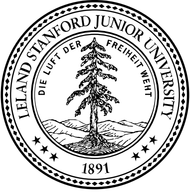

CASE: A-200
DATE: 12/18/2008

DISCLOSURE DILEMMA: FINANCIAL REPORTING OF CONTINGENT AND ENVIRONMENTAL LIABILITIES

Key stakeholders disagree on how well the SEC has defined the requirements for environmental disclosure, with some saying that certain aspects of the requirements provide too much flexibility and are too narrowly scoped, while others maintain that the flexibility is warranted and the scope adequate.

—U.S. Government Accountability Office (GAO)[1]

We agree that existing guidance does not provide sufficient information in a timely manner to assist users in assessing the likelihood, timing and amounts of cash flows associated with loss contingencies.

—Anne Stausboll, Interim Chief Investment Officer of CalPERS[2]

Instead of benefiting users, adopting these proposed changes would add uncertainty, complexity, new liability, and a great deal of cost while compelling companies to provide potentially unreliable, and often immaterial, information about pending litigation.

—U.S. Chamber of Commerce[3]

INTRODUCTION

The Financial Accounting Standards Board (the Board or FASB) was between a rock and a hard place. In 2008, it was revisiting guidance for the accounting of contingent liabilities and the Board faced very different views from two of its biggest constituencies—the consumers of financial statements (investors) and the preparers of financial statements (companies and their auditors). The guidance governing contingencies had been in place since 1975, but had increasingly come under criticism as being inadequate. Among the voices calling for change

[1] United States Government Accountability Office, "Environmental Disclosure – SEC Should Explore Way to Improve Tracking and Transparency of Information," July 2004, p.1.

[2] Anne Stausboll, Interim CIO, CalPERS, Comment Letter to FASB re FAS 5, August 8, 2008.

[3] David Hirschmann and Lisa Richard, U.S. Chamber of Commerce, Comment Letter to FASB re FAS 5, August 8, 2008.

This case was prepared by Nathan T. Blair and Professor Alan D. Jagolinzer of the Stanford Graduate School of Business and C. Gregory Rogers of Advanced Environmental Dimensions, LLC as the basis for class discussion. It is not intended to present an opinion regarding the appropriateness of current or proposed financial reporting guidance for environmental liabilities.

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were a growing group of Socially Responsible Investors (SRIs). SRIs focused not only on financial performance of companies, but also their impact on society and the environment.

In addition to screening companies based on social or environmental criteria, many SRIs also engaged in advocacy for better corporate practices regarding societal, environmental or governance concerns. One of those issues was the manner in which companies disclosed or recognized environmental liabilities. Groups like the Rose Foundation argued that, for many firms, disclosure and recognition of environmental liabilities were understated or misstated in public filings and, as such, investors were unable to make sound investment decisions with the information provided to them.[4] They recommended comprehensive changes to financial statements in order to better assess potential under-disclosed claims to current and future cash flows.

On the other side of the issue were the companies responsible for reporting about their contingencies and the auditors and attorneys who advised them. This group generally believed that the existing guidance from the FASB and the Securities and Exchange Commission (SEC) was adequate. They feared that additional disclosure requirements would take undue cost and effort to prepare and would require making quantitative estimates about future events that could be misleading. They also worried that expanded disclosure or recognition requirements could enhance plaintiffs' cases regarding current or potential litigation, claims and assessments, including environmental liabilities.

FASB chose to revisit its prior guidance for the disclosure and recognition of contingent liabilities for two reasons. The first was an overall effort to improve financial reporting and regain investor confidence following several high profile corporate failures such as Enron and WorldCom. These failures led to the passage of the Sarbanes-Oxley Act of 2002 and to a review of environmental disclosure commissioned by members of the U.S. Senate and completed by the U.S. Government Accountability Office.[5] The second was to move towards convergence of U.S. GAAP and International Financial Reporting Standards (IFRS) as set forth in the Norwalk Agreement in 2002.[6] The effort to make the two standards compatible opened the door for many U.S. accounting standards to be revisited by the FASB.

Background of Existing Guidance

When a contingency arises, financial reporting guidance generally prescribes one of three reporting outcomes: no disclosure, disclosure, or disclosure with associated recognition of a liability and a charge to income. The implications of these three outcomes are very different and there is considerable variation across current and proposed guidance regarding when each of

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[4] The Rose Foundation is a California-based organization whose stated purpose is to promote "community-based advocacy to protect the environment, public health, and consumers". http://www.rosefdn.org/, cited December 14, 2008.

[5] United States Government Accountability Office, "Environmental Disclosure – SEC Should Explore Way to Improve Tracking and Transparency of Information," July 2004.

[6] The FASB and IASB met in Norwalk, CT on September 18, 2002 where they pledged to "make their existing financial reporting standards fully compatible as soon as is practicable and … to coordinate their future work programs to ensure that … compatibility is maintained". This pledge is known as "The Norwalk Agreement". See www.fasb.org/news/memorandum.pdf (cited December 17, 2008).

these three outcomes is considered appropriate, and the nature and scope of the information provided.

FAS 5 – Accounting for Contingent Future Outcomes

Financial Accounting Standard (FAS) 5, issued in March 1975, was the foundation for existing guidance for the accounting of contingent assets and liabilities, including environmental liabilities. The statement defined "contingency" as follows: "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss that will ultimately be resolved when one or more ***future events*** occur or fail to occur."[7] In addition to environmental liabilities, other common types of contingencies governed by FAS 5 included pending or threatened litigation, collectability of receivables and product warranty obligations.

FAS 5 provided guidance for when an enterprise should recognize or disclose a gain or loss that is contingent on future events occurring or not occurring. For this purpose, the statement relied on the terms "Probable," "Reasonably Possible," and "Remote," defined as follows, to determine the proper accounting for a contingency.

> **Probable** – The future event or events are likely to occur.
> **Reasonably Possible** – The chance of the future event or events occurring is more than remote but less than likely
> **Remote** – The chance of the future event or events occurring is slight.

FAS 5 stipulated that a loss from a loss contingency was to be accrued by a charge to income along with recognition of an associated liability if: 1) it was *probable* that a liability had been incurred, and 2) the amount of loss could be *reasonably estimated*. If only the first condition was met, or if the possibility of a loss was only *reasonably possible*, then FAS 5 required disclosure, but not accrual of a charge.

Additional Guidance – Expanding and Clarifying FAS 5

FIN 14

FASB Interpretation No. 14 (FIN 14), issued in September 1976, interpreted the reasonable estimation criterion in FAS 5 and set forth the measurement technique to be used for recognized liabilities. It stated that a loss was reasonably estimable when a range of loss could be determined. It further stated that the loss that is accrued should be the amount that is a better estimate than any other amount within the range. If all losses within the range were equally likely and there was no single best estimate, FIN 14 stated that the minimum amount in the range was to be accrued. For example, assume an enterprise has a pending lawsuit where the range of potential outcomes is between a loss of $1 million and $3 million. If the enterprise believes that the most likely outcome is a $2 million loss, then FIN 14 states that $2 million should be accrued. However, if the enterprise has no basis for believing that one of these dollar amounts is most likely, then $1 million should be accrued.

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[7] Financial Accounting Standards Board, "Statement of Financial Accounting Standard No. 5 – Accounting for Contingencies," March 1975, paragraph 1. Emphasis added.

FAS 141R

FAS 141R, revised in 2007, dealt with accounting for business combinations. FAS 141R provided specific guidance for when and how acquiring firms must recognize the acquisition of their target firms' liabilities at the point of combining the entities. If there was uncertainty about whether the target firm had an existing liability, FAS 141R provided the following guidance:

> Acquiring firms must recognize a liability for all loss contingencies arising from contractual arrangements (e.g., warranties, insurance contracts, rebates, environmental indemnities). Acquiring firms must also recognize a liability for all loss contingencies arising from noncontractual conditions (e.g., lawsuits, environmental cleanup responsibilities), when it is *more likely than not* that a present obligation currently exists.[8]

Although subtle, one key difference between FAS 5 guidance and FAS 141R guidance was that FAS 5 focused on the probability that *future loss would occur*, while FAS 141R focused on the likelihood that a *present obligation already exists based on prior events*.

FAS 141R further required that recognized liabilities be recorded by the acquirer at the acquisition date at fair value determined in accordance with FAS 157 guidance (see **Exhibit 1**). This was a particular concern for firms acquiring target companies that had existing environmental liabilities, since the settlement amount and the timing of payment for these liabilities were often both uncertain. FAS 141R (through FAS 157 fair value guidance) required firms to make probabilistic assumptions of timing and loss amounts to arrive at estimates for the fair value of these types of liabilities.

Other U.S. Guidance

Other FASB pronouncements and SEC regulations that provided further guidance for contingency recognition and disclosure are summarized in **Exhibit 1**.

EXISTING INTERNATIONAL GUIDANCE

IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

International Accounting Standard (IAS) 37 was the guidance that pertained to contingencies with respect to IFRS. IAS 37 used different terms for liabilities that are accrued on the balance sheet and those that are only disclosure items. A *provision*, as defined in the statement, was a liability of uncertain timing or amount that meets the following criteria:

1) An entity has a present obligation (legal or constructive) as a result of a past event;
2) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
3) A reliable estimate can be made of the amount of the obligation.[9]

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[8] Financial Accounting Standards Board, "Statement of Financial Accounting Standard No. 141 – Business Combinations," Revised 2007, paragraph B24 (emphasis added).

[9] IASB Standards, "International Accounting Standard 37 – Provisions, Contingent Liabilities and Contingent Assets," p. 4.

If a liability did not meet these three criteria, or if an obligation was only possible, then IAS 37 defined that liability as a *contingent liability*. Contingent liabilities were to be disclosed unless the possibility of an outflow of resources embodying economic benefits was remote.

Though the International Accounting Standards Board (IASB) and FASB guidance used different terminology, the effect of the two statements up to that point was similar. There were, however, critical differences between the two. The first was how the two statements defined the term "probable." In FAS 5, an event was "probable" if it was "likely to occur" and more likely than "reasonably possible." In practice, the term was interpreted to mean a "high likelihood of a future outflow of resources."[10] Alternatively, IAS 37 stated, "For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e. the probability that the event will occur is greater than the probability that it will not."[11] A 2002 report described how these definitions can impact the likelihood of reporting contingencies, as "[s]everal studies in private enterprise settings in the U.S. and abroad have determined that the mean numerical equivalent of the term Probable can range from about 65% to 79%," and, in two other studies, "Probable was perceived to indicate a higher numerical probability than [more likely than not]."[12]

The other area where there were significant differences between U.S. and international guidance was with respect to measurement. First and foremost, IAS 37 set forth an expectation that only in "extremely rare" cases could an entity not estimate an obligation that is sufficiently reliable for disclosure. FASB guidance provided no such expectation. Except in those extremely rare cases, IAS 37 stated that entities will recognize the "best estimate of expenditure required to settle the present obligation at the end of the reporting period,"[13] thereby establishing a present value measurement methodology.

In the case of measuring a single obligation, IAS 37 envisioned that an entity would develop a range of possible values similar to FIN 14. However, the two statements differed on which number within that range to record. IAS 37 stated that if there were a range of equally likely outcomes, then the mid-point of that range would be considered as the estimate. If outcomes within the range differed in likelihood, IAS 37 stated that a probability-weighted expected value would be used as the estimate. IAS 37 also stipulated that obligations that are similar should be considered as a whole when assessing the probability of an outflow and materiality, a principle referred to as aggregation.

A Call for Change

In their decision to examine potential changes to FAS 5, FASB stated that, "[i]nvestors and other users of financial information have expressed concerns that disclosures about loss contingencies under the existing guidance … do not provide adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with

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[10] FAS 141R, op. cit., paragraph B226.

[11] IASB, op. cit, p. 6.

[12] Vicky B. Hoffman and James M. Patton, "How Are Loss Contingency Accruals Affected by Alternative Reporting Criteria and Incentives?", *Journal of Accounting and Public Policy*, Summer 2002.

[13] IASB, op. cit., p. 7.

loss contingencies."[14] FASB further cited the key issues that some constituents had with existing guidance:

a. The initial disclosure of specific information about a loss contingency often does not occur until a material accrual is recognized for that loss contingency.
b. The *at least reasonably possible* threshold for disclosing loss contingencies has not resulted in the disclosure of the full population of an entity's existing loss contingencies that would be of interest to financial statement users.
c. The option to state that "an estimate of the possible loss or range of loss cannot be made" is exercised with such frequency by financial statement preparers that users often have no basis for assessing an entity's possible future cash flows associated with loss contingencies.
d. The amounts recognized in the financial statements related to loss contingencies are not transparent to users.[15]

While many investors shared these views, one of the more vocal groups on the matter were socially responsible investors.

SRIs Weigh In

According to the Social Investment Forum *2007 Report on Socially Responsible Investing Trends in the United States*, there were $639 billion in assets invested in socially responsible funds in 1995. By 2007, that number had grown to $2.71 trillion, a 324 percent increase. During the same period, other assets under professional management increased by only 260 percent, to $25.1 trillion. The trend appeared to be gaining steam, as growth in social investing between 2005 and 2007 was 18 percent compared to 3 percent for other assets.[16] This increase in assets gave SRIs and their advocates a larger stake on corporate governance issues and increased resources to make their voices heard.

Tim Little of the Rose Foundation was a prominent voice on issues of governance and fiduciary duty with respect to environmental obligations. Through publications, petitions to the SEC and shareholder resolutions, Little communicated the issues that many SRIs had with existing disclosure requirements and suggested changes. In a 2003 report published by the Rose Foundation titled, *The Gap in GAAP – An Examination of Environmental Accounting Loopholes*, the authors cited multiple studies that found widespread underreporting of environmental liabilities, contributing factors to underreporting and recommendations for improvement.[17] In addition to increased enforcement by the SEC for reporting violations, the report recommended the amendment of accounting standards to:

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[14] FASB Exposure Draft No. 1600-100, "Proposed Statement of Financial Accounting Standards – Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)," June 2008, p. v.
[15] Ibid. paragraph A3.
[16] Social Investment Forum, "2007 Report on Socially Responsible Investing Trends in the United States – Executive Summary," p. ii.
[17] Susannah Blake Goodman and Tim Little, "The GAP in GAAP – An Examination of Environmental Accounting Loopholes," December 2003.

1) Require aggregation of environmental liabilities before determining materiality;
2) Require companies to accrue and report liabilities at their expected value, not the minimum of a range.

A Different Approach – The Global Reporting Initiative

A few years earlier in 1997, another group called the Global Reporting Initiative (GRI) was formed to develop a standard disclosure framework for sustainability reporting. Unlike the Rose Foundation, GRI developed recommendations and a framework for reporting on economic, environmental and social performance outside of a company's financial statements. In 1999, GRI became a collaborating center of the United Nations Environment Programme, and 20 organizations released sustainability reports based on GRI guidelines. The third iteration of its framework was published in 2006. In 2008, more than 1,500 organizations used the GRI framework for their sustainability reporting, including Dow Chemical, Starbucks, and Intel.[18]

THE FASB PROPOSES NEW GUIDANCE

In June 2008, the FASB published an exposure draft of a proposed revision to the disclosure provisions for loss contingencies contained in FAS 5 and FAS 141R.[19] The guidance proposed under the draft differed significantly from existing guidance and increased disclosure requirements while reducing the threshold for disclosure. It did not, however, change guidance with respect to the recognition or measurement of loss contingencies. Rather, FASB indicated that its revision of existing standards for contingencies would be approached in two phases. The first phase would deal only with disclosures. The second phase would address recognition and measurement principles.

In setting a new threshold for disclosure, the draft required <u>all</u> loss contingencies to be disclosed except when:

1) The likelihood of a loss is remote; or
2) A claim is unasserted, unless the likelihood of assertion is probable and the likelihood of a loss, if the claim or assessment were to be asserted, is more than remote.

The exposure draft also stated that all loss contingencies expected to be resolved within a year, regardless of the likelihood of a loss, should be disclosed if the loss contingency could have a severe impact (greater than material) on the entity's results or financial position.

The exposure draft also required more information to be disclosed about loss contingencies, including:

- The amount of the claim, or absent that, the entity's best estimate of the maximum exposure to loss;
- A description of the contingency, including background information, its legal or contractual basis, current status and anticipated timing of resolution;

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[18] 2008 GRI Reports List, http://www.globalreporting.org/GRIReports/2008ReportsList/

[19] FASB Exposure Draft No. 1600-100, op. cit.

- A description of factors likely to affect the outcome along with their potential effect;
- The entity's qualitative assessment of the most likely outcome and underlying assumptions;
- Description of insurance or indemnification that could lead to recovery of all or a portion of the loss;
- A tabular reconciliation for loss contingencies recognized in the entity's financial statements.

The exposure draft stated that loss contingencies of a similar nature may be aggregated for disclosure purposes. It also allowed for information that would be prejudicial to the outcome of the liability to be aggregated at a higher level such that it would not be prejudicial, or in *rare* circumstances, allowed an entity to not disclose prejudicial information. However, it went on to state that, "[i]n no circumstance may an entity forgo disclosing the amount of the claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to a loss)."[20]

CONTROVERSY ERUPTS

The June 2008 exposure draft comment deadline was August 8, 2008. The controversial nature of the issue was evidenced by the volume of comment letters the FASB received—240—compared to an average of 98 for the other exposure drafts issued between January 2006 and June 2008.[21]

Comment letters came from a variety of constituents, including investors, corporate managers, auditors, attorneys, and even a business school accounting professor. Excerpts from some of those letters are included below.

Financial Statement Users

Financial statement users were generally in favor of the new guidance and viewed it as an improvement over existing guidance.

For example, Standard and Poor's wrote:

> [U]nder the current accounting framework around contingencies, the potential financial effects of a loss contingency are difficult to discern and quantify by leveraging information available in public disclosures. Therefore, we believe that relevant, meaningful, and reliable qualitative and quantitative disclosures of litigation matters and other loss contingencies, as set forth in paragraph 7 of the Proposed Statement, would be very beneficial to our analysts.[22]

Similarly, the Teamsters Union wrote:

> In light of recent economic upheaval and corporate scandals, we do not have confidence in the ability of companies to accurately estimate or report the

[20] FASB Exposure Draft No. 1600-100, op. cit., paragraph 11.

[21] Data compiled from Comment Letters section of FASB website http://www.fasb.org/ocl/fasb-selectproject.php

[22] Standard and Poors' Ratings Services, Comment Letter to FASB re FAS 5, August 8, 2008.

> likelihood of severe financial threats. Thus, we applaud the Board for proposing the disclosure of "remote" loss contingencies that could have a significantly financially disruptive effect on the company.[23]

Not all investor representatives, however, embraced the proposal as written. Some cited concerns with how firms might implement the new standard. For example, Ameriprise Financial wrote:

> We believe that the concerns of financial statement users regarding disclosures about loss contingencies are best addressed by a Statement that would provide guidance on how those contingencies should be measured. We believe that the expanded disclosures required under this Proposed Statement would not address the concerns of financial statement users but would in fact raise new concerns by providing information that is unreliable and misleading to financial statement users and that is prejudicial to the entities (and their shareholders) that are providing these additional disclosures.[24]

Others thought the proposal still did not go far enough in pursuing disclosure. For example, the Social Investment Forum wrote:

> While we are pleased with this important step and supportive of the progress it represents, there are a few points of concern that we would like to take this opportunity to raise briefly. In particular, SIF is concerned with how the draft treats severe long-term risks. At FAS 5 Exposure Draft paragraph 6, the draft only requires disclosure of severe financial threats that a company deems remotely probable if the issue is expected to be resolved within a year. Many of SIF's members are long-term investors and are acutely aware that there is a long and troubled history of companies underestimating the likelihood of severe financial threats—Enron, the subprime lending crisis, and asbestos liabilities are three recent examples. All too often we have seen that these momentous issues were looming for many years and eventually resulted in catastrophic consequences for investors. For these reasons, we believe FAS 5 should require companies to disclose all known severe threats whether or not they are expected to be resolved within a year. Recognizing the need to ensure that disclosures are made in a cost effective manner, SIF would like to suggest that "remotely probable" risks that are not expected to be resolved within one year be described in a narrative form, but would not need to be quantified other than to specify that they may be severe.[25]

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[23] James P. Hoffa, General President, International Brotherhood of Teamsters, Comment Letter to FASB re FAS 5, August 8, 2008.

[24] David K. Stewart, SVP and Controller, Ameriprise Financial, Comment Letter to FASB re FAS 5, August 8, 2008.

[25] Lisa Woll, CEO, Social Investment Forum, Comment Letter to FASB re FAS 5, July 23, 2008.

Financial Statement Preparers

Financial statement preparers were generally opposed to the new guidance. Some acknowledged that existing guidance needed to be changed, but argued for a different approach, while others believed that FAS 5 in its current form was fine and the issues were more in application than the guidance itself. Concerns from this group touched on nearly every aspect of the new guidance, but particularly focused on firms' inability to speak with certainty about inherently uncertain situations. Concerns also centered on the time and cost of developing the required disclosures, preparers' inability to implement the new guidance in the proposed time frame, and how the new disclosures would be used by current and potential litigants and the media. Not one comment letter from this group was supportive of the new guidance.

For example, Dove Saddlery wrote:

> FASB's proposal … assumes that senior management has some magical crystal ball that can see into the future and encourages litigation for blackmail and profit. The proposal goes way beyond accurately reporting [of] the present financial condition of a company into the murky and often misleading waters of creating pro formas. No good will come of this proposal.[26]

Stanford University wrote:

> Consider the following … a student expelled from the University brings a claim alleging wrongful expulsion and seeking an unstated amount of damages to compensate them for the loss of higher lifetime income had they graduated from an Ivy League University. What number, or range of numbers, would the University disclose as potential damages? Would it depend if the student were a business major or a music major? An 'A' student or a 'C' student?[27]

Pfizer wrote:

> We posit that "uncertainty" is often a basic fact associated with contingencies and that the disclosure of that uncertainty *as* uncertain may be the most relevant and reliable disclosure. The current standard of disclosure requires meaningful information. Presenting amounts that are probable and estimable is meaningful; presenting the range of reasonably possible loss in excess of amounts recorded is meaningful; and asserting that such estimates cannot be made is extraordinarily meaningful. We do not believe that some of the proposed disclosures, such as maximum exposures even if remote or amounts claimed, will prove meaningful; in fact, it is likely that they will be misleading and/or confusing.[28]

Similarly, Dell wrote:

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[26] Stephen L. Day, President, Dover Saddlery, Comment Letter to FASB re FAS 5, September 18, 2008.

[27] Debra Zumwalt, VP and General Counsel, Stanford University on behalf of it and ten other universities, Comment Letter to FASB re FAS 5, August 18, 2008.

[28] Loretta V. Cangialosi, SVP and Controller, Pfizer Inc., Comment Letter to FASB re FAS 5, August 7, 2008.

> We are not aware of a significant void in the current disclosure process that this standard would address. We acknowledge that there may be diversity in practice in applying FASB Statement No. 5 – Accounting for Contingencies ("SFAS 5"); however, it is our opinion that SFAS 5 represents a principle-based standard. The current direction of the Board is to converge with IFRS and focus on principle-based standards. We do not believe this proposal is within the spirit of that goal.[29]

Advisors

Auditors, attorneys, and environmental consultants were also generally opposed to the new guidance. Just as preparers expressed concerns about their inability to quantify certain loss contingencies, advisors were concerned with their ability to support or verify those assessments. There was also a concern among auditors and attorneys that attorney-client and attorney-work product privileges would make the necessary communications in the audit process impossible to conduct.

For example, Deloitte and Touche wrote:

> We are concerned about an auditor's ability to obtain a reasonable level of assurance in auditing some of the proposed disclosures, such as (1) estimates of the entity's maximum exposure to loss, (2) underlying assumptions used in arriving at that estimate, (3) the most likely outcome, and (4) whether a disclosure meets the prejudicial exemption. The information that management might use to develop estimates and support amounts included in the related disclosures could come from sources to which the auditor does not have access. For example, management may have conversations with attorneys that are covered by attorney-client privilege and in which auditors would not be able to participate.[30]

And the American College of Trial Lawyers wrote:

> Although the proposed amendments speak in terms of disclosures by an entity, disclosures regarding litigation-related loss contingencies normally emanate from or consist of information and advice provided by the trial lawyer who represents the entity (the "client"). In most instances, the nature, extent and presentation of that information and its potential disclosure to others than the client will have a profound effect upon the trial lawyer's performance of his or her obligations to the client, to the justice system, and to the legal profession. Therefore, the proposed amendments would have a direct impact on the trial lawyer as well as on the client.[31]

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[29] Thomas W. Sweet et al., Dell Inc., Comment Letter to FASB re FAS 5, August 1, 2008.

[30] Deloitte and Touche LLP, Comment Letter to FASB re FAS 5, August 7, 2008.

[31] James P. Garland, American College of Trial Lawyers, Comment Letter to FASB re FAS 5, August 4, 2008.

ASSESSING CURRENT GUIDANCE IN PRACTICE – NOVARTIS

To gain better insight regarding whether disclosure and recognition standards for contingencies should be modified or expanded, some recent actual disclosures from Novartis are presented below.

Overview

Novartis AG (Novartis) was a manufacturer of branded and generic prescription pharmaceuticals, vaccines and over-the-counter medications, based in Basel, Switzerland. In 2006, Novartis' sales and net income from continuing operations were $36 billion and $7 billion, respectively. Formed in 1996 through the merger of Ciba-Geigy and Sandoz, Novartis traced its history as far back as 1758, with the founding of Geigy. Though focused exclusively on health care, over the years Novartis' predecessor businesses manufactured products including dyes, sweeteners, adhesives and insecticides.[32] Novartis stated the following in its 2006 annual report:

> Novartis strives to minimize all environmental impacts and some of the biggest challenges are inherited as a result of operations and practices in past years. Responsibility for historical landfills and brownfields inherited by Novartis from predecessor companies remains a relevant environmental issue today.
>
> Novartis shares a number of confirmed or potential liabilities on the surveillance and remediation of old industrial premises and historical landfills with other companies.
>
> In order to responsibly manage these cases and related environmental risks, Novartis, as a principle, takes a cautious science-based approach, in full cooperation with the respective local authorities and governmental agencies. Where and whenever potential risks are identified, investigations and assessments are carried out in a systematic manner and remediation actions taken when necessary. Novartis has set aside the financial reserves to manage these liabilities worldwide.[33]

Novartis reported on environmental matters in its financial disclosures per IFRS, in its MD&A per SEC regulations and as a supplement in its annual reports per GRI guidelines, which it adopted in 2004. (**Exhibit 3** provides excerpts of these various disclosures by Novartis for their 2006 fiscal year.)

The Bonfol Dumpsite

One of the dumpsites that had received particular attention was in the city of Bonfol, Switzerland, located 43km west of Basel. The site, which was in operation for 15 years, stopped receiving waste in 1976 and contained 114,000 tons of waste, making it the largest toxic waste

[32] Novartis corporate website, Novartis History, www.novartis.com/about-novartis/company-history/index.shtml
[33] Novartis 2006 Annual Report, p. 80.

dump in Europe.[34] In early 2000, The Swiss office of Greenpeace highlighted the issue with an eight-week protest at the site, and pressed governmental authorities and the companies who dumped the waste to clean it up. In October 2000, Basel Chemical Industries (BCI), an interest group formed by Basel's chemical companies in 1962, including Novartis, signed an agreement with the cantonal authorities accepting responsibility for cleaning up the site. At that time, BCI estimated the cost of cleanup at $200 million Swiss Francs, which equated to approximately $112 million US Dollars.[35]

However, it was not until December 2005 that BCI and Swiss authorities reached an agreement about who would pay to clean up the Bonfol site. That agreement called for the cantonal government to determine each individual company's share of the cleanup costs, which at that time were estimated to cost $280 million Swiss Francs, or $215 million US Dollars.[36]

Novartis disclosed the following regarding that agreement in its 2005 Annual Report: "Novartis jointly with other Swiss companies reached an agreement with local authorities in November 2005 regarding the Bonfol hazardous-waste landfill in Switzerland, which operated from 1961 through 1976. Under the agreement, the landfill will be excavated and the contents incinerated."[37] There was no disclosure of the associated cost.

Finally, in September 2007, Novartis entered into an agreement with Swiss authorities whereby it would establish a foundation in the amount of $200 million Swiss Francs, approximately $170 million US Dollars, to fund its share of the cleanup costs of Bonfol and remove Novartis from any future obligations stemming from the site.[38]

CONCLUSION

It seems clear that the FASB was in a very difficult position regarding whether and how to implement change to its guidance for disclosure and recognition of contingencies. In light of the strong opinions from financial statement preparers and users, both for and against change, and in light of the desire for timely convergence of standards, the question was—what should the FASB do?

[34] Michael Hollingdale, "Chemical Industry Assumes Responsibility for Bonfol Clearance" October 17, 2000. http://www.swissinfo.ch/eng/swissinfo.html?siteSect=43&sid=508595&ty=

[35] Ibid.

[36] Swissinfo news service, "Chemical Firms Will Pay to Clean Up Waste Site," December 8, 2005. http://www.swissinfo.org/eng/swissinfo.html?siteSect=43&sid=6301178&ty=st

[37] Novartis 2005 form 6-K, p. 64.

[38] Novartis Q3 2007 Conference Call Slide Presentation, slide 23. http://www.novartis.com/downloads/investors/sales-results/2007-Q23-9M-results-conf-call-slides.pdf

QUESTIONS

1. Using historic and publicly available information provided on pp. 12-13 and in **Exhibits 2 and 3**, develop an estimate for what you would expect Novartis to report as its 2007 ending Environmental Provision balance (i.e., the bottom rows in the **Exhibit 2** blacked-out area). What data did you find most useful for developing this estimate? What assumptions did you make in developing this estimate? What is your confidence in your estimate (you can infer this by estimating an upper- and lower-bound range where you feel ninety-nine percent confident that this estimated range will include the real reported provision value)? Assume you are an investor with a substantive "long" equity position in Novartis. How important is the accuracy of this estimate to you for assessing the "health" of this investment? What additional information might you seek to obtain to increase your confidence level in your estimate and what costs might you incur to get it?

2. If the firm were mandated to disclose a FAS 157 fair value estimate of the contingency (e.g., as required by FAS 141R for contingencies acquired in business combinations) or if it were mandated to disclose the additional information proposed in the exposure draft, would it improve your estimate? Why or why not?

3. What is your personal opinion regarding the FAS 141R mandate that firms must recognize the fair value estimate of certain acquired contingencies? What is your personal opinion of the proposed disclosure mandates in the FASB exposure draft? Do your opinions differ if you are a prospective investor versus an existing shareholder? Do your opinions differ if you are a CEO, CFO, or auditor who has to certify financial statements? Do your opinions differ if you provide corporate legal counsel?

4. Can you identify any unique issues that arise with FAS 141R or the exposure draft with respect to environmental liabilities?

5. What recommendations do you have for the FASB to help develop guidance that satisfies both financial statement preparers and users with respect to contingencies?

Exhibit 1
Summary of Additional Guidance and Regulations

Other FASB pronouncements and SEC regulations provided further guidance for contingency recognition and disclosure.

FAS 143 and FIN 47

FAS 143 – Accounting for Asset Retirement Obligations, was issued in 2001. The statement made clear that obligations associated with the retirement of long-lived assets shall be recognized as liabilities when incurred. The measurement standard for the recognition of the liability was fair value. In using a fair value approach, FAS 143 anticipated that uncertainty regarding the existence of an obligation or amount of obligation would be factored into the expected value of the liability. FIN 47 was issued in 2005 to clarify and provide examples for how to estimate an asset retirement obligation.

FAS 157

FAS 157 took effect in November 2007 to provide general guidance for how to measure the fair value of assets and liabilities that must be reported at fair value under other applicable accounting standards.[39, 40]

FAS 157 stated that the fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date (exit price).[41] A quoted price for the identical liability in an active market is the best evidence of fair value.[42] If an active market does not exist, FAS 157 stated that companies must estimate the exit price based on the assumptions that market participants would use in pricing the liability, including expected present value, probabilistic analysis of future uncertainty, risk premium, and profit margin.[43]

Applying these rules to environmental remediation liabilities and asset retirement obligations proved very challenging, particularly since most environmental-related obligations did not have actively traded markets from which one could ascertain value.

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[39] *See* "Fair Value Measurement of Environmental Liabilities," C. Gregory Rogers, ABA Environmental Disclosure Committee Newsletter Vol. 3, No. 1 - October 2005.

[40] FASB Staff Position No. FSP 157-2 (Feb. 12, 2008) provided a one-year extension for application of SFAS 157 to certain non-financial liabilities, including asset retirement obligations (AROs).

[41] Financial Accounting Standards Board, "Statement of Financial Accounting Standard No. 157 – Fair Value Measurements," September 206, paragraph 5.

[42] Ibid., paragraphs 22 and 24.

[43] Ibid., paragraph B2. See also proposed FASB Staff Position (FSP) FAS 157-c, regarding clarification of Statement 157 on the measurement of liabilities. http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-c.pdf.

Exhibit 1
Summary of Additional Guidance and Regulations (continued)

SEC Regulations
The GAO report on environmental disclosure cited three sections of Regulation S-K, the SEC's omnibus disclosure regulation, that are most likely to elicit environmental disclosures:

- S-K Item 101, under the narrative description of the business section, "Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries."[44]
- S-K Item 103 deals with the disclosure of legal proceedings and includes criteria for the disclosure of proceedings "arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment."[45]
- S-K Item 303 deals with management's discussion of financial condition and requires disclosure of issues (including environmental or other contingent liabilities) that could materially impact liquidity or result in a material charge.

[44] SEC Regulation S-K.
[45] Ibid.

Exhibit 2
Novartis Financial Summary

Novartis Group Financial Data[1]
USD Millions

	FYE Ending December 31,				
	2003	**2004**	**2005**	**2006**	**2007**
Income Statement Data - Results from Continuing Operations					
Net Sales	24,864	28,247	32,212	36,031	38,072
Gross Profit	18,970	21,622	23,658	26,450	27,915
Net Income	5,016	5,767	5,141	7,019	11,968
Balance Sheet Data					
Total Assets	49,317	54,469	57,732	68,008	75,452
Property, Plant and Equipment	7,597	8,497	8,679	10,945	12,633
Total Liabilities	18,798	20,548	24,568	26,714	26,056
Provisions and Other Current Liabilities	4,876	4,939	4,979	5,736	6,787
Provisions and Other Non-Current Liabilities	3,149	3,350	4,449	4,534	4,272
Environmental Provision Detail					
Beginning Balance	163	179	218	202	253
Impact of Business Combinations	-	-	-	18	-
Cash Payments	(4)	(9)	(19)	(15)	
Releases	(18)	(4)	(1)	-	
Additions	25	41	26	36	
Translation Effects & Interest	13	11	(22)	12	
Ending Balance	179	218	202	253	
Less Current Liability	(2)	(16)	(13)	(14)	
Ending Non-Current Liability	177	202	189	239	

1 All data from Novartis Annual Reports

Exhibit 3
Novartis 2006 Annual Report Excerpts

Below is the environmental liability footnote from Novartis' annual report.

19. Provisions and other non-current liabilities

	2006 USD millions	2005 USD millions
Accrued liability for employee benefits:		
– defined benefit pension plans	1 343	1 480
– other long-term employee benefits and deferred compensation	343	284
– other post-employment benefits	993	1 033
Liabilities for life insurance subsidiary activities	638	559
Environmental provisions	239	189
Provision for legal matters	634	621
Other non-current liabilities	344	283
Total	**4 534**	4 449

19.1) Environmental matters

Novartis has provisions in respect of environmental remediation costs in accordance with the accounting policy described in Note 1. The provision recorded at December 31, 2006 consists of USD 141 million (2005: USD 105 million) provided for remediation at third party sites and USD 112 million (2005: USD 97 million) for remediation at owned facilities. In the US, Novartis has been named under federal legislation (the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended) as a potentially responsible party (PRP) in respect to certain sites. Novartis actively participates in, or monitors, the clean-up activities at the sites in which it is a PRP. The estimated provision takes into consideration the number of other PRPs at each site and the identity and financial position of such parties in light of the joint and several nature of the liability.

The requirement in the future for Novartis ultimately to take action to correct the effects on the environment of prior disposal or release of chemical substances by Novartis or other parties, and its costs, pursuant to environmental laws and regulations, is inherently difficult to estimate. The material components of the environmental provisions consist of costs to fully clean and refurbish contaminated sites and to treat and contain contamination at sites where the environmental exposure is less severe. The Novartis future remediation expenses are affected by a number of uncertainties which include, but are not limited to, the method and extent of remediation, the percentage of material attributable to Novartis at the remediation sites relative to that attributable to other parties, and the financial capabilities of the other potentially responsible parties.

In connection with the 1997 spin-off of CIBA Specialty Chemicals AG (CSC) from Novartis AG, a Novartis subsidiary has agreed to reimburse CSC 50% of the costs: (i) associated with environmental liabilities arising in the US from the operations of the specialty chemicals business of the US subsidiary of the former Ciba-Geigy AG, and (ii) which exceed provisions agreed between that subsidiary and CSC. The reimbursement obligations are not subject to any time or amount limits but could terminate for certain liabilities in the US upon the occurrence of certain contingencies which include the merger of CSC or the sale of its assets.

In connection with the acquisition of the Hexal group of companies, a subsidiary within the Sandoz Division has entered into a lease agreement for a factory in Radebeul, Germany owned by a Hexal company that was not acquired by Novartis. Because the Radebeul site has supported chemical manufacturing for many years Novartis is continuing, with the support of the local Saxony government, a thorough review of potential environmental contamination. Novartis believes that it has limited liability exposure for pre-existing environmental contamination or health risks associated therewith, if any, and should liability accrue, Novartis has been indemnified by the Sellers under the Hexal acquisition documents and separately by commitments of the local government.

Novartis believes that its total provisions for environmental matters are adequate based upon currently available information, however, given the inherent difficulties in estimating liabilities in this area, it cannot be guaranteed that additional costs will not be incurred beyond the amounts provided. The effect of resolution of environmental matters on results of operations cannot be predicted due to uncertainty concerning both the amount and the timing of future expenditures and the results of future operations. Management believes that such additional amounts, if any, would not be material to the Group's financial condition but could be material to the results of operations or cash flows in a given period.

The following table shows the movements in the environmental liability provisions during 2006 and 2005:

	2006 USD millions	2005 USD millions
January 1	**202**	218
Impact of business combinations	18	
Cash payments	-15	-19
Releases		-1
Additions	36	26
Translation effects	12	-22
December 31	**253**	202
Less current liability	-14	-13
Non-current liability at December 31	**239**	189

Exhibit 3 (continued)
Novartis 2006 Annual Report Excerpts

The table below shows select data reported by Novartis per GRI guidelines.

NOVARTIS HEALTH, SAFETY AND ENVIRONMENT DATA 2006

	Novartis Group*		Pharmaceuticals		Novartis Research		Sandoz*		Consumer Health		Hexal*/Eon Labs		Former Chiron*
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
Associates HSE Personnel [number of associates working at least 50% for HSE]	495	523	210	214	24	23	128	159	132	125	34	29	29
Health/safety Lost time accident rate [accidents per 200 000 hours worked]	0.40	0.44	0.43	0.46	0.18	0.15	0.54	0.64	0.32	0.35	0.93	1.51	0.78
Production Total production [1000 t = metric tons]	608	655	23	24	0	0	86	92	499	505	11	10	0.8
Resources Water use [million m^3]	89.4	91.5	19.6	18.9	1.2	1.1	60.2	64	8.3	7.4	0.7	0.7	0.8
Energy use [million GJ]	17.1	17	5.4	5.2	1.0	1.1	6.7	6.8	4.0	3.8	0.9	0.9	1.2
Emissions into water Effluent discharge [million m^3]	18.6	19.2	3.7	3.8	0.5	0.5	7.9	8.7	6.4	6.1	0.5	0.5	0.3
Chemical oxygen demand COD [1000 t]	3.77	3.73	0.62	0.36	0	0	2.64	2.79	0.50	0.50	0.05	0.05	0
Emissions into air Sulfur dioxide, SO_2 [t]	141	131	9	22	0	0	126	105	6	5	0	2	0
Nitrogen oxide NO_2 [t]	372	343	140	136	8	10	110	93	114	101	24	22	19
Volatile organic compounds (VOC) halogenated [t]	152	289	7	10	0	0	145	280	0	0	27	83	0
Volatile organic compounds (VOC) nonhalogenated [t]	1231	1 117	434	217	0	0	742	837	55	63	359	416	10
Emissions CO_2 / GHG Scope 1, Combustion and process [1000 t]	454	458	144	158	11	17	156	153	144	127	34	32	35
Scope 1, Vehicles [1000 t]	190	192	143	146	0	0	17	14	25	25	10	9	1
Scope 2, From purchased energy [1000 t]	907	858	214	197	66	61	340	334	287	262	47	41	48
Waste Nonhazardous operational waste [1000 t]	179	185	19.8	28.1	2.3	2.7	13.1	14.8	144	134	3.8	2.7	2.5
Hazardous operational waste [1000 t]	115	102	71	75.8	0.8	0.6	40.8	23.7	2.1	2.3	4.8	4.5	0.6
Debris, nonhazardous [1000 t]	121	349	100	347	1.3	0.1	18.7	0.9	0.4	0.8	1.1	0.2	4.5
Debris, hazardous [1000 t]	13.0	113	12.9	113	0	0.08	0.15	0.01	0	0.01	0	0	0.12
Hazardous operational waste landfilled [1000 t]	0.46	1.12	0	0.23	0	0	0.45	0.89	0	0.01	0.01	0	0.07

*HSE figures for Novartis Group exclude Hexal and Eon Labs and the former Chiron sites. Hexal and Eon Labs were consolidated by Novartis for only part of 2005, and are not included in the Sandoz data. The former Chiron sites were consolidated by Novartis for only part of 2006. Full-year data for the former Chiron sites are provided in a separate column in the table; comparable figures for 2005 are not available.

The Reporting Process

The HSE Data Management System and data-collection process are key elements of Corporate Citizenship Management at Novartis. In gathering this data, we take into account impacts originating from our own operations (Scope 1) – as well as major material flows across boundaries and CO_2 emissions from purchased energy (Scope 2). We currently do not monitor impacts for the manufacture and delivery of purchased goods, nor use of energy and related CO_2 emissions for activities outside company boundaries (Scope 3), such as transportation by third parties.

HSE data is collected and reviewed on a quarterly basis. The 2006 environmental and resource data published in the Annual Report and on our website are actual data for the period from January through September and best estimates for the period October through December, which will be updated with actual data in the first quarter of 2007. Significant deviations will be reported on our website and restated in next year's Annual Report. The Employees and Health/Safety data are actual from January through December 2006.

Restatement of 2005 data

The emission and resource data published in the 2005 Annual Report included estimates for the October through December period that in several areas required subsequent adjustments. Inaccuracies identified in data from previous years were also corrected. The Data Table in the 2006 Annual Report includes full-year actual values for 2005.