

the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events \* \* \* [and] the effect of the change would be material to the financial statements. ”

*Question 2:* Do the facts presented above describe an uncertainty that requires disclosures under Statement 5 and SOP 94–6?

*Interpretive Response:* Yes. The staff believes the judgmental adjustments to historical experience for insufficiently understood claims activity noted above results in a loss contingency within the scope of Statement 5 and SOP 94–6. Based on the facts presented above, at a minimum the Company’s financial statements should disclose that for purposes of estimating IBNR claim reserves, past experience was adjusted for what management believes to be abnormal claims experience related to the recent acquisition of Company A and accelerated claims processing. It should also be disclosed that there is a reasonable possibility that the claims experience could be the indication of an unfavorable trend which would require additional IBNR claim reserves in the approximate range of \$XX–\$XX million (alternatively, if Company management is unable to estimate the possible loss or range of loss, a statement to that effect should be disclosed).

Additionally, the staff also expects companies to disclose the nature of the loss contingency and the potential impact on trends in their loss reserve development discussions provided pursuant to Property-Casualty Industry Guides 4 and 6. Consideration should also be given to the need to provide disclosure in MD&A.

*Question 3:* Does the staff have an example in which specific uncertainties involving an individual claim or group of related claims result in a loss contingency the staff believes requires disclosure?

*Interpretive Response:* Yes. A property-casualty insurance company (the “Company”) underwrites product liability insurance for an insured manufacturer which has produced and sold millions of units of a particular product which has been used effectively and without problems for many years. Users of the product have recently begun to report serious health problems that they attribute to long term use of the product and have asserted claims under the insurance policy underwritten and retained by the Company. To date, the number of users reporting such problems is relatively small, and there is presently no

conclusive evidence that demonstrates a causal link between long term use of the product and the health problems experienced by the claimants. However, the evidence generated to date indicates that there is at least a reasonable possibility that the product is responsible for the problems and the assertion of additional claims is considered probable, and therefore the potential exposure of the Company is material. While an accrual may not be warranted since the loss exposure may not be both probable and estimable, in view of the reasonable possibility of material future claim payments, the staff believes that disclosures made in accordance with Statement 5 and SOP 94–6 would be required under these circumstances.

The disclosure concepts expressed in this example would also apply to an individual claim or group of claims that are related to a single catastrophic event or multiple events having a similar effect.

#### *X. Deleted by SAB 103*

#### *Y. Accounting and Disclosures Relating to Loss Contingencies*

*Facts:* A registrant believes it may be obligated to pay material amounts as a result of product or environmental remediation liability. These amounts may relate to, for example, damages attributed to the registrant’s products or processes, clean-up of hazardous wastes, reclamation costs, fines, and litigation costs. The registrant may seek to recover a portion or all of these amounts by filing a claim against an insurance carrier or other third parties.

*Question 1:* Assuming that the registrant’s estimate of an environmental remediation or product liability meets the conditions set forth in paragraph 132 of SOP 96–1 for recognition on a discounted basis, what discount rate should be applied and what, if any, special disclosures are required in the notes to the financial statements?

*Interpretive Response:* The rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm’s-length transaction with a third party. SOP 96–1 further states that the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free<sup>1</sup> and have maturities comparable to that of the environmental or product liability.

If the liability is recognized on a discounted basis to reflect the time

value of money, the notes to the financial statements should, at a minimum, include disclosures of the discount rate used, the expected aggregate undiscounted amount, expected payments for each of the five succeeding years and the aggregate amount thereafter, and a reconciliation of the expected aggregate undiscounted amount to amounts recognized in the statements of financial position. Material changes in the expected aggregate amount since the prior balance sheet date, other than those resulting from pay-down of the obligation, should be explained.

*Question 2:* What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental remediation liabilities?

*Interpretive Response:* Paragraphs 9 and 10 of Statement 5 identify disclosures regarding loss contingencies that generally are furnished in notes to financial statements. SOP 96–1 identifies disclosures that are required and recommended regarding both recorded and unrecorded environmental remediation liabilities. The staff believes that product and environmental remediation liabilities typically are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant’s financial condition, results of operations, or liquidity. In addition to the disclosures required by Statement 5 and SOP 96–1, examples of disclosures that may be necessary include:

- Circumstances affecting the reliability and precision of loss estimates.
- The extent to which unasserted claims are reflected in any accrual or may affect the magnitude of the contingency.
- Uncertainties with respect to joint and several liability that may affect the magnitude of the contingency, including disclosure of the aggregate expected cost to remediate particular sites that are individually material if the likelihood of contribution by the other significant parties has not been established.
- Disclosure of the nature and terms of cost-sharing arrangements with other potentially responsible parties.
- The extent to which disclosed but unrecognized contingent losses are expected to be recoverable through insurance, indemnification arrangements, or other sources, with

<sup>1</sup> As described in Concepts Statement 7.