

Public Company Advisor

Practical Insights for Public Company Counsel

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King & Spalding's Public Company Practice Group periodically publishes the Public Company Advisor to provide practical insights into current corporate governance, securities compliance and other topics of interest to public company counsel.

A “Roadmap” to Accrual and Disclosure Requirements under ASC 450

Of the types of information required to be disclosed by public companies, information about “contingencies” is often one of the more sensitive disclosures for the company and may be closely scrutinized by analysts and investors. Disclosure of pending lawsuits and government investigations also has the potential to impact an underlying proceeding, since adversaries may attempt to discern the company’s outlook and strategy from the disclosure. Concern over a company’s contingencies disclosure continues to grow given the nature of high-stakes litigation, aggressive government enforcement initiatives, and the large loss contingency charges recorded during the financial crisis.

The Securities and Exchange Commission (“SEC”) and the Financial Accounting Standards Board (“FASB”) have focused on how public companies disclose their loss contingencies and they have explored the possibility of requiring additional contingencies disclosure. In this edition of the *Public Company Advisor*, we provide a helpful guide or “roadmap” to the basic tenets of a company’s obligation to accrue for and disclose loss contingencies. This roadmap focuses on the requirements under the accounting literature that often drive the most sensitive disclosures - FASB Accounting Standards Codification Topic 450 (“ASC 450”) (formerly Financial Accounting Standards No. 5).

We note that the determination of whether a company is required to record an accrual or make disclosure of a loss contingency in the notes to its financial statements is an accounting matter, which must be made by the company and its independent auditors. Our “roadmap” is intended to provide a basic overview of applicable requirements for others who may be involved in the financial reporting process, such as company attorneys, senior management and members of the audit committee.

Overview

Public companies are required to disclose information about contingencies, such as litigation and governmental proceedings, in several areas of their periodic reports. For example, Item 103 of Regulation S-K requires disclosure about pending legal proceedings, while Item 303 of Regulation S-K requires that a company describe (in its Management’s Discussion and Analysis) certain types of “trends and uncertainties” as well as items that may affect its liquidity. However, as a practical matter, the requirements under ASC 450 -- which could require the accrual of a charge for a contingency or the disclosure of a contingency in the notes to the financial statements -- often drive the most sensitive disclosures.

ASC 450 defines a “contingency” as an existing condition, situation or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur.¹ We have developed a “roadmap” reference chart (which is contained in the Appendix to this *Public Company Advisor*) to illustrate the process for determining whether a company (a) is required to record an accrual for a loss contingency, (b) is required to make disclosure about a loss contingency, or (c) may proceed with neither an accrual nor disclosure of the matter. The following description walks through this roadmap.

Assessing the Likelihood of a Material Loss

The analysis under ASC 450 begins with a determination of the likelihood that the company will incur a material² loss, with there being three ranges of “likelihood” -- remote, reasonably possible and probable.

- A material loss is “remote” if the chance of the future event is slight.
- A material loss is “probable” if the future event is likely to occur.
- A material loss is “reasonably possible” if the likelihood falls in the range between being remote and probable.

If the Likelihood of a Material Loss is Remote

If the likelihood of a material loss is remote, there is no requirement for the company to either record an accrual or make disclosure of the contingency under ASC 450.

In 2010, the FASB proposed amendments to ASC 450 that would have required disclosure of remote contingencies if the potential impact is severe (e.g., contingencies that might have disrupted the normal functioning of the company); however, these amendments were not ultimately adopted in the wake of strong criticism of the proposal. Nevertheless, some companies may choose to disclose loss contingencies they consider to be remote. In this case, a company should consider disclosing that such pending matters are considered to have a remote likelihood of a material loss.

- Illustration: A company with net assets of \$2 billion is the subject of a *qui tam* complaint, alleging false claims of \$300 million, which could be trebled if determined adversely. The company has concluded that there is a remote likelihood of a material loss, but provides detailed disclosure about the case. The company also discloses that it believes it has defenses to all the allegations in the case and indicates that it may disclose contingencies for which it believes the likelihood of a material loss is remote.

¹ While ASC 450 covers both gain contingencies and loss contingencies, in this *Public Company Advisor* we only consider loss contingencies because they typically represent the more difficult contingency disclosures for public companies.

² By its terms, the provisions of ASC 450 need not be applied to immaterial items. For purposes of ASC 450, materiality is determined under SAB 99, which discourages overreliance on quantitative thresholds in determining materiality and sets forth a non-exclusive list of qualitative factors that might cause a relatively small amount to be deemed material. With respect to Regulation S-K Item 103 (legal proceedings) and Item 303 (MD&A disclosure of uncertainties), materiality is determined using different standards developed under the securities laws.

If the Likelihood of a Material Loss is Probable

If the likelihood of a material loss is probable, then the company must determine whether the amount of the loss is reasonably estimable or not reasonably estimable.

If the amount of the loss is reasonably estimable, then the company is required to make an accrual for the loss contingency. The company is required to accrue either (a) the company's estimate of the loss, or (b) if the reasonably estimable loss is a range, then it must accrue either: (i) the amount within the range that appears to be the better estimate than any other amount in the range or (ii) the minimum amount in the range, if there is no amount in the range that is a better estimate than any other amount.

A company making an accrual is generally not required to disclose either that it has made the accrual or the amount accrued, except that it is required to disclose the nature and amount of the accrual if necessary to make the financial statements not misleading. As a practical matter, large or unusual accruals are often disclosed.

- Illustration: A company has been the subject of a multi-year government investigation and has made disclosure of the investigation for several quarters although it has recorded no accrual. Now, the company has reached an agreement in principle to settle the matter for an amount that is material to its results of operations, financial condition and cash flows. The company records an accrual and also discloses the amount of the accrual.

If the amount of the loss is not reasonably estimable, then the company is not required (or permitted) to record an accrual for the contingency. Instead, it is required to disclose the nature of the contingency, and describe why it is unable to estimate the amount of the loss.³

If the Likelihood of a Material Loss is “Reasonably Possible” -- Meaning More Likely than Remote, but Less Likely than Probable

ASC 450 provides definitions for the terms “remote” and “probable”, but the term “reasonably possible” is defined only as a likelihood that is more likely than remote, but less likely than probable. Because a loss contingency that is reasonably possible is, by definition, not probable, the company does not make an accrual for the contingency, but instead is required to make disclosure about the contingency.

In determining the disclosure that is required for a reasonably possible loss, the company must first consider whether or not the amount of the reasonably possible loss (or range of loss) is estimable. If the amount of the reasonably possible loss is estimable, then the company must disclose the nature of the contingency and also provide its estimate of the amount or range of loss.

- Illustration: A company is involved in a lawsuit with a fixed (estimable) amount of damages. The company denies liability and believes that an unfavorable verdict is not probable but is reasonably possible. Because the loss contingency is reasonably possible, but not probable, the company does not make an accrual for the contingency, but is required to disclose the nature of the contingency and an estimate of any amount of loss that is reasonably possible.

³ One common question with respect to the ASC 450 analysis concerns the treatment of legal fees and expenses associated with the underlying loss contingency. In our experience, while a proceeding or investigation is pending, a company ordinarily records quarterly charges for legal fees and expenses on an ongoing basis (in the absence of an accrual for the matter itself).

If the company cannot estimate the amount of the reasonably possible loss, then it must disclose the nature of the contingency and describe why it is unable to estimate the amount of the loss.

- Illustration: A company may be unable to make an estimate of a reasonably possible loss contingency for a pending lawsuit because (a) the matter is at an early stage, (b) the matter involves unresolved questions of fact, or (c) the matter involves novel types of claims or unresolved questions of law.

In the wake of the financial crisis in which many financial institutions took large write-offs, the staff of the SEC began to review companies' previous disclosure of contingencies to determine whether the companies had appropriately warned the market of reasonably possible contingent losses. In many instances, the staff found that companies had recorded large write-offs for matters that had not been the subject of previous disclosure (meaning that the contingency had gone from remote to probable, with no intervening disclosure of a reasonably possible loss). As a result of this focus, the staff of the SEC has recently issued comments on periodic reports that call for additional disclosure about reasonably possible losses.

In the SEC staff's comments under ASC 450, it has emphasized that:

- where companies are unable to estimate the amount or range of reasonably possible losses, they must provide disclosure about the contingency that allows users of the financial statements to evaluate the magnitude of the matter;
- as legal proceedings continue and approach resolution, the company should disclose additional quantitative information about the matter; and
- even after a company has recorded a loss accrual, it must continue to consider whether there are reasonably possibly losses in excess of the amount of the accrual (in which case disclosure may be required).

Treatment of Unasserted Claims

While the attached "roadmap" covers asserted claims or pending proceedings, ASC 450 uses similar constructs to deal with unasserted claims. A company is not required to make disclosure with respect to an unasserted claim if there is no manifestation by a potential claimant of an awareness of a possible claim, unless assertion of the claim is probable and there is a reasonable possibility that the outcome will be unfavorable.

- Illustration: A company might be required to disclose the possibility of claims being asserted if: (a) the company becomes aware that it has sold defective products that have recently caused a series of deaths or critical injuries, but these deaths and injuries are not yet known to the general public, or (b) the company becomes aware that it has infringed upon a competitor's intellectual property and believes the competitor is likely to become aware of the infringement.

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Roadmap of Accrual and Disclosure of Loss Contingencies Under ASC 450

