There has been widespread analysis regarding the impacts of the Sarbanes-Oxley Act of 2003 (“Sarbanes-Oxley” or the “Act”) on corporate reporting of financial information. Although the Act does not contain any specific requirements relating to reporting of corporate environmental costs and liabilities, Sarbanes-Oxley promises to have implications for SEC reporting of environmental costs and liabilities as well, and business lawyers would be well served by a general understanding of these implications.

Environmental Disclosure Requirements

Disclosure obligations for environmental liabilities are not a new development. The following rules and guidelines for financial reporting of environmental liabilities have been in existence since the 1970s:

SEC Regulation S-K, Item 101: Description of Company’s Business requires a company to identify any material effects that compliance with existing or anticipated environmental laws and regulations may have upon the capital expenditures, earnings and competitive position of the company and its subsidiaries.3

SEC Regulation S-K, Item 103: Legal Proceedings requires disclosure of “any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party.” Registrants are also required to disclose any matter, irrespective of materiality, if it involves a claim that exceeds 10 percent of the registrant’s current assets or if a governmental authority is a party to a proceeding that involves a potential monetary sanction, unless the registrant reasonably believes that such proceeding will not result in a monetary sanctions exceeding $100,000. Item 103 instructs companies to apply the standard for materiality separately to each proceeding or set of proceedings presenting “in large degree the same legal and factual issues as other proceedings pending or known to be contemplated”.4

SEC Regulation S-K, Item 303: Management Discussion & Analysis requires management to discuss and analyze the company’s financial condition and results of operations. This includes a discussion of business trends or events likely to have a material effect on the company’s financial condition. Environmental issues such as greenhouse gas emission reduction requirements, proposed hazardous substance restrictions or other regulatory constraints could qualify as “trends or events” that should be included in financial reports.5

Continued on next page
Statement of Financial Accounting Standards No. 5 ("FAS 5") addresses accounting and reporting of loss contingencies such as projected costs for site clean-up or remediation. Under FAS 5, loss contingencies must be accrued only if (i) it is “probable” that an asset has been impaired or that a liability has been incurred, and (ii) the amount of the loss can be “reasonably estimated.”

SEC Staff Accounting Bulletin 92 ("SAB 92") provides guidance on accounting and disclosure obligations for contingent environmental liabilities and expands on FAS 5. SAB 92 provides that the minimum loss estimate in a range can be used for accrual purposes if no amount within a range is a better estimate than any other amount within the range.

American Institute of Certified Public Accountants Statement of Position 96-1 ("SOP 96-1") provides guidance for recognizing, quantifying, and disclosing environmental liabilities, including benchmarks for making materiality determinations at various stages of assessment and remediation.

Existing environmental disclosure requirements turn on whether these liabilities are deemed to be “material.” While the exact parameters for materiality have not been defined, SEC Guidance and a number of U.S. Supreme Court decisions have concluded that a matter is material if:

- There is a substantial likelihood that a reasonable person would consider it important. An auditor must consider both “quantitative” and “qualitative” factors in assessing a matter’s materiality;\(^6\)
- The judgment of such person relying on a particular item would have been changed or influenced by the inclusion or correction of the item;\(^7\) or
- There is a substantial likelihood that a fact would be viewed by a reasonable investor as significantly altering the “total mix” of the information made available.\(^8\)

Sarbanes-Oxley: Implications and Recommendations for Environmental Reporting

Sarbanes-Oxley established a system of increased responsibility and accountability for public company financial disclosures, which will affect the way that environmental information is collected, evaluated and reported. Of particular relevance for environmental reporting, the Section 404 requirement that a publicly held company have in place an “internal control program” to assure the accuracy of its financial reporting and disclosure and that its CEO and CFO certify under Section 302(a) to the effectiveness of the controls, as well as the accuracy of the financial statements, underscores the importance of good communications among the environmental, business and financial managers and the lawyers.

In designing its internal control program, a company may be able to build on programs already in place. For example, many companies already use environmental auditing or similar compliance assurance programs, which can be used to identify current and
anticipated environmental compliance costs and liabilities that must be evaluated for SEC reporting. More and more companies are now using environmental management systems, including self-assessments and management review, to track and improve environmental performance. Increasingly, companies design information flow systems to include the type of environmental information that will need to be disclosed to auditors and, potentially, to the SEC.

A number of companies developed or modified their information gathering systems in response to the seminal Caremark decision in 1996, which held that corporations owe their shareholders a duty to put programs in place to ensure timely flow of information concerning operations, risks, potential liabilities and matters of similar import to the business managers and directors so as to enable responsible business decisions to be made. Even before Caremark, a number of companies had internal “compliance certification” programs under which plant managers would certify to the next tier of management that all of the facilities and activities under their jurisdiction were in compliance with all applicable laws, except as specifically disclosed. These certifications then would be made up the line by the regional managers, ultimately to the CEO. This type of program is often supported by the legal department to help maintain a high level of compliance and can be a key component in the development and evaluation of environmental information for SEC reporting.

To the extent that programs such as these do not exist, or lack adequate comprehensiveness and rigor, the environmental lawyer can play a vital role in their design and effective implementation. Good models for environmental management systems include the ISO-14001 EMS standards and the companion ISO-14004 guidelines, as well as EPA’s “Compliance-Focused Environmental Management System - Enforcement Agreements Guidance” (revised August 2002).

The one framework which has been specifically recognized by the SEC for an internal control system under Sarbanes-Oxley is Internal Control - Integrated Framework, developed by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). In September 2004, COSO released Enterprise Risk Management - Integrated Framework, which is expected to become a commonly accepted model for discussing and evaluating a company’s risk management processes. The components of the new framework include: internal environment description, objective setting, event identification, risk assessment, risk response, control activities, information and communication, and monitoring. This principles-based framework is designed to enable companies and other organizations to identify all the aspects that should be present in an enterprise risk program and how they should be implemented.

Features that practitioners should ensure are addressed in any information-gathering system for SEC reporting include:

- A process for gathering information on capital and operating costs of equipment, systems or processes expended or budgeted
for compliance with any environmental legal requirements and other policy measures the company implements to protect the environment or to minimize the risks arising from environmental matters.

- Guidance on an internal reporting threshold for materiality. Based on the size and nature of the business, it may be possible to determine an approximate dollar amount for disclosure to the SEC. But for internal information gathering, the number must be far lower because items of a similar nature must be aggregated, and doubts should be resolved in favor of inclusion.

- Guidance on including items where the liability is likely, but the actual amount is uncertain (see FAS 5 and SAB 92 for guidance on loss contingencies and contingent environmental liabilities; ASTM’s “Standard Guide For Disclosure of Environmental Liabilities” (ASTM E2173-01) and ASTM’s “Standard Guide For Estimating Monetary Costs and Liabilities For Environmental Matters” (ASTM E2137-01).

- Requests for environmental information should be integrated with, or at least harmonized with, the company’s overall information gathering procedures for SEC reporting.

- Requests for information should be made early enough to allow time to resolve uncertainties and address information gaps.

- A multi-disciplinary team should be established to review and evaluate the data. Ideally, this team should include the legal department, the budgeting and accounting offices and risk managers. Senior business managers should be available to the team as needed.

Although the full implications of Sarbanes-Oxley on environmental reporting have yet to be realized, companies must be able to demonstrate they have established reliable, validated protocols for identifying, tracking, analyzing, and judging the potential materiality of existing and contingent environmental liabilities, and that they have adhered to the letter and the spirit of Sarbanes-Oxley in their financial disclosures.

Footnotes

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Footnotes Continued

3 17 CFR §229.101.
4 17 CFR §229.103.
5 17 CFR §229.303.
7 Id., quoting FASB Statement of Financial Accounting Concepts No. 2.