

## FASB Revises its Proposal Regarding Disclosure of Loss Contingencies

On July 20, 2010, the Financial Accounting Standards Board (the “FASB”) issued an exposure draft that revises its July 2008 exposure draft concerning revisions to the requirements for disclosure of certain loss contingencies set forth in Topic 450 (*Contingencies*) of the FASB Accounting Standards Codification (“Topic 450”).<sup>1</sup> Like the 2008 proposal, the revised proposal would significantly amend the existing disclosure requirements and has generated a substantial number of written comment letters. The comment deadline for the revised proposal is September 20, 2010. As currently contemplated, the revised proposal would be effective for fiscal years and subsequent interim periods ending after December 15, 2010.

Topic 450 establishes the disclosure and accounting requirements for all gain and loss contingencies, with limited exceptions. The stated purposes of the revised proposal is to address the concerns of investors and other users of financial statements that under the existing requirements disclosures about loss contingencies do not provide adequate and timely information to assist in assessing the likelihood, timing and magnitude of future cash outflows associated with loss contingencies. To address these concerns, the revised proposal creates a disclosure objective that would require entities to report qualitative and quantitative information about loss contingencies that would enable financial statement users to understand:

- The nature of the loss contingencies,
- Their potential magnitude, and
- Their potential timing (if known).

In reaching this objective, entities would follow the following principles with required disclosure evolving over the life cycle of the loss contingency:

- During the early stages, an entity would disclose information that is available to enable users to understand the loss contingency’s nature, potential magnitude and potential timing. Available information may be limited so disclosure may be less extensive in the 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.
- An entity may aggregate disclosures about similar contingencies so that the disclosures are understandable and not too detailed.
- Disclosure would be required of certain remote loss contingencies with a potentially severe impact. A “severe impact” is proposed to be defined as a significant, financially disruptive effect on the normal functioning of an entity. Severe impact is a higher threshold than material, but it includes matters that are less than catastrophic, such as those that would result in bankruptcy.

- An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when determining whether disclosure is required.

The revised proposal does not impact the standards for when a charge for a loss contingency must be accrued.

## The Disclosure Requirements

Under the revised proposal, an entity will be required to disclose information about a contingency if there is at least a reasonable possibility that a loss may have been incurred regardless of whether an amount has been accrued. “Reasonably possible” is the chance of a future event occurring being more than remote but less than likely.

Disclosure is not required of an unasserted claim if there has been no manifestation by a potential claimant of an awareness of a possible claim unless both of the following conditions are met:

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

Disclosure of asserted but remote loss contingencies may be necessary due to their nature, potential magnitude or potential timing to inform users about the entity’s vulnerability to a potential severe impact. When determining whether to disclose remote contingencies, an entity should consider the following factors:

- The potential impact on the entity’s operations
- The cost to the entity for defending its contentions
- The amount of effort and resources management may have to devote to resolve the contingency.

If disclosure would be required, the following must be disclosed:

- Qualitative information to enable users to understand the loss contingency’s nature and

risks, including for accrued loss contingencies, the nature of the accrue and the estimated liability;

- During the early stages of asserted litigation contingencies, at a minimum, the contentions of the parties, while in subsequent periods, the disclosure shall be more extensive as additional information about a potential unfavorable outcome becomes available and shall include, if known, the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies;
- For individually material contingencies, sufficiently detailed information to enable users to obtain additional information from publicly available sources, such as court records;
- When disclosure is provided on an aggregated basis, the basis for aggregation and information that would enable users to understand the nature, potential magnitude and potential timing of loss (if known);
- For all contingencies that are at least reasonably possible:
  - Publicly available quantitative information, such as the amount claimed by the plaintiff or the amount of damages indicated in testimony by an expert witness\*
  - If it can be estimated, the possible loss or range of loss and any amount accrued
  - If the possible loss cannot be estimated, a statement that an estimate cannot be made and the reasons why not
  - Other non-privileged information that would be relevant to users to enable them to understand the potential magnitude of the possible loss\*
  - Information about possible recoveries from insurance and other sources only if, and to the extent it has been provided to the plaintiff 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\*

- Information if an insurance company has denied, contested or reserved its rights related to the claim for recovery; and
- For every annual and interim reporting period, reconciliations by class, in a tabular format, of recognized (accrued) loss contingencies to include:
  - Carrying amounts of the accruals at the beginning and end of the period
  - Amount accrued during the period for new loss contingencies recognized
  - Increases for changes in estimates for loss contingencies recognized in prior periods
  - Decreases for changes in estimates for loss contingencies recognized in prior periods
  - 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
  - Disclosure must be made of the line items in the statement of financial position and the statement of financial performance in which recognized (accrued) loss contingencies are included.

## Aggregation of Disclosures

In determining whether to aggregate loss contingencies into various classes for disclosure purposes, an entity will be required to evaluate whether contingencies are sufficiently similar to be included in one class primarily on the basis of their nature, terms and characteristics. To determine the appropriate level of aggregation, an entity must exercise judgment and strike a balance between obscuring important information and overburdening users with excessive detail. If an entity aggregates its disclosures, it will be required to provide the basis for aggregation. In addition, if an issuer aggregates its disclosures, it should consider disclosing:

- The total number of claims outstanding,

- The average amount claimed, and
- The average settlement amount.

## Impact of Insurance or Other Forms of Indemnification

The revised proposal makes clear that when assessing the materiality of loss contingencies to determine whether disclosure is required, an entity must not consider the possibility of recoveries from insurance or other indemnification arrangements.

## Conclusion

Although the effective date is one of the provisions that has generated concern among interested parties, it is currently contemplated that, if adopted, the revised proposal will be effective for fiscal years ending after December 15, 2010. Accordingly, to avoid a potential scramble at the last minute to gather and disclose the required information, companies should already be determining how they will gather the relevant data for disclosure in compliance with the revised proposal.

## Endnote

<sup>1</sup> For more information on the 2008 proposal, see our July 28, 2008 Securities Update “How the Proposed Changes to FAS 5 Would Impact Disclosures by Public Companies,” available at <http://mayerbrown.com/publications/article.asp?id=5305&nid=6>.

\* This information shall also be provided when disclosing remote contingencies.

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*If you have any questions about the revised proposal or its impact on public companies, please contact the author of this Legal Update, Michael Hermsen, at +1 312 701 7960, any of the attorneys listed below or any member of our Corporate and Securities group.*

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