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Accounting

FASB to Issue Proposal Requiring More Judgment for Loss Contingencies

NORWALK, Conn.—Users and preparers of financial statements should expect a proposal requiring entities to disclose information about all loss contingencies except those that meet certain narrow criteria, the Financial Accounting Standards Board said March 11.

The FASB said it would issue an exposure draft for a 60-day comment period by the end of April with proposed enhanced and amended disclosures about loss contingencies in FASB Statement No. 5, Accounting for Contingencies—an issue particularly contentious among litigators for large U.S. corporations.

The guidance would be effective for annual financial statements issued for years beginning after Dec. 15, 2008, and interim periods within those fiscal years.

According to current guidance under FAS 5, a liability contingency is recorded only when probable and estimable. The board said, however, that users of financial statements have found disclosures under such accounting to be ineffective, inadequate, and limited in practice.

FASB said the exposure draft therefore would be aimed at enhancing transparency about the effect of loss contingencies on the financial statements.

Due to the expected controversy surrounding the issue, the board said it will hold a public roundtable that would include preparers, auditors, and financial statement users near the end of its proposed comment period—expected to be mid-July.

FASB Hopes Disclosures Remove Problems. Overall, constituent concerns surrounding FAS 5 stem from users and investors who complain of lack of quantitative information in disclosures, which prevents them from being able to assess the likelihood, timing, and amounts of future cash flows, according to a FASB handout.

In addition, some constituents have said there are significant differences between the information desired by financial statement users—which is typically fair value-based estimates—and the ability of financial statement preparers to fulfill those desires with representationally faithful information.

Due to the inherent uniqueness of individual contingencies and the inherent uncertainty around a contingency, constituents have said the recognition and measurement of contingencies—especially those that are noncontractual in nature—are some of the most difficult assets and liabilities to reliably measure.

Through enhanced disclosures, the board said it is hoping that an understanding of an entity's exposure may alleviate some of those concerns.

Assessment Required. Under the proposal, the basic principle underlying the scope requirements would be that entities would need to have made an assessment of the contingency and determined that the likelihood of loss is remote.

In addition, entities would be required to determine that the contingency could not have a near-term severe impact on the entity even if the likelihood of loss is determined to be remote.

For all loss contingencies within the proposed scope, entities would be required to disclose the claim amount, or in absence of a claim amount, an estimate of the maximum potential exposure to loss.

Entities would be allowed the option to include a supplemental disclosure of their best estimate of the possible loss or range of loss if they believe the claim or maximum amount is not indicative of the entity's actual exposure.

Litigators in particular have argued that litigation is inherently unpredictable and favor the current FAS 5 model requiring a contingency to reach a level of being probable and estimable before it is recorded.

Such constituents said that determining when during litigation the probability of loss changes and by how much is highly judgmental and could prove to be flawed or misleading.

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Calls for Earlier Recognition. However, other constituents have stated that recognition of a liability under FAS 5 takes place far too long after the filing of a lawsuit or the bringing of a claim, and are of the view that fair value should be used so that recognition of a liability in the financial statements occurs earlier.

Typically, although it may be remote, entities do not want to be surprised with something that could result in a major hit to their cash flow results from operations—or a major impact on their balance sheets, according to a FASB staff person.

FASB said the exposure draft will require a tabular reconciliation of the total amount recognized in the aggregate for loss contingencies in the statement of financial position at the beginning and end of each annual period—thus increasing transparency.

Among other requirements, entities would need to disclose information that would make transparent facts surrounding the contingency and the risks it poses to the entity, including:

- a description of the contingency,
- a description of the factors that are likely to affect the ultimate outcome of the contingency,
- management's qualitative assessment of the most likely outcome of the contingency, and
- any assumptions made by management in estimating the amounts in its quantitative disclosures and in assessing the most likely outcome.

Comprehensive Contingency Overhaul on Hold. FASB said the proposal will only address the disclosure requirements for loss contingencies and not the recognition and measurement criteria for contingencies in FAS 5.

In addition, it will not change the disclosure requirements related to gain contingencies, primarily because financial statement users have not expressed dissatisfaction with those requirements.

As far as the comprehensive contingency project considered in 2007, the FASB decided to suspend it because the International Accounting Standards Board currently has a project that would amend International Accounting Standard (IAS) 37, which addresses contingencies.

The board has stated that it would decide on how to move ahead with an overall revision of accounting for contingencies based on the outcome of the IASB's project.

By Denise Lugo

Further information is available at http://www.fasb.org/project/certain_nonfinancial_liabilities.shtml.

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