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More Lawsuits May Go on the Books

As FASB debates the best way to improve accounting for contingent liabilities, one thing is clear: potential lawsuit losses are more likely to show up on company balance sheets.

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Companies might need to put more liabilities on their balance sheets if the Financial Accounting Standards Board lowers the threshold for recognizing potential loss from pending litigation.

That's one of the options mentioned by FASB board member Leslie Seidman at the Fifth Annual Financial Reporting Conference at Baruch College in New York City on Thursday. FASB has been contemplating a fair value approach for contingent liabilities, but Seidman suggested that another alternative might simply be to reduce the threshold for when a liability should be recognized.

Currently, under Financial Accounting Standard 5, Recognition and Measurement in Financial Statements of Business Enterprises, public companies must disclose any lawsuit that is likely to produce a loss. To meet that requirement, a defendant in a lawsuit must estimate an 80 percent probability of losing the case and being required to pay damages.

FASB might lower the threshold to 51 percent, the "more likely than not" or "reasonably possible" zone in the probability spectrum, said Seidman.

By contrast, the International Accounting Oversight Board skips the recognition threshold and says a liability should be measured at fair value using expected cash flows. For example, if a company is being sued for $100 million, and it believes it has only a 10 percent chance of losing the legal battle, it should book a $10 million liability.

The possible shift in the recognition threshold for contingent liabilities could be just an interim step in the FASB's march toward fair value and convergence with international accounting standards. Yet some observers express concern about the implications of fair value estimates.

"As [does] any company, we have thousands of lawsuits at any one time," said James Barge, senior vice president and controller at Time Warner. "I'm concerned about someone else's judgment of them." Barge wondered about how a third party's judgment of a fair value assessment of contingent liabilities such as pending lawsuits could impact managers' budgets and compensation.

The debate continues as FASB is considering whether the FAS 5 model for recognizing when a loss is probable is still relevant, especially given the board's goal to improve guidance for measuring fair value.