

FASB
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Re: Disclosure of Loss Contingencies 450 File 1840-100
By: Dr. Joseph S. Maresca CPA, CISA

Colleagues,

Thank you for the opportunity to critique the Disclosure of Loss Contingencies as enhanced.

Background:

During the early stages in the life of a loss contingency, a determination should be made regarding the nature of the loss, its magnitude and the timing. IAS 37 has provisions for contingent liabilities and contingent assets with similar requirements. The FASB seeks to find out a number of things regarding the disclosure of loss contingencies like the auditability, operational feasibility and enhancement of disclosure to readers of the financial statements who rely. There is a broadening of the requirement with regard to the potential magnitude and timing of future cash outflows for contingencies.

Management is precluded from netting insurance recoveries against the accrual for loss contingencies for a very obvious reason. Smaller companies may ask that they be allowed to take insurance recoveries into account for practicality reasons. Related litigation disclosures can be problematic because legal counsels may be very reluctant to admit any liability publicly.

The environmental loss contingency schema has been expanded understandably in light of the recent Gulf Oil Spill.

715-80 Compensation for Retirement Benefits for Multiple Employer Plans has been expanded as to the required disclosure threshold for withholding which gives rise to remote contingencies that meet the threshold for disclosure.

An employer participating in a multi-employer plan shall recognize as net pension cost or net periodic post retirement benefit cost, the required contribution for the period, which should include both cash and the fair market value of non-cash contributions, and shall recognize as a liability any unpaid contributions required for the period. I concur.

For contingencies having a severe impact, the threshold may be increased for material items. pp. 7 The determination of a loss contingency involves the probability that an asset has been impaired or liability created as at the financial statements or thereabouts. The date and amount of the loss can be estimated. The purpose of the disclosure requires an accrual of losses when reasonably estimable and related to the current or a prior period. **I concur.**

As more information becomes available about the catastrophic event, more detailed disclosures may be made to inform users of the financial statements. Matters that are catastrophic are those which may result in bankruptcy. Disclosure is preferable to the accrual when a reasonable estimate cannot be made. **I agree.**

450-20-50 The disclosure threshold is reasonably possible but greater than

remote that a loss has occurred. The potential impact to the entity operations and cost to defend its contentions to resolve the contingency are known or can be estimated. P. 10 The amount claimed by the plaintiff's expert witness is known. P. 12 The entity's estimate of probable liability in the near term is reasonably possible. P. 13 Event losses cannot be grouped together with different timings. P. 25. **I agree.** This section would be clarified to apply to product warranties including disclosures in the proposed amendments.

An expropriation must be imminent and the compensation must be less than the carrying amount of the asset to trigger a loss disclosure. **I agree.**

450-20-55-15 The assertion of a claim must be probable or reasonably estimable. **I agree.**

450-20-55-23 The complete damages at trial are indeterminate, although a range of claims may be constructed.

805-20 Business Combinations - Identifiable Assets, Liabilities and any Non-Controlling Interest: Disclosure of loss contingencies as they arise from business combinations would be set forth in the new amendment.

825-10-50 : Certain entities must disclose the fair value of their financial guarantees issued. An entity must disclose a contingent loss subject to the threshold guidance. **I agree.** Disclosure of 815 guidance relates to guarantees under derivatives.

470-60-50-2: Troubled Debt Restructurings: A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to 470-60-35-7. The debtor should disclose conditions under which the amounts would become payable or be forgiven. **Generally, I concur** that amounts contingently payable should be fairly disclosed to the extent determinable (practically) by the debtor and included in the carrying amount of a restructured payable.

Critique:

Entities are faced routinely with **loss contingencies**. For example, Aramco, the Gulf Oil Spill and others involved significant efforts to contain oil spills, extract usable oil and cleanup the environment thereafter. Catastrophies can happen in other arenas like nuclear power incidents. Major earthquakes can trigger horrendous contingencies along earthquake faultlines like the New Madrid fault line.

Initially, an early estimate of probable losses can be made with refinements as more information becomes known. All of these types of events trigger massive staff commitments over long periods of time. In addition, property damage and site reconstruction are related costs which must be incurred for the foreseeable future. The environmental loss contingency disclosure is intended to provide users of financial statements with more pertinent disclosure.

Loss contingencies can occur in situations where natural riparian rights have been impaired by a user(s) upstream. For instance, the builder of a dam may restrict water destined for common users downstream. International precedent favors downstream users if an upstream user alters the natural course or flow of the water by some manmade device or instrumentality. What could be the remedy? The remedy could involve dismantling the dam so that the natural flow of water remains undisturbed to the common users downstream. This dam deconstruction could involve

tremendous engineering costs, as well as risks due to the unleashing of millions of gallons of water back into the natural contour of the water flow in order to restore riparian rights to the downstream users.

Loss contingencies may be realized due to a lack of an operable and tested disaster recovery and business resumption plan in nuclear power operations.

815 Guidance Relating to Guarantees Under Derivatives

Strategically, the FASB seeks to promote disclosure of derivative instruments by underlying risk i.e. interest rate, credit, foreign exchange stability or overall price. This information provides users of the financial statements with more informed data about the nature of risks and volatility in the different forms. Interest rate risks fluctuate in response to the Federal Reserve control over the money supply and the economic environment of inflation, deflation, a normalized money supply and the cost of money in the USA. Overseas, interest rates are impacted by the governing actions of bourses and the expectations of foreign investors, as well as governmental activities/dispositions.

Credit risks are a function of credit scoring criteria of the major agencies, past collection experience and overall investment portfolio exposure. Foreign exchange risks are a function of currency stability. A stable currency will have a fairly predictable expectation by investors. An unstable currency will be the subject of very risky speculation with gains to the insiders and losses to the investor public . A systemic instability may be due to governmental crises or expropriatory tendencies.

All of these factors come together in arriving at an overall profile which fairly depicts the financial environment of hedging activity, the determination of notional amounts, fair valuation of derivative instruments and the constancy of investor expectations. **Contingency features are a factor in derivative instrument payment acceleration clauses. These derivative instrument contingencies also attain for major contingent features and material adverse change clauses in arriving at a net liability position.** The going concern concept may be enhanced with normalized capitalization ratios, obtaining additional capital contributions, formulation of a derivative business strategy, increasing new capitalization and the involvement of major shareholders in affirming existing commitments or making new ones.

[It is difficult to generalize on what a proper capitalization ratio should be. An indicator on either side of 35% is fairly typical for larger companies.]

Signs of increased risk include major increments in non-accrued loans, increases in related party transactions, the probability that preferred shareholders will exercise liquidation rights and the existence of major options under Executive Plans. Well-founded assumptions of the ongoing concern concept include lower or normalized capitalization ratios, stability of capital contributions, **a superior derivative business strategy**, rational increases in new contributions of capital and the overall contentment of major shareholders and the investor public.

The management of derivative instruments and hedging takes on an important dimension in major Quasi-Reorganizations in bankruptcy. Major reorganizations require the dating of retained earnings for 10 years and additional disclosure and monitoring of plan reorganization requirements. The purpose of a quasi-reorganization is to provide the entity with a rational second chance. The management can direct its business activities to a more profitable genre. Financial activities can be shed when there is a strong causative connection to the bankruptcy condition which occasioned the need for a quasi-reorganization.

In this light, a rational management of derivative activities and a more heightened risk averseness is in order. Forward contracts may be made to lock in interest rates on the issuance of debt. Hedging seeks to manage the underlying interest paid on debt through interest rate swaps . The management of fixed and floating rates is another issue in debt portfolio strategy. When deficit retained earnings are too high i.e. > 40% of capital contributions, , the entity is critically undercapitalized. There may be a need for a Capital Restoration Plan and no dividends may be paid without prior approval of governmental or quasi-governmental agencies; such as the FDIC. Concurrent with the need for a rational Capital Restoration Plan is the need for a strategic plan to manage and disclose derivatives and their impact on the entity financial position, results of operations and cash flow.

Disclosure is required of the aggregate fair value of assets to be posted as collateral. Timely collateral valuation, volatility of collateral and double counting of collateral are all problematic areas requiring a heightened audit awareness.

The disclosure of the existence of contingent features is encouraged. Circumstances which trigger the contingent features at the end of the period are another important disclosure to the readers of financial statements and the investor public because they document the conditions precedent to rational expectations of the strategic constituencies of an entity.

Environmental Loss Contingencies:

The EPA has issued guidance which explains the environmental footprint of the various energy sources from the highest energy consumers to lower level ones. These guidelines may be used to clarify the environmental costs and overall impact.

*Source: [http://epa.gov/climate change/emissions/co2/human/htm](http://epa.gov/climate_change/emissions/co2/human/htm)
www.epa.gov*

Extrapolating from this estimate of the EPA, most industrial entities should fall within the following band:

Fossil Fuel Consumption at 160 units

Non-energy use of fuels at 140 units

Natural Gas Systems at 26 units

Muni Solid Waste at 25 units

Annonia Production and Urea Consumption at 13 units

Other at 5 units

Totals = 369 units

369/519 = 71% of all emissions

The remainder of the emissions deal substantially with manufacturers. i.e. Iron and Steel Production, Cement Manufacture, Lime Manufacture, Limestone/Dolomite Use, Aluminum Production and Petrochemical Production . Cropland may be disaggregated, as well.

Practically speaking, these estimates provide a quantifiable benchmark for GHG emission discussions on the financial statements .