

FASB Holds Roundtable Discussion on Disclosure of Certain Loss Contingencies

March 13, 2009

In June 2008, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft of proposed amendments to Statement of Financial Accounting Standards No. 5, Accounting for Contingencies ("FAS 5"), and Statement of Financial Accounting Standards No. 141(R), Business Combinations.¹ The comment period on the Exposure Draft closed on August 8, 2008. The FASB received almost 250 comment letters on the Exposure Draft, including comment letters from Dewey & LeBoeuf.² Many of the comment letters criticized the proposal. Financial statement users generally supported the Exposure Draft, while financial statement preparers and the legal profession generally opposed it. Most of the significant concerns raised about the Exposure Draft are summarized in the Dewey & LeBoeuf Letters.

Effective Date Delayed

In September 2008, the FASB decided to delay the proposed effective date of the new statement on disclosures about loss contingencies to no sooner than for fiscal years ending after December 15, 2009.³

Alternative Model and Field Testing

Also in September 2008, the FASB decided on a plan for redeliberations of the Exposure Draft and directed the FASB staff to prepare an alternative model to address the concerns raised about the Exposure Draft. The FASB also directed the FASB staff to field test the alternative model along with the Exposure Draft.

The alternative model has not been distributed broadly and is not available for public comment. It represents "a collection of ideas" and is not intended to represent either the

¹ The Exposure Draft is available at http://www.fasb.org/draft/ed_contingencies.pdf. For a summary of the proposed amendments to FAS 5, see our Client Alert "Upcoming Deadlines for Proposed Amendments to SFAS No. 5 Accounting for Loss Contingencies" of July 23, 2008, available [here](#).

² Our comment letters on the Exposure Draft are available at <http://www.fasb.org/ocl/1600-100/52602.pdf> (the "Dewey & LeBoeuf Letters").

³ In the Exposure Draft, the FASB had contemplated applying the new standard to financial statements for fiscal years ending after December 15, 2008 and interim and annual periods thereafter.

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FASB staff's or the FASB's proposal for a final statement on disclosures about loss contingencies. The alternative model:

- Focuses on factual qualitative and quantitative information about the contingency;
- Requires disclosure of information about the likely outcome, factors affecting the outcome and assumptions only if that information would not be prejudicial to disclose; and
- Provides examples of the type of disclosure sought.

Quantitative disclosure under the alternative model is intended to give the reader "a sense of the potential magnitude" of the loss contingency. Other required disclosures considered under the alternative model include: (a) assertions made against the entity and the entity's response, (b) a qualitative description of the potential effect of a negative outcome on operations and liquidity, (c) information about a large number of similar claims and (d) information about the class period for class action securities litigation.

Roundtable Discussion

On March 6, 2009, the FASB held two public roundtable discussions on the disclosure of certain loss contingencies. The participants in these roundtable discussions included, among others, representatives from the Securities and Exchange Commission, the Public Company Accounting Oversight Board, the American Institute of Certified Public Accountants and the American Bar Association, FASB board members, representatives of the Big Four accounting firms and law firms as well as preparers and users of financial statements. Dewey & LeBoeuf was one of three law firms invited to participate in the roundtable discussion.

The roundtable discussion focused on:

- The appropriate threshold for disclosure about loss contingencies;
- The type of qualitative and quantitative disclosure that should be required if the disclosure threshold is met, including whether disclosure about possible recoveries of loss contingencies through insurance or other arrangements, as well as a tabular reconciliation of recognized loss contingencies should be mandated; and
- Audit considerations, including the difficulty of obtaining adequate audit evidence to support management's assertions of the company's exposure from a loss contingency in light of the limitations under the American Bar Association ("ABA") Statement of Policy Regarding Lawyers Responses to Auditors' Requests for Information (1975) (the "ABA Treaty").

Many preparers, auditors and lawyers participating in the roundtable expressed the view that FAS 5 is working and that there is no need to change the existing standard. Users of financial statements, on the other hand, said they would like to receive more information about contingencies and the related risks facing companies, and that the current standard does not result in adequate disclosure of that information. Lawyers and financial statement preparers participating in the roundtable noted that the benefits of additional disclosure need to be balanced against the additional cost that companies would incur to develop that disclosure. They also emphasized the risks of requiring too much disclosure, including the risk of inundating users of financial statements with conjecture and potentially misleading information pertaining to immaterial risks. They also warned that mandatory disclosure that revealed a company's litigation strategy, its assessment of the likelihood of success and/or its best estimate of the loss it may incur in the event of an unfavorable outcome could do more harm than good to investors to the extent it would tilt the litigation playing field in favor of plaintiffs, impinge on the protections afforded by the attorney-client privilege and promote larger (and in some cases premature) settlements.

Publicly Available Factual Information vs. Predictions

During the discussion, a consensus appeared to emerge that encouraging (and perhaps requiring) disclosure about certain types of publicly available factual information pertaining to material loss contingencies could be helpful to users of financial statements and should generally not be objectionable from the preparer's point of view, because that type of information would not be prejudicial. The type of publicly available factual information that would fall into this category would include, for example, a statement of the basis for the claims and the parties' contentions, as described in publicly available court filings. Requiring disclosure of predictions relating to loss contingencies (such as the potential outcome of a lawsuit or an estimate of the maximum exposure), on the other hand, was viewed as problematic (given the difficulty in predicting the outcome of litigation, particularly at the early stages of a case), impractical (given lawyers' reluctance under the ABA Treaty to express any opinion on the outcome of litigation), potentially misleading (given the inherent uncertainty and unpredictability of litigation), highly prejudicial (given how such information may be used by a plaintiff to extract a larger settlement or at trial) and difficult for auditors to confirm.

Participants disagreed as to whether companies should be required to disclose the amount of a claim, even if specified in publicly available court filings. While users of financial statements generally favored such disclosure, preparers and lawyers cautioned against mandating disclosure of the amount claimed, given that the amount set forth in a complaint is often exaggerated and bears little or no relationship to the true value of the potential exposure. Mandating such disclosure could end up misleading investors, would have to be heavily caveated and may result in the disclosure of litigation that does not pose a material risk, simply because the amount claimed in the complaint was unreasonably high. Preparers and lawyers thus urged against mandating such disclosure in all cases,

while encouraging it in cases where the company and its counsel believe it appropriate to do so. Indeed, this appeared to be a general theme, *i.e.*, that care needs to be taken in formulating the scope of any disclosure mandate, and that a principles-based disclosure standard would be preferable to a less flexible, rules-based disclosure standard.

Disclosure about insurance coverage

Participants disagreed about whether disclosure about possible recoveries of loss contingencies through insurance or other arrangements should be mandated. While users of financial statements indicated that they would find this disclosure very useful, preparers and attorneys pointed out that in cases where information about insurance coverage must be disclosed to the court and the plaintiff (such as in federal litigation), the information is confidential, inadmissible at trial and not publicly available from court filings. Participants representing insurance companies noted that an insurance company will typically not confirm insurance coverage until the case is closed and that premature disclosure about insurance coverage, and disputes regarding coverage, could be harmful to defendants.

Settlement Offers

Participants appeared to agree that given the delicate nature of settlement discussions, no disclosure about settlement offers should be mandated. Premature disclosure of settlement offers could be misleading and influence or even derail negotiation of a settlement.

Disclosure Threshold

The FASB staff asked roundtable participants for their thoughts about alternative disclosure thresholds that are different from the current "at least reasonably possible" standard, for example a "more likely than not" standard. Participants pointed out that during the audit process the auditors would want to see evidence that supports management's assertion that a loss either is or is not "more likely than not." The company's outside lawyers would not be able to provide such evidence, not only because the ABA Treaty is tailored around the "at least reasonably possible" standard in FAS 5, but also because the ABA would likely not support a change in the ABA Treaty to a "more likely than not" standard, given the professional limitations lawyers would face in making an assessment that something is "more likely than not."

Next Steps

At the close of the roundtable discussion, the FASB staff indicated that it will develop a new project plan, continue to analyze what disclosure about loss contingencies should be mandated and discuss the matter with the FASB.

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.

For more information about this topic, please contact any of the lawyers listed below or your Dewey & LeBoeuf relationship partner.

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