SEC Requirements for Disclosure / Accrual of Litigation, Governmental Proceedings and Other Loss Contingencies

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Overview of Public Company Disclosure

Disclosure by public companies is driven by:

- SEC Regulations
  - SEC Forms under the Securities Exchange Act and Regulation S-K
    - Annual Report on Form 10-K
    - Quarterly Report on Form 10-Q
    - Current Report on Form 8-K
  - Regulation S-X and GAAP Accounting Requirements

- NYSE Listing Requirements

Combination of disclosing:

- Required line items
- Additional information so as to avoid omissions
- Material non-public information whenever the company or “insiders” may be buying or selling securities
Overview of Public Company Disclosure *(continued)*

Litigation and Governmental Investigations

- Required to be disclosed in quarterly and annual filings with the SEC
- Disclosure may be triggered for securities transactions
- Upon the occurrence of certain events in litigation or government proceedings, it may be prudent or required for a company to make real time disclosure, even though there is no specific “line item” requirement
Overview of Disclosure Requirements Applicable to Litigation, Investigations and Loss Contingencies

Public company disclosures about loss contingencies primarily arise from the following disclosure obligations:

Body of Exchange Act Reports

- Legal Proceedings -- Item 103 of Regulation S-K
- Management’s Discussion and Analysis (MD&A) -- Item 303 of Regulation S-K
  - disclosure of uncertainties
  - disclosure of critical accounting policies
- Risk Factors -- Item 503(c) of Regulation S-K

Financial Statements

- Financial Accounting Standards Board (FASB) -- Accounting Standards Codification (ASC) Topic 450--Contingencies
Legal Proceedings -- Item 103 of Regulation S-K

- Requires disclosure of:
  - material pending legal proceedings
  - material proceedings known to be contemplated by governmental authorities
  - material proceedings to which an officer, director or greater than 5% holder is a party adverse to the company

- Disclosure not required for:
  - ordinary routine litigation incidental to the business
  - claims for damages for less than 10% of the current consolidated assets of the company

- Heightened standard (lighter trigger) for environmental claims
Legal Proceedings -- Item 103 of Regulation S-K (continued)

- Disclosure required under Item 103:
  - name of court or agency
  - date instituted
  - principal parties
  - description of factual basis alleged
  - relief sought
Timing of Reporting Legal Proceedings

- Forms 10-K and 10-Q require quarterly Item 103 disclosure for all material proceedings and additional disclosure regarding termination of proceedings during the period covered.
- Form 10-Q permits omission of any information previously reported, so that a company is only required to disclose material developments.
  - As a practical matter, most companies report the full information each quarter due to ease of presentation and sensitivity of the disclosure.
- After period end, but before filing date:
  - Common practice to include post-period material developments to previously disclosed proceedings, but rare to report newly initiated proceedings.
MD&A -- Item 303 of Regulation S-K

- MD&A includes a broad range of disclosure items that address the company’s results of operations, liquidity and capital resources
  - Requires disclosure of known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance
  - View the business through the eyes of management

- Materiality determination required
  - Probability that event will occur
  - Magnitude of the loss
MD&A -- Item 303 of Regulation S-K (continued)

- When an uncertainty, trend, demand, commitment or event is known, management must make an assessment:
  - Is it likely to come to fruition?
    - If not reasonably likely to occur, then no disclosure required
  - If unable to determine that an event is not reasonably likely to occur:
    - Objectively evaluate the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition
    - Disclosure required unless company is able to determine that a material effect on financial condition or results of operations is not reasonably likely to occur
MD&A -- Disclosure of Critical Accounting Policies

- SEC encourages companies to explain in MD&A
  - effects of their critical accounting policies
  - judgments made in application of critical accounting policies
  - likelihood of materially different results, if judgments turn out to be incorrect
- Auditors and audit committees are part of the process
- See SEC Release 33-8040, “Cautionary Advice Regarding Disclosure About Critical Accounting Policies” (December 12, 2001)
Risk Factors

- Regulation S-K 503(c) requires the company to provide under the caption "Risk Factors" a discussion of the most significant factors that make an offering of the company’s securities speculative or risky
  - Discussion must be concise and organized logically
  - Do not present risks that could apply to any issuer or any offering
Disclosure of Contingencies in Real Time

The SEC’s Current Report on Form 8-K does not have a “line item” for litigation or contingencies.

Still, public companies may be required to disclose contingencies in “real time” -- examples:

- Settlement or important ruling in “bet the company” litigation
- Catastrophic event likely to result in claims
- Raid by government agency or initiation of certain types of proceedings by governmental agencies

In evaluating real time disclosure, company should consider factors such as:

- Will adverse party / government make disclosure?
- Tactical or strategic purpose in making disclosure
- Company and its insiders may be unable to purchase or sell securities in the absence of disclosure
- Company desire to discuss litigation developments with investors and analysts
- Likelihood of rumors

Also note NYSE requirements for immediate public disclosure of material information and clarifications relating to rumors
Loss Contingencies -- ASC 450

- ASC 450 defines a “contingency” as:
  - an existing condition, situation or set of circumstances
  - involving uncertainty as to possible gain or loss to an entity
  - that will ultimately be resolved when one or more future events occur or fail to occur
- For purposes of this presentation, we will focus on loss contingencies, and especially those arising from:
  - pending or threatened litigation
  - governmental investigations and enforcement actions
- There are many other types of loss contingencies
  - damage to property by natural disasters or other hazards
  - tax disputes
  - warranty claims or product recalls
Financial Statement Accrual or Disclosure -- Analysis under ASC 450

ASC 450 is the applicable standard under US GAAP

See attached “Decision Tree”

First question: What is the likelihood of a material loss?

Three choices of “likelihood” -- probable / reasonably possible / remote
  o Probable: the future event is likely to occur
  o Reasonably possible: the chance of the future event occurring is more than remote but less than likely
  o Remote: the chance of the future event is slight

Note that ASC 450 applies only to “material” items
Treatment of Contingencies -- Remote Possibility of Material Loss

- Remote likelihood of a material loss -- no requirement for accrual or disclosure
- Some companies make disclosure of remote contingencies
  - Large claims, as to which company does not want to be wrong
  - While SEC objects to over-accruing, it does not object to over-disclosing
- 2010 FASB “Exposure Draft” (described below) would have amended ASC 450 to require disclosure of remote loss contingencies if potential impact is “severe”
Financial Statement Accrual or Disclosure -- Analysis under ASC 450 (continued)

Treatment of Contingencies -- Material Loss is **Possible**

- If material loss is **probable**, company must make **accrual** if amount of loss is **reasonably estimable**

- What is the amount required to be accrued?
  - estimated loss
  - if reasonably estimable loss is a **range**, then accrue:
    - amount that appears to be **better estimate** than any other estimate in the range, or
    - **minimum amount** in the range, if no amount is better estimate than any other amount

- If amount of loss is **not estimable**, then proceed as if in “Reasonably Possible” range (i.e., required to make disclosure, but no accrual)
Treatment of Contingencies -- Material Loss is Probable (continued)

- If the company makes an accrual, it is generally not required to disclose that it has made the accrual or to disclose the amount of the accrual
  - Exception: Company is required to disclose the nature of an accrual and the amount accrued if necessary to make the financial statements not misleading

- As a practical matter, large accruals will often be disclosed
Financial Statement Accrual or Disclosure -- Analysis under ASC 450 (continued)

Treatment of Contingencies -- Material Loss is Reasonably Possible

Disclosure of contingency is required if there is at least a reasonable possibility of loss and
   - an accrual is not made because either the loss is not probable or the amount cannot be reasonably estimated, or
   - the reasonably possible loss is in excess of an accrued amount

What disclosure is required?
   - nature of the contingency and
   - either (1) estimate of the amount or range of the reasonably possible loss or (2) a statement that an estimate cannot be made (and the reasons it cannot be made)
FASB Exposure Drafts -- Amendments to ASC 450

Exposure Drafts issued by FASB in June 2008 and July 2010

July 2010 version of the Exposure Draft would have imposed additional disclosure requirements relating to loss contingencies. Companies would have been required to disclose:

- additional information about material proceedings, similar to information required under Item 103 of Regulation S-K
- remote loss contingencies that could have potentially severe impact
- amounts of accruals, subject to some aggregated disclosure

Companies would have been prohibited from considering insurance and indemnification coverage in assessing materiality

Fire storm -- comments from public companies, business groups, corporate counsel and others

Amendments were not adopted, but note de facto adoption of some elements through SEC comment process (described below)
Treatment of Contingencies Under IFRS

Relevant Standard is IAS 37 -- Provisions, Contingent Liabilities and Contingent Assets

- characterized by the same sorts of ambiguity as ASC 450
- this ambiguity allows company to employ similar range of judgments

International Accounting Standards Board (IASB) had series of exposure drafts for proposed amendments, in the same timeframe as the FASB (2005 and 2010)

- theme of greater precision / rigor in accruals; probability-based assessments with fair value determinations
- now, back to the drawing board for the IASB, and these amendments do not seem to be a priority

Given low priority of IAS 37 (for the IASB) and lack of momentum for “convergence”, fair to say that IFRS is having minimal impact on approaches taken by US companies
Recent SEC Focus on Loss Contingencies

- During the financial crisis, the SEC noticed financial institutions recording large losses arising from matters that had not previously been disclosed
  - Going from remote to probable with no intervening disclosure
- SEC staff made speeches and sent comment letters questioning whether companies were complying with disclosure standards
  - SEC’s Chief Accountant: disclosure may state that an estimate cannot be provided “with certainty” or “with confidence” but registrant is expected to demonstrate that it attempted to estimate the loss before concluding it could not be estimated
  - SEC took the position that boilerplate statement that proceeding is not expected to have material adverse affect on business amounted to an estimate, and that companies must provide these estimates
  - SEC suggested that where companies are unable to estimate possible loss (or range), they should consider providing additional disclosure for investors to evaluate
Recent SEC Focus on Loss Contingencies (continued)

- In 2011, influx of SEC filings disclosing “reasonably possible” litigation losses in response to SEC pressure
- Chief Accountant took the position that disclosure of a “reasonably possible” range of loss may be done in the aggregate for multiple matters
  - Aggregate range of reasonably possible losses where able to provide an estimate
  - Alert investors that not able to provide a meaningful estimate of reasonably possible loss or range for all litigation
- Many financial institutions disclosed very broad ranges of reasonably possible losses and did not disclose which of their proceedings are included within the range
Recent SEC Focus on Loss Contingencies (continued)

- SEC requiring companies to disclose why they are unable to estimate reasonably possible losses
- Companies often cite the following reasons for being unable to make estimates:
  - early stage of litigation / discovery
  - unresolved questions of fact
  - uncertainty regarding the scope and size of class, time period covered by claims, prevalence of alleged misconduct, etc.
  - novel types of claims / unresolved question of law
Recurring Scenarios under ASC 450 -- Unasserted Claims

No disclosure necessary if
- there is no manifestation by a potential claimant of an awareness of a possible claim
- **unless** assertion of the claim is probable and there is a reasonable possibility the outcome will be unfavorable

Consider scenarios such as:
- government investigating competitor’s business practices, which are also used by the company
- company has infringed on a competitor’s patent rights
- catastrophe or accident
Recurring Scenarios under ASC 450-- Routine Claims for Damages

Issue: A company has a large number of relatively small claims for damages, most of which arise in the ordinary course of its business. None of these claims individually meets the “materiality” threshold of applicable accounting or legal standards. In some of the cases, the company believes that it is “probable” that it will have a loss, though this loss is not expected to be material.

Analysis:

- The company is not required to make disclosure with respect to any of these individual matters, but may find it prudent to disclose that it is subject to such matters in the normal course of its business
- Companies typically record accruals on a claim-by-claim basis, regardless of the fact that each of the claims is immaterial, rather than recording losses on a “cash” basis
- Companies have internal procedures for tracking matters and recording quarterly accruals
- The amount of accruals for these matters is not required to be disclosed
Recurring Scenarios under ASC 450 -- Legal Fees and Expenses

While litigation is ongoing, company will ordinarily record quarterly charges for legal fees and expenses, on an ongoing basis

- Accrual for the litigation itself usually comes relatively late in the proceeding, so there is nowhere for the legal fees and expenses to go, except current charges

- When the company eventually makes an accrual for the costs of the underlying litigation, it will usually include estimated legal fees and expenses to completion of the proceeding

- Usually, too speculative for company to make estimate of future legal fees and expenses; not reasonably estimable, in the absence of accrual for the case itself
Recurring Scenarios under ASC 450 -- Insurance Coverage

- ASC 450 and exposure drafts when read together suggest that, under current guidance, a company may consider its insurance coverage in evaluating likelihood of material loss (i.e., having adequate insurance for an insurable loss suggests no accrual or disclosure)
  - ASC 450 does not contain a specific instruction to consider insurance in evaluating a loss
    - Exposure draft would have changed the general approach (of considering insurance) but was not adopted
    - Typical practice seems to call for a facts and circumstances analysis that includes consideration of insurance coverage
- Under ASC 450 the absence of insurance against losses for property damage is a loss contingency (an existing condition involving uncertainty about a loss that might occur)
  - However, absence of insurance does not mean an asset is impaired or liability incurred prior to the incurrence of the event causing damage
Recurring Scenarios under ASC 450 -- Settlement Discussions

- Issue: Once a company has commenced settlement negotiations and made an offer of settlement, is the company required to accrue the offer as the “minimum amount” of a range for a probable loss?

- Review of large settlements of recent government investigations shows that:
  - Companies do not generally accrue a charge until the settlement negotiations proceed to “advanced discussions” or until the parties reach an “agreement in principle”
  - Company estimates turn out to be accurate

- Key consideration in analyzing settlement offers, made to a third party or the government:
  - Accrual is only required (or permitted) if the loss contingency is “reasonably estimable”
  - An offer is not, de facto, a reasonable estimate of the loss contingency
  - “Integrity of financial statements” is a primary concern of the accounting standards
Recurring Scenarios under ASC 450 -- Settlement Discussions (continued)

- Questions to ask in considering whether a settlement offer will trigger an accrual
  - Which party initiated settlement discussions, the company or adverse party / government?
  - Is the company merely testing the waters in settlement talks or is it committed to settling?
  - How does the company’s board feel about settling the case?
  - Is the company able to pull the settlement offer off the table?
  - What is the range between the offer by company and demand by adverse party / government?
  - Is there a track record of similar cases settling? Commercial valuation of cost to settle?
  - Does the company continue to have option of litigating the claims?
Recurring Scenarios under ASC 450 -- Settlement Discussions (continued)

Throughout settlement discussions:

- company must continue to consider whether loss is probable and whether loss is reasonably estimable
- the factors described above may shift suddenly or there may be gradual narrowing of the “bid” and “ask”
Recurring Scenarios under ASC 450 -- Timing of Accrual / Disclosure

- Consider scenario in which settlement discussions progress during the period between the end of fiscal quarter (e.g., September 30) and filing of the Form 10-Q (e.g., November 5)
  - Progress in settlement discussions after end of fiscal quarter, but before filing of Form 10-Q may require accrual at end of fiscal quarter (September 30)
  - Literature suggests distinction between recognition certainty and measurement certainty
- There is often pressure to bring settlement discussions to closure (accrual), by end of the fiscal period (September 30)
Attorney Letters

In order to assist independent auditors in evaluating litigation contingencies, the company general counsel and outside law firms provide letters to the independent auditors, describing cases that they are handling.

These “attorneys response letters” are governed by the ABA Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information (December 1975), known as the “ABA Statement” or the “Treaty.”

Attorneys Response Letters take different approaches to:

- Overtly threatened or pending litigation -- attorneys provide auditors with assessment of the matter
- Unasserted possible claims -- law firm confirms to auditors that it brings these matters to the attention of the company
Management Representation Letters

- AICPA U.S. Auditing Standards (AU), Section 333 covers “Management Representations”
- Auditor obtains written representations from management to complement other auditing procedures
- Independent auditors typically follow the “Illustrative Management Representation Letter” included in AU 333, but add representations to address the most critical matters
- Management typically provides representations as to numerous subjects, including:
  - no violations or possible violations of law or regulations whose effects should be considered for disclosure or accrual
  - no unasserted claims or assessments that lawyer has advised are probable of assertion and must be disclosed under ASC 450
- Management representation letter will typically be 5 to 10 pages, signed by CEO, CFO and CAO; other officers may sign as to representations within their areas of expertise
How it all fits together

- Three different regimes requiring the disclosure of litigation and investigations -- SK Item 103; S-K Item 303 and ASC 450
  - In theory, each of these regimes calls for different information, and the SEC Staff has specifically noted the different disclosure objectives served or intended to be served
- Information must be presented in financial statement footnotes; in other places many companies either use cross references to financial statement footnotes, or repeat the disclosure from the financial statements, rather than tailoring the disclosure to the different requirements
How it all fits together (continued)

- “Risk Factor” and “Critical Accounting Policies” disclosures speak in different voices, so that specific matters are less likely to be disclosed in full.

- Companies could conclude that no disclosure is necessary under ASC 450 (e.g., a remote possibility of a material loss) while a materiality determination under S-K Item 103 (e.g., a low probability of loss but the anticipated magnitude is significant) could still require disclosure, or vice versa.

- Most important for company attorneys - being able to spot the issues and to discuss these issues within the framework of applicable accounting and legal requirements.
ASC 450 – Loss Contingencies – Decision Tree

Start

Is amount of loss estimable (amount of the loss can be “reasonably estimated”)?

Yes

Record accrual for loss contingency and follow steps 1, 2 and 3, as applicable

No

Probable (material loss is likely to occur)

What is likelihood of material loss?

Remote (chance of material loss is slight)

Reasonably Possible (chance of material loss is more than remote but less than likely)

Is amount of loss or range of loss estimable?

Yes

Is loss in excess of accrued amount “reasonably possible”?

No

Accrue estimated loss or, if reasonably estimable loss is a range, accrue either

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Amount that appears to be better estimate than any other estimate in the range OR

Minimum amount in the range, if no amount is better estimate than any other amount

Is disclosure of accrual necessary to make financial statements not misleading?

Yes

No

Yes

No

Remote

No accrual or disclosure is required

Disclose nature of contingency and estimate of amount of reasonably possible loss or range of loss (in excess of any accrual, if applicable)

No additional accrual or disclosure required

Disclose nature and amount of accrual

No disclosure required