CFA INSTITUTE
Centre for Financial Market Integrity

7 August 2008

Mr. Robert Herz
Chair, Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116
USA

Re: File Reference: Exposure Draft *Disclosure of Certain Loss Contingencies an amendment of FASB Statements No. 5 and 141(R)*

Dear Mr. Herz:

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC),[2] appreciates the opportunity to comment on the Financial Accounting Standards Board (FASB) Exposure Draft, *Disclosure of Certain Loss Contingencies an amendment of FASB Statements No. 5 and 141(R)* (ED).

The CFA Institute Centre represents the views of investment professionals, particularly the CFA Institute membership, which includes portfolio managers, investment analysts, and advisors worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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General Comments

The ultimate objective of the wealth-generation process is to generate cash. Thus, it is critically important for investors to understand how companies generate cash and the risks associated with the nature, amount, and timing of future cash flows. To meet this objective, investors must be provided with transparent and accessible information related to loss contingencies to incorporate into their analyses and judgments. The need for adequate disclosures is even more critical given the dominant characteristic (i.e., uncertainty) of contingencies. Most sophisticated users of financial information realize that measuring contingencies involves making assumptions in order to estimate the future cash flows required to settle a given contingency. In other words, they expect the measurement of contingencies to change from one reporting period to the next until cash flows and other facts are certain. Transparent disclosures regarding loss contingencies provide information that is essential to an investor's understanding of these risks and uncertainties.

Investors have long expressed the concern that disclosures required by FASB Statement No. 5, *Accounting for Contingencies,* do not provide sufficient and transparent information in a timely manner to enable investors to assess the nature, likelihood, timing, and amount of future cash flows related to loss contingencies. The disclosures provided by the ED would enhance the ability of investors to make such assessments, which are essential to their analysis and use of the information contained in the financial statements.

Survey Results Regarding Cash Flows and Footnote Disclosures

In a CFA Institute corporate disclosure survey conducted in 2007, ninety-seven percent of the 406 respondents indicated that information about a company's capacity to generate future cash flows was important to their analysis or investment decision-making process. Respondents were also asked to rate both the importance and quality of note disclosures regarding contractual or future commitments for outflows of cash. On a five-point scale, the respondents rated the importance of such disclosures at 4.3 and their quality at only 3.1[3]. This indicates a problematic gap between the importance respondents place on note disclosures and the quality they actually experience.

Further, regarding contingencies and exposures to risks, the results of corporate disclosure surveys of CFA Institute members conducted in 2007, 2003, and 1999, identified deficiencies in financial reporting of both quantitative and qualitative information. While respondents rated

[3] Importance scale: 1= not important to 5=very important; Quality scale: 1=not useful and/or not provided to 5=very useful. The ratings shown represent the weighted average mean based on the total responses for each question and/or specific item set within a given question. If respondents selected "no opinion" or did not make a selection, this response or lack thereof is not included in the total responses used to calculate the mean rating.

highly the importance of disclosures for contingencies and risks in all three surveys, they assigned a lower rating to the quality of the information they received.

The following tables provide a snapshot of survey results:

Importance	**Survey Year**		
	2007	2003	1999
Contingencies related to litigation and potential exposure	4.0	4.1	n/a
Risks and exposures to risks (e.g., business, financial and market risk factors)	4.1	4.1	3.9

Quality	**Survey Year**		
	2007	2003	1999
Contingencies related to litigation and potential exposure	3.1	2.8	n/a
Risks and exposures to risks (e.g., business, financial and market risk factors)	3.1	2.8	3.0

The gaps in information quality as noted by these results clearly indicate the need to improve the disclosure about the nature, timing and magnitude of potential claims on an enterprise's assets and cash flows. We strongly support many of the FASB proposals and feel that they offer meaningful improvement in the disclosures required by investors.

Recognition and Measurement

Although disclosures are not a substitute for recognition and measurement, they are essential to enrich an investor's understanding of the financial statements. The role of disclosure is to provide a comprehensive explanation of events or transactions that have been recognized. These disclosures should have the same qualitative characteristics as the elements in the financial statements (including understandability, completeness, relevance, and comparability). To the greatest extent possible, these written disclosures should pertain to the individual characteristics and circumstances of the entity and avoid routine, legal boilerplate.

We encourage the FASB to address as soon as possible recognition and measurement issues currently under consideration. In particular, we stress the importance of establishing a sound definition of a liability, broadly defined as a present obligation of (or claim against) an entity.

In more detail, as described in our *Comprehensive Business Reporting Model*, a liability exists when[4]:

a. The entity is obligated to act or perform in a certain way (or refrain from acting or performing).
b. The obligation exists at the financial statement date.
c. The obligation is economic—it is an obligation to provide economic resources to others or to stand ready to do so.

We elaborate on our views in response to specific questions in the remainder of this letter.

Responses to Specific Questions

Question 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?

Disclosures are essential to an investor's understanding and analysis of the financial statements. The enhanced disclosures proposed by the FASB will add significantly to the overall understanding of risks and uncertainties related to loss contingencies. These disclosures, provided they contain both sufficient qualitative and quantitative information, will close the gaps in information referenced previously in our general remarks.

We believe that the following disclosures proposed by the FASB provide meaningful information required by investors to fully understand the risks associated with loss contingencies:

- A description of the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;

- A description of the factors that are likely to affect the ultimate outcome of the contingency, along with their potential effect on the outcome;

- A qualitative assessment of the most likely outcome;

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[4] CFA Institute, *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, July 2007, page 15. The full report can be found at: www.cfapubs.org/doi/abs/10.2469/ccb.v2007.n6.4818

- The significant assumptions made, in estimating the amounts disclosed and in assessing the most likely outcome; and

- A quantitative and qualitative description of any related insurance and indemnity arrangements.

Furthermore, requiring disclosure—even if the likelihood of the loss is deemed remote—when a contingency (1) is expected to be resolved in the "near term" and (2) could have a severe impact on the entity's financial position, cash flows, or results of operations, is important information for investors as well. In such circumstances, disclosure about the sources of liquidity that would be available to the entity to meet contingencies meeting the above criteria would be useful.

Minimal extra costs should be incurred to report the information in accordance with the new requirements since the data should be readily accessible and part of the entity's existing risk management practice.

Question 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 obligations, which are currently subject to the provisions of Statement 5? Why or why not?

Yes, we agree with the Board's decision to include obligations that may result from withdrawal from a multiemployer plan for a portion of its unfunded benefit obligations. Subjecting these obligations to the same requirements as other loss contingencies will provide additional meaningful information to investors. Given the lack of meaningful disclosure requirements about multiemployer plans, financial statement users currently have no information about the financial impacts of possible withdrawal.

Question 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?

Yes, we agree that an entity should disclose a loss contingency—regardless of the likelihood of loss—if it is expected to be resolved in the near term and the contingency could have a severe impact on the entity's financial position, cash flows, or results of operations. Disclosing near-term contingencies that could have a financially significant disruptive effect on the normal functioning of an entity is an important disclosure. Complete, transparent disclosures relating to these events will enable investors to make appropriate independent judgments either to include or exclude these contingencies from their analysis, as they deem appropriate.

Question 4. Paragraph 10 of Statement 5 requires entities to "give an estimate of the possible loss 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?

We agree that this provision is an improvement to the existing disclosure requirements. In practice, many entities often claim that a "reasonable estimate" cannot be made and, therefore do not disclose the information. By requiring an entity to disclose the claim or assessment (or if there is no such amount, the entity's best estimate of the maximum possible exposure to loss), an investor will be able to better assess the risks and financial statement effects of such claims or assessments. This information should be supplemented by sufficient information as to the nature of the events and circumstances of the loss contingency.

Furthermore, we believe that an entity should be *required* to disclose the possible range of loss if it believes the amount of the claim or assessment is not representative of its best estimate of the maximum exposure to loss. It is our experience that if an entity has an option to disclose it will choose not to do so.

These requirements would provide investors with information regarding a range of possible outcomes, instead of the current boilerplate disclosures that have no information content.

Ultimately, investors are interested in whether the existence of loss contingencies may have large, medium or small effects on an entity's results of operations, financial position and cash flows (liquidity) and whether those contingencies will require a fast, medium or slow use of

liquidity. Thus, we support qualitative or quantitative disclosures that provide help investors estimate reasonably the potential range and patterns of cash outflows that may be required to settle loss contingencies.

Question 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?

We believe that an entity will be able to reasonably estimate its maximum exposure to loss based on its internal assessment of the merits of claim and potential damages using the facts and circumstances known to it at the time it prepares its financial statements. It is our view that if the entity provides a reasonable estimate of the claim accompanied by the critical assumptions used to develop its estimate, this will enable investors to make appropriate adjustments to the information as they deem appropriate. If an entity is unable to make a reasonable assessment of the claim amount, its reasons for failing to do so should be clearly disclosed.

Question 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?

Settlement offers should be disclosed along with sufficient qualitative information to fully understand the nature of the offer. We believe that an entity should evaluate its exposure to loss and determine the potential damages or claims based on the current facts and circumstances as part of effective risk management. If the situation is in a discovery stage or still developing whereby more information will likely be presented, then those facts should be disclosed.

While settlement offers may expire quickly, they can still provide reasonable quantitative information regarding the exposure. Moreover, investors will be informed about whether such offers are considered reasonable by management and how such offers are being evaluated. Investors are in the best position to determine what information is relevant to their analysis and therefore should be given the fullest information possible—including settlement offers—and allowed to select their information and adjust accordingly.

Question 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?

We strongly prefer a tabular reconciliation that provides greater transparency regarding the effects of contingencies on the financial statements. Tables can be an efficient and effective means of communicating information.

The following information proposed by the Board would be very helpful to an investor's assessment of the amounts recognized in the statement of financial position and how such amounts may affect the amount, nature and timing of cash flows:

a. Increases for loss contingencies recognized during the period;
b. Increases resulting from changes in estimates of the amounts of loss contingencies previously recognized;
c. Increases for recognized loss contingencies of subsidiaries acquired or newly consolidated;
d. Increases (decreases) resulting from changes in foreign currency rates used to translate the recognized amounts stated in currencies other than the reporting currency;
e. Decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized;
f. Decreases resulting from cash payments (or other forms of settlement) for loss contingencies;
g. Decreases resulting from deconsolidation or sale of subsidiaries.

We urge the Board to require that the components of the reconciliation be presented on a gross basis, and not netted. Specifically, increases from changes in estimates in amounts of loss contingencies should be reported separately from decreases in estimates; increases from new subsidiaries should be reported separately from decreases due to deconsolidation; and so forth. Having the information reported on a gross basis provides at least an initial basis to inquire of management as to the nature of and reason for potentially material refinements in estimates that would be obscured if those amounts were netted.

We stress that in addition to the specific reconciliation requirements, an entity should provide a qualitative description of the significant activity in the reconciliation.

Question 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?

We agree that a limited exemption from disclosing prejudicial information should be granted in certain circumstances. However, we would advocate that such an exemption be used in *extremely rare* situations rather than in merely *rare* situations. As we stated to the International Accounting Standards Committee[5]:

> "…Users need more disclosures in cases where the quality of the accounting measurement is not ensured. However, we also understand that in extremely rare

[5] Comment Letter to International Accounting Standards Committee, *Proposed International Accounting Standard, Provisions, Contingent Liabilities and Contingent Assets (E59)*, 7 January 1998. View the full letter at www.cfainstitute.org/centre/topics/comment/1998/e59.html

> circumstances (i.e., litigation), extensive disclosure may be prejudicial to the interests of the enterprise. In those cases, we agree that the amount of the provision need not be disclosed as long as facts and circumstances are sufficiently disclosed so that users understand the nature of the provision and its likely consequences for the enterprise."

We understand that there is a certain amount of opposition to the proposed changes with respect to loss contingencies related to litigation. In particular, there is the belief that any incremental disclosures, other than a description of the legal action, could potentially be useful to a plaintiff.[6] It is purported that the expanded disclosure would make it difficult for a preparer to avoid disclosures that would, or could, be prejudicial and that litigation be removed from the scope of the project and the current requirements of FAS 5 remain in effect. However, we disagree with this notion and feel that informative disclosures when properly crafted could fulfill investors' need for the information and still protect the company from disclosing prejudicial information.

We propose consideration of the following disclosures which should not prove prejudicial to the merits of the litigation:

- The reason why the company is the subject of litigation;
- The amount of damages being sought by the plaintiff (all publicly available information in the court filings);
- The company's response to the complaint, including a description of the defense and why the company is using that defense.

Disclosure of this information will enable existing and potential investors to better assess the risks associated with their investment.

Question 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?

We agree that the two-step approach of first aggregating information at a higher level and then by nature of the contingency enables preparers to disclose information without allowing a counterparty to take advantage of the information to the detriment of the entity. This disclosure should be disaggregated to the lowest level possible so as not to disclose sensitive information specific to the case. The highest aggregation point should be at the business segment level, otherwise the benefit of the disclosure is minimized. We are concerned that preparers may have a tendency to over-aggregate and thus significantly reduce the usefulness of the information provided.

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[6] Letter to Robert H. Herz, Chairman, Financial Accounting Standards Board, 17April 2008, Re: *Disclosures about Loss Contingencies-Potential Amendment of FAS 5*, Financial Executives International.

Question 10. The International Accounting Standards Board (IASB) continues to deliberate changes to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* but has 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?

We support using the term *extremely rare* to describe circumstances under which the prejudicial exemption may be exercised. We anticipate that those cases will be so infrequent as to become virtually non-existent, but in such extremely rare cases the exemption should still be available. Furthermore, using a definition that is consistent with IAS 37 *"Provisions, Contingent Liabilities and Contingent Assets"* is in keeping with the move toward convergence of financial accounting standards.

Question 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?

Yes, we agree that the description of prejudicial information as proposed by the Board is appropriate.

Question 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?

We believe that it is operational for entities to disclose all of the proposed information in both the interim and annual periods, including tabular reconciliation with each. Investors require information on a timely basis and the receipt of disclosure relating to loss contingencies is important information to receive in both interim and annual reporting periods.

Tracking this activity on an on-going basis should be built into the entity's risk management practice and, therefore, this information should be readily available.

Question 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?

The ED appears to capture much of the needed disclosure. We reiterate that the principles of transparency, consistency, and completeness, along with an intention to communicate clearly, must form the basis for disclosure elements wherever they are found. Preparers should be

required to follow these principles when identifying any other information regarding contingencies they deem important to investors. It is critical that the relevant facts, once identified, should be disclosed in as clear and transparent a manner as reasonably possible.

We offer the following additional observation that we believe would simplify and streamline the information about loss contingencies included in financial reports:

There is a large amount of detailed disclosure provided about loss contingencies in the financial reports of companies that file periodic reports with the SEC. This information can be found under "Notes to Financial Statements," "Management's Discussion & Analysis" and "Legal Proceedings." We recommend that the FASB work with the staff of SEC to develop a more streamlined approach to the disclosure about loss contingencies in such periodic reports without compromising or diminishing the goal of full disclosure. For example, the use of a tabular presentation would be useful to summarize such data as: the nature of each kind of loss contingency, the number of lawsuits, plaintiffs, and class actions, and the amounts of expenses related to such contingencies recognized in the financial statements.

Question 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?

We believe that entities should have disclosure information readily available to allow for the implementation of the proposed standard in fiscal years ending after December 15, 2008. Gathering, analyzing, and tracking information with regard to loss contingencies is a best practice for entities with a good risk management process.

In closing, we would like to reiterate our general support of the overall direction the FASB is taking to strengthen disclosures relating to loss contingencies. We feel that investors should be fully informed about all contingencies and risks when they arise.

We appreciate the opportunity to provide comments to the FASB and its staff regarding Exposure Draft *Disclosure of Certain Loss Contingencies an amendment of FASB Statements No. 5 and 141(R).* If you or your staff should have questions or seek further elaboration of our views, please contact Matthew Waldron, at 434.951.5321 or matthew.waldron@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht

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