

INTRODUCTION TO SARBANES OXLEY AND CORPORATE FINANCIAL REPORTING ON ENVIRONMENTAL RISKS & LIABILITIES

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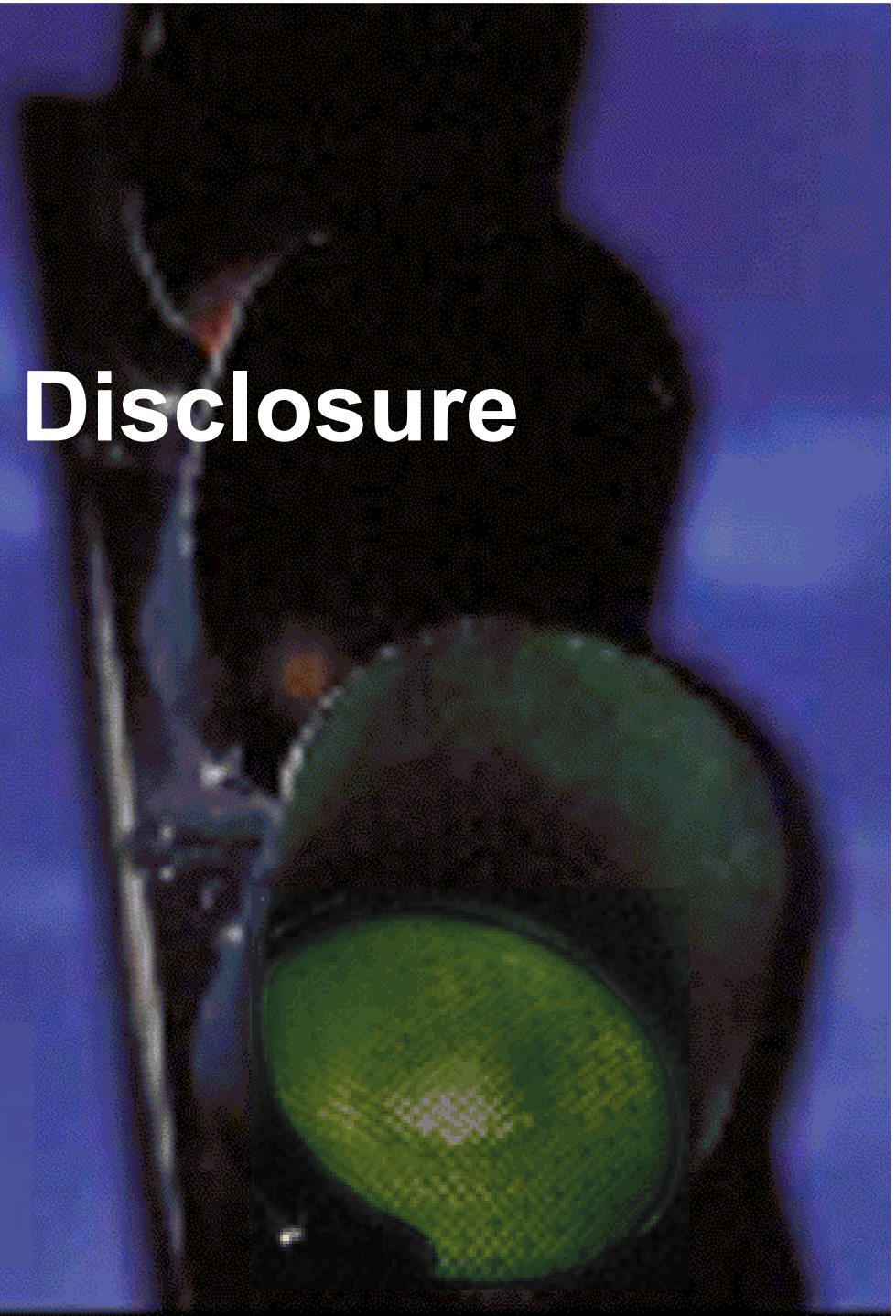
Sarbanes Oxley and the EHS Professional

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Overview

- SEC Environmental Disclosure Requirements
 - Narrative Disclosures
 - Financial Statements
- Sarbanes-Oxley “Enhancements”
- Trends & Recent Developments

Environmental Disclosure Requirements



Environmental Disclosure Requirements

Guiding Principles

- All investors are entitled to information about potential investments prior to purchase
- SEC requires public companies to disclose material financial and non-financial information to enable investors to make informed investment decisions
- 33 Act and 34 Act generally require disclosure of “material” costs and liabilities to shareholders

“Materiality”

- An item is material “if there is a substantial likelihood that a reasonable shareholder would consider it important” such that it has “significantly altered the ‘total mix’ of information” available.” *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).
- Materiality viewed through the eyes of a reasonable investor. *Basic v. Levinson*, 485 U.S. 224 (1988).
- Contingent liabilities – materiality determination should consider both probability that event will take place and magnitude of event.
- SEC warns against using a quantitative “rule of thumb.” (SEC Staff Accounting Bulletin No. 99)

Environmental Disclosure Requirements

- SEC has had environmental disclosure requirements since 1970s.
- These requirements cover:
 - Narrative Disclosures in Public Filings (Annual Report, Form 10-K, Form 10-Q, etc.)
 - Financial Statements

Narrative Disclosure Requirements

- SEC Regulation S-K (17 CFR 229)
- Company must disclose all “material” information, unless Regulation S-K requires disclosure of more specific information.
 - Costs of achieving compliance with existing laws
 - Liabilities from actual or threatened legal proceedings
 - Potential impacts based on regulatory trends and uncertainties

Item 101 of Regulation S-K

Description of Business

- “Disclose material effects” that compliance with environmental legal requirements may have on capital expenditures, earnings and competitive position.
- Must include “material estimated capital expenditures for environmental control facilities.”

Example

“disclose material effects”

Typical 10-K Disclosure:

“The costs to comply with complex environmental laws and regulations, as well as internal voluntary programs and goals, are significant and will continue for the foreseeable future. Even though these costs may increase in the future, they are not expected to have a material impact on the company's competitive or financial position, liquidity or results of operations.”

Item 103 of Regulation S-K

Legal Proceedings

- Disclose pending or contemplated administrative or judicial proceedings under environmental laws if:
 - Material to the company's business or financial condition;
 - Claims for damages, potential monetary sanctions, capital expenditures, deferred charges, etc., exceed 10% of current assets;
OR
 - Government authority is a party and proceeding involves potential monetary sanctions, unless reasonable belief that monetary sanctions will be less than \$100,000.
- If disclosure required, must include name of court or agency, date proceeding instituted, principal parties, alleged factual basis, and relief sought.

Example

Legal Proceedings

From the 2004 filing of a power company:

“Management is unable to estimate the loss or range of loss related to the contingent liability for civil penalties under the CAA proceedings. Management is also unable to predict the timing of resolution of these matters due to the number of alleged violations and the significant number of issues yet to be determined by the Court. If [the] subsidiaries do not prevail, any capital and operating costs of additional pollution control equipment that may be required, as well as any penalties imposed, would adversely affect future results of operations, cash flows and possibly financial condition unless such costs can be recovered through regulated rates and market prices for electricity .”

Item 303 of Regulation S-K

Management's Discussion and Analysis

- Must discuss “known trends . . . events or uncertainties . . . that are reasonably likely to have a material impact on liquidity, capital, sales, revenue or income.”
- Material events and uncertainties that would cause financial information not to be indicative of future financial condition
- SEC Interpretive Release:
 - Proposed legislation or regulation requiring future capital expenditures to install pollution control devices;
 - Designation as a PRP at a Superfund site; and
 - Recurring costs associated with managing hazardous substances and pollution in connection with ongoing operations.

Item 303 of Regulation S-K

MD&A

■ SEC Test:

- Is the known trend, demand, commitment or uncertainty likely to come to fruition? (If not reasonably likely, no disclosure required)
- If yes or unclear, must objectively evaluate consequences of event or uncertainty.
- Disclosure required unless management determines that a material effect on financial condition or results of operations is not reasonably likely.

Item 102 of Regulation S-K

Description of Property

- “Location and general character” of principal plants, mines, other physical properties.
 - Including whether title to the property is held subject to “any major encumbrance.”
- Inform investors as to the “suitability, adequacy, productive capacity and extent of utilization” of facilities.

Financial Disclosure Requirements

- SEC Regulation S-X
- Generally Accepted Accounting Principles (GAAP)
- Statement of Financial Accounting Standards No. 5
- SEC Staff Accounting Bulletin No. 92
- AICPA Statement of Position 96-1

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Statement of Financial Accounting Standards (SFAS) No. 5

- Covers treatment of “loss contingencies”
 - Recording of expenses in financial statements.
 - Disclosure in notes to financial statements.
- General rule: A loss contingency must be accrued if the potential loss is **material**, is **probable** to occur, and is capable of being **reasonably estimated**

Statement of Financial Accounting Standards (SFAS) No. 5

“contingency”

an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur

Statement of Financial Accounting Standards (SFAS) No. 5

Categories of Loss Contingencies

- “Remote” - chance of occurrence is slight
 - Neither recording nor disclosure is required, but disclosure in a note may be prudent.
- “Reasonably possible” - chance of occurrence is between likely and remote
 - Disclosure in a note is required, but recording of estimate is not.
- “Probable” - future event(s) likely to occur
 - Estimated loss from contingency must be recorded on balance sheet. Note disclosure is required if loss cannot be estimated.

American Institute of Certified Public Accountants Statement of Position 96-1 (SOP 96-1)

- Addresses recognition, measurement and disclosure of environmental remediation liabilities.
- Guidance on display of environmental remediation liabilities in financial statements and environmental cost related accounting principles.

SOP 96-1

General Rules

- A remediation loss is considered “probable” (FAS 5) if
 - it has been asserted (or is likely to be asserted) that the company is responsible for participating in a remediation process because of a past event, and
 - it is probable that the company will be held responsible for participating in the remediation
- “Reasonably estimating” (FAS 5) a remediation liability can be difficult, but a range can usually be developed and refined over time

SEC Staff Accounting Bulletin No. 92 (SAB 92)

- Provides guidance regarding loss contingencies, specifically addressing environmental loss exposures.
- Addresses estimation of environmental losses.
- Addresses PRP liability and insurance and other third party recoveries.

SEC Staff Accounting Bulletin No. 92 (SAB 92)

- If there is exposure for a known environmental liability, the amount of loss will be deemed reasonably estimable, and must be accrued, even if there are significant uncertainties with respect to amount and/or timing of the loss.
- If loss will fall within a range, and a better estimate within the range is not available, you must report the range and accrue the minimum amount of the range.

Sarbanes-Oxley “Enhancements” to Environmental Disclosure



Sarbanes-Oxley Act

Overview

- Creates the Public Company Accounting Oversight Board to oversee audits of public companies (Title I)
- Establishes requirements regarding the independence of auditors of public companies (Title II)
- Enhances corporate responsibility for the accuracy of financial reporting (Title III)
- Enhances requirements for certain financial disclosures (Title IV)
- Significantly increases civil and criminal enforcement mechanisms and penalties for fraud and for failure to comply with securities laws (Titles VIII, IX, XI)

Sarbanes-Oxley Act

Corporate Responsibility

- Requires CEO and CFO to **certify** in periodic reports that:
 - the reports are accurate and not misleading
 - the officers have evaluated the companies internal controls for financial disclosure and have disclosed any material weaknesses in those controls as well as any corrective actions (§ 302)
- Prohibits improperly influencing, manipulating or misleading an accountant engaged in an audit, and imposes serious penalties for violations (§ 303)
- Creates new sanctions for CEOs and CFOs for material noncompliance, including possible **disgorgement** of bonuses and other income (§ 304)
- Requires SEC to issues rules of professional responsibility for lawyers, including requiring an attorney to report a securities violation to the chief legal counsel, and if the chief lawyer does not act, reporting the violation to the Board (§ 307)

Sarbanes-Oxley Act

Enhanced Financial Disclosures

- Requires management to establish and maintain **internal controls and procedures** for financial reporting, and to assess annually the effectiveness of those controls and procedures (§ 404)
- Requires accountant to attest to, and report on, management's assessment of the company's controls and procedures (§ 404)
- Requires company to disclose whether or not it has adopted a **code of ethics** for senior financial officers requiring honest and ethical conduct; full, accurate and timely disclosure in periodic reports; and compliance with laws (§ 406)

Sarbanes-Oxley Act

Increased Penalties & Enforcement

- Increases penalties, provides longer statutes of limitation for violations
- Enhances “whistleblower” protection, including requirements for special reporting procedures
- Creates new federal crimes, including falsification of any record intended to influence or impede the investigation of any matter within the jurisdiction of any U.S. federal department or agency – 20-year prison term (§§ 802, 1102)
 - Now, even a response to an EPA information request is subject to scrutiny for completeness, accuracy and thoroughness

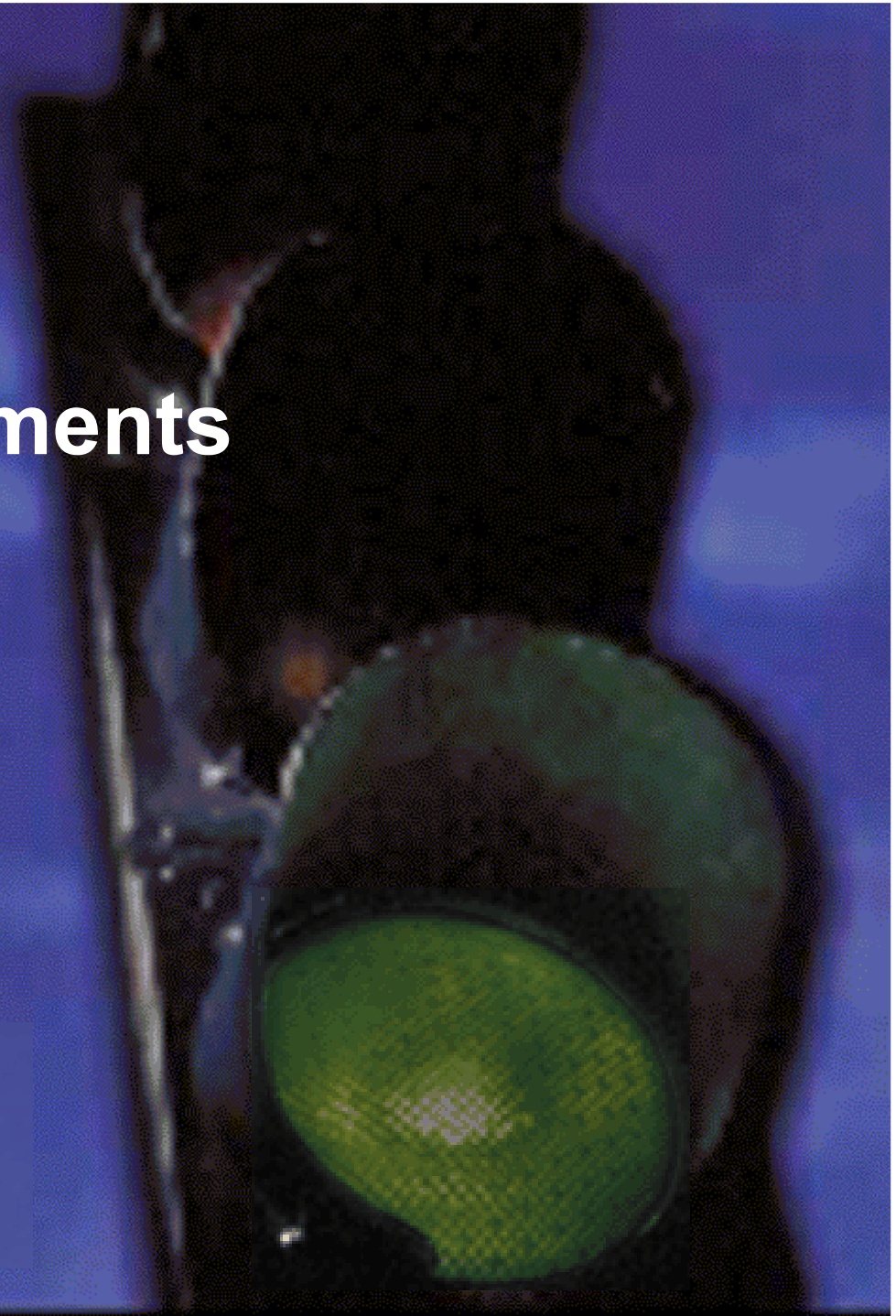
Has Sarbanes-Oxley Changed the World?

- Act made no substantive changes to provisions of the SEC disclosure requirements that specifically address environmental matters.
- But the Act significantly changed the consequences of violations and provided new enforcement tools.

Has Sarbanes-Oxley Changed the World?

- Increased External/Public Scrutiny
 - In light of all the problems that gave rise to Sarbanes-Oxley, the SEC and stakeholders are going to want to know everything.
- Increased Internal Scrutiny
 - Senior officials are on the hook for personal liability, and are going to make sure the information that is disclosed is complete and accurate.

Recent Developments and Trends



Current Developments

Compliance

- EPA OECA Enforcement Alert (Oct. 2001) informing companies of duty to disclose environmental legal proceedings pursuant to SEC regulations or face fines.
- State and Federal governments, as well as NGOs, have made publicly available large amounts of information regarding the environmental compliance of individual companies (e.g., EPA, State Websites).

Current Developments

Compliance (cont'd)

- SEC conducted a study of the public filings of Fortune 500 companies (Feb. 2003)
 - Concluded, among other things, that a number of companies needed to “enhance” their disclosure in the area of environmental liabilities.
 - Found that many companies did not provide adequate disclosure in the environmental area.
- SEC has established a hotline for advice on environmental disclosures.
- EPA, SEC, and DOJ have made efforts to cooperate regarding enforcement of requirements for environmental disclosures.

Current Developments

Compliance (cont'd)

- SEC Release No. 33-6835 (May 1989)
 - “Where a material change in a company’s financial condition or results appears ... and the likelihood of such change was not discussed in prior reports, the Commission staff ... will inquire as to the circumstances existing at the time of the earlier filings to determine whether the registrant failed to discuss a known ... uncertainty as required by Item 303d.”

Current Developments

GAO Report

- Recent GAO Report (July 2004), requested by members of Congress. Concluded that:
 - "little is known about the extent to which companies are disclosing environmental information in their filings with the SEC."
 - SEC does not systematically track environmental issues and thus does not have the information needed to analyze the frequency of problems, identify trends, or identify areas in which additional guidance would be warranted.
 - GAO identified four enforcement cases related to inadequate environmental disclosure since 1977.

Current Developments

GAO Report (cont'd)

■ Recommendations.

- That SEC track the information arising from its reviews of company filings.
- That SEC explore the creation of a database of SEC letters commenting on companies' filings and company responses that would be accessible to the public.
- That SEC and EPA improve coordination to ensure that SEC takes better advantage of EPA data that may be relevant to environmental disclosure.

Current Developments

ASTM Standards

- American Society for Testing and Materials International (ASTM) issued new guidelines:
 - Estimating Monetary Costs and Liabilities for Environmental Matters (ASTM E 2137-01)
 - Disclosure of Environmental Liabilities (ASTM E 2173-01)
- Intended to supplement GAAP, FASB and SEC requirements.

Current Developments

ASTM Estimation Standard (2137)

- Hierarchy of Four Cost Estimation Methods:
 - Expected Value Approach
 - Most Likely Value Approach
 - Range of Values Approach
 - Known Minimum Value Approach
- Must quantify potential loss even if magnitude and probability of outcome are difficult to predict.

Current Developments

ASTM Disclosure Standard (2173)

- Addresses MD&A disclosure, and requires disclosure if an entity believes its environmental liabilities for an individual circumstance or in the aggregate are material.
- If environmental liabilities **in the aggregate** are material, provides minimum disclosure requirements.

Current Developments

SRI Initiatives

- Corporate Sunshine Working Group
- Rose Foundation (*The Environmental Fiduciary: The Case for Incorporating Environmental Factors Into Portfolio Management Practices*)
- Petition for SEC Rulemaking that mandates disclosure of environmental liabilities in accordance with ASTM Standards – SEC currently considering Petition

Current Developments

Climate Change

- Significant press coverage regarding assessment and disclosure of climate change risks.
- Numerous reports and analyses of corporate financial disclosures regarding climate change.
- Institutional investor activity
- Record numbers of shareholder resolutions in 2003-2005

Current Developments

Climate Change

- Advocates' argument for disclosure:
 - Various types of risk exist (Regulatory, Physical, Reputation, Competitiveness, Litigation)
 - Climate change risk is a “known uncertainty” (Item 303)
 - Climate change regulation is already in place or imminent in many jurisdictions (EU, CA, NY, NE U.S.) (Item 101)
 - Some companies have been sued in tort for climate change impacts (Item 103)

Current Developments

Climate Change – Reports

- FOE, *Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies* (Sept 2002)
- Robert Repetto and James Henderson, *Environmental Exposures in the U.S. Electric Utility Industry* (Feb 2003)
- Robert Repetto, *Silence is Golden, Lead, and Copper – Disclosure of Material Environmental Information in the Hard Rock Mining Industry*
- SAM and WRI, *Changing Drivers: The impact of climate change on competitiveness and value creation in the automotive industry* (2003)
- CERES, *Electric Power, Investors, and Climate Change: A Call to Action* (June 2003)
- CERES, *Corporate Governance and Climate Change: Making the Connection* (July 2003)
- CERES, *Electric Power Climate Risk Disclosure – A Comparison of 2004 Reports Released by American Electric Power, Cinergy, and TXU* (April 2005)
- Law Review articles, etc.

Current Developments

Climate Change – Institutional Investors

- Apr 2004 – 13 pension funds ask SEC to issue clarification that climate change is a material risk that must be disclosed in filings
- Feb 2005 – CalPERS launches coordinated plan to seek greater disclosure of environmental liabilities, particularly global warming

Current Developments

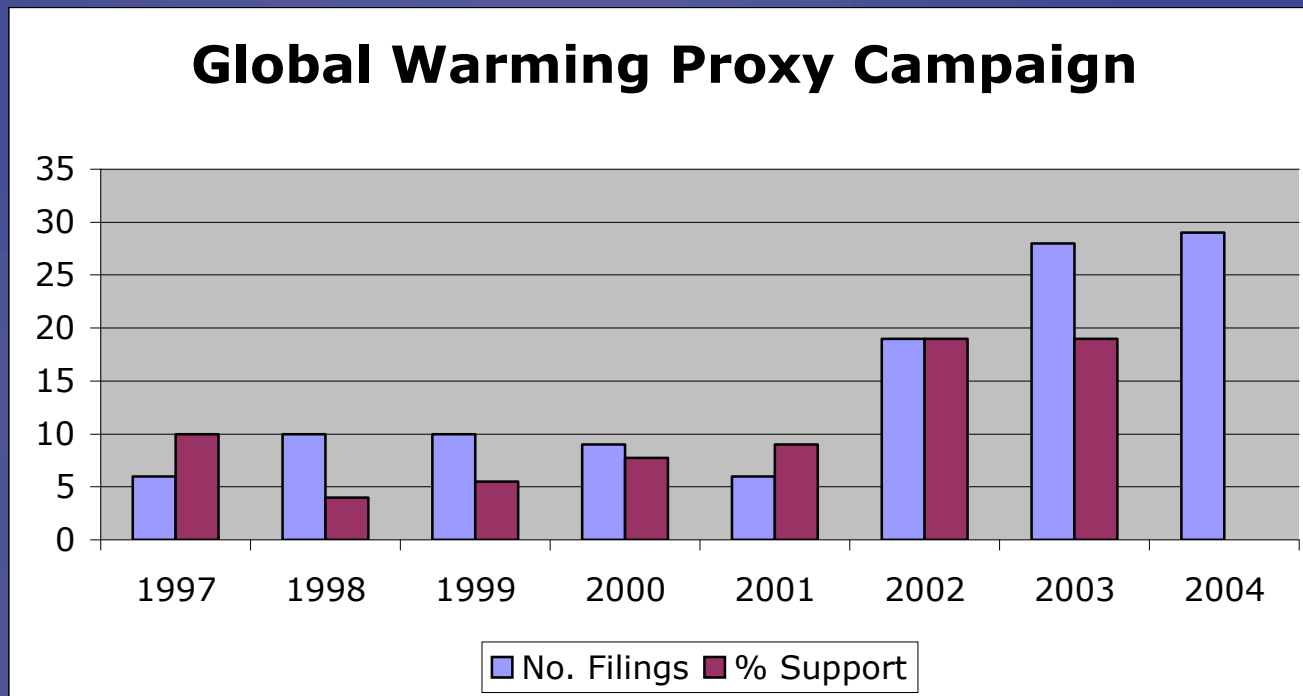
Climate Change – Institutional Investors

■ Carbon Disclosure Project

- 143 institutional investors representing \$20 trillion funds ask large companies to disclose information on GHG emissions
- “Do you believe climate change, the policy responses to climate change and/or adaptation to climate change represent commercial risks and/or opportunities for your company?”
 - If yes, specify the implications, detail the strategies adopted and actions taken to date.
 - If no, please indicate why.”

Current Developments

Climate Change



Source: CERES (2005)

Current Developments

Climate Change

American Electric Power (2004)

“RESOLVED: AEP Shareholders request that a committee of independent directors of the Board assess actions the company is taking to mitigate the economic impact on our company of increasing regulatory requirements, competitive pressures, and public expectations to significantly reduce carbon dioxide and other emissions, and issue a report to shareholders (at reasonable cost and omitting proprietary information) by September 1, 2004.”

Current Developments

Climate Change

Anadarko Petroleum Corp. (2005)

“RESOLVED: Shareholders request that a committee of independent Board directors assess how the company is responding to rising regulatory, competitive, and public pressure to significantly reduce carbon dioxide and other greenhouse gas emissions and report to shareholders (at reasonable cost and omitting proprietary information) by September 1, 2005.”

Current Developments

Climate Change

- Late 2004 – AEP, Cinergy, TXU issued reports to shareholders on climate risk in response to shareholder pressure
 - Acknowledge that limits on GHG emissions will occur
 - Point out tremendous uncertainty in US GHG regulatory environment
 - AEP and Cinergy analyzed future regulatory scenarios and implications for the company

Conclusions



Conclusions

- Applicable environmental financial disclosure requirements afford some latitude in determining when disclosure is required.
 - This latitude has resulted in considerable variation in the ways public companies in the U.S. are disclosing (or not disclosing) environmental liabilities and contingencies.

Conclusions

(cont'd)

- The last 5 years have seen increased public attention to financial disclosures concerning environmental matters, including organized shareholder and environmental advocacy in support of stricter requirements.
 - In response to this pressure, some sectors have begun to report on environmental contingencies that may not be technically required (e.g., power producers reporting on climate change risks)

Conclusions

(cont'd)

- Enhanced penalties, personal liability and organizational controls created by Sarbanes-Oxley have put a premium on establishing good internal systems for ensuring compliance with existing environmental financial disclosure requirements.

Conclusions

(cont'd)

- Against these trends toward greater disclosure, companies must also weigh the potential consequences of additional reporting, including:
 - Decline in share price due to adverse disclosure
 - Legal actions by shareholders or SEC due to failure to disclose earlier
 - Personal liability of directors and officers
 - Potential violation of contracts or debt covenants