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12 September 2008

Constitution Review – Public Accountability and Composition of the IASB

Dear Sirs

As a large multinational group which has been using IAS/IFRS since 1990 and has been closely involved in their development, we greatly appreciate the opportunity to give you our comments on the proposals. First some general remarks, along the lines of our letter of 9 June, which does not appear to have made it to your web-site for some reason. Then we respond in a more focussed way to the specific questions raised in your latest document.

First, briefly to Roche. The Basel-based group has a turnover of CHF 46 bn a year (EUR 28 bn.) derived from its healthcare business – pharmaceuticals and diagnostics – and employs nearly 80,000 people worldwide. We have a market capitalisation (end 2007) of CHF 171 bn. (EUR 103 bn.)

General Remarks

Over the last two decades we have been actively involved in the standard setting process. We delegated one of our senior management as a member of the IASC and have continuously tried to support the process through participation in round tables, discussions, field tests, etc. and through commenting on proposals both directly and in collaboration with SwissHoldings, BUSINESS-EUROPE and the European Round Table of Industrialists. We have also actively supported the efforts of EFRAG. With this amount of involvement we are naturally gratified to see how widely IFRS are becoming accepted around the world and are also cognizant and appreciative of the Trustees' efforts in recent years to improve the IASB's governance and due process. Nonetheless, our confidence – as preparers – in the effectiveness of that governance and due process has seldom been at a lower ebb. Why?

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You will already have read many of the concerns which we have in the European Parliament's "Radwan Report", to which we can wholeheartedly subscribe. In essence, we appreciate that, by achieving acceptance of IFRS round the globe, the IASB is helping to improve the international acceptance of our own financial reporting. However, we do not believe that the standard setting process – for all the additional steps and safeguards which have been built in – is resulting in the kind of standards which the capital and other financial markets need. Financial reporting is not an end in itself, and it is unfortunate that the IASB is, as both judge and jury, interpreting "high quality standards" in a manner which places prime emphasis on theoretical concepts but relegates practical usefulness to a fairly minor role. By practical usefulness we mean that standards should give preparers and users – the primary parties involved in financial reporting – the tools to communicate and exchange financial information which is meaningful and understandable in a form that reflects the way in which the business runs and which meets the needs of the users. We expand on this point in the appendix. How is it possible for this situation to arise if governance and due process are effective? The Trustees should particularly bear in mind that the IASB is now well on the way to having in effect a world-wide monopoly on financial reporting standards, and market economies usually take special care to ensure that safeguards exist to protect their economies from the potentially deleterious effects of such market dominance.

To improve the congruence between standards produced and the markets' needs, we would invite the Trustees to consider the following governance and due process measures:

1. Change paragraph 2 of the Constitution on objectives to specify explicitly that the terms "public interest" and "high quality standards" are to be understood as reflecting practical usefulness for preparers and users, based on the way business actually operates. Work on standards should only be undertaken when a need has been clearly identified and corroborated by preparers and users. (Regulators' needs may be considered in developing the detail of the standards themselves, e.g. in the disclosure requirements.) There is a clear need to specify that the Board's "independence" does not extend to the freedom to impose theoretical requirements which the participants in the markets do not need or support.
2. The Monitoring Body being proposed should be actively involved in the setting of the Board's agenda – including rigorously testing proposed agenda items against the criteria of market needs and practical usefulness – and in holding the Board to account, on a regular basis, for the work it carries out – again against these criteria. To assist that body, a mechanism for consulting preparers and users on agenda proposals and on Board performance needs to be set up on a basis which is completely independent of the Board itself. We do have some reservations about the creation of an additional body, as there is a risk of "transmission losses" between various organs. However, as the Trustees unfortunately do not appear to see this important activity as part of their role, another body is probably necessary.
3. The Board has won acclaim for its governance and due process system. However, a system is only as good as it is "lived". There is little to be gained from tweaking the system if the Board only pays it lip service and goes through the motions but then, for example, treats input from constituents in the due process dismissively. The Monitoring Body would need to be aggressively critical in this respect: it should not accept, for instance, that the Board receives overwhelmingly negative comments to a proposal but nevertheless presses ahead with it with the argument that the feedback did not bring to light any new arguments not previously

considered or that the commentators obviously had not understood the proposal.

4. As part of the governance system, the Trustees should not place too much emphasis on cost/benefit analyses made at the end of the standard setting process or on ex-post reviews done by the Board. In the case of cost/benefit analyses, the best that can be expected is an objective listing of the costs and benefits, but a meaningful and balanced evaluation would have to be done independently. In the case of the ex-post reviews, it is too late: preparers and users will already have incurred whatever costs are involved in implementing the standard.
5. Finally, on Board representation, the Trustees appear to be focusing on geographical representation. We would urge them not to neglect at the same time the need to ensure that Board members have practical experience. A start has already been made here, which we appreciate, but opportunities could be sought to accelerate the process of enriching the Board in this sense.

Questions related to the Monitoring Group

Q1 Do you support the creation of a link to a Monitoring Group in order to create a direct link of public accountability to official institutions?

In principle we support this proposal as means of promoting the IASB's public accountability, but we do have some reservations. Apart from those set out in responses to questions 2-4 we mention here:

- The risks of fragmentation, duplication and omission of efforts and responsibilities (see also point 2 above.)
- The Memorandum of Understanding between the Monitoring Group and the Trustees. This will be absolutely crucial in ensuring proper public accountability and credibility of the Monitoring Body and the IASC and should be open for public consultation.
- The meaning of "in the public interest". The IASC and IASB are already supposed to act in this way, but we are not convinced by the results. A clear statement of how that phrase is to be understood will be essential.
- The IASB agenda. Of utmost concern to us is the setting of the IASB's agenda. Just from the proposals it is not obvious to us that either the proposed Monitoring Group or the Trustees would provide a mechanism for ensuring that the IASB focuses on work which is practically useful to the capital and other financial markets rather than devoting resources to theoretical matters. Without such a mechanism we would not be sanguine about the effectiveness of either body. (See also points 1 and 2 above under "General Remarks".)

Q2 The proposals contemplate a Monitoring Group comprising representatives of seven public authorities and international organisations with a link to public authorities. While recognising that the Monitoring Group is an autonomous body, the Trustees would welcome comments regarding the Monitoring Group's membership and whether other organisations accountable to public authorities and with an interest in the functioning of capital and other financial markets should be considered for membership.

There seems to us excessive emphasis on regulatory bodies in the proposal. When one recalls that financial reporting is about communication between preparers and users, who would not be represented, it seems a little bizarre that organisations like the World Bank and the IMF are regarded as being able to form a more informed opinion on such matters. Alternatively, in establishing the Memorandum of Understanding, the Trustees may like to consider some mechanism for ensuring that both they and the Monitoring Group regularly receive input on how the whole due process is being perceived by the primary parties involved in financial reporting nearer the ground (see point 2 above under "General Remarks".)

A further aspect on which improvement seems desirable is on the fact that the proposals give inadequate weight to the need for the diversity in the world's financial cultures to be properly reflected. We believe that the composition of the Monitoring Group should be regionally rather more diverse and less US-weighted.

One area where there may be some sensitivity in certain quarters is on the proposed Monitoring Group's impartiality. For instance, the composition suggests a danger of leaning towards US ideologies. Some indication of what mechanisms will be put in place to ensure the impartiality of the body would be helpful.

Q3 The Trustees will remain the body primarily responsible for the governance of the organisation and the oversight of the IASB. Their responsibility to a Monitoring Group will enable regulatory and other
authorities responsible for the adoption of IFRSs to review the Trustees' fulfilment of their constitutional duties. Does the formulation of the Monitoring Group's mandate and the Trustees' reporting responsibilities, as described in the proposed Section 19, appropriately provide that link, while maintaining the operational independence of the IASC Foundation and the IASB?

It is difficult to judge from section 19 whether the Monitoring Body's responsibilities as proposed will actually work to eliminate the weaknesses in the whole standard setting process which we have alluded to above. Again, it all depends how they are "lived". If the Trustees are going to continue to accept the IASB's apparent understanding of its independence as meaning that it has no obligation to focus on matters which are practically useful and helpful to market participants and the Monitoring Body also accepts that acquiescence, we would not see much benefit for the markets.

Q4 Given the proposed creation of a Monitoring Group, would there be a continued need for the Trustee Appointments Advisory Group in the selection of Trustees? If so, what should be the role and composition of the Trustees Appointments Advisory Group?

We are not close enough to the actual functioning of this process to be able to give a meaningful, informed response.

Questions related to the IASB's composition

Q5 Do you support the principle behind expanding the IASB's membership to 16 members in order to ensure its diversity, its ability to consult, liaise and communicate properly across the world, and its legitimacy?

We also see the IASB's diversity and ability to consult, liaise and communicate properly across the

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world as extremely important. In recent years we have found individual IASB members very willing to enter into dialogue with us as constituents, which we very much appreciate, and if it has been shown to be necessary to increase the Board's size to improve constituent cover we can only welcome the step. We are unable to judge whether 16 is "the right number": presumably the Trustees have carried out the appropriate analysis. As far as legitimacy is concerned, we believe that this is not dependent on size and can only be achieved by having the appropriate mix of backgrounds in the Board (see Question 6 below) – and, even more importantly, by the quality and usefulness of the Board's output.

However, it seems to us unacceptable not to change voting majorities in line with this increase.. To ensure legitimacy of decisions we suggest that the voting majority for a standard should at no time be less than two-thirds of the IASB members.

Q6 Do you agree with the geographical formulation suggested by the Trustees?

No. The proposals maintain a strong tendency to potentially give excessive weight to countries with an "Anglo-Saxon" accounting tradition. It would theoretically be quite possible for 15 of the 16 members to be chosen from such countries – and the South American could feel quite lonely. The Trustees may like to consider (e.g.) changing (a) to 4 members from Asia (only) and (c) to 4 members from North America and Australasia, and setting an overall maximum of 50% of members from the UK and its ex-colonies (incl. USA.)

Furthermore, we find that at least 2 of the North American places should be contingent upon the USA firmly committing to adopt IFRS within the next 5-6 years, on the principle of "no representation without taxation"! Similarly we think that the Trustees need to review very critically the arrangements between the IASB and FASB. We see no reason for the favoured treatment of the latter over (e.g.) the Japanese standard-setter and hope that the Trustees will reconsider this.

Also very important for ensuring legitimacy is the continued enrichment of the Board with "practical experience", on which a good start has been made over the last couple of years. We strongly recommend acceleration of this process to support legitimacy, along with a closer definition of "practical experience": at least 5 years' recent experience of actually preparing, using and front-line auditing of financial reporting enhances the Board's legitimacy and credibility amongst most constituents, while practical experience limited to the lecture hall and the technical desk does not automatically do so.

Q7 The Trustees are suggesting that the Constitution should provide flexibility on the matter of part-time membership. Do you support that proposal?

We agree that the Constitution should provide the flexibility. Where such an arrangement is workable, we think that the Board can only benefit from maintaining direct contact with actually preparing, using and front-line auditing of financial reporting. However, we fully realise the practical problems which such members face and leave it to the Trustees to identify viable solutions.

We trust that the Trustees will find our remarks useful in their deliberations. It is extremely important for us that those deliberations achieve a useful outcome. We hope that the Trustees take

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the opportunity to help prevent IFRS financial statements degenerating into mere filing documents, with preparer and analyst attention being focused on non-GAAP measures and the management commentary/financial review as the key vehicles for useful financial communication.

Sincerely,

F. Hoffmann-La Roche AG

Dr. Erwin Schneider
Head of Corporate Finance
Accounting & Controlling

Alan Dangerfield
Corporate Finance Accounting & Controlling
External Relations

Appendix: Preparers' and users' needs

- In a recent newspaper article a leading financial analyst expressed the feeling that standard setters were living on a different planet. This feeling is widely shared. What are preparers' and users' needs for financial reporting which apparently diverge so substantially from the Board's vision and from the standards which it is developing?

- Firstly, the preparers' perspective. This is first and foremost one of information on flows. What economic resources are being created, and what economic resources are being consumed in that process? What cash flows are arising in this business process? What return has been generated with the capital invested? Information on the financial position and changes in it are in this sense secondary. Both for internal management reporting and for reporting to investors and other external parties, preparers want to be able to show how the business has performed in the way in which it really runs rather than according to hypothetical constructs of how it could have been. Many preparers share the view recently expressed by another leading analyst that the Board's work in recent years had tended to make it more rather than less difficult to identify and understand performance, as irrelevant elements have been introduced into the income statement. (The awareness of the fact that what is relevant for the financial position is not necessarily relevant for performance, as a expressed by a Board member with a user background, does not seem to be general in the Board.) Also, for preparers to be able to explain business performance both internally and externally, standards should avoid increased theoretical complexity which substantially impedes understandability. Why quantum physics when basic mechanics will also work?

- At Roche we have constantly tried to ensure that we keep our internal and external financial reporting in line with each other. As IFRS have developed away from the business, this has become increasingly difficult. Similarly, it gives rise to a move towards non-GAAP reporting in order to explain the business to analysts. An example is the reporting of research and development which is crucially important for a healthcare group like Roche.

Despite our objections, changes to IAS 38, Intangible Assets, required us to capitalise any separately purchased R&D projects (in contrast to our internal R&D work) and created an informational disconnect both internally – based on how we manage R&D – and externally – as analysts focus on R&D spending as a whole. Hence, we now disclose outside of the financial statements in our "financial review" the "true" R&D spending as we and the users view it.

- We analyse internally the trend of the amount of quantitative data given in our annual group external report since we started publishing it back in 1973. Since our first report "in accordance with IAS" in the early 1990's this shows a **six-fold increase**, which is only marginally due to the addition of voluntary quantitative disclosures made to assist users' understanding of performance. Much of this data is not of use for internal purposes, which leads us to question its usefulness for financial analysts and other users.

- Next, the users' perspective. It may seem presumptuous for us as preparers to comment on users' needs. However, as preparers we would be far more positively oriented towards IFRS developments if they were clearly supported as necessary by our "information customers". But we are regularly confronted with evidence that many users are dissatisfied with developments. Just as with preparers, there is obviously not one single, consistent user view on financial reporting. However, our regular contacts with analysts give a sufficiently consistent picture of their needs and views to enable us to assert that there is substantial congruence between the preparers' perspective outlined above and that of most analysts. It is unfortunate that, as the Board itself has found, the active users have not in the past articulated their views on IFRS proposals very systematically and have passively left it to "representative bodies" to do the job. Based on our own contacts with users and on various other evidence referred to below, we perceive an appreciable divergence between the views expressed by the headquarters of those "representative bodies" and those of active, grass-roots users. It has been most gratifying that the Corporate Reporting Users Forum (CRUF) has now emerged to articulate the views of leading active analysts more effectively: even if it does so with several caveats, it is consistent enough for one to draw quite concrete conclusions on users' needs. The message from CRUF is pretty clear: that the Board's direction is quite a way away from what users need. Further clear evidence of this is provided by the three surveys of investors' views carried out by PwC and published during 2007.

- Finally, a brief word on convergence. We share the Trustees' and Board's enthusiasm for a single set of accounting standards worldwide, though being practical and pragmatic we have always added to that support "but not at simply any price". The actual implementation of the original stated approach to IFRS/US-GAAP convergence, whereby the IASB and FASB would either adopt the better of the two existing standards or develop a new best one, has rather disappointed us. On both borrowing costs and joint ventures the Boards decided to adopt what was generally commented on as being the less good existing standard, while with business combinations convergence seems to have been taken as an excuse to try to push through various changes which nobody else appeared to want. This gives us concerns for the next round following the new Memorandum of Understanding. If the ostensible desire to accommodate US idiosyncracies for the run-up to a possible adoption for US domestic registrants in 2014 leads to the imposition of SEC-/FASB-style bureaucratic, complicated legalistic solutions to problems which we do not now have, many European constituents' enthusiasm for convergence could rapidly diminish.

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Mr. Gerrit Zalm
Chairman of the Trustees
International Accounting Standards Committee
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30 Cannon Street
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9 June 2008

Constitution Review – first part

Dear Mr Zalm

We would like to give you some preliminary input for the Trustees' constitution review, from a large multinational group which has been using IAS/IFRS since 1990 and has been closely involved in their development.

First, briefly to Roche. The Basel-based group has a turnover of CHF 46 bn a year (EUR 28 bn.) derived from its healthcare business – pharmaceuticals and diagnostics – and employs nearly 80,000 people worldwide. We have a market capitalisation (end 2007) of CHF 171 bn. (EUR 103 bn.)

Over the last two decades we have been actively involved in the standard setting process. We delegated one of our senior management as a member of the IASC and have continuously tried to support the process through participation in round tables, discussions, field tests, etc. and through commenting on proposals both directly and in collaboration with SwissHoldings, BUSINESSEUROPE and the European Round Table. We also actively support the efforts of EFRAG. With this amount of involvement we are naturally gratified to see how widely IFRS are becoming accepted around the world and are also cognizant and appreciative of the Trustees' efforts in recent years to improve the IASB's governance and due process. Nonetheless, our confidence – as preparers – in the effectiveness of that governance and due process has seldom been at a lower ebb. Why?

You will already have read many of the concerns which we have in the European Parliament's "Radwan Report", to which we can wholeheartedly subscribe. In essence, we appreciate that, by achieving acceptance of IFRS round the globe, the IASB is helping to improve the international acceptance of our own financial reporting. However, we do not believe that the standard setting process – for all the additional steps and safeguards which have been built in – is resulting in the kind of standards which the capital markets need. Financial reporting is not an end in itself, and it is

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unfortunate that the IASB is, as both judge and jury, interpreting "high quality standards" in a manner which places prime emphasis on theoretical concepts but relegates practical usefulness to an insignificant role. By practical usefulness we mean that standards should give preparers and users – the primary parties involved in financial reporting – the tools to communicate and exchange financial information which is meaningful and understandable in a form that reflects the way in which the business runs and which meets the needs of the users. We expand on this point in the appendix. How is it possible for this situation to arise if governance and due process are effective?

To improve the congruence between standards produced and the capital markets' needs, we would invite the Trustees to consider the following governance and due process measures:

1. Change paragraph 2 of the Constitution on objectives to specify explicitly that the terms "public interest" and "high quality standards" are to be understood as reflecting practical usefulness for preparers and users, based on the way business actually operates. Work on standards should only be undertaken when a need has been clearly identified and corroborated by preparers and users. (Regulators' needs may be considered in developing the detail of the standards themselves, e.g. in the disclosure requirements.) There is a clear need to clarify that the Board's "independence" does not extend to the freedom to impose theoretical requirements which the participants in the capital markets do not need or support.
2. A monitoring body as currently being discussed should be actively involved in the setting of the Board's agenda – including rigorously testing proposed agenda items against the criteria of capital market needs and practical usefulness – and in holding the Board to account, on a regular basis, for the work it carries out – again against these criteria. To assist that body, a mechanism of consulting preparers and users on agenda proposals and on Board performance needs to be set up on a basis which is completely independent of the Board itself. We do have some reservations about the creation of an additional body, as there is a risk of "transmission losses" between various organs. However, as the Trustees unfortunately do not appear to see this important activity as part of their role, another body is probably necessary.
3. The Board has won acclaim for its governance and due process system. However, a system is only as good as it is "lived". There is little to be gained from tweaking the system if the Board only pays it lip service and goes through the motions but then, for example, treats input from constituents in the due process dismissively. A monitoring body would need to be aggressively critical in this respect: it should not accept, for instance, that the Board receives overwhelmingly negative comments to a proposal but nevertheless presses ahead with it with the argument that the feedback did not bring to light any new arguments not previously considered or that the commentators obviously had not understood the proposal.
4. As part of the governance system, the Trustees should not place too much emphasis on cost/benefit analyses accompanying standards or on ex-post reviews done by the Board. In the case of cost/benefit analyses, the best that can be expected is an objective listing of the costs and benefits, but a meaningful and balanced evaluation would have to be done independently. In the case of the ex-post reviews, it is too late: preparers and users will already have incurred whatever costs are involved in implementing the standard.
5. Finally, on Board representation, the Trustees appear to be focusing on geographical representation. We would urge them not to neglect at the same time the need to ensure that Board members have practical experience. A start has already been made here, which we appreciate, but opportunities could be sought to accelerate the process of enriching the Board in

this sense. Incidentally, the Trustees should also consider extending the application of the same criterion in the selection of staff.

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We trust that the Trustees – and the Constitution Committee in particular – will find our remarks useful in their deliberations. It is extremely important for us that those deliberations achieve a useful outcome. We hope that the Trustees take the opportunity to prevent IFRS financial statements degenerating into mere filing documents, with preparer and analyst attention being focused on non-GAAP measures and the management commentary/financial review as the key vehicles for useful financial communication.

Sincerely,

F. Hoffmann-La Roche AG

Dr. Erwin Schneider
Head of Corporate Finance
Accounting & Controlling

Alan Dangerfield
Corporate Finance Accounting & Controlling
External Relations

cc: Mr A. Vegezzi

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- We also attach for your information a summary that we prepare internally of the trend of the amount of quantitative data given in our annual group external report since we started publishing it back in 1973. The six-fold increase since our first report "in accordance with IAS" in the early 1990's is only marginally due to the addition of voluntary quantitative disclosures made to assist users' understanding of performance. For the rest, it would be an interesting exercise to ask a sample of analysts which data they could easily do without if we were to reduce by one third.

- Next, the users' perspective. It may seem presumptuous for us as preparers to comment on users' needs. However, we as preparers would be far more positively oriented towards IFRS developments if they were clearly supported as necessary by our "information customers".

But we are regularly confronted with evidence that many users are dissatisfied with developments. Just as with preparers, there is obviously not one single, consistent user view on financial reporting. However, our regular contacts with analysts give a sufficiently consistent picture of their needs and views to enable us to assert that there is substantial congruence between the preparers' perspective outlined above and that of most analysts. It is unfortunate that, as the Board itself has found, the active users have not in the past articulated their views on IFRS proposals very systematically and have left it to "representative bodies" to do the job. Based on our own contacts with users and on various other evidence referred to below, we perceive an appreciable divergence between the views expressed by those bodies and those of active, grass-roots users. It has been most gratifying that the Corporate Reporting Users Forum (CRUF) has now emerged to articulate the views of leading active analysts more effectively: even if it does so with several caveats, it is consistent enough for one to draw quite concrete conclusions on users' needs. It is disappointing that the Board – and the FASB – has treated CRUF so dismissively rather than trying to understand better what their needs really are. The message from CRUF is in any case pretty clear: what the Board is doing is quite a way away from what users need. With few exceptions (e.g. financial statement presentation), the priorities suggested by CRUF in a recent presentation do not reflect those laid out in the latest Memorandum of Understanding. (Perhaps the divergence would have been less if the latter had been properly subjected to due process?!) Similarly enlightening were the three surveys of user needs carried out by PwC during 2007, which likewise highlighted a considerable gulf between what users want and what the Board thinks they ought to want.

- Finally, a brief word on convergence. We share the Trustees' and Board's enthusiasm for a single set of accounting standards worldwide, though being practical and pragmatic we have always added "but not at simply any price". The actual implementation of the original stated approach to IFRS/US-GAAP convergence, whereby the IASB and FASB would either adopt the better of the two existing standards or develop a new best one, has rather disappointed us. On both borrowing costs and joint ventures the Boards decided to adopt what was generally commented on as being the less good existing standard, while with business combinations convergence seems to have been taken as an excuse to try to push through various changes which nobody else appeared to want. This gives us concerns for the next round following the new Memorandum of Understanding. If the ostensible desire to accommodate US idiosyncracies for the run-up to a possible adoption for US domestic registrants in 2013 leads to the imposition of SEC-/FASB-style bureaucratic, complicated legalistic solutions to problems which we do not now have, many European constituents' enthusiasm for convergence could rapidly diminish.