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Alert Memo

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FASB Reproposes Disclosure Requirements for Loss Contingencies

The FASB has republished for comment proposed amendments to the accounting standard for disclosure of loss contingencies.[1] The reproposal responds to comments on the FASB's original proposal issued in June 2008.[2] That proposal would have significantly expanded both the universe of contingencies to be disclosed and the scope of the required disclosures. The original proposal attracted strong criticism, notably from public companies and the private bar, based on concerns that the disclosures could be highly prejudicial to a company's litigation strategy and ability to preserve the benefits of the attorney-client privilege and other applicable protections.

The FASB has called for comments by August 20, 2010 and proposed that the amendments would take effect in time for 2010 annual reports.[3] In view of the extensive comment process that preceded the reproposal, there is reason to think that the FASB would prefer changes to be limited. However, although the reproposal addresses many of the defects of the original proposal, it continues to raise substantial concerns and fails adequately to take account of the realities of today's litigation environment. The following points are of particular note:

- The reproposal does not retain the exemption for prejudicial information included in the original proposal in part due to concerns about auditing a company's reliance on the provision and the impact that could have on the attorney-client privilege. The Exposure Draft notes that "many of the . . . less factual and more speculative" disclosures have been eliminated in the reproposal. While that may be true, the reproposal continues to call for both qualitative and quantitative information that can be highly prejudicial to a company's litigation posture. In particular, the tabular reconciliation of accruals exposes a company to increased risk of discovery about the level of individual accruals and changes in them over

[1] Financial Accounting Standards Board, Exposure Draft, Proposed Accounting Standards Update, Contingencies (Topic 450), Disclosure of Certain Loss Contingencies, File Reference No. 1840-100 (July 20, 2010), *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821001041&blobheader=application%2Fpdf.

[2] Financial Accounting Standards Board, Exposure Draft, Proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies, an Amendment of FASB Statements No. 5 and 141(R)*, File Reference No. 1600-100 (June 5, 2008), *available at* http://www.fasb.org/draft/ed_contingencies.pdf.

[3] Under the reproposal, the amendments would be effective for public companies for fiscal years ending after December 15, 2010.

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time. If discovery is granted, this information will operate as a "floor" for settlements of claims that might otherwise be resolved by the company on more favorable terms.

- Information about loss contingencies may be aggregated under the reproposal by class or type, but the accompanying implementation guidance suggests the need for a rather refined classification that would require a time-consuming, judgment-driven analysis and could still result in disclosure that prejudices the company in resolving the contingencies.

- Possible insurance or indemnification recoveries may not be considered in determining whether disclosure of a loss contingency is required. For many companies, this will expand significantly the number of loss contingencies subject to disclosure.

- The reproposal retains the requirement for disclosure about remote contingencies that could expose a company to a "potential severe impact" due to their nature, potential magnitude or potential timing (if known). The reproposal retains this requirement only for *asserted* claims. Nevertheless, it may ultimately force disclosure about matters that do not significantly aid an investor's understanding of the company's financial prospects, particularly since potential insurance or indemnification recoveries cannot be considered.

- Even in the form reproposed, the new disclosures will expose companies to meaningful additional risk of further litigation on the basis of the antifraud rules of the U.S. federal securities laws. While this is the case with all public company disclosures, the FASB should be especially sensitive to this risk in the case of forward-looking information that is both highly sensitive and inherently speculative. It is important in this connection that financial statement disclosures do not benefit from the safe harbor for forward-looking statements under the Public Securities Litigation Reform Act.

The Current Standard

Under the current standard set forth in FASB Accounting Standards Codification Topic 450 (formerly Statement of Financial Accounting Standards No. 5) and related FASB interpretations:

- A company must accrue an estimated loss from a loss contingency if both: (a) information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements, and (b) the amount of loss can be reasonably estimated. If the reasonable estimate of a probable loss is a range, the best estimate within that range must be accrued, unless no amount within the range is a better estimate than any other amount, in which case the minimum amount in the range must be accrued.[4]

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[4] FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (Sept. 1976), *available at* http://www.fasb.org/pdf/fin%2014.pdf.

- Even if no accrual is made (or with respect to potential loss exceeding the amount accrued), a company must disclose the contingency in the footnotes to its financial statements if there is at least a "reasonable possibility" that a loss or an additional loss may have been incurred. The disclosure must describe the nature of the contingency and either give an estimate of the loss or range of loss or state that an estimate cannot be made.

The outcome of litigation and other contingencies is difficult to predict, and ASC 450 therefore allows for the exercise of significant judgment. Critics have complained, however, that this latitude makes the standard susceptible to abuse, and they assert that companies often delay disclosure of the amount of potential charges beyond the point when a range of loss could have been reasonably estimated. The FASB's initiative to review ASC 450 is aimed at striking a better balance between these competing considerations.

The Reproposal

Disclosure Principles

- ***Increased Disclosure Over a Contingency's Life Cycle.*** A key driver of the revised standard is that the level of disclosure should depend on the availability of information, which will change over time. In the "early stages of a contingency's life cycle," less information may be available, and therefore less disclosure is required. Disclosure would be more extensive in later periods as information about a potential negative outcome becomes available.

- ***Aggregated Disclosures Permitted.*** The reproposal retains the concept of aggregated disclosures about loss contingencies. However, it calls for an aggregation analysis that ultimately will result in more disaggregated information than would have been the case under the original proposal. Contingencies may be aggregated by class or type (used interchangeably in the reproposal), but companies must consider the "nature, terms, and characteristics" of contingencies in deciding whether aggregation is appropriate. The reproposal suggests, for example, that it may not be appropriate to aggregate litigations with "significantly different timings of expected future cash outflows" or "litigations in jurisdictions that have different legal characteristics that could affect the potential timing or the potential magnitude of the loss."

    - The level of refinement implicit in this guidance would not appear to be workable. For large companies with significant litigation or other proceedings in a variety of U.S. and overseas venues that involve widely varying claims subject to equally numerous procedural and substantive challenges that could affect outcomes, determining a classification framework could, at a minimum, be a very time-consuming exercise. If developed with the level of detail suggested by the reproposal, it is also conceivable that the classification of particular proceedings could change over time, making period-to-period comparisons more difficult. Companies using this approach will have to apply considerable practical judgment.

- The reproposal requires disclosure of the basis for aggregation and reiterates that companies should disclose further information to enable financial statement users to understand the aggregated contingencies' nature, magnitude and potential timing (if known).

- We expect that most companies will favor less detailed classifications, for both practical and substantive reasons. Since the amendments could take effect in time for the 2010 annual reporting season, companies should review existing contingencies now with a view to developing a classification framework. It may be appropriate to accelerate consideration of the framework with the external auditors to the extent permitted by applicable regulations and auditing standards.

When Disclosure Required

- ***"Reasonably Possible" Standard Retained.*** The reproposal retains in most respects the disclosure threshold under the existing standard for asserted and unasserted claims – *i.e.*, disclosure is required if the likelihood of loss is at least reasonably possible (which the reproposal treats as equivalent to "more than remote"). As described below, like the original proposal, the reproposal expands the scope of loss contingencies that must be disclosed in one important respect: a company must consider whether disclosure of "asserted but remote" contingencies is appropriate "to inform users about the entity's vulnerability to a potential severe impact."

- ***Consideration of Insurance or Indemnification Recoveries Prohibited.*** In an important change from both the existing standard and the original proposal, which was silent on the point, the reproposal prohibits consideration of possible insurance or indemnification recoveries in determining the need for disclosure. This provision will likely expand the number of contingencies subject to disclosure.

  - The FASB cites some commenters' views that insurance coverage is often "uncertain" and may be subject to litigation with the insurer. This argument is in our view wholly unpersuasive and fails to acknowledge the central role of insurance in risk management and timely claims resolution. Indeed, in U.S. federal courts, the importance of insurance to motivate settlement is reflected in mandatory discovery of certain insurance information.[5] Moreover, loss contingencies are themselves uncertain; it seems inappropriately asymmetric to exclude consideration of these common mitigating factors on the grounds that they are also contingent. Indeed, insurance recoveries present a much less uncertain contingency in view of the significant body of case law in the insurance area. Finally, in a standard that is otherwise driven by highly fact-intensive inquiry, there is no principled justification for excluding consideration of these recoveries. A more sensible approach would be to caution companies to give due

[5] Fed. R. Civ. P. 26 (a)(1)(A)(iv).

consideration to the likely timing and magnitude of recoveries, as well as factors that may prevent or delay them in whole or in part.

- ***Disclosure Required About Asserted But Remote Contingencies Involving Potential "Severe Impact."*** The reproposal limits disclosure of remote contingencies to those involving asserted claims. The original proposal would also have required disclosure of any contingency expected to be resolved within the next year that could have a "severe impact," regardless of whether the claim had been asserted or was likely to be asserted. This standard was highly objectionable insofar as it could, for example, have spotlighted unasserted claims with a low probability of success, but some settlement value, thus increasing the likelihood of their assertion.

  - A "severe impact" is defined as a higher threshold than material, but less than catastrophic, and means a "significant financially disruptive effect on the normal functioning of an entity."

    This relatively high bar appears to give companies significant latitude in reaching a judgment that no disclosure is required, and companies are well-practiced in balancing the likelihood that an event will occur with the magnitude of its consequences when making materiality judgments.[6] But the reproposal constrains that latitude by imposing a more detailed analytical framework that excludes a key input, namely, potential insurance and indemnification recoveries, which are the main ways companies seek to avoid financial disruption. The reproposal would not appear to affect consideration of other ways companies mitigate financial disruption, such as raising new funding or selling assets.

  - The reproposal clarifies, contrary to the original proposal, that the amount of damages sought by a plaintiff is not, by itself, determinative of whether a contingency could have a severe impact, given the potential that a claim may be "frivolous with an artificially inflated amount." Instead, the reproposal relies on a facts-and-circumstances analysis. The reproposal thus takes better account of the fact that complaints may not specify an amount of damages or may specify an amount unrelated to the merits or likely resolution of the claim.

Required Qualitative Disclosures

- The amendments will require significant new qualitative disclosures, but the changes are of far lesser scope than the original proposal. The original proposal called for considerable detail about nonpublic information, notably the factors likely to affect the outcome of the

[6] *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 238 (1988) ("with respect to contingent or speculative information or events . . . materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event . . .'"), citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 849 (2d Cir. 1969) (en banc), *cert. denied*, 394 U.S. 976 (1969).

contingency, an assessment of the likely outcome, and the assumptions made in reaching that conclusion and developing estimates of possible loss. Many commenters objected based on the often speculative nature of these disclosures and the highly prejudicial effect they could have on a company's litigation posture, including the potential to result in a waiver of the attorney-client privilege.

Addressing the most acute of these concerns, the reproposal calls for qualitative disclosures that:

- permit a user of financial statements to understand the nature of the loss contingencies and their risks;
- in early stages of a contingency, at a minimum include the contentions of the parties;
- as the loss contingency develops over time, become "more extensive as additional information about a potential unfavorable outcome becomes available . . . .";
- provide, in the case of any individually material loss contingency, sufficient information to enable users to obtain further information from public sources (*e.g.*, court records), the current status and, if known, the "anticipated timing of, or the next steps in the resolution" of, the contingency; and
- in the case of aggregated disclosures, enable users to understand the nature, potential magnitude and timing (if known) of any loss.

These requirements improve on the original proposal, but they state open-ended principles that will be difficult to apply. The additional detail concerning individual cases will also undercut some of the benefits of aggregated disclosure.

Required Quantitative Disclosures

- ***Disclosure of Best Estimate of Maximum Loss Eliminated.*** The reproposal eliminates some of the most criticized quantitative disclosure requirements of the original proposal. The original proposal would have required companies to disclose the amount claimed or assessed or, if none, the company's best estimate of the maximum exposure to loss. Many commenters objected, based on the challenges and cost of estimating the maximum exposure and on the potential prejudicial impact of the disclosure.

- ***Disclosure Refocused on Publicly Available and Non-Privileged Information.*** The reproposal refocuses disclosure on publicly available and non-privileged information. Companies must disclose:

  - publicly available information, such as the amount claimed by the plaintiff or the damages indicated by expert testimony;

- other non-privileged information that is relevant to an understanding of the potential magnitude of the loss; and

- where it has been provided to the plaintiff, is discoverable by the plaintiff or a regulatory agency or relates to a recognized receivable for recoveries, information about recoveries from insurance or other sources.

While an improvement over the original proposal, this approach remains problematic. For example:

- The amount of damages indicated by expert testimony may not be useful disclosure. Litigation often features a "battle of the experts." A company is not likely to credit testimony by a plaintiff's expert and may even conclude that the required disclosure would be misleading, particularly if the company intends to challenge the expert's very status as such. Even if mitigating disclosure were permitted (*e.g.*, about the company's expert testimony), it is hard to see the value of this disclosure to investors, since it will present a necessarily incomplete and confusing perspective about the potential magnitude of the loss contingency.

- The reproposal would require disclosure of other "publicly available" quantitative information, but does not limit this information to that which is available in the proceeding, nor does it explain how this element would relate to non-litigation contingencies that do not involve a similar, systematic fact-finding process.

- Other "non-privileged" information would include all information exchanged during the discovery process. This information is not publicly available unless it is introduced into evidence or filed with the court in connection with motions or other submissions. The requirement exposes companies to a costly and time-consuming review of discovery materials developed for litigation purposes, an exercise with objectives that are fundamentally distinct from those underlying financial statement preparation. This requirement also risks disclosure that will at best provide minimal insight into a contingency and, at worst, be confusing or misleading.

- The requirement to provide information about recoveries from insurance or other sources that is "discoverable" effectively compels companies to evaluate whether information is, in fact, discoverable and, if so, to disclose it, even if that information has not been affirmatively sought by plaintiffs or regulators and is not otherwise required to be provided to them. As noted above, U.S. federal court proceedings require disclosure of certain insurance-related information, but that may not be the case in proceedings brought in other jurisdictions.

- ***Disclosure of Accruals.*** For contingencies that are at least reasonably possible, the reproposal would require disclosure of any amount accrued, and, if it can be estimated, the

possible loss or range of loss in excess of any accrual. If an estimate is not possible, companies would have to say so and explain why not.

Exemption for Prejudicial Information Eliminated

- Unlike the original proposal, the reproposal contains no exemption from disclosures that would be prejudicial to the company's litigation posture. The FASB decided to eliminate this exemption in part due to the audit consideration we note above. The commentary accompanying the reproposal also states that because the amendments would eliminate "many of the [original proposal's] proposed disclosures that are less factual and more speculative in nature," the exemption may not be needed. The FASB also believes that the ability to aggregate disclosures further mitigates concerns about disclosure of prejudicial information. As noted above, while the reproposal reflects significant improvement in this respect, it does not go far enough. Given today's high stakes litigation environment, companies should object to the absence of this exemption, unless the required disclosures are narrowed further.

Tabular Reconciliation of Recognized Loss Contingencies

- ***Tabular Presentation Retained.*** As in the original proposal, a company would be required to provide, for each period for which an income statement is presented, a reconciliation in tabular form of recognized loss contingencies (*i.e.*, accruals). Unlike the original proposal, however, this reconciliation must be by class, rather than on an overall aggregate basis. The reconciliation would include, at a minimum:

  - carrying amounts of the accruals at the beginning and end of the period;
  - amount accrued during the period for new loss contingencies recognized;
  - increases for changes in estimates for loss contingencies recognized in prior periods;
  - decreases for changes in estimates for loss contingencies recognized in prior periods; and
  - decreases for cash payments or other forms of settlements during the period.

  By permitting information to be aggregated only on a class basis, the reproposal heightens the concerns raised with respect to the original proposal that companies will be required to disclose prejudicial information. To the extent changes in accruals can be traced to a particular litigation or other contingency, the disclosure invites discovery by plaintiffs, making the disclosure potentially outcome-determinative of the contingency itself. The risk in fact is imposed on companies as a result of the reproposal's faulty premise that class-by-class aggregation is called for by ASC 450. The reproposal cites the requirement in ASC 450 that disclosure of accruals may be required in certain cases to avoid misleading

financial statements. Although we do not disagree with that standard, it does not justify a class-by-class presentation if the result would be disclosure about immaterial matters that would nevertheless be highly prejudicial to the company.

Aggregation also provides only partial protection. Where a company is involved in a single legal dispute, for example, aggregation will be impossible. Even when aggregated with one or more smaller claims, it will often be evident that a particular claim accounts for the bulk of an aggregated provision.

- ***Additional Disclosure about Accrual Activity Required.*** A company would be required to describe the significant activity in the reconciliation and disclose the line items in its income statement and balance sheet in which recognized contingencies were recorded. If the underlying cause and ultimate settlement of a contingency occurred in the same period, the contingency would be excluded from the reconciliation.

* * *

The FASB's reproposal is a considerable improvement over the 2008 approach. That said, even among those who concede the importance of a fresh look at ASC 450, the reproposal continues to call for a disclosure framework that is unworkable in several important respects and exposes companies to significant prejudice in pending proceedings, as well as to meaningful risk of additional liability based on the new disclosures.

Please contact any of your regular contacts at the firm or any of our partners and counsel listed under the "Corporate Governance," "Litigation and Arbitration" and "Securities Enforcement and White Collar Defense" sections of our website if you have questions.

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