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MEMORANDUM FOR ASSISTANT SECRETARIES OF THE MILITARY DEPARTMENTS
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES
PRINCIPAL DEPUTY GENERAL COUNSEL OF THE
DEPARTMENT OF DEFENSE
COMPTROLLER OF THE JOINT STAFF
COMPTROLLER OF THE U.S. SPECIAL OPERATIONS
COMMAND
COMPTROLLER OF THE U.S. TRANSPORTATION COMMAND

SUBJECT: New Reporting Requirement for Contingent Legal Liabilities

This memorandum details policy on the reporting requirements for contingent legal liabilities when categorizing the likelihood of loss, per Statement of Federal Financial Accounting Standards (SFFAS) 5, "Accounting for Liabilities of the Federal Government," and SFFAS 12, "Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government." This policy also requires disclosure of the claimed amount when there is at least a reasonable possibility that a loss may have occurred, but there is no estimate of the possible liability.

A new section will be added to Volume 4, Chapter 12, of the Department of Defense Financial Management Regulation 7000.14-R (DoD FMR), as Section 120403, paragraph E, to incorporate the changes for reporting contingent legal liabilities. Attachment 1 includes the pending change to the DoD FMR based on the recommendation found in the related implementation guidance at Attachment 2. This policy is effective immediately.

My action officer for this matter is Ms. Alice Rice. Please reach her via 703-693-3618 or alice.r.rice2.civ@mail.mil.

A handwritten signature in black ink, appearing to read "Mark E. Easton", is positioned above the printed name and title.

Mark E. Easton
Deputy Chief Financial Officer

Attachments:
As stated

cc:

Director, Program & Financial Control, Office of the Under Secretary of Defense (Comptroller)

Director, Defense Business Management, Analysis, and Optimization, Office of the Chief
Management Officer

Deputy Inspector General for Auditing, Department of Defense Office of Inspector General

**Pending Changes to
Department of Defense Financial Management Regulation 7000-14R,
Volume 4, Chapter 12, Section 120403
as of February 2016**

Contingent Liability Arising From Litigation, Claims, and Assessments

It is the component management's responsibility, with legal counsel's advice, to assess the likelihood of adverse outcomes for legal cases and decide whether to recognize them as liabilities and/or disclose them in the notes to the financial statements. The component should obtain evidence relevant to the following factors with respect to litigation, claims, and assessments:

1. The existence of a condition, situation, or set of circumstances indicating uncertainty as to the possible loss to the Component arising from litigation, claims, and assessments;
2. The period in which the underlying causes for legal action occurred;
3. The likelihood (probable, reasonably possible, or remote) of an unfavorable outcome; and
4. The amount or range of potential loss, if able to estimate.

The only available categories to assess contingent losses based on the likelihood of the loss, per Statement of Federal Financial Accounting Standards (SFFAS) 5, "Accounting for Liabilities of the Federal Government," and SFFAS 12, "Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government, are Probable, Reasonably Possible, and Remote." When legal counsel cannot indicate whether the unfavorable outcome is probable or remote, (e.g., "unable to express an opinion," "unable to determine," or other similar phrases), the component should categorize the outcome as Reasonably Possible, and management should determine the disclosures required in the notes to the financial statements.

The disclosure should include the nature of the contingency and an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made. When disclosing that an estimate cannot be made, the claimed amount should be disclosed. Disclosures and amounts described in this paragraph may be aggregated for presentation in the notes to the financial statements.

Implementation Guidance
Contingent Liabilities Arising From Litigation, Unable to Estimate
April 2018



Description of the Issue

The Office of the Assistant Secretary of the Navy (Financial Management & Comptroller) (FM&C) requested guidance on procedures to recognize or disclose contingent loss liabilities in financial statements and notes, where Legal Representation Letters from entity legal counsel do not estimate the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss.

For Fiscal Year 2016 financial statement audits, the Services provided to the DoD Office of Inspector General (DoD OIG) office legal representation letters for all litigation, claims, and assessments exceeding their individual materiality thresholds. The Assistant Deputy Chief Financial Officer (ADCFO), Office of the Under Secretary of Defense (Comptroller), reviewed the management summary schedules and individual legal representation letters provided by the Services and noted the Services often assess the likelihood of loss on a case as “unable to express an opinion” or “unable to determine” rather than “reasonably possible” and do not provide an estimate of the range of potential loss amount or state that an estimate cannot be made. In other words, the Services are reporting an “unable to express an opinion” or “unable to determine” reporting category that is not provided for in generally accepted accounting principles of the United States (U.S. GAAP) and the Government Accountability Office (GAO) Financial Audit Manual (FAM) guidance for the auditors and not providing further information on the potential range of loss. The Services may not be recording liabilities for these legal contingencies, nor disclosing the nature of these contingencies.

Federal Accounting Standards Advisory Board (FASAB) guidance, Statement of Federal Financial Accounting Standards (SFFAS) 5, “Accounting for Liabilities of the Federal Government,” paragraphs 38-39, for recognizing contingent liabilities is required when all of these three conditions are met: (1) a past event or exchange transaction has occurred (e.g., a federal entity has breached a contract with a nonfederal entity), (2) a future outflow or other sacrifice of resources is probable (e.g., the nonfederal entity has filed a legal claim against a federal entity for breach of contract and the federal entity’s management believes the claim is likely to be settled in favor of the claimant), and (3) the future outflow or sacrifice of resources is measurable (the federal entity’s management determines an estimated settlement amount). The estimated liability may be a specific amount or a range of amounts. If some amount within the range is a better estimate than any other amount within the range, that amount is recognized. If no amount within the range is a better estimate than any other amount, the minimum amount in the range is recognized and the range and a description of the nature of the contingency should be disclosed.

FASAB requires that a contingent loss liability should be disclosed in the notes to the financial statements if any of the conditions for liability recognition are not met and there is at least a reasonable possibility that a loss or an additional loss may have been incurred. Disclosure should include the nature of the contingency, an estimate of the possible liability, an estimate of the range of the possible liability, or a statement that such an estimate cannot be made.

Entity management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements, in accordance with U.S. GAAP.

The American Bar Association (ABA) also has issued a professional standard for evaluating losses that may arise from litigation, “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information,” (December 1975). The ABA’s policy seeks to preserve attorney-client confidences by providing a structure for dialogue between auditors and reporting entity counsel, i.e., financial statement presentation of information on pending and potential litigation. The ABA Statement of Policy regarding audits caution management’s counsel against providing certain kinds of information to outside auditors, thereby risking a violation of the Rule regarding client confidentiality. Once adopted by state licensing authorities, the ABA Rules of Professional Conduct and accompanying statements of policy become mandatory professional standards. Failure to comply with these mandatory standards can result in the loss of an attorney’s license to practice law.

While both the ABA and accounting standards provide frameworks for evaluating losses that may arise from litigation, the ABA interpretation of its Rules of Professional Conduct is not part of the accounting codification and the requirements of U.S. GAAP.

In addition to FASAB and the ABA guidance described above, Treasury Financial Manual (TFM), Volume 1, Part 2, paragraph 4705.60a, provides U.S. Department of the Treasury (Treasury) guidance to federal agencies regarding Legal Representation Letter reporting requirements. The TFM provides that agencies should refer to SFFAS No. 5, “Accounting for Liabilities of the Federal Government,” when assessing the likelihood of loss from a contingency. Agencies are instructed to avoid excessive use and misuse of the term “unable to determine” in assessing the likelihood of loss, using it to categorize matters only when legal counsel is unable to express an opinion. If the likelihood of a loss of a case is notated on the Management Schedule (required by TFM) as being “unable to determine,” agencies should provide a footnote on the Management Schedule with the information that was evaluated that lead to that assessment. If a footnote is not provided, the agency should provide justification as to why a footnote is not necessary. Agencies may be asked by the Treasury to provide written documentation of their internal process for using the “unable to determine” status for legal cases.” Although the TFM permits agencies to use an “unable to determine” loss likelihood category on the Management Schedule, it does not prohibit or constrain an agency from concluding and reporting that the likelihood of unfavorable outcome for such matters is reasonably possible.

In this regard, although not technically applicable to a reporting entity’s management, the GAO FAM section 1002, “Inquiries of Legal Counsel,” provides guidance to auditors regarding procedures to obtain evidence that the financial accounting and reporting of contingencies regarding litigation, claims, and assessments conform to U.S. GAAP. The FAM, section 1002.31 states, “...when legal counsel cannot indicate whether the unfavorable outcome is probable or remote, management and the auditor should conclude that the outcome is reasonably possible, and management should determine the disclosure.”

The root cause of legal counsel assessments of “unable to express an opinion” includes reticence on the part of counsel to make an estimate out of concern that doing so may violate applicable Rules of Professional Conduct issued by their licensing authority. Disclosing an estimate/position to auditors for use in a public financial statement might become known to opposing counsel and be used as an admission of liability against the government – an outcome that could be seen as a violation of legal counsel’s obligation regarding client confidentiality and result in disciplinary action by legal counsel’s state licensing authority. Also, there are cases where counsel is awaiting completion of the litigation discovery process, e.g., production of documents by the claimant, depositions, or input from experts to clarify the merits of the case. The ABA’s “Statement of Policy Regarding Lawyers’ Responses to Auditors’ Requests for Information” explains the concerns of the legal counsel and the nature of the limitations that an auditor might encounter when communicating with the entity’s legal counsel about litigation, claims, and assessments.

Financial reporting is management’s responsibility. Management needs to implement suitable controls to assure compliance with U.S. GAAP when recognizing contingent legal liabilities on the financial statements and disclosing cases that are judged as reasonably possible of an adverse outcome. Per the above cited FAM guidance, any cases currently being scored as “unable to express an opinion” or “unable to determine” should be reported by management as “reasonably possible” and an estimate made of the range of loss. When the range of loss cannot be reasonably measured, SFFAS 5 requires a statement in the notes to the financial statements that an estimate cannot be made. However, in all the cases that ADCFO reviewed the amount claimed was specified which could possibly be used as the estimated loss amount absent a better estimate.

Issue Implications

Management, through both legal and financial reporting functions, is the primary source of information about events or conditions considered in the financial accounting and reporting of litigation, claims, and assessments because these matters are within the direct knowledge and, often, control of management. Accordingly, the financial statement auditor’s procedures with respect to litigation, claims, and assessments may include:

- Making inquiries of management, which may include a discussion about the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims and assessments involving the reporting entity that may give rise to a risk of material misstatement, and
- Obtaining written representations from management, that all known actual or possible litigation, claims, and assessments whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with U.S. GAAP.

FASAB requires recognition of a contingent loss liability when the likelihood of adverse outcome is likely (and measureable) and additionally, the disclosure of contingent liabilities

when an adverse outcome is reasonably possible. When the likelihood of adverse outcome is assessed to be remote, no financial statement disclosure is required. FASAB does not establish or define an “unable to express an opinion” or “unable to determine” category.

The GAO Financial Audit Manual, section 1002, “Inquiries of Legal Counsel,” advises auditors that when the attorney cannot indicate the likelihood of unfavorable outcome, the case should be categorized by management and the auditor as reasonably possible since the likelihood of loss is not considered to be remote. Cases assessed to be reasonably possible require disclosure in the financial statement footnotes, including an estimate of the range of the possible liability, or a statement that such an estimate cannot be made. Although the FASAB recognizes there are situations where an estimate cannot be made of the adverse claim amount, apart from provisions newly added in 2017 into the TFM at paragraph 4705.60a there are no provisions to categorize the likelihood of loss on a case as “unable to express an opinion.” Even so, currently this practice persists in DoD’s financial statement reporting. Because there is a current misalignment of the categories applied by management and the categories that will be applied by a financial statement auditor, there is greater risk that this area will result in potential misstatements, inaccurate disclosures, and audit findings.

Authoritative Guidance

- **SFFAS No. 5**, “Accounting for Liabilities of the Federal Government” (FASAB Handbook v.15 (06/16))
- **SFFAS No. 12**, “Recognition of Contingent Liabilities Arising from Litigation: An Amendment of SFFAS 5, Accounting for Liabilities of the Federal Government” (FASAB Handbook v.15 (06/16))
- **DoD Financial Management Regulation 7000.14-R**
 - Volume 4, Chapter 12, “Other Liabilities,” 120403.C., 1., “Contingent Liability,” (February 2016)
 - Volume 6B, Chapter 10, “Note 16. Commitments and Contingencies,” 101801.C – “Required Disclosures” (April 2013)
 - Volume 6B, Chapter 4, “Balance Sheet, Commitments and Contingencies,” 040303.F.3 (November 2016)
- **GAO FAM, section 1002**, “Inquiries of Legal Counsel” [non-authoritative guidance] (July 2008)
- **OMB Bulletin 17-02**, “Audit Requirements for Federal Financial Statements, Section 9: Legal Representation Letters and Management’s Schedules” (September 29, 2017)

- **Treasury Financial Manual, Volume I, Federal Agencies, Part 2, Central Accounting and Reporting, Chapter 4700**, “Agency Reporting Requirements for the ‘Financial Report of the United States Government’,” Section 4705.60a, “Legal Letter Reporting Requirements” (July 2017)
- **OMB Circular A-136**, “Financial Reporting Requirement, V. Government-Wide Financial Report, V.4 Legal Representation Letter” (August 15, 2017)
- **DoD OIG D-2006-054**, “Financial Management, DoD Process for Reporting Contingent Legal Liabilities,” (February 24, 2006)

Options Considered

The component management, not legal counsel, is responsible for financial accounting and reporting of contingent legal liabilities. The only available categories to assess contingent losses based on the likelihood of the loss, per SFFAS 5, “Accounting for Liabilities of the Federal Government,” are Probable, Reasonably Possible, and Remote. When legal counsel cannot indicate whether the unfavorable outcome is probable or remote, e.g., “unable to express an opinion”, the component should categorize the outcome as Reasonably Possible, and management should determine the disclosure in the notes to the financial statements.

Option 1: Adopt Office of the Under Secretary of Defense (Comptroller) (OUSDC) policy to align with GAO FAM guidance (section 1002) for when legal counsel cannot indicate whether the unfavorable outcome is probable or remote. Under this option, as under Option 2 below, in appropriate cases legal counsel would use “unable to express an opinion” in lieu of estimating loss likelihood, consistent with ABA policy and the Rules of Professional Conduct. In such situations the FAM advises auditors that management and the auditor should conclude that the outcome is reasonably possible, and management should determine the disclosure in the notes to the financial statements, which includes estimating loss amount or range. The following are component management procedures and considerations when adopting OUSDC policy to align with GAO FAM guidance:

- Should legal counsel provide an estimate of the loss amount, management should report the estimate of the loss amount, or, if only a range of amounts is provided and no amount in the range is a better estimate than others, report the lower end of the range as the estimate. While the FAM allows for including a statement that an estimate cannot be made, to avoid situations where legal counsel declines to provide an estimate, OUSDC policy instructs management to disclose the claimed case amount for these situations;
- Option 1 moves financial statement reporting entities away from categorizing the likelihood of loss on a case as “unable to express an opinion” because such a category (likelihood of unfavorable outcome) is not available under FASAB standards for reporting loss contingencies; and

- Further, this option emphasizes that entity management, to include the financial reporting and legal functions, is responsible for implementing policies and procedures to identify, evaluate, account for, and disclose litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with U.S. GAAP. The recommendation does not intend that management will take a position without coordinating with legal counsel, but provides guidance for cases where legal counsel declines to provide an estimate of the potential loss amount.

Option 2: Status quo, reporting entities' legal counsels continue to report a separate unfavorable outcome category "unable to express an opinion" in the legal representation letters, and management incorporates this input in financial statements. The following are problematic considerations for maintaining the status quo:

- Option 2 exposes reporting entities to challenges by auditors over lack of disclosure information for cases where legal counsel cannot indicate whether the unfavorable outcome is probable or remote; and
- This option complicates the auditor's ability to determine the magnitude of potential legal claims.

Recommendation(s) and Basis for Recommendation(s)

Option 1: Prepare OUSD(C) policy memo that formally (1) adopts the GAO Financial Audit Manual section 1002, "Inquires of Legal Counsel" guidance, and (2) instructs management to disclose the claimed case amount for situations where legal counsel cannot indicate the likelihood of the outcome and states an estimate cannot be made. The FAM guidance for how federal agencies are to account for contingent losses based on the likelihood of the loss and measurability is as follows:

Likelihood of future outflow or other sacrifice of resources	Loss amount can be reasonably measured	Loss range can be reasonably measured	Loss amount or range cannot be reasonably measured
Probable: Future confirming event(s) are likely to occur	Accrue the liability	Accrue liability of best estimate or minimum amount in loss range if there is no best estimate, and disclose nature of contingency and range of estimated liability	Disclose nature of contingency and include a statement that an estimate cannot be made
Reasonably Possible: Possibility of future confirming event(s) occurring is more than remote and less than likely	Disclose nature of contingency and estimated amount.	Disclose nature of contingency and estimated loss range.	Disclose nature of contingency and include a statement that an estimate cannot be made
Remote: Possibility of future event(s) occurring is slight	No action is required	No action is required	No action is required

Component management, as the primary source of information about events or conditions considered in the financial accounting and reporting of contingent legal liabilities, should be prepared to:

- Respond to auditor inquiries and, when applicable, others within the entity, including in-house legal counsel;
- Provide a description and evaluation of litigation, claims, and assessments that existed as of the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including an identification of those matters referred to legal counsel; and
- Review legal expense accounts and any invoices from external legal counsel.