

August 7, 2008

Technical Director – File Reference No. 1600-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

believe the Board has reached the appropriate balance to meet the objective.



LETTER OF COMMENT NO. 82

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to comment on the FASB Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141 (R) (the proposal). While AcSEC applauds the Board's objective of providing enhanced disclosures related to loss contingencies, we question whether the proposal has gone too far. Our primary concerns are that (1) companies would be forced to disclose numbers that are inherently unreliable and (2) certain of the required disclosures might compromise a company's litigation strategy by providing information to an adversary or causing a breach of attorney-client privilege. AcSEC believes that the benefits of achieving the objectives should be weighed against the challenges to preparers, the legal system, and the capital markets. As drafted, we do not

'e, along with the AICPA's Auditing Standards Board (ASB) are also concerned with the impact of the proposal on an auditor's ability to obtain sufficient appropriate audit evidence regarding management's assertions underlying the proposed disclosures. Management will need to balance the proposed disclosure requirements with its fiduciary duty to protect the interests of the company. The company's legal counsel will undoubtedly be concerned that by disclosing certain information to the auditor and/or including such information within the financial statements, the company may be harming its legal defenses. A letter of audit inquiry to a client's lawyer is often the auditor's primary means of obtaining corroboration of information furnished by management concerning litigation, claims, and assessments. (See paragraph .09 of AU section 337, Inquiry of a Client's Lawyer.) The American Bar Association's (ABA) "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" (December 1975) ("ABA/AICPA treaty") explains the concerns of lawyers and the nature of the limitations an auditor is likely to encounter, and provides guidance to lawyers on responding to auditors' letters of audit inquiry. The information that would need to be developed to comply with the proposed disclosure requirements were not contemplated when the existing audit standards and interpretations and the ABA/AICPA treaty were developed. Lawyers may assert that they are constrained by the ABA Statement of Policy and more generally by attorney-client privilege in responding to auditors' requests for information that would corroborate certain of the proposed disclosures. We believe audit standard-setters need to evaluate the need for revisions to auditing standards and/or for other guidance for auditors. Such a standard-setting project will necessarily involve input from the audit profession, the legal profession, and the preparer community, and may involve a revision of the ABA/AICPA treaty. We believe that project needs to be completed before finalizing the changes to the existing disclosure requirements in FASB Statement No. 5.

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For the primary reasons discussed above, we do not believe the proposal should go forward unless significant revisions are made. In particular, AcSEC recommends that in certain instances, the Statement permit the omission of quantitative information when such information is not reasonably estimable or would be prejudicial to the company. The prejudicial exemption, as currently drafted, does not achieve its objective and should be revised.

That said, assuming the Board was to make the significant revisions we have suggested, we believe the final Standard would benefit financial statement users and would represent an incremental improvement in practice. This is because a more thorough disclosure of facts about a pending contingency will provide meaningful information to investors and will allow a more detailed assessment to be made of the magnitude of such contingencies as well as the potential timing of their resolution.

A more complete response to the Board's specific questions, including AcSEC's recommended alternatives, is included in Appendix A. Representatives of AcSEC (and ASB with respect to auditing issues) are available to discuss our comments with the Board members and staff.

Yours truly,

Ben Neuhausen, Chair Accounting Standards Executive Committee

Brett Cohen, Chair Disclosures of Certain Loss Contingencies Task Force

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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?

AcSEC generally agrees with the Board's objective of providing enhanced disclosures about loss contingencies. However, AcSEC is concerned that the proposed Statement fails to achieve the right balance and that the benefit of some of the required disclosures does not outweigh the incremental costs. In our view, those incremental "costs" include:

- Forcing a company to breach attorney-client privilege and other legal protections,
- Harming a company's negotiating position by disclosing sensitive information,
- Potentially exposing the company to further litigation when disclosed estimates ultimately prove unreliable, and
- Creating undue tension between the auditor and the company's legal counsel as the auditor attempts
 to obtain sufficient corroborating evidence while the attorneys strive to protect their client's legal
 positions. In a worst case scenario, this might cause the auditor to be unable to issue a "clean" audit
 opinion.

In addition, certain structural changes will be required for the proposed Statement to be operational. Chief among those is the development of appropriate auditing guidance, which may involve the renegotiation of the 1975 ABA/AICPA treaty in light of these additional required disclosures.

To make the proposed Statement operational, we recommend that certain changes be made to the proposal, as described below in our responses to the respective questions.

We also recommend that the Board continue to solicit input from affected constituents to help in evaluating the benefits vs. incremental costs of the proposed disclosures. In particular, we would encourage the Board to solicit additional input from long-term investors, as well as from users in the private company marketplace. While certain financial statement users might desire extensive additional information, AcSEC believes that the objective of enhanced transparency in this area needs to be carefully balanced with the legitimate need of a company to avail itself of legal protections (including attorney-client privilege) and not jeopardize its position by providing potentially damaging information to an adversary in a legal proceeding.

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?

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AcSEC agrees with the Board's decision to include within the scope of the proposed Statement obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligation, as we believe it would be more confusing to further segregate what loss contingencies are included in the scope of the proposed Statement.

Similarly, AcSEC believes that additional guidance, aside from that listed in Appendix B of the proposal, may need to be amended to indicate whether such loss contingencies are included in the scope of the proposed Statement. For example, the following standards contain references to items that are accounted for as loss contingencies under FASB Statement No. 5, but are not listed in Appendix B:

- a. FASB Statement No. 43, Accounting for Compensated Absences (paragraph 1)
- b. FASB Statement No. 48, Revenue Recognition When Return Rights Exists (paragraph 7),
- c. FASB Statement No. 71, Accounting for the Effects of Certain Types of Regulation (paragraphs 38 and 45)

Additionally, with respect to the scope of the proposal, we recommend that paragraph 3(c) be rephrased to clearly state that all contingent liabilities related to insurance contracts be excluded. As currently worded, paragraph 3(c) indicates that "liabilities for unpaid claim costs related to insurance" are excluded from its scope; however, we believe the intent of the Board (based on the discussion in paragraph A8) was to exclude *all* contingent liabilities related to insurance contracts and not just those related to unpaid claim costs.

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?

AcSEC believes that an entity should not be required to provide disclosures about loss contingencies for which the risk of loss is remote, notwithstanding the fact that resolution is expected to occur within one year and could be severe. We are concerned that if the final Statement requires a large volume of disclosures related to remote contingencies, there is a risk of boilerplate disclosure (similar to what is often seen in required SEC disclosures of risks and uncertainties). Accordingly, AcSEC recommends deleting the requirement in paragraph 6 of the proposal.

If the Board decides to retain paragraph 6, AcSEC requests that the Board clarify what is meant by "...or combination of loss contingencies..." We assume the Board intended this to apply to situations such as a class-action lawsuit, covering a large numbers of claimants whose cases involve common questions of law and/or fact. However, if left as stated, it is unclear how the Board intends this guidance to be applied.

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- 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?

AcSEC generally agrees with the requirement to disclose the amount of the claim or assessment against the entity; however, in certain instances, disagrees with the requirement to disclose the entity's best estimate of the maximum possible exposure to loss (in the absence of a stated claim or assessment). In particular, AcSEC believes that an estimate of the maximum exposure to loss should only be provided if such amounts can be either determined by operation of law or reasonably estimated. However, in many instances, AcSEC believes that it will not be possible to calculate a reliable best estimate of the maximum possible exposure to loss. This is particularly relevant as it relates to unasserted claims or early stage litigation. Furthermore, the ABA/AICPA treaty currently provides guidance to lawyers not to confirm an estimated settlement amount unless the range provided has "only a slight chance of being inaccurate." Therefore, we recommend that the Board continue to permit disclosure that a reasonable estimate cannot be made, if such a statement is factual.

AcSEC agrees with the Board's decision that disclosing the possible loss or range of loss should be optional because the information disclosed may be prejudicial to the company's position and could create a breach of attorney-client privilege. In AcSEC's view, if management were to provide such information in its financial statements, the disclosures may be used by claimants as a roadmap to settlement and may be admissible evidence in a court proceeding.

However, in cases where a maximum exposure to loss cannot be reasonably estimated, AcSEC recommends that the proposed Statement require disclosure of the entity's best estimate of the loss or range of loss (refer to our response to question 5 below), presuming such amounts would not otherwise be considered prejudicial and thus subject to the exemption.

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Accordingly, in limited circumstances where quantitative information cannot be reasonably estimated or if disclosure of such amounts would be prejudicial, AcSEC believes that no quantitative information would be disclosed. In these cases, AcSEC recommends that the company be required to state that a reasonable estimate of loss cannot be made and the reasons for such omission (refer to our response to question 5 below).

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?

In cases where there is no specific claim amount, AcSEC is concerned that companies may not have the ability to provide a reliable estimate of the maximum exposure to loss in all instances. AcSEC agrees with the Board in requiring disclosure of the claim amount if it is available; however, AcSEC believes that no quantitative disclosure should be provided in cases where the information is not subject to reasonable estimation or is prejudicial to the company. This would be most apparent in cases of early-stage litigation or unasserted claims. Under these circumstances, how does a company reliably estimate its maximum exposure to loss? This requirement is in essence forcing a defendant company to quantify and disclose its potential maximum exposure in an adversary proceeding in instances where the claimant has either been unwilling or unable to quantify the exposure.

Assessments of pending litigation are highly uncertain and subject to factors outside the control of the company and in many cases, litigation tends to be highly dependent on individual facts and circumstances. Furthermore, AcSEC is not sure how meaningful it would be for a company to disclose its maximum exposure to other non-litigation-related loss contingencies.

AcSEC believes that if a specific claim amount does not exist, an entity should only provide quantitative disclosure of the maximum loss if the loss can be determined either by operation of law, or can be reasonably estimated. AcSEC further recommends that if a company cannot reasonably estimate its maximum exposure to loss but can estimate its actual exposure to loss or the range of loss, then those amounts should be disclosed in lieu of the maximum exposure to loss, presuming such amounts would not otherwise be considered prejudicial.

In instances where a company cannot reasonably estimate its maximum exposure to loss, its best estimate of loss, or a range of loss, AcSEC recommends that the company disclose that such estimates cannot be made at that time and the reasons why.

Therefore, AcSEC recommends revising paragraph 7a in the final Statement as follows:

7. An entity shall disclose the following information about loss contingencies required to be disclosed under paragraph 5-or-6:

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- a. Quantitative information about the entity's exposure to loss from the contingency (including any amounts already recognized in the financial statements but excluding potential recoveries disclosed under paragraph 7(c)), as follows:
 - (1) The amount of the claim or assessment against the entity (including damages, such as treble or punitive damages), if applicable
 - (2) If there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss <u>determined in the following manner:</u>
 - Operation of law; or
 - A reasonable basis of calculation.
 - (3) If no reasonable basis exists upon which to develop an estimate of the maximum exposure to loss, an entity shall disclose its best estimate of the possible loss or range of loss;
 - (4) If no reasonable basis exists to quantify either the maximum exposure to loss, possible loss or range of loss, the entity shall state that such estimates cannot be made and the reasons why.

An entity may disclose its best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of the entity's actual exposure.

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?

AcSEC agrees with the Board's decision not to require disclosures of settlement offers made between counterparties in a dispute, as we believe it would be difficult in many cases to accurately convey the relevance of a settlement offer. This could lead to disclosure of potentially misleading information.

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?

When information would not be prejudicial, AcSEC agrees that an aggregated tabular reconciliation will generally allow the user of the financial statements to make a judgment about the company's risk profile and possible future outflows of resources.

As it relates to the interaction of the prejudicial exemption and the tabular reconciliation, AcSEC requests clarification on how the proposal is intended to be applied. For example, if a company is compelled to invoke the prejudicial exemption, does that exempt the company from disclosing a tabular reconciliation in its entirety or will it only exempt the company from disclosing the prejudicial information? If the latter is

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true, then a complete population of recognized loss contingencies will not be captured in the table and the beginning and ending balances will not reconcile to the balance sheet.

On balance, the majority of AcSEC members believe that in cases where disclosure of information in the tabular reconciliation is considered prejudicial, there should be no requirement to disclose an aggregated tabular reconciliation of the non-prejudicial information, as omission of significant (prejudicial) information or cases would cause the table to become potentially misleading to financial statement users.

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?

AcSEC agrees with including a prejudicial exemption in the final Statement; however, we are concerned that the minimum disclosures required, regardless of the use of the prejudicial exemption, may still be prejudicial to a company and its litigation strategy. In addition, AcSEC struggles to see the usefulness of such an exemption in many cases. This is because companies often either have a single case or class of exposures (e.g., asbestos) that pose a significant threat to the company. In many instances, users of the financial statements could decipher those significant cases from others even in the aggregate thereby not solving a company's problem of disclosing prejudicial information.

Additionally, deciding which disclosures meet such an exemption will require a great deal of judgment by preparers, their legal counsel, and their auditors. Auditors will need to consider the type of evidence that will be needed to corroborate management's assertions to support their use of the exemption.

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?

AcSEC generally agrees with the two-step approach, as described in paragraph A27 of the proposed Statement. However, AcSEC questions how aggregation will be applied as it relates to the qualitative disclosures. AcSEC is also concerned that when the prejudicial exemption is invoked, certain of the required minimum quantitative and qualitative disclosures would nonetheless prove to be prejudicial.

As it relates to the first step, it is not clear if the Board intended aggregation to apply to both quantitative and qualitative disclosures. And if it is intended to apply to qualitative disclosures, how would a company go about aggregating to a level higher than by the nature of the contingency, while still providing meaningful information to users?

In regards to the second step, AcSEC believes that even after applying the prejudicial exemption, the minimum quantitative and qualitative requirements could still be prejudicial to the outcome of the contingency. AcSEC recommends the removal of some of the less generic mandatory disclosures prescribed in paragraph 11 of the proposed Statement that "in no circumstances may an entity forgo disclosing." In particular, AcSEC is concerned that the following minimum disclosures could indeed be prejudicial:

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- An estimate of the entity's maximum exposure to loss, and
- A description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact to the outcome
- 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?

AcSEC agrees with the Board's decision to not include the word *extremely* to describe the circumstances under which the prejudicial exemption may be exercised. However, AcSEC recommends that the word *rare* also be deleted from paragraph 11 to read as follows:

In those rare-instances in which the disclosure of information required by paragraph 7, when aggregated at a level higher than by the nature of the contingency, or of the tabular reconciliation would be prejudicial (for example, if an entity is involved in only one legal dispute), the entity may forgo disclosing only the information that would be prejudicial to the entity's position.

AcSEC believes that the use of the prejudicial exemption will be more frequent than anticipated as companies often only have one major litigation pending. Therefore, if the Board intended the word rare not to mean never, as disclosed in a footnote to the proposed Statement, then AcSEC recommends that the word rare be removed. Including the word rare only serves to confuse rather than clarify the applicability of the exemption. AcSEC believes that by removing the word rare, a more consistent application of the exemption will result.

AcSEC also appreciates the Board's goal of moving towards convergence with International Accounting Standards but believes that the U.S. is a very different environment from that in which IAS 37 is currently being applied. This is in part due to the more highly litigious environment in the U.S. where lawsuits (or the threat of them) are often used to resolve disputes. We also believe that the majority of enterprises that are currently applying IAS 37 tend to be large multinationals, whereas the vast majority of U.S. companies that would be required to apply the proposed Statement would be small, privately-held companies. Accordingly, AcSEC believes that in the U.S. marketplace it would not be rare for companies to be compelled to invoke the prejudicial exemption.

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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?

AcSEC agrees with the description of prejudicial information as described in the proposed Statement; however, consideration should be given to the Statement providing more guidance on "prejudicial" information, including examples of what would or would not constitute such information.

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?

AcSEC acknowledges the requirements in APB 28, Interim Financial Reporting, paragraph 22, that essentially requires repeating contingency disclosures in interim and annual reports until the contingency has been resolved, as well as similar guidance for public registrants in Regulation S-X, Rule 10-01. Therefore, we are generally supportive of requiring the proposed disclosures in both interim and annual reporting periods. However, AcSEC questions whether there is sufficient incremental benefit to financial statement users from providing the tabular reconciliation during interim periods. On balance, we believe the tabular reconciliation should only be provided for annual reporting periods. We note that this is consistent with the requirements in both FIN 48, Accounting for Uncertainty in Taxes and SOP 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises.

In addition, AcSEC requests clarification of the term *period*, as used in the last sentence of paragraph 8 of the proposed Statement. For example, would a loss contingency that arose in the first quarter but was settled in a later quarter of the same fiscal year be excluded from the reconciliation? And would the answer differ if the company were subject to interim reporting requirements?

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?

AcSEC believes that proposed disclosures in paragraph 9 related to recoveries from insurance or indemnification arrangements be expanded to include a description of the line items in the statement of financial position in which the recoveries are included.

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?

AcSEC does not believe it is operational for entities to implement the proposed Statement in the current fiscal year. If finalized, as proposed, companies will have insufficient time to adopt and implement the new requirements. Many of the new disclosures will be highly sensitive and judgmental and will require companies to immediately begin working with legal counsel to ensure they are able to provide the appropriate level of information. Management may also not be in a position to provide some of the

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required disclosures on its own and will need to seek input from outside experts (e.g., engineers and environmental specialists). Companies will need to support and document their analysis and related judgments. Lastly, auditors will need to audit the new disclosures. This will almost certainly necessitate additional correspondence and dialogue between the company's auditors and its internal and external counsel.

AcSEC also notes that to comply with the requirements of the Statement as proposed, the beginning period of the tabular reconciliation will precede the issuance date of the final Statement. In discussing the need for presenting comparative information for earlier periods, the Board concluded that it would be impractical for entities to gather the necessary information (paragraph A30). For the same reasons, AcSEC believes it would be inappropriate for the tabular reconciliation to be required for retroactive periods that precede the issuance date of the final Statement.

Lastly, AcSEC believes that necessary audit standard-setting, including discussions related to revisions of the ABA/AICPA treaty, and what can be confirmed to auditors under that treaty may take a significant amount of time and effort to finalize. AcSEC recommends that the Board not proceed with determining an effective date until auditing guidance is developed regarding how auditors should obtain audit evidence to corroborate management's assertions. In any event, AcSEC recommends that the Statement be effective no sooner than for <u>annual</u> periods ending after December 15, 2009, with retrospective applicability to the beginning-of-the-year.