

DISCLOSURE OF LOSS CONTINGENCIES -- FASB MOVING SLOWLY ON SMALLER SCALE¹

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On June 5, 2008, the Financial Accounting Standards Board (“FASB”) issued a proposed amendment to Financial Accounting Standard 5 and 141(R) (“FAS 5” and FAS 141(R)”) designed to require substantially more robust disclosures about contingent losses, including pending and threatened claims and environmental liabilities. The proposal struck a nerve. Two hundred and forty two comment letters were submitted on the proposal; 201 opposed it, including each of the twenty law firms that made submissions.² Almost two years later, the proposal is still on the FASB’s agenda, not abandoned, but moving slowly and substantially scaled back.

A company’s responsibility, or potential responsibility, for an environmental investigation and clean-up is a prime example of a contingent loss: a situation or condition involving some uncertainty about a potential loss to the company in which the existence and amount of that loss will be determined in the future. Accounting for a contingent loss could be triggered, for example, by: receipt of a notice letter asserting potential responsibility for a contaminated site; the discovery of a condition that regulations require be investigated and cleaned up; receipt of a clean-up order; or being named in litigation related to clean-up or harm from or exposure to hazardous materials.

FASB had perceived that, under existing standards, too little information was being disclosed about loss contingencies (the focus was not primarily environment-related loss contingencies) for a variety of reasons. The reasons included that: 1) information

¹ This article is an updated version of the article that appeared in the December 2009, *American Bar Association, SEER Disclosure Committee Newsletter*.

² On August 6, 2009, FASB staff issued a Final Comment Letter Summary, which is available at www.fasb.org/accounting_for_contingencies.shtml, along with the proposal (Exposure Draft), the individual comment letters, and a summary of recent related decisions of the Board.

about loss contingencies was not being disclosed until a material accrual was recognized; 2) the existing threshold for reporting under FAS 5, that the contingency be “at least reasonably possible” was too often leading to the nondisclosure of potentially material contingencies; and 3) the option of the reporting entity to state that “an estimate of the possible loss or range of loss cannot be made” was used too frequently to deny investors of any information regarding the quantitative nature of a potential loss. In general, FASB had concluded that more information needed to be provided to investors regarding potential loss contingencies, earlier.

In June 2008, FASB issued its proposal as a Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, amending FAS 5, “Accounting for Contingencies,” which is the primary document for evaluating and accounting for contingent losses, and FAS 141(R) (see also FSP 141R-1), “Business Combinations,” which requires accounting for contingent losses, if possible on a “fair market basis” in the buying and selling of a company.

The proposal was issued as “an exposure draft” (issued for public comment) that would expand the scope of loss contingencies to be disclosed, require disclosure of specific quantitative and qualitative information about the loss contingencies, and require tabular reconciliation of recognized loss contingencies to allow the overall amounts to be more readily tracked over time. The proposal would allow an exemption from disclosure in certain limited circumstances where disclosure would be prejudicial to the disclosing entity’s position in a dispute. By way of example, under the proposal, an entity would have had to disclose the amount of a claim or assessment against the entity, such as the plaintiff’s demand in a complaint, or, if no claim or assessment amount is provided, the reporting entity’s best estimate of the maximum exposure to the loss.

A significant number of the comment letters received expressed grave concerns about the potential prejudicial effects that the proposal might have on disclosing entities. Central among the concerns were fears that the attorney/client privilege and work

product protections might be lost due to the nature of the information required, for example, the evaluations of maximum exposures in litigation. In addition, concerns were raised about the ability of the auditor to obtain the information necessary to support the disclosure, given attorneys' concerns about confidentiality obligations. Other concerns related to potential strategic disadvantages to disclosing companies in litigation and negotiations, as well as the concern that disclosure in securities filings of the full amount of a plaintiff's demand in a lawsuit might be inherently misleading and result in a disproportionate effect on stock prices. Concern was expressed that the mere threat of a lawsuit that would trigger disclosures could potentially force companies into settling meritless claims to protect the stock price.

On March 6, 2009, FASB held roundtable meetings with interested parties. Thereafter, staff started working on recommendations to the Board. The FASB Board began re-deliberations on the disclosure of contingent losses on August 19, 2009. At the meeting, FASB focused on loss contingencies associated with litigation and, according to the summary it published on its website, decided on the following general objective:

An entity shall disclose qualitative and quantitative information about the loss contingency to enable a financial statement user to understand the nature of the contingency and its potential timing and magnitude.

The Board also at least tentatively established three broad principles it would apply moving forward:

1. Disclosures about litigation contingencies should focus on the contentions of the parties, rather than predictions about the future outcome.
2. Disclosures about a contingency should be more robust as the likelihood and magnitude of loss increase and as the contingency progresses toward resolution.
3. Disclosures should provide a summary of information that is publicly available about a case and indicate where users can obtain more information.

Notably, the Board also tentatively decided:

- To maintain the existing requirement to disclose asserted claims and assessments whose likelihood of loss is at least reasonably possible;
- To clarify that “at least reasonably possible” and “more than remote” have the same meaning;
- That certain remote loss contingencies should be disclosed (and directed staff to develop possible approaches for discussion at a future meeting);
- To maintain existing threshold requirements for unasserted claims and assessments and agreed to enhance the existing interpretive guidance about the threshold;
- That entities should not consider the possibility of recoveries from insurance or indemnification arrangements when assessing whether a contingency should be disclosed;
- Not to require entities to disclose information about settlement negotiations; and
- To require disclosure about possible recoveries from insurance and other sources if and to the extent that the information has been provided to the plaintiff in discovery.

With reference to the push for more quantitative information in disclosures, the Board directed the staff to develop an approach that would focus on disclosure of non-privileged, quantitative information relevant to estimating potential losses. This will be considered by the Board at a future meeting. One issue that has already generated some discussion is how any amendment could disclaim registrants’ need to be predictive without actually narrowing existing obligations, given that that the determinations required by FAS 5 are inherently predictive, in the sense that they

require the disclosing company to make judgments about the probability of the loss occurring.

As to timing, the Board has already gone by its original proposed effective date of December 15, 2009. Given the public involvement in response to the disclosure draft, and the likelihood that what will be issued will be considered some narrow subset of what had been considered in that draft, the Board may issue something on this topic without a further disclosure draft in 2010.