Investor Environmental Health Network

HEALTHY PEOPLE...HEALTHY BUSINESS

September 20, 2010

Russell Golden, Technical Director
Financial Accounting Standards Board
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Comments on behalf of Investor Environmental Health Network Regarding
FASB Exposure Draft - Disclosure of Certain Loss Contingencies
Accounting Standards Update of Topic 450 - File Reference No. 1840-100

Dear Mr. Golden and Members of the FASB Board:
I am writing with comments of the Investor Environmental Health Network regarding the exposure draft on Disclosure of Certain Loss Contingencies, Accounting Standards Update of Topic 450.

Summary

The current exposure draft addresses a critical need for improved disclosure to investors regarding contingent liabilities. As detailed in our report, *Bridging the Credibility Gap: Eight Corporate Liability Disclosure Loopholes That Regulators Must Close* (2009), the outdated standards of FAS 5 fail to provide timely information to investors regarding liabilities associated with current operations and transactions. We offered specific examples, out of many possible instances, focusing on asbestos product liability examples:

- Johns-Manville. Previously disclosed quarterly report liability estimate, $350 million; estimate on bankruptcy, $2 billion.
- Kaiser Aluminum. Previously disclosed liability estimate $160 million; liability at bankruptcy amounted to billions of dollars.
- Dow Chemical. Acquired Union Carbide without disclosure of $2.2 billion in asbestos liabilities, only estimated later.

In general, we are supportive of the Board's proposal to expand the amount of information available to investors regarding contingent liabilities. However, we recommend certain refinements to make the proposed disclosure framework operational, and to increase its effectiveness in supporting the needs of investors. In addition, we

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respond to assertions by some commenters that the FASB proposals would require disclosures that may prejudice companies in ongoing litigation. We believe the Board has struck an appropriate balance between the needs to protect privileged information and for investors to be able to place reasonable reliance on company disclosures.

Detailed Comments

The Investor Environmental Health Network (IEHN) is a coalition of investors concerned with risks and opportunities associated with toxic chemicals in corporate products and operations. IEHN has previously participated in the board's deliberations on contingent liability disclosure reforms, with comments on the 2008 exposure draft, and by participation in the FASB stakeholders' roundtable on this topic in March 2009.

When investors are unaware of impending financial losses at companies in which they hold stock, they often face expensive surprises. Securities laws and related financial accounting principles are intended to arm investors with information to instill the confidence needed to invest with reasonable understanding of the risks involved. The accounting safeguards have so far proven inadequate to the task. Notable failures include the collapse of Enron and other companies, the subprime lending crisis, and massive bankruptcies related to asbestos product liability.

We recognize that the Board and staff have trod a long path since the Board concluded in 2008 that its existing disclosure guidance on contingent liabilities (Financial Accounting Statement 5, established 1975) failed to provide investors and analysts with needed information regarding these liabilities, including the likelihood, timing, and amount by which they will affect future cash flows. Although the current draft dramatically scales back on the original 2008 proposal, shifting from a focus on better disclosure of corporate liability estimates to a more modest goal of providing information to allow investors to conduct *their own* assessments of contingent liability levels, the proposal is still meritorious and could place investors in a better position than they would be under the outdated FAS 5 standard.

Making disclosure principles operational.
We agree with the principled framework for disclosure of qualitative and quantitative information to enable financial statement users to better understand potential loss contingencies. For instance the proposal states:

> **450-20-50-1A** An entity shall disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following:
> a. The nature of the loss contingencies
> b. Their potential magnitude

> c. Their potential timing (if known).
>
> **Principles**
> **450-20-50-1B** To achieve the objective in the preceding paragraph, an entity shall consider the following principles in determining disclosures that are appropriate for their individual facts and …
>
> * * *
>
> **During early stages of a loss contingency's life cycle, an entity shall disclose information that is available to enable users to understand the loss contingency's nature, potential magnitude, and potential timing (if known). Available information may be limited and, therefore, disclosure may be less extensive in early stages of a loss contingency. In subsequent reporting periods, disclosure shall be more extensive as additional information about a potential unfavorable outcome becomes available.** [Emphasis added]

Clearly, this principle makes logical and practical sense -- more information is available to a financial statement preparer and therefore should be made available in the financial statement as a case proceeds**. The problem with stating such a broadly principled approach, however, is that without specific operational guidelines about *which* information must be disclosed at specific points in the process, little information will be disclosed merely based on this idea of "more information later."** The principle of "more information later"is not operational without additional guidance.

There are a few discrete data points identified and disclosable under the standard. For instance, the current proposal notably does require companies to disclose "publicly available quantitative information, for example, in the case of litigation contingencies, the amount claimed by the plaintiff where the amount of damage is indicated by the testimony of expert witnesses."

But when the proposed accounting statement requires disclosure of "other nonprivileged information that would be relevant to financial statement users to enable them to understand the potential magnitude of the possible loss," it stops short of the specifics needed to inform filers regarding what kinds of information they are and are not required to disclose. For instance, if a company has information about the amount of settlements or judgments issued in similar cases at other companies, are they obliged to disclose it? The need for such benchmarking against parallel litigation at other companies can and should be explicitly specified by the statement or in its illustrative examples.

In general, the illustrative examples of disclosure contained in the accounting statement should be expanded. Right now, the proposal only includes a relatively "easy" disclosure example, regarding contract liability. At a minimum, we believe a product liability

example should be added describing disclosure of, for instance, the number of the company's relevant products currently in commerce, demographics of users, and outcomes of litigation where similar injuries to those asserted in the current litigation were found to exist.

Clarify further the categories of nonprivileged information that should be disclosed in financial statements.

We support the elements of the new proposal calling for additional disclosures of nonprivileged qualitative and quantitative information on contingent liabilities in financial reports to allow investors to better analyze the magnitude of potential liabilities. Of particular importance is the proposal to require disclosure of any expert estimates advanced as testimony in litigation. We believe that this disclosure requirement should also include any such estimates that have been provided on a nonconfidential basis through the discovery process. In addition, the finalized version of the Statement should clarify that relevant publicly available information should also include settlements and judgments in litigation facing other companies in similar matters, so that such information will also be disclosed where it is potentially relevant, to allow investor benchmarking of liabilities.

Scientific literature indicative of risks of products or operations is relevant to long-term liabilities as well as accruals.

We are supportive of the newly added requirement that the appearance in scientific literature of issues regarding hazards of corporate products and operations can serve as a trigger for disclosure. Under the section on accruals, the proposed accounting statement identifies as a potential trigger "the existence of studies in reputable scientific journals (or other credible sources that other entities in the same industry generally review) that indicate potential significant hazards related to the entity's products or operations."

However, including this reference in the context of accrual, but not also in the context of qualitative disclosures relevant to longer term risks, including remote or unasserted liabilities, leaves a concern that this reference will have limited impact. The final version should clarify that such scientific literature can trigger other contingent liability disclosures beyond accruals. These emerging issues in scientific literature should also be a trigger for disclosure of potentially severe long-term liabilities, even if viewed as remote by the management, or as evidence that there may be unasserted claims, and the final Statement should clarify this.

For example, consider the not-so hypothetical scenario in which a company is utilizing innovative nanomaterials which have already been shown in scientific studies to cause asbestos-like health impacts. We reviewed this scenario and existing company disclosures in our reports, *Bridging the Credibility Gap: Eight Corporate Liability*

Accounting Loopholes that Regulators Must Close[1] and *Toxic Stock Syndrome: How Corporate Financial Reports Fail to Apprise Investors of the Risks of Product Recalls and Toxic Liabilities.*[2] We found that under current accounting and SEC disclosure rules, nanomaterials companies are not disclosing to investors whether and when they are using such materials. Yet, these issues may well prove to be tomorrow's asbestos. When the scientific literature is rife with cause for concern, as it is regarding some of these materials, investors should at a minimum know when a portfolio company is focusing on the use of such problematic materials identified in the literature. A company whose product lines involve substantial usage of such materials should be obliged under the accounting rules, as well as SEC rules, to qualitatively disclose the use of the materials and existence of the literature, even if they also note that no claims have been asserted and that the management views potentially severe claims and outcomes as remote.

Liabilities judged as remote by management with potential for severe financial implications.

The concept of remote liabilities is an essential element of the proposed accounting standard. It is a positive development that the Board has decided to require reporting of certain remote liabilities. There is a striking tendency of filers to underestimate the likelihood –treat as "remote"–various potentially severe contingent liabilities and to thereby conceal the risks. Typically, such large issues can loom undisclosed for many years, with eventual catastrophic consequences for investors. *Yet under the proposed standard, companies are allowed to avoid disclosing such severe threats if they characterize the claims filed in litigation as "frivolous" or if there are as yet no asserted claims.* **At a minimum, the Board should define "frivolous" in a manner that prevents abuse of this potential loophole.**

Secondly, unasserted claims should also be disclosed where the implications are severe. Under the current proposal, liabilities judged by management as "remote" would only be required to be disclosed if they have potential for severe impact and are either "asserted" claims or relate to unasserted claims that the management has concluded are likely to be asserted and are reasonably likely to be resolved unfavorably to the company. In practice, this means that unasserted claims will seldom if ever be disclosed, even though the management may have every reason to think the company may eventually face a raft of lawsuits on an issue.

The exposure draft does not require disclosure of the unasserted claims unless the financial statement preparer concludes both that it is probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. This is an inappropriate threshold for instances where the management is aware of potentially

[1] http://iehn.org/publications.reports.eightloopholes.php
[2] http://iehn.org/publications.reports.toxicstock.php

severe liability scenarios, even though no claims have yet been asserted. **A footnote requirement (rather than a quantitative disclosure) should be required for potentially severe liabilities, even where claims may be unasserted and viewed as remote by the management.**

Expert witness estimates are an important element of the standard.

One of the most important explicit new requirements stated in the financial accounting standard is the requirement to disclose liability estimates when they have been put forward, for instance, by expert witnesses. The board should stand by this requirement, which provides essential information to investors.

When it comes to legal assertions regarding "prejudicial" information, the current exposure draft makes an appropriate compromise – preserving legally privileged information while ensuring disclosures needed to avoid perpetuating misleading financial statements.

As we have seen in other comment letters submitted on the exposure draft, once again the reporting community and corporate bar have launched an assault on elements of the Board's contingent liability exposure draft. In particular, the corporate bar has opposed the proposals requiring disclosure of prior average settlement amounts, discoverable amounts of liability insurance coverage and quarterly tabular reporting of evolving liabilities.

Objections regarding the potential for investor disclosures to provide information that could be used in some way by plaintiffs have existed as long as there have been securities laws and accounting principles. Incidental disclosure of some information that may be relevant and useful to a diverse array of stakeholders, including consumers and their lawyers for instance, is a price that we pay for relying largely on disclosure, rather than government micromanagement, for protection of investor interests. The original FAS 5 was greeted with similar objections, as were proposals for various elements of the SEC's securities regulations -- especially disclosure of "risk factors" and publication of the Management Discussion and Analysis. The legal sky did not fall with the establishment of those requirements; nor would the set of disclosures proposed by the exposure draft significantly alter the shape of the current litigation environment.

The current proposal is also consistent with a balanced approach taken by the judiciary regarding the use of potentially prejudicial information in the courts. **The courts take the view that often potentially prejudicial information which is "more probative than prejudicial" should be allowed into evidence. In the current proposed standard, the information disclosures required are also "more probative than prejudicial" from the standpoint of investor interest, as contrasted with the relatively minor potential prejudicial impact on litigation.**

Thus, in our opinion, the approach taken by the Board in the latest draft presents an appropriate compromise. It preserves legally privileged information, but requires disclosure of nonprivileged information, the concealment of which could essentially encourage companies to issue intentionally misleading financial statements. The accounting rules should not countenance such a scenario.

For example, benchmarking pending cases against a company's own results to date is certainly being done internally by any well-managed company; these results should be shared with investors. Similarly, investors should stand, at minimum, in the same position as litigants, in being able to ascertain whether and to what degree pending liabilities may be insured.

Tabular reporting framework should include additional details.

The proposed tabular reporting framework should include additional details so that investors can have sufficient information to understand loss contingencies.

Expand Item (g)(2), "Amount accrued during the period for new loss contingencies recognized," to separately disclose accruals arising from:

a. new loss contingencies;

b. pre-existing loss contingencies not previously recognized;

c. liability for loss contingencies assumed in business combinations or other business transactions.

Eliminating the "prejudicial disclosure" exemption.

We agree that now that the board has eliminated a requirement for the management to disclose its worst-case liability estimate, and has based the principal disclosure obligations on publicly available, nonprivileged information, it is no longer necessary or appropriate to include a separate prejudicial disclosure exemption within the Statement.

Conclusion: Contingent liability disclosure, sustainability and effective corporate management.

In closing, we wish to note that the issue of contingent liability disclosure is relevant to the international attention being brought to integration of sustainability data and financial statement accounting. As a result, the importance of contingent liability disclosures will likely grow in significance in coming years.

With the recent creation of the International Integrated Reporting Committee (IIRC) including high-level participation from regulators and accounting professionals from Europe and the US, it is likely that contingent liability disclosure of sustainability related

issues in particular will face growing scrutiny and demands. As the Committee's website states:

> The IIRC's remit is to create a globally accepted framework for accounting for sustainability: a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format - put briefly, in an "integrated" format. The intention is to help with the development of more comprehensive and comprehensible information about an organization's total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model.

With the current chairman of the FASB, Robert H. Herz, as one of the members of this committee, it is essential that the Board stay the course in expanding the amount of contingent liability disclosures available to investors.

Other bodies have already recognized the need for sustainability related liability disclosures. For instance, the Climate Standards Disclosure Board was formed at the 2007 meeting of the World Economic Forum in response to increasing demands for standardized reporting guidelines on climate change information. That board has prepared a draft Climate Change Reporting Framework which includes the following language regarding reporting of climate related financial impacts:

> b. Financial impacts
>
> Where possible, provide details of the current and future financial implications related to capital and operating expenditures, liquidity, commitments, liabilities or revenues associated with climate change strategies, risks and greenhouse gas emissions. Where there remains regulatory uncertainty, financial estimates can be provided in the form of ranges based on stated assumptions or scenarios.

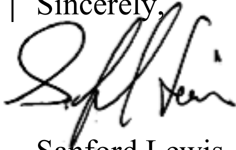
Thus, sustainability data includes not only performance criteria such as amounts of particular pollution emissions, but also data related to contingent liabilities regarding social and environmental issues. Getting this issue wrong at this time could undermine progress toward sustainability reporting and integrated reporting.

In addition to the importance of the contingent liability disclosure enhancements for investors interested in sustainability, the role of disclosure standards in assisting effective corporate management should also not be underestimated. A company that wants to effectively manage its contingent liabilities, and underlying sources of those liabilities, needs complete information –more so than currently required for disclosure. But as Attorney/CPA C. Gregory Rogers has noted in his 2009 paper for the American Bar

Association, "Corporate Environmental Disclosure Policy[3]," if a company chooses to develop such information for its internal use (a second set of books), it may risk accusations of investor fraud. By contrast, when a company is managed with only the information mandated for disclosure currently, it cannot effectively manage those contingent liabilities. The current proposal, by requiring more detailed tracking of contingent liabilities for purposes of disclosure, will also assist companies to be more attentive to the internal tracking and management of contingent liabilities.

Thank you for your consideration.

Sincerely,



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[3] http://www.advancedenvironmentaldimensions.com/documents/Corporate%20Environmental%20Disclosure%20Policy.pdf