Investor Environmental Health Network

HEALTHY PEOPLE...HEALTHY BUSINESS

August 8, 2008

Russell Golden, Technical Director
Financial Accounting Standards Board
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Comment on Exposure Draft - Disclosure of Certain Loss Contingencies
Amending FAS 5 - File Reference No. 1600-100

Dear Mr. Golden,

I am writing as counsel to the Investor Environmental Health Network (IEHN), a collaborative partnership of investment managers focused on issues related to toxic chemicals in products with $41billion in assets under management.[1]

1. Investors need improved disclosure.

The investors in IEHN are concerned with the financial risks and opportunities posed by the presence of toxic materials in the supply chain of their portfolio companies. Awareness of product toxicity issues, and the adoption of safer materials, has led a number of companies to produce excellent financial results by anticipating and acting on long term financial risks of liability and market or regulatory exclusion, as well as the opportunities presented by being early adopters of alternative materials. In contrast, a larger number of other companies are currently failing to disclose or act on the immediate to long term risks posed by toxic materials, which we believe places some of them at serious financial risk. These shortcomings were highlighted in our recent report, *Toxic Stock Syndrome*, which assessed the extent of disclosure of issues related to product toxicity in corporate securities filings. The report found widespread failures to disclose relevant information. The report is available on our website at IEHN.org.

Our experience and analysis indicates that the existing disclosure system is not working. It is clear from our research that the Board is accurate in its assessment that the existing Statement No. 5 has failed to produce "adequate information to assist users of financial statements in assessing the likelihood, timing, and amount of future cash flows associated with loss contingencies." FAS 5 has not been overhauled despite more than 30 years of experience with its implementation. Over the last 30 years the demand for transparency

[1] I wish to acknowledge the assistance of Daniel Gatti, JD, and Ellen Hewitt in the preparation of these comments.

and accountability has grown dramatically. FAS 5 is outdated, and in our opinion and experience it is overdue for revisions.

Maintaining the status quo is not an option that FASB should contemplate. Serious improvements are needed to yield corporate disclosures that better reflect financial conditions and risks.

Changes are also needed to eliminate the skewed managerial incentives caused by current accounting. IEHN members are vividly aware of the relationship between disclosure practices and issues management. Disclosure of issues and numbers in financial statements affects investment decisions, but it also affects the management of the underlying issues. When reporting entities are required to disclose and characterize issues, they are also more accountable to investors for how those issues are managed.

Since many investors hold stock for the long term, it is essential that major long term risks be identified and managed. As has been noted in recent work by the Aspen Institute, the Conference Board, and the Marathon Club, there is a growing sense within the investment community of a need to align public policy and investment strategy to allow investors to weigh longer term returns, not just quarterly and annual returns. Accounting rules play a significant role in whether this will be done.

It is in this context that I wish to offer comments on the FAS 5 exposure draft.

2. The FAS 5 Exposure Draft makes some moves in the right direction, but is in need of refinement.

In our analysis, the Exposure Draft offers promising steps towards more useful financial statement disclosures. As will be discussed in greater depth below, it is necessary for FASB to:

1) **Require at least a descriptive (narrative) disclosure of all short or long term severe impact risks known to management, including unasserted claims, even if they are viewed as "remotely probable";**
2) Eliminate or better circumscribe the proposed 'prejudicial' exemption to ensure that use of this exemption remains rare;
3) Implement the draft language that would expand the pool of loss contingencies that are disclosed;
4) Implement the draft language that would ensure greater quantification of loss contingencies;
5) Expand the scope of the proposed statement to include all loss contingencies, including asset impairments.

FASB standards must anticipate and counteract the strong institutional incentives to manipulate accounting in order to avoid disclosure of loss contingencies. **Accounting standards containing to the greatest extent possible objective reporting criteria**

rather than those requiring subjective "judgment-calls" will be necessary to counteract this tendency. In the exposure draft, the FASB recognizes that two elements of the existing Statement No. 5 are being regularly manipulated to minimize disclosure - at core these manipulations occur because of the great latitude for **subjectivity** in reporting.

First, the exposure draft notes that the requirement that reporting entities must disclose loss contingencies that are "*at least reasonably possible*" has led to failure to disclose contingences that, in fact, happen. The existing statement defines "reasonably possible" with the vague guideline "the chances of the future confirming event or events occurring is more than remote but less than probable." This leaves enormous discretion to a reporting company. Not surprisingly, the Proposed Statement finds that this standard "has not resulted in the disclosure of the full population of an entity's existing loss contingencies that would be of interest to financial statement users." Indeed, there is now a massive track record of events happening despite apparent corporate assessments (based on nondisclosure) they were not "at least reasonably possible" and therefore reportable. As will be discussed below, we believe the exposure draft moves in the right direction in requiring that severe loss contingencies be disclosed even though judged "remotely probable" by the management. But in our opinion it does not go far enough because it truncates the timeline for discloseable "severe" scenarios.

Second, the existing FAS 5 allows reporting entities to avoid estimating their likely exposure to risk if they find that such an estimate "cannot be made." This exception has been used and abused frequently, again because it allows a judgment call as to whether an estimate "can" be made. The existing statement requires reporting entities to "give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." However, all loss contingencies involve some degree of uncertainty. The existing statement fails to provide any clear guidelines to determine how certain a loss estimate must be before it triggers an obligation to disclose. The result is that reporting entities almost always find that a reasonable estimate cannot be made.

Scott A. Taub, Deputy Chief Accountant for the SEC, has argued that "[t]hose who complain about the detailed nature of some recent accounting pronouncements need only look to the accounting and disclosure of contingencies that fall into the scope of Statement 5 to see why standard-setters sometimes move to more detailed guidance." Given this track record, it is imperative that the FASB revise its accounting standards to minimize the opportunity for *concealment by interpretation*.

The Proposed Statement makes two important contributions towards such a goal. First, the Proposed Statement replaces "at least reasonably possible" with a general duty to disclose all loss contingencies other than those that fit into one of a few narrowly defined criteria. This will expand the pool of loss contingencies that are disclosed, and thus may improve investor access to relevant information.

Second, the Proposed Statement provides an alternative form of reporting for reporting entities that 'cannot estimate.' Under the proposed rules, reporting entities that cannot

estimate the likely loss of a contingency will instead be required to disclose their maximum exposure to loss. This will create a strong incentive for reporting entities to undertake greater effort to provide realistic estimates of their likely loss exposure. It will also give reporting entities in many instances an objective solution to the estimation problem – to simply disclose the amount of the claim, rather than attempting to conduct a probabilistic estimation exercise. The proposal thus offers reporting entities a series of options – to estimate the claims, to disclose the plaintiffs' amount of claims, or to describe a "worst case" scenario which the management can also characterize as only remotely likely. This set of options should provide reporting entities with sufficient flexibility to choose a suitable way of providing some form of estimate. The additional option of aggregating claims where individual disclosure may be prejudicial will in many instances suffice to preserve the legal, financial and judicial interests of the reporting entity.

3. Refinements are needed to the proposed "remotely probable" severe impacts disclosure standard (FAS 5 Exposure Draft, para. 6) to ensure disclosure of short and long term liabilities.

While reporting entities often choose to characterize the probability of a severe impact risk as "remote," such judgments – later proving erroneous - have been at the core of the poor disclosure records preceding the breaking news of many of the key corporate scandals of the last ten years. Thus, creating an accounting standard that requires disclosure of severe impact threats, even in the face of ostensible "remoteness", promises to provide disclosures that are far more protective of investor interests.

The current draft improves upon the existing FAS 5 statement by requiring disclosure of "severe" impact risks even if viewed as remotely probable, *but only if the underlying issue is expected to resolve in the near term, i.e. within a year.* The exposure draft notes that this near term element was inserted to balance the costs and benefits of the new disclosure rule.

To the contrary, reporting entities must be required to disclose all loss contingencies that could have a severe impact upon the operations of the company viewed as "remotely probable," regardless of the timing of the resolution of the issue. It is clearly essential for investors to have access to information about all liabilities known to management that could pose a severe threat to the company.

The proposal's myopic focus on short-term severe impact liabilities will fail to adequately inform investors about some of the largest threats to the viability of an investment. Given the portion of investors in the marketplace with long term stakes in companies, it does not make sense to limit disclosure of severe risks, even if judged as remote by a company, to those that will resolve in the short term.

For example, there is currently scientific evidence emerging on the environmental and health consequences of certain nanomaterials, some of which have been proven to resemble asbestos in structure and to cause mesothelioma (a disease otherwise know only to be caused by asbestos) in rats. The leading producers of these materials, especially if they represent a significant portion of their business, could be subject to devastating lawsuits similar to the litigation that has imposed $70 billion worth of costs on the asbestos industry and driven 66 asbestos producing companies into bankruptcy.

The producers of these materials, known as carbon nanotubes, are probably aware of this potentially severe medium and long term threat. Nevertheless, under the lenient standards of the exposure draft, they would not be required to provide any information on this risk to investors, as long as they determined that the probability of loss is “remote.” After all, any major liability would likely be several years in the future.

Accordingly, FAS 5 should be revised to require the disclosure of remote but severe impact risks regardless of the time horizon on which they would be resolved. In order to address the concerns regarding the relative costs and benefits of such disclosure, we propose a compromise approach -- that for disclosures of remote, severe losses that may take more than a year to resolve, **the disclosure duty could entail a narrative description of the severe impact contingency, without quantification.**

By eliminating the requirement for quantification of such longer term losses, the benefits of such disclosures would far exceed the costs. These benefits include an ability for long term investors to better understand any potentially ***severe*** long term impacts on their holdings, and to make visible the judgments by management that such impacts are remote. Long term institutional investors would be enabled to consider these longer term issues, and gain the opportunity to inquire further where such issues are flagged. Another benefit would be better management of long term risks by reporting entities – who would no longer be empowered by financial rules to ignore consideration of issues that may pose severe impacts in the longer run.

The cost of such a disclosure, without an obligation to quantify the amount of the remote liability other than to acknowledge that it could be “severe,” would be minimal relative to the benefits of such disclosure. Any substantial costs would be more likely associated with calculating the *amount* of a severe impact; allowing a disclosure that acknowledges the potential for the liability to pose a severe impact without quantification is an appropriate compromise to the balance of interests.

In addition, the FASB should clarify that the duty to disclose remote, severe losses, whether resolveable within a year or in the long term, would apply to **unasserted claims** as well as to any claims that have been asserted but are considered “remotely likely” to pose severe impacts.

An essential element of this aspect of the exposure draft, and of our response to it, is to acknowledge that **a potential severe impact threat, even if judged as remote by the management of a reporting entity, is in fact material to investors.** Any assumption

that investors would only want to know about such threats if the management would view it as "reasonably likely" is erroneous. The recent history embodied in Enron, subprime lending and the asbestos bankruptcies places one harsh lesson in bright light – reasonable investors must look closely at "severe impact" threats even if the management may be casting them as only "remote." Without an accounting rule to embody this lesson, the investing public is at the mercy of those whose judgment about the severe threats is skewed toward "improbability" and nondisclosure.

4. The proposed prejudicial exemption (FAS 5 Exposure Draft, para. 11) is open to legal manipulation and merits elimination or refinement.

FASB is clearly in a difficult position in revising existing standards to ensure better disclosure of loss contingencies while ensuring that the disclosures do not affect "to the entity's detriment, the outcome of the contingency itself." The current disclosure regimen is one in which large impending liabilities remain unestimated and often undisclosed until after a settlement or judgment. In many instances, this yields abrupt stock price adjustments after the liability amount becomes known. As shown in the array of comments received by FASB, it is difficult to find the right balance of disclosure and privilege to both reduce these abrupt bumps in valuation and not detrimentally impact the reporting entity in adversarial proceedings.

I believe the current proposal on "prejudicial" disclosures represents a first attempt at balancing those interests, but that the proposal must be either eliminated or refined sharply to avoid problems in its implementation. As currently drafted the exemption could be subject to widespread abuse, and urge a cautious revisiting of the exemption by FASB before adoption.

The exception by FASB to the prejudicial information exemption, requiring quantification of liabilities in the aggregate in any event, is an important and helpful limitation to the prejudicial information proposal.

There will be enormous incentives for reporting entities to interpret this prejudicial exception broadly. In complex litigation, it is not always clear what information may become relevant to an ongoing dispute. The permissive "could" indicates that reporting entities may use this exception any time their lawyers can come up with a scenario in which releasing the information would affect the outcome of the contingency.

It is inevitable that reporting entities' attorneys will work to interpret any and all exceptions to the duty to disclose information as expansively as possible; the "potentially prejudicial" exemption would provide the broadest possible opportunity to legally bar disclosure. Counsel could issue such interpretations in a context in which there would be very low probability that their legal interpretations would ever be reviewed or challenged by any independent authority. With little to filter spurious or aggressive legal interpretations of "prejudicial," disclosures could be limited broadly. In such a context it

is essential that at a minimum a company engage in quantitative disclosure of liabilities in the aggregate.

The FASB should reconsider the prejudicial exemption. The adoption of the "prejudicial" exemption as currently drafted could prove a long-lasting error that may create more problems than it would solve and would take decades to correct. The expectation that it would be rarely used would be as erroneous as the prior expectation regarding "cannot estimate."

In the event that FASB believes it must address potentially prejudicial information in some manner, there are less open-ended ways of doing so -- by establishing detailed criteria to determine the circumstances in which exemption would apply, and by adding criteria that would help to avoid misinterpretation or abuses of disclosures.

For example, there are various source documents which would provide relevant information and which cannot be deemed prejudicial in any manner. These include the text of complaints, administrative proceedings and court filings that are not under seal. A rule could be crafted by FASB to require disclosure of estimates (claims amounts), when possible, based on such public documents which are outside of the range of potentially prejudicial information. As proposed in the exposure draft, management could be free to add its own characterization of the likelihood of the listed claims succeeding.

It should be noted that already many disclosures contained in **current** financial statements are based on advice of counsel. The fact that a corporation may rely on advice of counsel to issue a financial statement is not new; the new disclosure criteria can be integrated to legal routines in the same manner as prior statements.

It is not an unintended consequence of corporate disclosure regulations that disclosure of certain loss contingencies will lower the value of stock. The purpose of requiring a corporation to disclose a loss contingency is to allow investors to understand the impact of a potential future loss on the present day value of a company when they make a decision about whether to make an investment. A possible consequence of the release of that information would be to lower the value of corporate stock; if that impact is by itself considered prejudicial, then all loss contingencies could be categorized as prejudicial. Once the marketplace understands the new FASB requirements, the results should be readily accommodated in pricing decisions. Attention should be given to providing ample lead time and information to the analysts and reporting entities that the implications and any limitations of the expanded information flow are well understood.

To the extent that there are legitimate concerns about the disclosure of sensitive information, a clear, narrowly tailored "prejudicial" rule would be more appropriate than the open ended proposal in the exposure draft. Such a rule should focus on specific forms of disclosure that would actually have a material impact on pending litigation, for example, the prejudicial exception rule could permit companies to avoid disclosure of information that would both be considered a waiver of attorney-client privilege and would materially impact one of the specific elements of a pending legal claim.

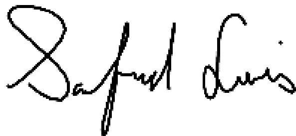
FASB should ensure that the prejudicial exception is not used merely to avoid embarrassing disclosures that may reduce the price of corporate stock, or to avoid disclosures that could be misinterpreted as a settlement offer or an admission of guilt.

5. FASB should also address asset impairments in parallel with liabilities.

Despite finding that the current disclosure standards for loss contingencies are inadequate, the Proposed Statement retains current disclosure standards for loss contingencies that would be recognized as **asset impairments. The scope of the exposure draft should be expanded to include all loss contingencies under its new disclosure and quantification criteria**.

I would welcome the opportunity to discuss these comments further with the Board, in a Roundtable or other appropriate forum. Thank you again for the opportunity to comment.

Sincerely,



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