CORPORATE ENVIRONMENTAL DISCLOSURE COLUMN

# Expanded Disclosure Distress and Two Classes of Loss Contingencies

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## INTRODUCTION

There is the view that many, if not most, public companies disclose in their financial statements fewer loss contingencies than exist and lower loss contingency costs than are realistic, including for environmental loss contingencies. Investors holding this view contend that this under-representation of loss contingencies leaves them unable to evaluate sufficiently company liabilities. Acknowledging this view, the Financial Accounting Standards Board (FASB) has developed two new standards, one proposed and the other finalized, for companies to implement, beginning in 2009, in reporting loss contingencies.[2] Are these standards likely to result in near-term improvements or complications?

Both, it should be expected. Since the proposed standard expands the qualitative and quantitative information that companies must provide in financial statements about loss contingencies, it should improve the

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[2] A loss contingency is: An existing condition, situation, or set of circumstances involving uncertainty as to possible…loss (hereinafter a 'loss contingency') to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. (FASB, 1975)

Examples of loss contingencies that companies may face are pending or threatened litigation, actual or possible claims and assessments, product warranties and defects, collectibility of receivables, guarantees of indebtedness, and standby letters of credit. Environmental loss contingencies may arise from pending or threatened lawsuits, pending or threatened regulatory agency actions, listing as potentially responsible party for waste disposal site cleanup, suspected onsite or offsite contamination, and uncompleted onsite remediation.

FASB defines liabilities as: Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide other services to other entities in the future as a result of past transactions or events. (FASB, 1985)

The word *probable* in this definition of liabilities is used with its general meaning and refers to that which can be reasonably expected, but is neither certain nor proved. This is different from the specific accounting or technical sense in which the word is used in FASB Statement of Accounting Standards No. 5, *Accounting for Contingencies*, as will be indicated later in this text.

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information basis for investors' evaluations of loss contingency liabilities. It may not increase the population of loss contingencies that companies reveal, however. Detractors contend this proposed standard will add to the compliance burden of companies and will make them vulnerable to their subjective and risky judgments, which can prove wrong.

The other of the new standards, the finalized one, imposes more inclusive recognition criteria and fair value measurement methods on loss contingences, so it is expected that more loss contingencies will be disclosed and at higher, more realistic estimated costs. It pertains, however, only to a subset of companies, to the surviving entity in acquisitions and mergers, and applies only to their acquired properties, not to all the company's properties, so the population of loss contingencies disclosed will increase only slightly. It may be difficult, at least initially, for companies to develop fair value measurements of loss contingencies, including environmental loss contingencies, because the methodology is new for most companies. As well, in applying this new standard, companies will create a second class of loss contingencies and that will complicate liability management, for at least the near term, because the older standard still applies at existing properties and has different instructions for recognizing and measuring loss contingencies. The newer class of loss contingencies will have relatively greater liability value than the older class. This second class of loss contingencies also will complicate investors, who will have to determine from financial statement information those companies having two classes of loss contingencies. Since most other companies will have only one, investors will find it difficult to compare loss contingency liability values among companies for which there are differences both in the nature of the loss contingencies and the standards applied in recognizing and measuring them.

In this column, we look more closely at these and related developments that may be expected to arise from companies implementing the proposed standard, as currently written, and the finalized standard, beginning in 2009.

## WHAT ARE THOSE NEW STANDARDS?

The proposed standard is FASB's *Disclosure of Certain Loss Contingencies*, released on June 5, 2008 as an exposure draft, File Reference No. 1600-100. It amends the loss contingency disclosure requirements of FAS 5 and 141R. FASB originally scheduled it to be effective for annual financial statements issued for fiscal years ending after December 15, 2008, and for interim and annual periods in subsequent years. FASB accepted comments on this exposure draft through August 8, 2008. In response to comments and for time to re-deliberate and address concerns raised, FASB decided that finalized requirements "will be effective no sooner than for fiscal years ending after December 15, 2009" (Fanning, 2008). This means beginning with the 2009 annual report for calendar year companies.

The finalized standard is FAS 141R, *Business Combinations*, released in December 2007. It is to be applied prospectively to business combinations, e.g., acquisitions and mergers, for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December

15, 2008. This would be beginning in calendar year 2009 for most (acquiring) companies. FASB prohibits early implementation. This new standard applies to all transactions in which an entity (the acquirer) gains control of one or more businesses, including those referred to as true mergers or mergers of equals. As indicated above, the disclosure requirements of FAS 141R are amended by the proposed standard.

The proposed standard also amends the disclosure requirements of FAS 5, *Accounting for Contingencies*. Since July 1975, FAS 5 has been the primary standard applicable for all companies in recognizing, measuring, and disclosing loss contingencies.

Since October 1976, providing interpretation of FAS 5 has been FASB's Interpretation No. (FIN) 14, *Reasonable Estimation of the Amount of a Loss*. Also applying to all companies, it instructs on estimation of loss contingency costs.

## THE VIEW OF INADEQUATE DISCLOSURE ABOUT LOSS CONTINGENCIES

FASB has explained that the proposed standard, which amends FAS 5 and 141R, is the product of its effort to "address constituents' concerns" that disclosures of loss contingencies:

> …Under existing guidance [referring to FAS 5] do not provide sufficient information in a timely manner to assist users [of financial statements] in assessing the likelihood, timing, and amounts of cash flows associated with loss contingencies. (FASB, 2008)

FASB has recognized a primary concern that:

> The *at least reasonably possible* threshold for disclosing loss contingencies has not resulted in the disclosure of the full population of an entity's existing loss contingencies that would be of interest to financial statement users. (FASB, 2008)

And further that:

> The option to state that 'an estimate of the possible loss or range of loss cannot be made' 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. (FASB, 2008)

FASB has indicated that the objective of the finalized standard, FAS 141R, is to:

> …Improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports… (FASB, 2007)

## WHAT HAS CAUSED THIS VIEW OF INADEQUATE DISCLOSURE?

Under FAS 5, a company recognizes and discloses a loss contingency if it is *probable* that a liability has been incurred and the amount of loss can be *reasonably estimated*. Both criteria must be met. The information

reasonably available to it before issuing a financial statement is a company's basis for making this determination.

As used in FAS 5, *probable* requires a high degree of expectation. FASB has acknowledged that *probable* in the FAS 5 context is interpreted appropriately as *highly likely*, as in a high likelihood that a company will have a future sacrifice as a result of the contingency, a highly likely future expenditure. Under FAS 5, a company is required to consider uncertainty (probability) in its determination of whether to recognize and disclose a liability and to apply the high threshold of high likelihood in making that determination. This is the first of the dual recognition and disclosure criteria under FAS 5.

In the second of the recognition and disclosure criteria, whether the amount of loss is *reasonably estimable*, a company may decide it is not. FASB's FIN 14 provides additional instructions concerning cost estimation. Under FIN 14, when a company can discern the range of a loss, i.e., when it can identify low and high values, then the company must conclude it can reasonably estimate the cost of the loss contingency. This means, according to the requirements of FIN 14, that a company should not delay recognition and disclosure until it has a single, best cost estimate, because having a cost range is sufficient evidence of a cost being reasonably estimable. It still is possible for a company to delay recognition and disclosure, however, by contending that the high value in a range cannot be estimated yet.

FASB also has indicated in FIN 14 that if one amount in a range is better than others, then that most likely value should be used. When no amount in a range is a better estimate, then the low value of the range is to be used, i.e., the *known minimum value*. Rogers has observed that, "In practice, most environmental liabilities are recorded at their *known minimum value*" (Rogers, 2008).

Hence the view, apparently held by a considerable number of investors and acknowledged by FASB, that historically the application of FAS 5 (and FIN 14) by reporting companies has disclosed in financial statements neither a full population of loss contingencies nor a full representation of their liability value.

## WHAT IS FASB CURRENTLY DOING ABOUT THIS PERCEIVED DISCLOSURE PROBLEM?

FASB has taken what it describes as a near-term task to improve *disclosure* of loss contingencies and a longer-term task to improve *recognition* and *measurement*. The proposed standard released in June 2008 is a product of the near-term task. FASB has stated that it expects the proposed standard's improvement in *disclosure* will "expand the population" of loss contingencies reported in financial statements. It expects improvement in disclosure quality from requiring "specific quantitative and qualitative information" about loss contingencies and "tabular reconciliation" of recognized loss contingencies (FASB, 2008).

While FASB has not indicated a product date for its longer-term task of improving *recognition* and *measurement* of loss contingencies, professionals

generally expect that FASB will bring to loss contingencies the fair value measurement model that it has advanced in FAS 157, *Fair Value Measurements*. In applying the fair value measurement model to loss contingencies, companies consider uncertainty (probability) in the *measurement* of liabilities, reducing probability's role in *recognition*.

FASB already has required companies to apply the fair value model to asset retirement obligations, beginning in 2009, under FAS 143, *Accounting for Asset Retirement Obligations*, and FIN 47, *Accounting for Conditional Asset Retirement Obligations*. FASB has noted in FAS 143 that application of "the objective of recognizing the fair value of [a liability] will result in recognition of some [liabilities] for which the likelihood of [resolution], although more than zero, is less than probable from a Statement 5 prospective" (FASB, 2001).

As already observed, the fair value measurement model applies under the new standard FAS 141R, beginning in 2009, for loss contingencies at acquired properties in business combinations.

## WHAT WOULD RESULT FROM IMPLEMENTATION OF THE PROPOSED STANDARD?

Companies would disclose more information about loss contingencies than currently is required of them under FAS 5. Here are some of the requirements of the proposed standard (FASB, 2008):

- *Qualitative* information makes up most of the additional disclosure that companies must provide under the proposed standard, as compared with FAS 5. Under the proposed standard, companies must describe the contingency, how it arose, its legal or contractual basis, its current status, and when it is expected to be resolved; the factors likely to affect resolution and their potential effect on the outcome; and the most likely outcome, with the significant assumptions used in determining this outcome and in estimating costs.
- *Quantitative* information, i.e., an estimation of loss contingency costs, is required in the proposed standard, as in FAS 5. The proposed standard indicates that the amount of a claim or assessment against the company should include damage estimates, if applicable, such as treble or punitive damages. Under the proposed standard, if a company has no claim or assessment amount to use, then it comes up with a best estimate of its *maximum* exposure to loss. This is different from applying FAS 5 and FIN 14 guidance, under which it is satisfactory to report a minimum value, not a maximum, when there is uncertainty in estimating cost, i.e., when no amount in a range is a better estimate.
- *Qualitative and quantitative* description of insurance and indemnification arrangements that could lead to recovery of some or all the possible loss.

- *Tabular reconciliation* of the aggregated amount recognized for loss contingencies, reconciling the beginning and end of each reporting period.

Under the proposed standard, in theory, companies would be providing information about loss contingencies they already have disclosed, rather than disclosing new loss contingencies, except as new contingencies arise. In meeting the FAS 5 requirements, companies have considered three levels of probability in evaluating their loss contingencies, which are *probable*, *reasonably possible*, and *remote*. FAS 5 requires *disclosure* when loss contingencies are either *probable* or at least *reasonably possible*. (As already noted, it also requires *recognition* when loss contingencies are *probable*.) The disclosure requirements in the proposed standard are equivalent, with *disclosure* being required unless the *probability* of a loss contingency is *remote*. So, meeting the requirements of the proposed standard theoretically should not "expand the population" of loss contingencies (beyond those already disclosed in complying with FAS 5 requirements).

The proposed standard does have the requirement that, regardless of probability, loss contingencies are disclosed if they are expected to be resolved in the near term and may have a severe impact on the company's financial condition. This likely results, at most, in only a small increase in the population of loss contingencies disclosed.

The proposed standard imposes no changes from FAS 5 in how loss contingency costs are measured, aside from including damage estimates and using an estimated maximum exposure to loss when no claim or assessment is apparent. So, overall, no significant changes in liability values for already-disclosed loss contingencies should be expected.

Detractors contend that developing the expanded information required under the proposed standard will add to the compliance burden that companies face. They also contend that companies will be vulnerable to subjective and risky judgments they must make about their loss contingencies for meeting the proposed standard's information requirements, because such judgments can prove wrong.

In fact, companies complying with FAS 5 already have established their basis for recognizing and disclosing their loss contingencies. The proposed standard essentially requires that companies in their disclosures be more transparent about how they made those determinations. So, it is not necessarily true that companies will have additional information to develop. Nor is it necessarily the case that they will become more vulnerable to the consequences of their judgments by providing more information about how those judgments were made.

A bit of a riddle can be acknowledged. One may contend that implementing the proposed standard, as currently written, primarily moves information about loss contingencies that investors need from company files into investors' hands. Consistent with this view is the observation that the proposed standard requires no changes in how loss contingencies are recognized and measured. Companies confident in their loss contingency determinations to date should have no distress in contemplating compliance with the proposed standard.

There is the view, however, portrayed at the beginning of this text, that loss contingencies historically have been under-represented in number and estimated cost. For this view to apply means companies have avoided making disclosures under FAS 5 requirements. In which case, then, the proposed standard has the messy job, exceeding its specific scope, of bringing companies into compliance with FAS 5 recognition and measurement requirements, as well as with the proposed standard's disclosure requirements.

By its August 8, 2008 deadline, FASB had received more than 200 letters commenting on the proposed standard. Reason has reported that the majority of the comments were negative, with "many arguing that the proposal should be scrapped in its entirety" (Reason, 2008). In a *Wall Street Journal* (*WSJ*) editorial, the proposed standard was sharply criticized as being "a wealth transfer from corporations to trial lawyers, [with] FASB doing no favors to the investors it claims to represent" (*Wall Street Journal*, 2008). It appears, however, that the *WSJ* editorial staff may have misread the proposed standard and the historical standard it is intended to replace. The editorial expressed concern, for example, that companies must set about calculating the fair value of uncertain contingencies, when actually the proposed standard imposes no new measurement requirements (historic costs under FAS 5 still apply) and the words "fair value" are no where in its text. It is FAS 141R, not the proposed standard, that does require measurement of loss contingencies at fair value, pertaining only to loss contingencies for acquired properties, as will be described later in this column. The editorial asserted also that under the current system (of FAS 5 requirements), a company discloses the potential cost of a contingency, such as a lawsuit, "only when the [company] believes it is 'probable.'" In fact, under FAS 5, a company must disclose an estimated loss if a liability is at least *reasonably possible*, not just *probable*, or state that such an estimate cannot be made (*Wall Street Journal*, 2008; FASB, 1975).

In his letter to the *WSJ* responding to the editorial, FASB Chairman Robert Herz reminded readers that the purpose of the proposed standard was not accounting change, but additional disclosure. He wrote that it is because of:

> …The strong and extensive input we've received from investors who want greater transparency relating to a wide range of contingencies—including litigation—that we are proposing these expanded disclosures. (Herz, 2008)

It seems reasonable to anticipate that the companies likely to experience a significant additional compliance burden in implementing the proposed standard, as currently written, are those that to date may have misapplied FAS 5 disclosure requirements such that they have avoided identification of loss contingencies that already should have been indicated in financial statements.

While investors may welcome the expanded disclosure from implementation of the proposed standard, as written, companies and their advisors, perhaps some facing new disclosure, have raised particular concerns. Here are examples: susceptibility to claims having little basis, but for the purpose of forcing quick, unfavorable (for the company) settlements;

potential liability from differences (higher or lower) in estimates of "maximum exposure" and actual losses; and insufficient protection from being prejudiced in litigation, despite the prejudicial information exception (Ritchie, 2008). As already indicated, for time to address such concerns, FASB has moved the effective date for this proposed standard forward at least a year, to no sooner than 2009 (Fanning, 2008).

## IMPLEMENTING THE REQUIREMENTS OF THE FINALIZED STANDARD

In implementing the finalized standard, FAS 141R, companies apply different recognition and measurement requirements than those of FAS 5 for determining loss contingencies. Under 141R, companies recognize:

- All contractual loss contingencies.
- All other loss contingencies (noncontractual) that are more likely than not to give rise to a liability.

FAS 141R requires that companies measure the acquisition-date fair value of those loss contingencies. That may seem difficult, as least initially, because application of fair value methodology is new for most companies.

As already noted, this finalized standard pertains only to a subset of companies, to the surviving entity in acquisitions and mergers, and applies only to their acquired properties, not to all the entity's properties.

While FASB indicates it is proceeding slowly on the matter, it may well broaden its fair value measurement applications. Fair value measurement currently is required for asset retirement obligations and with FAS 141R is being extended to the loss contingencies of acquired properties. There is reason to believe it may come to include all loss contingencies.

Until that time, however, acquiring companies, in implementing FAS 141R, will be creating for themselves a second class of loss contingencies. This will complicate their liability management, for at least the near term. The newer class of loss contingencies under FAS 141R will have relatively greater liability value, which results from application of the more inclusive recognition criteria and the more realistic measurement methods of FAS 141R, as compared with those of FAS 5, used for the company's older class of loss contingencies. This second class of loss contingencies also will complicate investors, who will have to discern from financial statement information those companies having two classes of loss contingencies. Most other companies will report loss contingencies only from FAS 5 requirements. Investors will find it difficult to compare the loss contingency liability values of companies that determined loss contingencies under both FAS 5 and FAS 141R with those that applied only FAS 5 because the liability values will be affected by differences in both the nature of the loss contingencies and the standards applied in recognizing and measuring them.

## CONCLUSIONS

If there is distress among companies about compliance with FASB's proposed standard, as currently written, tentatively scheduled for

implementation beginning in 2009, which requires expanded disclosure about loss contingencies, it may derive, at least in part, from prior misapplication of FAS 5 disclosure requirements, wherein companies may have avoided identification of loss contingencies that already should have been indicated in financial statements. This would be consistent with the view that many, if not most, public companies have disclosed fewer loss contingencies than exist and lower contingency costs than are realistic, including for environmental loss contingencies. It would mean that the proposed standard, if it proceeds to finalization, would have the messy job, beyond its specific scope, of bringing companies into compliance with FAS 5 recognition and measurement requirements, as well as with the proposed standard's disclosure requirements.

By imposing more inclusive recognition criteria and more realistic (fair value) measurement methods for a subset of loss contingencies, those for acquired properties, FASB, with its finalized standard FAS 141R, may be indicating the future for the recognition and measurement of all loss contingencies. Until that future, however, (acquiring) companies complying with FAS 141R, which is effective beginning in 2009, will have the complication of managing two classes of loss contingencies, with the newer, second class having higher liability value from implementation of the FAS 141R requirements. This second class of loss contingencies also will complicate investors, who will have to determine from financial statement information those companies having two classes of loss contingencies. Since most other companies will have only one, investors will find it difficult to compare loss contingency liability values among companies for which there are differences both in the nature of the loss contingencies and the standards applied in recognizing and measuring them.

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