Weil Briefing:
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FASB Proposes Expanded Disclosure About Litigation and Certain Other Loss Contingencies

The Financial Accounting Standards Board ("FASB") recently issued an Exposure Draft of a new Statement of Financial Accounting Standards concerning disclosure about loss contingencies, including litigation. The new statement would amend FASB Statement No. 5, *Accounting for Contingencies* ("Statement 5"), and, with regard to certain loss contingencies recognized as a result of a business combination, FASB Statement No. 141(R), *Business Combinations* ("Statement 141"). The proposed amendments would require expanded disclosure in the notes to financial statements prepared in accordance with U.S. generally accepted accounting principles regarding most loss contingencies currently accounted for under Statement 5, including a qualitative assessment of the most likely outcome of the contingency.

The new standard may have significant implications not only for financial reporting but also more generally for disclosure regarding litigation and other loss contingencies and the tasks that legal counsel and independent auditors will need to undertake as companies assess the likelihood, timing and amount of the future cash flows associated with loss contingencies in order to satisfy the new disclosure requirements. The Exposure Draft is available at http://www.fasb.org/draft/ed_contingencies.pdf. The deadline for comments from interested parties on the Exposure Draft is August 8, 2008.

Proposed Effective Date

The proposed amendments would be effective for annual financial statements issued for fiscal years ending after December 15, 2008 and for subsequent interim and annual periods. Accordingly, companies with calendar fiscal years should be prepared to apply the new standards next Winter when preparing their fiscal 2008 financial statements.

Proposed Amendments

The proposed amendments will significantly increase the disclosure required concerning most *loss contingencies*, as defined in Statement 5, notably including pending and threatened litigation. The definition in Statement 5 and the requirements of Statement 5 regarding the recognition and measurement of loss contingencies in financial statements will not be changed by the proposal (but are to be reviewed in a future FASB project). Accordingly, as currently, an estimate of the loss from a contingency will be required to be accrued only where the loss is probable and the amount of loss can be reasonably estimated. However, additional information will be required with regard to the potential and actual effects of a loss contingency on the company's financial position, cash flows, and results of operations, including the magnitude of the risks and the estimation of the amounts associated with the loss contingency, even where no amount is required to be accrued in the financial statements for the loss contingency. Asset impairments and certain other loss contingencies for which disclosure requirements are provided by other existing authoritative accounting literature would not be subject to the new standard.

Under the new standard, additional quantitative and qualitative disclosure will be required about the risks loss contingencies pose to a company's financial position, cash flows and results of operations, including information regarding the estimation of potential losses. These disclosure requirements will supersede the current provisions of Statement 5, which permit companies to dispense with disclosure about the estimated loss or range of loss associated with a loss contingency by stating that an estimate cannot be made. The FASB indicated that this change addresses the view of some financial statement users that "a highly uncertain estimate supplemented with a qualitative description" is better than "no quantification of a potential loss as commonly occurs under existing practice." The expanded disclosure will be required except where disclosure of the information would prejudice the company's position with respect to resolution of the contingency.

Other significant changes that would be made by the proposed amendments include:

- expansion of the population of loss contingencies for which disclosure is required to include contingencies for which a loss is considered remote, if resolution of the contingency is expected within one year and an adverse resolution would have a severe impact upon the company; and
- required tabular reconciliation of amounts recognized on account of loss contingencies at the beginning and end of the period reported on.

Expansion of the Population of Loss Contingencies Required to be Disclosed

Under the proposed amendments, as currently, disclosure would *not* be required with respect to the following loss contingencies:

- asserted claims as to which the company has made an assessment of the risk of loss and determined that the likelihood of loss is remote; and
- unasserted claims in which there has been no manifestation by a potential claimant of an awareness of a possible claim unless (1) it is probable that a claim will be asserted and (2) the likelihood of the loss, if the claim were to be asserted, is more than remote.

However, under the proposed amendments, the exceptions above would be inapplicable and disclosure would be required, even though the likelihood of loss is assessed to be remote, if a loss contingency (1) is expected to be resolved in the *near term* (a period of time not to exceed one year from the date of the financial statements) AND (2) could have a *severe impact* on the company's financial position, cash flows, or results of operations. A "severe impact" is intended to involve "a significantly disruptive effect on the normal functioning" of the company and to be a higher threshold than a material effect.

Expanded Quantitative and Qualitative Disclosure

Under the proposed amendments, with respect to each loss contingency (or group of loss contingencies of the same nature, e.g., product liability or warranty claims) disclosure generally will be required of the amount claimed or assessment asserted (including damages) or, if there is no claim or assessment amount, the company's best estimate of the maximum possible exposure to loss.

Qualitative information about a loss contingency (or group of loss contingencies of the same nature) sufficient to enable users to understand the risks posed to the company will be required, including, at a minimum, a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution. In addition, the disclosure is to include:

- a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome;
- the company's qualitative assessment of the most likely outcome of the contingency; and
- the significant assumptions made by the company in estimating the quantitative amounts disclosed and in assessing the most likely outcome.

In addition, a quantitative and qualitative description of any related insurance arrangements and potential recoveries thereon is to be included. The proposed statement does not elaborate on the information that is to be provided with respect to a qualitative assessment of the most likely outcome.

Tabular Reconciliation of Recognized Loss Contingencies

The proposed amendments require that, for each period for which a statement of income is presented, a tabular reconciliation of the total amount recognized in the aggregate for loss contingencies in its statement of financial position at the beginning and end of the period is presented. Such reconciliation must include at a minimum, the following:

- 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.

It should be noted that in the reconciliation amounts recognized for all loss contingencies may be aggregated in order to alleviate concerns that information about specifically identified recognized loss contingencies could be used in legal disputes. In addition, loss contingencies whose underlying cause and ultimate settlement occur in the same period may be excluded. A qualitative description of the significant activity reflected in the reconciliation must be included and the line items in the statement of financial position in which recognized loss contingencies are included must be disclosed. A principal purpose of the reconciliation is to "provide users with valuable information about significant and sensitive estimates and changes in those estimates that are subject to significant measurement judgment."

Total recoveries from insurance or indemnification arrangements that are related to the loss contingencies included in the tabular reconciliation must be included. Requirements with respect to a tabular reconciliation of recognized contingencies is not required for earlier periods that are provided for comparative purposes. A separate reconciliation of loss contingencies arising out of a business combination would be required, consistent with the accounting for business combinations required by Statement 141.

Exemption for Prejudicial Information

Information that would be prejudicial to a company's position with respect to the outcome of a contingency need not be disclosed. A company may, instead, aggregate the required disclosures at a level higher based on the nature of the contingency such that disclosure of the information is not prejudicial. In rare instances, a company may forgo disclosing the information altogether if it would be prejudicial even when aggregated at the higher level (for example, where there is only one material loss contingency). In the event no such disclosure is provided on such basis, the company must disclose the fact that, and the reason why, the information has not been disclosed.

Interaction with International Accounting Standards

Currently, International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets*, contains disclosure requirements with respect to loss contingencies similar to, but differing in certain material respects from, the proposed FASB statement. The International Accounting Standards Board is currently discussing potential changes to IAS 37 and is expected to evaluate the disclosure requirements in FASB's proposed statement when it reconsiders the IAS 37 disclosure requirements. Accordingly, both the adoption of the proposed FASB statement and the reconsideration of IAS 37 will provide an opportunity for greater convergence of U.S. and international accounting standards.

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If you have any questions, please do not hesitate to speak with your regular contact at Weil, Gotshal & Manges LLP or members of the Firm's Public Company Advisory Group: Howard B. Dicker, 212-310-8858; Cathy Dixon, 202-682-7147; Gil Friedlander, 214-746-8178; Holly J. Gregory, 212-310-8038; P.J. Himelfarb, 202-682-7197; Robert L. Messineo, 212-310-8835; and Ellen J. Odoner, 212-310-8438. Our e-mail protocol is firstname.lastname@weil.com.