



August 8, 2008

Russell G. Golden, CPA
Technical Director
FASB
File Reference No. 1600-100
401 Merritt 7
PO Box 5116
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Re: June 5, 2008 Exposure Draft (ED) of a Proposed Statement of Financial Accounting Standards (SFAS), *Disclosure of Certain Loss Contingencies*—an amendment of FASB Statements No. 5, *Accounting for Contingencies*, and 141(R), *Business Combinations*

Dear Mr. Golden:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the ED and is providing the following comments for your consideration.

As previously requested, TIC would like to send a representative to the Board's public roundtable for this ED to express our views from the private entity perspective.

GENERAL COMMENTS

Issues for Private Entities

TIC is concerned that the amendments proposed in the ED are driven by the needs and concerns of public company investors without sufficient representation from private company users. Members of TIC believe that the enhanced disclosures required by the ED are unnecessary for nonissuers and, if adopted, would create numerous accounting and reporting issues for both preparers and independent accountants and auditors that would not be offset by added value for financial statement users.





Based on the collective experience of TIC members, the concerns about existing loss contingency disclosures outlined in paragraph A3 of the ED are not shared by the lenders and other creditors that are the primary users of private entity financial statements. Lenders and bonding agents within TIC's constituency generally have not cited "surprise" contingent liabilities due to lack of disclosure in a prior period or alleged any other operational failure of SFAS No. 5. Additionally, TIC has not identified any issues arising from concerns from regulators of nonissuers.

The extensive disclosures required by the ED are also less relevant to users of many private company financial statements. Analysts of public companies focus on the company's potential future value and earnings potential and may need to predict short-term and long-term stock prices for the entity. Lending decisions for private companies are based on anticipated cash flows over the term of the loan rather than the precision of a stock price. Therefore, disclosures that reflect a high degree of uncertainty have less predictive value for the private company user group. Litigation in early stages is especially unpredictable, and little benefit will be derived from guessing what the ultimate outcome may be.

In addition, when a reasonably possible loss is disclosed, lenders have the ability to discuss the litigation risk directly with the company. Based on TIC members' experience, these discussions revolve around the status of the case and other qualitative aspects—not a point estimate of the possible loss. This information is enough for lenders to make their own determinations of estimated loss. They do not need additional disclosures, which may be more harmful than helpful in assessing cash flow.

Disclosing the entity's best estimate of the maximum exposure to loss when no claim or assessment amount has been stated will be speculative at best and could prove to be detrimental to the outcome of the litigation.

The prejudicial exemption is insufficient for private entities. It provides relief from only two disclosure items such that the disclosures are still onerous. It also provides no safe harbor for entities with either one case or one case in each of two or more classes of claims. The disclosures may be attributed to specific cases, such that additional litigation may occur when past disclosures differ from the final outcome. Disclosure of prejudicial information is likely to be more common in TIC's constituency since these entities tend to have fewer claims.

TIC is also concerned that the amendments proposed in the ED will lead to disclosure overload. Companies may effectively inoculate readers of the financial statements with a





myriad of remote or nearly remote contingency disclosures. To quote from AICPA Statement of Position No. 94-6, *Disclosure of Risks and Uncertainties*,

...financial statements should not be burdened in an attempt to describe every possible risk and uncertainty facing the reporting entity [paragraph B-3].

New disclosure requirements should effectively separate the significant matters that warrant reporting from the host of lesser risks and uncertainties that do not [paragraph B-4].

If the significant disclosures are intermingled with the less important, financial statement users will be more likely to miss important information out of sheer frustration with the volume of disclosures. TIC is concerned that notes to the financial statements will begin to look like the risk disclosures in public company filings, which tend to lose their meaning in the “legalese” of the verbiage.

TIC believes the subsequent events provisions of the ED (paragraph 10) will not be operable in practice. The ED states,

After the date of an entity's financial statements but before those financial statements are issued, information may become available indicating that a liability was incurred after the date of the financial statements or that it is more than remote that a liability was incurred after that date. In those situations, an entity shall provide the disclosures required in paragraph 7.

At present no authoritative accounting guidance exists for subsequent events. Further, the ED disturbs the delicate choreography for auditing and report dating by extending the responsibility for disclosure of the subsequent events up to the date of issuance. Current auditing standards extend only to the date of the report and not to the date of issuance.

The new disclosures will come at a high cost for private entities. The entity will incur higher attorney fees to obtain the required disclosure items, and audit fees will increase to cover the additional cost to audit the disclosures. TIC is also concerned that attorneys would not be willing to respond to auditors' requests for information under the new standard until the 1975 *American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information* (the 1975 ABA Statement contained in AICPA Professional Standards, Volume I, AU Section 337C) had been revised to conform to the amended SFAS No. 5.





TIC also believes the precise nature of the disclosures will lead to a higher number of scope limitations and GAAP departures. Such exceptions will affect the quality of financial statements and create engagement issues at every level of service (audits, reviews and compilations).

The proposed effective date, which would imply a transition period of no more than three or four months, is not operational considering the added volume of disclosures required and the additional time needed to develop the information for the disclosures, especially for calendar year-end entities. Additional transition time may also be needed if the 1975 ABA Statement requires revision before the effective date.

Short transition periods also present other implementation problems. The final standard will be issued after the summer training months, so many practitioners and preparers may not be aware of its effective date or have time to attend relevant continuing professional education classes. It is also likely that vendors will not have time to fully integrate the new disclosures into their 2008 disclosure checklists.

In the spirit of international convergence, TIC believes it would be a mistake to revise contingency disclosures now, only to revise them again when the International Accounting Standards Board (IASB) reconsiders International Accounting Standard No. 37, *Provisions, Contingent Liabilities and Contingent Assets*. Frequent changes to the same standard add complexity and impair comparability.

Additional discussion of many of the above points is contained in the section below entitled Specific Comments on FASB's Questions for Respondents.

TIC Recommendations

Based on the concerns discussed above, TIC recommends that private entities be exempt from the disclosure provisions of the proposed amendment. The Board's urgency to issue this ED as a final standard may be relevant and appropriate for the public company environment, but not for private entities. TIC believes extensive field testing is needed among private entities to ensure that the additional cost and time needed to develop the new disclosures will provide added value to lenders and other financial statement users and not be prejudicial to private entities that have a smaller number of contingencies. TIC believes the new disclosures will not pass the cost/benefit test.

In addition, precedent exists for providing exemptions to nonpublic entities when





disclosures are not requested by their financial statement users or when additional research is needed to adapt a public company standard to the private sector (for example, SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, see paragraphs 115-118).

If the proposed amendment is finalized as written and is therefore applicable to all entities, TIC believes there is justification for a deferred effective date for nonissuers. The proposal has been controversial, and many implementation questions remain. Private entities would benefit from the experiences of public companies in adopting the standard. A deferral would also allow field-testing at the private company level to determine whether unique issues may exist that could affect its applicability to TIC's constituency. TIC believes such requests are reasonable since there is no immediate demand for these disclosures in the private company arena.

TIC recommends that separate effective dates always be considered for private entities whenever short transition periods are deemed necessary for standards that respond to urgent public company issues. A request for deferral of this standard is consistent with the concerns expressed in TIC's unsolicited comment letter to the FASB dated March 10, 2008 on the standards rollout process.

Another reason to defer the effective date for private companies for this particular project is to allow the international convergence process to move forward. The FASB is setting a new standard on contingency disclosures without having formal input on the issues from the International Accounting Standards Board (IASB) and its constituents. While this may be necessary to resolve issues with public company disclosures in the U.S. in the short term, the new standard should not be extended to private entities until due process on the joint FASB/IASB contingencies project has been completed. Contingency disclosures that emerge from the joint project may differ from the current proposal. TIC believes change should occur at one time, preferably at the conclusion of the joint project, to avoid added complexity and disruption in the financial reporting process.

SPECIFIC COMMENTS ON FASB'S QUESTIONS FOR RESPONDENTS

The responses to the following questions for respondents include TIC's general concerns about the proposal as well as specific concerns from the private entity perspective.

- 1. Will the proposed Statement meet the project's objective of providing enhanced disclosures about loss contingencies so that the benefits of those disclosures justify the incremental costs? Why or why not? What costs do you expect to incur if the**





Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?

No. As discussed above, TIC believes the proposed Statement would create significant incremental costs for preparers without providing sufficient additional value for financial statement users. Contrary to the statement in paragraph A3 of the ED, users of private company financial statements have not expressed concerns regarding the contingency disclosures in the financial statements under SFAS No. 5. TIC believes lenders and other creditors would find little value in attempting to predict the cash flow effect of claims (asserted or unasserted) where the likelihood of loss is “more than remote” but less than “reasonably possible.”

One of the main incremental costs would be for attorneys to measure the quantitative and qualitative factors necessary to assess the litigation at an early stage. This would be a time-consuming effort, especially if the disclosures must be updated for every interim period presented. Many private entities prepare GAAP financial statements on a monthly basis and should not be required to update their disclosures unless an important triggering event has occurred. The information provided at such an early stage may be speculative and may likely be misleading and inaccurate when compared to the final outcome. Some other incremental costs might include the following:

- a. Auditor may not be able to obtain the necessary corroborating evidence to support the information provided by the client and its attorneys. There may also be conflicting information provided by the client and its attorney due to the client wanting to underestimate the potential litigation outcome while attorneys may overestimate the outcome in order to protect themselves.
- b. The entity’s thinking and strategy for dealing with the claim may be revealed with the required qualitative disclosures which may result in a significant impact on the outcome, in particular if the entity is forced to reveal its own best estimate of the maximum exposure to loss.
- c. The required disclosures may constitute admissible evidence, which may cause consequences for attorney-client privilege and work product protection. These required disclosures may even change the outcome of the proceedings.
- d. These disclosures may also cause additional claims and litigation if the required disclosures and estimates turn out to be incorrect.

TIC also believes the ED will create operational issues for auditors and accountants who perform review and compilation engagements. Preparers will





have increasing difficulty obtaining the following information from attorneys or developing such assertions on their own:

- Assurances that the likelihood of loss will be remote for contingencies within the scope of the ED, and
- Estimates of the maximum exposure to loss where no specific claim amount or assessment is available.

These issues are likely to result in scope limitations, which will lead to an increasing number of disclaimers of opinion for audits and will disallow the performance of review engagements completely. Auditors may also have difficulty obtaining sufficient evidence to audit the disclosures. GAAP departures for all types of engagements will increase if preparers believe that required disclosures could reveal prejudicial information. Report modifications resulting from cost/benefit issues with selected standards have increased in recent years to the detriment of the users of financial statements. To prevent this trend from continuing, TIC believes these issues need to be factored into the operational “cost” of implementing this ED.

- 2. Do you agree with the Board’s decision to include within the scope of this proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligation, which are currently subject to the provisions of Statement 5? Why or why not?**

TIC believes that the current SFAS 5 disclosure model for multiemployer plan contingencies works well and no change is required. While TIC understands that contingencies surrounding an employer’s withdrawal from a multiemployer plan would be included within the scope of the ED for consistency purposes, issues may arise in obtaining the information needed for the new disclosures. The obligations related to these plans are typically not well defined and can be quite significant. TIC is concerned about the ability of an employer in a multi-employer plan to obtain the needed information from the plan, since many plans do not provide detailed disclosures of obligations to contributing employers. The Board should consider an exemption for the inability to obtain the necessary information—similar to the exemption in FIN 46R, *Consolidation of Variable Interest Entities*.

- 3. Should an entity be required to provide disclosures about loss contingencies, regardless of the likelihood of loss, if the resolution of the contingencies is expected to occur within one year of the date of the financial statements and the**





**loss contingencies could have a severe impact upon the operations of the entity?
Why or why not?**

TIC does not believe that an entity should be required to provide disclosures about loss contingencies, when the likelihood of loss is remote, even if the resolution of the contingencies is expected to occur within one year of the date of the financial statements and the loss contingencies could have a severe impact upon the operations of the entity. As stated above, entities and their attorneys will be forced to measure the subjective factors available at an early stage of the litigation which may lead to misleading and inaccurate disclosures. These disclosures may potentially cause changes to the course of the settlement, and may lead the way to additional litigation if the required disclosures are later alleged to be incomplete or misleading in any way.

Paragraph 3(c) of Statement 5 defines remote as *“the chance of the future event or events occurring is slight.”* TIC believes that the costs of providing enhanced disclosures on future events for which the chance of occurrence is slight significantly outweighs the benefit and adds to disclosure overload for financial statement users.

- 4. Paragraph 10 of Statement 5 requires entities to “give an estimate of the possible loss range or range of loss or state that such an estimate cannot be made.” One of financial statement users’ most significant concerns about disclosures under Statement 5’s requirements is that the disclosures rarely include quantitative information. Rather, entities often state that the possible loss cannot be estimated. The Board decided to require entities to disclose the amount of the claim or assessment against the entity, or, if there is no claim or assessment amount, the entity’s best estimate of the maximum possible exposure to loss. Additionally, entities would be permitted, but not required, to disclose the possible loss or range of loss if they believe the amount of the claim or assessment is not representative of the entity’s actual exposure.**
- a. Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?**
 - b. Do you believe that disclosing the possible loss or range of loss should be required, rather than optional, if an entity believes the amount of the claim or assessment or its best estimate of the maximum possible exposure to loss is not representative of the entity’s actual exposure? Why or why not?**
 - c. If you disagree with the proposed requirements, what quantitative**





disclosures do you believe would best fulfill users' needs for quantitative information and at the same time not reveal significant information that may be prejudicial to an entity's position in a dispute?

TIC agrees with the proposed Statement to require entities to disclose the amount of the claim or assessment against the entity; however, TIC is concerned with the requirement to disclose the entity's best estimate of the maximum possible exposure to loss if there is no claim or assessment amount. TIC does not believe this latter disclosure would result in an improvement in the reporting of quantitative information about loss contingencies. The entity disclosing and revealing its best estimate of the maximum exposure to loss or a range of possible losses may cause a significant impact on the outcome. These disclosures may create evidence that may be used against the entity and may distort the case by providing a range for which the litigation may be resolved. Also, additional liability may arise if the disclosures are inconsistent to the final outcome of the case. Auditors may also find it difficult to obtain corroborating evidence to support these estimates, which would be highly subjective in nature.

TIC believes that disclosing the possible loss or range of loss should be optional since the disclosure may reveal significant information that may be prejudicial to the entity's position in a dispute and also due to the reasons stated above.

TIC believes that the entity should only disclose the amount of the claim or assessment if the amount of loss can be reasonably estimated as defined in paragraph 8(b) of SFAS No. 5.

- 5. If a loss contingency does not have a specific claim amount, will an entity be able to provide a reliable estimate of the maximum exposure to loss (as required by paragraph 7(a)) that is meaningful to users? Why or why not?**

The entity providing its own estimate of the maximum exposure to loss may encounter significant difficulties in obtaining a reliable estimate, which may result in a disclosure that is misleading or meaningless to the users. This disclosure may create repercussions in the legal outcome of the case that were not intended by the Board, and may even result in additional litigation caused by incorrect estimates upon which the users will rely. Auditors may find it difficult to obtain and audit corroborating support for these estimates.

TIC agrees with the Board that the amount of the claim or assessment against the





entity should be disclosed if available; however, if this amount is not available, then the entity should be required to disclose a possible loss or range of loss that can be reasonably estimated or corroborated by legal counsel. Furthermore, if the entity cannot provide a possible loss or range of loss that can be reasonably estimated, then the entity should be able to disclose that such an estimate cannot be made and the reasons why.

6. **Financial statement users suggested that the Board require disclosure of settlement offers made between counterparties in a dispute. The Board decided not to require that disclosure because often those offers expire quickly and may not reflect the status of negotiations only a short time later. Should disclosure of the amount of settlement offers made by either party be required? Why or why not?**

TIC agrees with the Board in not requiring the disclosure of settlement offers made between counterparties in a dispute since this information may be misleading and meaningless. In addition, disclosure of settlement offers may be prejudicial or precluded under the terms of the settlement offer.

7. **Will the tabular reconciliation of recognized loss contingencies, provided on an aggregated basis, provide useful information about loss contingencies for assessing future cash flows and understanding changes in the amounts recognized in the financial statements? Why or why not?**

TIC believes the tabular reconciliation may not be as useful as narrative disclosures. Nonpublic entities typically have a limited number of contingencies that are being recognized, and the substance of each issue is better explained in a narrative fashion. Therefore, TIC does not believe the FASB should prescribe the form of disclosure if the substance has been disclosed.

The tabular reconciliation would be especially prejudicial for private entities with one contingent liability. The opposing party in litigation would frequently have access to the defendant's financial statements as part of the discovery process and would see how the defendant was changing its loss estimates as the litigation progressed. (Plaintiffs often request a copy of the defendant's financial statements claiming that they are needed to assess the defendant's ability to pay damages.) The combination of plaintiff access and explicit disclosure could have serious, adverse consequences for the entity.





- 8. This proposed Statement includes a limited exemption from disclosing prejudicial information. Do you agree that such an exemption should be provided? Why or why not?**

TIC generally agrees with the concept of an exemption from disclosing prejudicial information in the proposed Statement. However, TIC does not feel that the prejudicial exemption in the ED adequately mitigates the prejudicial risks posed by disclosure. Unlike most large public companies, smaller entities often have a single claim or a group of claims constituting a significant portion of the total exposure. In such cases, there is a greater threat to the entity that the users of the financial statements may decipher those cases from the others, even with the aggregated quantitative and qualitative disclosures. TIC feels that the current disclosure requirements under SFAS No. 5 are adequate and appropriate in prejudicial situations.

- 9. If you agree with providing a prejudicial exemption, do you agree with the two-step approach in paragraph 11? Why or why not? If not, what approach would you recommend and why?**

TIC generally agrees with the principles behind the two-step approach in paragraph 11, however, the approach will not provide sufficient relief for private entities. Step one, aggregating the quantitative and qualitative disclosures at a level higher than by nature of the contingency, is very difficult to achieve without revealing prejudicial information, especially within the qualitative disclosures. When disclosing a limited number of cases that are dissimilar in nature (e.g., product liability v. environmental liability), aggregation often cannot effectively mask the prejudicial information.

In Step two, most of the required disclosures in the last sentence of paragraph 11 may not be waived under any circumstances. Therefore the permitted disclosure exemptions provide little relief from the potential disclosure of prejudicial information.

- 10. The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, but have not yet reconsidered the disclosure requirements. The existing disclosure requirements of IAS 37 include a prejudicial exemption with language indicating that the circumstances under which that exemption may be exercised are expected to be *extremely rare*. This proposed Statement includes language indicating that**





the circumstances under which the prejudicial exemption may be exercised are expected to be *rare* (instead of *extremely rare*). Do you agree with the Board's decision and, if so, why? If not, what do you recommend as an alternative and why?

As discussed in the foregoing, TIC feels the prejudicial exemption will not be "rare" for the large number of private entities having a small number of contingencies subject to the disclosure requirements of the ED. The Board should consider modifying language to indicate that the prejudicial exemption will be more common in such cases.

It should be noted that the IASB has a potential vehicle in its IFRS for Private Entities project to differentiate between public and private companies. Currently, the FASB has no such vehicle and as a result must differentiate within each standard itself. We encourage the Board to do so with respect to the "rare" language.

11. Do you agree with the description of prejudicial information as information whose "disclosure ... could affect, to the entity's detriment, the outcome of the contingency itself"? If not, how would you describe or define prejudicial information and why?

TIC agrees with the description of prejudicial information as information whose "disclosure ... could affect, to the entity's detriment, the outcome of the contingency itself."

12. Do you believe it is operational for entities to disclose all of the proposed requirements for interim and annual reporting periods? Should the tabular reconciliation be required only annually? Why or why not?

TIC does not believe it is operational for entities to disclose all of the proposed requirements for interim and annual reporting periods. Paragraph 22 of APB Opinion No. 28, "Interim Financial Reporting" states that contingencies and other uncertainties should be disclosed in interim reports in the same manner required for annual reports until the contingencies have been removed, resolved or become immaterial. However, TIC believes that with the new enhanced disclosure requirements, entities may find it difficult and costly to obtain all the required information for interim reporting periods. For the reasons previously stated in the answers above, TIC is concerned that the required disclosures may lead to





misleading and volatile information when entities are forced to disclose all of the proposed requirements at interim periods. The Board should consider revising the proposed Statement to reduce the required disclosures for interim reporting.

If the Board elects to mandate the tabular form of disclosure, TIC believes that, consistent with paragraph 21 of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, the tabular reconciliation should be required at the end of each annual reporting period since a tabular reconciliation may be redundant when little activity occurs from month-to-month or quarter-to-quarter and may not be useful to the users. Interim disclosure could be limited to the occurrence of material changes in circumstance (such as a settlement or a verdict) within the period.

13. Do you believe other information about loss contingencies should be disclosed that would not be required by this proposed Statement? If so, what other information would you require?

TIC believes no other information about loss contingencies should be disclosed that would not be required by this proposed Statement. However, TIC recommends that the Board consider reducing the proposed requirements to find a balance between providing the users of the financial statements with transparent, useful and timely disclosures and a protection of the entity's legal interest to preclude disclosing information that could be prejudicial to the entity.

14. Do you believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008? Why or why not?

TIC does not believe it is operational for entities to implement the proposed Statement in fiscal years ending after December 15, 2008. The entities will not have sufficient time to understand what is required by the proposed Statement to adopt and implement the new proposed requirements. The required disclosures may be cumbersome and expensive to apply since the information may be sensitive and subjective in nature, and hence there must be extensive communication and consensus between the entity, its legal counsel and the auditors. If the Board does not elect to give private entities an exemption from the disclosure requirements of the ED, TIC believes that this proposed Statement should be effective for annual financial statements issued for fiscal years ending after December 15, 2009, and annual periods in subsequent fiscal years. TIC requests an exemption from proactively updating the disclosures for private entities at each interim period unless





a triggering event occurs that would require disclosure. TIC agrees that the tabular reconciliation of recognized loss contingencies should not be required for earlier periods that are provided for comparative purposes. Delaying this proposed Statement would give entities, legal counsel and auditors more time to understand how to gather the information and will assist in providing users with more useful and accurate information.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen Bodine, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committee

