MINUTES

To:	Board Members
From:	Disclosure of Certain Loss Contingencies (Milne, ext. 393)
Subject:	Minutes of the March 6, 2009 Afternoon Session Roundtable Meeting: Disclosure of Certain Loss Contingencies
Date:	May 26, 2009
cc:	FASB: Bielstein, Golden, Stoklosa, Proestakes, Leisenring, Elsbree, Lott, Posta, Glotzer, C. Smith, Mechanick, Hood, Brickman, Fanning, Milne, Gabriele, Chookaszian, Klimek, Galloway (GASB), Intranet; IASB: Brown, Baldurs

The Roundtable minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic:	Disclosure of Certain Loss Contingencies
Basis for Discussion:	Exposure Draft, *Disclosure of Certain Loss Contingencies* FASB Roundtable Agenda and Examples of Disclosures (See Appendixes 2 and 3)
Length of Discussion:	2:00–4:30 p.m.
Attendance:	See Appendix 1

Objective of Meeting:

1. The objective of this meeting was to solicit feedback from constituents regarding the proposed improvements to disclosures of certain loss contingencies. The basis for discussion was the FASB Exposure Draft, *Disclosure of Certain Loss Contingencies*.

Introduction

2. Mr. Elsbree provided a summary of the topics discussed at the morning roundtable.[1] He said one of the key ideas that received broad consensus was that disclosures should focus on contentions and factual information rather than predictions about the potential outcome of the contingency. He also mentioned concerns that had been expressed about disclosing certain types of factual information, citing as examples possible insurance recoveries and the claim amount. He noted that the group also discussed the sensitivity of settlement negotiations and the purpose of the Treaty.[2]

Claim Amount

3. Mr. Golden noted that in the morning session, it was clear that disclosing information that needed to be predicted was more difficult than disclosing factual information. He stated that, nevertheless, the morning participants seemed concerned that disclosing the actual amount of a claim could be misleading.

4. Ms. Griggs stated that the amount of the claim could be inflated and not based on reality, which could lead investors to believe the company is in a worse situation than it actually is. Mr. Golden asked if it would be reasonable for a company to describe why it believes a claim amount is inappropriate. Ms. Griggs said it would depend on the stage and nature of the case and whether the company had prior experience with a similar claim. She stated that if a company included helpful disclosure about why it felt the claim amount was a misleading number, the auditors would have to audit that assertion and the numbers, which would likely prove challenging for the relationship between the auditors and the attorneys.

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[1] For more information about the discussions at the morning roundtable, see “Minutes of the March 6, 2009 Morning Session Roundtable Meeting: Disclosure of Certain Loss Contingencies.”

[2] The term *Treaty* refers collectively to AICPA Statement on Auditing Standards No. 12, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments* (codified as AU Section 337), and the American Bar Association’s *Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information*.

5. Mr. Uhl stated that he shares Ms. Griggs' concerns that the claim amount could be inflated. He noted that there could be two different cases with the same claim amount. In one case, the claim amount is inflated, and in the other case, the claim amount is based on a reasonable analysis. By just disclosing the claim amount, it could be misleading because it tells the reader nothing about what went into determining that amount. If the defendant were required to disclose its views about the claim amount, information supporting that analysis likely would be subject to attorney-client privilege; therefore, auditors would not have access to the necessary information to audit management's assertions.

6. Mr. Dimitrief posed the question of whether a disclosure is the appropriate place for a company to try a lawsuit. He said that even asking a company to provide a fair, factual description of cases puts a burden on a company. The description of the case will be assessed by others, including the opponent, who may claim some information is left out of the disclosure. For example, the plaintiff might ask why a certain defense being presented in the case was not listed in the financial statement disclosures and argue that its absence means the defendant must not have believed too strongly in that defense. Effectively, all of the standards of litigation then are imported into the disclosure standard. He said the additional burden is an unintended consequence of a well intended desire for better disclosure. He also raised concerns that it may be difficult to provide all of the relevant information in a short summary for the footnotes.

7. Mr. Genovese stated that the claim amount would not be helpful to users because it does not have sufficient predictive value. He said that in his company's experience, the claim amount is not reasonably related to the actual disposition value of the case. The number may also be confusing to financial statement users unless a very detailed description of the lawsuit is provided.

8. Mr. Golden asked if disclosing the claim amount along with management's estimate of the ultimate outcome or how management plans to defend the case would have predictive value. Mr. Genovese said that disclosing management's evaluation of

the ultimate outcome would tie the company's hands when defending a case. Disclosing an amount would make it very difficult to settle a case for less than that amount; it would not be useful to shareholders because it would decrease shareholder value. He stated that preparers could include some discussion, such as the factual description of the claim, the defenses, and the name of the case and filing dates, so that large sophisticated users could gather their own information from public systems like Lexis, Westlaw, or PACER. He noted that this information would be more useful and less prejudicial than including an exposure assessment.

9. Ms. Griggs stated that the stage of the case would determine if this information would be useful. In the early stages of the case, a company might not know how it will defend the case. She said having a basic principle to tell people what the risks are would be more useful because there is no way to require the same specific types of disclosures for all types of cases.

10. Mr. Linsmeier asked what the difference is between providing a link in the footnotes to the court documents (which would include the claim amount) and providing the claim amount itself in the footnotes. Either way, the user is going to gain access to the claim amount.

11. Mr. Genovese replied that there is a very different perspective and analysis when a sophisticated user looks at the entire case docket, including briefs, attorney's opinions, and so on versus when a user has only a short disclosure with the claim amount and not much discussion around the amount.

12. Mr. Siegel asserted that a link to where the claim amount can be found would lead a user to the plaintiff's filing, which would give only a one-sided view of the case and would be more prejudicial. Mr. Genovese replied that a user looking at a case docket could review all of the relevant documents from both sides and obtain a balanced view of the case. Nevertheless, there may not be much on the docket for an outsider to review early in the case.

13. Mr. Linsmeier stated that in the morning session, the participants discussed developing a disclosure requirement that states: (a) do not reveal predictive information and (b) present disclosures of publicly available, material facts related to the case. He asked Mr. Genovese if his view would change about disclosing the claim amount if the disclosure explicitly stated that the amounts were not predictive but were merely a summary of the case. Mr. Genovese said he still believes that disclosing the claim amount would not be useful because it is not relevant, reliable information. He indicated that he believes other relevant qualitative information would be more useful to users.

14. Ms. Griggs said just putting factual information in the financial statement disclosures, without anything else, may be misleading. She noted that management may believe disclosing only the plaintiff's contentions would unduly alarm investors and, therefore, they would want to provide follow-up disclosures, and the follow-up disclosures are what raise concerns for her. A user might read the contentions of the parties and still not understand the risks. She said if companies were required to explain the risks it would provide more meaningful information.

15. Mr. Linsmeier stated that a risk presentation would seem to be predictive. Ms. Griggs acknowledged this and indicated that it may not be possible to provide in all situations. She said it needs to be up to the company, and that is why she is suggesting a principles-based approach. Mr. Linsmeier expressed concern that this approach might yield the type of disclosure included in Example 1.[3]

16. Mr. Smith questioned Ms. Griggs because she seemed to support never disclosing the facts of the case. He observed that there was almost unanimous consensus in the morning session that Example 1 was relatively useless but now there seemed to be a different tone among the afternoon participants. Ms. Griggs responded that there is already a requirement in Item 103, *Legal Proceedings*, of Regulation S-K to disclose the facts alleged and relief sought for all material litigation.

[3] The examples discussed are included in Appendix 3, *Examples of Disclosures for Discussion Purposes*, which was circulated to roundtable participants.

17. Ms. Seidman asked Ms. Griggs if she disagreed with this requirement or had a different scope in mind than what is already required. Ms. Griggs replied that the disclosure in Item 103 does not give rise to a dialogue about the consequences. She said her concern is that if an entity provided the dialogue in the notes to financial statements, it would raise questions about what the users will really understand.

18. Ms. Seidman asked how that dialogue would be different from what sophisticated investors would find if they took the time to look in the court dockets. Ms. Griggs stated that the briefs are very long, perhaps 50 pages, and no one would want disclosures of that length in the notes to financial statements. Ms. Seidman asked Ms. Griggs if her concern was more about the ability to summarize all of that information in a meaningful way than about the possible prejudicial effects of that disclosure. Ms. Griggs answered yes, if many papers that have been filed.

19. Mr. Prezioso stated that there are many factual elements of a case. He said that it is difficult to find an approach in which one can determine in advance how to deal with the wide range of different scenarios that can arise in litigation. He noted that not every relevant fact in a case is in the public domain. He said there is an evolution that takes place in litigation, and the knowledge that the parties have about a case, as well as their analysis of the situation, will change over time. He stated that management may not want to make disclosures about certain claims just because they meet a very low standard, and they may not want to dignify such a claim with a response. Additionally, the company may not have had time to formulate its response within the time frame required for the financial statements because it does not control when the plaintiff files documents. He advised against a prescriptive approach to disclosure requirements because it would take away a critical aspect of the process, namely, evaluating what information is truly useful to users and what the company can make known.

20. Ms. Minke-Girard asked if the difference between having the information in the notes to the financial statements versus having it in Item 103 is that the notes are audited. Ms. Griggs responded that the Item 103 disclosure was meant to be a

factual description of material litigation that was filed. This excludes litigation in the ordinary course of business. Over time, auditors have insisted that this description be included in the audited financial statements. As a result, oftentimes the Item 103 disclosures are in the footnotes and incorporated by reference into Item 103. Thus the regulation is not being used as it was originally intended, but it would still be a good way to approach the disclosures. Item 103 has a materiality test as well, and the footnotes do not have an exclusion for ordinary course litigation. Ms. Minke-Girard confirmed that, based on her limited review of companies' filings in preparation for the roundtables, most companies included their Item 103 disclosures in the footnotes and incorporated those by reference into Item 103.

21. Mr. Genovese observed that the footnotes do have a disclosure threshold for cases with a possible material adverse affect. He noted that it would be difficult to have a rule to satisfy every case or circumstance but suggested a compromise of disclosing a description of the case, a description of the claim, any known defenses, and the procedural posture. He explained that he was concerned about having to disclose quantitative assessments. He supported limiting the disclosure to factual information and making the name of the case available so that investors could look it up. He thought this approach would be beneficial to users.

22. Mr. Golden asked users if they would be satisfied by this information.

23. Mr. Hurwich stated that the purposes of disclosures are to enable users to assess risk and make a valuation of whatever the person is considering investing in. He said that the information recommended by Mr. Genovese does not provide the ability for an investor to make a decision. He noted that materiality is relative and that just because a company is not bankrupt does not mean it is a good investment. He said that the type of disclosure recommended by Mr. Genovese would not enable an investor to determine that an investment trading at $50 is really only worth $40. He asked Mr. Genovese what kind of disclosure he would encourage that would allow this distinction to be made. Mr. Genovese replied that he would be concerned

about including a valuation because it could damage shareholder value if the entity ended up having to pay more to settle the litigation due to the inclusion of a quantitative amount. Mr. Hurwich stated that in the morning session there seemed to be agreement that some sort of metric needs to be developed that gives the probability of an event and the magnitude associated with the event occurring. Mr. Genovese stated that there is some quantitative information that could be disclosed, such as jury verdicts as in Example 2, but it would depend on the case and whether the information would be prejudicial. Mr. Hurwich asked him if he supported aggregation. Mr. Genovese said it depends because sometimes aggregation works but smaller companies would still face issues with the information being prejudicial.

24. Ms. Griggs commented that litigation is so unpredictable that in many cases the company honestly does not know what the outcome will be. She cited the Wyeth Supreme Court case,[4] which was discussed in the morning session. She said companies need to be challenged to say what they do know.

25. Mr. Herz stated that the concern has been whether the problems arise from (a) inadequate implementation of existing requirements or (b) the requirements falling short of eliciting the necessary information. He said that figuring out how to improve practice without creating self-fulfilling prophecies is the real challenge.

26. Ms. McEnally stated that investors are in the business of evaluating risk and returns. She noted that there are no amounts in the financial statements that are 100 percent certain, but investors are grateful for every piece of information provided because management is in the best position to provide the estimates. She said the key question is: What is necessary to give investors sufficient comfort to make their investment and minimize the company's cost of capital while maximizing the amount of capital available to the company? She said a balance must be reached so companies will provide enough information to maximize their opportunities to access capital markets and still not take undue risk. She asked how much

[4] See *Wyeth v. Levine* Opinion of the Supreme Court of the United States.

information managers can disclose to provide assurance to investors so they understand the risks. She noted that information in the public domain should comprise some of the minimum set of information to be disclosed. She asserted that management is not hurting the company by providing a summary of the key information in the court filings that can help investors assess the potential risks and rewards. She asked preparers what the problem would be with making disclosures similar to Example 2.

27. Mr. Genovese said that the disclosure in Example 2 is possible because the cases are far along in the litigation process and the information is not prejudicial. Many of the quantities provided are either government fines or jury verdicts, which do have predictive value. He noted that the open cases seem very similar to the cases that have been completed, so there is some likelihood that they will be resolved in the same way as in the past. Ms. McEnally asked specifically about the quantitative estimate of the possible additional exposure in the last paragraph of Example 2. Mr. Genovese speculated that in earlier years this company may not have provided such estimates but that he did not know for certain. He said he is not sure every company would be in a position to make such an estimate.

28. Ms. McEnally observed that the company in Example 2 has one of the lowest costs of capital and has never had difficulty obtaining capital; meanwhile, it has, more often than not, been very forthcoming in its disclosures.

29. Mr. Dimitrief responded that the company in Example 2 is comfortable making the disclosure because the exposure is reasonably estimable at this stage. He said he would be concerned if the company had made the disclosure early in the litigation process because then the amounts probably would not be reliable. He commented that there is no problem with existing disclosures because companies usually do not have reasonable estimates to share. He said requiring information at a premature stage would suggest a false degree of precision.

30. Ms. McEnally said that she generally agrees with Mr. Dimitrief's points and noted that all cases have a life cycle of their own with different information available at

each stage. She said that there is qualitative information available about the nature of the cases in Example 2, and such information could be disclosed to assist investors with further research.

Threshold for Disclosure

31. Mr. Golden asked what the threshold for disclosure should be and whether there should be different disclosure requirements based on either the likelihood of loss or some other criterion.

32. Mr. Pippolo stated that if the likelihood of a contingency is remote, disclosure of that contingency seemed to be less useful. Therefore, such a contingency seems to require less disclosure. Mr. Leisenring noted that reaching a conclusion that the contingency will be remote or not material involves making a prediction. He observed that this seemed to conflict with the conclusion in the morning session about focusing the disclosures on the contentions of the parties rather than predictions. He also noted that some participants seemed to be asserting that some facts are appropriate to disclose but that other facts would be misleading. He said a company cannot pick and choose what it is willing to make predictions about or what facts it will disclose.

33. Mr. Pippolo supported a disclosure approach that focuses on facts because that information could be easily audited. Predictive information is much more difficult to audit and requires much greater reliance on counsel.

34. Mr. Santarelli wondered how one would audit an assertion that certain claims are frivolous and asked Mr. Leisenring whether he thought *more than remote* was not an appropriate threshold. Mr. Leisenring responded that he was merely observing that people seemed to think making predictions was appropriate in certain circumstances but not in others. Mr. Herz responded to Mr. Leisenring’s observation that it seemed preparers want to make predictions if it allows them to exclude disclosures.

35. Mr. Lewis said that if a contingency is remote but could have a severe effect (for example, *bet-the-company* kinds of risks), that fact should be disclosed along with some information surrounding the case. However, trying to make a quantitative disclosure in that circumstance probably would not be the best use of the company's resources.

36. Ms. Seidman said that investors want good information about the nature, timing, likelihood, and magnitude of a claim. She summarized that it seems when a loss contingency is remote, far into the future, and involves low dollar amounts, not much would be disclosed in the financial statements. On the other hand, when a loss is likely, near-term, and involves large dollar amounts, thorough disclosures should be included in the financial statements. She suggested that a principle could be developed around these ideas. Cases can evolve over time, and the level and preciseness of disclosure should change accordingly.

37. Mr. Genovese liked Ms. Seidman's description but was still concerned about being required to disclose information that would tie a company's hands when trying to defend a lawsuit. He thought a principle like that could work if everyone agreed that a company would not have to disclose information that would tie its hands.

38. Mr. Santarelli asked if there would be value in a disclosure simply about the existence of remote litigation, perhaps with a narrative description of the litigation but without numbers. Ms. Seidman clarified that it depends on the facts and circumstances. If the information available indicates the amounts could be large, that might influence what a company discloses.

39. Mr. Linsmeier stated that separating likelihood from magnitude may not be productive. He said the real issue is materiality. A case could have a low probability of loss but a large magnitude of potential loss, and a company should be disclosing that information. Mr. Santarelli argued that a case does not become material until a loss becomes likely. Mr. Linsmeier responded that if there is a risk that the company could cease to exist, even if that risk is very low, that is

potentially material information. Mr. Santarelli raised the concern that a company might have to disclose every possible risk under that view.

40. Mr. Santarelli stated that the $2.2 billion disclosed in Example 2 is possible because that amount is not material to a company with $100 billion in cash. He wondered whether the company in question would disclose the $2.2 billion of additional possible loss if it had only $2.2 billion in cash. Mr. Elsbree noted that the opposite view also has been argued, namely that large companies cannot make too much disclosure because they have the deep pockets and everyone would go after them.

41. Mr. Genovese stated that there must be some sort of a threshold because companies may have thousands of outstanding claims, many of which are frivolous. He said that disclosing all remote claims would not be useful for a company or the users.

42. Mr. Hurwich indicated that he agreed with Mr. Genovese's comments but expressed concern that a company might apply that logic to situations that, while remote, are causing the CEO anxiety. He felt that a standard needs to be drafted to capture those circumstances. He noted that the degree of subjectivity involved causes investors to want disclosures to be more inclusive. He reiterated his point from the morning session that management and the stakeholders of a company do not have the same interests.

43. Ms. Griggs stated that the Supreme Court has already articulated such a standard that instructed to balance the probability against the magnitude. Mr. Linsmeier stated that this is similar to what he meant: do not split likelihood and magnitude but bring them together to look at materiality. He said the struggle has been that the standards written are time and case invariant. He summarized that he hears from preparers, auditors, and lawyers that if the disclosure requirements are too prescriptive and more consistent with the level of information that is available in the late stage of a case, those requirements will force companies to disclose too much information about cases that are in an early stage. Companies want to protect themselves from having to disclose frivolous cases. He commented that if standard setters respond to that and allow those cases not to be disclosed, there may be

difficult cases that go undisclosed that result in losses. He agreed with Ms. Seidman that the Board needs to develop a principles-based standard that discusses the issues that need to be explored and can adapt over time as more factual information becomes known. He said under the current Statement 5, if an amount is not reasonably estimable quantitative disclosures are not required, which results in quantities never being disclosed. Mr. Herz commented that companies disclose quantitative information only if they want to dispel uncertainties.

44. Mr. Herz noted that he is confused by people saying that cases are very idiosyncratic and anything can happen. He made an analogy to financial institutions that wrote liquidity arrangements related to off-balance sheet items. The likelihood of losses from those arrangements was viewed as remote and not material, but it turned out that those arrangements were *bet-the-company* kinds of transactions. He commented that he hears arguments that lawsuits are so unpredictable, yet people want a cut-off to exclude things from disclosure, and he struggles to reconcile those two points.

45. Mr. Dimitrief responded to Mr. Herz' comments by saying that when a company has an asset on its balance sheet, it has an obligation to value that asset. There is only one party assessing the relevant information; there is no plaintiff involved who takes a different view about that asset. He noted that a lawsuit is not an asset. He said that in litigation, by definition there is a disagreement and an adversarial process in which different parties have an incentive to overstate a claim. He asked why valuation disclosures should be required that would benefit the other side. Mr. Herz clarified that he was not talking about valuation of cases but about making a judgment that something is remote or making a materiality judgment (probability multiplied by amount) to conclude that disclosure of a contingency is not required. He said that the circumstances are very unpredictable, and making an evaluation that something is remote seems counter to that assertion.

46. Mr. Santarelli stated that the level of predictability increases as the case proceeds. He noted that a transition disclosure could be included to show where the case was in the past and how it is proceeding. Investors could even use this disclosure to score the accuracy of a company's disclosures.

47. Mr. Smith noted that part of the standard setters' concern is that recent experience has shown that people's assessment of what is remote is not very good. He said that to the extent something is deemed remote and, therefore, not disclosed causes concern that the disclosures are inadequate.

48. Mr. Pippolo stated that there needs to be a threshold for disclosure because if a company disclosed every single case, the truly significant cases would be buried in excessive disclosures. Mr. Smith noted that this conclusion was different from the morning session's because in that discussion, from a practical standpoint, all litigation was considered to be at least reasonably possible. Mr. Genovese indicated that many cases may be immaterial, and that he meets with the auditors quarterly to get them comfortable with the company's assessment of those cases and the amounts accrued.

49. Mr. Linsmeier clarified that the question is not whether there should be a threshold; the threshold is always materiality. The question is whether there should be a unique threshold for loss contingencies. He said that he is not convinced there is a benefit to using the likelihood of loss to modify the materiality threshold.

50. Mr. Uhl said that his firm's comment letter proposed having two thresholds for disclosure: (a) magnitude, for example based on the term *severe* used in the Exposure Draft and (b) a tiered approach so that remote contingencies do not require the same disclosure as reasonably possible contingencies. He suggested requiring only qualitative disclosures for remote contingencies and both qualitative and quantitative disclosures for reasonably possible contingencies. Ms. McEnally expressed some concern that if those were the requirements, all loss contingencies

would be assessed as remote. Several participants responded that they thought auditors would not allow that to happen.

Legal Constraints

51. Mr. Golden asked about the legal constraints surrounding the disclosures, including attorney-client privilege and the Treaty.

52. Mr. Prezioso said that a balance needs to be reached between the likelihood of loss and the magnitude. He noted that this balance entails looking at the potential for the company or its shareholders to be hurt by the disclosures. He emphasized that the U.S. legal system does not involve a neutral party trying to ascertain the facts and come to a conclusion; rather, it is an adversarial system. In this context, it is critical for companies to be able to speak candidly to their lawyers. He said that the protection of this communication provides the counterbalance that makes the entire system work. He noted that there is a high degree of uncertainty in litigation and stated that there is a real risk that prejudice can be created and that the disclosure may not even be beneficial to users. The challenge is to ensure that audits are of a high quality, and, at the same time, clients' privileges are adequately protected. Auditors have felt a lot of pressure recently to understand and document the views of lawyers, and lawyers have felt that pressure in a way that suggested privilege may need to be waived. He stated that there are definitely things that could be done to improve disclosures, but it may need to be done in a broader context than merely the financial statement disclosures, for example, in *Management's Discussion and Analysis of Financial Condition and Results of Operations* (MD&A). He said a company cannot be required to disclose something it does not know, and there is a particular risk that if something is expressed in the wrong way, it can be used against the company. He commented that providing additional guidance in terms of a principle would be useful. However, trying to create a system that assumes a company can do something that it cannot or to create a rigid framework that lays out exactly what should be disclosed in all circumstances would not be appropriate because judgment will always be part of the process.

53. Mr. Golden asked about the tension that was created by the Exposure Draft with regard to attorney-client privilege and the Treaty. He asked what would need to change in the auditing literature and the understanding between the auditors and the attorneys. He said that in the morning session, a view was expressed that the Treaty would still be able to function without any changes, but that this view differed from what he had read in many of the comment letters. He asked participants to focus on the proposal in the Exposure Draft.

54. Mr. Pippolo expressed concern about being able to audit (a) an assertion that certain information is prejudicial, (b) management's estimate of the maximum potential loss, and (c) management's qualitative assessment of the most likely outcome, none of which are contemplated by the Treaty. The Treaty provides for counsel to provide an opinion on the likelihood of the outcome only if it is *probable* or *remote*, with probable being an extremely high threshold and remote being an extremely low threshold. No assessment of likelihood is given for anything that is between those two categories, so as an auditor he would not expect to receive information about the most likely outcome from an attorney's letter. Also, there is language in the Treaty that states that an attorney should not provide an estimate of the possible loss or range of loss unless there is only a slight possibility that the actual outcome could be different. Without access to the information and lacking legal expertise, auditors are not in a position to audit those disclosures without the input of clients' counsel.

55. Mr. Uhl agreed with Mr. Pippolo's comments and expanded on the issue of auditing a client's assertion that a particular disclosure would be prejudicial. He said Deloitte considered whether a representation in management's representation letter would be sufficient audit evidence for that assertion and thought maybe it would not be. If auditors ultimately conclude that management's representation alone is not sufficient audit evidence, they will seek additional evidence from attorneys. The Treaty does not contemplate attorneys providing that information to the auditors.

56. Mr. Hasty commented that auditors' obligation is to obtain sufficient appropriate audit evidence and that they look to management for that evidence. The role of a specialist, in this case an attorney, is to corroborate management's assertions. In this context, he addressed a comment that was made during the morning session by Mr. Keller who stated that auditors could take comfort from the fact that a company's attorneys are involved in either drafting or reviewing the company's disclosures about litigation.[5] From an audit perspective, he said, this would not constitute sufficient appropriate audit evidence.

57. Mr. Genovese expressed concern that the proposed disclosures would require management to provide a vast amount of precise information to auditors, potentially waiving attorney-client privilege and making it more difficult for the company to defend itself. He commented that in-house counsel works to preserve shareholder value and is concerned about keeping costs low, whereas outside counsel does not necessarily have the same concerns. He noted that evaluating disclosure of cases under the Exposure Draft would be an expensive process and would damage shareholder value, especially in the early stages when there is even more uncertainty. In-house counsel, outside counsel, internal accountants, and external auditors would all be involved, and the external auditors may feel they need to consult with their own legal experts, which would further increase costs.

58. Mr. Santarelli stated that he was unsure what auditors would do with the additional information because they are not attorneys. An auditor would have to completely rely on attorneys for prediction outcomes of cases and damages. He said the quality of legal letters that auditors receive in the private company world is highly varied. He said he was concerned about the auditability of the disclosures and would expect that many audit reports would include scope limitations for private companies, which is not desirable.

59. Mr. Burzenski said in his experience with private companies, managers and investors are usually the same people. They are concerned about the prejudicial

[5] See paragraph 84 of "Minutes of the March 6, 2009 Morning Session Roundtable Meeting: Disclosure of Certain Loss Contingencies."

issues and rely on their accountants and attorneys to tell them how much information the company is required to disclose. He stated that there is an entirely different approach to looking at contingencies from a private company's point of view. He noted that a majority of the example disclosures provided were foreign to him.

60. Mr. Santarelli stated that the primary users of private company financial statements, other than the owners, are lenders. Lenders have the ability to directly negotiate with the preparers of the financial statements. He said Statement 5 works very well for private company users and noted that there were very few cases in which users were surprised because of an inadequate disclosure.

61. Mr. Leisenring asked what the difference is between what is being discussed and the auditing literature, which states that an auditor should obtain evidential matter related to the degree of probability of an unfavorable outcome and the amount or range of potential loss.[6] The literature also states that a letter to a client's attorney should request an evaluation of the likelihood of an unfavorable outcome and an estimate of the amount or range of potential loss *if one can be made*.[7] He asked if the omission of the phrase *if one can be made* is the cause of resistance. He said he did not understand the difference between this literature and the Exposure Draft. He said if nobody is complying with the existing auditing literature, that is a different issue. Mr. Herz commented that the assertion is that, due to the uncertainties in litigation, an evaluation and estimate cannot be made until very late in the litigation proceedings.

62. Mr. Golden asked how an auditor evaluates whether there is sufficient evidential matter that an estimate cannot be made. Mr. Santarelli said that, in most cases, the auditor would have the legal letter and management's representation letter upon which to rely.

[6] See paragraph .04 of AU Section 337.
[7] See paragraph .09 of AU Section 337.

63. Mr. Golden asked how the relationship (a) between the attorney and auditor or (b) between the attorney and the client regarding attorney-client privilege would be affected if there were a *more likely than not* threshold.

64. In response, Mr. Prezioso drew a distinction between what the literature requires and what happens in the audit process. He noted the audit process involves additional risks for privilege even though the audit literature indicates that a waiver of privilege is not required for the audit process as a routine matter.[8] He said the Treaty tries to balance what disclosure can be made and how it can be made against the waiver of privilege and the risks associated with a waiver. He commented that he believes under a *more likely than not* threshold, auditors likely would feel the need to understand and document whatever assessment is made in a way that would, in most cases, result in very serious waiver issues. Mr. Golden asked why there would be more of an issue with *more likely than not* than with the current requirements of *probable* or *remote*. Mr. Prezioso replied that it goes back to the balancing point. There are end points at which people have agreed that the balance shifts and attorneys can, in fact, state that the likelihood of loss is probable or remote. These are meant to be exceptions that affect only a small number of cases.

65. Mr. Herz asked if *more likely than not* is too scientific for assessing the potential outcomes of cases. Mr. Prezioso responded that, leaving aside the related financial statement issues of recognition and disclosure, he believes that there would be serious professional limitations to making such an assessment with limited facts and a limited ability to predict the future. Beyond the issue of waiver, lawyers have certain professional responsibilities. Bringing the discussion back to the audit process, he noted that if a company assesses a case as *more likely than not*, the auditors would want to understand and document that assessment. Doing so would require speaking with the lawyers and would raise the privilege issues.

[8] See paragraphs .08 and .09 of AU Section 9337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337*.

66. Mr. Herz commented that IFRS, as currently written, uses a threshold of *more likely than not* for recognition. He asked how companies that prepare financial statements in accordance with IFRS that are subject to U.S. litigation deal with the requirement.

67. Ms. Griggs indicated that she had spoken with a foreign private issuer who prepares financial statements in accordance with IFRS. That company has not yet confronted this issue. She stated that the Treaty instructs lawyers that it is very unlikely they will be able to reach a judgment that an adverse outcome is probable. She indicated that if the threshold were changed to *more likely than not*, the American Bar Association (ABA) would not be able to support a corresponding change to the Treaty because attorneys are not able to make the necessary predictions in light of the vagaries of litigation. She said that when auditors push attorneys to make assessments under the current regime, attorneys are not ethically allowed to make the decision to waive attorney-client privilege. That decision rests with the client.

68. Mr. Linsmeier asked whether lawyers would always conclude that everything should be disclosed if the threshold for disclosure were changed to materiality, more likely than not, or some other threshold. Mr. Golden rephrased Mr. Linsmeier's question as follows: if the threshold were based on materiality, to what extent could attorneys help their clients evaluate materiality and provide that information to auditors?

69. Mr. Leisenring asked how companies are complying with the recognition criteria of accruing items when probable. Mr. Genovese stated that large companies maintain reserves for cases that are probable and reasonably estimable. He pointed out that many cases are not reasonably estimable but if companies can make reasonable estimates, they do set aside reserves for those losses.

70. Mr. Golden asked attorneys if they would be more comfortable providing analysis about materiality because that concept is engrained in law.

71. Ms. Griggs reiterated her earlier comment that she believes the ABA would not be willing to change the Treaty. Mr. Prezioso noted that the ABA has heard concerns that people push too far for waiver of privilege, and there is a general sentiment among attorneys that there needs to be a strengthening in attorney-client privilege. He said materiality ties back into the idea of broader disclosure—what the SEC requires, what belongs in financial statement disclosures, and what belongs in MD&A. He observed that there are different ways of preparing those two types of disclosures, and they are subject to different levels of liability and audit scrutiny. Responding to the specific question about materiality, he noted that attorneys rarely make close decisions about materiality without talking to the client, because management knows the business and what is important to investors better than the lawyers do. Ms. Griggs stated that there is a practical problem with changing to a materiality standard in the Treaty. She noted that materiality, from a federal securities law standpoint, is something disclosure lawyers are comfortable assessing. The lawyers litigating the case, on the other hand, are often different people (usually outside counsel), and they do not have the same comfort level making such judgments.

72. Mr. Young commented that the concept of *reasonably possible* is very broad and many things fall within it, resulting in a lot of disclosure. He said materiality is a more flexible concept, and a more vigorous discussion would be necessary because everyone has an opinion about materiality. He stated that he believes less disclosure would result under a materiality standard than under the existing reasonably possible standard.

73. Ms. Seidman asked whether the Treaty even needed to be discussed if the requirements were based around disclosing contentions rather than predictions. Mr. Young commented that he was perplexed about why the Treaty was being discussed. Mr. Golden explained that the Treaty discussion helped in assessing the extent to which more disclosure could be required based on the likelihood of the case. He said he was concerned about whether auditors would have enough

evidence to support additional disclosures that might be required for cases for which an unfavorable outcome is closer to probable.

74. Mr. Uhl stated that he could audit disclosures that contain factual amounts. However, if there were a prejudicial exemption, auditors would still have problems auditing an assertion that disclosing certain information would be prejudicial because they lack expertise about the litigation system. Mr. Linsmeier asked whether there would still be an issue about prejudicial information if only factual information is disclosed. Mr. Young replied that he thought many problems will disappear if predictions are not required.

75. Mr. Hasty noted that from the perspective of the auditing standards, the auditors still have an obligation to obtain sufficient appropriate audit evidence supporting management’s assertion, and that involves seeking corroboration from the company’s attorneys. Anything that would prevent auditors from obtaining that corroborating evidence would be problematic.

76. Ms. Seidman asked whether auditors would really need attorneys’ assistance if the Board defined the term *prejudicial* as “information that could potentially adversely affect the outcome of the litigation.” Mr. Uhl asked whether the prejudicial exemption will be taken out if the Board requires only factual information to be disclosed. Mr. Golden clarified that if only factual information is required, there probably will not be a need for a prejudicial exemption; however, right now it is not clear what the Board will decide.

77. Mr. Lewis proposed that factual information should always be disclosed and predictions should be required if disclosing the prediction would not be prejudicial. For example, if an entity has asbestos exposure, it could provide a comparability analysis. He noted that oftentimes the amount accrued is less than the total exposure, and he asserted that the accrued amount would be misleading on its own without predictions about the possible total exposure if such predictions can be developed.

78. Mr. Prezioso wanted to clarify what is meant by *factual information*. He noted that there are different types of factual information. On the one hand, there is information that is publicly available in a record of litigation, for example, "the plaintiff filed a complaint on this date." On the other hand, there is information about what happened in a situation, that is, the matter that is the subject of the dispute. Mr. Leisenring stated that the participants in the morning session focused on *contentions*, not on *facts*. Mr. Young clarified that by contentions he meant the relevant circumstances and what the parties may argue based on those circumstances. For example, "We entered into a contract." That is a fact. "We asserted that we did not breach it." That is a contention. A statement about how it is likely to turn out is a prediction, and that would be for the court to decide. Mr. Genovese noted that Example 7 seemed to take this approach.

Private Companies

79. Mr. Golden turned the discussion to issues specifically related to private companies. He asked those involved with private companies what type of questions users typically ask private companies about their contingencies, in light of the access users have to private company management that may not be available in the case of public companies.

80. Ms. Johnson replied that the current Statement 5 requirements are satisfactory to their financial statement users, which consist primarily of creditors and rating agencies. She said that to her knowledge, the company does not have extensive dialogues with those users about loss contingencies. She noted that there are different investor requirements for information about private companies than there typically are for public companies. She said that some credit agreements have requirements for periodic litigation updates, but creditors often back off from those requirements, so it seems they do not really need that information. She commented that users' relationship with management and their access to the overall perspective of management allow them to gain a solid overall understanding of how management approaches risk, so that contingencies are not evaluated in a vacuum.

81. Mr. Smith noted that almost all roundtable participants in both the morning and afternoon sessions seemed to agree that the level of disclosure proposed in the Exposure Draft will not be obtainable. He asked if there would be any problems for private companies to disclose contentions but not predictions. Ms. Johnson responded that she would need to better understand how that approach might differ from the current requirements. She indicated that one of her company's businesses has asbestos litigation and that the company's financial statements provide extensive disclosure about that litigation as well as other matters that the company deems material that meet the Statement 5 criteria. Additional information about other matters would not necessarily be useful to readers of her company's financial statements.

82. Mr. Golden asked Mr. Lomax whether, as a surety user, he has access to the information creditors might request from private company management regarding contingency updates. Mr. Lomax responded that usually private companies prepare a complete set of financial statements only on an annual basis. He stated that Liberty Mutual Surety does underwriting throughout the year and requires interim financial statements that are typically internal-use statements. He said that litigation is typically revealed only through a credit report, the financial statements, a personal meeting, or by checking with the producer or agent on the account about any changing circumstances. He noted that litigation is in a constant state of flux, so his company continually checks the status of any cases that are material. He said the most important thing is that his company is made aware of the case. Ms. Seidman asked how he gets the information. Mr. Lomax responded that his company usually gets the information in discussions with the producers who represent the particular contracts. He said that as long as his personnel are aware of a case, they can ask about its current status. He said that sometimes an attorney summarizes all outstanding cases, whereas other times his company is focused only on a particular case. Because his company makes long-term credit commitments, it needs to assess whether there is a risk of a material change in the financial condition of the company over the duration of the relevant project.

83. Mr. Santarelli noted that the information Mr. Lomax described surfaces through the financial statement disclosures. Mr. Lomax responded that it also may come from the agent on the account who talks with the client. Mr. Santarelli continued that if the case is disclosed in the financial statements under Statement 5, a user of a private company's financial statements would have access to obtain more data from management. He noted that this is quite different from public companies because of the constraints on information sharing that apply to them. He asserted that the system functions very well in the private company realm.

84. Mr. Leisenring questioned the assertion that the Statement 5 paradigm works well in the private company realm. He indicated that, in his experience, the auditors often needed to hire an attorney to speak to the client's attorney because the quality of the letter from the client's attorney typically was poor. Mr. Santarelli indicated that the overall quality of attorneys' letters has improved since then. Mr. Herz stated that this is not an issue for the standard setter. Mr. Leisenring responded that it did raise an issue about the quality of the information provided in the process.

85. Mr. Lomax was asked whether his company's attorneys would be involved if the company thought a surety bond was at risk. Mr. Lomax responded that his company's attorneys would be involved if there was a possible claim against his company or if there was a going-concern risk to the business in question.

86. Ms. Seidman asked for a clarification about the contact between the attorneys for Mr. Lomax's company and the attorneys for a contractor for whom a surety bond had been written. Specifically, she asked if such contact results in a waiver of privilege. Mr. Lomax responded that when there is a claim on a surety, usually the defense is tendered, and the independent counsel assigned by the contractor works in coordination with the claims department at his company.

87. Mr. Siegel asked Mr. Lomax if he agreed Statement 5 works well. Mr. Lomax responded that Statement 5 works to some extent but sureties generally feel that more facts should be disclosed in the footnotes.

88. Ms. McEnally noted that Mr. Lomax's industry is directly at risk of the quality of disclosures and the outcomes that will occur. She said that he needs to clearly understand the facts and the expectations to conduct his business, but Statement 5 is not delivering all of his information needs. She said this is consistent with her views about Statement 5. She said that most investors do not have the information they need to make decisions. She summarized that most outside equity investors do not have the power to command more information; the best they can do is hope that the standards are improved so they can have a reasonably clear understanding. She encouraged the regulators and the standard setters to look closely at these issues and to try to reach a solution in spite of the barriers, so that those who bear risk can have better quality information.

Tabular Reconciliation

89. Mr. Golden asked users if they thought a tabular reconciliation of recognized losses would be useful.

90. Mr. Hurwich said he did not have a problem with either solution and could work with both. He expressed concern that U.S. GAAP is primarily rules-based and that disclosures about contingencies are probably more amenable to a principle-based approach.

91. Mr. Young noted that because the reconciliation deals with accruals, it inherently deals with predictions, which could be problematic. He suggested maintaining a prejudicial exemption if a tabular reconciliation is required, because disclosing those amounts might affect the outcomes of cases. Ms. McEnally asked exactly what Mr. Young found problematic in the reconciliation. Mr. Young responded that anything involving an accrual of the anticipated outcome of litigation involves a prediction. He observed that disclosing an accrual could be particularly problematic in the context of ongoing settlement negotiations, for example, if a company increased its accrual by $10 million because it planned to make a settlement offer in the near future. Mr. Smith noted that this would particularly be a problem if a company had only one lawsuit outstanding.

92. Ms. Griggs stated that developments in a particular quarter could also be problematic because someone following the litigation could predict the reaction of management to whatever occurred. She said the reconciliation would give the plaintiff a tool to evaluate what the defendant thinks the loss might be. Mr. Herz clarified that this would be a problem if there is only a small number of cases or if there is one case that is much more significant than the others. Mr. Young agreed. Mr. Genovese stated that a user could easily draw a connection between a large change in the accrual disclosed in the reconciliation and a significant development on a particular case in the same period.

93. Ms. McEnally asked why these concerns did not matter to the company in Example 2. Mr. Genovese responded that the disclosures in Example 2 related to cases at the end of their life cycle when the company is no longer disputing the amounts in question. He speculated that the company may not have disclosed such information in previous financial statements. He indicated that there may also be other reasons the company disclosed the information. He also observed that the amounts in Example 2 were aggregated and several cases were described, which would make it more difficult for plaintiffs' counsel to link changes to a particular case.

94. Ms. McEnally noted that litigation is in no way different from other major contingencies for which aggregation is not an option. She asked why the disclosure of information for litigation is different from disclosure of other contingencies that have similar negative economic effects. For example, she indicated that the disclosure of a loss of a major customer has detrimental effects on a company. Mr. Young replied that it is different because litigation is adversarial. He said litigation is like a game of poker, and he compared providing too much disclosure to trying to bluff when all the cards are on the table.

95. Mr. Santarelli said he would be more interested in a table that disclosed over- and under-accruals for material cases and whether the company is smoothing accruals over time. Mr. Santarelli was asked whether this was relevant to private companies and he said no.

96. Mr. Leisenring observed that paragraph 3 of FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, states that once a company accrues the minimum amount of the range of possible loss, it also must disclose the nature of the contingency and the additional exposure to loss if there is at least a reasonable possible loss in excess of the minimum. He said that given the previous discussion, companies cannot comply with the current accounting rules without being prejudicial. Some participants replied that an accrual only occurs when probable. Mr. Leisenring emphasized that the disclosure of the additional exposure is required if the additional loss is at least reasonably possible, rather than probable.

General Announcements

97. Mr. Golden announced that any additional input could be written to either him or Mr. Elsbree and will be treated as a subsequent comment letter. He said that the FASB staff will meet to digest what it learned at the roundtables and will develop a project plan for redeliberations. Mr. Golden thanked the roundtable participants for their contributions to the discussions.

APPENDIX 1

DISCLOSURE OF CERTAIN LOSS CONTINGENCIES ROUNDTABLE
Norwalk, CT
March 6, 2009
Session 2
2:00–4:30 p.m.

Participant List

Participants		Comment Letter Numbers
	Regulator:	
Jenifer Minke-Girard	Securities and Exchange Commission	N/A
	Auditing Standards Setters:	
Greg Scates	Public Company Accounting Oversight Board	N/A
Hiram Hasty	American Institute of Certified Public Accountants	N/A
	Auditors:	
Carlo Pippolo	Ernst & Young	23
Bob Uhl	Deloitte & Touche	70
Philip Santarelli	AICPA's Technical Issues Committee	216
John Burzenski	Private Company Financial Reporting Committee	137
	Lawyers:	
Giovanni Prezioso	American Bar Association	36
Michael Young	Willkie Farr & Gallagher	30
Linda Griggs	Morgan, Lewis & Bockius LLP	213
	Preparers:	
John Genovese	MetLife	53
Nicole Johnson	Koch Industries	95
David Weiss	Developers Diversified Realty	108
Alex Dimitrief	Association of Corporate Council	16
	Users:	
Sanford Lewis	Investors Environmental Health Network	121
Rebecca McEnally	Investors Technical Advisory Committee	229
David Lomax	Liberty Mutual Surety	N/A
Adam Hurwich	Calcine Management LLC	N/A

Bob Herz	FASB Board Chairman
Thomas Linsmeier	FASB Board Member
Leslie Seidman	FASB Board Member
Marc Siegel	FASB Board Member
Larry Smith	FASB Board Member
Jim Leisenring	IASB Board Member
Russell Golden	FASB Director and Moderator
Peter Proestakes	FASB Assistant Director
David Elsbree	FASB Practice Fellow

APPENDIX 2

Financial Accounting Standards Board

FASB ROUNDTABLE MEETING AGENDA
Disclosure of Certain Loss Contingencies

March 6, 2009

Norwalk, Connecticut

Threshold for Disclosure

1. Are there some contingencies that are material to users of financial statements, and therefore should be disclosed, even though the likelihood of loss is remote? If so, do such loss contingencies require the same level of disclosure as those for which the likelihood of loss is more than remote (that is, at least reasonably possible)?

Quantitative Disclosure

2. Paragraph 10 of FASB Statement No. 5, *Accounting for Contingencies,* requires entities to "give an estimate of the possible loss or range of loss or state that an estimate cannot be made." Users have indicated a need for quantitative information about loss contingencies and feel that entities too often provide no quantitative information and state that an estimate cannot be made. Preparers have indicated that, in fact, an estimate of the range of loss often cannot be made and even in circumstances in which an estimate can be made, disclosing that estimate may be prejudicial to the entity.

    a. If an estimate of the possible loss or range of loss can be made, should disclosure of that estimate be required? Should there be a prejudicial exemption from providing such an estimate?
    b. In circumstances in which an estimate of the possible loss or range of loss cannot be made (or would be prejudicial to the entity), what other relevant quantitative information that would be useful to users could be provided?
    c. Is there a meaningful way to convey to users the potential magnitude of a contingency using qualitative information rather than quantitative information?

Qualitative Disclosure

3. What qualitative information about loss contingencies would be useful to users? Are there different types of disclosures that should be required for different types of cases?

4. Some preparers have expressed concerns about disclosing information in the notes to the financial statements that is already available in public documents (for example, court filings). What is the basis for those concerns?

Recoveries from Insurance or Other Arrangements

5. Financial statement users have indicated that they would like disclosures to include information about possible recoveries of loss contingencies through insurance, indemnification, or other similar arrangements. Some preparers and attorneys have indicated that this information could be prejudicial. Do you believe that such information should be required to be disclosed? Why or why not? Under what circumstances would such information be prejudicial, and how could those circumstances be addressed?

Tabular Reconciliation of Recognized Loss Contingencies

6. Does a tabular reconciliation of recognized loss contingencies, on an aggregated basis, provide meaningful information to users? What is the appropriate level of aggregation? Would it be appropriate to omit the table if it would be prejudicial to include it (for example, if any entity has only a limited number of cases outstanding)?

Private Entity Matters

7. What is the appropriate level of disclosure about loss contingencies for private entities in their general purpose financial statements? Do users of private entities' financial statements require the same level of disclosure? Why or why not?

Audit Considerations

8. How would enhanced disclosures of the kind that are being considered by the Board affect the audit process? Will auditors be able to obtain adequate audit evidence and satisfy the requirements of PCAOB Auditing Standard No. 3, *Audit Documentation*?

Costs of Enhanced Disclosures

9. Preparers have indicated that the costs of enhanced disclosures about loss contingencies could be significant. Those costs would include additional losses from litigation because of the disclosures putting them in a disadvantageous position, as well as costs associated with additional litigation that may result from the disclosures. How can the quality of disclosures about loss contingencies be enhanced while minimizing the cost of those disclosures? To what extent are investors willing to absorb the costs associated with enhanced disclosures?

APPENDIX 3

Financial Accounting Standards Board

FASB ROUNDTABLE MEETING
Disclosure of Certain Loss Contingencies
Examples of Disclosures for Discussion Purposes

March 6, 2009

Norwalk, Connecticut

Note: The example disclosures set forth below are taken from publicly available SEC filings and are included for discussion purposes only. Neither the Board nor the staff has evaluated these disclosures for compliance with generally accepted accounting principles.

Part 1: General Examples

Example 1

The Company and its subsidiaries are involved in a number of legal and arbitration proceedings, including class actions, concerning matters arising in connection with the conduct of their respective business activities. The Company believes it has meritorious defenses to each of these actions and intends to defend them vigorously. In the course of its business, the Company and its subsidiaries are also subject to governmental examinations, information gathering requests, subpoenas, inquiries and investigations. The Company believes that it is not a party to, nor are any of its properties the subject of, any pending legal, arbitration, regulatory, tax or investigative proceedings that would have a material adverse effect on the Company's consolidated financial condition or liquidity. However, it is possible that the outcome of any such proceedings could have a material impact on results of operations in any particular reporting period as the proceedings are resolved.

Example 2

Government competition law matters. In March 2004, the European Commission issued a competition law decision that, among other things, ordered us to license certain Windows server protocol technology to our competitors. In March 2007, the European Commission issued a statement of objections claiming that the pricing terms we proposed for licensing the technology as required by the March 2004 decision were "not reasonable." Following additional steps we took to address these concerns, the Commission announced on October 22, 2007 that we were in compliance with the March 2004 decision and that no further penalty should accrue after that date. On February 27, 2008, the Commission issued a fine of $1.4 billion (€899 million) relating to the period prior to October 22, 2007. In January 2008, the Commission announced that it was opening two new competition law investigations. These investigations relate primarily to interoperability with respect to our Microsoft Office family of products and the inclusion of various capabilities in our Windows operating system software, including Web browsing software. These investigations were precipitated by complaints filed with the

Commission by a trade association of Microsoft's competitors and a firm that offers Web browsing software. In May 2008, we filed an application with the European Court of First Instance to annul the February 2008 fine. We paid the $1.4 billion (€899 million) fine in June 2008.

We are subject to a Consent Decree and Final Judgment that resolved lawsuits brought by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions. The Consent Decree imposed various constraints on our Windows operating system businesses. Portions of the Consent Decree were scheduled to expire on January 31, 2008; we voluntarily agreed to extend other elements of the Consent Decree to November 2009. In October 2007, some states filed a motion with the U.S. District Court for the District of Columbia seeking to have most of the remaining provisions of the Final Judgment in the action to which they are party extended for five years. The U.S. Department of Justice and other states advised the Court that they would not seek any extension of the Final Judgments to which they are party. In January 2008, the court issued a decision granting the states' motion to extend these additional provisions of the consent decree until November 2009.

In other ongoing investigations, various foreign governments and several state attorneys general have requested information from us concerning competition, privacy, and security issues.

Antitrust, unfair competition, and overcharge class actions. A large number of antitrust and unfair competition class action lawsuits have been filed against us in various state, federal, and Canadian courts on behalf of various classes of direct and indirect purchasers of our PC operating system and certain other software products. We obtained dismissals of damages claims of indirect purchasers under federal law and in 15 states. Courts refused to certify classes in two additional states. We have reached agreements to settle all claims that have been made to date in 19 states and the District of Columbia.

Under the settlements, generally class members can obtain vouchers that entitle them to be reimbursed for purchases of a wide variety of platform-neutral computer hardware and software. The total value of vouchers that we may issue varies by state. We will make available to certain schools a percentage of those vouchers that are not issued or claimed (one-half to two-thirds depending on the state). The total value of vouchers we ultimately issue will depend on the number of class members who make claims and are issued vouchers. The maximum value of vouchers to be issued is approximately $2.7 billion. The actual costs of these settlements will be less than that maximum amount, depending on the number of class members and schools that are issued and redeem vouchers.

The settlements in all states have received final court approval. Cases in Arizona, Mississippi and Canada have not been settled. We estimate the total cost to resolve all of these cases will range between $1.7 billion and $1.9 billion. The actual cost depends on factors such as the quantity and mix of products for which claims will be made, the number of eligible class members who ultimately use the vouchers, the nature of hardware and software that is acquired using the vouchers, and the cost of administering the claims. At June 30, 2008, we have recorded a liability related to these claims of approximately $900 million, which reflects our estimated exposure of $1.7 billion less payments made to date of approximately $800 million, mostly for administrative expenses, vouchers, and legal fees.

Other antitrust litigation and claims. In November 2004, Novell, Inc. filed a complaint in U.S. District Court in Utah, now transferred with other cases to Maryland, asserting antitrust and unfair competition claims against us related to Novell's ownership of WordPerfect and other productivity applications during the period between June 1994 and March 1996. In June 2005, the trial court granted our motion to dismiss four of six claims of the complaint. Both parties appealed, and in October 2007, the court of appeals affirmed the decision of the trial court, remanding the case to that court for further proceedings.

Patent and intellectual property claims. We are vigorously defending more than 45 patent infringement cases. Microsoft and Alcatel-Lucent are parties to a number of legal proceedings relating to certain patents of each of the companies. Some of these actions began before the merger of Alcatel and Lucent in 2006. For simplicity, we refer to the post-merger entity as Alcatel-Lucent throughout this discussion.

- In 2003, we filed an action in U.S. District Court in California seeking a declaratory judgment that we do not infringe certain Alcatel-Lucent patents. Alcatel-Lucent has asserted claims under these patents against computer manufacturers that sell computers with our operating system and application software pre-installed. In February 2007, the jury returned a verdict in Alcatel-Lucent's favor in the first of a series of patent trials, and awarded $1.5 billion in damages. In August 2007, on our motions for judgment as a matter of law, the trial court overturned the jury verdict and entered orders dismissing plaintiff's claims on multiple grounds. Alcatel-Lucent appealed. The trial court previously dismissed Alcatel-Lucent's claims with respect to a second group of patents and two patents in a third grouping. In April 2008, a jury returned a verdict in Alcatel-Lucent's favor in a trial on a consolidated group of video and user interface patents. The jury concluded that Microsoft had infringed two patents and awarded $367 million in damages. On June 19, 2008, the trial judge increased the amount of damages to $512 million, which includes the $367 million of damages and $145 million of interest. Microsoft will appeal the verdict.
- In March 2006, Alcatel-Lucent filed a lawsuit against us in U.S. District Court in California, claiming Windows Vista, Windows Media Player, and the Xbox 360 infringe one of its patents. In response, we asserted counterclaims that Alcatel-Lucent infringes 10 Microsoft patents by its sale of various products. The case went to trial in April 2008 on Alcatel-Lucent's video patent and four Microsoft counterclaim patents. The jury returned a verdict in Microsoft's favor on June 4, 2008, finding no infringement of Alcatel-Lucent's patent. The jury also found no infringement of Microsoft's counterclaim patents.
- In November 2006, Alcatel-Lucent filed two patent infringement cases against us in U.S. District Court in Texas, asserting Mediaroom and various networking functionalities violate seven of its patents. In April 2007, we asserted infringement counterclaims based on four of our patents relating to functionality similar to that accused by Alcatel-Lucent. The trial on all of the patents is set for January 2009.

- In February 2007, we filed a complaint against Alcatel-Lucent with the International Trade Commission claiming Alcatel-Lucent is infringing four Microsoft patents related to our unified communications technology and seeking to prevent the import into the U.S. of certain Alcatel-Lucent unified communications products. Trial of this matter took place in October 2007. The administrative law judge ruled that Alcatel-Lucent infringed one of the four asserted patents. The Commission reversed that decision in May 2008. We are appealing that ruling to the U.S. Court of Appeals for the Federal Circuit.
- In April 2007, the Multimedia Patent Trust filed a complaint against Microsoft, Dell, and Gateway in San Diego, California accusing the parties of infringing three video-related patents that originally belonged to Alcatel-Lucent. Alcatel-Lucent created the Multimedia Patent Trust prior to the companies' merger and transferred the patents at issue to the trust. In June 2008, the plaintiff dismissed one of the patent claims.

The actual costs to resolve these cases will depend upon many factors such as the outcome of post-trial motions, any appeals, and the results of the remaining trials. Adverse outcomes in some or all of the matters described in this section may result in significant monetary damages or injunctive relief against us that would adversely affect distribution of our operating system or application products. We may enter into material settlements because of these risks.

Other. We are also subject to a variety of other claims and suits that arise from time to time in the ordinary course of our business. Although management currently believes that resolving claims against us, individually or in aggregate, will not have a material adverse impact on our financial position, our results of operations, or our cash flows, these matters are subject to inherent uncertainties and management's view of these matters may change in the future.

As of June 30, 2008, we had accrued aggregate liabilities of approximately $600 million in other current liabilities and approximately $500 million in other long-term liabilities for all of the contingent matters described in this note. While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could be up to $2.2 billion in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial position, results of operations, and cash flows for the period in which the effects become reasonably estimable.

Part 2: Examples of Specific Types of Disclosure (Relevant Excerpts Only)

Example 3 – Range of Possible Loss

The range of environmental remediation costs that is reasonably possible is $24.6 million to $61.2 million, which is subject to change in the near term.

Example 4 – Estimate of Loss

Based on the Company's experience and analysis of trends in asbestos bodily injury litigation, the Company has endeavored to project the number and ultimate cost of all present and future bodily injury claims expected to be asserted, based on actuarial principles, and to measure the probable and estimable liabilities under generally accepted accounting principles. The Company has accrued $973.2 million at December 31, 2002, as its estimate of the cost to resolve all asbestos-related bodily injury cases in the future, and all pending property damage cases for which sufficient information is available to form a reasonable estimate of the cost of resolution.

Example 5 – Quantitative Information about the Amount Sought

The grand jury charges that the conspiracy took place from 1976 to 2002 and also charges that the alleged endangerment to the areas surrounding Libby continues to the present day. According to the U.S. Department of Justice, the Company could be subject to fines in an amount equal to twice the after-tax profit earned from its Libby operations or twice the alleged loss suffered by Libby victims, plus additional amounts for restitution to victims. The indictment alleges that such after tax profits were $140 million. The Company has categorically denied any criminal wrongdoing and intends to vigorously defend itself at trial.

Example 6 – Quantitative Information about the Amount Sought

Although the complaint does not specify the amount of damages sought, plaintiffs have stated in recent court filings that they intend to seek a verdict of more than $20 billion in alleged damages. Plaintiffs' expert witness on damages has generally testified to that effect in the pending jury trial. While there are many potential outcomes of the pending trial, in the event of a final, non-appealable, and enforceable judgment against the Company that is in an amount commensurate with the Plaintiffs' maximum theory of damages, it would not have sufficient assets to pay such a judgment.

Example 7 – Quantitative and Qualitative Information

Mr. Hennigan brought a claim in the United States District Court for the District of Arizona. Mr. Hennigan claims the exclusive right to sell our products to many of the largest law enforcement, corrections, and military agencies in the United States. He seeks monetary damages that may amount to as much as $400 million against us allegedly arising in connection with his service to us as a distributor. His claims rest on theories of our failure to pay commissions, breach of contract, promissory estoppel, breach of fiduciary duty, and on related theories. No written contract was ever signed with Mr. Hennigan. We also believe that he has no reasonable basis for claims based on informal or implied contractual rights and will be unable to prove his damages with reasonable certainty…. We believe that the claims against the Company are without merit and that the litigation will have no material adverse effect on the Company's business, financial condition or results of operations.

Example 8 – Qualitative Information

Smoking and Health Litigation

Overview: Plaintiffs' allegations of liability in smoking and health cases are based on various theories of recovery, including negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, nuisance, breach of express and implied warranties, breach of special duty, conspiracy, concert of action, violations of deceptive trade practice laws and consumer protection statutes, and claims under the federal and state anti-racketeering statutes. Plaintiffs in the smoking and health actions seek various forms of relief, including compensatory and punitive damages, treble/multiple damages and other statutory damages and penalties, creation of medical monitoring and smoking cessation funds, disgorgement of profits, and injunctive and equitable relief. Defenses raised in these cases include lack of proximate cause, assumption of the risk, comparative fault and/or contributory negligence, statutes of limitations and preemption by the Federal Cigarette Labeling and Advertising Act.

Smoking and Health Class Actions: Since the dismissal in May 1996 of a purported nationwide class action brought on behalf of allegedly addicted smokers, plaintiffs have filed numerous putative smoking and health class action suits in various state and federal courts. In general, these cases purport to be brought on behalf of residents of a particular state or states (although a few cases purport to be nationwide in scope) and raise addiction claims and, in many cases, claims of physical injury as well.

Class certification has been denied or reversed by courts in 57 smoking and health class actions involving PM USA in Arkansas (1), the District of Columbia (2), Florida (2), Illinois (2), Iowa (1), Kansas (1), Louisiana (1), Maryland (1), Michigan (1), Minnesota (1), Nevada (29), New Jersey (6), New York (2), Ohio (1), Oklahoma (1), Pennsylvania (1), Puerto Rico (1), South Carolina (1), Texas (1) and Wisconsin (1). A class remains certified in the *Scott* class action discussed above.

In addition to the cases brought in the United States, three smoking and health class actions have been brought against tobacco industry participants, including certain PMI subsidiaries in Brazil (2) and Israel (1). In one class action in Brazil, a consumer organization is seeking damages for smokers and former smokers, and injunctive relief. The trial court found in favor of the plaintiff in February 2004. The court awarded R$1,000 (currently approximately U.S. $500) per smoker per full year of smoking for moral damages plus interest at the rate of 1% per month, as of the date of the ruling. Actual damages are to be assessed in a second phase of the case. The size of the class is currently unknown. Defendants appealed the decision to the São Paulo Court of Appeals and the case, including the judgment, is currently stayed pending appeal. In addition, the defendants filed a constitutional appeal to the Federal Supreme Court on the basis that the consumer association does not have standing to bring the lawsuit. Both appeals are pending.

There are currently pending two purported class actions against PM USA brought in New York (*Caronia*, filed in January 2006 in the United States District Court for the Eastern District of New York) and Massachusetts (*Donovan*, filed in March 2007 in the United States District Court for the District of Massachusetts) on behalf of each state's respective residents who: are age 50 or older; have smoked the *Marlboro* brand for 20 pack-years or more; and have neither been diagnosed with lung cancer nor are under examination by a physician for suspected lung cancer. Plaintiffs in these cases seek to impose liability under various product-based causes of action and the creation of a court-supervised program providing members of the purported class Low Dose CT Scanning in order to identify and diagnose lung cancer. Neither claim seeks punitive damages. Plaintiffs' motion for class certification is pending in *Caronia*.

Example 9 – Insurance Arrangements

The Company has product liability insurance for claims brought in the Vioxx Personal Injury Lawsuits of up to approximately $630 million after deductibles and co-insurance. This insurance provides coverage for legal defense costs and potential damage amounts that have been or will be incurred in connection with the Vioxx Personal Injury Lawsuits. The Company believes that this insurance coverage extends to additional Vioxx Personal Injury Lawsuits that may be filed in the future. Certain of the Company's insurers have reserved their rights to take a contrary position with respect to certain coverage and there could be disputes with insurers about coverage matters. The Company currently believes that it has at least approximately $190 million of Directors and Officers insurance coverage for the Vioxx Securities Lawsuits and the Vioxx Derivative Lawsuits, and at least approximately $275 million of insurance coverage for the Vioxx ERISA Lawsuits. Additional insurance coverage for these claims may also be available under upper level excess policies that provide coverage for a variety of risks. There may be disputes with insurers about the availability of some or all of this insurance coverage.

Example 10 – Insurance Arrangements

We are substantially self-insured with respect to general, product liability, and securities claims. The absence of significant third-party insurance coverage increases our potential exposure to unanticipated claims or adverse decisions. Product liability claims, product recalls, securities litigation, and other litigation in the future, regardless of their outcome, could have a material adverse effect on our financial position, results of operations, or liquidity.

Example 11 – Insurance Arrangements

Our insurance coverage will not cover our total liabilities and expenses in these lawsuits, in part because we have a significant deductible on certain aspects of the coverage.