ρ

Director, Accounting Standards
Canadian Accounting Standards Board
277 Wellington Street West
Toronto
Ontario M5V 3H2
CANADA

Basel, May 19, 2006

Discussion Paper on "Measurement on Initial Recognition" (IASB)

Dear Sir/Madam

The Roche Group has turnover of CHF 36 bn. a year (USD 28 bn.) derived from its pharmaceuticals and diagnostics businesses and nearly 70,000 employees worldwide. We have been preparing our consolidated financial statements according to IFRS/IAS since 1990 and therefore have a substantial interest in how these will develop, so we very much welcome this opportunity to give our feedback on the Discussion Paper (DP).

Before discussing the detailed points made in the paper, we would like to make some general comments. May we emphasise that our comments are in any case made from the viewpoint of an industrial entity: much of the DP seems to have the perspective of financial institutions, for whom fair values may – or may not – be "just a few keystrokes away" in more instances than they are for industrial assets and liabilities. Also, many of our comments relate to the application of the fair value measurement basis in general, not just to its use on initial recognition, as we do not believe it to be cogent to consider measurement on initial recognition separately from subsequent measurement. We concentrate on the decision-usefulness aspects of financial reporting as this is the focus of the DP, but we insist that the stewardship/accountability aspects of financial reporting warrant much deeper reflection than the DP has had the time and space to give them and that such reflection would result in less support for the fair value conclusions arrived at.

We have looked forward for some time to a general debate on financial reporting but are somewhat disappointed by this start. A key weakness of the DP is that the discussion seems to take place in a theoretical vacuum, rather than establishing first how the decision usefulness objective of financial reporting mentioned in the paper should be translated into arguments for changing the way assets and liabilities are measured today. Financial reporting is essentially a practical mechanism for communication between preparers and users of financial statements. It does not have a raison d'être outside of serving that purpose, and it needs to be considered in terms of its fulfilling that purpose, not

F. Hoffmann-La Roche Ltd Corporate Finance CH-4070 Basel | Accounting and Controlling Bldg 52/804 | Tel. +41-61-688 42 34 Fax +41-61-688 42 82

against more general, philosophical criteria (i.e. no "art for art's sake").

The implication of the DP that fundamental changes to financial reporting are required is not confirmed by the requests that we receive in our regular contacts with analysts. The latter ask rather for more information about markets and competitive positions, performance of business segments, innovation, prospects for new products and services, and the strategic options open to the company. A few specific areas for improvement in financial reporting are sometimes mentioned in these contacts. However, such areas for improvement appear to be far more limited than requiring fundamental changes to the accounting model – especially after the advances which we and other preparers have made in recent years in transparency and in implementing new and revised standards. It is by no means clear to us that the calls for fundamental changes from some groups of users are at all representative of users at large rather than of a small if enthusiastic minority. In short, there appear to us to be as yet no reliable indications among the primary parties involved in financial reporting – preparers and users – of any need or desire for a fundamental change in the accounting model.

Nevertheless, a debate would indeed be very welcome on financial reporting from the practical viewpoint of what preparers and users wish the financial statements to show differently so that they are more useful for economic decision-making and for stewardship purposes in order to clearly confirm the primary parties' positions. A necessary precursor would be to establish a generally accepted position on the bases for performance measurement and for capital maintenance. The question of the measurement basis – whether on initial recognition or subsequently – could then follow on logically from consensus related to which assets and liabilities should be shown differently in the balance sheet. This approach would also eliminate the problem that measurement on initial recognition cannot be sensibly divorced from subsequent measurement: the two are logically closely connected. We believe that it would be more difficult than the paper somewhat ingenuously suggests to revise conclusions on measurement on initial recognition in the light of discussions on subsequent measurement at a later stage of this project.

Among the many unsupported assertions in the DP is that fair values are more useful for economic decision-making. Users want reliable information to enable them to make forecast of future long-term cash flows as the basis for their valuation of the entity. While market *exit* values may be interesting if the entity is planning to sell its assets and settle its liabilities shortly after the balance sheet date, it is by no means clear to us – or to the analysts with whom we have talked – how such values would be of use in general in doing the valuations. Indeed, there is considerably more support for having reliable information on the actual, transaction-based historical-cost results with which the analysts can work up their cash flow forecasts. Similarly, the DP offers neither theoretical arguments nor empirical support that would justify the implicit assumption of the superior relevance of fair values of individual assets for deriving the value of companies. It is questioned whether the value of the entity can be readily derived from the summation of individual assets and liabilities. As we understand it, analysts use estimates of future (free) cash flows from continuing business as a basis for their valuation of companies. These cash flows are projected on the basis of analyses of historical, actual cash flows of companies and/or individual business segments. This approach is also applied internally by companies for the evaluation of investment and acquisition opportunities. From this standpoint the DP appears to fall into the trap of assuming that the value of the entity as a whole can be derived from the sum of the values of its assets and liabilities.

Equally, it is quite unclear from the DP how market values rather than entity-specific values could be used by – and be more useful to – analysts in forecasting future cash flows. Today's fair value of a chemical production plant which is going to be used for manufacturing active pharmaceutical substances for the next 20 years is not necessarily closely connected with the entity's future cash flows and therefore its total value.

F. Hoffmann-La Roche Ltd Corporate Finance CH-4070 Basel | Accounting and Controlling Bldg 52/804 | Tel. +41-61-688 42 34 Fax +41-61-688 42 82

The thrust of the DP and of the implied general application of a fair value measurement basis is somewhat disturbing for a further reason. They would move us further towards a purely monetary presentation of the business (change in values of net assets, a "black box") and away from a presentation of the business as a real process of creating new real products by the use of existing real resources. This is the key to the traditional income statement, which shows the actual realised value of resources created (sales) with the value of the resources consumed in doing so, reflected at the amounts actually invested to acquire them. This idea of the successful (or otherwise!) real economic process is the crux of business which theoretical valuations obscure. Most grass-roots analysts understand that this must be their focus: at analysts' conferences our management primarily faces questions about the operating profit, the products-in-development pipeline, sales prospects for key products, trends in cost development, etc. and seldom – if ever – about unrealised gains and losses on available-for-sale investments.

The DP makes some fairly bold assumptions about the possibilities of taking quantitatively into account the effects of inefficiencies and other factors which make markets less than perfectly efficient. What may be basically tenable for some commodity or currency markets is inapplicable to far more other markets than the DP suggests. Observable evidence does not support the view that a single fair value is generally readily derivable, and where management judgment has to be applied in deriving such a value the neutrality of the financial reporting is potentially at risk. Many of the arguments adduced in favour of the fair value measurement basis do not apply if there is no efficient market. (Any illusions about the predominance of efficient markets will be quickly dispelled by a reading of Prof. John Kay's "The Truth about Markets" and of Tim Harford's "The Undercover Economist".) Also, it is difficult to understand the conclusion that fair value can be a relevant measurement basis where no market exchanges take place (e.g. taxes).

The difficulties of putting the favoured fair value measurement basis into practice are substantially understated in the DP. Fair-valuing investments in frequently traded equity securities "a few keystrokes away" on the Reuters or Bloomberg screen is a very different matter from fair-valuing a complex, 12-year old chemical production plant. Experience of applying current-cost accounting in past years leads us to expect that the real, on-going costs of doing such valuations to be substantial for non-financial, non-traded assets and liabilities, and we have considerable difficulty in identifying any economic benefits from doing so. While we acknowledge that the DP does not advocate widespread use of current cost accounting, that experience is relevant because fair value measurement could in our view prove an equally, if not even more, difficult and costly process to implement for many assets and liabilities. Jurisdictions with an endorsement process could well have difficulty in accepting such appreciable extra costs as being in the public interest, especially as the primary parties involved are unlikely to widely support it and it is not at all clear who would actually want such a theoretical approach to financial reporting. Even many bankers are expressing considerable doubts on the usefulness of fair value information already received. Given the level of transparency already achieved in financial reporting, one could even imagine that the oft cited reduction in costs of capital from applying IFRS might turn into an increase though the reduced understandability and reliability of the information reported more extensively on a fair-value basis.

Finally, we would like to devote a few words to considering the "post-Enron" financial markets. All parties involved express the need to improve the credibility of financial statements damaged by the various "accounting scandals". We believe that applying more extensively a fair value measurement basis in financial reporting would in fact have the opposite effect as it would move us away from showing real transaction amounts to hypothetical, in many cases scarcely verifiable amounts, which could undergo dramatic and rapid changes during periods of high market volatility. Such amounts would not necessarily be more objective than currently accepted measurements, because some degree of management judgement will be required to estimate fair value in all cases where no observable market price exists for an asset or liability. Even the discussion in the DP on faithful representation

F. Hoffmann-La Roche Ltd Corporate Finance CH-4070 Basel Accounting and Controlling Bldg 52/804 Tel. +41-61-688 42 34 Fax +41-61-688 42 82

strikes us in this sense as somewhat off-track: we would argue that showing a chemical production plant which has just been completed after a 3-year construction period in the balance sheet at an amount which a hypothetical buyer and seller – if they could be found and if all of the entity-specific factors could have been eliminated – would have been willing to exchange if a transaction had theoretically taken place, would represent less faithfully the reality of the asset than the accumulated costs incurred in the construction.

In short, it is our opinion that, from the point of view of an industrial group, the DP:

- starts too late in the conceptual process (without having considered what we want financial reporting to show and thus what performance measurement and capital maintenance bases to adopt) and finishes too early (without considering the inseparable question of subsequent measurement);

- does not demonstrate convincingly that there is any need for a fundamental change in the current accounting model;

- does not provide convincing arguments why a market value measurement objective would be preferable to an entity-specific measurement objective, nor does it faithfully present the advantages and arguments for the use of a historical-cost basis;

- does not adequately consider stewardship aspects;

- fails to show that there would be significant economic advantages from the adoption of fair values as the central measurement basis sufficient to outweigh the consequent substantial economic costs to the economy.

We provide replies to your specific questions in the appendix.

Yours sincerely

F. Hoffmann-La Roche Ltd

Erwin Schneider Head of Corporate Finance Accounting & Controlling	Alan Dangerfield Corporate Finance Accounting & Controlling External Relations

F. Hoffmann-La Roche Ltd Corporate Finance CH-4070 Basel Accounting and Controlling Bldg 52/804 Tel. +41-61-688 42 34 Fax +41-61-688 42 82

Appendix – Replies to specific questions in the DP on “Measurement on Initial Recognition”

1	*List of measurement bases sets out those that should be considered* Agree
2	*Working terms and definitions* Agree
3	*Fundamental sources of differences between measurement bases on initial recognition* Disagree. This is because the DP is looking at too narrow an area, considering a valuation issue at one moment. One needs to go back further in the discussion, to reflect on what preparers and users need to see in the financial statements for their practical use, also within the context of performance and capital maintenance. This would of course also encompass the present approach of historical cost, showing how the capital obtained was invested: the standpoint is different, it is not globally accepted that the balance sheet should be an attempt to “value” the entity or its parts. See also the main body of our letter.
4a)	*Definition of market value measurement objective* Agree
4b)	*Definition of “market”* From a theoretical viewpoint we have some doubts about the adequate reflection of economic rent. More importantly, however, we wish to point out that situations in line with this definition are something of a rarity. Furthermore, we would like to stress the wide gap between “real” markets and “virtual” markets of the kind which the DP recommends “inventing” where a “real” market does not exist, in preference to using historical prices of real transactions.
4c)	*Market value measurement objective* Agree with the definition, but not at all with the conclusion that it is preferable to the entity-specific measurement objective.
5	*Definition and discussion of entity-specific measurement objective* Agree
6	*Comparison of market value and entity-specific measurement objectives and conclusion that the former is more relevant* Completely disagree – It is precisely because users are trying to understand the entity itself that entity-specific information is more relevant to them. The imposition of a market value approach would effectively mean making data less relevant for their purposes because they would have to adjust these for their perceptions of the cash flows which the entity can actually be expected to generate from them. Differences of value between entities represent real economic differences and real transactions.
7a)	*Only one market (fair) value possible on a measurement date* While this may be true in theory, it is wide of the mark in practice. Even with homogeneous products which are widely traded, there are within-day fluctuations, differences which permit arbitrage, spreads and other factors. But far more difficult to “wish away” are the conditions in other less than perfect markets (information asymmetry etc.)
7b)	*Differences between apparent market values* Disagree – although the DP would like it to be true that there is only one fair value, it has been unable to reconcile this with observable evidence.
8	*Promise to pay has same fair value whether asset or liability* Agree in principle
9	*Proposed unit of account approach* Agree as a general principle, but this needs to be finessed in respect of tangible assets where components may be replaced.
10	*Reference to market in which asset/liability was acquired/issued* Agree – and wonder why, if this is the case, the DP so obdurately rejects making it a rebuttable presumption that fair value on initial recognition is the actual value of the transaction value. On

	liabilities, we have considerable concerns in respect of those which are not normally incurred in an exchange transaction (e.g. taxes, environmental liabilities, legal claims): here we believe that fair value is not meaningful for measurement.
11	*Definition of transaction costs, exclusion from fair value* We have doubts about the practicability of the definition as it may often not be possible to differentiate the parts of a price at which an asset could be sold on, especially in respect of non-financial assets which represent one of our main concerns with the DP. Also, if we understand correctly, while customs duty on an imported machine would be included in the fair value and treated as an asset, its installation cost would not, as it would not be recoverable from a buyer.
12	*Selection of most relevant reliable basis* Agree – but we disagree with the DP on what is most relevant.
13	*Limitations on measurement reliability* Agree in principle, but “sufficiently reliable” needs fleshing out.
14	*Fair value as the most relevant measure on initial recognition* For an industrial business, only under certain extremely limited circumstances if at all – we refer to the DP’s discussion of relevance and to our general comments in the main body of our letter. On predictive value, it is unclear to us that users would be better served by financial statements reflecting fair values rather than historical costs in their forecasting of future cash flows, except where the assets and liabilities involved are to be turned into cash shortly after balance sheet date. What a theoretical buyer might theoretically be willing to pay to acquire our (real) 12-year old chemical production plant is just not going to figure in any sensible analyst’s calculations of the enterprise value of Roche. Far more important are the cash flows which Roche has managed to generate in the past on capital invested. The same applies to liabilities which have not arisen out of exchange transactions (see Q.10 above) where “fair value” is just not meaningful. It is accepted, however, that there may be certain balance sheet items – e.g. held-for-trading securities – where fair values may be more helpful than historical costs so long as their realisation is not subject to any significant uncertainties. Even here, however, we would like to see concrete evidence that analysts generally build up their valuations by type of asset. At most we could foresee a mixed-attribute approach to measurement under these circumstances.
15	*Fair value not capable of reliable estimation in some common situations* Agree completely. And in many other situations not capable of reliable estimation without substantial cost, time and effort.
16	*Analysis and conclusions of comparative relevance and reliability* Strongly disagree – this whole section of the DP is far from neutral. Once the market value measurement objective is preferred to the entity-specific, with little supporting argument, fair value is a foregone conclusion. This leads to overstatement of the strengths of fair value and of the weaknesses of other bases, especially of historical cost. See the main body of our letter.
17	*Application of substitutes for fair value consistent with fair value* While this may seem reasonable, we suspect that, in such circumstances, it is quite likely that, because of the inefficiency or non-existence of markets in these cases, the relevance of fair value is probably rather limited.
18	*Proposed hierarchy* Since we do not accept that the DP has demonstrated conclusively that a market value measurement objective and fair value measurement basis are to be preferred, we are not in a position to agree with the proposed hierarchy.
19	*Other comments* See the main body of our letter.

F. Hoffmann-La Roche Ltd Corporate Finance CH-4070 Basel Accounting and Controlling Bldg 52/804 Tel. +41-61-688 42 34 Fax +41-61-688 42 82