FASB Issues Revised Exposure Draft on Accounting for Loss Contingencies

On July 20, 2010, the Financial Accounting Standards Board (FASB) issued a revised exposure draft (Exposure Draft) that would amend the disclosures for loss contingencies in Section 450-20 of the FASB's Accounting Standards Codification (ASC), *Accounting for Contingencies* (originally issued as FASB Statement No. 5).

The FASB's current proposal addresses some of the concerns that companies and other constituents had raised on the FASB's earlier June 5, 2008 Exposure Draft (2008 Exposure Draft), which was subject to widespread criticism.[1] Commenters on the earlier 2008 proposal expressed concern that the proposed quantitative and qualitative disclosures could force companies to waive attorney-client privilege and be detrimental to a company's ability to defend itself in litigation proceedings due to disclosure of prejudicial information.[2] Although the revised Exposure Draft purports to address these concerns by removing the requirements to include certain disclosures that could be considered to be prejudicial, the disclosure principles and quantitative and qualitative disclosures in the latest Exposure Draft are broadly drafted and nonetheless could result in disclosure of sensitive litigation strategies and concerns about waiver of the attorney-client privilege. In addition, the Exposure Draft requires enhanced disclosure about certain remote loss contingencies, which is likely to be the subject of continued controversy.

In particular, companies are likely to find the following aspects of the revised Exposure Draft troublesome:

- The required quantitative disclosures are no longer limited to contingencies that are *at least reasonably possible*,[3] the current standard. Disclosure about certain remote

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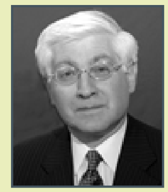

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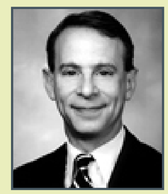

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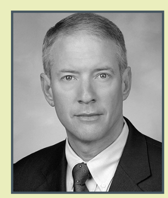

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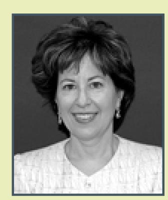

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1 Of 241 comment letters that the FASB received on the 2008 Exposure Draft as of October 6, 2008, 201 were opposed. *See* FASB Final Comment Letter Summary, *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156421386. In addition, many companies and other commentators raised significant concerns at two roundtables which the FASB held on March 6, 2009, to obtain feedback on the 2008 Exposure Draft.

2 *See* FASB Final Comment Letter Summary, *id.*

3 "Reasonably possible" is defined to mean that the chance of the future event occurring is more than remote

loss contingencies, due to their nature, potential timing, or potential magnitude, would also be required if necessary to inform users about the company's exposure to a potential severe impact. Judgment would be required in assessing whether disclosure of a remote loss contingency is necessary.

- The Exposure Draft no longer includes an exemption from disclosing information for certain contingencies when such disclosure could be prejudicial to a company's position. The absence of a prejudicial exemption in the final modifications will require that companies consider carefully their disclosures to avoid unintentionally signaling to adversaries information that can be used in disputed matters against them.

In comparison to the 2008 Exposure Draft, the revised Exposure Draft:

- Places more emphasis on publicly available, factual information, rather than predictions about future outcomes;
- Is less likely, in FASB's view, to result in a waiver of attorney-client privilege because generally only publicly available and non-privileged information needs to be provided by attorneys. However, in practice, the Exposure Draft's requirements may strain the current agreement between the legal and auditing professions regarding the information that lawyers must provide in response to auditor inquiries regarding loss contingencies and the information that auditors may review to support their opinion on the financial statements. Thus, the revised Exposure Draft may continue to raise concerns about waiver of the attorney-client privilege.

The 2008 Exposure Draft included a limited exemption from disclosing prejudicial information. The FASB eliminated this exemption in the revised Exposure Draft because it believes the revised proposal requires companies to disclose only publicly available, factual information rather than predictive information. In addition, FASB believes that the exemption for prejudicial information is no longer necessary because companies will be permitted to aggregate disclosures of similar contingencies. The FASB has asked for comments on whether any of the disclosure requirements in the new Exposure Draft would be prejudicial.

The proposed disclosures apply to all companies except that the tabular reconciliation of accrued contingences (discussed below) would not be required for nonpublic companies.

FASB currently anticipates that a final standard can be issued in time to take effect in 2011 for calendar year companies. If adopted on the schedule anticipated by FASB, the new disclosures would be applicable for annual financial statements of public companies for fiscal years ending after December 15, 2010, and for interim and annual periods in subsequent years. Calendar year companies would be required to include the new disclosures in annual financial statements for the year ended December 31, 2010. For nonpublic companies, the new guidance would defer the effective date for one year and become effective for the first annual period beginning after December 15, 2010, and for interim periods of fiscal years subsequent to the first annual period. The revised Exposure Draft only requires enhanced disclosure in the year of adoption for the current year, and companies presenting comparative financial statements will be under no obligation to amend their disclosures for comparable periods.

Comments on the revised Exposure Draft are due by August 20, 2010. Due to the short 30-day comment period, companies should begin to assess now how the Exposure Draft may affect disclosures in their financial statements.

Disclosure Objective and Principles

The Exposure Draft requires companies to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand their nature, potential timing, and potential magnitude. To achieve this objective, a company must consider the following principles in determining disclosures that are appropriate for its individual facts and circumstances:

- During early stages of a contingency's life cycle, a company must disclose information (even though its availability may be limited) to help users understand

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but less than likely, with "remote" being defined as "slight."

the nature, potential magnitude, and potential timing (if known) of a loss contingency. In subsequent reporting periods, companies are required to disclose more extensive information as additional information becomes available.

- A company may aggregate disclosures about similar contingencies (for example, by class or type) so that the disclosures are understandable and not too detailed. If a company provides disclosures on an aggregated basis, it must disclose the basis for aggregation.

Proposed Disclosures for Loss Contingencies

Disclosure Thresholds

The Exposure Draft revises the applicable disclosure thresholds as follows:

- ***Disclosure Required When Loss is at Least Reasonably Possible.*** The current requirement to disclose asserted claims and assessments with a likelihood of loss that is at least reasonably possible remains unchanged, but the amount of information that must be disclosed for all loss contingencies has increased. The required disclosure is described under "Qualitative Disclosures" and "Quantitative Disclosures" below.
- ***Disclosure Required When Loss is Remote.*** The Exposure Draft states that disclosure of certain remote loss contingencies, due to their nature, potential timing, or potential magnitude, may be necessary to inform users about the company's vulnerability to a potential severe impact. The term "severe impact" is defined as "a significant financially disruptive" effect on the normal functioning of a company. While "severe impact" is a higher threshold than material, it nonetheless includes matters that are less than catastrophic. A company will need to exercise judgment in assessing its specific facts and circumstances to determine whether disclosure about remote contingencies is necessary. Factors that a company may consider in making this determination include any of the following:

  — The potential effect on the company's operations

  — The cost to the company for defending its contentions

  — The amount of effort and resources management may have to devote to resolve the contingency

The plaintiff's amount of damages claimed, by itself, does not necessarily determine whether disclosure about a remote contingency is necessary although it could be one of the factors to be considered in this determination.

When assessing the materiality of loss contingencies to determine whether disclosure is required, the company must not consider the possibility of recoveries from insurance or other indemnification arrangements.

Unasserted Claims and Assessments. Currently, unasserted claims and assessments need not be disclosed unless it is probable that the claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. The Exposure Draft maintains such limitations but highlights that an entity should consider all information of which it is aware when determining the degree of probability that a claim will be asserted and an unfavorable outcome could occur. It remains to be seen whether FASB's slight change in emphasis regarding unasserted claims and assessments will result in auditors seeking additional information concerning such matters and the effect of any such change on disclosure practices or requests for information about such matters from outside counsel (which currently are limited by the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information).

Qualitative Disclosures

For all contingencies that meet the disclosure threshold (i.e., all loss contingencies that are at least reasonably possible and those remote contingencies that meet the thresholds discussed above), a company must disclose the following qualitative information (in addition to the tabular reconciliations discussed below):

- Information to enable users to understand the nature and risks of a contingency or group of contingencies.
- During early stages of asserted litigation contingencies, at a minimum, the contentions of the parties (for

example, the basis for the claim and the amount of damages claimed by the plaintiff and the basis for the company's defense or a statement that the company has not yet formulated its defense). In subsequent reporting periods, more extensive disclosure as additional information about a potential unfavorable outcome becomes available. Furthermore, if known, a company must disclose the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies.

- For individually material contingencies, disclosure that is sufficiently detailed to enable financial statement users to obtain additional information from publicly available sources such as court records. (For example, a company must disclose the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties to the litigation, a description of the factual basis alleged to underlie the proceedings, and current status.)
- When disclosure is provided on an aggregated basis, the basis for aggregation and information that would enable financial statement users to understand the nature, potential timing (if known), and potential magnitude of loss.

The Exposure Draft's qualitative disclosures, when combined with the tabular disclosure requirements and disclosure principles, are broadly drafted and could result in disclosure of litigation strategies, especially where a company faces only a limited number of loss contingencies during a given period.

Quantitative Disclosures

Contingencies That Are "At Least Reasonably Possible." For all contingencies that are at least reasonably possible, companies must disclose:

1. Publicly available quantitative information, for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses.
2. An estimate of the possible loss or range of loss and the amount accrued, if any.[4]
3. If the possible loss or range of loss cannot be estimated, a statement that an estimate cannot be made and the reason(s) why.
4. Other non-privileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss.
5. Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable either by the plaintiff or by a regulatory agency, or it relates to a recognized receivable for such recoveries. If the insurance company has either denied, contested, or reserved its rights related to the company's claim for recovery, the company must disclose that fact.

Under item 2 above, for all contingencies that are at least reasonably possible, companies must disclose an estimate of the possible loss or range of loss and the amount accrued, if any. Currently, under ASC 450-20, reporting companies are not required to disclose the amount accrued for a litigation contingency except "in some circumstances" where disclosure of the amount accrued "may be necessary for the financial statements not to be misleading." This change in the required disclosure for accruals could arm a company's adversaries with formidable information in settlement negotiations because

4 Currently, under ASC 450-20, a company must accrue a loss contingency when (1) it is "probable" that an asset had been impaired or a liability had been incurred at the date of the financial statements; and (2) the amount of the loss can be reasonably estimated. Where the amount of the loss can be reasonably estimated within a range, the second condition is met and an amount must be accrued for the loss. If no accrual is required with respect to a loss contingency because these two conditions are not satisfied, or if exposure to loss exists in excess of any amount accrued, then the notes to a company's financial statements currently must include disclosure about the loss contingency where there is at least a "reasonable possibility that a loss or an additional loss may have been incurred." The footnote disclosure must set forth the nature of the loss contingency and the range of probable loss if it can be reasonably estimated. However, if the range of probable loss cannot be estimated, it does not have to be disclosed. Loss contingencies that are "remote" are not currently required to be disclosed.

loss contingencies are only accrued if it is "probable" that an asset had been impaired or a liability incurred and the amount of loss can be reasonably estimated. Although aggregation of similar disclosures is permitted if the basis for aggregation is disclosed, this will do little to help a company that only has a few large cases.

The 2008 Exposure Draft included a requirement to disclose a company's best estimate of the maximum exposure to loss in cases where there is no claim or assessment amount. This would have forced companies to come up with an estimate even when the plaintiffs could not or did not do so, thereby potentially setting a floor for a company's adversaries settlement negotiations.[5] The revised Exposure Draft eliminates this requirement but retains a requirement to disclose the amount of a claim as asserted by the plaintiff in the complaint. Many companies and attorneys objected to mandated disclosure of this amount in all cases, even where the amount is publicly available, because plaintiffs often exaggerate the amount of their claim in court filings. Thus, the amount claimed may not be indicative of the company's potential exposure. Similarly, the amount of damages in testimony of expert witnesses is often speculative and inflated. FASB indicated in the Exposure Draft that it believes that publicly available disclosures about a contingency would not prejudice the outcome of the contingency.

In addition, the requirement that information about possible recoveries from insurance and other sources must be provided if it is discoverable by the plaintiff is problematic because such information could readily become the subject of discovery. Disclosure of a company's liability coverage could be prejudicial to a company's case.

Remote Contingencies. For remote contingencies that meet the disclosure threshold, companies would be required to disclose the quantitative information required by items 1, 4, and 5 above but would not be required to include the information described in items 2 and 3 above. Thus, for remote contingencies, a company would not have to provide an estimate of the possible loss or range of possible loss, the amount accrued (if any), or furnish a statement regarding why the company cannot estimate the possible loss or range of loss. In this respect, FASB has addressed the complaint that disclosing information about remote loss contingencies could confuse and potentially mislead users of financial information because such estimates might be speculative.

However, based on prior comment letters and the FASB's roundtable on March 6, 2009, we anticipate that many companies are likely to object to the required disclosures for remote loss contingencies. Item 1 above requires disclosure of publicly available information such as the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses. These amounts may not be indicative of the loss that a company may ultimately incur. In addition, item 4 above requires disclosure of non-privileged information that may be relevant to financial statement users, even if such information is not publicly available. Finally, commenters have also expressed concern about disclosing information about possible recoveries from insurance and other sources.

Tabular Reconciliation

For every annual and interim reporting period for which a statement of financial position and a statement of financial performance is presented, public companies must disclose, in tabular format, reconciliations by class of loss contingencies that have been recognized or accrued. The reconciliations would include all of the following:

- The 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.

5 The 2008 Exposure Draft further stipulated that if a company believes the amount of the claim or assessment or the maximum exposure to loss is not representative of the company's actual exposure, the company would be permitted, but not required, to also disclose the company's assessment of the possible loss or range of loss.

- Decreases for cash payments or other forms of settlements during the period.

The tabular reconciliation requirement in the Exposure Draft is problematic because disclosure of increases or decreases in estimates for loss contingencies recognized in prior periods can provide adversaries with valuable signals regarding the reporting company's assessment of legal claims or strategies.

Loss contingencies whose underlying cause and ultimate settlement occur in the same period should be excluded from the tabular reconciliation. A public company must describe the significant activity in the reconciliations described above and disclose the line items in the statement of financial position and the statement of financial performance in which recognized (accrued) loss contingencies are included. All loss contingencies recognized in a business combination must be included in the reconciliations but shown separately if they have a different measurement attribute (for example, fair value).

Aggregation

In permitting a company to aggregate loss contingencies by class or type for the purposes of disclosure, the Exposure Draft provides that an entity must exercise judgment and strike a balance between the obscuring of important information and overburdening a user of financial statements with excessive detail. While aggregating contingencies, entities must evaluate whether contingencies are sufficiently similar to be included in one class based on their nature, terms and characteristics.

If disclosures are to be aggregated, an entity should disclose information that would enable financial statement users to understand the nature, potential magnitude and potential timing, if known, of loss contingencies. The revised Exposure Draft provides that if there are a large number of similar claims that an entity wishes to aggregate for disclosure purposes, the entity should consider disclosing the matters by reference to a number of factors, which could include:

- The total number of claims outstanding
- The average amount claimed
- The average settlement amount

The 2008 Exposure Draft had included an exemption from disclosing information for certain contingencies, such as pending or threatened litigation, when such disclosure could be prejudicial to a company's position. In circumstances in which disclosure of the information required would be prejudicial to a company's position in the underlying litigation proceeding, the June 2008 Exposure Draft provided that a company could omit certain information, such as its best estimate of loss or range of loss, so long as it has aggregated its disclosures for all loss contingencies at a level higher than by the nature of the contingency such that the disclosure of the information is not prejudicial. Furthermore, in an instance in which even that level of disclosure would be prejudicial, which the FASB suggested should be "rare," such as where there is only a single loss contingency, a company could forego disclosing the information that would be prejudicial so long as it discloses that the information has not been disclosed and the reason why, along with sufficient information about the contingency to provide appropriate factual information about the contingency, its status, and factors likely to affect the ultimate outcome of the contingency.

In light of modifications to the Exposure Draft to delete requirements as to predictive or speculative information and instead provide predominantly factual information, FASB decided to not include a prejudicial exemption. The absence of a prejudicial exemption in the final modifications will require that entities consider carefully their disclosures and any use of aggregation to meet the conflicting requirements of the new provisions while not unintentionally signaling to adversaries information that can be used in disputed matters against the information provider.

Implementation

Any potentially affected parties who wish to provide comments to FASB on the revised Exposure Draft will need to act quickly to ensure that their concerns are raised, and given that the Exposure Draft already reflects the views of FASB to the many comments provided in 2008 and continuing debate within FASB, parties can expect that the Exposure Draft is not likely to change to any significant degree. Thereafter, assuming that the changes to disclosure requirements set forth in the Exposure Draft are adopted on the schedule included in the Exposure Draft, entities with fiscal years ending on December 31, 2010 will need to begin analysis, consideration and drafting of any changes to their disclosures that will be required going forward.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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