

WSGR ALERT

AUGUST 2010

FASB'S REPROPOSED AMENDMENT ON LOSS CONTINGENCIES STILL RAISES SIGNIFICANT CONCERNS

On July 20, 2010, the Financial Accounting Standards Board (FASB) issued an exposure draft that proposes amendments to Accounting Standards Codification (ASC) Topic 450, *Contingencies* (previously FASB Statement No. 5, *Accounting for Contingencies*).¹ Like the FASB's June 2008 proposal, discussed in a previous WSGR Alert,² the exposure draft would redefine the disclosure requirements in Topic 450 for certain loss contingencies, including potential losses from pending and threatened litigation. If adopted, the new requirements would be effective for fiscal years ending after December 15, 2010. FASB has stated that the proposed amendments stem from a concern that disclosures about loss contingencies under the existing Topic 450 standards do not provide adequate and timely information to assist users of financial statements to assess the likelihood, timing, and magnitude of future cash flows associated with loss contingencies.

The exposure draft continues to raise significant concerns, including potentially requiring disclosure of key elements of a company's litigation strategy, the possible waiver of attorney-client privilege and attorney work-product protection, and creating a potential source of additional litigation. In addition, the new disclosures may embolden plaintiffs to continue what otherwise may be problematic litigation and potentially increase amounts paid in settlement.

Given the significance of the issues involved, the FASB recently extended the deadline for comments on the exposure draft from August 20, 2010, to September 20, 2010.

Existing Standard

FASB Statement No. 5, as now codified in Topic 450, established three categories of loss contingency: "probable," "remote," and "reasonably possible." Under Topic 450, "probable" means that the future event is likely to occur, "remote" means that the chance of the future event occurring is slight, and "reasonably possible" means that the chance of the event occurring is more than remote but less than likely. A company must accrue for loss contingencies, such as pending or threatened litigation, when the loss is probable and the amount of loss can reasonably be estimated. If there is no accrual because both of these two conditions are not met, then disclosure of the loss contingency must be made in the financial statement notes when there is at least a reasonable possibility that a loss may have been incurred. The disclosure should set forth the nature of the loss contingency and the range of probable loss if reasonably estimable, or state that such an estimate cannot be made.

As a practical matter, because the standards for judging a loss contingency to be either probable or remote are so high, most loss contingencies fall into the category of

reasonably possible. In addition, it is not common for companies to make an estimate of loss for loss contingencies deemed reasonably possible because of the inherent uncertainties in litigation. Further, legal counsel generally refrains from giving an estimate of loss or range of probable loss in responding to auditors' requests for information because the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Request for Information (ABA Treaty), the applicable ABA standard, cautions lawyers against making estimates where the likelihood of inaccuracy is other than slight.

Proposed 2010 Amendments

FASB's June 2008 proposal resulted in significant concern and commentary: over 240 comment letters were received, and FASB held two roundtables to elicit further feedback from companies, auditors, and attorneys. The July 2010 proposal is FASB's attempt to address the issues raised by its previous proposal.

The recent exposure draft would require companies to disclose substantially more information about their litigation loss contingencies and would lower the disclosure threshold in some instances.

Accrual Standard

The exposure draft does not change the

¹ The exposure draft is available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821001041&blobheader=application%2Fpdf>.

² This WSGR Alert, "Proposed Amendment to FASB Statement No. 5, Accounting for Contingencies, Raises Significant Concerns," is available at http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/clientalert_fas5.htm.

Continued on page 2...

FASB's Reproposed Amendment on Loss Contingencies . . .

Continued from page 1...

threshold for accrual of a liability on the financial statements (i.e., the loss must still be probable and the amount of the loss must be reasonably estimable).

Disclosure Threshold

As with the present standards, the exposure draft would require disclosure of information about a contingency if there is at least a reasonable possibility (i.e., more than a remote possibility) that a loss may have been incurred. Disclosure would be required regardless of whether the company has accrued for such a loss (or any portion of that loss). Also consistent with present standards, disclosure would not be required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless the company has determined that both of the following conditions are met:

- It is considered probable that a claim will be asserted
- There is a reasonable possibility that the outcome will be unfavorable

In a change from present standards, under the exposure draft, remote loss contingencies that have been asserted would have to be disclosed if, due to their nature, potential magnitude, or potential timing (if known), the remote loss contingency could have a "severe impact," meaning a significant, financially disruptive effect in the near term (i.e., within one year). Factors a company would consider in determining whether a remote loss contingency must be disclosed include:

- Potential impact on operations
- Cost of defense
- Management effort and expense required to resolve the contingency

Disclosure Standards

If any of the disclosure thresholds stated above are met, a company would be required to include both quantitative and qualitative

information about the contingency in the notes to its financial statements to enable readers to understand each of the following:

- Nature of the loss contingency
- Potential magnitude
- Potential timing (if known)

Quantitative disclosure about the loss contingency would include:

- Publicly available quantitative information, e.g., the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses
- An estimate of the possible loss or range of loss and the amount accrued, if any
- If no such estimate is possible, a statement that an estimate cannot be made and the reason(s) why
- Other non-privileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss
- Information about possible insurance and other 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

If the loss contingency meets the disclosure standard for remote loss contingencies, however, the company would not be required to provide the second and third disclosures above.

Notably, companies may not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required.

Qualitative disclosure would depend on the stage in the life cycle of the loss contingency. During the early stages of a litigation contingency, disclosure would include, at a minimum, the contentions of the parties, namely:

- The basis for the claim
- The amount of damages claimed by the plaintiff
- The basis for the entity's defense or a statement that the entity has not yet formulated its defense

In subsequent reporting periods, disclosure would become more extensive as additional information about a potential unfavorable outcome becomes available. For example, for individually material contingencies, the disclosure would include:

- The anticipated timing of, or the next steps in, the resolution of the litigation contingency, if known
- Sufficiently detailed information to enable financial statement users to obtain additional information from publicly available sources such as court records

Issuers may aggregate disclosure about similar loss contingencies to improve the understandability and length of disclosure, provided that the company discloses the basis for aggregation.

For public companies, tabular reconciling disclosure of accrued loss contingencies in each reporting period, by class of loss contingency, would also be required, including:

- Carrying amounts of the accruals at the beginning and end of the period
- Amount accrued during the period for new loss contingencies recognized
- Increases or decreases for changes in estimates for loss contingencies recognized in prior periods
- Decreases for cash payments or other forms of settlements during the period

Concerns regarding Proposed 2010 Amendments

While the FASB has attempted to address some of the concerns commentators had with the 2008 proposal, a number of concerns remain with respect to the proposed 2010 amendments.

Continued on page 3...

FASB's Reproposed Amendment on Loss Contingencies . . .

Continued from page 2...

Concerns with Quantitative Disclosures

One of the concerns with FASB's 2008 proposal was the potential for disclosure of confidential and privileged information. While the exposure draft appears to focus litigation disclosures on "publicly available quantitative information [and] relevant non-privileged information," in fact it might still call for disclosure of confidential and privileged information, as well as information that may be confusing and not useful for investors.

For example, disclosure of loss estimates and accruals could lead to disclosure (and therefore potential waiver) of attorney-client or work-product privileged information, since such estimates and accruals are typically based in part on advice of counsel. Disclosure of all accruals, which under existing standards are required to be disclosed only "in some circumstances" where it "may be necessary for the financial statements not to be misleading," might impact settlement discussions, as adverse parties would learn the amount of loss that the company believes is "probable" and "reasonably estimable." Tabular disclosure of changes in litigation accruals would provide litigation opponents with a period-by-period window into the company's judgments on its loss accruals. Also of concern is that the required disclosures may themselves be admissible in evidence against the company in the proceedings that is the very subject of the disclosure (i.e., an admission against self interest). Further, since auditors are likely to want to test the qualitative analysis and loss estimates as part of their audit work, there may be increased pressure for them to seek privileged information in order to test the disclosures, which also could further erode protection under the attorney-client privilege and work-product privilege.

In addition, disclosure of expert witness testimony regarding damages, merely because it is publicly available, may not be useful to investors and could even be misleading. Damage claims are often intensely contested, and litigation opponents frequently offer expert testimony on damages

that can differ materially. Such testimony can last for several hours—even days or weeks—and is not easily summarized into concise, balanced, easily understood financial statement disclosure. The exposure draft appears to require disclosure of an opponent's expert witness testimony so long as it is public, forcing a company to disclose such information even if it believes that the testimony is unsubstantiated or misleading. In addition, assuming that an opponent's experts have testified or otherwise made their opinions public and the company's experts have not, the company might be compelled to disclose its litigation strategy and preview its expert testimony in its public disclosure, giving its litigation opponents an advantage in court.

Similarly, disclosure of discoverable information regarding insurance and other recoveries would disadvantage a company in future litigation. Such information is typically discoverable, and thus would almost always be disclosed. Disclosure of a company's insurance coverage limits would therefore make public information that today is typically kept confidential outside of the discovery context, and would give future litigation opponents a window into the company's insurance coverage.

Finally, disclosure of "non-privileged" information about the proceeding is also problematic: information that is not privileged may still be highly confidential. For example, all information exchanged by litigation opponents in discovery is non-privileged, but discovery often remains confidential and not available to the public. Requiring a company to review all discovery produced in litigation for information that is "relevant to financial statement users" on the amount of loss could well be an expensive and time-consuming exercise that in the end may result in no benefit to investors.

Inability to Consider Insurance and Indemnification in Materiality Determinations

Under the exposure draft, companies that are assessing the materiality of a loss

contingency to determine whether disclosure is required may not consider the possibility of recoveries from insurance or other indemnification arrangements. These mechanisms, however, are primary ways in which companies attempt to mitigate risks from loss contingencies, and consideration of such mechanisms is integral to a company's ability to determine whether disclosure regarding a loss contingency would be material to an investor's complete understanding of the company's financial statements. The inability to consider insurance and indemnification recoveries makes it even more complex for companies to determine whether to disclose asserted, remote contingencies, as required by the exposure draft, particularly since the standard for disclosure of such loss contingencies is whether it would cause a "potential severe impact."

Litigation Arising from Disclosure

Since litigation assessments are inherently uncertain, the disclosures required by the exposure draft may themselves become a source of securities litigation. Assessments of pending and threatened claims, particularly those involving litigation, are inevitably forward looking, uncertain, and subject to factors outside the control of any of the parties. As a result, the required disclosures and estimates may be sources of additional claims and litigation in the event that they prove to be inaccurate, including claims of fraud. This concern is exacerbated by the fact that the safe harbor protection for forward-looking statements contained in the federal securities laws does *not* apply to statements made in financial statement disclosures.

Inconsistency with the ABA Treaty

Wilson Sonsini Goodrich & Rosati believes that the proposed standards in the exposure draft are still inconsistent with the current standards in the ABA Treaty between the American Bar Association and the American Institute of Certified Public Accountants governing lawyers' responses to auditors' inquiries. As discussed above, it is uncommon

Continued on page 4...

FASB's Reproposed Amendment on Loss Contingencies . . .

Continued from page 3...

for legal counsel to estimate a loss or range of loss in responding to auditors' requests for information because of guidelines in the ABA Treaty. As a result, significant litigation usually is disclosed in the financial statement notes on a limited basis, with such disclosure describing the nature of the claims with no qualitative assessment and no estimate of loss or range of loss. The new standards clearly will put pressure on legal counsel to provide additional qualitative analysis, such as whether asserted remote loss contingencies may have a "severe impact," as well as loss estimates when responding to auditors' requests. They will also put additional pressure on the ABA Treaty.

Inconsistency with Current SEC Disclosure Obligations

The exposure draft could also conflict with the Securities and Exchange Commission's litigation disclosure standards contained in Item 103 of Regulation S-K. Item 103 requires a brief description of "any material pending legal proceedings, other than ordinary routine litigation incidental to the business," but does not require disclosure of "any proceeding that

involves primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets" of the company. The exposure draft does not address Item 103.

Comment Period

Comments in writing are due on the exposure draft by September 20, 2010. Comments may be sent by email to director@fasb.org, File Reference No. 1840-100. The firm understands that the American Bar Association, business trade associations, and investor groups are focusing on the significant issues presented by the exposure draft and may submit written comments.

For any questions or more information on these or any related matters, please contact Mark Bertelsen, Don Bradley, Keith Eggleton, Bahram Seyedin-Noor, Ann Yvonne Walker, Richard Cameron Blake, Glenn Luinenburg, your regular Wilson Sonsini Goodrich & Rosati contact, or any member of the firm's corporate and securities practice or securities litigation practice.



Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

This WSGR Alert was sent to our clients and interested parties via email on August 27, 2010. To receive future WSGR Alerts and newsletters via email, please contact Marketing at wsgr_resource@wsgr.com and ask to be added to our mailing list.

This communication is provided for your information only and is not intended to constitute professional advice as to any particular situation. We would be pleased to provide you with specific advice about particular situations, if desired. Do not hesitate to contact us.

650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300 Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com

© 2010 Wilson Sonsini Goodrich & Rosati,
Professional Corporation
All rights reserved.