

## Upcoming Deadlines for Proposed Amendments to SFAS No. 5 Accounting for Loss Contingencies

July 23, 2008

### Deadline for Participation in Discussions of Proposed Amendments

In June 2008, the Financial Accounting Standards Board issued an “Exposure Draft” of proposed amendments to Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (“SFAS No. 5”).<sup>1</sup> These would change the disclosure requirements for loss contingencies in GAAP financial statements.

The deadline to register to participate in a Roundtable on the proposals is July 25, 2008. Any person or organization that wants to participate in the Roundtable must send an email to [director@fasb.org](mailto:director@fasb.org) by July 25, 2008, and must submit comments by August 8, 2008.

### Background

The proposals, if adopted (as SFAS 16x), would not only require corporations to disclose a vastly increased range of loss contingencies, but would also dramatically increase the scope of the disclosures. The proposed rule would apply to most loss contingencies within the scope of SFAS No. 5 or SFAS No. 141(R), *Business Combinations*.

We believe the draft would impose significant burdens and legal complexities on companies preparing GAAP financial statements and could, among other things, significantly prejudice their legal positions in pending and threatened litigation. At the same time, it is unclear whether these disclosures would provide benefits to users of financial statements that justify the increased costs and litigation risks.

If the amendments are adopted, they will become effective for annual financial statements issued for fiscal years ending after December 15, 2008. They would also apply to interim and annual periods for later years.

Americas

Europe

Russia/CIS

Asia Pacific

Africa

Middle East

[www.dl.com](http://www.dl.com)

---

<sup>1</sup> The document, *Disclosure of Certain Loss Contingencies, an amendment of FASB Statements No. 5 and 141(R)*, is available at [http://www.fasb.org/draft/ed\\_contingencies.pdf](http://www.fasb.org/draft/ed_contingencies.pdf).

## The Existing Rule

Under SFAS No. 5,<sup>2</sup> a company must disclose, in notes to its financial statements, loss contingencies from threatened or existing litigation *if* there is “at least a reasonable possibility that a loss . . . may have been incurred.”<sup>3</sup>

Paragraph 10 of SFAS No. 5 thus requires a contingency to be disclosed where:

- It is “probable” that a loss has been incurred, but no accrual is made because the amount of loss cannot be reasonably estimated (see below); *or*
- It is not “probable” that a loss has been incurred, but there is a “reasonable possibility” that a loss may have been incurred at the date of the financial statements.

Furthermore, paragraph 8 of SFAS No. 5 requires an estimated loss from a loss contingency to be accrued and disclosed if two conditions are met:

- Information available before the financial statements are issued 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.

Finally, paragraph 37 of SFAS No. 5 makes it clear that the mere filing of a lawsuit or the formal assertion of a claim does *not* automatically mean that a loss accrual may be appropriate. The need for disclosure is based on a reasoned assessment of the claim, incorporating a variety of factors and judgments.

In sum, existing SFAS No. 5 generally requires disclosure only when it is at least “reasonably possible” that a loss has occurred, and only requires a company to disclose the range of potential loss when it is “probable” that a loss has occurred and the company can make a reasonable estimate of the amount.

## The Proposed Changes

According to the Exposure Draft, the proposed amendments were provoked by comments that the existing disclosure standard failed to give readers of financial statements adequate disclosures about loss contingencies.

The proposed amendments to SFAS No. 5 would thus significantly increase the scope and detail of loss contingency disclosure.

---

<sup>2</sup> The text of SFAS No. 5 is available at <http://www.fasb.org/pdf/fas5.pdf>.

<sup>3</sup> The FASB defines a “reasonable possibility” to be one that is “more than remote but less than likely” and defines “remote” to mean “slight.” SFAS No. 5, §§ 3(b) and (c).

### ***Expanded Duty to Disclose***

The proposed expanded duty to disclose arises under two conditions:

- For existing or threatened claims, a company would have to disclose *all* loss contingencies, *unless* it can determine that the likelihood of a loss is “remote.” (Again, “remote,” in this context, means “slight.”); and
- Even if the risk of a loss is “remote,” the company would still have to disclose the contingency if it is “expected to be resolved in the near term” (meaning one year), and if it could have a “severe impact” on the company. (“Severe impact” means a “significant financially disruptive effect on the normal functioning of an entity.”).

### ***Expanded Content of Disclosure***

If these conditions trigger a disclosure obligation, the proposed amendments would then require three specific types of disclosure: quantitative information; qualitative information; and insurance and indemnification information.

#### 1. “Quantitative Information”

- This includes the amount of the claim (including punitive damages), *or*
- If there is no claim amount, then the company’s “best estimate of the maximum exposure to loss”; *and, in either event,*
- These amounts must *exclude* the company’s possible recovery from any insurance or indemnification.

This requirement would apparently require the company to either (a) disclose the amount demanded by the plaintiff in the case (however unreasonable); *or* (b) place an estimate on its maximum exposure at the outset of the case, well before it has had any meaningful opportunity to fully analyze, much less litigate, the applicable measure of damages, engage experts to assist in quantifying damages, or conduct relevant discovery.

#### 2. “Qualitative Information”

This includes enough information to allow users of the financial statements “to understand the risks posed.” The information must include, at a minimum:

- A description of the contingency, including:
  - How it arose;
  - Its legal basis;
  - Its current status; and
  - The anticipated timing of its resolution;
- The factors likely to affect the ultimate outcome along with their “potential effect on the outcome”;

- The company’s qualitative assessment of the most likely outcome of the contingency; and
- “[S]ignificant assumptions” made in estimating the amounts of the claim and the most likely outcome.

### 3. Insurance and Indemnity Arrangements

This includes a “qualitative and quantitative description” of the terms of any 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 recovery.

#### ***Tabulated Reconciliation of Loss Contingencies***

The proposed amendments require a tabular reconciliation showing the periodic increases or decreases in loss contingencies, keyed to line items in the financial statements.

At a minimum, the reconciliation must 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 de-recognition of loss contingencies previously recognized; and
- Decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

#### ***“Aggregated” Disclosures***

The disclosure can normally be “aggregated” by type of loss (for example, product liability or antitrust), although how, exactly, this would be accomplished, given the nature of the specific disclosures required, is unclear.

#### ***The “Prejudicial Information” Exemption***

When disclosures of pending or threatened litigation would be “prejudicial,” a company can aggregate the loss contingencies at a higher level or, in limited cases, forego disclosing the prejudicial information. (It must, however, disclose the non-disclosure and the reason for it.)

While, by their very nature, it is difficult to envision how the required disclosures would not be “prejudicial” to the company in litigation (see below), the Exposure Draft warns

that use of the exemption should be “rare.” (The only real guidance it provides as to what this is intended to mean in practice, at §11, is that the “term *rare* is not intended to mean *never*.”)

Even in those “rare” cases where the “Prejudicial Information” exemption does apply, the company must *still* make, at a minimum, many of the standard “qualitative” disclosures, including:

- The amount of the claim (or, if there is no claim amount, an estimate of the maximum exposure to loss);
- A description of the loss contingency including:
  - How it arose;
  - Its legal or contractual basis;
  - Its current status; and
  - The anticipated timing of its resolution; and
- A description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome.

\*\*\*

In sum, the proposals are meant to give the financial statement user meaningful strategic information about claims against the company. However, the most conspicuous aspect of this disclosure is that the company’s claimants will now get the identical information as the user, and will be able to use that strategic information against the company and, ultimately, against the user’s own interests.

## **Insurance Contract Exemption**

Appendix A8 appears to exempt insurance company insurance claims from the proposed amendments. The scope of the exemption is ambiguous. As a practical matter, the exemption seems to be of limited value anyway, since the insured itself will need to make the same disclosures in its own financial statements.

## **The Probable Impact of the Proposed Change**

Although the concept behind the proposal<sup>4</sup> is something of a truism, the reality is that it is fraught with potential hazards for reporting companies.

---

<sup>4</sup> As the FASB expressed it in the Exposure Draft (A16), “Financial statement users . . . prefer to have a highly uncertain estimate supplemented with a qualitative description than no quantification of a potential loss as commonly occurs in existing practice.”

- The filing of a lawsuit does not mean that the litigation will ever rise to a serious level or that there will ever be any recovery at all. That said, few litigators will ever be prepared to opine at the pleading stage that the chances of an adverse outcome are “remote.” Thus, the proposed amendments effectively require the company to make disclosure and include an estimate of the loss contingencies whenever a lawsuit is filed.
- These loss contingency estimates will in the first instance almost certainly have to be prepared before the company has any meaningful information about the claim, including before any discovery.
- Litigation is highly unpredictable and evolving. A facially non-frivolous complaint can be demolished by a motion to dismiss, through discovery, at the summary judgment stage or at trial. Rarely, therefore, will a company be in a position to make a credible assessment at the start of a case regarding the anticipated timing of its resolution, the factors likely to affect the ultimate outcome, or their potential effect on the outcome, let alone the most likely outcome.
- Indeed, outside counsel will almost certainly not be prepared to offer opinions on such issues (nor, under current ABA guidelines governing responses to auditors inquiries, are they required to do so), putting companies in the untenable position of having to try to make such assessments themselves.
- Good-faith, but inaccurate “quantitative” and “qualitative” assessments of a claim, compelled by the proposed amendments, may create a new form of liability for a company whose premature assessments turn out to be wrong in hindsight.
- Good-faith assessments of a claim frequently produce a significant range of credible loss contingencies, forcing the company to make early and possibly uninformed judgments about specific amounts.
- Compelling companies to make the required, necessarily speculative, “qualitative and quantitative disclosure” creates a strong incentive for those companies to settle a newly filed claim, to which the plaintiff has assigned a huge, but quite possibly purely fictional, “amount.” The proposals would, in effect, create a new market for strike suits, and breathe new life into the very types of practices that the Private Securities Litigation Reform Act of 1995 was intended to end.
- The FASB purportedly decided to provide the “Prejudicial Information” exemption to limit the value of the information to the litigation claimants themselves. If this exemption works effectively, and does prevent the claimants from extracting valuable strategic information from the financial statements, the proposed amendments would then provide no significant value.

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2008 Dewey & LeBoeuf LLP  
All rights reserved.

For further information on Dewey & LeBoeuf, please visit [www.dl.com](http://www.dl.com)

- Invoking the “Prejudicial Information” exemption may, however, arguably give rise to an adverse inference with which the company will have to contend in the litigation.
- Both the “qualitative” disclosure requirements regarding the company's views of the merits of a claim, and the “quantitative” disclosure requirements requiring it to publicly disclose its “worst case scenario” damages estimate (as well as the “significant assumptions” made in estimating the amount of the claim and the most likely outcome), in effect force companies to disclose what would otherwise be protected as privileged and work-product information to their adversaries at the start of a case and to update such information as the case progresses.
- Such disclosures also threaten to compromise the attorney-client privilege and work-product privileges more broadly and could in the extreme be argued to affect a general subject-matter waiver.
- The quantitative “worst case” damages disclosure requirement will also invariably be used against the company in any negotiations to settle the claim.

These are the downsides of the proposed amendments.

The theoretical “upside” of the proposed amendments is, basically, to give users all the information they want. But that well-meaning goal could actually result in excessive and premature disclosure of inaccurate information. In fact, that type of disclosure seems to fall right into the category of information that the Supreme Court criticized for its potential to “bury the shareholders in an avalanche of trivial information, a result that is hardly conducive to informed decision making.” *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49, 453 (1976).

The proposed, highly-detailed disclosure requirements would create a similar “avalanche.” The proposals could help claimants, and undermine the company’s own efforts to defend claims; or, if the “Prejudicial Information” exemption were used, would be worthless to users. At the same time, by creating new levels of mandatory, but improvident disclosures, the proposals could create extra litigation. In short, the proposed amendments may cause more harm than good.

*If you have any questions or would like additional information, please contact Steven Levitsky, at 212-424-8309, or [steven.levitsky@dl.com](mailto:steven.levitsky@dl.com); Donald Murray, at 212-259-6575, or [dmurray@dl.com](mailto:dmurray@dl.com); Richard Reinthaler, at 212-259-6090, or [rreinthaler@dl.com](mailto:rreinthaler@dl.com); K. Oliver Rust, at 212-259-8571, or [krust@dl.com](mailto:krust@dl.com); John M. Schwolsky, at 212-259-8667 or [jschwols@dl.com](mailto:jschwols@dl.com); Joseph L. Seiler III, at 212-259-8137, or [jseiler@dl.com](mailto:jseiler@dl.com); James P. Smith, at 212-259-7594, or [jpsmith@dl.com](mailto:jpsmith@dl.com); or your Dewey & LeBoeuf LLP relationship partner.*