

FASB PROPOSES AMENDMENTS TO SFAS NO. 5, *ACCOUNTING FOR CONTINGENCIES*, THAT RAISE SERIOUS CONCERNS

To Our Clients and Friends:

On June 5, 2008, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft that proposed amendments to Statement of Financial Accounting Standards No. 5 and No. 141(R) ("FAS 5 and 141(R)"). The amendments would "replace and enhance the disclosure requirements" in FAS 5, *Accounting for Contingencies*, for loss contingencies that are recognized as liabilities in a financial statement and for certain unrecognized loss contingencies that meet the definitional criteria of amended FAS 5. Among the loss contingencies included in FAS 5 are potential losses from pending and threatened litigation, claims and assessments. The proposed standard would also apply to loss contingencies recognized in a business combination accounted for under FAS 141(R), *Business Combinations*. If adopted, the new requirements will be effective for fiscal years ending after December 15, 2008.

FASB has stated that the amendments stem from "concerns expressed by investors and other users of financial information...that disclosures about loss contingencies under the existing guidance in [FAS 5] do not provide adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies."

The Existing FAS 5 Standard

Under FAS 5 today, only those loss contingencies involving losses that are "probable" of occurrence require the quantitative accrual of a liability in the financial statements. All other contingent losses involving "at least a reasonable possibility that a loss...may have been incurred" must be disclosed in a note to the financial statements that sets forth the nature of the loss contingency and the range of probable loss, if it is estimable. If the range of probable loss cannot be estimated, it does not have to be disclosed. Loss contingencies that are deemed "remote" do not have to be disclosed at all.

The Proposed FAS 5 Amendments

FASB's proposed amendments to FAS 5 change the standard in significant ways. They both lower the disclosure threshold in some cases and increase substantially the amount of information that must be disclosed for all loss contingencies that meet the definitional requirements. The amendments do not change the threshold for accrual of a liability on the financial statements with the requirement for accrual continuing to be that the likelihood of loss be "probable." FAS 5, as amended, will require that all loss contingencies be disclosed unless the chance of loss is "remote." Even such "remote" loss contingencies must be disclosed if the matter is likely to be resolved in the next year and, if determined adversely to the company, could have a "severe impact" (defined as "significantly financially disruptive" effect) on the company's financial position, cash flows, or results of operations.

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For loss contingencies that meet the disclosure threshold, both quantitative and qualitative disclosures will be required. The required quantitative disclosures include the amount of the claim or assessment (including damages such as punitive or treble damages if applicable) or, if no amount is claimed, the company's "best estimate of the maximum exposure to loss." The company may report its estimate of the possible range of loss if the amount of the claim or assessment is not representative of the actual exposure. The qualitative disclosure must include, at a minimum, "a description of the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; 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 entity's qualitative assessment of the most likely outcome of the contingency; and significant assumptions made by the entity in estimating the amounts disclosed in [the quantitative assessment]." In addition, there must be a quantitative and qualitative assessment of relevant insurance and indemnification arrangements. Item 103 of Regulation S-K already requires some of this disclosure and one could wonder why FASB wants to require what may be partly redundant disclosure in the footnotes to financial statements.

Questions and Concerns Raised by the Proposed FAS 5 Amendments

The proposed amendment raises a number of issues of which companies should be aware.

- 1. The company must provide its own estimate of its maximum loss exposure where the claimant has not stated a claim amount.** In cases where no claim amount is stated, the defendant company itself must provide its "best estimate" of its maximum exposure. This requirement forces a defendant company to quantify and disclose its potential maximum exposure in an adversary proceeding where the claimant itself has been unwilling or unable to quantify the maximum loss.
- 2. The required qualitative disclosures may reveal the company's thinking and strategy for dealing with the claim.** The required disclosure of the company's "qualitative assessment of the most likely outcome, ...the anticipated timing of [the claim's] resolution...and the significant assumptions made by the [company] in estimating the amounts disclosed" runs the risk of revealing aspects of the defendant company's thinking that historically have been carefully guarded in adversary proceedings.
- 3. The disclosures themselves may constitute admissible evidence or affect the course of the action.** These required estimates and disclosures may be found to be admissible in evidence against the company in the proceeding itself or they may alter the outcome of the proceeding by changing the course of settlement discussions or other outcome determining matters.
- 4. The proposed disclosures may lead to waivers of the attorney/client privilege and lawyer's work product immunity.** Since the required disclosures may be based on confidential communications between companies and their counsel who are handling the matter under consideration, there is a risk that the disclosures will constitute waivers of the attorney/client privilege or work product immunity. In addition, since independent auditors will likely want to test these estimates and disclosures as part of their audit work, there may be increased pressure for them to seek detailed information from counsel in the course of their work that will also pose waiver risks.

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5. Disclosures and estimates that turn out to be wrong may be sources of additional litigation. Assessments of pending and threatened claims, particularly those involving litigation, are inevitably uncertain and subject to factors outside the control or ability to foresee of any of the parties. As a result, the required disclosures and estimates themselves, when they prove to be inaccurate, as some inevitably will, may be sources of additional claims and litigation.

6. FASB's proposal to deal with information prejudicial to a company's position may not be sufficient. FASB specifically recognizes that for certain loss contingencies such as pending or threatened litigation disclosure of certain information about the contingency may be prejudicial to the company's position. In that event, the proposal provides that disclosures may be aggregated and reported at a higher level or, "in rare instances," omitted altogether. This approach may not address the problem since for many companies a single case or subset of cases poses a much greater threat of loss than others and sophisticated users of the company's financial statements are likely to know that and be able to decipher those cases from the others in the "aggregate" quantitative and qualitative disclosures.

FASB's proposed amendment contains a second level attempt to deal with the problem of prejudice in those "rare instances" where even aggregation at a high level would not prevent it. In such cases, the company could omit its qualitative assessment of the most likely outcome but would still have to disclose the amount of the claim or its estimate of the likely maximum loss exposure and describe the factors that will likely affect the outcome of the matter. FASB has made clear that even this limited protection will only be available in "rare instances."

Future Actions

Comments in writing are due on this proposed amendment by August 8, 2008 and FASB will thereafter host an open forum on the issue at which those who have submitted comments may testify. We are aware of a high degree of interest in the proposal among a variety of groups including the American Bar Association, business trade associations and investor groups. If you desire further information on this matter, please contact any of the undersigned.



Gibson, Dunn & Crutcher's [Securities Regulation and Corporate Governance Practice Group](#) is available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn attorney with whom you work, or any of the following:

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