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FASB Proposes Expanded Disclosure of Litigation and Certain Other Loss Contingencies

The Financial Accounting Standards Board ("FASB") recently issued an Exposure Draft of a proposed Statement of Financial Accounting Standards regarding Disclosure of Certain Loss Contingencies.[1] The objective of the proposed Statement is to significantly expand disclosures about certain loss contingencies by amending FASB Statement No. 5, *Accounting for Contingencies*, and FASB Statement No. 141(R), *Business Combinations*. The Exposure Draft was issued in response to concerns expressed by investors and others about the inadequacy of information currently available regarding the likelihood, timing and amount of future cash flows associated with loss contingencies. The new standard may have significant implications not only for financial reporting but also more generally for disclosure regarding litigation and other loss contingencies and the tasks that legal counsel and independent auditors will need to undertake as companies assess the likelihood, timing and amount of future cash flows associated with loss contingencies in order to satisfy the new disclosure requirements. The proposed Statement would:

- Expand the population of loss contingencies that are required to be disclosed;
- Require disclosure of specific quantitative and qualitative information about those loss contingencies;
- Require a tabular reconciliation of recognized loss contingencies to enhance financial statement transparency; and
- Provide an exemption from disclosing certain required information if disclosing that information would be prejudicial to a company's position in a dispute.

A company would be required to provide additional disclosures to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies that are (or would be) recognized as liabilities in a statement of financial position. Those disclosures include information about the risks that loss contingencies pose to the company and their potential and actual effects on the company's financial position, cash flows, and results of operations.

Statement No. 141(R) establishes the accounting and reporting for gain and loss contingencies recognized in a business combination, while Statement No. 5 establishes the accounting and reporting for all other gain and loss contingencies. The term loss contingency, as defined in Statement No. 5, includes losses that may result from the loss or impairment of an asset or the incurrence of a liability. The proposed Statement would replace the disclosure requirements in Statement No. 5 for loss contingencies that

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[1] FINANCIAL ACCOUNTING STANDARDS BOARD, No. 1600-100, *Proposed Statement of Financial Accounting Standards: Disclosure of Certain Loss Contingencies*, *Exposure Draft in* FINANCIAL ACCOUNTING SERIES (June 5, 2008). The Exposure Draft is available at http://www.fasb.org/draft/ed_contingencies.pdf.

are recognized as liabilities in a statement of financial position and for unrecognized loss contingencies that would be recognized as liabilities if the criteria of the proposed Statement were met.

I. Expansion of the Population of Loss Contingencies Required to be Disclosed

Currently, disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable[2] that a claim will be asserted and there is a reasonable possibility[3] that the outcome will be unfavorable.

Under the proposed amendments, disclosure would be required even though the likelihood of loss is assessed to be remote[4], if a loss contingency (1) is expected to be resolved in the near term[5] and (2) could have a severe impact[6] on the company's financial position, cash flows or results of operations. Asset impairments and certain other loss contingencies for which disclosure requirements are provided by other existing authoritative accounting literature would not be subject to the new standard.

Under the proposed amendments, disclosure would not be required with respect to the following loss contingencies:

- Asserted claims as to which the company has made an assessment of the risk of loss and determined that the likelihood of loss is remote; and
- Unasserted claims in which there has been no manifestation by a potential claimant of an awareness of a possible claims unless (1) it is probable that a claim will be asserted and (2) the likelihood of the loss, if the claim were to be asserted, is more than remote.

II. Expanded Quantitative and Qualitative Disclosure

Under the proposed amendments, with respect to each loss contingency (or group of loss contingencies of the same nature, e.g., product liability or antitrust matters), disclosure will be required of the amount claimed or assessment asserted (including damages) or, if there is no claim or assessment amount, the company's best estimate of the maximum possible exposure to loss. A company must also disclose qualitative information about the contingency sufficient to enable users to understand the risks posed to the company. This information will include at a minimum:

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[2] The term "probable" means the future event or events are likely to occur. FASB Statement No. 5.

[3] The term "reasonable possibility" means the chance of the future event or events occurring is more than remote but less than likely. FASB Statement No. 5.

[4] The term "remote" means the chance of the future event or events occurring is slight. FASB Statement No. 5.

[5] The term "near term" means a period of time not to exceed one year from the date of the financial statements. AICPA Statement of Position ("SOP") 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

[6] The term "severe impact" means a significant financially disruptive effect on the normal functioning of a company. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the company. Some events are material to an investor because they might affect the price of a company's capital stock or its debt securities, but they would not necessarily have a severe effect on (disrupt) the company itself. The concept of severe impact, however, includes matters that are less than catastrophic. Matters that are catastrophic include, for example, those that would result in bankruptcy. SOP 94-6.

- a description of the contingency, including 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;
- the company's qualitative assessment of the most likely outcome of the contingency;
- significant assumptions made by the company in estimating the amounts disclosed and in assessing the most likely outcome; and
- a qualitative and quantitative description of the terms of any relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss.

III. Tabular Reconciliation of Recognized Loss Contingencies

The proposed amendments would require that, for each period for which a statement of income is presented, a company must provide a reconciliation, in tabular format, of the aggregate amount recognized for loss contingencies in its statement of financial position at the beginning and end of the period. The reconciliation shall include at a minimum:

- Increases for loss contingencies recognized during the period;
- Increases resulting from changes in estimates of the amounts of loss contingencies previously recognized;
- Decreases resulting from changes in estimates or de-recognition of loss contingencies previously recognized; and
- Decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

A company must provide a qualitative description of the significant activity in the reconciliation and must also disclose the line items in the statement of financial position in which recognized loss contingencies are included. All loss contingencies recognized in a business combination must be included in the reconciliation. However, other loss contingencies whose underlying cause and ultimate settlement occur in the same period are excluded from the reconciliation. In addition, the total amount of recoveries from insurance or indemnification arrangements recognized in each statement of financial position and statement of income presented that are related to the loss contingencies included in the tabular reconciliation must be disclosed. Amounts recognized for loss contingencies that are accounted for in accordance with Statement 141(R) are to be shown separately from amounts for loss contingencies that are accounted for in accordance with Statement No. 5.

IV. Exemption from Disclosing Prejudicial Information

Information that would be prejudicial to a company's position with respect to the outcome of a contingency need not be disclosed. For certain contingencies, such as pending or threatened litigation, disclosure of certain information about the contingency may be prejudicial to a company's position (that is, disclosure of the information could affect, to the company's detriment, the outcome of the contingency itself). In those circumstances, a company may aggregate the required disclosures at a level higher than "by the nature of the contingency" such that disclosure of the information is not prejudicial. The Board believes that this step will enable preparers to disclose information that is valuable to users without enabling the counterparty in a dispute to take advantage of the information to the detriment of the entity, because the information could not be linked to its specific case.

In those rare[7] instances in which the required disclosure, when aggregated at a level higher than "by the nature of the contingency," or of the tabular reconciliation would be prejudicial (for example, if a company is involved in only one legal dispute), the company may forgo disclosing only the information that would be prejudicial to the company's position. In those circumstances, a company must disclose the fact that, and the reason why, the information has not been disclosed. In no circumstance may a company forgo disclosing the amount of the claim or assessment against the company (or, if there is no claim amount, an estimate of the company's maximum exposure to loss); providing a description of the loss contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; and providing a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome.

V. Interaction with International Accounting Standards

Disclosures that would be required by the proposed Statement are similar, but not identical, to those required by International Accounting Standard ("IAS") 37, *Provisions, Contingent Liabilities and Contingent Assets*. The proposed Statement would require disclosures about a broader population of contingencies than required by IAS 37 and would specifically require disclosures about loss contingencies, regardless of the likelihood of loss, if the contingencies are expected to be resolved in the near term and if the contingencies could have a severe impact on the entity's financial position, cash flows, or results of operations. IAS 37 does not require disclosures for remote loss contingencies regardless of the expected timing of resolution or potential severity of the contingency. The International Accounting Standards Board is expected to evaluate the disclosure requirements in the proposed Statement when it reconsiders the IAS 37 disclosure requirements, which will provide an opportunity for greater convergence of U.S. and international accounting standards.

VI. Effective Date

The proposed amendments would be effective for annual financial statements issued for fiscal years ending after December 15, 2008 and for interim and annual periods in subsequent fiscal years. Accordingly, companies with calendar fiscal years should be prepared to apply the new standards next Winter when preparing their fiscal 2008 financial statements. The FASB invites individuals and organizations to send written comments on all matters in the proposed Statement by August 8, 2008.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jon Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com.

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[7] The term "rare" is not intended to mean "never." The circumstances described are not intended to represent the only circumstance in which a disclosure might be sufficiently prejudicial as to warrant omission of that disclosure. All of the facts and circumstances must be considered and significant judgment must be applied to determine in what circumstances disclosures might be prejudicial.