

ESH Financial Reporting and Sarbanes-Oxley Compliance

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Breadth. Depth. **Results**

Four Topics

1. SEC disclosure rules
2. Sarbanes-Oxley's requirements and impact
3. Proposal to SEC to use ASTM E 2137 to estimate liabilities
4. Government Accountability Office's Recent Recommendations to SEC

SEC Disclosure Requirements

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

REGULATION S-K TABLE OF CONTENTS

Subject

17 CFR

Subpart 229.1 — General
General

229.10

Subpart 229.100 — Business

229.101

(Item 101) Description of Business

229.102

(Item 102) Description of Property

229.103

(Item 103) Legal Proceedings

Why Now?

- SEC disclosure requirements since 1982
 - Sarbanes-Oxley Act of 2002
 - New SEC rules
 - Increased public attention
 - Corporate governance

Three Disclosure Rules

- **Item 101** Costs of achieving compliance
- **Item 103** Liabilities from actual or threatened legal proceedings
- **Item 303** Prospective financial impacts that may result from emerging trends in environmental regulations and developments

SEC Disclosure Requirements

Item 101

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

REGULATION S-K
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229.101 (Item 101) Description of Business

229.102 (Item 102) Description of Property

229.103 (Item 103) Legal Proceedings

Item 101 of Reg. S-K

1. Report on impact of environmental compliance on:
 - earnings
 - capital expenditures
 - competitive position
2. Recognition of contingent liabilities

Item 101 of Reg. S-K

Impact of Environmental Compliance

“Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries.”

Item 101 of Reg. S-K

Impact of Environmental Compliance

- **Material** = if there is a substantial likelihood that its disclosure would be viewed by a “reasonable investor” as having altered the “total mix” of information.

Item 101 of Reg. S-K

Impact of Environmental Compliance

■ Material

- No quantitative threshold
- No rule of thumb, such as 5% or 10% of total assets
 - SEC Staff Acct. Bulletin No. 99 (SAB 99)

Item 101 of Reg. S-K

Impact of Environmental Compliance

- Factors to consider:
 - Consultant recommendation for pollution control or order placed
 - Settlement offer of particular control technology
 - Adopted regulations with future effective date
 - Closure costs

Item 101 of Reg. S-K

Accounting for Contingent Liabilities

- Present Financial Statements Fairly
- Generally Accepted Accounting Principles (GAAP)
 - Reliance on Financial Accounting Standards Board (FASB)
 - Setting Reserves

Item 101 of Reg. S-K

Accounting for Contingent Liabilities

- **FASB No. 5:**
- Accrue on financial statements when:
 - “Probable” that an asset is impaired
 - or -
 - “Probable” that a liability is incurred
- And, amount is “reasonably estimable”
- And, amount is “material”

Item 101 of Reg. S-K

FASB No. 5

- If outcome is probable but amount is not reasonably ascertainable, must identify but not necessarily reserve.
- Use best estimate in range, but if no estimate is better than any other, then at least the minimum – in many cases, zero

Item 101 of Reg. S-K

FASB No. 5

➤ FLEXIBILITY

- “Probable” = JUDGMENT CALL
 - Valid defenses to liability = not probable
- “Reasonably Ascertainable” = JUDGMENT CALL
 - SEC says, cannot delay until only a single amount can be estimated

NO. 1099-001 | JUNE 17, 2004

Financial Accounting Series

EXPOSURE DRAFT

Proposed Interpretation

**Accounting for Conditional Asset
Retirement Obligations**

an Interpretation of FASB Statement No. 143

This Exposure Draft of a proposed Interpretation is issued
by the Board for public comment.
Written comments should be addressed to:

Technical Director
File Reference No. 1099-001

Comment Deadline: August 1, 2004



Financial Accounting Standards Board
of the Financial Accounting Foundation

Accounting for Contingent Liabilities

FASB Proposal

- Proposal relating to asbestos
- FASB Stmt No. 143 – Legal obligations associated with retirement of long-lived assets
 - By agreement
 - From governmental action
- What to do when retirement of asset is **conditional on a future event** such as a plant closing or major renovation?
 - Upon acquisition, or only when obligation to perform matures, e.g., plant closure

Proposed Interpretation FASB 143

Asbestos

- Entity acquires factory that contains asbestos
- Duty to dispose upon renovation or demolition
 - Asset retirement obligation recognized at acquisition
 - Fair value of liability can consider uncertainty and timing of method of settlement

Proposed Interpretation FASB 143

- Ability to defer settlement does not relieve the entity of the obligation
 - Telecommunications - wood poles
 - Aluminum smelter – kiln bricks
- But what if there is an indeterminate useful life by maintenance and replacement?
 - Oil refinery example with regulatory closure obligation

Proposed Interpretation FASB 143

Indeterminate useful life

- Company cannot reasonably estimate the fair value of the obligation
- As such:
 - Do not recognize liability
 - Disclose: (1) obligation, (2) that liability has not been recognized, and (3) why FV cannot be estimated reasonably

SEC Disclosure Requirements

Item 103

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Item 103 of Reg. S-K

- Reporting of Legal Proceedings
 - Judicial
 - Administrative

Item 103 of Reg. S-K

- Must describe “any material pending legal proceeding” other than ordinary, incidental to business
- **OR**, if > 10% of assets of registrant and its subsidiaries
- **OR**, if management “reasonably believes” sanctions of >\$100,000 - disclose regardless of materiality

Item 103 of Reg. S-K

Sanctions

- “Reasonable Belief”
 - Environmental penalties = \$32,500 per day
 - Government settlement offer
 - Company offer in negotiations
 - Company demand to insurer
- Reasonable belief should be documented (SAB 92)

SEC Disclosure Requirements

Item 303

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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Item 303 of Reg. S-K

- Management's Discussion and Analysis of Financial Condition and Results of Operations
- Purpose of disclosure = allow a would-be investor to see inside the company through management's eyes

Item 303 of Reg. S-K

- MD&A = narrative explanation of financial statements
 - Describe trends “reasonably likely” to affect
 - Liquidity
 - Capital expenditures
 - Describe trends or uncertainties materially affecting **income** from continuing operations

Item 303 of Reg. S-K

- “Reasonably likely” < “more likely than not” < “probable”
- Discuss trending operating costs
- Discuss deferred environmental expenditures
- Discuss upcoming environmental requirements
- What are rival companies identifying?

Disclosure Difficulties

- Subjective and vague
 - >\$100,000 does not apply if management reasonably believes that it has a defense to sanction
 - FASB = best estimate in range, but if no estimate is better than any other, then at least the minimum – in many cases, zero

Other Difficulties

- Prematurely estimating sanctions could compromise negotiation process
- If government has a remedy cost estimate, can company ignore without developing its own estimate?
- Disagreement over what is BACT?
- Does making settlement offer set threshold?

Under-disclosure

- A public perception that disclosure is not being made
 - 1998 EPA study: 75% failed to disclose legal action being taken by the agency
- A corporate concern that appropriate disclosure be made

Sarbanes-Oxley

- CEOs must submit two certifications:
 1. Accuracy of quarterly and annual SEC reports
 2. Of having in place appropriate internal procedures for preparing and disclosing required information
 - Effectiveness of controls were evaluated within 90 days preceding the report

Sarbanes-Oxley Effective Controls

- To address two risks:
 - **Characterization:** That the filed report discloses properly the potential and actual liabilities/costs that management identifies
 - **Identification:** That management, in fact, has not omitted, miscalculated or misallocated a cost that should have been included

Effective Controls

- Companies need established protocols for identifying, tracking, estimating, and judging the materiality of environmental matters
- Should have objective evidence to support the effectiveness conclusion

Effective System

- Has management developed and installed necessary controls?
- Does working environment support?
 - Workers motivated to comply?
- Support mechanisms to monitor and correct noncompliance?
- Are systems being audited to ensure proper function?

ESH Reporting

Who is fulfilling these roles?

- SEC Coordinator?
- Reserve Coordinator?
- Remediation Manager?
- ESH Manager?

ESH Reporting

Who is performing these actions?

- Approval of narrative descriptions
 - New matters
 - Updates
- Review of and modification to reserves
- Review of internal audit controls
- Ensure that timely corrective action is tracked and implemented
- Review of rival company's disclosures

ESH Reporting

Who is performing these actions?

- Regulatory/legislative tracking
- Document decision-making

Additional Considerations

- Sarbanes-Oxley effectively changes what constitutes “reasonable inquiry”
- Certifications required by existing environmental laws
 - “responsible official” under CAA Title V certification of permit compliance
 - “responsible corporate officer” under CWA NPDES Discharge Monitoring Reports (DMR)

Document Retention

- 18 USC 1519: document destruction in advance of a federal proceeding
 - In relation to or in contemplation of matters within the jurisdiction of a federal agency
 - "If EPA ever learns about this, we'll be ..."

Whistleblower

- A crime to retaliate against a person who provides truthful information relating to the possible commission of a crime to a law enforcement officer
 - Any officer or employee authorized to engage in or supervise the prevention or detection of an offense

ASTM E 2137



Designation: E 2137 - 01

Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters¹

This standard is issued under the fixed designation E 2137; the number immediately following the designation indicates the year of original adoption or, in the case of revision, the year of last revision. A number in parentheses indicates the year of last reapproval. A superscript epsilon (ϵ) indicates an editorial change since the last revision or reapproval.

EPA OSWER Directive 9610.17 concerning use of risk-based decision making, 1995.⁶

1. Scope

1.1 *Purpose*—The purpose of this document is to provide a standard guide in the United States for estimating costs and liabilities for environmental matters.² Many possible uses for estimates of costs and liabilities for environmental matters exist, including but not limited to business decision making, communications and negotiations involving change of property ownership, regulatory requirements, third-party lawsuits, insurance premium calculation and claim settlement, change of property use, revitalization, compliance planning, construction, analysis of remedial alternatives, budgeting, strategic planning, financing, and investment analysis by shareholders. The use of estimated costs and liabilities developed in accordance with this standard may be subject to other standards applicable to the matter involved. For example, it is not intended to supersede accounting and actuarial standards including those by the Financial Accounting Standards Board and the U.S. Security and Exchange Commission. This standard does not address the establishment of reserves or disclosure requirements.

1.2 *Objectives*—The objective of this standard is to provide guidance on approaches for estimating costs and liabilities for environmental matters.

2. Referenced Documents³

- 2.1 *ASTM Standards*:
 - E 1527 Environmental Site Assessments: Phase I Environmental Site Assessment Process⁴
 - E 1739 Risk-Based Corrective Action Applied at Petroleum Release Sites⁴
 - PS 104-98 Provisional Guide for Risk-Based Corrective Action⁵
- 2.2 *Other Document*:

3. Terminology

3.1 Definitions:

3.1.1 *allocation or allocated share*—the portion of cost or liability for which a party is responsible for payment or reimbursement.

3.1.2 *environmental compliance*—operations, permits, equipment, facilities, products, records, documentation, reports, training, procedures, inspections, certifications, monitoring, controls, or other conditions or activities that must conform to environmental statutes including, but not limited to, CAA, CWA, OPA, RCRA, CERCLA, TSCA, FIFRA, SDWA, and state and local laws.

3.1.3 *costs and liabilities*—economic expenses, accrued liabilities, and loss contingencies.

3.1.4 *estimator*—an individual or entity that prepares and analyzes costs and liabilities.

3.1.5 *event*—a condition or incident which occurred, or may occur, with respect to an environmental condition and/or environmental compliance issue, that affects or leads to potential costs and liabilities. Examples of events include: a hazardous waste site that requires remediation, a claim for personal injury related to an alleged environmental incident, or the need to comply with NPDES standards as a result of a process change.

3.1.6 *liability*—an actual or potential obligation that may or may not be accrued.

3.1.7 *orphan share*—liability assigned to a PRP that cannot be located or that is insolvent, or the liability associated with pollutants which cannot be attributed to a PRP.

3.1.8 *potentially responsible party (PRP)*—any individual, legal entity, or government—including owners, operators

ASTM E 2137

- Rulemaking Request to SEC
 - Seeks to address uncertainty of estimating
 - Seeks to aggregate liabilities for threshold

ASTM E 2137

- Provides hierarchy of estimation methods
- Key is whether probable outcomes can be assigned. If so:
 - “Expected Value.” Weighted average over range of all possible values.
 - “Most Likely Value.” Where one (or cluster) scenario is believed to be most likely to occur.

ASTM E 2137

Expected Value

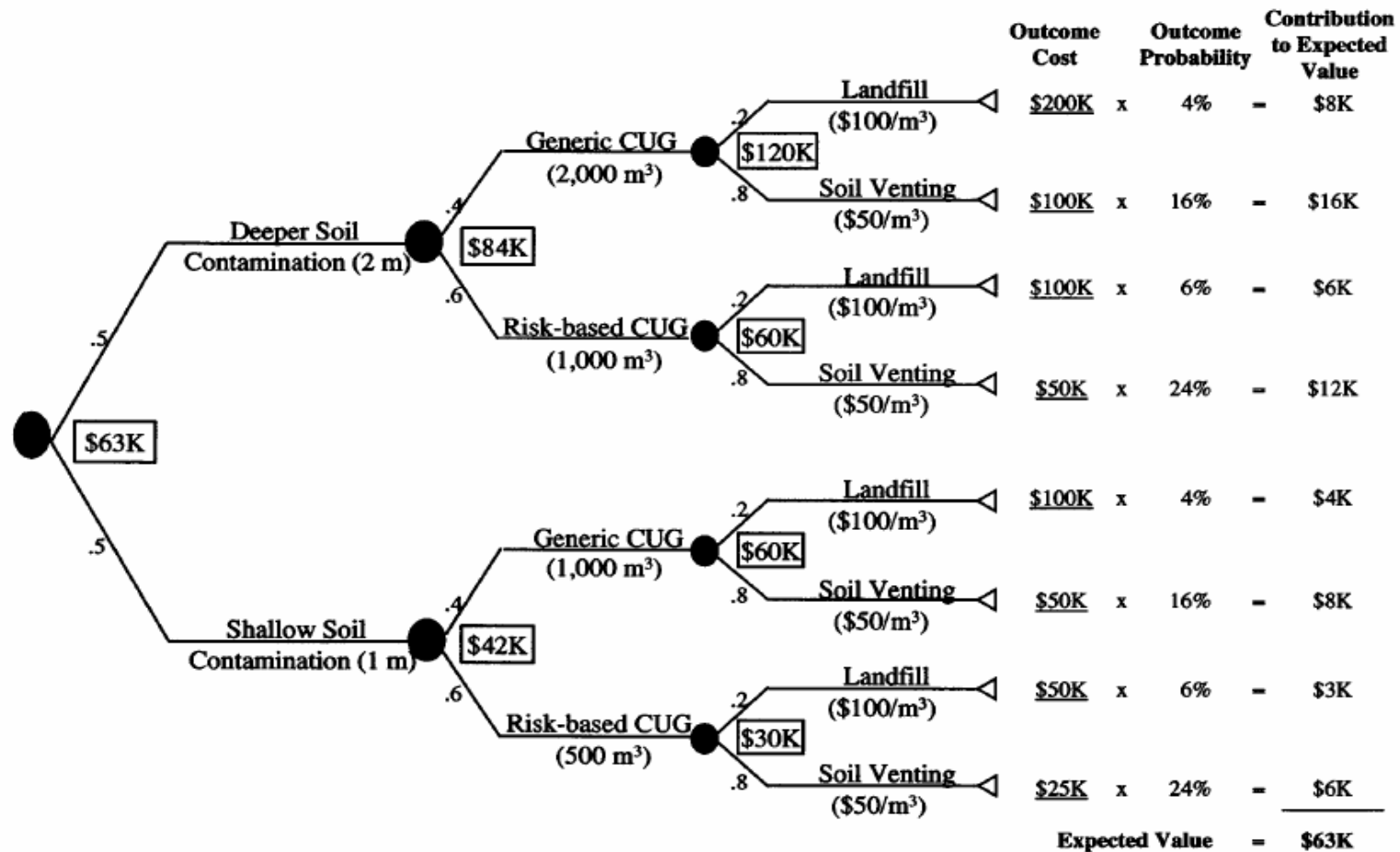


FIG. X2.2 Example Event Tree Expected Value

ASTM E 2137

Expected Value

3 Variables

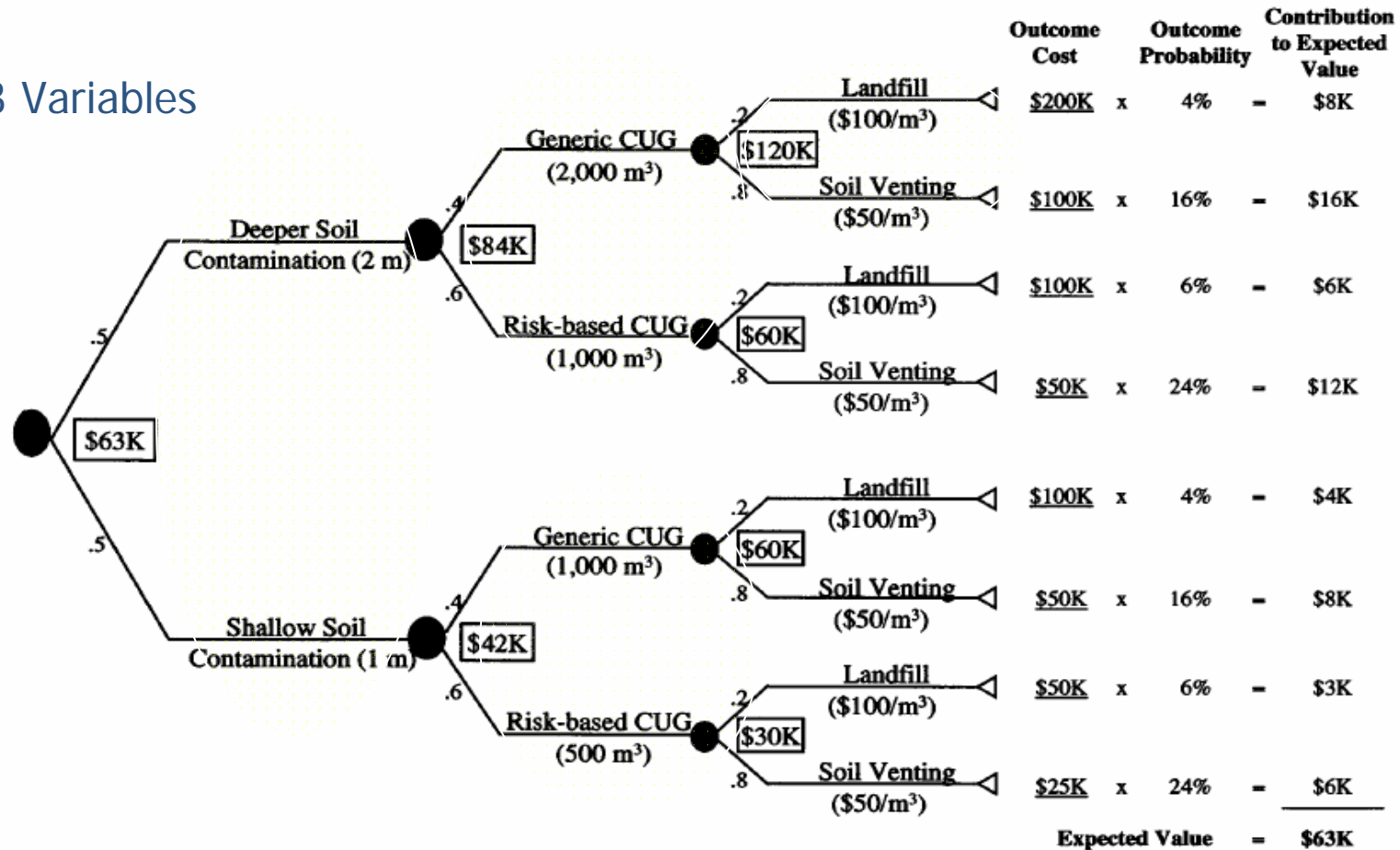


FIG. X2.2 Example Event Tree Expected Value

ASTM E 2137

Expected Value

Range of Costs

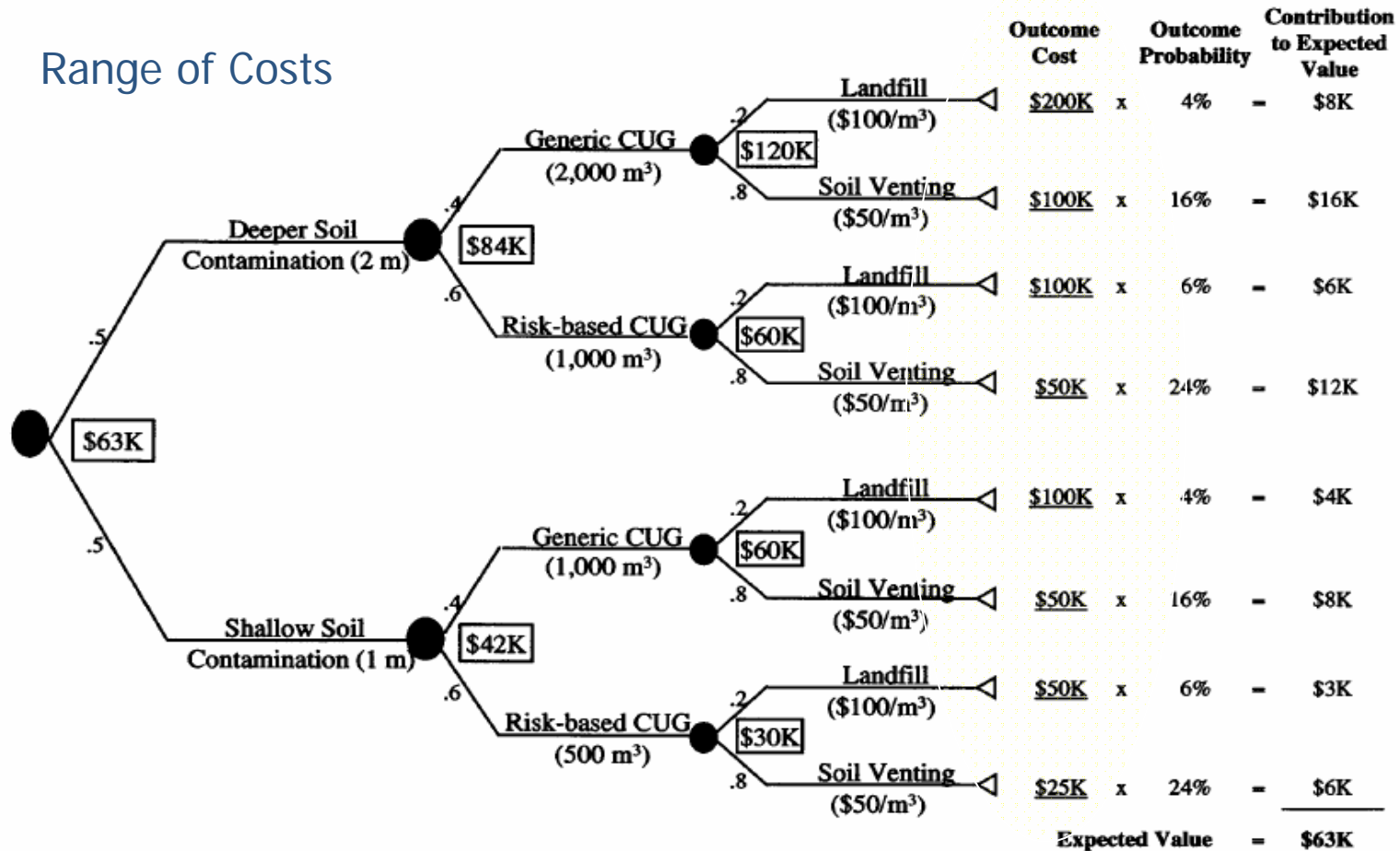


FIG. X2.2 Example Event Tree Expected Value

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Expected Value

Probability of Occurrence

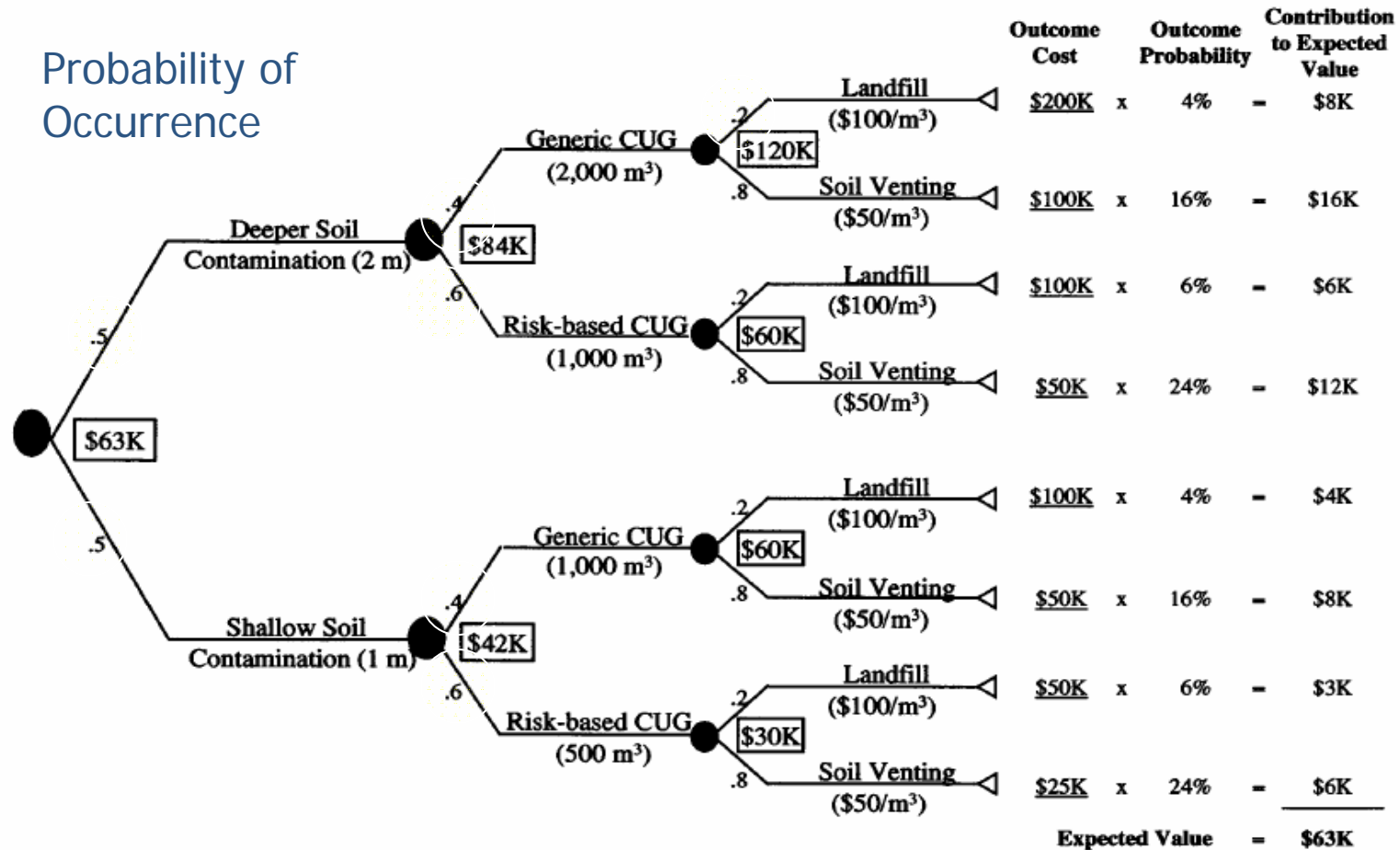


FIG. X2.2 Example Event Tree Expected Value

ASTM E 2137

Expected Value

Probability of Occurrence

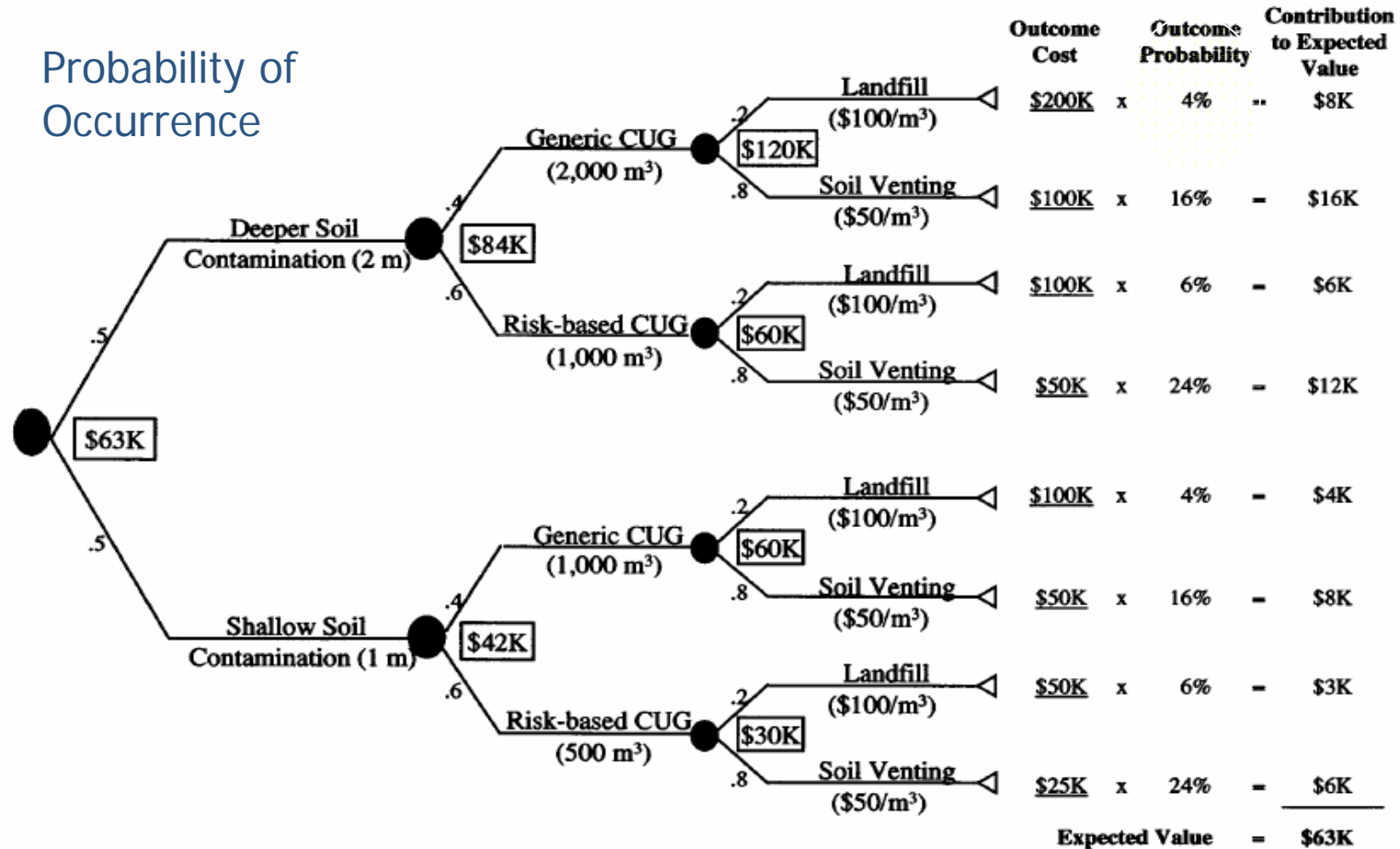


FIG. X2.2 Example Event Tree Expected Value

ASTM E 2137

Expected Value

Probability of Occurrence

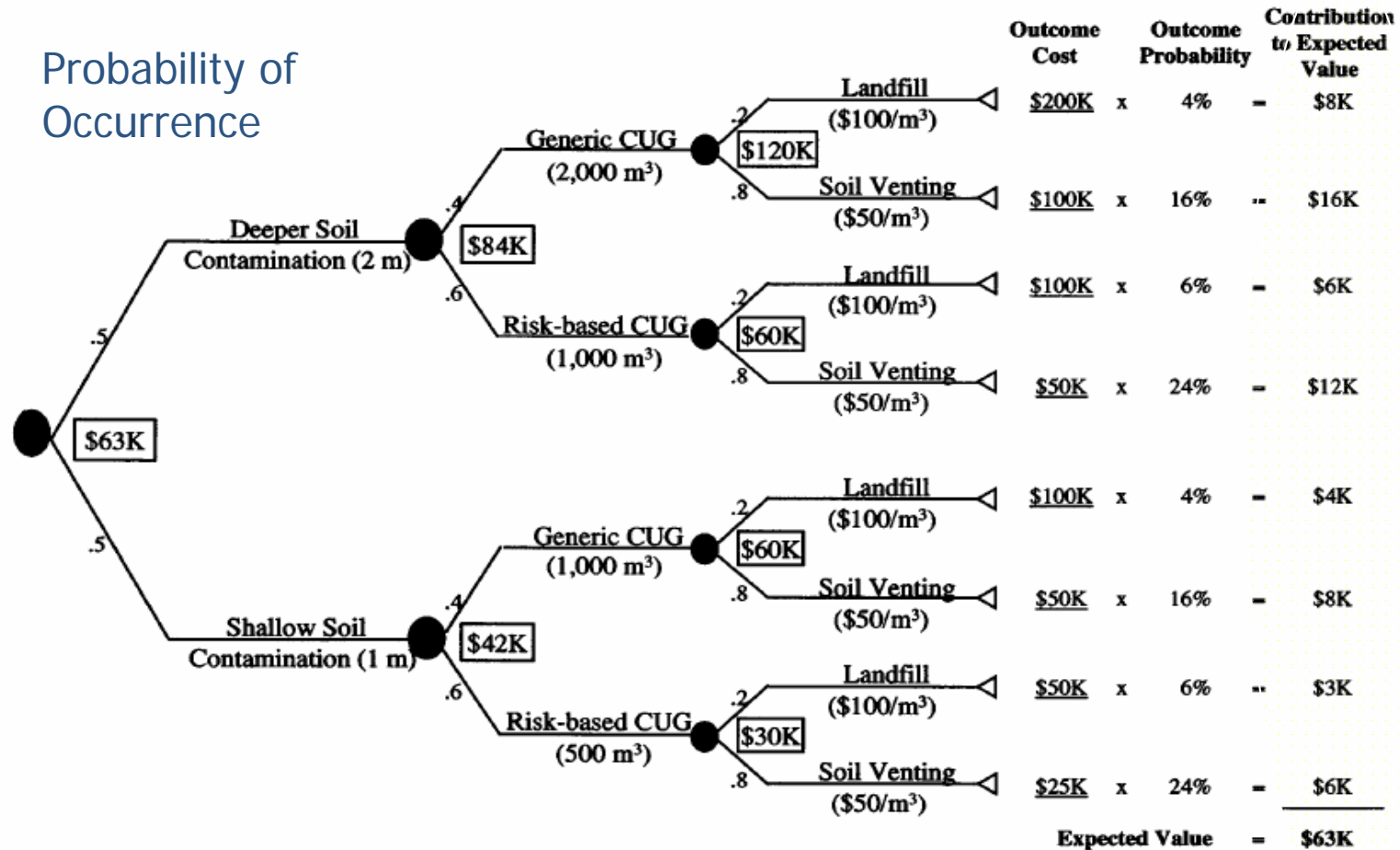


FIG. X2.2 Example Event Tree Expected Value

ASTM E 2137

Expected Value

Probability of Occurrence

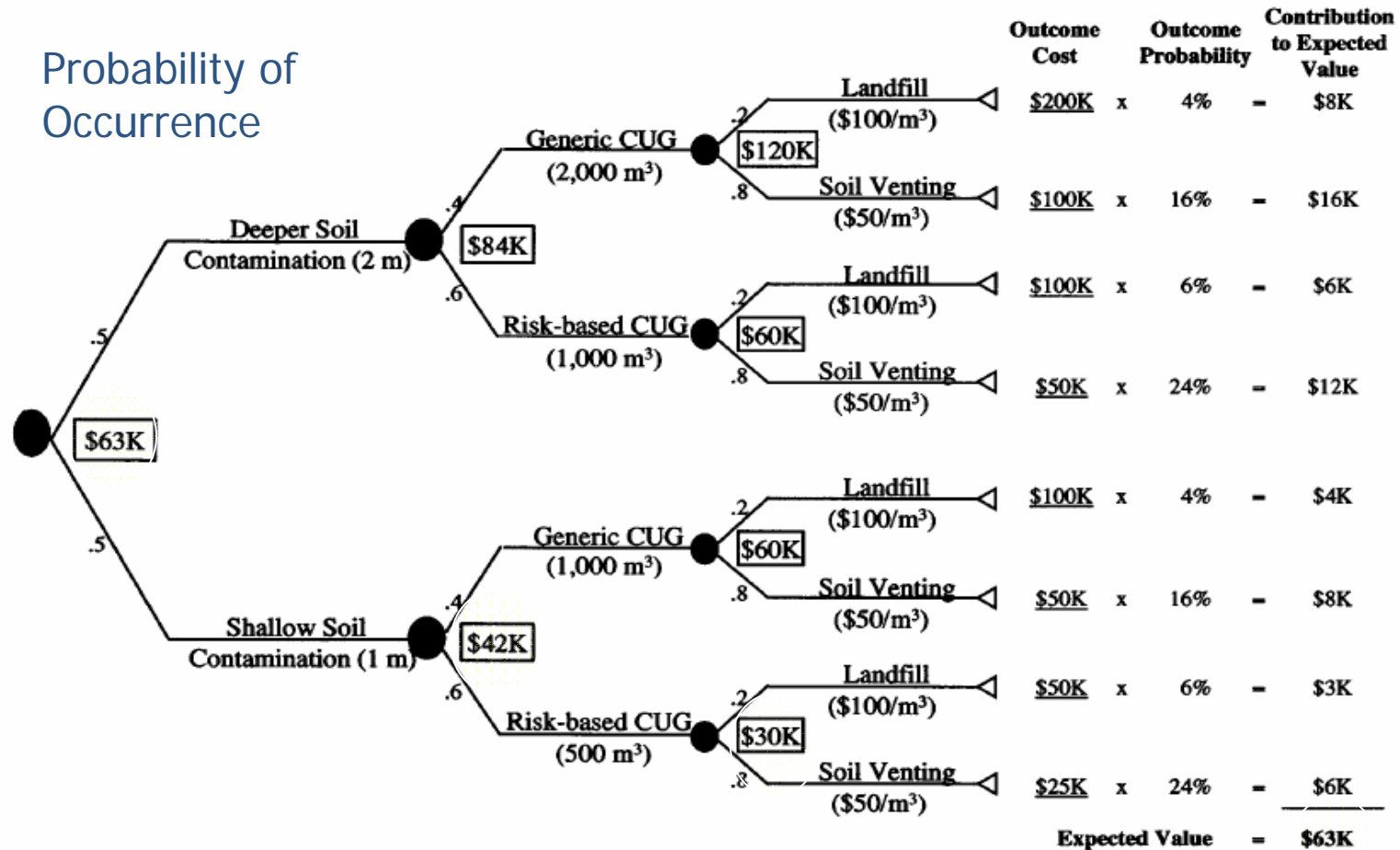
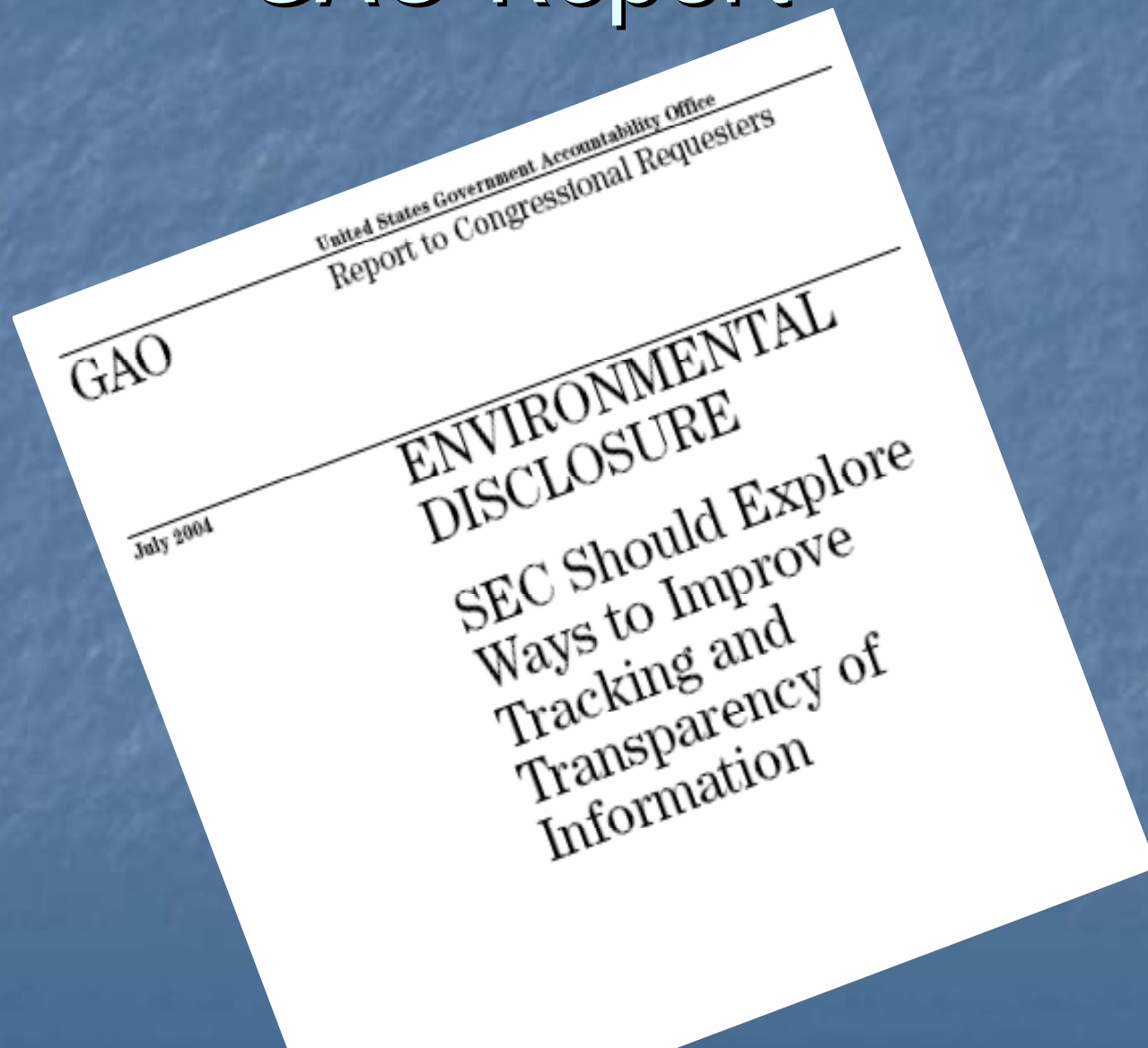


FIG. X2.2 Example Event Tree Expected Value

ASTM E 2137

- Where probabilities of outcome cannot be assigned.
 - "Range of Values."
 - "Known Minimum Value." Use where outcome and uncertainties are so great that it is premature to use one of the other three approaches.

GAO Report



GAO Report

- “SEC Should Explore Ways to Improve Tracking and Transparency of Information”
 - Government Accountability Office, July 2004
- Studied whether existing SEC disclosure requirements are adequate

GAO Report

- Two recommendations:
 1. SEC should create database to serve as repository for SEC comment letters and corporate responses
 - Publicly available
 2. SEC should work with EPA to better utilize EPA data relevant to environmental disclosure

GAO Report

- Stakeholder disagreement over adequacy of disclosure
- GAO could not conclude that existing disclosure is inadequate
- “Determining what companies should be disclosing is extremely challenging...”
 - no access to company records
 - flexibility in disclosure requirements

GAO Report

EPA – SEC Cooperation

- In past, sporadic
- Currently, SEC has access to EPA's "Enforcement and Compliance History Online" (ECHO)
 - <http://www.epa.gov/echo/>

Concluding Observations

- Establish method for evaluating potential liabilities in enforcement actions
- Establish procedure for evaluating clean-up costs under regulatory programs (CWA, CAA, RCRA)
- Specify responsibility for identifying and documenting emerging trends
- Involve senior management in evaluating information

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Item 101 of Reg. S-K

FASB No. 5

- **Auditor Inquiry Letter to Outside Counsel**
 - Seeks information regarding threatened or asserted claims.

Item 101 of Reg. S-K

FASB No. 5

- Counsel's Response – Not Helpful

Evaluation of Outcome: Since the likelihood of an unfavorable outcome to the Company is neither "probable" nor "remote," as those terms are defined in the ABA Statement of Policy referred to in the last paragraph of this letter, we have not formed a professional judgment on the likelihood of an unfavorable outcome to the Company in this matter.

Item 101 of Reg. S-K

FASB No. 5

- Tension between auditor inquiry and legal defense.
 - FASB considers probable as "likely to occur."
 - ABA Statement defines probable as "extremely doubtful" to prevail; success of defense is "slight."
 - Lawyer's estimate: only if amount or range of potential loss is vary narrow