

Taiwan Semiconductor Manufacturing Company, Ltd.



LETTER OF COMMENT NO.

300-77新竹科學工業園區力行六路8號

8, Li-Hsin Rd. 6, Hsinchu Science Park, Hsinchu, Taiwan 300-77, R. O. C. Fax: 886-3-5637000 Tel: 886-3-03-5636688 Ext.712

Via email

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

8 August 2008

Request for Comments on a Proposed Statement, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141 (R) (File Reference No. 1600-100)

Dear Mr. Golden:

TSMC1 appreciates this opportunity to comment on the Proposed Statement, Disclosure of Certain Loss Contingencies (the "proposed Statement") and welcomes any endeavor to help provide primary consumers of financial reports with accurate and reliable information to help them make better investment decisions. We feel it is very important to help address the concerns of investors, especially individual investors, whose perspectives have been accorded "pre-eminence" by standards-setters. Such alignment of interest with the investor community has enabled us to win over the years numerous international awards and recognition in corporate governance and investor relations. Therefore in reviewing any newly proposed accounting standards, care must be had to ensuring that such standards actually help provide reliable information to our investors.

On this note, we respect the views of the comment letters³ supporting the Proposed Statement. Yet we cannot ignore the other letters discussing numerous accounting, auditing and legal issues⁴. We feel that a long-term workable solution falls somewhere between these two camps.

We believe the Proposed Statement's accounting and disclosure rules on loss contingencies related to litigation will be harmful to investors for the reasons explained in various comment letters⁵. Our letter: (1) supplements certain concerns as relevant to an international hi-tech

¹ With a market capitalization of over US\$48 billion, TSMC is the world's leading contract manufacturer of semiconductor wafers with world-wide operations. Its common shares are listed on the Taiwan Stock Exchange with ADRs listed on the New York Stock Exchange under the symbol "TSM".

² See Recommendation 2.1 in Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission dated August 1, 2008, p. 57. ³ Such as the letter from individual investor Mr. James McRitchie.

⁴ Such as letters from the American Bar Association, the Chicago Bar Association, Association of Corporate Counsel and Pfizer (signed by numerous other established U.S. corporations), especially on the severe negative impact on attorney-client and work product privileges. (Almost all respondents to the IASB's Exposure Draft of Proposed Amendments to IAS37 commented on the difficulties of applying the revised IAS 37 to litigation and voiced similar concerns. See Summary of Comment Letters, paragraphs 87 & 95 to Exposure Draft of Proposed Amendments to IAS37 Provisions, Contingent Liabilities and Contingent Assets.)

See letters from the Committee on Corporate Reporting of Financial Executives International and Lawyers for Civil Justice.

company involved in cross-jurisdictional litigation, especially complex intellectual property disputes; and (2) suggests various general "intermediate approaches".

Complex international IPR⁶ disputes will generate complex disclosures

The required quantitative and qualitative disclosures in the Proposed Statement will force many hi-tech preparers that conduct business world-wide to make unreliable estimates and assumptions for such disclosures just in order to comply. This is so for two reasons.

IPR disputes are inherently even more complex to permit reliable disclosures

First, the subject matter of intellectual property right disputes (especially those involving patents and trade secrets) are by nature highly technical and complex. Most lawyers and judges still require expert consultants to explain the fine intricacies of such dispute, even after having read hundreds (if not thousands) of pages of court papers and evidence which typically are generated. Any disclosure beyond the presently existing Statement No. 5 disclosure regime will likely be lengthy and complicated. This in turn will confuse most lay investors given the sheer complexity of the subject matter of IPR disputesand hence be contrary to financial reporting goals of clarity and certainty⁷.

Further, the center of most complex IPR disputes involve trade secrets, which encompass vital manufacturing processes, industrial or commercial secrets. Contrary to patents, trade secrets are protected without registration, that is, trade secrets are protected without any procedural formalities. Consequently, a trade secret can generally be protected for an unlimited period of time so long as the rightful owner of the information takes reasonable steps to keep it secret (e.g., through confidentiality agreements). Because trade secrets (unlike patents) can be protected for an unlimited period of time, they are very valuable to the company's investors and are often capitalized as an intangible asset on the balance sheet. Hence management is under a fiduciary duty to safeguard such assets and must ensure that at all times, even during the litigation process, they are kept secret (often with use of protective court orders) from the adversary as well as parties unrelated to the litigation or risk losing the legal protection accorded to them. We are concerned that qualitative disclosure requirements in the Proposed Statement about trade secrets may render such trade secrets vulnerable to legal challenges by adversaries. This risk will force concerned preparers to seek protective court orders to limit the nature and extent of their required qualitative disclosures in the interest of safeguarding valuable investors' asset.

In addition, courts will issue protective orders preventing clients, opposing parties, and any relevant third parties from even reading certain legal briefs and court papers filed with respect to IPR lawsuits. Only the lawyers representing the parties may have access to such papers. Their clients often do not have such access to some if not substantial amounts of evidentiary materials. This is done to protect sensitive trade secrets from being leaked to the opposing party or to unrelated third parties. Under such practice, it will be extremely difficult for preparers to even begin assessing the outcome of their pending litigation. Such preparers are intentionally kept "out of the loop". As such, any disclosures forced to be made will lack sufficient basis.

Not to mention the cost and effort required by auditors to analyze the technical issues involved in such disputes even with the aid of independent consultants hired during the auditing process of preparers' disclosures.

8 "[D]isclosure of factors that are likely to affect the ultimate outcome of the contingency along with

⁶ Intellectual Property Rights, (or "IPR")

⁸ "[D]isclosure of factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome, a qualitative assessment of the most likely outcome of the contingency, and any assumptions made in estimating the amounts in the quantitative disclosures and in assessing the most likely outcome." Proposed Statement, Assumption 18, p.11.

Also, many times for strategic purposes, a preparer may intentionally manage a lawsuit at the first instance just so it may more quickly appeal its position on a point of law. Or, as often occurs, many judgments are overturned or modified on appeal especially as relates to damages. Requiring preparers to make extensive disclosures will undermine the preparers' litigation strategy by removing procedural flexibility again, to the detriment of investors. The disclosures made with respect to these situations may provide investors with an inaccurate account of the underlying dynamics of the litigation and therefore be misleading.

We note that the Proposed Statement provides a two-step exemption from certain prejudicial disclosures. Yet, as other comment letters have noted, the minimum disclosures required even when step two is invoked would themselves be prejudicial. As such, preparers will likely resort to seeking other means to protect investors' interests against prejudicial disclosures, such as seeking preliminary court orders enjoining themselves (their counsels or even third parties such as auditors, depending on the seriousness of the underlying case) from making disclosures that would be construed as waiving trade secret protections, as well as attorney-client or attorney work product privileges. This situation is very probable because the U.S. is notoriously litigious and so must be avoided for fear of upsetting the current "Treaty" established between the legal and auditing communities that has governed lawyers' responses to auditors' inquiries since the 1970s.

Hi-tech preparers will also be hard-pressed to disclose a specific claim amount because such claims are typically made without specifying a total damage amount. Thus, hi-tech preparers will often need to comply with the proposed alternative of providing a reliable estimate of the maximum exposure to loss. We note that FASB itself encountered difficulties in trying to quantify the costs and benefits of issuing the Proposed Statement. Similarly, it is equally difficult for preparers involved in IPR disputes to formulate a method to objectively provide a reliable estimate of the maximum exposure to loss that is not unreliable or misleading. The nearest surrogate for estimating the quantitative outcome of such disputes would be to use an expected cash flow approach, which had been proposed by the IASB as the basis for estimating a non-financial liability. Such as lawsuits. But, most commentators indicated that no reliable statistical data will be available. But, most commentators will produce an "unsupportable measurement of a liability which cannot be easily verified via the audit process." This explains why most major liability insurers

"[T]here is no method to objectively measure the costs to implement an accounting standard or to quantify the value of improved information in financial statements" such that its assessment of the costs and benefits of issuing [the proposed Statement] is "unavoidably more qualitative than quantitative". Proposed Statement, Assumption 34, p.15.

⁹ ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information, adopted by the ABA Board of Governors in 1975, and the AICPA Statement on Auditing Standards No. 12, adopted in 1976 and supplemented up to 1998.

Most of the letters have explained the unreliable and misleading nature of trying to quantify potential maximum exposure to loss from litigation. See letter from the Professional Standards Committee of the Texas Society of Certified Public Accountants suggesting to delete paragraph 7(a)(2) from the proposed Statement.

¹² Exposure Draft of Proposed Amendments to IAS37 Provisions, Contingent Liabilities and Contingent Assets, paragraph 31.

¹³ IASB Comment Letters Summary, Amendments to IAS 37 and IAS 19, paragraph 70.

¹⁴ *Ibid.* Many of these commentators also reasoned that "lawsuits are typically binary outcome non-financial liabilities that pose particular measurement difficulties. Many highlight that lawsuits are inherently unique. As result they state that the selection and justification of each variable in the measurement process is particularly difficult because there are no comparable cases or historical data to use as a reference point." *Ibid.* at paragraph 92.

exclude coverage for IPR (including trade secret) related losses because the underlying risks involved may not be reliably assessed 15.

Being forced to provide a "best estimate" of the maximum loss exposure at all times will encourage more frivolous IPR litigation because any dollar amount or estimate so disclosed will help certain professional IP plaintiffs (often known in the trade as "trolls") succeed in their "fishing expeditions" to extract some sort of settlement from the preparer.

International disputes are inherently too unpredictable to permit reliable disclosures

Not all litigation forums allow discovery of evidence. For instance, TSMC is currently involved in a major IPR dispute in China. This lack of a meaningful discovery mechanism and meaningful precedents on which to base disclosure estimates and assumptions increases the likelihood of unreliable disclosures. We note that FASB had assumed that many entities already have the information needed to make the required disclosures 16. This may not be so in foreign jurisdictions¹⁷.

Uneven application of Proposed Statement discriminates among investors

The Chairwoman of the Private Company Financial Reporting Committee of FASB was concerned that the additional disclosure requirements "could provide opposing counsel with a road map" used in litigation¹⁸. This information disparity discriminates between two groups of similarly situated investors or users.

Not all preparers will be subject to the Proposed Statement¹⁹. In a litigation involving parties not all subject to the Proposed Statement, the investors of the preparer subject to such additional disclosures will be discriminated vis-a-vis the investors of the preparer who need not comply. This is because the latter investors or users (such as a government agency) receives the benefit of a litigation or enforcement action "road map" showing them (a) any claims or defenses their invested company (or government agency) may have missed, (b) any admissions of fact or liability which their invested company (or government agency) may use against the other side, and (c) any settlement leverage their invested company (or government agency) may gain from knowing the "best estimate" of maximum range of loss of the other side.

Actions involving a government enforcement agency using such "road maps" against a preparer, its officers, directors, employees and other insiders, especially in criminal enforcement actions may even invite serious constitutional challenges to the validity of the

¹⁵ One letter proposed that a loss contingency need not be disclosed if it is adequately insured. If adopted, this proposal would unduly penalise hi-tech preparers involved in IPR disputes. This is because insurers either exclude liability for such claims or charge a very high level of premium so as to render coverage uneconomical.

^{16 &}quot;The Board believes that many entities already have the information necessary to fulfil these disclosure requirements and that including the information should not require substantial additional cost or effort." Proposed Statement, Assumption 36.

International litigations also raise additional factors (such as choice of law and venue) particular to the forum that further undermines the preparers' ability to provide accurate assessments. Depending on the rules of the relevant forum, the mere posting of any documents on a preparer's website containing such disclosures may give opposing parties grounds to sue the preparer in their jurisdiction, which may be located in another country.

18 Letter from Gilman Ciocia, Inc., p.2.

¹⁹ Persons exempt may be regulators, government enforcement agencies, individuals, small nonaccelerated filers (as suggested by one comment letter), foreign preparers following IAS 37 (assuming the same remains unamended) or preparers who have successfully persuaded a court of the forum to desist from making the required disclosures so as to protect legal privileges.

qualitative disclosure rules in the Proposed Statement. Under most Anglo-American legal systems, it is the duty of the prosecution to discharge its burden of proof by showing the guilt of defendants beyond a reasonable doubt. Defendants should not be required to risk incriminating themselves by making certain qualitative statements in the required disclosures before a pending or threatened prosecution and during the enforcement action. The Proposed Statement should avoid undermining vital U.S. constitutional guarantees.

Such "informational arbitrage" causes one group of investors or users to become enriched at the expense of another group of similarly situated investors or users. This discrimination resulting from such informational imbalance among investors or users seems to offend traditional notions of justice and fair-play because it allows one group to acquire a distinct unbargained-for advantage over another group whereas the goals of financial reporting is to disseminate comparable information about similarly situated companies involved in the same underlying economic activity. One alternative is to exempt a preparer from the Proposed Statement with respect to litigations in which any party would not otherwise be subject to the Proposed Statement so as to create an "even playing field"²⁰.

Aggregation fails to remove prejudice for firms with well managed IPR portfolio

Most hi-tech preparers actively manage their portfolio of IPR so as to maximize commercial opportunities and minimize legal exposures. Those hi-tech preparers with a well managed IPR portfolio will be involved in proprotionately less litigation than those preparers who do not have a well managed IPR portfolio. For a company with a market capitalization of over US\$48 billion, TSMC is involved in few IPR litigation relative to its market size. Yet, it will be likely that TSMC will need to invoke the two step exemption from prejudicial disclosures for each of the IPR litigation in which it is involved. The issue arises is whether the first exemption step "aggregation at a higher level" will shield preparers like TSMC from prejudicial disclosures?

For preparers involved in numerous IPR litigation cases, aggregating discolsures at a higher level may alleviate their concerns about prejudicial disclosures. But, preparers with well managed IPR portfolios may have only a few large loss contingencies that are being or threatened to be litigated. Aggregating those contingencies does not seem to protect these preparers from releasing highly prejudicial information. Preparers like TSMC may also have large claims that have received much publicity in the media such that anyone evaluating the aggregation is likely to know that the majority of the exposure comes from a particular claim²¹.

Suggested Intermediate Approaches

 Put Proposed Statement in abeyance pending the issuance of a statement of policy on the exercise of professional judgment by the SEC or PCAOB.

The Final Report of the Advisory Committee on Improvements to Financial Reporting to the U.S. SEC²² ("CIFR") (issued on August 1, 2008) recommends "that the SEC should issue a

²⁰ The other alternative to require parties not otherwise subject to the Proposed Statement to make similar disclosures would create practical difficulties, such as when such a party is a foreign company to which the Proposed Statement would not be applicable. There would be no juridiction for the Proposed Statement to apply.

TSMC already commented on the viability of step two of the exemption on page 3.

Last year, the U.S. SEC created the SEC Advisory Committee on Improvements to Financial Reporting, comprised of members representing investors and other key constituencies in America's capital markets. The work of this committee was to make financial reporting less complex and more useful to investors.

statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments." This recommendation comes at a right time because the application of the Proposed Statement requires a significant amount of professional judgment in making (and auditing) the required quantitative and qualitative disclosures. And, because "[g]uidance on judgments may provide investors with greater comfort that there is an acceptable rigor that companies follow in exercising reasonable judgment."

For example, regarding the proposed quantitative disclosures, we point out the concern of CIFR when it recognized that "there can be significant judgments that need to be made in estimating the actual amount to record". Regarding the proposed qualitative disclosures, we point out the concern of CIFR that "the sufficiency of the evidence used to support the conclusion must also be evaluated. In practice, this is typically one of the most subjective and difficult judgments to make."

This concern about the use of significant judgment seems to be the golden thread running through most of the comment letters because preparers (and their investors) fear the risk of being second-guessed by auditors, regulators, potential plaintiffs, and the media. Comment letters supporting the Proposed Statement do not indicate how preparers or auditors should overcome such risk. Since the Proposed Statement introduces fundamental conceptual changes in the disclosure of litigation loss contingencies, this warrants in-depth debate and consideration in a broader context along with the CIFR recommendation on a guidance on judgment.

• Put Proposed Statement in abeyance pending the integration of existing FASB and U.S. SEC litigation loss contingency disclosure requirements into a cohesive whole.

The CIFR also recommends that "[t]he SEC and the FASB should work together to develop a disclosure framework to ... [i]ntegrate existing SEC and FASB disclosure requirements into a cohesive whole to ensure meaningful communication and logical presentation of disclosures, based on consistent objectives and principles. This would eliminate redundancies and provide a single source of disclosure guidance across all financial reporting standards."²⁷

It may seem more prudent to first streamline existing requirements with the SEC. It may be that after the result of such integration, investors will receive clearer financial information so as to reduce the need for the Proposed Statement. There are two particular areas that need attention.

- Organise disclosures about pending lawsuits, competitive threats and other environmental
 factors relevant to future sale logically in a single location to eliminate redundancies and
 increase investors understanding.²⁸ Currently these disclosures appear in different parts
 of the annual report.
- 2. Eliminate duplicative requirements between FASB and SEC guidance on contingencies. The CIFR found that the disclosures required by Item 103 of Regulation S-K are largely

²³ supra footnote 2, p.93.

²⁴ *Ibid*. at p.89.

²⁵ *Ibid.* at p.90.

²⁶ *Ibid*. at p.91.

²⁷ *Ibid*. at p. 34.

²⁸ *Ibid.* at p.37.

redundant with the basic disclosure requirements of SFAS No. 5, Accounting for Contingencies.²⁹

• Exclude any description about the frequency of the use of the two step prejudicial exemption.

This will decrease tension between preparers' counsel and auditors in debating about whether the need for invoking use of the exemption is sufficiently "rare".

• Consult U.S. Congress and state legislatures to grant immunity for disclosing preparers.

To prevent disclosures made by preparers from being used against them during the ligitation process, FASB ought to consult the U.S. Congress to adopt amendments to the Federal Rules of Civil Procedures and state legislatures to adopt parallel amendments to their respective state rules of civil procedures.

• Consult U.S. Department of Justice and relevant state agencies as to impact on defendants' constitutional right to a fair trial.

Key executives of preparers risk incriminating themselves by making the required disclosures before or during the course of a criminal proceeding or administrative suit with criminal consequences (such as anti-trust and insider trading proceedings). FASB should seek an opinion from the U.S. Department of Justice (or other relevant state and federal agencies) as to this likely impact on U.S. constitutional protections to avoid constitutional challenges.

• Set a cut-off date for making proposed disclosure requirements.

It is foreseeable that litigation claims could be filed intentionally a few days prior to the end of a preparer's accounting period or shortly before its financial statements are issued. We ask that FASB establish a cut-off date for making the proposed disclosures in such instances. Otherwise, investors will be deprived of important financial information when preparers are unable to timely complete and issue their financial statements.

• <u>Alternatively, exclude disclosure of litigation loss contingencies from the scope of the Proposed Statement.</u>

Making the required qualitative and quantitative disclosures for litigation loss contingencies will be more an act of faith than science. The literature and comment letters for this Proposed Statement shows the lack of an objectively verifiable basis for the estimates and assumptions underlying such disclosures. As such, investors should be very concerned about the reliability and accuracy of the information which they nevertheless will receive.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience or participate in the planned roundtables on the Proposed Statement.

²⁹ *Ibid.* at p.38 footnote 71.

Very truly yours,

For and on behalf of Taiwan Semiconductor Manufacturing Corporation

By:_____Name: Lora Ho
Title: CFO

Date:

Name: Dr. Richard Thurston

Title: Vice President & General Counsel

Date: