Environmental Disclosures in Financial Statements
New Developments and Emerging Issues

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How to Promote Corporate Social Responsibility through Disclosure

Portrait of Gertrude Stein

"Everybody thinks that she is not at all like her picture, but never mind, in the end she will manage to look just like it." -- Pablo Picasso

Environmental Disclosure Pivotal to CSR
The Philosophical Perspective

The less you know,

the more you believe.

-- Bono

Environmental Disclosure Pivotal to CSR: The Operational Perspective

The Compliance Driver:

Internally, compliance with disclosure requirements generates better information, allowing corporate leadership to prevent, detect, respond to and/or remedy environmental concerns in a timely manner.

The Commercial Driver:

Externally, better environmental disclosure increases transparency, allowing stakeholders to make informed decisions and enhancing the competitive advantage of the socially responsible corporation.

Environmental Disclosure: Myths vs. Reality

<u>Myth 1</u>: The Sarbanes-Oxley Act imposes new and significant disclosure requirements that will restore public trust and end the corporate governance crisis.

<u>Myth 2</u>: There is less in the Sarbanes-Oxley disclosure requirements than meets the eye, especially from the environmental compliance perspective, and will have no long-term impact on corporate abuse.

<u>Reality</u>: The Sarbanes-Oxley Act is neither a long–term panacea nor a short-term palliative for the corporate governance crisis. The success of this Act in promoting greater transparency and accountability depends on the business community's and the stakeholders' commitment to ensure that its requirements are faithfully, creatively, and strategically applied – and, where possible, in concert with other disclosure requirements and voluntary initiatives.

Existing Environmental Disclosure Requirements

Existing SEC Disclosure Rules:

- Reg. S-K Item 101: Material effects of environmental compliance
- Reg. S-K Item 103: Environmental enforcement action
  - Material;
  - Damage claims exceeds 10% of net worth; or
  - Probable liability is equal to or greater than $100,000
- Reg. S-K Item 303: MD&A discussion on environmental trends and uncertainties

Existing Environmental Disclosure Requirements (cont.)

Contingent liabilities section of financial statement, including footnotes, should include environmental liabilities when "probable that an asset" is "impaired" or liability is incurred and amount in question is "material."

Related Guidance

SEC Staff Accounting Bulletin 92:

- Quantification of Environmental Loss Contingency

SEC Staff Accounting Bulletin 99:

- Concept of Materiality

Existing Disclosure Guidelines and Initiatives

AICPA SOP 96-1: Environmental Remediation Liabilities:

Presumes unfavorable outcome for site remediation claims, unless management can document otherwise

ASTM E 2173-01: Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters:

Provides guidance on estimating costs and liabilities for environmental matters

ASTM E 2171-01: Standard Guide for Disclosure of Environmental Liabilities:

Voluntary, Supplements GAAP Analysis for Disclosures

Establishes Industry Best Practices

EPA/Corporate-Wide Voluntary Audit Agreements

Eco-Management and Audit Scheme

Global Reporting Initiative/CERES

Sarbanes-Oxley Disclosure Requirements

Section 401:

- Disclosure of Material Correction Adjustments
- Disclosure of Off-Balance Sheet Transactions

Section 404:

- Disclosure of Management Assessment of Internal Controls

Sections 302 and 906:

- Officer Certification Requirements

Related Sarbanes-Oxley Provisions

Section 307:

- Attorney Reporting Requirements: Broad interpretation could cover environmental attorneys

Section 408:

- Tri-annual SEC Review: Could result in material restatement

Section 806:

- Whistle Blower Protection

Sections 802, 804, 807, 1104 & 1106:

- Criminal Sanction Provisions

Executive Perks

Executive Perps

Liability for Failure to Comply with Disclosure Requirements

Common Law Theory of Liability: Respondeat Superior

Regulatory Initiatives:

- EPA/SEC Coordination on Disclosure Initiatives
- EPA ECHO Web Site

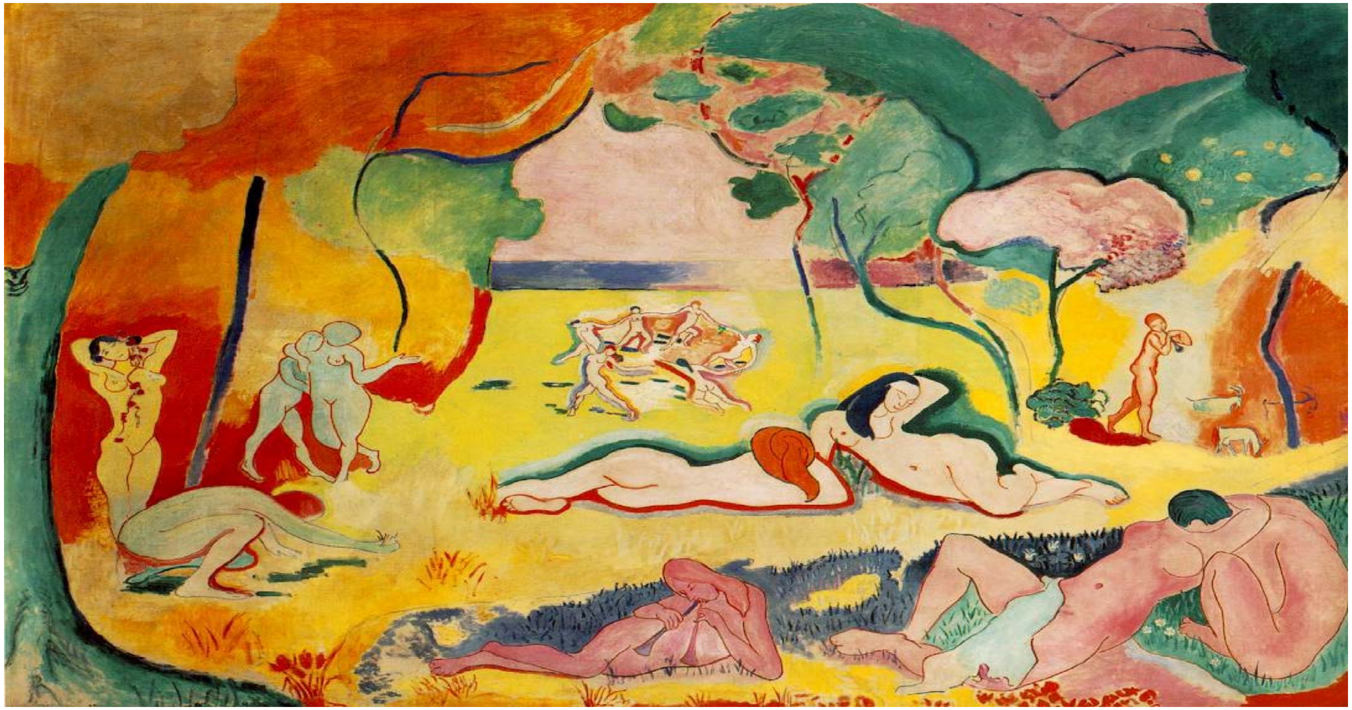
Civil Liability:

- *In re Caremark Int'l Inc.*

Criminal Liability:

- Federal Sentencing Guidelines Section 8A1.2(k)

Stated Differently ….
(And with Apologies to Henri Matisse)



Disclosure is like making an expressive gesture

with the advantage of permanence

What to Expect (Hope?) from Sarbanes-Oxley:

- Closer scrutiny of EHS performance to ensure compliance with disclosure requirements
- Improved record-keeping and document retention
- Ensure consistency in disclosure; make material corrections to past statements
- Enhance timely interaction between CEO/CFO and EHS management function
- Emphasize corporate-wide risk management practice

What to Expect (Hope?) from Sarbanes-Oxley:

Foster Trend to Step-Up Disclosure, Facilitate Synergy with Related Requirements

8-K Revisions Proposed

- **Enhanced "real time" disclosure requirements include environmental**
  - **applicable to pro forma earnings and off balance sheet financing**
  - **rapid disclosure regarding material changes in financial conditions or operations**

Close the Environmental Accounting Loophole

- **"The Environmental Fiduciary," by Rose Foundation**

Halt Underreporting of Environmental Liability in SEC Filings

- **WRI Reports**

Review/Reassess Parent/Subsidiary EHS Interaction

Opportunity to Disclose Environmental Assets

Enhanced Capacity to Conduct Environmental Due Diligence of Acquisitions, Financing and Investment

A View from the Trenches: Key Disclosure Considerations

Reported amounts in SEC disclosures to be consistent with regulatory submissions (i.e., to EPA), claims made to insurers, consultants' reports, transactional evaluations, or loan documentation

EHS management systems must ensure company collects, processes and discloses environmental information, including:

- Immediate compliance obligations and costs; and
- Expected capital costs to meet environmental obligations

Document all rationale for disclosure decisions <u>when they are made</u>

Companies with pre-existing voluntary EHS disclosure policies and practices will have an advantage

A View from the Trenches: Enhanced CEO/CFO and EHS Manager Interaction

CEO/CFO Certifications should build on “enterprise-wide” issues

EHS information gathered must be communicated to appropriate executives with sufficient speed to allow “timely” decisions on disclosure – “Bottom Up” paper flow

Tools to support EHS risk assessments need to include:

- Phase II environmental assessments
- Portfolio risk management
- Environmental insurance
  - “Cap” remediation costs
  - Supplement D&O coverage

A View from the Trenches: Corporate Parent/Subsidiary Interaction

- **How Parents Support Subs:**
  - Appoint common officers/directors
  - Inter-company loans of employee
  - Sign permits, manifests or property transfers
  - Use uniform corporate sourcing policy
  - Loans, letters of credits, support agreements or corporate guarantees
  - Transfer contaminated assets into special purpose entities (SPEs)
  - Allow use of real or personal property
  - Extend insurance blanket to consolidated enterprise
  - “Invest” in subsidiaries

A View from the Trenches: Corporate Parent/Subsidiary Interaction

Unintended Consequences of Parental Support

- May impose environmental obligations on parent
- May allow environmental claimants to disregard corporate form

A View from the Trenches: Managing Corporate Parent/Subsidiary Interaction

Educate the governance committee of the corporate board on the need to balance oversight/support with environmental liabilities considerations and enhanced reporting requirements

Make managing environmental risk part of doing business and include in corporate strategic planning

Decide when it is appropriate for the corporate parent to assume the environmental obligations of a sub

Establish regular meetings with EHS managers at corporate and subsidiary levels to share information and exchange views

A View from the Trenches: Managing Corporate Parent/Subsidiary Interaction (cont.)

Be timely informed of all major EHS initiatives at corporate and subsidiary levels

Conduct periodic reviews of all EHS permits held and applications pending to ensure that the responsible entities are appropriately identified

Consider current and future environmental implications of corporate structure or governance activities at the time planned

Coordinate with responsible environmental personnel to assess and report environmental liabilities and compliance costs

A View from the Trenches: Managing Corporate Parent/Subsidiary Interaction
(cont.)

Consider environmental ramifications up and down the corporate chain

Bridge temporal and spatial separation between senior corporate management and environmental compliance officer

Ask whether corporate parent will control the O&M of subsidiary relating to hazardous waste sites, materials and waste; if so, relationship should be structured to minimize the potential environmental risk to the parent

Beyond Compliance: Getting the Most Out of Sarbanes-Oxley

Why push the Sarbanes-Oxley Act beyond the compliance envelope?

Because:

- **"The United States is a nation of laws: badly written and randomly enforced." -- Frank Zappa**
- **Commerce is global, but regulatory requirements are national**
- **The objectives of social responsibility can be achieved more readily by leveraging the forces of commerce as well**
- **CSR is more than compliance with law. It also encompasses corporate reputation, good will and global citizenship**

Beyond Compliance: Getting the Most Out of Sarbanes-Oxley

- Disclosure is not limited to only making public environmental liability
- Balance Financial Statement and SEC Filings with disclosure of environmental assets
- Some examples of environmental assets
  - Emissions Credits
  - Joint Implementation/Clean Development Mechanisms under Kyoto
  - Socially Responsible Sourcing/Supply Chain Practice
  - Cost savings from implementation of ISO 14001, material substitution, waste reduction, energy efficiency and/or recycling programs

Beyond Compliance: Getting the Most Out of Sarbanes-Oxley (cont.)

- Financial institutions, fund managers, asset managers, investors and companies seeking acquisitions may benefit, as compliance with disclosure requirements will lead to:
  - Compilation of greater available and higher quality EHS compliance and operational information
  - Availability of environmental reports with more factual detail and independent consultant judgment
  - Availability of metrics linking environmental and financial performances
  - Implementation of corporate-wide environmental management system, shedding light on corporate policies and practices
  - Senior executives and directors becoming more knowledgeable of EHS matters

Beyond Compliance: Getting the Most Out of Sarbanes-Oxley (cont.)

Lenders, investors and companies making acquisitions can facilitate and strengthen environmental due diligence of the target company by making use of the corporate "infrastructure" developed to meet disclosure requirements, such as:

- Environmental information collected and records prepared to support and document environmental disclosure decisions
- Corporate governance and auditing materials, policies and procedures manuals relevant to environmental matters
- Corporate EMS and/or environmental auditing practices implemented to support CEO/CFO certification
- Corporate-wide information gathering and communication process and procedures used to meet disclosure requirements

Beyond Compliance: Getting the Most Out of Sarbanes-Oxley (cont)

- The Results of such due diligence could be rendered into appropriate contract language representing that:
  - Issuer/Seller/Borrower is in compliance with all disclosure requirements, including Regulation S-K and the Sarbanes-Oxley Act, pertaining to environmental matters
  - Issuer/Seller/Borrower has made available all material environmental records relevant to its compliance with Regulation S-K and the Sarbanes-Oxley Act disclosure requirements
  - Issuer/Seller/Borrower did not and does not expect to restate its financial statements or correct SEC filings with respect to any environmental matters in order to achieve compliance with Regulation S-K and the Sarbanes-Oxley Act disclosure requirements

Beyond Compliance: Getting the Most Out of Sarbanes-Oxley(cont)

- Other contractual provisions may include:
  - Indemnity by Issuer/Seller/Borrower for any loss or liability arising from failure to comply with disclosure requirements with respect to environmental matters
  - Covenant by Issuer/Seller/Borrower to make all required environmental disclosures on or before closing

Beyond Compliance: A View from the Mountain Top

Making environmental disclosure should be more than the public airing of liabilities – actual or contingent. The use of environmental disclosure measures can foster a culture of transparency and an ethos of accountability that guides corporate behavior over time.

Forward-looking companies and stakeholders should appreciate the Sarbanes-Oxley Act and other required or voluntary disclosure measures for not only their mandatory aspects but also their transformative potentials. For these provisions allow companies to see themselves in a different light and better find their way to the path of social responsibility.

When we talk about preservation of the environment, it is related to many other things. Ultimately, the decision must come from the human heart, so I think the key point is to have a genuine sense of universal responsibility.

-- Dalai Lama, 1990

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