



FASB Proposes Expanded Disclosures Regarding Loss Contingencies

Posted by Charles M. Nathan, Latham & Watkins LLP, on Thursday August 26, 2010

Editor's Note: [Charles Nathan](#) is Of Counsel at Latham & Watkins LLP and is co-chair of the firm's Corporate Governance Task Force. This post is based on a Latham & Watkins Client Alert by [Robert J. Malioneck](#), [Kim Marie K. Boylan](#) and [Adam J. Goldberg](#).

The Financial Accounting Standards Board (FASB) proposes to “retain” existing disclosures and “enhance them with additional information” by updating the requirements in what is now known as FASB Accounting Standards Codification Topic 450 (formerly Statement of Financial Accounting Standards No. 5) (ASC 450) for disclosure of certain loss contingencies.¹ The FASB's proposal is the culmination of an extended study following its 2008 proposal to amend the standards regarding loss contingencies.

The prior proposal would have expanded vastly the disclosures required by US issuers, particularly with respect to litigation loss contingencies, and generated significant comments and debate as to whether, among other concerns, the expanded disclosures would have infringed upon the attorney-client privilege and work product protections.²

The proposed amendments both expand the universe of loss contingencies that must be disclosed and increase the quantitative and qualitative description of those contingencies, specifically regarding pending and threatened litigation proceedings, but not to the same degree as FASB's 2008 proposal. If adopted, the amendments would become effective for annual financial statements issued for fiscal years ending after December 15, 2010 and for subsequent interim and annual periods. Comments on the proposal are due by August 20, 2010

¹ See Financial Accounting Standards Board Exposure Draft, Proposed Accounting Standards Update, Contingencies (Topic 450) — Disclosure of Certain Loss Contingencies, dated July 20, 2010, available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821001041&blobheader=application%2Fpdf>.

² See 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), dated June 5, 2008, available at http://www.fasb.org/draft/ed_contingencies.pdf.

The Current ASC 450 Standard

ASC 450 governs the accrual and disclosure of loss contingencies in a company's financial statements. The existing version of ASC 450 categorizes loss contingencies as "probable" (likely to occur), "reasonably possible" (less than likely but more than remote) or "remote" (slight). ASC 450 requires a company to accrue a loss contingency when the loss is probable and the amount of the loss "can be reasonably estimated." When the standards for accrual are not met, the company still must disclose the loss contingency if there is at least a reasonable possibility that the loss will occur. A disclosure of a loss contingency must describe "the nature of the contingency" and provide an estimate of the possible loss, if one can be made.

Under the existing ASC 450 standard, reporting companies typically do not disclose an estimate of their loss exposure due to the difficulty of providing an accurate figure. Companies frequently describe the basic relevant facts and procedural history of the litigation or claim, and indicate the company's general position regarding the matter (e.g., the company will defend its interests vigorously).

The Proposed Amendments to ASC 450

Scope of Disclosures

The proposed accounting standard would replace the disclosure requirements applicable to "certain loss contingencies" within the scope of ASC 450, including pending and threatened litigation.³ ASC 450's existing standards for accrual and measurement of contingencies would continue to apply. Also consistent with the current ASC 450, the proposed amendments would continue to mandate that all loss contingencies be disclosed, regardless of whether they are accruable, unless they are remote — with one exception: Under the proposed new standard, even a remote loss contingency must be disclosed if, due to its nature, potential magnitude or potential timing (if known), it could have a "potential severe impact." The FASB defines a "severe impact" as a "significant financially disruptive effect on the normal functioning of an entity," which is a higher threshold than "material."

In addition to this broadening of the types of contingencies that must be disclosed, the scope and detail of the required disclosures in the notes to a company's financial statements would exceed those currently required under ASC 450, whether or not there has been an accrual, as discussed below.

³ This Client Alert focuses specifically on loss contingencies arising from pending and threatened litigation.

Quantitative Disclosures

Under FASB's proposal regarding necessary disclosures, if the claimant requests a specific sum, that amount must be included in the company's disclosure. Currently, companies typically disclose only the specific amount sought by claimants, if stated publicly. It is noteworthy, however, that the FASB's proposal in June 2008 would have required, if the claimant failed to specify the amount of damages or other monetary relief sought (as is often the case), the reporting company instead would need to disclose the company's estimate of its "maximum exposure" to the claim. That proposal led to significant public opposition, and FASB's current proposal no longer contains this requirement. However, the current exposure draft proposes to require a company to disclose an estimate or range of possible loss for all loss contingencies that are at least reasonably possible, although the new standard would allow companies to aggregate disclosures about similar contingencies, so long as the basis for aggregation is also disclosed.

Qualitative Disclosures

The revised ASC 450 would require additional qualitative disclosure to enable users to understand the loss contingency's nature and risks, including:

- The contentions of the parties
- The anticipated timing of the contingency's resolution
- Information about potential recoveries from insurance and other sources only if, and to the extent it has been provided to the plaintiff in a litigation contingency, it is discoverable by either the plaintiff or a regulatory agency, or relates to a recognized receivable for such recoveries
- Publicly available qualitative information and other non-privileged information that would be relevant to users to enable them to understand the potential magnitude of loss; and
- Sufficiently detailed information to enable users to obtain additional information from publicly available sources such as court records

FASB recognizes in the exposure draft that "[a]vailable information may be limited and, therefore, disclosure may be less extensive in early stages of a loss contingency," but disclosure likely would be more extensive in subsequent reporting periods.

Significantly, the 2008 proposal would have required a disclosure of the factors likely to affect the outcome of the contingency, along with their potential effect on the outcome. The current proposal does not retain that provision. The FASB noted that many comment letters opposed this disclosure because compiling the required information would be difficult and costly, particularly with respect to litigation contingencies, which can be ongoing for many years. In addition, the

FASB acknowledged the concern raised by some comment letters that this disclosure would require “judgments that are more predictive or speculative in nature rather than factual.”

In addition, as to all accrued loss contingencies, the proposed amendments provide that the footnotes to the financial statements must contain a tabular reconciliation of the total amount recognized for the contingencies at the beginning and end of the reporting period. The reconciliation must 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 settlement during the period.

Issues Raised by the Proposed Amendments

FASB’s proposed reworking of the disclosure requirements applicable to litigation contingencies resolves many of the significant concerns raised with respect to the prior proposal, but still raises certain issues.

Potential Inconsistency and Confusion

ASC 450 has governed the disclosure of loss contingencies for over 30 years, and its guidelines are well understood by reporting companies, investors, auditors and attorneys. One of the overall purposes of financial statements is to provide information to users that is material — an inherently judgmental term intended as a balance between providing too little information and too much. Reporting companies have been entrusted to exercise reasonable judgment — within the guidelines of GAAP — to provide what is appropriately considered material. With respect to loss contingencies, companies have done so by following ASC 450’s straightforward requirement that the company describe the “nature” of a possible loss and estimate the possible loss or range of loss if the company can make such an estimate. The standard, if adopted, also will need to be analyzed in comparison to other GAAP disclosure requirements, including those related to tax contingencies under FASB Interpretation No. 48.

Pressure on Attorney-Client Protections

In promulgating the new exposure draft of ASC 450, FASB acknowledged that public comments raised significant issues regarding the 2008 proposal. The FASB received 241 comment letters to the 2008 exposure draft and held two roundtable discussions in March 2009. In particular, FASB agreed with comments expressing concern about disclosure of the “maximum exposure” of a loss contingency and decided to eliminate that requirement in the new proposed amendments. Furthermore, on the basis of comments and the roundtable discussions, FASB “decided to focus

the quantitative disclosures on non-privileged information and not to add any new quantitative disclosures that are based on management's predictions about a contingency's resolution." Nonetheless, the newly proposed standard may continue to raise privilege issues.

For instance, the new ASC 450 could destabilize the 1975 "Treaty" between the legal and accounting professions over lawyers' responses to auditors' inquiries regarding certain loss contingencies, as memorialized in the ABA's "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information."⁴ The Treaty aims to protect against the waiver of the attorney-client privilege in communications by the company's attorney to the outside auditors regarding litigations and claims, by setting forth guidelines as to what information, confirmations and opinions the lawyer may provide and the auditor may expect. As an example, the Treaty does not contemplate that a lawyer's "audit letter" will describe whether "remote" losses may be resolved in the near-term and could have a "severe impact" on the company. Nor does it provide for lawyers to express a view to the auditors on the outcome of a loss contingency or the range of loss, unless the possibility that the lawyer's prediction is incorrect is "slight."

Proposed Amendments and Regulation S-K

Some commentators have noted that FASB's 2008 proposal could have been considered to conflict with the SEC's regulations governing a company's disclosures of legal proceedings in SEC filings, and some of these potential inconsistencies may remain. Specifically, Item 103 of Regulation S-K requires that the issuer disclose "the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought."⁵ Item 103 further provides that "[n]o information need be given with respect to any proceeding that involves primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis." FASB's proposal does not discuss Regulation S-K.

Conclusion

The practical implications of FASB's proposed amendments to ASC 450 are far from certain, but the disclosure requirements contemplated by the amendments may continue to raise questions. With only a thirty-day comment period, there will be little time to react before the effective date of the new ASC 450, if adopted. To discuss the proposed amendments or the FASB comment process, please contact any of the authors of this Alert, or any of the attorneys listed below.

⁴ Available at <http://www.abanet.org/buslaw/attorneyclient/policies/aicpa.pdf>.

⁵ 17 CFR 229.103.