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## FASB Proposes Changes to FASB Statement No. 5, Accounting for Contingencies

The Financial Accounting Standards Board (the “FASB”) has issued a proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies – an amendment of FASB Statements No. 5 and 141(R), which would require expanded disclosures for material loss contingencies unless certain criteria are met. The proposed Statement would be effective for fiscal years ending after December 15, 2008.

According to FASB, the Statement has been proposed because investors and other users of financial information have expressed concerns that disclosures about material loss contingencies under the existing Statement No. 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.

Many in-house counsel, corporate and defense lawyers disagree with the FASB’s rationale for the proposed Statement and are concerned that if adopted as proposed, the Statement could put reporting entities at a significant disadvantage when defending lawsuits. These attorneys believe that the proposed disclosure requirements would require reporting entities to disclose their litigation strategies and to waive the attorney-client privilege. Additionally, attorneys expect more securities fraud claims to be made because reporting entities will not always be able to accurately predict the outcome of pending litigation or potential claims and will be unable to accurately estimate eventual loss amounts.

### Current Disclosure Requirements for Loss Contingencies

Statement of Financial Accounting Standards No. 5 currently provides that an estimated loss from a material loss contingency shall be accrued by a charge to income if both of the following conditions are met:

- (a) Information available prior to issuance of the financial statements indicates that it is probable (i.e., likely) that an asset had been impaired or a liability had been incurred at the date of the financial statements; and
- (b) The amount of the loss can be reasonably estimated.

Statement No. 5 also provides that if no accrual is made for a loss contingency because one or both of the above conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the contingency shall be made when there is at least a reasonable possibility (i.e., more than remote but less than likely) that a loss or an additional loss may have been incurred. Such disclosure must include the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

### Disclosure Requirements Under the Proposed Amendment

According to the proposed Statement, an entity shall disclose all loss contingencies within the scope of Statement No. 5 except those where it has been determined that the likelihood of a loss is remote (although if a loss contingency is expected to be resolved in the near

term and it could have a severe impact on the entity's financial position, cash flow or results of operations, such loss contingency must be disclosed regardless of the likelihood of loss).

Information required to be disclosed about such loss contingencies includes the amount of the claim or assessment (including punitive or multiple damages, if applicable) and, if there is no claim or assessment amount, the entity's best estimate of the maximum loss exposure. Additionally, an entity must disclose qualitative information about the contingency sufficient to enable users to understand the risks posed to the entity. Such information must include at least the following:

- (a) a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;
- (b) a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome;
- (c) the entity's qualitative assessment of the most likely outcome of the contingency; and
- (d) significant assumptions made by the entity in estimating the amounts disclosed and in assessing the most likely outcome.

An entity also must include as part of its loss contingency disclosure a quantitative and qualitative description of the terms of relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss, including any caps, limitations, or deductibles that could affect the amount of the recovery. For each period for which a statement of income is presented, an entity also must provide a reconciliation, in tabular format, of the amount recognized in the aggregate for loss contingencies in its statement of financial position at the beginning and end of the period, and must provide a qualitative description of the significant activity in the reconciliation.

The proposed Statement does allow for these loss contingency disclosures to be aggregated by the nature of the loss (i.e., product liability or antitrust matters), and does include an exemption from disclosure of certain information in limited circumstances.

### **Exemption from Disclosing Prejudicial Information**

FASB has recognized in the proposed Statement that for certain material loss contingencies, such as pending or threatened litigation, disclosure of certain information about the contingency may be prejudicial to an entity's position. Under such circumstances, an entity may aggregate its loss contingency disclosures at a level higher than by the nature of the contingency. In the event that the required disclosure, when aggregated at a level higher than by the nature of the contingency, or the tabular reconciliation would be prejudicial, the entity may refrain from disclosing only the information that would be prejudicial to the entity's position.

### **Potential Effects of the Adoption of the Statement as Proposed**

FASB has stated that current accounting practice will be improved by the proposed Statement by enhancing disclosures about loss contingencies, and specifically by expanding the population of loss contingencies that are required to be disclosed, by requiring disclosure of specific quantitative and qualitative information about those loss contingencies, by requiring a tabular reconciliation of recognized loss contingencies to enhance financial statement transparency, and by providing an exemption from disclosing certain required information to the extent such disclosure would be prejudicial to an entity's position in a dispute.

Many attorneys question whether enhanced disclosure concerning loss contingencies will result if the proposed Statement is adopted, especially given the increased emphasis on making estimates and predicting the future with respect to loss contingencies. Additionally, there are several disadvantages to disclosing entities of the adoption of the proposed Statement, including increased accounting and legal fees to prepare the proposed additional disclosures, and putting defendants at a distinct disadvantage during litigation. As the ABA Task Force on Attorney-Client Privilege has stated in a memo soliciting comments to be incorporated into its official comments to the FASB: "The estimate itself will tip the defendant's hand in a case where the plaintiff itself may not have been able to estimate the potential outcome." The required disclosures may also become evidence that a plaintiff may claim as an admission of the defendant and such disclosures are likely to provide

a plaintiff with a substantial advantage in the discovery process. The ultimate result of the disclosures could be higher settlement costs or jury verdicts than if the proposed Statement were not adopted.

The disclosure requirements of the proposed Statement are also likely to increase the risk of claims of securities fraud because it will be very difficult for reporting entities to accurately estimate eventual loss amounts or to predict the likely outcome of a litigation matter, especially prior to the completion of discovery and prior to the determination by the courts of various legal and procedural issues. When an actual loss exceeds the disclosed estimates or when a predicted outcome is materially different from that disclosed in an entity's financial statements, plaintiffs' counsel will be ready to take action.

### Status of the Proposed Statement

Comments on the Exposure Draft of the Proposed Statement were due on August 8, 2008 and FASB plans to hold one or more public roundtable meetings on the topic sometime thereafter. Whether or not the proposed Statement is adopted, or whether it will be modified, remains to be seen. One thing that is certain, however, is that the proposed Statement is controversial and will not be adopted without challenge from various attorney groups, including the American Bar Association and the Association of Corporate Counsel.

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