

ENVIRONMENTAL & PRODUCT LIABILITY DISCLOSURE: Brattle Survey Shows an Array of Inconsistent Practices

INTRODUCTION

Since the passage of the Sarbanes-Oxley Act in 2002, companies have been paying more attention to the disclosure of environmental and product liability matters. However, the debate continues regarding the scope of disclosure and the necessity of formal SEC rule revisions.

After more than a decade of engaging in cases involving environmental and product liability estimation and disclosure, The Brattle Group sponsored a web-based survey to benchmark the current attitudes, practices, challenges, and trends relating to this area. This newsletter summarizes the results of the survey, focusing on the extent to which companies disclose liabilities, define what is “material,” and are aware of recent and proposed changes in disclosure standards, guidance, and procedures.

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For more information on The Brattle Group’s work in environmental and product liability estimation and disclosure, please contact Gayle S. Koch in Cambridge at 617.864.7900.

Current securities regulation and accounting guidance require that companies disclose the “material” financial effects of their liabilities, including those relating to the environment and products manufactured, used, or sold. However, there has been much debate about the clarity and specificity of these requirements, the extent to which companies are complying with these requirements, and the necessity for changes. For example:

- The U.S. Government Accountability Office (GAO) released a report in July 2004 which recommended that the Securities and Exchange Commission (SEC) improve the tracking and transparency of environmental disclosure information and coordinate better with the U.S. Environmental Protection Agency (EPA). Environmental interest and investor groups asserted that the existing requirements allow too much flexibility and are too narrowly scoped to provide adequate disclosure. Reporting companies, however, generally viewed the existing requirements as sufficiently well defined, with the flexibility needed to accommodate individual circumstances.
- Environmental organizations are campaigning for stronger and more specific disclosure requirements, such as the Rose Foundation for Communities and the Environment’s petition to the SEC for the adoption of liability estimation and disclosure standards issued by the American Society of Testing and Materials (ASTM) International.
- But some companies maintain that developing more specific guidance is not feasible. They claim that international market forces — not additional SEC, legal, or accounting requirements — ensure and drive adequate and evolving disclosure practices. Such market forces include initiatives by industry groups to establish corporate social responsibility and citizenship standards, demands from shareholder and investor groups for greater disclosure, and new insurance policy exclusions for securities law violations by corporate officers.
- The adoption of the Sarbanes-Oxley Act has bolstered the importance of proper and adequate disclosure controls and procedures with the threat of civil and criminal penalties for noncompliance. The passage of the Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 47, affecting accounting for asset retirement obligations, also promises to have an impact on disclosures.

Additionally, in the course of our environmental and product liability estimation work for companies involved in cost recovery, insurance allocation, and disclosure cases, questions often arise about the extent and timing of disclosing such estimates.

With so much ongoing discussion and debate about environmental and product liability disclosure in financial reporting, *The Brattle Group* sponsored a survey to create a snapshot of current disclosure practices. We also examined whether companies are changing their disclosure procedures, and whether they expect future changes. This newsletter presents the results of this survey.

SURVEY DESIGN

Invitations to participate in our survey were mailed to *Brattle* clientele and contacts who were likely to be involved with environmental and product liability disclosure. These contacts included company legal, financial, and environmental personnel; outside counsel; accountants; financial consultants; and environmental consultants. The survey was available online from December 2004 through February 2005. To maintain confidentiality, individual and corporate identities were not collected with the responses — only generic background information was collected to allow us to segment and interpret the survey data more fully.

The survey was designed to obtain input and comment on the following disclosure issues:

- How, where, and to what extent environmental and product liabilities are currently disclosed.
- Whether current reporting guidelines are sufficient to determine which, and to what extent, liabilities are disclosed.
- The impact of recent changes to disclosure standards, guidance, and procedures.
- Reaction to proposed changes in disclosure standards, guidance, and procedures.

The survey was not designed to reach a large, random sample and is therefore not statistically significant. However, certain commonalities as well as striking inconsistencies are apparent in the results.

PARTICIPANT BACKGROUND INFORMATION

The respondents were about equally divided between those that worked directly in companies that routinely report to the SEC and those that worked for outside (“supporting service”) firms. In total, approximately 75 reporting companies were represented by survey respondents. The table below provides a breakdown of the survey respondents by position type:

Survey Respondents by Position Type			
Position Type	Reporting Company	Outside Firm	Total
ACCOUNTING/ FINANCE	15%	0%	15%
LEGAL	7%	50%	57%
ENVIRONMENTAL	21%	7%	28%
TOTAL	43%	57%	100%

Manufacturing is the most prevalent industry represented by the respondents. Additional industries that were frequently reported include waste management and remediation, oil and gas, utilities, finance, and real estate. All company respondents have operations both in the U.S. and abroad, and 25% of the outside firm respondents reported that their clients/customers have operations abroad. The gross revenues of the companies that were represented in the survey generally range from \$100 million to more than \$5 billion.

THERE IS DISCLOSURE, BUT FEW TAKE IT TO THE BOTTOM LINE

In accordance with SEC regulations, a company is required to disclose “material” environmental and product liabilities in their filings. In addition, accrual and disclosure of liabilities in financial statements are required if they are probable and reasonably estimable.

When asked whether and where the respondents disclose their environmental and product liabilities, all respondents affirmed disclosing their environmental liabilities, and 57% of the respondents affirmed disclosing product liabilities as well. The respondents reported disclosing their liabilities in their

annual reports (Form 10-Ks), mostly in the “Legal Proceedings” and “Management Discussion and Analysis” (MD&A) sections, and as footnotes in their financial statements. Only 14% of the respondents reported accruing liabilities on their financial statements.

STRUGGLING WITH WHAT IS “MATERIAL”

The SEC has not defined what exactly is “material,” instead relying on judgments made by the courts and the discretion of the reporting companies. Questions in the survey asked how the respondents identified and quantified their potential liabilities and determined whether they were “material” for reporting purposes. For most of the questions asked, multiple responses were allowed.

Respondents reported using resources and data from internal departments, company counsel, and outside counsel and consultants to identify their liabilities. Thirty-six percent of the respondents reported using a bottom-up quantification of their liabilities before performing a materiality test, and 43% of the respondents reported conducting a materiality test before quantifying those liabilities that exceed the test. One respondent reported not considering materiality to determine its liabilities.

The respondents reported quite a variety of tests to determine materiality. The most common test reported is the filing of a legal claim (50% of respondents). Other specific tests frequently reported include specific dollar amounts (21% of respondents) and expecting resolution of liability within the next five years (21% of respondents). Twenty-nine percent of the respondents reported not having a specific test for materiality.

The responses to subsequent questions on how the liabilities are quantified and whether they are aggregated for the purposes of determining materiality also show considerable variability:

- 50% of the respondents reported using only one year’s costs or the “minimum” value to determine materiality.
- 43% and 57% reported using the expected value and “single best estimate,” respectively, to determine materiality.
- 29% reported “always” or “frequently” aggregating the liabilities to determine materiality, and 43% reported only “sometimes” aggregating them.

In summary, there is considerable variability in how liabilities are determined to be “material” and quantified for reporting purposes.

But opinions regarding whether there is sufficient guidance to determine what is “material” were about evenly split between those respondents that answered “yes” and those respondents that answered “definitely no” or “probably no.” Interestingly, some of the respondents who answered “probably yes” reported not having a specific test for materiality, which suggests their preference for some flexibility in determining what is “material.” Conversely, some of the respondents who answered “definitely no” or “probably no” appear to want additional guidance, as they had also reported not having a specific test for materiality.

THERE IS WIDE DISCRETION IN HOW AND WHEN ESTIMATED COSTS OF LIABILITIES ARE REPORTED

Respondents reported total environmental liabilities ranging from \$1 million to \$500 million. Of the respondents that affirmed disclosing product liabilities as well, the reported amounts range from less than \$1 million to \$500 million. The types of environmental liabilities reported include:

- CERCLA and RCRA sites.
- Other cleanup liabilities.
- Inactive, retired, or divested sites with potential liability.
- Compliance with solid waste, air, and water regulations.

The types of product liabilities frequently reported include asbestos (43% of respondents), company products (21% of respondents), and silica (21% of respondents). The events used to trigger disclosure of particular liabilities include internal discovery, notification by a regulatory authority or third party, investigation or study, and legal action.

We asked how respondents report the estimated costs of the liabilities, and found considerable variability in their responses:

How are the estimated costs of the liabilities reported? Check ALL that apply.

Responses	Percentage of Respondents
RANGE	43%
MOST LIKELY VALUE	43%
EXPECTED VALUE	36%
AMOUNT FOR A DEFINED PERIOD OF TIME (USUALLY WITHIN THE NEXT YEAR)	29%
KNOWN MINIMUM	21%
WITH UNCERTAINTY	21%
DID NOT ANSWER	14%

Only 7% of the respondents stated that the reported estimates are consistent with estimates provided to insurance companies. Forty-three percent of the respondents “always,” “frequently,” or “sometimes” report their potential recoveries from insurers, prior owners, or other potential indemnifiers, but with no clear trend as to how these potential recoveries are reported (*e.g.*, separately, netted before or after the materiality test). Twenty-one percent of the respondents reported applying a discount rate to their liabilities using a risk-free or corporate risk-based rate.

With so much variability in how the estimated costs of the liabilities are ultimately reported, we then asked respondents what factors influence the timing and magnitude of their disclosures. The most influential factor is the “outcome of pending litigation or government action,” which was reported by 64% of the respondents. Other factors mentioned include “outcome of insurance recovery effort(s)” and “potential impact to level of shareholder information.”

EXCEPT FOR SARBANES-OXLEY, RECENT CHANGES TO DISCLOSURE GUIDANCE HAVE HAD LIMITED INFLUENCE

About half of the respondents reported that the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 96-1 and the FASB Statement of Financial

Accounting Standards No. 143 “significantly” or “moderately” influence their company’s disclosure. AICPA’s SOP 96-1 provides additional guidance on accounting for environmental liabilities, including specific benchmarks for which specific types of reporting should occur. FASB No. 143 states that environmental remediation liabilities resulting from the retirement of a long-lived asset shall be recognized.

Eighty-six percent of the respondents reported that the Sarbanes-Oxley Act “significantly” or “moderately” influences their company’s disclosure.

AWARE OF POTENTIAL FUTURE CHANGES...

Seventy-one percent of the respondents are at least somewhat aware of the U.S. GAO environmental disclosure report and an SEC proposed rule requiring public companies to provide a detailed narrative disclosure and sensitivity analysis about “critical accounting estimates.” Such estimates are defined as “approximations” by management about matters that are “highly uncertain” at the time the estimates are made, and under circumstances where different estimates that management reasonably could have used would have a material impact on the company’s financial condition.

Fifty percent of the respondents are at least somewhat aware of the Rose Foundation’s petition for the adoption of more specific ASTM disclosure standards.

...BUT LET’S WAIT-AND-SEE WHAT HAPPENS

Twenty-one percent of the respondents reported not planning or foreseeing any significant changes in the way they will disclose their environmental and product liabilities. Only 7% of the respondents anticipate greater disclosure. One respondent expects his disclosure practices will change more or less in lockstep with changes in SEC requirements and American Bar Association guidance.

Fourteen percent of the respondents commented that the EPA compliance data are inaccurate, which would compromise the reliability of the information shared with the SEC.

CONCLUSION

The survey responses indicate that disclosure practices are inconsistent and mixed. Some respondents, however, apparently prefer the lack of specificity and clarity in disclosure requirements and guidance. There is wide discretion in the extent to which reported liabilities ultimately impact the bottom line. Finally, some companies do not appear to see significant changes on the horizon, and are taking a wait-and-see approach.

The rules of disclosure are evidently still unclear, which is problematic to those who want to establish a common and well-defined ground for estimating, disclosing, and understanding more precisely the nature, type, and extent of environmental and product liability. What is even more unclear is exactly how, and to what level, disclosure of environmental and product liability will evolve. Will Sarbanes-Oxley regulation affect disclosure processes? Will there eventually be better definition and, just as important, stricter enforcement of disclosure requirements? How will FIN 47 on accounting for “conditional” asset retirement obligations and FASB proposals on fair value measurements affect disclosures? Will forthcoming changes in ASTM International’s environmental liability estimation and disclosure standards have an impact?

Regulatory and market forces and stakeholders continue to play a role but from different angles, including the SEC, non-governmental organizations, shareholder and investor groups, insurers, and companies seeking to use disclosure as a benchmark for performance. Perhaps recently heightened activity in securities class action litigation relating to inadequate or inaccurate disclosure will become a significant factor, garnering enough of the attention from all stakeholders to provide the needed momentum towards achieving a common ground. It will be interesting to see whether a significant change will occur.

RELATED *BRATTLE* PUBLICATIONS

The Brattle Group has published several articles on topics related to environmental and product liability estimation and disclosure, including:

- *Damages — Estimating Product Liability*
- *Filling the GAAP: An Approach to Improve SEC Disclosure of Environmental Liabilities*
- *Estimating Contingent Environmental Liabilities: An Approach to Achieve SEC Compliance*
- *Evaluating Environmental Costs — Accounting for Uncertainties*
- *Toxic Torts — The Science of Estimating Damages*
- *Controlling Costs and Improving Performance: Strategic Analysis of Litigation*
- *Financial and Discount Rate Issues for Strategic Management of Environmental Costs*
- *Estimating & Disclosing Environmental Liabilities: New Standards Expected to Pass*
- *Using Decision Analysis to Manage Environmental Costs*
- *Damages Valuation and Settlement Analysis for Mass Toxic Tort and Product Liability Claims*

Please contact us at publications@brattle.com for copies of these articles.

RECENT *BRATTLE* PUBLICATIONS

Chris Chan, Greg Brusseau, and Gayle Koch of *The Brattle Group* published an article "Lessons Learned: Using Decision Analysis to Estimate Toxic Tort Liabilities" in the Winter 2006 issue of *Natural Resources & Environment* (20(3): 48-49, 71-72). In this article, they share the lessons learned from using decision analysis to evaluate and estimate risks and liabilities within the context of toxic tort litigation. Applying these lessons will improve quantification and understanding of potential liabilities, allowing effective management of those liabilities and communication of risk in a more comprehensive, strategic manner. If you would like a copy of this article, please contact us at publications@brattle.com.

ASTM REVIEWS STANDARDS

ASTM International recently initiated review of its standards on environmental liability estimation and disclosure. Topics being addressed include the impact of Sarbanes-Oxley, fair value measurements, and FIN 47 on accounting for asset retirement. If you are interested in learning more about this review process, please contact Gayle Koch in Cambridge at gayle.koch@brattle.com or at 617.864.7900.

THE BRATTLE GROUP LAUNCHES BRUSSELS CONSULTING PRACTICE

The Brattle Group has launched an office in Brussels to provide consulting services in utility regulation, competition analysis, antitrust, and other areas. The office is headed by Dr. Boaz Moselle, who joins the firm from Ofgem, where he worked as Managing Director of Corporate Strategy and sat on the Ofgem board. Dr. Moselle was responsible for developing policy and managing Ofgem's work in European energy regulation, environmental policy, and other strategic areas.

NATURAL RESOURCE DAMAGES

The Brattle Group is currently engaged in a number of cases involving the estimation of natural resource damages (NRD). NRD can represent a significant liability and be estimated by a wide variety of methods. To estimate the potential NRD for a large river system, we compiled and analyzed available data on NRD assessment and settlement costs for comparable sites throughout the U.S. In other matters, we are evaluating and scoping potential approaches to estimating NRD that consider the use and non-use values of the injured resources. These potential approaches include the contingent valuation methodology, hedonic analysis, habitat equivalency analysis, and market-based analyses such as replacement value analysis.

ASBESTOS AND INSURANCE:
HOW TO FACILITATE A SETTLEMENT

In a recent issue of our newsletter *ECONOMICS*, *The Brattle Group* describes the typical analyses and methodologies used in asbestos insurance settlement negotiations. In particular, we focus on the methods used to forecast and evaluate future asbestos-related claims and to allocate the liabilities to insurance coverage. Understanding these methods can facilitate a reasonable settlement for both the insured and insurers. If you would like a copy of *ECONOMICS*, please contact us at publications@brattle.com.

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