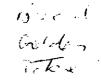
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Senior Vice President & Associate General Counsel
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December 4, 2007



LETTER OF COMMENT NO. 2

Robert H. Herz, Chairman Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116

Sir David Tweedy, Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

## Dear Sirs:

Each of us is a senior litigator for a large U.S. corporation. Although we are not accountants, we believe that it is important to provide our perspective on the Financial Accounting Standard Board's (FASB) recent decision to add a project on accounting for contingencies to its agenda. We have followed developments related to accounting for contingencies with great interest subsequent to issuance of the 2005 Invitation to Comment, Selected Issues Related to Assets and Liabilities with Uncertainties. We also are aware of recent decisions made by the FASB with respect to the guidance on subsequent measurements in the forthcoming standard on business combinations. A critically important element within the broad spectrum of potential assets and liabilities within the scope of this project is the area of litigation, which has attributes that require special consideration in the Board's deliberations on new accounting and disclosures related to contingencies. As litigators, we are intimately familiar with the complexities that arise in the consideration of potential liabilities related to asserted and unasserted claims, the practical realities associated with recognition and measurement based on limited information, as well as the nature of the legal system, which adds to the general uncertainty of outcomes.

We understand that many FASB and (IASB) members are concerned that recognition of a liability under SFAS 5<sup>1</sup> takes place far too long after the filing of a lawsuit or the bringing of a claim, and their view that fair value should be used so that recognition of a liability in the financial statements occurs earlier. We do not believe that the fair value of contingent assets and liabilities related to litigation can be reliably measured in many cases, especially in the early stages of an asserted claim. In addition, we believe that such a requirement could lead to significant unintended consequences. For all of the criticism that has been leveled against it, we believe that the SFAS 5 model for accounting for contingencies is appropriate and well-understood by all constituents, including investors, and is capable of high quality application and audit because it requires a contingency to reach a level of being "probable and estimable" before it is recorded.

Litigation is inherently unpredictable. Proof of that unpredictability can be seen in cases, such as the infamous case against McDonald's involving damages from a spilled cup of coffee, the differing verdicts for the first Vioxx cases tried against Merck or in a variety of other contexts. Moreover, determining when during litigation the probability of loss changes and by how much is highly judgmental. The SFAS 5 standard of recognizing a liability only when it is probable and estimable embraces this judgment. It also is consistent with the recognition that the filing of a lawsuit in today's environment is not necessarily a significant event affecting the company's financial exposure. Too often, lawsuits are filed for publicity or to pressure companies, only to be dropped later: either voluntarily or as a result of being dismissed by the Court. Moreover, even if not dismissed at the outset, it is the experience of the undersigned that what the lawsuit is really about, and the potential financial consequences it poses, if any, only comes into focus over the lengthy litigation process of discovery – and the relevant factors for making that determination often bear no resemblance to those presented in the initial filing.

Accordingly, recognizing these potential assets and liabilities at fair value at the outset of the matter would be both flawed and misleading. In a majority of the cases, the IASB proposal discussed in the ITC will require recognition of potential liabilities related to transient circumstances. These temporary liabilities often will result in no future cash outflows. We do not believe that it is helpful to users of financial statements to require assets or liabilities to be recorded for what might, and in some instances most likely will not, happen. Without a probable threshold, investors will have to evaluate the merits of large numbers of cases that have no chance of prevailing in the courtroom. Moreover, requiring companies to recognize an obligation could lead to abuse by adversaries seeking to take advantage of the financial impact a lawsuit could have on a company. Thus, an adversary could threaten suit, with the acknowledgement that there only is a 1% chance of winning a billion dollar verdict, and then agree to settle for \$5 million before the suit is filed so that the company can avoid having to recognize a \$10 million potential obligation. Furthermore, even if this "arbitraging" of claims did not occur, the "stand-ready" obligation, if discovered by the plaintiff during the litigation, would no doubt set a new

<sup>&</sup>lt;sup>1</sup> Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies"

floor for any negotiations over the value of the litigation – thereby almost certainly rendering the reserve inaccurate from the start.

We also observe that utilizing a fair value measurement is an extremely costly and timeconsuming exercise because of the complex nature of litigation. There are dozens of judgments and weightings inherent in evaluating any litigation, and all of them could significantly impact "fair value". For example, factors (some of which may not be readily known) might include: applicable case law and common law, the venue, the practices of the lawyers involved, the practices of the judge and/or magistrate involved, the current political and media environment, potential outcomes of other companies facing similar litigation, seriousness of the alleged damage, prior settlement amounts, the strength of viable legal theories, the outcome of factual disputes, potential defense costs, the presence of third parties – such as government agencies, etc. And, even after all of this time and effort have been invested, a projected outcome is still likely to be inaccurate, especially at the outset of a matter. In addition to all of these considerations, we are unsure of the effect of the new standard on fair value measurements on this measurement process. We understand that this new guidance would require estimation of the theoretical exit price for the transfer of this liability to a third party, including determination of an appropriate risk premium that would be necessary to compensate for the significant uncertainty inherent in such claims.

Under existing accounting standards, the difficult recognition and measurement issues are considered only after it is deemed probable that the plaintiff will prevail. The proposed model, in contrast, would embrace recognition of a lawsuit that has any probability of success whatsoever. In a model that blurs the distinction between traditional notions of recognition and measurement, it is unclear as to how one can differentiate between changes in fair value and correction of errors. With the irregular pattern and intervals in which information relevant to the required valuations becomes available, it would seem logical to assume that the receipt of new information would always be of the former type. However, the caution that accountants and auditors will exercise in the current environment of accounting and auditing scrutiny will make these assessments unduly burdensome and time-consuming. For example, after-the-fact reviews of the valuations could be judged by what the company "should have known" in making the determination as opposed to what information it actually possessed. In addition, we are concerned about how auditors will attest to the accuracy and validity of these measurements, as they are not experts in this area and even experts would find it difficult to corroborate or refute what is inherently a highly judgmental determination.

Omitting the probability criterion for recognition of non-financial liabilities also appears to be in a direct conflict with the accounting concept of a liability as defined in CON 6<sup>2</sup>, which says liabilities are <u>probable future sacrifices</u> of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. The use of *probable* in CON 6 refers to that

<sup>&</sup>lt;sup>2</sup> Statements of Financial Concepts No. 6, "Elements of Financial Statements—a replacement of FASB Concepts Statements No.3 (incorporating an amendment of FASB Concepts Statements No. 2)."

which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. These definitions by their nature require probability to be analyzed to determine the company's expected outflow. If a liability is not expected or probable, it should not be recognized in the financial statements, for doing so is likely to present a distorted view of an entity's liquidity, working capital, and financial position. Recognition of such items, as a result of the proposed "stand ready" obligation, would contradict the well-understood concepts of liability and probability, and would undoubtedly be misleading and confusing to the user community.

Lastly, we request that the Board engage in a dialogue with knowledgeable attorneys before field testing any proposal to record contingent liabilities at fair value because we believe that there is the potential for unintended economic consequences to corporations defending litigation. We would be pleased to participate in a Professional Education session to explain in greater detail to members of the Board and Staff the perspective we have on the implications of the ITC proposal on accounting for contingencies related to litigation.

We appreciate the opportunity to provide our views to the FASB and IASB on this matter, which we believe to be of critical importance to all constituents.

Very truly yours,

Sandra L. Phillips

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Dennis P. Lynch

Vice President and Chief Litigation Counsel - Tyco International

**David Onorato** 

Deputy General Counsel - Bank of America

George Selby

Corporate Vice President Law - Litigation - Motorola, Inc.