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LETTER OF COMMENT NO. 56

August 7, 2008

Via Electronic Mail

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

File Reference No. 1600-100 Re:

Exposure Draft - Disclosure of Certain Loss Contingencies

Ladies & Gentlemen:

This letter provides my comments on the outstanding Exposure Draft Disclosure of Certain Loss Contingencies. I write to express my overall support for the objectives of better and more complete disclosure, but also to express certain reservations regarding certain of the proposed changes to FASB Statement No. 5.

Thirty years ago, the FASB set out the objectives of financial reporting in Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises. Among the key objectives noted therein were:

- Provid[ing] information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions (\P 34);
- Provid[ing] information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts...(\P 37);
- Provid[ing] information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources (¶ 40).



Some users of financial information have indicated dissatisfaction with the exemption provided in FASB Statement No. 5 for contingencies that cannot be reasonably estimated, as the Board notes in ¶ A16 of the Exposure Draft. No doubt that exclusion has been overused by some issuers of financial statements, resulting in the omission of disclosures that could reasonably have been made. In attempting to achieve greater transparency in the disclosure of contingencies, the Board's efforts are on target. While I generally support the Board's efforts, there are areas in which I think the proposed amendment goes too far.

The treatment of gain and loss contingencies has historically been asymmetric: loss contingencies are booked and disclosed far sooner than gain contingencies. The current exposure draft threatens to increase that asymmetry by requiring even more disclosure of potential losses - even if the likelihood of loss is remote (see, e.g., ¶ 6 of the Exposure Draft). I do not see the value to adding such disclosure where the likelihood of loss is remote.

To illustrate, I will give you an example from my own experience as a provider of litigation services, damage analysis and expert testimony for more than thirty years. My client, a publicly traded company, was sued by a supposed competitor for alleged antitrust activity. The plaintiff claimed that it had developed a competing technology, but had been kept from the market by the alleged illegal activity of the defendant. Plaintiff wanted approximately one billion dollars in damages.

My analysis of the claim documented the following facts, which caused me to conclude that plaintiff's claims were wildly speculative, grossly inflated and *extremely* unlikely to prevail:

- The plaintiff company had no offices, manufacturing or other physical presence.
 In contrast, the defendant and its competitors had invested hundreds of millions of dollars in physical assets over the prior decades.
- The plaintiff company had only one employee, an individual who had previously been convicted of felonious fraudulent activities. The defendant and competitors each employed thousands or tens of thousands of employees.
- The plaintiff company had no funding with which to manufacture, market or distribute its supposed product. Defendant and its competitors had hundreds of millions of dollars of shareholder equity and additional hundreds of millions of available credit.



- The plaintiff company had no customers and no sales. Defendant and its competitors had revenues approaching a billion dollars each.
- The plaintiff company had no orders for its supposed product. Defendant and its competitors had order backlogs in the tens or hundreds of millions of dollars.
- The plaintiff company had no business records whatsoever, claiming that they had been lost when its IT provider had shut down its server. Defendant and competing firms had the robust records one would expect a real company to have.
- The plaintiff company had not invested any funds in research and development, despite its claims to have developed a product that would revolutionize diagnostic testing. The defendant company and virtually every legitimate competitor in the field spent tens of millions of dollars annually on research and development.

It was easy to conclude that the likelihood of loss to the defendant company was extremely remote. Yet ¶ 6 of the Exposure Draft would require such a claim to be disclosed, since (a) it was expected to be resolved near term (the suit was, in fact, dismissed within weeks of my report and declaration) and (b) the contingency - had it materialized - would have had a severe impact on the defendant company.

In addition to this problem, the Exposure Draft proposes that the reporting entity disclose quantitative information about the entity's exposure to loss. Where there has been public disclosure of a claim, e.g., in the complaint or other pleading, this poses no significant problems. In other circumstances, however, the Exposure Draft would require the entity to disclose its best estimate of the maximum loss exposure. This, too, is problematic for a number of reasons, some of which have been anticipated by the Board, and others of which may not have been.

First, as the Board has noted, disclosure may compromise the positions the entity takes in the underlying litigation, arbitration or other matter. Again, that disclosure is asymmetric. The opposing party - for whom one would presume there is a potential gain contingency - is not required to disclose its *worst* case estimate. Thus, to the extent such a disclosure potentially impacts the conduct, negotiating positions or settlement of the matter, it does so to the detriment of only one party, and potentially to the benefit of the other.

That asymmetry might be tolerable if the benefit of the disclosure were evident and significant. That, too, is doubtful. FASB Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, is instructive here:



- "That information should be reliable as well as relevant is a notion that is central to accounting." (¶ 58) The glossary of terms defines reliable as reasonably free from error and bias and faithfully representing what it purports to represent.
- "The quality of verifiability contributes to the usefulness of accounting information because the purpose of verification is to provide a significant degree of assurance that accounting measures represent what they purport to represent." (¶81) Verifiability, in turn, is defined as the ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias.

When we consider the reliability and verifiability of an estimate of loss, we see some considerable difficulty. Just as plaintiff's expert and defendant's expert frequently have widely diverging opinions on the quantum aspects of the litigation, practitioners will have sharply divergent views on the values to be disclosed in the financial statements. That, in turn, undermines the usefulness of the disclosure to the users of the financial statements.

Moreover, the relative unreliability and lack of verifiability of the amounts could give rise to unwarranted litigation against the issuer of the financial statements and/or the auditor. In circumstances where management intends to mislead investors, or where the auditor has been complicit in illegal activity or negligent in discharging its duties, such actions may be warranted. But where legal action is taken simply because the actual result was different from the issuer's best estimate - an estimate the auditor must consider as part of its audit work - there is much room for mischief.

Finally, the Board asked in its question number 6 whether the disclosure of settlement offers should be required. It should not. Settlement discussions have historically been accorded great confidentiality, and there is no pressing reason to disturb that historic precedent. The requirement for disclosure of confidential negotiations will likely have foreseeable negative impact on such negotiations, particularly in multiparty actions that may have multiple settlement discussions ongoing.

To summarize, I concur in the Board's efforts to improve the timeliness and amount of disclosure of loss contingencies in the financial statements. I cannot, however, endorse the requirement to disclose every near term contingency no matter how flaky and remote it may be, nor can I adopt the Board's suggestion that an issuer should be required to disclose its estimate of the maximum potential loss.

Very truly yours,

Richard E. Walck CPA/ABV, CMA, CFM