404 How to Set a Reserve

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Faculty Biographies

Christopher M. Holmes

Christopher M. Holmes serves as national director of SEC matters for Ernst & Young (E&Y) in Washington, DC. Mr. Holmes is partner in the national professional practice for E&Y's assurance and advisory business services. Mr. Holmes has extensive experience with corporate financial reporting and SEC filing requirements. Mr. Holmes represents Ernst & Young on the SEC regulations committee of the American Institute of Certified Public Accountants (AICPA). Mr. Holmes also has represented Ernst & Young on the AICPA's task force on acquired in-process research and development and the AICPA's task force on valuing private company equity securities.

Mr. Holmes has served as the coordinating partner for a global information technology company and he currently serves as the concurring partner on a global consumer products company. Mr. Holmes completed a two-year fellowship in the office of the chief accountant at the Securities and Exchange Commission. As a professional accounting fellow, Mr. Holmes was responsible for consulting with registrants on accounting and reporting matters, principally business combinations, the impairment of intangible assets, and non-monetary transactions. Mr. Holmes began his career in the firm's audit practice in Winston-Salem, North Carolina where he served large public manufacturing companies.

Mr. Holmes is a member of the AICPA and the North Carolina Association of Certified Public Accountants.

Mr. Holmes received a B.S. in business administration from the University of North Carolina at Chapel Hill.

Joseph St. Denis

Joseph St. Denis is associate director of risk assessment in the Office of Financial Analysis and Risk Assessment of the Public Company Accounting Oversight Board in Washington, DC.

Mr. St. Denis formerly served as senior director of accounting research and policy at Fitch Ratings, and as an assistant chief accountant in the Securities & Exchange Commission's Division of Enforcement. Mr. St. Denis has also worked as an auditor with Coopers & Lybrand and as a chief financial officer and controller in the technology industry.

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FAS 5 “Accounting for Contingencies”

- Adopted by FASB in 1975
- Principles-Based Accounting Standard
- No “Bright-Line” Rules

FAS 5 Definition of “Loss Contingency”

- An existing condition, situation, or set of circumstances involving uncertainty as to possible loss
- Ultimate resolution requires one or more future events to occur or fail to occur
- Resolution of the uncertainty confirms incurrence of liability (or asset impairment)

FAS 5 Accounting Model

Likelihood	Reasonably Estimable	Action
Probable	Yes	Accrue
Probable	No	Disclose
Reasonably possible	Either	Disclose
Remote	N/A	None

FAS 5 Definitions of Uncertainty

- Probable: "likely to occur"
- Reasonably possible: more than remote but less than likely
- Remote: "slight chance"

Other Probability Definitions in Accounting

- "More likely than not" (a likelihood of more than 50 percent): FAS 109 para. 17 regarding deferred tax valuation allowances
- "Determinable beyond a reasonable doubt": FAS 141 para. 26 regarding recognition of contingently issuable purchase consideration
- "Probable" (that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved): Concepts 6 footnote 18 regarding definition of asset

Accrued Loss Contingencies

- An estimated loss must be accrued if both of the following conditions are met:
  - Information available prior to issuance of the financial statements indicates that it is probable that one or more future events will occur confirming the fact an asset had been impaired or a liability had been incurred at the date of the financial statements
  - The amount of loss can be reasonably estimated

Accrued Loss Contingencies (cont'd)

- Requires consideration of events and developments after the balance sheet date
  - "Type 1 subsequent events" require accounting recognition until the financial statements are issued
  - EITF D-86: filing in SEC report or wide distribution to shareholders; website posting does not qualify
- Disclosure of the nature of an accrual, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading

Disclosed Loss Contingencies

- Disclosure required when there is at least a reasonable possibility that a loss, or an additional loss, may have been incurred
- Disclosure must indicate the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made
- Interim financial statements: For material contingencies, disclosure is required even if there were no significant changes since year end

No Disclosure Required

- Loss contingencies deemed remote
- Unasserted claim or assessment (unless it is probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable)

Considerations for Litigation and Claims

- Nature of the litigation, claim, or assessment
- Progress of the case (until the financial statements are issued)
- Opinions or views of legal counsel and other advisers
- Experience of the enterprise in similar cases
- Experience of other enterprises
- Any decision by management how to respond (e.g., contest the case vigorously, seek an out-of-court settlement)

Reasonable Estimation of Loss

- FASB adopted FIN 14 in 1976
  - When an amount within a range of the likely loss is a better estimate than any other amount, accrue that amount
  - When no amount within the range is a better estimate than any other amount, accrue the minimum amount in the range
  - Disclose reasonably possible losses in excess of the amount accrued

Scenario One

Your company is named as a defendant in a lawsuit and you conclude that on balance you will lose $1,000,000 if a judgment is obtained by the plaintiff. However, you also think that there's only a 30% chance of losing. In such a case, your company's reserve should be:

(a) $300,000
(b) Zero
(c) $1,000,000
(d) None of the above

Scenario Two

Your company is named as a defendant in a lawsuit and you conclude that on balance you will lose $1,000,000 if a judgment is obtained by the plaintiff. You also think that there's a 75% chance of losing. In such a case, your company's reserve should be:

(a) Zero
(b) $750,000
(c) $1,000,000
(d) None of the above

Scenario Three

Your company is named as a defendant in a lawsuit and you conclude that on balance you will lose $1,000,000 if a judgment is obtained by the plaintiff. You are unable to evaluate your company's chance of success if the case goes to trial. In such a case, your company's reserve should be:

(a) Zero
(b) $1,000,000
(c) $500,000
(d) None of the above

Scenario Four

Your company is named as a defendant in a lawsuit and you think that there's a 75% chance of losing, but you are unable to estimate the amount of the loss (it could fall anywhere between zero and $1,000,000). In such a case, your company's reserve should be:

(a) Zero
(b) $750,000
(c) $1,000,000
(d) None of the above

Setting Reserves Tool Kit

- Legal department should establish communication and credibility with:
  - Executive Management
  - Controller
  - Outside Auditors

Setting Reserves Tool Kit

- Speak the Same Language
  - Define the terminology the Legal and Finance/Accounting Departments will use when discussing reserves
  - Co-develop a report that provides historical and analytical information about prior cases
  - Use that report as a tool to:
    - analyze current cases
    - identify possible trends
    - set reserves

Setting Reserves Tool Kit

- Establish a procedure that identifies who makes the final decision on Setting a Reserve
- This procedure should:
  - be approved by Executive Management
  - outline who may provide input into the decision
- The Who (?)
  - CEO
  - General Counsel
  - Chief Litigation Counsel
  - Other Executive

Setting Reserves Tool Kit

- Establish Quarter/Year End Procedures
  - Determine what work can be done before the end of the quarter (i.e. settle, close, or adjust reserves)
  - Representation Letters
    - Internal Certifications
    - Outside Auditor Legal Letters
  - Meeting schedule
    - Outside Counsel
    - Controller
    - Outside Auditors

Materiality Considerations

- Staff Accounting Bulletin No. 99 considerations:
- Does the item
  - Lend itself to precise measurement? Estimate?
  - Mask change in earnings or other trend?
  - Hide failure to meet consensus estimates?
  - Change a loss to income?
  - Concern a key segment?
  - Affect regulatory or loan covenant compliance?
  - Increase management comp?
  - Conceal an unlawful transaction?

Enforcement Actions Involving SFAS 5

- Microsoft
  - Undisclosed reserves used to manage earnings
  - Combined SFAS 5 concepts with securities laws' books & records requirements
- Harlow
  - Undocumented litigation reserves
  - Part of "cookie jar" restructuring

SEC Off-Balance Sheet Report

- Report required under SOX was issued June 15, 2005 and focused on balance sheet transparency – whether accounting reflects underlying economics
- Findings:
  - In practice, FAS 5 disclosures are rarely detailed enough to allow an investor to take into account multiple possible loss outcomes
  - 64% of 200 sample issuers disclosed litigation contingencies in their financial statement notes
  - Less than 10% of the sample issuers disclosed any accrual / reserve for any legal contingent obligation ($10 billion)
  - Sample issuers disclosed almost $32 billion in possible exposures to legal contingencies
  - In many cases, sample issuers disclosed contingent legal obligations, but recognized no liability and disclosed no amount of possible loss

Accounting for Legal Costs

- EITF Topic D-77: Accounting policy election to be disclosed
  - Expense as incurred
  - Accrue when probable and reasonably estimable

SEC Disclosure Requirements

- S-K Item 103
  - Material pending legal proceedings (other than ordinary routine litigation incidental to the business) & proceedings known to be contemplated by governmental authorities
  - Disclose if the amount involved, exclusive of interest and costs, exceeds 10 percent of consolidated current assets, aggregating similar proceedings (lower materiality standards apply to environmental matters)
  - Describe briefly, including: the name of the court or agency, the date instituted, the principal parties, the factual basis alleged and the relief sought
- Schedule II—Valuation and qualifying accounts (?)

Preacquisition contingencies

- FAS 141, *Business Combinations*
  - Record at fair value within allocation period
  - Use FAS 5 if fair value is indeterminable
- FASB Exposure Draft, *Business Combinations*
  - Record at acquisition date fair value
  - Subsequent changes in fair value generally recorded in income

Income Tax Contingencies

- FASB Exposure Draft , *Uncertain Tax Positions*
  - Removes income taxes from scope of FAS 5
  - Recognize benefit if position is “probable” of being sustained
    - Evaluate technical merits of each position individually
    - Assume taxing authority will discover
    - Record “best estimate” of tax benefit
  - Derecognize benefit if position is no longer “more-likely-than-not” of being sustained

International Financial Reporting Standards (IFRS)

- IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*
  - Provide for legal or constructive obligations that are "more likely than not" to require settlement
  - Record the best estimate amount if reliable
  - Derecognize when no longer "more likely than not"
- Proposed amendment to IAS 37
  - Record provisions using an expected cash flow technique (i.e., fair value)

Example Disclosures

Disclaimer: The information below was obtained from SEC filings made by the respective company and presents only excerpts of the full disclosure made by the respective company. This information may have been updated in subsequent filings. For more current information and the full disclosures, please refer to the company's filing, available on EDGAR.

Financial Statement Disclosures: Litigation and Other Contingencies – Litigation

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Exxon Mobil Corporation	10K	12.31.2004	PWC	Energy, Chemicals and Utilities	Footnote; MD&A

Footnote

A variety of claims have been made against ExxonMobil and certain of its consolidated subsidiaries in a number of pending lawsuits and tax disputes. The Corporation accrues an undiscounted liability for those contingencies where the incurrence of a loss is probable and the amount can be reasonably estimated. The Corporation does not record liabilities when the likelihood that the liability has been incurred is probable but the amount cannot be reasonably estimated, or when the liability is believed to be only reasonably possible or remote. ExxonMobil will continue to defend itself vigorously in these matters. Based on a consideration of all relevant facts and circumstances, the Corporation does not believe the ultimate outcome of any currently pending lawsuit against ExxonMobil will have a materially adverse effect upon the Corporation's operations or financial condition.

A number of lawsuits, including class actions, were brought in various courts against Exxon Mobil Corporation and certain of its subsidiaries relating to the accidental release of crude oil from the tanker Exxon Valdez in 1989. The vast majority of the compensatory claims have been resolved. All of the punitive damage claims were consolidated in the civil trial that began in May 1994.

In that trial, on September 24, 1996, the United States District Court for the District of Alaska entered a judgment in the amount of $5 billion in punitive damages to a class composed of all persons and entities who asserted claims for punitive damages from the Corporation as a result of the Exxon Valdez grounding. ExxonMobil appealed the judgment. On November 7, 2001, the United States Court of Appeals for the Ninth Circuit vacated the punitive damage award as being excessive under the Constitution and remanded the case to the District Court for it to determine the amount of the punitive damage award consistent with the Ninth Circuit's holding. The Ninth Circuit upheld the compensatory damage award, which has been paid. On December 6, 2002, the District Court reduced the punitive damage award from $5 billion to $4 billion. Both the plaintiffs and ExxonMobil appealed that decision to the Ninth Circuit. The Ninth Circuit panel vacated the District Court's $4 billion punitive damage award without argument and sent the case back for the District Court to reconsider in light of the recent U.S. Supreme Court decision in Campbell v. State Farm. On January 28, 2004, the District Court reinstated the punitive damage award at $4.5 billion plus interest. ExxonMobil and the plaintiffs have appealed the decision to the Ninth Circuit. The Corporation has posted a $5.4 billion letter of credit.

On January 29, 1997, a settlement agreement was concluded resolving all remaining matters between the Corporation and various insurers arising from the Valdez accident. Under terms of this settlement, ExxonMobil received $480 million. Final income statement recognition of this settlement continues to be deferred in view of uncertainty regarding the ultimate cost to the Corporation of the Valdez accident. Management believes that the likelihood of the judgment being upheld is remote. While it is reasonably possible that a liability may have been incurred arising from the Exxon Valdez grounding, it is not possible to predict the ultimate outcome or to reasonably estimate any such potential liability.

On December 19, 2000, a jury in the 15th Judicial Circuit Court of Montgomery County, Alabama, returned a verdict against the Corporation in a dispute over royalties in the amount of $88 million in compensatory damages and $3.4 billion in punitive damages in the case of Exxon Corporation v. State of Alabama, et al. The verdict was upheld by the trial court on May 4, 2001. On December 20, 2002, the Alabama Supreme Court vacated the $3.5 billion jury verdict. The case was retried and on November 14, 2003, a state district court jury in Montgomery, Alabama, returned a verdict against Exxon Mobil Corporation. The verdict included $63.5 million in compensatory damages and $11.8 billion in punitive damages. On March 29, 2004, the district court judge reduced the amount of punitive damages to $3.5 billion. ExxonMobil believes the judgment is not justified by the evidence, that any punitive damage award is not justified by either the facts or the law, and that the amount of the award is grossly excessive and unconstitutional. ExxonMobil has appealed the decision. Management believes that the likelihood of the judgment being upheld is remote. While it is reasonably possible that a liability may have been incurred by ExxonMobil from this dispute over royalties, it is not possible to predict the ultimate outcome or to reasonably estimate any such potential liability. On May 4, 2004, the Corporation posted a $4.5 billion supersedeas bond as required by Alabama law to stay execution of the judgment pending appeal. The Corporation has pledged to the issuer of the bond collateral consisting of cash and short-term, high-quality securities with an aggregate value of approximately $4.6 billion. This collateral is reported as restricted cash and cash equivalents on the Consolidated Balance Sheet on page 51. Under the terms of the pledge agreement, the Corporation is entitled to receive the income generated from the cash and securities and to make investment decisions, but is restricted from using the pledged cash and securities for any other purpose until such time the bond is canceled.

On May 22, 2001, a state court jury in New Orleans, Louisiana, returned a verdict against the Corporation and three other entities in a case brought by a landowner claiming damage to his property. The property had been leased by the landowner to a company that performed pipe cleaning and storage services for customers, including the Corporation. The jury awarded the plaintiff $56 million in compensatory damages (90 percent to be paid by the Corporation) and $1 billion in punitive damages (all to be paid by the Corporation). The damage related to the presence of naturally occurring radioactive material (NORM) on the site resulting from pipe cleaning operations. The award has been upheld at the trial court. ExxonMobil has appealed the judgment to the Louisiana Fourth Circuit Court of Appeals and believes that the judgment should be set aside or substantially reduced on factual and constitutional grounds. Management believes that the likelihood of the judgment being upheld is remote. While it is reasonably possible that a liability may have been incurred by ExxonMobil from this dispute over property damages, it is not possible to predict the ultimate outcome or to reasonably estimate any such potential liability.

In Allapattah v. Exxon, a jury in the United States District Court for the Southern District of Florida determined in January 2001 that a class of all Exxon dealers between March 1983 and August 1994 had been overcharged between 1.03 and 1.4 cents per gallon for gasoline. Exxon sold a total of 39.8 billion gallons of gasoline to its dealers during this period. The estimated value of the potential claims associated with the 39.8 billion gallons of gasoline is $494 million. Including related interest, the total is approximately $1.3 billion. On June 11, 2003, the Eleventh Circuit Court of Appeals affirmed the judgment and on March 15, 2004,

denied a petition for Rehearing En Banc. On October 12, 2004, the U.S. Supreme Court granted review of an issue raised by ExxonMobil as to whether the class in the District Court judgment should include members that individually do not satisfy the $50,000 minimum amount-in-controversy requirement in federal court. Members of the class could file claims through December 1, 2004. Claims representing over 90 percent of the gallons have been filed. In light of the Supreme Court's decision to grant review of only part of ExxonMobil's appeal, ExxonMobil took an after-tax charge of $550 million in the third quarter reflecting the estimated liability, including interest and after considering potential set-offs and defenses, for the claims in excess of $50,000.

MD&A

Based on a consideration of all relevant facts and circumstances, the Corporation does not believe the ultimate outcome of any currently pending lawsuit against ExxonMobil will have a materially adverse effect upon the Corporation's operations or financial condition. There are no events or uncertainties known to management beyond those already included in reported financial information that would indicate a material change in future operating results or financial condition.

Financial Statement Disclosures: Other Commitments and Contingencies – Litigation

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Masco Corporation	10K	12.31.2004	PWC	Retail and Consumer Products	Footnote

As the Company reported in previous filings, late in the second half of 2002, the Company and its subsidiary, Behr Process Corporation, agreed to two Settlements (the National Settlement and the Washington State Settlement) to resolve all class action lawsuits pending in the United States involving certain exterior wood coating products formerly manufactured by Behr.

The following is a reconciliation of the Company's Behr Process Settlement liability, in millions:

	2004	
	WASHINGTON STATE SETTLEMENT	NATIONAL SETTLEMENT
Balance at January 1	$ 53	$10
Payments on claims	(13)	(1)
Insurance proceeds	(9)	(1)
Adjustment of accrual	(20)	-
Balance at December 31	$ 11	$ 8

The deadlines for filing claims were September 2, 2003 for the National Settlement and January 17, 2004 for the Washington State Settlement.

During 2004, the Company estimated the average cost per claim received related to the Washington State Settlement, and, as a result, estimated that the remaining unpaid claims and administration costs would be approximately $20 million less than estimated at December 31, 2003. Accordingly, the Company reduced the litigation accrual (recognizing income) by $20 million in 2004.

Proceeds from insurance carriers are recognized as income when Behr and its carriers agree on such amounts. The Company expects that the evaluation, processing and payment of claims for both the Washington State Settlement and the National Settlement will be substantially completed by March 31, 2005.

Financial Statement Disclosures: Other Commitments and Contingencies – Litigation

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Masco Corporation	10K	12.31.2003	PWC	Retail and Consumer Products	Footnote

As the Company reported in previous filings, late in the second half of 2002, the Company and its subsidiary, Behr Process Corporation, agreed to two Settlements (the National Settlement and the Washington Settlement) to resolve all class action lawsuits pending in the United States involving certain exterior wood coating products formerly manufactured by Behr. As a result, in the third quarter of 2002, the Company took a litigation charge of approximately $68 million for the estimated cost of the Washington Settlement. This charge did not reflect any offsets for amounts the Company expected to receive from Behr's insurers. The charge included $55 million for the payment of claims, notice, claims administration and plaintiff's litigation costs, and $13 million for Class Counsel fees. In the first quarter of 2003, the Company recorded income of approximately $14 million, principally to reflect an agreement with Behr's insurers to fund a portion of the Class Counsel fees, notice and claims administration costs and plaintiff's litigation costs. Pursuant to the terms of the Washington Settlement and orders entered by the trial court in October and December 2003, the Company and Behr's insurers made partial payments totaling $2 million on 412 claims that had been recommended for payment by the claims administrator. The deadline for claims in the Washington Settlement was January 17, 2004. Until all claims are processed, the Company has determined that no further adjustment of its original estimate would be appropriate. The Company expects that the evaluation, processing and payment of claims will be completed by September 30, 2004. The total amount of the insurers' contribution related to these claims will not be reasonably estimable until the claims process is completed. The remaining accrual for claims and administration costs is approximately $53 million, reflecting the receipt of approximately $14 million in 2003 from Behr's insurers.

In the third quarter of 2002, the Company also took a litigation charge of $96 million for the estimated cost of the National Settlement, which included $66 million for the payment of claims, $25 million for Class Counsel fees and $5 million for notice and claims administration costs. As with the Washington Settlement, the charge did not reflect any offsets for amounts the Company expected to receive from Behr's insurers. In the fourth quarter of 2002, the Company recorded income of $19 million to reflect an agreement with Behr's insurers to fund a portion of the Class Counsel fees, and notice and claims administration costs. The filing deadline for claims in the National Settlement was September 2, 2003 and the Company received approximately 3,700 claims, which was a fraction of the number originally projected. The Company estimated the average cost per claim received and, as a result, estimated that the total cost of claims related to the National Settlement will approximate $8 million compared with the $66 million recorded in the third quarter of 2002. Accordingly, the Company reduced the litigation accrual by $58 million in the third quarter of 2003. The total amount of the insurers' contribution related to these claims will not be reasonably estimable until the claims process is completed. The remaining accrual at December 31, 2003 related to claims and administrative costs is approximately $10 million. The Company expects to complete the processing, evaluation and payment of such claims by June 30, 2004.

Financial Statement Disclosures: Commitments and Contingencies – Litigation, Claims and Assessments

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Sprint Corporation	10K	12.31.2004	KPMG	Technology, Communications and Entertainment	Footnote

In March 2004, eight purported class action lawsuits relating to the recombination of the tracking stocks were filed against Sprint and its directors by holders of PCS common stock. Seven of the lawsuits were consolidated in the District Court of Johnson County, Kansas. The eighth, pending in New York, has been voluntarily stayed. The consolidated lawsuit alleges breach of fiduciary duty in connection with allocations between the FON Group and the PCS Group before the recombination of the tracking stocks and breach of fiduciary duty in the recombination. The lawsuit seeks to rescind the recombination and monetary damages. In February 2005, the court denied defendants' motion to dismiss the compliant. All defendants have denied plaintiffs' allegations and intend to vigorously defend this matter.

A number of putative class action cases that allege Sprint failed to obtain easements from property owners during the installation of its fiber optic network in the 1980's have been filed in various courts. Several of these cases sought certification of nationwide classes, and in one case, a nationwide class was certified. In 2002, a nationwide settlement of these claims was approved by the U.S. District Court for the Northern District of Illinois, but objectors appealed the preliminary approval order to the Seventh Circuit Court of Appeals. In October, 2004, the Seventh Circuit Court of Appeals overturned the settlement approval and remanded the case to the trial court for further proceedings. The settling parties have filed a petition for certiorari to the U.S. Supreme Court. In 2001, Sprint accrued for the estimated settlement costs of these suits.

In 2003, participants in the Sprint Retirement Savings Plan, the Sprint Retirement Savings Plan for Bargaining Unit Employees and the Centel Retirement Savings Plan for Bargaining Unit Employees filed suit in the U.S. District Court for the District of Kansas against Sprint, the committees that administer the plans, the plan trustee, and various current and former directors and officers. The consolidated lawsuit alleges that defendants breached their fiduciary duties to the plans and violated the ERISA statutes by making the company contribution in FON common stock and PCS common stock and including FON common stock and PCS common stock among the more than thirty investment options offered to plan participants. The lawsuit seeks to recover any decline in the value of FON common stock and PCS common stock during the class period. All defendants have denied plaintiffs' allegations and intend to vigorously defend this matter.

In September 2004, the U.S. District Court for the District of Kansas denied a motion to dismiss a shareholder lawsuit alleging that Sprint's 2001 and 2002 proxy statements were false and misleading in violation of federal securities laws to the extent they

Legal Contingencies

described new employment agreements with senior executives without disclosing that, according to the allegations, replacement of those executives was inevitable. These allegations, made in an amended complaint in a lawsuit originally filed in 2003, are asserted against Sprint and certain current and former officers and directors. The lawsuit seeks to recover any decline in the value of FON common stock and PCS common stock during the class period. Following denial of the dismissal motion, the parties stipulated that the case can proceed as a class action. All defendants have denied plaintiffs' allegations and intend to vigorously defend this matter. The allegations in the original complaint, which asserted claims against Sprint, certain current and former officers and directors, and Sprint's former independent auditor, were dismissed by the court in April 2004.

Various other suits, proceedings and claims, including purported class actions, typical for a business enterprise, are pending against Sprint.

While it is not possible to determine the ultimate disposition of each of these proceedings and whether they will be resolved consistent with Sprint's beliefs, Sprint expects that the outcome of such proceedings, individually or in the aggregate, will not have a material adverse effect on the financial condition or results of operations of Sprint or its business segments.

Disclosure from 2001 Form 10-K

A number of putative class action cases that allege Sprint failed to obtain easements from property owners during the installation of its fiber optic network are in process, some of them seeking certification as nationwide classes. Settlement negotiations directed to a nationwide, industry-wide settlement of these claims have resulted in an agreement, not yet approved by all parties involved in the actions or by the Court. Sprint recorded a charge for estimated settlement costs of $24 million in the fourth quarter of 2001.

Financial Statement Disclosures: Legal Proceedings and Contingencies

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Bristol-Myers Squibb Company	10K	12.31.2004	PWC	Health Sciences	Footnote

Various lawsuits, claims, proceedings and investigations are pending against the Company and certain of its subsidiaries. In accordance with SFAS No. 5, Accounting for Contingencies, the Company records accruals for such contingencies when it is probable that a liability will be incurred and the amount of loss can be reasonably estimated. These matters involve antitrust, securities, patent infringement, the Employee Retirement Income Security Act of 1974, as amended (ERISA), pricing, sales and marketing practices, environmental, health and safety matters, product liability and insurance coverage. The most significant of these matters are described below. There can be no assurance that there will not be an increase in the scope of these matters or that any future lawsuits, claims, proceedings or investigations will not be material. Management continues to believe, as previously disclosed, that during the next few years, the aggregate impact, beyond current reserves, of these and other legal matters affecting the Company is reasonably likely to be material to the Company's results of operations and cash flows, and may be material to its financial condition and liquidity.

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Bristol-Myers Squibb Company	10K	12.31.2003	PWC	Health Sciences	Footnote

Various lawsuits, claims, proceedings and investigations are pending against the Company and certain of its subsidiaries. In accordance with SFAS No. 5, Accounting for Contingencies, the Company records accruals for such contingencies when it is probable that a liability will be incurred and the amount of loss can be reasonably estimated. These matters involve antitrust, securities, patent infringement, the Employee Retirement Income Security Act of 1974, as amended (ERISA), pricing, sales and marketing practices, environmental, health and safety matters, product liability and insurance coverage. The most significant of these matters are described below.

In the fourth quarter of 2003, the Company established reserves for liabilities of $250 million, comprised of $150 million in relation to wholesaler inventory issues and certain other accounting matters as discussed below under Other Securities Matters, and $100 million in relation to pharmaceutical pricing and sales and marketing practices as discussed below under Pricing, Sales and Promotional Practices Litigation and Investigations. It is not possible at this time to reasonably assess the final outcome of these matters. In accordance with GAAP, the Company has determined that the above amounts represent minimum expected probable losses with respect to these groups of matters. Eventual losses related to these matters may exceed these reserves, and the further impact of either one of these groups of matters could be material. The Company does not believe that the top-end of the range for these losses can be estimated.

Financial Statement Disclosures: Litigation and Contingencies – Pending Litigation and Proceedings

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Hewlett-Packard Company	10K	10.31.2004	E&Y	Retail and Consumer Products	Footnote

The Government of Canada conducted cost audits of certain contracts between Public Works and Government Services Canada ("PWGSC") and each of Compaq Canada Corp. and Hewlett-Packard (Canada) Co. relating to services provided to the Canadian Department of National Defence ("DND"). Compaq Canada Corp. was combined with Hewlett-Packard (Canada) Co. following HP's acquisition of Compaq. HP cooperated fully with the audit and has conducted its own inquiry, sharing the results of its investigation with PWGSC and DND. On May 14, 2004, HP announced that it had resolved the dispute with the Government of Canada. HP Canada agreed to reimburse the Government of Canada the sum of CDN$146 million (approximately US$105 million), an amount determined by both parties to be appropriate upon investigation. HP recorded $70 million in the second quarter of fiscal 2004 and had recorded $35 million in the prior fiscal year. HP determined that it was important for HP to honor its contractual obligations, rather than engage in protracted litigation with the Government of Canada, despite the lack of evidence that HP employees derived any improper benefit from the complex scheme designed to exploit both parties. HP has initiated proceedings to recover these funds from responsible individuals, and continues to consider further proceedings against others to recover additional funds.

HP is involved in lawsuits, claims, investigations and proceedings, including those identified above, consisting of intellectual property, commercial, securities, employment, employee benefits and environmental matters, which arise in the ordinary course of business. In accordance with SFAS No. 5, "Accounting for Contingencies," HP makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. HP believes it has adequate provisions for any such matters. HP reviews these provisions at least quarterly and adjusts these provisions to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Based on its experience, HP believes that any damage amounts claimed in the specific matters discussed above are not a meaningful indicator of HP's potential liability. Litigation is inherently unpredictable. However, HP believes that it has valid defenses with respect to legal matters pending against it. Nevertheless, it is possible that cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies.

Financial Statement Disclosures: Commitments and Contingent Liabilities

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Cardinal Health, Inc.	10K	6.30.2004	E&Y	Health Sciences	Footnote

Latex Litigation

On September 30, 1996, Baxter International Inc. ("Baxter") and its subsidiaries transferred to Allegiance Corporation and its subsidiaries ("Allegiance"), which were acquired by the Company in February 1999, Baxter's U.S. health care distribution business, surgical and respiratory therapy business and health care cost-management business, as well as certain foreign operations (the "Allegiance Business") in connection with a spin-off of the Allegiance Business by Baxter (the "Baxter-Allegiance Spin-Off"). In connection with this spin-off, Allegiance Corporation, which merged with a subsidiary of the Company on February 3, 1999, agreed to indemnify Baxter, and to defend and indemnify Baxter Healthcare Corporation ("BHC"), as contemplated by the agreements between Baxter and Allegiance Corporation, for all expenses and potential liabilities associated with claims arising from the Allegiance Business, including certain claims of alleged personal injuries as a result of exposure to natural rubber latex gloves. The Company is not a party to any of the lawsuits and has not agreed to pay any settlements to the plaintiffs.

As of June 30, 2004, there were 36 lawsuits pending against BHC and/or Allegiance involving allegations of sensitization to natural rubber latex products, and some of these cases were proceeding to trial. The total dollar amount of potential damages cannot be reasonably quantified. Some plaintiffs plead damages in extreme excess of what they reasonably can expect to recover, some plead a modest amount and some do not include a request for any specific dollar amount. Not including cases that ask for no specific damages, the damage requests per action have ranged from $10,000 to $240 million. All of these cases name multiple defendants, in addition to Baxter/Allegiance. The average number of defendants per case exceeds 25. Based on the significant differences in the range of damages sought and, based on the multiple number of defendants in these lawsuits, Allegiance cannot reasonably quantify the total amount of possible/probable damages. Therefore, Allegiance and the Company do not believe that these numbers should be considered as an indication of either reasonably possible or probable liability.

Since the inception of this litigation, Baxter/Allegiance have been named as a defendant in 834 cases. During the fiscal year ended June 30, 2002, Allegiance began settling some of these lawsuits with greater frequency. As of June 30, 2004, Allegiance had resolved more than 90% of these cases. About 20% of the lawsuits that have been resolved were concluded without any liability to Baxter/Allegiance. No individual claim has been settled for a material amount and all the settled claims through June 30, 2004 amounted to, in the aggregate, approximately $28 million. Due to the number of claims filed and the ongoing defense costs that will be incurred, Allegiance believes it is probable that it will incur substantial legal fees related to the resolution of the cases still pending. Although the Company continues to believe that it cannot reasonably estimate the potential cost to settle these lawsuits, the Company believes that the impact of such lawsuits upon Allegiance will be immaterial to the Company's financial position, liquidity or results of operations, and could be in the range of $0 to $20 million, net of insurance proceeds (with the

range reflecting the Company's reasonable estimation of potential insurance coverage, and defense and indemnity costs). The Company believes a substantial portion of any liability will be covered by insurance policies Allegiance has with financially viable insurance companies, subject to self-insurance retentions, exclusions, conditions, coverage gaps, policy limits and insurer solvency. The Company and Allegiance continue to believe that insurance recovery is probable.

Derivative Actions

On November 8, 2002, a complaint was filed by a purported shareholder against the Company and its directors in the Court of Common Pleas, Delaware County, Ohio, as a purported derivative action. On or about March 21, 2003, after the Company filed a Motion to Dismiss the complaint, an amended complaint was filed alleging breach of fiduciary duties and corporate waste in connection with the alleged failure by the Board of Directors of the Company to (a) renegotiate or terminate the Company's proposed acquisition of Syncor, and (b) determine the propriety of indemnifying Monty Fu, the former Chairman of Syncor. The Company filed a Motion to Dismiss the amended complaint and the plaintiffs subsequently filed a second amended complaint that added three new individual defendants and included new allegations that the Company improperly recognized revenue in December 2000 and September 2001 related to settlements with certain vitamin manufacturers. The Company filed a Motion to Dismiss the second amended complaint and, on November 20, 2003, the Court denied the motion. Discovery is proceeding in this action. The defendants intend to vigorously defend this action. The Company currently does not believe that the impact of this lawsuit will have a material adverse effect on the Company's financial position, liquidity or results of operations.

Financial Statement Disclosures: Commitments, Contingencies and Guarantees – Litigation

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Merrill Lynch & Co., Inc.	10K	12.31.2004	D&T	Financial Services	Footnote

Merrill Lynch has been named as a defendant in various legal actions, including arbitrations, class actions, and other litigation arising from its activities as a global diversified financial services institution. The general decline of equity securities prices between 2000 and 2003 has resulted in increased legal actions against many firms, including Merrill Lynch, and has resulted in higher professional fees and litigation expenses than those incurred in the past. Some of the legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. In some cases, the issuers who would otherwise be the primary defendants in such cases are bankrupt or otherwise in financial distress. Merrill Lynch is also involved in investigations and/or proceedings by governmental and self-regulatory agencies. The number of these investigations has also increased in recent years with regard to many firms, including Merrill Lynch.

Given the number of these matters, some are likely to result in adverse judgments, settlements, penalties, injunctions, fines, or other relief. Merrill Lynch believes it has strong defenses to, and where appropriate, will vigorously contest many of these matters. In accordance with SFAS No. 5, Accounting for Contingencies, when resolution of cases is both probable and estimable, Merrill Lynch will accrue a liability. In many lawsuits and arbitrations, including class actions, it is not possible to determine whether a liability has been incurred or to estimate the ultimate or minimum amount of that liability until the case is close to resolution, in which case no accrual is made until that time. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, Merrill Lynch cannot predict what the eventual loss or range of loss related to such matters will be. Merrill Lynch continues to assess these matters and believes, based on information available to it, that the resolution of these matters will not have a material adverse effect on the financial condition of Merrill Lynch as set forth in the Consolidated Financial Statements, but may be material to Merrill Lynch's operating results or cash flows for any particular period and may impact ML & Co.'s credit ratings.

Financial Statement Disclosures: Contingencies

Company Name:	Form Type:	Fiscal Period Ending Date:	Auditor:	Industry:	Filing Section:
Citigroup Inc.	10K	12.31.2004	KPMG	Financial Services	Footnote

As described in the "Legal Proceedings" discussion on page 141, the Company is a defendant in numerous lawsuits and other legal proceedings arising out of alleged misconduct in connection with:
(i) underwritings for, and research coverage of, WorldCom;

(ii) underwritings for Enron and other transactions and activities related to Enron and Dynegy;

(iii) transactions and activities related to research coverage of companies other than WorldCom; and

(iv) transactions and activities related to securities sold in initial public offerings.

During the 2004 second quarter, in connection with the settlement of the WorldCom class action, the Company reevaluated and increased its reserves for these matters. The Company recorded a charge of $7.915 billion ($4.95 billion after-tax) relating to (i) the settlement of class action litigation brought on behalf of purchasers of WorldCom securities, and (ii) an increase in litigation reserves for the other matters described above. Subject to the terms of the WorldCom class action settlement, and its eventual approval by the courts, the Company will make a payment of $2.575 billion, or $1.59 billion after-tax, to the WorldCom settlement class. As of December 31, 2004, the Company's litigation reserve for these matters, net of the amount to be paid upon final approval of the WorldCom class action settlement, was $6.64 billion on a pretax basis.

The Company believes that this reserve is adequate to meet all of its remaining exposure for these matters. However, in view of the large number of these matters, the uncertainties of the timing and outcome of this type of litigation, the novel issues presented, and the significant amounts involved, it is possible that the ultimate costs of these matters may exceed or be below the reserve. The Company will continue to defend itself vigorously in these cases, and seek to resolve them in the manner management believes is in the best interests of the Company.

In addition, in the ordinary course of business, Citigroup and its subsidiaries are defendants or co-defendants or parties in various litigation and regulatory matters incidental to and typical of the businesses in which they are engaged. In the opinion of the Company's management, the ultimate resolution of these legal and regulatory proceedings would not be likely to have a material adverse effect on the consolidated financial condition of the Company but, if involving monetary liability, may be material to the Company's operating results for any particular period.

E. Contingent Obligations and Guarantees

1. Nature of Arrangements and Financial Reporting Requirements

Issuers are often involved in situations where uncertainty exists about whether an obligation to transfer cash or other assets has arisen and/or the amount that will be required to settle such obligation. Examples include:

- Where an issuer is a defendant in a lawsuit and any payment is contingent upon the outcome of a settlement or an administrative or court proceeding;
- Where an issuer provides a warranty for a product it sells and any payment is contingent on the number of products that actually become defective and qualify for benefits under the warranty; and
- Where an issuer acts as a guarantor on a loan for another entity and any payment is contingent on whether the other entity defaults.

Broadly, these kinds of situations are referred to as contingent obligations.[164] The difficult accounting question is what, if any, liability should be recognized before such contingencies are resolved. SFAS No. 5, Accounting for Contingencies, provides general guidance regarding the accounting for contingent obligations, although certain contingent obligations are specifically addressed in other standards.[165] Under SFAS No. 5, contingent obligations are treated in one of three ways depending on the circumstances. In order to conclude which treatment is applicable, an initial two-fold determination is made as to whether the loss itself is deemed "probable" to occur and whether the amount of the loss is estimable.

Recognition of a liability is required if the loss is deemed "probable" and estimable; the amount to be recognized is the most likely outcome—i.e., the individual loss amount with the highest probability. No liability is recognized on the balance sheet, but disclosures are required to inform users of the existence of the potential loss if a) the loss is deemed "probable," but an amount cannot be reasonably estimated, or b) the loss is deemed "reasonably possible," but not "probable." Neither recognition of a liability nor disclosure is required if the probability of loss is deemed "remote."

Consider an example where an issuer is a defendant in a lawsuit. Assume the following three possible outcomes and related probabilities of occurrence:

Outcome	Probability (A)	Amount to be Paid (B)	Probability-Weighted Amount to be Paid (A x B)
Issuer is found liable	5 %	$500,000	$ 25,000
Issuer settles	90 %	$ 50,000	$ 45,000
Issuer wins lawsuit	5 %	$ 0	$ 0
Total	100 %		$70,000

Under SFAS No. 5, the loss would be deemed "probable," given the 95% likelihood of a loss occurring. A liability would be recognized in the amount of $50,000, because this amount is the most likely loss amount.

Required disclosures under SFAS No. 5 include the nature of the contingency, the range of the reasonably possible losses, and the amount recognized on the balance sheet, if any.[166]

SFAS No. 5 addresses uncertainty by using the probability of loss as a threshold in determining whether a liability should be recognized and for how much. In the context of SFAS No. 5, there appear to be some range of interpretations as to how high the likelihood of occurrence must be to be deemed "probable," but by all accounts this likelihood is substantially higher than a 50%+ threshold that common parlance might assign to the term. If a liability is recognized, that liability is measured as the amount that constitutes the most likely outcome.

In contrast to the SFAS No. 5 approach, some recent accounting guidance requires that certain obligations that include contingencies be recognized at fair value. Under a fair value approach, the degree of uncertainty associated with a contingent liability is reflected in the measurement of the liability, rather than in the determination of whether a liability is recognized.

Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, issued in 2002 in light of the then-recent corporate scandals and passage of the Sarbanes-Oxley Act, requires certain guarantees to be initially recognized on the balance sheet at fair value.[167]

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[164]Although contingencies may represent either potential assets or liabilities, the Staff focuses here on contingent obligations, as these tend to result in more reporting questions.

[165]For example, guidance related to the accounting for insurance is provided by SFAS No. 60 and other standards, and guidance related to the accounting for derivatives is provided by SFAS No. 133.

[166]Additional disclosures regarding loss contingencies may be required by Staff Accounting Bulletin Topic 5Y, Accounting and Disclosures Relating to Loss Contingencies, Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties, and Statement of Position No. 96-1, Environmental Remediation Liabilities, among others. In addition, Item 103 of Regulation S-K requires certain descriptive information to be disclosed regarding legal proceedings.

[167]In developing the fair value model, FASB indicated that, over the life of a guarantee, a guarantor takes the obligation to "stand ready" to honor the guarantee, and that the stand-ready obligation is not itself

One method used by issuers in determining the fair value of contingent obligations is presented by SFAC No. 7, Using Cash Flow Information and Present Value in Accounting Measurements. This method of estimating fair value is based on probability-weighted discounted cash flows consistent with the economic concept known as "expected value".

For example, consider a simple example in which an issuer who writes a guarantee covering the default on a third-party's debt with the following three outcomes and probabilities:

Outcome	Probability (A)	Amount to be Paid (B)	Probability Weighted Amount to be Paid (A x B)
Third party defaults entirely	5 %	$100,000	$ 5,000
Third party defaults on ¾ of debt	10 %	$ 75,000	$ 7,500
Third party does not default	85 %	$ 0	$ 0
Total	100 %		$12,500

If a contingency accounted for under the SFAS No. 5 approach had the above potential outcomes, no liability would be recognized, since the occurrence of a loss is not "probable" (i.e., a loss occurs with only 15% probability). However, under the accounting specified by Interpretation No. 45, the writer of this guarantee would recognize a liability of $12,500, which constitutes the fair value[168] of the guarantee.

Notably, all types of guarantees are not included in the scope of Interpretation No. 45. Further, the requirement of Interpretation No. 45 to recognize guarantees on the balance sheet at fair value only applied to those issued or modified after December 31, 2002. However, Interpretation No. 45 introduced new disclosure requirements, which were applicable regardless of the date of the guarantee's issuance or modification. The disclosures required in the notes to the financial statements include, but are not limited to, the following:[169]

- Nature of the guarantee;
- Maximum potential future payments;
- Current amount of liability on the balance sheet; and
- Certain product warranty information, including a reconciliation of changes in the liability.

The Commission's Financial Reporting Release No. 67, mandated by section 401(a) of the Act, also requires additional disclosures in the Off-Balance Sheet section of MD&A regarding certain guarantee contracts. Disclosure is required to the extent

contingent. The liability for the stand-ready obligation is reduced over time as the guarantee performs (that is, as it fulfills its obligation to stand ready over the life of the contract).

[168]The time value of money is ignored in this example.

[169]The required disclosures are presented in paragraphs 13-16 of Interpretation No. 45.

necessary to provide an understanding of the issuer's material off-balance sheet arrangements as well as the material effects of those arrangements. For guarantee contracts these disclosures may include:

- Nature and business purpose of the guarantee contracts;
- Importance of the guarantee contracts to liquidity, capital resources, market risk or credit risk support, or other benefits;
- The financial impact of the guarantee contracts and the issuer's exposure to risk as a result of the guarantees; and
- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits of the guarantee contracts.

2. Off-Balance Sheet Issues in Accounting for Contingent Obligations and Guarantees

In accounting for contingent liabilities, how uncertainty is taken into account will affect which items are reflected on the balance sheet. Although both approaches appear to generate information that would be useful to users of financial statements, differing views exist as to which treatment provides the most relevant information.

If uncertainty is taken into account in the recognition of liabilities, as is the case for contingencies accounted for under SFAS No. 5, the balance sheet will report those liabilities that are highly likely to reduce cash or other assets available for distribution to shareholders. In addition, the items on the balance sheet would be reported at the amount most likely to be paid or received. However, several issues arise from this treatment. First, while the SFAS No. 5 accounting results in the recording of a liability that reflects the most likely payment, the balance sheet reflects information about only that outcome. Information about the other potential outcomes is ignored for the purpose of recording the liability. While disclosures in the notes to the financial statements might help to provide this information, in practice those disclosures are rarely detailed enough to allow an investor to take into account multiple possible loss outcomes.

Difficulties in applying the SFAS No. 5 approach also arise because that approach requires an analysis of whether a loss is probable. Although accountants generally agree, in practice, on the percentage likelihood that is necessary to conclude that a loss is probable, determining whether the loss in a particular situation exceeds that threshold can be subjective. In addition, it may be difficult for others to independently verify management's judgments in these areas. Application issues have also arisen in regards to determining the most likely amount of a loss when a range of possible losses exists. If one amount within the range is a better estimate than any other amount, that amount should be recognized. If no amount is considered a better estimate than any other amount, the minimum amount in the range is recognized.[170] In practice, zero may arguably be the low point of the range in many cases, resulting in no liability being

[170]FASB Interpretation No. 14, "Reasonable Estimate of the Amount of Loss".

reflected. The Staff has long believed that the application of SFAS No. 5 by issuers should be improved, and has commented on this numerous times in speeches and other venues. The needed improvements include better application of both the recognition and disclosure criteria of SFAS No. 5.

Some of the difficulties in accounting for contingencies under SFAS No. 5 are not faced in accounting for contingencies under pronouncements in which uncertainty is reflected in measurement, rather than recognition, of a liability. If uncertainty is taken into account in measuring the contingent liability, the value reflected on the balance sheet represents the value the market would assign to the contingent liability in assessing the value of the issuer; thus, information that a market participant would consider relevant is not ignored. However, the liability recorded in these situations may not actually represent a possible outcome upon ultimate resolution of the contingency.[171]

Reflecting uncertainty in the measurement of the liability also removes some of the pressure on the "probable" determination, and on the identification of the particular outcome that is most likely. In addition, this approach would rarely, if ever, omit a contingent obligation from the balance sheet entirely. However, if determining the probability of loss and the most likely amount of that loss, as required under SFAS No. 5, is difficult and subject to judgment, determining the probabilities of multiple potential outcomes, as required under Interpretation No. 45, may be even more difficult. Some argue that a fair value approach could result in less reliable financial statements and make auditing those statements even more challenging. Others, however, note that the fair value approach ensures that contingencies relevant to assessing an issuer's value are at least acknowledged in a fair value approach, in contrast to the SFAS No. 5 approach, which could allow many of those contingencies to go entirely unrecognized.

3. Empirical Findings from Study of Filings by Issuers

In this section, the Staff presents empirical findings from the Study of filings by issuers related to contingent obligations, including guarantees. The Staff also extrapolates from these findings to estimate amounts for the approximate population of active U.S. issuers.

Table III(E)(1) describes the percentage of issuers reporting certain contingent liabilities. As indicated in the table, approximately 64% of the sample issuers report information about some litigation contingencies in their notes to the financial statements and approximately 55% report information about guarantees. Substantially fewer, 21%, report information about environmental contingent obligations. The Staff noted during its analysis of the filings that disclosures about contingent obligations vary widely in terms of format and location in the filing. As a result, the data for contingent obligations was difficult to collect in a consistent manner across issuers.

[171] In the example used previously, the three possible outcomes are losses of zero, $75,000, and $100,000, yet the fair value that would be recorded is $12,500.

TABLE III(E)(1): Issuers Reporting Certain Contingent Obligations [a]

Categorized by Type of Contingent Obligation [b]	Full Sample (n=200) (%)	Sub-Samples: Large Issuers (n=100) (%)	Sub-Samples: Random Issuers (n=100) (%)	Estimate for Population (N=10,100) (%)
Issuers reporting legal contingent obligations	63.5	81	46	46.3
Issuers reporting environmental contingent obligations	20.5	31	10	10.2
Issuers reporting guarantees	54.5	74	35	35.4

[a] These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.
[b] These categories are not mutually exclusive.

Table III(E)(2) describes the percentage of issuers reporting recognition of liabilities on their balance sheets for certain contingent liabilities. Less than 10% of the sample issuers report that they have recognized any amount of liability on their balance sheets for any legal contingent obligation, even though approximately 64% of the sample issuers report general information regarding legal contingent obligations. Approximately 23% of the sample issuers report that they have recognized a liability for guarantees, less than half of the 55% of issuers reporting information about the existence of guarantees. Before the implementation of Interpretation No. 45 in 2002, the Staff suspects that few of these guarantees would have been recognized as liabilities on issuer balance sheets.

TABLE III(E)(2): Issuers Reporting Liabilities for Certain Contingent Obligations on their Balance Sheets [a]

Categorized by Type of Contingent Obligation [b]	Full Sample (n=200) (%)	Sub-Samples: Large Issuers (n=100) (%)	Sub-Samples: Random Issuers (n=100) (%)	Estimate for Population (N=10,100) (%)
Issuers recognizing liabilities for legal contingent obligations	9.5	14	5	5.1
Issuers recognizing liabilities for environmental contingent obligations	10	15	5	5.1
Issuers recognizing liabilities for guarantees	22.5	35	10	10.2

[a] These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.
[b] These categories are not mutually exclusive.

The analysis of this topic so far has focused on the proportion of issuers reporting information about various types of contingent obligations. We now turn to an analysis of the amount of liabilities recognized on issuer balance sheets and the exposures reported in the notes to the financial statements.

Table III(E)(3) presents reported amounts of contingent obligations recognized as liabilities on issuer balance sheets, to the extent they are reported as such in the notes to the financial statements.[172] Issuers in the sample report that they had recognized liabilities on their balance sheets of approximately $10 billion related to legal contingent liabilities, approximately $9 billion related to environmental contingent liabilities, and almost $86 billion related to liabilities related to guarantees. In each of these three categories, at least 98% of the total liability recognized was recognized by the large issuer sub-sample.[173] An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that legal contingent liabilities reported by the total population are approximately $12 billion, environmental contingent liabilities are approximately $19 billion, and guarantees are approximately $124 billion.

TABLE III(E)(3): Amounts Reported as Liabilities on Issuer Balance Sheet Related to Certain Contingent Obligations [a]

Categorized by Type of Contingent Obligation	Full Sample (n=200) (*millions*)	Sub-Samples		Estimate for Population (N=10,100) (*millions*)
		Large Issuers (n=100) (*millions*)	Random Issuers (n=100) (*millions*)	
Legal contingent liabilities	$10,725	$10,714	$11	$11,814
Environmental contingent liabilities	$9,219	$9,123	$96	$18,723
Guarantee liabilities	$85,834	$85,449	$385	$123,949

[a] These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.

As discussed earlier, SFAS No. 5 and Interpretation No. 45 require disclosures about exposure to "possible loss or range of loss" in the notes to financial statements.[174] Table III(E)(4) presents amounts related to these exposures reported by issuers. Issuers in the sample report almost $32 billion in possible exposures related to legal contingencies, only approximately $5 billion related to environmental contingencies, and approximately $4 trillion related to guarantees. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that potential losses reported by the population are approximately $52 billion potential losses for legal contingent obligations, approximately $23 billion for environmental contingent obligations, and more than $46 trillion for guarantees.

[172]Many such contingencies may not be reported as a separate line item on the balance sheet. Thus, users of financial statements must usually rely on disclosures to indicate the magnitude of the contingent obligations recognized.

[173]This represents a disproportionate difference between the large issuer sub-sample and the random issuer sub-sample in that the ratio of total liabilities of the random issuer sub-sample to the large issuer sub-sample is approximately 1:100; the difference in contingent liabilities recognized by the two groups is 1:1000.

[174]See SFAS No. 5, paragraph 10.

TABLE III(E)(4): Reported Exposures for Certain Contingent Obligations [a]

Categorized by Type of Contingent Obligation	Full Sample (n=200) (*millions*)	Sub-Samples		Estimate for Population (N=10,100) (*millions*)
		Large Issuers (n=100) (*millions*)	Random Issuers (n=100) (*millions*)	
Legal contingent obligations	$31,762	$31,554	$208	$52,354
Environmental contingent obligations	$4,604	$4,414	$190	$23,414
Guarantees	$4,053,499	$3,624,389	$429,110	$46,535,389

[a] These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.

The Staff notes that the amounts of possible losses disclosed by the sample of issuers are largely unrelated to the liabilities recognized by issuers as reported in Table III(E)(3). For the most part, issuers seem to have concluded that they need not disclose quantitative information concerning additional potential losses related to those contingent losses recognized as liabilities on the balance sheet.175 The Staff further notes that in many cases, issuers disclose the existence of the contingent legal obligation, but recognize no liability and disclose no maximum loss or range of loss.

[175]For example, of the $10.328 billion in legal contingent liabilities recognized (see Table III(E)(3)), only approximately $717 million are disclosed in conjunction with quantitative information about additional potential losses. Indeed, approximately 97% of the $23,761 billion of potential legal contingent losses disclosed for the entire sample relate to instances where no liability was reported as being recognized on the balance sheet. In some cases, where liabilities are recognized, issuers may not deem additional losses to meet the "reasonably possible" criteria in SFAS No. 5.

NOW, NEVER OR IN BETWEEN?: SOMEWHERE

The Nuts and Bolts of Setting Reserves

Your company has received word from the head of one of your business divisions that a former customer is alleging your company supplied millions of dollars of defective product and the former customer now wants its money back. Although you have been assured that the product met all industry standards and was manufactured properly, you, as in-house counsel, are now faced with a myriad of questions. Does the suit have merit? Is settlement a viable option, or should the case be vigorously defended?

Apart from those purely legal considerations, you also must help determine whether the company is required to recognize the potential loss contingency in the financial statements and disclose the existence of the potential suit to shareholders. How you go about making that decision is often a convoluted task, and one that must be undertaken in coordination with the accounting and financial department of your company. If you reach the wrong decision, your company could be required to restate its financial statements, and perhaps face shareholder litigation, SEC enforcement action, or criminal charges.

Before you start digging out your resume, though, take heart. The good news is that there are standards governing what to do in the case of loss contingencies; the bad news is that the standards are less than straightforward. This article will help you gain a firm understanding of the basics of the pertinent rules, and will enhance your understanding by applying those principles to several hypotheticals. By examining the most difficult accounting and financial scenarios, we will provide you practical solutions to those issues, so you will know when—and how—to set a reserve.

BY PETER J. BRENNAN, CHRIS HOLMES, AND BILL PHELAN

This article is drawn from one of ACC's most popular webcasts, "When to Set Reserves," originally offered in June 2003, and moderated by Kathie S. Lee, Litigation Committee Vice Chair. *The authors gratefully acknowledge the assistance of Mary Murphy in transforming the webcast into an article, and for the additional research she provided.*

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LOSS CONTINGENCIES: WHAT EXACTLY ARE THEY?

A loss contingency is a loss (i.e., the impairment of an asset or the incurrence of a liability) arising from a past event, the amount of which, if any, will be confirmed by a future event that is not within the company's control.[1] Examples of loss contingencies include, but are not limited to, the threat of or pending lawsuits against the corporation, or its officers if they have been indemnified by the company.[2] Such a contingency can, in certain cases, obligate the corporation to record a reserve in anticipation of a judgment against the corporation or a settlement, or perhaps disclose the existence of the contingency in its financial statements. In such circumstances, it is essential that members of the in-house counsel and accounting staff work together to assess the corporation's obligations and evaluate what if any disclosure must be made, and the amount, if any, of the loss contingency that must be recognized.[3]

The uncertainty surrounding the reporting and disclosure obligations is due in large part to the standards established by the Financial Accounting Standards Board (FASB) that require the exercise of judgment in applying the standards' basic principles. In particular, FAS 5, which establishes standards for financial accounting and reporting for loss contingencies, dictates in paragraph eight that a loss contingency must be recognized as a charge to income if both of the following standards are met:

a. Information available prior to issuance of the financial statement indicates that it is *probable* that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be *probable* that one or more future events will occur confirming the fact of the loss; and
b. The amount of loss can be *reasonably estimated*.[4] (Emphasis added.)

FAS 5 was one of the initial standards adopted (in March 1975) by the FASB. While the passage of time has seen the adoption of over 140 additional standards, there has been little modification to the basic principle of this particular rule—that a loss contingency must be recognized as an expense if the loss is probable and the amount can be estimated.

The first of those two conditions—the probability of the loss—is often difficult to assess because the threshold for recognition is not established in terms of numerical probability.

FAS 5 recognizes a range of probabilities that such a future event will occur and uses the terms probable, reasonably possible, and remote to identify the three areas within that range:

❑ *Probable*: The future event or events are likely to occur;
❑ *Reasonably possible*: The chance of the future event or events occurring is more than remote, but less than likely; or
❑ *Remote*: The chance of the future event or events occurring is slight.

This classification is significant, as it determines the company's obligation to make an accrual and/or a disclosure, as discussed below (*see also* "What the Future Holds . . . and How to Account for It," p. 34).

Accrual yes, disclosure. . .perhaps? Accrual no, disclosure . . . maybe?

The initial challenge for in-house counsel and accounting is to accurately assess whether the accrual must be made at all. If an accrual is made, a disclosure of the nature of the accrual, and in some circumstances the amount accrued, must be set forth in the financial statements if required in order to prevent the statement from being misleading.[5] However, even if in-house counsel and accounting arrive at a consensus that no accrual must be made because the two conditions in paragraph eight have not been satisfied, the corporation may still be required to make a disclosure of the contingency if it is determined to be reasonably possible.[6] In such a case, a corporation must "indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made."[7]

There are exceptions to this rule, however. A corporation would not always be required to disclose a loss contingency where the claim is unasserted, such as where the potential claimant has not demonstrated an awareness of an entitlement to a claim. If, however, it is probable that a claim will be asserted, and there is a reasonable possibility that the claimant will prevail on such claim,[8] then a disclosure is mandated.

Rolling the Dice

Correctly determining the likelihood of a future event that will resolve a loss contingency under these standards is no simple task, as evidenced by the lengthy appendix to FAS 5 that contains examples of applications of the conditions for accrual of loss contingencies and disclosure requirements. The statement is careful to note that "no set of examples can encompass all possible contingencies or circumstances," and goes on to warn that "accrual and disclosure of loss contingencies should be based on an evaluation of the facts in each particular case."[9]

Nevertheless, FAS 5 provides factors to be considered in determining the required accrual and/or disclosure where there is pending or threatened litigation. They are:

a. the period in which the underlying cause (i.e. the cause of action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred;
b. the degree of probability of an unfavorable outcome; or

What the Future Holds . . . and How to Account for It

A future event confirming the amount a loss contingency is reasonably possible, the statement provides, when "the chance of the future event or events occurring is more than remote but less than likely." On the other hand, such a chance is remote when "the chance of the future event or events occurring is slight." If the loss contingency is determined to be probable, the loss should be recognized, provided it can be reasonably estimated. The chart below sums it up:

Likelihood of Event?	Reasonably Estimable?	Action?
Probable	Yes	Accrue
Probable	No	Disclose
Reasonably possible	Either	Disclose
Remote	N/A	None

c. the ability to make a reasonable estimate of the amount of the loss.[10]

Timing Is Everything

The statement's rule that a corporation must make an accrual only if it had information, prior to the issuance of the financial statements, that indicated that it was probable that a loss had been incurred as of the date of the financial statements seems very straightforward. Thus, an event or condition which occurs after the date of the financial statements but before the statements are issued, and gives rise to a new loss contingency, would not require an accrual; however, it still may require disclosure. For example, a major industrial accident that occurs shortly after the end of the year may require disclosure, but its effects would not be recognized in the annual financial statements of the previous year.

If, however, a corporation—after the date of the financial statements but before the statements are issued—becomes aware of a claim based on an event that occurred on or before the date of the financial statements, accrual might be required. Two conditions in paragraph eight, though, must be met before accrual is required in this circumstance—the likelihood of the future event is probable, and the amount of loss can be reasonably estimated.[11]

In assessing when to set a reserve for an event that occurred before the date of the financial statements, in-house counsel and accounting must work together to determine if the future event—such as a judgment against the company or a settlement—is probable. In making this evaluation, FAS 5 directs that the following factors should be considered:

a. the nature of the litigation, claim or assessment,
b. the progress of the case (including progress after the date of the financial statements but before those statements are issued),
c. the opinions or views of legal counsel and other advisers,[12]
d. the experience of the enterprise in similar cases,
e. the experience of other enterprises,
f. any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement).[13]

If a lawsuit or claim is filed before the financial statements are issued, it is not an automatic conclusion that an accrual must be recorded. Rather, only if the likelihood of an unfavorable outcome is probable must a loss be recognized as of the balance sheet date. If, after reviewing all relevant facts, you determine that it is reasonably possible but not probable that the claimant will prevail, the statement provides that no accrual need be made. Similarly, no accrual would be required if the amount of loss that could be incurred from the lawsuit or claim cannot be reasonably estimated. In both cases, however, you would still be required to make a disclosure in the financial statement.[14]

IN OTHER CASES WHERE THE CORPORATION KNOWS OF A POTENTIAL CLAIM THAT COULD BE MADE AGAINST IT BUT THERE IS NO EVIDENCE THAT THE CLAIMANT EITHER KNOWS OF THE RIGHT OF ACTION OR INTENDS TO FILE SUCH A CLAIM, YOU MUST DETERMINE IF THE ASSERTION OF THE CLAIM IS PROBABLE.

Claims Down the Pike: Out of Sight, Out of Mind?

If the claim has not yet been filed, you cannot sit tight and hope that it doesn't materialize. Instead, you must determine how likely it is that a suit will be filed, as well as the possibility that the plaintiff will succeed on the claim. Events such as a catastrophe, an accident, or the initiation of a governmental investigation require the evaluation of the possibility of subsequent private suits for redress against the enterprise.[15] In such cases, the probability of a claim being asserted and the likelihood of success must be evaluated on a case-by-case basis.[16] In other cases where the corporation knows of a potential claim that could be made against it but there is no evidence that the claimant either knows of the right of action or intends to file such a claim, you must determine if the assertion of the claim is probable. If it is not, then no accrual or disclosure would be required.[17]

If, however, you determine that it is probable that a claim will eventually be asserted, you must then evaluate the likelihood that the claimant will succeed on that claim. If your assessment is that an unfavorable outcome against the entity is probable and you determine that the amount of loss can be reasonably estimated,[18] then you must accrue a loss. [19] It is important to recognize that both findings must be made in order for an accrual to be required. Thus, even if you determine that it is likely that the claimant will prevail in the suit or claim against the company, you are under no obligation to make an accrual if you cannot reasonably estimate the amount of the loss.[20] Don't forget the disclosure requirements in such a case, though, as you would still be required to disclose the existence of the claim or lawsuit where the unfavorable outcome can be characterized as probable, and you would be required to disclose that the amount of the probable loss could not be reasonably estimated.[21]

THE CORPORATION MUST ALSO DISCLOSE THE POTENTIAL LIABILITY ON THE OTHER ASPECT OF THE LITIGATION "IF THERE IS A REASONABLE POSSIBILITY THAT ADDITIONAL TAXES WILL BE PAID."

More than Mere Guesswork

FAS 5 requires that the amount of loss be reasonably estimable for an accrual to be required. This requirement "is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements."[22]

In some cases, however, it may be difficult to determine the exact range of probable loss. For example, an unfavorable judgment in a case on one count could require the corporation to pay a specified sum in taxes, but an unfavorable judgment on other counts that "might be open to considerable interpretation" could result in additional liability. In such a case, the statement directs that accrual of the loss that is likely to be assessed for the specified tax sum is required if that is considered a reasonable estimate of the loss. However, the corporation must also disclose the potential liability on the other aspect of the litigation "if there is a reasonable possibility that additional taxes will be paid."[23]

In 1976, the FASB issued an interpretation of FAS 5 that was to be used in determining the reasonably estimable amount of a probable loss. FASB Interpretation No. 14[24] (FIN 14) indicates that a company should make its best estimate of what that amount is; however, to the extent that there is a range and no amount within the range is a better estimate, the company should accrue the low end or the minimum amount in the range, and then disclose the additional amount that would fall into the reasonably possible category.

When evaluating the potential loss, companies diverge on when to recognize the cost of a legal defense. Since the accounting rules don't address this issue specifically, there are two acceptable accounting policy elections. Many companies expense the costs of defending a legal claim as incurred. Others, however, accrue the costs of their legal defense under the probable and reasonably estimable model in paragraph eight of FAS 5. In either case, the SEC has indicated through an Emerging Issues Task Force announcement that it would expect companies to disclose the costs of a legal defense, if material, and to establish a policy and apply it consistently.

Beyond Disagreement Over Likely Outcomes

Setting a reserve was never an easy task. In the aftermath of Sarbanes-Oxley, however, the stakes are even higher. The impact of the new reporting-up-the-ladder requirements on the reserve-setting process is a complex topic, and indeed could be an article unto itself. You can bone up on Sarbanes-Oxley with these ACC resources:

- Michael Cahn and Michael Scanlon, "Tools You Can Use: Helping the Audit Committee Manage its Relationship with the Outside Auditor," *ACC Docket* vol. 22, no. 5 (May 2004), available on ACCA Online℠ at *http://www.acca.com/protected/pubs/docket/may04/tools.pdf*.
- "In-house Counsel Standards Under Sarbanes-Oxley," an ACC InfoPAK℠, available on ACCA Online℠ at *http://www.acca.com/protected/infopaks/sarbanes.pdf*.

PUTTING THE PRINCIPLES INTO PLAY

One of the greatest challenges in determining whether to set a reserve is defining the probability of loss. While the accounting standard provides general guidance, in application there is no bright-line rule for determining what is probable, reasonably possible, or remote. While, for example, the standard as written defines remote as slight, in practice the estimates from counsel are couched in terms of how likely it is that the entity will lose.

Speaking the Same Language, Reaching a Common Ground

Sometimes those calls are easy, such as when it is apparent that the likelihood of a judgment against the corporation is remote. The more problematic areas, however, arise where the possibility falls in the reasonably possible or probable spectrum. In those cases, you as in-house counsel must decide what you really think about the case, and be able to couch it in terms that will help the financial department make the right accounting and reporting decision.

But be forewarned. Expect pressure from accounting and financial officers to determine the category in which the risk falls. As the case develops and the potential liability increases, in-house counsel assumes increased responsibility to evaluate a case and fit the risk into one of the FAS 5 categories so that the company will know what if any reporting and/or disclosure obligations it has. Typically, in-house counsel's estimates of loss probability are in terms of percentages, so the challenge for financial players is to interpret whether those percentages are probable, reasonably possible, or remote for reporting and disclosure purposes. In short, in-house counsel and the finance department must learn to speak the same language so that a consistent and accurate accounting determination can be made.

RESERVE OR NO RESERVE: YOU BE THE JUDGE

Having tackled the basics, it's time to test your knowledge with some hypothetical scenarios that explore the application of the statement in different situations.

Scenario Number One:

Your company is named as a defendant in a lawsuit and you conclude that on balance you will lose \$1 million if a judgment is obtained by plaintiff. However, you also think that there's only a 30 percent chance of losing. In such a case, your company's reserve should be:

A. \$300,000
B. Zero
C. \$1 million
D. None of the above.

Answer: B. Zero *or* D. None of the Above.

The answer to this question is governed by one of the factors discussed in FAS 5 for determining whether a loss accrual is appropriate when a lawsuit is filed or threatened.[24] That factor—whether the case will be vigorously defended or whether settlement is considered—determines whether or not an accrual should be made. Even though there is a relatively small (30 percent) likelihood that the corporation will lose in the above scenario, if settlement negotiations are undertaken or anticipated and you are likely to settle, then the corporation must accrue the amount of the settlement, presumably something less than the full amount of the claim. Thus, the answer would be "D. None of the above."

However, if you determine that the case is going to be contested, then the figure of a 30 percent likelihood of losing would, in most reasonable people's opinions, not amount to a probable risk that would require the entity to record a loss contingency. Thus, in that case, no amount would need to be accrued, and the answer would be "B. Zero."

But the inquiry is not over, for the entity must then determine whether the 30 percent, although not a probable risk of loss, nevertheless represents a reasonably possible risk that the company will pay out a judgment somewhere in the range of \$1 million. If that amount is material to the financial statements, FAS 5 requires that the contingency be disclosed.

In addition to disclosure requirements contained in FAS 5, public companies must also disclose significant legal proceedings under SEC Regulation S-K Item 103. That regulation requires disclosure in both the annual report on Form 10-K and the quarterly report on Form 10-Q of material legal proceedings, unless the claim(s) are less than 10 percent of the company's current assets.[25] Thus, in scenario number one, if the company had current assets of less than \$10 million, S-K Item 103 may require the company to describe the pending legal proceedings, unless it is ordinary, routine litigation incidental to the business—even though it represents only a 30 percent likelihood of loss.

Scenario Number Two:

Your company is named as a defendant in a lawsuit and you conclude that on balance you will lose \$1 million if a judgment is obtained by plaintiff. You also think that there's a 75 percent chance of losing. In such a case, your company's reserve should be:

A. Zero
B. \$750,000
C. \$1 million
D. None of the above.

Answer: C. \$1 million.

In a case where the likelihood exceeds 50 percent (i.e., 50.1 percent), most would conclude that the risk of loss is "more likely than not." Whether the risk ultimately falls into the probable range is in large part dependent upon whether the company has a policy establishing a standard that any risk greater than *x percent* is probable for reporting and disclosure purposes. This will vary from company to company. The figure of a 75 percent likelihood of losing would, in most reasonable people's opinions, represent a probable risk that would require the entity to record a loss contingency. Thus, their answer would be C. \$1 million.

However, there is no clear numerical demarcation between "reasonably possible" and "probable." For example, some might conclude that a 65% likelihood is "probable" and record an accrual, while others might conclude that it is only "reasonably possible"—somewhere between remote and probable—and conclude that while no accrual is required, disclosure considerations would apply.

This highlights one of the most important points in applying what is essentially a subjective accounting judgment: *establish a company policy and apply it in a consistent fashion over time.*

The key is to develop a policy and document its application, so that if your decision not to make an accrual is ever challenged, you can demonstrate that you have applied a reasoned policy consistently over time. Recent events have seen companies finding themselves at the center of SEC investigations because they have been too opportunistic in setting and maintaining reserves. It is best to avoid establishing a track record that in a good year a company accrues a loss at 65 percent, while in a tough quarter it applies an 80 percent threshold for determining whether or not to accrue a loss. Consistency is the key.

From this point on . . .
Explore information related to this topic.

- Listen to the replay of the Webcast When to Set a Reserve, Now, Never or Somewhere in Between, available on ACCA Online[SM] at *http://www.acca.com/networks/webcast/webcast.php?key=20030822_11819.*
- ACC's InfoPAK Outside Counsel Management, available on ACCA Online[SM] at *http://www.acca.com/infopaks/ocm.html.*
- ACC's Practice Profile Indemnification and Insurance Coverage for In-house Lawyers: What companies are doing, available on ACCA Online[SM] at *http://www.acca.com/protected/article/insurance/lead_liability.pdf.*
- Check out what's going on with ACC's Litigation Committee, available on ACCA Online[SM] at *http://www.acca.com/networks/litigation.php.*

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Scenario Number Three:

Your company is named as a defendant in a lawsuit and you conclude that on balance you will lose

$1 million if a judgment is obtained against the company. You are unable to evaluate your company's chance of success if the case goes to trial. In such a case, your company's reserve should be:

A. Zero
B. $1 million
C. $500,000
D. None of the above

Answer: A. Zero.

If you find yourself in the predicament of not being able to evaluate the company's chance of success in litigation—which generally happens in the early stages of the litigation—you should expect to experience some serious pressure from accounting and financial officers when you declare that you simply can't make a call on this one. In such a case, your experienced judgment as a litigator takes on enhanced significance because if you can't make a call on the chance of success, it follows that you can't set a reserve on it either. In that case, the company would set no reserve, and the answer would be A. Zero.

From a controller's standpoint, however, in-house counsel's inability to assess such a case does not resolve the company's accounting and disclosure requirements, and counsel should expect to be asked to conclude in which category the legal exposure falls: remote, reasonably possible, or probable.

What is the threshold at which you are deemed to have enough information to be able to make an evaluation? The answer to that question will vary from case to case, and will require you to re-evaluate the litigation as it evolves. Facts change, testimony changes, and documents reveal information not previously known to the parties; thus, a case initially thought to be troublesome turns out not to be much of an issue at all. Sometimes, however, the reverse is true; that nuisance case that came in the door has taken on a life of its own, and at second glance promises to be a nightmare.

This situation will engender significant discussion between financial and legal departments, as they work together to evaluate the likelihood of an unfavorable outcome and explore where the case falls—more towards probable (and thus requiring an accrual) or more towards remote (for which no accrual or disclosure would be necessary). Such a case highlights the importance of establishing a company policy that defines the ranges of risks and eliminates speculation in complying with accrual and disclosure regulations.

As the defense strategy develops, your ability to make an evaluation increases. If the case involves allegations about your company's conduct, your own investigation might yield enough facts to allow you to make an evaluation rather quickly. Sometimes, however, if the facts are beyond your control, you may have to wait until discovery develops to have a basis to make an evaluation. The challenge is clear communication with accounting as you develop the necessary information to make an informed judgment.

Giving a Practical Assessment

Among all the lawyers that service a company, in-house counsel play a very special role in the reserving process.

In general, opinions of outside counsel will follow the procedures set forth in the ABA Statement of Policy regarding Lawyers' Responses to Auditors' Requests for Information. Those responses often will not be very satisfying to those in the financial reporting organization of a company, because the responses frequently will say that the litigation is ongoing and that the outcome is difficult to predict. That is where in-house counsel become critical.

The in-house lawyer needs to give the financial reporting organization a very practical assessment of what he or she thinks is going to happen with a particular piece of litigation. For example, suppose a company gets hit with a jury verdict for compensatory damages and substantial punitive damages. The in-house lawyer will need to make a judgment about whether some, all, or none of the compensatory and punitive damages will be upheld either by the trial court or on appeal. Armed with a practical assessment of the likelihood of getting relief from that jury verdict, a good financial reporting organization will then be able to use that assessment to make the required reserving and disclosure opinions.

If the numbers are very large on any particular piece of litigation, in-house counsel can expect to be asked to put his or her bottom line assessment into writing.

No Accrual, but What About Disclosure?

As a practical matter, however, if you are unable to evaluate the chances of success, then by necessity you cannot say that the case falls into the remote

category—which is significant as it is the sole category that excuses companies from making a disclosure.

In a case where you cannot evaluate the chance of success, most practitioners would agree that the case most likely falls into the reasonably possible category, and would thus have to be disclosed under FAS 5. Moreover, under S-K Item 103, if the case is material to the organization as the possible loss represents more than 10 percent of the company's current assets, it must be disclosed.

In practice, many public companies have some sort of legal proceedings disclosure in their financial statements that puts the financial statement user on notice that as a normal course of business, the company is subject to suit on occasion and such cases are being worked or are in various stages of evolution. If none of those cases are thought to be very significant or to expose the company to serious potential liability, many companies would typically assert that the resolution of legal contingencies would not be expected to have a material effect on the financial statements. A company should carefully assess, however, whether it is reasonably possible that an unfavorable outcome could materially affect its financial position (including compliance with loan covenants), operations, or cash flows (including liquidity) in assessing whether a general disclosure of this nature is appropriate.

Scenario Number Four:

Your company is named as a defendant in a lawsuit and you think that there's a 75 percent chance of losing, but are unable to estimate the amount of the loss (it could fall anywhere between zero and $1 million). In such a case, your company's reserve should be:

A. Zero
B. $750,000
C. $1 million
D. None of the above

Answer: A. Zero.

The first task at hand is determining whether the likelihood of losing falls into the probable or reasonably possible category. Once you determine that the percentage puts the case into the probable category for which an accrual would be required, you must then determine the appropriate dollar amount of that reserve. If you don't really have an idea, but know that the loss could be anywhere between zero and $1 million, what do you do?

FIN 14 requires that if you have a claim or loss that is probable and you have a range of outcomes, you must record the best estimate in that range. If there is no best estimate in that range, you are required to record only the low end of the range. In either case, FAS 5 also requires disclosure of the amount of any additional reasonably possible exposure above the amount accrued.

In this scenario, then, if our range is zero to $1 million, you would be required to only accrue the low end of that range—zero—in this case. However, there would still be disclosure requirements associated with this situation, so you would have to disclose the case and the range of the reasonably possible loss.

This very scenario occurs frequently in real life. There are small cases that stem from an event where you know that the company is at fault. Thus, while it is probable that a judgment will be assessed against the company if a claim is brought, the value of a potential settlement or judgment will be minimal. However, it is also possible that while the initial assessment yields a particularly minimal estimation, it may be uncertain whether the case will escalate in size. Examples of such cases include those that begin as an individual case and are elevated to a nationwide class action suit, or cases that have the potential to yield a significant punitive award. Thus, while you may be certain that the outcome will not be favorable for the corporation, the magnitude of the loss is very difficult to estimate. The role of in-house counsel in such a situation is to explain your view of the case and allow accounting to make a judgment about the appropriate accounting treatment.

While FAS 5 would not require an accrual if the loss is not capable of estimation,[26] it would still require a disclosure if the estimate of loss is either probable at least reasonably possible. Thus, you would be required to disclose the nature of the claim as well as the fact that the company is unable to determine the amount of the loss. S-K Item 103 would also require a disclosure if the claim is material to the company.

ANSWERS TO THOSE THORNY QUESTIONS

As helpful as these scenarios are, there are still some particular issues that are worth exploring. The following questions represent common inquiries from in-house counsel regarding reporting and disclosure requirements.

1. Settlement offers: Can they come back to haunt you?

In general, no. Companies may make settlement offers as business decisions because it is possible to settle for less than the anticipated cost of the litigation. Such cases, as well as those where a company makes an offer to dispose of a meritless or nuisance case, evidence that there are incentives to settling a case that have nothing to do with the probability of loss for the company based on the merits of the case if litigated.

However, in the accrual arena, the treatment of settlement offers reveals a different mindset between legal and accounting departments. In a lawyer's eyes, a settlement offer may be tactical and may not reflect a company's belief that the loss is probable or estimable. Accounting may have a different view, however, believing that a company would not have made an offer unless in-house counsel truly believed that there was a chance the company was going to lose. As a result, you need compelling reasons to overcome the presumption that a settlement offer has established the low end of a range of probable loss that should be accrued. That presumption would be difficult to overcome if the settlement offer remains outstanding at the date the financial statements are issued.

2. Are disclosures about loss contingencies a wise idea?

The obligation of a company to disclose the existence of the suit and related exposure in the financial statements when the loss is reasonably possible poses some unique questions for in-house counsel. There is often a tension between financial reporting and defending a company's financial interests.

This tension is the product of a perception that public disclosures compromise a company's position in litigation. Thus, the natural tendency is to be reluctant to include specific disclosures in the company's financial statements or SEC filings concerning specific pieces of litigation, believing that doing so is an acknowledgment of liability.

In reality, however, that concern is misplaced. Still, it is a challenge to craft a disclosure in a way that adheres to the disclosure requirements while at the same time not tipping your hand and alerting the plaintiff to the company's valuation of the case.

3. Do financial statements tip your hand in litigation matters?

This question focuses on whether the fact that a company has recorded a reserve can be discovered by a competitor or plaintiff and used as an admission of liability. The short answer is no, for two reasons.

One, the reserve is "baked into" all of the financial statements so it would be difficult for a competitor or party to discern the figure from the basic financial statements. Typically, financial statements contain a great deal of financial information, not just pertaining to litigation reserves. It would be difficult for a reader to discern the specific sum set aside for a particular piece of litigation because the litigation reserve would not be a specific line item in the financial statements. Rather than being called out on a case-by-case basis, such sums would be included with other liabilities and reserves.

While the SEC had considered adopting rules that would have significantly expanded the requirement for supplemental information in SEC filings, requiring an analysis of changes in liability accounts (including liabilities related to litigation and other loss contingencies), the uproar over the potential competitive damage that could be achieved through the disclosure of such information caused the SEC to abandon that proposal.

Secondly, disclosure about the nature and amount of a contingency for which the company has accrued a loss is required only as needed to keep the financial statements from being misleading. Thus, in most cases, disclosure of the specific amount reserved is not required in the financial statements. More frequently, the SEC's rules on MD&A (Management's Discussion and Analysis of Financial Condition and Results of Operations, Regulation S-K Item 303) will require a company to disclose that an accrual for a loss contingency (or the adjustment of reversal of a previous accrual) had a material effect on reported results. Consequently, in most cases the risk that accruing a legal reserve could be used successfully against a company is diminished.

4. Should all potential and existing cases be treated the same for FAS 5 purposes?

Theoretically, the answer is yes; FAS 5 applies equally to all loss contingencies. However, in practice the materiality of the contingency affects the amount of analysis to be performed. For example, companies can establish internal policies and practices regarding

Disclose, But Don't Tip Your Hand to Plaintiffs

The following disclosures offer a guide to meeting disclosure requirements without broadcasting your valuation to plaintiffs' counsel:

For cases in which no reserve is established:

On July 17, 2004, an action was filed in U.S. District Court against the Company by a former customer which purchased product manufactured by the Company in 2002 and 2003. The complaint alleges that the product, as manufactured, was defective and as such the plaintiff is seeking approximately $5 million for full refund of the purchase price, plus treble damages. *The Company believes that this claim lacks merit and intends to defend itself vigorously against it.*

Alternate ending if a reserve has been established:

The Company believes that the allegation is without merit and is preparing to defend itself vigorously. Based on a review of the current facts and circumstances with counsel, management has provided for what is believed to be a reasonable estimate of the loss exposure for this matter. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material effect on its earnings, cash flows, or financial position.

Alternate ending if reasonable estimate of the likely loss cannot be established and outcome may be material:

As of this date the Company is still in the process of reviewing the plaintiff's allegation and as such no provision has been recorded for it. Should the Company ultimately be determined to be liable for this matter, the Company could be subject to a loss of as much as $20 million.

claims that are not material, either individually or in the aggregate. Similarly, a company may establish a policy as to the minimum amount of a reserve that it would record. This is because accounting rules do not have to be applied to items that are not material.[27]

Furthermore, what some companies have done in practice is to stratify cases into two populations: one being cases that individually are not material, and the other for material cases where the threshold is material or for a significant amount of money (e.g., $1 million.) For the smaller cases, companies evaluate what the historical settlement rate has been for such cases and then record a figure based upon the number of cases multiplied by the average settlement rate for those cases. This prevents the legal and accounting departments from having to expend excessive time conducting a case-by-case analysis of these numerous smaller matters. For the more material cases, an individual analysis as outlined in the FAS 5 rules would be appropriate.

5. How do you account for insurance coverage of claims for which reserves are taken?

The likely amount of insurance coverage for the loss does not play a role in making a determination of the reasonably estimable amount of loss. That is because the SEC staff's position is that there must be separate evaluations of the likelihood of loss to the primary obligor, and then the likelihood of insurance recovery. Although the net impact on income may be minimal, the full loss needs to be recorded as its probable and estimable amount, and then to the extent that the company could substantiate that receipt of an insurance recovery is probable, it should be recorded separately as an asset. It would be inappropriate to offset the receivable for a probable insurance recovery against the accrued loss contingency in the company's balance sheets. These transactions would have to be recorded separately because they involve two different parties: a payment to one party, and a receivable from a different party.

Knowing how and when to set a reserve—and when to make a disclosure—is an important and often intimidating task for in-house counsel. One of the most important tasks is to ensure that the company establishes a realistic policy for evaluating the likelihood of loss contingencies from potential claims and lawsuits, and that the policy is applied consistently over time. A coordinated effort between legal and accounting departments to arrive at realistic estimates and mutual assessments of the consequent accounting and disclosure will go a long way to assuring that the company maintains high quality and transparent financial reporting.

Notes

1. Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, Financial Accounting Standards Board, March 1975), paragraph 1, p. 4, *www.fasb.org/st/sumary/stsum5.html.*
2. FAS 5, paragraph 4 lists the other examples of loss contingencies.
3. This subject was the topic of a ACCA Conference Call June 2003, entitled "When to Set a Reserve: Now, Never, or Somewhere In-between." The conference call was moderated by Kathie Lee, Vice Chair of the Litigation Committee of ACC. Panel members included Peter Brennan, Chair of the Litigation Committee of the ACC and Associate General Counsel for Litigation with Sears Roebuck and Company, Chris Holmes, a partner at Ernst and Young where he also serves as National Director of SEC Matters, and Bill Phelan, Assistant Controller for Sears, Roebuck and Co.
4. FAS 5 paragraph 8 (a) and (b).
5. Id. at paragraph 9.
6. Id. at paragraph 10.
7. Id.
8. Id.
9. Id. at Appendix A, paragraph 21.
10. Id. at paragraph 33.
11. Id. at paragraph 35.
12. However, the statement makes clear, the inability of legal counsel to render an opinion that the corporation will prevail in the litigation or claim does not mean that the conditions in paragraph 8(a) have been met and that an accrual for loss should be made.
13. Id. at paragraph 36.
14. Id. at paragraph 37.
15. Id. at paragraph 38.
16. Id.
17. Id.
18. Id. at paragraph 8.
19. Id. at paragraph 38.
20. Id.
21. Id.
22. Id. at paragraph 59.
23. Id. at paragraph 39.
24. See footnote 13, infra.
25. SEC Reg. 229.202 Subpart 229.103.
26. FAS 5 paragraph 8(b).
27. However, it is important to remember that materiality must be judged, in both quantitative and qualitative terms, based on the importance that a reasonable investor would place on the matter.