LEGISLATION

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The Sarbanes-Oxley Act & Safety

On July 30, 2002, then President George W. Bush signed into law legislation that changed the corporate landscape in the U.S. in regard to financial reporting and auditing for publicly traded companies. The Sarbanes-Oxley (SOX) Act of 2002 (Public Law 107-204) (http://www.soxlaw.com) was written with the intent of addressing some issues brought to light during the collapses of Enron and Arthur Andersen.

An offshoot of this legislation is the impact that it could have on SH&E professionals who work at companies subject to Security and Exchange Commission (SEC) (http://www.sec.gov) reporting requirements. This article addresses how SH&E professionals can understand the implications of the SOX Act on their company. Their departments, organizations and even their jobs may depend on it.

Basic Outline of the Law

The law has far-reaching effects into the financial reporting systems of U.S. companies subject to SEC reporting requirements. In addition to establishing records retention requirements for audit papers, the law creates a new oversight board for accounting firms that audit publicly traded companies. The law also addresses auditor independence, corporate responsibility at publicly traded companies, financial disclosures of publicly traded companies and conflicts of interests of financial analysts. It also creates protections for whistleblowers applicable to private and public companies, and imposes new criminal penalties related to fraud, conspiracy and interfering with investigations.

Environmental Liability Disclosure

Following is a brief summary of federal securities laws and regulations, as well as guidance from SEC and various accounting authorities, applicable to the assessment and disclosure of environmental liabilities. It also highlights provisions of the SOX Act that may have a substantial impact on public companies with environmental liability concerns.

Three sections of Regulation S-K (which provides the disclosure requirements for periodic reports filed with SEC) require the disclosure of environmental liabilities: Item 101, relating to the description of a company's business; Item 103, relating to disclosure of legal proceedings; and Item 303, relating to management's discussion and analysis of financial condition and results of operations.

In addition, SEC and other accounting authorities have published bulletins and statements regarding the assessment and disclosure of environmental liabilities, including:

1) Statement of Financial Accounting Standards No. 5. Addresses accounting and reporting of loss contingencies, such as site cleanup or remediation.

2) SEC Staff Accounting Bulletin 92. Using a question-and-answer format, provides guidance regarding accounting and disclosure obligations for contingent environmental liabilities.

3) American Institute of Certified Public Accountants Statement of Position 96-1. Provides guidance with respect to the recognition, measurement, display and disclosure of environmental liabilities, including benchmarks for making materiality determinations at various stages of assessment and remediation.

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With the SOX Act's passage, environmental liability assessments and disclosures are now subject to unprecedented scrutiny. At the same time, the SOX Act increases the personal accountability of corporate officers and directors for inaccurate or misleading disclosures. Among its many provisions, the SOX Act:

•establishes new certification, attestation, internal control and disclosure control requirements as well as increased penalties and statutes of limitations for violations of these and other securities laws;

•creates new sanctions for CEOs and CFOs, including the possible disgorgement of bonuses and income from equity-based incentives in connection with certain financial restatements, gives the SEC the ability to freeze an executive's compensation under certain circumstances and increases SEC's powers to bar persons from future service as officers or directors of public companies;

•establishes new requirements for codes of ethics, codes of conduct or codes of corporate responsibility;

•enhances protections for corporate whistleblowers, including requiring procedures for whistleblowers to report directly to the audit committee, increasing the penalties for taking action against whistleblowers and increasing civil and criminal protections for whistleblowers;

•imposes significant monetary and criminal penalties for fraudulently influencing, coercing, manipulating or misleading an accountant engaged in an audit to render a company's financial statements financially misleading.

Even the most sophisticated companies acknowledge that assessing and quantifying environmental liabilities can be challenging. For example, making *materiality* determinations with respect to contingent environmental liabilities, quantifying a company's preallocation share

of remediation expenses at a joint site, determining diminished value or marketability of environmentally impaired property, and assessing potential claims or penalties following an industrial accident or spill are complex exercises that require specialized, multidisciplinary expertise and analysis.

To minimize the possibility of inaccurate or misleading disclosure, companies and their directors and executive officers increasingly rely on counsel and consultants to evaluate internal controls and disclosure procedures, conduct due diligence, analyze and document material environmental liabilities, and review existing environmental liability disclosures for compliance with applicable securities laws, including the SOX Act.

Potential Impact

While the expectation is that a series of legal proceedings will address SH&E issues under the SOX Act, some legal scholars have suggested that the act will go further than financial reporting and will require disclosure of a series of company operations, including SH&E. The act addresses compliance management from a high perspective and does not indicate whether SH&E performance is excluded. A significant SH&E incident has the potential to affect a company's operations or organizational structure, which leads to the assumption that SH&E exposures meeting still-yet-to-be determined criteria or standards would also need to be disclosed.

Fundamentally, these rules do not require companies to do anything that they were not already required to do.

An organization is required to report an operation that has a failure (safety, environmental or property) that may *significantly impact* the organization's financial soundness. For example, if a chemical spill occurred on company property and required extensive time and money to clean up, it could trigger the reporting element. However, if during the normal course of business a key production tool in a manufacturing plant was damaged beyond repair and replacement was necessary, this may not necessarily require reporting. It may require reporting if the same scenario has a substantial impact on the total production capacity of the plant and if the operations' financial underpinnings were at stake.

The SOX Act also places a higher level of scrutiny on CEOs and board of director members. Since the enactment, many have asked for insight about the communication of significant SH&E exposures and hazards up the chain of communication to senior management. The act reinforces that ignorance of a law does not excuse the violation. Companies and corporations can still be cited and can face penalties to the full extent of the law. Under such circumstances, it would be incumbent upon the organization to prove compliance, as the burden of proof is on the organization.

What This Means to the SH&E Profession

What does this public law mean for SH&E professionals? It means that SH&E professionals may need to implement new procedures and policies in public companies to safeguard their employers, employees, colleagues and themselves. From the perspective of ASSE's Council on Practices and Standards (http://www.asse.org/practicespecialties), the following is suggested:

1) Obtain a copy of this law, background materials about it and discuss it with senior management and legal counsel so that all parties are aware of what is expected. A legal opinion written by corporate counsel would also be prudent.

2) Write and publish a policy addressing SH&E disclosure in regard to how it fits in with the SOX Act.

3) Write, implement and document communication structures detailing how information is passed up the communication chain to senior management.

4) Conduct thorough assessments to identify significant SH&E exposures and the means used to communicate them to those in a position of authority.

5) Ensure that SH&E audits are independent and that the results are reported and acted upon. Those SH&E professionals who author/sign those audit reports and who fail to follow up on the recommended actions may be subject to sanctions such as listed under the new law. They now have a duty that goes beyond just informing management.

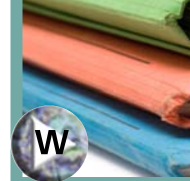
6) Follow ASSE's Code of Conduct (http://www.asse.org/about/conduct_code.php).

Sarbanes-Oxley: Environmental Management Impact

In 2002, Congress enacted Sarbanes-Oxley with the stated purpose of "protecting investors by improving the accuracy and reliability of corporate disclosures." Although the primary focus in the media and in many corporate boardrooms has been on financial disclosure, many companies will also need to take a close look at their environmental controls and reporting procedures. Recent SEC studies indicate that many public companies have not consistently complied with environmental reporting requirements. Changes brought about by the SOX Act, including increased enforcement, more accountability and tougher penalties, will likely turn this trend around.

Top executives must now certify the accuracy of each quarterly and annual report. Executives must also certify that the company has procedures and controls in place that will uncover and report to the top any material liabilities. These requirements make the CEO and CFO ultimately responsible for ensuring that potential environmental liabilities are disclosed to the public.

The SOX Act also requires SEC to conduct regular and systematic reviews of reporting companies' financial statements. Now that EPA (http://www.epa.gov) enforcement actions are public information and EPA regularly shares information with SEC, the focus of these reviews will



most certainly include environmental liabilities. With the potential for criminal and civil liability for noncompliance greatly increased, it is essential that executives understand the requirements for environmental disclosure and determine whether their current system is in compliance.

Arguably the most influential changes made by the SOX Act are those intended to increase accountability at the top level of corporations. The act requires the CEO and CFO to certify many issues in each quarterly and annual report, such as:

•the report does not contain any untrue statements of a material fact or omit to state a material fact;

•s/he is responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the company and that these have been evaluated within the last 90 days.

These requirements and others are designed to undercut the "I did not know" defense for executives. In light of these rules, companies must evaluate their current environmental reporting systems. In effect, senior management must certify that procedures are in place to transmit environmental information to the top, that environmental disclosures comply with periodic and annual reporting requirements and that environmental liabilities are accurately reflected in the financials in accordance with generally accepted accounting principles.

The required controls and procedures must be designed to ensure that information required to be disclosed is recorded, processed, summarized and reported within the time periods specified. The term "disclosure controls and procedures" has a broader meaning than internal controls and is intended to refer to both financial and nonfinancial disclosures.

Since environmental costs and liabilities are required to be disclosed, the veracity of this certification depends to some extent on the integrity of the company's environmental management systems. Steps must be taken to ensure that information about potential liabilities and costs are gathered and communicated to management to allow timely decisions regarding disclosure. Since management must certify that these steps are taken, failure to do so can result in SEC sanctions even when the failure does not lead to a lack of disclosure.

Fundamentally, these rules do not require companies to do anything that they were not already required to do. However, the certification requirement provides increased incentive for companies to ensure that they do them properly. The requirements for adequate controls and procedures are complex. Because of the liability and sanctions associated with failure to meet them, counsel should be involved in the implementation and review of these procedures.

At a basic level, the controls and procedures should meet several guidelines:

1) The procedures must be documented and must be communicated to all personnel.

2) The procedures should be reviewed and evaluated for effectiveness in a formal session conducted by top management on a quarterly basis for U.S. companies and on an annual basis for non-U.S. companies.

Congress reacted strongly to the fact that SEC had not meaningfully reviewed Enron's filings for the 5 years preceding its collapse. The SOX Act requires "regular and systematic review" of reporting companies' financial statements. Under no circumstances may any company's filings be reviewed less than once every 3 years.

A recent push from various fronts has called for increased enforcement. EPA has conducted many studies and has reported that most reporting companies do not meet environmental disclosure obligations, putting investors at risk. EPA has also begun a policy of distributing to reporting companies notices of their duty to disclose potential liabilities in the face of enforcement actions. In addition, EPA has launched the Enforcement and Compliance History Online (http://www.epa.gov/compliance/data/systems/multimedia/echo.html), which allows the public to compare the environmental history of a company to disclosures made in SEC filings, also available online.

The Solution: Management Systems

Sarbanes-Oxley requires management controls and accountabilities to be firmly in place. However, just like OSHA requirements, it does not include the "how to" portion. Management systems [e.g., ANSI Z10 (https://www.asse.org/cartpage.php?link=3388)] provide the structure and mechanisms to provide repeatable controls to ensure that accountabilities are implemented and enforced.

Corporate governance is a new focus for businesses today. In response to a wave of corporate scandals laws

such as the SOX Act and new nongovernmental initiatives such as ISO 26000 have been or are being developed to encourage companies to do the right thing. This is a complex area with the potential for substantial impacts for SH&E programs.

SH&E issues can have substantial impact on a company's financial performance. Companies that have failed to manage their SH&E issues have incurred multimillion dollar cleanup liabilities, faced significant erosion of their business reputation or gone bankrupt when they failed to anticipate the importance of an emerging issue, such as the potential carcinogenicity of a key ingredient in their product.

Why Is This Important Now?

Four drivers have focused increased attention on corporate governance:

1) Corporate accountability laws. Laws such as Sarbanes-Oxley focus new attention on the internal controls companies have in place to ensure sound fiscal management and accurate financial reporting.

2) Trade globalization. The development of a global marketplace means companies must be concerned about regulatory requirements wherever they plan to market their products. This makes environmental regulations such as the European Union's (http://europa.eu) WEEE and RoHS directives important throughout the global business chain.

3) Reputational risk. A 2004 survey of World Economic Forum (http://www.weforum.org/en/index-.htm) members found that more than half of the survey respondents estimated that corporate brand or reputation represents more than 40% of a company's market capitalization. Given the public interest in environmental issues, negative environmental publicity impacting a company's reputation is a significant corporate concern.

4) Expanding potential liability. Increasingly, laws and standards are shifting from buyer beware to a focus on minimizing a product's potentially harmful environmental and safety impacts throughout all aspects of its lifecycle. This has lead to an increased focus on those entities along the product distribution chain that have the ability or means to prevent potential harmful impacts. With a global marketplace, this also means that ignoring safety and environmental issues may create significant worldwide liability.

Seven Key Requirements for Effective SH&E Corporate Governance

The following is excerpted with permission from ENLAR Compliance Services Inc. (http://iso14000expert.com/sarbanes-oxley.html).

1) Top management involvement. Studies of SH&E programs unanimously conclude that effective SH&E performance starts at the top. Informed, involved and committed top management is critical to effective EHS performance.

2) Defined roles and responsibilities. SH&E programs are only effective when there is ownership. This only happens when roles and responsibilities for SH&E performance are clearly defined and individual performance reviews include an evaluation of how well those responsibilities have been met.

3) Appropriate and consistent metrics. It is impossible to proactively manage processes if you do not know where you are, where you are going or how far along you are toward meeting your goals. The development and ongoing monitoring of clear, concise and relevant performance metrics is critical to effective SH&E performance. For organizations with multiple business units, these metrics must provide consistent data reporting to support sound decision making.

4) Impartial evaluations by competent assessors. It can be difficult for those involved in implementing and maintaining systems to provide an impartial evaluation of their performance. In addition, system audits require competent auditors.

5) Effective communication. Management requires timely and effective communication. Responsibilities will be unfulfilled if they are not communicated. Metrics are meaningless unless they are available when decisions must be made. Evaluation serves no purpose unless it drives system improvements.

6) Availability of required resources. Good intentions are wonderful, but safety initiatives and environmental protection require resources—money, manpower and corporate support.

7) Consideration of sustainability and social responsibility. In today's global marketplace, country-specific laws and regulations can no longer be the exclusive focus of SH&E programs. Laws will never address all aspects of what is fair, ethical and consistent with company values. Rather than ignoring questions of ethics and values, companies must confront these questions directly and proactively.

ISO 26000: ISO's Initiative on Social Responsibility

International Organization for Standardization (ISO) (http://www.iso.org/iso/home.htm) has decided to develop an international standard providing guidelines for social responsibility. ISO's goal is to involve many stakeholders—industry, government, labor, consumers and nongovernmental organizations—in the development of a guidance document to assist organizations in acting in a socially responsible way. It is anticipated that the standard will be published as ISO 26000.

Sarbanes-Oxley

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SEC Environmental Disclosure Obligations

The following SEC rules require the disclosure of environmental costs and liabilities:

•Item 101 of Regulation S-K requires companies to disclose material effects of compliance (or noncompliance) with environmental laws.

•Item 103 of Regulation S-K requires disclosure of pending, nonroutine litigation (with environmental litigation typically considered nonroutine).

•Item 303 of Regulation S-K requires disclosure of business trends or events likely to have a material effect of a company's financial condition. One can easily see how certain environmental trends or events such as discovery/disclosure of environmental contamination (e.g., PCB in fish) might have such a material effect.

Four Steps to Consider in Enhancing Environmental Controls

ENLAR Compliance Services Inc. offers these four steps for enhancing environmental controls.

1) Review current processes. SOX requires the CEO to personally certify that adequate systems are in place to ensure that accurate and material information is made known to those certifying the financial statements. This requirement suggests that top management will want to evaluate the adequacy of any processes currently used to identify and quantify environmental costs and liabilities. These would include the processes for identifying environmental legal requirements, determining compliance with environmental laws, estimating environmental compliance and remediation costs and tracking important environmental trends and events that may impact the bottom line.

2) Establish an environmental management system. Given increased public interest in environmental issues and substantial liabilities associated with environmental lawsuits, such as Superfund and toxic tort cases, many corporations have replaced their environmental compliance programs with environmental management systems based on ISO 14001.

An ISO 14001 management system can assist in establishing environmental financial controls by:

•defining environmental responsibilities and internal communication processes;

•establishing procedures for identifying legal requirements and evaluating compliance;

•establishing processes for identifying and quantifying environmental risks;

•monitoring stakeholder interests and establishing public communication mechanisms.

Do not assume that just because the company is ISO 14001 certified that environmental internal controls meet SOX requirements. Many existing ISO 14001 management systems do not adequately address the SOX requirements related to litigation risk identification and evaluation, financial materiality determination and timely internal risk communication.

3) Consider periodic independent third-party reviews. One key concept underlying an environmental management system is continual improvement through a program of periodic evaluations or audits. Although these audits can be conducted in-house, many companies find significant benefits associated with independent, third-party reviews.

First, internal auditors may be reluctant to criticize colleagues with whom they must continue working or programs they helped develop. Second, external auditors can bring a broader perspective to help identify typical areas of environmental concern or departures from commonly accepted industry best practices. Finally, greater public credibility is often given to outside, impartial evaluations.

Given these benefits, corporate directors and officers may want to have an independent third party conduct periodic reviews.

4) Evaluate current processes for environmental product stewardship. Increasingly, environmental laws and regulations focus on minimizing SH&E impacts throughout a product's lifecycle. Companies must have systems in place to address such regulatory initiatives and the SH&E impacts of their products and services.

Annual Reports

If you do not already generate an SH&E annual report for your company officers, you should consider creating one. In addition to informing all company business units of your overall impact and benefit to the company bottom line, it is a great marketing tool both internally and externally. Most importantly, it is a document third-party auditors will evaluate to ensure accountability of company officers overseeing SH&E.

My own belief is that those who lack SH&E experience and knowledge will look for those who oversee SH&E at the corporate level. I believe this will come to fruition due to the attendant risks of incorrect reporting and severe accountability when found not in compliance in this area. If you oversee SH&E and do not thoroughly understand it with the attendant risks, you will be compelled to ensure you have someone on the corporate staff who does. If you do not, you may risk paying the price for incorrect reporting.

Your annual report should include such items as:

•goals for the year, accomplishments, initiatives, budgets, success stories, performance awards, performance milestones, staffing, trends, etc.;

•summary of serious incidents and corrective actions taken and status;

•summary of all SH&E audits conducted throughout the year with corrective actions and status;

•environmental characterization of all properties owned or leased and bought or sold by the company and their status;

•benchmarking of your management system (or equivalent) across business units.

SOX Moves EHS Auditing

The role of SH&E auditors and the information they assess is currently undergoing a sea change. Traditionally, SH&E auditors have assessed company-specific information using company-specific metrics for use by an internal audience within the company. Recent developments, such as the SOX Act and increased adoption of the Global Reporting Initiative (GRI) (http://www-.globalreporting.org/Home), are broadening the scope of information collection and modes of data delivery as well as the audience.

SH&E professionals addressed this dynamic at the annual Auditing Roundtable (http://www.auditing-roundtable.org/fw/main/Home-1.html) conference on "The Role and Practice of EHS Auditing in a New Era of Corporate Governance and Management Systems." SH&E auditing is overseen by the Board of Environmental, Health and Safety Auditor Certifications (http://www.beac.org), a joint venture between the Auditing Roundtable, and the Institute of Internal Auditors (http://www.theiia.org).

Historically, SH&E auditors have been charged with assessing SH&E information for purposes of compliance, due diligence, risk assessment and voluntary standards such as ISO 14001, an environmental management certification. The underlying purpose of these audits is expanding under SOX. SOX places greater emphasis on ensuring that disclosures are accurate and complete in all material aspects. The act also requires that processes are in place to bring all relevant information to senior management's attention. In other words, SH&E auditors have been moved from the backroom to the boardroom.

"EHS auditors are now asked to generate and submit information directly to the most senior management levels, including the CEO, the CFO and the board of directors," says Roberto Jiménez, a director on the Auditing Roundtable's board. The revised SOX rules require two separate certifications by the CEO and CFO for each 10-K and 10-Q (and any amendments) filed with SEC under Sections 302 and 906 of SOX. Corporate officers face potential civil and criminal penalties for violations, so these officers are likely to have zero tolerance for surprises from SH&E audits.

A critical issue for auditors is the need for financial information that "fairly presents" the business position. "Be careful—SH&E professionals should know that their work may make its way to SEC based on conclusions about material risks that fairly impact the valuation of companies," warns Brian Carroll, special counsel at SEC's Philadelphia district office.

Information assessed in SH&E audits is now considered with a seriousness rivaling financial information. SH&E data collected and verified during internal audits is no longer held as tightly under the confines of privilege and confidentiality clauses. This increased transparency accentuates the importance of SH&E auditor independence. "Without independence, no matter how competently the audit is performed, the resulting report will be potentially compromised," says Jeff Davidson, partner at Wilmer, Cutler, Pickering, Hale and Dorr.

While financial audits and reporting in 10-Ks by publicly traded companies largely address historical information, SH&E auditors are involved in areas of SEC reporting that require significant estimation of contingent liabilities and future expenditures. Therefore, SH&E auditors are required to do a certain amount of crystal-ball gazing, meaning they will need to be crisp and articulate in how they audit.

The growing importance of SH&E auditing is a mixed blessing—increased responsibility brings with it increased accountability. "While EHS auditors are likely to play a more important and visible role, they are also likely to be held more accountable, with an insistence on verification of processes and a drive by executives to come to accurate hard numbers more quickly," says Paul Michalski, a partner at Cravath, Swaine & Moore.

Conclusion

SH&E professionals with compliance responsibilities will be placed into the position of navigating uncharted waters in regard to this Act. Little doubt exists that a series of legal proceedings will provide more frameworks for the reporting/disclosures requirements included in the Act. All SH&E professionals should be aware of this Act and what potentially could play a significant role in the practice of the profession. Management systems provide the tools to monitor implemented processes and controls. ✪

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