CORPORATE ENVIRONMENTAL DISCLOSURE COLUMN

That Fuss over Loss Contingency Disclosures

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1. Introduction

The Financial Accounting Standards Board (the Board or FASB) retreated again from completing revisions for loss contingency disclosures, meaning revisions would not be in time for the 2010 reporting year, as previously planned. Instead, the Board would continue to deliberate over the more than 300 comment letters, mostly unfavorable, it had received through September 20, 2010, which was the close of the comment period for the exposure draft (ED) it released in July 2010.

The Board had retreated once already, after receiving nearly 250 comment letters, mostly unfavorable, in response to an earlier exposure draft it released in June 2008. It subsequently convened two roundtable discussions for additional, direct input. The Board deliberated and then released the 2010 exposure draft.

Why is this being difficult for the Board? What is the fuss about? What do the unfavorable comments reveal about companies’ concerns for loss contingency disclosures? What are main issues? Where does this leave the Board’s efforts to develop revisions to the existing standard?

The following pages are a consideration of comment letters in response to the Board’s most recent effort, the 2010 exposure draft. This is not a scientific analysis. Rather, it is a sampling and review of the letters to discover the complaints of their authors, and to look for trends and wisdom in the expressions of their concerns.

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2. Accrual, reconciliation, and aggregation

a. Requirements

The exposure draft required companies to disclose “the amount accrued, if any,” for recognized loss contingencies. It allowed aggregation of similar contingencies, as described below. (ED 450-20-50-1B.b, -1F.e.2)

As well, it required companies to show reconciliations of those loss contingency accrual amounts. Reconciliations were beginning and ending amounts for reporting periods for the accrued loss contingencies. It applied for “every annual and interim reporting period.” The exposure draft called for reconciliations in “tabular format.” It instructed that reconciliations would be by “class” of loss contingencies, not by individual loss contingency. (ED 450-20-50-1F.g)

Companies were to supply qualitative information, as well, under the exposure draft. This included, for example, as loss contingency conditions matured, disclosure if management expected a “potential unfavorable outcome” or “loss increases.” (ED 450-20-50-1F.b)

Companies were allowed to aggregate disclosures for similar contingencies. Aggregations were “by class or type.” Companies were required to “disclose the basis for aggregation.” (ED 450-20-50-1B.b)

b. FASB’s explanation

The Board asserted that disclosures of accrual amounts were normal and already required of companies for some circumstances. It defended reconciliations as sources of valuable information for financial statement users. It acknowledged concerns about disclosure of prejudicial information, but claimed the opportunity for companies to aggregate contingencies met that concern and obviated the need for exemptions.

Appropriateness of accrual disclosure

The Board contended that loss contingency disclosures of companies were insufficiently transparent under the existing standard. This was a “primary criticism” from financial statement users, according to the Board. (ED BC3)

It held that the requirement to disclose accrual amounts under the exposure draft should be considered normal. That is, it already was required under the existing standard for some circumstances. Those circumstances would be as “necessary for the financial statement not to be misleading.” (ED BC35)

Usefulness of reconciliation

The Board required disclosure of reconciliations along with accrual amounts for more transparency. It considered reconciliations a source of “valuable information about significant estimates and changes in those estimates that were subject to significant measurement judgment.” (ED BC26)

The Board believed users found interim information “as important” as annual. So it required reconciliations in both interim and annual reporting. (ED BC29)

It required that tabular reconciliations be “presented separately for each class of contingencies.” This would prevent the aggregation of dissimilar contingencies, according to the Board. (ED BC31)

Issue of prejudicial information and exemption

The Board acknowledged the contention by some that "detailed quantitative disclosure" of accrual amounts and reconciliations "may be prejudicial to the reporting entity." (ED BC31) It disagreed, however, and countered that the opportunity for companies to disclose accrual amounts by class, plus the disclosure of reconciliations also by class, would "address many of the concerns about having to make prejudicial disclosures." (ED BC35)

The Board decided against providing companies exemption from prejudicial disclosures. It gave two reasons. First, it claimed there was no need since companies could aggregate loss contingencies and because it had "eliminate[d] many of the speculative or predictive disclosures" that were part of an earlier draft. Second, it agreed with concerns that instructions for such an exemption "would be difficult to interpret and apply." (ED BC36)

Role of aggregation

The Board contended that aggregation of contingencies should "mitigate concerns regarding disclosure of individual contingencies that may be prejudicial." It anticipated also that aggregation would reduce the possibility of "overwhelming users with too much information." (ED BC10, BC31)

The Board noted that "class" and "type" were interchangeable terms. It counseled that in aggregating, a company should consider "the nature of contingencies and the facts and circumstances specific to the entity." The Board advised companies "to exercise judgment in determining the appropriate level of aggregation and the appropriate classes of similar contingencies." It instructed companies to "strike a balance" between obscuring important information with too much aggregation and burdening financial statements users with excessive detail. (ED BC10)

c. Commenters' concerns

Commenters observed that loss contingency accruals already were part of financial statements in the gross aggregate, and perhaps this was adequate. They worried that in disclosing accrual amounts, companies would risk admissions of liability, set settlement floors, and increase litigation and losses. They worried about disclosure of prejudicial information and wanted exemption from it. They complained that judgments required of companies for the accrual disclosures would expose management's predictions and jeopardize attorney-client privilege. They contended that adverse consequences for companies from these disclosures would outweigh information gains for financial statement users.

Already affects gross aggregate

Commenters noted that financial statements already reflected loss contingency accruals in the gross aggregate, and perhaps that should be considered adequate.

> It is important to recognize the accrual will already be reflected in the company's financial statements. (ABA, 2010)
>
> Under existing guidance, loss accruals are reflected in the aggregate in the income statement and on the balance sheet. (Valero, 2010)

Admissions of liability

Commenters worried that companies risked admissions of liability from disclosures of loss contingencies accrual amounts.

> Plaintiff's counsel is likely to assert that the accrued amount represents admission of guilt/wrongdoing or estimate of fair compensation for damages. (BDO, 2010)
>
> A company's characterization of its liability in a particular matter would be portrayed to juries as an admission of liability and would make it virtually impossible to argue to juries that the damages should be less than the amount of the accrual. (Honeywell, 2010)
>
> The disclosures themselves could become admissible evidence and affect the outcome of the litigation, and any similar claims or litigation. (Valspar, 2010)
>
> The [additional] effect of such an 'admission' would be to raise expected settlement value, which in turn would drive the loss accrual even higher. (Valero, 2010)

Settlement floor, increased litigation and losses

Commenters feared that in disclosing accrual amounts, companies would set floors for settlement negotiations and make more favorable outcomes difficult to obtain. They worried the result would be more litigations and higher litigation losses for companies.

> The amount of any accrual…inevitably will establish a 'floor' for settlement negotiations. (ABA, 2010)
>
> The information could operate as a floor for settlement negotiations where a more favorable outcome may have been possible. (Kodak, 2010)
>
> The requirement…exposes public companies to the risk of providing loss accrual information so specific that it could be used by litigation adversaries to obtain an advantage in settlement negotiations. (Jacobs, 2010)
>
> These disclosures may compromise a company's ability to defend itself in litigation, and at the very least reduce its negotiating position. (Eli Lilly, 2010)
>
> The proposed disclosures of speculative information may open companies up to additional litigation. (EEI, 2010)
>
> In the course of litigation, the adversary is always trying to know the maximum the company will pay in settlement and is also trying to move that number upward. (Valero, 2010)
>
> Companies could not expect to settle claims for less than the accrual, with the unfortunate result of increasing litigation losses and encouraging additional litigation, all to the detriment of the company and its shareholders. (Valspar, 2010)

Prejudicial information, in general, and need for exemption

Commenters feared that disclosure of accruals and reconciliations would be prejudicial to the litigation defense positions of companies. They contended that companies should have exemption from disclosure of prejudicial information.

> We believe that requiring this disclosure [of accrual amounts] in all circumstances risks substantial prejudice to a company's defense position in litigation. (ABA, 2010)
>
> Such disclosure could provide an adverse party critical insight into a company's views regarding the prospects of litigation. (ABA, 2010)
>
> The ability to aggregate similar loss contingencies would not avoid the prejudicial impact of the accrual disclosure. (ABA, 2010)

> The typically varying nature, risk profile, and time horizon of contingencies will too often either make aggregation inappropriate or inadequate to avoid revelation of prejudicial information. (Kodak, 2010)
>
> We believe that due to the nature of litigation contingencies, incremental benefits from financial statement disclosure greater than currently required cannot be achieved without disclosure of prejudicial information. (EEI, 2010)
>
> We do not support the proposed requirement to provide a quarterly tabular reconciliation because we believe that it harms companies and shareholders by potentially providing confidential information to opposing parties in litigation. (Excelon, 2010)
>
> The level of disaggregation required in the tabular reconciliation and disclosure of potential magnitude of loss contingency may result in the disclosure of prejudicial information. (Eli Lilly, 2010)
>
> Therefore, without other changes to the [exposure draft], we believe that an explicit exemption from disclosing information that is prejudicial to the reporting entity is necessary. (Kodak, 2010)

Problem of few contingencies

Commenters worried that companies unable to aggregate, e.g., having few loss contingencies, would be particularly vulnerable to prejudicial disclosure.

> Small and mid-sized companies…are exposed to even greater risk of compromising its position in litigation, especially in circumstances where there may only be one material case pending. (AFP, 2010)
>
> When an entity has one (or only a few) claims, the tabular reconciliation may result in the disclosure of prejudicial information because of the entity's inability to aggregate claims. (Deloitte, 2010)
>
> We do not believe that [the exposure draft] resolves the issue of avoiding disclosure of prejudicial information in cases where the litigation contingency is the only accrued contingency within the respective contingency class and the entity believes that of the estimated loss accrual would be detrimental to the outcome of the litigation. (BDO, 2010)
>
> For a company…with minimal material litigation, the tabular reconciliation is likely to disclose case-specific evaluations and reserves, the thereby prejudice the company's position in litigation, particularly in settlement negotiations. (Excelon, 2010)

Exposing management's predictions

Commenters complained that accrual and reconciliations disclosures by companies could expose management's predictions. They argued against the Board's assertion that disclosures required no "new information that is based on management's prediction about a contingency's resolution" (beyond what is required already in the existing standard). (ED BC19) Commenters expressed fear that companies would be vulnerable to "hindsight challenge." They worried about the lack of "safe harbor" for companies from liability for exposing predictive information in financial statements.

> We believe the [exposure draft] does require new disclosures based on management's predictions about a contingency's resolution. (Kodak, 2010)
>
> Also, the requirement to disclose a tabular reconciliation, by class, including a description of significant activity in the period would provide insight into management's predictions about a contingency's, or class of contingencies', resolution as well as other prejudicial information. (Kodak, 2010)
>
> Even reasonable judgments by management, and the auditor's assessment of these judgments, [leave a company] particularly vulnerable to hindsight challenge. (Deloitte, 2010)

> Although companies were granted safe harbor from liability for certain forward-looking statements under the Private Securities Litigation Act of 1995, the safe harbor provisions do not apply to financial statements and notes. (EEI, 2010)

Jeopardizing attorney-client privilege

Commenters complained that companies could jeopardize attorney-client privilege with disclosures about accruals and reconciliations that followed from attorney-client discussions. Commenters worried that companies could be vulnerable to adversaries seeking the privileged basis for the accruals and reconciliations.

> The specific amount of an accrual largely reflects a legal judgment about the likelihood of risk. (Valero, 2010)
>
> This means the adversary can argue that the specific disclosure represents a waiver of attorney-client privilege, entitling him or her to the privileged basis for the accrual. (Valero, 2010)
>
> The disclosure of the amount accrued may result in auditors' demands for additional evidence to support a company's accrual.
>
> This could result in a waiver of attorney-client privilege and loss of work product protection as to counsel's underlying advice and analysis. (ABA, 2010)
>
> The proposed requirement that the amount of the accrual and the tabular reconciliation be provided on a quarterly basis compounds these issues. (ABA, 2010)

Unbalanced consequences and problems from subjectivity, inconsistency

Commenters complained that adverse consequences for companies from the accrual and reconciliations disclosures would outweigh information gains for financial statement users. They worried about disclosure of prejudicial information by companies and the effort required to prepare the information. They feared the information disclosed by companies about accruals and reconciliations would be subjective and inconsistent, absent better instructions, making comparisons of information difficult for users.

> We do not believe that the information this reconciliation provides to financial statement users is sufficiently decision-useful to mitigate this concern [about disclosing prejudicial information], or the incremental effort required to compile it. (Excelon, 2010)
>
> The benefit to users of the added itemization would not outweigh the significant disadvantage to companies resulting from that disclosure. (ABA, 2010)
>
> Aggregation in all its facets will be time-consuming and costly, and will be laden with subjectivity and inconsistency among disclosing companies. (Alston & Bird, 2010)
>
> In the absence of additional guidance [about aggregation criteria], significant diversity could occur between entities and make information less comparable for users. (Deloitte, 2010)

3. Disclosure of remote contingencies having potential severe impact

a. Requirements

The exposure draft required companies to disclose "asserted but remote loss contingencies" that caused them "vulnerability to potential severe impact." (ED 450-20-50-1D) The existing standard, by comparison, has no disclosure of "remote" loss contingencies, and no use of "severe impact" as a threshold.

In determining their need for disclosure, companies were instructed to evaluate a remote loss contingency's "potential impact" on operations, the cost "for defending its contentions," and the "effort and resources needed" for it to resolve the contingency. This disclosure requirement applied for all remote loss contingencies, not just litigation contingencies. (ED 450-20-50-1D) "Severe impact" was a higher threshold than "material" and lower than "catastrophic." (ED Amendments to Master Glossary)

b. FASB's explanation

The Board contended that disclosing asserted remote loss contingencies having potential severe impact was necessary for improving the timeliness of decision-useful information for financial statements users. It expected companies to "exercise judgment" in reviewing "facts and circumstances" for decisions about disclosing asserted remote loss contingencies. The Board acknowledged, for example, that companies could encounter "frivolous" claims for "artificially inflated" amounts. (ED BC14)

c. Commenters' concerns

More litigation and higher claims

Commenters complained that in disclosing the potential severe impact of contingencies, companies would be encouraging more litigation by adversaries and higher claims.

> We…are concerned that adoption of a severe impact exception to remote asserted claims would encourage claimants to initiate lawsuits with greatly inflated damages claims so as to use the disclosure requirement to extract a quick settlement from companies that otherwise would contest the claim. (ABA, 2010)
>
> The proposed disclosure requirements regarding…cases with a potential "severe impact," regardless of likelihood of loss, would incentivize plaintiffs to make baseless and/or artificially high damage claims in order to leverage disclosure obligations into a settlement of otherwise frivolous claims, thereby exposing companies to meaningful additional litigation risk. (Honeywell, 2010)

Exposure from prejudicial and predictive information

Commenters worried that by disclosing remote contingencies, companies would be providing prejudicial information to adversaries and exposing themselves to the liabilities of speculative and predictive information.

> Requiring disclosure of information that involves speculation or prediction can itself be a source of liability, based upon claims that the disclosure was misleading when results turn out differently than predicted. (ABA, 2010)
>
> Disclosure of any remote contingency would be predictive and speculative in nature. (EEI, 2010)
>
> The requirement to disclose remote loss contingencies would be prejudicial. (Kodak, 2010)

Problem of unrealistically high liabilities

A commenter feared that companies with environmental remediation contingencies could find themselves portraying unrealistically high liabilities, as from disclosure of costs for very expensive remediation alternatives that were part of administrative records.

> Often the most expensive alternative [for a range of potential environmental remedies for a site] may cost orders of magnitude higher than the range of reasonably possible

> alternatives and is being screened solely for the purpose of creating an administrative record that the alternative was considered and rejected. (FMC, 2010)
>
> Requiring disclosure of a remote outcome is likely to mislead investors about the environmental remediation risks faced by a disclosing entity. (FMC, 2010)
>
> Aggregating such remote alternatives from several sites could present a very unrealistic picture of a company's environmental liabilities. (FMC, 2010)

Inadequate guidance

Commenters claimed the exposure draft provided inadequate guidance for disclosure of remote loss contingencies. They predicted the result would be too much information disclosed by companies for contingencies that, being remote, had little financial impact on the company. They complained that the (1975) ABA Statement of Policy would not be relevant for remote contingencies.

> The [exposure draft] creates a very subjective standard as to what remote contingencies should be disclosed. Companies are likely to over-disclose to avoid the risk of securities law violations and shareholder lawsuits. As a result, investors are likely to receive voluminous information about litigation contingencies that are extremely unlikely to occur and have no meaningful impact on the value of the company. (Valspar, 2010)
>
> The current ABA Statement of Policy which provides guidance for counsel regarding audit letters does not include provisions for 'remote' losses that could have a significant impact on a reporting entity. (Vulcan, 2010)
>
> In light of this fact, it is likely that counsel will be unwilling to provide the necessary precision and detail to auditors to achieve sufficient audit evidence related to contingency disclosures and management's judgment. (Vulcan, 2010)

Preferred threshold, needed condition

Commenters considered "material" a better threshold than "severe impact" for decisions about disclosures. They suggested that a "near-term" condition was needed so companies would not have to look indefinitely into the future for remote contingencies.

> We do not believe it is in the best interests of investors to increase the threshold from material to severe impact since material is defined as matters that are important enough to influence a user's decisions. (CalPERS, 2010)
>
> We are concerned that the "potential severe impact" standard sets the threshold too low. A very large claim has the *potential* to severely affect an entity even if the likelihood of its doing so is extremely low. (Deloitte, 2010)
>
> In addition, because the [exposure draft] does not contain the 'near term' condition that was prescribed in the 2008 ED, entities would need to look indefinitely into the future to assess whether claims will potentially have a severe impact. (Deloitte, 1)
>
> Consistent with principles reflected in existing accounting literature, as well as in the revised exposure draft, companies [already] review the likelihood of an adverse outcome on loss contingencies on a quarterly basis. (ABA, 2010)
>
> If, upon such review, a remote asserted claim is considered no longer to be remote but reasonably possible, appropriate disclosure about that contingency will then be made. (ABA, 2010)
>
> Accordingly, we do not believe it is necessary to create a severe impact exception for remote contingencies. (ABA, 2010)

Unintended consequences

Commenters contended there could be unintended consequences for financial statement users from the remote contingency disclosure requirements, which could mean much more information to review, confusion, and comparability problems.

> The requirement to disclose remote loss contingencies…could cause more confusion than clarity, and would not justify the incremental effort required on the part of financial statement issuers. (Kodak, 2010)
>
> This requirement could dramatically increase the population of remote loss contingencies that would need to be disclosed, and we are uncertain whether this was the FASB's intent. (Deloitte, 2010)
>
> We are concerned about the potential effect on comparability of financial statement of inconsistent interpretation of an entity's vulnerability to a "severe impact. (EEI, 2010)

4. Disclosure of claims and expert testimony

a. Requirements

The exposure draft required companies to disclose "publicly available quantitative information," such as claim amounts from plaintiffs or damage amounts from expert witness testimony. This applied for all contingencies that were "at least reasonably possible," i.e., for contingencies that were "more than remote." Companies would not have to disclose an "unasserted claim or assessment" unless both an assertion was "probable" and an unfavorable outcome was "reasonably possible." (ED 450-20-50-1C, -1F.e.1) The existing standard, by comparison, does not specifically require disclosure of claim amounts from plaintiffs or damage amounts from expert witnesses.

b. FASB's explanation

The Board contended that lack of disclosure of quantitative information under current U.S. GAAP was "one of financial statement users' most significant concerns." Users read, instead, too often, that "the possible loss [could not] be estimated," the Board complained. (ED BC22)

The Board insisted the requirement to report plaintiff claims would not be "prejudicial to the reporting entity" because disclosures were limited to information that was "publicly available." As well, the fact of a damage claim did not, by itself, establish that disclosure was necessary, the Board noted. As already mentioned, the Board acknowledged there could be "frivolous" claims for "artificially inflated" amounts. (ED BC14, BC25)

c. Commenters' concerns

More claims, including copycats

Commenters feared that disclosure of loss contingency claims could expose companies to more litigation, including copycat claims. This would be part of the larger concern expressed by companies about prejudicial disclosure under this and other aspects of the exposure draft requirements.

> We believe the [exposure draft] will provide fodder to complainants seeking to negotiate settlements with companies. (Jacobs, 2010)

> Because the proposed threshold for disclosure is low, an entity might also be required to disclose speculative claims, which could result in 'copycat' claims filed against that entity. (Deloitte, 2010)

Misrepresentative information

Commenters complained that claim amounts from plaintiffs and estimates from their experts would misrepresent the loss contingency exposures of companies.

> "It is important to recognize that the litigation process, especially in the United States, is fraught with uncertainties. (ABA, 2010)
>
> The asserted claim in remote litigation contingencies is often unrelated to an entity's actual exposure to loss. Disclosure of this information could therefore mislead users. (Deloitte, 2010)
>
> As anyone who has been involved in any US litigation can attest, plaintiffs and their experts often make exaggerated claims. (Valero, 2010)
>
> The proposed quantitative disclosures of "the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses" will lead to misleading information that may be inconsistent with the company's view of the actual outcome of the litigation. (EEI, 2010)
>
> Expert testimony may be speculative and without merit and the information may not provide a fair representation of the amounts that will be claimed or recovered by plaintiffs. (EEI, 2010)
>
> The testimony or opinion of a paid expert in litigation is not a sound basis for disclosure and is likely speculative and misleading information to investors. (Valspar, 2010)
>
> Supplied by itself, such 'publicly available quantitative information' will be misleading. (Valero, 2010)
>
> Experts are hired by one party to the litigation. As a result, inherently biased and unrealistic damages calculations are promulgated by experts. (Vulcan, 2010)
>
> Including the potential damages calculated by experts in the financial statements could have the unintended consequence of misleading users. (Vulcan, 2010)
>
> It is difficult to effectively communicate the potential bias of an expert in the disclosure to the financial statements. (Vulcan, 2010)
>
> Engaging in a 'battle of the experts' in the notes to the financial statements would present, in any given period, an incomplete, confusing and changing prospective about the potential magnitude of a loss. (Honeywell, 2010)
>
> Many lawsuits are filed with exorbitant damage claims. These claims are backed by very well-written briefs prepared by attorneys for the sole purpose of advocating their client's position. They are not trying to present a balanced view of the contingency for investors to read. (Jacobs, 2010)

Inadequate guidance

Commenters held that current guidance was inadequate on these matters: about using other than publicly available information for litigation contingency disclosures; about disclosure of non-litigation contingencies; about synchronizing materiality for FASB disclosures with SEC requirements; and about disclosures for other than simplistic litigation scenarios, including for loss contingency liabilities that are shared with other defendants.

> The call for disclosure of publicly available quantitative information "neither limits this information to that which is available through the relevant proceedings nor

> provides guidance as to how this requirement would relate to non-litigation contingencies. (Honeywell, 2010)
>
> Would materiality for purposes of ASC 450 litigation contingencies disclosure be synchronized with materiality for purposes of Item 103 of Regulation S-K legal proceedings disclosure in filings with the SEC? (Item 103 of Regulation S-K defines “material” as a claim for damages that exceeds 10% of current assets.) Disclosure at a level below that required by the SEC would seem appropriate for neither public nor private companies. (BDO, 2010)
>
> The proposed requirements and examples assume simplistic litigation scenarios that involve a single claimant and a single defendant. (FMC, 2010)
>
> In many situations, including antitrust, environmental and toxic tort litigation, the cases involve multiple defendants. (FMC, 2010)
>
> In such cases, disclosure of contentions and demands and updating those disclosures would present an enormous challenge for any disclosing entity. (FMC, 2010)
>
> The [exposure draft] does not provide guidance as to how such disclosures might be done. (FMC, 2010)
>
> Disclosing generic contentions made against all parties and an overall demand as to all parties would present an unrealistic view of any one party’s reasonably possible liability, and there may not be a clear statement in the public domain that would identify specific contentions against any individual company. (FMC, 2010)

5. Recoveries from insurance and indemnification

a. Requirements

The exposure draft instructed companies not to “consider the possibility of recoveries from insurance or other indemnification arrangements” when “assessing the materiality of loss contingencies to determine whether disclosure is required.” Companies would disclose information about possible insurance and other recoveries “only if, and to the extent that it has been provided to plaintiff(s) in a litigation contingency, or it is discoverable by either the plaintiff or a regulatory agency.” This pertained for all contingencies that were “at least reasonably possible,” i.e., for contingencies that were “more than remote.” It applied also for “asserted but remote loss contingencies” that caused a company “vulnerability to a potential severe impact.” (ED 450-20-50-1E, -1F.e.5)

Companies were required to report information about a possible recovery that was relevant to a “recognized receivable.” They would disclose if an insurance company had “denied, contested, or reserved its rights” in response to a claim for recovery. They were prohibited specifically from netting (offsetting) recognized insurance and indemnification recoveries against accrued contingency losses in their financial statements, however, except within the limits described in ASC 210-20-45. (ED 450-20-50-1F.e.5)

b. FASB’s explanation

Issue about uncertainty

The Board agreed with the view that insurance coverage for loss contingencies “often is uncertain and could be subject to litigation with the insurer.” The result, the Board contended, was that companies could be exposed to loss even though they believed their loss contingencies were “fully covered by insurance.” The Board concluded, therefore, that when assessing materiality for loss contingency disclosure, companies could “not consider the possibility of recovery from insurance or other indemnification arrangements." (ED BC15)

Inclusion of non-litigation contingencies

Companies could have non-litigation loss contingencies, the Board noted. That is, the Board recognized "there may not be a plaintiff and discovery in the case of some loss contingencies." For example, a company could have environmental loss contingencies from actions taken by governmental regulatory agencies. So the Board required companies to include information discoverable by regulatory agencies. (ED BC41)

Netting not normal

The requirements directed companies to restrictive criteria in ASC 210-20-45 that must be met before they could offset (net) loss contingency liabilities with potential insurance recoveries in their financial statements. The Board held that it "would be unusual" for companies to meet those criteria. In other words, it did not consider netting of loss contingencies with recoveries to be a normal occurrence. The Board expected, instead, that companies would present loss contingencies and recoveries separately in their gross amounts. (ED BC42)

c. Commenters concerns

Prejudicial information, more claims

Commenters feared information disclosed about insurance coverage would be prejudicial against companies, increasing their exposure to litigation adversaries. They worried that companies instead of courts would have to make judgments about discoverability of information. This could include information not yet sought by plaintiffs or regulators. They were concerned that companies could lose the opportunity to seek protection of information by courts from plaintiffs.

> This disclosure [about insurance recoveries] would prejudice reporting entities by providing other potential litigation adversaries the reporting entities liability coverage terms—potentially serving as a catalyst for additional litigation. (Vulcan, 2010)
>
> Courts often issue protective orders requiring companies to keep insurance policy terms confidential to avoid this outcome. (EEI, 2010)
>
> Moreover, by requiring disclosure of 'discoverable' information regarding insurance coverage, the [exposure draft] would compel companies rather than courts to make the judgment as to discoverability and disclosure information that has not yet been sought by plaintiffs or regulators. (Honeywell, 2010)
>
> The proposed disclosures would make the terms of a company's insurance coverage regarding certain claims public information and may encourage additional claims against the company. (EEI, 2010)
>
> Such disclosures could create (1) an opportunity or incentive for future claims by parties that become aware of an entity's access to insurance coverage and (2) the likelihood of an insurance claim being 'denied, contested, or reserved' on the basis of existing claims. Such parties might not have filed a claim if they were unaware of such insurance coverage. (Deloitte, 2010)
>
> By requiring disclosure of potential insurance and indemnification recoveries, the [exposure draft] would provide non-public information to both current plaintiffs and third parties who may be considering litigation against the company, thereby leading

> to a potential increase in the number of claims against the company. (Honeywell, 2010)
>
> Requiring companies to broadcast their liability coverage terms to potential litigation adversaries may encourage additional litigation against prudently insured companies to the detriment of their shareholders. (Valspar, 2010)

But netting is normal

Commenters asserted that netting contingency losses against insurance and indemnification recoveries was logical and normal practice for companies, and was important in risk management programs. They contended the materiality of loss contingencies should be assessed with the same approach. They suggested that companies risked misrepresenting financial impact from loss contingencies if they were not able to include consideration of insurance and indemnification recoveries.

> The ABA considers it anomalous that the [exposure draft] would deny companies the ability to take into account coverage and indemnification in assessing materiality while at the same time requiring disclosure of potential insurance and indemnity coverage in many cases. (ABA, 2010)
>
> Insurance and indemnification are important and routine elements of a company's risk management program and therefore companies should be able to take such matters into account in assessing the materiality of a loss contingency. (ABA, 2010)
>
> Insurance and indemnification recoveries should be considered in determining the need for disclosure and, if disclosure is warranted, considering the net amount of loss contingency involved. (EEI, 2010)
>
> It would be misleading to an investor to believe a company will be incurring losses, when in fact those losses are expected to be mitigated by insurance or indemnification recoveries. (EEI, 2010)
>
> It is counterintuitive to exclude the consideration of key mitigation factors because due to their uncertainty when the loss contingencies themselves are inherently uncertain; in most cases the likelihood of insurance recoveries and indemnification is less certain than the outcome of the loss contingencies themselves. (Honeywell, 2010)
>
> Requiring a company to estimate a loss contingency without considering insurance coverage presents a misleading picture of the likely financial impact of the loss contingency. (Valspar, 2010)
>
> We believe the requirement to disclose and discuss loss contingencies separate from related recoveries runs counter to how we (as well as most other companies in our industry, we believe) monitor and review loss contingencies. (Jacobs, 2010)
>
> Bifurcating the claim from potential recoveries also presents a view of loss contingencies that is fundamentally different from how management assesses the potential net cash outflows of the business. (Jacobs, 2010)

6. Need, effort, and consequences

a. FASB's contentions

The Board contended the need for improvements resulted from three primary problems with loss contingency disclosures under the existing standard. As a result of those problems, it asserted, financial statement users were unable to make key assessments about loss contingencies. The Board identified its intended audience for improved disclosures from companies, and held that preparation of disclosures should not be a burden for companies.

Improved disclosure needed

The Board identified three primary problems with loss contingency disclosures under the existing standard: disclosures sometimes were too late to be useful to financial statement users; companies were not disclosing the full population of loss contingencies of interest to financial statement users; and accrual amounts for loss contingencies were not transparent to financial statement users. As a result of these problems, financial statement users were not being able to assess the "potential likelihood, timing, and magnitude of cash outflows" from loss contingencies, according to the Board. (ED BC3)

From its discussions with users and regulators, as well as its own research, the Board asserted that a company's financial statement was affected significantly by recognition and derecognition of loss contingencies, and by revisions to estimates for the loss contingencies. (ED BC52)

Intended audience

"Present and potential investors, creditors, donors, and other capital market participants" were who the Board identified as its intended audience for improvements in financial reporting. (ED BC49)

No substantial additional effort

The Board insisted that "many entities" already had the information needed, so their fulfillment of the proposed disclosure requirements should mean no "substantial additional cost or effort." (ED BC51)

b. Commenters' concerns

Need not demonstrated

Commenters complained that the Board had not demonstrated a true need for the loss contingency disclosures proposed. They contended the perceived need was an enforcement issue, not a shortcoming in requirements. They suggested that first the Board should identify the specific concerns of financial statement users, and then set about crafting changes that balanced users' gains with preparers' costs. They stated that changes should minimize risks and unintended consequences for companies. They observed that litigation inherently was uncertain and unpredictable, and could account for surprises to users, instead of disclosure failures.

> We do not believe it has been established that under the existing disclosure standards users of financial statements are failing to receive the information about pending or potential litigation that they need in order to assess a company's financial condition. (ABA, 2010)
>
> Our experience is that companies endeavor to provide this information, and therefore we question the underlying rationale for the proposed change. (ABA, 2010)
>
> We are not aware of any push for these changes by broad sections of the financial community. We are also not aware of any empirical data that the current disclosure requirements are not working (e.g., large volume of litigation, SEC enforcement actions, or other substantial adverse outcome resulting from undisclosed contingencies. (Honeywell, 2010)
>
> The exposure draft is a 'solution' in search of a problem. (Valero, 2010)
>
> The perceived need to improve disclosure of loss contingencies is an enforcement issue, not a shortcoming in guidance. (Valero, 2010)

> In an ironic lack of transparency, the Board does not identify which users or classes of users have voiced these criticisms or whose interests are actually being served by the changes [from the existing standard] in the [exposure draft]. (Valero, 2010)
>
> We believe it is incumbent of the FASB to identify the specific concerns that have been expressed by investors, and then craft tailored changes to existing guidance that balances the benefits to investors against the cost to preparers, and considers the other risks and unintended consequences that such changes may bring. (Jacobs, 2010)
>
> The FASB should recognize that it is the uncertainty and unpredictability of litigation, rather than any failure of disclosure, which often accounts for the surprises that users have complained about. (ABA, 2010)

Too much additional effort

Commenters contended that the time and effort for companies to prepare the additional disclosures would exceed the likely benefits to financial statement users.

> We firmly believe that the time and effort required to prepare the tabular reconciliation on a quarterly basis, along with the cost for the auditor to review, outweigh the benefit of this information to financial statement users. (Vulcan, 2010)
>
> Additional disclosures cannot eliminate or even reduce the magnitude of judgment required or the variation in how this standard will be implemented by reporting entities. (Vulcan, 2010)
>
> The concerns expressed by users of financial statements do not justify the extensive changes required by the [exposure draft]. (Jacobs, 2010)

Misrepresent companies, mislead users

Commenters complained the disclosures would contain premature, unsubstantiated, and speculative information that would misrepresent companies about their true risk from loss contingencies, and would mislead financial statement users.

> Requiring companies to disclose premature and unsubstantiated information could potentially mislead users of the financial statements. (AFP, 2010)
>
> Will cause the disclosures to be less meaningful as comparability among reporting entities will be difficult. (Vulcan, 2010)
>
> The proposal set forth in the [exposure draft] will harm investors by providing them with large quantities of useless and misleading information, while burdening their companies with more litigation claiming larger damages, and a diminished ability to defend it. (Valspar, 2010)
>
> We believe the proposed requirements call for disclosure of information that could mislead or confuse investors regarding the potential magnitude of loss contingencies. (FMC, 2010)
>
> The proposed disclosures will inundate readers of the financial statements with reams of data without providing meaningful information. (Jacobs, 2010)
>
> Interim reporting of the reconciliation is inconsistent with the basis of condensed information reported at interim. (Eli Lilly, 2010)
>
> We believe this will significantly expand the number of loss contingencies subject to disclosure…without enhancing the investor's understanding of the true risk presented by a company's loss contingencies. (Honeywell, 2010)
>
> Additionally, we do not believe that the information this reconciliation provides to financial statement users is sufficiently decision-useful to mitigate this concern, or the incremental effort required to compile it. (Excelon, 2010)
>
> Our fundamental concern is that the [exposure draft] will require speculative information that is not helpful to investors. (EEI, 2010)

Detrimental to companies and shareholders

Commenters worried that, as a result of loss contingency disclosures, companies could damage their positions in legal proceedings, enhance the positions of adversaries, cause market reactions unfavorable to themselves, and increase their cash outflows.

> Disclosures of loss contingencies, especially litigation contingencies, should avoid adversely affecting the outcome of those contingencies to the detriment of companies and their shareholders. (ABA, 2010)
>
> We believe that due to the nature of litigation contingencies, incremental benefits from financial statement disclosure greater than currently required cannot be achieved without disclosure of prejudicial information. (EEI, 2010)
>
> Our fundamental concern is that the [exposure draft] will require speculative information that is not helpful to investors and may adversely affect a company's position in legal proceedings, the result of which will be borne by the shareholders, a subset of the users of financial statements. (EEI, 2010)
>
> The [exposure draft] will benefit constituencies whose interests are adverse to a company and its shareholders, including plaintiff's lawyers eager to maximize recoveries, short sellers, and competitors. (Valspar, 2010)
>
> Requiring companies to disclose premature and unsubstantiated information could potentially…cause an unnecessary, unfavorable and unwarranted market reaction. (AFP, 2010)
>
> …Doubt that existing shareholders would support any changes that are fundamentally detrimental to a company's performance. (Valero, 2010)
>
> [Compliance with the exposure draft] will directly harm shareholders by increasing the cash outflow from compliant companies. (Valero, 2010)

7. What's to be done?

a. Companies' worries

The concerns expressed by companies in response to the Board's most recent exposure draft for revising loss contingency disclosure requirements fell into five main worries.

Disclosing prejudicial information

Companies worried about disclosing prejudicial information, which could undermine their litigation defenses. They feared exposure to more litigation and higher litigation losses.

Disclosing management's predictions

Companies worried about disclosing management's predictions, which could leave them vulnerable to "hindsight challenge." They were concerned about the lack of "safe harbor" from liability for predictive information in financial statements.

Waiving attorney-client privilege

Companies worried about unintentionally waiving attorney-client privilege as a result of disclosures. They feared exposure to adversaries seeking the privileged basis for the disclosures.

Being prohibited from offsetting

Companies worried about being prohibited from offsetting contingency losses with insurance and indemnification recoveries, and consequently conveying an unrealistic and compromised financial position in their financial statements.

Having inadequate guidance

Companies worried that having inadequate guidance for disclosures would make their preparations inefficient and costly, and result in criticisms from financial statement users that their disclosures were confusing and subjective.

b. Companies' preferences

Companies preferred the requirements in the existing standard to those of the exposure draft. That is, they preferred the *status quo*. In case the Board would not continue the *status quo*, they suggested these modifications to the exposure draft: an option for exemption from disclosure of prejudicial information; no reporting of remote contingencies; and the opportunity to offset loss contingencies with insurance and indemnification recoveries. They also preferred no disclosure of reconciliations or, if reconciliations were required, aggregation of all loss contingency amounts for the reconciliations.

c. Concluding thoughts

It's clear that commenters had problems with the Board's "publicly available information" approach to loss contingency disclosure revisions in the exposure draft. The Board has stepped back to re-deliberate. Commenters disliked the prospect of using plaintiffs' claims and their experts' estimates in loss contingency disclosures. They contended the values would be excessive and unreliable.

If, however, companies also reported their judgments about the claims and estimates that they disclosed from public information and countered with their own values, they risked compounding their problems by revealing management's predictions, leaving them vulnerable to "hindsight challenge." As well, to the extent their judgments and disclosures followed from attorney-client discussions, they also risked unintentionally waiving attorney-client privilege.

Meanwhile, under the existing standard for disclosure of loss contingencies, companies already have been making management's decisions, in particular about whether loss contingencies were "material," "probable," or "estimable," which affect gross accruals disclosed in their financial statements. From those management decisions, however, companies did not reveal information about their individual accruals, except when they chose to disclose accrual amounts to prevent their financial statement from being misleading, as instructed by the existing standard. No companies complained in comment letters about having problems about disclosing in those circumstances, it can be noted.

As compared with disclosing accrual amounts in those circumstances (so as not to be misleading) under the existing standard, however, companies would be reporting more accrual information under the exposure draft requirements, meaning greater exposure of management's decisions. Still, good management decisions follow good analyses, which along with preserving supporting documentation are part of minimizing exposure problems such as "hindsight challenge."

There is one thing about which commenters were distinctively enthusiastic and that was the value to them of offsetting contingency losses against potential recoveries from insurance and indemnification arrangements. This was good risk management, in their view. Instead of severely limiting it, perhaps the Board should consider finding a way to encourage netting—to create a motivating factor for disclosure. For example, since companies have written contracts with their insurance policies, could uncertainty about recoveries be reduced with third-party reviews of the contracts, effectively, audits?

Would developing motivating factors for disclosure be useful for the Board to consider? Could disclosure requirements for non-litigation contingencies be separated from those for litigation contingencies, which tend to have uncertainty that is much more difficult to manage? Should measurement and disclosure requirements for non-litigation contingencies be revised together to facilitate development of motivating factors for disclosure?

Can the Board be creative in responding to concerns expressed in the comment letters, and proceed to solve its problem about completing revisions to loss contingency disclosure requirements?

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