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Overview of Environmental Liability Disclosure Requirements, Recent Developments and Materiality

American Bar Association
1993 Annual Meeting
Toxic & Hazardous Substances &
Environmental Law Committee Program
New York, New York
August 9, 1993

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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OVERVIEW OF ENVIRONMENTAL LIABILITY DISCLOSURE REQUIREMENTS, RECENT DEVELOPMENTS AND MATERIALITY

I. INTRODUCTION

As society strives to maintain and to improve our environment, costs are imposed that may need to be disclosed to investors under our federal securities laws. These environmental costs have reached staggering proportions in recent years and are one of the critical issues facing businesses today. Compliance costs associated with regulations restricting development and limiting harmful emissions can and often do have a material effect on the operating expenses of a company. Moreover, environmental laws can impose large liabilities, particularly with respect to past generators of waste materials.

While the aggregate numbers concerning potential environmental costs are staggering, what is almost just as frightening is the massive amount of acknowledged environmental cost that has yet to be reflected in corporate financial statements. Despite the growing importance of environmental issues, a 1992 survey conducted by Price Waterhouse revealed that 62% of the issuers responding to the survey have known environmental liability exposures not yet recorded in their financial statements.[1] Thus, environmental liability, if not already, will soon become a prominent concern for virtually all securities marketplace participants.

At the Commission, the large dollar amounts of anticipated environmental liability costs have produced increased pressure to monitor the adequacy of issuer disclosure. During the past several years, the staff of the Commission's Division of Corporation Finance has been looking closely at the adequacy of environmental disclosure in connection with its review of filings. I expect this scrutiny to continue generally and even to become more intense with respect to issuers that are in industries

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[1] Accounting for Environmental compliance: Crossroad of GAAP, Engineering, and Government, a survey of corporate America's accounting for environmental costs conducted by Price Waterhouse (1992, second in a series), at 1 ("Price Waterhouse Survey").

which are significantly effected by environmental risks such as insurance companies, pulp and paper companies, primary metal manufacturers, and industrial organic chemical manufacturers, among others. When the staff finds material omissions or deficiencies relating to environmental matters, it will continue to request corrective disclosure and, in egregious cases, may refer the matter to the Division of Enforcement.

II. PRINCIPLE REPORTING REQUIREMENTS

A. Historical Role of the Commission

As everyone here is aware, the federal securities laws are designed to promote full disclosure of material facts. I will discuss in more detail the concept of materiality from a financial statement viewpoint later.

The general securities antifraud provisions impose liability on persons who make false statements or omissions of material facts in connection with the purchase or sale of securities. In certain cases, these general antifraud provisions will require disclosure to investors of the material effect of environmental laws and potential environmental liabilities on an issuer.

In addition to complying with these general antifraud provisions, issuers registering public offerings of securities under the Securities Act of 1933 ("Securities Act"), or filing periodic reports under the Securities Exchange Act of 1934 ("Exchange Act"), must comply with the applicable line-item disclosure requirements under Regulation S-K or Regulation S-B.

With the increase in regulation and environmental liability since the early 1970s, the Commission has attempted to refine through interpretive releases the disclosure obligations raised by environmental legislation and the regulations promulgated

thereunder.[2] In addition, several prominent enforcement actions instituted by the Commission against issuers that failed to disclose known environmental liabilities and compliance costs have highlighted the importance of accurate disclosure in this area.[3]

B. Regulations S-K and S-B

Three provisions of Regulation S-K have particular significance for issuers that are subject to potential environmental liabilities and risks. These provisions have been incorporated into new Regulation S-B, which applies to small business issuers, without substantive change.

1. Item 101 - Description of Business

Item 101 of Regulation S-K requires an issuer to provide a general description of its business. In addition, it requires specific disclosure of the material effects that compliance with federal, state and local environmental laws may have upon the capital expenditures, earnings, and competitive position of the issuer. An issuer must disclose any material estimated capital expenditures for environmental control facilities.

2. Item 103 - Legal Proceedings

Item 103 requires that the issuer disclose any material pending legal proceeding, including specified proceedings arising under federal or state environmental laws. Specifically, Item 103 requires disclosure of any administrative or judicial proceeding arising under environmental laws if: (a) such proceeding is material to the business or financial condition of the issuer; (b) such proceeding includes a claim for damages or costs in an amount exceeding 10% of current consolidated assets; or (c) a governmental authority is a party to the proceeding, unless any sanctions are reasonably expected to

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[2] See, e.g., Securities Act Release Nos. 33-5170, 34-9252 (July 19, 1971); Exchange Act Release No. 5386 (April 20, 1973).

[3] See In the matter of Occidental Petroleum Corp., Exchange Act Release No. 16950 (July 2, 1980); In the matter of United States Steel Corporation, Securities Exchange Act Release No. 16223 (Sept. 22, 1979); SEC v. Allied Chemical Corp., No. 77-373 (D.D.C. filed March 4, 1977).

be less than $100,000. It is important to note that any such proceedings known to be contemplated by governmental authorities also are required to be disclosed.

3. Item 303 - Management Discussion and Analysis

Finally, the Management Discussion and Analysis ("MD&A") item, Item 303, requires management to discuss the issuer's historical results and its future prospects. This forward-looking disclosure is triggered by any "known" trends, demands, commitments, events, or uncertainties that are reasonably likely to have a material effect on the issuer's operating results, liquidity, or financial condition. The purpose of the MD&A is to give investors a look at the company through the eyes of management. MD&A and the related financial statements are the heart of an issuer's disclosure document.

The Commission previously issued an interpretive release on MD&A which set forth the Commission's views regarding several disclosure matters that should be considered by companies in preparing MD&As.[4] This release emphasized the distinction between prospective information that is required to be disclosed and voluntary forward-looking disclosure. Required disclosure is based on presently known data which will impact upon future operating results or financial condition, while voluntary forward-looking disclosure involves anticipating a future trend, event, or uncertainty (e.g., what-if's of the future). The release states that if there is a known trend, demand, commitment, event, or uncertainty, management must make two assessments to determine what prospective information is required.

First, management must determine whether the known trend, demand, commitment, event, or uncertainty is likely to come to fruition. If management determines that it is not reasonably likely to occur, no disclosure is required.

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[4] Securities Act Release No. 6835 (May 18, 1989).

Second, if management cannot make the determination that the event is not likely to occur, it must evaluate objectively the consequences of the known trend, demand, commitment, event, or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that the effect would not be material to the company's financial condition or results of operations. Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made. The release clarifies that the safe harbor rules apply not only to voluntary forward-looking statements, but also to prospective information that is required to be disclosed.

Item 303 compels management to disclose the significant implications of environmental laws on the future operations of a company. The Commission's fairly recent enforcement action against Caterpillar, which was solely based on an MD&A violation, should make it clear, if it was not already, that the Commission treats MD&A disclosure very seriously.[5]

III. ACCOUNTING AND DISCLOSURE RELATING TO ENVIRONMENT LOSS CONTINGENCIES

Beyond the narrative discussions mandated by Regulations S-K and S-B, environmental matters also may have accounting implications for issuers. Generally accepted accounting principles ("GAAP"), specifically Financial Accounting Standards Board ("FASB") Statement No. 5, entitled "Accounting for Contingencies," indicate that an estimated loss from a loss contingency must be accrued by a charge to income if it is probable that a liability has been incurred and that the amount of the loss can be reasonably estimated.

It is the responsibility of management to accumulate on a timely basis sufficient relevant and reliable information to make a reasonable estimate of environmental

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[5] In the Matter of Caterpillar, Inc., Exchange Act Release No. 30532 (March 31, 1992).

liability. If management determines that the amount of the liability is likely to fall within a range and no amount within that range can be determined to be the better estimate, the issuer is required to record the minimum amount of the range.[6] Any amount or range of loss in excess of the amount recognized that is reasonably possible should be disclosed in a footnote, or management should state that this amount cannot be estimated. Changes in estimates of the liability should be reported in the period that they occur.[7] The measurement of the liability should be based upon currently enacted environmental laws and upon existing technology.

The recognition and measurement of the liability must be evaluated separately from the consideration of any expected insurance recoveries. If information available prior to the issuance of the financial statements indicates that it is probable that a environmental liability had been incurred at the date of the financial statements, the amount of the company's liability should be recognized and recorded, if it can be estimated, regardless of whether the issuer is able to estimate the amount of recoveries from insurance carriers. In assessing the probability of an insurance recovery, issuers should consider the success of similar claims and the insurer's financial viability.

Identifying and interpreting environmental risks will continue to challenge the accounting industry. Accountants should increase their efforts to assess the proper financial statement presentation and disclosure of environmental contingencies. Hopefully, as the spotlight on environmental issues becomes more focused, as cleanup technology and equipment improve, and as estimating cleanup costs becomes easier, earlier recognition of liabilities in financial statements will result.

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[6] FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

[7] See APB Opinion No. 20.

IV. RECENT DEVELOPMENTS

Before I delve into the concept of materiality, I wish to mention two developments which have occurred recently in the environmental liability disclosure area.

A. SAB 92

The first recent development that I wish to discuss is Staff Accounting Bulletin No. 92 ("SAB") which was issued by Commission staff in June. The SAB, which sets forth the staff's interpretation of GAAP regarding contingent liabilities, will effect in particular those issuers that may have incurred environmental liabilities. The SAB's guidance is intended to promote timely recognition of contingent losses and to address the diversity in practice with respect to the accounting and disclosures in this area. Hopefully, publication of the SAB will improve environmental liability disclosure practice.

The SAB presents the view of Commission staff regarding: (1) the manner in which a contingent liability and any related asset representing claims for recovery should be displayed in the financial statements (offsetting); (2) the appropriate discount rate to be used for recognition of a contingent liability presented at its present value to reflect the time value of money (discounting); and (3) the disclosures that are likely to be of particular significance to investors in their assessment of these contingencies. The most controversial aspect of the SAB is likely to be the view of Commission staff that, for the vast majority of situations, contingent liabilities should be displayed on the face of the balance sheet separately from amounts of claims for recovery from insurance carriers or other third parties.[8]

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[8] The exception being that offsetting is permissible when the conditions of FIN 39 are met. See infra note 9. This will probably be a rare circumstance.

I wish to discuss in a little more detail the issues of offsetting and discounting which are discussed in particular in the SAB.

1. Offsetting

Rather than recognize and display separately the liability representing the likely settlement amount of a contingent liability and the asset representing the amount likely to be recovered from the insurance carrier, many issuers recognize the liability net of the insurance claim. This practice is equivalent to "offsetting" the probable insurance receivable against the probable contingent liability.

In the view of Commission staff, presentation in the balance sheet of the gross, rather than net, amount of the liability most fairly presents the potential consequences of the contingent claim on the issuer's resources. For example, the issuer's liquidity may be effected materially if cash settlement of the liability must be made prior to receipt of insurance proceeds. Separate display of the gross liability and the amount likely to be recovered highlights the different factors that effect these two estimated outcomes and the related cash flows. Offsetting the two components may leave investors unaware of the magnitude of the liability and may lull them into a less rigorous consideration of the legal sufficiency of the issuer's claims for recovery and the creditworthiness of the party from whom recovery is anticipated.[9] Separate display

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[9] Accounting Principles Board Opinion No. 10, "Omnibus Opinion --1966" ("APB 10"), states that "[i]t is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." This general proscription was strengthened by the FASB in a recently issued interpretation, Financial Accounting Standards Board Interpretation No. 39, "Offsetting of Amounts Relating to Certain Contracts" ("FIN 39"). FIN 39 indicates that the prohibition on setoff in the balance sheet should be applied more comprehensively than it may have previously been in practice.

Paragraph 5 of FIN 39 states that a right of setoff exists when all of the following conditions are met:

a. Each of the two parties owes the other determinable amounts.
b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

would not effect the measurement of income or stockholders' equity.

Separate display of the claim for recovery is expected to lead to more rigorous consideration of the uncertainties effecting realization of that claim. The SAB's limitation on offsetting is consistent with the notion that financial statement preparers must evaluate separately the circumstances under which the amount deemed recoverable from an insurance carrier or other third party may qualify for recognition as an asset. In my opinion, the SAB is also consistent with current accounting literature, in particular APB 10 and the FASB's recent interpretation regarding setoffs as contained in FIN 39.[10]

I know there are many issuers that presently recognize contingent liabilities reduced by an undisclosed setoff of claims for recovery which are probable of realization. The SAB indicates that Commission staff will not object if an issuer continues to account for a claim for recovery that is probable of realization as an offset against the contingent liability, rather than display it within total assets, until the effective date of FIN 39. I understand that the FIN 39 standard is effective for financial statements for fiscal years beginning after December 15, 1993. In the interim, however, issuers are advised to disclose in a note to the financial statements the gross amount of probable recoveries that are netted against the contingent liability.

2. Discounting

A second issue of great significance to issuers discussed in the SAB is the ability to recognize an estimated liability at its present value, rather than at the gross amount expected to be payable. Because the ultimate settlement of environmental liabilities

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c. The reporting party intends to set off.
d. The right of setoff is enforceable at law.

[10] See supra note 9.

may not occur for many years, the effect of discounting the liability to reflect the time value of money may be quite important to some issuers.

The SAB indicates that discounting an environmental liability for a specific cleanup site to reflect the time value of money is appropriate only if the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for that site. In terms of the appropriate discount rate to be used, with the SAB, the Commission staff have chosen to limit the discount rate to one no higher than the rate on risk-free monetary assets.[11] That rate is objectively determinable, and this should enhance comparability of financial statements between issuers. The SAB only establishes a ceiling at the rate on risk-free monetary assets.

3. General

While the SAB is not a rule or interpretation of the Commission but represents the interpretations and practices followed by the Commission's Division of Corporation Finance and Office of the Chief Accountant, I agree with the staff positions set forth in the SAB and wholeheartedly endorse its publication. I am of the opinion that its publication will assist practitioners in the environmental liability accounting area. I strongly recommend that practitioners in this area carefully review the SAB.

B. GAO Report

The other recent development in the environmental liability disclosure area that I wish to mention is the recently issued General Accounting Office ("GAO") report concerned with environmental liability disclosure by property and casualty insurers.[12]

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[11] Paragraph 4(a) of Statement of Financial Accounting Standards No. 76, "Extinguishment of Debt," indicates that risk-free monetary assets are limited to direct obligations of or obligations guaranteed by the U.S. government or securities backed by U.S. government obligations.

[12] Environmental Liability: Property and Casualty Insure Disclosure of Environmental Liabilities (GAO/RCED-93-108) (June 2, 1993).

Certainly one of the major threats to the solvency of the property and casualty insurance industry is the risk of contract interpretation that could impose enormous unforseen environmental cleanup costs on that segment of the insurance industry.[13] Of course, litigation is underway on several fronts over the policy coverage in this area; and while no definite litigation outcome pattern has been established, at least some of the early results have not been favorable for the insurance industry.[14]

In its report on disclosure of environmental liabilities, the GAO recommends that the Commission adopt guidance which requires "that, at a minimum, insurance companies routinely disclose in their annual reports (1) the number and type of reported environmental claims and (2) an estimated range or minimum amount of associated claims costs and expenses." This disclosure would be required whether or not the information is material to an investor.

While arguably the GAO proposed disclosure could be worthwhile from a public policy standpoint as a means to a more complete picture of environmental cleanup costs or in order to facilitate the public's understanding of the distribution of these costs, historically, as I indicated earlier, that does not reflect the traditional materiality analysis of securities law disclosure requirements. As I mentioned, the federal securities laws are designed to promote full disclosure of material facts. While there are those that advocate that the Commission should attempt to enforce the securities laws in a manner that effectively regulates corporate environmental conduct, I am more comfortable with the traditional Commission role of pressing for clear disclosure of all environmental information that is economically material to the issuer.[15]

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[13] See "The Hurricane Called Superfund," Business Week (Aug. 2, 1993), at 74.

[14] See Gordon, "Unclear wording favors large policyholders," Business Insurance (May 25, 1992), at 25.

[15] See Ferman, "Environmental Disclosure and SEC Reporting Requirements," 17 Delaware Journal of Corporate Law 483 (1992).

Thus, I suppose that I would be inclined to oppose GAO's suggested requirement that insurers "routinely disclose" certain facts about environmental claims. The existing disclosure rules appear sufficient to trigger disclosures that would be material to investors in the securities of property and casualty insurers, and I am inclined to be satisfied with the scope of those rules, at least for the present.

No doubt property and casualty insurers could do a better job of disclosing the impact of potential environmental liabilities on their operations.[16] In the filing review area, Commission staff have been scrutinizing the potential impact of environmental liabilities on the insurance industry, and I anticipate that such scrutiny will continue. There are indications from the most recent Form 10-Q filings and elsewhere that the environmental liability disclosure of property and casualty insurers is improving, although, as I mentioned, more improvement is probably needed.[17]

I suspect that an argument could be made that Items 103 and 303 of Regulation S-K already provide a basis for requiring disclosure of the GAO desired information from property and casualty insurers. Conceivably this information may be material. While I do not wish to take up more time today on the subject, if necessary, I suppose that this matter could be pursued further by Commission staff through the comment process or even through more formal means such as with an interpretive release.[18] In any event, it may be interesting to review the Commission's response to the GAO recommendation.

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[16] See Marley, "Is there security in numbers?; Insurer executives warn that surplus is misleading," Business Insurance (Feb. 22, 1993), at 3.

[17] See Lenckus, "Aetna boosts loss reserves; Travelers to take charge tied to real estate investments," Business Insurance (Feb. 8, 1993), at 2.

[18] One possibility would be the issuance of a short release, similar to the Statement Of The Commission Regarding Disclosure Obligations Of Companies Affected By The Government's Defense Contract Procurement Inquiry And Related Issues, Securities Act Release No. 33-6791 (Aug. 1, 1988).

V. MATERIALITY

Since I have already alluded to the importance of the concept of materiality in the environmental liability disclosure preparation process, I wish to spend the remainder of my time today focusing on the topic of financial statement materiality.

Materiality is a concept used to measure the influence that knowledge of certain facts could have on the decision of a prudent investor. A conclusion regarding the significance of a situation may be more easily reached if the impact can be quantitatively determined in dollars or percentages. In addition to such quantitative considerations, however, the qualitative nature of a set of facts may nevertheless influence the prudent investor, and may therefore be material, even when a quantitative threshold is not met.

Illegal acts, for example, may not qualify as material from a quantitative perspective, but would likely be material to an investor, who is entitled to assume a market free from such acts. A related party transaction, for another example, although quantitatively insignificant, may be material from a qualitative perspective to the investor who assumes that the financial statements reflect economic transactions consummated at "arms length."

The concept of materiality is grounded in both the law and the accounting literature. The Supreme Court decision of TSC Industries v. Northway decided that "[a]n omitted fact is material if there is substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[19] Item 405 of Regulation C under the Securities Act and Rule 12b-2 under the Exchange Act define "material" information as information "to which there is a substantial likelihood that a

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[19] 426 U.S. 438, 449 (1976).

reasonable investor would attach importance" in securities transactions. This standard of materiality is supported in the Supreme Court decision of Basic Incorporated v. Levinson.[20]

The topic of materiality was the subject of a Discussion Memorandum published by the FASB in 1975. The FASB's objective was to "establish materiality criteria, the application of which would result in consistent financial reporting of matters necessary for an understanding of an enterprise's financial activities." This document presented an exhaustive review of the literature and research studies and discussed the topics of quantitative characteristics and non-quantitative aspects of materiality. Materiality was defined as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." This definition is consistent with the TSC decision.

In response to the FASB's discussion memorandum, two views of thought developed. A minority view held that the FASB "should promulgate a set of quantitative materiality guides or criteria covering a wide variety of situations that preparers could look to for authoritative support." The prevailing view held that materiality judgments can properly be made only by those who have all the facts of a particular situation and that specific quantitative standards were not needed. The latter position, which recognized both quantitative and qualitative factors, was adopted by the FASB in its Statement of Financial Accounting Concepts No. 2, which was issued in 1980 and has become a cornerstone of external financial reporting by business enterprises.

Materiality remains very much of an issue both inside and outside the Commission. Materiality from a quantitative perspective is usually expressed as a

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[20] 485 U.S. 224 (1988).

percentage based upon a comparison of dollar amounts. The staff of the Commission has long applied an informal "rule of thumb" as a guideline in determining materiality from a quantitative perspective:

above 10%--material

5-10%--may be material

under 5%--usually not material

The bases to which the percentages are frequently applied have been gross profit, net income, stockholders' equity, and the specific line item that may be misstated in the financial statements. The percentage deemed to be material may vary from the quantitative rule of thumb as the qualitative characteristics are scrutinized.

This rule of thumb is grounded in several sources. It was illustrated in the FASB Discussion Memorandum published in 1975, was reinforced by an extensive study conducted by the Financial Executives Research Foundation in a 1976 publication entitled "The Concept of Materiality in Financial Reporting," which found that the guideline was widely used in practice, and was referenced in Accounting and Auditing Enforcement Release No. 270 issued in September of 1990.

Application of the quantitative rule of thumb is made only with discretion after an evaluation of the trends in an issuer's financial results, consideration of unusual situations, (such as the reporting of a nominal amount of net income or a loss by the issuer in a fiscal period), a determination of unique characteristics of the entity or the industry in which the entity competes, and with the realization that an absolute dollar amount may or may not be material.

The assessment of materiality from a qualitative perspective in some respects is a more slippery evaluation than the quantitative perspective. While I will not take up much more time today on the qualitative aspect of materiality, one qualitative factor, at least from an auditor's perspective, that must weigh heavily in the materiality

determination is whether senior management knew of or took part in financial statement fraud. Reasonable investors want to know when those occupying a stewardship position in the company have breached their duty of loyalty to the shareholders and to the company. Further, any intentional misstatement or omission by senior management may have pervasive implications.

Usually the smaller the quantitative impact of an incident on the financial statements, the higher the level of qualitative factors (such as fraudulent conduct by a high level of management or other egregious circumstances) should be in order to reach the level of "materiality" where there is a substantial likelihood that a reasonable investor would find the incident important in making investment or voting decisions. Conversely, the greater the impact on financial statement line item amounts, the lower the level of qualitative factors needs to be in order to warrant a finding that a reasonable investor would consider the incident important.

Remarks from a speech delivered by then Commissioner Al Sommer in 1975, at a two day conference which addressed materiality, are still relevant. Materiality as a concept:

> has always been a slippery, elusive and uncertain one. Like the concept of negligence, the value of the concept of materiality derives from its very breadth, imprecision and defiance of exact definition. It reflects the complexity of human affairs, the multitude of situations in which human beings find themselves involved and the multiplicity of relationships that they create. As with negligence, so with materiality, we have defined this concept in terms of a hypothetical human being possessed of certain qualities of prudence and judgment that at least escapes us as individuals.

The title of the speech, "The Slippery Slope of Materiality," is still most appropriate.

As you grapple with the elusive, amorphous concept of materiality, I wish you the best of luck.

VI. CONCLUSION

In conclusion, I should emphasize that I believe that aggressive enforcement of environmental laws will increase in the 1990s. "Environmental due diligence" is a

phrase that will grow increasingly familiar to the attorneys that represent both public issuers and investors.

I am pleased to observe the heightened awareness of the need for, and the improvements in, the practice of environmental liability disclosure that have apparently taken place in recent times. This is reflected in the Price Waterhouse Survey where 23% of the respondents reported that they have empowered a board committee to oversee the issuer's environmental compliance, up from 14% in the prior survey. One-third of the respondent issuers also now have written environmental accounting policies, up from only 11% in the previous survey. Further, 26% of the respondents now disclose their environmental accounting policy in the accounting policies footnote to their financial statements — a significant increase over only 4% in the prior survey.[21] I hope that this progress continues.

I challenge each of you here today to acquaint yourselves with the environmental regulations and with the environmental liability disclosure requirements, and in particular, with the accounting literature regarding contingent losses, including the SAB, and to focus seriously on whether your employer or client has adequately disclosed and accounted for the short-term and long-term effects of environmental laws on their operations.

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[21] See Price Waterhouse Survey, supra note 1, at 1.