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IASC Foundation Constitution Review Part 2

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 this subject. This letter contains some general remarks: we respond in a more focussed way to the specific issues raised in your latest document in Appendix 1.

First, briefly to Roche. The Roche Group has a turnover of CHF 46 bn. a year (EUR 29 bn.) derived from our worldwide healthcare business - pharmaceuticals and diagnostics - and employs over 80,000 worldwide. We have a market capitalisation (end 2008) of CHF 141 bn. (EUR 95 bn.)

General Remarks

For the first part of your review we submitted comments on September 12. For this second part we have updated our points in that letter in various respects to take account of:

- the outcome of the first part, as we understand it (in the unfortunate absence of any feedback statement), and
- various intervening developments such as the apparent change in the SEC's position on IFRS under the new US Administration and the IASB's approach to consideration of preparer and user requirements as manifested in the recent Discussion Paper on Financial Statement Presentation.

Over the last two decades we have been actively involved in the standard setting process. We delegated one of our senior managers 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

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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, even after the "Part 1" changes. Why?

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 Appendix 2 to this letter.) How is it possible for such a situation to arise if governance and due process are working effectively?

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 (a) 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. The words in that paragraph, "…in the public interest" and "… to help participants in the world's capital markets and other users make economic decisions", often seem to be set aside in the Board's approach. Work on standards should only be undertaken when a need has been clearly identified and corroborated by preparers and users. (In June 2008, in a presentation to the IASB, the highly respected Corporate Reporting Users Forum (CRUF) urged them to take an "evidence-based" approach to standard-setting, focussing on areas where practical needs have been identified. We wholeheartedly support CRUF's viewpoint.) 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 Trustees should become actively and vigorously involved in the setting of the Board's agenda, and this involvement should include rigorously testing proposed agenda items against the criteria of market needs and practical usefulness and holding the Board to account, on a regular basis, for the work it carries out – again against these criteria. To assist the Trustees, a mechanism for consulting preparers and users on agenda proposals and on Board performance and adherence to due process needs to be set up on a basis which is completely independent of the Board itself. We do have some reservations about the effectiveness of the new Monitoring Group, as there is a risk of "transmission losses" between various organs. However, we are gratified that the governance system has at least formally been modified to permit this essential oversight function to be carried out.
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 then, for example, treats input from constituents in the due process dismissively. Both the new Monitoring Body and the Trustees need to be aggressively critical in this respect: they 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 itself. 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. We believe that there is a good case for these activities to be carried out independently of the Board itself.
5. Finally, we would urge the Trustees not to focus solely on geographical spread when making Board appointments but also to take account of 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.

- 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 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,

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Appendix 1: Questions for consideration

Objectives of the organisation

Q1 Appropriateness of the current primary objective

As we hope we have made clear in our general remarks, we strongly believe that the Constitution should make explicitly clear that the definition of "high quality" standards should mean that they are, inter alia, practically useful. Standards should really be conducive to financial reports which "help participants in the world's capital markets and other users make economic decisions". No changes in standards should be worked on for purely theoretical reasons: the agenda should be developed to reflect practical needs via an evidence-based approach.

On the question of NPAEs, our view is that the evolution of the project so far has clearly demonstrated that it does not fit well into the main IASB process, experience and criteria. Our suggestion would be to make it the responsibility of a separate committee of the IASC Foundation.

Q2. Specific reference to a principle-based approach

We agree entirely with the Trustees that the commitment to this approach should be enshrined in the Constitution. Although it is not necessarily easy to put into practice – as the explosion from 1995's 740 pages of IAS to 2008's 2,719 closely printed pages of IFRS well illustrates – the Constitution should permanently remind the Board of the importance of that tenet.

Q3. Focus on listed companies

We would not wish to diminish the needs of (e.g.) not-for-profit entities or the public sector. However, we are of the opinion that the IASB should really focus on the practical needs of the capital markets in respect of listed companies' financial reporting for the next five years. This period threatens to be dominated by questions of financial stability, where listed companies are really in the front line.

Q4. Closer collaboration beyond standard-setting bodies

We have the impression that the Board's work since it was set up has suffered to some extent from excessive "accounting-introversion" by concentrating on relationships with other standard-setters, first and foremost with the FASB. We would certainly support any encouragement which the Trustees could give the Board to reinforce their work with a wider range of standard-setters from outside the Anglo-Saxon accounting culture like the Japanese and Chinese standard-setters, as well as with EFRAG. This would help to ensure a better coverage of possibly diverging but equally valid approaches. On collaboration with *other* types of organisation, we find the idea supportable in principle – especially with regard to working with preparers and users, the primary parties involved in financial reporting. Nevertheless, it would be necessary to consider three particular risks:

- The Board's resources are limited, and we would not be supportive at this stage of any further significant increase. Having to devote time and effort to wider collaboration could presumably mean, for instance, delegating more work to other standard-setters – a route which has not, from our viewpoint, borne edible fruit in the past.

- On the other hand, we are convinced that more contact with such organisations as CRUF could substantially enrich the Board's work – if the Board approaches it in an open-minded manner – and need not absorb a large amount of resources as such organisations would themselves not necessarily have the current capacity to increase their involvement substantially. Limited, focussed contacts could be very efficient in ensuring the Board stays in touch with trends and opinions outside the standard-setting world.

- We must confess a certain unease that the Board might seek merely to develop collaboration with organisations which agree with it or that it might find itself overwhelmed by lobbying-groups. Both of these eventualities would not be conducive to producing standards of general benefit.

We suggest that the Trustees might set up an internal group to explore how such collaboration might be set up in a balanced and beneficial manner and, of course, expose its conclusions for comment.

Governance of the organisation

Q5. Creation and role of Monitoring Group

In our comments on "Part 1" we expressed some concerns that the Monitoring Group might have only a limited and formal presence with little impact and that an effective improvement in the implementation of the Board's governance to ensure focus on standards of practical usefulness might not be achieved. As we suggested in our general remarks above, how the Constitution and governance system are "lived" by the Board is rather more critical to "tweaking the paragraphs".

Trustees

Q6. Geographical selection of Trustees

A geographical distribution does appear to us to be appropriate, but one which better reflects actual use of IFRS – or at least clear commitment to future adoption – would be far more palatable than the present arrangement. Similarly, as with Board composition, the tendency exists to favour countries with an Anglo-Saxon accounting culture should also be addressed in a reconsideration. Such a reconsideration would be appropriate and welcome.

Q7. Trustees' oversight activities

As indicated in our general remarks we have not yet noted any marked signs of more effective oversight. A much more active oversight, especially over agenda-setting and due process, is urgently needed. We believe that responsibility for that tighter oversight should rest with the Trustees, though they may not currently have the time or resources to exercise it properly and therefore need to make further arrangements. This might for instance be some permanent infrastructure independent of the IASB and financed out of IASC income, sub-committees of the Trustees or a re-shaping of the SAC to act as the Trustees' extended arm.

Q8. Financing

The question of funding is very much connected with the perceived quality of the IASB's output. If that continues to be perceived as theoretical, impractical and not very helpful for the purposes of capital market participants, voluntary funding may not be a viable long-term solution. However, the Trustees should also ask themselves what the need is which has to be funded. We are not convinced that an organisation of the IASB's current dimensions is even necessary. The current work plan contains much which, in our view, is unlikely to bring substantial benefits for capital market participants.

International Accounting Standards Board

Q9. Agenda-setting and independence

It appears to us that a common-sense reading of the full paragraph 2(a) of the Constitution would have led to agenda-setting which concentrated on practically useful projects. The Board's independence has been extended from technical matters back into the agenda- and priority-setting phase, a phase which we strongly believe requires a more distanced approach to identify real needs. In our opinion agenda-setting proposals should be subject to meaningful public consultation (to which attention must be paid) and formal approval by the Trustees. Agenda proposals could be formulated by the IASB as today but actually reflecting recommendations from (e.g.) the SAC and identifying why improvement is necessary and what the specific expected benefits for the capital markets would be in practical, concrete terms. The Trustees would weigh the input from the public consultation and from the SAC on the proposals and formally define the agenda, with explicit documentation of their reasoning. The Board's independence would then kick in after this stage.

Q10. Recent enhancements to due process

We have not yet noted any significant improvement in the situation since the enhancements were introduced. For some this may be just a matter of time. However, as we pointed out in our general remarks, we do not think that changes in the formal process are likely to bring the improvements needed without the governance arrangements actually being "lived". To foster that change in approach, however, we strongly recommend the Trustees to consider making the due process more independent, possibly directly under their own auspices or under a revamped SAC. In addition to the change in agenda-setting referred to above, measures seem to be needed to counter the following tendencies we have observed since the IASB came into being:

- The output from the consultation process is very often not taken as seriously as it should be and has little influence on the final shape of the standard. Comments are often dismissed as not giving any new insight beyond what the Board already knew or as showing that commentators had not understood proposals, and the dismissal of feedback exhibiting a large degree of consensus does not help to diminish an impression of arrogance on the standard setters' part. Comments are analysed by staff employed by the Board with a vested interest in their projects. For a significant improvement in the process from a constituents' viewpoint, we strongly recommend the Trustees to make the due process itself more independent, perhaps via a sub-committee of the Trustees or a revamped SAC, endowed with the appropriate resources required. This "body" would independently and objectively analyse comment letters and other input from constituents, review feedback statements drafted by the IASB prior to publication of the final standard for having adequately considered input and explaining why specific input has been rejected in the final decisions made, and presenting their conclusions on the adequacy of the due process to both the Board and the Trustees before the Board finalises its decision.

There are three further points we would like to make on IASB process and procedures:

- In "Part 1" of the Constitution Review we mentioned the importance of adjusting the voting majority required for approval of a standard in line with the increase in the number of members. We ask the Trustees to ensure that this remains at least two-thirds of IASB members, to reinforce the legitimation of the decision where there are differing views in the Board.

- We again stress the importance of a more balanced geographical representation in the Board, avoiding a predominance of Anglo-Saxon accounting cultures.

- Currently full-time members are appointed for a term of up to five years, renewable once. To ensure that the Board stays closely in touch with the environment it is supposed to serve, we recommend that the Trustees give consideration to excluding renewal where the member was previously engaged full-time for more than five years in standard-setting (e.g. with a national standard setter) or in a function which was not preparing, using or front-line auditing of financial statements. We also point out that, although paragraph 19 of the current Constitution refers to "practical experience" as one of the two main qualifications for IASB membership, this is not mentioned in the annex, "Criteria for IASB Members" – we believe that this omission should be remedied.

Other than the feedback statement and effects study on business combinations we are not aware of any actual output of this kind on which we could comment.

Q11. "Fast track" procedure

Recent experience does not speak well for decisions on complex technical issues being rushed. Neither are we aware of any widespread major problems which have arisen because of the present absence of a fast-track procedure. The Trustees should only consider such an innovation once confidence in the normal procedure has been restored.

Standards Advisory Council

Q12 and Q13.

We have the impression that the SAC may have been too low-profile in the past for its important input to the Board to be reflected in Board considerations. This is a pity but possibly also reflects some weaknesses in the definition and understanding of the SAC's role. The Trustees may wish to consider "beefing up" this body's role to have a greater beneficial impact on the whole standard-setting process.

At several points in this letter we have mentioned the possibility of modifying the SAC to be able to act as the extended arm of the Trustees in certain governance matters (agenda-setting, due process monitoring, etc.) If this route were chosen, the SAC's position would have to worked over to ensure that, for it too, appropriate governance mechanisms are in place, in particular to ensure that it does not become dominated by individual and potentially unrepresentative interest groups..

Appendix 2: Preparers' and users' needs

- In a newspaper article last year 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*** (income and cash.)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 run if it had been some other hypothetical market participant. 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 from the financial statements, as irrelevant elements have been introduced into the income statement. Also, for preparers to be able to explain business performance both internally and externally, standards should avoid increased theoretical complexity which substantially impedes understandability.

- 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 being 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 active users' needs. The message from CRUF is pretty clear: that the Board's direction is quite a way away from what active users need. Further clear evidence of this is provided by the three surveys of investors' views carried out by PwC and published during 2007. The Discussion Paper on Financial Statement Presentation recently published by the IASB was rather disturbing in this respect. Very bold assertions on "what users want" are made in it which we are quite unable to relate to the wants and needs expressed by our own users in our regular, intensive dialogues or by CRUF, whose views we find are generally very much in line with what we hear from our active users. The Board has apparently taken a very restrictive approach to its polling of user opinion which we find particularly unacceptable when it potentially leads to the imposition of costly reporting changes which do not appear to be strongly supported by a significant number of active users, even if the views which it does take into account are doubtless well researched and sincerely held.

- As mentioned in the cover letter, we congratulate the Trustees and the Board on their immense success in gaining almost global acceptance of IFRS over the last eight years. The success in producing high quality standards as we would understand the term has been less startling. Very subjectively, from the point of view of a Swiss industrial preparer and its financial-statement users, we would identify the following pluses:

  - a standard to reflect the cost of share-based payments (even if the standard itself leaves a great deal to be desired),
  - for our users, reductions in the number of options in financial reporting;
  - also for our users, certain additional disclosures to improve transparency and understandability.

If we were an EU company we would probably also add the pragmatic simplifications made to ease first-time application for companies in that region, which were greatly appreciated.

This appears to us to be a rather meagre yield in practical terms given the resources expended. It does not even consider the "retrograde steps" in business combinations and capitalisation of acquired development costs and the needs clearly identified by users which have not been met (see presentations by members of the Corporate Reporting Users Forum during 2008 to the IASB/FASB joint meeting, to the IASB itself and to the IFRS Conference.)

- 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 approach, 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. (CRUF referred to it as a "retrograde step.") This gives us concerns for the next round following the new Memorandum of Understanding. Especially if the SEC is no longer willing to support the approach that financial reporting standards set by the IASB are to be used by domestic issuers in the US – unless, presumably, the standard-setting process is under US control – we are very uncomfortable with the whole convergence approach. Even if a plan is eventually adopted for IFRS adoption by US domestic registrants next decade and so the ostensible desire of the IASB to accommodate various specific US issues, as they laudably did for the European Union and are doing for Canada, becomes justifiable again, the imposition of SEC-/FASB-style complicated, legalistic solutions to problems which we do not now have could rapidly reduce many European constituents' enthusiasm for convergence.