Wednesday, October 3, 2012
11:00 AM - 12:30 PM

1309 – Understanding Financial Statements and Basic Accounting Concepts

Samuel Cheris
General Counsel
Integrated Asset Services LLC

William Gupp
Chief Administrative Officer, General Counsel & Secretary
Trex Company, Inc.

Emmy Hessler
Attorney
N/A

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Faculty Biographies

Samuel Cheris

Samuel Cheris is the general counsel of Integrated Asset Services LLC. His responsibilities include contract review and negotiation, handling of claims and litigation, legal aspects of employee benefits plans, entity governance and risk management.

Mr. Cheris has also been general counsel to Relera, Inc., a data center start-up and Blackhawk Geophysical Company, an entity involved in many aspects of geophysical work, including the discovery and remediation of UXO (unexploded ordnance). He was previously a partner and chief financial officer of Hall & Evans LLC.

He is currently the treasurer of the Aurora Bar Association and is past president and treasurer of ACC's Colorado Chapter. He is also chairman of International Hearing Dog, a 501(c)(3) organization, which provides dogs to deaf and deaf-blind recipients, the vice president of the Legal Commission of the International Fencing Federation and the chairman of the Fencing Officials Commission of USA Fencing.

Mr. Cheris received his BS in accounting from Brooklyn College (CUNY) and his MBA and JD from Stanford University.

William Gupp

William R. Gupp is the chief administrative officer, general counsel and secretary of Trex Company, Inc., a NYSE company based in Winchester, VA. Trex Company is the world's largest manufacturer of wood-alternative decking and railing products. He has primary responsibility for legal, corporate governance, compliance and HR matters at the company, and serves as secretary to the board of directors.

Prior to joining Trex, Mr. Gupp was employed by Harsco Corporation, an international industrial services and products company, based in Harrisburg, PA, most recently as senior counsel and director-corporate development. Prior to Harsco Corporation, Mr. Gupp was an associate at Harter, Secrest & Emery, in Rochester, NY.

Mr. Gupp received a BS in accounting from Syracuse University and a JD from the University of Pennsylvania Law School.

Emmy Hessler

Emmy Y. Hessler most recently served as vice president and general counsel of Aspen Dental Management, Inc., a privately held dental practice management company operating in 22 states.

Ms. Hessler began her legal career with the law firm of Skadden, Arps, Slate, Meagher & Flom LLP, focusing on M&A, securities and general corporate matters. She has spent more than a decade in-house, including a number of roles with medical device manufacturer Boston Scientific Corporation (NYSE: BSX) and with the Cleveland Clinic, a $6 billion nonprofit health system. Prior to embarking on a legal career, Ms. Hessler served as a senior staff auditor with Bank of Boston Corporation (now part of Bank of America).

A Phi Beta Kappa graduate of Wellesley College, Ms. Hessler earned her JD with honors from The University of Chicago Law School.

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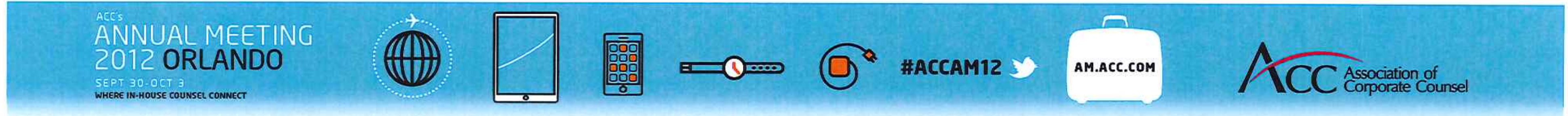

Understanding Financial Statements and Basic Accounting Concepts

Panelists:

William R. Gupp – CAO, General Counsel & Secretary, Trex Company, Inc.
Samuel D. Cheris – General Counsel, Integrated Asset Services LLC
Emmy Y. Hessler – Former General Counsel, Aspen Dental Management, Inc.

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Outline of Presentation

- Introduction
- Framework for Understanding Financial Statements
  - Auditors' Opinion
  - The Balance Sheet
  - The Income Statement
  - Statement of Cash Flows
  - Statement of Changes in Stockholders' Equity
- Introductory Financial Analysis
- Notes to Financial Statements
- Financial Statement Wrap-Up
- Role of the Lawyer

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Introduction

Financial Statements v. Tax Returns

- Companies are required to keep two sets of books:
  - Tax Purposes
  - Financial Statements
- For the most part, these two books will be the same, but there are some differences
- For today, we will be focusing on financial statements only

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Rule Makers and Rules

- **SEC** – Securities and Exchange Commission
  - Founded in 1934
  - Enforces federal securities laws and stock exchanges
  - Has statutory authority to establish financial accounting and reporting standards for publicly held companies, but relies on private sector for this function
- **FASB –** Financial Accounting Standards Board
  - Founded in 1973, and overseen by FAF (Financial Accounting Foundation)
  - Establishes standards of financial accounting that govern the preparation of financial reports by nongovernmental entities
  - Standards are officially recognized by SEC
  - Funded by accounting support fees collected from all public companies and sales of publications
  - Replaced APB (Accounting Principles Board)

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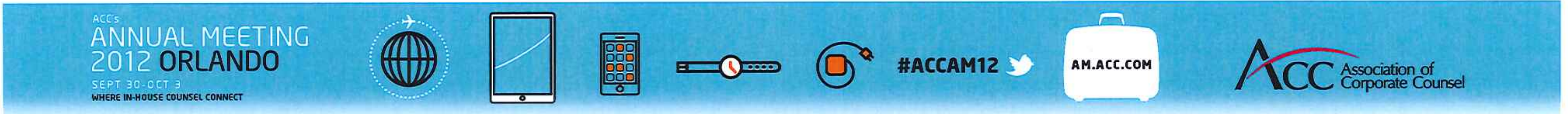

- **GAAP** – Generally accepted accounting principles. Standard framework for accounting and preparation of financial statements, developed over time. Basic principles are:
  - Historical cost
  - Revenue recognition
  - Matching
  - Full disclosure
  - Conservatism
- **FASB Pronouncements** – Used prior to 2009. Included Statements of Financial Accounting Standards, Statements of Financial Accounting Concepts, Interpretations, Technical Bulletins, and Staff Positions
- **ASC** - On July 1, 2009, FASB announced the launch of its Accounting Standards Codification ("ASC"), which organizes the many pronouncements that constitute U.S. GAAP into a consistent, searchable format

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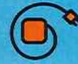

- **PCAOB** – Public Company Accounting Oversight Board
  - Non profit corporation established under Sarbanes-Oxley to oversee the audits of public companies
  - Established in wake of a number of accounting scandals where the accuracy of the independent audited financial statements was called into question
  - Previously, audit profession was self-regulated
  - Five members of PCAOB Board are appointed to staggered five-year terms by SEC after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury
  - Sarbanes-Oxley established funding for PCAOB activities, primarily through annual fees assessed on public companies in proportion to their market capitalization and on brokers and dealers based on their net capital

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Fundamental Accounting Equation (Double-Entry Bookkeeping)

- Assets = Liabilities + Owners' Equity

Assets	Liabilities + Owners Equity

- The accountant will record each transaction or event that occurs with corresponding entries that keeps the basic accounting equation correct
- Examples:
  - Company pays $100 in cash to buy some inventory – Reduce cash (an asset) by $100 and increase inventory (an asset) by $100
  - Company buys the inventory on credit for $100 – Increase accounts payable (a liability) by $100, and increase inventory by $100. When this accounts payable is eventually paid, decrease cash by $100 and decrease accounts payable by $100

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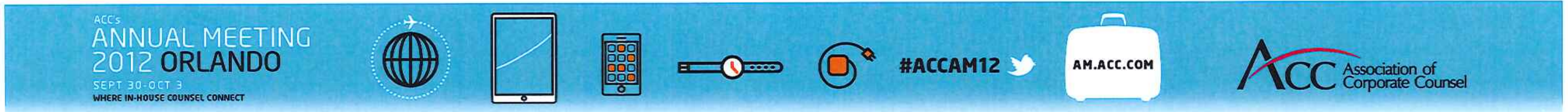

- Examples:
  - Company sells for $150 in cash the inventory it purchased for $100 - Increase cash by $150, decrease inventory by $100 and increase retained earnings (owners' equity) by $50
  - Company sells for $150 on credit the inventory it purchased for $100 - Increase accounts receivable (an asset) by $150, decrease inventory by $100 and increase retained earnings by $50. When the accounts receivable is collected, decrease accounts receivable and increase cash
- Cash v. Accrual Accounting
  - Accrual - Transactions are counted when the order is made, the item is delivered, or the services occur, regardless of when the money for them (receivables) is actually received or paid
  - Cash - The cash method is the more commonly used method of accounting in small business. Under the cash method, income is not counted until cash (or a check) is actually received, and expenses are not counted until they are actually paid

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Framework for Understanding Financial Statements

- At the end of our presentation, you will have a framework that will empower you to:
  - Be more valued by your clients and more successful in your role
  - Prioritize your work better
  - Make better career and personal finance decisions
- You will also become privy to Every Accountant's Little Secret
- Best of all: You already know everything you need to know to understand financial statements.

(You just might not be aware of it.)

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"Swing Thoughts"

- Don't get hung up on the math
- Don't get bogged down in the jargon
- Don't try to do everything at once: Distinguish between "financial statements" and "financial analysis"
  - Like law vs. legal analysis, a firm grounding in the former is a necessary prerequisite to the latter
- Bear in mind Every Accountant's Little Secret...

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Every Accountant's Little Secret

(and every other member of a learned profession)

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The Framework

"**Balance Sheet**" *"Statement of net worth"*
(point in time snapshot)

Basic Equation: Got - Committed elsewhere = Got for real
A - L = E

"**Income statement**"
"**Statement of cash flows**" *"Checkbook register"*
"**Statement of changes in Stockholders' Equity**" (in/out activities over a period of time)

Basic Equation: $ in - $ out = Net

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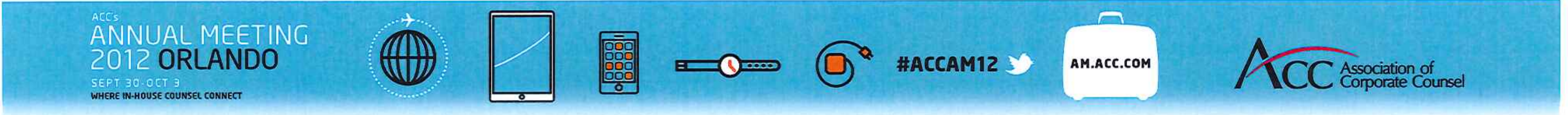

Auditors' Opinion

The Auditor's Opinion tells the reader what statements the CPA looked at, what standards they used to audit these statements, their opinion as to whether the statements present fairly the financial position of the Company and the fact that they have issued a separate report on the internal controls of the Company

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Balance Sheet

- The Balance Sheet provides the reader with a snapshot of the Company's Assets, Liabilities and Owner's equity.

- Most assets are shown on the basis of historical cost, adjusted for depreciation or amortization if the asset has a determinable useful life and adjusted downward to reflect a recognizable diminution in value.

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Income Statement

(*a.k.a.* statement of income, statement of earnings, statement of operations, statement of operating results, P&L)

- Purpose: Summarizes on an accrual basis the company's $ inflows (*i.e.*, sales, or revenues), and $ outflows (*i.e.*, expenses, or costs) to generate them, over a period of time

- What's left over (*i.e.*, the "net") is the profit (or loss) for the period

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Income Statement

Framework		TYPICAL PRESENTATION		Vernacular		*Also known as:*
$ in		Net Sales		"Top line"		Revenues, gross revenues
- $ out		*- Cost of Sales*		- costs of production		Cost of goods sold; cost of revenue; may include line items for R&D, materials and production, "non-recurring"
	ST	Gross income				Gross profit
- $ out		*- SG&A*		- overhead		Operating expenses. May include line items for marketing and administrative; asset writedowns
	ST	Income (loss) from operations				Operating income; operating profit (loss); EBITDA (unless D&A is incl. in cost of sales);
- $ out		*- Other Income & Expenses*		- catch-all		May include line items for: Interest, D&A, non-operating income (losses), foreign exchange gains (losses), unusual and "non-recurring" events and "special items" incl. discontinued operations, "extraordinary items", effects of accounting changes, "other"
	ST	Pretax Income (loss)				Income (loss) before provision for income taxes
- $ out		*- Taxes*		- government		
Net		Net Income		"Bottom line"; profit		Net profit; net earnings

*Below the bottom line, information is provided that helps show how the profit is allocated among the shareholders, ultimately arriving at earnings per share (EPS).

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Statement of Cash Flows

(*a.k.a.* cash flow statement, funds flow statement)

- Purpose: Summarizes the company's sources ($ in) and uses ($ out) of cash over a period of time
- 3 ways to generate cash, and each has certain cash outflows associated with it
  - Operating activities
  - Investing activities
  - Financing activities

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Statement of Cash Flows

		$ In (examples)	$ Out (examples)	Net
Operating Activities *(presented as a reconciliation of net income – an accrual-based concept – to net cash from operations)*		Cash from customers	Paying suppliers for raw materials and inventory; paying employees	Net cash from operating activities
Investing Activities *(presented as transactions)*		Sales of long-term assets; Returns on financial instruments	M&A purchases; buying/building other long-term assets (plants, IP, etc.)	Net cash from investing activities
Financing Activities *(presented as transactions)*		Proceeds from borrowings and equity issuances	Principal payments on loans; debt and equity buybacks	Net cash from financing activities
			Total:	Net increase (decrease) in cash and cash equivalents

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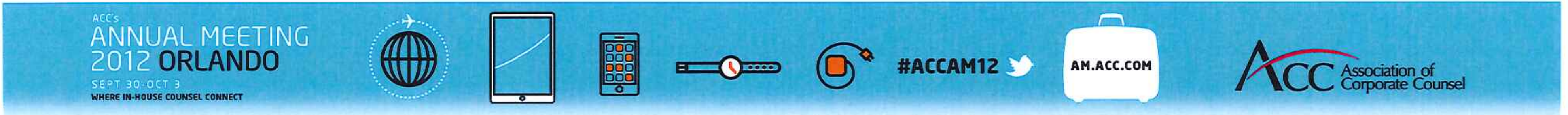

Overview

- Note: Net Earnings and Net Cash can be calculated from the face of the balance sheet

- The Income Statement and Statement of Cash Flows merely provide additional information about inflows and outflows to show what's behind the Balance Sheet picture.

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Statement of Changes in Stockholders' Equity

The Statement of Changes in Stockholders' Equity traces the changes to the Capital Structure of the Company. It will show sales of the Company's Stock, Profits and Losses, Employee Stock Purchase and Option Plans, Repurchases of Stock, Stock-based Compensation and Repurchase of Convertible Notes.

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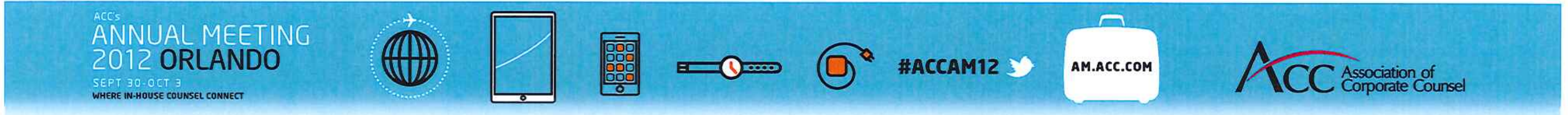

Introductory Financial Analysis

The Balance Sheet can be used with Income Statement information to determine certain key relationships relating to Liquidity, Operational Efficiency and Solvency. There are other ratios that rely solely on Income Statement data.

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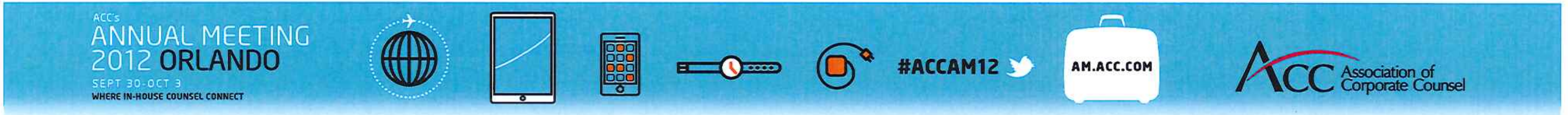

- LIQUIDITY:
  - Current Ratio = Current Assets/ Current Liabilities

2011 - $102.0/120.6 = .85

2010 - $112.2/46.2 = 2.43

What caused the change?

What is a good ratio?

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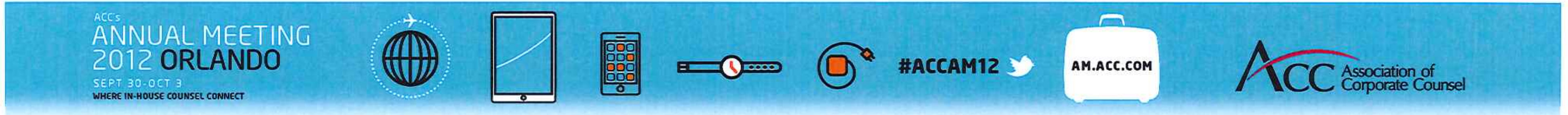

– Quick Ratio = Current Assets – Inventory/ Current Liabilities

2011 - $73.1/120.6 = .61

2010 - $83.2/46.2 = 1.80

Test of ability to pay short term obligations

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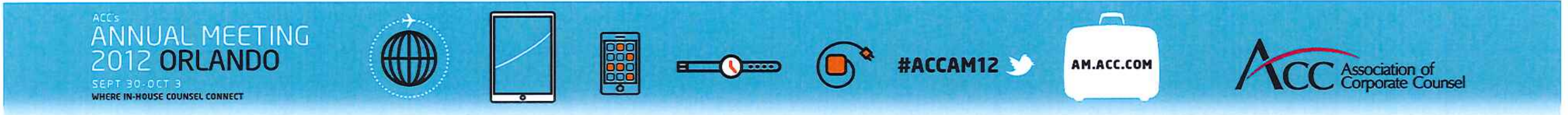

- OPERATIONAL EFFICIENCY
  - Accounts Receivable Turnover = Sales/ Average Accounts Receivable

  $266.8/41.3 = 6.46

  Measure of Asset Utilization

  Low Ratio May Indicate Collection Issues

  - Inventory Turnover = Cost of Goods Sold/Average Inventory

  $204.0/ 29.0 = 7.03

  Low Ratios Points to Slow Moving Inventory

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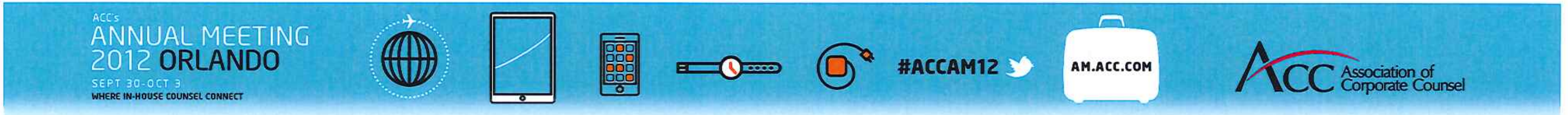

- SOLVENCY
  - Debt to Equity = Total Debt/Average Stockholders' Equity

  $86.4/97.7 = .88

  A High Ratio Could Indicate a Need to Restructure some Debt

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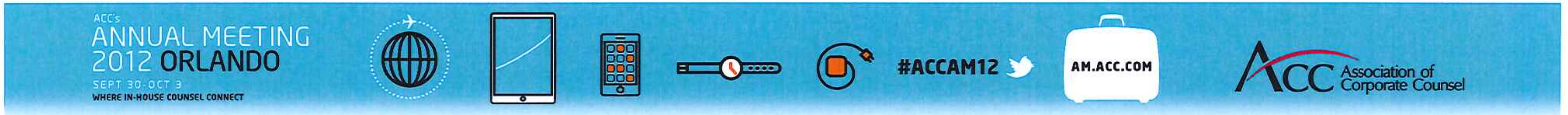

Notes to Financial Statements

The footnotes provide explanatory and supplemental information about the Company and its financial statements. They describe the significant accounting principles utilized in the preparation of the statements, provide detail on specific items on the statements and disclose information not included on the statements, such as Commitments and Contingencies.

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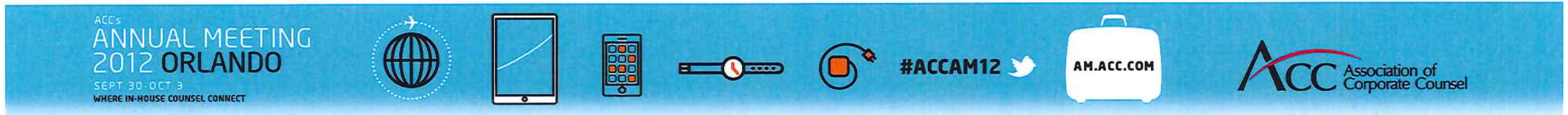

- Note 1 – Business and Organization
  - This Note will describe the type of business in which the company is involved and its form or business organization.
  - Trex manufactures and distributes wood-plastic composite decking and railing

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- Note 2 – Summary of Significant Accounting Policies
  - Basis of Accounting
    - US GAAP
    - Consolidated statements with wholly-owned subsidiary
    - Investment in 35% equity interest accounted for using equity method – investment in equity and note receivable not recoverable – charge recorded to earnings to fully reserve investment

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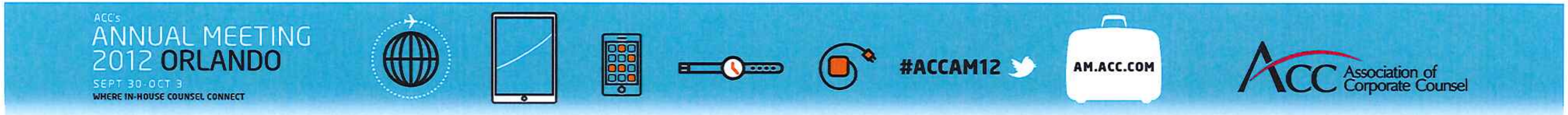

- Iron Deck Acquisition – description of 2011 acquisition transaction
- Cash and Cash Equivalents – definition
- Concentrations and Credit Risks
  - Deposits in excess of FDIC insurance
  - Evaluation of financial strength of customers and recording of allowance for bad debts
  - Description of sales to customers, which account for more than 10% of sales
  - Description of percentage of purchases from four largest suppliers

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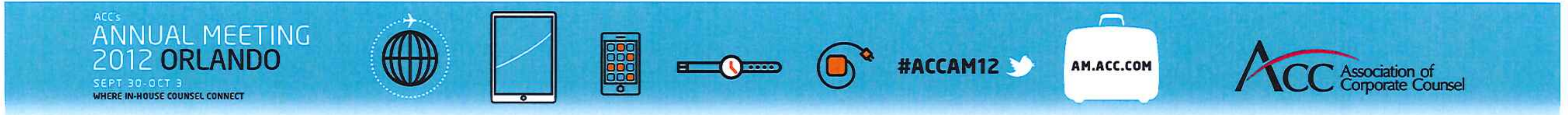

- Inventories
  - LIFO (lower of cost or market)
  - Excess of replacement cost over LIFO
  - Reclaimed scrap

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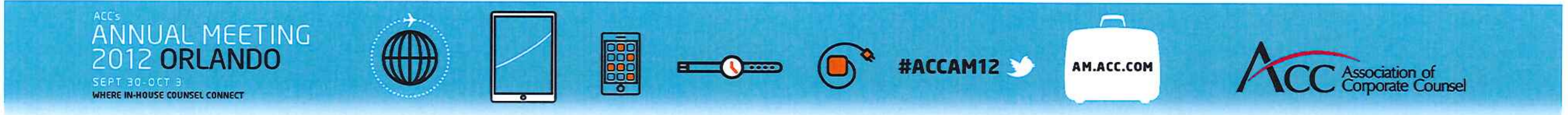

- Property, Plant and Equipment
  - Historical cost
  - Capitalization of additions and improvements
  - Expensing of Maintenance and repairs
  - Straight-line depreciation – lives noted
  - Reduction of carrying values based on prices for similar assets and condition of the fixed assets

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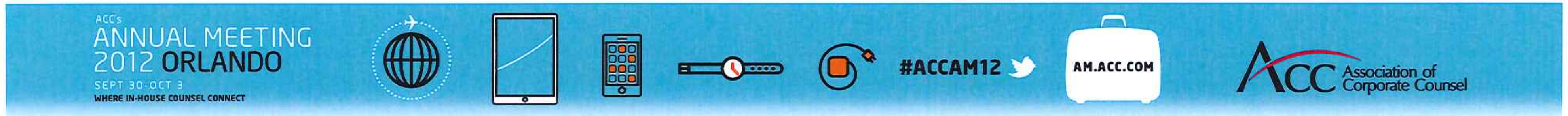

- Contract Termination Costs – accounting for sublease
- Goodwill – excess of cost over net assets acquired – reviewed annually – FMV of unit versus carrying value
- Product Warranty – Company establishes reserves to provide for estimated future expenses as a result of product defects that result in claims
- Revenue Recognition – When title transfer to customer
- Stock-Based Compensation – recognized on grant date of award – based on FMV allocated over vesting period, net of estimated forfeiture rate

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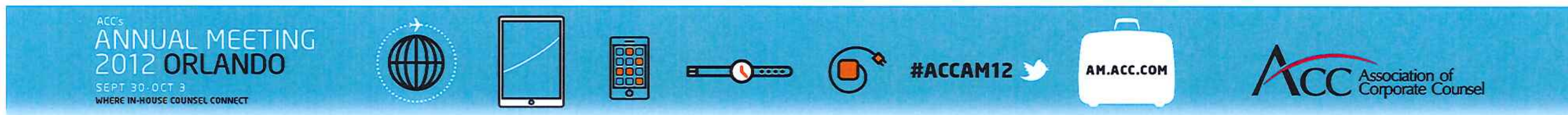

- Income Taxes – Note defines methodology for determining deferred tax liabilities and assets
- Research and Development Costs – Expenses as incurred
- Advertising Costs – branding and advertising communication costs are expenses as incurred; production costs are deferred and expensed when advertised is first used.
- Fair Value of Financial Instruments – Company estimates value of its Convertible Senior Subordinated Notes based on quoted market prices

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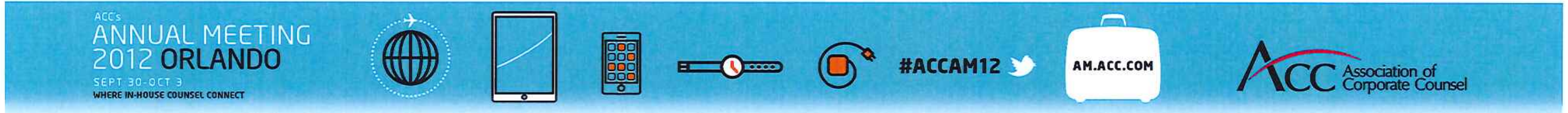

- Comprehensive Loss – deals with interest rate swap contract losses and net unrealized gains and losses
- New Accounting Standards – This section deals with new accounting standards promulgated by the Financial Accounting Standards Board and how the Company anticipates such new standards will impact the Company's financial statements

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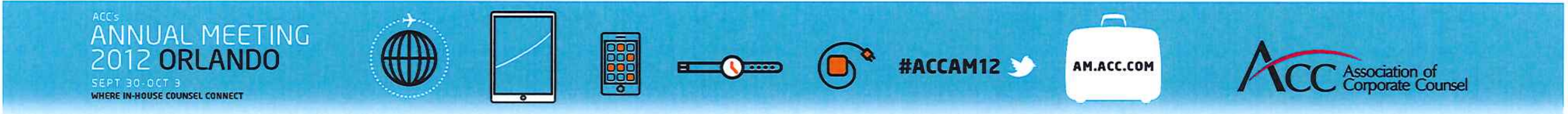

- Note 6 – Debt
  - This note will describe the various forms of debt issued by the Company including the Convertible Notes and the Revolving Credit Facility
    - It includes information relating to the change in the Revolving Credit Facility that occurred after 12/31/11, the end of the accounting period.
    - It includes discussion of debt covenants under the old and new credit facility and the effect of failure to comply with those covenants.

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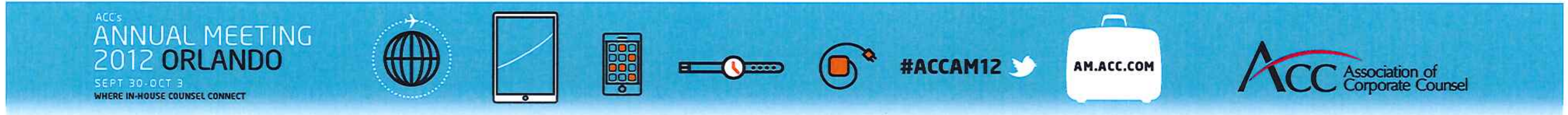

- Note 8 – Earnings Per Share – calculation including any dilution effect of SARS and options, Restricted stock or convertible notes.
- Note 9 – Stock-Based Compensation – This note defines the elements of the stock compensation plan
  - Stock Options and SARS
  - Restricted Stock
  - Employee Stock Purchase Plan

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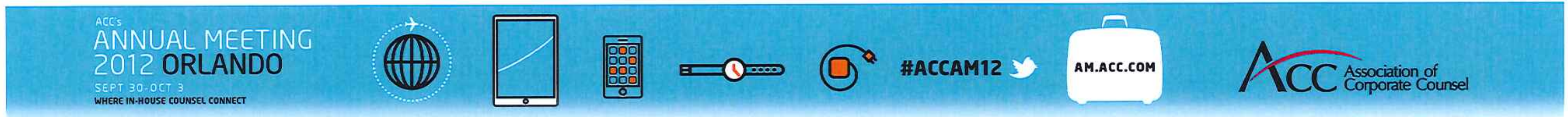

- Note 10 – Leases – shows minimum annual payments under non-cancellable leases going forward
- Note 11 – Employee Benefit Plans – describes 401(k) Profit Sharing Plan in effect
- Note 12 – Income Taxes – This note delineates the income tax provision for the years ended 12/31/2011, 2010 and 2009 and deferred tax assets and liabilities as of 12/31 2011 and 2010

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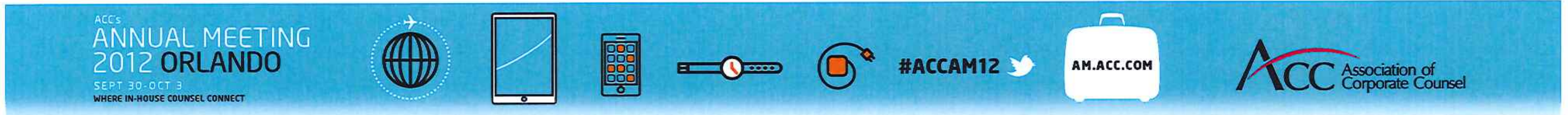

- Note 13 – Commitments and Contingencies
  - Legal Matters – this portion would discuss any cases in which the Company was involved
  - Purchase Commitments
  - Contract Termination Costs
  - Product Warranty

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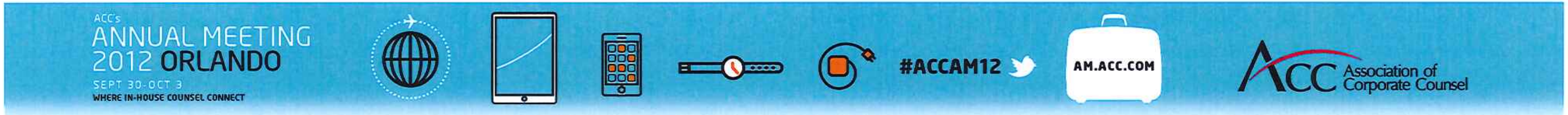

Financial Statement Wrap-Up

To understand a Company's financial statements all aspects of them must be read and understood. At that point additional questions may have to be asked to make sure you have all of the information you need to enter into the transaction you are considering.

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Reaching the Goals

- Become more valued and more successful:
  - Understand and apply the framework to your company's financial statements
  - Read financial statement notes, earnings releases, MD&A
  - Frame communications in the language of your clients
- Prioritize your work:
  - For each transaction/matter, ask "What is the financial statement impact?"
  - Note the importance of time horizon
- Career/Personal Finance decisions:
  - Understand what your own "financial statements" look like
  - Understand the relationship between your company's financial health and your financial health

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Role of the Lawyer

- Why is it important that lawyers understand basic accounting and financial statements?
  - In everything we do, we must consider both legal implications and business implications, which almost always involve financial implications
  - Strategy – Financial implications are critical
  - Corporate Development – i.e., acquisitions
  - Periodic Management meetings – In most companies, financial statements are generated on a monthly basis, and management meets to discuss the results and discuss plans for the following periods. A basic understanding of financial statements is critical to this process

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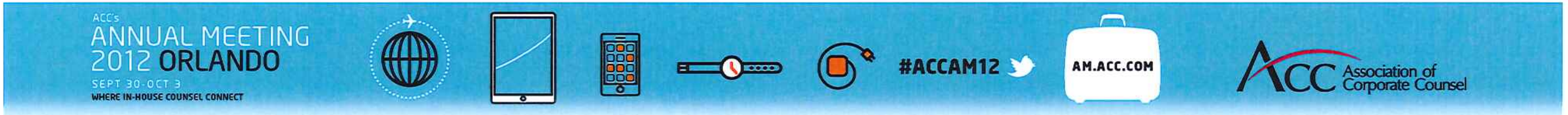

- Why is it important that lawyers understand basic accounting and financial statements?
  - Board of Directors and Audit Committee Meetings – General Counsels typically attend these meetings, especially if Secretary
  - Executive compensation – In-house attorneys involved in the development and implementation of executive compensation programs must understand the financial statement implications of cash bonuses, equity grants, etc. Tax implications too!!!

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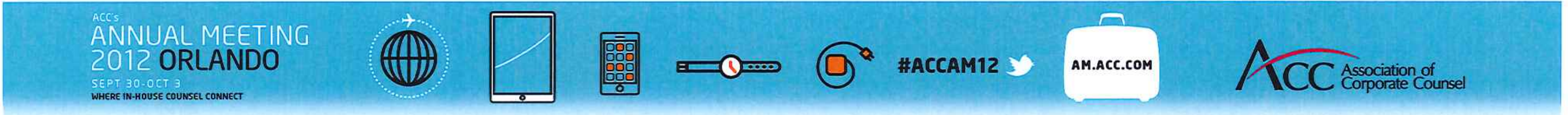

Corporate Counsel's Relationship with Outside Auditor

- GAAP requires disclosure of "Contingent Liabilities." As part of audit, auditors must make inquiries to legal counsel
  - Beware of inadvertent waiver of attorney-client privilege
  - Provide response in accordance with "Treaty"
  - What you should provide: identification of the proceedings or matter, the stage of the proceedings, the claim(s) asserted, and the position taken by the client

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- What you should not provide: a judgment as to the outcome, except in remote cases where an unfavorable outcome is either "probable" or "remote"
  - Probable - Prospects for claimant not succeeding are "extremely doubtful" and prospects for client succeeding are "slight"
  - Remote - Prospects for client not succeeding are "extremely doubtful" and prospects for claimant succeeding are "slight"
- My canned response – "With respect to the above-described lawsuits, I am unable to determine at present time that an outcome unfavorable to the Company is either probable or remote"

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- Recent Developments in Lawyer – Auditor Relationship
  - 1975 – FASB issues Statement No. 5, "Accounting for Loss Contingencies"
  - 1975/6 – The ABA and the AICPA agree on the "Treaty"
  - June 5, 2008 – FASB issued an Exposure Draft of proposed amendments to FASB Statement no. 5, Accounting for Contingencies, substantially enhancing a Company's required disclosure on loss contingencies
  - August 2008 – The ABA issued a formal comment letter
  - 2009 – In Accounting Standards Codification, FASB Statement No. 5 was codified into ASC Subtopic 450-20
  - July 20, 2010 – FASB issued Proposed Accounting Standards Update, Contingencies (Topic 450) "Disclosure of Certain Loss Contingencies"
  - September 20, 2010 – The ABA issued a formal comment letter

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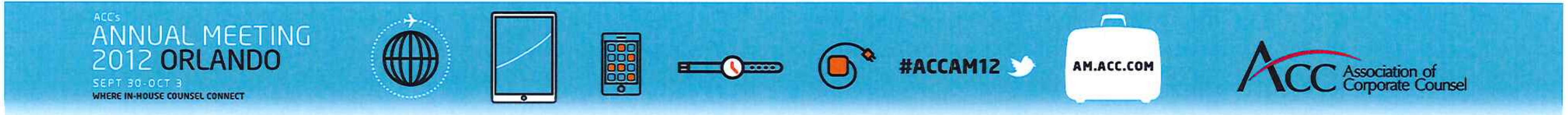

- Existing Accounting Standards require disclosure "if there is at least a reasonable possibility (that is, more than remote possibility) that a loss may have been incurred regardless of whether the entity has accrued for such a loss (or any portion of that loss)"
- Proposed Accounting Standard would add a requirement to disclose an asserted remote loss contingency if there is a "potential severe impact." Furthermore, for all loss contingencies disclosure of both "qualitative" and "quantitative" information would be required:

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- Qualitative - include the contentions of the parties, the court, the date instituted, the principal parties to the proceedings, a description of the factual basis alleged to underlie the proceedings, and a current status of the litigation contingency
- Quantitative - information would include the amount claimed by the plaintiff (if public), the possible loss or range of loss and the amount accrued (if it can be estimated), or a statement that an estimate cannot be made and the reasons why, and insurance information.

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- Concerns of ABA:
  - Litigation is inherently uncertain, and the precision the Proposal seeks is an illusory goal
  - Disclosures should avoid prejudicing the outcome
  - Requiring disclosure of information that involves speculation or prediction can itself be a source of liability, based upon claims that the disclosure was misleading when results turn out differently than predicted
  - The Proposal would severely compromise the attorney-client privilege, in that disclosure to the auditors of privileged information would be necessary to comply with the disclosure requirements
  - Requiring disclosure of "remote" contingencies doesn't make sense. Once a company concludes that an adverse outcome in pending litigation is remote, assessing whether the impact of an adverse outcome would be "severe" would be "a theoretical and speculative exercise"

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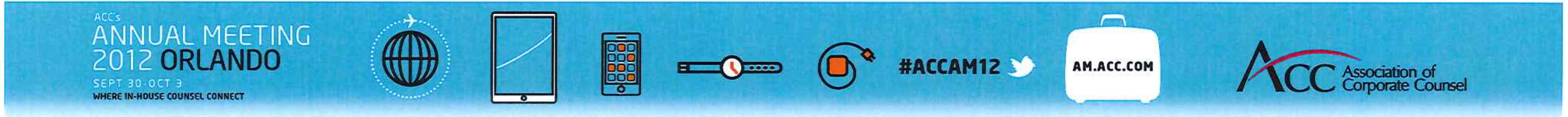

Questions?

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Report of Ernst & Young LLP, Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Trex Company, Inc.

We have audited the accompanying consolidated balance sheets of Trex Company, Inc. as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2011. Our audits also included the financial statement schedule listed in Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Trex Company, Inc. at December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Trex Company Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 7, 2012 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Richmond, Virginia
March 7, 2012

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TREX COMPANY, INC.

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2011	2010
	(In thousands)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 4,526	$ 27,270
Restricted cash	37,000	—
Accounts receivable (net of allowance for doubtful accounts of $0.3 million at December 31, 2011 and 2010)	29,192	53,332
Inventories	28,896	29,021
Prepaid expenses and other assets	2,118	1,539
Income taxes receivable	322	70
Deferred income taxes	—	1,004
Total current assets	102,054	112,236
Property, plant and equipment, net	115,212	126,857
Goodwill	10,558	6,837
Other assets	266	1,885
Total Assets	$228,090	$247,815
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 11,892	$ 15,107
Accrued expenses	16,187	23,479
Accrued warranty	6,000	7,003
Deferred income taxes	124	—
Current portion of long-term debt	86,425	590
Total current liabilities	120,628	46,179
Deferred income taxes	2,819	3,614
Accrued taxes	60	3,126
Non-current accrued warranty	10,345	7,469
Debt-related derivative	—	312
Long-term debt	—	84,193
Other long-term liabilities	1,739	—
Total Liabilities	135,591	144,893
Commitments and contingencies		
Stockholders' Equity:		
Preferred stock, $0.01 par value, 3,000,000 shares authorized; none issued and outstanding	—	—
Common stock, $0.01 par value, 40,000,000 shares authorized; 15,602,132 and 15,458,002 shares issued and outstanding at December 31, 2011 and 2010, respectively	156	155
Additional paid-in capital	99,885	98,905
Accumulated other comprehensive loss	—	(184)
Retained earnings (deficit)	(7,542)	4,046
Total Stockholders' Equity	92,499	102,922
Total Liabilities and Stockholders' Equity	$228,090	$247,815

See accompanying notes to financial statements.

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TREX COMPANY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2011	2010	2009
	(In thousands, except share and per share data)		
Net sales	$ 266,789	$ 317,690	$ 272,286
Cost of sales	203,998	244,875	191,759
Gross profit	62,791	72,815	80,527
Selling, general, and administrative expenses	60,620	67,764	65,257
Impairment of long-lived assets	—	—	23,251
Income (loss) from operations	2,171	5,051	(7,981)
Interest expense, net	16,364	15,288	14,699
Loss before provision for income taxes	(14,193)	(10,237)	(22,680)
Benefit for income taxes	(2,605)	(171)	(5,811)
Net loss	$ (11,588)	$ (10,066)	$ (16,869)
Basic loss per common share	$ (0.75)	$ (0.66)	$ (1.12)
Basic weighted average common shares outstanding	15,388,456	15,187,028	15,061,603
Diluted loss per common share	$ (0.75)	$ (0.66)	$ (1.12)
Diluted weighted average common shares outstanding	15,388,456	15,187,028	15,061,603

See accompanying notes to financial statements.

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TREX COMPANY, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings (Deficit)	Total
	Shares	Amount				
			(Dollars in thousands)			
Balance, December 31, 2008	15,320,612	$153	$92,825	$(1,092)	$ 30,981	$122,867
Comprehensive loss:						
Net loss	—	—	—	—	(16,869)	(16,869)
Net unrealized losses on interest rate swaps, net of tax	—	—	—	(55)	—	(55)
Net derivative losses reclassified to earnings, net of tax	—	—	—	882	—	882
Total comprehensive loss	—	—	—	—	—	(16,042)
Employee stock purchase and option plans	42,352	1	416	—	—	417
Repurchases of common stock	(38,938)	—	(572)	—	—	(572)
Stock-based compensation	73,067	—	3,528	—	—	3,528
Balance, December 31, 2009	15,397,093	154	96,197	(265)	14,112	110,198
Comprehensive loss:						
Net loss	—	—	—	—	(10,066)	(10,066)
Net unrealized losses on interest rate swaps, net of tax	—	—	—	(110)	—	(110)
Net derivative losses reclassified to earnings, net of tax	—	—	—	191	—	191
Total comprehensive loss	—	—	—	—	—	(9,985)
Employee stock purchase and option plans	27,140	1	169	—	—	170
Repurchases of common stock	(54,922)	—	(1,089)	—	—	(1,089)
Stock-based compensation	88,691	—	3,628	—	—	3,628
Balance, December 31, 2010	15,458,002	155	98,905	(184)	4,046	102,922
Comprehensive loss:						
Net loss	—	—	—	—	(11,588)	(11,588)
Net unrealized losses on interest rate swaps, net of tax	—	—	—	27	—	27
Net derivative losses reclassified to earnings, net of tax	—	—	—	157	—	157
Total comprehensive loss	—	—	—	—	—	(11,404)
Employee stock purchase and option plans	139,228	1	1,426	—	—	1,427
Repurchases of common stock	(62,543)	—	(3,092)	—	—	(3,092)
Stock-based compensation	67,445	—	3,146	—	—	3,146
Repurchases of convertible notes	—	—	(500)	—	—	(500)
Balance, December 31, 2011	15,602,132	$156	$99,885	—	$ (7,542)	$ 92,499

See accompanying notes to financial statements.

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TREX COMPANY, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2011	2010	2009
	(In thousands)		
Operating Activities			
Net loss	$(11,588)	$(10,066)	$(16,869)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	18,170	20,788	24,485
Debt discount amortization	10,538	8,149	6,833
Loss on extinguishment of debt	621	—	—
Impairment of long-lived assets	—	—	23,251
Deferred income taxes	165	200	997
Derivatives	—	—	(827)
Stock-based compensation	3,146	3,628	3,528
Equity method losses	—	1,224	252
Loss on disposal of property, plant and equipment	711	436	29
Changes in operating assets and liabilities:			
Accounts receivable	23,931	(21,915)	(17,413)
Inventories	125	1,083	24,332
Prepaid expenses and other assets	(19)	2,474	2,950
Accounts payable	(3,215)	(1,407)	1,087
Accrued expenses and other liabilities	(8,385)	6,604	(12,367)
Income taxes receivable (payable)	(353)	7,796	(5,205)
Net cash provided by operating activities	33,847	18,994	35,063
Investing Activities			
Expenditures for property, plant and equipment	(7,419)	(9,966)	(6,919)
Proceeds from sales of property, plant and equipment	28	85	45
Purchase of acquired company, net of cash acquired	(2,075)	—	—
Notes receivable, net	99	108	236
Net cash used in investing activities	(9,367)	(9,773)	(6,638)
Financing Activities			
Financing costs	(135)	—	(798)
Principal payments under mortgages and notes	(2,542)	(545)	(31,147)
Borrowings under line of credit	—	44,000	—
Principal payments under line of credit	—	(44,000)	—
Restricted cash	(37,000)	—	—
Repurchases of convertible notes	(5,882)	—	—
Repurchases of common stock	(3,092)	(1,089)	(572)
Proceeds from employee stock purchase and option plans	1,427	169	417
Net cash used in financing activities	(47,224)	(1,465)	(32,100)
Net increase (decrease) in cash and cash equivalents	(22,744)	7,756	(3,675)
Cash and cash equivalents at beginning of year	27,270	19,514	23,189
Cash and cash equivalents at end of year	$ 4,526	$ 27,270	$ 19,514
Supplemental disclosures of cash flow information:			
Cash paid for interest, net of capitalized interest	$ 6,349	$ 6,526	$ 7,002
Cash paid (received) for income taxes, net	$ 658	$ (7,553)	$ (2,301)

See accompanying notes to financial statements.

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TREX COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BUSINESS AND ORGANIZATION

Trex Company, Inc. (together with its subsidiary, the "Company"), a Delaware corporation, was incorporated on September 4, 1998. The Company manufactures and distributes wood/plastic composite products, as well as related accessories, primarily for residential and commercial decking and railing applications. The majority of its products are manufactured in a proprietary process that combines waste wood fibers and reclaimed polyethylene ("PE material"). The Company operates in one business segment.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and include the accounts of the Company and its wholly-owned subsidiary, Trex Wood-Polymer Espana, S.L. ("TWPE"). Intercompany accounts and transactions have been eliminated in consolidation.

TWPE was formed to hold the Company's 35% equity interest in Denplax, S.A. ("Denplax"), a joint venture with a Spanish Company responsible for public environmental programs in southern Spain and with an Italian equipment manufacturer. The joint venture was formed to recycle polyethylene at a facility in El Ejido, Spain. The Company's investment in Denplax is accounted for using the equity method. During 2010, the Company determined that its investment in Denplax and a related note receivable were no longer recoverable and recorded a $2.4 million charge to earnings to fully reserve the equity investment and note. Both the equity investment and note remain fully reserved as of December 31, 2011.

Iron Deck Acquisition

On May 2, 2011, the Company completed the acquisition of substantially all of the assets of Iron Deck Corporation, a manufacturer of steel deck-framing systems located in Denver, Colorado, for approximately $2 million in cash plus the assumption of certain liabilities. The provisions of the purchase agreement allow for future payments contingent upon certain future sales targets. The contingent payments were estimated as purchase consideration at the acquisition date. This acquisition enhances the Company's goals of product extension and growth in market share. As a result of the acquisition, the Company recorded an increase of $3.7 million to Goodwill. No other material tangible or intangible assets were identified.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and the accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash equivalents consist of highly liquid investments purchased with original maturities of three months or less.

Concentrations and Credit Risk

The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents, restricted cash, and trade accounts receivable. The Company from time to time may

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have bank deposits in excess of insurance limits of the Federal Deposit Insurance Corporation. As of December 31, 2011, substantially all deposits are maintained in one financial institution. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk related to its cash and cash equivalents.

The Company routinely assesses the financial strength of its customers and believes that its trade receivables credit risk exposure is limited. Trade receivables are carried at the original invoice amount less an estimate made for payment discounts and doubtful accounts. A valuation allowance is provided for known and anticipated credit losses and disputed amounts, as determined by management in the course of regularly evaluating individual customer receivables. This evaluation takes into consideration a customer's financial condition and credit history, as well as current economic conditions.

The Company recorded a decrease to the allowance for doubtful accounts of approximately $43 thousand in the year ended December 31, 2011. In the years ended December 31, 2011, 2010 and 2009, sales to certain customers accounted for 10% or more of the Company's total net sales. For the year ended December 31, 2011, one customer of the Company represented approximately 24% of the Company's net sales. For the year ended December 31, 2010, one customer of the Company represented approximately 28% of the Company's net sales. For the year ended December 31, 2009, the Company's two largest customers represented approximately 24% and 10%, respectively, of the Company's net sales. As of December 31, 2011, three customers represented 29%, 14% and 10%, respectively, of the Company's accounts receivable balance.

Approximately 33%, 41%, and 30% of the Company's raw materials purchases for the years ended December 31, 2011, 2010 and 2009, respectively, were purchased from its four largest suppliers.

Inventories

Inventories are stated at the lower of cost (last-in, first-out, or "LIFO" method) or market value. The Company periodically reviews its inventory for slow moving or obsolete items and writes down the related products to estimated realizable value. The Company has not established significant reserves for estimated slow moving products or obsolescence. At December 31, 2011, the excess of the replacement cost of inventory over the LIFO value of inventory was approximately $28.2 million. Due to the nature of the LIFO valuation methodology, liquidations of inventories will result in a portion of the Company's cost of sales being based on historical rather than current year costs. We cannot estimate at this time the effect of future reductions, if any, in inventory levels on future operating results.

The majority of the Company's products are made in a proprietary process that combines waste wood fibers and reclaimed polyethylene. The Company grinds up scrap materials generated from its manufacturing process and inventories deemed no longer salable and reintroduces the "reclaimed" material into the manufacturing process as a substitute for raw materials. The reclaimed material is valued at the costs of the raw material components of the material.

Property, Plant and Equipment

Property, plant and equipment are stated at historical cost. The costs of additions and improvements are capitalized, while maintenance and repairs are expensed as incurred. Depreciation is provided using the straight-line method over the following estimated useful lives:

Buildings	40 years
Machinery and equipment	5-11 years
Furniture and equipment	10 years
Forklifts and tractors	5 years
Computer equipment and software	3-5 years

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Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life of the asset.

Long-Lived Assets

The Company reviews its long-lived assets, including property, plant and equipment, whenever events or changes in circumstances indicate that the carrying amount of the assets may not be fully recoverable. To determine the recoverability of its long-lived assets, the Company evaluates the probability that future estimated undiscounted net cash flows will be less than the carrying amount of the long-lived assets. If the estimated cash flows are less than the carrying amount of the long-lived assets, the assets are written down to their fair value. The Company's estimates of anticipated cash flows and the remaining estimated useful lives of long-lived assets could be reduced in the future. As a result, the carrying amount of long-lived assets could be reduced in the future.

In September 2009, the Company recorded a pre-tax impairment charge of $23.3 million related to the long-lived assets held at the Company's Olive Branch facility to reduce the carrying value of those groups to their estimated fair value. The fair value measurement used to determine the impairment was based on prices for similar assets and considered the condition of the related fixed assets. Of the Company's net property, plant and equipment at December 31, 2011, approximately $9.9 million is located at the Olive Branch, Mississippi manufacturing facility. Management does not currently anticipate further impairments on the remaining assets. However, changes in the expected cash flows related to the facility in the future may result in additional impairment charges and reduced earnings.

Contract Termination Costs

In anticipation of relocating the Company's corporate headquarters, the Company entered into a lease agreement in 2005. The Company reconsidered and decided not to move its headquarters. The lease, which began on January 1, 2006 and extends through June 30, 2019, obligates the Company to lease 55,047 square feet. The Company has executed subleases for the entire 55,047 square feet it currently leases. The terms of the existing subleases expire in years 2012 to 2015. The Company estimates that the present value of the estimated future sublease rental receipts, net of transaction costs, will be less than the Company's remaining minimum lease payment obligations under its lease for the office space. Accordingly, the Company accounts for the expected shortfall as contract termination costs and has recorded a liability in accordance with FASB ASC Topic 420, "*Exit or Disposal Cost Obligations.*"

To estimate future sublease receipts for the periods beyond the term of the existing subleases, the Company has assumed that the existing subleases will be renewed or new subleases will be executed at rates consistent with rental rates in the current subleases. However, management cannot be certain that the timing of future subleases or the rental rates contained in future subleases will not differ from current estimates. Factors such as the delivery of a significant amount of new office space or poor economic conditions could have a negative effect on vacancy rates and rental rates in the area. The inability to sublet the office space in the future or unfavorable changes to key management assumptions used in the estimate of the future sublease receipts may result in material charges to selling, general and administrative expenses in future periods.

Goodwill

Goodwill represents the excess of cost over net assets acquired resulting from the Company's 1996 purchase of the Mobil Composite Products Division and the 2011 purchase of the assets of the Iron Deck Corporation. The Company evaluates the recoverability of goodwill annually or more frequently if an event occurs or circumstances change in the interim that would more likely than not reduce the fair value of the asset below its carrying amount. Goodwill is considered to be impaired when the net book value of the reporting unit exceeds its estimated fair value.

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In the evaluation of goodwill for impairment, the Company first compares the fair value of the reporting unit to its carrying value. If the carrying value of a reporting unit exceeds its fair value, the goodwill of that reporting unit is potentially impaired and step two of the impairment analysis is performed. In step two of the analysis, an impairment loss is recorded equal to the excess of the carrying value of the reporting unit's goodwill over its implied fair value should such a circumstance arise.

The Company measures fair value of the reporting unit based on a present value of future discounted cash flows or a market valuation approach. The discounted cash flows model indicates the fair value of the reporting unit based on the present value of the cash flows that the reporting unit is expected to generate in the future. Significant estimates in the discounted cash flows model include: the weighted average cost of capital; long-term rate of growth and profitability of the business; and working capital effects. The market valuation approach indicates the fair value of the business based on a comparison of the Company against certain market information. Significant estimates in the market approach model include identifying appropriate market multiples and assessing earnings before interest, income taxes, depreciation and amortization (EBITDA) in estimating the fair value of the reporting unit.

For the years ended December 31, 2011, 2010 and 2009, the Company completed its annual impairment test of goodwill and noted no impairment. The Company performs the annual impairment testing of its goodwill as of October 31 of each year. However, actual results could differ from the Company's estimates and projections, which would affect the assessment of impairment. As of December 31, 2011, the Company had goodwill of $10.6 million that is subject to at least annual review of impairment.

Product Warranty

The Company warrants that its products will be free from material defects in workmanship and material and will not check, split, splinter, rot or suffer structural damage from termites or fungal decay. This warranty extends for a period of 25 years for residential use and 10 years for commercial use. With respect to the Company's Transcend and Enhance product, the Company further warrants that the product will not fade in color more than a certain amount and will be resistant to permanent staining from food substances or mold (provided the stain is cleaned within seven days of appearance). This warranty extends for a period of 25 years for residential use of the Transcend product, 20 years for residential use of the Enhance product, and 10 years for commercial use of either product. If there is a breach of such warranties, the Company has an obligation either to replace the defective product or refund the purchase price. The Company establishes warranty reserves to provide for estimated future expenses as a result of product defects that result in claims. Reserve estimates are based on management's judgment, considering such factors as cost per claim, historical experience, anticipated rates of claims, and other available information. Management reviews and adjusts these estimates, if necessary, on a quarterly basis based on the differences between actual experience and historical estimates.

Revenue Recognition

The Company recognizes revenue when title is transferred to customers, which is generally upon shipment of the product to the customer. The Company does not grant contractual product return rights to customers other than pursuant to its product warranty. The Company does not expect future product returns to be material and, consequently, does not maintain an allowance for product returns.

The Company records all shipping and handling fees in sales and records all of the related costs in cost of sales. The Company offers several sales incentive programs to dealers and distributors, including rebates, pricing discounts, favorable payment terms and cooperative advertising, many of which result in cash consideration made to dealers and distributors. The Company accounts for consideration made pursuant to these programs in accordance with accounting guidance that governs consideration given by a vendor to a customer. With the exception of cooperative advertising, the Company classifies sales incentives as a reduction in revenue in "Net sales." Sales incentives are recorded in the period in which they are earned by customers. The Company's

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cooperative advertising program meets the requirements for exclusion from net sales and the costs are recorded as expenses in "Selling, general and administrative expenses" in the accompanying consolidated statements of operations. Cooperative advertising costs are accrued as incurred.

Stock-Based Compensation

The Company recognizes share-based compensation at the grant date of the award based on the fair value, and is recognized on a straight line basis as expense in the accompanying consolidated statements of operations over the vesting periods of the award, net of an estimated forfeiture rate.

Income Taxes

The Company accounts for income taxes and the related accounts in accordance with FASB ASC Topic 740, "*Income Taxes*". Deferred tax liabilities and assets are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted rates expected to be in effect during the year in which the differences reverse. Management periodically assesses the likelihood that the Company will be able to recover its deferred tax assets and reflects any changes in estimates in the valuation allowance. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion, or all, of the deferred tax asset will not be realized. At December 31, 2011, the Company had a valuation allowance of $24.2 million primarily attributable to the uncertainty related to the realizability of its excess deferred tax assets. The Company considered all available evidence, both positive and negative, in determining the need for a valuation allowance. Based upon this analysis, including a consideration of the Company's cumulative loss history in the three-year period ended December 31, 2011, management determined that it is not more likely than not that its excess deferred tax assets will be realized.

Research and Development Costs

Research and development costs are expensed as incurred. For the years ended December 31, 2011, 2010 and 2009, research and development costs were $2.5 million, $1.9 million and $5.3 million, respectively, and have been included in "Selling, general and administrative expenses" in the accompanying consolidated statements of operations.

Advertising Costs

The Company expenses its branding and advertising communication costs as incurred. Significant production costs are deferred and recognized as expense in the period that the related advertisement is first used. At December 31, 2011 and December 31, 2010, $0.9 million and $0.4 million, respectively, were included in prepaid expenses for production costs.

For the years ended December 31, 2011, 2010 and 2009, branding expenses, including advertising expenses as described above, were $19.4 million, $20.6 million and $16.2 million, respectively.

Fair Value of Financial Instruments

The Company considers the recorded value of its financial assets and liabilities, consisting primarily of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and other current liabilities, and real estate loans to approximate the fair value of the respective assets and liabilities at December 31, 2011 and 2010. At December 31, 2011, the fair value of the Company's $91.9 million 6.00% Convertible Senior Subordinated Notes due July 1, 2012 was estimated at $99.7 million based on quoted market prices.

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Comprehensive Loss

Comprehensive loss consists of net loss and net unrealized gains and losses on interest rate swap contracts. For the years ended December 31, 2011, 2010 and 2009, comprehensive loss was $11.4 million, $10.0 million and $16.0 million, respectively.

Investment in Denplax

The Company owns 35% of a joint venture, Denplax, with a Spanish environmental company and an Italian equipment manufacturer to operate a plant in Spain designed to recycle waste polyethylene. Denplax qualifies as a variable interest entity per relevant accounting guidance. Denplax was financed with initial equity contributions from the Company and the other partners and debt financing. The Company is not contingently liable for any of Denplax's obligations. The Company does not control Denplax and records its proportional 35% share of Denplax's operating results using the equity method. During 2010, the Company determined that its investment in Denplax and a related note receivable were no longer recoverable and recorded a $2.4 million charge to earnings to fully reserve the equity investment and the note. Both the equity investment and note remain fully reserved as of December 31, 2011.

New Accounting Standards

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-04, "*Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*." ASU 2011-04 provides additional guidance on fair value measurements that clarifies the application of existing guidance and disclosure requirements, changes certain fair value measurement principles and requires additional disclosures about fair value measurements. The updated guidance is effective on a prospective basis for the Company on January 1, 2012. Based on the Company's evaluation of this ASU, the adoption of this standard is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In June 2011, the FASB issued ASU 2011-05, "*Presentation of Comprehensive Income*." ASU 2011-05 requires the components of net income and other comprehensive income to be either presented in one continuous statement, referred to as the statement of comprehensive income, or in two separate, but consecutive statements. The current option to report other comprehensive income and its components in the statement of stockholders' equity will be eliminated. While ASU 2011-05 changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. This new guidance is effective for the Company beginning January 1, 2012 and requires retrospective application. As this guidance only amends the presentation of the components of comprehensive income, the adoption will not have an impact on the Company's consolidated financial position or results of operations.

In September 2011, the FASB issued ASU 2011-08, "*Testing Goodwill for Impairment*." ASU 2011-08 allows entities testing goodwill for impairment the option of performing a qualitative assessment to determine the likelihood of goodwill impairment and whether it is necessary to perform the two-step impairment test currently required. ASU 2011-08 also expands upon the examples of events and circumstances that an entity should consider between annual impairment tests in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The updated guidance is effective for the Company on January 1, 2012, with early adoption permitted. The Company early adopted ASU 2011-08 for the year ended December 31, 2011. The adoption of this standard did not have a material impact on the Company's consolidated financial position or results of operations.

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3. INVENTORIES

Inventories (at LIFO value) consist of the following as of December 31 (in thousands):

	2011	2010
Finished goods	$ 29,980	$ 29,983
Raw materials	27,134	27,589
Total FIFO inventories	57,114	57,572
Reserve to adjust inventories to LIFO value	(28,218)	(28,551)
Total LIFO inventories	$ 28,896	$ 29,021

Inventory is stated at the lower of LIFO cost or net realizable value. The Company periodically reviews its inventory for slow moving or obsolete items and writes down the related products to estimated net realizable value.

During the year ended December 31, 2009, due to the liquidation of inventories, a portion of the Company's cost of sales is based on prior year costs rather than current year costs. As a result, the Company recognized a benefit of $3.4 million in 2009. The effect of the liquidation of inventories in 2011 and 2010 on the Company's cost of sales was immaterial.

4. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following as of December 31 (in thousands):

	2011	2010
Building and improvements	$ 57,512	$ 56,889
Machinery and equipment	224,611	216,481
Furniture and fixtures	2,445	2,457
Forklifts and tractors	5,095	4,497
Computer equipment	5,774	6,646
Construction in process	2,425	6,137
Land	8,858	8,858
	306,720	301,965
Accumulated depreciation	(191,508)	(175,108)
Total property, plant and equipment, net	$ 115,212	$ 126,857

The Company had construction in process as of December 31, 2011 of approximately $2.4 million. The Company expects that the construction in process will be completed and put into service in the year ending December 31, 2012.

Depreciation expense for the years ended December 31, 2011, 2010 and 2009 totaled $18.4 million, $19.6 million and $22.9 million, respectively.

In September 2009, the Company recorded a pre-tax impairment charge of $23.3 million related to the long-lived assets held at the Company's Olive Branch facility to reduce the carrying value of those groups to their estimated fair value. The fair value measurement used to determine the impairment was based on prices for similar assets and considered the condition of the related fixed assets and is a Level III fair value measurement. Of the Company's net property, plant and equipment at December 31, 2011, approximately $9.9 million is located at the Olive Branch, Mississippi manufacturing facility. Management does not currently anticipate further impairments on the remaining assets. However, changes in the expected cash flows related to the facility in the future may result in additional impairment charges and reduced earnings.

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5. ACCRUED EXPENSES

Accrued expenses consist of the following (in thousands):

	2011	2010
Accrued compensation and benefits	$ 2,116	$ 6,687
Accrued interest	2,807	3,526
Accrued rent obligations	1,821	1,938
Accrued sales and marketing costs	5,831	2,584
Accrued taxes and penalties	33	200
Other	3,579	8,544
Total accrued expenses	$16,187	$23,479

6. DEBT

Indebtedness. At December 31, 2011, the Company's indebtedness, excluding unamortized debt discount, totaled $91.9 million and the annualized overall weighted average interest rate of such indebtedness was approximately 6.0%.

Convertible Notes Offering. On June 18, 2007, the Company issued $85.0 million principal amount of its 6.00% Convertible Senior Subordinated Notes due July 1, 2012 (the "Notes") through an underwritten public offering. The Company used a portion of net proceeds of $82.1 million from the sale of the Notes to repay in full $24.0 million principal amount of its 8.32% senior secured notes due July 19, 2009 and $45.7 million principal amount of borrowings outstanding under its revolving credit facility. The Company paid a prepayment penalty of $0.6 million in connection with the retirement of the senior secured notes. On July 12, 2007, the underwriters of the Notes offering exercised their over-allotment option to purchase an additional $12.5 million principal amount of Notes. The Company received net proceeds of $12.1 million from the sale of the additional Notes, which it issued on July 17, 2007.

Holders may convert the Notes into the Company's common stock at their option before the close of business on any business day prior to April 1, 2012 only under the following circumstances:

- during any fiscal quarter of the Company commencing after September 30, 2007, if the last reported sale price of the Company's common stock for at least 20 trading days during a period of 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter is greater than or equal to 130% of the applicable conversion price on each applicable trading day;
- during the five business-day period after any ten consecutive trading-day period in which the trading price per Note for each day of that measurement period is less than 98% of the product of the last reported sale price of the common stock and the applicable Note conversion rate on each such day; or
- upon the occurrence of specified corporate events.

On and after April 1, 2012, until the close of business on the third business day immediately preceding the maturity date, holders may convert their Notes at any time, regardless of the foregoing circumstances.

Upon conversion of any Notes, the Company will pay cash up to the principal amount of the Notes converted and deliver shares of its common stock to the extent the daily conversion value exceeds the proportionate principal amount of such Notes based on a 40 trading-day observation period. The conversion rate will be 45.9116 shares of common stock per $1,000 principal amount of Notes, which is equivalent to a conversion price of approximately $21.78 per share of common stock. The conversion rate will be subject to adjustment in some events. In addition, following specified corporate transactions that occur before the maturity date, the conversion rate will be increased for a holder who elects to convert the holder's Notes in connection with such a corporate transaction in certain circumstances. Shares issued as a result of the conversion of any Notes would have a dilutive effect on earnings per share.

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The Company may not redeem the Notes. If the Company undergoes a fundamental change, as defined in the Notes, holders may require the Company to purchase the Notes in whole or in part for cash at a price equal to 100% of the principal amount of the Notes to be purchased, plus any accrued and unpaid interest.

The Notes are the Company's direct, senior subordinated, unsecured obligations and rank equally in right of payment with all of the Company's existing and future senior subordinated indebtedness, senior in right of payment to all of the Company's existing and future subordinated indebtedness and junior in right of payment to all of the Company's existing and future senior indebtedness.

The Company accounts for its convertible notes per FASB ASC SubTopic 470-20, "*Debt with Conversion and Other Options*," which requires the proceeds from the issuance of convertible debt instruments that may be settled in cash upon conversion, be allocated between a liability and an equity component, with the resulting debt discount amortized, as non-cash interest expense, over the period the convertible debt is expected to be outstanding. The amortization of the discount recorded on the Company's outstanding convertible notes resulted in a $10.5 million, $8.1 million and $6.8 million increase to interest expense for the years ended December 31, 2011, 2010 and 2009, respectively.

The following table provides additional information regarding the Company's convertible debt instruments that are subject to ASC 470-20 (in thousands, except conversion price):

	December 31, 2011	December 31, 2010	December 31, 2009
Principal amount of the liability component	$ 91,875	$ 97,500	$ 97,500
Unamortized discount of liability component	(5,450)	(15,258)	(23,407)
Net carrying amount of liability component	86,425	82,242	74,093
Carrying amount of the equity component	23,360	23,860	23,860
Remaining amortization period of discount	6 months	18 months	30 months
Conversion price	$ 21.78	$ 21.78	$ 21.78
Effective interest rate on liability component	18.41%	18.41%	18.41%
Interest expense at coupon rate (6.0%)	$ 5,726	$ 5,850	$ 5,850
Non-cash interest in accordance with ASC 470-20	$ 10,538	$ 8,149	$ 6,833

In 2011, the Company used cash on hand to repurchase approximately $5.6 million of its $97.5 million outstanding convertible bond notes. ASC 470-20 requires that upon extinguishment of a convertible debt obligation, the total fair value of the settlement consideration is first allocated to the extinguishment of the liability component in an amount equal to the fair value of that component immediately prior to extinguishment, with any difference between this allocation and the net carrying amount of the liability component recognized in the statement of operations as a gain or loss on debt extinguishment. Any remaining settlement consideration is allocated to the reacquisition of the equity component and recognized as a reduction of stockholders' equity. As a result of the repurchase of a portion of its convertible awards during the year ended December 31, 2011, the Company recorded a loss of approximately $0.6 million as additional interest expense.

The Company determined that the fair value of the debt component of its convertible debt awards was approximately 104%. This fair value measurement was determined based on an analysis prepared by a specialist hired by the Company. The analysis considered the future principal and interest payments as well as an estimated market yield. The market yield was determined by considering the Company's credit worthiness and corroboration of similar debt instruments and was considered a Level 2 measurement in accordance with FASB ASC Topic 820, "*Fair Value Measurements and Disclosures*."

Revolving Credit Facility.

Indebtedness through December 31, 2011. On November 4, 2009, we entered into a Credit Agreement (the "Credit Agreement") with Branch Banking and Trust Company ("BB&T"), BB&T Capital Markets, and TD

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Bank, N.A. (collectively, the "Lenders") under which the Lenders provided us with one or more Revolver Loans in a collective maximum principal amount of $60,000,000 (the "Revolver Loans"); and one or more Reducing Revolver Loans in a collective maximum principal amount of $25,000,000, (the "Reducing Revolver Loans.") Included within the Revolver Loan limit were sublimits for a Letter of Credit Facility in an amount not to exceed $15,000,000 (the "Letter of Credit Facility"); and a Swing Advance Loan in the maximum amount of $5,000,000 (the "Swing Advance Loan.") The Revolver Loans, the Reducing Revolver Loans, the Letter of Credit Facility and the Swing Advance Loan are collectively referred to herein as the "Loans." The Loans were obtained for the purpose of raising working capital and refinancing our existing indebtedness. Together, the Loans provided us with an aggregate maximum of $85,000,000 in available credit.

On October 28, 2011, we entered into the First Amendment to Credit Agreement with BB&T, as Administrative Agent, Letter of Credit Issuer and as a Lender (the "Amendment.") Prior to the Amendment being executed, TD Bank, N.A. assigned all of its commitment obligations under the Credit Agreement to BB&T.

The Amendment, among other things, provided for the following amendments to the Credit Agreement:

- the extension of the termination date to December 31, 2012;
- a reduction in the maximum principal amounts of the Revolver Loans from $60,000,000 to $40,000,000, and the Reducing Revolver Loans from $25,000,000 to $15,000,000;
- the requirement that we grant to BB&T a Deed of Trust to its facility located in Fernley, Nevada;
- the addition of new provisions requiring the establishment and maintenance of a BB&T deposit account over which the Administrative Agent will have sole control, and a requirement that we maintain on deposit in such account at least $37,000,000 from October 28, 2011 to May 31, 2012, and not less than 50% of the outstanding principal balance of our outstanding Convertible Senior Subordinated Notes ("Senior Subordinated Notes") as of June 1, 2012 for the time period beginning June 1, 2012 until the Senior Subordinated Notes have been redeemed in full; and
- the addition of a new provision requiring us to repay or prepay each outstanding borrowing, and to repay or otherwise reduce the Letter of Credit obligations, such that the outstanding principal amount of all advances and the outstanding Letter of Credit obligations be $0 on April 30, 2012; provided, however, that Letters of Credit in an aggregate stated amount not to exceed $5,000,000 could remain issued and outstanding on and after April 30, 2012, so long as such Letters of Credit were cash-collateralized in a manner satisfactory to the Letter of Credit issuer. On and after April 30, 2012, unless and until all outstanding senior subordinated notes were redeemed in full, no additional borrowings could be made (and no additional Letters of Credit could be issued, except for Letters of Credit in an aggregate stated amount not to exceed $5,000,000 that were cash-collateralized in a manner satisfactory to the Letter of Credit Issuer), other than any borrowing, the proceeds of which were used to redeem all or any portion of our outstanding senior subordinated notes.

In connection with the execution of the Amendment, we also executed a new replacement Revolver Note payable to BB&T in the principal amount of the lesser of $40,000,000 or the outstanding revolver advances made by BB&T, and a replacement Reducing Revolver Note payable to BB&T in the principal amount of $15,000,000 or the outstanding reducing revolver advances made by BB&T. The Amendment did not materially change any loan covenant.

Amounts drawn under the Loans are subject to a borrowing base consisting of certain accounts receivables, inventories, machinery and equipment and real estate. At December 31, 2011, the borrowing base was approximately $54.9 million. As of December 31, 2011, the Company had no outstanding balance on the Loans.

Indebtedness following December 31, 2011. On January 6, 2012, we entered into an Amended and Restated Credit Agreement (the "Amended Credit Agreement") with BB&T, as a lender, Administrative Agent, Swing

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Line Lender, Letter of Credit Issuer and a Collateral Agent; Wells Fargo Capital Finance, LLC ("Wells Fargo") as a lender and a Collateral Agent; and BB&T Capital Markets ("BB&T Capital"), as Lead Arranger to amend the Credit Agreement. BB&T and Wells Fargo are referenced herein as the "New Lenders."

Under the Amended Credit Agreement, the New Lenders agreed to provide us with one or more revolving loans in a collective maximum principal amount of $100,000,000 (the "New Revolver Loans.")

Included within the New Revolver Loan limit are sublimits for a Letter of Credit Facility in an amount not to exceed $15,000,000 (the "New Letter of Credit Facility"); and Swing Advances in an aggregate principal amount at any time outstanding not to exceed $5,000,000 (the "New Swing Advance Loan.") The New Revolver Loans, the New Letter of Credit Facility and the New Swing Advance Loan are collectively referred to herein as the "New Loans." The New Loans were obtained for the purpose of raising working capital and refinancing our existing indebtedness.

The New Revolver Loans, the New Swing Advances and the New Letter of Credit Facility provide us, in the aggregate, the ability to borrow a principal amount not to exceed $100,000,000 at any one time outstanding (the "New Revolving Loan Limit") (subject to certain Borrowing Base requirements as described in the Amended Credit Agreement which include limits on Eligible Accounts and Inventory as described in the Amended Credit Agreement and any written agreement which may be executed from time to time by us and each of the Collateral Agents). We are not obligated to borrow any amount under the New Revolving Loan Limit. Within the New Revolving Loan Limit, we may borrow, repay, and reborrow, at any time or from time to time while the New Revolving Loans are in effect.

Base Rate Advances (as defined in the Amended Credit Agreement) under the New Revolver Loans and the New Swing Advances accrue interest at the Base Rate plus the Applicable Margin (as defined in the Amended Credit Agreement) and Euro-Dollar Advances for the New Revolver Loans and Swing Advances accrue interest at the Adjusted London InterBank Offered Rate plus the Applicable Margin (as defined in the Amended Credit Agreement). Repayment of all then outstanding principal, interest, fees and costs is due on January 9, 2015, provided that we may, prior to January 9, 2013, request that the New Lenders extend the termination date to January 9, 2016, and the New Lenders may elect to do so, in their sole and individual discretion.

The New Letter of Credit Facility provides that upon our application, BB&T shall issue to our credit one or more letters of credit in the aggregate amount of up to $15,000,000, or such lesser amount as may be required by law. We shall reimburse BB&T for all amounts payable, including interest, under a Letter of Credit at the earlier of (i) the date set forth in the application or (ii) on business day after the payment under such Letter of Credit by BB&T.

The New Revolver Note, New Swing Advance Note and New Letter of Credit Facility replaced in their entirety the Revolver Note, the Swing Advance Note and the Letter of Credit Facility, respectively in their entireties. No additional fees were due or owing as a result of the termination of the aforementioned agreements.

Amounts drawn under the New Revolver Loans are subject to a borrowing base consisting of certain accounts receivables, inventories, machinery and equipment and real estate. Based on December 31, 2011 balances, the borrowing base, under the Amended Credit Agreement, was approximately $72.5 million.

Compliance with Debt Covenants and Restrictions. Our ability to make scheduled principal and interest payments and to borrow and repay amounts under any outstanding revolving credit facility, and continue to comply with any loan covenants depends primarily on our ability to generate substantial cash flow from operations. Prior to the termination of the Loans, to remain in compliance with financial covenants in the Credit Agreement, we were required to maintain specified financial ratios based on levels of debt, capital, net worth, fixed charges, and earnings (excluding extraordinary gains and extraordinary non-cash losses) before interest,

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taxes, depreciation and amortization, all of which are subject to the risks of the business, some of which are discussed in this report under "Risk Factors." We were in compliance with all covenants contained in our Loans at December 31, 2011. The material financial covenants were as follows:

(a) Minimum Consolidated Tangible Net Worth. we agreed to maintain Consolidated Tangible Net Worth (as defined in the Credit Agreement) of not less than the sum of (i) $87,000,000, plus (ii) 50% of Consolidated Net Income (as defined in the credit agreement) after December 31, 2008 (taken as one accounting period), but excluding from such calculation of Consolidated Net Income any quarter in which Consolidated Net Income is negative, measured as of the end of each fiscal quarter commencing with the fiscal quarter ending September 30, 2009.

(b) Fixed Charge Coverage Ratio. We agreed not to permit the Fixed Charge Coverage Ratio (as defined in the Credit Agreement) to be less than 1.1 to 1.0, measured as of the end of each fiscal quarter, commencing with the fiscal quarter ending September 30, 2009, for the four-quarter period then ended; provided, however, that if Excess Availability (as defined in the credit agreement) exceeds $35,000,000, measurement of the Fixed Charge Coverage Ratio shall be made as of the end of each fiscal year.

(c) Consolidated Debt to Consolidated EBITDA Ratio. We agreed not to permit the Consolidated Debt to Consolidated EBITDA Ratio (as defined in the credit agreement) to exceed: (i) 6.0 to 1.0 as of December 31, 2009 and December 31, 2010, (ii) 5.5 to 1.0 as of December 31, 2011, and (iii) 4.5 to 1.0 as of December 31, 2012, and as of the end of each fiscal year thereafter.

Under the Amended Credit Agreement, the material financial covenants and restrictions are as follows:

(a) Minimum Consolidated Net Worth. We agreed that we will maintain Consolidated Net Worth, measured as of the end of each Fiscal Quarter, commencing with the Fiscal Quarter ended December 31, 2011, of not less than $85,000,000.

(b) Fixed Charge Coverage Ratio. We agreed that we will not permit the Fixed Charge Coverage Ratio to be less than 1.15 to 1.0, measured as of the end of each Fiscal Quarter, commencing with the Fiscal Quarter ended December 31, 2011.

(c) Consolidated Debt to Consolidated EBITDA Ratio. We agreed that we will not permit the Consolidated Debt to Consolidated EBITDA Ratio to exceed (i) 4.25 to 1.0 measured as of the end of each Fiscal Quarter, commencing with the Fiscal Quarter ended December 31, 2011 (and in the case of Consolidated EBITDA, for the four-quarter period ending on such date), prior to the date on which the Senior Subordinated Notes have been redeemed in full, and (ii) 3.5 to 1.0 measured as of the end of each Fiscal Quarter (and in the case of Consolidated EBITDA, for the four-quarter period ending on such date) after the date on which the Senior Subordinated Notes have been redeemed in full.

(d) A prepayment obligation requiring us to repay or prepay each outstanding borrowing, and to repay or otherwise reduce the Letter of Credit obligations, such that the outstanding principal amount of all advances and the outstanding Letter of Credit obligations be $0 on April 30, 2012; provided, however, that Letters of Credit in an aggregate stated amount not to exceed $5,000,000 shall remain issued and outstanding on and after April 30, 2012, so long as such Letters of Credit are cash-collateralized in a manner satisfactory to the Letter of Credit issuer. On and after April 30, 2012, unless and until all outstanding senior subordinated notes are redeemed in full, no additional borrowings may be made (and no additional Letters of Credit may be issued, except for Letters of Credit in an aggregate stated amount not to exceed $5,000,000 that are cash-collateralized in a manner satisfactory to the Letter of Credit Issuer), other than any borrowing, the proceeds of which are used to redeem all or any portion of our outstanding senior subordinated notes.

(e) We are required to maintain on deposit through June 5, 2012, an amount not less than $25,000,000, and from June 6, 2012, and thereafter, until the senior subordinated notes have been retired in full, an amount not less than 50% of the outstanding principal balance of the Senior Subordinated Notes as of June 5, 2012.

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Failure to have complied with our Loan covenants, which contain cross-default provisions, could have been considered a default of our repayment obligations under our Credit Agreement. Similarly, failure to comply with our New Loan covenants, which contain cross-default provisions, could be considered a default of our repayment obligations under our Amended Credit Agreement. Among other remedies, a default in our repayment obligations could have accelerate payment of the outstanding balance under our Amended Credit Agreement and could result in a cross-default under our $91.9 million principal amount of outstanding convertible notes.

The types of events which might have triggered a cross-default include without limitation:

(a) a failure to make any payment in respect of debt, other than the Company's promissory notes in connection with the Loans, of more than $250,000 after expiration of any applicable cure or grace period;

(b) an event or condition which (i) resulted in the acceleration of the maturity of a debt outstanding of more than $250,000 (ii) resulted in the mandatory prepayment or purchase of such debt prior to the scheduled maturity, or (iii) enabled the holders of such debt or commitment to provide such debt to accelerate the maturity, terminate any such commitment or require the mandatory prepayment or purchase prior to the scheduled maturity;

(c) a material default or event of default that occurred and was continuing under any material contract or any failure to perform any material obligation under any material contract which remained uncured beyond any applicable cure or grace period;

(d) the occurrence of any default or event of default occurring under any indenture or senior subordinated notes; and

(e) a default under any other lien or encumbrance placed on the property, or any interest therein (legal or equitable), or any part thereof, either inferior or superior in right to the lien of a deed of trust beyond any applicable grace period.

Long-Term Debt. The Company's Notes have been reduced by debt discounts of $5.5 million and $15.3 million as of December 31, 2011 and 2010, respectively, in accordance with the terms of ASC 470-20.

Long-term debt consists of the following as of December 31 (in thousands):

	2011	2010
Real estate loans	$ —	$ 2,541
Convertible notes	91,875	97,500
Total long-term debt	91,875	100,041
Less unamortized debt discount	(5,450)	(15,258)
	86,425	84,783
Less current portion	(86,425)	(590)
Long-term debt, excluding current portion	$ —	$ 84,193

Future debt maturities are as follows (in thousands):

Years ending December 31,	
2012	$91,875
2013	—
2014	—
2015	—
Thereafter	—
Total long-term debt	$91,875

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7. FINANCIAL INSTRUMENTS

The Company considers the recorded value of its financial assets and liabilities, consisting primarily of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and other current liabilities, and real estate loans to approximate the fair value of the respective assets and liabilities at December 31, 2011 and December 31, 2010. At December 31, 2011, the fair value of the Company's 6.00% Convertible Senior Subordinated Notes due 2012 was estimated at $99.7 million based on quoted market prices.

The Company has, at times, used interest rate swaps to manage its exposure to fluctuations in the interest rates on variable-rate debt. At December 31, 2010, the Company had one fixed-for-floating interest rate swap that effectively converted the Company's variable-rate real estate note to a fixed-rate obligation. At December 31, 2010, the fair value of the Company's interest rate swap was $0.3 million and was classified as a long-term liability in the accompanying condensed consolidated balance sheets. The fair value of the interest rate swap was determined by performing a discounted cash flow analysis using observable market interest rate data at the measurement date and was considered a Level 2 measurement in accordance with ASC 820. The interest rate swap instrument qualified for, and was designated as, a cash flow hedge of a forecasted transaction and the change in fair value of this instrument was recorded, net of tax, in "Accumulated other comprehensive loss" in the accompanying consolidated balance sheets. At December 31, 2010, $0.2 million of unrealized losses, net of tax, were recorded in "Accumulated other comprehensive loss" in the accompanying consolidated balance sheets. During the year ended December 31, 2011, in conjunction with paying off its variable-rate real estate note, the Company paid approximately $0.3 million to settle its interest rate swap. As a result of the settlement of its interest rate swap, the Company reclassified a $0.2 million loss (net of tax expense of $0.1 million) previously included in "Accumulated other comprehensive loss" to "Interest expense, net."

8. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except share and per share data):

	Year Ended December 31,		
	2011	2010	2009
Numerator:			
Net loss	$ (11,588)	$ (10,066)	$ (16,869)
Denominator:			
Basic weighted average shares outstanding	15,388,456	15,187,028	15,061,603
Effect of dilutive securities:			
SARS and options	—	—	—
Restricted stock	—	—	—
Convertible notes	—	—	—
Diluted weighted average shares outstanding	15,388,456	15,187,028	15,061,603
Basic loss per share	$ (0.75)	$ (0.66)	$ (1.12)
Diluted loss per share	$ (0.75)	$ (0.66)	$ (1.12)

The Company has excluded the dilutive effect of stock options, stock appreciation rights, convertible notes and restricted stock for the years ended December 31, 2011, 2010 and 2009, due to a net loss for these periods.

9. STOCK-BASED COMPENSATION

The Company has one stock-based compensation plan, the 2005 Stock Incentive Plan (the "2005 Plan"), which was amended by its shareholders on May 7, 2008. The 2005 Plan is administered by the Compensation

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Committee of the Company's Board of Directors. Stock-based compensation is granted to officers, directors and certain key employees in accordance with the provisions of the 2005 Plan. The 2005 Plan provides for grants of stock options, stock appreciation rights ("SARs"), restricted stock and performance share awards. The total aggregate number of shares of the Company's common stock that may be issued under the 2005 Plan is 3,150,000 shares. For the years ended December 31, 2011, 2010 and 2009, stock compensation expense related to awards under the 2005 Plan was $3.1 million, $3.6 million and $3.5 million, respectively. This expense is included in "Selling, general and administrative expenses" in the accompanying consolidated statements of operations.

Stock Options and Stock Appreciation Rights

The 2005 Plan authorizes the grant of stock options and SARs. Stock options are granted with an exercise price and SARs are granted with a grant price equal to the closing market price of the Company's common stock on the date of grant. These awards have ten-year contractual terms and vest based on the terms of the individual awards. The options and SARs are generally forfeitable upon termination of a holder's service as an employee or director, unless the individual's service is terminated due to retirement, death or permanent disability. The Company recognizes compensation cost on a straight-line basis over the vesting period for the award. Prior to 2006, the Company granted stock options and all stock options outstanding at December 31, 2011 are fully vested. In 2006, the Company began the use of SARs instead of stock options.

As of December 31, 2011, there was $1.4 million of unrecognized compensation cost related to SARs expected to be recognized over a weighted-average period of approximately 1.7 years. The fair value of each stock option award and SAR is estimated on the date of grant using a Black-Scholes option-pricing model. For SARs issued in the years ended December 31, 2011, 2010 and 2009, respectively, the assumptions shown in the following table were used:

	Year Ended December 31,		
	2011	2010	2009
Dividend yield	0%	0%	0%
Average risk-free interest rate	2.0%	2.6%	1.6%
Expected term (years)	5	5	5
Volatility	65.0%	66.3%	57.9%

Expected Volatility. Volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company has used the historical volatility over the average expected term of the options granted as the expected volatility.

Risk-Free Interest Rate. This is the U.S. Treasury rate having a term that most closely resembles the expected term of the option.

Expected Term. The expected term is the period of time that the SARs granted is expected to remain unexercised. SARs granted during the year ended December 31, 2011 had a maximum term of ten years. The Company used historical exercise behavior with further consideration given to the class of employees to whom the equity awards were granted to estimate the expected term of the SAR.

The forfeiture rate is the estimated percentage of equity awards granted that are expected to be forfeited or canceled before becoming fully vested. The Company estimates forfeitures based on historical experience with further consideration given to the class of employees to whom the equity awards were granted.

The weighted-average grant date fair value of SARs granted during the year ended December 31, 2011 was $25.76.

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Stock option activity under the 2005 Plan and a predecessor stock incentive plan is as follows:

	Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value as of December 31, 2010
Outstanding at December 31, 2008	268,439	$33.03		
Granted	—	$ —		
Exercised	—	$ —		
Canceled	(18,924)	$30.19		
Outstanding at December 31, 2009	249,515	$33.22		
Granted	—	$ —		
Exercised	(1,483)	$23.34		
Canceled	(25,586)	$34.41		
Outstanding at December 31, 2010	222,446	$33.20		
Granted	—	$ —		
Exercised	(57,027)	$27.94		
Canceled	(20,350)	$31.71		
Outstanding at December 31, 2011	145,069	$38.08	2.3	$14,712
Vested at December 31, 2011	145,069	$38.08	2.3	$14,712
Exercisable at December 31, 2011	145,069	$38.08	2.3	$14,712

At December 31, 2011, the price range of options outstanding was as follows:

	Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Options Exercisable	Weighted-Average Exercise Price
$ 0.00 – 19.99	—	$ —	—	—	$ —
20.00 – 29.99	28,578	$24.60	2.1	28,578	$24.60
30.00 – 39.99	60,393	$37.05	1.7	60,393	$37.05
40.00 and over	56,098	$46.09	3.1	56,098	$46.09
Total	145,069	$38.08	2.3	145,069	$38.08

SAR activity under the 2005 Plan is as follows:

	SARs	Weighted-Average Grant Price Per Share
Outstanding at December 31, 2008	951,136	$13.07
Granted	251,695	$13.52
Exercised	(22,334)	$16.63
Canceled	(47,145)	$12.88
Vested at December 31, 2009	817,782	$13.69
Exercisable at December 31, 2009	542,283	$15.58
Outstanding at December 31, 2009	1,133,352	$13.25
Granted	136,666	$17.94
Exercised	(12,359)	$23.27
Canceled	(11,164)	$24.02
Vested at December 31, 2010	834,175	$14.21
Exercisable at December 31, 2010	799,482	$14.41
Outstanding at December 31, 2010	1,246,495	$13.70
Granted	96,765	$25.76
Exercised	(180,555)	$28.34
Canceled	—	$ —
Outstanding at December 31, 2011	1,162,705	$13.17
Vested at December 31, 2011	1,145,996	$13.34
Exercisable at December 31, 2011	930,748	$14.24

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Restricted Stock

The fair value of the restricted stock is determined based on the closing price of the Company's shares on the grant date. Shares of restricted stock vest based on the terms of the awards. Unvested restricted stock is generally forfeitable upon termination of a holder's service as an employee, unless the individual's service is terminated due to retirement, death or permanent disability. In the years ended December 31, 2011, 2010 and 2009, 67,945, 91,845 and 106,874 restricted shares were granted at $25.86, $17.41 and $13.44 per share, respectively. The total fair value of restricted shares vested for the years ended December 31, 2011, 2010 and 2009 was $4.1 million, $2.7 million, and $1.8 million, respectively. In the years ended December 31, 2011, 2010 and 2009, $1.6 million, $1.7 million and $1.6 million of compensation expense, respectively, was recognized related to restricted stock awards. At December 31, 2011, there was $1.9 million of total compensation expense related to unvested restricted stock remaining to be recognized over a weighted-average period of approximately 1.7 years. Compensation expense related to restricted stock is included in "Selling, general and administrative expenses" in the accompanying consolidated statements of operations.

Restricted stock activity under the 2005 Plan is as follows:

	Restricted Stock	Weighted-Average Grant Price Per Share
Nonvested at December 31, 2008	346,308	$11.69
Granted	106,874	$13.44
Vested	(126,781)	$14.50
Forfeited	(34,621)	$12.21
Nonvested at December 31, 2009	291,780	$11.79
Granted	91,845	$17.41
Vested	(136,849)	$19.72
Forfeited	(2,340)	$16.21
Nonvested at December 31, 2010	244,436	$13.65
Granted	67,945	$25.86
Vested	(151,706)	$27.06
Forfeited	(500)	$17.41
Nonvested at December 31, 2011	160,175	$22.99

Employee Stock Purchase Plan

The Company has an employee stock purchase plan ("ESPP") that permits eligible employees to purchase shares of common stock of the Company at a purchase price which is the lesser of 85% of the market price on the first day of the calendar quarter or 85% of the market price on the last day of the calendar quarter. Eligible employees may elect to participate in the plan by authorizing payroll deductions from 1% to 15% of gross compensation for each payroll period. On the last day of each quarter, each participant's contribution account is used to purchase the maximum number of whole shares of common stock determined by dividing the contribution account's balance by the purchase price. The aggregate number of shares of common stock that may be purchased under the plan is 300,000. Through December 31, 2011, employees had purchased approximately 186,000 shares under the plan. In the years ended December 31, 2011, 2010 and 2009, compensation expense of $86.3 thousand, $52.1 thousand and $117.9 thousand, respectively, was recognized related to the discount on ESPP purchases. Compensation expense related to ESPP purchases is included in "Selling, general and administrative expenses" in the accompanying consolidated statements of operations.

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10. LEASES

The Company leases office space, storage warehouses and certain office and plant equipment under various operating leases. Minimum annual payments under these non-cancelable leases as of December 31, 2011 were as follows (in thousands):

Year Ending December 31,	
2012	$ 7,562
2013	5,581
2014	5,193
2015	4,599
2016	2,546
Thereafter	7,191
Total minimum lease payments	$32,672

For the years ended December 31, 2011, 2010 and 2009, the Company recognized rental expenses of approximately $8.0 million, $8.4 million and $8.4 million, respectively.

11. EMPLOYEE BENEFIT PLANS

Through December 31, 2011, the Company had a 401(k) Profit Sharing Plan for the benefit of all employees who meet certain eligibility requirements. The plan covered substantially all of the Company's full-time employees. The plan documents provide for the Company to match contributions equal to 100% of an employee's contribution to the plan up to 6% of base salary. The Company's contributions to the plan totaled $1.6 million, $1.5 million and $1.2 million for the years ended December 31, 2011, 2010 and 2009.

12. INCOME TAXES

Income tax provision (benefit) for the years ended December 31, 2011, 2010 and 2009 consists of the following (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Current income tax provision (benefit):			
Federal	$(2,738)	$ (16)	$(5,172)
State	(32)	(355)	(1,636)
	(2,770)	(371)	(6,808)
Deferred income tax provision (benefit):			
Federal	164	136	913
State	1	64	84
	165	200	997
Total income tax provision (benefit)	$(2,605)	$(171)	$(5,811)

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The income tax provision (benefit) differs from the amount of income tax determined by applying the U.S. federal statutory rate to income before taxes as a result of the following (in thousands):

	Year Ended December 31,		
	2011	2010	2009
U.S. federal statutory taxes	$(4,826)	$(3,502)	$(7,725)
State and local taxes, net of U.S. federal benefit	(650)	(1,971)	(928)
Permanent items	96	(1)	(30)
Federal credits	(59)	(66)	(61)
Other	(275)	(503)	(1,255)
Increase in valuation allowance	3,109	5,872	4,188
Total income tax provision (benefit)	$(2,605)	$ (171)	$(5,811)

Deferred tax assets and liabilities as of December 31, 2011 and 2010 consist of the following (in thousands):

	As of December 31,	
	2011	2010
Deferred tax assets:		
Net operating losses	$ 23,043	$ 20,457
Warranty reserve	6,306	5,642
Stock-based compensation	3,254	3,116
Accruals not currently deductible and other	3,959	5,932
Inventories	4,137	4,458
State tax credit carryforwards	4,252	3,850
Gross deferred tax assets, before valuation allowance	44,951	43,455
Valuation allowance	(24,199)	(21,090)
Gross deferred tax assets, after valuation allowance	20,752	22,365
Deferred tax liabilities:		
Debt discount	(2,103)	(5,949)
Depreciation and other	(21,592)	(19,026)
Gross deferred tax liabilities	(23,695)	(24,974)
Net deferred tax asset (liability)	$ (2,943)	$ (2,610)

The valuation allowance as of December 31, 2011 of $24.2 million is primarily attributable to the uncertainty related to the realizability of the Company's excess deferred tax assets. The increase in the valuation allowance during 2011 resulted from an increase in the Company's excess deferred tax assets. The excess deferred tax assets increased due to the fact that deductions included in the Company's financial statements exceeded allowable current tax deductions. The Company has considered all available evidence, both positive and negative, in determining the need for a valuation allowance. Based upon this analysis, including a consideration of the Company's cumulative loss history in the three-year period ended December 31, 2011, management determined that it is not more likely than not that its excess deferred tax assets will be realized. The Company's future realization of its excess deferred tax assets ultimately depends on the existence of sufficient taxable income in the carry-forward periods under the tax laws. The Company will analyze its position in subsequent reporting periods, considering all available positive and negative evidence, in determining the expected realization of its excess deferred tax assets.

The Company has federal net operating losses of $65.3 million at December 31, 2011 which expire starting 2027.

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The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in ASC 740) on January 1, 2007. As a result of the adoption, the Company recorded a charge of $2.7 million to the January 1, 2007 "Retained earnings" balance in the accompanying consolidated balance sheets. The Company had $0.1 million, $3.1 million and $3.8 million of unrecognized tax benefits as of December 31, 2011, 2010 and 2009, respectively. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Unrecognized tax benefits balance at January 1	$ 3,126	$3,752	$ 3,070
Gross increases related to prior year tax positions	1	—	2,528
Gross decreases related to prior year tax positions	(2,760)	—	(167)
Gross increases related to current year tax positions	—	—	—
Settlements	(245)	(609)	(1,368)
Lapse of statute of limitations	(62)	(17)	(311)
Unrecognized tax benefits balance at December 31	$ 60	$3,126	$ 3,752

The total liabilities associated with unrecognized tax benefits that, if recognized, would affect the effective tax rates were $0.1 million and $0.4 million at December 31, 2011 and December 31, 2010, respectively.

The Company recognizes interest and penalties related to tax matters as a component of "Selling, general and administrative expenses" in the accompanying consolidated statements of operations. As of December 31, 2011 and December 31, 2010, the Company had accrued interest related to uncertain tax positions of $0.1 million and $0.6 million, respectively, and accrued penalties related to uncertain tax positions of $15 thousand and $81 thousand respectively, in the accompanying consolidated balance sheets.

The Company operates in multiple tax jurisdictions and, in the normal course of business, its tax returns are subject to examination by various taxing authorities. Such examinations may result in future assessments by these taxing authorities and the Company has accrued a liability when it believes that it is not more likely than not that it will realize the benefits of tax positions that it has taken or for the amount of any tax benefit that exceeds the cumulative probability threshold in accordance with ASC 740. The Company believes that adequate provisions have been made for all tax returns subject to examination.

The Company has taken tax positions in certain taxing jurisdictions for which it is reasonably possible that the total amounts of unrecognized tax benefits may decrease within the year ending December 31, 2012. The possible decrease could result from the closing of the statutes for federal and state tax purposes in some taxing jurisdictions and would be approximately $2 thousand.

13. COMMITMENTS AND CONTINGENCIES

Legal Matters

On January 19, 2009, a purported class action case was commenced against the Company in the Superior Court of California, Santa Cruz County, by the lead law firm of Lieff, Cabraser, Heimann & Bernstein, LLP and certain other law firms (the "Lieff Cabraser Group") on behalf of Eric Ross and Bradley S. Hureth and similarly situated plaintiffs. These plaintiffs generally allege certain defects in the Company's products, and that the Company has failed to provide adequate remedies for defective products. On February 13, 2009, the Company removed this case to the United States District Court, Northern District of California. On January 21, 2009, a purported class action case was commenced against the Company in the United States District Court, Western District of Washington by the law firm of Hagens Berman Sobol Shapiro LLP (the "Hagens Berman Firm") on behalf of Mark Okano and similarly situated plaintiffs, generally alleging certain product defects in the

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Company's products, and that the Company has failed to provide adequate remedies for defective products. This case was transferred by the Washington Court to the California Court as a related case to the Lieff Cabraser Group's case.

On July 30, 2009, the U.S. District Court for the Northern District of California preliminarily approved a settlement of the claims of the lawsuit commenced by the Lieff Cabraser Group involving surface flaking of the Company's product, and on March 15, 2010, it granted final approval of the settlement. On April 14, 2010, the Hagens Berman Firm filed a notice to appeal the District

Court's ruling to the United States Court of Appeals for the Ninth Circuit. On July 9, 2010, the Hagens Berman Firm dismissed their appeal, effectively making the settlement final.

On March 25, 2010, the Lieff Cabraser Group amended its complaint to add claims relating to alleged defects in the Company's products and alleged misrepresentations relating to mold growth. The Hagens Berman firm has alleged similar claims in its original complaint. In its Final Order approving the surface flaking settlement, the District Court consolidated the two pending actions relating to the mold claims, and appointed the Hagens Berman Firm as lead counsel in this case. The Company believes that these claims are without merit, and will vigorously defend this lawsuit.

On December 15, 2010, a purported class action case was commenced against the Company in the United States District Court, Western District of Kentucky, by the lead law firm of Cohen & Malad, LLP ("Cohen & Malad") on behalf of Richard Levin and similarly situated plaintiffs, and on June 13, 2011, a purported class action was commenced against the Company in the Marion Circuit/Superior Court of Indiana by Cohen & Malad on behalf of Ellen Kopetsky and similarly situated plaintiffs. On June 28, 2011, the Company removed the Kopetsky case to the United States District Court, Southern District of Indiana. On August 11, 2011, a purported class action was commenced against the Company in the 50th Circuit Court for the County of Chippewa, Michigan on behalf of Joel and Lori Peffers and similarly situated plaintiffs. On August 26, 2011, the Company removed the Peffers case to the United States District Court, Western District of Michigan. The plaintiffs in these purported class actions generally allege certain defects in the Company's products and alleged misrepresentations relating to mold growth. The Company believes that these claims are without merit, and will vigorously defend these lawsuits.

The Company has other lawsuits, as well as other claims, pending against it which are ordinary routine litigation and claims incidental to the business. Management has evaluated the merits of these other lawsuits and claims, and believes that their ultimate resolution will not have a material effect on the Company's consolidated financial condition, results of operations, liquidity or competitive position.

Purchase Commitments

The Company fulfills requirements for raw materials under both purchase orders and supply contracts. In the year ended December 31, 2011, the Company purchased substantially all of its waste wood fiber requirements under purchase orders, which do not involve long-term supply commitments. Substantially all of the Company's PE material purchases are under short-term supply contracts that average approximately two years, for which pricing is negotiated as needed. The PE material supply contracts have not had a material adverse effect on the Company's business.

The waste wood and PE material supply contracts generally provide that the Company is obligated to purchase all of the waste wood or PE material a supplier provides, if the waste wood or PE material meets certain specifications. The amount of waste wood and PE material the Company is required to purchase under these contracts varies with the production of its suppliers and, accordingly, is not fixed or determinable. As of December 31, 2011, the Company had waste wood and PE material supply contracts of $16.8 million for the year ending December 31, 2012.

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The Company outsources the production of certain products to third-party manufacturers under supply contracts that commit the Company to purchase minimum levels for each year extending through 2012. The Company has purchase commitments under the third-party manufacturing contracts of $5.4 million for the year ending December 31, 2012.

Contract Termination Costs

In anticipation of relocating the Company's corporate headquarters, the Company entered into a lease agreement in 2005. The Company reconsidered and decided not to move its headquarters. The lease, which began on January 1, 2006 and extends through June 30, 2019, obligates the Company to lease 55,047 square feet. The Company has executed subleases for the entire 55,047 square feet it currently leases. The terms of the existing subleases expire in years 2012 to 2015. The Company estimates that the present value of the estimated future sublease rental receipts, net of transaction costs, will be less than the Company's remaining minimum lease payment obligations under its lease for the office space. Accordingly, the Company accounts for the expected shortfall as contract termination costs and has recorded a liability in accordance with ASC 420.

To estimate future sublease receipts for the periods beyond the term of the existing subleases, the Company has assumed that the existing subleases will be renewed or new subleases will be executed at rates consistent with rental rates in the current subleases. However, management cannot be certain that the timing of future subleases or the rental rates contained in future subleases will not differ from current estimates. Factors such as the delivery of a significant amount of new office space or poor economic conditions could have a negative effect on vacancy rates and rental rates in the area. The inability to sublet the office space in the future or unfavorable changes to key management assumptions used in the estimate of the future sublease receipts may result in material charges to selling, general and administrative expenses in future periods.

As of December 31, 2011, the minimum payments remaining under the Company's lease over the years ending December 31, 2012, 2013, 2014, 2015, and 2016 are $1.6 million, $1.7 million, $1.7 million, $1.7 million and $1.8 million, respectively, and $4.5 million thereafter. The minimum receipts remaining under the Company's existing subleases over the years ending December 31, 2012, 2013, and 2014 are $1.6 million, $1.3 million and $1.0 million, respectively, and $0.0 million thereafter.

The following table provides information about the Company's liability under the lease (in thousands):

	2011	2010
Balance as of January 1,	$ 567	$ 485
Less: cash payments	(161)	(186)
Accretion of discount	46	43
Add: charge for minimum lease payments in excess of estimated sublease receipts, net	—	225
Balance as of December 31,	$ 452	$ 567

Product Warranty

The Company warrants that its products will be free from material defects in workmanship and material and will not check, split, splinter, rot or suffer structural damage from termites or fungal decay. This warranty extends for a period of 25 years for residential use and 10 years for commercial use. With respect to the Company's Transcend and Enhance product, the Company further warrants that the product will not fade in color more than a certain amount and will be resistant to permanent staining from food substances or mold (provided the stain is cleaned within seven days of appearance). This warranty extends for a period of 25 years for residential use of the Transcend product, 20 years for residential use of the Enhance product, and 10 years for commercial use of either product. If there is a breach of such warranties, the Company has an obligation either to

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replace the defective product or refund the purchase price. The Company establishes warranty reserves to provide for estimated future expenses as a result of product defects that result in claims. Reserve estimates are based on management's judgment, considering such factors as cost per claim, historical experience, anticipated rates of claims, and other available information. Management reviews and adjusts these estimates, if necessary, on a quarterly basis based on the differences between actual experience and historical estimates.

The Company continues to receive and settle claims related to material produced at its Nevada facility prior to 2007 that exhibit surface flaking and, during 2011, recorded an increase of $10.0 million to the warranty reserve for this material. The increase in the reserve was primarily driven by a change in estimate regarding the number of future claims to be received, and to a lesser extent, an increase in the estimated future cost per claim. In the prior year, we anticipated that the effects of the settlement of a class action lawsuit related to surface flaking would subside and the number of claims received would substantially diminish. The number of claims received related to the surface flaking material has declined significantly since 2007 and has continued to decline during 2011. Cash payments for surface flaking claims have decreased from $28 million in 2007 to $8 million in 2011. The rate of decline of claims received in 2011, however, fell short of previous projections. The effect of the shortfall in the rate of decline on claims projections caused the estimated number of future claims to increase. The Company has revised its estimates accordingly. The increase in the estimated future cost per claim is a result of an increase in recent actual costs to settle claims, which management uses to estimate future costs. The cost per claim may vary due to a number of factors, including the average size of affected decks, the type of replacement material used and the method of claim settlement. As a result of these developments, the Company recorded an increase to the warranty reserve of $10.0 million in 2011.

The Company's analysis is based on currently known facts and a number of assumptions. However, projecting future events such as new claims to be filed each year and the average cost of resolving each claim could cause the actual warranty liabilities to be higher or lower than those projected which could materially affect our financial condition, results of operations or cash flow. We estimate that the number of claims received will continue to decline over time. If the level of claims does not diminish consistent with the Company's expectations, it could result in additional increases to the warranty reserve and reduced earnings in future periods. The Company estimates that a 10% change in the expected number of remaining claims or the expected cost to settle claims may result in approximately a $1.6 million change in the warranty reserve.

The following is a reconciliation of the Company's warranty reserve (in thousands):

	2011	2010
Beginning balance, January 1	$14,472	$ 11,524
Provision for estimated warranties	9,976	14,960
Settlements made during the period	(8,103)	(12,012)
Ending balance, December 31	$16,345	$ 14,472

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14. INTERIM FINANCIAL DATA (Unaudited)

	Three Months Ended							
	December 31, 2011 (a)	September 30, 2011	June 30, 2011	March 31, 2011	December 31, 2010 (b)	September 30, 2010	June 30, 2010 (c)	March 31, 2010
	(In thousands, except per share data)							
Net sales	51,462	67,916	78,405	69,006	75,272	60,579	115,499	66,340
Gross profit (loss)	(1,052)	17,272	23,542	23,029	18,552	9,179	29,871	15,214
Net income (loss)	(18,255)	(496)	2,106	5,057	(512)	(8,821)	4,775	(5,508)
Basic net income (loss) per share	$ (1.18)	$ (0.03)	$ 0.14	$ 0.33	$ (0.03)	$ (0.58)	$ 0.31	$ (0.36)
Diluted net income (loss) per share	$ (1.18)	$ (0.03)	$ 0.12	$ 0.30	$ (0.03)	$ (0.58)	$ 0.30	$ (0.36)

The Company's net sales, gross profit and income from operations have historically varied from quarter to quarter. Such variations are principally attributable to seasonal trends in the demand for Trex. The Company has historically experienced lower net sales during the fourth quarter because holidays and adverse weather conditions in certain regions reduce the level of home improvement and new construction activity.

(a) Three months ended December 31, 2011 was materially affected by a pre-tax increase of $10.0 million to the warranty reserve.

(b) Three months ended December 31, 2010 was materially affected by a pre-tax increase of $5.0 million to the warranty reserve.

(c) Three months ended June 30, 2010 was materially affected by a pre-tax increase of $9.0 million to the warranty reserve.

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TREX COMPANY, INC.

SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

(In Thousands)

Descriptions	Balance at Beginning of Period	Additions (Reductions) Charged to Cost and Expenses	Other	Deductions	Balance at End of Period
Year ended December 31, 2011:					
Allowance for doubtful accounts (a)	$ 335	$ 23	$ —	$ (66)	$ 292
Warranty reserve	$14,472	$ 9,976	$ —	$ (8,103)	$16,345
Income tax valuation allowance	$21,090	$ 3,109	$ —	$ —	$24,199
Year ended December 31, 2010:					
Allowance for doubtful accounts (a)	$ 1,457	$ (185)	$ —	$ (937)	$ 335
Warranty reserve	$11,524	$14,960	$ —	$(12,012)	$14,472
Income tax valuation allowance	$15,218	$ 5,872	$ —	$ —	$21,090
Year ended December 31, 2009:					
Allowance for doubtful accounts (a)	$ 1,489	$ 732	$ —	$ (764)	$ 1,457
Warranty reserve	$21,856	$ 250	$ —	$(10,582)	$11,524
Income tax valuation allowance	$11,338	$ 4,188	$(308)	$ —	$15,218

(a) Reserve related to accounts receivable

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FINANCIAL ACCOUNTING SERIES

EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: July 20, 2010
Comments Due: August 20, 2010

Contingencies (Topic 450)

Disclosure of Certain Loss Contingencies

This Exposure Draft of a proposed Accounting Standards Update of Topic 450 is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. 1840-100

Financial Accounting Standards Board
of the Financial Accounting Foundation

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The *FASB Accounting Standards Codification*™ is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites individuals and organizations to send written comments on all matters in this Exposure Draft of a proposed Accounting Standards Update. Responses from those wishing to comment on the Exposure Draft must be received in writing by August 20, 2010. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1840-100. Those without email should send their comments to "Technical Director, File Reference No. 1840-100, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116." Do not send responses by fax.

All comments received constitute part of the FASB's public file. The FASB will make all comments publicly available by posting them to its website and by making them available in its public reference room in Norwalk, Connecticut.

An electronic copy of this Exposure Draft is available on the FASB's website until the FASB issues a final Accounting Standards Update.

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Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

Proposed Accounting Standards Update

Contingencies (Topic 450)

Disclosure of Certain Loss Contingencies

July 20, 2010

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

Investors and other users of financial reporting have expressed concerns that disclosures about loss contingencies under the existing guidance on contingencies in Topic 450 do not provide adequate and timely information to assist them in assessing the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would apply to all entities, both public and nonpublic, except that nonpublic entities would not be required to provide a tabular reconciliation of accrued loss contingencies.

What Are the Main Provisions?

The amendments in this proposed Update would establish the following disclosure objective:

> An entity shall disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following:
>
> a. The nature of the loss contingencies
> b. Their potential magnitude
> c. Their potential timing (if known).

To achieve the above objective, an entity would consider the following principles in determining disclosures that are appropriate for its individual facts and circumstances for loss contingencies that meet the disclosure threshold:

a. During early stages of a loss contingency's life cycle, an entity would disclose information that is available to enable users to understand the loss contingency's nature, potential magnitude, and potential timing (if known). Available information may be limited and, therefore, disclosure may be less extensive in early stages of a loss contingency. In subsequent reporting periods, disclosure would be more extensive as

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additional information about a potential unfavorable outcome becomes available.

b. An entity may aggregate disclosures about similar contingencies (for example, by class or type) so that the disclosures are understandable and not too detailed. If an entity provides disclosures on an aggregated basis, it would disclose the basis for aggregation.

With respect to the disclosure threshold, the amendments in this proposed Update would require disclosure of certain remote loss contingencies. This proposed change in the disclosure threshold would expand the population of loss contingencies that are required to be disclosed to achieve more timely disclosure of remote loss contingencies with a potentially severe impact.

When assessing the materiality of loss contingencies to determine whether disclosure is required, an entity would not consider the possibility of recoveries from insurance or other indemnification arrangements.

The proposed amendments would retain the current qualitative disclosures and enhance them by requiring additional disclosures, for example, in the case of litigation contingencies, disclosure of the contentions of the parties and how users can obtain additional information about the litigation. Similarly, in addition to the quantitative disclosures required under current U.S. generally accepted accounting principles (GAAP), the amendments in this proposed Update would require disclosure of publicly available quantitative information (such as the claim amount for asserted litigation contingencies), other relevant nonprivileged information, and, in some cases, information about possible recoveries from insurance and other sources. Furthermore, a public entity would be required to provide tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the reporting period.

How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

The amendments in this proposed Update would retain the disclosures required under current U.S. GAAP and enhance them with additional information. The proposed disclosures are intended to enable users to understand the nature, potential magnitude, and potential timing (if known) of loss contingencies.

The FASB staff will continue to work with the Public Company Accounting Oversight Board, the American Institute for Certified Public Accountants, and the American Bar Association (ABA) to identify and address any potential implications of the proposed requirements for the U.S. auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information.

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When Would the Amendments Be Effective?

For public entities, the new guidance would be effective for fiscal years ending after December 15, 2010, and interim and annual periods in subsequent fiscal years. For nonpublic entities, the new guidance would be effective for the first annual period beginning after December 15, 2010, and for interim periods of fiscal years after the first annual period.

How Do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?

The disclosures that would be required by the amendments in this proposed Update are similar, but not identical, to those required by IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. The IASB currently is deliberating changes to IAS 37. The IASB's plan is to complete its project in 2010. The IASB's project, however, has a much broader scope that includes initial recognition, subsequent measurement, and disclosures. The scope of this proposed Update is limited to improving disclosures.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: Are the proposed disclosures operational? If not, please explain why.

Question 2: Are the proposed disclosures auditable? If not, please explain why.

Question 3: The June 2008 FASB Exposure Draft, *Disclosure of Certain Loss Contingencies,* had proposed certain disclosures based on management's predictions about a contingency's resolution. The amendments in this proposed Update would eliminate those disclosure requirements such as estimating when a loss contingency would be resolved and the entity's maximum exposure to loss. Do you agree that an explicit exemption from disclosing information that is "prejudicial" to the reporting entity is not necessary because the amendments in this proposed Update would:

a. Not require any new disclosures based on management's predictions about a contingency's resolution

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b. Generally focus on information that is publicly available
c. Relate to amounts already accrued in the financial statements
d. Permit information to be presented on an aggregated basis with other similar loss contingencies?

If not, please explain why.

Question 4: Is the proposed effective date operational? If not, please explain why.

Question 5: Do you believe that the proposed disclosures will enhance and improve the information provided to financial statement users about the nature, potential magnitude, and potential timing (if known) of loss contingencies?

Question 6: Do you agree that *nonpublic entities* should be exempt from the tabular reconciliation disclosures required in the amendments in this proposed Update? If not, please explain why. Are there any other aspects of the amendments that should be applied differently to nonpublic entities? If so, please identify and explain why.

Question 7: The amendments in this proposed Update would defer the effective date for nonpublic entities for one year. Do you agree with the proposed deferral? If not, please explain why.

Question 8: Do you believe that the proposed and existing XBRL elements are sufficient to meet the Securities and Exchange Commission's requirements to provide financial statement information in the XBRL interactive data format? If not, please explain why.

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Amendments to the *FASB Accounting Standards Codification*™

Introduction

1. This proposed Update addresses the disclosure of certain loss contingencies within the scope of the amendments in this Update. The amendments would lower the current disclosure threshold and broaden the current disclosure requirements to provide adequate and timely information to assist users in assessing the likelihood, potential magnitude, and potential timing (if known) of future cash outflows associated with loss contingencies. The Subtopics listed below represent the primary changes to the Accounting Standards Codification as a result of the amendments in this proposed Update. The listed amendments will require changes to additional Subtopics that may be linked or related to the Subtopics noted below.

2. The following Subtopics would be amended:

Codification Subtopics	Action	Description of Changes
450-20 Contingencies—Loss Contingencies	Amended	• The proposed amendments would amend the guidance on disclosure of certain loss contingencies.
210-20 Balance Sheet—Offsetting	Consequential Amendment	• The substance of the guidance in this Subtopic would not be changed by the proposed amendments. • However, the proposed amendments would clarify that insurance or other recoveries related to loss contingencies should not be netted against the amounts accrued for loss contingencies.

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Codification Subtopics	Action	Description of Changes
275-10 Risks and Uncertainties—Overall	Conforming Amendment	• The substance of the guidance in this Subtopic would not be changed by the proposed amendments.
410-30 Asset Retirement and Environmental Obligations—Environmental Obligations	Conforming Amendment	• Disclosure of loss contingencies as they arise from environmental obligations would be expanded to include the disclosures in the proposed amendments.
460-10 Guarantees—Overall	Conforming Amendment	• Disclosure of loss contingencies related to guarantees, excluding product warranties, would be removed from Section 450-20-50. • Section 450-20-50 would be clarified to apply to product warranties, including disclosures in the proposed amendments.
470-60 Debt—Troubled Debt Restructurings by Debtors	Conforming Amendment	• The substance of the guidance in this Subtopic would not be changed by the proposed amendments.
715-80 Compensation—Retirement Benefits—Multiemployer Plans	Conforming Amendment	• The disclosure threshold for withdrawals from a multiplayer plan would be expanded to include withdrawals that may give rise to certain remote contingencies that meet the threshold for the disclosures in the proposed amendments. • Overall disclosures of loss

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Codification Subtopics	Action	Description of Changes
		contingencies as they arise from withdrawals from multiemployer plans would be expanded to include the disclosures in the proposed amendments.
720-20 Other Expenses—Insurance Costs	Conforming Amendment	• The substance of the guidance in this Subtopic would not be changed by the proposed amendments.
805-20 Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest	Conforming Amendment	• Disclosures of loss contingencies as they arise from business combinations would be expanded to include the disclosures in the proposed amendments.

3. The Accounting Standards Codification is amended as described in paragraphs 4–34. In some cases, not only are the amended paragraphs shown but also the preceding and following paragraphs are shown to put the change in context. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Master Glossary

4. Amend the following existing Master Glossary term and add it to Subtopic 450-20, with a link to transition paragraph 450-20-65-1, as follows:

Severe Impact

(Used in reference to current vulnerability due to certain concentrations, loss contingencies, or both.) A significant financially disruptive effect on the normal functioning of an entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity's capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the entity itself. The concept of severe impact, however, includes matters that are less than

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catastrophic. Matters that are catastrophic include, for example, those that would result in bankruptcy.

Amendments to Subtopic 450-20

5. Amend paragraph 450-20-15-2, with a link to transition paragraph 450-20-65-1, as follows:

Contingencies—Loss Contingencies

Scope and Scope Exceptions

> Transactions

450-20-15-2 The following transactions are excluded from the scope of this Subtopic because they are addressed elsewhere in the Codification:

a. Stock issued to employees, which is discussed in Topic 718.
b. Employment-related costs, including deferred compensation contracts, which are discussed in Topics 710, 712, and 715. However, certain postemployment benefits are included in the scope of this Subtopic through application of paragraphs 712-10-25-4 through 25-5. Also, obligations that may result from withdrawal from a multiemployer plan are included in the scope of this Subtopic through application of paragraph 715-80-35-2 and paragraph 715-80-50-2.
c. Uncertainty in income taxes, which is discussed in Section 740-10-25.
d. Accounting and reporting by insurance entities, which is discussed in Topic 944.

6. Amend paragraph 450-20-25-2, with a link to transition paragraph 450-20-65-1, as follows:

Recognition

450-20-25-2 An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. 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.
b. The amount of loss can be reasonably estimated.

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The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. Paragraphs 450-20-55-1 through 55-17 and Examples 1–2 (see paragraphs 450-20-55-18A~~450-20-55-18~~ through 55-35) illustrate the application of the conditions. As discussed in Section 450-20-50~~paragraph 450-20-50-5~~, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.

7. Supersede paragraph 450-20-50-1 and its related heading, with a link to transition paragraph 450-20-65-1, as follows:

Disclosure

~~> Accruals for Loss Contingencies~~

450-20-50-1 Paragraph superseded by Accounting Standards Update 2010-XX. ~~Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 450-20-25-2, and in some circumstances, the amount accrued, may be necessary for the financial statements not to be misleading. Terminology used shall be descriptive of the nature of the accrual, such as estimated liability or liability of an estimated amount. The term *reserve* shall not be used for an accrual made pursuant to paragraph 450-20-25-2; that term is limited to an amount of unidentified or unsegregated assets held or retained for a specific purpose. Examples 1 (see paragraph 450-20-55-18) and 2, Cases A, B, and D (see paragraphs 450-20-55-23, 450-20-55-27, and 450-20-55-32) illustrate the application of these disclosure standards.~~

8. Add paragraphs 450-20-50-1A through 50-1F and their related headings, with a link to transition paragraph 450-20-65-1, as follows:

> Objective

450-20-50-1A An entity shall disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following:

a. The nature of the loss contingencies
b. Their potential magnitude
c. Their potential timing (if known).

> Principles

450-20-50-1B To achieve the objective in the preceding paragraph, an entity shall consider the following principles in determining disclosures that are

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appropriate for their individual facts and circumstances for loss contingencies that meet the disclosure threshold:

a. During early stages of a loss contingency's life cycle, an entity shall disclose information that is available to enable users to understand the loss contingency's nature, potential magnitude, and potential timing (if known). Available information may be limited and, therefore, disclosure may be less extensive in early stages of a loss contingency. In subsequent reporting periods, disclosure shall be more extensive as additional information about a potential unfavorable outcome becomes available.
b. An entity may aggregate disclosures about similar contingencies (for example, by class or type) so that disclosures are understandable and not too detailed. If an entity provides disclosures on an aggregated basis, it shall disclose the basis for aggregation. (See paragraphs 450-20-55-1A through 55-1D for additional guidance on implementing this aggregation principle.)

> Disclosure Threshold

450-20-50-1C An entity shall disclose information about a **contingency** if there is at least a reasonable possibility (that is, more than **remote** possibility) that a loss may have been incurred regardless of whether the entity has accrued for such a loss (or any portion of that loss). Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

a. It is considered probable that a claim will be asserted.
b. There is a reasonable possibility that the outcome will be unfavorable.

[Second sentence moved from paragraph 450-20-50-6]

450-20-50-1D Disclosure of asserted but remote loss contingencies may be necessary, due to their nature, potential magnitude, or potential timing (if known) to inform users about the entity's vulnerability to a potential **severe impact**. An entity will need to exercise judgment in assessing its specific facts and circumstances to determine whether disclosure about a remote contingency is necessary. Factors that an entity should consider in making this determination include any of the following:

a. The potential impact on the entity's operations
b. The cost to the entity for defending its contentions
c. The amount of effort and resources management may have to devote to resolve the contingency.

A plaintiff's amount of damages claimed, by itself, does not necessarily determine whether disclosure about a remote contingency is necessary, although it could be one of the factors to be considered in this determination. Although

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some of the guidance in this paragraph (to help an entity determine whether disclosure about an asserted remote contingency is necessary) is written in the context of a litigation contingency, the disclosure threshold applies to all contingencies required to be disclosed in accordance with Section 450-20-50.

450-20-50-1E When assessing the materiality of loss contingencies to determine whether disclosure is required, an entity shall not consider the possibility of recoveries from insurance or other indemnification arrangements.

> Disclosure Requirements

450-20-50-1F An entity shall disclose the following about a loss contingency or classes (types) of similar loss contingencies that meet the disclosure threshold described in paragraphs 450-20-50-1C through 50-1E:

a. Qualitative information to enable users to understand the loss contingency's nature and risks. For accrued loss contingencies, the terminology used shall describe the nature of the accrual, such as estimated liability. The term *reserve* shall not be used for an accrual made in accordance with paragraph 450-20-25-2; that term is limited to an amount of unidentified or unsegregated assets held or retained for a specific purpose.
b. During early stages of asserted litigation contingencies, at a minimum, the contentions of the parties (for example, the basis for the claim and the amount of damages claimed by the plaintiff and the basis for the entity's defense or a statement that the entity has not yet formulated its defense). In subsequent reporting periods, disclosure shall be more extensive as additional information about a potential unfavorable outcome becomes available, for example, as the litigation progresses toward resolution, if the likelihood or magnitude of loss increases, or both. Furthermore, if known, an entity shall disclose the anticipated timing of, or the next steps in, the resolution of individually material asserted litigation contingencies.
c. For individually material contingencies, sufficiently detailed information to enable financial statement users to obtain additional information from publicly available sources such as court records. For example, for a litigation contingency, an entity shall disclose all of the following:
    1. The name of the court or agency in which the proceedings are pending
    2. The date instituted
    3. The principal parties to the proceedings
    4. A description of the factual basis alleged to underlie the proceedings
    5. The current status of the litigation contingency.
d. When disclosure is provided on an aggregated basis, the basis for aggregation and information that would enable financial statement users

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to understand the nature, potential magnitude, and potential timing (if known) of loss.

e. For all contingencies that are at least reasonably possible (that is, more than remote), the following quantitative information:
   1. Publicly available quantitative information, for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses
   2. If it can be estimated, the possible loss or range of loss and the amount accrued, if any
   3. If the possible loss or range of loss cannot be estimated, a statement that an estimate cannot be made and the reason(s) why
   4. Other nonprivileged information that would be relevant to financial statement users to enable them to understand, the potential magnitude of the possible loss
   5. Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable by either the plaintiff or a regulatory agency, or it relates to a recognized receivable for such recoveries. If the insurance company has denied, contested, or reserved its rights related to the entity's claim for recovery, an entity shall disclose that fact. See guidance in paragraph 210-20-45-18 about offsetting (netting) of contingencies and insurance recoveries.

f. For those remote contingencies that meet the disclosure threshold in paragraph 450-20-50-1D:
   1. Publicly available quantitative information, for example, in the case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses
   2. Other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the loss
   3. Information about possible recoveries from insurance and other sources only if, and to the extent that, it has been provided to the plaintiff(s) in a litigation contingency or it is discoverable by either the plaintiff or a regulatory agency. If the insurance company has denied, contested, or reserved its rights related to the entity's claim for recovery, the entity shall disclose that fact.

g. For every annual and interim reporting period for which a statement of financial position and a statement of financial performance is presented by a **{link to second definition}public entity{link to second definition}**, reconciliations by class, in a tabular format, of recognized (accrued) loss contingencies to include all of the following:
   1. Carrying amounts of the accruals at the beginning and end of the period
   2. Amount accrued during the period for new loss contingencies recognized

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3. Increases for changes in estimates for loss contingencies recognized in prior periods
4. Decreases for changes in estimates for loss contingencies recognized in prior periods
5. Decreases for cash payments or other forms of settlements during the period.

Loss contingencies whose underlying cause and ultimate settlement occur in the same period should be excluded from the tabular reconciliation. A public entity shall describe the significant activity in the reconciliations described above and disclose the line items in the statement of financial position and the statement of financial performance in which recognized (accrued) loss contingencies are included. All loss contingencies recognized in a business combination in accordance with Topic 805 shall be included in the reconciliations but shown separately if they have a different measurement attribute, for example, fair value.

9. Amend paragraph 450-20-50-2, with a link to transition paragraph 450-20-65-1, as follows:

450-20-50-2 If the criteria in paragraph 275-10-50-8 are met, paragraph 275-10-50-9 requires disclosure of an indication that it is at least **reasonably possible** that a change in an entity's estimate of its **probable** liability could occur in the near term. ~~Example 3 (see paragraph 450-20-55-36) illustrates this disclosure for an entity involved in litigation.~~

10. Supersede paragraphs 450-20-50-3 through 50-6 and their related heading, with a link to transition paragraph 450-20-65-1, as follows:

~~**> Unrecognized Contingencies**~~

450-20-50-3 Paragraph superseded by Accounting Standards Update 2010-XX. ~~Disclosure of the **contingency** shall be made if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following conditions exists:~~

~~a. An accrual is not made for a **loss contingency** because any of the conditions in paragraph 450-20-25-2 are not met.~~
~~b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 450-20-30-1.~~

~~Examples 1-3 (see paragraphs 450-20-55-18 through 55-37) illustrate the application of these disclosure standards.~~

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450-20-50-4 Paragraph superseded by Accounting Standards Update 2010-XX. ~~The disclosure in the preceding paragraph shall include both of the following:~~

a. ~~The nature of the contingency~~
b. ~~An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.~~

450-20-50-5 Paragraph superseded by Accounting Standards Update 2010-XX. ~~Disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 450-20-25-2(a) but that is not accrued because the amount of loss cannot be reasonably estimated (the condition in paragraph 450-20-25-2[b]). Disclosure also shall be made of some loss contingencies that do not meet the condition in paragraph 450-20-25-2(a) namely, those contingencies for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.~~

450-20-50-6 Paragraph superseded by Accounting Standards Update 2010-XX.~~Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:~~

a. ~~It is considered probable that a claim will be asserted.~~
b. ~~There is a reasonable possibility that the outcome will be unfavorable.~~

[Content moved to paragraph 450-20-50-1C]

11. Amend paragraph 450-20-50-9 and its related heading, with a link to transition paragraph 450-20-65-1, as follows:

> Losses Arising ~~After~~after the Date of the Financial Statements

450-20-50-9 Disclosure of a loss, or a loss contingency, arising after the date of an entity's financial statements but before those financial statements are issued, as described in paragraphs 450-20-25-6 through 25-7, may be necessary to keep the financial statements from being misleading if an accrual is not required. If disclosure is deemed necessary, the financial statements shall include both of the following:

a. The nature of the loss or loss contingency
b. An estimate of the amount or range of loss or possible loss or a statement that such an estimate cannot be made and the reasons why the estimate cannot be made.

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12. Amend paragraph 450-20-55-1, with a link to transition paragraph 450-20-65-1, as follows:

Implementation Guidance and Illustrations

> Implementation Guidance

450-20-55-1 This Section includes implementation guidance for the application of the conditions for accrual of **loss contingencies** and for the disclosure requirements of this Subtopic. This guidance does not address all possible applications of the requirements of this Subtopic. Furthermore, the examples illustrate some but not all of the disclosure requirements. Therefore, accrual and disclosure of loss contingencies should be based on an evaluation of the facts and circumstances in each particular situation.

13. Add paragraphs 450-20-55-1A through 55-1D and their related heading, with a link to transition paragraph 450-20-65-1, as follows:

> > Aggregation

450-20-55-1A In determining the appropriate classes or types of loss contingencies for disclosure purposes, an entity should evaluate whether contingencies are sufficiently similar to be included in one class primarily on the basis of their nature, terms, and characteristics. For example, it may not be appropriate to aggregate amounts related to product warranties issued in an entity's normal course of business with amounts related to warranties that are subject to litigation, or to aggregate contingencies related to environmental contingencies with product liabilities, warranties, or other loss contingencies that are dissimilar to environmental contingencies. Similarly, it may not be appropriate to aggregate amounts related to individual litigations with those related to class-action lawsuits or to aggregate litigations in jurisdictions that have different legal characteristics that could affect the potential timing or the potential magnitude of the loss. Furthermore, it may not be appropriate to group together in one class loss contingencies that have significantly different timings of expected future cash outflows (that is, near term versus longer term).

450-20-55-1B To determine the appropriate level of aggregation, an entity needs to exercise judgment and strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements users with excessive detail that may not assist them in understanding the nature, potential magnitude, and potential timing (if known) of the entity's loss contingencies.

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450-20-55-1C Paragraph 450-20-50-1B(b) requires disclosure of the basis for aggregation if an entity provides disclosures on an aggregated basis. For example, an entity may have aggregated claims based on the following:

a. Its different segments or product lines
b. Because there are a large number of similar claims for a single product and the claim amounts are not material individually but are material on an aggregated basis.

450-20-55-1D Paragraph 450-20-50-1F(d) requires that if disclosures are provided on an aggregated basis, an entity should disclose information that would enable financial statement users to understand the nature, potential magnitude, and potential timing (if known) of loss contingencies. For example, if there are a large number of similar claims, an entity should consider disclosing the activity (for example, in a rollforward) in the following:

a. The total number of claims outstanding
b. The average amount claimed
c. The average settlement amount.

14. Amend paragraphs 450-20-55-9 through 55-10, with a link to transition paragraph 450-20-65-1, as follows:

> > Threat of Expropriation

450-20-55-9 The threat of expropriation of assets is a contingency (as defined) because of the uncertainty about its outcome and effect. The condition in paragraph 450-20-25-2(a) is met if both of the following are true:

a. Expropriation is imminent.
b. Compensation will be less than the carrying amount of the assets.

Imminence may be indicated, for example, by public or private declarations of intent by a government to expropriate assets of the entity or actual expropriation of assets of other entities. The condition in paragraph 450-20-25-2(b) requires that accrual be made only if the amount of loss can be reasonably estimated. If the conditions for accrual are not met, the disclosures described in Section 450-20-50~~paragraphs 450-20-50-3 through 50-8~~ would be made if there is at least a reasonable possibility that an asset has been impaired.

> > Litigation, Claims, and Assessments

450-20-55-10 The following factors should be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

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a. The period in which the underlying cause (that is, the cause for 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
c. The ability to make a reasonable estimate of the amount of loss.

Examples 1 through 2 (see paragraphs 450-20-55-17B~~450-20-55-18~~ through 55-35) illustrate the consideration of these factors in determining whether to accrue or disclose litigation.

15. Amend paragraphs 450-20-55-14 through 55-16, with a link to transition paragraph 450-20-65-1, as follows:

450-20-55-14 With respect to unasserted claims and assessments, an entity must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. An entity should consider all the information that it is aware of when determining the degree of probability that a claim will be asserted and an unfavorable outcome could occur. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 450-20-25-2. For example:

a. A catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable.
b. An investigation of an entity by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case.
c. An entity may believe there is a possibility that it has infringed on another entity's patent rights, but the entity owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, ~~a judgment~~an assessment must first be made as to whether the assertion of a claim is probable.
d. An entity may be aware of the existence of studies in reputable scientific journals (or other credible sources that other entities in the same industry generally review) that indicate potential significant hazards related to the entity's products or operations. In such circumstances, an assessment must first be made as to whether the assertion of a claim is probable.

450-20-55-15 If the ~~judgment~~assessment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the ~~judgment~~assessment is that assertion is probable, then a second ~~judgment~~assessment must be made as to the degree of probability of an

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unfavorable outcome. The disclosures described in Section 450-20-50 ~~paragraphs 450-20-50-3 through 50-8~~ would be required in either of the following circumstances:

a. An unfavorable outcome is probable but the amount of loss cannot be reasonably estimated.
b. An unfavorable outcome is reasonably possible but not probable.

> > > > Assessing Whether a Loss Is Reasonably Estimable

450-20-55-16 As a condition for accrual of a loss contingency, the condition in paragraph 450-20-25-2(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 450-20-25-2[a]), but the range of possible loss is wide. Examples 1 through~~and~~ 3 (see paragraphs 450-20-55-17B through 55-43~~450-20-55-18 and 450-20-55-36~~) illustrate the application of the standards in this Subtopic when the range of possible loss is wide.

16. Add paragraph 450-20-55-17B, with a link to transition paragraph 450-20-65-1, as follows:

> Illustrations

450-20-55-17B Examples 1 through 2 illustrate, in certain situations, the recognition and measurement requirements only (not disclosures), and Example 3 illustrates the progression of the disclosures about an example litigation contingency over its life cycle.

> > Example 1: Litigation Open to Considerable Interpretation

450-20-55-18 An entity may be litigating a dispute with another party. In preparation for the trial, it may determine that, based on recent developments involving one aspect of the litigation, it is probable that it will have to pay $2 million to settle the litigation. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the entity may have to pay an additional $8 million over and above the $2 million.

450-20-55-19 In that case, paragraph 450-20-25-2 requires accrual of the $2 million if that is considered a reasonable estimate of the loss.

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17. Supersede paragraphs 450-20-55-20 through 55-21, with a link to transition paragraph 450-20-65-1, as follows:

450-20-55-20 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the accrual and depending on the circumstances, may require disclosure of the $2 million that was accrued.~~

450-20-55-21 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-3 through 50-8 require disclosure of the additional exposure to loss if there is a reasonable possibility that the additional amounts will be paid.~~

> > Example 2: Multiple Case Litigation Example

450-20-55-22 The following Cases illustrate application of the accrual and disclosure requirements in the following stages of litigation:

a. The trial is complete but the damages are undetermined (Case A).
b. The trial is incomplete but an unfavorable outcome is probable (Case B).
c. The trial is incomplete and unfavorable outcome is reasonably possible (Case C).
d. There is a range of loss and one amount is a better estimate than any other (Case D).

> > > Case A: Trial Is Complete but Damages Are Undetermined

450-20-55-23 An entity is involved in litigation at the close of its fiscal year and information available indicates that an unfavorable outcome is probable. Subsequently, after a trial on the issues, a verdict unfavorable to the entity is handed down, but the amount of damages remains unresolved at the time the financial statements are issued or are available to be issued (as discussed in Section 855-10-25). Although the entity is unable to estimate the exact amount of loss, its reasonable estimate at the time is that the judgment will be for not less than $3 million or more than $9 million. No amount in that range appears at the time to be a better estimate than any other amount.

450-20-55-24 In this Case, paragraph 450-20-30-1 requires accrual of the $3 million (the minimum of the range) at the close of the fiscal year.

18. Supersede paragraphs 450-20-55-25 through 55-26, with a link to transition paragraph 450-20-65-1, as follows:

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450-20-55-25 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the contingency and, depending on the circumstances, may require disclosure of the amount of the accrual.~~

450-20-55-26 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-3 through 50-8 require disclosure of the exposure to an additional amount of loss of up to $6 million.~~

> > > Case B: Trial Is Incomplete but Unfavorable Outcome Is Probable

450-20-55-27 Assume the same facts as in Case A, except it is probable that a verdict will be unfavorable and the trial has not been completed before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25). In that situation, the condition in paragraph 450-20-25-2(a) would be met because information available to the entity indicates that an unfavorable verdict is probable. An assessment that the range of loss is between $3 million and $9 million would meet the condition in paragraph 450-20-25-2(b).

450-20-55-28 In this Case, if no single amount in that range is a better estimate than any other amount, paragraph 450-20-30-1 requires accrual of $3 million (the minimum of the range) at the close of the fiscal year.

19. Supersede paragraphs 450-20-55-29 through 55-30, with a link to transition paragraph 450-20-65-1, as follows:

450-20-55-29 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the contingency and, depending on the circumstances, may require disclosure of the amount of the accrual.~~

450-20-55-30 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-3 through 50-8 require disclosure of the exposure to an additional amount of loss of up to $6 million.~~

20. Amend paragraph 450-20-55-31, with a link to transition paragraph 450-20-65-1, as follows:

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> > > Case C: Trial Is Incomplete and Unfavorable Outcome Is Reasonably Possible

450-20-55-31 Assume the same facts as in Case B, except the entity had assessed the verdict differently (for example, that an unfavorable verdict was not probable but was only reasonably possible). The condition in paragraph 450-20-25-2(a) would not have been met and no amount of loss would be accrued. ~~Paragraphs 450-20-50-3 through 50-8 require disclosure of the nature of the contingency and any amount of loss that is reasonably possible.~~

> > > Case D: Range of Loss and One Amount Is a Better Estimate than Any Other

450-20-55-32 Assume that in Case A and Case B the condition in paragraph 450-20-25-2(a) has been met and a reasonable estimate of loss is a range between $3 million and $9 million but a loss of $4 million is a better estimate than any other amount in that range.

450-20-55-33 In this Case, paragraph 450-20-30-1 requires accrual of $4 million.

21. Supersede paragraphs 450-20-55-34 through 55-35, with a link to transition paragraph 450-20-65-1, as follows:

450-20-55-34 Paragraph superseded by Accounting Standards Update 2010-XX. ~~Paragraphs 450-20-50-1 through 50-2 require disclosure of the nature of the contingency and, depending on the circumstances, may require disclosure of the amount of the accrual.~~

450-20-55-35 Paragraph superseded by Accounting Standards Update 2010-XX.~~Paragraphs 450-20-50-3 through 50-8 require disclosure of the exposure to an additional amount of loss of up to $5 million.~~

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22. Supersede paragraphs 450-20-55-36 through 55-37, with a link to transition paragraph 450-20-65-1, as follows:

> > Example 3: Illustrative Disclosure

450-20-55-36 Paragraph superseded by Accounting Standards Update 2010-XX.~~Entity A is the defendant in litigation involving a major competitor claiming patent infringement (Entity B). The suit claims damages of $200 million. Discovery has been completed, and Entity A is engaged in settlement discussions with the plaintiff. Entity A has made an offer of $5 million to settle the case, which offer was rejected by the plaintiff; the plaintiff has made an offer of $35 million to settle the case, which offer was rejected by Entity A. Based on the expressed willingness of the plaintiff to settle the case along with information revealed during discovery and the likely cost and risk to both sides of litigating, Entity A believes that it is probable the case will not come to trial. Accordingly, Entity A has determined that it is probable that it has some liability. Entity A's reasonable estimate of this liability is a range between $10 million and $35 million, with no amount within that range a better estimate than any other amount; accordingly, $10 million was accrued.~~

450-20-55-37 Paragraph superseded by Accounting Standards Update 2010-XX.~~Entity A provides the following disclosure in accordance with Section 450-20-50.~~

> ~~On March 15, 19X1, Entity B filed a suit against the company claiming patent infringement. While the company believes it has meritorious defenses against the suit, the ultimate resolution of the matter, which is expected to occur within one year, could result in a loss of up to $25 million in excess of the amount accrued.~~

23. Add paragraphs 450-20-55-38 through 55-43, with a link to transition paragraph 450-20-65-1, as follows:

450-20-55-38 Entity A is the defendant in litigation involving a major customer (Entity B) claiming a breach of contract. The illustrative disclosures below describe the developments in each period.

22

> > > Period 1

450-20-55-39 Entity A provides the following disclosure in period 1, in accordance with Section 450-20-50.

December 31, 20X1

Entity A entered into a contract to provide 1,000 widgets for $1 million to Entity B by December 15, 20X1. Lightning struck Entity A's manufacturing plant on November 30, 20X1, and Entity A did not deliver the widgets. Entity B has sued Entity A in the case of Entity B versus Entity A, which was filed in the First District Court of California on December 29, 20X1, on the basis of a contention that Entity A breached the contract. At the time of this report, Entity B has not specified an amount claimed for damages, and discovery has not yet begun. Entity A has not completed its analysis of the relevant laws about performance under a contract in these circumstances and has not formulated its defense. As a result, Entity A is unable to estimate a potential loss or range of loss, if any, at this time. Entity A anticipates that discovery will take place during the second and third quarters of 20X2. At this time, the court has not set a trial date.

Entity A's business interruption insurance carrier has agreed to defend Entity A with a reservation of rights. There is no deductible for defense funding; Entity A has a deductible of $500,000 for actual damage claims, if any.

> > > Period 2

450-20-55-40 Entity A provides the same disclosures as those for the period ended December 31, 20X1, because there were no further developments during period 2 (March 31, 20X2), in accordance with Section 450-20-50.

> > > Period 3

450-20-55-41 Entity A provides the following disclosure in period 3, in accordance with Section 450-20-50.

June 30, 20X2

Entity A entered into a contract to provide 1,000 widgets for $1 million to Entity B by December 15, 20X1. Lightning struck Entity A's manufacturing plant on November 30, 20X1, and Entity A did not deliver the widgets. Entity B sued Entity A in the case of Entity B versus Entity A, which was filed in the First District Court of California on December 29, 20X1, on the basis of a contention that Entity A breached the contract.

It is Entity A's contention that its performance was excused by an act of god. Entity A's contract with Entity B did not specifically have an Act of God clause excusing lack of performance. Entity A contends that the Rules of Commerce in California do not require an Act of God clause within the

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contract to successfully use such a defense. Entity B contends that such a clause must be within the contract to use such a defense.

During discovery, Entity B has provided an analysis claiming damages of $2 million for lost profits as well as penalties for late delivery to its customer under a contract, which required the use of Entity A's widgets. Entity A has not yet completed its analysis to counter this claim but believes that damages could have been mitigated by reasonable efforts by Entity B. As a result, Entity A is unable to estimate a potential loss or range of loss, if any, at this time.

Entity A's business interruption insurance carrier has agreed to defend Entity A with a reservation of rights. There is no deductible for defense funding; Entity A has a deductible of $500,000 for actual damage claims, if any.

Entity A anticipates that discovery will continue during the third quarter of 20X2. Entity A has filed a motion to dismiss on the basis of the Act of God defense for which such a clause was not included in its contract. Entity A anticipates a ruling on that motion during the third quarter.

> > > Period 4

450-20-55-42 Entity A provides the following disclosure in period 4, in accordance with Section 450-20-50.

September 30, 20X2

Entity A entered into a contract to provide 1,000 widgets for $1 million to Entity B by December 15, 20X1. Lightning struck Entity A's manufacturing plant on November 30, 20X1, and Entity A did not deliver the widgets. Entity B has sued Entity A in the case of Entity B versus Entity A, which was filed in the First District Court of California on December 29, 20X1, on the basis of a contention that Entity A breached the contract.

Entity A filed a motion to dismiss, contending that its performance was excused by an act of god. Entity A's contract with Entity B did not specifically have an Act of God clause excusing lack of performance. Entity A contended that the Rules of Commerce in California do not require an Act of God clause within the contract to successfully use such a defense. Entity B responded that such a clause would be required to be within the contract. On September 15, 20X2, the court ruled in favor of Entity B and rejected Entity A's motion to dismiss. On the basis of this ruling, Entity A believes a loss related to this matter is probable.

During discovery, Entity B has provided an analysis claiming damages of $2 million for lost profits as well as penalties for late delivery to its customer under a contract that required the use of Entity A's widgets. Entity A has produced an analysis indicating that replacement widgets were available to Entity B at comparable costs and had Entity B exercised due care to procure

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replacement widgets, actual damages incurred by Entity B for lost profits and penalties for late delivery could have been limited to a range of $50,000 to $200,000. Because Entity A is unable to estimate a specific amount within this range as more likely than any other amount within this range of loss, Entity A has accrued the low end of the range, $50,000, as of September 30, 20X2. This amount is included in the balance sheet caption *Litigation Accrual*, and the expense for the period is included in *Litigation Expense.*

Entity A's business interruption insurance carrier has agreed to defend Entity A with a reservation of rights. There is no deductible for defense funding; Entity A has a deductible of $500,000 for actual damage claims, if any.

The court has set a trial date of January 15, 20X3.

Tabular reconciliation (assumes one class of contingency, but could be aggregated with other similar lawsuits):

Litigation		
Accrual at June 30, 20X2	$	-
New loss contingencies recognized in period		50,000
Accrual at September 30, 20X2	$	50,000

> > > Period 5

450-20-55-43 Entity A provides the following disclosure in period 5, in accordance with Section 450-20-50.

December 31, 20X2

Entity A entered into a contract to provide 1,000 widgets for $1 million to Entity B by December 15, 20X1. Lightning struck Entity A's manufacturing plant on November 30, 20X1, and Entity A did not deliver the widgets. Entity B has sued Entity A in the case of Entity B versus Entity A, which was filed in the First District Court of California on December 29, 20X1, on the basis of a contention that Entity A breached the contract.

During discovery, Entity B has provided an analysis claiming damages of $2 million for lost profits as well as penalties for late delivery to its customer under a contract that required the use of Entity A's widgets. Entity A has produced an analysis indicating that replacement widgets were available to Entity B at comparable costs and had Entity B exercised due care to procure replacement widgets, actual damages incurred by Entity B for lost profits and penalties for late delivery could have been limited to a range of $50,000 to

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$200,000. At the time, Entity A was unable to estimate a specific amount within this range as more likely than any other amount within this range and accrued the low end of the range, $50,000, as of September 30, 20X2.

Entity A's business interruption insurance carrier has agreed to defend Entity A with a reservation of rights. There is no deductible for defense funding; Entity A has a deductible of $500,000 for any actual damage claims.

The court set a trial date of January 15, 20X3. On December 30, 20X2, Entity A and Entity B entered into a settlement agreement under which Entity A agreed to pay Entity B $125,000 to settle all claims. This amount is included in the balance sheet caption *Litigation Accrual*, and the expense for the period is included in *Litigation Expense*. Entity A's insurance carrier has agreed to apply the amount paid against the $500,000 deductible.

Tabular reconciliation (assumes one class of contingency, but could be aggregated with other similar lawsuits):

Litigation		
Accrual at September 30, 20X2	$	50,000
New loss contingencies recognized in period		-
Increase for changes in estimates for loss contingencies recognized in prior periods		75,000
Accrual at December 31, 20X2	$	125,000

24. Add paragraph 450-20-65-1 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2010-XX, *Contingencies (Topic 450): Disclosure of Certain Loss Contingencies*

450-20-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2010-XX, *Contingencies (Topic 450): Disclosure of Certain Loss Contingencies:*

a. The pending content that links to this paragraph shall be effective for fiscal years ending after December 15, 2010, and interim and annual periods in subsequent fiscal years except that for a **{link to fifth definition}nonpublic entity,{link to fifth definition}** it shall be effective for the first annual period beginning after December 15, 2010, and for interim periods of fiscal years after the first annual period.

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b. In the period of initial adoption, the reporting entity shall not be required to provide the disclosures otherwise required by the pending content that links to this paragraph for any previous periods presented for comparative purposes.
c. In periods after initial adoption, comparative disclosures of the pending content that links to this paragraph shall be required only for periods ending after initial adoption.
d. Early adoption of the pending content that links to this paragraph is permitted.

Amendments to Subtopic 210-20

25. Add paragraph 210-20-45-18 and its related heading, with no link to a transition paragraph, because it does not represent new guidance but instead clarify that an entity should already be complying with the offsetting guidance discussed below, as follows:

Balance Sheet—Offsetting

Other Presentation Matters

> Contingencies and Insurance Recoveries

210-20-45-18 If an entity has recognized insurance or other recoveries related to its loss contingencies, the potential recovery amounts shall not be netted (offset) against amounts accrued for loss contingencies.

Amendments to Subtopic 275-10

26. Amend paragraph 275-10-60-5, with a link to transition paragraph 450-20-65-1, as follows:

Risks and Uncertainties—Overall

> Contingencies

275-10-60-5 See Example 3 (paragraphs 450-20-55-38 through 55-43~~paragraphs 450-20-55-36~~) for an illustration of the kinds of disclosures required for risks and uncertainties related to loss contingencies.

Amendments to Subtopic 410-30

27. Amend paragraph 410-30-50-13, with a link to transition paragraph 450-20-65-1, as follows:

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Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

BC2. In September 2007, the Board added a project to its agenda on the accounting for certain nonfinancial liabilities and contingencies, including contingencies under Topic 450. The Board decided to conduct this project in two phases: a short-term phase to amend and enhance the disclosure requirements for loss contingencies and a long-term phase to comprehensively reconsider the recognition and measurement guidance for certain nonfinancial liabilities.

BC3. The short-term phase of the project was undertaken to address constituents' concerns that the disclosures about certain loss contingencies under existing guidance do not provide sufficient and timely information to assist users in assessing the potential likelihood, timing, and magnitude of cash outflows related to loss contingencies. The loss contingencies affected are those that are (or would be, if the criteria in paragraph 450-20-25-2 were met) recognized as liabilities in a statement of financial position that do not have other applicable disclosure guidance, such as liabilities arising from litigation. The following are the primary criticisms of disclosures about such loss contingencies that are addressed in this project:

a. The initial disclosure of specific information about a loss contingency often does not occur until a material accrual is recognized for that loss contingency, sometimes taking investors by surprise.
b. The *at least reasonably possible* threshold for disclosing loss contingencies has not resulted in the disclosure of the full population of an entity's existing loss contingencies that would be of interest to financial statement users.
c. The amounts recognized in the financial statements related to loss contingencies are not transparent to users.

BC4. To address these concerns, in June 2008, the Board issued an Exposure Draft to improve disclosures about certain loss contingencies. The

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Board received 241 comment letters. In March 2009, the Board held two roundtable discussions to obtain additional input from users, preparers, auditors, and attorneys. The Board redeliberated the issues raised and suggestions made in the comment letters and at the roundtable discussions. The proposed amendments represent the Board's revised proposal in response to the input received on the Exposure Draft. The Board decided to reexpose the proposal to obtain additional input on whether it meets the needs of financial statement users and whether it is operational and auditable.

Disclosure Objective

BC5. Paragraph 4 of the Exposure Draft states:

> An entity shall provide disclosures to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies that are (or would be) recognized as liabilities in a statement of financial position. Those disclosures shall include information about the risks those loss contingencies pose to the entity and their potential and actual effects on the entity's financial position, cash flows, and results of operations.

BC6. Some respondents to the Exposure Draft (comment letter respondents) and some participants in the March 2009 roundtable meetings noted that it would be difficult, if not impossible, to meet the above-described disclosure objective because it would require information that is predictive in nature and does not adequately take into account the inherent uncertain nature of loss contingencies, especially those related to ongoing litigation.

BC7. In response to those concerns, the Board decided to revise the disclosure objective as follows:

> An entity shall disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following:
>
> a. The nature of the loss contingencies
> b. Their potential magnitude
> c. Their potential timing (if known).

BC8. The revised disclosure objective recognizes the uncertainty inherent in predicting the amount of future cash flows by referring to both qualitative and quantitative information. Therefore, an entity would include more robust qualitative disclosures in situations in which quantitative disclosures are limited because of, for example, the inherent uncertainties about the final resolution of litigation contingencies.

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Disclosure Principles

BC9. At the March 2009 roundtables, there was a broad consensus on certain key principles about loss contingency disclosures. On the basis of that input and further deliberations by the staff and the Board, the proposed amendments include the following principles that an entity would consider when determining disclosures that are appropriate for its individual facts and circumstances so as to achieve the disclosure objective:

a. During early stages of a contingency's life cycle, an entity would disclose information that is available to enable users to understand the loss contingency's nature, potential magnitude, and potential timing (if known). Available information may be limited and, therefore, disclosure may be less extensive in early stages of a loss contingency. In subsequent reporting periods, disclosure would be more extensive as additional information about a potential unfavorable outcome becomes available.
b. An entity may aggregate disclosures about similar contingencies (for example, by class or type) so that disclosures are understandable and not too detailed. If an entity provides disclosures on an aggregated basis, it would disclose the basis for aggregation.

BC10. With respect to the above aggregation principle, additional implementation guidance is included in the proposed amendments. An entity will need to exercise judgment in determining the appropriate level of aggregation and the appropriate classes of similar contingencies. The terms *class* and *type* are used in the proposed amendments interchangeably and an entity would determine them on the basis of the nature of contingencies and the facts and circumstances specific to the entity. The Board added the aggregation principle to avoid overwhelming users with too much information and also to mitigate concerns regarding disclosure of individual contingencies that may be prejudicial to the reporting entity. The issue of providing a specific exemption from disclosing prejudicial information is discussed in BC32–BC36.

Disclosure Threshold

BC11. Financial statement users have stated that, on balance, the *at least reasonably possible* threshold in paragraph 450-20-50-1 (originally issued as paragraph 3 of FASB Statement No. 5, *Accounting for Contingencies*) results in delayed disclosure of relevant information about loss contingencies. Therefore, in the Exposure Draft, the Board proposed a change in the disclosure threshold to expand the population of loss contingencies that are required to be disclosed, to achieve a more timely disclosure.

BC12. While users generally supported the proposed disclosure threshold, several other comment letter respondents opposed it. Respondents who disagreed raised questions and made assertions, including the following:

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a. The disclosure of certain remote loss contingencies will effectively "bury" financial statement users in unnecessary disclosures and obscure otherwise meaningful information about loss contingencies.
b. It is not clear whether changing the disclosure threshold from *at least a reasonable possibility* to *more than remote* would have a significant effect on the population of loss contingencies disclosed. Constituents appear to have different views about whether these two phrases mean the same thing.
c. Disclosing information about remote loss contingencies could confuse and potentially mislead users because the underlying facts and circumstances may be unclear even to the reporting entity itself. As a result, the reporting entity's assessment about whether the remote loss contingency would be resolved in the near term and whether it would have a *severe impact* on the entity will be little more than a guess. Some respondents noted that less sophisticated users would misjudge the accuracy of these assessments and give them undue credence when making investment-related decisions.

BC13. On the basis of the above input, the Board decided not to introduce the new phrase *more than remote* to describe the disclosure threshold because the Board agrees that this new phrase has the same meaning as the phrase *at least reasonably possible*. The Board decided to maintain the existing requirement to disclose asserted claims and assessments whose likelihood of loss is at least reasonably possible. The Board also decided to maintain the existing threshold for unasserted claims and assessments and agreed to enhance the existing interpretive guidance about the threshold (see paragraph 450-20-55-14 in the proposed amendments).

BC14. The Board, however, continues to believe that to improve the timeliness of disclosures about loss contingencies, disclosure of certain asserted remote loss contingencies is necessary to inform users about the entity's vulnerability to a potential severe impact. Therefore, the proposed amendments would expand the population of loss contingencies that are required to be disclosed. Assessment of a loss contingency as remote does not necessarily mean that no disclosure would be made until the loss contingency is assessed to be reasonably possible (that is, more than remote). An entity will need to exercise judgment in assessing its specific facts and circumstances to determine whether disclosure about an asserted remote contingency is necessary. The proposed guidance includes examples of factors that an entity would consider in making this determination. A plaintiff's amount of damages claimed, by itself, does not necessarily determine whether disclosure is necessary because, in some cases, the claim may be frivolous with an artificially inflated amount.

Insurance Recoveries

BC15. The Exposure Draft did not specifically address whether an entity would consider the possibility of insurance recoveries when assessing whether a loss

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contingency would be disclosed. Several roundtable participants and comment letter respondents observed that insurance coverage often is uncertain and may be subject to litigation with the insurer. Therefore, an entity may be exposed to loss even when it believes that the loss contingency is fully covered by insurance. The Board agrees with these views and, therefore, decided that the proposed amendments would include the following guidance under disclosure threshold:

> When assessing the materiality of loss contingencies to determine whether disclosure is required, the entity shall not consider the possibility of recoveries from insurance or other indemnification arrangements.

Qualitative Disclosures

BC16. The Exposure Draft proposed that an entity disclose a description of the contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution. Many entities already may be providing some of the proposed disclosures when describing the nature of the contingency as currently required by Subtopic 450-20 on loss contingencies.

BC17. The Exposure Draft also proposed disclosure of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome, a qualitative assessment of the most likely outcome of the contingency, and any assumptions made in estimating the amounts in the quantitative disclosures and in assessing the most likely outcome. This information was intended to enable users to perform their own analyses and better understand the entity's potential future cash outflows.

BC18. Many comment letter respondents opposed the proposed qualitative disclosures mainly because compiling the required information would be difficult and costly, particularly with respect to ongoing litigation contingencies. Specifically, respondents stated that legal cases can go on for many years, which makes it difficult to estimate the timing of their resolution. Any assessment of the case prepared by the entity would be highly subjective and could easily change depending on the location of the trial, the jury, evidentiary rulings, and other procedural matters. Those respondents questioned the benefit of such information to users.

BC19. Some comment letter respondents stated that the proposed disclosures would require judgments that are more predictive or speculative in nature rather than factual. For example, the Exposure Draft proposed that the disclosures include a description of the factors that are likely to affect the ultimate outcome of the contingency along with their potential effect on the outcome and the entity's qualitative assessment of the most likely outcome of the contingency. The Board acknowledges these operational concerns and, therefore, decided not to require disclosure of any new information that is based on management's prediction

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about a contingency's resolution beyond what is already required under current U.S. GAAP as described in Topic 450.

BC20. On the basis of the input received on the Exposure Draft, the disclosure objective, and the broad disclosure principles, the Board decided that the proposed amendments would require certain qualitative disclosures about a loss contingency or classes (groups) of similar loss contingencies, such as:

a. Information to enable users to understand their nature and risks
b. Certain minimum disclosures during early stages of asserted litigation contingencies while requiring more robust disclosures in subsequent reporting periods
c. For individually material contingencies, sufficiently detailed disclosure to enable financial statement users to obtain additional information from publicly available sources such as court records
d. When disclosure is provided on an aggregated basis, disclosure of the basis for aggregation and information that would enable financial statement users to understand the nature, potential magnitude, and potential timing (if known) of loss.

BC21. The Board believes that the disclosure in item (a) above is consistent with the overall disclosure objective. The disclosures in items (b) and (c) above incorporate suggestions made at the March 2009 roundtable discussions and by some Board members during redeliberations. Consistent with the aggregation principle, an entity can aggregate disclosures by classes of similar contingencies to avoid voluminous data for contingencies that may not be material individually but may be material in the aggregate. Item (d) above, therefore, would require additional qualitative disclosure when information is presented on an aggregated basis. Furthermore, disclosure about the potential timing of a loss contingency (for example, the next steps in its resolution) is limited to the extent it is known to the entity.

Quantitative Disclosures

BC22. In the Exposure Draft, the Board noted that one of financial statement users' most significant concerns about disclosures under current U.S. GAAP is that they rarely include quantitative information. Rather, an entity often states that the possible loss cannot be estimated. To address this issue, paragraph 7 of the Exposure Draft proposed the following requirements for disclosure of quantitative information:

> An entity shall disclose the following information about loss contingencies required to be disclosed under paragraph 5 or 6:
>
> a. Quantitative information about the entity's exposure to loss from the contingency (including any amounts already recognized in the financial statements but excluding potential recoveries disclosed under paragraph 7(c)), as follows:

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(1) The amount of the claim or assessment against the entity (including damages, such as treble or punitive damages), if applicable

(2) If there is no claim or assessment amount, the entity's best estimate of the maximum exposure to loss.

An entity also may disclose its best estimate of the possible loss or range of loss if it believes that the amount of the claim or assessment or the maximum exposure to loss is not representative of the entity's actual exposure.

BC23. Financial statement users generally supported the proposed disclosure requirements. However, financial statement preparers and attorneys generally opposed them for the following reasons:

a. It would be too difficult and costly to estimate the maximum exposure to loss.
b. It would be prejudicial to disclose such a number, because it would inherently involve counsel's opinion about the case, which would jeopardize attorney-client privilege. Disclosing the number would put defendants at a disadvantage in settlement negotiations.
c. If an entity decided not to disclose its best estimate of the possible loss or range of loss, users might inappropriately conclude that the disclosed maximum exposure to loss represents a reasonable estimate of the possible loss.

BC24. The Board notes that the initial recognition criteria in Subtopic 450-20 already require entities to assess, on the basis of the available information, whether it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements and whether the amount of loss can be reasonably estimated. However, the Board agrees with the concerns expressed about disclosing the entity's estimate of its maximum exposure to loss and, therefore, decided to eliminate that requirement in the proposed amendments. Furthermore, on the basis of the input received in the comment letters and the March 2009 roundtable discussions, the Board decided to focus the quantitative disclosures on nonprivileged information and not to add any new quantitative disclosures that are based on management's predictions about a contingency's resolution. Accordingly, the proposed amendments generally are consistent with many of the disclosures that are required under current U.S. GAAP (such as the amount accrued, if any, and an estimate of the possible loss or range of loss) but they also enhance the currently required disclosures with additional information such as:

a. Publicly available quantitative information, for example, in case of litigation contingencies, the amount claimed by the plaintiff or the amount of damages indicated by the testimony of expert witnesses

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b. Other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss
c. In some cases, information about possible recoveries from insurance and other sources.

BC25. The Board believes that the disclosure in item (a) above is limited to publicly available information, and, therefore, the disclosure of the claim amount would not be prejudicial to the reporting entity. Information in item (b) above does not prescribe any specific disclosure but would require the entity to exercise judgment to determine which nonprivileged information would be relevant to financial statement users' understanding of the potential magnitude of the possible loss. Lastly, information in item (c) above is consistent with the input received at the March 2009 roundtable discussions and important in assessing the potential magnitude of loss contingencies.

Tabular Reconciliation

BC26. To provide more transparency about the effects of loss contingencies on the financial statements, the Board decided to include in the Exposure Draft a requirement for a tabular reconciliation for recognized loss contingencies. The Board believes that a tabular reconciliation will provide users with valuable information about significant estimates and changes in those estimates that are subject to significant measurement judgment.

BC27. The tabular reconciliation disclosure proposed in the Exposure Draft would require an entity to reconcile the total amount recognized in the aggregate for loss contingencies in its statement of financial position at the beginning and the end of the period. The reconciliation would include at a minimum:

a. Increases for loss contingencies recognized during the period
b. Increases resulting from changes in estimates of the amounts of loss contingencies previously recognized
c. Decreases resulting from changes in estimates or derecognition of loss contingencies previously recognized
e. Decreases resulting from cash payments (or other forms of settlement) for loss contingencies.

BC28. The Exposure Draft also proposed that an entity provide a qualitative description of the significant activity in the reconciliation and disclose the line items in the statement of financial position in which recognized loss contingencies are included.

BC29. During its deliberations before the issuance of the Exposure Draft, the Board considered whether the tabular reconciliation would be required for annual periods only or for both interim and annual periods. Some Board members expressed concerns about the amount of effort required for preparers to collect and auditors to review this information in the short time available for performing

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these activities between the end of an interim period and the quarterly filing deadline for SEC registrants. However, a majority of Board members supported requiring the tabular reconciliation in both interim and annual financial statements because financial statement users generally consider interim information to be as important as annual information.

BC30. The Board decided that loss contingencies whose underlying cause and ultimate settlement occur in the same period would be excluded from the tabular reconciliation. The Board reasoned that the short period of time involved in those circumstances raises questions about whether the items meet the definition of a *contingency*. Additionally, the Board noted that for those items, the loss is recognized in the same period as cash is paid or other assets transferred. Therefore, there is no effect on the financial statements across reporting periods, and including those items would not fulfill the purpose of the tabular reconciliation. The Board noted that, in contrast, loss contingencies initially recognized in a business combination are not recognized in earnings. The Board concluded that it was important to include those loss contingencies in the tabular reconciliation because they will result in payments of cash, transfers of assets, or recognition of income for which no corresponding loss was recognized at the time of initial recognition. However, if loss contingencies recognized in a business combination have a different measurement attribute (for example, fair value) than other loss contingencies, they would be presented separately in the tabular reconciliation.

BC31. Many comment letter respondents who are users expressed support for the tabular reconciliation disclosure; however, some preparers and attorneys argued that a detailed quantitative disclosure may be prejudicial to the reporting entity. On balance, the Board decided to retain the tabular reconciliation disclosure requirement with a clarification that it would be presented separately for each class of contingencies so that dissimilar contigencies are not aggregated. The Board decided to permit aggregation by class of contingencies to address concerns about prejudicial disclosure of individual contingencies. The Board noted, however, that users of financial statements of nonpublic entities have access to information that is not available generally to users of financial statements of public entities and that the benefits of a tabular reconciliation may not justify the costs. Therefore, the Board decided not to require nonpublic entities to disclose a tabular reconciliation.

Exemption from Disclosing Prejudicial Information

BC32. Paragraph 11 of the Exposure Draft provided an exemption from disclosing prejudicial information as follows:

> For certain contingencies, such as pending or threatened litigation, disclosure of certain information about the contingency may be prejudicial to an entity's position (that is, disclosure of the information could affect, to the entity's detriment, the outcome of the contingency

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itself). In those circumstances, an entity may aggregate the disclosures required by paragraph 7 at a level higher than by the nature of the contingency such that disclosure of the information is not prejudicial. In those rare instances in which the disclosure of the information required by paragraph 7, when aggregated at a level higher than by the nature of the contingency, or of the tabular reconciliation would be prejudicial (for example, if an entity is involved in only one legal dispute), the entity may forgo disclosing only the information that would be prejudicial to the entity's position. In those circumstances, an entity shall disclose the fact that, and the reason why, the information has not been disclosed. In no circumstance may an entity forgo disclosing the amount of the claim or assessment against the entity (or, if there is no claim amount, an estimate of the entity's maximum exposure to loss); providing a description of the loss contingency, including how it arose, its legal or contractual basis, its current status, and the anticipated timing of its resolution; and providing a description of the factors that are likely to affect the ultimate outcome of the contingency along with the potential impact on the outcome. [Footnote reference omitted.]

BC33. Several comment letter respondents and roundtable participants expressed concerns about the proposed exemption. For example, some respondents commented that despite the permitted aggregation at a level higher than by the nature of the contingency for the tabular reconciliation disclosure, an entity may not be able to avoid disclosure of prejudicial information.

BC34. At the March 2009 roundtable meeting, one auditor expressed concern that it would be difficult to audit an assertion that disclosing certain information would be prejudicial because the auditor does not have the necessary legal expertise to determine which disclosure would be prejudicial to the reporting entity. Some attorneys also expressed concern that the attorney-client privilege would be breached if an auditor tried to determine whether certain disclosure would be prejudicial to the reporting entity. Other constituents stated that if the requirement was for factual disclosure instead of speculative or predictive disclosure, then there would be no need for a prejudicial exemption. The Board notes that the proposed amendments would eliminate many of the Exposure Draft's proposed disclosures that are less factual and more speculative or predictive in nature, for example, the entity's best estimate of the maximum exposure to loss and the anticipated timing of a loss contingency's resolution. The proposed amendments would require disclosures about the potential timing of a loss contingency (for example, the next steps in its resolution) only if it is known to the entity.

BC35. The Board disagrees with some comment letter respondents' assertions that the proposed tabular disclosures of contingencies would be prejudicial to the reporting entity. The Board notes that if the specified criteria are met, current U.S. GAAP requires disclosure of the accrual of loss contingencies. Specifically, paragraph 450-20-50-1 states that, in some circumstances, disclosure of the

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amount accrued may be necessary for the financial statements not to be misleading. As would be permitted by the aggregation principle in the proposed amendments, tabular disclosure by class of contingencies rather than by individual contingency would address many of the concerns about having to make prejudicial disclosures.

BC36. The Board decided to not provide a prejudicial exemption because the proposed amendments would eliminate many of the speculative or predictive disclosures that were proposed in the Exposure Draft and because of some comment letter respondents' concern that the proposed exemption would be difficult to interpret and apply.

Disclosure of Possible Recoveries from Insurance or Indemnification Arrangements

BC37. The Exposure Draft contained a proposed requirement to disclose:

> A qualitative and quantitative description of the terms of relevant insurance or indemnification arrangements that could lead to a recovery of some or all of the possible loss, including any caps, limitations, or deductibles that could affect the amount of recovery. [paragraph 7(c)]

BC38. Financial statement users generally supported the proposed requirements about possible recoveries. Some financial statement preparers and attorneys objected to the proposed requirements because the disclosure could be prejudicial. In particular, they argued that if the plaintiff learned that the loss is covered by insurance, it might be encouraged to seek more money.

BC39. Some opponents of this proposed requirement also argued that the insurance coverage may be subject to dispute and, therefore, disclosing the insurance information might mislead users into believing that the reporting entity will be able to recover more of the loss than it ultimately does. Some opponents also argued that making disclosures about the coverage might also be prejudicial in a dispute with the insurance carrier. Insurance entities argued that such disclosures may compromise their ability to defend their policyholders if they are required to do so under the policy.

BC40. On the basis of the above input and the discussions at the March 2009 roundtables, the Board decided to include the following disclosure requirement in the proposed amendments:

> Information about possible recoveries from insurance and other sources only if, and to the extent that it has been provided to the plaintiff(s) in a litigation contingency, it is discoverable by either the plaintiff or a regulatory agency, or it relates to a recognized receivable for such recoveries. If the insurance company has denied, contested, or reserved its rights related to the entity's claim for recovery, the entity shall disclose that fact.

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BC41. The Board decided that the disclosure about possible insurance recoveries would be made if it is discoverable, even if information has not yet been provided to the plaintiff in discovery so that the disclosure is timely. Furthermore, the Board decided to expand the scope of the requirement to include regulatory agencies because all loss contingencies are not necessarily subject to litigation. In other words, there may not be a plaintiff and discovery in the case of some loss contingencies. For example, some environmental contingencies may relate to actions by a governmental regulatory agency. The Board also believes that if an entity has recognized a receivable for insurance recoveries, a disclosure of that fact would be helpful to users.

BC42. As to the presentation of potential insurance recoveries, Subtopic 210-20 specifies the criteria that must be met to offset an asset and a liability in a statement of financial position. The Board believes that it would be unusual for those criteria to be met in the case of a possible recovery from an insurance, indemnification, or other similar arrangement related to a loss contingency primarily because there usually are more than two counterparties involved. Accordingly, loss contingencies and their related recoveries usually must be presented separately in a statement of financial position at their gross amounts. Paragraph 210-20-45-18 includes that clarification.

Settlement Offers

BC43. The Exposure Draft would not have required that settlement offers made between counterparties in a dispute be disclosed. The Board notes that settlement offers may represent negotiation tactics and may be withdrawn or changed quickly. Therefore, a settlement offer that is outstanding and included in the disclosures may not represent a realistic resolution of a loss contingency. However, at the request of one Board member, a question had been included in the notice for recipients of the Exposure Draft about settlement offers.

BC44. A few user comment letter respondents supported requiring disclosure of settlement offers. Those respondents stated that if settlement offers were disclosed, then it would be an indicator of potential lower and upper boundaries of the possible outcomes. However, the majority of respondents agreed with the Board's decision not to require disclosure of settlement offers. Those who supported the Board's decision stated that disclosing settlement offers could be misleading because they are often used as a negotiating tool and may significantly differ from the entity's ultimate exposure. A few respondents noted that disclosing such offers is prejudicial, as evidenced by the fact that information about such offers is inadmissible in court under the Federal Rule of Evidence and state law.

BC45. For the above-described reasons, the Board decided to not require disclosure of settlement offers in the proposed amendments.

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Effective Date and Transition

BC46. The proposed disclosure requirements would be effective for annual financial statements issued for fiscal years ending after December 15, 2010, and for interim and annual financial statements thereafter except that for nonpublic entities the disclosures would be effective for the first annual period beginning after December 15, 2010, and for interim periods of fiscal years after the first annual period. The Board believes that it is important that enhanced disclosures be available to financial statement users as soon as practicable. The Board also believes that most of the information required by the proposed amendments already is available and that collecting that data from various locations in year-end reporting packages would be feasible for public entities whose fiscal years end after December 15, 2010. The Board also decided that the tabular reconciliation would not be required for earlier periods that are presented for comparative purposes, because of concerns that it may be impracticable for entities to gather the necessary information.

Similarities and Differences with International Accounting Standards

BC47. The disclosures that would be required by the proposed amendments are similar, but not identical, to those required by IAS 37. IAS 37 requires disclosure of the carrying amount of provisions at the beginning and end of the period as well as changes during the period. This requirement is largely consistent with the tabular reconciliation of recognized loss contingencies in the proposed amendments.

BC48. The IASB currently is deliberating changes to IAS 37. The IASB's project, however, has a much broader scope that includes initial recognition, subsequent measurement, and disclosures. In June 2005, the IASB published an Exposure Draft of the proposed amendments. Since then the IASB has been reviewing the proposals in light of comments received. It has tentatively decided to change some of the proposals in the Exposure Draft. In particular, the IASB has decided to provide more guidance on applying the proposed measurement requirements. In January 2010, it published for public comment an Exposure Draft of the proposed new guidance on measurement. Comments were due by May 19, 2010. To enable interested parties to see the revised measurement guidance in the context of the proposed new IFRS as a whole, the IASB has prepared a working draft of the IFRS, which is available on its website. The working draft is based on the 2005 Exposure Draft, as amended, to take into account the decisions the IASB has made since then. The IASB's plan is to complete its project in 2010.

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Benefits and Costs

BC49. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Current and potential investors, creditors, donors, and other users of financial information benefit from the improvements in financial reporting, while the costs to implement new guidance are borne primarily by current investors. The Board's assessment of the costs and benefits of issuing accounting guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement accounting guidance or to quantify the value of improved information in financial statements.

BC50. The Board's assessment of the proposed amendments' benefits and costs is based on discussions with preparers, auditors, regulators, and users of financial statements. The Board considered the incremental costs of providing the additional disclosure requirements, particularly the tabular reconciliation of recognized loss contingencies, and concluded that those costs do not outweigh the benefits of improved information about loss contingencies.

BC51. The Board recognizes that the effort for gathering the necessary data to provide the disclosures that would be required by the proposed amendments may be significant for some entities and that the review and audit procedures of such disclosures may require additional effort. Notwithstanding the above additional costs, these disclosures were developed with the goal of providing users of financial statements with pertinent information about potential cash flow requirements of an entity. Furthermore, the Board believes that many entities already have the information necessary to fulfill those disclosure requirements and that including the information would not require substantial additional cost or effort.

BC52. The Board believes that the proposed amendments would require disclosures that provide relevant qualitative and quantitative information about loss contingencies. This will enable users to make a more informed assessment of the likelihood, timing, and amount of future cash outflows relating to loss contingencies. Discussions with users and regulators as well as the Board's research indicated that the recognition or derecognition of a loss contingency, or a change in the estimate of a loss contingency, can have a significant impact on an entity's financial statements. Therefore, the Board concluded that the benefits of the disclosures in the proposed amendments outweigh the costs.

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Stephen N. Zack
President

AMERICAN BAR ASSOCIATION

321 North Clark Street
Chicago, IL 60654-7598
(312) 988-5109
Fax: (312) 988-5100
E-mail: abapresident@abanet.org

September 20, 2010

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update, "Disclosure of Certain Loss Contingencies" (the "Revised Exposure Draft"): File Reference No. 1840-100

Dear Mr. Golden:

On behalf of the American Bar Association ("ABA"), which has nearly 400,000 members, I am pleased to present our enclosed Comments on the Financial Accounting Standards Board ("FASB" or the "Board") Revised Exposure Draft referenced above. The ABA's Comments were prepared by several leading members of our Business Law Section, including Thomas White (Chair of the Section's Law and Accounting Committee), Stanley Keller (until recently Chair of the Section's Committee on Audit Responses), James Rosenhauer (current Chair of the Section's Committee on Audit Responses), Linda Griggs, Richard Rowe, Catherine Dixon, Randolph McClanahan and Michael Scanlon. Our Comments also include input from in-house and outside lawyers with a broad range of expertise and experience.

As explained more fully in the enclosed Comments, although the ABA commends the FASB for addressing many of our previous comments on the FASB's 2008 initial exposure draft and shares the FASB's goal of providing investors with meaningful and timely information regarding contingent liabilities, we continue to question the need for the FASB to make changes to the existing disclosure standards under Accounting Standards Codification ("ASC") Subtopic 450-20. We also continue to have significant concerns regarding certain aspects of the Revised Exposure Draft. Therefore, if the Board is intent on revising the disclosure standards, we urge it to adopt the further revisions recommended in our enclosed Comments, which we believe would accomplish the objectives of enhanced and timely information for investors without eroding fundamental attorney-client privilege and work product protections or creating unnecessary problems for companies. The ABA also respectfully requests that the FASB adopt a later effective date for the new requirements contained in the Revised Exposure Draft in order to allow companies and their auditors adequate time to implement these changes.

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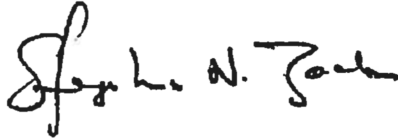
September 20, 2010
Page 2

Thank you for considering our views on this critical subject. If you have any questions or need more information, please contact Thomas White at (202) 663-6556 or Stanley Keller at (617) 239-0217.

Sincerely,



Stephen N. Zack

Enclosure

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COMMENTS OF THE AMERICAN BAR ASSOCIATION

ON THE

FINANCIAL ACCOUNTING STANDARDS BOARD PROPOSED ACCOUNTING STANDARDS UPDATE TITLED "DISCLOSURE OF CERTAIN LOSS CONTINGENCIES"; FILE REFERENCE NO. 1840-100

September 20, 2010

The American Bar Association[1] ("ABA") is submitting these comments on the Financial Accounting Standards Board ("FASB") Proposed Accounting Standards Update, "Disclosure of Certain Loss Contingencies," File Reference No. 1840-100, issued on July 20, 2010 (the "Revised Exposure Draft").

Introduction

At the outset, the ABA commends the FASB for its responsiveness to the comments that the ABA and others submitted on the FASB's 2008 exposure draft, "Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements No. 5 and 141(R)" (the "Initial Exposure Draft"). The Revised Exposure Draft addresses many of the comments we raised regarding the Initial Exposure Draft. As with this letter, our prior letter dated August 5, 2008[2] focused on loss contingencies involving litigation and claims that could result in litigation. The ABA shares the FASB's goal of providing users of financial statements with meaningful and timely information regarding contingent liabilities. However, we continue to have serious concerns about some aspects of the Revised Exposure Draft. These concerns are based upon the significant prejudicial impact that certain proposed disclosures would have on companies and their investors without, in most cases, providing material information to users of the financial statements. We also are concerned about the risks these disclosures would create for fundamental attorney-client privilege and work product protections, both as a result of the disclosures called for by the Revised Exposure Draft and because of the information auditors may seek in connection with auditing those disclosures. Recent judicial decisions have demonstrated the fragility of these protections when information is provided to auditors. We refer you to our prior comment letter for further explanation of our concerns and discussion of the importance of preserving these protections and the role they play in ensuring legal compliance.

Because of our concerns, as well as those of others, we question the need for the FASB to make changes to the existing disclosure standards under Accounting Standards Codification

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[1] The ABA is the largest voluntary professional membership organization and the leading organization of legal professionals in the United States. The ABA's membership of nearly 400,000 spans all 50 states and other jurisdictions and includes attorneys engaged in legal matters in various settings. The ABA is dedicated to the rule of law, the efficient administration of justice and the preservation of fundamental legal rights.

[2] The ABA's letter to the FASB dated August 5, 2008 and attached Comments regarding the FASB's exposure draft titled "Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements 5 and 141(R)" are available at http://www.abanet.org/poladv/priorities/privilegewaiver/2008aug5_privwaiv_fasb_l.pdf.

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("ASC") Subtopic 450-20. We do not believe it has been established that under the existing disclosure standards users of financial statements are failing to receive the information about pending or potential litigation that they need in order to assess a company's financial condition. Our experience is that companies endeavor to provide this information, and therefore we question the underlying rationale for the proposed changes. If the FASB believes that it must take action because of concerns about the adequacy of the implementation of the existing standards, it could consider providing guidance with respect to the disclosures required by the existing standards. If, however, the FASB determines to proceed with changes to ASC Subtopic 450-20, we suggest below revisions to the proposals which we believe are necessary in order to reduce the prejudice to the liability position of companies. We also believe these revisions are necessary to avoid the erosion of the fundamental attorney-client privilege and work product protections that could result from expanded disclosures about loss contingencies. Balancing the objectives of providing disclosure to users of financial statements with preserving these fundamental protections is at the heart of the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (the "ABA Statement")[3], which has been in effect for 35 years.

These comments explain our substantive concerns with the Revised Exposure Draft, recommend certain revisions intended to ensure that preparers of financial statements only disclose material and non-prejudicial information about loss contingencies, and set forth our views with respect to the impact of the Revised Exposure Draft on the ABA Statement. In particular, we are concerned about the prejudicial impact on companies of the proposed changes to ASC Subtopic 450-20 that would require disclosure of the amount of accruals and presentation of a tabular reconciliation, as well as of the possible premature disclosure of defenses and information regarding the availability of insurance coverage under the circumstances set forth in the Revised Exposure Draft. We also urge the FASB to defer the effective date of any new requirements to provide companies and their auditors adequate time to plan for the new requirements.

General Considerations

We believe it is useful to set forth some general considerations that provide context for our more specific comments on the Revised Exposure Draft.

- *Principles-based approach.* Because of the complexity and variability of dealing with loss contingencies, the FASB should follow a principles-based approach to establishing disclosure requirements. The Revised Exposure Draft appears to recognize the appropriateness of this approach but then departs from it by unnecessarily mandating detailed disclosures. A principles-based approach, in contrast to a prescriptive approach, affords companies the flexibility to exercise judgment in dealing with disclosures in a complex area where outcomes can be uncertain, especially when those disclosures can be prejudicial to a company's litigation position and harmful to its shareholders.

[3] The ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information, adopted by the ABA Board of Governors in 1975, and the related background report, is available at http://www.abanet.org/buslaw/attorneyclient/policies/aicpa.pdf.

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- *Litigation is inherently uncertain.* It is important to recognize that the litigation process, especially in the United States, is fraught with uncertainties. This uncertainty also means that the precision the Revised Exposure Draft sometimes seeks is an illusory goal. The FASB should recognize that it is the uncertainty and unpredictability of litigation, rather than any failure of disclosure, which often accounts for the surprises that users have complained about.

- *Materiality should be the touchstone.* Any disclosure regime must be based upon the bedrock principle of materiality of the information to users. Without this guiding principle, there is a risk that disclosures may mask what is important and, more importantly, may be harmful to companies without providing any corresponding benefit to users. Thus, the criteria for disclosure should not be what might be of interest to a user of the financial statements but rather what is material for users. The inclusion of immaterial disclosures in financial statements undermines established legal and accounting precepts. The existing legal framework focuses on the materiality of disclosures to investors, and the FASB should not be creating a new regime. As an example, the current accounting standard relies on the existing legal framework by requiring disclosures of accruals only when necessary so that the financial statements are not misleading.

- *Disclosures should avoid prejudicing the outcome.* Disclosures of loss contingencies, especially litigation contingencies, should avoid adversely affecting the outcome of those contingencies to the detriment of companies and their shareholders. Thus, information that could be prejudicial should not be required unless that information is necessary so that the financial statements are not misleading.

- *Unnecessary mandated disclosures can themselves become a source of liability exposure.* Requiring disclosure of information that involves speculation or prediction can itself be a source of liability, based upon claims that the disclosure was misleading when results turn out differently than predicted. Merely being named in such a suit can be injurious to companies, regardless of the ultimate outcome. Thus, there can be significant adverse consequences to requiring disclosures that do not meet the materiality threshold. This exposure to liability is exacerbated by the inapplicability of the statutory forward-looking information safe harbor to financial statement disclosures.

- *Priority of protection of attorney-client privilege.* The ABA Statement, along with its counterpart in Statement of Auditing Standard ("SAS") No. 12, were developed to preserve the fundamental protections of the attorney-client privilege while providing auditors an ability to obtain evidential support in connection with the audit process. Thus, the AICPA in AU Section 9337.09 stated that:

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> Although ordinarily an auditor would consider the inability to review information that could have a significant bearing on his audit as a scope restriction, in recognition of the public interest in protecting the confidentiality of lawyer-client communications (see section 337.13), section 337.05*c* is not intended to require an auditor to examine documents that the client identifies as subject to the lawyer-client privilege.

These objectives are as important now as they were when the ABA Statement and SAS No. 12 were adopted and need to be preserved.

Specific Comments on the Revised Exposure Draft

Disclosure of Amounts of Accruals and Tabular Reconciliations. The ABA has serious concerns about the proposed requirement for a company to disclose the amount of its accrual for loss contingencies, whether pursuant to proposed paragraph 450-20-50-1F.e.2. or in the tabular reconciliation required by proposed paragraph 450-20-50-1F.g. We believe that requiring this disclosure in all circumstances risks substantial prejudice to a company's defense position in litigation. Such disclosure could provide an adverse party critical insight into a company's views regarding the prospects of the litigation. The amount of any accrual — which will reflect the preparer's judgment that a payment is probable and an estimate of possible loss — inevitably will establish a "floor" for settlement negotiations. An adversary may also seek to assert in court that the amount of the accrual is an admission as to the merits of its claim and the amount of liability. The disclosure of the amount accrued may result in auditors' demands for additional evidence to support a company's accrual. This could result in a waiver of attorney-client privilege and loss of work product protection as to counsel's underlying advice and analysis. The proposed requirement that the amount of the accrual and the tabular reconciliation be provided on a quarterly basis compounds these issues.

In 2000, the Securities and Exchange Commission (the "SEC") proposed to require expanded disclosure about changes in valuation and loss accrual accounts for litigation and other expense items.[4] Many comment letters expressed concern that disclosure of the loss accruals related to probable losses from pending litigation would not be in the best interests of investors. The commenters on the SEC proposal noted that even disclosure of litigation reserves on an aggregate basis, as proposed, would seriously harm a company's litigation position, while at the same time not providing material information to investors.[5] One commenter noted that the materials and analysis underlying the reserve calculation would probably be discoverable in the pending litigation because of the disclosure of the amount of the reserve. The commenter noted that the ability of a plaintiff to obtain access to the company's analysis of the amount of the

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[4] Securities Act No. 7793, "Supplementary Financial Information" (Jan. 21, 2000), available at http://www.sec.gov/rules/proposed/34-42354.htm.

[5] E.g., Letter from Joanne T. Marren, Chair, Federal Regulation Committee of the Securities Industry Association, dated April 24, 2000 (hereinafter cited as the "SIA"); Letter from Philip D. Ameen, Chairman of the Financial Executives Institute Committee on Corporate Reporting, dated April 19, 2000 ("The Commission's proposal could increase the incidence of such lawsuits by providing a needless level of detailed disclosures and "red flags" upon which opponents could pounce.")

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reserve would significantly disadvantage the company and its ability to defend the litigation.[6] The SEC did not adopt the 2000 proposal.

We disagree with the suggestion in paragraph BC 35 of "Background Information and Basis for Conclusions" that the disclosure of an accrual and changes in the accrual through the tabular reconciliation would not be prejudicial because the amount of accruals must be disclosed under current requirements. The existing provision, paragraph 450-20-50-1, requires disclosure of the amount accrued "if necessary for the financial statements not to be misleading." This permits the exercise of judgment based on the circumstances, in contrast to the proposed requirements that would mandate disclosure of the amount of accruals in all cases, along with the tabular reconciliation. Proposed paragraphs 450-20-50-1F.e.2. and 450-20-50-1F.g. would eliminate the exercise of judgment and require the disclosure regardless of its significance to an understanding of the financial statements. It is important to recognize that the accrual will already be reflected in the company's financial statements and thus the benefit to users of the added itemization would not outweigh the significant disadvantage to companies resulting from that disclosure.

As explained more fully below with respect to aggregation, the ability to aggregate similar loss contingencies would not avoid the prejudicial impact of the accrual disclosure. The aggregation criteria are too narrow and will likely not be applicable to the larger lawsuits that would be affected most adversely by the disclosure of the defendant's view of its prospects with respect to the lawsuit. Moreover, the ability to aggregate will not assist companies with few pending lawsuits that are material, or with lawsuits that cannot be aggregated, and these companies will have to make potentially prejudicial disclosure.

We recommend that, rather than adopting the proposals to require disclosure of the amount accrued and the tabular reconciliation, the FASB require disclosure of the amount of the accrual only if necessary for the financial statements not to be misleading, consistent with the current requirement. This could be accompanied by guidance indicating that, if the amount has been otherwise disclosed publicly, such as in management's discussion and analysis of financial condition and results of operations, it ordinarily would be expected to be disclosed in the financial statements. Disclosure about the accrued amount would be required by current SEC rules to be included in the management's discussion and analysis if that information is material to an understanding of a company's results of operations, financial condition or cash flow.

If the FASB nevertheless adopts the requirements to disclose the amounts of accruals and to provide a reconciliation of changes in accruals, we believe that these requirements should be modified in several important ways. If adopted, these requirements: (i) should only apply to annual financial statements; (ii) should permit aggregation of the accrual information at the highest level of aggregation — such as the aggregate amount of the accruals for all pending lawsuits and asserted legal claims or the aggregate amount of the accruals for all environmental contingencies — in order to mitigate the prejudicial impact of the disclosures; and (iii) because of the prejudicial impact of the proposed disclosure on companies with few loss contingencies or loss contingencies that cannot be aggregated, should also provide for an exception from the requirement when a company concludes that the disclosure would prejudice its litigation position. Companies relying on the prejudicial exception could be required to disclose, to the extent

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[6] SIA, *supra* note 5.

consistent with the foregoing, information intended to assist investors in understanding the impact of the loss contingency or contingencies on the future operations of the company.

Aggregation Requirements. We disagree with the FASB's assertion in paragraph BC 35 that the ability to aggregate similar claims "would address many of the concerns about having to make prejudicial disclosure." Because the Revised Exposure Draft would permit aggregation only in limited circumstances, it is likely that the disclosure of the amount accrued would advantage plaintiffs in many circumstances to the detriment of defendant companies and their investors. Proposed paragraph 450-20-55-1A of "Implementation Guidance and Illustrations" explains that "it may not be appropriate to aggregate amounts related to individual litigations with those related to class-action lawsuits or to aggregate litigations in jurisdictions that have different legal characteristics that could affect the potential timing or the potential magnitude of the loss" or to "group together in one class loss contingencies that have significantly different timings of expected future cash outflows (that is, near term versus longer term)." This guidance might be interpreted to rule out the aggregation of complaints filed in different states, individual claims with class action claims and claims filed at different times. Rather than calling on the application of judgment, the guidance in practice is likely to be treated as creating a presumption preventing otherwise appropriate aggregation. Moreover, it is likely that in many cases significant claims would not be able to be aggregated. Furthermore, an entity with few claims may be unable to aggregate any of those claims.

As noted above, we recommend that the FASB retain the current requirement pursuant to which companies must disclose an accrued amount to the extent necessary for the financial statements not to be misleading, accompanied by guidance that disclosure of the amount accrued ordinarily would be expected when the company has otherwise disclosed the amount publicly.

Disclosure of "Remote" Contingencies. The ABA disagrees with the requirement in proposed paragraph 450-20-50-1D for disclosure about an asserted but remote loss contingency if it would, if adversely determined, have a severe impact. Once a company concludes that an adverse outcome of a pending lawsuit or other asserted claim is remote, assessing whether the impact of an adverse outcome would be severe, especially in view of the absence of any time horizon for that analysis, would be a theoretical and speculative exercise. We believe such disclosures would be at odds with the SEC's efforts to reduce disclosures of theoretical risks that mask important disclosures. Such a speculative exercise would be inconsistent with the FASB's comment in paragraph BC 19 of the Revised Exposure Draft that it has "decided not to require disclosure of any new information that is based on management's prediction about a contingency's resolution beyond what is already required under current U.S. GAAP as described in Topic 450." We also question whether any disclosure of asserted claims where the likelihood of an adverse outcome is remote, and especially claims where the likely impact would be speculative, would provide any meaningful information to users of financial statements. We also note that, in our experience, a conclusion that an asserted claim is remote is reached infrequently and only after careful consideration. Therefore, remoteness is already a high standard that does not require the addition of an exception. Finally, we are concerned that auditors' will consider it necessary to obtain evidentiary support for the disclosure, which itself would put attorney-client privilege and work product protection at risk.

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This requirement also would distort materiality concepts. Materiality, as defined by the Supreme Court in *Basic v. Levinson*, is a combination of magnitude and probability assessments, whereas the FASB's proposed requirement would not permit a weighing of magnitude versus probability. If standards for materiality judgments are to be changed, it should be done by the SEC or the courts and not through the FASB's adoption of accounting standards.

We also are concerned that adoption of a severe impact exception to remote asserted claims would encourage claimants to initiate lawsuits with greatly inflated damages claims so as to use the disclosure requirement to extract a quick settlement from companies that otherwise would contest the claim.

Consistent with principles reflected in existing accounting literature, as well as in the Revised Exposure Draft, companies review the likelihood of an adverse outcome on loss contingencies on a quarterly basis. If, upon any such review (taking into consideration developments with respect to the claim and any related proceedings), a remote asserted claim is considered no longer to be remote but reasonably possible, appropriate disclosure about that contingency will then be made. Accordingly, we do not believe it is necessary to create a severe impact exception for remote contingencies, and recommend that no change be made to the existing standard reflected in Topic 450 not to require disclosure about remote contingencies.

If the FASB nevertheless considers an exception necessary, it should be based upon requiring disclosure of a remote asserted claim if the disclosure would be necessary for the financial statements not to be misleading. This would permit judgment to be exercised based on existing concepts of materiality.

Disclosure About Insurance Coverage and Other Sources of Recoveries. The ABA considers it anomalous that the Revised Exposure Draft would deny companies the ability to take into account insurance coverage and indemnification in assessing materiality while at the same time requiring disclosure of potential insurance and indemnity coverage in many cases. Insurance and indemnification are important and routine elements of a company's risk management program and therefore companies should be able to take such matters into account in assessing the materiality of a loss contingency. This materiality assessment would require a company to determine whether recovery from these sources has the requisite certainty and to disclose any material uncertainties regarding such recoveries. We therefore disagree with the conclusion expressed in paragraph BC 15 that insurance coverage should always be excluded from consideration because it is sometimes uncertain and may be subject to litigation. Rather, this should be a matter for the exercise of judgment by companies, accompanied by appropriate disclosure when necessary.

Whether or not insurance coverage can be taken into account in assessing materiality, we also are concerned that the requirement that insurance coverage be disclosed under the circumstances set forth in proposed paragraphs 450-20-50-1F.e.5. and 450-20-50-1F.f.3. (that is, "if it is discoverable, even if information has not yet been provided to the plaintiff in discovery," as explained in BC41) would inappropriately interfere with the litigation process in several ways, potentially prejudicing the outcome of such litigation and any settlement to the ultimate detriment of shareholders.

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First, whether information is discoverable is not an easy determination and can depend on a range of factors, making this a predictive exercise. Moreover, even if information is generally discoverable, it may not be discoverable in a particular situation because there may be defenses to that discovery. It may not be known until a court rules whether any particular information is discoverable.

In addition, the possibility that insurance coverage may be discoverable does not mean that a plaintiff has sought such information. Even if the plaintiff has sought that information, its being provided in discovery does not make the information public. Discovery is generally a private process and, when disclosure of insurance coverage is permitted, it is to permit the plaintiff to assess settlement values. Furthermore, the rules of many courts provide that disclosure of insurance coverage is inadmissible as prejudicial even though a plaintiff may be able to obtain that information in discovery. We are particularly concerned that a requirement to publicly disclose the information if it is discoverable fundamentally misperceives the function of discovery. The discovery process is not to make information publicly available but rather to provide information to the parties about the case.

Requiring public disclosure of otherwise non-public discovery would be harmful to defendant companies because a court could deny a defendant the protection from admissibility if the information has already been disclosed in its financial statements. In other words, the FASB proposed requirement may make admissible in a court proceeding information that, without the FASB requirement, would not have been admissible.

Accordingly, we suggest that any requirement that insurance coverage (or any other discovery information) be disclosed be limited to those situations when the information has actually been admitted into the proceedings. At the very least, there should be no required disclosure of insurance coverage (or any other discovery information) unless the information has actually been provided to the plaintiff through discovery or otherwise or to the government agency whose actions gave rise to the loss contingency (and, even then, not when public disclosure of such information has been precluded by law or a protective order or other judicial action). Because the standard we suggest, as well as the less desirable alternate standard, would be factually based, it would avoid the need for auditors to make legal determinations, through inquiry of counsel or otherwise, whether something is "discoverable" or "admissible" under applicable law. Indeed, whether information is discoverable or admissible is a determination made by courts during the proceeding and is often difficult to predict beforehand.

We also are concerned that the proposal to require the disclosure about possible recoveries "if it is discoverable by . . . a regulatory agency" is vague and subject to confusion. If this requirement is retained, we suggest that this language be clarified to state as follows: "if it is discoverable by either the particular plaintiff or the regulatory agency whose actions give rise to the loss contingency." For the reasons noted above, this also should be conditioned on the absence of defenses to discovery, as well as the absence of any legal bar to such disclosure. This clarification would not be required if the FASB adopts either our suggestion that insurance coverage be disclosed only if it has been previously admitted in a proceeding or the less desirable alternative that insurance coverage be disclosed only if it has been previously provided to the plaintiff or the applicable regulatory agency.

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Finally, we believe that 450-20-50-1F.e.5. should make clear that the requirement to disclose whether the insurance company has denied, contested, or reserved its rights related to coverage applies only if such insurance coverage has been otherwise disclosed.

Disclosure of the Amount of the Claim. The requirement in proposed paragraphs 450-20-50-1F.b., 450-20-50-1F.e.1. and 450-20-50-1F.f.1. to disclose the amount claimed by a plaintiff, even if the amount bears little relationship to the allegations or reality, could result in a significant risk of misleading or confusing disclosure. In addition, such a requirement would result in different disclosures depending upon the jurisdiction in which a complaint is filed. Many jurisdictions prohibit inclusion of claim amounts in complaints filed in such jurisdictions precisely because, among other things, such amounts may have little relationship to the factual or legal claims in the complaint and may potentially have a misleading and prejudicial impact. Disclosure of a claimed amount, if permitted by court rules in the complaint, also would be misleading in connection with class actions in view of the issues that often need to be resolved regarding certification of the class and whether the actual class size will be consistent with class size asserted in the complaint. Moreover, as noted above, this disclosure requirement could encourage claimants to make excessively inflated damages claims to achieve settlement negotiation leverage. A defendant company's ability to accompany the disclosure of the amount of the claim with information about why the company believes the amount is unjustified does not mitigate our concerns, because the mere inclusion of an unrealistically excessive claim amount could be misleading to investors. Investors may conclude that the presence of the information in a company's financial statements means the claim meets specified standards and therefore has some credibility that is unjustified. In addition, auditors would likely seek evidentiary support for any mitigating information a company chooses to include in its financial statements, which could itself result in the loss of the attorney-client privilege or work product protection.

We also are concerned that putting companies in the position of having to explain why they believe a claim amount is unjustified would unnecessarily subject companies to ongoing disclosures that provide a roadmap for plaintiffs regarding the litigation to the prejudice of the company and its shareholders.

If the FASB determines to require this disclosure notwithstanding our concerns, we suggest that companies be given the ability to omit the disclosure of the amount of the claim where the company has determined that such omission is necessary to avoid misleading disclosure to users because the amount of the claim bears little relationship to the allegations or to reality.

Additionally, the guidance provided by the FASB should make clear that testimony of expert witnesses is to be taken into account only if that testimony is considered reliable and is admissible under prevailing judicial standards. The Supreme Court in the *Daubert* case established the rule that courts need to be satisfied regarding the reliability of expert testimony before it actually is admissible.

Disclosure of the Contentions of the Parties. The ABA believes that the requirement in proposed paragraph 450-20-50-1F.b. to disclose the "basis for the entity's defense or a statement that the entity has not yet formulated its defense" may suggest that the disclosure is required even though the defense has not yet been disclosed in court filings or other public documents or to the plaintiff. Premature disclosure regarding a company's defense strategy could be prejudicial to the defense and could adversely affect a company's ability to properly manage the litigation. We

recommend that this requirement be revised to require disclosure of information about the company's defense to the litigation only to the extent that information is publicly available. At the very least, that information should not be required before it has actually been disclosed to the plaintiff.

Relevance of External Studies. Proposed paragraph 450-20-55-14 adds subparagraph d., which identifies studies in scientific journals and other credible sources that indicate potential hazards related to a company's products or operations as an example of information a company should consider in determining the probability that a claim will be asserted and the likelihood of an unfavorable outcome. We understand that example to be illustrative and not to deprive a company of the ability to exercise judgment as to the relevance and credibility of such information. However, we are concerned that singling out this specific type of information will give it undue weight and prevent companies from being able to exercise the appropriate judgment. In addition, this example might be interpreted as requiring companies to identify and become familiar with, and assess the accuracy of, studies in scientific journals, which would impose an unjustified burden on companies. The relevance and credibility of external studies can vary widely, are subject to change and are often contradictory. They are just one item of information a company may have to consider, depending on the circumstances, but they should not be singled out and given undue weight. Thus, we urge deletion of new subparagraph d.

Materiality of Disclosure. The ABA recommends that proposed paragraph 450-20-50-1F be revised to make clear that no disclosure is required about individually immaterial loss contingencies unless they are material on an aggregate basis. Although a materiality assessment is suggested by proposed paragraphs 450-20-50-1E and BC21, we believe this clarification is appropriate in proposed paragraph 450-20-50-1F. We believe that revising the first sentence of paragraph 450-20-50-1F as follows would appropriately clarify the disclosure requirement: "An entity shall disclose the following about individually material loss contingencies (or classes (types) of similar contingencies) and loss contingencies (or classes (types) of similar contingencies) that are material in the aggregate, if such loss contingencies meet the disclosure threshold described in paragraphs 450-20-50-1C through 50-1E."

Effect on ABA Statement

The ABA agrees that auditability is a relevant consideration for assessing the changes in accounting standards proposed by the Revised Exposure Draft. In that connection, we note the Board's statement that it will continue to work with the ABA, the PCAOB and the AICPA to identify and address any potential implications of the proposed changes for the ABA Statement and related U.S. auditing standards. For the reasons explained below, we do not at this time believe that the revisions proposed in the Revised Exposure Draft, as we understand them, or as they may be revised to reflect our recommendations, would require any changes to the ABA Statement as such, although steps can be taken as described below to provide guidance to lawyers regarding the effect of any revision of ASC Subtopic 450-20. The ABA, of course, would be happy to participate in discussions should that be helpful.

In our view, the ABA Statement has stood the test of time and has been successful in achieving its purposes. These purposes include providing information to auditors regarding specified loss contingencies and allowing auditors to rely upon counsel having fulfilled their professional responsibility to advise the client, when appropriate in connection with counsel's

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engagement, regarding the client's disclosure obligation, while, at the same time, maintaining client confidences and ensuring preservation of the fundamental protections of the attorney-client privilege and the work product doctrine. The ABA Statement was carefully designed through an understanding between the legal profession and the accounting profession to strike the appropriate delicate balance. The purposes underlying the ABA Statement are as important now, and perhaps even more important, than they were when the ABA Statement was approved over 30 years ago.

We do not believe that the information requirements of the Revised Exposure Draft, both quantitative and qualitative, require changes to the ABA Statement. The ABA Statement does not detail the information a lawyer is to provide an auditor regarding claims and therefore no change is necessary to reflect any enhanced disclosure requirements.

We also have considered whether the proposed change to the disclosure threshold to require disclosure of asserted claims that are remote but may have a potentially severe impact would require a change in the ABA Statement. Although, as discussed above, we do not favor such change to the disclosure threshold, if the change were to be adopted, we do not believe a change in the ABA Statement would be necessary. The ABA Statement contemplates that counsel, when requested by the client, will identify all material asserted claims to which counsel has devoted substantive attention without regard to their likely outcome, and thus a change in the threshold for disclosure of asserted claims would not affect audit responses under the ABA Statement. Moreover, the potentially severe impact of a matter is not a legal determination for counsel to make but rather, like the probability of the assertion of an unasserted claim, is a determination for the client to make. Similar to counsel having the professional responsibility to advise counsel's client regarding disclosure of unasserted claims, counsel has the professional responsibility to advise the client regarding disclosure of asserted claims when that is within the scope of his or her engagement. Paragraph 6 of the ABA Statement makes clear that this professional responsibility applies generally.

We expect that, if necessary and to the extent appropriate, the ABA Business Law Section's Committee on Audit Responses will issue a statement reflecting the foregoing. In that event, we expect that, if the FASB were to change the disclosure threshold, such statement from the Committee would make clear that a lawyer would need to take that change into account in advising the client, to the extent within the scope of the lawyer's engagement, regarding the client's disclosure obligation with respect to asserted remote claims. We also expect such a statement would alert lawyers to the additional information requirements resulting from a revision of ASC Subtopic 450-20 that should be considered by a lawyer in responding to an auditor in accordance with the existing ABA Statement. See the Committee's "Statement on Effect on FIN 48 on Audit Response Letters," 64 Bus. Law. 389 (2009), for a similar statement on the effect of a change in accounting standards for tax contingencies on audit responses.

Request for Deferral of Effective Date

The Exposure Draft provides that, for public companies, the new guidance will be effective for fiscal years ending after December 15, 2010, and for interim and annual periods in subsequent fiscal years. Compliance with the proposed effective date would be extremely burdensome, particularly if, notwithstanding our comments on the Revised Exposure Draft, the requirements are adopted substantially as proposed.

In view of the breadth of the disclosure requirements in the Exposure Draft as compared to the current standard, companies will have to dedicate substantial resources to collect relevant information and consider disclosure obligations under the new guidance. The need to prepare an inventory of all pending litigation, with the requisite case-specific information for all material contingencies, to assess the appropriate extent of permissible aggregation of loss contingencies and prepare a description of the bases for such aggregation, and to prepare the qualitative and quantitative disclosures, including the description of the bases for the claims and any defenses, would take a considerable amount of time and deliberation. Moreover, the inevitable implementation questions that arise with the application of a significant new standard, coupled with what is certain to be the sensitive nature of some loss contingency disclosures, including the need to consider the impact of such disclosures on the attorney-client privilege and work product protections, militate in favor of providing public companies sufficient time to permit them to make disclosure decisions with care.

In addition, public companies will need time to modify their internal control systems and disclosure controls and procedures to ensure that these controls and procedures are effective in providing timely, relevant and reliable information to company management in order to comply with the new disclosures. Extending the adoption schedule for the new guidance also would benefit audit committees, management and auditors by providing a reasonable time frame for these parties to engage in an informed dialogue about the guidance and to evaluate expectations in relation to the disclosure requirements. Once disclosures are prepared, audit committees likely will want to discuss the narrative descriptions with management and satisfy themselves that such descriptions, particularly the descriptions of the bases for the claims and the companies' defenses, are accurate and consistent with the FASB's requirements and do not adversely affect shareholders' interests. There will simply not be enough time for calendar year companies to do this by the proposed effective date.

To allow public companies adequate time to implement the final guidance, the ABA encourages the FASB to change the proposed effective date so that it is effective for public companies for fiscal years ending after December 15, 2011, and then for interim and annual periods, as applicable, in subsequent fiscal years. A similar one-year deferral should be made for private companies so that they can benefit from the experience of public companies and have additional time to deal with the revised requirements.

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The ABA appreciates the opportunity to comment on the Revised Exposure Draft and is available to discuss these comments should the FASB or its staff so desire.

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