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Contacts

[Olga Khvatskaya](#)

200 Park Avenue
New York, New York 10166-0091
(212) 309-1034
okhvatskaya@hunton.com

[Susan S. Failla](#)

200 Park Avenue
New York, New York 10166-0091
(212) 309-1238
sfailla@hunton.com

[Jack A. Molenkamp](#)

1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1959
jmolenkamp@hunton.com

[J. Steven Patterson](#)

1900 K Street, NW
Washington, DC 20006-1109
(202) 419-2101
spatterson@hunton.com

Changes to Loss Contingency Disclosure Regime under FASB's Exposure Draft

On July 20, 2010, the Financial Accounting Standards Board ("FASB") released the long-anticipated exposure draft for its Proposed Accounting Standards Update addressing disclosure of loss contingencies (the "2010 Proposal").¹ This proposal, which would amend Accounting Standard Codification ("ASC") Topic 450 if adopted, would increase the amount of information regarding potential loss contingencies presented in the footnotes to financial statements. These changes would affect several areas of disclosure, most notably litigation, beginning in fiscal years ending after December 15, 2010, for public companies and the following fiscal year for nonpublic entities. The deadline for comments on the exposure draft, which was originally August 20, 2010, has been extended by FASB to September 20, 2010. The 2010 Proposal, while a significant retreat from the original proposal published in 2008, remains a source of concern for many companies and their advisors, especially those subject to significant litigation. Thus far, the 2010 Proposal has not been met with significant commentary by the American Bar Association (the "ABA")

¹ Financial Accounting Standards Board Exposure Draft, Proposed Accounting Standard 2010 Proposal, Contingencies (Topic 450) - Disclosure of Certain Loss Contingencies, July 20, 2010, available at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157116458.

and other professional organizations, but a response from the ABA is anticipated.

While many of the 2010 Proposal's requirements would also impact nonpublic entities, this summary focuses on disclosure obligations for public companies.

Background

The Current Standard

The current ASC 450 is the successor to Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* ("FAS 5").² ASC 450 mandates disclosure of contingencies (such as litigation contingencies) in companies' footnotes to financial statements issued in connection with periodic reports and registration statements (such as Forms 10-Q and 10-K as well as Forms S-1, S-3, and S-4). The purpose of this standard is to provide meaningful disclosure of litigation that is pending, threatened, or, in certain circumstances, unasserted. The disclosure requirement is not limited to litigation for which the company has

² Prior to the ASC, FASB promoted its accounting regulations through various standards, Earning Issues Task Force (EITF) guidance and other releases. In an effort to "simplify user access" and create a single, unified source of US GAAP accounting standards, FASB created the ASC, which became effective on July 1, 2009. Many preexisting standards, such as FAS 5, were given new citations in the codification but remained substantively the same.

accrued a liability, and it extends to litigation for which a loss is “reasonably possible,” as described below.

ASC 450-20, which is the subtopic governing loss contingencies, splits such contingencies into three classes: “probable,” “reasonably possible,” and “remote.” Probable contingencies are those that are likely to result in an asset impairment or liability, and they are required to be accrued when the loss can be “reasonably estimated.” “Reasonably possible” contingencies are less than probable but more than remote. Contingencies fitting this description are not recognized on a company’s financial statements, but the nature of the contingency must be disclosed in the footnotes to the financial statements along with a reasonable estimate of potential loss, if possible, or an explanation as to why the estimate cannot be made. Finally, no disclosure is required for remote contingencies, with remote being defined as only a “slight” chance of occurring. The current standard allows companies to exercise judgment on disclosure matters. Partly because of this flexibility, the current standard has been criticized as providing less than adequate disclosure.

Because ASC 450 is an accounting standard, it is part of the audit response process that involves the reporting company and the litigating counsel who provides responses directly to the company’s auditors. Precisely because this process contemplates communications between the company’s counsel and a third party (auditors), it raises issues of potential violations of attorney-client privilege. For this reason, the audit response process follows the guidelines issued by the ABA that are tailored to the current ASC 450 standard, specifically, the ABA’s Statement

of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information (the “ABA Statement”).³

The 2008 Proposal

The 2010 Proposal is not FASB’s first attempt at enhancing contingency loss disclosure. In June 2008, FASB issued its initial exposure draft (the “2008 Proposal”) on this topic, with the goal of making disclosure under FAS 5 more robust. The 2008 Proposal contained a number of significant changes to FAS 5 and FAS 141, *Business Combinations*. One of the concerns expressed in the 2008 Proposal was that the current standard based on disclosure of contingencies that are “reasonably possible” was not compelling adequate disclosure. Therefore, the 2008 Proposal would have required disclosure of a broader range of loss contingencies, including remote contingencies that were expected to be resolved within one year and could result in a “significant financially disruptive effect.” Companies would have been obligated to disclose the “amount of the claim or assessment” against them or, in the event there was no claim or assessment amount, their “best estimate of the maximum exposure to loss.” Last, and perhaps most controversial, the 2008 Proposal would have required companies to include a number of sensitive assessments in their litigation disclosures, including a “qualitative assessment of the most likely outcome.”

The 2008 Proposal was met by widespread protests in the corporate,

³ American Bar Association Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information, approved December 8, 1975. A Statement on Auditing Standards, which coordinates with the approach set forth in the ABA Statement, was approved on January 7, 1976, by the American Institute of Certified Public Accountants Auditing Standards Executive Committee.

accounting and legal communities. Many parties expressed the view that FASB’s new requirements in the 2008 Proposal, if adopted, could result in disclosure of sensitive information, infringe on attorney-client privilege and allow plaintiffs to use the information from a company’s disclosure against it. FASB attempted to address these concerns by including an exemption for “prejudicial information,” but this exemption was so limited that the ABA and other professional organizations published strong statements of opposition. The public outcry delayed ratification of the amendments and eventually led to the release of the 2010 Proposal, a scaled-back version of the 2008 Proposal.

The 2010 Proposal

Purpose

The 2010 Proposal is intended to address issues that are similar to the 2008 Proposal, namely investor concerns that disclosures about loss contingencies under ASC 450-20 “do not provide adequate and timely information” for proper assessment of “the likelihood, timing, and magnitude” of potential losses. The 2010 Proposal is aimed specifically at enabling financial statement users to understand the nature of loss contingencies, their potential magnitude and their potential timing, if known. Unlike the 2008 Proposal, however, the 2010 Proposal focuses on the disclosure of publicly available information rather than on estimates of likelihood of exposure.

Scope of Disclosure

The 2010 Proposal applies to all loss contingencies covered by ASC 450-20, which includes pending and threatened litigation. While this alert’s focus is on the impact of litigation disclosure, it is important to note that the disclosure practices imposed

by the 2010 Proposal would also apply to several other categories of loss contingencies, many of which the 2008 Proposal did not address. The categories covered in the 2010 Proposal include environmental obligations (ASC 410-30), guarantees (ASC 460-10), retirement benefits under multiemployer plans (ASC 715-80), and business combinations (ASC 805-20).

Disclosure Threshold

Some of the existing standards under the current ASC 450-20 remain in the 2010 Proposal. Companies must still recognize “probable” loss contingencies and disclose “reasonably possible” (more than remote) contingencies in the notes to their financial statements. Accrual and measurement of contingencies remain the same as under the existing ASC 450-20.

However, the 2010 Proposal adds a new threshold requiring that certain remote loss contingencies must also be disclosed. Disclosure of a remote contingency may be required due to the “nature, potential magnitude, or potential timing (if known) to inform users about the entity’s vulnerability to a potential severe impact.” The term “severe impact” is defined as a “significant financially disruptive effect on the normal functioning of an entity.” It is a higher threshold than a “material” impact, but it includes matters that are less than “catastrophic.” “Catastrophic” events are those that would cause bankruptcy.

To help companies make the determination as to whether a remote contingency could cause a “severe impact,” the 2010 Proposal provides several criteria to consider. While an individual company will have to “exercise judgment in assessing its specific facts and circumstances,” each should consider a remote

contingency’s potential impact on operations, the cost of defending its contentions, and the effort and resources that management will be forced to expend in resolving the contingency. With regard to litigation, the amount of damages claimed would not be the sole determining factor for disclosure, although it should certainly be included in the analysis. However, companies should not consider potential recoveries from other sources, such as insurance and indemnification arrangements, in assessing whether disclosure is required.

Qualitative Disclosure Requirements

In addition to expanding the threshold for disclosure, the 2010 Proposal would increase the amount of information disclosed in connection with loss contingencies. The 2010 Proposal promotes enhanced disclosure as contingencies become less uncertain and more facts become available. To that end, disclosures should be “more extensive as additional information about a potential unfavorable outcome becomes available.”

As to the contents of a company’s disclosures, the 2010 Proposal dictates inclusion of the following information for contingencies that meet the previously described disclosure thresholds:

- Information that enables users to understand the loss contingency’s “nature and risks”
- “For individually material contingencies, sufficiently detailed information to enable financial statement users to obtain additional information from publicly available sources such as court records”
- For aggregated disclosure, the basis for aggregation and “infor-

mation that would enable financial statement users to understand the nature, potential magnitude, and potential timing (if known) of loss.”

FASB provides additional guidelines for disclosure of litigation contingencies. Such disclosures should include:

- the name of the court or agency in which proceedings are pending;
- the date proceedings were instituted;
- the principal parties;
- the factual basis for the claim;
- the basis for the defense or a statement that the company has not yet formulated its defense;
- the current status of a litigation contingency; and
- for litigation that has advanced beyond the early stages, more extensive disclosure regarding potential unfavorable outcomes (such as increases/decreases in the magnitude or likelihood of loss) as information becomes available and, if known, the anticipated timing of, or next steps toward, resolution.

Note that many of the foregoing items are already required to be disclosed by public companies pursuant to Item 103 of the Securities and Exchange Commission’s (SEC) Regulation S-K.

Quantitative Disclosure Requirements

Perhaps the most significant expansion of disclosure requirements under the 2010 Proposal would be the quantitative estimates of losses. The 2010 Proposal does not require companies to estimate a maximum amount of loss, as would have been required

under the 2008 Proposal. However, the 2010 Proposal requires disclosure of amounts claimed by plaintiffs or indicated in expert witness testimony. It is unclear what type of disclosure is contemplated in the 2010 Proposal if there are multiple expert witnesses or the amounts claimed differ from various expert opinions. Similar to the current standard, the 2010 Proposal mandates disclosure of an estimated range of loss or an explanation as to why such an estimate cannot be made. The 2010 Proposal also allows companies to aggregate their disclosure of similar contingencies as long as they also provide the basis for such aggregation.

Each company would be required to disclose the following for any contingency that meets the “reasonably possible” standard:

- Publicly available quantitative information, such as the amount claimed by a plaintiff or the amount of damages indicated by the testimony of an expert witness.
- If it can be estimated, the potential loss or range of loss and the amount accrued, if any.
- If the potential loss cannot be estimated, the reason why.
- Any other relevant non-privileged information that “would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss.”
- Information about possible recoveries from insurance and other sources *only if* “it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable by either the plaintiff or a regulatory agency, or it relates to

a recognized receivable for such recoveries.”

- In making a disclosure regarding insurance recoveries, a company must also disclose any denial, contestation or reservation of rights by an insurer over those recoveries. Furthermore, the company may not offset its potential recovery amounts against its loss contingencies.

For remote contingencies that meet the previously outlined disclosure threshold, a company must provide the same publicly available quantitative information, relevant non-privileged information, and information regarding potential recoveries as for “probable” and “reasonably possible” contingencies, but it is *not* obligated to disclose estimates of losses.

No Exemption for Prejudicial Disclosures

Unlike the 2008 Proposal, the 2010 Proposal does not include an exemption for disclosure if such disclosure would be prejudicial to the detriment of the disclosing company. FASB’s rationale for the omission of the exemption is its belief that the 2010 Proposal does not require the disclosure of prejudicial information (e.g., predictions regarding likelihood of loss). FASB also believes that aggregation of disclosure by class of litigation further eliminates concerns about violations of attorney-client privilege. However, the 2010 Proposal did not eliminate all concerns about attorney-client privilege and still remains problematic, as discussed further below.

Tabular Presentation

In addition to new qualitative and quantitative disclosures, the 2010 Proposal also would require public companies to present a table showing reconciliations

of recognized loss contingencies by class. Such a table would present:

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

A reconciliation would need to be shown for each separate type of contingency. Furthermore, public companies would be obligated to describe “significant activity in the reconciliations” 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. Loss contingencies that occurred and were resolved in the same period would be excluded from the table unless they were incurred in connection with a business combination.

Effective Date

For public companies, the 2010 Proposal amendments would take effect for fiscal years ending after December 15, 2010, and interim periods in the subsequent fiscal years. Nonpublic companies would not be required to adopt the amendments until the first annual period beginning after December 15, 2010, and for the interim periods occurring after that initial annual period.

FASB would not require comparative disclosures for any period occurring before initial adoption, but early adoption would be permitted.

Anticipated Issues

Although the 2010 Proposal eliminated several provisions of the 2008 Proposal that presented the most significant issues, it still raises a number of concerns, including the following:

- The enhanced disclosure requirements under the 2010 Proposal may result in the unintended waiver of the attorney-client privilege as auditors seek more litigation-specific language from litigation counsel. It is unclear whether, as a result of expanded disclosure requirements, the ABA Statement will remain unchanged or whether additional guidance will be issued to assist litigating counsel in responding to auditors' requests.
- The requirement to disclose claimed amounts may be misleading because often these amounts are inflated.
- In addition, it is unclear how not taking into account insurance or indemnification recoveries could be helpful in assessing the potential impact of remote contingencies.
- The examples of disclosure offered in the 2010 Proposal, which provide model disclosures detailing the claims, defenses, and other non-privileged, discoverable details of two opposing parties, raise a number of issues

regarding the density and ultimate usefulness of the resulting litigation disclosure, compared to the burden of reviewing discoverable material for identification of such details as well as performing analyses of whether any such matters are in fact non-privileged and discoverable. Most corporate litigation matters in the United States are complex and entail numerous claims and defenses, and the disclosure of all allegations, defenses, and claims could be prohibitively expensive, lengthy, and possibly meaningless to the investors yet extremely useful to the adversaries.

- The requirement to disclose "remote" contingencies with potentially severe impact necessitates speculation, which may result in meaningless or misleading disclosure.

Further, the aggregation method described in the 2010 Proposal does not allow for aggregated disclosure for loss contingencies that are not sufficiently similar in "nature, terms, and characteristics." Even where various cases address a similar issue, the 2010 Proposal states that matters 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" should not be disclosed on an aggregated basis. These guidelines could result in disclosures that are impractically lengthy for users of financial statements and maddeningly time-consuming for companies to prepare. In addition, limiting

the extent to which similar loss contingencies can be aggregated increases the likelihood that a company may have to disclose prejudicial information that is traceable to a specific matter.

- Notably, the disclosures of contingencies are subject to antifraud liability, and requirements to disclose information that is potentially misleading or speculative (such as aggregation of litigation, disclosure of remote contingencies with potential severe impact, omission of potential insurance or indemnification recoveries, or recitation of expert testimony on damages) may put companies at risk for securities litigation by investors for material misstatements or omissions in documents submitted to the SEC.
- The 2010 Proposal would require quantitative disclosure of numerous items, including claimed amounts, numbers of pending cases, accrued amounts and amounts of damages offered by expert witnesses, among others, all of which would have to be presented in Interactive Data Format (i.e., XBRL). These requirements could make the preparation of public filings of financial statements an excessively complicated and lengthy affair, requiring significantly more preparation and resources than the current process.

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