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Governing Disclosure Of Loss Contingencies

Law360, New York (October 14, 2010) -- Investors have expressed concern in recent years about the adequacy of companies' financial statement disclosures of nonfinancial loss contingencies, including claims arising from litigation. In response to this criticism, the Financial Accounting Standards Board (FASB) undertook a project to improve disclosure requirements and guidance in this area.

The FASB's initial exposure draft was issued in June 2008 and, after extensive comments and roundtable discussions, the revised draft was issued in July 2010.[1] The stated objective was to require sufficient qualitative and quantitative information about loss contingencies to enable users of financial statements to understand the nature of the loss contingencies as well as their potential magnitude and timing.

The comment period for the revised draft expired Sept. 20, 2010; 320 comment letters were submitted, many of which indicated that the revised draft may still be problematic in a number of areas. Below are five issues that, based upon comment letters to the FASB, appear to be of special concern to lawyers and accountants.

1) Adversaries Could Gain a Tactical Advantage from the Proposed Expanded Disclosures.

As a general principle, financial disclosures should present useful information to users of financial statements, not alter the outcome of the matters that are disclosed.[2] Many commenters challenge certain proposed requirements in the revised draft as inconsistent with that principle because they could substantially prejudice a company's defense position in litigation.

For example, the proposed requirement that companies disclose the amount of any accrual for loss contingencies, along with quarterly tabular reconciliations of material changes to those accruals (for public companies), has drawn significant criticism.[3]

Commenters note that if an accrual could be traced to a particular case, the company's adversary could seek to use that accrual in court as an admission by the company of the merits of the claim and the amount of liability.[4]

In addition, disclosure of accruals could establish a floor for settlement negotiations; one commenter states, "[o]nce a company has disclosed the specific amount accrued for a litigation contingency, no plaintiff would rationally settle for a lower amount, because the company itself has valued the claim at the accrued value."[5]

The revised draft discussed the possibility of aggregation of claims,[6] in part to prevent an accrual from being tied to a particular case, but a number of commenters opine that aggregation would not solve the problem. Companies with fewer claims might not be able to aggregate at all.[7]

Because the FASB's proposed guidance discouraged aggregating individual and class action suits, or suits filed in different jurisdictions or at different times,[8] companies with litigation in multiple states or countries might find aggregation inappropriate.[9]

Certain commenters deem aggregation similarly unworkable for quarterly tabular reconciliations because those too could identify particular cases and categorizations that were "likely to change over time, making period-to-period comparisons more difficult."[10]

Without aggregation, companies would face increased odds of receiving discovery requests from adversaries seeking information underlying the public disclosures and of being required to produce otherwise confidential information to their detriment.[11]

Commenters also express concern about the proposed requirement to disclose possible recoveries from insurance and other sources (including information about whether the insurer has denied, contested, or reserved its rights relating to coverage) if such information is "discoverable by either the plaintiff or a regulatory agency."[12]

For instance, commenters note, insurance information is frequently disclosed in litigation only under a confidentiality order,[13] and many courts exclude evidence of insurance coverage at trial as unduly prejudicial;[14] if this information has already been made public due to FASB requirements, such disclosure could trump the court rules and thereby affect the outcome of the case.

Additionally, the proposed rules would require companies to disclose "other nonprivileged [quantitative] information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss."[15]

A number of commenters question how an auditor would audit the completeness of management disclosures of "other nonprivileged information that would be relevant," as this necessarily would involve legal judgments and research into what information qualifies as nonprivileged and eligible for public disclosure.[16] A lack of completeness in this or other disclosures, judged in hindsight, could add new avenues for litigation against companies.

2) A Requirement to Disclose Remote Loss Contingencies with Potentially Severe Impact Would Be Problematic.

Auditors and lawyers alike express concern about the proposal that remote loss contingencies that might have a potentially severe impact on the entity ("severe impact" meaning "a significant financially disruptive effect on the normal functioning of an entity") might also need to be disclosed.[17]

A number of accounting firms are skeptical that disclosures relating to remote loss contingencies would be "decision-useful" to financial statement users, as they would add significantly to the volume of disclosures, making it difficult to determine which matters had the highest chance of actually resulting in loss to the company.[18]

In addition, auditors note that disclosures regarding remote loss contingencies are outside the scope of information normally provided to auditors by legal counsel.[19]

Lawyers express concern that the disclosures relating to remote loss contingencies could invite forward-looking and speculative statements that would be outside the scope of the PSLRA's safe harbor provision (which is not applicable to financial statements and notes thereto).[20]

In addition, by calling for disclosure of contingencies with a remote likelihood of occurrence, the proposed rule also could create confusion regarding the traditional securities law standard of materiality, which requires consideration of both probability and magnitude of loss in making disclosure judgments.[21]

Finally, a number of lawyers echo the concern that disclosures regarding remote loss contingencies could lead to a potential waiver of work product protection for the legal analysis underlying those disclosures or litigation based upon a hindsight view of the accuracy of the predictions.[22]

3) Legal Conclusions and Judgments May Not be Auditable.

"Legal letters" — responses to auditors' inquiries regarding pending or threatened litigation — are typically a primary source of audit evidence upon which auditors rely in testing management assertions as to litigation matters.[23]

The information to be disclosed in such letters is essentially prescribed by the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, adopted by the ABA Board of Governors in 1975, which is consistent with, and an exhibit to, AICPA Statement on Auditing Standards (SAS) No. 12.

The statement of policy, negotiated between the ABA and AICPA, was intended to strike a balance between the auditor's need to corroborate management's assertions regarding litigation contingencies as they might affect the company's financial statements and the company's and lawyer's need to preserve attorney-client privilege and work-product protection as to those matters.

The statement of policy contemplates that lawyers may be requested by their client to furnish information to the auditor about overtly threatened or pending litigation and about contractually assumed obligations or unasserted possible claims or assessments which the client has specifically identified (if the lawyer was engaged to represent the client professionally with respect thereto and devoted substantive attention to such matters during the period under examination).

Many accounting firms express the belief that legal counsel could cite the current ABA statement of policy as a reason not to provide the information requested for the expanded disclosures. Without an expanded scope of legal letters, they say, auditors would not be able to audit the company's expanded disclosures regarding, for example, remote loss contingencies, the "discoverability" of insurance information, and the "nonprivileged information that would be relevant" to financial statement users discussed above.[24]

The AICPA declares that the revised draft cannot be operational "unless the ABA and audit standard setters can appropriately revise their agreement and then subsequently initiate the appropriate due process procedures to put through corresponding revisions to both sets of auditing standards."[25]

If auditable information is not forthcoming from legal counsel, a number of accounting firms question what procedures would be available to an auditor to corroborate the information provided by management regarding the expanded disclosures that would be called for in the revised draft.[26]

4) Attorney-Client Privilege and Work Product Protections Could Be Undermined.

As can be seen from the above discussion, much of the information that would be required in the proposed expanded disclosures calls for input from legal counsel — for example, accruals for litigation with quarterly reconciliations of any changes in those accruals; categorization of litigation matters for aggregation purposes; discoverability of insurance information; and identification of remote loss contingencies with potentially severe impact, among others.

Ordinarily, generally accepted auditing standards do not require an auditor to examine attorney-client privileged documents;[27] certain commenters, however, expressed the belief that auditing these expanded disclosures could require auditors to do precisely that.[28]

Of particular concern to lawyers and accountants is the impact of the proposed enhanced disclosures on claims of attorney-client privilege or attorney work product, if auditors required access to traditionally confidential materials in order to audit the expanded disclosures.

There is legal authority suggesting that disclosure of attorney-client communications to auditors destroys the attorney-client privilege; the majority rule appears to be that work product protections are not necessarily waived by such disclosure.[29]

Courts, however, have not been unanimous on this subject,[30] and many commenters worry that companies would risk waiver of these protections by giving auditors access to the legal analysis needed to audit the expanded disclosures.[31]

An added downside identified in the comment letters is the risk that full and frank communications between management and legal counsel, or between company and auditor, might be chilled for fear that such communications might later become discoverable in litigation, and that this chilling effect would be contrary to corporate and shareholder interests as well as long-standing public policy.[32]

5) A Dec. 15, 2010, Time Frame for Implementation Is Unreasonably Short.

The FASB requested comment on the proposal that the expanded disclosures in the Revised Draft become effective for fiscal years ending after Dec. 15, 2010 — in other words, in less than two months. This proposed effective date is widely panned as unworkable for companies, auditors and lawyers.

For companies to prepare for these enhanced disclosures, they would need to, for instance, have audit committees and management evaluate the final guidance and implementation issues; expand their systems and reporting packages to capture the newly required information; develop, document and test their controls and processes for gathering this information; survey all of their litigation and loss contingencies under the newly expanded definition; and then prepare the actual disclosures.[33]

The difficulty of these tasks would be compounded for companies operating in multiple jurisdictions or in a decentralized manner.[34]

As noted above, auditors hold the firm belief that the ABA statement of policy would need to be revised to enable the proposed expanded disclosures to be audited, and that this process would likely involve negotiating and harmonizing standards and guidance among the ABA, the PCAOB, the AICPA and the IASB, with input from the auditing profession, the legal profession, the preparer community and the SEC.[35]

Assuming a revised statement of policy could be agreed upon, it would thereafter take time for the legal and accounting professions to understand, train on, and implement the new requirements.[36]

The comment letters to the revised draft indicate that, while there is much support for the goal of improving meaningful disclosures for users of financial statements regarding loss contingencies, the FASB's revised draft raises significant issues of policy as well as implementation that likely will not be resolved quickly.

It seems clear that for these issues to be resolved in a workable manner, many constituencies — including preparers of financial statements, the legal and accounting professions, and regulators — will need to balance the competing policy interests and take into account the practical implications of expanded disclosures in this sensitive area before issuing a final set of rules and guidance.

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[1] Financial Accounting Standards Board Proposed Accounting Standards Update, "Disclosure of Certain Loss Contingencies," File Ref. No. 1840-100 (July 20, 2010) ("Revised Draft").

[2] E.g., Comment Letter 280 (American Bar Association) at 3.

[3] Revised Draft ¶¶ 450-20-50-1F(e)(2), (g).

[4] E.g., Comment Letter 280 (American Bar Association) at 4; Comment Letter 133 (General Counsels of Selected Companies) at 5-6.

[5] Comment Letter 41A (Association of Corporate Counsel) at 3.

[6] Revised Draft ¶ 450-20-50-1B(b).

[7] E.g., Comment Letter 280 (American Bar Association) at 4; Comment Letter 314 (AICPA) at 3.

[8] Id. ¶ 450-20-55-1A.

[9] Comment Letter 61 (Alston & Bird LLP) at 3-4.

[10] Comment Letter 66 (Cleary Gottlieb Steen & Hamilton LLP) at 3 n.3.

[11] E.g., Comment Letter 158 (Dewey & LeBoeuf LLP) at 3-4; Comment Letter 300 (Paul, Hastings, Janofsky & Walker LLP) at 2.

[12] Revised Draft ¶ 450-20-50-1F(e)(5).

[13] E.g., Comment Letter 41A (Association of Corporate Counsel) at 8; Comment Letter 133 (General Counsel of Selected Companies) at 8.

[14] E.g., Comment Letter 280 (American Bar Association) at 8.

[15] Revised Draft ¶¶ 450-20-50-1F(e)(4), (f)(2).

[16] E.g., Comment Letter 66 (Cleary Gottlieb Steen & Hamilton LLP) at 4; Comment Letter 237 (KPMG LLP) at 3; Comment Letter 297A (Wilson Sonsini Goodrich & Rosati, P.C.) at 3.

[17] Revised Draft ¶ 450-20-50-1D and page 7.

[18] Comment Letter 82 (PricewaterhouseCoopers LLP) at 3; see also Comment Letter 241 (Grant Thornton LLP) at 4; Comment Letter 222 (BDO USA, LLP) at 3.

[19] E.g., Comment Letter 157 (Ernst & Young LLP) at 6; Comment Letter 222 (BDO USA, LLP) at 2.

[20] E.g., Comment Letter 41A (Association of Corporate Counsel) at 6 & n.2.

[21] Id. at 6 (citing Basic, Inc. v. Levinson, 485 U.S. 224 (1988)); see also Comment Letter 133 (General Counsels of Selected Companies) at 8-10.

[22] E.g., Comment Letter 61 (Alston & Bird LLP) at 3; Comment Letter 41A (Association of Corporate Counsel) at 5-6 & n.2.

[23] Comment Letter 267 (Deloitte & Touche LLP) at 4.

[24] E.g., Comment Letter 130 (Crowe Horwath LLP) at 1; Comment Letter 82 (PricewaterhouseCoopers LLP) at 3; Comment Letter 157 (Ernst & Young LLP) at 6; Comment Letter 222 (BDO USA, LLP) at 1; Comment Letter 237 (KPMG LLP) at 3, 8; Comment Letter 241 (Grant Thornton LLP) at 1-2; Comment Letter 267 (Deloitte & Touche LLP) at 4; Comment Letter 314 (AICPA) at 3.

[25] Comment Letter 314 (AICPA) at 2.

[26] E.g., Comment Letter 157 (Ernst & Young LLP) at 2; Comment Letter 82 (PricewaterhouseCoopers LLP) at 3.

[27] AICPA Professional Standards AU § 9337.09.

[28] E.g., Comment Letter 41A (Association of Corporate Counsel) at 4-5.

[29] E.g., United States v. Deloitte LLP, 610 F.3d 129, 139 (D.C. Cir. 2010) (noting that most district courts to address issue have found no waiver of work product protection by disclosure to independent auditor, and citing cases).

[30] E.g., United States v. Textron Inc., 577 F.3d 21, 31 (1st Cir. 2009) (en banc) (vacating district court's order upholding work product protection for tax accrual workpapers; "the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements").

[31] E.g., Comment Letter 41A (Association of Corporate Counsel) at 4-5; Comment Letter 280 (American Bar Association) at 4.

[32] E.g., Comment Letter 41A (Association of Corporate Counsel) at 5.

[33] E.g., Comment Letter 41A (Association of Corporate Counsel) at 9; Comment Letter 79 (MetLife) at 2; Comment Letter 133 (General Counsels of Selected Companies) at 12-13; Comment Letter 158 (Dewey & LeBoeuf LLP) at 3.

[34] E.g., Comment Letter 157 (Ernst & Young LLP) at 7.

[35] E.g., Comment Letter 314 (AICPA) at 1, 3.

[36] E.g., Comment Letter 82 (PricewaterhouseCoopers LLP) at 3; Comment Letter 309 (McGladrey & Pullen LLP) at 3; Comment Letter 157 (Ernst & Young LLP) at 2; Comment Letter 267 (Deloitte & Touche LLP) at 4-5.

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