

# Saw the Lightning, Still Waiting for the Thunder: **The Third Year of SOX**

By Greg Rogers, J.D., CPA

Since the enactment of the Sarbanes-Oxley Act of 2002 (SOX), many experts have speculated that strengthened financial reporting requirements might spell the end of mothballing — the practice of indefinitely sequestering contaminated properties to delay or avoid cleanup costs. Indeed, some have predicted that the law will open the corporate property floodgates, causing thousands of brownfield sites to become available for redevelopment.

Will SOX force public companies to account fully for environmental liabilities, and, if so, will this be enough to motivate companies to transfer their contaminated properties? Almost three years after the enactment of SOX, both remain open questions. We saw the lightning, but are still waiting for the thunder.

It might be a mistake, however, to confuse silence with inactivity. SOX is still in its infancy. Management and auditors are still working their way up a very steep learning curve and environmental is on the other side of the crest. Also, because of the technical complexities and legal sensitivities, environmental disclosure is an issue most managers, auditors and internal control consultants would prefer to put off as long as they can.

But how long will SOX allow deferral of the issue? With the first round of internal control audits out of the way, will 2005 be the year that environmental accounting moves to center stage? As we move into the third full year of the SOX era, there are several leading indicators to keep an eye on.

## Asset Retirement Obligations

Watch to see how the Big Four public accounting firms address environmental issues in their client updates on "conditional asset retirement obligations." The Financial Accounting Standard Board (FASB) plans to issue, in the first quarter of 2005, an interpretation of SFAS 143, Accounting for Asset Retirement Obligations, that will

address conditional obligations (legal obligations the company believes it can avoid indefinitely).

FASB comments indicate that the forthcoming interpretation will require financial statement recognition of certain environmental cleanup obligations associated with contaminated properties. The interpretation is also expected to clarify that SFAS 143 applies to environmental exit costs regardless of management's intent to hold a contaminated property indefinitely and regardless of the likelihood of future legal action to compel cleanup.

If the Big Four publicly acknowledge that the new interpretation makes SFAS 143 broadly applicable to environmental contamination at company-owned sites, you can expect to see increasing scrutiny of idled and underutilized properties by public accountants in 2005.

## Internal Control Deficiencies

Watch to see whether public companies report material weaknesses relating to accounting for loss contingencies and asset retirement obligations in their upcoming Form 10-Ks. On October 6, 2004, the Public Company Accounting Oversight Board (PCAOB) issued guidance stating that internal control over financial reporting under SOX 404 can extend to controls over the monitoring, identification, risk assessment, measurement and reporting of environmental liabilities, including unasserted legal claims.

The PCAOB says, for example, that internal control over financial reporting at a waste disposal company ordinarily would encompass controls for identifying and measuring environmental liabilities for existing and newly acquired landfills, even if there is no governmental investigation or enforcement under way. In order to exclude environmental compliance and operational controls from the scope of SOX 404, PCAOB says the likelihood of the company having a material undisclosed environmental liability must be remote.

## M&A Due Diligence

Watch to see if environmental internal control becomes an issue in pre-acquisition due diligence, particularly for transactions involving public companies on either side of the deal, or in deals in which an IPO or issuance of publicly-traded debt is part of the short-term financing picture.

It is one thing to have to manage and correct your own control deficiencies — quite another to unwittingly take on someone else's internal control problems.

"M&A advisors have recently begun asking for reviews of internal control as part of environmental due diligence," says Steve Courcier, chief financial officer for Chicago-based environmental due diligence firm GaiaTech, Inc. Courcier expects the trend to continue.

Jeff Smith, who heads up the environmental practice group at Cravath, Swaine & Moore LLP in New York, concurs that M&A activity likely will be a driving force for change.

"The power of deal acceleration, particularly on the M&A side, can churn changes through the system very quickly," says Smith. He adds, "Private equity, which is chasing a lot of deals now, has a short exit horizon and a need to know that the house they are buying is in order."

Even if the buyer is fully aware of the seller's environmental liabilities, inadequate financial disclosure and controls can become a barrier to exit when it's time for the buyer to sell.

Smith says, "\$300 to \$500 million companies and divisions of larger enterprises are the ones that get bought and sold more frequently and may well be the first to get 'turned' on to this issue." **BFN**

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