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## FASB PROPOSES SIGNIFICANT AMENDMENTS TO STATEMENT NO. 5, ACCOUNTING FOR CONTINGENCIES, THAT WILL HAVE SERIOUS CONSEQUENCES FOR COMPANIES, THEIR LAWYERS, AND THEIR AUDITORS

On June 5, 2008, the Financial Accounting Standards Board ("FASB") proposed amendments to Statement of Financial Accounting Standards ("SFAS") Nos. 5 and 141(R), with the announced objective of improving disclosures about loss contingencies, including pending and threatened claims, and unasserted claims and assessments. If adopted, the new requirements will be effective for fiscal years ending after December 15, 2008.

### Existing SFAS No. 5 Standards

Under SFAS No. 5 as currently in effect, loss contingencies are categorized as either (1) probable, (2) reasonably possible, or (3) remote. An estimated loss from a loss contingency is required to be accrued in the financial statements if the loss is both probable *and* subject to reasonable estimation. The current rules for disclosure of loss contingencies that are *not* required to be accrued in the financial statements are discussed below in comparison with the proposed amendments.

### New SFAS No. 5 Standards for Loss Contingencies Disclosure

The proposed amendments to SFAS No. 5 will not affect the thresholds to be met to accrue a loss contingency in the financial statements. The SFAS No. 5 amendments will, however, significantly increase the disclosures for loss contingencies that are not required to be accrued. The following is a summary of the changes to the thresholds for disclosure of loss contingencies that are not required to be accrued:

- The proposed general rule is that all loss contingencies must be disclosed unless the company has made an assessment and determined that the likelihood of a loss is remote. The current general rule requires disclosure of only those loss contingencies that are "reasonably possible." Although it may seem to be semantics, FASB makes a point of stating that the change from "reasonably possible" to "more than remote" is a substantive change intended to result in more disclosure.
- Notwithstanding the general rule, disclosure would not be required for an unasserted claim or assessment in which there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, unless it is (1) probable that a claim will be asserted, and (2) the likelihood of a loss is "more than remote." Again, the amendments change the second prong of this test from "reasonably possible" to "more than remote."
- Notwithstanding either of the above rules, any loss contingency, *regardless of the likelihood of loss*, would be required to be disclosed if the contingency is expected to be resolved in the "near term" (defined generally as one year from the date of the financial statements) and the contingency "could" have a "severe impact" (defined as a significant financially disruptive effect on the normal functioning of the entity) on financial position, cash flows, or results of operations. The amendments added this requirement in its entirety.

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## New SFAS No. 5 Disclosures

Under the proposed amendments, SFAS No. 5 will require the following disclosure in the footnotes to the financial statements for loss contingencies that are required to be disclosed:

- The amount of each claim or assessment or the company's "best estimate of the maximum exposure to loss." The company may *also* disclose its best estimate of the possible loss or range of loss if it believes that the amount of the claim or the maximum exposure is not representative of the company's actual exposure. The existing rules require an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. According to FASB, companies have abused the ability to state that an estimate cannot be made.
- Qualitative information that includes, at a minimum, a description of the contingency, how it arose, its legal or contractual basis, its current status, the anticipated timing of the resolution, a description of the factors that are likely to affect the ultimate outcome of the contingency, the entity's assessment of the most likely outcome, and significant assumptions made by the entity in estimating the amounts disclosed and assessing the most likely outcome. The current rules limit qualitative disclosure to the nature of the contingency.
- Changes in accrued loss contingencies presented in a tabular reconciliation. No similar requirement exists in the current version of SFAS No. 5. This change will highlight to users changes in estimates or the settlement or resolution of previously accrued loss contingencies and the accrual of new loss contingencies. FASB also makes a point of stating that the accrual of a loss contingency should not be the first time it is disclosed in the financial statements. As such, users will be able to compare the amount previously disclosed for a loss contingency with the amount subsequently accrued for the same loss contingency.

## Prejudicial Information Exception to New SFAS No. 5 Disclosures

The proposed amendments to SFAS No. 5 contain a prejudicial information exemption which permits a company:

- To aggregate the disclosure "at a level higher than by the nature of the contingency."
- In "rare" circumstances (that require consideration of all of the facts and circumstances and significant judgment), to forego disclosing information that would be prejudicial, but: "[i]n no circumstance may an entity forego disclosing the amount of the claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to loss); providing a description of the loss contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; and providing a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact of the outcome."

## New SFAS No. 5 Will Have Serious Consequences

The stated objective of new SFAS No. 5 is to improve disclosures. We believe any such improvement may come at a substantial cost to companies, auditors, legal advisors, and investors (in the form of adverse effects on stock price and shareholder value). Some of our concerns, and those expressed by other commentators, include the following:

- Litigation is inherently unpredictable. Estimates of maximum exposure may bear little resemblance to actual potential losses, but will be judged in hindsight as either too high or too low, presenting liability concerns for companies and their advisors.
- Claims may be made with little or no basis to force quick settlements by companies that wish to avoid disclosure.

- The enhanced obligation to disclose unasserted claims and assessments may provide notice to potential claimants of claims of which they were previously unaware.
- Companies may be forced to waive the attorney-client privilege to satisfy their disclosure requirements and to permit their auditors to document financial statement assertions. Once waived, legal advice provided to companies during the course of litigation will be available to opposing counsel.
- The prejudicial information exception will not protect companies from being prejudiced in litigation, especially given the information that must be disclosed in all circumstances. In many cases, any disclosure of the company's assessment or description of litigation or a potential claim will provide insight that may not otherwise be available to opposing counsel.
- The mergers and acquisitions market may be adversely affected by requirements to accrue or disclose SFAS No. 141(R) loss contingencies in connection with business combinations.
- Significant tension may be imposed on relationships among companies and their advisors. Lawyers may wrestle with competing professional responsibilities (i.e. duties of confidentiality and duties of disclosure), and companies, auditors, and lawyers may disagree on disclosures that attempt to predict inherently unpredictable outcomes.

## Requests for Comments

Comments in writing are due on the proposed amendment to SFAS No. 5 by August 8, 2008. We understand a number of groups are working on comments, including the ABA Committee on Law and Accounting and the ABA Attorney-Client Privilege Task Force. If you have any questions regarding the proposed amendments to SFAS No. 5, please contact any of the individuals listed on the first page of this Alert.

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