SFAS 5 – Accounting Firms From Probable To Remote Highlights Of The Proposed FASB Disclosure About Litigation And Certain Other Loss Contingencies

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The FASB recently issued an Exposure Draft of a Proposed Statement, Disclosure of Certain Loss Contingencies—an amendment of FASB Statements No. 5 and 141(R). The objective of the amendment is to assist the users of financial statements with information about the risks the loss contingencies pose to the entity, and their potential and actual effects on the financial position, cash flows and results of operations. The proposed Statement significantly expands disclosures about certain loss contingencies and requires detailed information on the likelihood, timing, and amounts of cash flows associated with loss contingencies. The new standard will have significant implications for companies, as well as their legal counsel and independent auditors. The recognition and measurement requirements currently in FASB Statement No. 5, Accounting for Contingencies (FAS 5), will not be changed by the proposal (but will be reconsidered by the FASB in the future). The Exposure Draft is available at http://www.fasb.org/draft/ed_contingencies.pdf. The deadline for public comments was August 8, 2008.

Key Highlights For The Proposed Amendments

Effective Date - The proposed Statement will be effective for annual financial statements issued for fiscal years ending after December 15, 2008 and subsequent interim and annual periods. Accordingly, companies with calendar year-end (i.e., December 31) would be required to comply with the new standards for their December 31, 2008 financial statements.

Scope – The proposed Statement will not apply to the following: assets covered under other existing literature: (1) asset impairment (i.e., allowance for doubtful accounts and impaired loans receivable), (2) guarantees, (3) accounting and disclosure of liabilities for insurance and reinsurance entities (however, loss contingencies that are either self-insured or unrelated to insurance or reinsurance contracts are within the scope of FAS 5 and therefore subject to the proposed disclosure requirement), and (4) liabilities for employment-related costs, including pensions and postemployment benefit obligations. Obligations resulting from the withdrawal from a multipayer plan for a portion of the unfunded benefit obligation would be subject to the proposed new requirements.

Population of Loss Contingencies Required To Be Disclosed – Currently, an entity is only required to disclose loss contingencies that meet the at least reasonably possible threshold in FAS 5. Such practice often resulted in the lack of full disclosures of existing potential loss contingencies to investors. The proposed amendment of FAS 5 would expand the population of loss contingencies required to be disclosed to include the entire population of loss contingencies except those contingencies that meet certain narrow criteria. Furthermore, under the proposed requirement, an entity would disclose remote loss contingencies if the contingency or contingencies: (1) are expected to be resolved within one year from the date of the financial statements; (2) could have a severe impact on the entity’s financial position, cash flows, or results of operations (i.e., a significant financially disruptive effect on the normal functioning of the entity).

Tabular Reconciliation Of Recognized Loss Contingencies

One of the notable changes in the proposed Statement is the requirement of a tabular reconciliation of the aggregated amount of loss contingencies recognized in the statement of financial position at the beginning and end of the period. The reconciliation shall include at a minimum:

- increase for loss contingencies recognized during the period;
- increase resulting from changes in estimates of amounts of loss contingencies previously recognized;
- decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized; and
- decreases resulting from cash payment (or other settlement) for loss contingencies.

In addition, an entity would be required to provide a qualitative description of the significant activity in the table. All loss contingencies recognized in a business combination would be shown separately in the reconciliation, while other loss contingencies that arise and are resolved within the same period would be excluded from the reconciliation. Finally, the amount of any recoveries shall be disclosed.

Exemption For Prejudicial Information

To alleviate the concern that certain information may be prejudicial to an entity’s position with respect to the outcome of a contingency, the proposed Statement provides an exemption that allows an entity to aggregate the required disclosure at a level higher than that set by the nature of the contingency such that disclosure of the information is not prejudicial. In rare circumstances, an entity may forgo disclosing the prejudicial information (for example, where there is only one material loss contingency) and instead disclose the fact that, and the reason why, the information has not been disclosed.

Other Considerations

Subsequent events – In the case of a loss arising after the financial statement date, the same information must be disclosed as for unrecognized loss contingencies, and if the amount of the liability incurred can be reasonably estimated, an entity may supplement the historical financial statements by disclosing pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements.

Unasserted claims and assessments – The proposed Statement retains substantially the existing guidance in FAS 5 on unasserted claims or assessment against the entity. The disclosure of a loss contingency related to an unasserted claim or assessment is not necessary unless it is probable that a claim or assessment will be asserted and the likelihood of loss (if the claim or assessment were to be asserted) is more than remote.