FINAL TRANSCRIPT

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**ACCA - WHEN TO SET A RESERVE: NOW, NEVER, OR SOMEWHERE IN-BETWEEN

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**ACCA - WHEN TO SET A RESERVE: NOW, NEVER, OR SOMEWHERE INBETWEEN

CORPORATE PARTICIPANTS

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ACCA - Vice Chair, Litigation Committee

Peter Brennan
ACCA - Chair, Litigation Committee

Chris Holmes
Ernst and Young - National Director, SEC

Bill Phelan
Sears Roebuck and Company - Assistant Controller

PRESENTATION

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

My name is Kathie Lee. I'm one of the Vice Chairs for the Litigations Committee of the American Corporate Counsel Association and our Web cast today is on the very critical question, with respect to specific litigations, which is, 'When to Set a Reserve: Now, Never or Somewhere In Between?' Let me start by introducing Peter Brennan, Chair of the Litigations Committee of ACCA and the Associate General Counsel for Litigations with Sears Roebuck and Company. Peter will provide an in-house litigator perspective for this issue. So Peter, if I can hand this off to you for now.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Thanks. I'd just like to introduce our two other participants in this Web cast. One is Bill Phelan. (ph) Bill has nearly 20 years experience in the accounting profession, including eight years with Deloitte & Touche as an auditor. In his current role as Assistant Controller (ph) for Sears Roebuck and Co. Bill oversees all accounting and reporting activity for that $40 billion company.

Also participating in this Web cast is Chris Holmes. Chris is National Director of SEC matters. He's a partner and serves as Ernst & Young's National Director of SEC matters, as I mentioned. Chris is part of the National Professional Practice of ENY's Assurance and Advisory Business Services and is based in Washington, D.C. As part of his practice Chris regularly consults with the SEC staff to resolve issues involving financial, accounting, and disclosure matters, and the interpretation and application of SEC rules and regulations.

Chris has extensive experience with SEC filings, securities, registrations, and initial public offerings. He also represents ENY on the SEC's regulations committee of the AICPA. Chris began his career in 1981 in Ernst & Young's audit practice in Winston-Salem, North Carolina, where he served large public manufacturing companies. He transferred to Washington, D.C., in 1989 and joined the area's professional practice groups and has been with the firm since he first joined in 1981.

So with that Kathie, we'll go back to you.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Thank you, Peter. Chris, if we can really start with you, and if you can kind of start off this program by explaining the basic accounting rules implicated in setting reserves, and if you could include just a brief discussion of the FAS-5 (ph)analysis.

Chris Holmes - *Ernst and Young - National Director, SEC*

Sure, Kathie, I'd be happy to. And I'll start off with just the basics and we'll build on that.

FAS-5 (ph) really goes back to 1975. Of course, it was one of the initial standards that was adopted by the FAS-5. We're up to, I think, 150 now. So there's been a lot that's happened in the meantime. But we might point back to FAS-5 (ph) as one of the earliest principle State (ph) standards. There hasn't been a lot of rule making or interpretation around the basic model that FAS-5 (ph) established back then, which is effectively that a lost contingency would be accrued. That is, an expense recognized when two conditions are met.

The first is that prior to the issuance of the financial statements it must be probable that one or more events will occur in the future confirming the facts that a loss has been incurred. So that creates some difficulty in application in that it isn't just an evaluation as of the balance sheet data, the financial statements. The company really has to be aware of factors up through the dates that they issue the financial statements, which the SEC has interpreted to be actually filing those financial statements with the SEC in a report or distributing them widely to shareholders. They've said that just posting financial statements on a corporate Web site isn't sufficient.

The second condition that has to be met is the amount of the loss needs to be capable of reasonable estimation. So, again -

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Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Chris?

Chris Holmes - *Ernst and Young - National Director, SEC*

Yes?

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Chris, I'm sorry. If I can just interrupt you just for a moment. I just got a note that there's a request if you can speak a little bit louder or come closer to your phone.

Chris Holmes - *Ernst and Young - National Director, SEC*

OK.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

It's a little hard to hear.

Chris Holmes - *Ernst and Young - National Director, SEC*

OK. I'll do that.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thank you, Chris.

Chris Holmes - *Ernst and Young - National Director, SEC*

Thank you. In addition to the provisions for the recognition of a loss contingency, FAS-5 (ph) also includes certain disclosure provisions. And it also provides some commentary on these assessments of the probability, although it does not provide any strict definitions in terms of quantitative probabilities. The definitions provided in the FAS-5 standard are more qualitative. And it defines probable as being likely, and it contrasts that to a situation that would be remote, where there be, as it says, a slight chance of occurrence.

And then between those two defined points, everything in the middle would be determined to be reasonably possible. And the standard does set forth some disclosure requirements (inaudible) a loss contingency is not probable but it is reasonably possible. There's a requirement to disclose the nature of that contingency, provide an estimate of the range of possible loss, if that is available, or disclose that such an estimate can be made.

Another aspect of the application of the probability standard is outside of a litigation case where you're dealing with an unasserted claim, it requires an assessment as to whether it's probable that that claim will be asserted. And if that is probable, then a further consideration, whether it's probable that a loss will be incurred as a result of that.

There's been one significant interpretation of FAS-5 (ph) that the FASB issued in 1976, and that's FASB interpretation number 14. And it basically provides some additional color around the determination of the reasonably estimable amount of the loss. And it indicates that a company should make their best estimate of what that amount is. But to the extent (ph) that has a range and no amount within a range is a better estimate, then the company must approve the low end, the minimum amount in the range, and then disclose the additional amount that would fall into the reasonably possible category.

So it's important, though, to recognize that this is a little different measurement principle than other cases where there are some probablistic (ph) weighting notions that a company might look at. You know, what is the amount of the exposure, look at the likelihood of the loss in the case, and determine a factor, if it's really an amount that once you cross that probable threshold - and we'll get into some of the fact patterns by examples - so that the company would need to accrue its best estimate of what that amount of ultimate probable loss might be.

And one other element I'll mention, just beyond the accounting for loss contingencies themselves, is the accounting for the costs of a legal defense. And that is an area where there is not a one-size-fits-all model but is actually an accounting policy election that a company might make. Most companies will expense the costs of defending a legal claim as incurred, but still others have determined to (ph) accrue those costs, you know, under this probable and reasonably estimable model. The SEC has said through an EITF announcement that that is when it's material and an accounting policy that they would expect companies to disclose and follow consistently.

So with that I'll stop with the basic background and turn it back to Kathie.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thank you, Chris. I'm still getting word that people are not able to hear as well as possible. So, Jim, if possible - I just sent you a message - if we can try to get the conference center to increase the volume in some form. And I guess we all need to speak louder ultimately. But I've gotten a few messages on the inability to hear clearly.

OK. Bill, do you have any comments or statements that you'd like to add initially from what Chris has said so far, from an in-house comptroller perspective?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Not really. I guess the only thing, you know, would really just want to echo Chris' comments that, you know, this accounting standard, you know, provides general guidance. And, you know, kind of the challenges or the biggest challenges we have are when we classify the probability of losses for a particular case is what exactly does "remote" and "probable" and "reasonably possible" mean. Because the standard as written defines remote as slight. However, in practice, you know, typically you'll get estimate from counsel of how likely is it that we'll lose. And typically those - at least my experience is those estimates are in terms of percentages. And the challenge is, is turning percentages - for example, five percent chance of loss, would we consider that remote.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Great. And, Peter.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Do you have any comments from an in-house litigator perspective?

Peter Brennan - *ACCA - Chair, Litigation Committee*

Sure. Kathie, from my perspective I think where we play the role is try to figure out what those percentages are. Sometimes the calls are very easy. Sometimes it's very clear that something's remote. Where it is much more difficult - and kind of we have our examples around it - is where you're in the reasonably possible or is it probable. Those are the times when you're going to have to make decisions about what you really think about the case. And it's not just sort of when you're evaluating, well, my range is, you know, 30 to 70. Well, that doesn't help our financial people make a decision. So that's when I thought you get pushed. And I think, quite frankly, we probably push the in-house people more than outside counsel. And as in-house counsel I think the litigators listening to this can expect, particularly as the numbers get bigger, to get pushed harder to really make a decision what bucket does it fall into.

Unidentified Participant

Might be on the line. I'm trying to -

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK, great. I'm still getting a few more messages about the volume. So hopefully that's going to be resolved very soon.

But why don't we move onto some of the scenarios that we've listed. And if we could start with scenario number one, jumping right in. Let me just read this for the benefit of those that do not have it. Number one. If your company is a defendant in a lawsuit and you conclude that on balance you will lose a million dollars if you lose the case, but you also think that's there's only a 30 percent chance of losing, then your company's reserves should be: A. 300,000, B. 0, C. one million, or D. none of the above.

Chris, can I start with you again? And just kind of go through some of the issues that you would consider or that you would suggest considering in setting up a reserve here?

Chris Holmes - *Ernst and Young - National Director, SEC*

Sure, Kathie. Some of the specific guidance that is provided in the basis for conclusions to FAS-5 (ph) is with specific respect to litigation and claims. And it suggests that in determining whether a loss accrual is appropriate the company should consider the nature of the litigation claim or assessment and the progress in the case, including progress that occurs after the date of the financial statements and before those financial statements are issued. It suggests considering the opinions or views of legal counsel and other

advisors, the experience of the company in similar cases, as well as the experience of other enterprises.

And also consideration of any decision that the enterprise's management has made as to how the company will respond to the lawsuit. For example, whether it is going to contest the case vigorously in court or try an seek an out-of-court settlement. So I think in the fact pattern that we're looking at here, in addition to the other factors, the company would need to consider, even though it assesses its likelihood of losing at 30 percent, whether it is going to entertain or consider making a settlement offer, and then, if so, potentially accrue the amount of any settlement offer made.

But presuming that the company is going to contest the case vigorously and believes that, in taking the case to the end, that it risks only a 30 percent chance of losing, I think most reasonable people would say that 30 percent is not likely, therefore the probable element that would be required to record a loss contingency has not been satisfied. So I'd generally think the answer to that question, then, would be B, that no amount would need to be accrued. And then a company would need to consider whether they believe 30 percent, though, is reasonably possible and then, you know, based on materiality considerations consider whether some disclosure is required in the financial statement footnotes.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Bill. How about you? And do you agree, disagree, and what do you feel that you need to know or consider in determining a reserve in this situation?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Great. Well, first of all, I agree with Chris that, you know, given this fact pattern that you would not record any reserve. However, you know, the important take-away, though, is if you do think that there's still a reasonably possible chance that you will have a material loss of a million dollars in this case, you are still required to disclose it. So you would have to disclose this contingency as a possible loss that may in fact occur. So that's the key take-away, that if there's a big loss or a reasonably possible chance that you would have a material loss, you would always have to disclose that.

To Chris' point, the other things you might want to consider would primarily be what is our defense strategy for this. So if, for example, are we going to vigorously pursue litigation or entertain any settlement discussions. Because, practically speaking, if we were going to entertain settlement discussions and possibly even make an offer, we might strongly consider recording that as a loss when we make that decision to extend such an offer.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Peter, how about maybe even going into this question of defense strategy?

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, I think it's going to depend on, you know, if you're dealing with your comptroller (ph) or anybody in the financial reporting area and you know you're going to make an offer for a case and you're pretty darned sure it's going to settle somewhere close to that offer, you certainly should disclose that to your financial people, even if you think it's more likely than not - significantly more likely than not that you're going to win that case. And that's one of the issues that when - at least when it gets above the materiality threshold - and that's obviously going to vary company by company - that's one of the key things that you need to be aware of and have a discussion, basically, back and forth with your financial reporting people.

I think I'd also point out is that when you - if you've hit the probable threshold, you are going to have an accrual. And we'll get to that in a second. But I think a lot of people might have answered this question, well, if you had a 30 percent chance of losing and it's a million-dollar case, you set a reserve at 300,000. And what you're hearing is that, in fact, is not the case and that's not the way the accounting standard works, at least for your normal public company. There are - and we're not going to talk much about it - but for insurance companies there are different standards. That's, I believe, controlled by FAS number 60. And if you happen to work for an insurance company and are listening to the Web cast, there's a whole different scenario that gets into that. But this answer might be different, and you'll obviously need to consult closely with your financial reporting folks.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Great.

Chris Holmes - *Ernst and Young - National Director, SEC*

I would just add to Bill's remarks that in addition to the consideration of disclosure within the financial statements that's suggested in FAS-5 (ph) there's an additional requirement for public companies under the SEC rules to disclose significant legal proceedings. That's under Regulation SK item 103, and that's a disclosure that's required in both the annual report on Form 10K as well as the quarterly report on Form 10Q. It establishes a disclosure threshold of 10 percent of the company's current assets.

So if the company in this example had current assets of less than 10 million, that disclosure threshold would have been tripped, and the requirement then would be to describe any material pending legal proceedings other than those that are ordinary, routine litigation that are incidental to the business. The company would need to assess whether the existence in (ph) this case even though it's assessed that a 30 percent likelihood loss would be one that might be required to be disclosed under that SEC rule.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

So we actually have several issues here. I mean, we have, obviously, the reserve issue and the FAS-5 (ph) analysis. But we also have a disclosure issue that may come into play as well here.

Chris Holmes - *Ernst and Young - National Director, SEC*

That's right.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Great. Why don't we go to our example number two, which is a similar scenario, but you conclude that there is a 55 percent chance of losing. Then your company's reserves should be: A. 0, B. 550,000, C. one million, or D. none of the above. Can I start with you again, Chris?

Chris Holmes - *Ernst and Young - National Director, SEC*

Sure, Kathie:. Fifty-five percent, clearly, subject to the considerations we discussed in the first case, you know, would take a company above what accountants would describe at least as more likely than not. Whether that hits a threshold where a company has established a policy or practice of assessing loss contingencies as likely would probably vary company by company.

I think as practice has developed under FAS-5 (ph), likely has generally been interpreted to be a threshold I'd say somewhat higher than more likely than not, which I would describe at a 50.1 percent chance. So some companies may, you know, with more conservative policies, be on the lower end, and those companies may conclude that 55 percent, you know, they judge as being a probable or likely amount of loss and in that case would accrue a million dollars. Other companies may conclude that 55 percent falls in the reasonably possible range, between remote and probable, and conclude that the disclosure considerations that we've talked about earlier would apply.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thank you, Chris. Bill, how about you? Do you concur or are you looking at other issues from an in-house perspective?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Well, I concur with Chris. And I think this is the most challenging example ...

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Right.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

... on the page. And what I would really recommend that, you know, what corporations do - I think what is the most important thing whenever you have a -- I'll call a "subjective accounting rule" that does require some interpretation in order to implement, is that you want to make sure that as an organization you apply those rules consistently over time. So here I think your prior practices are really important and you want to make sure that they are consistent. And what might make sense - I know what some companies do - is will actually develop an internal policy that says we, for example, will believe that anything between 65 percent and greater is probable, and kind of go through an internal process with the accounting function and, if you will, document the rationale for that. But to try to develop an internal policy, and develop it and, secondly, document it so that you can show that you've applied it consistently over time.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thanks, Bill. And, Peter.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, I think Bill and Chris have covered it. I think, as I said, the litigator's perspective is you've gotta come up with that analysis to give them the percentages. Because the financial reporting people obviously will not be able to evaluate the likelihood of success on occasion. And that's, again, the litigator's role.

Chris Holmes - *Ernst and Young - National Director, SEC*

And, Kathie, I'd just add again to Bill's remarks, I really do think that consistency is very important in the application of that judgmental standard as to what's probable. And clearly what we've seen are, you know, companies getting into trouble with the SEC in setting reserves and being somewhat opportunistic. And you clearly wouldn't want a case where in a good quarter a company is accruing a loss at a 55 percent level, but then in a tough quarter is applying an 80 percent threshold in determining whether or not to accrue a loss. So consistency is very important.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. So I think we've discussed using the past practices within a company and then maintaining consistency, which I think fall in place. And then do we also have a disclosure issue here as well? Any of you panelists?

Chris Holmes - *Ernst and Young - National Director, SEC*

Well, Kathie, FAS-5 (ph) - if the company determined that this is a probable loss and the reasonably estimable amount is the million and that's what they accrued, FAS-5 (ph) does not necessarily require a disclosure of the specifics in that case. It suggests that disclosure may be necessary for the financial statements not to be misleading, but it doesn't absolutely require disclosure in the case when an amount is accrued. That's not the same standard as the SK item 103 that I mentioned earlier. That would seem to suggest that disclosure would be required whether or not some amount has been accrued for that case or not. If the company had not accrued something, though, then the alternate analysis under FAS-5 (ph) would be if this is a material and reasonably possible loss, that disclosure would need to be made in the financial statements of that.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Bill? Do either of you have any comments to Chris' statement here? Anything you'd like to add? Bill.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

I think Chris covered it.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Great. Let me move onto our scenario number three, which is similar to two. And, by the way, there was a question asked on whether the scenarios are online. And they are. I believe they're on ACCA.com., A-C-C-A.com. And the hypotheticals are listed on the front sheet, I believe. On number three. Same scenario as number two except that you are unable to evaluate your company's chance of success. Then the reserve should be: A. zero, B. one million, C. 500,000, or D. none of the above. How about I flip it this time and I start with Peter?

Chris Holmes - *Ernst and Young - National Director, SEC*

Thank you, Kathie. I appreciate that.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Give you a break there, Chris.

Chris Holmes - *Ernst and Young - National Director, SEC*

Exactly.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, I think one thing you'll find, if you really say you're unable to evaluate the chance of success, that will be the case. But you'll get pushed pretty hard, I think, by financial reporting vehicles saying "You really can't tell me where you are on the spectrum?" Typically - the only time this is going to happen is real early on in litigation when you just don't know enough about the case. But it can happen, and it can also be because there is all sorts or facts and things beyond your control. So

you don't kind of know how you're pulling into the case. But that's the role that the litigator would serve. And I can tell you answer -- I believe the answer to this is going to be if you really can't evaluate it, then you really can't set a reserve on it either. But I'll let the financial people who know a lot more about this than me - I'll let Bill start.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

How about - right. Bill, do you agree with Peter or would you press Peter?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Well, I certainly would press Peter. But the important point is, if you can't evaluate it, number one, it means that (inaudible) remote. Because, remember, we've got three criteria for possibility of loss: one being remote, probable, and reasonably possible. And the category of remote means we really don't have to do anything. We do not have to record a reserve nor is there any disclosure. So if we can't conclude it's remote, well, that means that we would be required to disclose this case. I mean, if this case is material to the organization, or more than 10 percent, given the second regulation that Chris referred to, clearly it would have to be disclosed, because we cannot at this point characterize it as remote.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Chris.

Chris Holmes - *Ernst and Young - National Director, SEC*

This is a difficult one. And it would generally suggest to me that if you're unable to evaluate it, that it doesn't feel like it would be at a probable level but likely would fall into this reasonably possible category. And I would concur with Bill, it probably would be hard to say just because we can't evaluate. It also indicates while we can't make a probable conclusion, also can't make a remote conclusion either. But I think, as Peter said, it's one where there would be probably a lot of discussion as to why the company isn't able to evaluate the likelihood of an unfavorable outcome and really try and explore where in that middle ground of reasonably possible you may be and whether you're approaching whatever threshold the company has established as probable.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

This is Bill Phelan again. And, you know, to deal with this challenge, in practicality what has evolved over time is most public companies will have some sort of legal proceedings disclosure in their financial statements that will just put the financial statement user on notice that as a normal course of business we get sued from time to time or there's various litigation asserted against us, and these cases are being worked or in various stages of evolution. But in aggregate, you know, management would have to give their view on them.

And typically if there are no cases out there that are thought to be very, very significant or very, very bad, management would typically assert that the financial statements contain all the reserves necessarily or that were - we feel comfortable that the reserves were recorded will not be materially short from the what the ultimate deed will be for these cases. So most companies do try to do some sort of disclosure out there to just put the reader on notice that there are typically a number of lawsuits against it at any point in time.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Any last word there, Peter?

Peter Brennan - *ACCA - Chair, Litigation Committee*

I think they've covered it.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. OK. Let me go to our last hypothetical scenario. It is the same as number two, which is the 55 percent chance of losing, except you are unable to estimate the magnitude of the loss and that - and in that case then your reserves should be: A. zero, B. $1 million, C. 100,000, D. none of the above. And why don't we start with Bill to just keep this in a rotation.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Sure. Well, the issue here once again is - back to scenario two - is we've decided that it's 50 percent probability - you know, a 50 percent probability of loss. For the sake argument let's just assume that we've assumed that the 55 percent, while it's a very gray area, if we decided that that was probable and there would be some sort of accrual required, if we decided

we needed to establish a reserve, the question is what's the dollar amount of that reserve, given the fact that we don't really have an idea, that the loss could be anywhere between I guess zero and a million dollars. And actually this is one of the - one of the areas where accounting does not necessarily follow the convention of conservatism. Because there is a specific interpretation that Chris mentioned earlier that said if you do have a claim that is probable or a loss that is probable and you've got a range or outcomes, you're required to record the best estimate in that range. If there's no best estimate in that range, you know, no one number is better than any other, you are required to record only the low end of that range. So in this example, if our range is really from zero to a million dollars, you would be required to only book the low end of that range, or zero in this case. But, once again, we would have the disclosure requirements that come along with this so that we would have to disclose the case and most likely the fact there has been no reserve recorded for it.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. And, Peter, do you have anything to add there?

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, I would just add that in many ways the listener may think that this is not as real-life scenario. But it actually is a scenario. Because you can have cases that are small that may cost very little. It may not be zero, but you'll know very little to settle, of even if you lose the case. But what you won't know is whether there is going to be a - whether it's going to be a nationwide class action. You may not know early on whether it's going to be - whether you could have a substantial punitive award. So it may be that's it probable, you've done something that's inappropriate and that you could lose a case for. But the magnitude of that loss is very difficult to estimate. And, again, from a litigator's standpoint, the key thing is that you simply explain to the financial people what your view of the case is and then they can make a judgment about what the appropriate accounting treatment of that is.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK, Chris. And would you agree?

Chris Holmes - *Ernst and Young - National Director, SEC*

Yes, I would have a view consistent with Bill and Peter. You know, the fact pattern says that the company's unable to estimate. And as I said earlier, FAS-5 (ph) requires an ability to reasonably estimate the amount of loss in order to have an accrual. So if that isn't met, then there would be no need for an accrued loss contingency. But FAS-5 (ph) is specific on the disclosure that, you know, whether that is probable or reasonably estimable - and we had that as an issue in fact pattern two at the 55 percent - FAS-5 (ph) would say that disclosure would be required in the circumstances, disclosing that, the nature, and also that the company is unable to determine the amount of the loss.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thank you, Chris. At this point we are done with the hypotheticals, the scenarios that we've set up here. However, I wanted to, number one, thank all of the panelists, Chris, Peter, Bill, and ask if you want or have any last words or statements that you might want to impart before we go into the question section.

Chris, would you like to start off? Sorry to pick on you all the time.

Chris Holmes - *Ernst and Young - National Director, SEC*

Well, I guess, Kathie, I'd say that the - sort of building on what Bill was talking about earlier with some of the general, if you will, boiler plate disclosure that you often see in companies' financial statements, there clearly is a tension between financial reporting and defending the company's financial interests. I think there is a perception that public disclosure can tend to weaken a company's position. So I think historically companies have been very reticent to include a lot of a specific disclosure in their financial statements or their SEC filings regarding specific pieces of litigation, believing that, yes (ph), there's some disclosure that a reserve has been set aside, that basically it provides a road map for the other side to try and achieve that result.

And along those lines, the SEC - I think it's probably a couple of years ago now - had proposed some rules that would significantly expand what they were calling supplemental financial information that would need to be provided in SEC filings that would effectively require and analysis of changes in liability accounts, including liabilities related to litigation

and other loss contingencies. And there was a tremendous amount of concern expressed about the potential competitive damage that that would do to a company. So while the SEC hasn't moved on those rules, at least their public comments from the staff have indicated that they heard those concerns and would likely address those in any filing rule (ph) (ph) making that the SEC undertook.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thank you, Chris. Bill, any last comments?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

I would agree with Chris' view and say that it certainly is a challenge when you are crafting these disclosures. To use Chris' words, there's obviously some tension or potentially could be some tension between, you know, adhering the disclosure requirements we need to make our financial statements accurate and at the same time not trying to put a road map out there of what we exactly think this case is worth to us, you know, should settlement discussions come up.

Peter Brennan - *ACCA - Chair, Litigation Committee*

This is Peter. I think they've highlighted that tension. Obviously there are discussions around what the disclosure would be, and that's actually a good opportunity where both the law and the finance function work certainly very closely together.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Wonderful. I think that the panelists have done a wonderful job and have generated a great deal of questions. Let me start, so that we can try to get all through the Web cast.

The first question is - Chris, I think it's directed to you - which EITF relates to the accrual of legal defense cost in an accounting policy? Does that make sense?

Chris Holmes - *Ernst and Young - National Director, SEC*

Sure. I love easy (inaudible) objective. No, that's EITF topic D77 is where that's discussed. And it was potentially raised as an issue that the EITF would consider mandating. And while it was thought that most people are in the expenses incurred, it was identified that not everybody's in that boat. And the way it was resolved was the SEC and server just said to the extent material that the SEC would look for, disclosure of that is a significant accounting policy.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Thanks, Chris. This one may be more - we may start with Peter. Please express (ph) how settlement offers are viewed in the FAS-5 (ph) analysis if the (ph) settlement offers establish at a least possible minimum liability. For example, could a liability still be viewed as remote when it has made a - when a settlement offer has been made.

Peter Brennan - *ACCA - Chair, Litigation Committee*

I think it would be difficult to - assuming it was a case where it has a materiality threshold. So we're talking real money. To say that it's remote and yet you've offered a substantial settlement for. I suppose if you've offered $100 on a case or some inconsequential amount, then maybe you could still say it's remote. But I will tell you as a practical matter I don't think you will offer an insubstantial amount and be having any kind of discussion with your financial people, because it will be so far below the materiality threshold that it just won't be of concern to anybody in the finance function of the company.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Yes, I would agree with Peter that practically speaking extending a settlement offer would be inconsistent with the remote classification and that you wouldn't, obviously, extend that offer if you really thought the chance of loss was slight.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Chris, any comments?

Chris Holmes - *Ernst and Young - National Director, SEC*

I would agree that I think in practice most companies to the extent that they determine and actually extend a settlement offer are viewing that as sort of - at least a minimum amount of probable loss and are providing for that. Clearly, if the offer's been made and is outstanding at the date that the financial statements are issued, I'd say, you know, practices of most companies would provide for that. To the extent that

maybe a low-ball offer is extended and then withdrawn, you know, and the company determines to vigorously defend the case, you know, was sort of a nuisance case that they tried to make it go away to save the future cost of defense, then there may not be an accrual at that point.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. And I think that kind of falls in line with another question that I see here which is related to settlement offers. And the question is, if that's on the table, would that be considered probable and estimable. And I think we've just answered that question.

Chris Holmes - *Ernst and Young - National Director, SEC*

To the extent that the offer is out there and it's accepted, you know, it effectively is a binding settlement. It's sort of hard to defend that it's not probable and reasonably estimable.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. One of our - I guess one of our Web cast attendees - that's probably the best way to put it - noted that we have a final hypothetical which was 'does it make a difference if you are an insurance company?' I think we mentioned that earlier, that it does. And you may have mentioned it, Bill, that.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, actually I think it was me.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

I'm sorry. Peter.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Peter. And it is FAS number 60. And I can't tell you that I'm an expert on it. What I can - I can answer the question that it does make a difference. I can also tell you that in practice, at least that I've dealt with insurance companies, that generally they're not working across the spectrum of probable, reasonably possible. If you think you're going to make - you make an assumption that all cases are going to settle - maybe not all - but you basically assume that any particular case will settle. And you pick the number that seems most likely to be the number that it'll settle at.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Yes, but not getting into specifics. You know, generally speaking, an insurance company is in the business of providing coverage for losses like this. So this is their basic business. So there are different accounting rules recognizing that it, you know, relates to a different industry. So to Peter's point, generally speaking, in an insurance company, losses like this would almost be (inaudible) (ph) cost of sales for a manufacturer, because that's the business they're in, as I mentioned. So there are some different accounting rules for them.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. We have a question on example number - which I believe is number two - the 55 percent example. And I believe - well, we may not have answered it specifically. If a company does decide to set a reserve for this example, what amount? The entire one million?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Yes, yes. In this example it would be the entire $1 million. And to recap what happens under the accounting rules is really, you know, two test. You know, first is we decide is a loss probable. And once we decide it's probable, that means we have to accrue it. And then the second thing is, well, what's the amount that needs to be accrued. And that's a function of if it's estimable. And then you take your best estimate. And if you think the loss, the ultimate loss would be a million, that's the best estimate of what that loss would be, you do record the full million. You do not, you know - the accounting rule does not allow you to, if you will, risk weight it or say there's a 55 percent chance I would lose a million. It's really kind of a yes/no going into accrual or not. Yes. And then if I need to accrue, the amount you accrue is your best estimate as to what that loss will be should you lose.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. Let me just move on. We have a number of questions. With respect to scenario number three, which the same as the number two with the 55 percent, you are unable to evaluate the chances of success, but you develop more facts

about the case over a course of time and through discovery. What level of knowledge is required to trigger an appropriate evaluation of success such that disclosure is required? In other words, how much do you have to know about a case before you are deemed to have sufficient information to make an appropriate evaluation?

Peter Brennan - *ACCA - Chair, Litigation Committee*

This is Peter. I think I can take that. The answer is you need to know enough information. And the answer with enough is, is going to vary on every single case. The one thing that is true with every case is that you continually re-evaluate the case as you go along. So facts change, testimony changes, you may have documents that develop over time, you know, as documents get produced. So as that case - and I'm sure every litigator certainly listening has had that experience - sometimes you may get a case and you think you've got a real problem and it turns out you got no problem at all, and sometimes it may be the exact reverse.

You know, as a defense strategy is developing, you know, each way along the line you're going to make some assumption about some evaluation of what the case is. You know, typically after you're seen some documents, that's certainly helpful. If it involves your company's conduct, you can usually investigate relatively quickly and at least get some basis, some idea as to whether there's a good claim or not a good claim. But a lot of times it can involve factors that are not within your control and that have to be worked out through discovery.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Great. I have a number of questions on offer and settlement. Why does an offer without the expectation that there will be settlement require a reserve? The offer may be tactical and may not reflect that the case is either estimable or probable. The company may just be willing to offer a number that either is designed to be tactical or represents defense loss. This is not a disclosure question.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Let me just start with a - this is Peter. Let me just start with a slight introduction here. I think from the litigator's standpoint what you're providing the financial people is the probable, the reasonably estimable. And you can also disclose what the offer is made. But I think simply because you've made an offer, from the litigator's standpoint, doesn't mean that you think that it's probable that you will lose that case. But with that information, I think the financial reporting people will have a different answer.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Well, correct. I guess my take is the presumption or the overriding presumption would be that you wouldn't make an offer unless you really thought there was a chance the company was going to lose. Now, that's not to say that every time you absolutely make an offer you would necessarily have to record it, but I do think you'd have to have a pretty compelling reason to overcome that presumption that, you know, you made an offer because you thought that a loss was probable.

Peter Brennan - *ACCA - Chair, Litigation Committee*

And there might be a compelling reason. And as I'm thinking about this question, the compelling reason the questioner may be referring to is sometimes there is, depending on what jurisdiction you're in and the various statutes, there can be a reason to make what's called an offer of judgment or something similarly titled that will entitle you to attorney's fees when you win the case. So that might be the kind of exception, but it's a relatively rare exception, I think.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

That's right, Peter. And, in fact, we have a question related to that on the offer of judgment and whether attorney's fees need to be added. And I'm not sure that - and whether that required the defense, then (ph), to reserve the amount of the offer and the - do the attorney fees, plaintiff's or defendant's, need to be added as part of that. And if the offer is rejected, does the answer change? I think they pretty much follow along the same lines here.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, I think the answer on whether the fees need to be included when you're doing the reserve is going to turn on what the statutes are, you know, what statute's controlling, what it says about fees. If the answer is - if I were to tell Bill we've made an offer of judgment for $100,000 on a case, and if they accept that offer they're also entitled to another

$100,000 in fees - Bill will tell you his answer - but I believe his answer is going to be he's going to be accruing for $200,000 because he's knows that's what you're going to be paying.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Yes. This is Bill. And once again, you know, what's most important here, I would say, especially in regard to the legal fee component, is that you do consistently apply over time your policy or your company's practice. But once again I would say our working presumption here is whatever settlement offers are made should generally be accrued, unless there's a compelling reason that we can show the offer was made for some other reason other than we expected the other side to accept it and close the case.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Right. In fact, I have two comments. One from a listener where they state that companies may make settlement offers to avoid the cost of litigation even if they believe the ultimate likely loss is remote. So that's a possibility. Then I also have a question/comment that states that it's not the case that settlements are only considered win/loss as probable. In some cases it is appropriate business decision to settle when it is possible to do so for less than the anticipated cost of litigation. And when should a company accrue under these circumstances, even if loss is not otherwise probable? So there are some other incentives to settling a case and it's not necessarily because they're probable.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, I think that question - this Peter again. I think that question may have come in after I sort of gave the information.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Right, right.

Peter Brennan - *ACCA - Chair, Litigation Committee*

There may be a divergence between the way the litigators look at the case and the way the accounting profession looks at the case. The key thing is, if you're a litigator, make sure you give the financial reporting people the information they need to make the judgment they have to make.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK, let me just move to a couple of different questions. Can the fact that an accrual has been taken because of a probable negative result ever be used against a company in the litigation? Interesting question. Any comments from the panel?

Peter Brennan - *ACCA - Chair, Litigation Committee*

I guess I'm the most expert on that, and I have not had that tried in any case that I've worked on. I would think the answer is no. But I can tell you one thing, that anytime a disclosure is made - I guess there are sort of two kinds of disclosures. One you won't see publicly because it will be baked into all the financial statements. So in that case I've never heard - but maybe it's happened that somebody actually got discovery into your financials as to whether you accrued a loss for a piece of litigation. I find it hard to believe, however, that a court would ever give somebody access to that type of information, although anybody who's litigated has probably found lots of things that are hard to believe actually happen. So that's one component.

The other component would be if you actually had some disclosure out there explaining that you made payment of X dollars. And I think you can be pretty sure that the disclosure is going to say something like we were vigorously fighting the litigation, but for business reasons we decided it was better to move beyond it and move on with our business. And I don't think there would be any type of admission. But I would think it would be closer to being comparable to saying, well, gee, they settled another case, we should be able to use that. And I think the answer on that is almost always going to be no.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. And following in that line. How do you avoid having to disclose reserves in such a way that your adversary knows what your position is on the case, Peter?

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes, and I think that's basically the same answer.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

The same.

Peter Brennan - *ACCA - Chair, Litigation Committee*

If there are (ph) reserves on it, you're not going to be making - it's going to be baked into your financial statement. So even if it's a substantial reserve it will be baked into the statement.

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

You know, I mean, and Peter's point - typically the reserve would not be a specific line item in the financial statements. They would be included with other liabilities and other reserves. So you would generally call them out specifically or specifically - or not on a case-by-case basis.

Peter Brennan - *ACCA - Chair, Litigation Committee*

Right. So when I'm using the phrase "baked in," I believe mean you've got a lot of financial information that goes into any company's reporting. It's not just litigation reserves - it's everything. And so this would just be one component that would be put in there to make the whole financial picture come out.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. And is there always a materiality issue in setting reserves? Can a company establish a policy that losses could not exceed whatever X amount of dollars, a low non-material number such as 100,000, do not have to be considered (ph) for reserves, or do all cases where a loss is both estimable and probable be reserved at that loss amount regardless of how small that amount is?

Bill Phelan - *Sears Roebuck and Company - Assistant Controller*

Sure. I mean, generally speaking, accounting rules do not have to be applied to items which are not material. Now, that being said, I think what most companies have done in practice, and something that we do in practice as well, is we do, if you will, stratify cases into two populations. One being - you know, one, cases that are individually not material. They're generally very small. I think someone used the term nuisance cases. There's probably a lot of nuisance cases in there. And then we'll take all of those cases and based upon what our historical settlement rate have been for those cases just record a number based upon the number of cases we have times our average rate for these cases. And that way you're not spending a lot of time, you know, agonizing and reviewing these cases case by case. Because it certainly would take a great deal of time for a lot of attorneys and accounting professionals for a case that maybe is - the estimated loss is going to be $500 to $1,000. It certainly would not be time well spent. So I think what most folks would do in practice is stratify it into two populations, one for the minor cases and then for the material cases whatever that threshold is for a company - it could be a million, 10 million, you know, $50 million - and then deal with the material cases on a case-by-case basis as outlined in the FAS-5 (ph) accounting rules.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. And I believe we have time for one more question for the panelists. And that is, in making the determination of the reasonably estimable amount of loss, do you subtract the likely amount of insurance coverage for the loss, if any? In other words, do you only need to worry about the net loss to the company.

Chris Holmes - *Ernst and Young - National Director, SEC*

Kathie, I'll take that first. The SEC ruling provided some guidance, you know, the staff accounting bulletin that dealt (ph) specifically with environmental contingencies, but it has broader applicability to all loss contingencies. And that really sets out a framework where there would essentially need to be a separate evaluation of the likelihood of loss to the primary obligor and then the likelihood of insurance recovery. So there probably had been some practice before that staff accounting bulletin to look at those on a net basis. But it's pretty clear that the staff's position is that those are separate evaluations, record the loss at its probable and estimable amount, and then to the extent that the company could substantiate recognition of an insurance recovery receivable that is also probable, to record that. But I think their view is it would be inappropriate to offset that receivable in the liability in the company's financial statements.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Bill or Peter, any further comments on that one?

Peter Brennan - *ACCA - Chair, Litigation Committee*

No. I mean, I obviously agree with what Chris said. Basically they just have to be recorded as two separate transactions, because what you have is a million dollar reserve for a potential litigation matter and offset by, let's call it - I'm sorry, not offset - but then you would also have a $600,000 or $700,000 receivable from a different party. And the reason that we have to record these things as two separate transactions is because they are involving two different parties. You know, a payment to one party and a receivable from a different party.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

OK. I believe we are very running close to the end of this Web cast. And I'm going to through it back to Peter. But before I do, there was a question on whether - where - and I don't know if, Chris, you would know - someone could get a copy of the accounting rules being discussed. Is that on a Web site? Or if not we can get back to this individually.

Chris Holmes - *Ernst and Young - National Director, SEC*

Yes, I don't think the FASB provides copies of its standards free of charge. There are a number of services that provide copies and they're available by subscription from the FASB itself. But I think most companies will have access to the FASB standards and will be able to provide someone with a copy of FAS-5 (ph) itself.

Kathie Lee - *ACCA - Vice Chair, Litigation Committee*

Wonderful. Peter, can I give this back to you so we can close out the Web cast?

Peter Brennan - *ACCA - Chair, Litigation Committee*

Yes. That would be great. Just on behalf of the litigation committee, I'd like to thank Bill Phelanand Chris Holmes for doing an excellent job and providing the time and effort that they have to make this Web cast successful, and also thank our Vice Chair, Kathie Lee, for doing a great job moderating the Web cast. And with that we'll conclude the Web cast. Thank you, everyone, for listening.