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Financial Accounting Standards Board
Technical Director
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File Reference No. 1840-100 Exposure Draft:
Contingencies (Topic 450)
Disclosure of Certain Loss Contingencies

Dear FASB:

I would like to make a few comments on the exposure draft from the perspective of a financial statement user and educator. I am not an attorney so it is hard for me to evaluate the costs of implementing the proposed disclosures for litigation-related contingencies. Instead, I will focus on whether the disclosures have the potential to be useful to financial statement users including donors to not-for-profit entities. In addition, I believe I have identified some inconsistencies with respect to how these disclosures relate to existing and proposed guidance with respect to tabular roll-forward disclosures.

For purposes of classifying comment letters, my title is professor of accounting and I am employed at the University of Idaho. I have held my CPA license since 1977. Prior to beginning my 28-year academic career, I held a variety of positions including staff accountant in a small public accounting firm, controller for several small to medium-size business entities, and as director of finance for a large not-for-profit entity. As an active donor and small investor, I have occasion to read the financial information of charities and publicly-traded companies.

General comment on standards for contingencies

After listening to a KPMG webcast about the revised exposure draft, my initial reaction was that the disclosures were feasible and potentially useful. After studying the examples in the actual exposure draft and attempting to do research in the ASC with respect to existing GAAP, I am less sure. For one thing, the discussion of contingencies is surprising hard to get one's arms around using the ASC. The tabular display currently required for product warranty obligations (a contingent loss) is under section 460 and does not appear to be referenced at all in the exposure draft. The loss contingency for nonpayment by customers is in section 310. The exposure draft claims to apply to all loss contingencies but appears to be primarily focused on litigation. Maybe we need some new terminology to distinguish the routine recognition of certain contingencies that are a normal part of operations (bad debts, product warranty) from the recognition and disclosure of less routine loss contingencies that arise on an irregular basis. I am becoming aware of a difference in terminology between IFRS and US GAAP (something about provisions) so maybe the convergence will provide an opportunity to re-label contingencies that require different levels or types of disclosure.

As an educator, I have to think about ways to communicate clearly. Explaining the difference between regular estimates required in the accounting process and contingent liabilities has always been challenging. For one thing, the term "contingent liability" covers a number of routine situations (see Appendix A) as well as less common situations that tend to be irregular in occurrence and harder to estimate. A tabular roll-forward display for the routine items brings a number of benefits for financial statement users. A similar roll-forward of less routine contingencies is likely to be less useful because of the sporadic timing and the higher level of uncertainty involved. When one adds in the complexities of disclosing potentially prejudicial information regarding litigation, the utility of the roll-forward display is further reduced.

Another observation: FASB 5 (now ASC 450) has long been a favorite of business because it is purportedly principle-based and somewhat vague in application (a fine line between probable and reasonably possible?). I'm pretty sure that corporations in the 1970s and 1980s were making promises to provide health care benefits to retirees (contingent on continuing employment of sufficient length) but recognition was extremely rare until mandated by FASB 106. Environmental laws were being adopted but hardly anyone recognized a contingent liability for legally-mandated clean-up costs until FAS 143 was issued. Even after FASB 143, FASB had to come back with an interpretation to get a higher level of recognition and disclosure. If users demand better disclosures regarding litigation, I think FASB must play a role. Unfortunately, this particular request from financial statement users is complicated by our very litigious society and the laws that give rise to attorney-client privilege and forbid disclosure of private information. What users really want is probably the disclosures in the original ED.

The revised ED focuses on disclosure of publicly available factual information that a financial statement user could conceivably obtain from court filings and the like. Obviously, financial statement users like myself would incur a high cost to compile this information individually so mandating that the company should do the data collection and aggregation makes a certain amount of sense and reduces the cost to users. The fallacy in this argument becomes apparent if

the publicly accessible information is likely to be misleading or at least not of particular value in predicting the economic impact on the reporting entity. I am most concerned over the disclosure of unreasonably inflated plaintiff claims. The tabulation of all such claims is feasible (if costly) but fails to reveal what I really want to know: the amount of loss that is probable. Perhaps it is impossible to give users what they really want because of the very high level of uncertainty in litigation. In this case, I believe “less” would be better than “misleading” when it comes to disclosure.

Specific questions for respondents

Question 1: Are the proposed disclosures operational?

I did not comment on the first version of the exposure draft. Based on a KPMG webcast, it appears that the FASB has made a real effort to address expressed concerns regarding identified problems with that version. The revised exposure draft moves away from disclosure of management forecasts to the disclosure of “facts” like the amount of damages claimed by plaintiff. Accordingly, this version seems to be more operational than the previous version. So the real issue is whether the factual information is actually useful. We are all aware of egregious claims as well as settlements of huge amounts for relatively little harm (spilling hot coffee). So there is the possibility that users might over-react in situations where the amount of damages claimed bears little relationship to the amount at which the claim will be settled. See my general comments above as well as the comments under question 5 below.

Question 2: Are the proposed disclosures auditable?

I suspect auditing of factual disclosures regarding lawsuits could be performed although it would likely raise audit costs. Increased cost to obtain an audit is of real concern to small and medium not-for-profit entities. For not-for-profits, I expect the value of the disclosures to donors would not be sufficient to justify the increase audit cost. An audit has important value other than financial statement disclosures and it would be a shame to have not-for-profits “priced out” merely to comply with the multiple new accounting standards that are currently on the table.

Question 3: Do you agree that an explicit exemption from disclosing information that is “prejudicial” to the reporting entity is not necessary?

In this country and culture, we like rules. I would think one’s attorney would help one avoid making prejudicial disclosures but not every small entity has legal counsel on call. Therefore, having a clear statement that it is not necessary (or desirable) to disclose information that would be prejudicial to the entity’s position as defendant would be helpful. And I don’t think it would add more than a sentence or two of length to the ASC so putting it in doesn’t seem to give rise to any material cost.

Question 4: Is the proposed effective date operational?

An aside: I am now in the process of looking for the effective date – I know it is buried somewhere in this 50 page document. It would really help if the FASB would include references to the relevant page numbers WITH the questions for respondents! I'm going to give up and look at the KPMG slides. Okay – the effective date appears to be for years ending after 12/15/10 (so next year for public entities) and nonpublic entities are a year later. As a financial statement user, sooner is better. The difference for nonpublic companies is a good idea, however. Since I doubt the disclosures will be common among not-for-profit entities (other than hospitals), extra delay for implementation is not a problem to me. However, public companies are supposed to do the tabular roll-forward quarterly and that might well be an implementation problem if the FASB doesn't get around to making the ASU final until late in 2010. Perhaps the quarterly disclosures could be deferred until 2011.

Question 5: Do you believe that the proposed disclosures will enhance and improve the information provided to financial statement users about the nature, potential magnitude, and potential timing of loss contingencies?

Clearly, disclosures about litigation (the main focus of this ASU exposure draft) have not been particularly helpful in the past and have resulted in unpleasant surprises. Information on magnitude of potential loss is a good idea but I do not believe the disclosure of the amount of asserted claims will be much help since it appears that plaintiffs ask for the moon as a negotiating strategy. I strongly recommend that the monetary disclosure of claims be limited to those supported by evidence introduced as to the actual amount of damages. In the long example that begins in proposed 450-20-55-38, I don't think that useful information is available until year 4 when both parties have introduced evidence regarding damages (450-20-55-42). At that point, I could be pretty sure that any loss would be less than the \$2 million claimed but probably no less than the \$50-200 thousand argued by the defendant's expert witness.

In addition, I think it would be nice to have a less "cut and dry" example – we know from year one that the undelivered widgets had a selling price of \$1 million so the \$2 million claim is obviously not completely egregious. What about a case where a student sues a university for \$50 million because he did not get a job after graduation? Any settlement would likely be far less than the amount claimed and, in my opinion, there shouldn't be a settlement any higher than zero because the plaintiff's claim is so unreasonable. A jury might decide otherwise, of course. As a financial statement user, I don't believe knowing the \$50 million amount would be useful and it could potentially lead to a bad decision since it might make me wonder if the impact would be severe or catastrophic. Perhaps I'm worrying too much and a frivolous lawsuit would never rise to the reasonably possible or probable level and therefore something like this would require neither recognition nor disclosure.

However, what if the \$50 million is the amount claimed as damages by a student who was severely injured through some purported negligence on the part of the university. A reasonable settlement might be related to the forgone lifetime earnings plus medical costs. This amount can be estimated with existing techniques (since they did something of the kind to determine payouts

after the Sept. 11 terrorist attacks). Accordingly, disclosure of what an expert witness estimates as life-time earnings might be a useful disclosure while the initial amount claimed would have the potential to be misleading. Unlike my first example (lawsuit because student didn't find a job), the case of a student injured on campus would rise to at least the level of reasonably possible since some settlement would be likely. Unfortunately, the amount claimed might be 20 times the amount of the probable settlement.

That brings up another concern I have – if there is insurance, the out-of-pocket cost of any ultimate loss would be a lot less upon settlement of the injury claim. I note that the FASB has made it very clear that the possible insurance recovery is only disclosed “if and to the extent it has been provided to the plaintiff(s).” Again, as a user of financial information, I am likely to be misled if a factual (but inflated) claim is reported without any disclosure on the existence of insurance coverage. In other words, what I really want to know is the probable NET amount of any out-of-pocket loss the entity will incur. From the example disclosures, it appears that I would need to hire my own attorney to figure out whether the reporting entity will be severely impacted. And even then, there is so much uncertainty involved that I'd probably have wasted my money! In other words, the more I think about the proposed disclosures, the less I am convinced that I would be able to properly use the information to make decisions as an investor or donor.

Question 6: Do you agree that nonpublic entities should be exempt from the tabular reconciliation disclosures? Are there any other aspects of the amendments that should be applied differently to nonpublic entities?

Yes, please let nonpublic entities avoid the burden of making the tabular disclosure. See also my general comments on utility of the tabular disclosures for contingencies that are not a routine part of regular operations (including examples in Appendix A).

As I understand it, tabular roll-forward disclosures are being discussed for all major balance sheet accounts to supplement the statement of cash flow. I suggest that it would be reasonable to defer the decision on requiring a tabular display for public entities until that issue is resolved. At that point, the tabular disclosure would happen automatically if a contingent liability rises to the level of a “major” account.

Question 7: Do you agree with the deferral of the effective date for nonpublic entities?

The deferral is likely to be beneficial because the nonpublic entities including most not-for-profit organizations are less likely to have in-house expertise to help them understand and implement the data collection systems necessary to provide the expanded disclosures.

Conclusion

Thank you for the extension of the comment due date for this exposure draft. I came back from a long summer trip to find that the FASB has been very busy (the huge ED on financial instruments is dated the day after I left town). I now have a pile of printouts to read that must be

at least a foot tall. I will attempt to comment as appropriate in order of submission deadlines. As always, please let me know if any points I tried to make are unclear.

Sincerely,

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Appendix A – Thoughts on the Utility of Tabular Disclosures

The ASC glossary defines a contingency as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.” As an educator, I’ve often had occasion to explain GAAP to students and many accounting situations fit the definition:

1. We sell to customers on account with the expectation of future payment (the existing situation). Some customers will fail to pay (the future event) but we don’t know which ones so we estimate and accrue bad debts. If we knew which customers would be unable to pay, we would not sell to them. We accrue the loss (through bad debt expense and allowance for bad debts) because the future event is probable and can be estimated.
2. We have sold products with a warranty (the existing condition). We believe our products to be without defect but promise to fix any that break within the warranty period. If we knew which items were defective, we would fix them before the sale – so the “failure” of the product is the future event that gives rise to the potential loss contingency. We currently accrue the loss at date of sale because the future event is probable and the cost of repairs can be estimated. {Under the proposed new revenue recognition guidance, we would divide the selling price into parts and spread the warranty part of the revenue over the warranty period. However, it still seems like there would be a contingent loss to be recognized since the product has been sold, the future uncertain event (failure due to defect) is probable, and the cost of repair can be estimated. To avoid double counting (liability for both deferred revenue and estimated repair costs), perhaps we’ll only record any anticipated repair costs in excess of deferred revenue in accord with the IFRS notion of an onerous contract.}
3. A company with foreign operations is worried because a new government has come into power and may expropriate company assets in the country. If expropriation is imminent and compensation will be less than carrying value, this becomes a contingent loss to recognize.
4. A company can be sued for any number of reasons, some quite bizarre and unexpected. Once the company becomes aware of an existing circumstance (for example, dangerous product defect has led to customer injuries), the company must decide whether the current situation (injuries that have already occurred) will result in a loss (if/when a future event happens – settlement of claim, etc.).

As a user of financial statements, it seems to me that the first two examples are quite different than the third and fourth situations. A roll-forward tabular reconciliation of bad debts and anticipated warranty losses is useful in several ways. First, it would enable me to see the actual cash outflows (or loss of cash inflows) that were incurred during a period. Second, the details would help me assess the adequacy of the provision for future losses. Third, it lets me assess the ability of management to make projections of future costs and pose questions to management if past projections have been seriously misstated. In these routine business situations, management should presumably be able to make reasonable estimates or explain why prior estimates were so far off (e.g., bad economy meant more customers defaulted, higher than average failure rate for a new product component, etc.). With respect to less routine types of contingencies (examples 3 & 4 above), there is so much uncertainty that it might be unreasonable to expect that management would be able to predict and estimate the contingent loss in a timely manner. This is not to say

that it would not be useful to know the likely amount of the loss and the eventual amounts paid out. However, there would be little predictive value since the timing of cash flows is relatively random or at least sporadic. Instead, a narrative discussion of the general situation would probably be sufficient to support the liabilities recognized on the balance sheet.