

Evaluating Loss Contingencies In The COVID-19 Era

By **Gregg Peat and Chad Jimenez** (May 6, 2020)

The investor community and regulators closely scrutinize the accounting for and disclosure of pending lawsuits and government investigations because of the substantial potential impact on companies. Because the COVID-19 pandemic creates growing uncertainties and economic instability, investor community and regulatory scrutiny in this area is likely to increase once the true costs of the pandemic are revealed.

Generally accepted accounting principles presumptively require companies as well as their legal counsel to make judgment calls about contingent losses arising from pending or anticipated litigation and regulatory or law enforcement proceedings or investigations. With limited time and information, companies must evaluate and determine whether the likelihood of a contingent loss is remote, reasonably possible, or probable and, if possible, develop an estimate (or range of estimates) of the potential loss.

This determination has far-reaching consequences and directly affects the amount of accrued losses recorded and/or the nature and extent of disclosures about the various contingencies a company may face at any point in time.



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A Brief Background on Accounting for Loss Contingencies

Accounting Standards Codification Topic 450 presumptively requires companies as well as their legal counsel to evaluate the accounting and disclosure implications of existing conditions, situations and circumstances involving uncertainty as to possible losses (i.e., loss contingencies). While loss contingencies often arise from pending or anticipated litigation, regulatory changes, or enforcement proceedings or investigations, loss contingencies can arise from many circumstances.

When evaluating a loss contingency, companies must determine the likelihood, ranging from remote to probable, of an adverse outcome. Loss contingencies are recorded as losses and disclosed in financial statement notes when the loss is probable and can be reasonably estimated. Loss contingencies are disclosed, but losses are not recorded, when the amounts of a probable loss contingency cannot be reasonably estimated or the likelihood of loss is more than remote, but not probable.

Accounting for Loss Contingencies Relies Heavily on Judgment

First, a company must determine whether a loss contingency exists and, if so, whether an adverse outcome is remote, reasonably possible, or probable. Then a company must determine whether it can reasonably estimate this possible loss.

In practice, it is difficult to evaluate the likelihood and related accounting and disclosure consequences of every possible claim or assessment and threatened litigation. Determining whether an organization even has a loss contingency requires a significant degree of judgment, and identifying potential loss contingencies can be an onerous process. Exacerbating this process and increasing the degree of judgment required to identify

potential loss contingencies are the growing uncertainties regarding possible claims or assessments and threatened litigation resulting from the COVID-19 pandemic.

Even if an organization determines it has a loss contingency, U.S. GAAP does not currently afford companies and their legal counsel relief once (or if) this initial hurdle is overcome because this only triggers the obligation to analyze the probability the event will occur. The likelihood of an event occurring, from remote to reasonably possible, or from reasonably possible to probable, may hinge on subtle factual scenarios that can have significant implications.

Should a company conclude that a loss contingency exists and it is at least reasonably possible a loss will result, judgment must then be applied to estimate the possible loss or range of loss or determine that such an estimate cannot be made. This involves the use of past experience and other information to demonstrate the company's ability to reasonably estimate the loss.

Making this difficult judgment is compounded by the multitude of possible scenarios that may unfold when dealing with complex possible or asserted claims, assessments, and litigation. Given the unprecedented market fluctuations caused by the COVID-19 pandemic, companies may find it especially challenging to develop and support their estimates for loss contingencies.

The Status of Contingencies in Litigation, Compliance and Enforcement

Given the multiple judgment calls, it is no surprise these accounting decisions are actively litigated and continue to be a subject of compliance and enforcement interest today. Over the last year, there have been multiple federal securities class actions brought on behalf of shareholders alleging that companies have failed to properly account for and disclose contingent liabilities rendering their public financial statements materially false and misleading. The SEC also continues to settle multimillion-dollar cases involving charges of alleged failures to account for and disclose loss contingencies arising from government investigations.

This area of accounting was highlighted by the U.S. Securities and Exchange Commission's Division of Enforcement during the December 2019 American Institute of Certified Public Accountants Conference on Current SEC and PCAOB Developments. The SEC staff has also cautioned through various speeches that the recognition of a material loss contingency should typically be foreshadowed through previous disclosure, and that the SEC staff often reviews disclosures preceding the recognition of a loss contingency to assess a company's compliance with GAAP, a review that inherently includes the benefit of hindsight.

The SEC's Division of Corporation Finance also emphasized through its March 25 release of disclosure guidance that consideration should specifically be given to COVID-19-related loss contingency disclosures:

As companies assess COVID-19-related effects and consider their disclosure obligations, questions to consider with respect to their present and future operations include... Do you expect to disclose or incur any material COVID-19-related contingencies?[1]

This area of accounting when challenged by the investor community and regulators, can result in high-stakes litigation with multimillion-dollar exposures. Yet to be seen is the extent of the scrutiny over companies' accounting and disclosures of contingent losses

resulting from the COVID-19 pandemic, which may require significant consideration as organizations begin and continue to communicate the expected impacts that COVID-19 may have on their businesses.

Below are some best practices to limit exposure to scrutiny by the investor community and regulators when accounting for and reporting on this nuanced area of GAAP:

- Ensure there is a documented process in place to identify and evaluate possible claims and assessments, including those which may result from pending or anticipated litigation as well as regulatory or law enforcement proceedings or investigations. This process will provide evidence of the organization's assessment of loss contingency exposures and ensure there is a mechanism through which principal executive and financial officers learn of risks facing their organizations.
- When assessing the probability of and estimating a contingent loss, take into consideration, among other things, (1) the opinion of in-house and/or external legal counsel, including insights they can provide with respect to prior case law; (2) the entity's history and experience with similar cases; (3) how the entity intends to respond to the facts and circumstances underlying the contingency; (4) calculations of potential damages, nature of settlement mechanisms, and settlement offers; and (5) discussions with regulators. Weighing these factors internally can help limit challenges from regulators and the investor community who have the benefit of hindsight.
- Even where the likelihood of a potential loss is not probable, carefully consider whether disclosures are necessary to foreshadow reasonably possible loss contingencies that may ultimately come to fruition. Documented careful consideration of loss contingency disclosure requirements can help limit exposure to SEC staff review if or when loss contingencies are recognized.
- Lastly, revisit the facts and circumstances underlying previous determinations each reporting period, and ensure these periodic assessments are well documented should regulators come knocking on the door.

Undoubtedly, this area will continue to be actively litigated and a subject of compliance and enforcement interest going forward because the required analysis invites scrutiny. Especially as the once future events begin to unfold, and regulators and the investor community have the benefit of hindsight to challenge the previous judgments applied.

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[1] Division of Corporation Finance, Securities and Exchange Commission, CF Disclosure Guidance: Topic No. 9: Coronavirus (COVID-19); March 25, 2020; <https://www.sec.gov/corpfin/coronavirus-covid-19>.