Sarbanes-Oxley In a Global Business Environment

New Challenges and Opportunities for the Environmental Manager

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FPA-2007 Environmental Summit Agenda
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Current U.S. Perspective

“Be careful – Environmental, health and safety professionals should know that their work may make its way to the Securities & Exchange Commission based on conclusions about material risks that fairly impact the valuation of companies.”

Brian Carroll  
Special Counsel  
SEC Philadelphia District Office
Sarbanes-Oxley – Global Reach

- Applies to companies listed on U.S. Exchanges – New York Stock Exchange
  - U.S. domestic companies – publicly traded
  - Worldwide operations of public U.S. companies included within scope of Sarbanes-Oxley
  - Foreign companies with significant shareholders presence in U.S. covered
  - Potential tensions between laws of other countries and Sarbanes-Oxley
Sarbanes-Oxley – Global Issues

- Mixed global reactions
  - Whistleblower
  - Internal controls
  - Costs

- Some companies – London Exchange
  - Lower regulatory costs
  - Less access to capital
Sarbanes-Oxley – A Future “Best Practices” Standard

- Foley & Lardner LLP report – March 9, 2006
- 86% of privately-held companies significantly affected by Sarbanes-Oxley
- 70% of private companies – self-imposed corporate controls consistent with Sarbanes-Oxley
Private Company Effects

- Auditors play a role in private companies following Sarbanes-Oxley requirements
- Sarbanes-Oxley controls recognized as “best practices” by auditors/corporate governing boards
Quick Background

- What is Sarbanes-Oxley?
  - Establishes process requirements
  - Requires corporate system to assure financial statements are accurate (Section 404)
  - Chief Executive Officer/Chief Financial Officer certification of financial statements
  - “Whistleblower” provisions (Ex: Ashland Oil)
  - New crimes
    - “Conspiracy” to violate financial disclosure/ certification requirements
    - Record destruction
Quick Background

- What Sarbanes-Oxley is not
  - Does not impose new disclosure requirements
Investor Interest

  - “Environmental **risks and liabilities** are … conditions that if undisclosed could impair … sound investment decisions” (emphasis added)
  - “Socially responsible” investor groups rely on environmental disclosures
Environmental Disclosure Requirements

- Environmental liabilities
  - “Material” liabilities that are important to a reasonable investor
  - “Material” not defined
  - Brattle Group Study (2006) – wide variation in defining materiality (legal claim to $ threshold) and quantification (single site vs. aggregation)
  - Most often “legacy liability” related to cleanups
  - But, consider noncompliance with air/water requirements
Environmental Disclosure Requirements

- Environmental enforcement action
  - Likely exposure of $100,000 or more in penalties
  - Most U.S. EPA enforcement actions easily satisfy this threshold
Environmental Disclosure Requirements

- Management discussion and analysis
  - Forward looking discussion of potential risks and liabilities
  - Should identify new or regulatory issues related to environmental compliance and estimate costs
  - Global operations
    - Disclosures of greenhouse gas (Kyoto) effects
    - Registration, Evaluation and Authorization of Chemicals requirements – European Union
    - Mandated recycling – states/European Union
    - Cleanup of past contamination
Sarbanes-Oxley
Process Enhancements

- Chief Executive Officer/Chief Financial Officer certifications
  - Accuracy of financials
  - Controls in place so that all material information available to Chief Executive Officer/Chief Financial Officer

- Most significant practical effect on corporate behavior
Sarbanes-Oxley Process Enhancements

Large Companies:

- Section 404 “controls” – environmental cost estimates
  - Adjustments promptly made when new information on scope/extent
  - Regulatory requirements changes
  - Cleanup technology changes
  - Natural resource damage/property owner liability

- PCAOB Audit Standard 2: Based on types of company operations, controls need to be in place to address the above contingencies
Implications of Sarbanes-Oxley on Environmental Matters

- Significant scrutiny by auditors/internal staff on environmental disclosures
- Millennium Chemicals—2005 restated earnings to account for $52 million in environmental remediation
- Brattle Group Study (2006) 86% respondents – SOX “significantly” or “moderately” influenced environmental disclosures
Implications of Sarbanes-Oxley on Environmental Matters

- “Downstreaming” of disclosure verification
- Inside managers
- Outside attorneys
- Outside consultants
Implications of Sarbanes-Oxley on Environmental Matters

- Reliance on inside staff or outside consultants in setting reserves
  - Appropriate amount and justification
  - Adjusts – “up and down” – with care
Ashland Oil

- SEC investigation into the reduction of environmental reserves
- SOX whistleblower complaint filed by employee (settled)
- November 29, 2006 settlement with SEC
  - Outside auditor and outside consultant to oversee environmental reserve
  - Strengthen internal controls
  - Outside firm to review employee complaints
Practical Considerations

- Fundamental for both inside managers/environmental professionals
  - What is being requested?
  - How will the financial information be used?

- Essential procedures
  - Internal review process for financial-related responses
  - Documentation of procedures used for estimates
Estimation Process – American Society for Testing & Materials (ASTM) E-2173

- Four techniques
  - *Probabilistic or Expected Value*
    - Multiple options/uncertainties
  - *Most likely outcome*
    - One alternative highly likely
  - *Range of cost*
    - High/low
  - *Known cost*
    - Only use known data

- Companies disclosing methodologies used – Eastman Kodak
ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

ENVIRONMENTAL COMMITMENTS

Environmental liabilities are accrued based on estimates of known environmental remediation exposures. The liabilities include accruals for sites owned by Kodak, sites formerly owned by Kodak, and other third party sites where Kodak was designated as a potentially responsible party (PRP). The amounts accrued for such sites are based on these estimates, which are determined using the ASTM Standard E 2137-01, "Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters." The overall method includes the use of a probabilistic model that forecasts a range of cost estimates for the remediation required at individual sites. The Company's estimate includes equipment and operating costs for remediation and long-term monitoring of the sites. Such estimates may be affected by changing determinations of what constitutes an environmental liability or an acceptable level of remediation. Kodak's estimate of its environmental liabilities may also change if the proposals to regulatory agencies for desired methods and outcomes of remediation are viewed as not acceptable, or additional exposures are identified. The Company has an ongoing monitoring and identification process to assess how activities, with respect to the known exposures, are progressing against the accrued cost estimates, as well as to identify other potential remediation sites that are presently unknown.
Estimating Considerations

- **Expected value**
  - Simplistic view – decision tree type analysis
  - However, multiple contingencies often exist
  - Monte Carlo analysis may be more appropriate
  - Brattle Group Study (2006) – 36% used this approach for some liabilities
Estimating Considerations

- Most likely outcome
  - One reasonable alternative
  - More appropriate – design selected and approved
  - Brattle Group Study (2006) – 43% used this approach for some liabilities

- Range of costs
  - No probability; just a cost range
  - Financial 14 (accounting standard) implication; low end cost used
  - Brattle Group Study (2006) – 43% used for some liabilities
Practical Pressures

- Timing
- Pressures to adjust numbers
  - Reserves
  - Remedial costs
- Reuse existing numbers without review
- Reuse numbers prepared for different purpose
- Conspiracy versus cooperation – a fine line
Financial 47 – Accounting Disclosure Requirements

- Issued in March 2005; applies to fiscal year financials issued after December 2005
- Addresses “recognition” versus “measurement”/“valuation” issue
- Applies to U.S. based companies – global operations included
Financial 47 – Accounting Disclosure Requirements

- Applies to
  - Assets that are to be retired – virtually any physical asset except land
  - Pursuant to a legal obligation – law, rule, ordinance, oral or written contract
  - Examples – polychlorinated biphenyls/asbestos contaminated building, equipment

- Directly applies to “warehousing” of buildings to avoid environmental liabilities
Financial 47 – Applied to Environmental Liabilities

- **Background**
  - FASB – Financial Accounting Standards Board
  - Independent professional board to set standards for CPAs/auditors
  - FASB 143 – issued June 2001
  - Applied to “asset retirement obligations” (AROs)
Financial 47 – Applied to Environmental Liabilities

- Varying “interpretations” adopted by companies as to “recognition” of asset retirement obligations
- Most did not “recognize” contingent to environmental liabilities
- 2003 10-Ks: no AROs disclosed
- Issue – when is a contingent environmental liability to be “recognized” and how is it “valued”
FIN 47 – Corporate Response

- Most common ARO charges relate to:
  - Asbestos removal
  - PCB remediation
  - Uncharacterized site remediation

David Lanseth
Gradient Environmental
Dec. 2006
“Effective September 30, 2006 adopted FIN 47 and recorded a non-cash, after-tax charge of $7 million...The charge primarily relates to legal obligations at owned properties in the power solutions business.”
Financial 47 – Example

- 1995 company acquired a new division which includes buildings constructed in 1950s
- Buildings contain asbestos
- Used buildings in manufacturing
- Business plans anticipate potential move to China in 2010/2015
Financial 47 – Example (continued)

- Under Financial 47, when must asbestos remediation costs be determined
  - Financials for 2007
  - Financials when move to China announced
  - Financials when buildings no longer used
Asbestos requires special handling and costs; subject to a legal obligation

- Recognize liability in 2007 financials

- Uncertainties about future goes to “valuation”; not “recognition” of environmental liability
“An unambiguous requirement that gives rise to an ARO coupled with a low likelihood of required performance still requires recognition of liability. Uncertainty . . . is incorporated into the measurement of the fair value of that liability.”

Financial 47, at 23
2006 SEC Comment Letters on FIN 47

- Douglas Emmet, Inc.
- Citizen Communications Co.
- Hess Corp.
Financial 47 – Implications on Environmental Practice

- Determining future remediation costs
  - Trigger point – future business plans; confidentiality issue
  - Scope of investigation to determine costs
  - Estimating future remediation costs, methodology and assumptions
Financial 47 – Implications on Environmental Practice

- Transactions
  - Conforming cost “deductions” to disclosures
- Warehousing of properties
  - Disclosures
  - Municipal blight/Brownfields redevelopment
On the Horizon – Climate Change Disclosures

- No federal U.S. regulatory requirement, but European Union, California, New York, Northeast U.S. States
- May be a material issue in future (MD&A)
- Shareholder interest – CERES
- Lawsuits (public nuisance)
- Challenge for environmental professional
  - Disclosing/estimating
Sarbanes-Oxley – Opportunities for Improved Environmental Management?

- Environmental cost methodologies
  - Standardizing cost estimates
  - Cost estimating – American Society for Testing & Materials E-2317
  - Financial 47 requirements

- Incorporating standardized cost methods into the environmental aspects of transactions
Sarbanes-Oxley – Opportunities for Improved Environmental Management?

- Timely/periodic review of environmental developments and issues; no surprises for management
- Prioritizing environmental issues based on a greater understanding of financial effects
Conclusions

- Environmental professional must focus on disclosure issues throughout the year
- Estimates need to be updated if changed factors
- Clear communication between company and consultant
- Documentation – essential