

Client Alert

An informational newsletter from Goodwin Procter LLP

Proposed FAS 5 Amendment Poses Heightened Risks

FASB Proposes Expanded Disclosure for Loss Contingencies

The Financial Accounting Standards Board (“FASB”) recently issued an exposure draft proposing the amendment of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (“FAS 5”). If adopted, this amendment would require companies to make significantly more extensive disclosures in the notes to financial statements regarding loss contingencies – including loss contingencies relating to pending or threatened litigation. The Exposure Draft also proposes (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* (“SOP 96-1”). These proposed amendments would take effect for fiscal years ending after December 15, 2008.

Current FAS 5

Where there is a “reasonable possibility” that a loss has been incurred, FAS 5 currently requires the disclosure of the range of potential losses arising from pending or threatened litigation. Reasonable possibility means that the likelihood of the loss occurring is more than “remote” but less than “likely.” No further disclosures are currently required under FAS 5.

The Proposed Amendment

Under the proposed amendment, the circumstances under which an issuer would be required to make disclosure about a loss contingency would not differ dramatically from the current rule. The scope of the required disclosure, however, would be broadened substantially.

More specifically, companies generally would be required to disclose each loss contingency separately unless the chance of loss arising from a particular contingency would be “remote.” Even “remote” contingencies, however, would need to be specifically disclosed if the contingency were 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. Under the proposed amendment, “severe impact” is defined to be a “significant financially disruptive effect.”

For each loss contingency requiring disclosure under the proposed standard, the company would need to disclose more granular quantitative and qualitative information. Specifically, the required disclosures would include the “amount of the claim or assessment” or the company’s “best estimate of the maximum exposure to loss” where there is no claim or assessment amount. This change would eliminate the option currently available in FAS 5 to “state that such an estimate cannot be made.” Under the proposed amendment, the company also would need to provide an estimate of the possible loss or range of loss if the amount of the claim or assessment is not representative of the company’s actual exposure.

Other required disclosures would include, 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. The company would also need to provide a reconciliation that would highlight changes in estimates of the amounts of loss contingencies previously reported, for each reporting period. Finally, the company would be required to disclose the terms of relevant insurance and indemnification agreements applicable to the loss contingency.

The Exceptions

Recognizing the increased exposure to issuers that these expanded litigation risk disclosures could bring, FASB is proposing that expanded disclosure would not be required where it could be “prejudicial” to the company’s position in the litigation. The exception would allow the company to “aggregate” the required disclosures for litigation contingencies, and disclose them in such a way that the information would not be linked to each particular loss contingency. In “rare instances” when aggregation would not prevent prejudice, a company would be allowed to omit the disclosure of its qualitative assessment of the most likely outcome of the litigation. Nonetheless, the proposed amendment would still require disclosure of the amount of the claim or an estimate of likely maximum exposure, and the facts likely to affect the outcome.

Concerns Raised by the Proposed Amendment

- An obvious concern raised by the proposed amendment to FAS 5 is that the new disclosure regime would provide opponents with information that could be used against the company in litigation. The proposed amendment could also provide litigants with the company’s defense or settlement strategies for particular claims – thus undermining the effectiveness of those strategies.
- The disclosures, and particularly those that assess the likely outcome or gauge potential losses, could give rise to increased securities class action litigation if the assessments turn out not to be accurate and plaintiffs allege in hindsight that the disclosures were intentionally false. If the proposed amendment is adopted, it will put a premium on diligent use of

the Safe Harbor for Forward Looking Statements, which provides a meaningful defense – if used properly – against potential liabilities associated with forecasts of future results that turn out to be materially inaccurate.

- Although apparently intended to address the prejudice flowing from enhanced disclosure, the exceptions in the proposed FAS 5 amendment may not provide the intended protection, in part due to the vagueness of the exceptions' wording. For example, although aggregation of the potential loss flowing from multiple contingencies may be permissible, opposing parties in litigation may be able to “reverse engineer” the specific loss contingency information from the aggregated disclosure. Likewise, the proposed exception that would permit companies to omit “prejudicial” information in “rare instances” is not clearly defined. No doubt, the meaning of “prejudice” and “rare” will be hotly contested.
- Disclosure of the company's assessment of likely losses and outcome could be argued by opposing counsel to be a waiver of the attorney/client privilege and work product protection that normally would shield such assessments from disclosure during litigation.

Deadline to Submit Comments

The notice accompanying the proposed amendment of FAS 5 asks for comment on whether the proposal will “provid[e] enhanced disclosures about loss contingencies.” Because of the concerns listed above, companies will be motivated to avoid enhanced disclosures and rely heavily on the exceptions in the proposed amendment. Alternatively, issuers may feel compelled to choose to disclose opposing counsel's settlement demands and damages allegations in their complaints in order to avoid potential liability under the securities laws, regardless of whether such demands have any merit, thus not serving the proposed amendment's goal of providing more useful information to shareholders. For all these reasons, the amendment may fail to achieve its stated goal.

The FASB has set a deadline of August 8, 2008 for interested parties to submit comments on the proposal. Comments may be sent by e-mail to director@fasb.org, File Reference No. 1025-300. The FASB's Exposure Draft proposing the amendment to FAS 5 is available at <http://www.fasb.org>.

If you have any questions on this proposed change or any other issue, please contact your Goodwin Procter lawyer or any of the following members of Goodwin Procter's Securities Litigation & SEC Enforcement Group:

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