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**Loss Contingencies:
Will Companies Enhance
Disclosures in the Future?**

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For many years, investors have complained that public companies fail to warn them early enough, or at all, about risks relating to litigation and other claims that ultimately result in large settlements. Investors have asserted that such warnings are needed so that they can make informed investment decisions based on their understanding of the losses that companies may incur.¹

In recognition of these concerns, on June 5, 2008, the Financial Accounting Standards Board (the "FASB") proposed amendments to Statement of Financial Accounting Standards No. 5,² "Accounting for Contingencies" ("FAS 5"), and Statement of Financial Accounting Standards No. 141(R), "Business Combinations" ("FAS 141R"),³ to enhance the disclosures about claims, including litigation, and threatened claims (the "FAS 5 Proposal").⁴ The FAS 5 Proposal generated 242 comment letters, of which 201 were unfavorable. Unfavorable comments expressed concerns about, among other things, the prejudicial impact of the proposed additional disclosures about the likely outcome of loss contingencies, particularly litigation, the difficulties in estimating losses, particularly in light of the inherently unpredictable nature of lawsuits, the possible adverse consequences to assertion of the attorney-client privilege and the inability of auditors to audit the required disclosures.⁵ In response, the FASB delayed the proposed effective date of the FAS 5 Proposal from fiscal years ended after December 15, 2008 to fiscal years ending after December 15, 2009, field-tested alternative disclosure requirements, held roundtable discussions about the proposal on March 6, 2009, and began

1. For example, the Investors Technical Advisory Committee, an advisory committee formed by the Financial Accounting Standards Board (the "FASB"), stated as follows: "[Q]uestions are raised about the completeness and timeliness of past disclosures. Contingency related disclosures are critical to investors (both current and future) in making buy-sell or hold decisions because frequently they are associated with material amounts or events that have the potential to greatly affect a company's liquidity, capitalization, or business prospects. When investors are not provided timely, [sic] information regarding future losses and the resulting cash outflows, it can result in investors buying a security whose price is shortly thereafter negatively impacted by a 'surprise settlement or disclosure.'" Comment Letter to the FASB (Aug. 15, 2008). (available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175818461462&blobheader=application%2Fpdf>) (Commenting on the FASB's proposed revisions to the disclosure provisions of Statement of Financial Accounting Standard No. 5, "Accounting for Contingencies" (March 1975) ("FAS 5"), available at http://www.fasb.org/pdf/aop_FAS5.pdf).

2. This article references previous FASB standards and does not include cites to the FASB's Accounting Standards Codification, which is effective for financial statements for periods ending after September 15, 2009.

3. FASB, Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (Dec. 2007) ("FAS 141R"), available at <http://www.fasb.org/pdf/fas141r.pdf>.

4. FASB, "Exposure Draft of a Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)" (June 5, 2008) (the "FAS 5 Proposal"), available at http://www.fasb.org/draft/ed_contingencies.pdf.

5. See FASB Staff Final Comment Letter Summary ("Comment Letter Summary"), available at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156421386. The adoption of the proposed expanded disclosures would challenge the viability of the agreement that the legal and accounting professions reached in 1975 on how independent accountants satisfy the audit requirement for evidential support relating to litigation, claims and assessments (the "Treaty"). The Treaty was crafted to address the recognition and disclosure provisions of FAS 5 and not the expanded disclosures contemplated by the FAS 5 Proposal. The need for an entity to preserve the attorney-client privilege and its ability to defend claims would collide with the independent auditor's need for evidential support from the entity's outside counsel on the expanded disclosures, presenting a formidable challenge to any effort to revise the Treaty.

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reconsidering the proposals. At a meeting on August 19, 2009, the FASB agreed on various broad disclosure principles and directed its staff to develop specific language.⁶

This article summarizes existing accounting requirements applicable to loss contingencies under generally acceptable accounting principles in the United States (“U.S. GAAP”) and International Financial Reporting Standards (“IFRS”), describes possible changes to those requirements being considered by the International Accounting Standards Board (“IASB”) and FASB, including the FAS 5 proposal and FASB’s decisions made on August 19, 2009, and recommends consideration of an alternative approach to enhanced disclosure about loss contingencies.

U.S. GAAP

The requirements of U.S. GAAP applicable to loss contingencies are FAS 5, FASB Interpretation No. 14, “Reasonable Estimation of the Amount of a Loss, an interpretation of FASB Statement No. 5” (“FIN 14”),⁷ and the amendments to FAS 141R in FASB Staff Position 141(R)-1, “Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies” (“FSP 141R-1”).⁸ FAS 5 requires a company to account for an estimated loss from a loss contingency through a charge against income when the company determines that a loss as of the date of the financial statements is probable and it can reasonably estimate the amount of the loss.⁹ If no one amount within a range of estimated losses is the best estimate, FIN 14 requires a company to recognize the bottom of the range.¹⁰

FAS 5 and FIN 14 require a company to make the following disclosures about material loss contingencies:

- With respect to a contingency for which the company recognizes a loss, it must disclose the nature of the accrual, the amount accrued if such disclosure is necessary for the financial statements not to be misleading¹¹ and the amount of any additional reasonably possible loss beyond the accrued amount, such as the highest amount in the range of possible estimated losses;¹² and
- With respect to a contingency for which the entity does not recognize a loss, either because a loss is not probable or the amount of the loss cannot be reasonably estimated, if there is at least a reasonable possibility that a loss may have been incurred, the company must disclose the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.¹³

6. See “Project Update – Disclosure of Certain Loss Contingencies” (last updated Aug. 21, 2009) (“Project Update”), available at http://www.fasb.org/accounting_for_contingencies.shtml. The FASB’s recent decisions are discussed below under “Proposed Changes to Loss Contingency Requirements - FAS 5 Proposal.”

7. FASB, Interpretation No. 14, “Reasonable Estimation of the Amount of a Loss, an interpretation of FASB Statement No. 5” (Sept. 1976) (“FIN 14”), available at http://www.fasb.org/pdf/aop_FIN14.pdf.

8. FASB Staff Position 141(R)-1, “Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies” (Apr. 1, 2009) (“FSP 141R-1”), available at http://www.fasb.org/pdf/fsp_fas141r-1.pdf.

9. FAS 5, *supra* note 1, at paragraph 8.

10. FIN 14, *supra* note 7, at paragraph 3.

11. FAS 5, *supra* note 1, at paragraph 9.

12. FIN 14, *supra* note 7, at paragraph 4.

13. FAS 5, *supra* note 1, at paragraph 10.

FSP 141R-1, which the FASB issued on April 1, 2009, amended the provisions of FAS 141R relating to the accounting for and disclosure about contingencies acquired in a transaction in which the acquirer obtained control of one or more businesses (a “business combination”). As adopted in 2007, FAS 141R would have required companies to reflect at fair value all assets and liabilities, including contingent assets and liabilities, that an acquirer acquired in a business combination. With respect to contingencies, however, FAS 141R, as adopted in 2007, would have required the recognition at fair value of a non-contractual contingency (including a claim or threatened claim) only if a company concluded that the contingency was “more likely than not” to give rise to an asset or a liability, that is, that there was a greater than 50% chance that a gain or loss would occur.¹⁴ In addition, it required additional disclosures about the contingencies, including about the likely outcome of the contingency.¹⁵ FAS 141R became effective for business combinations on or after the beginning of fiscal years beginning after December 15, 2008.

In October 2008, the FASB began a project to review certain provisions of FAS 141R, including those related to loss contingencies, in response to comments expressing concerns about the treatment of contingencies, and particularly litigation-related contingencies.¹⁶ Similar to the concerns expressed with respect to the FAS 5 Proposal, commentators worried about, among other things, the difficulties of determining the fair value of litigation and the requirement to disclose potentially prejudicial information.¹⁷

With respect to loss contingencies,¹⁸ FSP 141R-1 replaced the provisions in FAS 141R relating to the accounting for and disclosures about loss contingencies with the provisions relating to the accounting for loss contingencies that were in Statement of Financial Accounting Standards No. 141, Business Combinations” (“FAS 141”).¹⁹ In summary, FSP 141R-1 requires a company to recognize a loss contingency assumed in a business combination at the acquisition-date fair value if such acquisition-date fair value can be determined during the measurement period.²⁰ If the acquisition-date fair value cannot be determined during the measurement period, the company must recognize the loss contingency in accordance with the standards of FAS 5 and FIN 14.²¹ That is, it must recognize a loss if information available before the end of the measurement period indicates that it is probable that a liability had been incurred at the acquisition date and the amount of the liability, or a range of such liability, can be reasonably estimated. FSP 141R-1 provides that a company must develop a systematic and rational basis for

14. FAS 141R, *supra* note 3, at paragraph 24. After initial recognition of a loss contingency at fair value, former FAS 141R would have required the recognition in the future of additional charges to the extent that the estimated amount of the loss, based on an analysis of new information in accordance with FAS 5, was higher than the acquisition-date fair value.

15. *Id.* at paragraph 68j.

16. FSP 141R-1, *supra* note 8, at paragraph 4.

17. *Id.*

18. FSP 141R-1 also relates to the recognition of and disclosures about gain contingencies.

19. FASB, Statement of Financial Accounting Standards No. 141, “Business Combinations” (June 2001) (“FAS 141”), available at http://www.fasb.org/pdf/aop_FAS141.pdf. The FASB did not carry forward footnote 14 in FAS 141, concluding that the footnote was inconsistent with the exit price notion of Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (Sept. 2006), available at http://www.fasb.org/pdf/aop_fas157.pdf. In addition, the FASB did not carry forward the guidance with respect to warranties in FAS 141.

20. FSP 141R-1, *supra* note 8, at paragraph 7. FAS 141R defines the measurement period as the period during which the acquirer can obtain additional information about the value of the acquired assets and liabilities, which must end no later than one year after the date of the acquisition. FAS 141R, *supra* note 3, at paragraph 51.

21. FSP 141R-1, *supra* note 8, at paragraph 8.

subsequently measuring and accounting for liabilities arising from contingencies.²²

Unlike FAS 141, however, FSP 141R-1 specifies certain required disclosures about loss contingencies. With respect to loss contingencies that have been recognized in the financial statements, FSP 141R-1 requires a company to disclose the amounts recognized at the acquisition date and the measurement basis applied, that is, whether the loss contingency was recognized at fair value or in accordance with FAS 5 or FIN 14.²³ For contingencies that are not recognized at the acquisition date, the company is required to provide disclosures in accordance with FAS 5.²⁴

The FASB warned in FSP 141R-1 that its decisions in FSP 141R-1 were “a temporary solution until it determines whether to separately address the accounting for all contingencies by reconsidering [FAS 5] or by participating in the IASB’s project [to amend, among other things, IASB’s standards relating to liabilities and contingent liabilities].”²⁵ Given the increase in the FASB’s issuance of standards that require the use of fair value, including FSP 141R-1, it would not be surprising for the FASB to consider requiring fair value recognition, if possible, for all loss contingencies.²⁶

IFRS

The accounting standards applicable to loss contingencies in IFRS are International Accounting Standard No. 37, “Provisions, Contingent Liabilities and Contingent Assets” (“IAS 37”),²⁷ and IFRS 3, “Business Combinations (as revised in 2008)” (“IFRS 3”), applicable to the accounting for business combinations.²⁸ IAS 37 requires a company to recognize through a charge to earnings any present obligation that is more likely than not to result in an outflow of resources to settle the obligation when a reliable estimate of the amount of the obligation can be made.²⁹ With respect to lawsuits, IAS 37 states that a company must take into account all available evidence, including, for example, the opinion of experts, to determine whether it is more likely than not that a present obligation exists. When a present obligation exists and an outflow of resources to settle the obligation is determined to be more likely than not, IAS 37 states that only in extremely rare cases is a reliable estimate of the amount of the obligation not expected to be possible.³⁰ The amount that an entity must recognize when there is no best estimate of

22. *Id.* at paragraph 11.

23. *Id.* at paragraph 14.a.

24. *Id.* at paragraph 14.b.

25. FSP 141R-1, *supra* note 8, at B10, referencing IASB, Exposure Draft, “Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits” (June 2005) (“IASB Proposal”), available at <http://www.iasb.org/NR/rdonlyres/1CFBC1A8-50F1-4BF3-9A33-579F849560C8/0/EDAmendstoIAS37.pdf>.

26. See, e.g., FASB, Statement of Financial Accounting Standards No. 146, “Accounting for Costs Associated with Exit or Disposal Activities” (June 2002), available at http://www.fasb.org/pdf/aop_FAS146.pdf; FASB, Statement of Financial Accounting Standards No. 143, “Accounting for Asset Retirement Obligations” (June 2001), available at http://www.fasb.org/pdf/aop_FAS143.pdf; FASB, Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” (June 2006), available at http://www.fasb.org/pdf/aop_FIN48.pdf; FASB, Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations” (March 2005), available at http://www.fasb.org/pdf/aop_FIN47.pdf.

27. International Accounting Standard No. 37, “Provisions, Contingent Liabilities, and Contingent Assets,” as amended through December 31, 2006 (“IAS 37”); *A Guide Through International Financial Reporting Standards* (IFRSs), IASC Foundation Education (July 2008) (“IFRS Guide”).

28. International Financial Reporting Standard 3, “Business Combinations (as revised in 2008)” (“IFRS 3”), IFRS Guide.

29. IAS 37, *supra* note 27, at paragraphs 14, 23. IAS 37 uses the word “probable” in the standard, but defines that word to mean that the probability that the event will occur is greater than the probability that it will not occur. IAS 37 provides that contingent liabilities are not recognized.

30. *Id.* at paragraph 25.

the amount among a range of estimates of possible losses is the mid-point of the range.³¹

IAS 37 requires the following disclosures about recognized liabilities, including liabilities relating to lawsuits, with similar types of liabilities disclosed on an aggregate basis:³²

- A reconciliation of the provisions at the beginning and end of the period, showing separately increases to existing provisions, amounts used during the period, unused amounts reversed during the period, and the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate;³³
- A brief description of the nature of the obligation and the expected timing of any resulting outflows;³⁴
- A brief description of uncertainties that affect the timing of the outflows and, where necessary, disclosure about major assumptions;³⁵ and
- The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.³⁶

If it is more likely that no present obligation exists at the end of the reporting period, or that no loss will result from a present obligation, or that a reliable estimate of the loss cannot be made, the obligation is considered to be a contingent liability that the company must disclose unless the possibility of a loss is remote.³⁷ The required disclosure is a description of the nature of the contingency and, where practicable, a best estimate of the amount required to settle the contingency, an indication of the uncertainties relating to the amount or timing of any cash outflows and the possibility of reimbursement.³⁸ When, in extremely rare cases, disclosure about a dispute with other parties can be expected to seriously prejudice the company's position in the dispute, the company is required to disclose only the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.³⁹

IFRS 3 imposes a different recognition and measurement regime for contingent liabilities assumed in a business combination than that in IAS 37. In addition, its requirements differ from FSP 141R-1.⁴⁰ IFRS 3 requires the recognition at fair value of "a contingent

31. *Id.* at paragraph 39.

32. IAS 37 explains that any aggregation of liabilities should be by "class of provision," that is, that liabilities can be aggregated depending upon "whether the nature of the items is sufficiently similar for a single statement about them to fulfil the [disclosure requirements]. Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings." *Id.* at paragraph 87.

33. *Id.* at paragraph 84.

34. *Id.* at paragraph 85(a).

35. *Id.* at paragraph 85(b).

36. *Id.* at paragraph 85(c).

37. *Id.* at paragraph 13.

38. *Id.* at paragraph 86.

39. *Id.* at paragraph 92.

40. The FASB and the IASB had jointly worked on improving the accounting for and reporting of business combinations. FAS 141R and IFRS 3 resulted from their effort to develop a common and comprehensive standard for the accounting for business combinations. The FASB's adoption of FSP 141R-1 increased the differences between US GAAP and IFRS for contingencies assumed in business combinations, but the standards differed even before the issuance of FSP 141R-1. See FAS 141R, *supra* note 3, at Appendix G.

liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably.”⁴¹ That means that, even if it is not probable that the contingent liability will result in a loss, the acquirer must recognize the fair value of that liability in accounting for the business combination. Thereafter, the contingent liability must be recognized at the higher of the fair value initially recognized, less any recognized cumulative amortization, or the amount that would be recognized in accordance with IAS 37.⁴² IFRS 3 requires disclosures about both recognized and unrecognized contingent liabilities in accordance with the provisions of IAS 37 as well as an explanation of why the fair value of a contingent liability could not be measured reliably in the event that the contingent liability was not recognized.⁴³

Proposed Changes to Loss Contingency Requirements

The FAS 5 Proposal was the product of the first phase of a two-phase project that the FASB undertook in September 2007 in connection with its project on the accounting for business combinations and in recognition of its increasing use of fair value measurements⁴⁴ and concerns that FAS 5 results in a delayed recognition of assets and liabilities.⁴⁵ The second phase was to review the accounting for loss contingencies. Although that project was removed from the FASB’s agenda, the FASB’s April 2009 comment in FSP 141R-1 warned that the accounting review is still possible.

The FASB may have believed that its two-phase project might facilitate convergence of US GAAP and IFRS standards applicable to the accounting for loss contingencies. As discussed above, those standards, which were already different, may become even more different as a result of a project that the IASB began in 2005.

IASB Exposure Draft: The IASB began to reconsider IAS 37 in 2005. It issued an exposure draft to amend IAS 37 that would eliminate the concept of a contingent liability, remove the probability standard applicable to the recognition of liabilities, and require recognition at fair value of all possible liabilities as long as they could be measured reliably (the “IASB Proposal”).⁴⁶ The IASB’s expectation is that “[e]xcept in extremely rare cases, an entity will be able to determine a reliable measure of a liability.”⁴⁷ The IASB Proposal stated that all pending and threatened litigation would meet the definition of a liability since an entity “that is involved in defending a lawsuit recognizes the liability arising from its unconditional obligation to stand ready to perform as the court directs.”⁴⁸

The IASB received comments discussing the practical difficulties that companies would have applying the proposal to lawsuits, and has discussed these difficulties with lawyers. Commentators, who expressed similar concerns to those raised by commentators on the FAS 5 Proposal, explained that the recognition of a liability for lawsuits could prejudice the company’s position in litigation and that the difficulty in measuring the value of

41. IFRS 3, *supra* note 28, at paragraph 23.

42. *Id.* at paragraph 56.

43. *Id.* at paragraph B64(j).

44. *See* note 26.

45. FASB, Minutes of the September 6, 2007 Board Meeting – Accounting for Contingencies, *available at* http://www.fasb.org/board_meeting_minutes/09-06-07_contingencies.pdf.

46. IASB Proposal, *supra* note 25.

47. *Id.* at paragraph 27.

48. *Id.*

lawsuits would be more frequent than “extremely rare.”⁴⁹ In 2006, the IASB decided that the mere start of legal proceedings by itself does not obligate an entity but is just another piece of evidence that may be relevant when determining whether a liability exists.⁵⁰ The IASB, however, has tentatively decided not to make any other changes in its proposals in response to the concerns expressed by companies subject to IFRS and their lawyers about the impact of the IASB Proposal on lawsuits.⁵¹

The IASB also decided not to make any changes in the proposal in response to concerns that United States companies would have practical problems applying the IAS 37 recognition and measurement requirements to litigation liabilities. A June 2009 IASB staff paper quoted the following language from the March 2009 FASB comment letter on the Securities and Exchange Commission’s (“SEC”) proposed roadmap towards the possible requirement that United States issuers prepare financial statements in accordance with IFRS (the “Roadmap”):⁵²

Moreover, several aspects of current IFRS might be difficult to apply in the U.S. For example, the IFRS standard on contingent liabilities has been argued to be incompatible with the legal environment in the U.S. because preparers would be compelled to reveal potentially damaging information about their litigation. Areas of accounting such as this represent potential challenges in any path forward that includes U.S. adoption of IFRS in its current form.⁵³

Despite the concerns about the litigious environment in the United States, the IASB concluded that the proposed changes to IAS 37 did not introduce any new factors that would cause problems in the United States environment.⁵⁴

FAS 5 Proposal: In its August 19 meeting, FASB made certain decisions related to disclosures about loss contingencies associated with litigation.⁵⁵ Their decisions suggest that the final amendments to FAS 5 will be quite different from the proposed amendments set forth in the FAS 5 Proposal, which are discussed below. Not only is the articulation of the disclosure objective different, but the FASB has decided against requiring disclosures that would have a prejudicial impact on litigation. There follows a summary of the principal differences between the FASB’s August 19, 2009 decisions and the FAS 5 Proposal:

Disclosure Objective: On August 19, the FASB decided that disclosures about loss

49. IASB Meeting Staff Paper, “Liabilities – Amendments to IAS 37, Applying the proposed requirements to litigation liabilities” (“IASB Staff Paper”), at paragraphs 17-19, available at <http://www.iasb.org/NR/rdonlyres/01F1BAEC-1D7E-4370-9A31-279F91147BB1/0/IAS370906b04Aobs.pdf>.

50. IASB Project Update, “Liabilities – Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits” (June 2009) (“IASB Project Update”), at paragraph 52, available at <http://www.iasb.org/NR/rdonlyres/B2EE99F3-C48E-40A1-8827-5137C92C0EF4/0/LiabIAS37ProjectJune09.pdf>.

51. *Id.* at paragraph 57.

52. Securities Act Release No. 33-8982, “Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers” (Nov. 14, 2008) (the “Roadmap Release”), available at <http://www.sec.gov/rules/proposed/2008/33-8982.pdf>. The SEC also acknowledged the difficulties that U.S. companies would have in complying with IFRS with respect to legal contingencies. In the Roadmap Release, the SEC noted concerns that auditors will be unable to corroborate information about litigation, claims and assessments because of the need for attorneys to preserve the confidentiality of certain information. *Id.* at fn. 80 and accompanying text.

53. IASB Staff Paper, *supra* note 49, at paragraph 37.

54. IASB Project Update, *supra* note 50, at paragraph 52.

55. The FASB decided to address other types of loss contingencies at a future meeting. Project Update, *supra* note 6.

contingencies should include “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.”⁵⁶ This objective seems more realistic than the objective articulated in the FAS 5 Proposal which contemplated specific disclosures about the amounts and timing of future losses.⁵⁷

Loss Contingencies to be Described: The FASB also decided to clarify the scope of the loss contingencies that would have to be described. It reached the following decisions about the types of loss contingencies that should be described:

- Asserted claims and assessments – The FASB determined to retain the disclosure requirement in FAS 5 that an asserted claim or assessment would only have to be described if it was “at least reasonably possible” that the claim or assessment would result in a loss.⁵⁸ The FAS 5 Proposal would have required disclosure about any asserted claim or assessment unless the likelihood of a loss was remote.⁵⁹
- Unasserted claims and assessment – The FASB determined to retain the disclosure requirement in FAS 5 that an unasserted claim or assessment would only have to be described if it was probable that a claim would be asserted and at least reasonably possible that the outcome would be unfavorable.⁶⁰ The FAS 5 Proposal would have required disclosure about any unasserted claim or assessment if it was probable that a claim would be asserted and the likelihood of a loss, if the claim or assessment were asserted, was more than remote.⁶¹
- Near term severe contingencies – The FASB directed its staff to consider possible approaches for disclosure about a loss contingency, or combination of loss contingencies, that is expected to be resolved in the near future and could have a severe impact on the company’s financial position, cash flows, or results of operations (“a near term severe contingency”).⁶² A possible approach would be one based on the standard of materiality articulated by the Supreme Court.⁶³ The FAS 5 Proposal would have required disclosure about a near term severe contingency regardless of the probability of a loss or whether a claim or assessment had been asserted.⁶⁴

Required Disclosures: The FASB staff recommended that the FASB consider only requiring disclosure of the following quantitative information: disclosure of the possible loss or range of loss or a statement that such an estimate cannot be made, which is required by FAS 5 today, publicly available factual quantitative information, such as the claim amount or the amount of damages indicated by the testimony of a plaintiff’s expert witness, and nonprivileged factual quantitative information that is available, regardless of

56. *Id.*

57. FAS 5 Proposal, *supra* note 4, at paragraph 4.

58. Project Update, *supra* note 6.

59. FAS 5 Proposal, *supra* note 4, at paragraph 6.

60. Project Update, *supra* note 6.

61. FAS 5 Proposal, *supra* note 4, at paragraph 5.b.

62. Project Update, *supra* note 6.

63. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (finding that “with respect to contingent or speculative information or events . . . materiality ‘will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event’” (*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1960))).

64. FAS 5 Proposal, *supra* note 4, at paragraph 6.

whether it is publicly available.⁶⁵ Notwithstanding its staff's recommendation, at the August 19 meeting, the FASB decided to direct its staff to "develop an approach that would focus on disclosure of nonprivileged quantitative information that would be relevant to making an estimate of the potential loss, for consideration by the Board at a future meeting."⁶⁶

In addition, the FASB agreed on three broad principles for the types of disclosure that companies should make about loss contingencies associated with litigation.⁶⁷ First, the FASB determined that the "[d]isclosures about litigation contingencies should focus on the contentions of the parties, rather than predictions about the future outcome."⁶⁸ Disclosure of the amount of the claim or assessment would likely be consistent with this principle, although commentators objected to the proposal to require that disclosure in the FAS 5 Proposal.⁶⁹ The principle does address, however, the concerns that companies often cannot predict the outcome of litigation and that disclosure of the likely outcome could prejudice the case. The FASB's agreement on this principle probably means that it will not retain the proposals in the FAS 5 Proposal to require disclosure of, among other things, a company's best estimate of the maximum exposure to loss when a plaintiff has not asserted an amount of the claim or assessment as well as qualitative information about the anticipated timing of the resolution of the contingency, factors that would likely affect the ultimate outcome, the company's qualitative assessment of the most likely outcome of the contingency and significant assumptions made by the company in estimating the quantitative amounts disclosed and in assessing the most likely outcome.⁷⁰

The FASB's decisions on August 19 with respect to disclosure about settlement negotiations and insurance and indemnification arrangements also evidence the FASB's understanding of commentators' concerns about the potential prejudicial impact of disclosures of those matters.⁷¹ The FASB decided that companies would not have to provide disclosures about settlement negotiations or about possible recoveries from insurance and other sources except to the extent that the information about recoveries had been provided to the plaintiff in discovery.⁷² The FAS 5 Proposal had proposed to require disclosures about the availability of insurance and possible recoveries from insurance.⁷³

The other two broad disclosure principles on which the FASB agreed are the following:

65. FASB Board Meeting Handout, "Disclosure of Certain Loss Contingencies" (Aug. 19, 2009) ("FASB Meeting Handout"), at paragraph 26, *available at* http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176156415683.

66. Project Update, *supra* note 6.

67. *Id.*

68. *Id.*

69. Paragraph 7.a. of the FAS 5 Proposal would require a company to disclose the amount of the claim or assessment against the entity. Commentators objected to this proposal, observing that the disclosure would be misleading when amounts are included "for effect and not because they have any real meaning." Comment Letter Summary, *supra* note 5, at paragraph 25.

70. FAS 5 Proposal, *supra* note 4, at paragraph 5.

71. Comment Letter Summary, *supra* note 5, at paragraphs 34, 43.

72. Project Update, *supra* note 6.

73. FAS 5 Proposal, *supra* note 4, at paragraphs 7.c. (requiring a quantitative and qualitative description of the terms of relevant insurance or indemnification arrangements) and 9 (requiring disclosure of the amounts of insurance or indemnification recognized).

- “Disclosures about a contingency should be more robust as the likelihood and magnitude of loss increase and as the contingency progresses toward resolution”,⁷⁴ and
- “Disclosures should provide a summary of information that is publicly available about a case and indicate where users can obtain more information.”⁷⁵

During the August 19 meeting, various FASB members commented that the proposed amendments to FAS 5 should not reduce the amount of information that companies are disclosing now about loss contingencies associated with litigation. Accordingly, the FASB is likely to retain the current requirements that companies disclose the amount recognized in the financial statements, where material to an understanding of the financial statements, and the amounts of reasonably possible losses from contingencies. The FASB may not require the reconciliation that was proposed in the FAS 5 Proposal. The FAS 5 Proposal would require a tabular reconciliation of recognized loss contingencies similar to that required now by IAS 37 and a narrative explanation of the significant matters in the reconciliation.⁷⁶

FASB's Next Steps: Notwithstanding the FASB staff's recommendation that the revised disclosure requirements be effective no sooner than for fiscal years ending after December 15, 2010,⁷⁷ the FASB has not ruled out requiring expanded disclosures about loss contingencies for fiscal years ending after December 15, 2009.⁷⁸ The FASB will need to finalize its reconsideration of the FAS 5 Proposal in the near future in order to give companies sufficient time to comply with any new requirements by the end of this year, however.

Alternative Approach

One concern with the FAS 5 Proposal is that the audit process might require disclosures to the independent auditors that could result in a loss of the attorney-client privilege because of the need for auditors to obtain independent evidential support for assertions in the financial statements.⁷⁹ Given that, it may be preferable for expanded disclosures about loss contingencies associated with litigation (and claims and assessments that might result in litigation) to be required outside the financial statements. Companies could then provide disclosures intended to provide investors with meaningful information about risks and uncertainties without the disclosures being subject to audit.

The Management's Discussion and Analysis of the Financial Condition and Results of Operations (“MD&A”) required in companies' annual reports on Form 10-K and registration statements⁸⁰ is intended “to provide information about the quality of, and potential variability of, an entity's earnings and cash flow, so that investors can ascertain

74. Project Update, *supra* note 6.

75. *Id.*

76. FAS 5 Proposal, *supra* note 4, at paragraph 8. The reconciliation would show the aggregate amounts recognized for loss contingencies in the statement of financial condition at the beginning and end of the period and increases and decreases resulting from new loss contingencies, changes in estimates, the derecognition of contingencies and cash payments (or other forms of settlement) shown separately.

77. FASB Meeting Handout, *supra* note 65, at paragraph 6.

78. Project Update, *supra* note 6.

79. Comment Letter Summary, *supra* note 5, at paragraph 68.

80. Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (2008).

the likelihood that past performance is indicative of future performance.”⁸¹ Item 303 of Regulation S-K specifically requires disclosures about “known trends or any known demands, commitments, events or uncertainties” that are reasonably likely to affect the company’s liquidity, capital resources or results of operations.⁸² The SEC has explained that this requirement means that companies should include in their MD&A a discussion about their critical accounting estimates, that is, those judgments that are particularly difficult to reach and that could have a material affect on their financial statements so as to provide “greater insight into the quality and variability of information regarding financial condition and operating performance.”⁸³

Accordingly, meaningful disclosure about material loss contingencies associated with litigation could be included in the MD&A to alert investors to possible future losses and to the difficult judgments that management must make as to whether to recognize losses with respect to such litigation. Since companies may not be consistently providing such disclosures, revisions to the MD&A requirements may be appropriate.

The SEC’s Advisory Committee on Improvements to Financial Reporting (“CIFiR”)⁸⁴ made a recommendation that evidences its view that current disclosures do not always address appropriately risks and uncertainties. In 2008, CIFiR recommended, among other things, that the SEC and the FASB establish a regular process of assessing the continued relevance of disclosure guidance and that the SEC and FASB work together to develop a disclosure framework to:

Require disclosures of the principal assumptions, estimates, and sensitivity analyses that may impact an entity’s business, as well as a qualitative discussion of the key risks and uncertainties that could significantly change these amounts over time. This would encompass transactions recognized and measured in the financial statements, as well as events and uncertainties that are not recorded.⁸⁵

In July 2009, the chairman of the FASB, Robert H. Herz, announced that the FASB had added to its agenda a project to establish a framework intended to make financial statement disclosures more effective, coordinated and less redundant. The press release noted that the project was added in response to recommendations from, among others, CIFiR.⁸⁶ The FASB’s project would be more effective if, at the same time, the SEC reviewed its disclosure requirements, including those with respect to loss contingencies associated with litigation. These requirements are Item 103 of Regulation S-K, requiring descriptions of material litigation, and Item 303 of Regulation S-K, relating to the MD&A.

81. Securities Act Release No. 8350, “Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations” (Dec. 19, 2003) (“MD&A Release”), at fn. 3, available at <http://www.sec.gov/rules/interp/33-8350.htm>.

82. Item 303(a)(1), (2) and (3) of Regulation S-K, 17 C.F.R. § 229.303 (2008).

83. MD&A Release, *supra* note 81, at Section V.

84. Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission (Aug. 1, 2008), available at <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>.

85. *Id.* at 34. Although the recommendation in the draft Final Report considered at CIFiR’s July 11, 2008 meeting referenced litigation as an uncertainty that would be encompassed by the disclosures about principal assumptions, estimates and sensitivity analyses, the reference to litigation was deleted from the Final Report. See Draft Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission (Aug. [x], 2008), at 36, 29, available at <http://www.sec.gov/about/offices/oca/acifr/acifr-dfr-071108.pdf>.

86. Press Release (July 8, 2009), available at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176156338441.

The SEC could consider integrating the disclosures required by Item 103 with the disclosures required by Item 303 and specifically requiring, in a principles-based provision, the following types of disclosures about loss contingencies associated with litigation, including claims or assessments that could result in litigation, to the extent that the risks relating to such claims or assessments could have a material affect on the company's liquidity, capital resources or results of operations:

- A description of the loss contingency, including how it arose, its legal or contractual basis, the amount of any publicly asserted damage claim and the current status of the claim; and
- As much quantitative and qualitative information about the risks that the loss contingency poses to the disclosing entity's financial position, cash flow, and results of operations as the disclosing entity can reliably provide, without adversely affecting the disclosing entity's ability to mitigate the loss or defend against the claim, and thereby reduce or eliminate the loss contingency.

Conclusion

The FASB's goal to require more meaningful information about loss contingencies is appropriate. Investors need to understand the risks posed by loss contingencies. Companies should be challenged to explain the risks without prejudicing their position in litigation. Perhaps SEC revisions to the MD&A to require expanded disclosures in the MD&A, rather than disclosures in the financial statements, would lead to enhanced disclosures about loss contingencies associated with litigation. Any such transparent disclosure would benefit companies as well by protecting them from claims that they did not warn investors about future possible losses.

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