
FASB Proposes Expanded Disclosure Standard for Loss Contingencies

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The Financial Accounting Standards Board (FASB), the standard-setting body for generally accepted accounting principles in the United States, has proposed a new disclosure standard that would expand dramatically the information that companies must disclose about loss contingencies, particularly losses that could result from pending or threatened litigation. The proposal has caused concerns within the corporate and legal communities over whether the required disclosures will reveal information that can be used to a company's detriment by adversaries in litigation and may impinge on the attorney-client privilege. The proposal is expected to be the subject of extensive public comment.

Responding to concerns expressed by investors and others that current standards "do not provide sufficient information in a timely manner to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies," the FASB issued an Exposure Draft for a new accounting standard on June 5, 2008. The new standard would supplant certain disclosure provisions of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (March 1975) (SFAS 5) and in the related standard for accounting for business combinations. If adopted, the new disclosure standard would take effect for annual financial statements for fiscal years ending after December 15, 2008, and for interim and annual statements thereafter.

The standard would establish the general principle that:

An entity shall provide 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 shall include information about the risks those loss contingencies pose to the entity and their potential and actual effects on the entity's financial position, cash flows and results of operations.

The proposed standard implements this principle with a number of detailed requirements, including the following:

- *Finding of remoteness.* Subject to certain exceptions, disclosure of *all* loss contingencies is required unless the entity has made an assessment of the contingency and affirmatively determined that the likelihood of a loss is remote. One exception is that unasserted claims need not be disclosed unless it is probable that the claim will be asserted and, if the claim is asserted, the likelihood of a loss is more than remote. (Although the standard refers to all loss contingencies, without any materiality limitation, it also notes generally that it "need not be applied to immaterial items.")
- *Contingencies with near-term severe impact.* Even if the risk of an unfavorable outcome is remote, contingencies must be disclosed if the contingencies are expected to be resolved in the "near term" (less than one year) and the contingency could have a "severe impact" on the entity's financial position, cash flows, or results of operations. A "severe impact" is defined as "a significant financially disruptive effect on the normal functioning of an entity." The FASB describes this standard as a higher threshold than material but states that it includes "matters that are less than catastrophic."
- *Quantitative information.* The entity must disclose either the amount claimed by the plaintiff in a litigation, including treble or punitive damages, or, if there is no claimed amount, the entity's "best estimate of the maximum exposure to loss." An entity may also disclose its best estimate of the possible loss or range of loss where it believes the amount claimed or the maximum exposure to loss is not representative of the entity's actual exposure.
- *Qualitative information.* The entity must disclose "qualitative information sufficient to enable users to understand the risks posed to the entity," including, at a minimum:
 - A "description of the contingency, including how it arose, its legal or contractual basis, its current status, and 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 entity's "qualitative assessment of the most likely outcome of the contingency;" and
 - Significant assumptions made by the entity in estimating the maximum exposure to loss and in assessing the most likely outcome.
- *Insurance and indemnification.* The entity must provide a quantitative and qualitative description of terms of insurance or indemnification that could lead to a recovery of some or all of the possible loss.

- *Tabular reconciliation.* For each reporting period, an entity must provide a tabular reconciliation of the total amounts recognized in the aggregate for loss contingencies at the beginning and end of the period. The reconciliation will break down the accruals between those accrued in connection with a business combination and other contingencies. The table must also show the following information for the relevant period:

- Increases for new loss contingencies accrued during the period;
- Increases resulting from changes in estimates of loss contingencies that had previously been accrued;
- Decreases resulting from changes in estimates or derecognition (reversal) of loss contingencies that had previously been accrued; and
- Decreases resulting from cash payments or other forms of settlement for loss contingencies.

Loss contingencies whose underlying cause and settlement occur within a period (other than loss contingencies recognized in a business combination) shall be excluded from the reconciliation.

- *Qualitative description of significant activity.* In addition to the tabulation, the entity must provide a qualitative description of significant activity in the reconciliation. The entity must disclose the line items in the balance sheets in which reserves for loss contingencies are included. Recoveries under insurance policies and indemnification arrangements related to contingencies included in the tabulation must also be disclosed.
- *Subsequent events.* The entity must disclose quantitative and qualitative information about loss contingencies that arise after the end of a period and before issuance of the financial statements. In some cases, pro forma information may also be provided, showing the effect of the loss as if it had occurred at the date of the financial statements.
- *Exemption for prejudicial information.* An entity may omit certain information about litigation if disclosure "may be prejudicial to an entity's position (that is, disclosure of the information could affect, to the entity's detriment, the outcome of the contingency itself)."
 - The Exposure Draft recognizes that in the ordinary course the required disclosures may be aggregated by the nature of the contingency. If disclosure would be prejudicial even at that level, the standard would allow an entity to aggregate disclosures "at a

level higher than the nature of the contingency such that disclosure of the information is not prejudicial."

- In "rare instances" where it would be prejudicial to include the information even at a higher level, or to include it in the tabular reconciliation (for example, where the entity is involved in only one legal dispute), the entity may omit the prejudicial information. (The FASB notes that "the term *rare* is not intended to mean *never*.) In such "rare instances," the entity must disclose the fact that, and reason why, information has not been disclosed.
- In any event, the entity may not forgo disclosing the quantitative information about the amount claimed or best estimate of maximum loss or qualitative information about the claim and a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome.

As the foregoing description indicates, the proposed standard raises many substantial issues. The Exposure Draft will be open for public comment until August 8, 2008. The FASB also expects to schedule a public roundtable to discuss the proposals thereafter.

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