

Setting Reserves With Confidence

By Peter N. Farley



Making recommendations with respect to the setting of reserves can absorb lots of time and attention. But, understanding the relevant accounting concepts, developing consistent communication between the legal and accounting departments, and setting reserves with confidence are invaluable to successful law department management.

When companies set reserves, they may seek recommendations from in-house counsel and may rely heavily on those recommendations. The challenge for many in-house counsel is getting comfortable with the estimates (determined by the accounting department) that will be the basis for the amounts recorded on the financial statements, a process that can pose unique challenges.

This article will discuss some of the accounting concepts used to establish reserves, the application of those concepts to legal matters, and thoughts on how in-house counsel can help facilitate setting reserves.

The Key Accounting Concepts

In the accounting world, a reserve is known as a “loss contingency.” The Financial Accounting Standards Board (FASB) defines a loss contingency as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur.”¹ Once a company determines that a loss contingency exists, it must evaluate the likelihood of occurrence and the amount of any potential loss. Both prongs of this two-step process must be satisfied in order to set a reserve.

Under FASB ASC 450-20-25, if a loss contingency exists, the first step is to determine the likelihood that it will materialize into an event impacting the financial statements. The guidance expresses likelihood with a range of certainty: probable (likely to occur), reasonably possible (more than remote but less than likely) and remote (slight). While these definitions are not particularly detailed, they do provide a structure with which to evaluate actual events and determine whether the threshold for setting a reserve has been reached. If it is “**PROBABLE** that an asset ha[s] been impaired or a liability ha[s] been incurred at the date of the financial statements...” (emphasis added) then the first requirement has been met.²

A number of practical conditions affect whether the loss contingency is probable, reasonably possible or remote. In litigation, these can range, for example, from a threat or demand letter, an investigation or inquiry, or to an administrative charge or complaint. If an environmental event has occurred, or if property or people are damaged, injured or destroyed, a loss contingency may arise even before the plaintiff’s bar ever begins blogging about it. The key here is this: as soon as an event occurs, in-house

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counsel and/or the accounting department should analyze it to see if it is “probable” that the asset has been impaired or liability has been incurred. If it cannot be determined that an impairment or loss is probable, then no further action is necessary at that time with respect to reserves.

Once it is determined that a loss is probable, then the second step is to evaluate whether the loss can be “**REASONABLY ESTIMATED**” (emphasis added). In other words, can we put a number on what happened? What is the amount of the impairment or property lost? What is the amount in the demand letter that is probable of an adverse determination? What is the probable impact on sales, marketing or intellectual property under assault? Do any mitigating factors exist? The answer to these questions can be straightforward in some contexts, such as a property loss. In others, the uncertainties of litigation or the impact of insurance may make answers more difficult. Even though this aspect of setting a reserve is mostly financial in nature, considerable involvement and judgment from counsel may be crucial to reaching the right answer.

Two issues converge here: whether the alleged loss or liability can be reasonably estimated, and what that estimate should be. Indeed, just because a plaintiff alleges your company caused the end of civilization as we know it, and believes liability is in the millions of dollars, does not necessarily mean a reasonable estimate can be determined if, for example, material and substantive defenses exist for the liability. Understanding at the outset of a matter whether the contingency can be reasonably estimated may be a challenge. When you cannot do it with some reasonable certainty, it may not need to be recognized (although it may need to be disclosed on the financial statements).³ The lawyer’s analysis and judgment here are critical, and no exact formula exists in many instances. However, a consistent policy or process and discussions with accounting personnel should yield a good estimate for the accrual.

If a reasonable estimate of the probable loss can be determined, such as in the case of a property loss (and insurance coverage is not in dispute), then the book value of that property, its fair market value, or some impaired amount should be accrued. In situations involving, or likely to lead to, litigation or an investigation where it

is more appropriate to estimate a range, FASB guidance calls for accruing the amount within that range that is most probable. This tends to favor the low end of the range as that usually holds the most certainty for counsel to predict where liability is likely to attach. However, this is a place for judgment, where in-house counsel rely on their experience and, often, the input of outside counsel to evaluate the probability of success.

Timing questions also arise when evaluating reserves. A recommendation to accrue an estimate generally relates to contingencies that exist at the time of the financial statements with the benefit of knowledge at the date of the financial statements.⁴ The reader of any financial statements wants to know that he or she is looking at the company's best estimate with the knowledge available to it during the period the financial statements cover. Waiting for exact certainty before recognition could distort (by omission) the financial statements, thereby undermining their reliability. Loss contingencies occurring after the reporting period but before publication of the financial statements are generally treated as subsequent events. These determinations can be complex.

Applying the Loss Contingency Guidance to Litigation

FASB ASC 450-20-55-10 states that for pending or threatened litigation, the following factors should be evaluated:

- (a) the period in which the underlying events of the potential litigation occurred, or when the claim is asserted;
- (b) “degree of probability of an unfavorable outcome;” and
- (c) “[t]he ability to make a reasonable estimate of the amount of loss.”

These requirements are fairly straightforward, and in many litigated matters, these questions can be answered with a degree of certainty sufficient to make a reserve. Under FASB ASC 450-20-55-12, the chance of an

unfavorable outcome is informed by:

- (i) the nature of the claim,
- (ii) the progress or status of the case,
- (iii) counsel's opinion or view of the merits,
- (iv) the company's or counsel's experience in similar cases,
- (v) experience of other companies with the same kind of case, and
- (vi) management's approach to the defense.

As mentioned above, just the filing of a lawsuit may not be enough. In-house counsel may be asked to make an initial evaluation of the probability of an unfavorable result, and revisit it during the course of the case.

In certain matters, the company's previous experience with the same kind of litigation, the same forum, or even the same opposing counsel may be relevant as to whether to set a reserve. Industry experience or trends in certain kinds of litigation, such as wage and hour cases, may need to be considered. In-house counsel may take a lead role in making recommendations based on such an analysis so that any loss contingency accrual is determined after a thoughtful and thorough process.

With an understanding of what it takes to set a reserve, a few practical examples should be helpful. First, let's look at a personal injury case. Evaluating the strengths and weaknesses of the plaintiff's case, typical jury verdicts for that kind of case, the existence of insurance, and the applicable deductible or retention may make calculation of the accrual fairly easy. Here, the best course of action may be to chart the items above, discuss the issues with accounting, and then keep your notes as privileged work product so that you can review them later if necessary and they will not become discoverable.

One practice tip with respect to insurance is worth noting here. While the company is considering its potential reserve, the insurer also will do the same thing. These two processes, however, may lead to different results, particularly where a deductible or self-insured retention exists. In-house counsel may want to simply reach an independent recommendation about the reserve, rather than merely follow the insurer's lead.

Second, let's look at an employment case. When such a case first comes in, it usually takes the form of an administrative charge or investigation. As any employment litigator will tell you, many charges never get out of the EEOC, and of those that end up in litigation, many are dismissed on summary judgment. So, at each step, you may need to re-evaluate the matter to determine if a reserve is appropriate, and if so, what the amount should be.


Third, what about an antitrust or other government investigation? Here, the initial issues may be too uncertain to permit setting a reserve. As the matter progresses and comes into sharper focus, you may wish to revisit whether a loss contingency is both probable and reasonably estimable. The key here is not to jump the gun: if you don't have enough information to reasonably estimate the loss, or its probability is too uncertain (i.e. remote), then no reserve action may be necessary, although disclosure may be required or advisable. On the flip side, deferral of setting a reserve may not be advisable if the company has enough information to make a reasonable judgment.

Several other informative examples exist in FASB ASC 450-20-55 for litigated matters. Reviewing them is helpful for assessing different stages of litigation, when the need to set a reserve arises, and what amount within the range is appropriate. As a general rule, the amount that can be estimated with the highest likelihood will be the correct reserve.

There is one final issue that deserves mention. FASB ASC 450-20-S99 notes that as no specific guidance exists regarding legal and other expenses incurred in connection with loss contingencies, a company's accounting policy of either including or excluding an estimate of such expenses as part of the reserve is appropriate. This issue should be reviewed with your accounting department and auditors, and as long as it is applied consistently, either course may be acceptable.

Setting the Reserve with Confidence

The standards and discussion in the preceding sections are an attempt to put substance around the role counsel plays in the reserve setting process. As you work through actual contingencies, you will get a sense for whether the reserve was correct, and whether your decisional analysis worked. Learn from the successes and failures from each reserve. Just like with any other part of the in-house function, experience will help you achieve the right numbers.

Making recommendations with respect to the setting of reserves is a responsibility that can absorb lots of time and attention from in-house counsel. The worlds of accounting and law do converge here. But, with a good working knowledge of the relevant accounting concepts and consistent communication between the legal and accounting departments, you can do so with confidence. Reserve setting is a great skill to learn and will be invaluable to successful law department management. 

1. FASB ASC 450-20-25-2 Glossary.
2. See FASB ASC 450-20-25-2
3. FASB ASC 450-20-25-2(a)
4. See FASB ASC 450-20-55, which notes the importance of a company's experience or precedent in certain matters as relevant to setting loss contingencies.