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The FASB's Revised Approach to Litigation Contingency Disclosure Raises Concerns

On July 20, 2010, the Financial Accounting Standards Board (“FASB”) issued an exposure draft regarding new proposed accounting standards designed to “enhance the disclosure requirements for loss contingencies,” including litigation contingencies. While the FASB has attempted to address some of the serious concerns presented by the draft standards it proposed in June 2008, the newly proposed standards remain deeply flawed and, if adopted, could have a prejudicial effect on entities facing litigation contingencies.

As noted in our [previous memorandum](#), in June 2008, the FASB issued an exposure draft designed to supplant the prevailing standards for loss contingency disclosure under FASB Statement No. 5, *Accounting for Contingencies* (later codified as FASB Accounting Standards Codification Subtopic 450-20). Motivated by the concern that the current standards had not resulted in adequate disclosure of the litigation contingencies that would be of interest to users of financial statements, the 2008 draft went way overboard. In particular, the 2008 draft threatened to result in waivers of attorney-client privilege and attorney work-product protections by requiring entities to disclose, among other things, their “best estimate of the maximum exposure to loss,” “a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect,” and “a qualitative assessment of the most likely outcome.”

The FASB received numerous comment letters objecting to the 2008 draft and, after further deliberation, issued its new draft last week. The revised draft attempts to meet the privilege-waiver concerns by eliminating the requirement that an entity disclose its “best estimate of the maximum exposure” to loss or its qualitative assessments regarding the “most likely outcome.” But the 2010 draft raises new and serious privilege-waiver concerns.

The highlights of the 2010 draft include the following:

Accrual Standard: The standard for accrual for litigation contingencies would remain unchanged. Accrual is required only when (a) the loss is “probable” and (b) the amount of loss is “reasonably estimated.”

Disclosure Thresholds: The 2010 draft would retain the current requirement that an asserted claim be disclosed in footnotes to financial statements if there is at least a “reasonable possibility . . . that a loss may have been incurred.” The disclosure threshold for unasserted claims also remains the same: disclosure is not required if 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 there is a “reasonable possibility that the outcome will be unfavorable.”

However, like the 2008 draft, the new draft would change the disclosure standard applicable to “remote” litigation contingencies. Under the current version of ASC 450-20, no

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such disclosure is required. The 2008 draft would have required disclosure of “remote” litigation contingencies expected to have a “severe impact” (i.e., a “significant financially disruptive effect”) in the “near term” (i.e., within one year). The new draft attempts to strike a middle ground by providing that disclosure of a remote contingency “may be necessary” to inform users about a “potential severe impact” and noting that an entity “will need to exercise judgment” in determining whether disclosure is necessary. Three factors to be considered in making this judgment are identified: the potential impact on operations; the cost of defense; and the amount of effort and resources management may have to devote to resolve the contingency.

Quantitative Disclosure Requirements: For “reasonably possible” contingencies, the new draft would require disclosure of the following “quantitative information”: (1) “publicly available quantitative information” such as “the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses;” (2) an estimate of the “possible loss or range of loss and the amount accrued, if any;” (3) if no such estimate is possible, a “statement that an estimate cannot be made and the reason(s) why;” (4) other non-privileged information that “would be relevant to statement users to enable them to understand the potential magnitude of the possible loss;” and (5) information about possible insurance recoveries only if and to the extent that it has been provided to the plaintiff(s) in discovery, is discoverable by either the plaintiff(s) or a regulatory agency, or relates to a recognized receivable for such recoveries. (For “remote” contingencies that meet the disclosure threshold described above, the same quantitative disclosures — other than the estimated loss or a statement explaining why no estimate can be made — are mandated.)

These requirements would alter the current disclosure standards with respect to “reasonably possible” contingencies in several highly significant respects. *First*, the current version of ASC 450-20 does not require entities to disclose the amount of their accruals for litigation contingencies except “in some circumstances” where it “may be necessary for the financial statements not to be misleading.” The new draft would replace this standard with one requiring disclosure of every accrual made for a litigation contingency. This could have two highly prejudicial consequences for reporting entities: (1) it could result in waiver of privilege or work-product protection because the amount of the accrual is typically predicated on the advice of counsel; and (2) it could give litigation adversaries a major tactical advantage in settlement negotiations by telling them the amount the entity has determined to be “probable,” “reasonably estimated” loss. As a practical matter, requiring entities to disclose the amount of their accrual for a particular litigation contingency may make it impossible for them to settle the litigation for an amount less than the amount accrued. *Second*, the current standard requires that the disclosure regarding “reasonably possible” contingencies include only the “nature of the contingency” and an “estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.” The new draft would effectively add a requirement for disclosure of information relating to possible insurance recoveries — a defendant’s liability coverage is generally subject to discovery and therefore would almost always have to be disclosed under the new proposed standard — and thus would prejudice companies by requiring them to broadcast their liability coverage terms to other potential litigation adversaries. *Third*, the current standard does not require the disclosure regarding the “amount of damages indicated by the testimony of expert witnesses.” By mandating such disclosure when the expert’s testimony is “publicly available,” the new draft would require entities to publicize in their financial statements the damage claims endorsed by the testifying experts retained by their litigation adversaries no

matter how speculative or baseless those claims might be. (The new draft does not appear to require such disclosure when the expert's testimony is not publicly available because, for example, a confidentiality order entered in the litigation prohibits the parties from disclosing deposition testimony that has been designated confidential by one of the litigants or a third party.)

Qualitative Disclosure Requirements: The new draft also would require the disclosure of “[q]ualitative information to enable users to understand the loss contingency’s nature and risks.” During early stages of a litigation, the entity must 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 entity’s defense or a statement that it has not yet formulated one). In subsequent reporting periods, the disclosure must be “more extensive as additional information about a potential unfavorable outcome becomes available” and must include the “anticipated timing of, or the next steps in, the resolution” of the disclosed contingency. In addition, the entity would have to disclose “sufficiently detailed information to enable financial statement users to obtain additional information from publicly available sources, such as court records.”

Tabular Reconciliation: The new draft would require an entity to present, in each reporting period, a tabular reconciliation, by class, of its accrued loss contingencies, including: (1) the carrying amounts of accruals at the beginning and end of the period; (2) the amount accrued during the period for new loss contingencies recognized; (3) increases and decreases for changes in estimates for loss contingencies recognized in prior periods; and (4) decreases for cash payments or other forms of settlements during the period. This new disclosure requirement, if adopted, would prejudice companies by giving their litigation adversaries a window into changes in the size of the accrual established for a particular litigation or class of litigations.

No Prejudice Exemption: The 2008 draft included a limited exemption for disclosing information about a contingency that “may be prejudicial to an entity’s position” because it “could affect, to the entity’s detriment, the outcome of the contingency itself.” The new draft would eliminate any such exemption in part because, in the FASB’s view, its proposed amendments “would eliminate many of the speculative or predictive disclosures” proposed in the 2008 draft.

If adopted, the new guidance would be effective for public entities for fiscal years ending after December 15, 2010. The FASB has set a deadline of August 20, 2010 to submit comments. Comments may be sent by e-mail to director@fasb.org, File Reference No. 1840-100. As noted above, the new draft does not solve the very serious problems of the 2008 draft and presents a grave threat to the litigation situation of most companies. We strongly recommend that companies file comments and make their views known.

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