FASB Proposes to Modify New Accounting Standard for Contingencies in Business Combinations

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In another important development following last summer's controversy over proposed disclosure standards for contingent liabilities, the Financial Accounting Standards Board (FASB) has taken steps to modify the provisions of Statement of Financial Accounting Standards No. 141 (revised 2007), Business Combinations (SFAS 141R), applicable to contingencies. SFAS 141R is the FASB's new accounting standard for acquisitions and takes effect for most companies on January 1, 2009.

If implemented, the FASB's proposed modifications will, to a large extent, reinstate the prior standard for recognizing loss contingencies, particularly litigation contingencies, in connection with acquisitions. Under the proposed FASB modification, reserves for litigation contingencies would have to be established in connection with acquisition accounting only if a liability is probable and the amount of the liability is reasonably estimable on the acquisition date. This change should substantially mitigate concerns about the impact of SFAS 141R's treatment of litigation contingencies assumed in an acquisition.

SFAS 141R, which the FASB adopted in 2007, made comprehensive changes to the accounting standards for business combinations, including accounting for pre-acquisition contingencies acquired or assumed in the transaction. SFAS 141R currently provides that "contractual" contingencies must be recognized at their fair value as of the acquisition date. "Non-contractual" contingencies (*e.g.*, litigation contingencies) that are "more likely than not" (greater than 50% probability) to give rise to an asset or liability must be recognized at their acquisition-date fair value. If it is not "more likely than not" that a non-contractual contingency gave rise to an asset or liability, the FASB's Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (SFAS 5), and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FIN 14), would govern whether a contingency had to be recognized and, if so, the amount of the accrual. Under SFAS 5 and FIN 14, a contingent liability is accrued only if, as of the relevant date, it is "probable" that a liability had been incurred and the amount of the liability can be "reasonably estimated."

SFAS 141R also established rules for when and how the amount of a liability recorded in a business combination would be remeasured and when it could be derecognized. Finally, SFAS 141R provided for expanded disclosures with respect to contingencies, including, among other things, amounts recognized at the acquisition date, the nature of recognized and unrecognized contingencies, and an estimate of the range of outcomes or, if the range could not be estimated, that fact and the reasons why a range could not be estimated.

In June 2008, in a separate project, the FASB proposed a new standard that would expand the disclosures with respect to non-contractual loss contingencies that fell within the scope of SFAS 5 and SFAS 141R. The proposal generated substantial opposition from the business and legal communities on the grounds that the disclosures that would be required by the new standard would be prejudicial to a company's position in pending litigation and could breach the attorney-client privilege applicable to a lawyer's communications with his or her client about pending litigation. In September 2008, in response to these concerns, the FASB decided to "redeliberate" this proposal.

The events last summer regarding SFAS 5 highlighted that SFAS 141R raised concerns similar to those posed by the proposed SFAS 5 disclosure standard. The two principal concerns were with applying the "more likely than not" standard and, if that standard applied, quantifying the "fair value" of a litigation contingency. Making these determinations and related disclosures, even if they were feasible given the uncertainties of litigation, could be prejudicial to a company's litigation position. In addition, concerns were raised about the ability of auditors to audit a company's determination of the likelihood and fair value of a litigation contingency.

In light of these considerations, at a meeting on October 29, 2008, the FASB initiated a project that should lead to a modification of SFAS 141R in early 2009. The FASB indicated that it will adopt a model similar to the one contained in Statement of Financial Accounting Standards No. 141, *Business Combinations* (SFAS 141), the current standard that is otherwise being superseded by SFAS 141R. In essence, if the fair value of a contingency can be reasonably estimated, it should be recognized at fair value as of the acquisition date. If fair value of a contingency cannot be reasonably estimated at the acquisition date, then the standards applicable to contingencies arising outside of a business combination--*i.e.*, SFAS 5 and FIN 14--will apply. As applied to litigation contingencies, the effect is to eliminate the distinction in SFAS 141R based on whether or not litigation was "more likely than not." No accrual will be required as to any litigation contingency unless the liability is both probable and can be reasonably estimated at the acquisition date.[1]

The FASB also proposed to modify the required disclosures for contingencies acquired or assumed in a business combination. In particular, it eliminated aspects of the disclosures in SFAS 141R that had raised concerns about the potential prejudicial impact on a company's litigation position. The Board determined that the disclosures should include the nature of the contingency, the measurement attribute applied (*i.e.*, whether or not recognized at fair value) and, if not measured at fair value, the reason that fair value could not be reasonably estimated. Additional disclosures would depend on the measurement attribute applied.

The FASB authorized its staff to draft a proposed FASB Staff Position (FSP) to reflect its decisions.

The FSP would have the same effective date as that of SFAS 141R. For calendar year companies, that would be January 1, 2009. The staff is expected to issue the proposed FSP soon, with a public comment period ending approximately January 15, 2009, and the Board expects to issue a final FSP in the first quarter of 2009. Thus, the final FSP should be in place before any company is required to report on a business combination that occurs in the first quarter of 2009.

The FASB's October 29 action represents a constructive response to the substantial concerns that were raised by a standard that required companies to specify the fair value of some litigation contingencies. The modified FASB standard will return to the historical SFAS 5/FIN 14 model, with which financial statement preparers, their lawyers and their auditors are familiar and are used to applying. However, it appears that the FASB will continue to consider the broader issues of whether a fair value approach to litigation contingencies should be adopted and/or whether more extensive disclosures about litigation contingencies should be required.

[1] The FASB's proposed changes are not limited to litigation contingencies. While the distinction between "contractual" and "non-contractual" contingencies will be eliminated, the FASB still expects that many contingencies--such as warranty claims--that are assumed in an acquisition will be recorded at fair value. Under SFAS 141, such a loss contingency must be recorded if fair value can be determined within the one-year allocation period following the closing date. In its October 29 action, the FASB adopted the phrase "reasonably estimable" in lieu of "can be determined" for purposes of this formulation. It instructed the FASB staff to clarify situations under which fair value is "reasonably estimable" similar to the guidance provided in another accounting standard, FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*. These changes likely will not affect how litigation contingencies are treated.

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