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FASB Proposal on Disclosure of Certain Loss Contingencies

On July 20, 2010, the Financial Accounting Standards Board (FASB) released the latest Exposure Draft proposing amendments for disclosure of certain loss contingencies under FASB Accounting Standards Codification Topic 450 (formerly FAS 5). FASB's objective for the proposal is to expand and enhance the disclosure requirements to provide more information about the possible outcomes of a loss contingency. It would lower the current disclosure threshold and expand the current disclosure requirements.

2008 Exposure Draft

FASB had previously issued an initial Exposure Draft regarding disclosure of certain loss contingencies in June 2008. The 2008 Exposure Draft received over 200 comment letters and prompted FASB to revise its proposal. While the 2010 Exposure Draft features a number of changes from the 2008 Exposure Draft, two differences are of note. First, under the 2008 proposal, a company would have been required to provide its best estimate of the maximum exposure to loss and a qualitative assessment of the most likely outcome. This requirement has been eliminated. Second, the 2008 proposal would have provided companies with an exemption from disclosing prejudicial information. This prejudicial exemption was not included in the 2010 proposal, however. FASB reasons that the exemption is no longer necessary as they believe the current proposal eliminates many of the speculative or predictive disclosures that were proposed in the 2008 Exposure Draft.

Disclosure Threshold

Accrual Standard

The standard for accruing for contingent litigation losses remains the same. Accrual is required only when (a) the loss is "probable" and (b) the amount of loss is "reasonably estimated."

Claims and Assessments

The new proposal maintains the current requirement that companies must disclose asserted claims and assessments whose likelihood of loss is reasonably possible. Disclosure of a loss contingency involving an unasserted claim or assessment also remains the same so that disclosure is not required unless both of the following conditions are met:

- it is considered probable that a claim will be asserted; and
- there is a reasonable possibility that the outcome will be unfavorable.

Remote Contingencies

FASB's proposal does expand the current disclosure requirements to require the disclosure of certain asserted remote loss contingencies. Under this new requirement, disclosure of a remote contingency "may be necessary" to inform financial statement users about a "potential severe impact." In determining

whether disclosure is required, consideration should be given to: potential impact on operations; cost of defense; and the amount of effort and resources management may have to devote to resolve the contingency.

When assessing the materiality of loss contingencies (remote or otherwise) to determine whether disclosure is required, a company may not consider possible recoveries from insurance or indemnification arrangements.

Required Disclosure

Quantitative Disclosure

For all contingencies that are at least reasonably possible, the following quantitative information must be disclosed:

- Publicly available quantitative information such as the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses.
- The amount accrued, if any, and an estimate of the possible loss or range of loss, if it can be estimated.
- If the possible loss or range of loss cannot be estimated, a statement that an estimate cannot be made and the reason(s) why.
- Other nonprivileged information that would be relevant to financial statement 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 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. A company must also disclose if the insurance company has denied, contested, or reserved its rights related to the company's claim for recovery.

For remote contingencies that meet the disclosure threshold described above, the same information must be disclosed other than an estimate of the possible loss or a statement that an estimate cannot be made.

Qualitative Disclosure

Under the proposal, a company must disclose "qualitative information to enable users to understand the loss contingency's nature and risks." During the early stages of a litigation, the company should disclose, at a minimum, the contentions of the parties (*e.g.*, the basis for the claim, the amount of damages claimed and the basis for the company's defense or a statement that it has not yet formulated its defense). In subsequent reporting periods, the disclosure should be more extensive as additional information about a potential unfavorable outcome becomes available including, for example, if the likelihood or magnitude of loss increases. Furthermore, if known, the company should disclose the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies.

- For individually material contingencies, the company should disclose sufficiently detailed information that will enable financial statement users to obtain additional information from publicly available sources such as court records. For example, for a litigation contingency, a company must disclose all of the following:
 - the name of the court or agency in which the proceedings are pending;
 - the date instituted;
 - the principal parties to the proceedings;
 - a description of the factual basis alleged to underlie the proceedings; and
 - the current status of the litigation.
- If disclosure is provided on an aggregated basis, the company should disclose 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.

Tabular Reconciliation

Public companies must provide, for each reporting period, tabular reconciliations explaining the period-to-period change in the accrual account for each class of recognized (accrued) loss contingency. Such tabular disclosure must include all of the following:

- the carrying amounts of the accruals at the beginning and end of the period;
- amount accrued for new loss contingencies recognized during the period;
- increases or decreases in estimates for loss contingencies recognized in prior periods; and
- decreases for cash payments or other forms of settlements during the period.

Effective Date

These new guidelines are intended to be effective for public companies with fiscal years ending after December 15, 2010 and all subsequent periods. For nonpublic companies, the proposed guidelines would be effective one year later, beginning with the first annual period after December 15, 2010. FASB has extended the comment period on the proposal until September 20, 2010.

Issues with the Proposal

While the current proposal addresses a number of concerns raised with respect to the 2008 Exposure Draft, a number of issues still remain:

- The proposed effectiveness for public companies by the end of this year does not allow much time for companies to review and analyze their contingencies and subsequently compile and prepare disclosure that satisfies the new requirements.
- Disclosing estimated amounts based on expert testimony is flawed and may be misleading since such testimony is often imprecise, speculative and subject to cross-examination.

- Disclosure of insurance coverage could tip off other potential plaintiffs to file a claim.
- Disclosing the possible loss or range of loss and the amount accrued for a particular contingency provides a bar below which it would be difficult for the company to settle. In addition, by providing a tabular reconciliation of accrued loss contingencies, plaintiffs could track the changes and determine the company's current thinking on a particular contingency's resolution placing the company at a further disadvantage in settlement negotiations. Although such disclosure may be aggregated for all loss contingencies, a significant contingency would still dominate the numbers.
- There is a risk of waiver of the attorney-client privilege due to the new disclosure requirements. Determinations of accrual amounts and whether information that would be relevant to the financial statement users to enable them to understand the potential magnitude of the possible loss is privileged or not is often based on the advice and analysis of counsel.
- Finally, the new required disclosure may also have an effect on the American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The ABA Statement of Policy has long provided guidance to lawyers and auditors with respect to disclosure of possible litigation losses. In response to the new disclosure requirements, auditors may expand the scope of their requests placing lawyers in the dilemma of not responding or risking waiver of the attorney-client or work product privilege.

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If you would like additional information or have any questions, please contact:**

Corporate

New York

Carlos T. Albarracín
+1 (212) 408-1081
calbarracin@chadbourne.com

Peter K. Ingerman
+1 (212) 408-5422
pingerman@chadbourne.com

Edward P. Smith
+1 (212) 408-5371
esmith@chadbourne.com

Marc A. Alpert
+1 (212) 408-5491
malpert@chadbourne.com

Sey-Hyo Lee
+1 (212) 408-5122
shlee@chadbourne.com

Kevin C. Smith
+1 (212) 408-1092
ksmith@chadbourne.com

A. Robert Colby
+1 (212) 408-5571
rcolby@chadbourne.com

Jonathan M.A. Melmed
+1 (212) 408-1002
jmelmed@chadbourne.com

London
Claude S. Serfilippi
+44 (20) 7337-8030
cserfilippi@chadbourne.com

William Greason
+1 (212) 408-5527
wgreason@chadbourne.com

J. Allen Miller
+1 (212) 408-5454
amiller@chadbourne.com

Washington
Sean P. McGuinness
+1 (202) 974-5680
smcguinness@chadbourne.com

Morton E. Grosz
+1 (212) 408-5592
mgrosz@chadbourne.com

J. Patrick Narvaez
+1 (212) 408-8006
pnarvaez@chadbourne.com

Charles E. Hord, III
+1 (212) 408-5353
chord@chadbourne.com

Marc M. Rossell
+1 (212) 408-1057
mrossell@chadbourne.com

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