

Group financial review

Reporting framework

Total and Adjusted results

The Group financial review discusses the operating and financial performance of the Group, its cash flows and financial position and our resources. The results for each year are compared primarily with the results of the preceding year.

Total results

Total reported results represent the Group's overall performance.

GSK also uses a number of adjusted, non-IFRS, measures to report the performance of its business. Adjusted results and other non-IFRS measures may be considered in addition to, but not as a substitute for or superior to, information presented in accordance with IFRS. Adjusted results are defined below and other non-IFRS measures are defined on page 42.

GSK believes that Adjusted results, when considered together with Total results, provide investors, analysts and other stakeholders with helpful complementary information to understand better the financial performance and position of the Group from period to period, and allow the Group's performance to be more easily compared against the majority of its peer companies. These measures are also used by management for planning and reporting purposes. They may not be directly comparable with similarly described measures used by other companies.

GSK encourages investors and analysts not to rely on any single financial measure but to review GSK's Annual Reports, including the financial statements and notes, in their entirety.

GSK is committed to continuously improving its financial reporting, in line with evolving regulatory requirements and best practice and has made a number of changes in recent years. In line with this practice, GSK expects in 2019 to continue to review its reporting framework (including, where relevant, the use of alternative performance measures).

Adjusted results

Adjusted results exclude the following items from Total results, together with the tax effects of all of these items:

- amortisation of intangible assets (excluding computer software) and goodwill
- impairment of intangible assets (excluding computer software) and goodwill
- major restructuring costs, which include impairments of tangible assets and computer software, (under specific Board approved programmes that are structural, of a significant scale and where the costs of individual or related projects exceed £25 million), including integration costs following material acquisitions
- transaction-related accounting or other adjustments related to significant acquisitions
- proceeds and costs of disposals of associates, products and businesses; significant legal charges (net of insurance recoveries) and expenses on the settlement of litigation and government investigations; other operating income other than royalty income, and other items
- the impact of the enactment of the US Tax Cuts and Jobs Act in 2017.

Costs for all other ordinary course smaller scale restructuring and legal charges and expenses are retained within both Total and Adjusted results.

As Adjusted results include the benefits of Major restructuring programmes but exclude significant costs (such as significant legal, major restructuring and transaction items), they should not be regarded as a complete picture of the Group's financial performance, which is presented in its Total results. The exclusion of other Adjusting items may result in Adjusted earnings being materially higher or lower than Total earnings. In particular, when significant impairments, restructuring charges and legal costs are excluded, Adjusted earnings will be higher than Total earnings.

GSK has undertaken a number of Major restructuring programmes in recent years in response to significant changes in the Group's trading environment or overall strategy, or following material acquisitions, including the Novartis transaction in 2015. Costs, both cash and non-cash, of these programmes are provided for as individual elements are approved and meet the accounting recognition criteria. As a result, charges may be incurred over a number of years following the initiation of a Major restructuring programme.

From time to time, the Group divests non-core investments, products and businesses and records the profit or loss on disposal as an Adjusting item. The most notable divestment in the past five years was the disposal of the Oncology business as one element of the three-part transaction with Novartis in 2015.

Significant legal charges and expenses are those arising from the settlement of litigation or government investigations that are not in the normal course and materially larger than more regularly occurring individual matters. They also include certain major legacy matters.

Reconciliations between Total and Adjusted results, providing further information on the key Adjusting items for 2017 and 2018 are set out on page 51 and for the five years to 2018 are set out on pages 232 to 234.

GSK provides earnings guidance to the investor community on the basis of Adjusted results. This is in line with peer companies and expectations of the investor community, supporting easier comparison of the Group's performance with its peers. GSK is not able to give guidance for Total results as it cannot reliably forecast certain material elements of the Total results, particularly the future fair value movements on contingent consideration and put options that can and have given rise to significant adjustments driven by external factors such as currency and other movements in capital markets.

Reporting framework continued

Historical record of Adjusting items

The reconciliations between Total and Adjusted operating profit over the last five years can be summarised as follows:

| | 2018 £m | 2017 £m | 2016 £m | 2015 £m | 2014 £m |
|--|------------|------------|------------|------------|------------|
| Total operating profit | 5,483 | 4,087 | 2,598 | 10,322 | 3,597 |
| Intangible asset amortisation | 580 | 591 | 588 | 563 | 575 |
| Intangible asset impairment | 116 | 688 | 20 | 206 | 150 |
| Major restructuring | 809 | 1,056 | 970 | 1,891 | 750 |
| Transaction-related items | 1,977 | 1,599 | 3,919 | 2,238 | 839 |
| Divestments, significant legal and other items | (220) | (119) | (424) | (9,561) | 545 |
| US tax reform | – | 666 | – | – | – |
| Adjusted operating profit | 8,745 | 8,568 | 7,671 | 5,659 | 6,456 |

The analysis of the impact of transaction-related items on operating profit for each of the last five years is as follows:

| | 2018 £m | 2017 £m | 2016 £m | 2015 £m | 2014 £m |
|--|------------|------------|------------|------------|------------|
| Novartis Consumer Healthcare Joint Venture put option | 658 | 986 | 1,133 | 83 | – |
| Contingent consideration on former Shionogi-ViiV Healthcare JV (including Shionogi preferential dividends) | 1,188 | 556 | 2,162 | 1,874 | 768 |
| ViiV Healthcare put options and Pfizer preferential dividends | (58) | (126) | 577 | – | – |
| Contingent consideration on former Novartis Vaccines business | 58 | 101 | 69 | 108 | – |
| Other adjustments | 131 | 82 | (22) | 173 | 71 |
| Transaction-related items | 1,977 | 1,599 | 3,919 | 2,238 | 839 |

Full reconciliations between Total and Adjusted results for 2014–2018 are set out on pages 232 to 234.

Further explanations on the Adjusting items for 2018 are reported on page 51.

Non-controlling interests in ViiV Healthcare

Trading profit allocations

Because ViiV Healthcare is a subsidiary of the Group, 100% of its operating results (turnover, operating profit, profit after tax) are included within the Group income statement and then a portion of the earnings is allocated to the non-controlling interests owned by the other shareholders, in line with their respective equity shareholdings (Pfizer 11.7% and Shionogi 10%). Each of the shareholders, including GSK, is also entitled to preferential dividends determined by the performance of certain products that each shareholder contributed. As the relative performance of these products changes over time, the proportion of the overall earnings of ViiV Healthcare allocated to each shareholder will change. In particular, the increasing sales of dolutegravir-containing products have a favourable impact on the proportion of the preferential dividends that is allocated to GSK. Adjusting items are allocated to shareholders based on their equity interests. GSK was entitled to approximately 85% of the Total earnings and 82% of the Adjusted earnings of ViiV Healthcare for 2018. Re-measurements of the liabilities for the preferential dividends allocated to Pfizer and Shionogi are included within other operating income.

Acquisition-related arrangements

As consideration for the acquisition of Shionogi's interest in the former Shionogi-ViiV Healthcare joint venture in 2012, Shionogi received the 10% equity stake in ViiV Healthcare and ViiV Healthcare also agreed to pay additional future cash consideration to Shionogi, contingent on the future sales performance of the products being developed by that joint venture, principally dolutegravir. Under IFRS 3 'Business combinations', GSK was required to provide for the estimated fair value of this contingent consideration at the time of acquisition and is required to update the liability to the latest estimate of fair value at each subsequent period end. The liability for the contingent consideration recognised in the balance sheet at the date of acquisition was £659 million. Subsequent re-measurements are reflected within other operating income/expense and within Adjusting items in the income statement in each period, and at 31 December 2018, the liability, which is discounted at 8.5%, stood at £5,937 million, on a post-tax basis.

Cash payments to settle the contingent consideration are made to Shionogi by ViiV Healthcare each quarter, based on the actual sales performance of the relevant products in the previous quarter. These payments reduce the balance sheet liability and hence are not recorded in the income statement. The cash payments made to Shionogi by ViiV Healthcare in 2018 were £793 million.

Because the liability is required to be recorded at the fair value of estimated future payments, there is a significant timing difference between the charges that are recorded in the Total income statement to reflect movements in the fair value of the liability and the actual cash payments made to settle the liability.

Group financial review continued

Reporting framework continued

The cash payments are reflected in the cash flow statement partly in operating cash flows and partly within investing activities. The tax relief on these payments is reflected in the Group's Adjusting items as part of the tax charge. The part of each payment relating to the original estimate of the fair value of the contingent consideration on the acquisition of the Shionogi-ViiV Healthcare joint venture in 2012 of £659 million is reported within investing activities in the cash flow statement and the part of each payment relating to the increase in the liability since the acquisition is reported within operating cash flows. Movements in contingent consideration payable to Shionogi were as follows:

| | 2018 £m | 2017 £m |
|---|------------|------------|
| Contingent consideration at beginning of the year | 5,542 | 5,304 |
| Re-measurement through income statement | 1,188 | 909 |
| Cash payments: operating cash flows | (703) | (587) |
| Cash payments: investing activities | (90) | (84) |
| Contingent consideration at end of the year | 5,937 | 5,542 |

Of the contingent consideration payable (on a post-tax basis) to Shionogi at 31 December 2018, £815 million (31 December 2017 – £724 million) is expected to be paid within one year.

Exit rights

Pfizer may request an IPO of ViiV Healthcare at any time and if either GSK does not consent to such IPO or an offering is not completed within nine months, Pfizer could require GSK to acquire its shareholding. Under the original agreements, GSK had the unconditional right, so long as it made no subsequent distribution to its shareholders, to withhold its consent to the exercise of the Pfizer put option and, as a result, in accordance with IFRS, GSK did not recognise a liability for the put option on its balance sheet. However, during Q1 2016, GSK notified Pfizer that it had irrevocably given up this right and accordingly recognised the liability for the put option on the Group's balance sheet during Q1 2016 at an initial value of £1,070 million. Consistent with this revised treatment, at the end of Q1 2016 GSK also recognised liabilities for the future preferential dividends anticipated to become payable to Pfizer and Shionogi on the Group's balance sheet.

The closing balances of the liabilities related to Pfizer's shareholding are as follows:

| | 2018 £m | 2017 £m |
|------------------------------|------------|------------|
| Pfizer put option | 1,240 | 1,304 |
| Pfizer preferential dividend | 15 | 17 |

Under the original agreements, Shionogi could also have requested GSK to acquire its shareholding in ViiV Healthcare in six month windows commencing in 2017, 2020 and 2022. GSK had the unconditional right, so long as it made no subsequent distribution to its shareholders, to withhold its consent to the exercise of the Shionogi put option and, as a result, GSK did not recognise a liability for the put option on its balance sheet.

However, during Q1 2016, GSK notified Shionogi that it had irrevocably given up this right and accordingly recognised the liability for the put option on the Group's balance sheet during Q1 2016 at an initial value of £926 million. In Q4 2016, Shionogi irrevocably agreed to waive its put option and as a result GSK de-recognised the liability for this put option on the Group's balance sheet directly to equity. The value of the liability was £1,244 million when it was de-recognised.

GSK also has a call option over Shionogi's shareholding in ViiV Healthcare, which under the original agreements was exercisable in six month windows commencing in 2027, 2030 and 2032. GSK has now irrevocably agreed to waive the first two exercise windows, but the last six month window in 2032 remains. As this call option is at fair value, it has no value for accounting purposes.

Free cash flow

With the introduction of the new R&D strategy in 2018, GSK has revised its definition of free cash flow, a non-IFRS measure, to include proceeds from the sale of intangible assets. This balances with the expenditure on purchases of intangible assets, which is deducted in calculating free cash flow, and makes the treatment of intangible assets consistent with property, plant and equipment. Free cash flow is now defined as the net cash inflow from operating activities less capital expenditure on property, plant and equipment and intangible assets, contingent consideration payments, net interest, and dividends paid to non-controlling interests plus proceeds from the sale of property, plant and equipment and intangible assets, and dividends received from joint ventures and associates. It is used by management for planning and reporting purposes and in discussions with and presentations to investment analysts and rating agencies. Free cash flow growth is calculated on a reported basis. A reconciliation of net cash inflow from operations to free cash flow is set out on page 56.

Free cash flow conversion

Free cash flow conversion is free cash flow as a percentage of earnings.

Working capital conversion cycle

The working capital conversion cycle is calculated as the number of days sales outstanding plus days inventory outstanding, less days purchases outstanding.

CER and AER growth

In order to illustrate underlying performance, it is the Group's practice to discuss its results in terms of constant exchange rate (CER) growth. This represents growth calculated as if the exchange rates used to determine the results of overseas companies in Sterling had remained unchanged from those used in the comparative period. CER% represents growth at constant exchange rates. £% or AER% represents growth at actual exchange rates.