Case 12-7

Claims, Litigation, Settlements, and More Claims!

Rossi Inc. (Rossi or the “Company”) is a diversified manufacturer of industrial products. In 2008, Rossi updated its asbestos litigation liability, including the costs of settlement payments and defense costs relating to currently pending claims and future claims projected to be filed against the Company through 2017 for losses incurred to date. Before 2008, the Company’s previous estimate was for claims projected to be filed through 2011. As part of the 2008 update to the asbestos litigation liability, Rossi engaged Thompson and Associates (Thompson), a consulting firm, to serve as an external specialist to estimate the claims liability for December 31, 2008. As a result of the 2008 update and the external specialist claims estimate, the Company significantly increased its recorded asbestos litigation liability by $586 million, arriving at a total liability estimate of $1,055 million as of December 31, 2008 (which equals the external specialist’s estimate). During 2009, additional payments against the reserve reduced the recorded liability to $962 million. As of December 31, 2009, the Company performed an analysis of the asbestos litigation reserve and determined that the asbestos litigation liability should remain at $962 million.

You are a member of the audit engagement team working on the Rossi audit of the December 31, 2009, financial statements. The engagement team has performed preliminary audit engagement planning activities, including a review of Rossi’s management memo regarding the asbestos reserves. An excerpt from that memo is provided below.

Excerpt From Rossi Management Memo

During 2009, Rossi experienced higher mesothelioma (an asbestos-related form of cancer) settlement amounts when compared to the assumptions underlying its models. In 2008, Rossi’s estimated settlement amounts approximated $29,000 per mesothelioma claim, compared to an actual average settlement of approximately $34,000 per claim in 2009. The Company also incurred higher legal expenses in 2009 than what was anticipated, largely related to the following:

- Rossi is pursuing a more aggressive approach on mesothelioma trial experts and specifically, more extensive use of experts. Rossi experienced increased legal costs in 2009, but this defense strategy resulted in a number of positive verdicts.

- Martin claim — unusually high legal fees defending this claim that ultimately resulted in a $2.5 million adverse judgment in July 2009, including interest and other costs; Rossi considered this unfavorable outcome, together with the incremental legal fees, to be atypical.

- Smith and Jones claims — Rossi dedicated six weeks in trial to defend what ultimately was an unfavorable Smith verdict in Detroit; similarly, Rossi dedicated six weeks in trial to defend what ultimately resulted in an unfavorable Jones verdict; the Company considered these unfavorable outcomes, which are currently on appeal, to
be atypical. Other than the Smith and Jones cases, all trials started this year ended in settlement or dismissal; this higher-than-normal volume of trial activity also drove the defense costs higher (the Company commenced over 15 trials in 2009).

• In correlation with the preceding point, Rossi incurred extensive appeal costs — the Smith and Jones claims, in particular, plus certain cases that resulted in favorable defense outcomes that have been appealed by plaintiffs; importantly, the Company had many successful summary judgment motions before trial/verdict. (The Company now has a compendium of over 60 key summary judgment decisions in its favor.)

• Group settlements caused an increase in Rossi’s settlement costs; however, in the long term, the Company expects overall defense costs to be favorably affected. Moreover, the risk of unfavorable trial outcomes, higher settlement costs per claim specific to these cases, and the related defense costs has been eliminated.

As part of the 2009 analysis, Rossi believes it will be able to generate more favorable trends in settlement costs for the following reasons:

• In the first half of 2009, Rossi hired a dedicated in-house counsel to manage all asbestos-related activities, including, together with general counsel, defense strategy. Specifically:
  o Rossi is pursuing a more aggressive approach on mesothelioma trial experts and specifically, more extensive use of experts that resulted in a number of victories in 2009.
  o Rossi revised its strategies specific to pre-trial scheduling, motions, and targeted discovery (the objective is to understand the claims/cases early to achieve more favorable total cost outcomes).

Rossi believes that in time, these measures will act as a disincentive for plaintiffs to file and try cases against the Company. The Company does not have insurance for these claims; accordingly, no recoveries are contemplated in the amounts accrued.

During 2009, Rossi again engaged Thompson to analyze past claim experience and develop a valuation of claims outstanding as of December 31, 2009. As part of the 2009 audit engagement procedures, you have obtained a copy of the external specialist report.

**Excerpt From External Specialist Report**

In December 2009, Thompson updated the asbestos litigation liability model, which resulted in an estimated total liability of $1,124 million (including claims and defense costs), an increase of $162 million from the recorded liability of $962 million at the end of 2009. The estimated increase of $162 million is primarily because of the increase in actual mesothelioma settlement payments in 2009 (an increase from estimated settlement amounts of $29,000 to actual settlements of $34,000). Thompson notes that the estimated increase in the asbestos litigation liability model does not reflect several positive factors that Rossi considers important. Specifically, these include the continuing refinement of
the Company’s legal defense strategy, which has the potential to reduce liability and defense costs in the future.

Thompson also noted that a detailed review of the unresolved claims outstanding against the Company suggested that current settlement values estimated in the 33-month calibration period (i.e., the retrospective view the Company takes to assess settlement values per claim over time) may be overstated for purposes of valuing pending claims because many claims still pending against the Company were filed more than four years ago. The failure of these older claims to move forward in litigation suggested that they may be of lower quality than the closed claims in terms of receiving a positive settlement and in terms of the size of the settlement payment. Preliminary statistical analyses conducted by Thompson support this rationale and the possibility that pending claims should be forecast using lower settlement values for future claims. However, a final analysis has not been completed to date to quantify the lower quality of the older claims.

As a consequence of these factors and the volatility of the asbestos litigation environment from year to year, Thompson agrees with Rossi’s assessment that there is no reasonable basis for adjusting the 2009 asbestos litigation liability (currently recorded at $962 million) at this time.

Appendix to the Thompson Report: Estimated Pending and Future Asbestos Liabilities — as of December 31, 2009

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Total settlement estimate</td>
<td>$ 574 million</td>
</tr>
<tr>
<td>Total defense cost estimate</td>
<td>$ 550 million</td>
</tr>
<tr>
<td>Total including estimated defense costs</td>
<td>$ 1,124 million</td>
</tr>
</tbody>
</table>

Excerpt From Audit Engagement Planning Memo

The audit engagement team determined that the asbestos litigation liability account is a material account balance as of December 31, 2009, because it is quantitatively significant ($962 million) and qualitatively significant because of its susceptibility to misstatement and the possibility of significant contingent liabilities arising from the underlying activities in the account. Further, the engagement team determined that the valuation of the claim-based liability is a significant risk because it is subject to management discretion and there is potential for earnings management.

Engagement materiality has been set at $12.5 million.

As part of the 2009 audit of the asbestos litigation liability, the audit team has performed the following procedures:

- Performed and documented its assessment of external specialist’s competence, capabilities and objectivity; and obtained an understanding of the work of the external specialist in accordance with firm policies.
- Tested the operating effectiveness of controls around the asbestos claims process to support the team’s planned substantive procedures.
• Tested the data and information provided to the external specialist for accuracy and completeness, and determined that data was accurate and complete, and confirmed that the data was used by the external specialist.

• Included an internal actuarial specialist to review the asbestos litigation liability calculation as well as review the significant assumptions used by the external specialists for its valuation.

Excerpt From Internal Actuarial Specialist Report

As part of our review, we performed the following:

• Reviewed the methodologies and assumptions contained within the Thompson report. We have not reviewed Thompson’s process and assumptions to remove duplicate claims filed against the Company from the Company’s historical database.

• Conducted our own sensitivity tests of the Company’s liability associated with pending and unasserted (future) asbestos-related claims using our internal asbestos model and data from Thompson’s database as of December 31, 2009. See the Appendix below for our sensitivity test.

In conducting our review, we have assumed that all data and information provided in the Thompson report and Thompson database are accurate and complete. We have relied on audit team staff to test the accuracy and completeness of the information provided to us. However, we confirmed that the underlying assumptions used in the Thompson report are based on the Thompson database provided to us. We also verified the calculations in the Thompson report. Please refer to the commentary and recommendation section under our conclusion below for more information.

We performed our own sensitivity tests of the Company’s liability associated with pending and unasserted asbestos-related claims using our internal asbestos model. We developed 20 scenarios with varying assumptions and time horizons (including 9, 10, 20, and 30 years, as well as no horizon period), which are based on the Company’s claimant data as of December 31, 2009. Some of our scenarios using a 9- to 10-year horizon indicate an asbestos liability similar to the Company’s recorded asbestos liability while others indicate a higher amount. Therefore, in our opinion, the Company’s recorded liability of approximately $962 million as of December 31, 2009, associated with all pending asbestos claims filed against the Company and unasserted asbestos claims (claims that have not yet been filed) that will be filed against the Company during the next 9 years is within a reasonable range. However, if the Company continues to settle mesothelioma claims for amounts similar to those observed during 2009, the Company will most likely need to adjust its recorded liability upward in the future. Please refer to the Appendix below for the results and support of our sensitivity tests.

The Company has elected not to adjust its recorded asbestos liability during the fourth quarter of 2009 even though the Company’s recorded asbestos liability of approximately $962 million as of December 31, 2009, is approximately $162 million lower than Thompson’s estimate claims liability of approximately $1,124 million. On the basis of
discussions with Company management, we understand that the Company believes that there was not enough new information learned since the December 31, 2008, Thompson analysis to warrant a change to its recorded liability. Further, the Company believes that the Thompson settlement estimate for pending asbestos claims is overstated since it assumes all pending claims will close with similar parameters as claims actually closed during 2007 through 2009. In our opinion, there is some merit to this argument. A significant portion of the pending claims population has been open for a longer period of time than those that have been closed and reside in states that have experienced asbestos tort reform in recent years. It is possible that a higher portion of these pending claims may be dismissed or settled for lower amounts on average than those already closed. Thompson’s estimate and our sensitivity tests do not take this into consideration. However, we do understand Thompson is researching methods to estimate the possible impact in the future.

With regard to the Thompson report, we conclude:

- The methods used by Thompson in its report to estimate the Company’s settlement liability as of December 31, 2009, associated with both pending and unasserted asbestos-related claims that will be filed against the Company during the next nine years is appropriate. Thompson relied on a frequency severity method, which is commonly used in the industry to estimate liabilities associated with asbestos.

- On the basis of our review of the information/data provided, it appears that the assumptions incorporated in Thompson’s methods are reasonable.

We have reviewed the Company’s rationale regarding its assumption that a liability estimate is not reasonably estimable, for potential asbestos claims filed beyond the next nine years. In consultation with the audit team, we believe that the Company’s nine-year horizon assumption is reasonable given the significant uncertainty with respect to asbestos liabilities.

### Appendix

<table>
<thead>
<tr>
<th></th>
<th>12/31/09</th>
<th>12/31/08</th>
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</thead>
<tbody>
<tr>
<td>Liability recorded per company</td>
<td>$962 million</td>
<td>$1,055 million</td>
</tr>
<tr>
<td>Liability per management’s expert</td>
<td>$1,124 million</td>
<td>$1,055 million</td>
</tr>
<tr>
<td>Range of liability per internal specialist (on the basis of three sensitivity analyses)</td>
<td>$907 million, $1,184 million, and $1,514 million</td>
<td></td>
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</tbody>
</table>

**Required:**

- You have been asked by the engagement partner to review the client’s accounting for the asbestos litigation liability and determine the appropriate accounting literature for Rossi’s recognition and measurement of the asbestos litigation liability.
Having identified the appropriate accounting literature, what additional audit procedures, if any, should you suggest to the engagement partner to evaluate the appropriateness of the asbestos litigation liability as of December 31, 2009?

Considering the range of the estimated claims liabilities, do you believe there is an uncorrected likely misstatement that the engagement partner should request the client to correct? (Note that you should qualitatively determine whether there is a likely misstatement; a quantitative measurement of the error is not required.)

Having identified the appropriate accounting literature under U.S. GAAP, what is the appropriate authoritative literature for recognizing and measuring the claims liability under IFRS Standards? Is there a difference in the recognition or measurement criteria in IFRS Standards compared to U.S. GAAP?