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Via e-mail: director@fasb.org



LETTER OF COMMENT NO. 218

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
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File Reference No. 1600-100—Exposure Draft, *Disclosure of Certain Loss Contingencies*

Dear Mr. Golden:

BDO Seidman, LLP is pleased to offer comments on the Exposure Draft (ED) of the Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R)*. While we understand that the Board added this project to its agenda to address concerns about the adequacy of disclosures about certain loss contingencies under the existing guidance, we do not support issuance of the ED as drafted, because we believe that the costs of application far exceed the benefits. In that regard, we have significant concerns regarding the operationality and auditability of the proposed guidance. Therefore, we recommend that the Board reconsider the entire ED, using the approach proposed in the next paragraph.

In our view, the real issue to be addressed is the implementation in practice of existing GAAP, in particular, paragraph 10 of FASB



Statement No. 5. We believe the existing disclosure requirements of paragraph 10 provide most, if not all, of the benefits of the disclosures required in the ED. We believe the users' concerns noted by the Board would be alleviated if more entities provided the quantitative information required under paragraph 10 of Statement 5. Accordingly, we believe a more productive approach to use as a starting point in this project would be for the FASB to convene roundtables, with representatives of preparers, auditors, attorneys, users, and regulators, to discuss current practice under paragraph 10 of Statement 5 and the existing obstacles to more informative disclosures. Based on the knowledge gained from those roundtables, the Board could develop appropriately focused remedies, which might include an amendment to paragraph 10 or additional guidance about when an amount can be reasonably estimated. The Board might also enlist the assistance of the AICPA or other professional organizations to develop a practice aid on best practices in disclosures of contingencies.

As loss contingencies related to potential litigation are the primary focus of the ED, we are surprised that the ED does not refer to the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, which sets the standards for communications between an entity's legal counsel and its auditors. We believe that the Statement of Policy would not allow attorneys to corroborate much of the information required by the ED. Without direct communication with the attorneys, auditors would have no way of assessing the reasonableness of loss contingency disclosures related to legal issues. Even if the Statement of Policy were reworked prior to the effective date, we suspect that many attorneys would be unwilling or unable to provide the required information. Furthermore, because of concerns about attorney-client privilege, we believe attorneys often may be



reluctant even to provide the information required by the ED to their clients.

Although we believe the best course of action would be to reconsider the entire approach reflected in the ED, we have answered the questions for respondents and provided specific suggestions in case the Board decides to proceed to a final Statement. Our specific comments follow below.

- 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?**

We do not believe the ED meets the aforementioned objective. The benefits of certain disclosures such as the estimated maximum exposure and information on contingencies for which the likelihood of loss is remote are not clear to us. The ED does not address why these amounts are considered relevant, except to say that certain users want the information. Concept Statement No. 2 states that "information is relevant to a situation if it can reduce uncertainty about the situation." We do not understand how disclosure of a "highly uncertain estimate" satisfies this condition.

In many cases, we believe entities will be unable to obtain



the required information. For certain contingencies related to litigation, the primary source for determining the amount or probability is the entity's external legal counsel. Under the ABA Statement of Policy adopted in 1975 (after a long period of negotiation with the accounting profession), attorneys are cautioned against providing information that a) might be considered a waiver of attorney-client privilege or b) might be treated as an admission or be otherwise prejudicial to the client. The Statement of Policy continues to conclude that "as a general rule, it should not be anticipated that meaningful quantifications of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation." More specifically, the Policy states that "[i]n view of the inherent uncertainties, the lawyer should *normally refrain from expressing judgments* as to the outcome [of litigation or unasserted claims] except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote'." (emphasis added) In that context "probable" means the "prospects for success by the client in its defense are judged to be slight" and "remote" means "prospects for success by the claimant are judged to be slight."

In discussing situations where the lawyer is asked to estimate, in dollar terms, the potential amount of loss or range of loss where the outcome of an unfavorable outcome of a case is not deemed to be remote, the Policy goes on to say that "[i]n such a case, the amount or range of possible loss will *normally be as inherently impossible to ascertain*, with any degree of certainty, as to the outcome of the litigation. Therefore, it is appropriate for the lawyer to provide an estimate of the amount or range of potential loss



(if the outcome could be unfavorable) only if he believes that the *probability of inaccuracy of the estimate of the amount or range of potential loss is slight.*” (emphasis added). The Commentary supporting the Policy states that “the total costs and damages that ultimately might be assessed against a client will, in most litigation, be a subject of wide possible variance at most stages; it is in rare cases where the amount is precise and where the question is whether the client against which the claim is made is liable either for all of it or none of it”. The Policy goes on to say that “[t]he considerations bearing upon the difficulty in estimating loss (or range of loss) where pending litigation is concerned are obviously even more compelling in the case of unasserted possible claims. In most cases, the lawyer will not be able to provide any such estimate to the auditor.”

The Policy deals with attorneys’ communications with auditors. We believe that the Policy, and concerns about attorney-client privilege, may affect the willingness of attorneys to provide information to clients, knowing that the clients will disclose the information in the notes to financial statements. If an entity’s external legal counsel is unable or unwilling to provide guidance, we don’t understand how an entity will be able to prepare the required disclosures or support those disclosures to their auditors.

In situations where the entity is able to obtain the necessary information, we believe significant out of pocket costs would be incurred. Many entities, especially smaller companies, lack the internal resources to appropriately calculate the required information and would need to hire external resources at additional cost.



We disagree with the Board's assertion in paragraph A36 that "many entities already have the information necessary to fulfill these disclosure requirements and that including the information should not require substantial additional cost or effort." While this might be true for certain qualitative information, we doubt that many entities have an estimate of the maximum exposure when that amount is not already known. This is particularly applicable to class actions, which have imprecise parameters, usually involve highly speculative theories of damages, and where useful information about potential exposure may not be obtainable. If entities do have such estimates, we believe those amounts should be considered in providing the disclosures of the estimated loss required under paragraph 10 of Statement 5.

Disclosure of certain information might have a detrimental effect on the outcome of the contingency. While the Board proposes a limited exemption for certain prejudicial information, the Board does not appear to have considered in the cost-benefit analysis the cost of disclosing prejudicial information not covered by the exemption. See our further comments on this topic in No. 8 below. In the absence of a conceptual framework for disclosures, we believe a critical and robust cost-benefit analysis is crucial for determining which disclosures should be required. In our opinion, the proposed standard does not adequately identify the benefits associated with the required disclosures and fails to consider certain costs.

- 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?

We do not object to the Board's ED to include obligations resulting from withdrawal from multiemployer plans for the portion of unfunded benefit obligation. We are not aware of significant practice issues on this topic, but in general we believe scope exceptions should be kept to a minimum.

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?

We do not believe disclosure should be required when likelihood of loss is remote, regardless of when the contingency is expected to be resolved or whether it could have a severe impact on the entity's financial statements. We don't believe that many entities currently gather this information, because it is not useful for managing the business; therefore, we fail to see how these disclosures are relevant or meaningful to users. We believe there would be significant costs associated with quantifying remote contingencies. As noted above, we question the operability of the requirement with respect to litigation contingencies, as an entity's outside attorney will generally be unwilling or unable to provide the necessary quantitative



guidance (which would likely render unauditable any disclosure prepared by the entity even if it could do so) and the entity will typically lack the required resources or expertise to provide the information independently.

We are concerned that this disclosure likely would become a lengthy list of useless boilerplate like many “risk factors” disclosed in SEC filings. For example:

- Every entity that enters derivatives transactions might have a rogue trader who has entered unauthorized transactions that will be revealed within 12 months.
- Every grain elevator, miller, sugar refiner, etc., might have a hazardous buildup of explosive dust because of a malfunctioning system or employee neglect that will result in an explosion within 12 months.
- Every grocer might have contaminated food on its shelves that will cause death or serious illness within 12 months.

In addition, we note that this proposed requirement represents an inconsistency with IFRS, creating another hurdle to convergence that, to us, seems unnecessary.

Finally, it should be recognized that the terms “severe impact” and “near term” as used in SOP 94-6 are applied to concentrations, which are far easier to identify and corroborate than the contingencies covered by the ED and which do not require quantification of hypothetical amounts. As such, there is substantially more “margin for error” in using those terms to develop the disclosures under the SOP. Because of the substantial judgment needed to apply those terms to the disclosure of remote contingencies under the



ED, the likelihood of a financial statement user to second guess the absence of any such disclosures is significant, creating the potential for an additional litigation contingency.

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.

- Do you believe that this change would result in an improvement in the reporting of quantitative information about loss contingencies? Why or why not?**
- 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?**



- **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?**

We agree that the disclosures would improve financial reporting if the amounts are known or can be reasonably estimated, but this is already required by paragraph 10. However, we generally disagree with the requirement to disclose the estimated maximum exposure when no claim or assessment amount is known.

When claim amounts are known, or are limited by contractual or legal factors, we believe the amounts can be determined and disclosed with little or no cost. On the other hand, when the amounts are not available or readily determinable, we don't believe that many entities currently gather this information, because it is not useful for managing the business. We believe the costs required to provide the information far outweigh any perceived benefits of disclosing highly uncertain estimates. We are concerned that companies will be unable to reasonably determine and support such a disclosure without the assistance of external legal counsel. We also question the relevance of such a disclosure in situations where the estimate is not based on any verifiable evidence and is considered an unlikely outcome. Further, in cases in which the plaintiff has not quantified a claim (which would include all unasserted claims plus many asserted claims), disclosing the reporting entity's estimate of its maximum exposure would likely be



beneficial to the plaintiffs and, therefore, detrimental to the reporting entity.

We believe disclosure of the possible loss or range of loss, as currently required by paragraph 10 of Statement 5, provides the most relevant information to users of financial statements. Since we believe this amount to be relevant, the costs to provide the disclosure are more likely to be justified. However, we believe there are many situations, particularly in the early stages of litigation, in which it is simply not feasible to require an entity to calculate and disclose this amount when it cannot be reasonably estimated. Also, we believe that attorneys would be reluctant to provide this information unless the stringent tests in the ABA Statement of Policy are met.

We do not understand why the Board would not require (rather than make optional) disclosure of the entity's estimate of the reasonably possible loss or range of loss, considering this disclosure is currently required by paragraph 10 of Statement 5. It appears as though the Board may be requiring disclosure of the maximum exposure to induce entities to voluntarily disclose their best estimates. In other words, an entity would feel compelled to disclose its best estimate of the loss to de-emphasize the maximum exposure when that amount is not representative of the entity's actual exposure. We disagree with this approach and prefer that the accounting guidance continue to straightforwardly require the disclosure considered to be most relevant.

As we've noted above, if users are concerned with the



manner in which Statement 5 has been applied, we believe it makes more sense to correct the source of the problem – the implementation of paragraph 10 of Statement 5. In that regard, we recommend that the Board provide guidance on when it believes an amount can be reasonably estimated. For example, the following situations would indicate that the range of loss can be reasonably estimated:

- The amount of the claim or assessment against the entity is known
- Maximum exposure is limited by contractual, legal, or other factors
- Entity’s past history of similar situations provides a basis for estimating the amount of the loss.

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?

Except in cases where exposure is limited by legal or contractual considerations, we do not believe this requirement is operational. As we stated above, the primary source for information related to litigation is an entity’s external legal counsel, who will ordinarily be unable or unwilling to provide an estimate of maximum disclosure under the terms of the ABA Statement of Policy. In the absence of counsel’s legal expertise, entities might have no reasonable method for determining a maximum amount of exposure.

Even in those rare instances where an entity’s external legal



counsel is willing to provide a dollar amount to the client, we believe counsel would be unwilling to provide corroborative evidence to the auditors. If counsel refused to corroborate the disclosure, an auditor would have no way to verify the reasonableness of the amount.

- 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?**

We agree that disclosure of settlement offers should not be required. Settlement offers span a spectrum. Some are “fliers” to “test the waters,” with little expectation that the other side will respond favorably. Others are more developed, after extensive discussions with the other side. However, we believe the existence of settlement offers should naturally be considered in determining an entity’s estimate of reasonably possible loss or range of loss.

- 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?**

We agree that the tabular reconciliation would provide



useful information when recognized contingencies represent a significant component of the entity's financial position, provided the disclosures are not prejudicial to the entity. This is also consistent with the Board's position in other projects

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?

We agree that an exemption for prejudicial information should be provided, but we believe that it should be broadened. We believe entities and their legal counsel often will be unwilling or unable to disclose the required information because of the potential detrimental effect on the outcome of the contingency.

As further explained below, we believe the exemption is too limiting to be effective. Currently, the exemption only allows an entity to forgo disclosing:

- The entity's qualitative assessment of the most likely outcome of the contingency
- Significant assumptions made by the entity in estimating the amounts disclosed in paragraph 7(a), and
- A qualitative and quantitative description of the terms of relevant insurance or indemnification arrangements that could lead to recovery of some or all the possible loss.

We believe the exemption should be expanded to all quantitative disclosures required in the ED, not just the three



items above. The ABA Statement of Policy indicates that a “danger inherent in a lawyer’s placing a value on a claim or estimating the likely result, is that such a statement might be treated as an admission or might be otherwise prejudicial to the client.” This would appear to apply to any quantitative information that might be discernable by a plaintiff from the aggregate information.

The exemption should not be permitted for items that are a part of the public record. Entities should always be required to disclose the qualitative description of the contingency, how it arose, the legal or contractual basis, and its current status, as we don’t see how any of that information would be prejudicial. The remaining disclosures should be provided unless they are prejudicial, in which case, the entity should disclose that certain items have not been provided if their disclosure could adversely affect the outcome of the contingency or waive attorney-client privilege.

If the Board does not agree with our recommendation to expand the exemption for prejudicial information, we believe the exemption should be revised to clearly state which disclosures can be omitted if the information is deemed prejudicial. We find the current wording of the exemption to be confusing. Among other things, we believe that the tabular reconciliation should not be disclosed at all if it excludes prejudicial information. That is, presenting a tabular reconciliation that excludes prejudicial information but includes information that is not prejudicial and, as a result, does not tie into the financial statements, would not be useful and should not be required.



- 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?**

As noted above, we do not believe the two-step approach will be effective and recommend the exemption be expanded to apply to all quantitative information.

Aggregation of the paragraph 7 disclosures is not helpful when an entity has a single significant contingency or few contingencies which would be easily identified and could be prejudicial to the entity. We believe this is the case with most entities that report under US GAAP, especially small and privately held entities.

Even for a large entity that is exposed to substantial litigation, several law firms have suggested that plaintiffs could use discovery to obtain the case-by-case detail behind the aggregated disclosures.

- 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 currently provided in the ED, we do not agree that these situations will be rare, let alone extremely rare. To the contrary, we believe an entity and its legal counsel will often consider the types of disclosures required by this ED to represent information that could adversely affect the outcome of the contingency if disclosed. Companies in the US operate in a highly litigious environment, which has little prospect of convergence with the environment in other countries, and any disclosure made in the financial statements could be perceived as an acknowledgement of liability and be admitted as evidence against the reporting entity. Further, the Board should recognize that the vast majority of entities that report under US GAAP are relatively small and, if they have litigation exposure, probably have only one significant case. Accordingly, we recommend the Board omit the word *rare* from the exemption.

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?

We agree with the Board's description, but recommend the Board expand the description of prejudicial information to include information whose disclosure could be considered a waiver of attorney-client privilege.



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?

We believe it is operational to present the tabular reconciliation for interim and annual reporting periods, but the disclosure for interim periods is probably not particularly relevant. We don't believe the Board provides a convincing rationale for why it believes the disclosure should be presented in interim reporting periods, particularly given that the Board reached the opposite conclusion in FASB Interpretation No. 48.

We observe that the provision allowing contingencies that arise and settle in the same period to be omitted from the reconciliation creates a difference in accounting treatment based solely on the timing of the contingency. For example, for a calendar year end company, a significant contingency arising on January 3 that settles on March 30 would not be included in the quarterly table while a contingency arising January 6 and settling April 2 would be included in the table.

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?

We do not believe other information about loss contingencies should be required.



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?

We believe the proposed effective date is unworkable. As noted previously, most entities do not currently compile information for some of the required disclosures, such as maximum exposures and information about remote contingencies, because it is not useful for managing the business. Entities will require substantial time to gather that information. In addition, entities will require substantive consultations with their external legal counsel to determine what information might be considered prejudicial. Finally, and most importantly, until and unless the ABA Statement of Policy is updated, there will be no effective way for auditors to gather sufficient appropriate audit evidence about litigation contingencies.

We also observe that ED would require the tabular reconciliation in the year of adoption, effectively requiring the entity to apply the provisions to periods prior to the effective date. We believe this is impractical and recommend the Board waive this requirement in the year of adoption.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Ben Neuhausen at 312-616-4661.

Very truly yours,
s/ BDO Seidman, LLP