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## SECURITIES LAW UPDATE

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### Full Fathom Five: FASB's Proposed Amendments to FAS 5 Could Sink Your Ship

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*Full fathom five thy father lies;  
Of his bones are coral made;  
Those are pearls that were his eyes;  
Nothing of him that does fade,  
But doth suffer a sea-change  
Into something rich and strange.  
Sea-nymphs hourly ring his knell:  
Ding-dong,  
Hark! Now I hear them – Ding-dong, bell.*

From "The Tempest" by William Shakespeare

The Financial Accounting Standards Board ("FASB") issued a proposed amendment of Statement of Financial Accounting Standards No. 5, Accounting for Contingencies ("FAS 5") in June of this year<sup>1</sup>. The proposed amendment would significantly expand the disclosure that companies would be required to make about loss contingencies in the notes to their financial statements. This expanded disclosure is likely to raise serious issues for companies discussing loss contingencies that relate to pending or threatened litigation. The FASB's proposed amendment also includes amendments to accounting standards related to loss contingencies arising from business combinations and environmental claims<sup>2</sup>. The proposed amendments would take effect for fiscal years ending after December 15, 2008.

Companies that are faced with the challenge of accounting for and disclosing loss contingencies must undertake a complex

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analysis that often involves the consideration of competing factors. As a practical matter, the analysis of loss contingencies related to litigation often requires a company to consider whether making a disclosure could give an adversary in a lawsuit valuable information, namely, an understanding of the disclosing company's internal assessment of its likelihood of prevailing and the amount of the damages for which it may be responsible. Further, if a loss contingency rises to the level of requiring the company to book a reserve to cover possible litigation losses, then a company's reported earnings may be significantly affected. If a company erroneously does not reserve for a loss contingency, it may be forced to restate its financial statements. In either case, the fear of investigation and enforcement proceedings by the Securities and Exchange Commission or shareholder lawsuits always looms over any determination of the appropriate accounting treatment and disclosure for any loss contingency. Moreover, the FAS 5 analysis is not facilitated by a bright-line rule or a quantifiable standard. As a result, companies are forced to exercise care, discretion and judgment and to seek the assistance of their outside accounting and legal advisors.

### **Requirements of the Current FAS 5**

In order to better understand the changes that would be wrought by the propose amendments, a brief review of current FAS 5 is helpful. FAS 5 defines a loss contingency as an existing condition, situation, or set of circumstances that involves uncertainty about the possible loss for a company that will ultimately be resolved when one or more future events occur or fail to occur. Pending or threatened litigation is a common form of loss contingency that ceases to be a loss contingency when the litigation is resolved as the result of a settlement or the final adjudication of the matter.

FAS 5 currently requires the assessment of the probability of a loss arising from a pending or threatened lawsuit. Depending on the probability of that loss, FAS 5 requires disclosure about the loss contingency and, in certain cases, a quantification of the amount of the loss, if possible. FAS 5 provides a framework of analysis, but it is only that – a framework. Those that have been involved in this analysis – whether as an executive of the company or as an accountant or attorney for the company – understand that this is a fact-specific analysis that is rife with challenge and risk.

Public companies must also consider the requirements of SEC Regulation S-K Item 103, which requires that material legal proceedings be disclosed in the annual and quarterly reports, subject to an exception that permits claims representing less

programs.

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than 10 percent of a company's current assets not to be disclosed.

***When Is a Litigation Loss Reserve Required?*** Under FAS 5, a company must create a litigation loss reserve if a loss is "probable" and the amount of the expected loss is material and reasonably estimable. Accordingly, a company first must assess whether a loss is "probable."

*Probable.* FAS 5 states that loss is "probable" if the loss is "likely to occur." FAS 5 states that a company need not determine that a loss is a "virtual certainty" in order for the loss to be considered "probable."

When considering whether a loss contingency is "probable," companies generally assess whether there is a high degree of likelihood that a loss will be suffered. Companies typically consider a variety of factors that relate to the merits of the dispute, the procedural status of the claim, the opinion of counsel handling the case for the company, the jurisdiction in which the case will be adjudicated, and management's litigation strategy. As the status of a claim changes over time, the company must re-assess the claim to determine whether an earlier conclusion about the probability of the loss conclusion is the current conclusion.

FAS 5 provides that a company must consider two other categories if the loss contingency is not "probable."

*Reasonably Possible.* If the "chance of the future event or events occurring is more than remote but less than likely," the adverse outcome is deemed "reasonably possible." A loss reserve is not required, but disclosure of the loss contingency may be required.

*Remote.* If the probability of a loss is deemed to be "remote," the company is not required to book a reserve or disclose the claim in its financial statements. Of course, if the probability of the loss contingency is considered at a later date to be greater than "remote," the financial statement reserve and disclosure obligation may arise. Accordingly, companies must re-assess their conclusions about the probability of a loss contingency each period.

***Is the Amount of a Probable Loss Reasonably Estimable?*** As noted above, a "probable" loss will require a company to book a reserve if the amount of the loss is material and is "reasonably estimable." This analysis does not require a company to assess the amount of the loss with

precision. It is acceptable under FAS 5 to consider a range of possible losses and to take a reserve using the best estimate of the amount of the loss within that range. There are a variety of factors that must be weighed in assessing the amount of the loss to be reserved, and it is important to consider the nature of the footnote disclosure that will be necessary to explain the nature of the reserve. The footnote disclosure should accurately and adequately disclose the factors that were relevant to determining the amount of the reserve and the factors that could cause the actual loss to be more or less than the reserve. Companies are often faced with a complicated process of preparing disclosure that, while complying with FAS 5, will not result in shareholder suits or a restatement and that will not telegraph too much of their litigation strategy to the opposing party in the suit.

### **The Proposed FAS 5 Amendment**

The proposed amendment of FAS 5 maintains the same general analytical framework to determine whether disclosure of a loss contingency is required. However, the proposed amendment significantly expands the amount of information required to be disclosed about a loss contingency, and expands the circumstances in which quantitative disclosure is required.

The FASB proposed this amendment in order to require companies to be more transparent about the nature and magnitude of loss contingencies and to address concerns of the FASB that too many companies do not quantify the potential loss associated with a contingency on the basis that the possible loss can not be estimated. However, the FASB did not provide any empirical evidence to establish that companies are improperly applying the current FAS 5 when they state that a possible loss can not be estimated. Instead, the FASB merely cited that this basis for omitting a quantitative measure of the loss "is exercised with such frequency by financial statement preparers that users often have no basis for assessing an entity's possible future cash flows associated with loss contingencies."

In a significant departure from current FAS 5, the proposed amendments require disclosure even for "remote" loss contingencies where the contingency is likely to be resolved within one year and could have a "severe impact" on the company's financial position, cash flows or results of operations. The proposed amendment defines a "severe impact" as a "significant financially disruptive effect." Under current FAS 5, once a loss contingency is determined to be "remote," the analysis is over—neither disclosure nor

quantification is required.

Furthermore, current FAS 5 permits a company to omit quantitative disclosure if the amount of the loss can not be estimated. However, in another significant change, the proposed amendment would require quantitative information to be disclosed about each loss contingency as to which disclosure is required. For these types of contingencies, the proposed amendment would require a company to disclose the "amount of the claim or assessment" if the claimant has quantified the claim or, if there is no claim amount, the "best estimate of the maximum exposure to loss." The proposed amendment makes such quantitative disclosure mandatory and would preclude a company from stating that it could not estimate the amount of the claim. Further, if a company discloses a claim amount because the claimant has identified the amount, then the company would be required to estimate and disclose the possible loss or range of loss if the company does not consider the amount of the claim or assessment to be representative of the company's actual exposure. As a result, with an exception discussed below, every claim for which disclosure is required must include a numerical quantification.

The proposed amendment also requires the following qualitative changes to disclosure about the loss contingency:

- a "qualitative assessment of the most likely outcome" of the matter,
- the "factors that are likely to affect the ultimate outcome," and
- the "significant assumptions made" by the company in determining the most likely outcome and loss amounts.

In addition, in each reporting period following the period in which disclosure of the loss contingency was first made, the proposed amendment would require the company to disclose the amount of any change in the estimate of the amount of the loss contingencies previously reported.

The inherent risk associated with the current FAS 5 disclosure obligation is the possibility that the disclosure of the contingent loss will itself increase the likelihood that the claim underlying the contingent loss will be harder to defend. This is clearly not the goal of the financial accounting rules, but it is equally clear that increasing the amount of required disclosure about pending litigation will increase the chance that those disclosures will tip the balance against the disclosing company

and create the possibility that FAS 5 disclosure of merely contingent liabilities becomes a self-fulfilling prophecy by creating actual liabilities.

Perhaps sensing this problem, the proposed amendment does not require the specific claim-by-claim quantitative disclosure if the required disclosure could be “prejudicial” to the company’s position in the litigation. The proposed amendment states that required disclosure would be “prejudicial” if the disclosure could affect, to the entity’s detriment, the outcome of the contingency itself. If the company determines that the disclosure required by the proposed amendment could be “prejudicial,” then the company may dispense with the specific, claim level disclosure of the amount of the claim or assessment by aggregating the disclosures at a higher level so that only the information that would be prejudicial to the entity’s position is not disclosed. However, the FASB states that it expects that this exception would be used in “rare” instances, with the caveat that “rare” does not mean “never.” In those “rare” circumstances, the proposed amendment requires that the company state the reason why the information has not been disclosed. This exception does not permit, however, the company to eliminate disclosure of

- the amount of the claim or assessment against the company (or, if there is no claim amount, an estimate of the company’s maximum exposure to loss)—however, this information would be disclosed on an aggregated basis,
- 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
- a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential impact on the outcome.

As a result, if the “prejudice” exception applies, the company is permitted to eliminate disclosure about the company’s qualitative assessment of the most likely outcome of the contingency and the significant assumptions made by the company in estimating the amounts disclosed in assessing the most likely outcome, and is permitted to disclose the amount of the claim or assessment on an aggregated basis, rather than on a claim-by-claim basis.

**Concerns With The Proposed Amendment – An Unnecessary and Potentially Dangerous Sea Change**

The current FAS 5 imposes disclosure obligations that require a company to carefully assess the nature of loss contingencies to craft adequate and informative disclosures. The FASB provides no evidence that current FAS 5 is being abused, but blandly suggests that the proposed amendment is designed to increase transparency and to reduce the frequency of instances in which a company discloses that the amount of a loss contingency can not be estimated, without providing any real arguments as to whether that would, given the potential downsides of the proposal, be a good result. The FASB's position stated through the proposed amendment seems to assume that companies are using the current FAS 5 framework to limit unfairly the disclosure, or worse yet, conceal disclosure about loss contingencies, especially in the circumstances in which the company states that the amount of a loss contingency can not be estimated. Since FASB gave no evidence of this problem, it is not at all clear that its proposed solution is necessary or properly calibrated. What is reasonably clear, however, is that the proposed amendment would be a sea change.

The proposed amendment fails to fully appreciate the complex process that companies undertake when they are faced with disclosing the information required by the current FAS 5 about a loss contingency that relates to pending or threatened litigation. Companies faced with a potential FAS 5 obligation to book a reserve and make disclosure are motivated by the specter of shareholder claims and enforcement proceeds brought by the SEC when determining whether a reserve and/or disclosure of the loss contingency is required. Because of the high stakes for failing to apply FAS 5 in good faith and in a careful and thoughtful manner and of the consequences for failing to disclose a loss contingency early enough and with adequate detail or to take an adequate reserve—stakes that involve the prospect of securities fraud claims, among others—companies already have significant motivation to faithfully comply with FAS 5. If many companies assert that a loss contingency cannot be estimated, could it not be that this is simply a reflection of the true situation? That in the incredibly uncertain world of litigation, the size of a loss, and the other details of the outcome sought by the proposal, really are too hard to estimate meaningfully?

The expanded disclosure obligations of the proposed amendment would increase the amount of information that could be used by plaintiffs in securities class action litigation because the assessments and disclosures required by the proposed amendment require a significant increase in the complexity of the analysis and the amount of detail in the disclosure. More specifically, these increased disclosures may

create self-fulfilling prophecies of litigation losses that could have been avoided or induce new litigation that otherwise would not have occurred. The FASB attempts to address the storm that may ensue from its proposal by the small shelter of the exception for “prejudicial” disclosure. But the FASB then artificially limits that exception to “rare” situations, even though the actual existence of prejudice may be anything but rare. Shouldn’t the availability of the exception be determined by objective circumstances—the existence of potential prejudice—rather than a prediction or hope that those circumstances only occur rarely? Again, what is clear is that a risk to the company, and its shareholders, is increasing, but, since no evidence of any problem is ever offered, this risk is being incurred without any clear offsetting benefit.

### **The Proposed FAS 5 Amendment: Full Fathom Five?**

The FASB’s proposed amendment to FAS 5 risks fomenting a tempest related to pending or threatened litigation and increases the likelihood that a strong and effective litigation defense will, like Ariel suggests to Ferdinand about his father, Alonso, lie at full fathom five amidst the coral.

<sup>1</sup> The FASB’s Exposure Draft proposing the amendment to FAS 5 and comments from companies and practitioners are available at <http://www.fasb.org>.

<sup>2</sup> In particular, the FASB has proposed (a) an amendment to FAS No. 141, Business Combinations, which if adopted would require enhanced disclosures for loss contingencies arising out of a business combination and (b) numerous changes to AICPA Statement of Position 96-1, Environmental Remediation Liabilities. This article will focus on the proposed FAS 5 amendments regarding loss contingencies in general, and the proposals regarding business combinations and environmental matters will not be discussed.

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**James J. Vieceli** Mr. Vieceli’s practice focuses on corporate and securities matters, including public and private offerings of equity and debt securities, capital markets transactions, mergers and acquisitions and venture capital investments. He also regularly advises clients on their SEC reporting and disclosure obligations and corporate governance requirements.

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