LITIGATION CONTINGENCY REPORTING: WHERE ARE WE WITH FASB AND THE SEC?

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Michael R. Young
Willkie Farr & Gallagher LLP
Former Member
Financial Accounting Standards Advisory Council to FASB

Wayne Carnall
Chief Accountant
Division of Corporation Finance
U.S. Securities and Exchange Commission

The following is a transcript of an informal dialogue sponsored by the New York City Bar Association on January 28, 2011.

City Bar: Thank you for coming out today and welcome to today's program on "Litigation Contingency Reporting: Where Are We with FASB and the SEC?" I'm now going to turn the program over to Michael Young.

Young: Thank you very much. Welcome everybody. The topic is "Litigation Contingency Reporting: Where Are We With FASB, Where Are We With The SEC?" There is enough going on that Wayne and I thought it would be a good idea to sort of give everybody the opportunity to get up to speed. As a threshold matter, let's do some quick introductions. Wayne?

Carnall: First of all, I'm delighted to be here. Mike and I actually chatted about having this conference or seminar last December. We were actually on a panel back in April at about the same time we were just beginning to issue comments, or I'll call it re-emphasis, on this very issue. We talked about it a little bit briefly and we've actually had a number of discussions over the last many, many months. Again, I'm delighted to be here.

Who I am? I'm the Chief Accountant in the Division of Corporation Finance. I've been with the Commission this term since 2007. I was previously with the Commission from 1991 through 1997 and, between 1997 and 2007, I was a partner with PricewaterhouseCoopers in their national office, and prior to that (going all the way back to 1981, so I am fairly old, I am a card-carrying member of AARP), I was with PricewaterhouseCoopers in Rochester, New York for approximately ten years.

In my role as the Chief Accountant in the Division of Corporation Finance, we have about 200 or so accountants that are highly dedicated to trying to review and improve the financial statements and the reporting of over 12,000 or so public companies. That part I can say fairly safely. Everything else I say this morning, though, are my views and my views alone; they don't necessarily represent the views of the Commission or any others on the staff. So the standard disclaimer that many of you have probably heard many times certainly applies.

But with that said, I also want to keep this very, very informal. Mike and I have a couple of things that we will be going back to, but the main reason I really wanted to do this is to actually answer questions. Mike did send me a couple of questions that he has already received but I encourage you, and again I want to keep this informal. The actual requirements – the standards – well, they've been around for about 30-plus odd years so it's not really new, actually longer almost 40 years, so again I'd like to basically try to answer the questions that you may have about what we're doing, the implementation, etc. So please do just raise your hand or yell out and we'll try to address it.

Young: Feel free to interrupt as we go along. This is not a situation where we need to save questions and answers to the end.

I am Mike Young. I'm a partner at Willkie Farr & Gallagher. By coincidence, as this whole area was becoming more of a controversial thing, I was finishing a tour of duty on FASB's main advisory council, the Financial Accounting Standards Advisory Council to FASB.

This is a busy crowd and it's a pretty high-powered crowd. I've looked at the list of participants. We've disciplined ourselves to keep this to one hour and here is how we're going to proceed. First, I'm going to (for about 10 or 12 minutes) talk about what is going on at the Financial Accounting Standards Board. Then Wayne is going to talk about what's going on with regard to the SEC. Then we're going to just open it up for Q&A.

As Wayne mentioned, I've been getting a lot of emails in anticipation of this program because we're right in the midst of 10-K season. A lot of people have a lot of questions on what is going on and how they should be approaching financial reporting for litigation contingencies. So we're not going to run out of things to talk about.

The main takeaway of this hour is that, this season, litigation contingency reporting is under a microscope. FASB has an exposure draft on the table. And I think it is fair to say it is highly controversial. The SEC is looking very, very carefully – Wayne and the people reporting to Wayne. And whether we end up with a new exposure draft, or a new standard from FASB (according to the public statements of FASB), turns in part on what they see in 10-Ks this season. So there is a lot going on.

With that, let's jump right in with FASB and ASC 450. By the way, you all know FASB has rearranged the accounting standards and given them new numbers just to keep things simple. So the old FAS 5 is now the new ASC 450.

As a brief departure point, let's just take a moment and remind us all as to what the current standard is. There are two basic concepts. One concept is accrual. The other concept is disclosure. The test for accrual is: If a loss is "probable" and the amount of the loss can be "reasonably estimated," then you accrue. If that test is not satisfied, but there is at least a "reasonable possibility" that a loss has been incurred, then you disclose. What do you disclose? You disclose "the nature of the contingency." And you disclose (and I think Wayne will have something more to say about this particular part) "an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made." Now there are lots of devils in those details, but that is the basic gist.

So, why the change? As Wayne says, this standard has been in place for more than 30 years. Why is FASB considering a change now? The answer to that starts with, basically, user discontent and by users I mean the people who actually read and use financial statements, lenders and investors. They have been complaining, and the main thing that they have been complaining about is what I refer to as the "big bang problem." Boiling it down, what they've been complaining about to FASB is that they are being taken by surprise by big settlements without understanding the big settlement was coming down the road. Now, I'm not offering a view as to whether that is a legitimate complaint or not a legitimate complaint. I'm simply passing on that this is what the investors have been telling FASB. As they describe it, they feel that they don't hear anything meaningful about a litigation. They know the litigation is there and there is some gobbledygook (as they would say) in the 10-K and in the notes to the financial statements. But they can't associate any risk with it. They can't associate any quantification with it. And then kaboom: They hear about a press release announcing a $500 million settlement.

As a matter of coincidence, this complaint has been accompanied by the establishment of something called the Investors Technical Advisory Committee, known as "ITAC." Under the FASB structure, the way FASB works is that it's got a number of different advisory councils and this is one of the newer ones, ITAC, and it has been particularly vocal as to discontent with ASC 450. In particular, they have been telling FASB, "We want more quantitative information, we want some numbers. Now we understand (they say) it's tough sometimes and we get that. But sometimes it's not so tough, and we want *some* numbers so that we can get a sense as to what is at stake."

FASB, for its part, views these guys – ITAC and the other users of financial statements – as their customers, as the customers for financial statements. And, they say, "Our goal is to try to be responsive."

Now, the SEC simultaneously has been expressing parallel concerns, and I'm going to leave those for Wayne in about ten minutes.

The culmination of this sort of simmering discontent was an exposure draft, a proposed revision of ASC 450, that came out in June 2008. It was the first in what turned out to be a chain in a highly controversial project. One of the main paragraphs was paragraph seven (and I'm not going to go through all of the stuff), but what FASB was trying to do in this exposure draft was to encourage companies to provide more numerical information, more quantitative information.

So, they say, "An entity shall disclose the following information: Quantitative information about the entity's exposure to loss from the contingency as follows." And then it says, "the amount of the claim or assessment." I'm not going to offer a view as to whether this is a good thing or a bad thing or whether we could live with it or not live with it, because as you read further down, it gets a lot more horrible very fast. And here is the worst part. It says, "If there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss." That is to be disclosed. And then, further down, you also disclose the entity's qualitative assessment of the most likely outcome of the contingency. And those are mandated disclosures.

So, basically, what FASB, while well intentioned, was putting in place with regard to litigation contingencies was a two-step process. Under the exposure draft, the first step is you predict if you are going to lose and how much you are going to lose. And the second step is you confess in your financial statements. And that was basically it. And, of course, if you confess, then that arguably becomes an admission which the jury gets to see.

The legal profession (without even getting to the preparer community) was understandably horror struck. Within weeks after the exposure draft came out, there was a call up to Norwalk – up to FASB – from representatives of the legal profession. And the question was: "Can we get together?" FASB, to its credit, said, "Absolutely, let's get together, let's talk about it," and there was a meeting. That meeting was on June 20, 2008. There were representatives of the legal profession, including Stan Keller (of the ABA), Lew Ferguson (former GC of the PCAOB, now about

to go on the PCAOB board), and some others. And there were two members of the FASB board and lots of FASB staff.

The lawyers explained the problem with calling for mandated disclosure of this kind of predictive information. It took FASB about two minutes to get it. Those who know me know I'm a big fan of FASB – I have described them as the best listeners on the planet. And we went over it, and their eyes grew wide, and they said, "We see the problem, let's talk about how to fix it."

The discussion really focused on what was going on, and that is, at root, it was a conflict of cultures. On the one hand, you had the culture of financial reporting, the culture that FASB is there to implement, which is the culture of transparency. On the other hand, you had our adversary system of justice, which does not involve transparency; and in fact, it's quite the opposite. There are rules of evidence which preclude transparency. The fundamental problem was those two coming into sharp conflict when it comes to financial reporting. How do we reconcile the two?

There was lots of discussion in the weeks and then months following that which culminated in what are known as "roundtable discussions." Now, many of you may have participated in roundtable discussions. What happens is you go up to Norwalk and there is a big room and there is literally a round table in the middle of the big room, and a bunch of people sit around the round table and there are seats and stuff for the press in the background. It's very public, very open. Around the table, you have sitting various representatives of different parts of the financial reporting community. So, for example, you have got preparers, you have auditors, you have investors, you have lenders, you have the SEC, you may have other government people there. At the roundtable, you literally sit down and talk about the problems and you try to work out the differences.

What came out of the roundtable discussions (and they were in March 2009) was that a lot of the angst, a lot of the problems, were coming out of one aspect of the exposure draft, and that was the focus on predictions. Basically, predictions can be really hard to make in litigation. If you can make them, you really don't want to tell the world if you think you are going to lose. That is not

consistent with our adversary system of justice. The focus, in particular, was on a hypothetical that I'm going to read because you will then see it sort of filtering it's way or working its way through other FASB discussions.

And here it is. This is a hypothetical disclosure of litigation:

> "We entered a contract to provide 1,000 widgets for $1 million. Lightning struck our manufacturing plant and we did not deliver the widgets. The would-be recipient has sued us based on a contention that we breach the contract. It is our contention that our performance was excused by an act of God."

Now, the thing that this hypothetical disclosure illustrates is that you can get a fair sense of what the litigation is about. You can get a fair sense of what the parties are contending (what they are arguing about) and you can get a fair sense of how much is at stake. But there is absolutely no predictive information in there. The critical thing that came out of the roundtable discussion was you can give the user community what it wants, but you don't need to mandate predictions. In fact, insofar as predictions are based on sort of understanding the past and the circumstances, let people make their own predictions.

That concept actually resulted in a consensus at the roundtable. In August, when the staff was reporting to FASB on what had come out and what they were recommending, the board meeting handout of August 19 said: "Issue Three, Broad Principles for Disclosure. The staff believes that there was broad consensus at the March 6, 2009 roundtables on the following key principles."

One of them was that disclosure about litigation contingencies should focus on the contentions of the parties, rather than predictions about the future outcome. That continues to be a dominating principle with regard to the approach to litigation contingencies.

So what happened next? What happened next was there was a new exposure draft and, sure enough, you can see FASB using the

"lightning struck our manufacturing capability" example in the hypothetical disclosure that it included at the end of the new exposure draft. Also (if you get into the meat of what FASB was trying to encourage people to report), you can see them trying to get people to report quantitative, informative information without getting into predictions. So, for example, they ask for qualitative information to enable users to understand the loss contingencies major risks, the contentions of the parties, information about publicly available sources such as court records, and so on.

Now some people had a negative reaction to this. Some people thought, "Gee, I guess this is stuff we can live with." But then there were five fateful words that sort of got everybody on edge, and here they are. In the fifth bullet it says, "If it can be estimated, the possible loss or range of loss" – well, that was already there, so no big surprise there. And then it went on to say "and the amount accrued, if any." The problem there is that the accrual (if you go back to the basics of how this works) is a prediction. It is a prediction that says, "We're probably going to lose, and here is our best estimate as to how much we're going to lose." If you have to disclose that, it's going to be a very short trial with the only remaining issue being prejudgment interest.

Now, this is the operative draft that is on the table at the moment. The irony is that there was a consensus at the roundtable along the lines of "We shouldn't be getting into further predictions," but at the same time there was this inclusion of disclosure of the amount accrued.

I'm now going to turn it over to Wayne, but I'm going to first highlight three takeaways from sort of the chronology of what has happened at FASB:

1. This is being driven by user discontent and FASB views the users as the customers for financial information. So they have continued to be, and we have to expect will try to continue to be, responsive to the desires of the users.

2. The main source of user discontent is the absence of quantification. They really like the description of the complaint but what they are trying to evaluate, and do not

want to be taken by surprise by, is a big settlement. How is this going to come out? How much money is at stake?

3. A goal for this financial reporting season – sometimes we can't do it, maybe most of the time we can't do it, but where we can do it – a laudable goal would be to try to give users some sense of the amount of money at stake in litigation. So that, when the thing is ultimately resolved, they can't run to FASB and complain, "We were taken by surprise."

Audience: What is the current view on what the words "if it can be estimated" mean?

Carnall: I do have a slide of that because it is an important issue. We do have many discussions where people say, "Well I can't estimate that amount." Sometimes, that is a very factually accurate statement. And, other times, we will push back on that assertion. It obviously depends on the facts and circumstances, but I'll cover that.

Young: You have astutely put your finger on one of the biggest issues in this whole area right now.

Carnall: A couple of things I want to touch upon just to put this a little bit in context in terms of the issues that we're seeing.

A number of people have asked us, "Well, what is the difference between what you have to disclose under" – I still call it FAS 5, and I told people those of us who are over 50 have been doing this for 30-odd years, we're still allowed to refer to the old standards. Eventually, perhaps, I'll learn the codification, but I still like to call it FAS 5. I still look at FAS 5 and then I'll try to find it in the codification.

But in terms of what is the difference between what is required for the accounting standards in S-K 103, are they the same? There are obviously similarities. But I do view those as very much different. We do see companies trying to comply with both with just one disclosure. We're not asking for a repetitive disclosure but the criteria are different. I look at 103 as really being more of a factual

discussion about a case. You have to provide the information that is outlined in the standard. And there is also materiality threshold; it's like ten percent of current assets, so if a case exceeds that amount, you have to disclose it. But that is really not providing any assessment in terms of the outcome and that is some of the issues where I do believe that the accounting standards are required.

I view the disclosures for accounting purposes to be more analytical. It doesn't necessarily require a case-by-case discussion. But it does, I believe, require quantification in certain situations, an assessment of it. I do view, again, ASC 450 as being more analytical, S-K 103 being more factual.

Can companies still continue to combine this? Yes, they can. But, again, we will be looking for compliance with the accounting standards when we're looking at financial statements.

I just want to briefly mention and expand upon a point that Mike was making in terms of what the existing criteria and existing standards require. ASC 450 basically addresses contingencies; it's not just litigation contingencies, it's all contingencies. It's a principle-based standard and it addresses lots of different aspects in terms of contingencies. The focus that we're talking about is litigation, but under that category (and something I do view as very similar is) I'll call "regulatory action." It could even be the SEC taking action against the company for a violation of rules, another State Attorney General. I view those as being very similar in terms of the types of disclosures that we would be looking for or expect.

The standard actually takes the entire possible outcome and requires it to be analyzed into three different buckets: whether something is probable, reasonably possible, or remote. Everything fits into one of those three categories. If something is remote, no accounting or disclosure is required. If something is probable and it can be estimated, you have to accrue it. If you can't estimate the amount, you have to disclose it and everything else. This is where probably most items fall into is this "reasonable possible loss" and that is where disclosure is required. Again, the accounting standard also has this concept of if you have a range of possible

losses, you have to basically record the best estimate or, if you can't determine a best estimate, you record the minimum amount and you disclose the maximum amount. It's a fairly basic concept: book them in and disclose the maximum amount.

One of the things that is interesting under the accounting standard is that there is actually more disclosure required about reasonable possible losses than probable losses. If you have a disclosure about probable losses, the standard just basically says you have to discuss it and it gives what I almost call like a 12b-20 concept in terms of quantification. It says you may have to disclose it to keep the information from being misleading. I will say, in practice, we see very few companies, probably for the reasons Mike was mentioning, disclose a liability for probable losses. Again, the standard does not explicitly require that. It just says that you need to keep the information from being misleading.

I want to actually go on to what we have been seeing in terms of some of the stuff we've been asking questions about in terms of our observations when we're looking at filings. As I mentioned, this is not a new standard, but we have a renewed emphasis on this and we started asking some questions earlier in the year or early last year to a number of financial institutions. We saw that they had pages and pages and pages of disclosure, lots of factual information. I'll call it more of a 103-type of disclosure. But what we did *not* see is information that I'll call the analysis of it. They didn't disclose any quantified information about reasonably possible losses. And so we started asking a number of questions.

We have also asked questions when we see settlements (to the point that Mike was making). We see settlements and we don't see disclosure about that issue in prior filings. We have started asking more questions. So, if we see a settlement, we will go back. We have gone back and looked at what prior filings say. Did they disclose anything about this? Was this a reasonably possible loss in prior filings? So, we are looking at that and, if we see settlements, we'll also ask, "Well, when was that amount accrued?"

We have had some interesting stories in that regard. We have seen a few situations where companies had a settlement for a fairly

large amount, and we say, “When was this accrued?” We’ll start looking for it because it’s by some sort of disclosure given the amount and sometimes we basically are told that they booked even amounts over a period of time and basically it’s booked up to what they expected to lose.

We think there should be a defined event that triggers the loss. There has to be a reason for the loss. If you think the loss is going to be $200 million, and you’re going to have to pay that in two years, we don’t think it’s appropriate to book $25 million a quarter. You have to look at it as what is the event so we will ask questions: “What is the event that triggers a loss?”

Some people say: “Until you know exactly the amount that you should record, let’s not record anything.” I don’t believe that is what the standard requires. I do believe you have to basically evaluate it. If the numbers change, that doesn’t mean what you did was wrong, but we do expect people to have a basis for what they’re doing and have support for when they make an accrual or they make an adjustment. We will again ask questions about that. So, whenever you have a settlement or an accrual, we will ask questions or we may ask questions about the basis for that in terms of determining whether it is in the appropriate period.

I will say that it has been my experience that it is very seldom that we will have a concern with a company recording an accrual too soon. This is an issue usually where questions about when it’s too late so we have asked questions and we will continue to do so.

A lot of our focus this past year has been on reasonably possible losses. Those are situations where we have seen very little disclosure about historically. We’ve had a number of conversations with companies, a number of exchanges of our letters, which all are a matter of public record. We had responses where companies say, “Well, I can’t determine this number with confidence, with precision.” Basically, they would try to qualify why they could not disclose a number or a range of numbers, because they couldn’t really determine the exact number. We recognize that you can’t do that, but we also don’t believe that there is a basis in the standard to have that type of degree of

precision or confidence as justification for *not* providing the information.

I do also want to emphasize that, when we're asking questions as we have done in the past and we will continue to do so in the future, we're basing it upon the existing standards. We are not looking – we're not making a statement about what we think the accounting standards should be. Obviously, the office of Chief Accountant of the Commission does work very closely with FASB in terms of their oversight of the standard-setting process. But our questions are simply focusing on what is the existing standard. If the standard changes, well, then that is how our focus will change. So, we're not really asking based on an anticipated standard. All of our questions are based on the existing FAS 5 or ASC 450.

We have gone back-and-forth with a number of companies and I'm actually delighted that, after a series of usually going back-and-forth, most companies have concurred with our perspective and have agreed to provide additional disclosure.

You can see some of this additional disclosure about ranges of reasonable possible losses in 10-Qs. A number of them agreed to file in their upcoming 10-Ks, and, while we've asked a lot of questions to financial institutions, it's certainly not limited to financial institutions. We've asked questions in this regard to a number of other companies. And we are seeing companies provide, I'll call it, better disclosure. We're seeing them provide information about the ranges of reasonable possible losses. So we are seeing an improvement in that area and, again, hopefully we will see further improvement in this area in the upcoming 10-Ks.

We have been out speaking on this issue to forums like this as well as we've mentioned it to the AICPA, American Bar Association, PLI, FEI. So we have been getting around trying to spread the word that we are looking at this issue. We do expect people to provide the information that is required by the standards.

The other thing that we sometimes will see when we ask questions about probable losses is that people will sometimes basically (and again it gets back to the range of loss) know they're going to have to pay something but they just don't know the upper end. Again,

the standard requires a company to book the minimum amount. So, if the company knows the sum amount that they're going to pay, but they just don't know the upper end, they do have to book the minimum amount.

We've also been asking questions (again, not just on litigation matters, but regulatory matters) and we've also asked for, when companies can't disclose the exact amount or the precise amount, sometimes certain litigation or regulatory issues are formulaic. They're based on a certain item, like there could be a fine if you did something, if you spilled something, or if you have something that is contaminating waters, you might have to pay a fine based on X times Y. And we'll ask for information about that and about the ranges and what those variables can be to allow a reader, an investor, to understand what is the exposure to the company.

We've also seen situations, somewhat ironically, where we have been (I'll call it) the source of the litigation matter such as under the Foreign Corrupt Practices Act. We can inquire about the timing of the loss recognition in these situations. When are they actually booking the accrual? We see where the accrual is almost coming in the same period as the settlement and, even if the company has self-reported them to the SEC, they know they're going to have to at least pay back the amount of money that they inappropriately made and then some. Sometimes, again, there is information that is available for them to make an estimate of an accrual before the settlement. So we are asking questions in this regard.

We will, again, look to see when there is a settlement, when the accrual was made. So, if we see a large settlement, we will ask questions. Probably the best way to avoid a question (and it makes it better for all parties concerned) is actually to provide the disclosure. I would say pretty much anticipate our questions and then provide the disclosure accordingly.

A couple items about the reasonable possible losses. Again, this is where we've had a focus of a number of our comments. To the gentleman's question, when we see issues that cannot be estimated. One of the things we'll see: Companies will describe, say, ten different cases and they'll basically say we can't estimate

what that potential loss is. And we'll ask questions. I can certainly acknowledge that there will be situations where you might not be able to provide an estimate for all of them. What companies have done is they have provided disclosure of the range of estimated loss for those that they can estimate and disclose that there are other cases in which they cannot estimate those amounts.

Again, the standard doesn't get into the issue about whether you have to describe each one of these individually or if you can describe this in aggregate. We have not objected to companies providing this information in aggregate. But, I will be honest with you, it would be sometimes more informative if it was case-by-case. But we have not required that. So, if you look at what some of the companies have been disclosing, they have been disclosing situations and they'll say, "For those that we can estimate, the range of our reasonable possible loss is between X and Y or up to X" and disclose that there are other cases for which they cannot provide an estimate.

I will caution people in terms of their relying on this concept that they "cannot estimate." We could ask questions about that assertion. We've had discussions internally and with registrants on this very fact. As time goes on, we will become more skeptical of the inability to assert a reasonable possible loss. You might have a basis for it but, again, I think it becomes more difficult as time progresses. So the standard *does* allow a company to make that assertion that they cannot estimate it. If that is factually accurate, then that is fine, and the company is, in fact, complying with requirements of the standard.

Another item that we will frequently see companies disclose (and we're looking for quantified information) is they'll disclose it's not material. Now, if a company makes a simple assertion that any amount in addition to what was accrued is not material to the financial statements, to me that is a form of quantification, just saying any additional amount is simply not material. And they don't have to provide any additional information. But, I will caution that, what we frequently will see are companies making an assertion that it will not be material to the balance sheet, but it could be material to the income statement and cash flows. If that is a factually accurate statement, there is no prohibition against the

company from making that statement. But I do not view that as providing the information as required by the standard. In other words, if you make that statement, we would still expect a company to provide quantified information about reasonable possible losses or the fact that they cannot estimate that amount. So, again, the distinction is one in making materiality assessments to the financial statements as a whole and the other in making materiality assessment to just part of the financial statements. We frequently will see more the latter than the former.

The other important aspect is we do expect companies to update this information. I don't want to say continuously, but on a periodic basis when they're reporting. So, if a company is providing information in their 10-Q, we would expect companies, if there is a significant change, to provide such disclosure. I think it is important to update this analysis continuously as events change.

How I almost envision a company could do this is called having (and perhaps over-simplification) but an Excel spreadsheet where they have a list of all their cases. Things move back-and-forth between the columns. Something could go from "remote" to "reasonably possible," perhaps to the "probable." You could have, in theory, one case against a company that could be in all three different categories. You could have a case where you know you're going to pay an amount. Somebody could sue you for an incredibly large sum of money. You might determine that, yes, you'll have to pay something and you accrue for that. You might disclose that, based on other cases, the courts would likely rule that it could be higher than that. So we have a reasonable possible loss, but any amount *in addition* to that amount would be remote and not have to provide disclosures.

We have seen some companies make an assertion in terms of disclosure for reasonable possible losses that, once somebody makes a claim, unless it's viewed as frivolous, they will view pretty much the upper end of what that person is making a claim for is to being the maximum amount of a reasonable possible losses. If a company wants to make that assertion, and they believe that is in compliance with the standard, then that disclosure would certainly be adequate or comply with it. We have seen

others where they will make more of an assessment, or a detailed analysis, of what that upper end of a reasonably possible loss should be made. Stepping back, the concept of what this is trying to do is to say, "You've accrued so much, that is on your balance sheet, the disclosures for that are relatively limited. This is to provide a reader with information that is in addition to what is accrued on the balance sheet."

One of the interesting aspects that we frequently see when we go out and talk to different groups is, I gave a speech at FEI, the Financial Executives International, back in November. A number of people came up to me afterwards (and these were the chief accounting officers, the controllers of some very large companies) and they said, "We agree with you but my lawyers will not let me touch the footnote on contingencies. I write everything else in the document but my lawyer, when I give them suggestions or edits to my financial statements, they tell me I cannot make those changes."

Obviously, I think the lawyers probably have a different perspective of that assertion, if you would, but I do believe that this requires a group effort. This requires the company's accountants. It requires the auditor's involvement. It requires the lawyer's involvement. It's not just one group just writing it and the other group accepting it. It does require, I think, a collaborative group. It's an important item. This year, our expectations, I would encourage you to take a fresh look at your disclosure this year. Take a look at it, take a look at the standard, and take a fresh look, as in: Don't simply repeat what was done last year. Clearly, comply with requirements of the standard.

In addition to that, one of the things that we have found is that people can comply with the standard and not necessarily provide meaningful information. Obviously, we're asking for compliance. But one of the things that we have found is really trying to understand these different buckets that people put items in and to put it in context because in a situation where you have multiple cases and some you can't estimate, some you can, and you provide information, it becomes very difficult to understand the context of that additional disclosure. What cases does that relate to and what does it not relate to?

So, again, I would encourage you, to the extent that you can, and that you don't believe that you are giving away information that would compromise the company's position, to try to make the disclosure as meaningful as possible. Look at it from the investors' perspective when writing.

Young: How did we do it? Our goal was to allow exactly 17½ minutes for questions, and that's exactly what we've accomplished. By the way, there has been a lot of information that has just, sort of, come. We've got tons of questions here, by the way. They have been emailed in anticipation of the program, and we can do those, but you guys have dibs because you're here, and they're not. So, what questions do you have? Yes, you.

Audience: I'm glad to (and I'll say it) be on this side of the table for a change. I want to key off of something that Wayne just spoke about in terms of some companies may be asserting that the claim amount is more or less the upper limit of the "reasonably possible loss" and then anything over and above that would be "remote" and that might be in the corporate . . . to know about the disclosure. Well, that certainly seems to sound a lot like the first Exposure Draft to a certain degree. And, Michael, I'd like to get your reaction to that in terms of how – because I know you're very uncomfortable with the whole concept of making predictions and disclosing predictions – but some of what Wayne is saying about what the disclosure requirements are today could certainly sound like it's predictive-type of information. How would you reconcile all of that?

Young: David, first of all, they tell me I have to repeat the question. So the gist of the question is: What is the reaction to disclosing the amount of the claim?

Audience: Not just that, but also the concept of maximum "reasonably possible" exposure which Wayne is saying is his view on how the standards are supposed [to be today].

Young: Well, there's a big difference between the two. On the amount of the claim, I know that very sophisticated heads of litigation have, in some instances, objected to that. I understand it.

I respect it. But when you balance the desire of users for quantifiable information and, if it's in the complaint, I mean you are not really letting too many cats out of the bag.

Now, to your point, David, on the estimate of the "reasonably possible" range of loss which is mandated by the standard – well, then, you've got to do it. If you can do it, and you can do it in compliance with the standard, and you can come to the right – a number that you're comfortable with – well, then, you do it. As a defense lawyer, gee, I really hate to see that. But that's the way the standard works. Wayne, what's your reaction?

Carnall: I can certainly appreciate the concern. I do agree with you, though, Mike. That is the way the standard currently works. I think in practice usually, as I said, I believe you could have one claim that fits into all three different buckets. I think the mere fact that somebody makes a claim – I do personally think it requires an analysis of – that there's going to be parts of it which may be frivolous and would hit the remote category and would not be part of the disclosure.

Also, a quick story: When I was in public accounting, I did a lot of work with non-U.S. companies. I was actually sued in Indonesia for a billion dollars. Well, I didn't have a billion dollars. So if I was making my personal financial statements, I would put that as remote. Luckily, it turned out to be zero, or else I probably wouldn't be here. I would be in an Indonesian jail. But I do think that the mere fact that somebody makes a claim or a loss doesn't mean that's a "reasonably possible loss."

Audience: Further to that same point, so the range, you know, the different terms that are being used. We've got "remote." There's also "possible." And then "reasonably possible." And then there's "probable." Right?

Carnall: Well, actually, the standard uses three terms.

Audience: I understand the standard uses three terms. But what a lot of people that I've been talking to have been wrestling with is: So "remote" they're familiar with. "Probable" they're familiar with. "Possible" you could sort of see as being in the range

between there. So what's the difference between just "possible" and "reasonably possible"?

Carnall: The middle bucket captures everything. The middle bucket would be: Again, you have the "probable." You have the "remote." "Reasonably possible" is everything in between. There is not (I'll call it) a fourth category.

Again, the issue is when, let's say, a company is sued for a billion dollars. Would that billion dollars fall into a reasonable possible loss? I think that depends on the circumstances. It may and it may not. You know, I think people could do an analysis and conclude that the upper end, based on all sorts of court rulings, may be just totally remote – very little chance. The fact is, again, if you look at the terms, "remote" doesn't say it could *never* happen. It's just not *likely* to happen.

Audience: Just to follow-up on that point. Because I know some people have said one analysis is: "What's the likelihood of loss?" So the likelihood of loss is – is it "probable," "reasonably possible," or "remote"? If I'm in the "reasonably possible" range, the standard then says: Disclose the amount of "possible loss" or "range of loss." It doesn't say "reasonably possible loss." So, some people have said, "Okay, once I'm in the "reasonably possible" bucket, I have a likelihood of loss which is really [possible]. The disclosure then can go to the range of loss. And the range of loss can be anything from zero to the claim amount or something beyond the claim amount. Just curious if that thought has entered into any discussions that you all have had.

Young: Let me do the hard part, which is to repeat the question, and then the easy part, Wayne, you can answer it. The question is: Once you trigger the "reasonably possible loss" threshold (so, now you're going to say something), do you give the "possible loss" (which could be a lot more), or do you give the "reasonably possible loss"?

Carnall: John, it's an interesting argument. I have not heard, in our discussions, people trying to make a determination – in other words, if I could get different numbers from "reasonably possible" and "possible" – I have not heard anyone make an assertion that I

would have a different number in that discussion. I have to admit, the answer is not anything I've given focus to . . . dissecting the words perhaps too much.

I know that I think lawyers, sometimes, do that more than accountants do in terms of dissecting these words. I have found, from my own personal experience, and when we get involved in rule-writing, sometimes, there could be distinctions that are not intended to be distinctions. I would actually have to go back, and look, and read the actual standard on that to know if anybody would have a distinction. But I have not heard anyone make that argument for having a different number disclosed in their financial statements.

Young: John, just to add to that in a way that is consistent. The way this is supposed to work, I would think they're thinking "reasonably possible loss." I wouldn't think that the intent is that, once you are past the "reasonably possible loss" threshold, now you are disclosing something that's "possible" but unreasonable.

Audience: But the point and the concern that can come out of that is: Am I giving away information now that could be prejudicial if I'm actually putting in there an amount that I think is "reasonably possible"? Where, if I disclose up to the claim amount, the claim amount is the amount that the plaintiff already gave me. So, there's really no harm nor foul in disclosing that. That is a "range of loss": zero to the claim amount. So, you get into a dialogue here . . . .

Young: Well, it takes us back to David's point. To follow up on something that Wayne said (which I actually view as quite important) is to keep in mind that the staff will not object if you aggregate the numbers among a number of litigations. So to the extent that you're concerned, understandably, about an admission, aggregation should take some of the sting out of that.

Carnall: You know one of the interesting aspects of this, Mike (the point you were actually just making), is that this can actually be more problematic or challenging for a smaller company than a bigger company. There could be some companies where they will just simply have one litigation matter and where the disclosure will

obviously just be about that case. Where some of the larger companies can have pages and pages of issues outstanding.

Young: Yes, sir.

Audience: From the SEC standpoint, in looking at a "reasonably possible loss" from a defendant that's not [quantifiable], what is the basic calculus for looking at plaintiff's books and trying to reconcile them?

Carnall: Well, in terms of a company having a contingent gain or a contingent loss, it is ordinary to not have symmetrical accounting between the two parties. So the person suing the company cannot record a contingent gain. So the gain would be recorded basically upon either the receipt or a court ruling in their favor. You could clearly have a loss before a company would record a gain.

We do sometimes look at issues when we see that there are matters that can impact more than one registrant. I'll either call both sides or multiple parties to a certain issue. We have looked at different filings to look for consistency of the disclosure, consistency of argument. Sometimes there's a reason for differences, and sometimes we will ask why there is a difference. Because we don't always think that there would be. So we don't look at symmetrical accounting. But we do look at calling multiple sides on occasion.

Young: Yes, sir.

Audience: Tell me if this question is outside of the scope of this discussion, but when you ask for more quantitative information, in my experience, it requires some dialogue, usually between the litigation people and the CFO and his staff or the outside accountants. So, you have to do some kind of analysis of the strengths and weaknesses of your case. When you have that communication, my impression is that's privileged as attorney work product. But I'd be interested in what you think about that, because that's obviously a very sensitive area, particularly as people start talking about being more quantitative or even as you're discussing what you're eventually going to disclose. You

may be discussing a lot of details that you don't want to leak out . . . .

Young: That is precisely within the scope and, to some extent, really strikes at the heart of what is going to be on the minds of pretty much 100% of the people here.

Let me just give you the general way the law has been working on this, so that we all probably know it. First of all, you are exactly right. The broad question is: "How does attorney-client privilege fit into all of this?" When you have these communications with the lawyers, that is, of course, privileged. And it is probably also work product, if you're talking about litigation.

Many courts have found (certainly the plaintiffs would argue) that, when you tell the auditor (even if it's real sensitive information like, "It's probable we are going to lose"), then that waives the privilege. And that is a *real* problem for the preparers. It's just a problem. That's the attorney-client privilege.

There is also work product, and many courts would find that the work product protection is still preserved. Not 100% of the courts, but many courts would find that the work product protection is still preserved. So, that's some comfort, but it's not as much comfort as cautious defense lawyers would like. Unfortunately, that's just sort of the state of play right now.

I have suggested to everybody I can get to listen (and now that will include this group) the real solution to that is a legislative solution where, if you tell the auditor, it can remain confidential. I think, my own view, is that there are very strong policy reasons in favor of that kind of outcome. But the alternative to the legislative solution is going to the courts one by one and trying to persuade them that it should be protected.

I want to follow-up, though, because you've introduced this concept of the interplay between the lawyers and the auditors. One of the questions (and it's actually question 3 on the chart) is the role in all of this of the so-called "treaty" between the accountants and the legal profession, where it's very highly scripted as to what

the dialogue is supposed to be. That's where the attorney inquiry letters come from and all of that.

One of the things we heard Wayne say is that financial statement presentation is called for which takes into account such things as the probability of loss, the reasonable estimate of the loss, the range of possible loss. However, the treaty says (now, it was largely crafted by lawyers so it says this in many, many words): Don't talk about such things, unless the risk of being incorrect is slight. The lawyer, whether it's outside lawyer or inside lawyer, is not to have that conversation on those subjects with the auditor, unless the risk of being wrong is slight.

One of the questions that comes up is (and Wayne, I'll be interested in your reaction if you can have a reaction): Suppose you are talking about mandated disclosure and the auditor asks you about it. You say to the auditor, "I'm not talking to you about that." Then it turns out that mandated disclosure ends up not being made, because you didn't talk to the auditor. And then somebody reporting to Wayne calls you up and says, "What's the story?" And you say, "I am protected by the ABA treaty." And the question is: "Does that work?

Carnall: I'll certainly share a view and I'll remind everyone of the disclaimer I gave this morning. But in terms of the treaty we – Mike and I – actually had an exchange about this very question last night.

The treaty is not part of the accounting codification in terms of GAAP. I looked last night, and it's not there. It is between two private organizations that have not gone through any form of (I'll call it) due process that an accounting standard goes through. The company has an obligation to comply with federal securities laws and has an obligation to file financial statements that comply with GAAP. GAAP is basically, as the codification, is authoritative GAAP. This treaty is not part of that.

So, to your situation, Mike, if you have that fact pattern, would that be a defense that we think would be satisfying – the company *not* providing disclosure that would be otherwise required by GAAP? I would say no. The company has the obligation to

comply with GAAP and the auditors have the requirement to audit such statements.

Young: Mitch?

Audience: If I could just come back, for a minute. In making your personal case about the Indian, sorry, Indonesian claim against you. If you get that claim, and you look at it, and say that, "This is a bunch of bologna. It's worth zero," but then you think about it a little bit more and think, "I'm going to have to litigate this case in Indonesia. You have to be there. And now you have to take into account: "What is likely to happen to me if I go all the way?" You can probably conclude that: "I'm not going to risk my billion dollars," if you had it. So you have to do something with this case, which probably means settling it. So what is your disclosure advice in those circumstances?

Carnall: It's an interesting question if you have a situation where you've got to make an offer to the other party just to get the case to go away. Now, whether you have to accrue for it – I think, if you make an offer back to the other party, I think there'd be, I would say, a presumption that you would accrue for that and you would record that.

I think, perhaps, you can make a situation where that may not be the case – where you might say: "Regardless of whether I make an offer back, and if I litigate this matter, I won't have to pay anything out," and they might not have accepted it.

Again, these are fact situations. If I think I have a "probable" claim, I would go through the assessment. I would determine whether I thought this was a frivolous case or that maybe, perhaps, there *was* something that was "reasonably possible." So I could, again, have something (I could have an amount that I've offered him, say, $1,000) which I accrue as probable. So that I could say: "If I actually *do* litigate this, based on all the court cases out there, that maybe the maximum I might have to pay is $2 million." So I see "reasonably possible loss" and that's what I would disclose in my financial statements and I would do the other part as just being "remote." I think it's the requirement of the specific fact pattern.

Audience: [Question]

Carnall: I think the argument here that you're trying to make is whether that would be prejudicial. And, as I say, I can appreciate that fact and, you know, we have not objected to companies providing information disclosing the facts and providing information in the aggregate.

While we're looking at this issue (and it's an item where people can say, "Well, geez, this will be bad if we have to disclose it"), we're looking at this fairly – I don't want to say overly simplistic, but we are expecting companies to comply with the standard. That is what we are asking for people to do.

We have found that we've issued this comment to a fairly large number of very large companies. And they are, in fact, changing their disclosure. They've done so in 10-Qs. They will do so in 10-Ks. So I do believe that companies can provide disclosures that are in compliance with the standard without prejudicing their case. I think a number of companies have done so.

Audience: [Suppose it's way too early in the game. But you're kind of feeling like, one day, you're going to have to pay some money in the case. You don't know how much. But you know you're going to have to pay somebody. How does that affect disclosure?]

Carnall: In terms of whether I should disclose a reasonable possible loss? I may have to. I guess I would throw the question back to you. What would you disclose?

Audience: If I had my choice as defense counsel?

Carnall: You're not defense counsel. You are the Chief Financial Officer and you're signing a 302 certification. What would you disclose?

Young: Let me add a fact. Let's say – and, believe it or not, I'm even going to make it more difficult. Let's say you think it's probable you're going to pay money. How much are you going to pay? Let's say, "Look, it's going to take $5 million to get out of

this case. And, in fact, to litigate it in Indonesia, it's going to cost me $10 million." So I have in my own mind: It is probable that I am going to pay $5 million. What do you do? I know what I would do. But I'm curious what would you do?

Carnall: I would say you would probably accrue it.

Young: That's how I came out. Let's now even make it *more* difficult. An additional fact. You don't know whether they are going to take $5 million. You're satisfied you're willing to pay it. It would probably take at least that much. But you think it's probably going to be rejected. And, if you litigate, you are going to win. So you're willing to pay $5 million. You think it's probable you would have to pay $5 million. You don't think the people are going to accept it. And, if you are going to litigate, you think you're going to win. What do you do?

Carnall: That could be a tough play. I could see it going, perhaps, both ways. I do think, if you're making an offer, it can be very difficult to assert that that's not your minimum amount.

Is it possible to make an assertion that you don't have to accrue for it? I think, perhaps, you could. But I would look at it very, very carefully. One of the great things when you're with the government, and you do these kinds of speeches, you can always fall back on, "It's facts and circumstances." And I'm not even a lawyer.

Audience: Would you have an answer if the case settles for $50 million dollars?

Young: Let me offer – at the risk of disagreeing with the SEC, which I would never do – let me, at least, make the argument. One of the things that the standard tries to get to is a philosophy about "What's going to happen? What do you really think is going to happen?" It's not just with regard to ASC 450. It's with regard to fair value accounting and so many other aspects of financial reporting. If you think that it is probable you are going to pay money, you're willing to offer $5 million, and you think it's going to be rejected: Therefore, you do not think it's "probable" that you are going to end up paying the $5 million. And you think it's

“probable” you are going to litigate, and you’re going to win. One argument would be: Notwithstanding your willingness to pay the $5 million, that you accrue nothing, because that’s how you think it’s likely to come out. That’s the “probable” scenario.

Carnall: Actually, I think I agree there. If you are offering something, it creates a somewhat . . . .

Young: I’m with you. I left out the offer part.

Carnall: I do think you could make out a situation where you would not accrue anything.

As time is winding down, I do want to make one other point. When you’re looking at this (and there is obviously a lot of subjectivity to this), we are not in the (people might think we are) business of second-guessing. We do ask questions. But one of the things that is important is companies actually can document their positions if they have a basis for an accrual. But they support that and things change. They have a basis for either changing the numbers or a basis for not changing the numbers. Again, it gets back to, in every period, I think this issue needs to be looked at. People have to make an assessment of what they should either account for, or disclose a continuous evaluation of the underlying facts and circumstances. If numbers either change, they have a basis. And if numbers don’t change, they have a basis for that.

Young: With that, we’re actually over the time, which trial lawyers are *never* supposed to do. I’m going to ask about getting everybody extra credit for coming out after a snowstorm and thank you very, very much.

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