Private Company Financial Reporting Committee
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Judith H. O'Dell CPA CVA
Chair

September 15, 2010

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: Proposed Accounting Standards Update, *Disclosure of Certain Loss Contingencies* ("Proposed ASU")

Dear Mr. Herz:

The PCFRC has reviewed and discussed the Proposed ASU and offers comments and recommendations below.

Responses to Specific Questions asked by the FASB in the Proposed ASU

1. *Are the proposed disclosures operational? If not, please explain.*

<u>PCFRC Response</u>:

The PCFRC believes that the existing disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (Accounting Standards Codification ("ASC") 450), and Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (ASC 275), when properly implemented, provide adequate information to users of private company financial statements about loss contingencies. The proposed ASU will be difficult to implement in the private company sector due to the subjective nature of the disclosures. More specifically, operational problems presented by the proposed ASU include:

- Disclosing items that are remotely possible will impair the credibility of all contingency disclosures. Adding additional rules to assist in making a judgment decision does not necessarily improve the decision making process. If a liability could be reasonably expected to occur, it should already be disclosed under the existing standards. Requiring disclosure of remote contingencies, only for certain contingent liabilities, and then allowing management to state that '*the scenario disclosed in the previous sentence is not likely to happen except under the most remote circumstances and neither management nor its expert advisors believe it is reasonably possible as defined in ASC 450-20-20*' does not improve the readers understanding of the underlying risk. This kind of disclosure can create questions in the mind of the financial statement user such as 'why disclose something that is not reasonably possible?' or 'are the rest of these disclosures also not reasonably possible?' The credibility of all contingency disclosures is impaired by disclosing items that are remote. The PCFRC believes stating that the contingency is not reasonably possible or disclosing items that are remote impairs the credibility of the entire disclosure process

- Disclosing contingencies that are remote or not reasonably possible, but could have a significant financial impact, may influence settlement decision making. Some private companies may decide to settle a frivolous lawsuit rather than disclose the suit and its remote outcome to avoid the prejudicial information that would impart to the reader. As plaintiff attorneys realize this, they will increase the claims of damages they make to even higher amounts to pressure defendants into a choice of disclosure and its ramifications or settlement.

  A company that would not otherwise settle a frivolous suit may elect to settle for some amount rather than disclose the ludicrous claims made in the suit. Claims made in suits are not facts. The fact that claims are made does not give the claim credibility, but stating the 'facts of a suit' gives those stated claims credibility they do not deserve and will influence some companies to settle rather than disclose.

- The distinction between frivolous and remote but significant is not clear and may lead to inconsistent reporting. It appears that a substantive change from the existing standard to the proposed standard is to change from disclosing contingencies that are merely possible, regardless of magnitude, to disclosure of contingencies based on magnitude regardless of probability. This will change the concept of disclosure, but not the inherent problem of disclosing an uncertainty. This change also introduces a different distinction that will be difficult and costly to implement - the distinction between a frivolous suit and a suit that has a very low probability of having a significant financial impact.

  There is no definition to separate frivolous from 'remote but severe' and the attest process will lead to more disclosure rather than less. Auditors will try to limit their risk by requiring more disclosure and disclosure of suits that are viewed as frivolous by management. Because of the similarity between frivolity and remote but significant lawsuits, confusion on the part of private company preparers, financial statement users and auditors will increase and result in inconsistent application of the standard.

2. *Are the proposed disclosures auditable? If not, please explain why.*

PCFRC Response:

The PCFRC reminds the FASB that not all private company financial statements are audited. When performing a review or compilation, there is no requirement to correspond with counsel. The proposed requirements could add unnecessary cost to a review or compilation engagement.

Also, the PCFRC believes that the proposed requirements would significantly increase costs in an audit environment. Under the proposed requirements, an assessment will have to be made about even remote outcomes and whether there would be a significant financial impact on the company as a result. That will require more legal time and expense to the company. This in turn will result in more audit time to review and discuss each of these remote outcomes. The overall audit costs will increase disproportionately for private companies as a result of the proposed standards since most private companies do not employ in-house counsel.

3. *The June 2008 FASB Exposure Draft, Disclosure of Certain Loss Contingencies, had proposed certain disclosures based on management's predictions about a contingency's resolution. The amendments in this proposed*
   Update would eliminate those disclosure requirements such as estimating when a loss contingency would be resolved and the entity's maximum exposure to loss. Do you agree that an explicit exemption from disclosing information that is "prejudicial" to the reporting entity is not necessary because the amendments in this proposed Update would:
   a. *Not require any new disclosures based on management's predictions about a contingency's resolution*
   b. *Generally focus on information that is publicly available*
   c. *Relate to amounts already accrued in the financial statements*
   d. *Permit information to be presented on an aggregated basis with other similar loss contingencies?*

If not, please explain why.

PCFRC Response:

No, the PCFRC believes there should be an explicit exemption of prejudicial information for private companies. Private companies may only have one contingency. Thus the aggregation rule has no effect and any disclosure could be prejudicial, even publicly available information. Also, the PCFRC believes no information should be included in disclosures that could lead a reader to believe an outcome is reasonably possible when that outcome is in fact remote. We believe making such a disclosure, even with a qualification, is prejudicial.

A common debate and legal strategy is to make a statement in order to place an extreme idea in the mind of the recipient. In court, these statements are often objected to and stricken from the record. The speaker knows the statement will have an objection and likely be disallowed, but he makes the statement because he knows that once verbalized, it can't be retracted from the mind of the listener. All information is used in forming an opinion or making a judgment regardless of the effort to exclude the information. Disclosing contingencies that are not reasonably possible is prejudicial in that it will change the decision making process for the financial statement user.

Influencing someone's decision making process with good information is different than influencing it with information that management believes is irrelevant and immaterial because its probability is remote (or not reasonably possible). That information can hinder good decision making and be viewed as disinformation disguised as useful information.

4. *Is the proposed effective date operational? If not, please explain why.*

PCFRC Response:

The PCFRC believes that a two year delay of the effective date for private companies is necessary instead of the proposed one-year delay. This would allow needed time for the public marketplace, audit firms, and attorneys to absorb the requirements of the proposed ASU.

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 (if known) of loss contingencies?*

PCFRC Response:

No, see prior responses to other questions. The proposed ASU will add disproportionately to the cost of preparing private company financial statements while providing no additional benefit to the users of private company financial statements.

6. *Do you agree that nonpublic entities should be exempt from the tabular reconciliation disclosures required in the amendments in this proposed Update? If not, please explain why. Are there any other aspects of the amendments that should be applied differently to nonpublic entities? If so, please identify and explain why.*

PCFRC Response:

While the PCFRC appreciates the proposed exemption from the tabular reconciliation, it appears that the Board has not fully considered the needs of users of private company financial statements, nor the additional costs private companies will bear in complying with the proposed ASU. Paragraph BC 31 states that "for private companies the benefits of the tabular reconciliation may not justify the costs." The real costs of implementation are the legal costs for outside counsel, outside communication with auditors as well as the additional audit costs. In comparison the costs to prepare the tabular reconciliation are insignificant.

The PCFRC recommends that a prejudicial exemption should be maintained for private companies. Should the exposure draft as proposed become GAAP and private companies do not have an exemption from disclosing information considered privileged, the exemption from the tabular reconciliation is necessary.

The Committee believes that private company financial statement users have access to information about contingencies in ways that some users of public company financial statements do not. For example, most loan agreements have clauses that require the borrower to inform the lender immediately about any "material adverse changes" and these typically do not include "remote contingencies with severe consequences." Because of this access, most private company users are better informed about the risks that may be present at private companies.

7. *The amendments in this proposed Update would defer the effective date for nonpublic entities for one year. Do you agree with the proposed deferral? If not, please explain why.*

PCFRC Response:

See the response to Question 4 above.

We appreciate the FASB's consideration of these comments and recommendations. Please feel free to contact me if you have any questions or comments.

Sincerely,

Judith H. O'Dell
Chair
Private Company Financial Reporting Committee

Dissenting Opinion of the PCFRC's surety financial statement user representative

The FASB's decisions regarding the proposed detailed disclosures, materiality, and the exemption from the tabular reconciliation requirement for nonpublic entities achieves an equitable balance. The nature of the loss contingencies, their potential magnitude, and their potential timing (if known) have long needed to be clarified for users of financial statements, particularly those without direct access to management. While the prejudicial aspect is important, claiming a loss is not material without revealing any details of the nature of the loss contingency would typically dissuade a user from further inquiry based solely on management's assertions. Disclosing factual information may cause some users to consider a "worst case scenario", however, it is far better to be informed and to inquire on a "potentially material" loss as opposed to blindly assuming the opposite due to a loss not being deemed material. Concessions were made to legal representation so as not to disclose prejudicial information. While further disclosure than what the FASB is proposing would have been welcome, the compromised solution in the proposed ASU is acceptable.

This area of loss contingencies disclosures was extremely watered down and financial statement users were not provided with the necessary information. Loss contingency notes rarely, if ever, provided surety users with adequate information. Should a financial statement user at every annual account meeting after receiving the financial statements need to ask the client for additional details on loss contingencies due to inadequate disclosure in the financial statements? What is prejudicial about revealing a mediation hearing date, arbitration date, binding or non-binding, court date, and other factual information? While offers made by parties to litigation rarely reflect true exposure, it does open a window into the thought processes of the offeror. Should all users "suffer" due to some users being potentially influenced?