



# Investor Environmental Health Network

HEALTHY PEOPLE...HEALTHY BUSINESS

## ***Investor Alert: Rare Opportunity to Improve Corporate Disclosure Investor Letters to FASB are Needed by August 8, 2008***

**Summary:** A proposed accounting standard would require corporations to disclose more to investors regarding their potential losses due to product toxicity, environmental remediation and other liabilities. However, the proposed standard stops short of requiring full disclosure of risks that would impact investors, **most notably neglecting to require disclosure of long-term severe impact risks.** The proposal may also allow corporate lawyers to routinely block disclosure of almost any information that they designate as prejudicial. Investor input is critical on these issues, as the corporate lobby is expected to turn out in force to oppose expanded disclosure. **Comments are due by August 8 to the Financial Accounting Standards Board.**

### **What's the Problem?**

When investors are unaware of impending financial pain at companies in which they hold stock, they often face expensive surprises. Securities laws and related financial accounting principles are supposed to arm investors with information to avoid these shocks, but these safeguards are proving 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.

Financial statements are required to contain disclosures of potential future losses, known to accountants as **"loss contingencies."** Along with other disclosures in corporate SEC filings, these disclosures could, if effectively regulated, inform investors on contractual liabilities, future product toxicity lawsuits, and likely environmental remediation costs, among other things.

**The Federal Accounting Standards Board (FASB) has concluded that its current disclosure standards do not provide investors and analysts with all of the needed information regarding these liabilities,** including the likelihood, timing, and amount by which they will affect future cash flows.<sup>1</sup> As a result, FASB issued an "exposure draft" in June 2008 to improve on the existing disclosure standards.<sup>2</sup>

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The Investor Environmental Health Network is a collaborative project of investment managers that tracks product toxicity issues. IEHN is a project of the Rose Foundation for Communities and the Environment. IEHN recently published a report, *The Toxic Stock Syndrome*, which analyzed the scope of current corporate disclosures on product toxicity. <http://iehn.org>.

<sup>1</sup> FAS 5 Exposure Draft, Summary, p. v.

<sup>2</sup> [http://www.fasb.org/project/accounting\\_for\\_contingencies.shtml](http://www.fasb.org/project/accounting_for_contingencies.shtml)

## **SUMMARY OF THE FASB PROPOSAL: PRESUMED DISCLOSURE AND QUANTIFICATION OF LIABILITIES**

The exposure draft would revise FASB Statement No. 5, *Accounting for Contingencies* (one of the bedrock disclosure standards, which has not been revised since enacted in 1975). The proposed changes would be an important step towards remedying accounting and disclosure deficiencies. However, the exposure draft contains several exceptions and loopholes that would diminish the value of the proposed changes.

Unlike the existing standards, the draft would require disclosure of all liabilities except those that meet certain narrow exceptions. Corporations currently can avoid *quantifying* future liabilities by claiming that they cannot estimate the level of the likely loss. The exposure draft would close this loophole by requiring these companies to at least report the *maximum possible loss*. For instance, a company that is a defendant in a lawsuit could be required to at least report the amount of the claim, even if the management believes it would cost less than that to settle it.

### **These proposed FAS 5 changes, however, would be subject to three important exceptions and loopholes.**

**Loophole 1)** The FASB proposal fails to require reporting companies to disclose all loss contingencies that could pose a “severe” threat to the company. A key pitfall for investors is the tendency of companies to underestimate the likelihood of severe financial threats and thereby conceal the risks – Enron, the subprime lending crisis, and asbestos liabilities are three examples. Typically, these large issues were looming 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 believe that a loss is only remotely likely, and that the issue would not be resolved during the coming year.* This exception will prevent investors from being able to access information that may be particularly crucial in determining the medium and long-term health of an investment. For example, some companies are now deploying newly developed materials known as carbon nanotubes, even though they have been linked in the laboratory to a form of cancer similar to that caused by asbestos fibers. The potential for severe liabilities seems real, but the timeline for formation of illness and eventual litigation could take decades. The history of asbestos-related bankruptcies demonstrates the value of requiring disclosure today by companies using materials with potentially severe long-term liabilities.

***Solution 1)** FASB should require a narrative disclosure of “severe impact risks” deemed by the reporting company to be remotely possible and long term.*

**Loophole 2)** The proposed new rule on presumptive disclosure and quantification would apply only to **legal liabilities**, not to **asset impairments**. So it would cover pending lawsuits and product warranty claims, but not information revealing, for instance, that as a result of climate change, a company’s property is at risk of being destroyed by flooding (an asset impairment).

***Solution 2)** FASB should apply the new standard to asset impairments, not just legal liabilities.*

**Loophole 3)** Under the proposal, a company would be allowed to avoid many disclosures by having their lawyers assert that the publication of information would be “prejudicial”. This is a vague legal standard that could be routinely abused (similar to the existing “cannot estimate” loophole which has allowed many companies to minimize liability quantification). While the draft statement indicates that this exception should be “rare,” it is too vague, and does not provide the kind of clear and objective standards that could ensure that the exception does not get abused.

***Solution 3)** FASB needs to eliminate or strictly limit this “prejudicial” exception to avoid misuse.*

It is critical that investors contact FASB regarding the proposed overhaul of the **FAS 5 Accounting for Contingencies** statement. In your comments, a) Recognize that FASB is proposing to take important steps to improve the quality and usefulness of corporate financial disclosures; b) Insist that the proposed FAS 5 rule be strengthened to close these three loopholes.

## **HOW TO COMMENT**

Submit your FAS 5 comment letter to FASB by August 8, 2008 by email to [director@fasb.org](mailto:director@fasb.org), File Reference No. . Those without email may send their comments to the Technical Director—File Reference No 1600-100 Financial Accounting Standards Board, Financial Accounting Foundation, 401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

See model letter from individual or institutional investors on next page . **Sign-on letters are also being developed if you prefer to join a group letter rather than sending your own.**

Contact Sanford Lewis at 413 549-7333 or [sanfordlewis@gmail.com](mailto:sanfordlewis@gmail.com) if you have questions regarding the standard or this action alert, or if you would like to join a sign-on letter.

***Model Comment Letter to FASB***

Russell Golden, Technical Director  
Financial Accounting Standards Board  
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PO Box 5116  
Norwalk, Connecticut 06856-5116

Comment on Exposure Draft - Disclosure of Certain Loss Contingencies  
Amending FAS 5 - File Reference No. 1600-100

Dear Mr. Golden,

As an investor [as an analyst / as an investment organization with \$\_\_\_ assets under management] it is critical to have accurate and complete information about liabilities in financial statements.

Therefore, I am [we are] writing to comment on the FAS 5 exposure draft on loss contingencies.

I agree with the FASB finding that the current statement on disclosure of loss contingencies fails to “provide 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 Exposure Draft, Summary, p. v). The changes proposed by the FAS 5 exposure draft *Accounting for Contingencies* represent an important step in improving disclosure.

However, I am [we are] very concerned with the draft’s treatment of severe long-term risks. The exposure draft only requires disclosure of severe financial threats that a company deems remotely probable if the issue is expected to be resolved within a year (FAS 5 Exposure Draft para. 6). There is a long history of companies underestimating the likelihood of severe financial threats – Enron, the subprime lending crisis, and asbestos liabilities are three examples. Typically, these large issues developed for many years, with eventual catastrophic consequences for investors. Therefore, FAS 5 should require companies to disclose all severe threats, regardless of whether they are resolved within a year.. **To ensure that these disclosures are cost-effective, we suggest that “remotely probable” risks including unasserted claims that are not expected to be resolved within one year could be described in a narrative, but need not be quantified other than to specify that they may be severe.**

In addition, in order to improve investor access to reliable information, I [we] urge that FASB:

- Implement the proposed draft language that would require disclosure of all loss contingencies except those that meet certain narrow criteria (FAS 5 Exposure Draft, para. A12).
- Implement the proposed draft language that would require a reporting company to quantify the maximum potential loss in circumstances where it cannot estimate the *likely* loss (FAS 5 Exposure Draft, para. 7a).
- Expand the scope of both the expanded population of required disclosures, as well as the maximum loss disclosure requirement to include asset impairments. These loss contingencies should be disclosed using the same standards as loss liabilities.
- Eliminate or further restrict and define the “prejudicial” information nondisclosure exemption to ensure that it remains a rare exception, and retain the proposed requirement that filers must in any event quantify their liabilities even if other information does qualify for the prejudicial exemption (FAS 5 Exposure Draft, para. 11).

Thank you for your consideration.

Sincerely,

[Name/Organization]