

## **FASB July 20, 2010 Exposure Draft re: Disclosure of Certain Loss Contingencies**

On July 20, 2010, the Financial Accounting Standards Board (“FASB”) issued a Proposed Accounting Standards Update, *Disclosure of Certain Loss Contingencies* (the “Proposed ASU”).<sup>1</sup> The Proposed ASU would update Accounting Standards Codification Topic 450—Contingencies (“ASC Topic 450”), which prior to codification was known as FASB Statement No. 5, *Accounting for Contingencies*.<sup>2</sup>

In response to “concerns” from “[i]nvestors and other users of financial reporting” that “disclosures about loss contingencies under the existing guidance on contingencies . . . do not provide adequate and timely information to assist them in assessing the likelihood, timing and magnitude of future cash outflows associated with loss contingencies”, the FASB proposes to expand the population of loss contingencies that are required to be disclosed by requiring disclosure of certain remote loss contingencies. (Proposed ASU at 1) The amendments to U.S. generally accepted accounting principles (“GAAP”) in the Proposed ASU would enhance disclosures required under current U.S. GAAP with additional information. In short,

“The Board . . . continues to believe that to improve the timeliness of disclosures about loss contingencies, disclosure of certain asserted remote loss contingencies is necessary to inform users about the entity’s vulnerability to a potential severe impact. Therefore, the proposed amendments would expand the population of loss contingencies that are required to be disclosed. Assessment of a loss contingency as remote does not necessarily mean that no disclosure would be made until the loss contingency is assessed to be reasonably possible (that is, more than remote). An entity will need to exercise judgment in assessing its specific facts and circumstances to determine whether disclosure about an asserted remote contingency is necessary.” (*Id.* at 37)

The FASB staff acknowledges that the proposed disclosures would change existing GAAP, and promises to continue its dialogue with the American Bar Association, among others, “to identify and address any potential implications of the proposed requirements for the U.S. auditing literature and the ABA’s Statement of Policy Regarding Lawyers’ Responses to Auditor’s Requests for Information.” (*Id.* at 2)

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<sup>1</sup> See *Disclosure of Certain Loss Contingencies* (July 20, 2010), available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821001041&blobheader=application%2Fpdf>.

<sup>2</sup> “The FASB Accounting Standards Codification is the source of authoritative [GAAP] recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended.” (Proposed ASU, Inside Cover). The Proposed ASU is reporting how authoritative GAAP is to be amended.

## I. BACKGROUND

After almost a year of consideration, in June 2008 the FASB issued an Exposure Draft aimed at improving disclosures about loss contingencies (the “Exposure Draft”).<sup>3</sup> The Exposure Draft was issued to address concerns that disclosures about loss contingencies under the existing guidance did not provide sufficient and timely information to assist investors and other users of financial reporting in assessing the potential likelihood, timing and magnitude of future cash outflows associated with certain loss contingencies. The loss contingencies at issue were those that were remote or for which the loss amount could not be reasonably estimated, such as liabilities related to litigation.<sup>4</sup> The June 2008 Exposure Draft “had proposed certain disclosures based on management’s predictions about a contingency’s resolution.” (*Id.* at 3)

In response, the FASB received 241 comment letters from law firms, accounting firms, public corporations, bar and industry groups, and others, many of which were critical.<sup>5</sup> The FASB withheld finalization of its Exposure Draft because of these comments.

In March 2009, the FASB held two roundtable discussions to obtain additional input from financial statement users, preparers, auditors and attorneys.

After reviewing the feedback it received from the comment letters and roundtable discussions, on July 20, 2010 the FASB issued the Proposed ASU. The FASB states that the Proposed ASU “would eliminate . . . disclosure requirements [in the June 2008 Exposure Draft] such as estimating when a loss contingency would be resolved and the entity’s maximum exposure to loss.” (*Id.* at 3)

The FASB put the Proposed ASU out for comment because it “decided to reexpose the proposal to obtain additional input on whether it meets the needs of financial statement users and whether it is operational and auditable.” (*Id.* at 35) The FASB specifically asks the market if the proposed disclosures are “operational” and “auditable” (*Id.* at 3), and whether the December 15, 2010 effective date makes sense.

Comments are due by August 20, 2010.

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<sup>3</sup> See *Disclosure of Certain Loss Contingencies* (June 5, 2008), available at [http://www.fasb.org/draft/ed\\_contingencies.pdf](http://www.fasb.org/draft/ed_contingencies.pdf). For further discussion, see our firm memorandum entitled, *FASB Proposes Expanded Disclosure of Litigation and Certain Other Loss Contingencies* (June 26, 2008), available at <http://cgrnyvs1/Firm%20Memos/FASB%20Proposes%20Expanded%20Disclosure%20of%20Litigation%20and%20Certain%20Other%20Loss%20Contingencies.pdf>.

<sup>4</sup> The term “remote” means the chance of the future event or events occurring is slight. ASC Master Glossary, available at <http://asc.fasb.org/glossary&letter=ALL> (login required).

<sup>5</sup> For example, some constituents expressed concern about (1) the difficulty that preparers would have in reliably estimating exposure to loss; (2) the potentially prejudicial nature of the required disclosures and the effect that the required disclosures could have on attorney-client privilege; and (3) the reasonable level of assurance that could be obtained with respect to some of the proposed disclosures.

## II. THE PROPOSAL

The Proposed ASU would “establish the following disclosure objective”:

“An entity shall disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following:

- “a. The nature of the loss contingencies;
- “b. Their potential magnitude; and
- “c. Their potential timing (if known).

“To achieve the above objective, an entity would consider the following principles in determining disclosures that are appropriate for its individual facts and circumstances for loss contingencies that meet the disclosure threshold:

- “a. During early stages of a loss contingency’s life cycle, an entity would disclose information that is available to enable users to understand the loss contingency’s nature, potential magnitude, and potential timing (if known). Available information may be limited and, therefore, disclosure may be less extensive in early stages of a loss contingency. In subsequent reporting periods, disclosure would be more extensive as additional information about a potential unfavorable outcome becomes available.
- “b. An entity may aggregate disclosures about similar contingencies (for example, by class or type) so that the disclosures are understandable and not too detailed. If an entity provides disclosures on an aggregated basis, it would disclose the basis for aggregation.” (*Id.* at 1-2)

Specifically, the proposed new “disclosure threshold” is as follows:

“An entity shall disclose information about a contingency if there is at least a reasonable possibility (that is, more than a remote possibility) that a loss may have been incurred regardless of whether the entity has accrued for such a loss (or any portion of that loss). Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

- “a. It is considered probable that a claim will be asserted.
- “b. There is a reasonable possibility that the outcome will be unfavorable.

The disclosure to be required is both *qualitative* and *quantitative*. Thus:

“The revised disclosure objective recognizes the uncertainty inherent in predicting the amount of future cash flows by referring to both qualitative and quantitative information. Therefore, an entity would include more robust qualitative disclosures in situations in which quantitative disclosures are limited

because of, for example, the inherent uncertainties about the final resolution of litigation contingencies.”  
(*Id.* at 35)<sup>6</sup>

***Disclosure of individually material contingencies.*** For contingencies that are “individually material”, the Proposed ASU would require “sufficiently detailed information to enable financial statement users to obtain additional information from publicly available sources such as court records. For example, for a litigation contingency, an entity shall disclose all of the following:

- “1. The name of the court or agency in which the proceedings are pending
- “2. The date instituted
- “3. The principal parties to the proceedings
- “4. A description of the factual basis alleged to underlie the proceedings
- “5. The current status of the litigation contingency.” (*Id.* at 11)

***Disclosure of aggregated loss contingencies.*** When disclosure is provided “on an aggregated basis”, the Proposed ASU would require disclosure of “the basis for aggregation and information that would enable financial statement users to understand the nature, potential magnitude, and potential timing (if known) of loss.” (*Id.* at 11-12)

***Disclosure of reasonably possible contingencies.*** For “all contingencies that are at least reasonably possible (that is, more than remote)”, the Proposed ASU would require the following quantitative information:

- “1. Publicly available quantitative information, for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses.
- “2. If it can be estimated, the possible loss or range of loss and the amount accrued, if any.
- “3. If the possible loss or range of loss cannot be estimated, a statement that an estimate cannot be made and the reason(s) why.
- “4. Other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss.

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<sup>6</sup> Disclosures that would be required by the [Proposed ASU] are “similar, but not identical, to those required by IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. The IASB currently is deliberating changes to IAS 37. . . . The IASB’s project, however, has a much broader scope that includes initial recognition, subsequent measurement, and disclosures. The scope of this [Proposed ASU] is limited to improving disclosures.” (*Id.* at 3)

- “5. Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable by either the plaintiff or a regulatory agency, or it relates to a recognized receivable for such recoveries. If the insurance company has denied, contested, or reserved its rights related to the entity’s claim for recovery, an entity shall disclose that fact.” (*Id.* at 12)

**Disclosure of remote contingencies.** For “those remote contingencies that meet the disclosure threshold”, the Proposed ASU would require the following quantitative information:

- “1. Publicly available quantitative information, for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses.
- “2. Other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the loss.
- “3. Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, or it is discoverable by either the plaintiff or a regulatory agency. If the insurance company has denied, contested, or reserved its rights related to the entity’s claim for recovery, an entity shall disclose that fact.” (*Id.* at 12)

**Presentation format.** For “every annual and interim reporting period for which a statement of financial position and a statement of financial performance is presented” the Proposed ASU would require “reconciliations by class, in a tabular format, of recognized (accrued) loss contingencies to include all of the following:

- “1. Carrying amounts of the accruals at the beginning and end of the period.
- “2. Amount accrued during the period for new loss contingencies recognized.
- “3. Increases for changes in estimates for loss contingencies recognized in prior periods.
- “4. Decreases for changes in estimates for loss contingencies recognized in prior periods.
- “5. Decreases for cash payments or other forms of settlements during the period.

“Loss contingencies whose underlying cause and ultimate settlement occur in the same period should be excluded from the tabular reconciliation. A public entity shall describe the significant activity in the reconciliations described above and disclose the line items in the statement of financial position and the statement of financial performance in which recognized (accrued) loss contingencies are included.” (*Id.* at 12-13)

The FASB acknowledges that the “proposed change in the disclosure threshold would expand the population of loss contingencies that are required to be disclosed to achieve more timely disclosure of remote loss contingencies with a potentially severe impact.” (*Id.* at 2)

The Proposed ASU would require entities to provide a qualitative description of the significant activity in the reconciliation and disclose the line items in the statement of financial position in which recognized loss contingencies are included. The Proposed ASU would also require loss contingencies that are initially recognized in a business combination to be included in the tabular reconciliation. If the loss contingencies recognized in a business combination have a different measurement attribute (*e.g.*, fair value) than other loss contingencies, they should be presented separately in the tabular reconciliation. The Proposed ASU would require each class of contingencies to be presented separately in the tabular reconciliation, so that dissimilar contingencies would not be aggregated. Similar contingencies could be aggregated by class in order to address concerns about prejudicial disclosure of individual contingencies. Loss contingencies whose underlying cause and ultimate settlement occur in the same period can be excluded from the tabular reconciliation.

### III. FASB IMPLEMENTATION GUIDANCE

The Proposed ASU provides “implementation guidance and illustrations” including illustrative disclosures (*see* Proposed ASU at 15-27) and states that “[a]n entity should consider all the information that it is aware of when determining the degree of probability that a claim will be asserted and an unfavorable outcome could occur.” (*Id.* at 17). As further clarification of this point the Proposed ASU states:

“An entity may be aware of the existence of studies in reputable scientific journals (or other credible sources that other entities in the same industry generally review) that indicate potential significant hazards related to the entity’s products or operations. In such circumstances, an assessment must first be made as to whether the assertion of a claim is probable.” (*Id.* at 17)

If the assessment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the assessment is that assertion is probable, then a second assessment must be made as to the degree of probability of an unfavorable outcome. *See* Proposed ASU at 17-18. Disclosures as detailed in the Proposed ASU would be required in either of the following circumstances: (i) an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, and (ii) an unfavorable outcome is reasonably possible but not probable.

The guidance contained in the Proposed ASU “would apply to all entities, both public and nonpublic, except that nonpublic entities would not be required to provide a tabular reconciliation of accrued loss contingencies.” (*Id.* at 1)

### IV. NO EXEMPTION FROM DISCLOSING PREJUDICIAL INFORMATION

The June 2008 Exposure Draft had provided an exemption from disclosing prejudicial information. This proposed exemption was especially relevant to loss contingencies arising from pending litigation where disclosure at certain levels could be seen as prejudicial to the reporting entity. *See* Proposed ASU at 42-43.

The FASB states that it has attempted to accommodate prior objections that its Exposure Draft required disclosure of attorney client privileged information, and that it eliminated many of the Exposure Draft's proposed disclosures that are less factual and more speculative or predictive in nature. *See* Proposed ASU at 43. The Proposed ASU "would require disclosures about the potential timing of a loss contingency (for example, the next steps in its resolution) only if it is known to the entity." (*Id.* at 43)

The Proposed ASU does not contain any exemption from disclosing prejudicial information.

"The Board decided to not provide a prejudicial exemption because the proposed amendments would eliminate many of the speculative or predictive disclosures that were proposed in the Exposure Draft and because of some comment letter respondents' concern that the proposed exemption would be difficult to interpret and apply." (*Id.* at 44)

The FASB states that the Proposed ASU would "not require any new disclosures based on management's predictions about a contingency's resolution", would "generally focus on information that is publicly available", would "relate to amounts already accrued in the financial statements" and would "permit information to be presented on an aggregated basis with other similar loss contingencies", and therefore is of the view that "an explicit exemption from disclosing information that is 'prejudicial' to the reporting entity is not necessary . . ." (*Id.* at 3-4) The FASB asks the market if it agrees with this conclusion. (*Id.* at 3-4)

## **V. DISCLOSURE OF POSSIBLE RECOVERIES FROM INSURANCE OR INDEMNIFICATION ARRANGEMENTS**

Information about possible recoveries from insurance and other sources is permitted "only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable by either the plaintiff or a regulatory agency, or it relates to a recognized receivable for such recoveries." *See* Proposed ASU at 44.

"If the insurance company has denied, contested, or reserved its rights related to the entity's claim for recovery, the entity shall disclose that fact." (*Id.* at 44)

## **VI. SETTLEMENT OFFERS**

The FASB has decided not to require disclosure of settlement offers in the Proposed ASU.

## **VII. EFFECTIVE DATE AND COMMENT PERIOD**

For public entities, the proposed disclosure requirements would be effective for annual financial statements issued for fiscal years ending after December 15, 2010, and for subsequent interim and annual financial statements. In the case of nonpublic entities, the disclosures would be effective for the first annual period beginning after December 15, 2010, and for interim periods of fiscal years after the first annual period.

The FASB is soliciting comments on the Proposed ASU. Comments are due by August 20, 2010.

## VIII. CAUTION

Consideration of the disclosure of loss contingencies requires the exercise of judgment and is highly dependent on individualized facts and circumstances. The Proposed ASU described in this memorandum is not final, and is subject to change.

We will follow the comments submitted in response to this Proposed ASU and any revisions thereof, and, as appropriate, issue a subsequent memorandum.



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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); or Abigail Darwin at 212.701.3240 or [adarwin@cahill.com](mailto:adarwin@cahill.com).

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80 Pine Street | NY, NY | 10005-1702 | Phone: 212.701.3000 | Fax: 212.269. 5420 | Cahill.com

CAHILL GORDON & REINDEL LLP