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Case underscores importance of lawyer-accountant communication

By: Joseph J. Floyd March 16, 2017

Accounting for many financial statement items requires open communications between company legal counsel and the accounting group, with accounting for litigation loss contingencies possibly requiring the most communication.

Litigation loss contingencies involve complicated judgments and predictions about future events. In addition to the complexity of estimating future events, the process is made more difficult by the sensitivity and importance of maintaining attorney work product privilege and not disrupting legal strategy.

That said, legal counsel is generally in the best position to provide facts and objective information to their clients' accounting departments so that proper financial reporting judgments may be made. If that communication doesn't happen, or material facts aren't shared, then problems like the ones General Motors Co. recently experienced can occur.

Last month, GM settled an action with the Securities and Exchange Commission related to deficiencies in its financial reporting process for product liability and recall obligations.

In particular, the SEC action arose out of GM's failure to comply with generally accepted accounting principles, or GAAP, for potential losses related to a defective ignition switch that resulted in auto accident claims and a product recall.

GM's settlement with the SEC involved accepting a cease-and-desist order, pursuant to Section 21C of the Securities Exchange Act of 1934, and paying a $1 million fine.

Of concern, company attorneys and others in early 2012 knew material facts that would indicate GM might incur significant liabilities from the defective switch. However, no one informed GM's accounting department about the facts or the problem until the end of 2013, at which time GM recorded a $41 million accrual.

Per the SEC, had the facts and information that the attorneys possessed been properly evaluated, GM would have at a minimum disclosed a liability to its investors for the defective ignition switch sooner.

Accounting rules require the disclosure of even "reasonably possible" losses that may be reasonably estimated, and the accrual of a charge for losses that are "probable" and similarly may be reasonably estimated.

In contrast, defense counsel's job is to argue zealously that no liability exists and to pursue every argument available to minimize the ultimate obligation.

Needless to say, making a public admission that a loss is even possible, leaving aside that it could be probable, is generally not consistent with most legal defense strategies and attorney work product privilege.

The GM case demonstrates the importance of legal counsel making sure their clients have sufficient information about litigation and other legal issues to make proper financial reporting judgments for loss contingencies.

Importantly, in-house counsel, as part of management, bears direct responsibility for helping fulfill the financial reporting requirements.

Remote, reasonably possible or probable?

Most attorneys are familiar with the American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information, which provides guidance on what to say and not to say about litigation matters to auditors.

Of note, the guidance states that "[i]n view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote.'"

The guidance describes "probable" as a situation in which the client not succeeding is "extremely doubtful and the prospects for success by the client in its defense are judged to be slight," a standard quite different than the GAAP definition for "probable," which is likely to occur.

Note that the "reasonably possible" level, which is a GAAP required level of assessment for financial reporting, is not a consideration in the ABA guidance.

GM's failures arose because of a flawed process, as well as the lack of adequate information flow to ensure the key facts obtained by counsel were being properly considered for financial reporting assertions and judgments.

Without question, the ABA rules for auditor communications are very limiting, as well as not consistent with the GAAP standards. That said, the open exchange of facts and information that impact a client's financial statement judgments is essential for fairly stated financial statements to be presented.

Below is an overview of the relevant financial reporting guidance, background information on GM's product recall, and a discussion regarding the flaws in timely informing the accounting department of the problem.

Under GAAP, a loss contingency, such as for a product recall or litigation matter, is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an entity that ultimately will be resolved when one or more future events occur or fail to occur.

Preparers of financial statements must assess the likelihood of whether a loss or impairment is remote, reasonably possible or probable, and there are defined financial reporting steps for each classification.

"Probable" means the future event (or events) is likely to occur. A loss is considered "reasonably possible" when the chance of the future event or events occurring is more than remote but less than likely. A loss is considered "remote" when the chance of the future event or events occurring is slight.

Importantly, when a loss is deemed probable and the amount of the loss can be reasonably estimated, GAAP requires that the estimated loss be recorded in the financial statements of the company.

If a loss is probable but a reasonable estimate of the amount of the loss cannot be made, a company is required to disclose the nature of the contingency and provide an estimate of the loss or range of loss or a statement that such an estimate cannot be made.

GAAP also requires that a loss contingency that is reasonably possible should be disclosed in the notes to financial statements. The reasonably possible category may be the hardest to assess, and easiest to second guess when the benefit of hindsight arises.

Finally, neither accrual nor disclosure is required if the loss contingency is remote.

In order to properly apply the accounting rules, company management must have a system in place to gather relevant information, including from legal counsel. Per Section 13(b)(2)(B) of the Exchange Act, issuers must devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions, including loss contingencies, are recorded as necessary to permit preparation of financial statements in conformity with GAAP.

What went wrong at GM

With this background, let's review what went wrong at GM, and specifically the instances when legal counsel could have alerted the accounting group about specific facts and the need to assess the accounting treatment for the defective switch product liability.

According to the SEC, in early 2012, GM engineers had knowledge of airbag non-deployment problems and claims in certain vehicles that had occurred over several years.

Per the release, by April 2012, a GM engineer determined that a probable cause of the airbag non-deployment problem was a defective switch involved in the ignition process. The information was immediately reported to an individual on one of GM's product liability committees and to a GM attorney.

Those facts, even without the benefit of hindsight, should have triggered a financial reporting review for a loss contingency.

Also per the release, in April 2013, during a deposition in a case arising from a crash of a GM vehicle with the defective switch, the plaintiff's attorney produced evidence that a component of the defective switch differed from the same component in an earlier model year.

A couple of months later, in July 2013, an expert retained by GM confirmed that certain model years did have a different ignition switch, and in October 2013, GM received documentary confirmation from the supplier of the ignition switch that there had been a part change in the defective switch. At that time, the engineers initiated GM's formal product liability and recall process.

According to the SEC release, it actually wasn't until November 2013 that the warranty group in the accounting department received information about a potential recall related to the defective switch. The following month, the defective switch was placed on the "emerging issues list" (which served as the company record for probable losses),

and the warranty group accrued approximately $41 million for estimated costs of recalling three models with the defective switch.

By that point, GM attorneys had known about the product problem for over a year and a half, and GM had issued several financial statements to investors that lacked consideration of the obligations arising out of the defective switch.

Certainly, based on the facts presented by the SEC, the possible loss threshold had been met, and perhaps even as of early 2012.

Under GM's system of internal accounting controls in place in 2012 and into 2014, only product liability and recall losses that met the probable and reasonably estimable standard were reported to the warranty group within the accounting department.

As such, the warranty group received information only about vehicle issues at the point at which a recall was considered probable.

Indeed, GM lacked any formal consideration or communication process to send information to the accountants for loss contingencies that met the possible standard. The warranty group therefore had no knowledge or ability to assess whether losses related to potential product liability and recall campaigns were reasonably possible and should be considered for disclosure, as required by GAAP.

Needless to say, it's essential for there to be an open communication process between legal counsel and their client's accounting and financial reporting professionals. GM's failures arose because of a flawed process, as well as the lack of adequate information flow to ensure the key facts obtained by counsel were being properly considered for financial reporting assertions and judgments.

Joseph J. Floyd, a CPA and attorney, is president of Floyd Advisory, a consulting firm in Boston that provides financial and accounting expertise in the areas of business strategy, valuation, SEC reporting and transaction analysis.