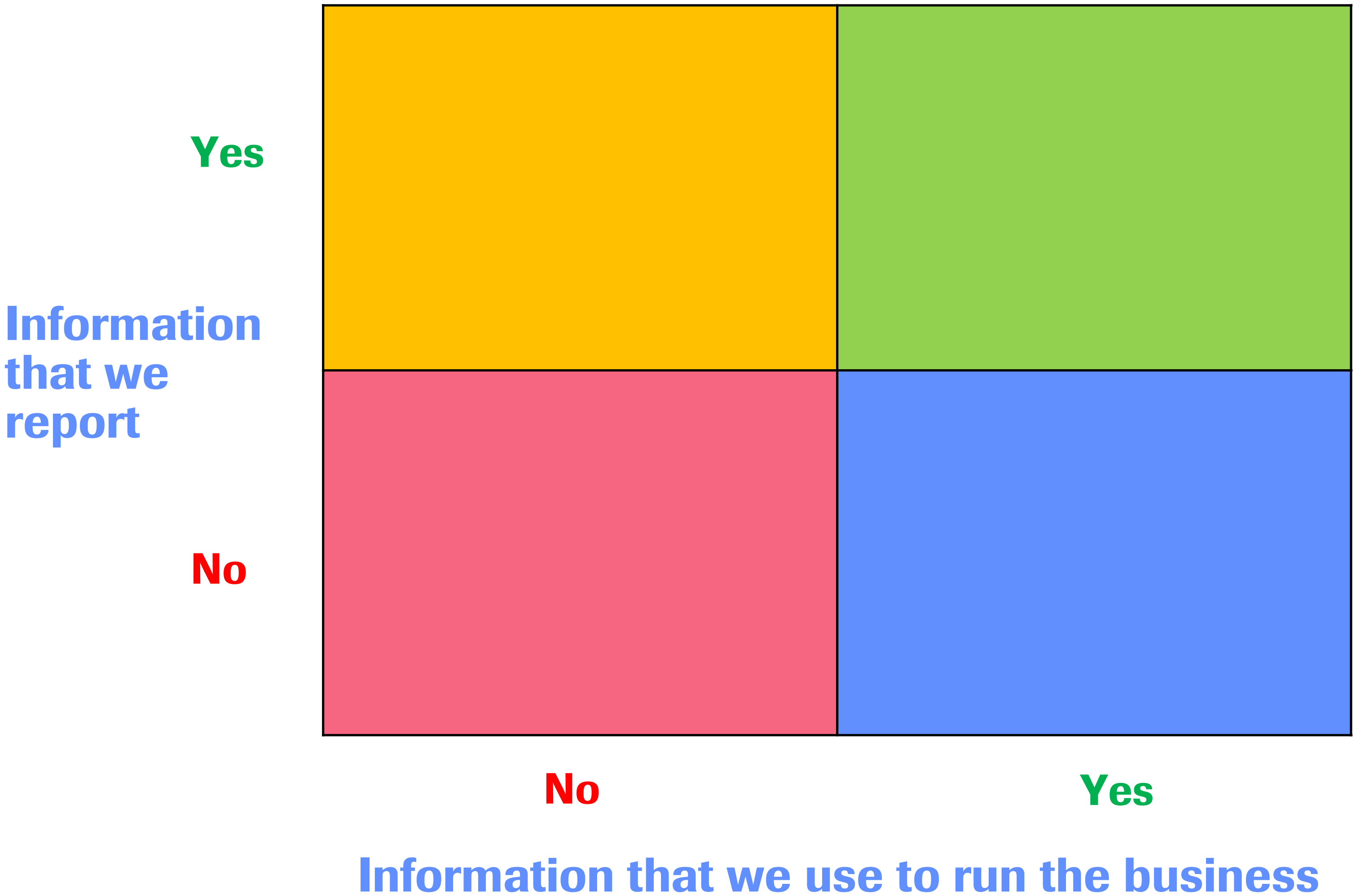
Financial information
- Coherent, Consistent, Credible.
- Understandable.
- Timely.

Decision-relevant information
- What has happened and why ?
- What are the potential consequences of what has happened ?
- What could happen in the future ?
- What are the opportunities and risks ?

-> Insight: All of the above precisely aligns with what internal users need. Every company will routinely produce all this (in one form or another) to run the business.

Constraints
- Corporate Mind-Set: Transparency.
- Commercial sensitivity.
- Forward-looking information.
- Resources needed to produce this information, for audited regulated external documents.

Philosophy on Corporate Reporting
The financial information matrix



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Goodwill and Business Combinations

Applying the financial information matrix

Information that we report / Information that we use to run the business	No	Yes
Yes	Goodwill IFRS 3 fair value of consideration and acquired assets Goodwill impairment disclosures	Rationale for the deal Subsequent performance - Revenues from acquired products - R&D pipeline - Segment reporting
No	Synergy reporting Routine monitoring of M&A deals in isolation from the rest of the business	True deal cost Details of assets acquired Potential future cash flows from the deal

Subsequent Performance of an Acquisition
What do we mean by "subsequent performance"

Transaction-related cash outflows

- Contingent consideration, performance milestones. IFRS 3 B64 (g) should be strengthened and require updated disclosures. Deal structures are becoming increasingly innovative.
- Payments to owners/shareholders that continue working.
- Other employee benefits. Retention schemes, "Golden Hellos", top-ups to acquiring company pension and stock-option plans, bonuses, etc.
- Transaction costs.
- Integration and restructuring costs.

What was acquired

- Readers would be better able to assess subsequent performance if they had a clearer idea of what was acquired in the first place.
- Breakdowns of major PPE, Intangibles (product rights, R&D projects) and other acquired assets and liabilities. Qualitative information when helpful (this should be defined).
- Then they can judge for themselves.

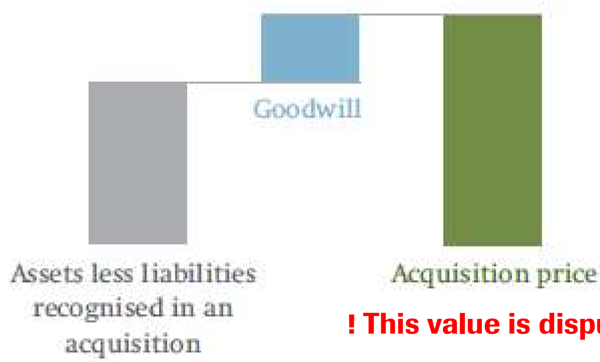
Synergies

- Should be split between revenue synergies and cost synergies.
- Good qualitative description, rather than arbitrary alternative reality data.
- Description of integration plans.

Goodwill
Is the concept itself fully impaired ?

The net assets acquired per IFRS 3 are **<u>not</u>** the real values

- Intangible assets at fair value -> not value in M&A model
  - Uses different discount rates and tax rates, and includes TAB.
  - Typically more access to information.
- Deferred tax
- Early-stage research, acquired workforce and know-how.
- Does not take into account impact on acquiring company.



! This value is disputed

! This value is disputed

The acquisition price per IFRS 3 is **<u>not</u>** the deal value

- Contingent consideration at fair value -> judgemental snapshot with little analysis
- Retention payments
- Transaction costs
- Integration / restructuring costs
- Bonuses

The goodwill that drops from the IFRS 3 calculations is not part of the deal mechanics. It is a mathematical residual and a "fake asset". People seem surprised that the subsequent accounting treatment does not then match business reality. It would be more surprising if it did.

Goodwill Impairment or Amortisation ?
Good question, glad you asked it …

Answer: "Who cares ?"

- Goodwill impairment is routinely adjusted out of APMs (internally and externally).
- Goodwill amortisation, if reintroduced, would without doubt also be routinely adjusted out.
- The DP implicitly recognises the irrelevance of the balance sheet value by proposing to disclose "Total equity excluding goodwill" (DP 3.115). If a balance sheet value is not useful how can we reasonably expect that the amortisation or impairment of that asset would be useful ?
- If expanded disclosures on M&A deals would give better information on the success of transactions, then why is goodwill impairment testing needed at all ?
- This topic is of doctrinaire interest rather than practical relevance.

What's the point anyway ?

- The original change away from the amortisation model, was driven largely by the alignment efforts to US GAAP, rather than any evidence-based concerns from IFRS users/preparers.
- "Goodwill impairment provides confirmation of an issue."
  - Maybe, but this will be situational and coincidental. Goodwill impairment occurs when the book value of a CGU exceeds the recoverable amount, which can be caused by any one of a number of factors either related or unrelated to the success of the acquisition.
- "Goodwill amortisation does not provide the reader with useful information."
  - True, but irrelevant. Why should we expect that it would ?

Goodwill and Impairment
Sustainable Solution

Intangible Assets (IAS 38 / IFRS 3)

- Comprehensive rethink of recognition criteria for intangible assets, to get consistent approach, regardless of whether acquired through M&A or self-developed.
  - More internally generated intangible assets from IAS 38
  - Less M&A generated intangible assets from IFRS 3
  - Goodwill is not an asset
- Booked at cost (fair value from M&A). Amortised over useful life, maximum 20 years.
- Expanded breakdowns and narratives.
- Capture details for alliances and collaborations.

Impairment Testing (IAS 36)

- Impairment testing is solved. There is no goodwill anymore to be tested and IAS 36 seems to work reasonably well for impairment testing on PPE and intangible assets.

Business Combinations (IFRS 3)

- Assets/liabilities recognised based on other standards (same rules as internally generated).
- Difference between deal costs and net assets acquired expensed on specific line item in P&L.
- Subsequent cash outflows from transaction expensed on the same P&L line with disclosure.
- Comprehensive disclosure of total deal costs, with follow-up in subsequent years.
- Comprehensive disclosure of acquired assets/liabilities with breakdowns and narratives.

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Goodwill, Intangibles and Business Combinations

Disclosure

Alternative Performance Measures

Creating long-term value

Disclosure
Cost and Benefits

Cost of disclosures

- Where companies prepare consolidations of global operations, collecting new disclosures usually requires amendment to existing systems and consequent roll-out to the organisation.
- Smaller companies do not usually have large internal accounting functions that can easily implement the requirements.
- Either way, the cost in terms of time and resources (including audit) is significant.
- **Preparers are consequently reluctant to provide optional disclosures as it is already a significant task to collect the compulsory disclosures.**

Benefits of disclosures

- In many cases the information required for disclosures is not routinely collected by the preparers for internal use; and if this information is not needed to run the business, it is debatable how much use it could be to external users.

Effective communication should be timely

- The volume of disclosure adds time to the year-end reporting process.
- Particular issue when preparers publish translations in other languages.
- May see an increase in the trend of preparers issuing earnings statements (with accompanying press releases, investor presentations and roadshows), and then several weeks or months later filing the full financial statements, which become relegated as a compliance exercise.

Disclosure overload
Is it driven by recognition/measurement issues ?

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Roche Group (31 December 2022)

- Market Capitalisation: CHF 239bn vs Balance Sheet Net Assets (IFRS basis): CHF 32bn

Roche Group consolidated balance sheet in millions of CHF

	31 December 2022
Non-current assets	
Property, plant and equipment [8]	23,075
Right-of-use assets [28]	1,133
Goodwill [9]	10,820
Intangible assets [10]	9,685
Deferred tax assets [5]	6,427
Defined benefit plan assets [26]	957
Other non-current assets [15]	2,238
Total non-current assets	**54,335**

Non-current liabilities	
Long-term debt [21]	(21,391)
Deferred tax liabilities [5]	(645)
Defined benefit plan liabilities [26]	(4,561)
Provisions [20]	(1,111)
Other non-current liabilities [18]	(1,189)
Total non-current liabilities	**(28,897)**

Disclosure – Case Study - Pensions
IAS 19 disclosures

Employee Benefits (½ page*)

- Maybe there is too little disclosure here. IAS 19 pp25 and pp171 give a free pass.
- Profit-sharing/bonus plans, retention plans, termination benefits, other fringe benefits etc.
- Number of employees is not a required disclosure.
- Executive Remuneration disclosures (local regulations) only covers senior management.

Pensions (7 pages*)

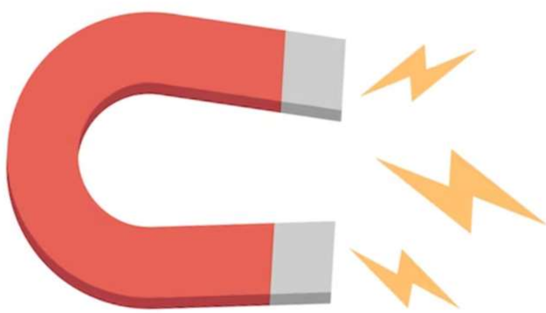
- Defined Benefit Plan disclosure requirements start on IAS 19 pp135 until pp152, across 6 pages.
- But too little information on the real cash-relevant situation:
  - Expected cash contributions for the next 5 years (defined and discretional).
  - Funded plans: expected funded status for next 5 years, including assumptions.
  - Statutory funding status, and potential requirements for additional funding.
  - Undiscounted obligations.
  - Split of funded and unfunded plans.
- Instead there are disclosures supporting the calculation of the balance sheet amounts.
- Very little interest from external readers (probably there should be more).

-> What is the thought process behind the disclosure requirements ?

* Roche Group Financial Statements 2022. 103 pages of Notes. Operating segment note is 4 pages long.

Disclosure Magnets

Most disclosure on peripheral topics



LEASES

PENSIONS

STOCK OPTIONS

GOODWILL

FINANCIAL INSTRUMENTS

Segment Reporting

Cash Flows

Equity

Resarch & Development

CapEx/PPE

Inventories

Intangibles (excl goodwill and impairment)

Disclosure
What can we observe ?

Disclosure overload
- The current nature and volume of disclosure is **driven by the requirements of the standards**, reinforced by regulators and auditors and not challenged by preparers.
- Preparers can for sure always improve readability, but financial statements are compliance documents and are mainly used as reference material.
- Recent standards typically include a high volume of new disclosure requirements, often greatly more than the previous standards that they replace. There is no one-in-one-out concept.
- It maybe that there is not too much disclosure in total. There is **too much of the wrong sort of disclosure** and **not enough of the right sort of disclosure**.

What is really driving the current disclosure environment ?
- More disclosure is seen casually as an easy win – a mind-set change is needed.
- Additional disclosure is used as a default solution where there is controversy and different views about the recognition and measurement. It is used to help achieve consensus.
- Where there are complicated, judgemental recognition and measurement rules, then disclosures are added, as if the reader is somehow going to recheck the accounting.

-> Disclosure is not a substitute for dealing with recognition/measurement issues.

Disclosure overload

Fix the debits and credits, then cut the disclosure

Employee Benefits – recognition and measurement

- Pensions paid from the company's own assets are liabilities. They can be dealt with by IAS 37. Any blocked/reserved assets should be reported as such.
- Pensions paid by third parties in principle are off-balance sheet, apart from any short-term pre-payment/accrual issues.
- Pensions paid by company pension funds:
  - Onerous positions can be dealt with by IAS 37. Disclosure of assumptions for calculations investment portfolio policy, etc. to allow readers to assess obligations.
  - Any controlled vehicles should be consolidated.
  - Disclosure of vehicles, funding status (legal not IFRS), governance.
  - Users want to know what the company's financial obligations are.

Employee Benefits disclosure

- Pensions:
  - Less disclosure on mechanics of IAS 19 Defined Benefit plan accounting.
  - More disclosure on future cash obligations for pension plans, looking 5-10 years ahead.
- Short-term employee benefits:
  - Split between fixed and variable remuneration.
  - Disclosure on terms and conditions for variable remuneration.

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Alternative Performance Measures

Creating long-term value

Alternative Performance Measures
Cash Flow Reporting

IAS 7 – not fit for purpose
- Does not reflect business reality. No-one runs their business this way.
- Small sample of the issues:
    - Income tax as operating cash flow.
    - Treatment of M&A activities.
    - Treatment of leasing.
    - Treatment of pensions.
    - Treatment of interest expenses.
    - Operating used as default.

Lack of cash flow disclosure elsewhere
- Capital expenditure – maintenance vs expansion.
- Cash commitments.
- Segmental / regional analysis.

False friends
- EBITDA is not the answer.
- Direct cash flow is not the answer.

Alternative Performance Measures

IAS 7 – some examples

Interest and dividends

31 Cash flows from interest and dividends received and paid shall each be disclosed separately. Each shall be classified in a consistent manner from period to period as either operating, investing or financing activities.

Taxes on income

35 Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

-> Observation: The definitions of "Operating" in IAS 7, IFRS 8 and the new Primary Financial Statements standard are all different and not reconcilable.

Alternative Performance Measures
Free Cash Flow – example (1)

Free cash flow in millions of CHF

	Pharmaceuticals	Diagnostics	Corporate	Group
2022				
Operating profit – IFRS basis	14,814	3,324	(662)	17,476
Operating profit cash adjustments	5,779	1,706	87	7,572
Operating profit, net of operating cash adjustments	**20,593**	**5,030**	**(575)**	**25,048**
(Increase) decrease in net working capital	(1,745)	(706)	33	(2,418)
Investments in property, plant and equipment	(1,744)	(1,619)	(86)	(3,449)
Principal portion of lease liabilities paid	(274)	(118)	(13)	(405)
Investments in intangible assets	(1,077)	(26)	0	(1,103)
Operating free cash flow	**15,753**	**2,561**	**(641)**	**17,673**
Treasury activities				(530)
Taxes paid				(4,102)
Free cash flow				**13,041**

Alternative Performance Measures

Free Cash Flow – example (2)

Divisional operating free cash flow information in millions of CHF

	Pharmaceuticals 2022	Pharmaceuticals 2021	Diagnostics 2022	Diagnostics 2021	Corporate 2022	Corporate 2021	Group 2022	Group 2021
Depreciation, amortisation and impairment								
Depreciation of property, plant and equipment	1,381	1,278	1,128	1,188	56	58	2,565	2,524
Depreciation of right-of-use assets	211	234	117	117	13	12	341	363
Amortisation of intangible assets	764	1,398	174	158	-	-	938	1,556
Impairment (reversal) of property, plant and equipment	108	(108)	15	105	0	0	123	(3)
Impairment (reversal) of right-of-use assets	5	5	0	0	0	0	5	5
Impairment of goodwill	0	0	0	0	-	-	0	0
Impairment of intangible assets	2,837	651	0	0	-	-	2,837	651
Total	**5,306**	**3,458**	**1,434**	**1,568**	**69**	**70**	**6,809**	**5,096**
Other adjustments								
Add back								
- Expenses for equity-settled equity compensation plans	571	513	106	98	61	52	738	663
- Net (income) expense for provisions	495	1,380	19	456	0	28	514	1,864
- Net (gain) loss from disposals	(606)	(486)	11	13	(9)	(1)	(604)	(474)
- Non-cash working capital and other items	138	281	331	315	0	2	469	598
Deduct								
- Utilisation of provisions	(743)	(719)	(244)	(331)	(61)	(73)	(1,048)	(1,123)
- Proceeds from disposals	618	513	49	43	27	1	694	557
Total	**473**	**1,482**	**272**	**594**	**18**	**9**	**763**	**2,085**
Operating profit cash adjustments	**5,779**	**4,940**	**1,706**	**2,162**	**87**	**79**	**7,572**	**7,181**

Alternative Performance Measures
Net Debt - example

Net debt in millions of CHF

At 1 January 2022	
Cash and cash equivalents	6,850
Marketable securities	6,181
Long-term debt	(16,076)
Short-term debt	(15,122)
Net debt at beginning of period	**(18,167)**
Change in net debt during 2022	
Free cash flow	13,041
Dividend payments	(7,832)
Transactions in own equity instruments	(1,257)
Mergers and acquisitions, net of divestments of subsidiaries	(250)
Hedging and collateral arrangements	(526)
Currency translation, fair value and other movements	(593)
Change in net debt	**2,583**
At 31 December 2022	
Cash and cash equivalents	4,991
Marketable securities	4,776
Long-term debt	(21,391)
Short-term debt	(3,960)
Net debt at end of period	**(15,584)**

For the definition of net debt see page 171.

Alternative Performance Measures
Some points for users to consider …

Why is the company doing this ?
- Are the APMs used in running the business or are they just for external reporting ?
- Are the APMs used for internal performance management ?

Coherent, Consistent, Credible
- Is there a published specific concept for the APMs ?
- Are there any “general/other” adjustment items ?
- Are the adjustment items found in the IFRS results ?
- Are there reconciliations to the IFRS results ?
- Are the effects on tax and non-controlling interests disclosed ?

Remember …
- The APMs give additional insight into the financial results.
- They also give insight into the way the company is run.

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Creating long-term value

Creating long-term value

The financial information matrix

Information that we report	No	Yes
Yes	Minimise Organise disclosures Challenge continuously	Do it, and do it well Coherent, Consistent, Credible
No	Monitor Understand possible change drivers Challenge proactively	Expand Listen to your customers Understand your own business

Information that we use to run the business

Doing now what patients need next