The Sarbanes-Oxley Act for the SH&E Professional

Mark D. Hansen, CSP, PE, CPEA, CPE
Vice President, Environmental & Safety
Range Resources Corporation
Ft. Worth, Texas

Introduction

On July 30, 2002, President George W. Bush signed into law legislation that changed the corporate landscape in the United States in regard to financial reporting and auditing for publicly traded companies. The Sarbanes-Oxley (SOX) Act of 2002 (Public Law 107-204) was written with the intent of addressing some of the issues brought to light during the incidents with 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 SEC (Security and Exchange Commission) reporting requirements. This paper will address how SH&E professionals can understand the implications of Sarbanes-Oxley on their company. The members departments, their 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 American 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 auditing publicly traded companies. This public law also addresses auditor independence, corporate responsibility at publicly traded companies, financial disclosures of publicly traded companies, and conflicts of interests of financial analysts. The new law also creates protections for "whistleblowers" applicable to private and public companies and imposes new criminal penalties relating to fraud, conspiracy, and interfering with investigations.

Environmental Liability Disclosure

Presented here is a brief summary of federal securities laws and regulations, as well as guidance from the 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 the 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, the SEC and other accounting authorities have published bulletins and statements regarding the assessment and disclosure of environmental liabilities, including:

- *Statement of Financial Accounting Standards No. 5*: addresses accounting and reporting of loss contingencies, such as site clean-up or remediation.
- *SEC Staff Accounting Bulletin 92*: using a question and answer format, provides guidance regarding accounting and disclosure obligations for contingent environmental liabilities.
- *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.

With the passage of the SOX Act, environmental liability assessments and disclosures will be 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 numerous 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 the 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.

Unfortunately, even the most sophisticated companies acknowledge that assessing and quantifying environmental liabilities can be extremely challenging. For example, making "materiality" determinations with respect to contingent environmental liabilities, quantifying a company's pre-allocation 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, multi-disciplinary expertise and analysis.

In order to minimize the possibility of inaccurate or misleading disclosure, companies and their directors and executive officers increasingly rely on counsel and consultants to assist in evaluating 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 there will be a series of legal proceedings to address SH&E issues under this SOX Act, the position has been taken by some legal scholars that the new SOX Act will go further than financial reporting and require disclosure of a series of company operations, including safety, health, and the environment. The SOX Act itself addresses compliance management from a high perspective and does not indicate whether SH&E performance is excluded. It is a fact that a significant SH&E incident certainly has the potential to impact a company's operations or organizational structure, which would lead to the assumption that SH&E exposures meeting a still yet to be determined criteria or standard would also need to be disclosed.

The point has been made that an organization will be 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 there were to be a spill of some sort of chemical on company property, requiring 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 the operations' financial underpinnings were at stake.

The SOX Act also places a higher level of scrutiny on Chief Executive Officers and Board of Director members. Since the enactment, there have been a series of inquiries to ASSE asking for insight about the communication of significant SH&E exposures and hazards up the chain of communication to senior management. The SOX Act itself reinforces that ignorance of a law does not excuse the violation. Companies and corporations can still be cited and face penalties to the full extent of the law. The point has also been made that under such circumstances it would be incumbent upon this organization to prove compliance as the burden of proof is on the organization.

Impact on the SH&E Profession

What does this public law mean for SH&E professionals? It means that new procedures and policies may have to be implemented by SH&E professionals in public companies in order to safeguard their employers, employees, colleagues, and themselves. From the perspective of the Council on Practices and Standards, 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 a prudent action to take.
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 through 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 practitioners 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. The point has been made that they now have a duty that goes beyond just informing management.
6. Follow the ASSE Code of Conduct.

Sarbanes-Oxley: Environmental Management Impact

Congress enacted Sarbanes-Oxley in 2002 as a response to the unprecedented financial fraud uncovered in companies such as Enron, WorldCom and others. The stated purpose of the SOX Act is to "protect 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 Securities and Exchange Commission studies indicate that many public companies have not consistently complied with the environmental reporting requirements. Changes brought about by the SOX Act, including increased enforcement, more accountability and tougher penalties, will likely turn this trend around.

After Sarbanes-Oxley, top executives must certify the accuracy of each annual and quarterly report. Executives must also certify the company has procedures and controls in place that will uncover and report to the top any material liabilities. These certification requirements make the chief executive officer and chief financial officer ultimately responsible for ensuring that potential environmental liabilities are disclosed to the public.

The SOX Act also requires the Securities and Exchange Commission to conduct regular and systematic review of the financial statements of reporting companies. Now that Environmental Protection Agency enforcement actions are public information and the EPA regularly shares information with the SEC, the focus of these reviews will most certainly include environmental liabilities.

With the potential for criminal and civil liability for non-compliance 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 the 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.
- He or she 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 didn't know" defense for executives. In light of these new SEC rules, it is imperative that companies evaluate their current environmental reporting system.

Senior management must, in effect, certify that procedures are in place to transmit environmental information to the top, that environmental disclosures comply with the 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 non-financial disclosures.

Because 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 make sure that information about potential liabilities and costs are gathered and communicated to management to allow timely decisions regarding disclosure. Because 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, the new SEC rules do not require companies to do anything that they were not already required to do. The certification requirement, however, provides increased incentive for companies to make sure they are doing them properly. The requirements for adequate controls and procedures are complex, and because of the liability and sanctions associated with the failure to meet them, counsel should be involved with both the implementation and review of these procedures.

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

- The procedures need to be documented and must be communicated to all personnel.
- 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 an annual basis for non-U.S. companies.

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

There has been a recent push from various fronts to increase enforcement. The EPA has conducted numerous studies and has reported that the vast majority of reporting companies are not meeting environmental disclosure obligations, putting investors at risk. The 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, the EPA has launched the Enforcement and Compliance History Online 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) provide the structure and mechanisms to provide repeatable controls to ensure accountabilities are implemented and enforced.

Corporate Governance. Governance is a new focus for businesses today. In response to a wave of corporate scandals, new laws - such as Sarbanes-Oxley - and new non-governmental initiative - 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 environmental, safety and health programs.

Environmental health and safety issues can have substantial impact on a company's financial performance. Companies who have failed to manage their EHS issues have incurred multi-million dollar clean-up 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? There are four drivers that have focused increased attention on Corporate Governance:

Corporate Accountability Laws - Laws such as Sarbanes-Oxley are focusing new attention on the internal controls companies have in place to ensure sound fiscal management and accurate financial reporting.

Trade Globalization - The development of a global marketplace means companies have to be concerned about regulatory requirements wherever they plan to market their products. This makes environmental regulations such as the European Union's WEEE and RoHS directives important throughout the global business chain.

Reputational Risk - A 2004 survey of the members of the World Economic Forum found that over 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.

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 life-cycle. 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 world-wide liability.

Seven Key Requirements for Effective EHS 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 EHS programs unanimously conclude that effective EHS performance "starts at the top." Informed, involved and committed top management is critical to effective EHS performance.

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

3. Appropriate & Consistent Metrics - It is impossible to proactively manage processes if you don't know where you are, where you are going or how far along you are toward meeting your goals. The development and on-going monitoring of clear, concise and relevant performance metrics is critical to effective EHS performance. For organizations with multiple business units, it is also critical that these metrics provide consistent data reporting to support sound decision-making.

4. Impartial Evaluations by Competent Assessors - Human nature being what it is, it is difficult for those who are involved in implementing and maintaining systems to provide an impartial evaluation of the system's 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 need to 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 requires resources - money, manpower and corporate support.

7. Consideration of Sustainability & Social Responsibility - In today's global marketplace, country-specific laws and regulations can no longer be the exclusive focus of EHS 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, increasingly companies need to confront these questions directly and proactively.

ISO 26000 - ISO's Initiative on Social Responsibility. ISO, the International Organization for Standardization, has decided to develop an international standard providing guidelines for social responsibility.

ISO's goal is to involve a variety of stakeholder groups - 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 in 2008 as ISO 26000.

Sarbanes-Oxley

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SEC Environmental Disclosure Obligations
The following Securities and Exchange Commission (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 non-compliance) with environmental laws
- Item 103 of Regulation S-K requires disclosure of pending, non-routine litigation (with environmental litigation typically being considered non-routine)
- 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.

While these SEC environmental reporting rules have been in place for several years, the passage of Sarbanes-Oxley focused additional corporate attention on identifying and quantifying environmental liabilities and costs. A December 2001 study by the SEC found that many companies did not provide adequate disclosure on environmental issues.

Four Steps to Consider For Enhancing Your Environmental Controls

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1. Review Your Current Processes. Sarbanes-Oxley requires the CEO to personally certify that adequate systems are in place to ensure 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 being 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 the 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 you 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

One word of caution - don't assume that just because you have an ISO 14001 certificate on the wall, your environmental internal controls meet the Sarbanes-Oxley requirements. Many existing ISO 14001 management systems do not adequately address the Sarbanes-Oxley requirements relating to litigation risk identification and evaluation, financial materiality determination and timely internal risk communication.

3. Consider Periodic Independent Third Party Reviews. One of key concepts 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 they have to continue working with 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, there is often greater public credibility given to outside, impartial evaluations.

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

4. Evaluate your Current Processes for Environmental Product Stewardship. Increasingly, environmental laws and regulations are focusing on minimizing safety, health and environmental impacts throughout a product's life cycle. One example of this is the European Union WEEE and RoHS directives. Company's need to have systems in place to address such regulatory initiatives and the environmental, safety and health 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 seriously consider adding that to your annual “to do” list. In addition to informing all company business units of your overall impact and benefit to the company bottom line it is also a great marketing tool both internally and externally. Most importantly, it will be a document third party auditors will evaluate to ensure accountability of company officers overseeing SH&E.

My own personal belief is that those who lack the experience and knowledge in SH&E will likely look for those who are to oversee SH&E at the corporate level. This, I believe, will come to fruition due to the attendant risks of incorrect reporting and severe accountability when found not in compliance in this area. The final answer is, if you are overseeing SH&E and don’t thoroughly understand it, with the attendant risks, you will be compelled to make sure you have someone on the corporate staff who does. If you don’t, 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.
- A summary of serious incidents and corrective actions taken and status
- A summary of all SH&E audits conducted throughout the year with corrective actions and status
- An environmental characterization of all properties owned or leased, and bought or sold by the company and their status.
- A benchmarking of your management system (or equivalent) across business units.

Sarbanes-Oxley 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 passage of Sarbanes-Oxley (SOX) and increased adoption of the Global Reporting Initiative (GRI), are broadening the scope of both information collection and modes of data delivery, as well as the audience.

SH&E professionals addressed this dynamic earlier this month in Philadelphia at the annual Auditing Roundtable conference, entitled 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 & Safety Auditor Certifications (BEAC), a joint venture between the Auditing Roundtable and the Institute of Internal Auditors (IIA).

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 Sarbanes-Oxley. SOX places greater emphasis on ensuring that disclosures are accurate and complete in all material aspects. SOX also requires that processes are in place to bring all relevant information to the attention of senior management.

In other words, SH&E auditors have been moved from the backroom to the boardroom.

"EHS auditors are now being asked to generate and submit information directly to the most senior management levels, including the CEO, the CFO, and the Board of Director," said Roberto Jiménez, a director on the board of the Auditing Roundtable.

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 the Securities and Exchange Commission (SEC) under sections 302 and 906 of Sarbanes-Oxley. 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--EHS professionals should know that their work may make its way to the SEC based on conclusions about material risks that fairly impact the valuation of companies," warned keynote speaker Brian Carroll, special counsel at the SEC's Philadelphia district office.

Information assessed in SH&E audits is now being considered with a seriousness rivaling financial information, SH&E data collected and verified during internal audits is no longer being 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," said Jeff Davidson, partner at Wilmer, Cutler, Pickering, Hale and Dorr.

While financial audits and reporting in 10-Ks by publicly traded companies largely deal with historical information, the SH&E auditors are involved in areas of SEC reporting that require significant estimation of contingent liabilities and future expenditures. SH&E auditors are therefore required to do a certain amount of crystal ball gazing – meaning they will have to be very crisp and very articulate about 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, said Paul Michalski, a partner at Cravath, Swaine & Moore.

Conclusion

SH&E professionals with compliance responsibilities are going to be placed into the position of navigating uncharted waters in regard to this Act. There is little doubt that a series of legal proceedings will provide more frameworks for the reporting/disclosures requirements included in the Act. It is incumbent upon all SH&E professionals to be aware of this Act and what potentially could play a very significant role in the practice of the profession. Management systems provide the tools to monitor implemented processes and controls.

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