Environmental and Litigation Liabilities:
Why Accounting Rulemakers Think the Accounting Standards for these Loss Contingencies Need Clean-up, and the Changes They Propose.

Ben T. Keller
Senior Attorney

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I. Is Reporting of Contingent Liabilities Inadequate and Untimely?

Are companies providing adequate and timely information about their contingent losses such as environmental liabilities and pending or threatened litigation? The Financial Accounting Standards Board (“FASB” or the “Board”) thinks not and plans to change the current reporting standards. In June, 2008, the Board issued an Exposure Draft entitled “Disclosure of Certain Loss Contingencies” which aimed to drastically expand the disclosure requirements for contingent losses, including environmental liabilities and pending or threatened litigation. The Exposure Draft would amend Accounting Standards Codification Section 450-20-50 (formerly, Statement of Financial Accounting Standards No. 5 – Accounting for Contingencies) which is the principal standard establishing the accounting treatment for contingent liabilities and Section 805-20-50 (formerly, Statement of Financial Accounting Standards No. 141 – “Business Combinations”) which sets forth the rules for accounting for contingent liabilities in the context of mergers and acquisitions.

The Exposure Draft generated tremendous opposition from interested parties, including attorneys concerned about the potential negative consequences that expanded disclosure requirements about the nature and extent of losses would have upon attorney-client privilege and work product protections. They feared that the new rules would require disclosure of litigation strategy through, amongst other things, the reporting of companies’ estimates of the maximum exposure to loss for environmental and litigation-related liabilities. The Board has since scaled back its proposed revisions, but nonetheless promises to impose substantial new guidance rules for loss contingency disclosures in the second quarter of this year.

What follows is a brief discussion of the current accrual and disclosures rules, the initial proposed revisions in the Exposure Draft, and the current status of proposed revisions.

II. Contingency Defined

A “contingency” is defined “as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.”

III. The Current Accrual and Disclosure Rules

ASC Section 450-20-50 sets forth the applicable standard for evaluating and accounting for contingencies. American Institute of Certified Public Accountants Statement of Position 96-1 “Environmental Remediation Liabilities” provides guidelines on the application of ASC 450-20-50 to environmental remediation.

Under Section 450-20-50, companies must group contingent losses into one of the three categories for purposes of accrual, disclosure, or non-disclosure: (1) Probable (likely to occur); (2) Reasonably Possible (more than remote but less than likely); and (3) Remote (occurrence is slight).

A. When Accrual of a Contingency is Required – Probable and Reasonably Estimable

An estimated loss from a contingent liability shall be accrued with a charge against income if the loss is probable and reasonably estimable. A company must determine the best estimate of the loss, which is the amount that appears to be the better estimate than any other value within a range, or in other words, the most likely value of the liability. When no
value within the range is a better estimate than any other amount, companies are permitted to accrue the lowest known amount in the range. When no estimate of the possible range of loss can be made, a company is not required to make any quantitative disclosure about the loss.

### B. When Disclosure is Required – Reasonably Possible

If a future outflow of resources from a loss contingency is probable but not reasonably estimable or is reasonably estimable, then accrual against income typically is not required, but disclosure is mandated. Disclosure requires an indication of the nature of the contingency and an estimate of the loss or range of loss or a statement that an estimate cannot be made.

### C. When Disclosure is Not Required – Remote

If the possibility of loss is remote, financial statement disclosure generally is not required, unless a third-party has guaranteed the loss.

### IV. Polluted Financials: The Problems Presented by the Current Standards

The FASB has determined that the existing disclosure rules fail to provide timely and adequate information about contingent losses. Specifically, FASB observed that:

- Disclosures were not provided until material accruals were already made;
- Material contingencies too often go undisclosed because the threshold for disclosure – that the occurrence of the contingency be reasonably possible – is simply too lenient; and
- Companies too frequently fail to disclose any quantitative information concerning losses by invoking the exception that an estimate cannot be made.

Critics of the current standards also suggest that permitting the accrual of the lowest known estimate in the range of potential liability serves to under-accrue the true liability. As support, these individuals argue that the disclosure problem is highlighted by the fact that most companies’ reserves for environmental liabilities continue to grow, notwithstanding the companies’ spending to remediate environmental liabilities. As cleanups progress, one would expect reserves to diminish. Instead, as companies remediate environmental sites, the trend is to continue to accrue additional costs for the cleanup, underscoring the inaccuracy of companies’ estimates of these contingent liabilities.

Further highlighting the alleged shortcomings of Section 450-20-50, the FASB has utilized “fair value” recognition criteria in every new accounting standard relevant to environmental liabilities since Section 450-20-50, which was originally issued as Statement of Financial Accounting Standards No. 5 in 1975. Under these newer standards, environmental obligations are to be valued at “market-based” fair value, as opposed to the “best estimate.” Generally speaking, “fair value” is the value a third party would place upon the assumption of the liability in an arms length transaction.

### V. Proposed Changes: Expansion of the Current Contingency Disclosure Rules

The Exposure Draft proposed sweeping changes to the disclosure requirements for loss contingencies, including expansion of the required level of qualitative and quantitative disclosure as well as increasing the contingencies subject to disclosure. The proposed changes have since been scaled

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back by the FASB following backlash by interested parties. The original key changes set forth in the Exposure Draft are as follows:

- Disclosure of all loss contingencies unless the company determines the loss to be remote or the potential claimant has not expressed an awareness of the claim, unless it is probable that a claim will be asserted and the likelihood of loss is more than remote;

- Disclosure of specific quantitative information concerning contingent losses, including the amount of damages claimed or maximum exposure to loss;

- A description of the contingency, how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution;

- A description of the factors likely to affect the ultimate outcome of the contingency;

- The company’s assessment of the most likely outcome of the contingency; and

- A description of any applicable insurance or indemnification agreement that may compensate the company for the contingency.

The Board received 242 comment letters on the Exposure Draft, including 20 from law firms critical of the proposed amendments. Attorneys expressed concern that the proposed revisions would compromise attorney-client privilege and the work product doctrine by requiring detailed disclosures about the nature of the contingency, its legal basis, and factors likely to affect the ultimate outcome, as well as specific quantitative information such as estimates of the maximum exposure to loss. For these same reasons, counsel also asserted that the Draft would pose a strategic disadvantage to companies in litigation and settlement negotiations. Following these concerns and the landslide of other critical comment letters, the Board has scaled back its revisions to the loss contingencies disclosure standards.

In August, 2009, the Board began re-deliberations on the topic and thereafter decided upon the following disclosure objective:

- An entity shall disclose qualitative and quantitative information about the loss contingency to enable a financial statement user to understand the nature of the contingency and its potential timing and magnitude.

The Board also established three broad principles for disclosures concerning loss contingencies:

- Disclosures about litigation contingencies should focus on the contentions of the parties, rather than predictions about future outcome;

- Disclosures about a contingency should be more robust as the likelihood and magnitude of loss increase and as the contingency progresses toward resolution; and

- Disclosures should provide a summary of information that is publicly available about a case and indicate where users can obtain more information.

The Board decided upon the following
likelihood of loss is at least reasonably possible and to clarify that “at least reasonably possible” and “more than remote” have the same meaning;

• That certain remote loss contingencies should be disclosed;

• That the entities should not consider the possibility of recoveries from insurance or indemnification arrangements when assessing whether a contingency should be disclosed;

• To maintain the existing threshold for disclosure of unasserted claims and assessments and to enhance the existing interpretative guidance about the threshold;

• To not require companies to disclose information about settlement negotiations; and

• That future guidance should focus on disclosure of non-privileged quantitative information that would be relevant to estimating the potential loss.

On this last point, the Board directed staff to develop an appropriate approach which will be considered at a future meeting. It also appears likely that the Board will impose disclosure requirements for remote contingencies that could have a severe impact upon an entity’s financial position. Financial statement users generally supported more disclosure on such remote contingencies in their comment letters.

VI. Timing of Final Guidance

The Board has previously indicated that the effective date of its changes would be December 15, 2009, and thus, the revisions would be effective for financial statements issued for fiscal years ending after December 15, 2009. The Board has now indicated that a final guidance document should be published in the second quarter of 2010. Although the exact timing and parameters of the FASB’s new guidance are unknown, one should keep a watchful eye out for the ultimate revisions imposed and their impact upon environmental and litigation-related liabilities.
Ben Keller is a member of Wyatt’s Natural Resources & Environmental Law Service Team. He is located in the Firm’s Lexington office.

859.288.7633
bkeller@wyattfirm.com
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