COMPLIANCE WEEK

New Regulations, Standards Influencing Environmental Disclosures

By Karen M. Kroll — November 2, 2004

Several events occurring over the past year may signal a sea change in the way that corporate executives report environmental liabilities in their SEC filings. Among the most significant were the SEC's new interpretation of "triggering events" that require an 8-K filing, and the FASB's issuance of guidance concerning FAS 143.

At the same time, calls by powerful institutional investors for greater environmental disclosure—combined with the results of a recent GAO report—have gotten the attention of the Securities and Exchange Commission, which is already pushing for more thorough disclosure of related risks in the "Management's Discussion And Analysis" sections of public company reports.

RELATED LINKS

Documents Mentioned

Interpretation Of FASB Statement No. 143

New SEC Form 8-K, Effective Aug. 23

GAO Report: SEC Will Track Environmental Disclosures

Related Coverage

Related Guidance, FAQs On SEC's New Form 8-K

As a result, experts say corporate executives should be considering whether their current disclosure policies adequately meet changing regulations and investor and public expectations.

The Changes

As most public company executives know by now, the SEC has modified its 8-K disclosure requirements, expanding the number of items that must be reported, and accelerating the speed with which they must be made. The new rule, which has been effective since Aug. 23, changed the definition of a "triggering event" that would compel companies to file an 8-K. "This is going to increase the number of items to trigger an 8-K," says Chris Curtis, vice president with consulting firm Ashton Partners, Chicago.

Several of the new triggering events concern environmental liabilities. One is Item 2.05, which is titled "Costs Associated with Exit or Disposal Activities." If, for instance, a company was disposing of idle property that required sanitization, and the cost of the clean up would be material, management would have to issue an 8-K.

Another is related to material impairments (Item 2.06). That's because concluding that an asset is "materially impaired" can indeed have an environmental angle. Should executives, for example, determine that one of the company's assets is contaminated to the point that its value is affected, under the new rules an 8-K would be in order. "In the past, this information was buried in the footnotes in a 10-Q," says Curtis.


Rogers

At about the same time that the 8-K changes took effect, the Financial Accounting Standards Board issued a proposed interpretation of FASB Statement No. 143, "Accounting for Conditional Asset Retirement Obligations." Two months later, it made the interpretation final. The new guidance relates directly to environmental obligations, says Greg Rogers, an environmental attorney with Guida Slavich & Flores in Dallas. "It's overwhelming in its implications."

Historically, FAS 5, "Accounting for Contingencies," had been the principal accounting standard governing environmental remediation liabilities, says Rogers. According to the accepted interpretation of FAS 5, unless a company had some legal action pending, it wasn't obligated to disclose anything. For example, if a company owned property it suspected was contaminated—but decided to rope it off and never sell, lease or develop it—then management wasn't obligated to report the potential liability.

Environmental remediation laws generally hadn't compelled companies to investigate and clean up contaminated sites, absent some government enforcement, says Rogers. "Many companies have understandably chosen to let sleeping dogs lie," says Rogers.

The latest interpretation calls that approach into question. “It says that if you’ll have to incur costs upon the retirement of a long-lived asset, you have to estimate the cost now and present it on the financial statements,” says Rogers.

In contrast to FAS 5, under FAS 143—even if there’s not a history of regulatory enforcement or the expectation of future legal action to enforce cleanup—executives still have to estimate and disclose the liability, Rogers notes. Going forward, it seems unlikely that a company could choose not to estimate a liability simply because it decided not to investigate a property even where it’s pretty clear there’s contamination.

Additional Pressures

Regulators aren’t the only ones calling for greater environmental disclosure in companies’ financial statements. A number of environmental organizations also are sounding the drumbeat. And while it was not uncommon for companies to disregard environmental groups as fringe—and subsequently not influential—activists, the groups have become increasingly influential, capturing the attention of governmental agencies and institutional investors. The institutions, in turn, have used their position in the market to exert additional pressure on regulators and the SEC.

For instance, a relatively unknown group in Oakland, Calif., The Rose Foundation for Communities and the Environment, was recently able to secure high-level meetings with the SEC that may ultimately impact environmental reporting requirements.

According to executive director Tim Little, the Rose Foundation met with SEC commissioners last year to discuss the group’s report, “The Gap in GAAP,” which examined environmental reporting loopholes. According to the report, companies are using Generally Accepted Accounting Practices “as a ceiling to limit disclosures rather than a foundation on which to build financial transparency.” The report focused on reporting practices that are considered acceptable within GAAP, but create loopholes that enable companies to underreport environmental liabilities.

RELATED LINKS

The Rose Foundation's “The Gap in GAAP”

2nd Report: “Fooling Investors & Fooling Themselves”

The commissioners instructed the group to do two things: provide fresh evidence that the companies were exploiting the loopholes identified in the report; and demonstrate that major institutional investors agreed with the Foundation’s assessment.

Little and his colleagues did just that, issuing a new report in July titled “Fooling Investors and Fooling Themselves.” Published with the support of a group of institutional investors that collectively hold some $2 trillion in assets, the report argued that environmental liabilities and risks meet definitions of “materiality”, and hence should trigger SEC disclosure requirements. “In much the same way that various off balance sheet arrangements and other financial manipulations were made infamous by Enron, Worldcom, Global Crossing and others,” noted the report, failure to quantify and disclose environmental liabilities was in may cases “artificially inflating the market’s assessment of a company’s shareholder value.”

The Rose Foundation reviewed the report with SEC commissioners, and elevated the issue further at a recent Congressional symposium. And while the SEC has yet to visibly act on the information, experts note that the report—and others like it—are starting to have an impact on how regulators and shareholders consider environmental issues. “Investors are paying more attention to off-balance sheet liabilities and risks that companies have,” says Dan Bakal, director of electric power programs with CERES, a Boston-based coalition of investors, public interest groups and environmental organizations. Even if companies can’t precisely determine the impact of environmental liabilities, notes Bakal, investors feel they have a right to information on how companies are dealing with risks.

The Investor Network on Climate Risk, a group of powerful pension fund leaders, is also pressing for increased disclosure on climate and environmental risks. In November 2003, the group hosted an Institutional Investor Summit on Climate Risk in United Nations in New York City, which elevated the issues further with pension funds, financial services firms, and others.

In April of this year, the group wrote a letter to the SEC, stating that publicly traded companies should disclose the financial risks of global warming in their securities filings. This convergence of forces has prompted at least a few companies to responding to investors’ requests for additional information.

RELATED LINKS

Pension Funds Want To See More Green In MD&A

Executive Summary Of The

Risk Disclosures

AEP Report

One such company is American Electric Power, a $14.5 billion electric company based in Columbus, Ohio. In August, AEP announced the release of a report assessing the actions the company has taken to mitigate the economic impact of increasing regulations—and heightened public expectation—to reduce emissions of carbon dioxide and other substances from its power plants. The report was prompted by an agreement the company reached with some shareholder groups, including The Connecticut Retirement Plans and Trust Funds, says company spokesperson Melissa McHenry.

The shareholder groups had also requested a broader report on 2002, asking the company to report on economic risks associated with its emission of carbon dioxide, sulfur dioxide, nitrogen dioxide, and mercury, as well as the economic benefits of substantially reducing emissions.

In contrast, the 2003 request asked the company to identify the steps it had taken to mitigate the potential economic impact of increasing regulatory requirements, competitive pressures and public expectation of reducing emissions. "For the report, we agreed to evaluate the impact of our CO2 emissions based on proposed climate change legislation, including the Carper and McCain-Lieberman legislation," says McHenry. Although the latter bill, known as the Climate Stewardship Act, did not pass the U.S. Senate back in 2003, its calls for large companies to reduce their emissions is still considered an industry benchmark. "This was very specifically related to the economic impact of emissions," adds McHenry.

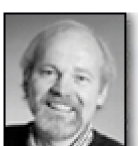
The report, to which 28 experts from outside the company contributed, concludes that AEP has taken appropriate steps to address emissions, including developing at least one power plant based on Integrated Gasification Combined Cycle technology, which could be operational as soon as 2010. IGCC plants emit lower levels of sulfur dioxide, nitrogen oxide and mercury than traditional plants. AEP also agreed to invest in renewable energy sources, including wind generation and biomass.

Cinergy, another energy company based in Cincinnati, announced in February that it was collaborating with The Mission Responsibility Through Investment Committee of the Presbyterian Church, to produce an environmental report. The report, which will outline the steps Cinergy is taking to address certain environmental issues, is scheduled to be out by the end of the year.

The Risk Of Under-Disclosure

The number of firms discussing climate change in their annual reports is slowly growing. That's according to the Third Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical and Utilities Companies, completed by the organization Friends of the Earth–U.S., located in Washington, D.C.

For instance, more than 90 percent of utilities companies discussed climate change in their 2003 reports, up from about 50 percent in 2001. About 20 percent of chemical companies included a discussion in their 2003 reports, up from about 5 percent in 2001.


Parenteau

Going forward, executives that decide not to address environmental liabilities in their firm's financial filings run several risks. For starters, the calls for increased disclosure are likely to intensify over the next few years, says Patrick Parenteau, professor of law at Vermont Law School.


Giaccia

In addition, executives that address issues upfront are better able to diffuse potential blow-ups. Andrew Giaccia, an environmental lawyer with Chadbourne & Parke in Washington, D.C., recalled one company that belatedly discovered an employee was diluting waste water samples so that they would pass an environmental test. While the water still was clean enough that no one would have suffered any ill effects, investors chopped 25 percent from the market value of the company when news leaked out. "Investors reacted to deliberate act of noncompliance," says Giaccia. "Even though it was small, it suggests mismanagement within the company."

Along with regulators and investors, insurers also are interested in companies' environmental disclosures. Many directors' and officers' policies contain "pollution exclusions," and don't cover claims resulting from the release or threatened release of pollutants. Instead, companies need to identify environmental risks and purchase separate policies to cover them.

To be sure, determining just how to estimate and disclose potential environmental risks isn't an exact science. The regulatory agencies could do a better job of providing guidance, says Bakal at CERES. "The SEC should say 'here is a way to provide useful information to investors.' The Commission could do an interpretive release, without revising the actual standards."

The difficulty notwithstanding, a proactive approach can pay off. "Getting in front of issues before they surface will serve the company well in the event of bad news or environmental crisis," says Curtis of Ashton Partners. "It's a lot easier to defend yourself if you have a track record."

Back