

# Environmental Transparency

## Areas For Concern

By Greg Rogers

An attorney details some of the pitfalls that companies face in assessing the significance of their potential environmental liability — and failure to act properly to disclose it.

In the aftermath of all the corporate scandals of recent years, CFOs should take a fresh look at potentially outdated policies and procedures for environmental disclosure. Here are five insights into the complex legal and accounting maze of environmental disclosure that every CFO should consider.

**1** Conformance no longer ensures compliance. Conformance with generally accepted accounting principles (GAAP) does not ensure compliance with Section 302 of Sarbanes-Oxley.

According to the Securities and Exchange Commission (SEC), when the CEO and CFO certify that the

company's financial statements "fairly present," in all material respects, the financial condition and results of operations of the company, this certification is not limited to a representation that the financial statements and other financial information have been presented in accordance with GAAP, and is not otherwise limited by reference to GAAP.

If GAAP does not require disclosure of material environmental information, what then? GAAP itself, and the independent auditor's assessment of the company's conformance with GAAP, provide no safe haven. The certifying officers are, therefore, individually accountable for determining whether disclosure "beyond GAAP" is necessary or prudent.

**2** Contingent environmental liabilities may not be "contingent" after all. The generally accepted assumption that environmental cleanup obligations are "contingent" liabilities is inconsistent with applicable legal principles, recently adopted financial accounting standards and market reality.

Statement of Financial Accounting Standard No. 5 defines a "loss contingency" as an existing condition, situation or set of circumstances involving uncertainty as to a possible loss that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the loss or impairment of an asset or the incurrence of a liability.

Examples of contingencies listed in FAS 5 include a) pending or threatened litigation and b) actual or possible claims and assessments. Environmental liabilities are almost always considered to fall within one of these two categories. Prior to the initiation of formal legal action, FAS 5 provides that accrual of a liability is not required unless: a) assertion of a claim or assessment is probable; b) an unfavorable outcome is probable; and c) the amount of the loss can be reasonably estimated.

If assertion of a claim or assessment is not probable, neither accrual nor disclosure is required. Applying FAS 5, legally enforceable obligations for environmental cleanup need not be disclosed, so long as legal action is neither pending nor considered probable.

The fallacy is that most environmental cleanup obligations are not "loss contingencies." Why? Because the obligating event — the "release" or "threatened release" of hazardous substances to the environment — has already occurred.

Under relevant legal standards, enforceable obligations are not "contingent" upon the future assertion of a formal legal claim. As stated by a federal bankruptcy court in a recent case involving unasserted asbestos claims, a contingent claim is one in "which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event. ...To say that the act of making the [formal legal] claim was the extrinsic event stretches the meaning of that phrase too far; the formal claim is not extrinsic to the underlying liability, nor is it an event creating liability where none existed before."

In the case of historical releases (as opposed to contemporaneous spills) of hazardous substances, immediate responsive action may or may not be required. As a matter of federal law, however, the current owner of contaminated property, among other potentially responsible parties, is subject to an enforceable obligation for cleanup costs. By law, the obligation exists and is not contingent upon future governmental enforcement.

Recently adopted accounting principles recognize that enforceable obligations for environmental costs are not "contingent" liabilities. Statement of Financial Accounting Standard No. 143 requires accrual of enforceable asset retirement obligations — including obligations for environmental cleanup costs — without regard to the probability of future legal action. Non-productive assets with environmental contamination may be subject to an impairment test under Statement of Financial Accounting Standard No. 144. An impairment exists when the carrying amount of the asset exceeds its fair market value — again, without regard to the probability of future legal action.



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As dealmakers know well, environmental obligations can hurt the marketability and fair market value of individual properties, as well as entire businesses. Enforceable, though unasserted, obligations for environmental remediation are routinely factored into real estate and business transactions.

Frequently, such matters kill the deal. More often, the parties will allocate environmental liabilities through a combination of price reductions, property carve-outs, affirmative covenants, indemnifications, escrows and insurance. The point is this: the market does not consider environmental cleanup obligations to be contingent upon future governmental enforcement.

**3** If your head is in the sand, your assets are exposed. Practices that are widely used in industry today to delay or avoid environmental cleanup costs are incompatible with effective internal control and could result in audit failure — or worse.

It is widely known that Fortune 100 companies, as well as individual property owners, are reluctant to offer for sale or initiate the investigation of properties with known or suspected environmental liabilities. Rather than face the ramifications of disclosing environmental contamination, owners often "mothball" or simply abandon the properties. When such properties are sold, the buyer may be required to agree not to perform an environmental investigation (before or after the sale) or take any other action that could precipitate enforcement of the seller's cleanup obligation.

The "don't ask, don't tell" strategy has the advantage of delaying, and potentially avoiding altogether, environmental cleanup costs. It has the disadvantage of denying information to management and shareholders needed to make informed business and investment decisions. Intentional failure to investigate known or suspected environmental conditions also runs counter to the principles of effective internal control. This raises the serious risk that the company's independent auditor will not attest to the company's internal controls under Section 404 of Sarbanes-Oxley. Worse yet, such practices conceivably could subject certifying officers to civil and criminal penalties under Sections 302 and 906 of Sarbanes-Oxley.

**4** What your auditor doesn't know can hurt you. Failure to fully inform the company's independent auditor of all potentially material environmental matters could subject the company's directors and officers to civil and criminal liability.

As directed by Section 303 of Sarbanes-Oxley, the SEC has adopted rules that, among other things, prohibit a director or officer, directly or

indirectly, from omitting to provide material information to an accountant in connection with an audit or the preparation of reports to be filed with the SEC. In the course of an audit, independent accountants generally rely on company employees to disclose known environmental liabilities. Depending on auditor's questions, however, employees may not provide the auditor with a comprehensive list of environmental obligations beyond those subject to pending legal action. The auditor may or may not conduct an independent investigation to verify the completeness of the company's disclosure, other than to send inquiry letters to the company's outside legal counsel. But audit inquiry letters are unlikely to fill in all of the gaps.

Audit inquiry letters ask attorneys to describe both pending legal matters and "unasserted claims." According to American Bar Association guidelines, however, attorneys are instructed not to provide the auditor with information about unasserted claims unless, and only to the extent that, the client has requested the attorney to comment on specific unasserted claims. In general practice, unasserted claims are not addressed by the auditor or the attorney in audit inquiry letters. This raises the very real possibility that the auditor will not be informed of potentially material environmental obligations, which — though legally enforceable — are not the subject of pending legal action.

**5** Materiality is in the eye of the beholder. If investors representing trillions of dollars in assets believe that more environmental disclosure is necessary to make informed investment decisions, then such information is by definition material.

Financial executives and public accountants routinely apply simplistic rules of thumb (such as less than 5 percent) as *per se* standards in assessing materiality. Though commonplace, there is no basis in the accounting literature or the law for exclusive reliance on a numerical threshold. The practice also contradicts guidance

from the SEC, which favors consideration of "all relevant considerations" — including qualitative factors and the aggregate effect of multiple, individually immaterial omissions.

According to the U.S. Supreme Court, an omitted fact is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." This standard raises two important questions. First, who are these so-called "reasonable investors?" Second, what information is important to them?

The Supreme Court's definition of materiality precludes the views of fringe environmental activists from setting the standard of disclosure for corporate America. In recent years, however, institutional investors and fiduciaries representing trillions of dollars in invested assets have become increasingly concerned about the paucity of environmental disclosure in financial reports. Given their size and sophistication, these investors are hardly fringe activists. Indeed, it is difficult to imagine a court concluding that they are not "reasonable investors."

Institutional investors and fiduciaries are increasingly looking at environmental factors as indicators of the quality of management and the sustainability of the enterprise, and they are frustrated with the quantity and quality of environmental disclosure. Recently, a coalition of pension fund leaders collectively representing over \$1 trillion dollars in assets issued a public demand for tough new steps by the SEC, corporate boards and Wall Street firms to increase corporate disclosure of environmental liabilities and risks, including the risks posed to investors by climate change. Apparently, these investors believe that material information is being withheld.

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