104:When to Set a Reserve-Now, Never, or Somewhere in Between

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Mr. Holmes recently concluded his role as the coordinating partner for a global information technology company, and he currently serves as the concurring partner on a large wireless communications company. He rejoined the firm in 1994 after 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. He began his career in the firm's audit practice in Winston-Salem, North Carolina where he served large public manufacturing companies.

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NOW, NEVER OR IN BETWEEN?: SOMEWHERE

The Nuts and Bolts of Setting Reserves

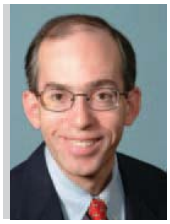
Your company has received word from the head of one of your business divisions that a former customer is alleging your company supplied millions of dollars of defective product and the former customer now wants its money back. Although you have been assured that the product met all industry standards 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 proceed-

ings, 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.

Scenario Number Three:

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

From this point on . . .
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$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.

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.

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

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.

When to Set a Reserve: Now, Never, or Somewhere in Between

ACC 2004 Annual Meeting
October 25, 2004

Presenters

- **Chris Holmes**
  Ernst & Young LLP
- **Patrick Thesing**
  Stewart Title Guaranty Company

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

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 (?)

International GAAP

- IAS 37: Contingent liabilities should not be recognized, but disclosed unless remote
- UK FRS 12: Contingent liabilities should not be recognized, but disclosed unless remote
- Switz. G F 10/4: Contingent liabilities “have to be valued and a provision has to be set up if needed”

When to Set a Reserve: Now, Never, or Somewhere in Between

Questions?

