

FASB Proposes Additional Disclosure of Loss Contingencies

by David R. Lamarre

Recent proposals by the Financial Accounting Standards Board (FASB) would significantly expand the disclosure of loss contingencies, including litigation, in the footnotes to financial statements. The change would apply to financial statements issued for fiscal years ending on or after December 15, 2008, and subsequent interim and annual periods. For calendar-year companies, therefore, the new requirements would first affect the preparation of their 2008 Annual Reports on Form 10-K. FASB has set a deadline of August 8, 2008 for public comments on its proposals.

Summary

The amendments were proposed in an Exposure Draft of a new Statement of Financial Accounting Standards, available at http://www.fasb.org/draft/ed_contingencies.pdf. The Exposure Draft calls for greatly expanded disclosures in connection with most loss contingencies, including pending and threatened litigation, currently accounted for under FASB Statement No. 5, Accounting for Contingencies (FAS 5), and loss contingencies recognized due to a business combination, FASB Statement No. 141(R), Business Combinations (FAS 141). The treatment of asset impairments would remain unchanged, as would a few specified liabilities (such as guarantees and certain insurance, employment and pension plan matters) governed by other accounting literature.

The proposed amendments would not affect FAS 5's definition of a loss contingency and its requirements for the recognition and measurement of loss contingencies in financial statements. As is currently the case, therefore, an estimate of the loss from a contingency must be accrued in the financial statements only where the loss is probable and the amount can be reasonably estimated. However, the proposed amendments would:

- elicit additional information about the potential effects of a contingency, including the estimated amounts associated with the contingency, even where no amount must be accrued;

- require disclosure even where a loss is considered remote, if resolution of the contingency is expected within one year and an adverse resolution could have a “severe” impact; and
- require a tabular reconciliation of the amounts recognized due to loss contingencies at the beginning and end of the period covered by the report.

The expanded disclosure would be required except where it would prejudice the company’s position with respect to resolution of a particular contingency. Even so, an aggregated (higher level) presentation would be required except in “rare” cases.

Expanded Quantitative and Qualitative Disclosure

Under the proposed amendments, for each loss contingency or group of similar contingencies (such as product liability claims), the company would be required to disclose the amount claimed or asserted or, if there is no claim or assessment amount, the company’s best estimate of the maximum possible exposure to loss. The FASB recognized that this would elicit disclosure of amounts that are unlikely to be realized, as a practical matter. Accordingly, if the maximum exposure is not representative of the actual exposure, the company would be permitted to disclose supplementally its best estimate of the possible loss or range of loss. Noting the common existing practice to state that an estimate of the loss or range of loss cannot be made (as permitted by paragraph 10 of FAS 5), the FASB indicated that the proposal reflects the significant concerns of some users of financial statements that existing FAS 5 rarely elicits quantitative information. According to the Exposure Draft, many users of financial statements prefer “a highly uncertain estimate supplemented with a qualitative description” to “no quantification of a potential loss as commonly occurs in existing practice.”

The proposals would also require the disclosure of qualitative information sufficient to allow the reader to understand the risks posed to the company by the contingency. This would include, “at a minimum”:

- a description of the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;
- a description of the factors that are likely to affect the ultimate outcome of the contingency, along with their potential effect on the outcome;
- a qualitative assessment of the most likely outcome;
- the significant assumptions made, in estimating the amounts disclosed and in assessing the most likely outcome; and
- a quantitative and qualitative description of any related insurance and indemnity arrangements.

The proposed statement does not elaborate on the information that the FASB expects to accompany the qualitative assessment of the “most likely outcome.” It is clear from the Exposure Draft that the FASB hopes that the disclosure about the “factors likely to affect the outcome” will assist investors in performing sensitivity analyses and otherwise “making their own assessments about the likelihood of future events related to the loss contingency as well as the potential cash flows related to those future events.”

Disclosure of Certain “Remote” Contingencies

Currently, disclosure is not required with respect to (1) asserted claims for which the likelihood of loss is deemed remote, and (2) unasserted claims in which the potential claimant has not manifested an aware-

ness of a possible claim unless it is probable that a claim will be asserted and the likelihood of the loss, if it were to be asserted, is more than remote.

By contrast, the Exposure Draft would require disclosure—even if the likelihood of loss is deemed remote—if a contingency (1) is expected to be resolved in the “near term” (a period of up to one year from the date of the financial statements) and (2) “could” have a “severe impact” on the company’s financial position, cash flows, or results of operations. The Exposure Draft states that a “severe impact” is intended to be a higher threshold than a “material” effect, and would involve “a significantly disruptive effect on the normal functioning of [the] entity” but which would not necessarily be “catastrophic.”

Tabular Reconciliation of Recognized Loss Contingencies

The Exposure Draft responds, in part, to concerns about the lack of transparency in respect of the effects of contingencies on the financial statements. Accordingly, the new standard would also require, in each period in which an income statement is presented, a tabular reconciliation of the total amount recognized for loss contingencies in the statement of financial position at the beginning and end of the period, as well as total recoveries from insurance or indemnification arrangements that are related to the loss contingencies included in the table. Contingencies recorded in a business combination would be shown separately from other contingencies.

The reconciliation would include at least the following (aggregated for all loss contingencies, to alleviate concerns about identification of individual contingencies):

- the beginning and ending balances;
- increases for loss contingencies recognized during the period;
- increases resulting from changes in estimates of the amounts of loss contingencies previously recognized;
- decreases resulting from changes in estimates or de-recognition of loss contingencies previously recognized; and
- decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

A qualitative description of the significant activity reflected in the table would also be included, further to the FASB’s aim of “provid[ing] users with valuable information about significant and sensitive estimates and changes in those estimates that are subject to significant measurement judgment.”

Companies would also be required to identify the line items in the statement of financial position in which loss contingencies were recognized.

Exemption for Prejudicial Information

The Exposure Draft contains an exception for information that would be prejudicial to a company’s position regarding the outcome of a contingency. Where that exception applies, the company may aggregate the disclosures at higher level, based on the nature of the contingency. In “rare” instances,¹ a company may forgo disclosing certain information altogether, if it would be prejudicial even when aggregated (for example, where there is only one material loss contingency). However, where the foregoing exception is relied upon, the company must disclose the fact that information has been omitted, and explain why. In addition, even if other information is omitted, the proposal would still require disclosure of (1) the amount of the

claim or assessment, (2) a description of the loss contingency including how it arose and its basis, status and anticipated timing of resolution, and (3) a description of the factors likely to affect the outcome.

Subsequent Events

The proposed Statement would require the foregoing quantitative and qualitative disclosures not only about loss contingencies incurred as of the balance sheet date, but also those arising after the balance sheet date but before the financial statements are issued. Where the amount of the loss can be reasonably estimated, the historical financials could be supplemented with pro forma financial data giving effect to the loss as if it had occurred at the balance sheet date.

Conclusion

The proposed amendments would significantly expand the information that must be disclosed in financial statement footnotes, starting with the Winter 2008 annual reporting season. They may have implications not just for financial reporting, but also for general disclosures about litigation and regulatory risks. Companies should begin to consider how they might need to revise their disclosure protocols and procedures to capture the incrementally required information and present it in the necessary format, including the new tabular reconciliation. They should also consider whether to use the remaining 10-Q filings in 2008 to lay the groundwork for any new information that would be likely to appear in the Spring 2009 Form 10-K, to reduce or eliminate any surprises from an investor relations perspective. Also, starting with the 2008 audit cycle, more time should probably be budgeted to allow for appropriate analysis and discussions between external and internal legal counsel, in generating their responses to auditors' routine requests for contingency-related information.

Live Link

Financial Accounting Standards Board; Financial Accounting Series; Proposed Statement of Financial Accounting Standards; June 5, 2008 (PDF, 46 pages)

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¹ The commentary accompanying the Exposure Draft notes that FASB did not intend "rare" to mean "never," as certain staff members had worried that word might be interpreted based on the experience with that phrase in other areas of accounting literature. See minutes of March 11-12, 2008 FASB Meeting, and footnote 3 to the Exposure Draft. The Exposure Draft recognizes that the decision to exercise this exemption will be a matter of "significant judgment that depends on the facts and circumstances."

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