

July 21, 2010

## **FINANCIAL ACCOUNTING STANDARDS BOARD ISSUES PROPOSED AMENDMENTS TO U.S. ACCOUNTING STANDARDS GOVERNING LOSS CONTINGENCIES**

To Our Clients and Friends:

On July 20, 2010, the Financial Accounting Standards Board ("FASB") issued an exposure draft (the "Exposure Draft") containing proposed amendments to Accounting Standards Codification Topic 450-20 (formerly Financial Accounting Standard No. 5), the U.S. Generally Accepted Accounting Principles ("U.S. GAAP") provision dealing with the disclosure of loss contingencies. The proposal would require enhanced disclosure of qualitative and quantitative information about loss contingencies, including litigation-related contingencies.

The current Exposure Draft removes some of the most significant shortcomings of the first exposure draft on this subject released by FASB in July 2008, such as the requirements to describe maximum possible losses from contingencies as well as to make predictions as to the likely future course and timing for resolution of the contingency. Nevertheless, the current Exposure Draft still contains a number of provisions that may be troublesome for companies. Companies should pay particular attention to the proposed revisions, given the significance of some of the revisions highlighted below. FASB also has proposed an accelerated effective date for the new standard, which could exacerbate some of the challenges in transitioning to the proposed disclosure requirements. Specifically, FASB has proposed that, for public companies, the revised standard would be effective for fiscal years ending after December 15, 2010.

An overview of the key provisions in the Exposure Draft is set forth below, and the full text is available [here](#). Comments on the Exposure Draft must be submitted to FASB by August 20, 2010.

### **Disclosure of Remote Contingencies**

Under the existing standard, certain disclosure about a loss contingency is required if the contingency is probable or reasonably possible; disclosure is not currently required for contingencies that are deemed remote. The Exposure Draft proposes to lower the disclosure threshold by requiring that certain remote loss contingencies also must be disclosed. In particular, the Exposure Draft states that disclosure of asserted, remote loss contingencies may be necessary where the entity is vulnerable to a "potentially severe impact" as a result of the remote contingency. The guidance in the Exposure Draft provides that a "severe impact is a higher threshold than material." Entities are directed to exercise their own judgment in determining whether a remote contingency has a potentially severe impact. The Exposure Draft suggests that among the factors that should be considered in making this determination are: (1) the potential impact on the entity's operations; (2) the cost to the entity for defending its contentions; and (3) the amount of effort and resources management may have to devote to resolve the contingency. The Exposure Draft notes that, for a remote litigation contingency, the magnitude of a plaintiff's claimed damages could be a factor in assessing whether the potential impact of the asserted

claim is severe, but such amounts alone should not lead to a determination that disclosure is necessary. Even if disclosure about a remote contingency is triggered, as with the current standard, no accrual is necessary for a remote contingency.

## **Aggregating Classes of Loss Contingencies**

The Exposure Draft would permit companies to aggregate disclosures about similar loss contingencies. Companies are required to exercise their own judgment in determining the proper level of aggregation and are asked to strike a balance between, on the one hand, aggregating too much and "obscuring important information" and, on the other hand, aggregating too little and "overburdening financial statement users with excessive detail." If a company elects to aggregate disclosures about loss contingencies, it must disclose the basis for such aggregation. For example, a company may choose to aggregate loss contingencies associated with different segments or product lines, or it may aggregate a large number of similar claims that, while not material individually, are material when aggregated.

## **Additional Qualitative Disclosure**

The Exposure Draft proposes that when disclosure about a litigation contingency is warranted, enhanced qualitative disclosure about the matter is required. Specifically, during the early stages of an asserted litigation contingency, a company must disclose at a minimum the contentions of the parties, including, for example, the amount of damages claimed, the basis for the company's planned defense, or a statement that the defense is being formulated. In future reporting periods, the Exposure Draft contemplates that more extensive disclosure would be required as the litigation progresses and additional information becomes available. Companies would have to disclose, for example, whether the likelihood or magnitude of the loss has increased. For individually material litigation contingencies, a company also would have to disclose, if known, the anticipated timing of, or next steps in, the matter's resolution. In addition, for individually material litigation contingencies, companies would be required to provide information sufficient to enable the users of financial statements to access the public records relating to the matter (*e.g.*, the name of the court, the date instituted and the principal parties). Presumably, under this revised standard, reporting companies will have to spend additional time in each reporting period assessing their material litigation contingencies (as well as other contingencies) to determine whether existing disclosures need to be updated. Companies also may be concerned that this disclosure updating process, revealing period-over-period changes to judgmental assessments about the evolution of a litigation matter, will give adverse parties an unfair window into a company's views on the matter, which among other things could complicate efforts to resolve the matter.

## **Additional Quantitative Disclosure**

The Exposure Draft also proposes additional quantitative disclosures about loss contingencies. For all contingencies that are at least "reasonably possible," companies would be required to disclose: (1) publicly available quantitative information, including, where publicly available, the amount claimed by the plaintiff or the amount of damages estimated by an expert witness; (2) the possible loss or range of loss and the amount accrued, if estimable; (3) possible recoveries from insurance or other sources, if

such information is discoverable by the plaintiff or a regulatory agency; and (4) other non-privileged information that would help financial statement users understand the potential magnitude of the loss. For remote contingencies that must be disclosed, companies would be required to provide the same information, except that the possible loss or range of loss would not be required to be disclosed. This Exposure Draft, unlike the 2008 draft, retains the concept contained in the current standard that permits a reporting company to decline to give an estimate of the amount of possible loss where it cannot be estimated.

## **Tabular Reconciliation**

In addition to the enhanced qualitative and quantitative disclosure, the Exposure Draft would require public companies to provide a tabular reconciliation of accrued loss contingencies in annual and interim financial statements. This tabular reconciliation would include: (1) the carrying amounts of the accruals at the beginning and end of the applicable period; (2) the amount accrued during the period for new loss contingencies recognized; (3) any increases or decreases for changes in estimates for loss contingencies recognized in prior periods; and (4) any decreases for cash payments or other forms of settlements during the period. Under the Exposure Draft, loss contingencies whose underlying cause and ultimate resolution occur in the same period can be excluded from the tabular reconciliation.

## **IFRS Deliberations on Loss Contingencies**

Although not addressed in detail in the Exposure Draft, FASB's revised standard comes as the International Accounting Standards Board ("IASB") is considering substantial modifications to the treatment of loss contingencies in International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets*. Loss contingencies are not a part of the formal convergence projects underway between FASB and IASB, yet it is worth noting that the proposed alterations of IAS 37, which include changes to the recognition, measurement and disclosure standards for loss contingencies, would increase the disparity between U.S. GAAP and International Financial Reporting Standards.

## **What Companies Should Do Now**

Companies should consider taking the following steps in light of the Exposure Draft:

- *Submit Comments to FASB.* Given the significance of the Exposure Draft's proposed modifications and the accelerated timeline for implementing the contemplated changes, companies should consider submitting comments to FASB by the August 20, 2010 deadline. Companies should note that FASB has requested comments on specific questions, including whether companies agree with FASB's decision *not* to include an exemption from the disclosure requirements for disclosures that would be prejudicial to the company.
- *Assess the Steps Required to Implement the Proposed Disclosures.* Companies, in particular those with calendar year-ends, should begin assessing now how to implement the proposed disclosure changes. This will require companies, among other things, to survey their litigation and other loss contingencies and consider what additional information may be required under

# GIBSON DUNN

the enhanced disclosure requirements set forth in the Exposure Draft and how such contingencies might be aggregated for disclosure purposes.



*Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these issues. To learn more about the firm's Securities Regulation and Corporate Governance Practice, please contact the Gibson Dunn attorney with whom you work, or any of the following:*

*John F. Olson - Washington, D.C. (202-955-8522, [jolson@gibsondunn.com](mailto:jolson@gibsondunn.com))  
Brian J. Lane - Washington, D.C. (202-887-3646, [blane@gibsondunn.com](mailto:blane@gibsondunn.com))  
Ronald O. Mueller - Washington, D.C. (202-955-8671, [rmueller@gibsondunn.com](mailto:rmueller@gibsondunn.com))  
Lewis H. Ferguson - Washington, D.C. (202-955-8249, [lferguson@gibsondunn.com](mailto:lferguson@gibsondunn.com))  
Amy L. Goodman - Washington, D.C. (202-955-8653, [agoodman@gibsondunn.com](mailto:agoodman@gibsondunn.com))  
Michael J. Scanlon - Washington, D.C. (202-887-3668, [mscanlon@gibsondunn.com](mailto:mscanlon@gibsondunn.com))  
James J. Moloney - Orange County (949-451-4343, [jmoloney@gibsondunn.com](mailto:jmoloney@gibsondunn.com))  
Elizabeth Ising - Washington, D.C. (202-955-8287, [eising@gibsondunn.com](mailto:eising@gibsondunn.com))*

© 2010 Gibson, Dunn & Crutcher LLP, 333 South Grand Avenue, Los Angeles, CA 90071

*Attorney Advertising: The enclosed materials have been prepared for general informational purposes only and are not intended as legal advice.*