

# point of view

## Disclosure of loss contingencies

**If the proposed accounting standard is finalized, could it impact the outcome of litigation?**

### Highlights

- The U.S. legal system provides certain protections to lawsuit defendants. The additional disclosures being proposed must be balanced against possible prejudicial impacts that could unfairly and adversely affect a company and its investors.
- Addressing these concerns before finalizing a new standard may take significant time and effort. Even if prejudicial and other concerns can be addressed, we believe any improvement in reporting over the current standard would be marginal.
- Given the already challenging standard-setting agenda, further work on this proposal should be deferred, pending completion of more important new standards.

### Does the proposal strike the right balance?

- Accounting standard setters are, at times, faced with determining an appropriate balance between transparency for investors and respecting a company's legal rights and proprietary strategies. This proposal is a prime example of the importance of that objective.
- Preparers and members of the legal community have voiced concerns that the proposed disclosures could adversely affect the outcome of litigation against a company. Examples cited include disclosure of amounts accrued for potential losses and descriptions of why those amounts increased or decreased. Such disclosures could provide plaintiffs with insight into management's thinking about litigation.
- Another element of balance that is needed is appropriate communications between attorneys and auditors. These communications are designed to provide auditors with information supporting contingency accruals and disclosures without compromising attorney-client privilege or other legal protections. The proposal may require a reassessment of previous, carefully-constructed agreements between the legal and accounting professions before the proposal is finalized.
- Aside from the prejudicial concerns expressed, we have other concerns with the proposal, such as the requirement to disclose certain remote contingencies. By definition, matters that are remote are unlikely to occur. We question whether disclosures of remote contingencies are relevant to financial statement users and whether such disclosures would make the analysis of a company's potential losses cumbersome.

# Balancing tensions created by the proposal is the challenge

**We believe the objective of improved guidance must be balanced against possible increased prejudicial impacts that could adversely affect a company and its investors.**

The Financial Accounting Standards Board (the "Board") issued a proposal titled *"Contingencies — Disclosure of Certain Loss Contingencies"* (the "proposal"). This proposal revises a previous one issued in 2008. Although it addresses a number of the concerns expressed in response to the original proposal, significant issues still exist.

## *The proposal*

The Board's objective is to enhance disclosures of certain loss contingencies, including litigation and environmental remediation liabilities. To address concerns over predictive disclosures, the Board modified the proposal to include more publicly available, factual information. The proposed disclosures include, for each type of contingency, the liability amounts accrued on the books, publicly available quantitative information (such as the claim amount for asserted litigation contingencies), and information about possible recoveries from insurance and other sources. Public companies would be required to provide a roll-forward of accrued amounts from the beginning to the end of each reporting period, and describe the significant activity reflected in the roll-forward. The proposed disclosures would be effective for public companies as early as their 2010 annual reports, and for nonpublic companies a year later.

## *Balancing investor interests*

We agree that financial statement users should be provided with transparent, comprehensive, and decision-useful information, including information relating to loss contingencies. We acknowledge the views of some that the current guidance could be improved, leading to enhanced disclosures. However, given the variability and uncertainty of litigation, we generally view discussions about the timeliness of today's contingency disclosures as more debates around the appropriate application of the existing guidance to specific facts rather than fundamental flaws in the guidance. Further, given the adversarial nature of litigation, and the existence of

certain rights and protections under the U.S. legal system, we believe the objective of issuing an improved standard must be balanced against possible prejudicial impacts that could adversely affect a company and its investors. This balancing occurs whenever standard setters and regulators consider the need for transparency at the same time as they consider the need for companies to maintain the confidentiality of information.

## *Working practices*

Before moving forward with the proposal, the Board should be comfortable that its application will be operational. Today there is a carefully-constructed agreement between the American Bar Association and the American Institute of Certified Public Accountants that allows auditors to obtain sufficient information to audit current legal disclosures without putting at risk attorney-client confidentiality protections under our legal system. This agreement facilitates meeting today's disclosure requirements to investors, while balancing legal considerations and the evidence needed by auditors to sign opinions on financial statements.

That balance will be strained by the nature and subjectivity of certain of the proposed disclosures, creating challenges for auditors to evaluate management's assessments and to obtain sufficient evidence to support them. We believe that the balance that exists today must be maintained. In our view, it is critical that the Board work with audit and securities regulators, the legal community, and auditors to ensure that the information provided by management to auditors and the content of legal letters provided by attorneys to auditors, continue to meet the needs of all involved and are operational under the new proposal. Because of the necessary but difficult balancing act, this process likely will be time-consuming if the proposed disclosures remain unchanged.

# Concerns with the proposal should be addressed before proceeding

**Accounting standards should not disadvantage a company in litigation.**

**We are not convinced that diverting already stretched resources at the Board to complete issuance of the proposal at this time is merited.**

## *Prejudicial concerns*

The legal community has voiced concerns about certain disclosures that could be prejudicial. One example is inclusion of a roll-forward disclosing liability amounts accrued and changes in such amounts by class or type of contingency. Disclosure of the underlying reasons for changes in accrued amounts would also be required. We believe that the aggregation allowed by the proposal will not always prevent plaintiffs from identifying the specific cases to which these disclosures relate. For example, companies may have a single or a dominant legal case within a contingency class or type.

Attorneys point out that some courts have considered information relating to changes in accrued amounts so prejudicial that they decline to admit it as evidence. Disclosing these amounts also could provide plaintiffs with an unfair advantage by informing them about management's assessment of the prospects of success in a case. This could influence a plaintiff's negotiating strategies and the outcome of the litigation by establishing a floor for settlement negotiations.

The proposal also requires disclosure of a company's insurance or indemnification arrangements. Disclosure of such information, especially when this information is "discoverable" but not yet discovered by, or provided to, a plaintiff may provide insights to plaintiffs or potential plaintiffs relating to possible settlement amounts and could influence potential plaintiffs to initiate additional claims against a company.

Another source of possible prejudice is the requirement to disclose the expected basis of a company's legal defense strategy. Prematurely disclosing this strategy could adversely affect a company's ability to successfully litigate a case.

## *Would all of the proposed disclosures be relevant?*

By definition, matters that are remote are unlikely to occur. Disclosures of asserted remote contingencies would increase the volume of disclosures for loss

contingencies, requiring users of financial statements to spend more time sifting through additional disclosures while attempting to discern which matters have the highest likelihood of actual loss. There is also a risk that disclosing remote claims may influence potential plaintiffs to initiate similar claims against a company.

## *Other costs to comply*

Incremental to the costs that may result from prejudicing legal positions, companies would likely incur costs to modify their systems to capture the necessary data and incur additional legal and audit costs to develop and audit necessary disclosures. Many wonder whether incurring these costs both initially and over the long term passes the cost-benefit test.

## *Operational issues*

As previously discussed, management may hesitate to provide to the company's auditors certain information supporting the proposed disclosures based on concerns that the information constitutes legal advice received from counsel. On the other hand, not providing such information would impair the auditor's ability to obtain sufficient audit evidence supporting disclosures or decisions not to disclose remote contingencies.

## *In conclusion*

We believe it is critical that the Board resolve these concerns prior to the issuance of any final standard. However, even if these concerns can be addressed, we believe that any improvement in reporting over the current standard would likely be marginal.

Given the already challenging standard-setting agenda, further work on this proposal should be deferred, pending completion of more important new standards, such as those on accounting for financial instruments and revenue recognition, to optimize benefits to users. We are not convinced that diverting already stretched resources at the Board to complete issuance of the proposal at this time, and asking preparers to implement it, is merited.

# Questions and answers

**Q:** Is the Board's proposal aligned with international accounting standards?

**A:** The Board's proposal is not part of a joint project with the International Accounting Standards Board. The U.S. proposal only addresses disclosures. The International Accounting Standards Board also has an active proposal on loss contingencies, but its proposal addresses the recognition and measurement of loss contingencies, as well as disclosures. While some have commented that the standard setters should converge this area of accounting, we suggest that resources not be devoted to this effort, and that neither proposal move forward, pending completion of more important new standards.

**Q:** What are some of the costs to comply with the new proposal that may not initially come to mind?

**A:** We believe the most significant cost is the potential for higher settlements if a company is put at a disadvantage in legal matters. However, other costs to comply will arise. As more detailed information and assessments of contingencies will be required, many companies believe that systems may need to be changed to capture more data, and documentation increased, to meet the disclosure requirements. For example, existing systems may not be designed to capture detailed activity in accrual balances by class or type of contingency from all of a company's consolidated reporting entities. Modifying systems could be costly, especially for a complex, multinational company that may have numerous reporting platforms. Additionally, audit and disclosure

committees may need to be educated on the new requirements, and contingency disclosure discussions with those committees may take more time in the future. Management would also need to consider any necessary systems or process modifications when making its assessment of, and required assertions involving, the design and operating effectiveness of the company's internal controls over financial reporting.

Many companies believe that management will likely need to have more frequent and more detailed communications with outside counsel to assist them in the reporting process, such as determining whether an asserted remote contingency meets the new threshold for disclosure. In turn, auditors likely will need to request additional information from management or increased communications with legal counsel to corroborate management's judgments and the completeness and accuracy of the disclosures. All of this will increase a company's costs.

**Q:** Is the proposed effective date realistic?

**A:** The Board has not ruled out the proposed 2010 effective date. If the Board decides to move to a final standard, given the remaining work needed to finalize the proposal and the challenges they entail, as discussed above, we are not in favor of a 2010 effective date.

## Contact Information

To have a deeper discussion about our point of view on contingency disclosures, please contact:

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