

## SECURITIES UPDATE

### How the Proposed Changes to FAS 5 Would Impact Disclosures by Public Companies

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The exposure draft of a proposed Statement of Financial Accounting Standards, *Disclosure of Certain Loss Contingencies* (the “Proposed Statement”), issued by the Financial Accounting Standards Board (the “FASB”) on June 5, 2008, would significantly amend Financial Accounting Standard No. 5, *Accounting For Contingencies* (“FAS 5”) and No. 141 (revised 2007), *Business Combinations* (“FAS 141(R)"). The comment deadline for the Proposed Statement is August 8, 2008. As currently contemplated, the Proposed Statement would be effective for fiscal years ending after December 15, 2008.

Together, FAS 5 and FAS 141(R) establish the accounting and reporting requirements for all gain and loss contingencies, with limited exceptions. The stated purpose of the Proposed Statement is to improve the quality of financial reporting by expanding the disclosures required about loss contingencies. The concerns that the FASB sought to address in the Proposed Statement were that:

- The initial disclosure of specific information about a loss contingency under existing requirements does not occur until a material accrual is recognized for that loss contingency;

- The current requirements for disclosing loss contingencies have not resulted in the disclosure of all existing loss contingencies that are of interest to financial statement readers;
- The readers of financial statements have no basis for assessing possible future cash flows associated with loss contingencies due to public companies having so regularly disclosed—as permitted under current requirements—that “an estimate of possible loss or range of loss cannot be made”; and
- The amounts recognized in financial statements related to loss contingencies are not transparent to readers.

In summary, the Proposed Statement would:

- Increase the loss contingencies that are required to be disclosed;
- Require disclosure of specific quantitative and qualitative information about those loss contingencies;
- Require a tabular reconciliation of recognized loss contingencies to enhance financial statement transparency; and

- Provide an exemption from disclosing certain required information if disclosing that information would be prejudicial to an entity's position in a dispute.

## Increase the Loss Contingencies Required to be Disclosed

The Proposed Statement would require disclosure of all loss contingencies<sup>1</sup> that are recognized as liabilities in accordance with FAS 5 or are recognized in a business combination in accordance with FAS 141(R), except for loss contingencies:

- For which the entity has made an assessment and determined that the likelihood of a loss is remote;<sup>2</sup> or
- Involving an unasserted claim or assessment in which there has been no manifestation by a potential claimant of an awareness of a possible claim, unless it is probable that a claim will be asserted and the likelihood of a loss, if the claim were to be asserted, is more than remote.

The exceptions would not apply, and therefore, disclosure would be required, if the contingency is expected to be resolved in the near term<sup>3</sup> and the contingency could have a severe impact<sup>4</sup> on the entity's financial position, cash flows or results of operation. As a result, if the Proposed Statement is adopted as proposed, public companies would be required to provide disclosure about a significantly greater number of loss contingencies than they do today.

In addition, under existing FAS 5 requirements, a loss contingency is required to be accrued if the available information indicates that it is probable that an asset

has been impaired, or a liability has been incurred, at the date of the financial statements and the amount of loss can be reasonably estimated. This accrual requirement would not be changed by the Proposed Statement. Additional disclosure is required if no accrual is made for a loss contingency or if an exposure exists in excess of the amount accrued, in each case when there is a reasonable possibility<sup>5</sup> that a loss or an additional loss may have been incurred.

## Require Disclosure of Specific Quantitative and Qualitative Information About Loss Contingencies

If a loss contingency is required to be disclosed, both quantitative and qualitative information would have to be provided. The quantitative information would be the amount of the claim or assessment (including damages), if an amount is identified, or, if not identified, the entity's best estimate of the maximum exposure to loss. The entity would be permitted to disclose its best estimate of the possible loss or range of loss if it believed that the amount of the claim or the assessment of the maximum exposure to loss is not representative of the entity's actual exposure. The qualitative information to be provided is that which is sufficient to enable a reader to understand the risks posed to the entity, including:

- A description of the contingency (including how it arose, its legal or contractual basis, its current status and the anticipated timing of its resolution);
- The factors that are likely to affect the ultimate outcome of the contingency,

along with the potential effect on the outcome of such factors;

- The entity’s qualitative assessment of the most likely outcome of the contingency; and
- Any significant assumptions made by the entity in estimating the amounts disclosed and in assessing the most likely outcome.

Finally, the disclosure would have to include a quantitative and qualitative description of the terms of relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss, including any caps, limitations or deductibles that could affect the amount of the recovery.

The required disclosures could be aggregated by the nature of the loss contingency (for example, product liability or antitrust matters).

Under existing FAS 5 requirements, the disclosure that must be provided must indicate the nature of the contingency and an estimate of the possible loss or range of loss. If such an estimate can not be made, the disclosure must so state.

The Proposed Statement requires substantially more disclosure regarding loss contingencies than is currently required in the footnotes to the financial statements. Moreover, it would require public companies to disclose their best estimate of their maximum exposure to loss, if a specific amount of damages has not been claimed, and it would require public companies to disclose their assessment of the most likely outcome of the contingency. Thus, if adopted as proposed, the

Proposed Statement likely will cause public companies to incur a significant amount of expense, including the possible retention of third party experts, to determine an estimate of the maximum exposure to loss as well as to assess the most likely outcome of a contingency or in trying to decide whether the likelihood of a loss is remote.

For a public company that is party to litigation, the proposed disclosures may be prejudicial to its interests in the litigation. As indicated below under “Provide an Exemption from Disclosing Certain Required Information if Disclosing That Information Would be Prejudicial to an Entity’s Position in a Dispute,” only in rare circumstances would the Proposed Statement allow a public company to avoid disclosure of prejudicial information. In addition, if the estimates disclosed prove to be wrong, a public company could be opening itself up to various claims under the federal securities laws. As a result, the Proposed Statement should be of concern to public companies and their advisors.

### Require a Tabular Reconciliation of Recognized Loss Contingencies to Enhance Financial Statement Transparency

For each period for which an income statement is presented, an entity would be required to provide a tabular reconciliation of the amount recognized in the aggregate for all loss contingencies in its statement of financial position at the beginning and end of the period. Amounts recognized for loss contingencies that are accounted for in accordance with FAS 5 are to be shown

separately from the amounts accounted for in accordance with FAS 141(R).

The tabular reconciliation would be required to include:

- 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 derecognition of loss contingencies previously recognized; and
- Decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

An entity would be required to provide a qualitative description of the significant items quantified in the reconciliation and to disclose the line items in the statement of financial position in which loss contingencies are recognized. An entity also would be required to disclose the total amount of recoveries from insurance or indemnification arrangements recognized in each statement of financial position and income statement presented that are related to the loss contingencies included in the tabular reconciliation. Finally, an entity would be required to provide these disclosures with regard to loss contingencies that arise after the date of an entity's financial statements but before the financial statements are issued.

Under existing FAS 5 requirements, there is no obligation to provide a tabular reconciliation of changes in loss contingencies during the period being reported on; some

public companies do provide a tabular reconciliation in response to SEC comments, particularly as they relate to various types of mass tort litigation where there are a number of individual lawsuits predicated on the same matter.

### Provide an Exemption From Disclosing Certain Required Information if Disclosing That Information Would be Prejudicial to an Entity's Position in a Dispute

If disclosure required by the Proposed Statement about a loss contingency would be prejudicial to the entity's position in the matter, the entity could aggregate the required disclosures at a higher level in order to avoid disclosing the prejudicial information. Information would be prejudicial if disclosure of the information could affect, to the entity's detriment, the outcome of the contingency itself.

In those instances (which the FASB expect will be rare) where either a higher-level aggregated disclosure or a reconciliation also would be prejudicial, the entity may omit the disclosure of the prejudicial information. However, the entity would be required to disclose the omission and the reasons why the information has not been disclosed. In no event may an entity omit disclosure of the amount of any claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to loss), a description of the loss contingency and a description of the factors that are likely to affect the ultimate outcome of the contingency.

FAS 5 currently contains no comparable disclosure exemption. The exemption is needed, generally, because of the proposed new disclosure requirements.

## Endnotes

- <sup>1</sup> All loss contingencies are addressed by the Exposure Draft, other than loss contingencies that are (or would be) recognized as asset impairments in a statement of financial position, guarantees that are within the scope of the disclosure requirements of FASB Interpretation No. 45, liabilities for unpaid claim costs related to insurance contracts or reinsurance contracts within the scope of FASB Statement No. 60, liabilities for insurance-related assessments within the scope of AICPA Statement of Position 97-3 and liabilities for employment related costs, other than specified obligations that may result from withdrawal from a multiemployer plan.
- <sup>2</sup> FAS 5 defines “remote” as the chance of a future event occurring being slight.
- <sup>3</sup> “Near term” means a period of time not to exceed one year from the date of the financial statements.
- <sup>4</sup> “Severe impact” means a significant financially disruptive effect on the normal functioning of an entity. It is intended that severe impact would be a higher threshold than just what is material to the entity.
- <sup>5</sup> FAS 5 defines “reasonably possible” as the chance of a future event occurring being more than remote but less than likely.

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*If you have any questions about the Proposed Statement or its impact on public companies and their lawyers, please contact the author of this Securities Update, Michael Hermsen, any of our other attorneys listed below or any member of our Corporate and Securities practice.*

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