



August 7, 2008

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

File Reference No. 1600-100

Dear Mr. Golden:

We appreciate the opportunity to comment on the Exposure Draft of the proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements No. 5 and 141(R) (the "Exposure Draft"). Huron Consulting Group helps clients address complex challenges that arise in litigation, disputes and investigations. Huron provides services to a wide variety of organizations, including Fortune 500 companies, medium-sized businesses, leading academic institutions, healthcare organizations, and the law firms that represent these various organizations.

We agree with the FASB's objective of improving disclosures of loss contingencies; however, we do not believe the Exposure Draft will achieve that objective. We believe the FASB should not issue a final standard for the following reasons, which we discuss in further detail below:

- We are concerned that the proposed qualitative disclosures in the Exposure Draft require information that may be prejudicial to the reporting entity and could, in a worst-case scenario, result in a waiver of the attorney-client privilege.
- Because of potential issues over privilege waivers and prejudicial information, we question whether auditors will be able to obtain information necessary to audit the proposed required disclosures. Given the realistic possibility that attorneys will not provide the information that supports the qualitative and/or quantitative disclosures, what should an auditor do to obtain the information it needs to support its opinion? The auditing standards note that information obtained from in-house counsel is not a substitute for information that outside counsel refuses to provide. It appears the Exposure Draft is creating a potential for conflict between the responsibilities of auditors to users of financial statements and the responsibilities of attorneys to their clients.

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• The proposed disclosure of loss contingencies where the reporting company has concluded that likelihood of an adverse outcome is remote is not consistent with the disclosures required under International Financial Reporting Standards ("IFRS"). We also question the usefulness to investors of that information.

If the Board issues a final standard, we believe the scope of that final standard should exclude loss contingencies arising from litigation for the reasons stated above. In addition, we believe the Board should consider the following matters if it intends to issue a final standard:

- We believe the FASB should provide application guidance on how companies are to assess whether the resolution of the contingency would have a "severe impact". If the Board concludes application guidance is not necessary, we believe it should delete the reference to "financial position, cash flows, or results of operations" in paragraph 6(b) of the Exposure Draft in order to mirror the discussion in AICPA Statement of Position No. 94-6, Disclosures of Certain Significant Risks and Uncertainties. SOP 94-6 focuses on the effect of the event on the normal functioning of the entity, not on any particular financial statement.
- We do not believe the final standard should require a company to estimate the maximum amount of a loss contingency arising from litigation when the plaintiff has not specified a claim.
- We believe the final standard should not require the quantitative and qualitative
  disclosures on a quarterly basis. The time and effort to prepare the qualitative and
  quantitative disclosures quarterly could negatively affect a public company's ability
  to meet its accelerated filing deadlines. We believe the SEC's existing rules requiring
  a company to update disclosures when material changes have occurred from the
  previous years' Form 10-K should be sufficient to provide users with relevant
  information.
- If the Board does not exclude loss contingencies arising from litigation from the scope of the final standard, we believe companies will require additional time for adoption. We believe the proposed effective date may not be achievable as companies will need to have their attorneys review the proposed disclosures to ensure they are not disclosing prejudicial information or information that could result in the company inadvertently waiving privilege. For larger companies with multiple loss contingencies arising from litigation, that process could take a significant amount of time.

Based on the discussion in paragraph A3 of the Background Information and Basis for Conclusions, it appears that financial statement users are alleging that companies are not complying with the disclosure requirements of FASB Statement No. 5, Accounting for Contingencies. If that truly is their concern, we do not understand how increasing the amount of information that companies are required to disclose addresses the fundamental complaint about the timeliness and adequacy of disclosures companies currently provide. Before proposing new rules that don't appear to address users' fundamental concerns, we believe the Board and its staff should first attempt to determine if, in fact, companies are not correctly interpreting or applying the existing guidance in Statement 5. If the Board

finds this to be the case, then it should seek to determine the reasons for the noncompliance. If the Board identifies problems with interpretation or application, it should issue a standard that addresses those problems.

We discuss each of our concerns in more detail in the remainder of this letter.

# Required Disclosures May Result in Waiver of Privilege or Be Prejudicial to Reporting Entity

We are concerned that the proposed disclosures will result in a reporting entity providing information that will prejudice its case or, worse, providing information that results in a waiver of privilege. In its June 24, 2008 publication, "FASB Proposes Amendments to SFAS No. 5, Accounting for Contingencies, That Raise Serious Concerns," Gibson, Dunn & Crutcher LLP identified the following concerns with the proposed disclosures in the Exposure Draft:

- 2. The required qualitative disclosures may reveal the company's thinking and strategy for dealing with the claim. The required disclosure of the company's "qualitative assessment of the most likely outcome,...the anticipated timing of [the claim's] resolution...and the significant assumptions made by the [company] in estimating the amounts disclosed" runs the risk of revealing aspects of the defendant company's thinking that historically have been carefully guarded in adversary proceedings.
- 3. The disclosures themselves may constitute admissible evidence or affect the course of the action. These required estimates and disclosures may be found to be admissible in evidence against the company in the proceeding itself or they may alter the outcome of the proceeding by change the course of settlement discussions or other outcome determining matters.
- 4. The proposed disclosure may lead to waivers of the attorney/client privilege and the lawyer's work product immunity. Since the required disclosures may be based on confidential communications between companies and their counsel who are handling the matter under consideration, there is a risk that the disclosures will constitute waivers of the attorney/client privilege or work product immunity. In addition, since independent auditors will likely want to test these estimates and disclosures as part of their audit work, there may be increased pressure for them to seek detailed information from counsel in the course of their work that will also pose waiver risks.

In addition to the concerns raised by Gibson, Dunn & Crutcher, we are aware of one case (*U.S. v Gulf Oil Corporation*, 760 F 2d 292 (Temp. Em. Ct. App. 1985)) where disclosure of information about a company's liabilities to an auditor did result in a waiver of privilege.

We are concerned whether the exemption from disclosing prejudicial information in paragraph 11 of the Exposure Draft will be sufficient. It seems clear that companies will need to apply the exemption to disclosures about loss contingencies arising from litigation, but it is not clear how a company would aggregate the disclosures required by paragraph 7 of the Exposure Draft at a level higher than by the nature of the contingency. If by aggregating the disclosures at a level higher than by the nature of the contingency the Board means, for example, combining all loss contingencies arising from litigation, we do not believe the exemption will be sufficient to avoid disclosing prejudicial information, particularly when a company is a party to a significant lawsuit. Contrary to the discussion in paragraph 11 of the Exposure Draft, we do not believe it will be rare that a company will conclude that the disclosures would result in prejudicial information, particularly given the U.S. legal environment. Finally, as discussed further below, we have concerns over requiring companies to estimate the maximum amount of a claim, even when the plaintiff has not made a demand.

While we understand the desire of financial statement users for more information regarding a company's loss contingencies, we do not believe the benefits of the proposed disclosures are worth the increased risk that the disclosures will expose current investors to losses by disclosing information that potentially prejudices the entity's case or results in a waiver of privilege. We believe the FASB should work with representatives of the American Bar Association to determine what information a company could provide that would neither prejudice the reporting entity's position <u>nor</u> create a waiver of attorney-client privilege before it issues further guidance on required disclosures of loss contingencies arising from litigation.

## Auditor's Request for Information

In order for an auditor to test the proposed disclosures, they will need to obtain information from outside counsel representing the company. The American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (the "Statement of Policy"), issued in December 1975, provides the following guidance on the information the attorney may provide to the auditor:

The information that lawyers may properly give to the auditor concerning the foregoing matters would include (to the extent appropriate) an identification of the proceedings or matter, the stage of proceedings, the claim(s) asserted, and the position taken by the client.

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote."

<sup>&</sup>lt;sup>1</sup> The Statement of Policy defines "probable" and "remote" differently than does Statement 5. For example, the Statement of Policy defines probable as when "an unfavorable outcome for the client is probable if ... the prospects for success by the client in its defense are judged to be slight."

The lawyer also may be asked to estimate, in dollar terms, the potential amount of loss or range of loss in the event that an unfavorable outcome is not viewed to be "remote." In such a case, the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as 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 should be unfavorable) only if he believes that the probability of inaccuracy of the estimate of the amount or range of potential loss is slight.

Based on the Statement of Policy, the information that attorneys can provide is consistent with the current Statement 5 disclosure requirements. However, the proposed qualitative and quantitative disclosure requirements go well beyond the information the Statement of Policy permits attorneys to provide. This may result in an attorney refusing to provide the auditors with the requested information. We encourage the Board to discuss with the American Bar Association the information attorneys can provide before changing the disclosure requirements. We do not believe creating conflict between an attorney's responsibilities to its client and an auditor's responsibility to obtain information to support its opinion on the financial statements will serve anyone's interests, especially financial statement users.

### Disclosure of Contingencies Where Likelihood of Loss is Remote

Given the AICPA's recognition of the International Accounting Standards Board ("IASB") and the increasing likelihood that the SEC will either allow or require US public companies to adopt IFRS, we are concerned that the Exposure Draft would create divergence between US GAAP and IFRS. In particular, the Exposure Draft would require disclosure of certain loss contingencies for which the likelihood of loss is remote. IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, does not require disclosure of such loss contingencies. We believe the FASB should strive to eliminate differences with IFRS rather than creating new differences.

In addition, we are struggling with the relevance to investors of information about contingencies for which the likelihood of loss is remote. We do not believe that the proposed disclosures will provide users incremental information about the timing and amount of cash flows, nor does the Exposure Draft explain the benefit of these particular disclosures to investors. The additional disclosures do not change the likelihood that the company will incur a loss. If the intent is to provide users with information they can use to test management's conclusion, we don't believe the Exposure Draft will achieve that objective. We do not believe the benefit of such a disclosure will outweigh its cost.

## **Definition of "Severe Impact"**

Although companies have experience applying the "severe impact" threshold in the context of the disclosures of concentrations required by SOP 94-6, we believe the Board should provide guidance on the application of the threshold to loss contingencies arising from litigation. In the absence of application guidance, we are concerned that diversity in

practice will result, with some companies considering the effect of an adverse outcome on net income, but others assessing the impact on liquidity or some other measure.

Our concern relates to the reference in the Exposure Draft to the "impact on the entity's financial position, cash flows, or results of operations." Does that mean a company should assess the potential impact against each of the basic financial statements? If so, a company might still be required to disclose a contingency that would not have a significant impact on its liquidity if the potential loss would be significant to net income. To avoid confusion, we believe the Board should mirror the condition described in paragraph 6(b) after the discussion in SOP 94-6.

## Estimating the Maximum Amount of a Claim

We do not understand the benefit to users of requiring a reporting entity to estimate its maximum exposure to loss when a plaintiff has not specified a claim against the entity, and we are concerned that disclosing an estimate of the maximum loss on a claim when the plaintiff has not done so may be prejudicial. We are also concerned with the quality of such an estimate, particularly early in litigation before the company has completed substantive discovery. The company usually only starts to understand its possible exposure to loss after a lengthy review and analysis. Disclosure of estimated loss amounts would be premature and could affect the course of the action.

# Proposed Disclosures May Not Meet the Objective of the Exposure Draft

The Exposure Draft's objective is to "provide disclosures to assist users of financial statements in assessing the likelihood, timing and amount of future cash flows associated with loss contingencies." We do not believe the proposed disclosures provide enough detail to convey the complexities of pending litigation, nor could they ever provide enough detail to convey those complexities without being overly legalistic. Because users of financial statements cannot be expected to understand the nuances of the legal system as well as an attorney, we are concerned they will not fully appreciate the qualitative disclosures and will reach conclusions that are not supported by a full analysis of the facts and circumstances of a particular case by one with an in-depth understanding of the law.

In addition, if a company is able to support the elimination or aggregation of quantitative information through the prejudicial exemption, we do not believe the tabular disclosure will be useful to users, particularly given their concern that amounts recognized in the financial statements are not "transparent."

Finally, the tabular disclosure will require a significant amount of time and effort to complete. We do not believe the benefit provided by the tabular disclosures is worth the effort required for companies to provide these disclosures, particularly if the company omits or aggregates certain information.

### **Interim Disclosures**

We are concerned that updating the proposed disclosures (in particular, the qualitative disclosures) may be difficult to perform in a timely manner, as well as result in increased the cost of preparing financial statements because of the need to involve outside counsel in reviewing the proposed disclosures. We ask the Board to eliminate the requirement that companies provide the full disclosure on a quarterly basis. SEC Regulation S-X, Rule 10-01(a)(5) requires companies to disclose when events occurring subsequent to the end of the most recent fiscal year end could have a material impact. We do not believe the Board should require companies to incur the additional time and cost to provide the disclosures when there has been no material change during the interim period. Finally, the required disclosures may endanger a company's ability to file on a timely basis when considering accelerated quarterly filing deadlines.

#### **Effective Date**

If the Board does not eliminate disclosures of loss contingencies arising from litigation, we do not believe there will be sufficient time for companies with calendar year ends to adopt the final standard, particularly if the Board does not issue a final standard until after it holds a round-table and conducts field-testing. We do not agree with the Board's presumption that the information is readily available, and we believe it will take significant time for companies to work through the privilege and prejudice issues with their outside counsel and for the legal community to reach agreement with accountants on what information they can and will provide.

We believe the Board could lessen the burden on preparers by reaching consensus with the American Bar Association on what information a company can disclose without jeopardizing its chances of success and revising the Exposure Draft accordingly. We believe that approach is preferable to issuing a final standard based on the Exposure Draft and expecting companies to work through the issues with their auditors and attorneys independently within the short timeframe allowed by the effective date of the Exposure Draft.

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We would be pleased to discuss any of our comments with the Board or the FASB staff. Please direct any questions or comments to Jeff Ellis at 312-880-3019.

Sincerely,

/s/ Jeffrey H. Ellis

Jeffrey H. Ellis Managing Director