

## Comments Received on the Proposed Amendments to FASB Statement No. 5: Disclosure of Certain Loss Contingencies

August 26, 2008

On June 5, 2008, the Financial Accounting Standards Board (the "FASB") issued an Exposure Draft of proposed amendments to (i) Financial Accounting Standards Statement No. 5 Accounting for Contingencies ("FAS 5"), which establishes accounting and reporting standards for certain contingencies, including pending or threatened litigation, claims and assessments, and (ii) Statement No. 141 (revised 2007) Business Combinations ("FAS 141(R)"), which sets standards for the accounting and reporting of gain and loss contingencies recognized in connection with business combinations. The Exposure Draft amendments increase the disclosure requirements for loss contingencies that would be recognized as liabilities in a statement of financial position, and for other contingencies that meet the criteria for loss contingencies as set forth in the amended FAS 5.<sup>1</sup> The amendments would not affect the treatment of asset impairments, the definition of a loss contingency under FAS 5, or the recognition or measurement of loss contingencies in financial statements. The proposed amendments would be effective for financial statements issued for fiscal years ending after December 15, 2008 and interim and annual periods in subsequent fiscal years.

This memo discusses:

- the current disclosure requirements of FAS 5;
- the proposed amendments; and
- a summary of several of the issues and concerns expressed with respect to the proposed amendments, as set forth in comment letters received by the FASB.<sup>2</sup>

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<sup>1</sup> FASB Exposure Draft: Proposed Statement of Financial Accounting Standards: Disclosure of Certain Loss Contingencies, Financial Accounting Standards Board (June 5, 2008). The Exposure Draft applies to all loss contingencies that are within the scope of either FAS 5 or FAS 141(R), except for loss contingencies that would be recognized as asset impairments in a statement of financial position, certain guarantees, liabilities for unpaid claim costs related to certain insurance and reinsurance contracts and assessments, and liabilities for certain employment-related costs, including pension and other postemployment benefits. See Exposure Draft paragraph 3.

<sup>2</sup> Comment letters received by the FASB on or before the August 8, 2008 deadline are posted on the FASB's website at <http://www.fasb.org/oc/fasb-getletters.php?project=1600-100>.

## EXISTING FASB STATEMENT NO. 5 STANDARD

The current FAS 5 standard prescribes different treatment for loss contingencies based on the likelihood of the occurrence. FAS 5 identifies three areas within the range of likelihood of occurrence: (1) probable (where the future event is likely to occur); (2) reasonably possible (where the chance of occurrence is “more than remote but less than likely”<sup>3</sup>); and (3) remote (where the chance of occurrence is “slight”<sup>4</sup>). If the loss is probable and the amount of loss can be reasonably estimated, the liability must be accrued in the financial statements. If the loss is reasonably possible, certain disclosures must be made, including the nature of the contingency and an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. If the loss is remote, entities are generally not required to disclose such loss contingencies. The amendments’ heightened disclosure requirements seek to address concerns that the existing FAS 5 standard provides insufficient information for financial statement users to assess the “likelihood, timing, and amount of future cash flows associated with loss contingencies.”<sup>5</sup>

## PROPOSED AMENDMENTS TO FAS 5

The significant changes introduced by the amended FAS 5 include an expansion of the types of loss contingencies that must be disclosed and the types of information that must be disclosed, an added requirement of a tabular reconciliation of recognized loss contingencies, and the creation of a “prejudice exemption”, which provides different disclosure requirements for information that may be prejudicial to an entity.

- The proposed amendments to FAS 5 significantly expand the types of loss contingencies that are required to be disclosed by creating a presumption in favor of disclosure of all loss contingencies. As proposed in the Exposure Draft, all loss contingencies would be required to be disclosed, except (1) where the likelihood of a loss is remote or (2) where a potential claimant has not manifested an awareness of a possible claim or assessment, unless it is probable the claim will be asserted and the likelihood of loss, if the claim or assessment were to be asserted, would be more than remote. However, the FAS 5 amendments would require disclosure even where the likelihood of loss is remote, if the contingency, or a combination of contingencies, is expected to

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<sup>3</sup> Statement of Financial Accounting Standards No. 5, Financial Accounting Standards Board 4 (March 1975).

<sup>4</sup> Id.

<sup>5</sup> Exposure Draft, paragraph 4.

be resolved within a year of the date of the financial statements, and where the contingency could have a "severe impact" on the entity's financial position, cash flows, or results of operations.<sup>6</sup>

- The FAS 5 amendments also expand the type of disclosures that must be made, requiring specific quantitative and qualitative information to be reported. If disclosure is required, the quantitative data that must be disclosed includes the amount of the claim against the entity, including damages, or the entity's best estimate of the upper limit of loss exposure where there is no claim amount. An entity may also disclose its best estimate of the possible loss or range of loss if it does not believe that the amount claimed or maximum exposure disclosed reflects the entity's actual exposure. The entity must also disclose qualitative information about the matter that is "sufficient to enable users to understand the risks posed to the entity".<sup>7</sup> At the very least, this must include:
  - details about the origin and the factual and legal nature of the contingency, as well as its current status and projected timing of resolution;
  - a review of the factors likely to affect the ultimate outcome of the contingency;
  - the entity's assessment of the most likely outcome of the contingency; and
  - the significant assumptions made by the entity in its quantitative disclosures and in its assessment of the most likely outcome.

The amendments also require a detailed quantitative and qualitative account of any insurance or indemnification arrangements that could lead to full or partial recovery of the loss.

The amendments also allow aggregation of any qualitative or quantitative information according to the nature of the loss contingency (e.g., antitrust matters or product liability).

- The FAS 5 amendments will require a detailed tabular reconciliation of recognized loss contingencies. For each period for which a statement of income is presented, the entity must provide a table with a reconciliation of the aggregate amount the entity has recognized for loss contingencies in its statement of financial position at the beginning and end of the period. At a minimum, this tabular reconciliation must include:
  - increases for loss contingencies recognized during the period;
  - increases or decreases resulting from adjustments in estimates of loss contingencies previously recognized; and
  - decreases resulting from any form of payment or settlement for loss contingencies.

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<sup>6</sup> "Severe impact" is defined as "a significant financially disruptive effect on the normal functioning of an entity." The term is meant to be a higher threshold than "materiality," but also includes matters that are less than "catastrophic." Exposure Draft, footnote 2.

<sup>7</sup> Exposure Draft, paragraph 7(b).

The entity must provide disclosure accompanying the tabular reconciliation describing (1) significant activity in the reconciliation and disclosing the line items in the statement of financial position in which the loss contingencies are included and (2) any related recoveries from insurance or indemnification arrangements recognized in the financial statements.

- Where the disclosure would be prejudicial to an entity's position in a dispute, the amendments provide an exemption from disclosure of certain information. The disclosure of certain information could affect the outcome of the contingency itself, to the detriment of the entity. The FAS 5 amendments provide that, in such a case, the entity may aggregate the disclosures at a higher level than by the nature of the contingency. If when aggregated, disclosure would still be prejudicial, in certain "rare" circumstances an entity can forgo disclosure of certain information it deems prejudicial.<sup>8</sup> In no circumstances, however, may an entity forgo disclosing the amount of the claim or assessment against the entity (or an estimate of the maximum exposure to loss), providing a description of the loss contingency, and providing a description of the factors likely to affect the ultimate outcome of the claim or assessment.

#### ISSUES AND CONCERNS WITH THE PROPOSED AMENDMENTS

On August 8, 2008, comment letters were due to the FASB on the proposed amendments to FAS 5. The proposed amendments have been the subject of heated controversy, with the FASB receiving over 225 comment letters. Among the letters submitted was (i) a letter from the American Bar Association, in which it expresses "serious concerns" with the proposal, (ii) a letter from the Association of Corporate Counsel, in which it states that, in the view of its membership, "the quality of the information that would result from the proposed amendments would not warrant the harm that they would inflict on companies and their shareholders," (iii) a letter co-signed by general counsels and senior litigation counsels of 12 large corporations, including Bank of America, Exxon Mobile Corporation, General Electric Company, General Motors Corporation, Johnson & Johnson, Lehman Brothers, Inc., Time Warner, Inc. and Viacom, Inc., in which the signatories outline "fundamental flaws" with the amendments, and (iv) a letter from PricewaterhouseCoopers LLP, in which it states that "the proposal has the potential to result in unintended costs that outweigh the intended benefits to users of having more information about a company's loss contingencies." Numerous letters were also submitted by proponents of the proposal, primarily from investors such as pension funds. Below is a summary of some of the prominent arguments in opposition to the amendments, as set forth in letters submitted to the FASB.

- The FAS 5 proposed amendments could threaten attorney-client privilege and work product immunity and strain the auditor-client relationship. The amendments put significant pressure on attorneys and others by arguably requiring disclosure in financial statements of highly sensitive and privileged information that would customarily be kept confidential in order to protect the interests of clients. In disclosing certain internal facts, estimates and assumptions

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<sup>8</sup> In determining which disclosures might be prejudicial, an entity must consider all facts and circumstances and exercise significant judgment. Exposure Draft, paragraph 11.

regarding specific claims, that information could lose the attorney-client privilege and other protections afforded such information. The new disclosure regime could also put pressure on the auditor-client relationships by prompting auditors to seek privileged information from counsel, further threatening the attorney-client privilege and work product immunity. These threats to the traditional confidence of communications between attorney and client and attorney work product could have a chilling effect on communications between client and attorney and impair an attorneys' important role in corporate governance and financial reporting and disclosure.

- The FAS 5 proposed amendments could prejudice issuers by potentially providing information with respect to an entity's strategy in resolving a claim to its adversary. Detailed disclosure of claim-related information, including potential sources of recovery, litigation strategy, cost estimates and availability of insurance, may compromise an entity's ability to manage or avoid the loss contingency. Issuers and attorneys would customarily keep such information confidential, and disclosure of this information may impair the effectiveness of the issuer's defense strategy. Claimants could seek to use internal evaluations as an admission of a defendant's liability or damages. Disclosure of insurance and indemnification arrangements can also prejudice defendants by increasing the costs of resolving a claim where it is believed a defendant may not be required to shoulder the full cost of a settlement or judgment.
- The FAS 5 amendments could spur the onset of new, meritless litigation. Potential claimants who were unaware of unasserted claims may be put on notice through the enhanced disclosure requirements of the amended FAS 5. The detailed disclosures of potential loss exposure, regardless of likelihood of success on the merits, may encourage the assertion of claims that lack merit and increase settlements by entities who wish to avoid disclosure for valid business reasons.
- Compliance with the FAS 5 amendments may lead to future Securities Act liability and may lead to confusing disclosure as an entity revises its prior disclosure based on new information. Section 18 of the Securities Exchange Act of 1934 provides liability for any issuer who makes any statement in reports filed under the Act that is, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact. Failure by an entity to correctly evaluate possible exposures and costs could lead some to question whether the statements made were false or misleading. This is of particular concern in litigation, which is inherently unpredictable and subject to extreme changes in potential loss exposures in a relatively short period of time. Further, it may be practically impossible at some stages of litigation to provide an accurate estimate of the cost of litigation when an entity has no information about the potential duration or extent of a possible dispute.
- The volume and detail of disclosure required by the FAS 5 amendments may lead to the disclosure of an overwhelming amount of information and statistics, obscuring the more material litigation and claims that are more likely to have a real impact on the entity. The increase in the type and extent of disclosures may not provide an accurate view of an entity's maximum loss exposure, making it less likely that users of financial statements will be able to accurately assess the import of potential liabilities. The volatility of cost estimates for potential

liabilities could make the FAS 5 amendments work against their stated goal of enhancing financial statement users' assessments. Financial statements will contain far more detailed information, which may or may not be relevant to users, and may require special expertise to decipher.

- The mandatory disclosure scheme under the FAS 5 proposed amendments can put reporting entities at a significant competitive disadvantage. Because an entity may be concerned that claimants could utilize internal evaluations as to the cost estimates, litigation strategy, or expected outcome of a claim as an admission of a defendant's liability or damages, reporting entities may be more likely to "overpay" claimants in order to avoid further disclosure and increased exposure to further claims.
- The FAS 5 amendments may not adequately protect an entity from disclosure of prejudicial information. The FAS 5 amendments recognize the potential prejudicial effect of enhanced disclosure requirements. The amendments allow an entity to aggregate certain information about multiple claims at a higher level than by the nature of the contingency if it thinks that disclosure of particular information with respect to a particular claim would be prejudicial. However, aggregation by itself may not adequately address the prejudice. Particularly where an entity has one or two major actual or potential claims against it, sophisticated users of the entity's financial statements may be capable of disaggregating major claims from minor ones. Further, although the amendments to FAS 5 permit the exclusion of some prejudicial information in rare circumstances, the amendments would still require qualitative information for all claims, such as an entity's projection of the most likely outcome of a contingent liability. As discussed above, this information could prove to be prejudicial to an entity in litigation with opponents as it may provide key insights and information that would otherwise not be available.
- The FAS 5 amendments require a significant increase in disclosure of specific information and internal estimates, and compliance with the disclosure requirements can present significant administrative costs. In order to comply with the FAS 5 amendments, entities may be required to create internal systems for handling and reporting potential and actual litigation that do not currently exist. An entity would need to gather not just additional data on existing claims, but may also be required to push management to make estimates on both asserted and unasserted claims based on the financial reporting schedule rather than the schedule that management would use based on the timing and stages of various litigations and claims.

#### FUTURE OF FAS 5

The amendments proposed in the Exposure Draft of FAS 5 present a significant shift from the previous standard, and may result in considerable costs and significant challenges to issuers seeking to provide the required disclosure without increasing exposures to contingent liabilities. The Financial Accounting Standards Board is currently reviewing the comment letters submitted in connection with the Exposure Draft and will host a forum to hear testimony from those who provided comment letters.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, [www.simpsonthacher.com](http://www.simpsonthacher.com).